UNIT-8

Murabaha and Musawamah

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Explain the need For MURABAHA and specific conditions associated with this type of contract.
- ✓ Explore the possible Structures of MURABAHA

Unit 8

Murabaha and Musawamah

Introduction

Trading is one of the most common activities of Islamic banks. While conventional banks simply finance trading businesses by providing funds, Islamic banks have to be involved in the sale and purchase process for goods according to the trading rules prescribed by the Shari'a. They are entitled to profit by undertaking business risk like real sector businesses.

However, Islamic banks' trading pattern is different from the general trading business. Banks' clients normally need a credit facility and the banks are selling goods on credit and thus creating receivables. Credit sale (Bai' Mu´ajjal) may take a number of forms, among which the important are:

1. Musawamah, or normal sale, in which parties bargain on price, a sale is executed andgoods delivered while payment is deferred.
2. Murabaha, a "cost-plus sale", in which parties bargain on the margin of profit over theknown cost price. The seller has to reveal the cost-incurred by him for acquisition of thegoods and provide all cost-related information to the buyer.

Experts in Islamic economics and finance generally advise the use of profit/loss sharing modes and discourage extensive use of Murabaha or other trading modes. But, as its permissibility is beyond doubt and all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional modes of credit, studying Murabaha from the point of view of Islamic banking is crucial, and hence is the subject of this unit.
The technique of Murabaha that is currently being used in Islamic banking is something different from the classical Murabaha used in normal trade. This transaction is concluded with a prior promise to buy or a request made by a person interested in acquiring goods on credit from any financial institution. As such, it is called "Murabaha to Purchase Orderer" (MPO).

BAI' Murabaha In Classical Literature

Murabaha is derived from Ribh, which means gain, profit or addition. In Murabaha, a sellerhas to reveal his cost and the contract takes place at an agreed margin of profit. This contract was practised in pre-Islamic times. Imam Malik has mentioned this sale in *Al-Mu'watta* –the first formally coded book on traditions of the holy Prophet (pbuh). A renowned Hanafijurist Al-Marghinani has defined Murabaha as "the sale of anything for the price at which itwas purchased by the seller and an addition of a fixed sum by

way of profit". Ibn Qudama,a Hanbali jurist, has defined it as "the sale at capital cost plus a known profit; the knowledge of capital cost is a precondition in it. Thus the seller should say: 'My capital involved in this deal is so much or this thing has cost me (Dm) 100 and I sell it to you for this cost plus a profit of (Dm) 10'. This is lawful without any controversy among the jurists".
According to Imam Malik, Murabaha is conducted and completed by exchanging goods and price including a mutually agreed profit margin, then and there. It is important to observe that to him, no credit is involved in Murabaha. Malik is as a whole do not like this sale as it requires so many conditions, the fulfilment of which is very difficult. However, they do not prohibit it.
Imam Shaf'ie in *Kitabul Umm* expanded this concept to include credit transactions. It has been defined in similar words in other books of Fiqh. By definition, therefore, it is basic for a valid Murabaha that the buyer must know the original price, additional expenses if any and the amount of profit. Accordingly, Murabaha is a contract of trustworthiness.

The Need for Murabaha

Actually, Murabaha is meant for some restricted situations. Al-Marghinani has suggested that the purpose of Murabaha (and Tawliyah) is the protection of innocent consumers lacking expertise in trade from the tricks and stratagems of cunning traders. A person who lacks skill in making purchases in the market on the basis of Musawamah is obliged to have recourse to a Murabaha dealer who is known for his honesty in this particular type of trade, and thus purchases the article from that person by paying him an agreed addition over the original purchase price. This leaves the actual buyer satisfied and secure from the fraud to which he was exposed for want of skill. Hence, it is evident that the main purpose of this form of Bai' is to protect innocent purchasers from exploitation by cunning traders.
Imam Ahmad prefers ordinary sale over Murabaha in the following words:
"To me, ordinary sale (Musawamah) is easier than Murabaha, because Murabaha implies a trust (reposed in the seller) and seeking of ease on behalf of the buyer, and it also requires detailed description to the buyer; there is every likelihood that selfishness may overcome the seller, persuading him to give a false statement or that mistake may occur which makes it exploitation and fraud. Avoidance of such a situation is, therefore, much better and preferable".
It is important to observe, however, that modern Murabaha is conducted mainly by banks and financial institutions on a deferred payment basis. Upon execution of Murabaha, a receivable is created that becomes the liability of the customer. The aspect of disclosing details of the banks' cost price, though a necessary condition of Murabaha, does not remain a serious issue between the parties, particularly in view of the fact that the customer himself is involved one way or the other in locating and purchasing the goods.

Specific Conditions of Murabaha

It is quite obvious that a transaction under Murabaha should meet all the general conditions applicable to an ordinary sale. The specific conditions regarding lawful transactions of

Murabaha pertain to the goods subject to Murabaha, the original price paid by the seller, any additional costs to compute the total costs serving as the basis of Murabaha and the margin of profit charged on the cost so determined. An account of these conditions follows:

1. Goods to be traded should be real, but not necessarily tangible. Rights and royalties are examples of non tangibles that can be traded through Murabaha, as they have value, are owned and can be sold on credit.
2. Any currency and monetary units that are subject to the rules of Bai' al Sarf cannot be sold through Murabaha, because currencies have to be exchanged simultaneously.
3. Similarly, credit documents that represent debt owed by someone cannot be the subject of Murabaha, first because debt cannot be sold except when it is subject to the rules of Hawalah and second because any profit taken on the debt would be Riba.
4. The seller must state the original price and the additional expenses incurred on the sale item and he must be just and true to his words. The additional expenses such as transport, processing and packing charges, etc. that enhance the value of the commodity in anyway, and that are added as a custom by the merchant community in the original price, can be added into the purchase price to form the basis of Murabaha. It is, however, requisite that the seller, in making or including such an addition, should say: "This article has cost me so much", and not: "I have purchased this at such a rate," because the latter assertion would be false. The traditional jurists had some differences in this regard. The Hanafi school permits the seller to include in the base price of Murabaha all expense she has incurred in relation to it, which have somehow modified the object (tailoring, dyeing for cloth) and those which have not modified it but were nevertheless incurred for the object's sake (transportation, storage costs, commission). The Malik is divide the expenses into three groups: expenses that directly affect the object of the sale and that can be added to the base price of the object; expenses that are incurred after the profit has been calculated and do not directly alter the sale object, like services which the seller might not have provided himself (transportation and storage expenses), which can also be added and expenses which represent the services that the seller could have provided himself but did not provide, such as packing charges, sales commission, etc. – these cannot be added. According to Shafi'es also, the expenses of the last category cannot be added to the cost. The Hanbalis' view is more pragmatic, according to which all expenses can be added with mutual consent, provided the buyer is informed about the break-down of these expenses.
5. The prospective seller in Murabaha is required to disclose all aspects relating to the commodity, any defects or additional benefits and the mode of payment to the original seller/supplier. All schools of thought are unanimous on the point that the buyer in Murabaha ought to be informed if the original price was on credit, since credit prices are often higher than cash prices.

6. The margin of profit on the price so reached has to be mutually agreed upon between buyer and seller. The price, once fixed as per agreement and deferred, cannot be further increased except for rebate received from the supplier as mentioned above.
7. Any Majhul (unspecified) price cannot become a basis for Murabaha, as it involves the semblance of uncertainty which renders Murabaha sale unlawful. It is, therefore, a prerequisite that the price or cost paid by the seller must be expressed in identical units, such as dirhams and dinars, or specific articles of weight or measurement; because if the original price is an article of which all the units are not similar, the exact price at which the original buyer has become owner of the article will remain unknown.
8. If the seller gives an incorrect statement about the original price/cost of goods, the buyer, according to Imam Malik, may withdraw the sale unless the seller returns to him the difference between his real and the stated cost, in which case the sale is binding. The Hanafis give the buyer the unqualified option to withdraw, while the Hanbalis consider the sale binding after the return of the difference between the correct and the stated costs. The Shafi‘es have two versions, one of which agrees with the Hanbalis and the other with the Hanafis.
9. The purchaser in Murabaha has the right of option, even in the absence of this condition or its stipulation in the contract. If he discovers that the seller has defrauded him by false statement regarding particulars of the article, its price, additional expenses or if the seller himself has bought the commodity on a deferred payment basis and sold it on prompt payment without informing him, or if any practice on the part of the seller involves the impression of illegal sale, the purchaser will be at liberty either to accept or reject the bargain as he pleases. If, however, the purchaser detects cheating after he has used that commodity or it has been destroyed in his hands, he is not entitled to make any deduction from the price according to Imam Abu Hanifa and his disciple Muhammad, because the commodity against which he has to practise his right of option does not exist.

Bai‘ Murabaha and Credit Sale (Murabaha–Mu’ajjal)

Murabaha as an alternative to interest-based financial transactions assumes importance only when it is transacted on a deferred payment basis. This, therefore, calls for a study of the concept of postponement of payment in Murabaha. The terms of payment in the classical Murabaha did not necessarily involve credit; they could be either cash or credit. It may, however, be pointed out that the legality of postponement of payment is one of the general features of lawful sales – termed Bai‘ Mu’ajjal, which refers to sale of goods or property against deferred payment (either in a lump sum or instalments). Bunched with the Murabaha, Bai‘ Mu’ajjal would mean sale with an agreed profit margin over the cost price along with deferred payment.

Possible Structures of Murabaha

Trading and other real sector business activities require specific expertise, which bankers mayor may not have. Further, it is not possible for banks to train all staff in trading, marketing and other real sector activities required for Islamic banking practices. One possible solution is that banks may establish specific purpose companies to undertake trading (and leasing) activities and the staff with relevant specialized expertise may be entrusted the job of trading in goods so as to fulfil the Shari'a essentials of Murabaha–Mu'ajjal.

Those companies would buy commodities and assets and sell them to their customers on the basis of deferred payment. Thus, the banks' specialized entities could use their entrepreneurial expertise, like all other profit-seeking businesses, to earn profit. Otherwise, the trading activities may be conducted either through the client as agent or through a third party agency. The options for conducting Murabaha are briefly discussed below.

Direct Trading by Bank Management

Direct trading by bank officials is the most ideal option with respect to fulfilment of the Murabaha essentials, but involving the bankers in retail trading business could lead to a lot of managerial problems and open the floodgates to corruption. This issue can be resolved through the introduction of effective internal controls. In the absence of such controls, this structure could be used only in cases of selected specific assets, wherein banks could purchase any high value asset or specific goods with trademarks in bulk for building inventory and sell to its clients on a cost-plus basis. For example, a bank's subsidiary dealing with agricultural finance may purchase fertilizer/pesticides and provide them to farmers on the basis of Murabaha through dealers. In such wholesale business, an additional benefit would be that the bank's sale price could be closer to the cash market price.

