



Meezan Bank's Guide to Islamic Banking



The Premier Islamic Bank



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The Premier Islamic Bank

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SECTION IV

ISLAMIC MODES OF FINANCING

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MURABAHA

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

Definition

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

The *Bai' Murabahah* involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on 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 on to the customer for a pre-agreed price.

Murabahah is a mode of financing as old as *Musharakah*. Today in Islamic banks world-over 66% of all investment transactions are through *Murabahah*.

Difference between *Murabahah* 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 *Murabahah*. A simple *Murabahah* is one where there is cash payment and *Murabahah Muajjal* is one on deferred payment basis.

Arguments against *Murabahah*

An argument that arises in *Murabahah* is that profit or interest both are the same and *Murabahah* financing is the same as conventional banking. Islamic scholars however argue that in several respects a *Murabahah* financing structure is quite different to an overdraft organized along conventional lines and the former offers several benefits to the bank and its customers. Depositors are made to share in profits of the bank 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 interest element then it will be void.

Basic rules for *Murabahah*

Following are the rules governing a *Murabahah* 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 an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed 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 *Murabahah* 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 his agent for purchasing the commodity on its behalf.
3. The client purchases the commodity on behalf of the institution and takes possession as the agent of the institution.
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 *Murabahah*. 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 *Murabahah*

Following are some of the issues in *Murabahah* financing:

1. **Securities against *Murabahah***

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 *Murabahah***

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 a person charging a fee for advancing a loan comes under the definition of *riba*.
- b) However the guarantor can charge for any documentation expenses.

3. **Penalty of default**

Another issue with *Murabahah* is that if the client defaults in payment of the price at the due date, the price cannot be changed nor can penalty fees be charged.

In order to deal with dishonest clients who default in payment deliberately, they 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 valid excuse then compensation can be demanded.

4. **Rollover in *Murabahah***

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

5. **Rebate on earlier payments**

Sometimes the debtors want to pay early to get discounts. However in Islam, 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 on its own, it is not objectionable especially if the client is needy.

6. Calculation of cost in *Murabahah*

The *Murabahah* 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 *Murabahah* cannot take place. In this case the sale will take place as *Musawamah* i.e. sale without reference to cost.

7. Subject matter of the sale

All commodities cannot be the subject matter in *Murabahah* because certain requirements need to be fulfilled. The shares of a lawful company can be sold or purchased on *Murabahah* basis because according to the principles of Islam the shares represent ownership into assets of the company 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.

Murabahah is not possible on things that cannot become the subject of sale. For example, *Murabahah* is not possible in exchange of currencies.

Basic mistakes in *Murabahah* 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 *Murabahah* 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 *Murabahah* cannot be used.
2. The document is signed for obtaining funds for a specific commodity and therefore it is important to study the subject matter of the *Murabahah*.
3. In some cases, the sale of commodity to the client is

affected before the commodity is acquired from the supplier. This occurs when the various stages of the *Murabahah* are skipped and the documents are signed all together. It is to be remembered that *Murabahah* 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 *Murabahah* is applied on already purchased commodities, which is not allowed in *Shariah* and can be effected on not yet purchased commodities.

Uses of Murabahah:

Murabahah can be used in following conditions:

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
- PC 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 Murabahah agreement (certificate) is allowed at par value only. Other wise certain rules of Islamic Finance must be met.

Bai' Muajjal

Bai' Muajjal is the Arabic acronym for "sale on deferred payment basis". The deferred payment becomes a loan payable by the buyer in a lump sum or installment (as agreed between the two parties). In *Bai' Muajjal* all those items can be sold on 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 *Shariah* scholars have an '*ijmah*' (consensus) that demanding a high price in 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 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 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.