

16. MURABAHA

Murabaha is one of the most commonly used modes of financing by Islamic banks and financial institutions.

Definition

Murabaha is a particular kind of sale where the seller expressly mentions the cost he has incurred for the sold commodity, and sells it to another person by adding some profit thereon. Thus, Murabaha is not a loan given on interest; it is a sale of a commodity for cash/deferred price.

The Bai' Murabaha involves the bank's purchase of a commodity on behalf of a client and its resale to the latter on a cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. In other words rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods to the customer for a pre-agreed price.

Murabaha is a mode of financing as old as Musharakah. Today in Islamic banks the world over, 66% of all investment transactions are through Murabaha.

Difference Between Murabaha and Sale

A simple sale in Arabic is called Musawamah - a bargaining sale without disclosing or referring to what the cost price is. However when the cost price is disclosed to the client it is called Murabaha. A simple Murabaha is a sale where there is cash payment and a Murabaha Muajjal is a sale based on a deferred payment.

Arguments Against Murabaha

An argument that arises in a Murabaha is that both profit or interest are the same and Murabaha financing is the same as conventional banking. Islamic scholars however argue that in several respects a Murabaha financing structure is quite different to an overdraft facility organized along conventional lines and the former offers several benefits to the bank and its customers. Depositors are made to share the bank's profit as a result of this financing. The basic difference is however, the Aqd or the contract which covers the Islamic conditions. If the contract has an element of interest then it is void.

Basic Rules for Murabaha

The following rules govern a Murabaha transaction:

1. The subject of sale must exist at the time of the sale. Thus anything that may not exist at the time of sale cannot be sold and its non-existence makes the contract void.
2. The subject matter should be in the ownership of the seller at the time of sale. If he sells something that he has not acquired himself then the sale becomes void.

3. The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity are passed on to him including the risk of its destruction.
4. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. For example, A tells B on 1st January that he will sell his car on 1st February to B, the sale is void because it is attributed to a future date.
5. The subject matter should be a property having value. Thus a good having no value cannot be sold or purchased.
6. The subject of sale should not be a thing used for an un-Islamic purpose.
7. The subject of sale must be specifically known and identified to the buyer. For example, A owner of an apartment building says to B that he will sell him an apartment. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed out to the buyer.
8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.
9. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.
10. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of the trade.

Step by Step Murabaha Financing

1. The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy the commodity from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up-to which the facility may be availed.
2. An agency agreement is signed by both parties in which the institution appoints the client as its agent for purchasing the commodity on its behalf.
3. The client purchases the commodity on the institution's behalf and takes possession as the institution's agent.
4. The client informs the institution that it has purchased the commodity and simultaneously makes an offer to purchase it from the institution.
5. The institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the client.

All the above conditions are necessary to effect a valid Murabaha. If the institution purchases the commodity directly from the supplier, it does not need any agency agreement.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.

The above is the only way by which this transaction is distinguished from an ordinary interest-based transaction.

Issues in Murabaha

The following are some of the issues in a Murabaha financing:

1. Securities against Murabaha

Payments coming from the sale are receivables and for this, the client may be asked to furnish a security. It can be in the form of a mortgage or hypothecation or some kind of lien or charge.

2. Guaranteeing the Murabaha

The seller can ask the client to furnish a 3rd party guarantee. In case of default on payment the seller may have recourse to the guarantor who will be liable to pay the amount guaranteed to him. There are two issues relating to this:

- a) The guarantor cannot charge a fee from the original client. The reason being that charging a fee for advancing a loan is analogous to Riba.
- b) However the guarantor can charge for any documentation expenses.

3. Penalty of default

Another issue with Murabaha is that if the client defaults on payment on the due date, the price cannot be changed nor can penalty fees be charged.

In order to deal with dishonest clients who deliberately default on payments should be made liable to pay compensation to the Islamic bank for the loss suffered on account of default. However, these should be made subject to the following conditions:

- a) The defaulter may be given a grace period of at least one month.
- b) If it is proven beyond doubt that the client is defaulting without a valid excuse then compensation can be demanded.