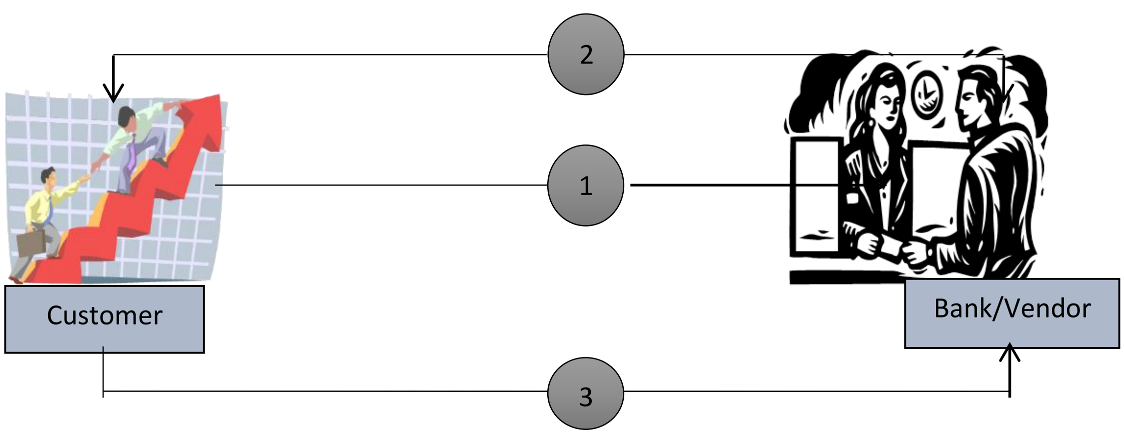

Fig: 8.1

Bank Purchases through a Third Party/Agent

One option in many cases may be to purchase goods through a third party agent to maintain inventory or to purchase according to clients' requests for Murabaha operations. This structure of Murabaha is most likely to accomplish the Shari'a requirement of taking possession and commercial risk by the bank for the period between the purchase of the assets from the supplier and their sale to the client on Murabaha. After purchase from the supplier, banks stand liable if anything goes wrong until handing the asset over to the Murabaha clients. The customer cannot guarantee the risk of transportation of the goods because the safety of the goods is the responsibility of the owner, that is, the bank. Banks can mitigate this risk by stipulating to get delivery at their godowns.

Banks may appoint qualified suppliers as agents for purchase according to their inventory creating plans or as and when required by their clients. For the latter arrangement, the package would comprise (i) an MoU or agreement to sell – the client's request and promise that he will purchase the specified commodity from the bank; it may also include a stipulation about the profit margin to be taken by the bank and, if possible, the sale price, that will include the cost price, the contract price and the payment date(s); for the profit margin, the bank may indicate at this stage any reference rate provided a definite price is stipulated at the time of execution of Murabaha; (ii) the sale deed executed at the time when the commodity is in the ownership and risk of the bank; and (iii) the "promissory note" signed by the client to the effect that he will pay the price of the goods purchased on a specified date. In addition to this, the agreement may include clauses about the security/collateral, description and quality of goods and the way out in case of defect in the goods and nonpayment by the client at the due date(s). According to the AAOIFI Standard, a promissory note or other guarantee can be obtained from the customer at the promise stage also. Of course, it is better that promissory notes be obtained after execution of the sale, because these generally contain the wording "against value received".

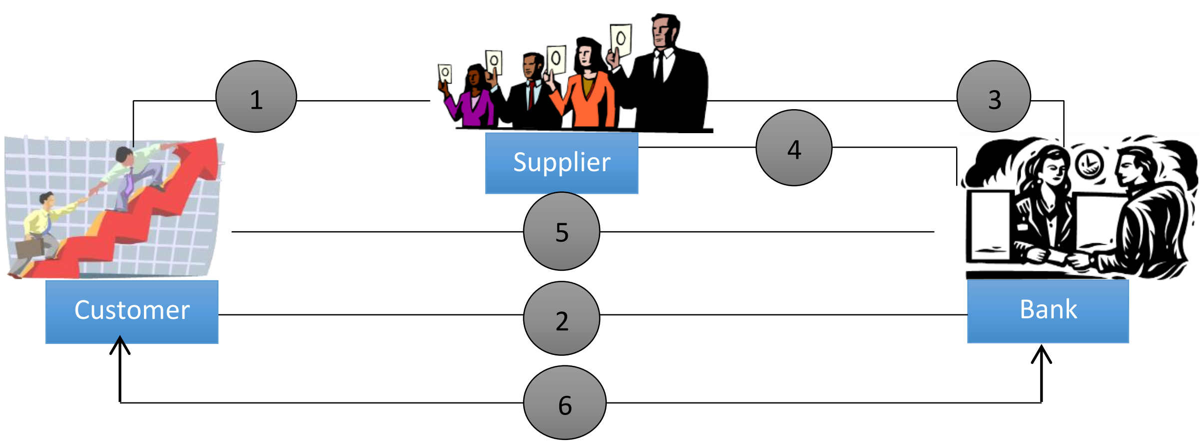

Fig: 8.2

Murabaha through the Client as Agent

The structure of trading through a client as the bank's agent is the safest way for banks to avoid commodity-based risks and related problems. But this arrangement is more likely to make Murabaha transactions a back door to interest and, therefore, requires extra care to keep it Shari'a-compliant. The foremost requirement is that goods come under the ownership and risk of the bank. Further, the customer should explain to the supplier about his agency status. If the bank does not purchase and own the items and only makes payment for any goods directly purchased and received by the client from the supplier/vendor under "Murabaha", that will be a remittance of the amount of money on behalf of the client, which shall be nothing but a loan to him and any profit on this amount shall be nothing but interest. As Islamic banks are normally using this structure, we discuss it in detail.

