MURABAHA FINANCING IN ISLAMIC BANKING AND ITS PRACTICES IN PAKISTAN

DEGREE PROGRAMME: LL.M.(CORPORATE LAW)

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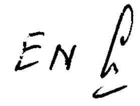

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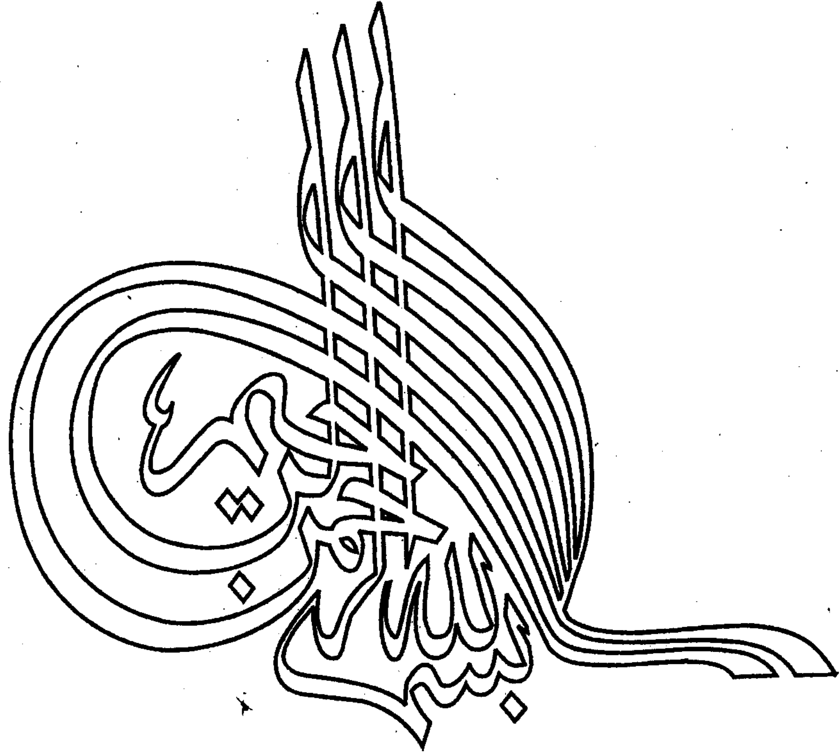
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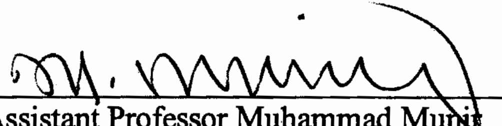

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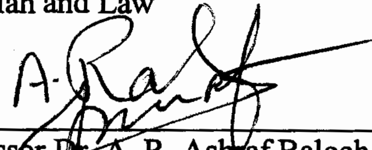

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Dedicated in gratitude and affection to my Late Father Muni Khan Khattak.
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Preface

Islamic Banking has been defined as banking in consonance with the culture and value system of Islam. The basic principle of Islamic banking is the prohibition of Riba (Usury or interest). The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

Islamic banking System is based on risk sharing, owning and handling of physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of finance. As such, Islamic banks deal with asset management for the purpose of income generation.

Islamic banking and financing has now been functioning as full fledged system globally. Islamic Banking System had been started in 1960s. The Last few years have witnessed an unexpected increase in Islamic Banking the world over.

Efforts started in 1977-78 for Islamic Banking in Pakistan. Pakistan was among the three countries in the world that had been trying to implement interest free Banking. From July 1, 1985, all commercial banking in Pak Rupees was made interest free. An Islamic modes of Financing were introduced and all Banks were asked to adopt the mark-up based technique for financing with or with out buy-back arrangement.

Federal Shariat Court declared the procedure adopted by banks in Pakistan since July 1, 1985 based on Mark-up technique un-Islamic in November 1991. Appeals were made in the Shariat Appellant Bench (SAB) of the Supreme Court of Pakistan. The SAB delivered its Judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. In the Judgment, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. It also directed the Government to set up, within specified time frame, a commission for Transformation of the financial system and two task Forces to

plan and implement the process of the transformation. Although this Judgment has already been remanded to Federal Shariat Court for its review but Islamization of Banking has taken a progressive start in Pakistan.

The present move towards Islamization of banking sector in Pakistan started in January 2003, when State Bank of Pakistan issued criteria for establishment of Islamic Banks in Private sector. A full fledged Islamic Banking department was set up in State Bank of Pakistan "SBP" in September 2003 to supervise the sector, review and process applications, issue guidelines along with a Shariah Board on December 2003 that advises the SBP on modes, procedure, laws and regulations for Islamic banking.

The Islamic banking industry is growing progressively all over the World including Pakistan and facing great challenges. Islamic Banks are facing great difficulties in its operation of day to day business activities. Usually problems arise in respect of different banking activities that whether these are Islamic or not? What kind of financing is permissible under Shariah and what is not permissible? How the permissible modes of financing can be practiced? How the particulars mode of financing can be made a Shariah compliant?

There are many problems of Islamic banking but we have restricted ourselves to the problem of *Murabaha financing in Islamic banking and its Practices in Pakistan.* Most often question arise that how this mode of financing can be practiced? There are serious objections against Murabaha financing that it is similar to interest based loan transaction. Therefore under this study the detail explanation regarding rules/principles of Murabaha and all other related issues have been discussed in depth.

The main objective of this study is to develop understanding of Murabaha financing and have a clear understanding with practical approaches. At present Banks are practicing this mode of financing but the biggest challenge for these Banks is the non- availability of

professional Islamic Bankers having understanding of Islamic modes of financing including Murabaha. Therefore this study will help to provide guidance to all those Professionals who wish to acquire expertise in Murabaha financing in Islamic Banking.

Abstract

The title of this study is Murabaha financing in Islamic banking and its Practices in Pakistan. Under this study introduction to Islamic banking and detail principles/rules with all related procedurals and operational problems and issues of Murabaha financing have been discussed with reference to Murabaha financing practices in Islamic banking of Pakistan.

In Chapter one, it has been explained that the important principle of Islamic banking is that it must be governed by Shariah and must be free of riba. Therefore introduction, basic principles and distinct characteristics, the origin and evolution of Islamic banking have been covered in this Chapter. At the end the development of Islamic banking in Pakistan has also been explained.

In Chapter two, it has been explained that Murabaha was originally a simple sale. It was not conceived of as a mode of finance, since it was not necessarily concluded on the basis of deferred payment. Murabaha sale for cash was the rule rather than the exception. Therefore introduction and nature of Murabaha, sale its basic conditions/principles, and basic principles/rules of Murabaha financing have been discussed.

In Chapter three, Procedure of Murabaha financing has been discussed in detail. In this regard, step wise procedure of Murabaha financing has been discussed to the extent that how it can be operated and practiced by the banks/financial institutions. Furthermore, related necessary rules and basic characteristics of Murabaha financing have been discussed to fulfill the Shariah Standards in Murabaha transaction. Therefore, rules of calculation to determine cost and profit, rollover, rescheduling, discount and extra charges have been discussed.

In Chapter four, Some critical issues and problems in operation of Murabaha financing

have been discussed in the light of Shariah. Therefore, matters of securities, guaranteeing Murabaha price and sale of debts (Murabaha receivables) have been clarified. Furthermore some serious objections against Murabaha financing have been addressed to clarify the misunderstanding about the Murabaha. At the end applications of Murabaha financing and penalty in case of default have been discussed.

In Chapter five, Murabaha financing practices in Pakistan have been highlighted with past and present Islamization processes. The operation of Murabaha by various banks has also been discussed. The Shariah Essentials of State Bank of Pakistan and Accounting Standard 1 for Murabaha financing of Securities and Exchange Commission of Pakistan have also been highlighted. At the end the conclusion of the study with recommendations has been given.

Chapter-1

Concept and Evolution of Islamic Banking

1.1 Introduction

Islamic Banking has been defined as banking in consonance with the culture and value system of Islam. It is governed and regulated by the principles laid down by Shariah in addition to the conventional good governance and risk management. Islamic banking is not only expected to avoid interest based transactions, prohibited in the Islamic Shariah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy.

Islamic banking and finance is part of the broader concept of Islamic economics, one aim of which, as suggested by Islamic scholars, is the introduction of the value system and ethics of Islam into the economic sphere.[1] Because of this ethical foundation, Islamic banking and finance for many Muslims is more than a system of mere commercial transactions. Following Islamic precepts in financial transactions is viewed by many as a religious obligation. The ability of an Islamic institution to attract investors successfully may depend not only on the profitability of that institution, but also on the perception that the institution faithfully observes Islamic religious restrictions.

