

CIFE10, 11, 12: UNDERSTANDING MURABAHA – COST PLUS FINANCING

Learn about the most widely used Islamic finance product: buy an asset for the customer; sell the asset at a premium in installments to the customer. That's a Murabaha. In these modules we introduce Murabahas and walk you through the steps necessary for a Murabaha's valid execution. We go on to discuss common mistakes bankers make when executing Murabahas and how to avoid them. We also look at risk management, default, early repayment, and profit calculation in Murabahas. And how does it work in the real world? We look at 6 practical examples of Murabahas based on installment repayments, bullet repayments, advance payments, and credit and import Murabaha.



A Murabaha is a sale in which the seller's cost of acquiring the asset and the profit earned from it are disclosed to the client or buyer.

Islamic banks offer the Murabaha to fulfill asset purchase requirements and not as a liquidity financing facility.

Murabaha Prerequisites

Subject Matter

1. Murabaha subject matter or the Murabaha asset must exist at the time of contract execution. For instance a Murabaha can be executed for a car that exists not for one that is to be manufactured.
2. The bank must own the asset and have either physical or constructive possession.

3. The subject matter must be an item of value and Shariah-compliant.
4. The subject matter must be a tangible good, clearly identified and quantified.

For instance, if the buyer wants to purchase rice, its exact quality and quantity in terms of weight must be clearly specified in the Murabaha contract to avoid gharar or uncertainty that leads to dispute between contracting parties.

Price

1. The Murabaha asset cost must be declared to the client.
2. The cost refers to all expenses involved in the asset's acquisition.
3. The asset's price includes all direct expenses where the bank pays for all indirect expenses.
4. Parties to the contract establish a profit rate by mutual consent or in relation to a specific and known benchmark.
5. The Murabaha price may be charged at spot or be deferred and paid as a lump sum at the end of the contract or in installments on fixed dates during the term.
6. The Murabaha profit must be disclosed as a specific amount.

It is important to remember that the Murabaha's execution must adhere to a certain sequence of procedures in order to ensure Shariah-compliance.

Steps of Murabaha Execution

1. The client's submission of a purchase requisition for Murabaha goods:
Based on the requisition the bank approves the credit facility before entering into an actual agreement.
2. The Master Murabaha Facility Agreement between the financial institution and the client. It includes:
 - i. An approval of the client's credit facility
 - ii. The terms and conditions of the Murabaha contract
 - iii. Murabaha asset specification
 - iv. Client's undertaking to purchase the Murabaha asset once the bank acquires it (if not included in the MMFA, it constitutes step 3)
3. The client's unilateral promise to purchase the Murabaha goods and the financial institution's acceptance of collateral. At this stage the bank in order to safeguard its rights in case the client backs out from entering into a Murabaha, requests the client to furnish a security or earnest

money called Haamish Jiddiah. In case the client backs out from entering into a Murabaha, the bank makes up for the actual loss from it and returns the remainder to the client.

4. The agency agreement between the financial institution and the client or a third party

Since banks do not possess the expertise or manpower to purchase the asset, they appoint the client as the agent to procure the asset from the supplier on their behalf.

Agency agreements are of two types:

Specific Agency Agreement: Agent is restricted to purchase a specific asset from a specific supplier

Global Agency Agreement: Agent may purchase the asset from any source of his choice. Such an agreement also lists a number of assets which the agent may procure on the bank's behalf without executing a new agency agreement each time.

Key points to remember about the agency

- During the agency stage, the bank's exposure to asset risk is highest and it is in the bank's interest to shorten this period as much as possible.
 - Bank may also minimize risk by ensuring the supplier receives payment for the Murabaha asset.
 - Bank must also ensure that the Murabaha asset to be purchased is not already in the client's possession. To maintain correct sequence, the bank must disburse the money to the agent before the agent purchases the goods.
 - The agency agreement is not a prerequisite but motivated by logistical ease.
 - Banks can procure Murabaha goods directly or establish a third party agency.
5. The possession of the Murabaha goods by the agent on behalf of the financial institution. After the agency agreement the client completes the purchase order form. The bank disburses the money to the client, who as agent pays it to the supplier and receives possession of the Murabaha goods.
 6. The exchange of an offer and acceptance between the client and the financial institution to implement the Murabaha sale. Either party can make the offer; the client may offer to buy the Murabaha goods or the bank may offer to sell them. The Murabaha sale is completed at the time of offer and acceptance.
 7. The transfer of possession of Murabaha goods from the financial institution to the client. The client is the owner of goods and all the associated risk and rewards however his obligation does not conclude until he makes complete payment of the Murabaha price.

Mitigating Murabaha Risks

- The Shariah validity of a Murabaha is strongly sensitive to following the designated steps in the correct sequence.
- A deferred Murabaha may not be executed for mediums of exchange (i.e. commodities such as gold, silver and currencies). Only a spot Murabaha may be executed for them.
- The bank must seek Shariah-compliant Takaful insurance for Murabaha goods to cover transit period risk (i.e. the risk posed to the bank once it purchases the goods from the supplier and has their possession and before it sells them to the client).

Default in a Murabaha

There is no concept of a late payment penalty in a Murabaha contract, however, a charity clause is established at contract execution to serve as a deterrent to default.

In case of a default in payment, based on the charity clause, the client is obliged to pay a predetermined amount to a designated charity.

Murabaha Prohibitions

A roll-over is the provision of an extension in return for an increase in the original payable amount and is impermissible in a Murabaha.

It constitutes *repricing* and *rescheduling*:

Repricing is prohibited because the Shariah does not permit an increase in debt once it is fixed.

Rescheduling is only permissible when the creditor provides an extension to ease the burden of a debtor, so a roll-over where the bank increases the debt in return for an extension is impermissible as the resulting amount of debt is analogous to *riba* or interest which is prohibited in Islam.

Calculating Murabaha Profit

From an accounting perspective, there are two stages in a Murabaha:

1st stage: The investment stage - Begins after the bank and client sign the agency agreement. It is the time period where the bank has disbursed money for the purchase of the asset from the supplier but has not yet acquired possession in order to sell it.

2nd stage: The financing stage - This stage begins when the bank receives the asset and goes ahead with the exchange of offer and acceptance with the client. It ends once the bank receives the Murabaha payment from the client. It is during this time that the bank has the right to accrue profit.

Example

A bank extends an advance for Murabaha to the client on the 1st of March, knowing that he will not purchase the asset until the 1st of June.

The client purchases the asset on the 1st of June and the Murabaha sale takes place between him and the bank on the same day.

If the tenure of the Murabaha is 4 months, it will commence on the 1st of June and last until the 1st of October.

The bank will begin calculating profit on the 1st of June and not the 1st of March so that no income accrues to the bank between 1st of March and 1st of June.

In case the client as agent is unable to purchase the asset on the 1st of June due to some unavoidable circumstances such as a supply shortage and the Murabaha is terminated, the bank is entitled to receive only the capital back and nothing more.

This is the key difference between a loan on interest and a Murabaha.