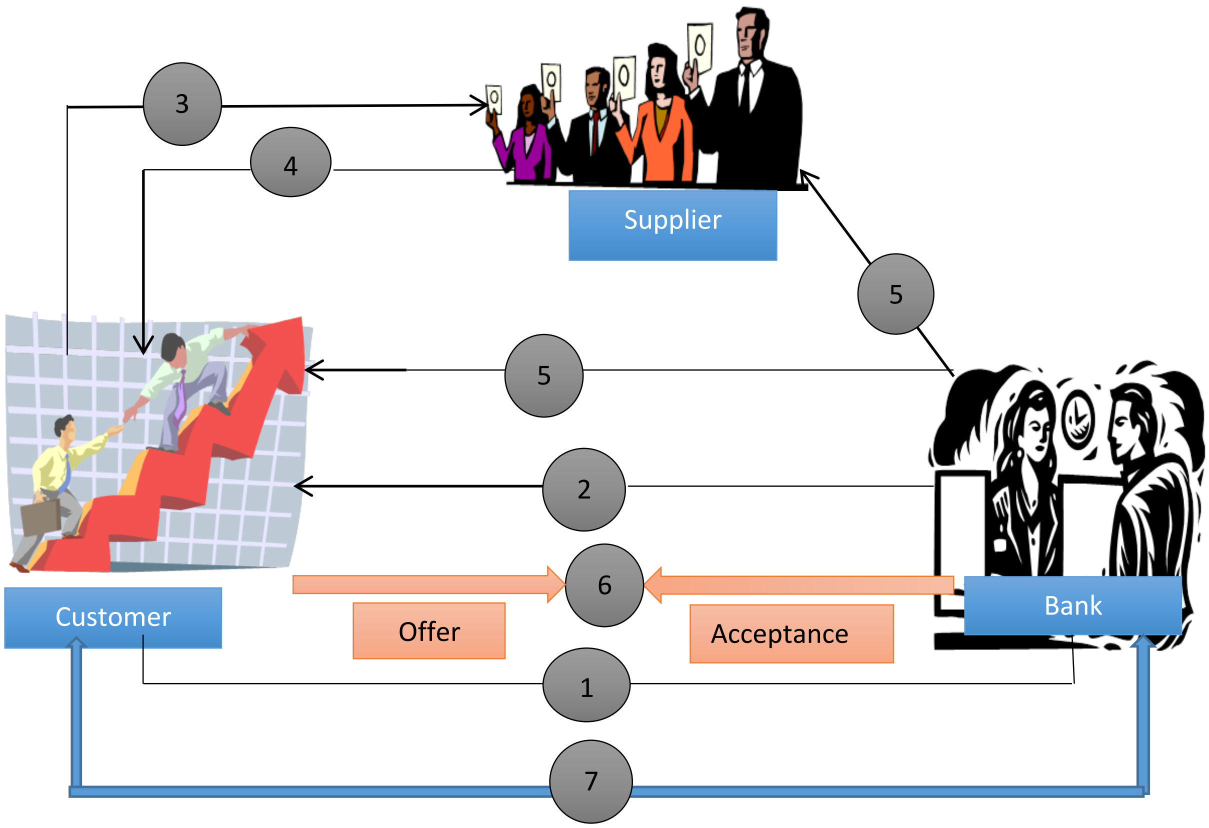

Fig: 8.3

Murabaha to Purchase Orderer (MPO)

Modern Murabaha transactions by banks normally take the form of Murabaha to Purchase Orderer (MPO) (Murabaha lil 'amri bil Shira or 'Murabaha li Wa'da bi Shira), which is an arrangement wherein the bank, upon request by the customer, purchases an asset from a third party and sells the same to the customer on a deferred payment basis. This variant is being widely used by almost all Islamic banks operating in various parts of the world and by the Islamic Development Bank for its foreign trade-financing operations. The need for MPO arises from the following factors:

1. Commercial banks, and likewise Islamic banks, do not normally undertake business where they might be maintaining inventories of various goods; they do not want to become grocers or traders because inventory storage, space and holding costs might be expensive.
2. It may not be possible for Islamic banks to purchase all items in advance for Murabaha to their clients because the list of goods could be very long and there could be continuous additions to the list.
3. The clients might be in need of specific quality goods and the banks might not be even aware of the source of their availability. If banks keep similar items in inventory, these might not be acceptable to the clients.
4. Regulators/central banks normally do not allow the banks to undertake trading as their core business, with the dual purpose of keeping them liquid/saving them from the asset and market risks related to goods and to avoid cartels and monopolies in the commodity market. As such, most of the Islamic banks purchase only those goods for which they receive requisition from their clients.

MPO – A Bunch of Contracts

Modern Murabaha also involves an agency relationship between the bank and any thirdparty or even the client. The Murabaha to Purchase Orderer in this form would comprise three distinct contracts:

1. A master contract which defines the overall facility to be availed, followed by an agreement to purchase or promise by the client to purchase the article when offered by the bank. Instead of being a bilateral contract of forward sale, the “agreement to buy” is a unilateral promise from the client which binds him and not the bank.
2. An agency contract whereby the agent, who could be a client or any third party, has to purchase the item from the market or the supplier identified by the client and take its possession on behalf of the bank; this should be separate from the Murabaha agreement.
3. The actual Murabaha contract. The actual Murabaha contract should be concluded when the bank owns the concerned commodity. Murabaha transactions that involve other contracts like promise, agency (Wakalah) andcredit along with an agreed rate of return for IFIs over the cost price lead to a number of issues: should the promise be unilateral or bilateral, binding or nonbinding? What is the remedy if the client backs out? What should be the sequencing of the various actions of the bank and the client? When the actual Murabaha is to be executed, what happens if the client makes early payment or delays in making payment of the settled price? To what extent can the bank’s loss be covered and mitigated? And last, but not least, what structure and modusoperandi of Murabaha can be adopted to fulfil the needs of various stakeholders along with ensuring Shari’a compliance? We discuss these matters in the following sections.

MPO – The Customer as the Bank's Agent to Buy and RelatedMatters

The general structure of this variant of Murabaha is the following:

1. The customer approaches the bank with a request for the purchase of any commodity that can be legally sold on credit.
2. The bank appoints the client its agent to purchase the item(s).
3. The bank purchases the commodity through the client as agent.
4. The bank makes payment to the vendor/supplier.
5. The customer takes delivery of the item on behalf of the bank as agent.
6. The customer makes an offer to purchase and the bank accepts the offer – the bank transfers the title over to the customer upon execution of Murabaha.
7. The customer makes payment on a deferred basis without any rollover, discount or rebate.

The above structure involves the following stages/steps: pre-promise understanding; promise stage; agency stage; acquiring possession; execution of Murabaha; post-execution of Murabaha. Each of these steps is crucial in its own right and neglecting essentials of any stage would render the whole arrangement unacceptable from the Shari'a angle:

1. The client and the bank sign an MOU or "agreement to sell", whereby the bank undertakes to sell and the client promises to buy a commodity for a purchase price plus a profit margin of X% that may or may not be tied with any benchmark, or a stipulated amount over the known cost.
2. The bank appoints the client as its agent for purchasing the commodity on its behalf, and both the parties sign an independent specific or general purpose agreement of agency.
3. The client purchases the commodity on behalf of the bank and takes its possession, for which the bank makes payment to the vendor/supplier. This is obligatory according to the AAOIFI Standard; however, some Islamic banks do not follow this instruction due to some procedural problems. The purchase order, material receiving report and delivery challan, under whatever title, should be in the name of the bank.
4. The client informs the bank that he has purchased the commodity on its behalf, has taken possession thereof, and makes an offer to purchase it from the bank at a profit margin over the cost, as agreed to in the "agreement to sell". This must be before the goods are consumed, otherwise the Murabaha will be invalid.
5. The bank accepts the offer and the sale is concluded, whereby the ownership as well as the risk of the commodity is transferred to the client. The nature of the relationship in the above arrangement would be:
    i. Bank and client: principal and agent.
    ii. Bank and client: promisor and promisee.
    iii. Bank and supplier: buyer and seller.

iv. Bank and client: seller and buyer.
v. Bank and client: creditor and debtor.

Prerequisites of the various stages of MPO with the client working as agent are discussed below.

Pre-Promise Stage – Facility Approval

The following points have to be kept in mind while approving the facility: it is essential that the transaction between the bank and the client must be genuine, involving the trade of goods. Murabaha cannot be used for providing liquidity or for cash financing. At the time of facility approval, banks should ensure that the client needs some goods. Further, this should exclude any prior contractual relationship between the client and the supplier whom the client is indicating for supply of the goods. It is not permissible to transfer a contract that has already been executed between the client and the supplier because this is tantamount to Bai' al 'Inah, which is prohibited. However, if any such prior understanding has not been finalized, the bank can enter into an Murabaha arrangement. The bank must also ensure that the supplier or the party from whom the item is being purchased is a third party and not the customer, his agent or any entity with more than 50% ownership by the customer.

The nature of the required commodity should be in the scope of valid Murabaha.
Commodities that are subject to the rules of Bai' al Sarf, like gold, silver and currencies, are not valid for Murabaha, because in such commodities and monetary units, exchange has to be hand to hand. The bank should also analyse the nature of goods from a risk management point of view, their marketing, any uniqueness that could affect their profitability and the cash flow and risk profile of the client.

Promise Stage – Master Murabaha Facility Agreement

After the initial analysis of the customer's request, the bank will enter into a master Murabaha facility agreement, or MoU, in which the limit of the facility, the nature of the commodity, the profit margin to be taken by the bank, the schedule of payment, the security to be submitted by the customer and other terms and conditions will be mutually stipulated. On the basis of one MoU there could be a number of consignments for purchase of the asset from time to time under sub-Murabahas. The MoU should also include specimens of purchaser equisition, a delivery report, a promissory note and the nature of collateral required. If both parties agree, the agency agreement can also be signed at this stage.

Purchase Requisition

As per the MoU, the client will submit a requisition to the bank to purchase the commodity as per his specifications. The requisition will contain details of the goods required to be purchased from the bank and if possible the name of the supplier, cost price and the expected date of delivery. Also at this stage, the bank should ensure that the goods are not already owned by the client, otherwise the Shari'a advisor might ask the bank to credit the income from this transaction to the Charity Account. The customer will also give an undertaking to the bank that he will buy the goods which the bank will acquire on his request.

Normally, a purchase requisition contains this promise. If the supplier is nominated by the client himself, the bank may demand a performance bond or guarantee for good performance to the effect that the goods provided by the supplier indicated by the client will be acceptable to him.

For purchasing the commodity it is advisable that the bank makes payment directly to the supplier to ensure that the funds are used for the actual purpose. Experience has shown that if funds are given to the client, there is a chance of misutilization that could also involve non-Shari'a-compliance. Advance payment can also be made to the supplier, and in this case, the bank would charge a higher profit margin than the case of post-supply payment.

Agency Stage

An agency agreement can be signed side by side with the signing of an MoU. But it should invariably be before the purchase of goods by the client. If the client purchases the goods before the agency agreement, it would mean the goods are already owned by him and the transaction would become Bai' al 'Inah, which is prohibited. An agency agreement could be "specific agency", when the purchase of the commodity is not of a consistent nature, or"general", when the purchase of the commodity is of a consistent nature.

Purchasing Stage

The client should purchase the goods as the agent of the bank and as per the specifications already decided. A number of situations could evolve at this stage. If the cost price is already given and the supplier gives some rebate, it should be passed on to the client at the time of execution of the Murabaha sale by reducing the cost of sale. If there is a rise in prices and the amount escalates from the amount agreed in the Murabaha limit, the bank or the principal must be informed in order to make a decision on whether to accept it or not. The bank has the right to reject the purchase if made at other than the agreed price. If the goods to be purchased are different from those given in the agency agreement, the change of commodity can be made with mutual consent. Normally, banks indicate a time within which purchase has to be made and if there is a delay, the bank may ask the client to refund the cost of goods without any opportunity cost.

Acquisition of Title and Possession of the Asset

For Shari'a compliance, it is necessary that the bank takes ownership and actual or constructive possession of the goods before the execution of Murabaha. The forms of taking possession of items differ according to their nature and customs. The requirement from the
Shari'a angle is that the goods must come under the responsibility and risk of the bank.
The Islamic Fiqh Academy of the OIC resolved, in its sixth session, in respect of the forms of "possession":

"Just as the possession of commodities may be physical, by taking the commodity in one's hand or measuring or weighing the eatables, or by transferring or delivering the commodity to the premises of the buyer, the possession may also be an implied or constructive possession, which takes place by leaving the commodity at one's disposal and enabling him to deal with it as he wishes. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf".

The time when the risk of the item is passed on from the supplier to the bank, and subsequently from the bank to the customer, must be clearly identified. This is why Shari'a scholars normally do not approve Murabaha of natural gas in pipes; the gas company cannot say that from "this" point possession of the gas and its risk has been transferred to thebank, and then from the bank to the client. Further, the goods must exist at the time of execution of Murabaha. Sometimes, it happens that the client takes delivery of the goods as agent and uses them in his process of production even before informing the bank and "offer and acceptance". This creates a Shari'a objection. Before execution of Murabaha, the bank must ensure that the item exists in its form and for this purpose it is advisable that the bank appoints any person for physical inspection. Further, all ownership-related expenses like Takaful until this point need to be paid by the bank. Any loss before that date also belongs to the bank, being the principal owner of the goods.

Execution of Murabaha Stage – Offer and Acceptance

After the customer acquires possession of the goods, as an agent, he should give a possession report and make an offer to purchase the goods acquired by him on the bank's behalf. The bank will accept the offer and the transaction will be completed. All the terms of the Murabaha transaction, such as contract price (cost plus profit), due date or schedule of payments, etc. must be mentioned in the bank's letter of acceptance. Upon execution of
Murabaha, the relationship of buyer and seller between the customer and the bank changes into the relationship of debtor and creditor. After this, the bank will not be liable for any harm to the goods.

Having taken delivery of the goods as per the purchase requisition, the customer should confirm that the goods have been examined and are satisfactory in respect of quality and suitability for his use. He should also relieve the bank from any loss or third party liability in respect of the goods sold to him. The AAOIFI Standard recommends that the bank should assign to the customer the right of recourse to the supplier to obtain compensation for any established defects which would otherwise be recoverable by the bank from the supplier.

Security/Collateral against Murabaha Price

The bank can ask the customer to furnish security to its satisfaction for timely payment of the deferred price. It is also permissible that the sold commodity itself is given to the bank as a security, provided possession is once given to the customer. In such a case, the customer would own the risk and reward of the goods. The bank can obtain any of the following types of security, depending upon the amount of facility, nature of business and credibility of the customer: a hypothecation charge on assets, a pledge of goods and/or marketable securities, a lien on deposits, a mortgage charge on movable and immovable properties, bank guarantees, personal guarantees or any other security mutually agreed between bank and client. Some Shari'aboards allow taking interest-bearing securities as collateral (Murabaha facility against TDRs and FDRs); in such a case the bank will have recourse to the extent of principal only. However, it is preferable not to take interest-bearing instruments as securities and the customer should be asked to encash the instruments and offer any Shari'a–compliant securities.

Issues In Murabaha

The above complex type of contractual arrangement could create a number of issues relating to the sale contract, credit price and legal implications of combining promise and agency with the actual Murabaha contract. One objection sometimes raised in this regard is that Murabaha operations by Islamic banks constitute two sales in one; the contract of promise and the sale deed. The objection is that as the promise is made binding, it takes on the character of a sale, leading to two contracts in one sale contract. A very simple fact, however, is that as it does not involve violation of any major Shari'a principle, almost all contemporary jurists have allowed the combination, as the promise does not take the form of a formal contract. The implications of a sale contract and a promise to purchase are different. A unilateral promise remains a promise and cannot take the form of a contract.
Some other issues are discussed below.

Avoiding Buy-back

Bai' al 'Inah, commonly known as "buy-back", is a double sale by which the borrower andthe lender sell and then resell an object between them, once for cash and again for a higher price on credit, with the net result of a loan with interest. As such, it is a legal device to circumvent the prohibition of Riba and therefore prohibited. Although banking authorities in
Malaysia consider it acceptable, the mainstream Shari'a experts from the Middle East and the rest of the world consider it non permissible. Therefore, Islamic banks, while conducting
Murabaha to Purchase Orderer, have to be vigilant that the goods being required by the client are not already owned by him. The AAOIFI also holds this view.

Khiyar (Option to Rescind the Sale) in Murabaha

Most scholars do not consider Khiyar (option) to be necessary in modern Murabaha. Some banks stipulate in the contract that any defect is the liability of the buyer if he examines the goods himself, or if they are described to him (in such a way) as to eliminate ignorance (about the goods), which could lead to dispute. However, any lack in the quantity of the goods or specification remains the liability of the seller. This latter case results in the sale price being reduced by an amount proportionally corresponding to the missing goods, with the buyer having the right to rescind the contract.

Hence, from a juristic point of view, if the goods are defective or not according to the stipulated specifications, Khiyar al 'Aib and Khiyar al Wasf are available to the client, and ifhe rejects the goods on the grounds of inferior quality before the execution of the Murabaha deal, the goods can be returned to the supplier and genuine quality goods can be acquired through the same or a new Murabaha. The bank can also stipulate that, after inspection of the goods by the client and execution of Murabaha, it will not be liable for any discrepancies.

As discussed above, in the case of warranties, the bank can also assign such rights to the client. If option is available to the customer, the bank will be carrying a much larger risk and may have to carry out, before agreeing to the financing, a more intensive market survey, that may not be possible for most of the Islamic banks in their present structure and stateof infancy. To avoid the risks, what the banks are doing in practice is to make the customer their agent for the purchase of the goods as well as for taking delivery from the supplier.

The client will be purchasing the goods with full care as per his requirement. Mostly, the client also identifies the supplier from which the bank should buy the goods. In this case, the bank can take from him a performance guarantee that he will be responsible in respect of the quality of the item.

Time of Executing Murabaha

Another issue is the point of time when the bank can legally sell the article to its client. The requirement in this regard is that a Murabaha contract should be conducted only after the bank gets ownership and possession and becomes responsible for any loss or any defects therein. Shari'a scholars generally recommend that a modern Murabaha operation is allowed provided the bank takes full possession of the object before selling it, including bearing the risk of its loss and the responsibility for returning it if it is defective. Murabaha has to be executed only after the bank has taken possession and the goods exist. However, there are references in some edicts to sale occurring before the bank has taken possession of the object. Such edicts might create a credibility problem for Islamic banking. Agency contracts for buying the goods by the client on behalf of the bank and immediately selling them to the client are made part and parcel of Murabaha contracts. Islamic banks must avoid this practice and treat agency contracts as being totally separate and independent from the Murabaha contracts. After the goods are taken into possession by the client as agent, there should be a separate offer and acceptance between the client and the bank.

Defaults by the Clients

In the conventional banking system, a delinquent customer has to reschedule his debt, usually at a higher rate. The additional interest cost to the customer may motivate him to pay on time. The question, therefore, is how to take care of the problem of deliberate delays in payments in the Islamic financial system. One option is that a bank stipulates in the

Murabaha agreement that in the case of a customer's delay in payment without any genuine reason, all remaining instalments will become due at once; thus, the customer will try to be more disciplined.

By means of an undertaking by the client, Islamic banks stipulate in the contracts that the client should pay to charity in case of default. Contemporary Shari'a scholars have evolved a consensus that banks are authorized to impose late fees on delinquent clients (this means that the clients that are really unable to pay will not be charged any such penalty).But the proceeds of such penalties are to be used for charitable purposes.

Rebates on Early Payment

Depending upon the cash flow, some clients may wish to pay earlier than the due date and demand a prepayment rebate as in the case of conventional banking. However, the majority of contemporary Shar¯ı´ah scholars do not allow remission for earlier payment in Murabaha operations by banks.

Rollover in Murabaha

"Rollover" in Murabaha means booking another Murabaha against receivables of any previous Murabaha, payment in respect of which has not been made by the client. Further mark-up is added to the receivable in default by a client. This is explicit Riba, as the bank is not entitledto any amount over and above the debt created in a Murabaha transaction, as a result of which ownership of the sold goods had already been transferred to the client. Now the bank has no right of re-pricing. Rescheduling is allowed, but re-pricing and, therefore, rollover is not allowed.

The bank, at its discretion, can reschedule the payment without any increase in the original receivable. Any amount taken from the client on account of late payment, as per his undertaking in the Murabaha agreement, would go to the charity account. However, there is the possibility of a fresh Murabaha facility through the sale of new goods.

Murabaha through Shares

In recent years, some Islamic banks have conducted shares Murabaha, i.e. they purchase shares through a client as agent and sell them on a Murabaha basis to the clients. As shares represent tangible assets of joint stock companies, their trading is permissible provided the screening criteria recommended by the Shar¯ı´ah scholars are taken into consideration. Their sale through Murabaha is also permissible, but Islamic banks need to take extra care with regard to Shar¯ı´ah compliance matters. Banks should make payment directly to the brokers and the client should not be appointed agent for purchasing the shares. After the paymentis made by the bank and the shares are transferred to it actually or through any central depository, the bank can sell them onward on a Murabaha basis. If settlement takes time, the bank shall wait for actual transfer. Generally, transfer takes three days; so the risk of price for three days has to be taken by the bank. Further, the shares in respect of which Murabaha is to be conducted should not be of any sister concern of the client; otherwise it will be "buy-back" and therefore prohibited.

Commodity Murabaha

Some banks in the Middle East and the West have been using commodity Murabaha on international commodity exchanges as a treasury operation. This is a very tricky issue and needs a special role of the Shar¯ı´ah advisors of the concerned banks. It refers to a short term placement mechanism involving purchase and sale of commodities in the international markets, e.g. London Metal Exchange (LME). Internationally, Islamic banks have relied mainly on this product for liquidity management.
The banks use Tawarruq and appoint a broker to purchase any metal and then sell the same on deferred payment to any third broker on the same date. Normally, Islamic banks make an agent of a conventional bank to buy on their behalf any metal from broker A against cash payment and then sell that to broker B on deferred payment. Nobody cares whether any actual transaction has taken place or not, and at which point in time risk was transferred to the bank. There are doubts about the quantity of metal being sufficient to cover the transaction volumes. As the brokerage cost makes the product less competitive, there is a chance that no actual transactions might be taking place. Islamic bankers need to understand that the Tawarruq arrangement, even in its genuine form, should be used in extreme cases where no option is available to avoid interest. It has not been approved by all scholars. Widespread use of such products is harmful to the Islamic banking industry in the long run.

Precautions in Murabaha Operations

In Murabaha, Islamic banks have to face additional asset risk, greater fiduciary risks, greater legal risk and the Shar¯ı´ah compliance risk. To mitigate the legal risk, special care has to be given to completing documentation for various contracts under the guidance of the bank's legal department. Adherence to the AAOIFI's Shar¯ı´ah Standards would enable the bank to get Shar¯ı´ah compliance. In this regard, the role of Shar¯ı´ah supervisory boards/advisors is of crucial importance in applying proper internal controls for Shar¯ı´ah compliance. Mistiming in documentation may lead to loss of income. Therefore, an Islamic bank must strengthen its internal Shar¯ı´ah control and risk management departments.

Musawamah (Bargaining On Price)

Musawamah is a general and regular kind of sale in which the price of the commodity to be traded is bargained between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from Murabaha in respect of the pricing formula. Unlike Murabaha, the seller in Musawamah is not obliged to reveal his cost. Both the parties negotiate on the price. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be used where the selleris not in a position to ascertain precisely the costs of commodities that he is offering to sell.
From a juristic point of view, Musawamah can be either cash or credit sale, but when used by banks it will generally be a deferred payment sale in which they will bargain with clients on the price of goods/assets. They will add their profit margin to their cost but will not be required to tell their clients the details of cost price and their profit in any transaction. A few Islamic financial institutions have a practice of obtaining a

discount from the supplier in the case of retail goods. In such a case, since actual profit is not brought to the notice of the customer, it is necessary that such a sale should be conducted through Musawamah and not Murabaha.

Musawamah as a Mode of Financing

Businesses normally use Musawamah, in that they are interested only in profit, which they earn through pricing, while Islamic banks mostly use Murabaha. This is because direct use of any benchmark is relatively easier in Murabaha than in the case of Musawamah. It is easier for the bank management and the regulators to manage the return rate structure in Murabaha. Further, chances of corruption are minimal in Murabaha, because whatever the level of price of the asset, the bank will be charging a profit margin tied up with the costprice of the asset.

Musawamah is more suitable for single huge transactions, wherein decisions are made normally at the top level and the price is bargained between the parties. For example, an airline in the Middle East may require credit purchase of an aeroplane costing about $500million. An Islamic bank may purchase the aeroplane for $450 million, for example, and sell it to the airline after adding its profit of $50 million, keeping in mind the credit period and the payment schedule. Details of the cost price to the bank will not be needed and the airline will be interested in the final price only. Similarly, Musawamah could be used in financing of all such purchases where it is not possible for banks to tell a number of minute details, as required in Murabaha.

Nature of Risk	Mitigating Tool(s)
Customer refuses to purchase goodsafter taking possession as agent.	Promise to purchase the ordered goods is obtained from customers. Also, Hamish Jiddiyah may be taken, from which the bank can cover its actual loss.
Customer did not purchase fresh assets/goods; has already purchased and now wants funds for the paymentto the supplier; involves Bai‘ al ‘Inah,so non-Shar¯ı´ah-compliant.	• Make direct payment to supplier through DD/PO.of invoice should not be earlier than thedate of agency agreement and not laterthan the declaration or offer to purchase. • In addition to invoice, obtain any other evidence, e.g. gate pass, inward register, entry in stock register, truck receipt. • Physical inspection of goods.

Fig: 8.4 Risk Management in Murabaha

The agency structure can also be used in Musawamah, but it is better and preferable that the bank directly purchases the assets, particularly expensive assets. However, the bank may involve the clients in selection of the supplier and the assets to ensure that the assets being purchased by the bank have all the specifications requested by the client. In the case of assets with a huge price, the structure used by banks will be Musawamah to Purchase Orderer, while in the case of less expensive goods, generally demanded by businesses and the public, banks or their specially created subsidiaries can maintain inventory for sale to the clients on a Musawamah basis as and when demanded by the clients.

The conditions of taking ownership, possession and business risk of the asset are equally applicable in Musawamah as in the case of Murabaha. Goods required for onward sale must come under the risk of the bank before execution of the sale contract with the customer.

Similarly, all conditions regarding subject matter, payment of the stipulated price and the treatment in case of default, etc. will be the same as in the case of Murabaha. The only difference is that the bank is not required to disclose details about its cost price or profit margin, and bargaining will be on the final price of the goods.

Further Reading:

- ✓ ***Handbook of Islamic Banking edited by Kabir Hassan, Mervyn Lewis***
- ✓ ***Risk and Regulation of Islamic Banking edited by Mervyn K Lewis, Mohamed Ariff, Shamsher Mohamad***