The central feature of the Islamic banking system is the prohibition in the Qur'an of the payment and receipt of riba, or interest. A closely related principle set forth in the Qur'an is the prohibition of *gharar*, or speculation. Both of these prohibitions were extended and

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[1] Daphne Buckmaster, "Overview of Islamic Banking and Finance", *Anthology of Islamic Banking*, ed., Asma Siddiqui, Institute of Islamic Banking and Insurance, London, 2000, p. 6.

elaborated on by the prophet Muhammad (pbuh) through the Sunnah. The Qur'an, which is the Islamic holy book, and the Sunnah, which are the deeds, statements and unspoken approvals of Muhammad (pbuh), are the two main sources of Islamic law, commonly referred to as the Shariah.

Although *riba* in a broad sense means any unlawful advantage by way of excess or deferment, in the context of financial transaction it is commonly understood to mean any form of interest. In recent years, there has been an attempt on the part of some Islamic law scholars and Islamic financial institutions to re-examine interest, or usury. That debate now appears to be over, however, and the prohibition of riba continues to be viewed as a prohibition of all interest.

The underlying policy behind the prohibition of gharar is the protection of the weak against exploitation by the strong. This policy has led to the formulation of a rule of general application to the effect that all transactions should be devoid of uncertainty and speculation. Islamic jurists believe that this objective can only be achieved if the contracting parties have complete knowledge of the terms of the transactions in which they engage.

1.2 What is Islamic Banking and Finance?

The structure of Islamic finance is firmly rooted in the Qur'an and the teachings of Muhammad (s.a.w.s), and the interpretations of these sources of revelation by his followers.[2] Nonetheless Islamic finance remains subject to a variety of misunderstandings by both Muslims and non-Muslims. For example, it is widely known that Islamic finance prohibits

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[2] Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague, Kluwer Law International, 1998, pp.1-2.

the charging of interest on loans. But most do not know that the capital provider is permitted an adequate return. For instance:

- If money is committed to another party to use for a period of time, compensation for the financing may not be a predetermined amount guaranteed by the other party to the contract; instead, it should be a share in the actual profits of the venture. Money is not treated as commodity, as in the West, but as a bearer of risk, and therefore subject to the same uncertainties as those borne by other partners in the enterprise.

- If investors finance the acquisition of tangible goods by sale or lease, they may legitimately compensate themselves for foregone opportunities. Profits deriving from lease payments or from credit sale may reflect, even explicitly, a time factor.

Given these ways in which finance is legitimately compensated, the term "profit banking" is a useful way to describe the system of credit extension in the Islamic world.

Islamic rules do permit businesses to utilize credit, and do not prescribe that all businesses be financed entirely with equity capital. Islamic businesses can and do utilize financial leverage in their capital structures, thereby exposing their owners to both the potential enhancement of returns on equity if things go well and to value reduction if results are disappointing.

The definition of an Islamic bank as approved by the Organization of Islamic Conference (OIC) is: "a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations".[3]

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[3] Nassiruddin Ahmed, "Islamic Banking and its Mode of Investments", *Anthology,* p. 307.

A common misunderstanding exist today that the only difference between Islamic banking and secular banking is the use of *riba*.[4] It is thought that if the element of riba or interest is to be removed from conventional banking, or if riba is named as something else, it would somehow sanctify and convert it into an Islamic banking system.

This concept that the removal of the element of riba would convert secular banking into Islamic banking is a fallacy. The two are different because they are products of two distinct philosophies. One is based on the law of the jungle, where you either eat others or you are eaten. The other is based on the timeless and divine principles that are universally applicable. Secular banking has no intrinsic moral bindings and implications. Islamic banking is based on the moral application of finance. Islam recognizes that the creation of a just society depends on the moral application of finance and trade principles.

The status of the Islamic bank in relation to its client is that of a partner, investor and trader, whereas in secular or Western banking the relationship is that of a creditor and investor. Islamic banks are thus equity based, whereas the secular/ Western banks are loan based.

Islamic scholars have on many occasions explained that the term "Islamic banking" means the conduct of banking operations in consonance with Islamic teaching[5]. The Islamic financial system cannot be introduced merely by eliminating *riba*, but by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance and dispensation of justice, equity and fairness. As an institution whose foundations are based on religious doctrines, the establishment and operations of an Islamic bank have raised many theoretical and conceptual considerations. Islamic banks therefore are not expected to have similar objectives and philosophies to those of other business entities.

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[4] Khaled Qayum, "Islamic Banking: Scope and Challenges", *Anthology*, . pp. 79-80.
[5] Sudin Haroon, "The Philosophy of Islamic Banking", *Anthology*, .pp. 55-56.

1.3 Basic Principles of Islamic Banking

The basic principles of Islamic banking are based on Islamic Shariah (Qur'an and Sunnah).[6] Therefore Islamic banking system must operate in accordance with Shariah. Islamic banks have certain traits prescribed by their specific nature, drawing their principles and rules from the Islamic Shariah, which considers that all wealth is possessed solely by Allah and is held in trust by man acting as His vicegerent[7]. In the light of the Shariah, the basic principles of Islamic banking can be described as under:

1.3.1 Shariah Governance

The first important principle of Islamic banking is that it must be governed by the Shariah, so it must be operating in accordance with the teaching of Islam.[8] Therefore, Islamic banks would be conducting those businesses that are permitted and must be avoiding those activities that are forbidden for Muslims and also to avoid unethical practices. This is the reason that the Islamic Banks do not finance gambling, liquor, hoarding and usury based lending are strictly avoided. The Bank does not, for example finance liquor manufacturing, transportation, storage or distribution companies.

1.3.2 Prohibition of *Riba* (Usury or Interest)

The second important principle of Islamic banking is the prohibition of *Riba* (Usury or Interest). [9] The word "Riba" means excess, increase or addition, which implies any excess or compensation without due consideration (consideration does not include time value of money).[10] This definition of Riba is derived from the Qur'an and is unanimously accepted

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[6] See Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idaratul Ma'Arif, Karachi, 1999, pp. 15-19.

[7] Z.A. Khan, "Characteristics and Structure of an Islamic Bank", Encyclopaedia of Islamic Banking and Insurance, Institute of Islamic Banking and Insurance, London, 1995, p. 111.

[8] See Ziauddin Ahmed, *Islamic Banking: State of the Art*, Islamic Research and Training Institute, Islamic Development Bank, 1994, Jeddah, p. 15.

[9] Ibid and also see www.Islamic-banking.com

[10] Muhammad Imran Ashraf Usmani, *MeezanBank's Guid to Islamic Banking*, Darul Ishaat, Karachi, 2002, p. 45.

by all Islamic scholars. Interest, known as Riba in Islam is forbidden. Hence, all banking activities must avoid interest. Instead of interest, the Bank earns profit (mark-up) and fees on financing facilities it extends to customers. Also, depositors earn a share of the Bank's profit as opposed to interest.

The meaning of *Riba* has been clarified in the following verses of Qur'an:[11]

" *O those who believe, fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged."* (Al Baqara 2:278-9)

An eminent scholar, Muhammad Ala Thanwi, author of Kashaf Istilahat al-Funun, has defined riba in the following words:

"Riba is an increase without any corresponding consideration which has been stipulated in favor of one of the two parties, in a contract of exchange."[12]

The following are the ingredients of the above definition:

- riba is an increase (actual or constructive),
- it is without corresponding consideration, i.e. without risk, labor, and capital;
- the increase is stipulated in favor of one party;
- it is stipulated in an exchange of property for property.

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[11] Ibid and also see Sayyid Tahir and others, "*IIIE's Blueprint of Islamic Financial System including Strategy for Elimination of Riba*", International Institute of Islamic Economics, International Islamic University, Islamabad, 1997, pp. 9-13.

[12] Muhammad Tahir Mansuri, *Islamic law of contracts and Business transactions*, Shariah Academy, International Islamic University, Islamabad, 2005, pp. 120-121.

The distinct feature of this definition is that it embraces in its ambit all forms of *riba* and does not restrict riba to loan transaction. It describes riba in a comprehensive sense to include the riba of loan transactions as well as riba of barter transactions. It encompasses very return and all excess arising from exchange of property for property regardless of whether exchange takes the form of loan or sale of money for money or barter transaction between two homogeneous articles or transaction between two different commodities.