4. Rollover in Murabaha

A Murabaha transaction cannot be rolled over for a further period when the old contract ends. It should be understood that a Murabaha is not a loan but rather a commodity sale, which is deferred to a specific date. Once the commodity is sold, its ownership transfers from the bank to the client and it is therefore no more the seller's property. Now what the seller can claim is only the agreed price and therefore there is no question of effecting another sale for the same commodity between the same parties.

5. Rebate on earlier payments

Sometimes debtors want to pay early to get discounts. However, in Islam, the majority of Muslim scholars including the major schools of thought consider this to be un-Islamic. However, if the Islamic bank or financial institution gives somebody a rebate at its own discretion without it being pre-agreed, it is not objectionable especially if the client is needy.

6. Calculation of Murabaha cost

The Murabaha can only be effected when the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained then a Murabaha cannot take place. In this case the sale will take place as a Musawamah i.e. a sale without reference to cost.

7. Subject matter of the sale

All commodities cannot be the subject matter in a Murabaha because certain requirements need to be fulfilled. The shares of a lawful company can be sold or purchased on a Murabaha basis because according to the principles of Islam, shares represent ownership in a company's assets provided all other basic conditions of the transaction are fulfilled. A buy back arrangement or selling without taking their possession is not allowed at all.

A Murabaha is not possible for things that cannot become the subject of a sale. For example, a Murabaha is not possible for the exchange of currencies.

Basic Mistakes in Murabaha Financing

Some basic mistakes that can be made in practical implications of the concept are as follows:

1. The most common mistake is to assume that a Murabaha can be used for all types of transactions and financing. This mode can only be used when a commodity is to be purchased by the customer. If funds are required for some other purpose, a Murabaha cannot be used.
2. The document is signed for obtaining funds for a specific commodity and therefore it is important to specify Murabaha subject matter.
3. In some cases, the sale of the commodity to the client is effected before the commodity is acquired from the supplier. This occurs when the various stages of the Murabaha are skipped and the documents are signed all together. It is to be remembered that a Murabaha is a package of different contracts and they come into play one after another at their respective stages.
4. It is observed in some financial institutions that a Murabaha is applied on already purchased commodities, which is not allowed in the Shariah and can be effected on not yet purchased commodities only.

Uses of Murabaha:

A Murabaha can be used for the following:

Short / Medium / Long Term Finance for:

- Raw material
- Inventory
- Equipment
- Asset financing
- Import financing
- Export financing (Pre-shipment)
- Consumer goods financing
- House financing
- Vehicle financing
- Land financing
- Shop financing
- Personal computer financing
- Tour package financing
- Education package financing
- All other services that can be sold in the form of package (i.e. services like education, medical etc. as a package)
- Securitization of Murabaha agreement (certificate) is allowed at par value only. Otherwise certain rules of Islamic finance must be met.

Bai' Muajjal

Bai' Muajjal is the Arabic acronym for "sale on a deferred payment basis." The deferred payment becomes a loan payable by the buyer in a lump sum or installments (as agreed between the two parties). In Bai' Muajjal all those items can be sold on a deferred payment basis which come under the definition of capital where quality does not make a difference but the intrinsic value does. Those assets do not come under definition of capital where quality can be compensated for by the price and the Shariah scholars have an ijmah (consensus) that demanding a high price for a deferred payment in such a case is permissible.

Conditions for Bai' Muajjal

1. The price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without qualms about Riba.
2. Complete/total possession of the object in question must be given to the buyer, while the deferred price is to be treated as debt against him.
3. Once the price is fixed, it cannot be decreased in case of an earlier payment nor can it be increased in case of default.
4. In order to secure the payment of price, the seller may ask the buyer to furnish a security either in the form of a mortgage or in the form of an item.
5. If the commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately.