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Murābaḥah Financing: Some Controversial Issues

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Abstract: In view of the prohibition of *ribā* in Islam – equated to the interest rate in conventional banking – Islamic banks have sought to develop *Sharīʿah* compliant financial products to meet the financing needs of Muslims. One of those modes is the 'mark-up' device, *murābaḥah*. While this financing mode is very commonly used by Islamic banks, it is also subjected to much criticisms by both scholars and the general public.

This article discusses some of the criticisms repeatedly levelled against *murābaḥah*. Arguments against those criticisms that are unjustified and unwarranted are put forward. However, when the use of *murābaḥah* violates the injunctions of the *Sharīʿah*, a return to the proper implementation of the 'genuine' *murābaḥah*, free from intentional or nominal deception, is advocated. In general, it is concluded that Islamic banks bear a large responsibility for clarifying any doubts or suspicions about their practices, the misgiving about *murābaḥah* among them, and should at all times keep away from doubtful or suspect practices, for the provision of services in conformity with the *Sharīʿah* is the source of their legitimacy.

I. Introduction

Fixed return modes of financing rank highest in use by most Islamic banks. In particular, the majority of the financing arranged by Islamic banks is based upon *murābaḥah*. The evidence, based on 1994-96 averages of the financing modes of ten leading Islamic banks, is that *murābaḥah* accounts for 70 percent of their total financing as compared to the profit-sharing modes at less than 14 percent (Iqbal *et al.*, 1998: 62).

A number of reasons have been advanced to explain the banks preference for *murābaḥah* financing. First, being basically a trading technique, it is an appropriate instrument, given that most of the

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finance provided by Islamic banks is directed to trade financing (Ahmad, 1987: 104). According to the statistics compiled by the IDB/IRTI, trading gets the biggest proportion of 42 percent of financing (Iqbal *et al*., 1998: 28). Second, *murābaḥah* has the advantage of being more amenable to short term finance, an aspect usually well liked by banks as they can liquidate their assets fairly quickly if the need arises (Ibid: 53). Third, *murābaḥah* has some desirable features, like low risk, as well as simplicity and convenience, as compared to other financing modes such as profit-sharing.

The extensive use of *murābaḥah* and the currently by insignificant practice of profit-sharing modes has given rise to much criticism of the Islamic banking industry. The Islamic financial institutions have, it is claimed, failed to respond adequately to the full range of financing needs of those seeking modes of Islamic finance (Moore, 1997: 113). Furthermore, *murābaḥah* as a banking product has itself been heavily criticized because, the critics maintain, the agreed profit margin in a *murābaḥah* sale is no more than a disguised form of interest. Others assert that the entire arrangement is artificial since the bank's operation is being turned into a trading function, whereas, conventionally the bank's role is perceived to be that of a financial intermediary not a trading partner.

In this paper, an attempt is made to discuss the main criticisms directed at *murābaḥah* as currently practiced by Islamic banks. Any violations of the injunctions of the *Sharīʿah* in the practice of *murābaḥah* will be highlighted. Also, based on the conditions specified by jurists for *murābaḥah*, its validity, or otherwise, as a banking product will be ascertained.

II. *Murābaḥah*: Its Origins and as a Bankable Mode

Derived from the Arabic word *ribḥ*, meaning profit or gain, *murābaḥah* historically refers to a sale transaction on a cost-plus-profit basis. The profit margin may either be specified as a percentage of cost or as a definite sum in money terms. Expressed in this form, *murābaḥah* is basically a trust sale, conditional upon the seller explicitly revealing his costs in acquiring the commodity.

The concept was originally referred to by Imām Mālik in his work *al-Muwaṭṭa'* under the title "Sale at a mutually agreed profit margin". It was later expanded by Imām Shāfi'ī to include credit

transactions as well as goods whose specifications have been described by the buyer to the seller (Al-Kaff, 1986: 7-9).

Taking into consideration the conditions stipulated by Imām Shāfi'ī, Hamoud then introduced the *murābaḥah* concept into Islamic banking. Hamoud presented *murābaḥah* financing as an alternative to the practice of discounting bills at interest by banks purchasing commodities for clients who could not afford to make full immediate payment (Ghuddah, 1987: 22). Thus *murābaḥah* was seen as a means of assisting clients to obtain commodities they needed, and for which payment is deferred to payment by instalments or other similar arrangements.

Murābaḥah as a banking product soon gained the collective approval of scholars, although many expressed serious reservations, and it became widely used by Islamic banks. The bank operated *murābaḥah* typically serves as a financing mechanism, facilitating short term trade transactions. A client wishing to purchase a particular good requests the Islamic bank to acquire it for him. The bank assumes the role of a trader, purchasing the good to the order of the client and selling the same to him at an agreed mark-up price, with payment being settled within an agreed time frame.

The essential elements added to convert the simple *murābaḥah* sale concept into a financing mode include, according to Tag-el-Din (2002), the following:

(i) Buying a good to the order of a client;

(ii) Taking a binding promise from the client to purchase the acquired good;

(iii) Selling at credit to the client;

(iv) Charging a mark-up in view of the deferred payment involved.

Because of the explicit addition of a profit margin to the cost price in the *murābaḥah* transaction, *murābaḥah* is often referred to as 'cost-plus financing'. It is also usually used in the same sense as *bai' mu'ajjal,* i.e. sale against deferred payment (Chapra, 1985: 261).

III. Some Objections to *Murābaḥah*

Although *murābaḥah* as a financing mode is widely accepted by jurists, several controversies surround its operating mechanism, the

practice of *murābaḥah* has, for instance, been described by Rashid (1984; cited in Al-Kaff, 1986: 14) "window dressing in case of sale at mutually agreed profit margin". Similar criticisms have been expressed by many others; the most common is that *murābaḥah* is a round-about way of charging interest, artificially transforming a financing transaction into one of purchase and sale, and increasing the sale price by selling the good on credit, repayable through deferred payment (Meenai, 2001: 10).

Discussions among scholars have mainly concerned the conditions that have been added to *murābaḥah* to adapt it as a mode of bank financing. The questions raised, for example, relate to such issues as (among others) the value of time, the use of interest rate as a benchmark for profit, the binding promise, and role of Islamic banks as traders.

3.1 '*Murābaḥah* is just an Interest-bearing Loan in Disguise'

Among the biggest objections to *murābaḥah* is the issue of compensation for value of time. It is said that the mark-up or increase in the price that the bank charges when it re-sells the ordered good on credit to the client, being justified in consideration of the time allowed to the client to complete payments, is analogous to the interest charged on a loan (Usmani, 1999: 112). The argument rests on the fact that, as in the case of loan transactions, the mark-up is charged for deferment of payment and therefore allows for value of time.

This argument, though it appears to be logical, is flawed. It equates a sale transaction with a loan, and it misunderstands re-selling at a higher price as being the same as usury (*ribā*). As against this objection, it is important that the following two points about *murābaḥah* financing and value of time are made clear: first, the financing service of the bank relates to a credit sale at a higher price, not to the provision of a loan to the client to finance his need; second, the *Sharīʿah* allows that value of time may be an element of the price in the case of a sale, but it prohibits in the case of loans.

Indeed, *murābaḥah* involves a credit sale to the client. The financing service provided by the bank in that it purchases a good ordered by the client on the spot and sells the same to the client on a deferred payment basis (Tag-el-Din, 2002). Thus, the nature of the transaction has changed from a conventional loan to that of a sale.

As regards the concept of value of time, it is well recognized by the *Sharīʿah*, but, with one important difference: that while time alone cannot be the subject of sale (as in deals involving lending and borrowing on interest), time does get value when the transaction involves the purchase and sale of real commodities. This difference in the treatment of time in respect of loans and sales is neither a confusion, nor a double standard in Islamic law. The simple explanation is that in Islamic jurisprudence, money lending (*qarḍ*) is recognized as a philanthropic activity where the lender willingly endures an income sacrifice in the hope of a future non-material reward (Tag-el-Din, 2000). In other words, the value of time is not denied as a *positive* fact in the case of loan, it is prohibited on a *normative* basis so as to release scarce resources from the utilitarian sector to the non-profit sector to help the poor and the needy (ibid). Given that ownership of the amount lent is transferred to the borrower, any benefit gained by the lender in excess of the principal is considered as *ribā* and forbidden as such.

Sale, on the other hand, is an exchange transaction where the seller is guided by the profit motive. Its permissibility is guided by the Qur'ānic verse (2: 275): 'Allah has permitted trade'. 'Trade' as commonly practiced embodies the convention of charging a trade profit and, should credit be involved in the sale transaction, value of time is recognized too. Such recognition is based on the juristic statement: 'deferred time commands share in price' – a statement conceded among the major schools of jurisprudence (Tag-el-Din, 1999: 3). It is also worthwhile noting that a sale involving a real good brings benefit to both the seller, who gets a higher price, and the buyer, who takes possession and has use of the good before paying the full price (Saadallah, 1994: 92).

Alleging that the increase in price when payment is deferred in the *murābaḥah* sale is the same as charging interest on a loan to offset deferral, would be like saying 'trade is like *ribā*' (Qur'ān 2: 275), as claimed by pre-Islamic Arabs. The Qur'ān responds to this claim by saying 'but God has permitted trade and forbidden *ribā*' (ibid).

That *murābaḥah* resembles interest-based banking practice, while at the same time being *Sharīʿah* compliant, should be seen as an advantage, not as a handicap to the Islamic banking system. Firstly, it reflects the inventiveness of scholars, in that they adapted an old

practice to the service of Islamic banks. Secondly, it offers the advantage of being a less risky financial instrument, thus helping Islamic banks to compete successfully with their conventional counterparts.

3.2 'The Use of Interest Rate as Benchmark for Determination of the Mark-up'

What has enhanced the scepticism that tends to equate *murābaḥah* financing with a form of interest-based financing, is the apprehension that has resulted from the Islamic banks' use of conventional benchmarks like LIBOR (London Inter-Bank Offer Rate) to determine their profit or mark-up margin (Usmani, 1999: 118). This practice has been criticized on the grounds that the use of interest as a benchmark makes the transaction resemble an interest-based financing and hence, renders it *ḥarām* (prohibited) as interest it self is *ḥarām*.

Admitting that it is undesirable to project *murābaḥah* financing as an interest-based transaction, Usmani nonetheless asserts that the mere use of an interest rate benchmark cannot invalidate the transaction altogether (ibid: 119). As the deal itself does not contain interest, he explains, it cannot turn into a *ḥarām* transaction by simply having its profit rate linked to the prohibited interest rate. Similarly, it could be argued, if conventional bankers used the Islamic mark-up to determine their interest rate, it would not make their transactions acceptable from a *Sharīʿah* point of view. As Usmani pointed out, what is far more important is that the *murābaḥah* deal satisfies all the conditions of a sale contract and abides by the Islamic principles. It is also the case that, so long as Islamic banks are operating within an environment where they must co-exist with conventional banks, comparison of the profit margin with the prevailing interest rate would be difficult to avoid (Hamoud, 1994: 74-75).

Nevertheless, it is important that the use of interest rate a an indicator to determine profit rate be avoided, so as to appease doubts about the legitimacy of Islamic banking operations. As a substitute for the interest rate benchmark, Usmani proposed the development and use of an inter-bank market rate based on Islamic guidelines. This can be done, he suggests, by, for instance, Islamic banks investing in assets

like property and shares, which they could sell to meet liquidity needs, and whose sale value could serve as an indicator for determining profit in *murābaḥah* (Usmani, 1999: 120).

3.3 Problem of Defaulting: Can a Penalty for Non-payment be Charged?

The concept of compensation for non-payment of the *murābaḥah* price is another controversy among scholars. It is agreed that in *murābaḥah* financing, once the contract is finalized, a fixed liability is created implying that the price once agreed cannot be increased or decreased in relation to time. Therefore, clients who pay early cannot be rewarded, and those who default in making payments on time can not be penalized (Meenai, 2001: 12). This would appear to increase the risk of default: dishonest clients have an incentive to default, as they incur no costs for doing so.

In practice, precisely to take account of this risk, Islamic banks have been including a default risk margin within the mark-up margin, thus making *murābaḥah* financing more expensive than conventional interest rate financing. This strategy, as well as being difficult to market, also justifies much of the discontent with contemporary Islamic banking practices (Tag-el-Din, 1999: 5).

As an alternative, some scholars have suggested the imposition of a financial penalty on wilful defaulters as a preventive measure against defaulting. This penalty is, however, subject to the dishonesty of the defaulter being proved, and subject to the condition that reminders warning of the consequence of non-payment be sent to him (Usmani, 1999: 132-33). The objective of the penalty must be to prevent the occurrence of default and to ensure prompt payments, and must not seek to compensate the bank for its opportunity cost or to increase its income (ibid: 139). Otherwise, charging a penalty will only perpetuate the conventional system where banks charge a punitive interest in case of re-payment delays (Meenai, 2001: 12). Accordingly, Islamic jurists contend that Islamic banks must not take any benefit from the penalties – these must be used exclusively for charitable purposes.

Other scholars have, however, disapproved the concept of a financial penalty. They argue that it does not conform to the

principles of the *Sharīʿah* since it is similar to the charging of additional amounts (*ribā*) during the days of *jāhiliyyah* when debtors were unable to effect payment at the due date. The ruling given by the Islamic Fiqh Academy of Jeddah, which had advised against the imposition of penalties supports this argument (*Majma' al-fiqh al-Islāmī*, Resolution No. 53, 5th Annual Session, Jeddah, Journal No. 6, V. 1, p. 447)

Evidently, this controversy has yet to be resolved. However, until a practical solution to the default risk problem is available, the alternative of a financial penalty might be used to serve as a deterrent for defaulting. At the same time, as a further protection against wilful defaulters, Islamic banks should keep and share records of customer profiles of defaulting clients, so that defaulters are deprived from enjoying future financial facilities (Usmani, 1999: 137).

3.4 Islamic Banks: Financial Intermediaries or Traders?

Some people find the whole *murābaḥah* arrangement artificial, since banks are not, in the first place, engaged in the trade business (Meenai, 2001: 10). Conventionally, their role is as financial intermediaries, not as traders – which *murābaḥah* financing requires them to be. According to Siddiqi (2000: 29), Islamic banks have been increasingly pushed by *Sharīʿah* scholars to become directly involved in purchase and sale deals. Presumably, this is in order to avoid the problem of selling a good they do not own.[1]

It is true that the primary role of banks is to function as financial intermediaries, mobilizing savings from depositors and making them available to investors. Islamic banks do carry out this financial intermediation function, with the difference that *murābaḥah* transactions constitute a 'non-pure financial intermediation': instead of providing funds directly to investors, the bank transfers an asset bought in its name to a client through credit sale (Siddiqi, 2000: 28). It seems therefore that Islamic banks have not replaced their role as financial intermediaries with that of traders; rather, they have added the latter function to that of financial intermediation (Hassan, 1987: 72).

According to Siddiqui (2000: 25), were Islamic banks to do business directly or in partnership with other businessmen, they

would be exposed to all the risks to which businesses are exposed, thus transferring the risks to depositors. Then, in an attempt to minimize their risks, Islamic banks would be unwilling to finance risky ventures, and so their partners would find it hard to find funds to finance their projects. By neglecting the financial intermediary role and preferring that of traders – a role they are not necessarily well-equipped to perform – Islamic banks would end up being in a disadvantaged situation. They would be marginalized as non-bank financial institutions and interest-based banks stepped in to offer the financial intermediary services so much needed by a modern society.

To avoid getting directly involved in trade transactions, banks tend to appoint third party agents to act on their behalf when purchasing the ordered goods, taking delivery, and reselling them to clients at a mark-up (Tag-el-Din, 2002). However, in such cases they are required to bear the commodity risk (*ḍamān*) from the time they take possession of the good until they resell it and the agent is not made liable to guarantee the outcome for the bank (ibid). According to Ibn Taymiyyah and Ibn al-Qayyim, it is not even important that the bank take actual possession of the good it has purchased for the client at the time of the contract. What matters most is the bank's ability to effect delivery (Tag-el-Din, 2001: 3). So long as the bank is able to do this and bears the *ḍamān* of the good to be resold, it may not necessarily be directly involved in the trade transaction.

3.5 Promise to Buy: Binding or Non-binding?

Another issue concerning *murābaḥah* is the nature of the promise to buy.[2] The question raised is whether or not the promise of the client to purchase the good he has requested the bank to acquire for him should be binding and if so, is it enforceable under *Sharīʿah* by a court of law?

Scholars tend to differ on the answer to this question. The majority opinion is that the promise only creates a moral obligation, but is neither mandatory (*wājib*) nor enforceable through a court of law, i.e. it is non-binding (Usmani, 1999: 122). The counter view is that fulfilling the promise is both morally and legally binding upon the buyer and that the promise can be enforced through a court of law. A third view on the matter suggests that if the client has caused

the bank to incur some liabilities it becomes mandatory that the client fulfills his promise to buy for which he may be driven to court. According to the Mālikī school, the stipulation of a promise in a contract of sale is itself considered unlawful (DeLorenzo, 1997: 100).

According to the resolution of the Second Conference on Islamic Banking, it is up to each individual bank to take a binding or non-binding promise from the client (Ghuddah, 1987: 29). What is required is for banks to lay down detailed rules about the enforceability of the promise and to carry out the promise 'contract' accordingly. The advantage of a binding promise, as pointed out by the resolution, is that it safeguards the *murābaḥah* transaction and makes it stable, which makes it lawful for the bank to insist on such a promise (DeLorenzo, 1997: 101). Equally, a non-binding promise may be sought by the bank. Hassan (1987:73) suggests that the bank may take such a promise in the form of an obligation to negotiate in good faith from its prime clients (Hassan, 1987: 73).

In practice, banks tend generally to impose a binding promise on their customers (Moore, 1997: 116). This is to ensure that the customers are legally bound to take the commodity purchased by the bank off its hands in accordance with pre-agreed terms (ibid). Hence, misgivings have been expressed that Islamic banks conveniently push all risks involved in the *murābaḥah* contract onto their clients; that they are in the business of making easy profits with a strategy of minimal risk bearing (Al-Qaranshawi, 1987: 239). Such suspicions about the promise to buy would be eliminated if it was regarded as non-binding, despite the higher risks to the banks. Dr. Ghuddah's view is that *murābaḥah* financing is after all a trade-based technique and, by its very nature, should be risky (Ghuddah, 1987: 30). However, it may be counter-argued that Islamic banks are only seeking to optimally protect themselves against default risks, while still being *Sharīʿah* compliant. In the end, honesty and fair dealing on both sides is needed so that a trusting bank-client relationship is established.

IV. Some Deviations in the Practice of *Murābaḥah*

While many of the criticisms of *murābaḥah* financing are without any theoretical basis, several are valid criticisms, and there are largely a

result of deviations in the application of *murābaḥah* by Islamic banks. Some banks have been criticized for adding some undesirable features onto the product. Others commit some basic mistakes in their practices. A few of the deviations in the practice of *murābaḥah* are noted below.

1. *Murābaḥah* being effected on commodities already owned by the client. The same goods cannot be re-purchased from the same suppliers. Or, if goods are purchased by the bank from clients and then sold back to the same clients, the problem arises of *'īna* (buy back), which is disallowed in *Sharīʿah*.

2. *Murābaḥah* being used as a mere vehicle to obtain funds, a fictitious deal is entered into based on a fictitious commodity, with no buying and selling activity taking place. The deal is a cover for borrowing. It is important for the *Sharīʿah* boards within the banking institution to have members who are fully conversant with modern financing techniques, so that the bank's dealings are effectively scrutinized to present such illegitimate practices.

3. Sale of the commodity is effected before the bank has acquired it from the supplier. This can happen when all the documents of the *murābaḥah* deal are signed at one time, without due consideration for the different stages of the transaction (Usmani, 1999: 149). To avoid such problems, care must be taken in observing that each stage of the transaction is effected at its due time.

4. Banks' adopting the 'mark-down' approach as a way of giving rebates for early repayment (Ariff, 1988, 13). This practice is highly questionable as it is time-based. It is also known in the Islamic literature as 'Give discount and receive soon' approach, which all four schools of Islamic jurisprudence disallow (Usmani, 1999: 141).

V. Conclusion

The dominance of *murābaḥah* has given rise to much negative feeling regarding the Islamic banking industry. The excessive resort to *murābaḥah* financing and the neglect of the pure financing modes by Islamic banks have raised doubts about these banks' sincerity, and their commitment to promoting the utilization of funds for longer term projects.

While it is true that there is a need for the adoption of the other legitimate modes of financing which encourage long term

investments, optimal risk management and the wide use of *murābaḥah* are not in themselves in violation of *Sharīʿah* injunctions, provided the *murābaḥah* contract itself is in conformity with Islamic principles. The criticisms about *murābaḥah* must be evaluated on the basis of *Sharīʿah* rulings since compliance with Islamic law is what distinguishes Islamic banking from conventional banking. It is worth noting most of the criticisms pertain to the formal structure of *murābaḥah*. What is disregarded is the important social function that it fulfils – specifically, that of offering credit to those clients in need of a specific commodity who cannot afford to make cash payment.

Nevertheless, given that *murābaḥah* is very much a border line transaction, Islamic banks should at all times take the necessary precautions so that the transaction does not ship into the area of interest-based financing (Usmani, 1999: 153). No 'quasi' *murābaḥah* transaction, comprising undesirable features, should be encouraged. Rather all efforts should be geared towards the proper implementation of 'genuine' *murābaḥah* deals, which are free from any intentional deception. It is also important for Islamic banks and scholars to demonstrate that the contract is sound from the *Sharīʿah* viewpoint, so that people's confidence in the product is retained, and the feasibility, credibility and usefulness of the Islamic banking system are not brought into doubt or disrepute.

Notes

1. Siddiqui (2000: 30) has enumerated several plausible reasons to explain why some Islamic banks act as traders in their own right. Two of them are: (i) *Sharīʿah* scholars approach the issue from a microeconomic perspective, and reflect on how an Islamic bank, as a financial firm, should conduct its transactions according to *fiqh* rules; they do not see it in a macroeconomic terms, with Islamic banks, as financial intermediaries, meeting the financing needs of society. (ii) Individual Islamic banks in Arab countries were established as small companies with little support from the legal system and the banking authorities. As such, it was difficult for them to deal with clients as intermediaries, and so they opted to act as traders themselves.
2. The *Sharīʿah* forbids that the bank sell a good of which it is not the owner. So, when a client seeks *murābaḥah* financing from the bank, no contract can be entered into until the ordered good is in the bank's actual or constructive possession. However, to ensure that the client purchases the commodity ordered, a 'promise to buy' is sought from the client prior to the bank's actual purchase of the commodity.

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