1.3.2.1. Kinds of *Riba*

There are two main kinds of riba: riba al-duyun and riba al-buyu (riba of debt transactions and riba of sale transactions). Riba al buyu is further divided into two kinds, i.e, riba al-fadl and riba al Nasiya.[13]

1.3.2.2 Riba Al Nasiya (riba of delay)

This is the real and primary form of Riba. Since the verses of Quran has directly rendered this type of Riba as haram, it is called Riba Al Qur'an.[14] Similarly since only this type was considered Riba in the dark ages, it has earned the name of Riba Al Jahiliya.

Imam Abu Bakr Jassas Razi has outlined a complete definition of Riba Al Nasiyah in the following words:

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined."

The famous Sahabi F'zala Bin O'baid has also defined Riba in the following words:[15]

"Every loan (qard) that draws profit is one of the forms of Riba."[16]

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[13] Ibid, pp.127-128.
[14] Muhammad Imran Ashraf Usmani, p. 46.
[15] Ibid.p. 47.
[16] See also Frank E. Vogel and Samuel L. Hayes, p.73.

Riba Al Nisaya refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest.[17] The prohibition of Riba Al Nasiya is one of those issues which have been confirmed in the revealed laws of all Prophets (AS). Some of the old testaments has rendered Riba as haram. It is fact that Riba Al Nisaya is categorically haram has never been disputed in the Muslim community.[18]

1.3.2.3 Riba Al Fadl (riba by way of excess)

The prohibition of Riba Al Fadl has been established on Sunnah, therefore it is also called Rabi Al Hadees. Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase and sale as explained in the famous hadith:[19]

From 'Ubadah Ibn Samit who said; "The Messenger of Allah (s.a.w.s.) said: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand. If those species differ, then sell as you like as long as it is from hand to hand."[20]

The prohibition of Riba Al Fadl is intended to ensure justice and remove all forms of exploitation through unfair exchanges and to close all back-doors to Riba Al Nasiya because in the Islamic Shariah anything that serves as a means to the unlawful is unlawful.[21]

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[17] Imran Usmani, p. 47.
[18] Ibid. p. 48.
[19] Ibid. p. 49.
[20] Muslim, *Sahih, Kitab al-Musaqat, Bab al-Sarf*-Hadith no. 1587, vol.3, p. 1211.
[21] See Imran Usmani, op.cit.p.52.

1.3.3 Partnership and Sharing of risks

The third important principle of Islamic banking is the business techniques and methods adopted for its business operations. This principle is the Partnership and the Sharing of Risks which is based on risk sharing, owning and handling of physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of finance. [22] As such, Islamic banks deal with asset management for the purpose of income generation. The return on savings and investment accounts are variable, and dependent on the Bank's performance and the profits from *Halal* business transactions only. While these profits are not necessarily guaranteed and are subject to a degree of risk, these are managed professionally to ensure better returns than many other conventional alternatives.

1.4 Distinct Characteristics of Islamic Banks

Based on the principles enumerated above, the distinct Characteristics of the Islamic Banking are as follows:

1. Islamic Banks do not transact on a credit basis[23]. They neither borrow nor lend on the basis of interest, whether it is fixed, floating, prepaid, deferred, deducted or in any other form. Islamic Banks operate on the principle of bearing risks and participating in the return- be it profit or loss. It means that Islamic Banks do not deal on the basis of interest, previously determined or determined subsequently, fixed or floating, since Shariah prohibits interest[24].
2. Islamic Banks do not offer cash loans, but provide facility in kind, thus, they do not utilize accumulated funds in its cash form i.e they are banks which do not trade in debts[25].

[22] See Ziauddin Ahmed, p. 15.
[23] Z.A. Khan, p. 111.
[24] Muhammad Ayub, *Islamic Banking and Finance, Theory and Practice*, State Bank of Pakistan, 2002, p. 209.
[25] Ibid.

3. Islamic Banks, by their nature, are multipurpose banks since they play the role of commercial, investment and development banks. They both operate in the short run like commercial banks, as well as in the medium and long run like non commercial banks[26].

4. The relation between Islamic Banks and their customers (fund owners or users) is a relation of partnership and trading partner, on the basis of sharing the risk and reward[27]. This basic characteristic leads to the following:

   (a) There is no previously fixed yield in ratio or in magnitude- on the resources deposited with the banks.

   Similarly, there is no previously fixed return on what Islamic banks provide for others to invest. The yield is only decided, to both sides, in the light of the profit realized from the transaction, the bank participates in or conducts.

   (b) There are no liabilities on the Islamic Bank to owners of deposited funds (except for current accounts) to return their resources, full and undiminished, on the date of maturity, as these resources share loss or profit, resulting from the transaction and deals they are invested in[28].

5. While utilizing their resources, Islamic Banks invest and trade directly, either by themselves or in participation with others, in the short, medium or long terms[29]. In doing this they run the business risk as well as the risk of default. Therefore, in addition to a careful and comprehensive study of the econometrics of the operation and the experience of the customer in the field of this activity, a continuous follow up of the assets financed and the proceeds of sales becomes unavoidable.

6. While the role of non-Islamic Banks as to attract financial resources and lend them so as to make profit, the Islamic banks mobilize financial resources in order to use them

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[26] Ibid.
[27] Ibid.
[28] Ibid
[29] Ibid.

to develop the society as a whole[30]. Profit is, no doubt, kept in sight, but that is not the sole objective of investment.

7. While conventional Banks are satisfied with the traditional review of accounts by certified auditors, Islamic banks are subject to additional reviews to ensure that money is being utilized and invested in ways that conform to Islamic principles[31]. The religious supervisory board has to approve each type of transaction that the bank undertakes, and also has the authority to look into individual transaction to extent needed to satisfy itself on their compliance with Shariah requirements. The religious boards of the Islamic banks also verify this and certify to that effect.

1.5 The Origins of Islamic Banking

It is clearly stated in the holy Qur'an that command and authority (Amr and hukm) belongs only to Allah (SWT). It says, "But, truly, the Command (Amr) is with God in all things."[32] This signifies that Islamic banking system must be governed by the command of God. It must be commanded by the Shariah. Shariah deals with every aspect of human life. It directs social, moral, and economic affairs. Nothing is beyond the scope of the Shariah. Islamic finance stems from injunctions found in the Qur'an and the Sunnah (Shariah). These inspired central tenets in the religious law of Islam concerning commercial dealings are as much part of the religion as is marriage[33].

1.6 Financing During the Prophet's (PBUH) Era

The Islamic history reveals that trade was the main economic activity of the tribe of Quraish, a good deal of its carvans were financed by persons who did not accompany the carvans.[34]

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[30] Z.A. Khan, p. 112.
[31] Ibid.
[32] Al Quran 6:57.
[33] Frank E. Vogel and Samuel L. Hayes, p. 4.
[34] See Monzer Kahf and Tariqullah Khan, *Principles of Islamic Finance*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1992, pp. 11-12.

Homoud quotes Al Razi as saying that in financing the battle of Uhud, the Quraish used funds accumulated by means of riba. The Islamic scholars and commentators of Quran make reference to the deep rooted practice of riba in pre-Islamic Arabia, especially among members of the tribes of Quraish and Thaqif and by the Jewish communities. They usually mention Hazrat Abbas (RATA), the uncle of the Prophet (pbuh), and several major families of Thaqif as prominent financiers in the Makkah economic life of that period. Moreover, with respect to the Quranic reference, many Jews were working as money lenders in Madinah. Therefore, one may conclude that the most dominant mode of financing during the pre-Islamic era was riba-based borrowing and that *mudarabaha* may perhaps have ranked second in terms of practical importance.

It is important to state while discussing the legitimacy of *mudarbaha*, the Fuqaha usually call attention to the mudarabaha enterpise the Prophet (pbuh) had with Khadijah which started more than fifteen years before the beginning of the revelation. They also mention the common practice of mudarabaha in the Makkan society.

Additionally, the agricultural society of Al Madinah used to practice crop sharing which was called *muzara'ah* and *musaqah* with the former applying to open fields used for crops and the latter to orchards of trees especially palm. Land in *muzara'ah* and land and trees together in musaqah are fixed assets put at the disposal of the working partner. These arrangements ensure the use of assets without actually paying for them which is tantamount to financing. Both *muzara'ah* and musaqah require sharing the gross output and allow for limited flexibility in the contractual distribution of operational expenses.

Sale on credit also existed in the Prophet's (pbuh) time. There are many sayings about the Prophet's (pbuh) buying on credit, taking loans and sometimes giving personal property as a security or lien. For instance, Hazrat A'mash narrated:[35]

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[35] Bukhari, "*Sahih al-Bukhari*", V.3,p. 248, Hadith No.454, Kazi Publication Lahore, Pakistan.

We argued at Ibrahim's dwelling place about mortgaging in Salam. He said "Aisha (RATA) said, 'The Prophet (s.a.w.s.) bought some foodstuff from a Jew on Credit and the payment was to be made by a definite period, and he mortgaged his iron armor to him."

Ibn 'Abbas narrated:[36]
"Allah's Apostle (s.a.w.s.) came to Madina and the people used to pay in advance the price of fruits to be delivered within one or two years."

In the above mentioned saying, credit is used to finance consumption. It is also used to finance production whereby the producer is paid cash for future delivery. The latter form of credit creates a kind of debt and is called Salam.[37]

Riba- ridden lending is forbidden and was generally eliminated from the Muslim society of the Prophet's (pbuh) era. Other forms of financing (e.g.) mudarabaha, benevolent lending, sale on credit, *muzara'ah*, musaqah and bai'al salam) dominated the financing practices of that period.[38]

1.7 Encouragement of Benevolent Lending

The Prophet (Pbuh) has advocated lending and sale on credit. Ibn Mas'ud narrates that the Prophet (pbuh) said:[39]
Whoever gives two loans will have a reward (equivalent to the reward) of one of them (be it given as charity). Reported by Ibn Majah.

Anas narrates that the Prophet (pbuh) said:[40]

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[36] Ibid.,p.243, Hadith No. 441.
[37] See Monzer Kahf and Tariqullah Khan, .p. 12.
[38] Ibid.p.13.
[39] Ibn Maja, *Sunan Ibnmaja*, V.7, Kitabul Qurd, p. 275.
[40] Ibid. p. 276.

The night I was taken up to Heaven, I saw written on the Heaven's gate 'Charity is (multiplied) ten times and a loan is (multiplied) eighteen times. I said 'O Jibril, why is a loan better than a charity? He said "because a beggar (may) ask while he has (wealth) and a borrower would not ask for a loan except out of need".

Suhaib narrates that the Prophet (pbuh) said:[41] Three (things) have blessings: Sale on credit, muqradah (i.e.,mudarabaha) and mixing wheat with barley for (food at) at home not for sale.

Lastly, the permissibility of bai'al salam, inspite of its violation of the rule against selling that which is not in the possession of the seller, points out an inclination to promote business credit among transactors.

1.8 Evolution of Modern Islamic Banking in the World

The history of modern Islamic banking is not so old that it cannot be recalled/traced easily. It was the era of 1950s when Farmer Credit Unions was established as a model Islamic bank in Pakistan.[42] Some financially sound landlords who formed the bank deposited funds at no interest, and then advanced in the shape of financial facility to small landowners for agricultural purposes. There was no interest payable on the credit advanced, but a small charge was levied to cover the bank's operational expenses. The charge was far lower than the rate of interest. However the project failed due to two main factors. First, the depositors' landlords regarded the deposits as a one-time event. With the increasing number of borrowers the gap between available capital and credit demanded was huge. Secondly, the bank staff did not have complete autonomy over its operation; depositors showed considerable interest in the way their money was lent out.

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[41] Ibid., p .68.

[42] See Rodney Wilson, "Islamic banking and its Impact", *Anthology*, .p. 69.

The second Islamic bank was the Mit Ghamr savings Bank, a small rural institution which was founded during the year 1963 in Egypt.[43] The operation of the bank was based on the idea of German Savings banks in combination with the principles of rural banking within the general framework of Islamic values. There was no-interest to the depositors or from the borrowers. The experiment soon became successful; more branches were opened in different parts of the country, and the amount of deposits increased. Although the project made a good start and initial results were more than encouraging, it suffered a setback owing to changes in the political atmosphere. In 1971 it was incorporated into a new government controlled institution, the Nasser Social Bank, which had the responsibility for the collection of Zakah, the Islamic wealth tax. This was the first Islamic bank in an urban setting based in Cairo. The bank is a public authority with an autonomous status. Its purpose was mainly to promote social concerns such as granting of interest-free loans for small projects on a profit-loss-sharing basis, and assistance to the poor and needy students for university and higher education.

Islamic banking emerged in Malaysia and a financial institution was developed for the pilgrims of Malaysia in response to what was the contention of the Malaysian Muslims that money spent on pilgrimage must be clean and untainted with *'Riba'*. Since this was not possible by depositing money with the ordinary banks, a special financial institution had to be created. Consequently, Pilgrims Saving Corporation was established in 1963, which was later on incorporated into the Pilgrims Management Fund Board (Tabung Hajji) in 1969.[44]

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[43] See Yusuf Talal DeLorenzo, *A Compendium of Legal Opinions on the Operations of Islamic Banks*, Institute of Islamic Banking and Insurance, London ,2001, P, (viii) by S. Sharifuddin Pirzada former Secretary General of Organization of the Islamic Conference.;
Monzer Kahf and Tariqullah Khan;
See Dr. M. Aslam Khaki and others versus Syed Muhammad Hashim and others, PLD 2000, Supreme Court of Pakistan. (It is the famous Judgment on Riba decided on 23rd December, 1999 by Supreme Court of Pakistan), p. SC 739.
[44] www.islamibankbd.com

Next to follow was the Dubai Islamic Bank in 1975. The Dubai Islamic Bank is a public limited company having its office at Dubai, U.A.E. with capital of 50 million Dirhams. Since then, a number of Islamic banks and financial institutions have been established in different parts of the world and have been functioning successfully.

The Islamic Development Bank based in Jeddah was established in 1975 by the Organization of Islamic Conference as pioneer of Islamic banking. The bank was originally meant for inter-governmental financial transactions providing funds for development projects in the member countries. But it is now providing trade finance facilities to the private sector also. The purpose of the bank is to support social and economic development in Muslim nations within an Islamic Framework. The subscribers of the capital are the founder governments.

A significant development in Islamic banking has been the granting of an Islamic bank license in Saudi Arabia to the fifty-year old "Al-Rajhi Company", a firm noted for its currency, exchange and commercial activities, whose assets exceed $5 billion. The firm started operation in 1985 under the name of "Al-Rajhi Banking Investment Corporation" and has since developed active relationships with major manufacturing and trading companies in Europe and several U.S. corporations. The emerging success of Al-Rajhi in operating profitably in different regions of the world has increased pressure on the Saudi government to go for full-fledged Islamic banking.

An Islamic bank/investment company was established in Bahamas in 1977 as a multi-national holding company under the name of Islamic Investment Company, ICC limited. Its purpose was to establish *'Mudaraba'* (partnership companies) in various parts of Islamic countries. The company has established two *'Mudaraba'* subsidiaries in Sharjah and Pakistan.

A second example of Islamic banking in the West comes from Luxembourg, where the

Islamic Banking System International Holding was established in 1978 as a joint-stock company. Its purpose was to establish international Islamic banks in different parts of the western countries where there are communities of Muslims, and to participate in investment projects in Islamic and non-Islamic countries.[45]

Islamic Banking has started in Bangladesh since August 1974 when Bangladesh signed the Charter of Islamic Development Bank and committed itself to reorganise its economic and financial system as per Islamic Shariah.

Iran has also initiated Islamization of Banking and special law, "The law for Usury-Free Banking Operations", was enacted in August 1983 to replace interest –based banking by interest-free banking.[46] The Islamization process to bring riba free banking system is still in progress. Various laws in this regard has already been passed and implementation is in process.

1.9 World Wide Operation of Islamic Banking

At present about 250 Islamic Financial Institutions are operating World wide in the following Countries:[47]

Albania, Algeria, Australia, Bahmas, Bangladesh, British Virgin Island, Brunei, Canada, Cayman Island, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan, Kazakhstan , Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, The Netherlands, Niger, Nigeria, Oman, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, South Africa, Sri

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[45] Ibid.

[46] See Munawar Iqbal, *Islamic Banking and Finance: Current Developments in Theory and Practice,* Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 2001, pp. 7-8.

[47] www.islamibankbd.com

Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad & Tobago, United Arab Emirates (Abu Dhabi, Dubai, Sharja), United Kingdom, United States, Yemen.

1.10 The Development of Islamic Banking in Pakistan

Efforts for Islamic Banking were started in 1977-78.[48] Pakistan was among the three countries in the world that had been trying to implement interest free Banking. Pakistan adopted a policy of gradual transformation of its banking system after several years of study and preparation by the government-appointed Council of Islamic Ideology. The process started when the President of Pakistan announced that interest was to be removed from the economy within a period of three years. Three of the specialized credit institutions-the House Building Corporation, National Investment Trust, and Mutual Trust Funds of Investment Corporation of Pakistan--were to remove interest from their financing operations immediately. Following the directive issued by the government in January 1981, separate counters were opened in the commercial banks for accepting deposits on a PLS basis. Commercial banks were instructed to create separate accounts for deposits in their interest-based operation and those received on the PLS basis.

From July 1, 1985, all commercial banking in Pak Rupees was made interest free. An Islamic modes of Financing were introduced and all Banks were asked to adopt the mark-up based technique for financing with or with out buy-back arrangement.[49] The legal framework of Pakistan's financial and corporate system was amended on June, 1980 to permit issuance of a new interest-free instrument of corporate financing. Amendments were also made in the Banking Companies Ordinance,1962 (The BCO, 1962) and related laws to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase. To mobilize deposits on profits and loss sharing basis, separate Interest free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman on January 1, 1981. In March, 1981 financing of import and inland bills and that of the then Rice Export

[48] www.sbp.org.pk

[49] See Munawar Iqbal, .pp. 5-6.

Corporation of Pakistan, Cotton Export Corporation and Trading Corporation of Pakistan were shifted to mark-up basis. From July 1, 1982 banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the technique of Musharaka.

Federal Shariat Court declared the procedure adopted by banks in Pakistan since July 1, 1985 based on Mark up technique un-Islamic in November 1991. Appeals were made in the Shariat Appellant Bench (SAB) of the Supreme Court of Pakistan. The SAB delivered its Judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001.[50] In the Judgment, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. It also directed the Government to set up, within specified time frame, a commission for Transformation of the financial system and two task Forces to plan and implement the process of the transformation. Although this Judgment has already been referred to Federal Shariat Court for its review but Islamization of Banking has taken a progressive start in Pakistan. According to the Commission, prior /preparatory works for introduction of Shariah compliant financial System briefly included creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and training program for bankers and their clients and an effective campaign through media for the general public to create awareness about the Islamic financial system.

The present move towards Islamization of banking sector in Pakistan started in January 2003, when State Bank of Pakistan issued criteria for establishment of Islamic Banks in Private sector. A full fledged Islamic Banking department was set up in State Bank in September 2003 to supervise the sector, review and process applications, issue guidelines along with a Shariah Board on December 2003 that advises the SBP on modes, procedure, laws and regulations for Islamic banking.

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[50] The PLD, 2000.

Al Baraka Islamic Bank Limited, Meezan Bank Limited, Dubai Islamic Bank Limited and now BankIslami Pakistan Limited are full fledged Islamic Banks of Pakistan providing Islamic modes of financing including Murabaha finance facility[51]. MCB, Standard Chartered Bank, Bank of Khyber, Bank Al Falah, Habib Bank A.G.Zurich, Bank Al Habib, Metropolitan Bank, Soneri Bank, Askari Commercial Bank and Habib Bank Limited were allowed to open Islamic Banking Branches. Together these Banks have 62 Islamic Banking Branches operating in 13 cities all over the Country.

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[51] www.bankislami.com.pk

Chapter-2

Murabaha -Its Basic Principles and Rules

2.1 Introduction to Murabaha

Murabaha is basically a trust sale (bay'al-amanah) in which the buyer depends and relies upon the integrity of the purchaser as regards the cost he mentions to buyer.[1] Thus, it is the moral and legal obligation of the seller to be honest and truthful in stating the price at which he purchased the goods, and if he succeeded in obtaining a discount or rebate, it should also be acknowledged and accounted for the benefit of the purchaser. In Islamic law, the contract of sale with regard to the cost of the sale's object to the seller, is divided into three kinds:

1. Tawliyha: resale at the stated original cost with no profit or loss to the seller.
2. Wadi' ah: resale at a discount from the original cost.
3. Murabaha: the resale at fixed surcharge or rate of profit on the stated original cost.

The main purpose of these sales is to "protect the innocent general consumer lacking experience in the various items of trade from the wiles and stratagems of sharp traders".[2]

Murabaha simply means mark-up sale. It is a particular type of sale that Islamic jurisprudence considers as a trust[3] contract, because the seller and the buyer do not negotiate

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[1] Muhammad Tahir Mansuri, *Islamic law of contracts and Business transactions*, Shariah Academy, International Islamic University, Islamabad, 2005, p. 214.
[2] Marghinani, *al-Hidayah*, vol. 3, p.56.
[3] The lexical meaning of trust or amana is the opposite of betrayal, and it denotes any legal responsibility charged to a person, including acts of worship or entrusted property. The classical jurists, however, used the word in two ways; as a noun, and as an adjective. The meaning of trust, as a noun, is that which is kept with a trustee. As an adjective, the term is used to denote trust sales, like Murabaha, in which the purchaser depends on the conscience of the seller and trusts his/her truthfulness. The Qur'an says: *"O you who believe! Do not be false to Allah and His Prophet, and do not knowingly be false to the trust that has been reposed in you"* (8:27). Moreover, the Prophet, upon him be peace, said, "He is not one of us who attempts to cheat us". This hadith was related by Muslim, Abu dawud, and Ibn Majah, from Abu Hurayrah.
It is for this reason that if any sort of misrepresentation should be discovered in a Murabaha sale, the buyer will have the option to retain the goods he/she purchased, or to return them .Some scholars have added that the

the price, but rather agree on a certain profit margin added to the cost, as faithfully declared by the seller.[4]

2.1.1 Nature of Murabaha

The word Murabaha is derived from the Arabic word Ribh that means profit, hence Murabaha is a sale on profit. Murabaha is a contract of sale between a buyer and a seller in which a seller purchases the goods needed by a buyer and sells the goods to the buyer on a Cost-Plus basis. Both the Profit (mark-up) and the time of repayment are specified in an initial contract.

Murabaha is in fact, a term of Islamic Fiqh and it refers to a particular kind of sale having nothing to do with financing in its original sense.[5] If a seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost, it is called a "Murabaha" transaction. The basic ingredient of "Murabaha" is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage.

The payment in the case of Murabaha may be at spot, and may be on a subsequent date agreed upon by the parties. The Murabaha does not necessarily imply the concept of deferred payment, as generally believed by some people who are not acquainted with the

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buyer will have the further option to subtract from the price whatever extra amount was falsely reported as the original purchase price, and then to subtract a corresponding percentage from the agreed upon margin of profit.*(Ref: See Kuwaiti Fiqh Encyclopedia, vol.6,pp.236-239,* Yusuf Talal DeLorenzo, *A Compendium of Legal Opinions on the Operations of Islamic Banks*, Institute of Islamic Banking and Insurance, London P, (xiii).

[4] Ridha Saadallah, *Financing Trade in an Islamic Economy*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1999, pp. 19-21.

[5] See Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idaratul Ma'Arif, Karachi, 1999, p. 95-96;

M.A.Mannan, *Understanding Islamic Finance: A Study of the Securities Market in an Islamic Framework* , Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1993, pp. 30-31.

Islamic jurisprudence and who have heard about Murabaha only in relation with the banking transactions.

Originally, Murabaha was not conceived of as a mode of finance, since it was not necessarily concluded on the basis of deferred payment. Murabaha sale for cash was the rule rather than the exception.[6]

Murabaha as stated above, in its original Islamic connotation, is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in Murabaha expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost.[7] If a person sells a commodity for a lump sum price without any reference to the cost, this is not a Murabaha, even though he is earning some profit on this cost because the sale is not based on a "cost- plus" concept. In this case, the sale is called "Musawamah".

This is the actual sense of the term "Murabaha" which is a sale, pure and simple. However, this kind of sale is being used by the Islamic banks and financial institution by adding some other concepts (concept of deferred payment or credit sale) to it, as a mode of financing. The validity of such transactions however, depends on certain conditions which should be duly observed to make them acceptable to Shariah. In order to understand these conditions correctly, one should, in the first instance, know that Murabahah is a sale with all its implications, therefore all the basic ingredients of a valid sale should be present in Murabahah also.

To understand the concept of Murabaha, it is necessary to explain the sale and its rules/conditions in order to understand its true sense. Therefore it seems appropriate to highlight the basic rules/conditions of sale before Murabaha as a mode of financing.

[6] See Ridha Saadallah, p. 19.
[7] See Taqi Usmani, pp. 95-96.

2.2 Sale and its Basic Rules and Conditions

'Sale' is defined in Shariah as 'the exchange of a thing of value by another thing of value with mutual consent.[8] It is defined as "an exchange of a useful and desirable thing for similar thing by mutual consent in a specific manner".[9] The word "useful" excludes from the purview of definition un-useful transactions such as the sale of one rupee for one rupee. While the word "desirable" excludes things such as carrion and dust from being valid objects of sale, as these things are not desired by the people. The words "in a specific manner" signify the modes of conveying consent such as offer and acceptance, and conduct. Some Jurists have added the words "for the alienation of property"[10] to the above definition to denote that the purpose of such a contract is to transfer property in goods to the buyer, and in price to the seller. Thus, the complete definition of sale will be as follows:

"Exchange of useful and desirable thing for a similar thing by mutual consent for the alienation of property". It can also be defined as "Exchange of property for property with mutual consent".

Following are important rules and conditions relevant to all sale contracts including Murabaha sale:

1. The parties to the contract must possess legal capacity necessary to execute and sign contract. They should be competent to enter into and to conclude a contract, i.e. major and sane.[11]

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[8] See Taqi Usmani, .p. 97.
[9] Kasani, *Bada'i Al-Sana'i'* vol. 5.p.133: Ibn al-Humam Fath al-Qadir vol.5, p.73.
[10] Shirbini, *Mughni al-Muhtaj* vol.2:2, Ibn Qudama, al-Mughni vol. 3, 559.
[11] See Tahir Mansuri, p. 192.

2. The subject of sale must be a property of value. Thus, a thing having no value according to the usage of trade eg. a leaf or a stone on a roadside cannot be sold or purchased.[12]

3. It is one of the necessary condition that the commodity of the sale should be any thing in which transactions are permissible in the Shariah. This means that it should be a pure substance ritually and legally clean. Therefore, any substance which is religiously and legally unclean and upon whose disposal there are restrictions, cannot serve as an object of sale: e.g. wine, pig, intoxicants, blood are not valid objects of sale.[13]

4. The subject of sale must be existing at the time of sale. Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to Shariah. Thus, if a person sells the unborn calf of his cow to B. The sale is void. Similarly sale of fish in water is a void sale.[14]

5. The subject of sale must be in the ownership of the seller at the time of sale. Therefore, what is not owned by the seller cannot be sold. If he sells something that he has not acquired himself then the sale becomes void.[15]
Example: A sells to B a car which is presently owned by C, but A is hopeful that he will buy it from C and shall deliver it to B subsequently. The sale is void, because the car was not owned by A at the time of sale.

6. The subject of sale must be in the physical or constructive possession of the seller

[12] See Muhammad Imran Ashraf Usmani, *MeezanBank's Guid to Islamic Banking*, Pakistan:Darul-Ishaat, Karachi, 2002, p. 77.
[13] See Tahir Mansuri, p. 192.
[14] See Taqi Usmani, p. 97.
[15] See Imran Ashraf Usmani, p. 78.

when he sells it to another person.

"Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control, and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction.[16]

Examples:

(i) A has purchased a car from B. B has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before taking its delivery from B, the sale is void.

(ii) A has purchased a car from B. B, after identifying the Car has placed it in a garage to which A has free access and B has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the Car has passed on to A.. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

Explanation:

The gist of the rules mentioned in paragraphs 4 to 6 is that a person cannot sell a commodity unless:[17]

(a) It has come into existence.

(b) It is owned by the seller.

(c) It is in the physical or constructive possession of the seller.

Explanation:

There is a big difference between an actual sale and a mere promise to sell. The actual sale cannot be affected unless the above three conditions are fulfilled.

[16] See Taqi Usmani, p. 98.

[17] Ibid, pp. 98-99.

However one can promise to sell something which is not yet owned or possessed by him. This promise initially creates only a moral obligation on the promisor to fulfil his promise, which is normally not justifiable. Nevertheless, in certain situations, specially where such promise has burdened the promise with some liability, it can be enforceable through the courts of law. In such cases the court may force the promisor to fulfil his promise, i.e. to effect the sale, and if he fails to do so, the court may order him to pay the promise the actual damages he has incurred due to the default of the promisor.

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.

Exception:

The rules mentioned in paragraphs 4 to 6 are however, relaxed with respect to two types of sale, namely;

(i) Bai' Salam

(ii) Istisna

7. 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. If the parties wish to effect a valid sale, they will have to effect it afresh when the future date comes or the contingency actually occurs.[18]

Examples:

(a) A says to B on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date.

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[18] See Imran Ashraf Usmani, pp. 76-77.

(b) A says to B, "If party X wins the elections, my car stands sold to you". The sale is void, because it is contingent on a future event.

8. The subject of sale should not be a thing which is not used except for a haram purpose, like pork, wine etc.[19] It means that the subject of sale should be usable, however its use must be permissible under Islamic law. Things which are usable but are forbidden in Shariah like pork, wine etc. can not be the subject matter of sale.

9. The commodity of sale should be known to the contracting parties. This requires that their subject matter should be ascertained. It can be realized through examination of the object if it is present in the session of contract or through a precise description if it is not available at the time of the contact. The description should be in detailed enough to do away with all vagueness and uncertainty. The majority of the jurists allow it. The Shafi'is do not allow sale by description and stipulate actual examination at the time of the contract as a necessary condition. Sale by description confers the "option of description" upon the buyer, whereby he can reject the goods if they do not conform to the description.[20]

Explanation:
The subject of sale may be identified either by pointation or by detailed specification which can distinguish it from other things not sold.

Example:
There is a building comprising a number of apartments built in the same pattern. A, the owner of the building says to B, "I sell one of these apartments to you"; B accepts. The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

[19] See Taqi Usmani, p. 100.
[20] Tahir Mansuri, p. 193.

10. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.[21]

Example :

A sells his car stolen by some anonymous person and the buyer purchases it under the hope that he will manage to take it back. The sale is void.

11. The certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.[22]

Example:

A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55". B agrees. The price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

12. The sale must be unconditional. A conditional sale is invalid, unless the condition is recognized according to the usage of trade as a part of the transaction.[23]

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Example:(1)

A buys a car from B with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.

Example:(2)

A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

13. Consideration may be deferred to a fixed future period but it cannot be suspended on an event the time of the occurrence of which is uncertain.[24] Thus, it is not lawful to

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[21] See Imran Ashraf Usmani, p. 76.
[22] See Taqi Usmani, p. 101.
[23] Ibid.
[24] Tahir Mansuri, p. 193.

suspend payment until the wind shall blow, or until it shall rain; nor is it lawful even though the uncertainty be so inconsiderable as almost to amount to a fixed term. Thus, it is not lawful to suspend payment until the sowing or reaping time.

The above condition of the sale clearly indicates that the payment against the sold commodity can be deferred to a future period and date but the date must be certain and there must not be any ambiguity in respect of the period and date on which the payment would be required to be made by the Purchaser to the Seller.

2.3 Definition of Murabaha to the purchase Orderer

It is a sale in which two parties or more negotiate and promise each other to execute an agreement according to which the orderer[25] asks the purchaser[26] to purchase an asset of which the latter will take legal possession.[27] The orderer promises the purchaser to purchase the asset which will be purchased by the orderer from the purchaser on cost plus pre-agreed profit. The two parties would conclude a sale after the possession of the asset is taken by the Purchaser. However, the purchase orderer may or may not be obliged to conclude the sale.[28] A Murabaha to the purchase orderer is usually based on deferred payment, however it can be a spot Murabaha as well. The profit being charged over and above the cost is pre-agreed and the date(s) for payment is also fixed before Murabaha transaction.

2.4. Difference between Murabaha, Ordinary Sale and Credit Sale (Bai' Mu'ajjal)

A simple sale in Arabic is called Musawamah - a bargaining sale without disclosing or

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[25] Orderer is the customer of bank/financial institution "bank" who requests to the bank to purchase the specific commodity and promise that he will purchase the same commodity from the bank after acquiring and taking possession from the seller.

[26] Purchaser is the financier (bank/financial institution "bank") of the customer who purchases the commodity at the request of the Purchase orderer from the Supplier/Seller and then sells the same commodity to the Puchase orderer.

[27] See Accounting and Auditing Organization For Islamic Financial Institutions's *Shariah Standard*, Manama, 2003, p. 134.

[28] It may, however be noted that the promise (if it is one sided) is binding and enforceable in Court of law. For detail, please see "Status of Promise" in Chapter-4.

referring to what the cost price is. However when the cost price is disclosed to the customer it is called Murabahah. A simple Murabahah is one where there is cash payment and Murabaha Muajjal is one on deferred payment basis.[29] Credit sale (bai Muajjal) refers to such a sale in which delivery is made on spot while payment is deferred but cost is not known.[30]

2.5 Murabaha Financing in Islamic Banking

A Murabahah transaction as a mode of financing in the Islamic Banking involves purchase of a commodity by a bank for and at the request/instructions of a customer from the seller and its resale to the customer on cost-plus-profit basis. Before purchasing the commodity, the bank obtains an undertaking from the customer whereby the customer promises that the commodity will be purchased by the customer from the bank. Under this arrangement the bank discloses its cost and profit margin to the customer. 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 commodity from a third party (seller) and sell those commodity on to the customer for a pre-agreed price.

Murabaha is known as Cost-Plus Sales. In this sale, the buyer knows the price at which the seller obtained the object to be financed, and agrees to pay a premium over that inifial price.[31] Thus, one may approach an Islamic financial institution and say "purchase this item on my behalf at this price, and I shall give you a profit (urbihuka) margin of $10, or "purchase this item on my behalf at this price, and I shall give you a profit (urbihuka) margin of 10%. The fact that the latter statement may be perceived to

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[29] Imran Ashraf Usmani, p. 125.

[30] Ziauddin Ahmad, A paper titled *"Some Misgivings about Islamic Interest Free Banking"* presented at Khartoum on November 21, 1985 as the Annual Lecture in the Annual Lecture Series of Faisal Islamic Bank of Sudan, p. 10.

[31] Muhmoud Amin El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance,* Islamic Society of North America, Plainfield 2000, p. 10-11.

make explicit a percentage payment should not be of concern, since it is not Riba if the sale satisfies the conditions of Murabaha. In this contract, the Islamic bank or financial institution must own the item at the time the customer buys it from them with the specified profit margin.

2.6 Basic Principles/Rules of Murabaha Financing

Murabahah financing is not a transaction of loan given on interest like in conventional banking where the borrower gets cash from the bank (lender) which can be even used for any purpose other than the purpose for which the loan is obtained but it (Murabaha) is the sale of a commodity for a deferred price which includes an agreed profit added to the cost payable in certain future date or dates as fixed and agreed upon by both the parties.[32] In conventional banking the loan is borrowed for one purpose and is applied for other purpose or purposes that may be non-productive but in the case of Murabaha the commodity is purchased by the bank (Financier) at the request/instructions of the customer from third party and sold to the customer after getting ownership and possession. Therefore financing under Murabaha is always backed by assets which is the basic principle of Islamic banking.

It is pertinent to state for the purpose of clarity that Murabaha financing being a sale and not a loan should also fulfill all the Basic rules/conditions necessary for a valid sale. Therefore the rules/principles discussed hereunder are in addition to the conditions of sale to be complied and adopted in Murabaha financing.

Following are the important rules and principles to be adopted in Murabaha financing. The focus is on the conditions which must be observed and complied by the Financial Institutions/Banks "Financial Institution" while entering into Murabaha contract with their clients/customers.

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[32] See Taqi Usmani, p. 105.

1. It is not permitted to carry out a Murabaha on deferred payment terms where the asset involved is gold or silver or currencies.[33] It is also impermissible to issue negotiable instruments where the underlying asset consists of Murabaha receivables or other receivables. Likewise, it is not permitted to conclude a Murabaha contract on a commodity that was the subject matter of a previous Murabaha contract with the same customer, i.e. to refinance the transaction.

2. It is one of the basic rules/condition for the validity of the Murabaha transaction that the customer (Purchaser in Murabaha contract) should Know the original price of the commodity.[34] Therefore the Financial Institution (Seller in Murabaha contract) should disclose the original price of the commodity to the customer. If the price is not disclosed in the session of contract, and contacting parties leave the contracting place, the contract will be invalid.

3. The profit to be charged over and above the original price must be fixed/determined and known to both the parties. It should must be mentioned in the contract of Murabaha.[35]

4. It is necessary for the validity of the Murabaha transaction that the exact price of the commodity ascertained and known.[36] If the exact price of the commodity is not known or it cannot be ascertained, then the commodity cannot be sold on Murabaha. This rules is required to be complied because that Murabaha financing transaction is based on Cost-Plus sales means thereby that both the original price and profit should be ascertained/known and fixed at the time of Murabaha contract.

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[33] *Shariah Standard*, p. 114.
[34] See Zuhayli, *al-Fiqh al-Islami wa adillatuhu*,vol.4.pp. 704-706 as quoted by Tahir Mansuri, p. 216.
[35] Tahir Mansuri, p. 216.
[36] See Taqi Usmani, p.143.

5. The first contract under which the Financial Institution purchased the commodity should be a valid contract.[37] This is required just because to confirm that the Financial Institution is a real and legal owner of the commodity. If the first contract is irregular, it means that the Financial Institution has not yet become the real and legal owner, so it cannot sell the commodity on Murabaha based transaction.

6. The Financial Institution is prohibited from selling any item in Murabaha transaction before having acquired the item.[38] Hence, it is not valid for the Financial Institution to conclude a Murabaha sale with the customer before concluding the purchase, from the supplier of the item, of the subject matter of the Murabaha, and before actual or constructive possession of the item. Likewise, the Murabaha is considered as void if the contract with the supplier is void, as in this case the Financial Institution would not have complete title to the item as explained above.

7. It is permitted that the contract between the Financial Institution and the supplier be completed by means of a meeting of the two parties to discuss the details, at which point the contract may be executed.[39] Likewise, it is permitted that the contract be completed through exchanging the notices of offer and acceptance, either in written form or correspondence by any form of modern communication customarily practiced according to known principles.

8. It is permissible to appoint an agent other than the customer of the Financial Institution to purchase the commodity for and on behalf of the Financial Institution. However the Financial Institution can appoint the customer as its agent in a situation

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[37] See Tahir Mansuri, p. 217.
[38] See *Shariah Standard*, p. 117 ;
Taqi Usmani, pp. 107-108.
[39] See *Shariah Standard*, p. 117.

of dire need. The original principle is that the Financial Institution itself purchases the commodity directly from the supplier.[40]

The customer being an agent of the Financial Institution must first take possession on behalf of the Financial Institution and inform it accordingly. However simultaneously offer to purchase the commodity can also be made and upon acceptance from the Financial Institution, the sale of Murabaha will take place. In short, in such a case, the provisions of item 10 should be observed.

9. In cases when the customer is appointed and authorized as an agent of the Financial Institution to purchase the commodity for and on behalf of the Financial Institution, it is obligatory to adopt and comply with the following procedures and conditions:[41]

   (a) that the Financial Institution itself pays to the supplier. It does not pay the price of the commodity into the account of the customer.

   (b) that the Financial Institution obtains from the supplier the documents that confirm that sale has taken place.

10. It is obligatory to separate the two liabilities of risk attaching to the purchased item, namely liability of the Financial Institution and the liability of the customer as agent of the Financial Institution.[42] This is achieved by having an interval in time between the performance of the agency contract and the execution of the contract of Murabaha to the customer. The customer will inform the Financial Institution about its performance of agency agreement that it/he has acquired and possessed the commodity on behalf of the Financial Institution and will offer to purchase the same in terms of the promise. The Financial Institution will accept the offer of the

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[40] Ibid.
[41] Ibid, pp. 117-118.
[42] Ibid.

customer. Consequently the Murabaha sale agreement will be executed and the repayment schedule (showing total price comprising the cost price of the Commodity plus profit) will be attached.

In other words in the above situation where the Financial Institution appoints the customer itself its agent to buy the commodity on its behalf. The customer first purchases the commodity on behalf of his financier (Financial Institution) and takes its possession as such. Thereafter, he purchases the commodity from the financier (Financial Institution) for a deferred price. His possession over the commodity in the first instance is in the capacity of an agent of his financier. In this capacity he is only a trustee, while the ownership vests in the financier and the risk of the commodity is also borne by it (Financial Institution) as a logical consequence of the ownership. But when the customer purchases the commodity from his financier (Financial Institution), the ownership, as well as the risk, is transferred to the customer.

11. The original principle is that all the documents and contracts concerned with the execution of the sale of the item must be in the name of the Financial Institution and not in that of the customer, even if the latter acts as the Financial Institution's agent in acquiring the item.[43]

12. It is permissible, at the time when the Financial Institution appoints someone as its agent for the acquisition of the item, that the two parties agree to authorize the agent to carry out the acquisition of the item as agent, without disclosing the existence of the agency agreement.[44] In this case, the agent will act as principal in dealing with other parties, and will undertake the purchase directly in itself/his name but on behalf of the Financial Institution as principal. However, it is preferable that the agent's role be disclosed.

[43] Ibid.
[44] Ibid.

13. It is obligatory that the Financial Institution's actual or constructive possession of the item be ascertained before its sale to the customer on the basis of Murabahah to the purchase orderer.[45]

14. The condition that possession of the item must be taken by the Financial Institution (before its onward sale to the customer) has a specific purpose: that the Financial Institution must assume the risk of the item it intends to sell. This means that the item must move from the responsibility of the supplier to the responsibility of the institution. Similarly, it is obligatory that the point when the risk of the item is passed on by the institution to the customer be clearly identified, with the reference to the stages in which the item is transferred from one party to another.[46]

15. The forms of taking delivery or possession of items differ according to their nature and different trade customs.[47] Taking possession may be actual in the case of physical delivery or transportation to the acquirer or its agent, but may also take place constructively by placing of the item at the acquirer's disposal so as to enable him to deal with it at his will, even though no physical delivery has taken place. Taking possession of an item of real property may also take place by means of the property being vacated and its being placed at the acquirer's disposal; if the latter is not able to have disposal of the purchased item, then the vacation of the property is not considered as conveying possession. In the case of moveable assets, possession will take place in accordance with the nature of the asset.

16. The receipt of a bill of lading by the institution or its agent, when purchasing goods on the international market, is considered as constructive possession. The same

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[45] Ibid.
[46] Ibid.
[47] Ibid.

would apply to the institution's receipt of certificates of storage issued by warehouses following appropriate and formalities.[48]

17. The original principle is that the institution itself must receive the item from the premises of the supplier or from a location that is specified in the delivery conditions.[49] The responsibility for the risk attached to the item is transferred to the Financial Institution upon its taking possession of the item. However, it is permissible for the Financial Institution to authorize another party to take delivery of the item on its behalf.

18. Providing insurance for the item sold by Murabaha is the responsibility of the institution at the stage of its acquiring ownership.[50] The institution undertakes this responsibility in its capacity as the owner of the item and also bears all the consequential risks. The insurance indemnity, if the need for a claim arises before ownership is transferred to the customer, belongs to the institution exclusively and not to the customer. The institution is entitled to calculate expenses as part of the purchasing cost that may be subsequently built into the price of Murabaha.

19. Agency in carrying out the procedures of obtaining insurance cover for the item at the stage of Financial Institution's acquisition of ownership of the asset is permitted. However, it is obligatory that the Financial Institution should bear the cost of insurance.[51]

20. Murabaha cannot be used as a mode of financing except where the client needs funds to actually purchase some commodities.[52] For example, if he wants funds to purchase

[48] Ibid, p. 119.
[49] Ibid.
[50] Ibid.
[51] Ibid.
[52] See Taqi Usmani, p. 105.

cotton as a raw material for his ginning factory, the Bank can sell him the cotton on the basis of Murabahah. But where the funds are required for some other purposes, like paying the price of commodities already purchased by him, or the bills of electricity or other utilities or for paying the salaries of his staff, Murabahah cannot be effected, because Murabahah requires a real sale of some commodities, and not merely advancing a loan.

21. It is also a necessary condition for the validity of Murabaha that the commodity is purchased from a third party.[53] The purchase of the commodity from the customer himself on 'buy back' agreement is not allowed in Shariah. Thus Murabaha based on 'buy back' agreement is nothing more than an interest based transaction.

22. It is essential to exclude any prior contractual relationship between the customer who is the Purchase orderer and the original Supplier of the item (commodity) ordered, if any, regarding the supply of the item.[54] It is a requirement of Murabaha to the Purchase orderer that the transaction between the two parties must genuinely, not fictitiously, exclude any prior contractual relationship.

When there is acceptance by the customer of an offer from the Supplier that is either addressed to it/him personally, or that has no addressee, then it is not permissible for the Financial Institution to carry out Murabaha to the Purchase orderer.[55] The reason is that by this, a sale contract has taken place between the customer and the Supplier in which case the commodity enters into ownership of the customer. This ruling will not be affected whether or not the customer has paid the price. This is because payment is not a condition for the validity and conclusion of a contract as payment of

[53] See *Shariah Standard*, p. 114.
[54] Ibid.
[55] Ibid, pp. 113-114.

the price is but a consequence of a contract and is not principal requirement or a condition for regarding a contract valid.[56]

The basis for the requirement that there must not be any contractual commitment between the customer and the Supplier is to safeguard against the contract being a mere interest-based financing.[57]

The basis for the requirement that the customer must not have any (business) connection with the Supplier is to avoid involving in an inah (sell and buy back) transaction that is prohibited by Shariah.

23. In the Murabaha sale agreement the Financial Institution can incorporate a clause whereby it will not be responsible for any defects in the assets. In such a case, it will assign to the customer the right of recourse to the Supplier. If such a clause is not incorporated in the agreement then the Financial Institution will be responsible for any defects in the assets.[58]

The essentials of Murabaha financing is to comply with its principles and rules while entering into the transaction. This ensure the compliance of the conditions necessary for a Murabaha transaction to make it a genuine sale. The transaction must be asset based. There are a number of requirements for this transaction to be a real one to meet the Islamic standards of a legal sale. At the first stage the customer requests the Financial Institutions to purchase the particular specified commodity which will be subsequently purchased by the customer from the Financial Institution. Hence this contract of sale under which the Financial Institution acquires the commodity must be a separate and a valid contract in

[56] Ibid, p. 128.
[57] Ibid.
[58] Ibid, pp. 120-121.

accordance with Shariah. Consequent upon acquiring the commodity by the Financial Institution, the Financial Institution sells the same commodity to the customer under Murabaha sale. This should also be a valid Murabaha sale in terms of the Shariah. Both the contracts, the one through which the Financial Institution acquired the commodity and the other through which it sells to the customer should be separate and real transactions.

Chapter-3

Procedure of Murabaha Financing

3.1 Introduction

There are a number of steps in procedure of Murabaha financing transaction to meet the Islamic standards of a legal sale. Each step has to be completed with due care to achieve the underlying objective to make the transaction a Shariah compliant. Basically Islamic banks are using Murabaha as financing technique and usually Murabaha to the purchase orderer is providing to the customers.

The customer approaches an Islamic bank to get finance in order to purchase a specific commodity. The bank purchases the commodity on cash and sells it to the customer on a profit. Since the customer has no money, he/it buys the commodity on deferred payment basis. Thus the customer got the commodity for which he wanted the finance and the Islamic bank made some profit on the amount it had spent in acquiring the commodity. In all this procedure the applicable rules of Murabaha financing must be applied and complied.

The whole of the procedure is pertaining to the two sale contracts, the one under which the bank purchases the commodity and the second under which the bank sells the same commodity to the customer. The first contract must be completed in all respect so that the bank becomes owner of the commodity. When the bank becomes the owner then it sells the commodity to the customer. However the prescribed

procedure is required to be followed in order to make the transaction Shariah compliant.

3.2 Procedure of Inland Mrabaha financing

In case the commodity is required to be acquired from the local market then the following stepwise procedure must be followed. However the basic concept to first become the owner and then sell the commodity to the customer is applicable to all cases irrespective of the matter whether the commodity is acquiring inland or from abroad.

1. The customer approaches the Bank/Financial Institution for Murabaha facility and provide description of commodity with quantity and quality with detail of price being required to the customer. Quotation from the supplier is obtained in the name of Financial Institution.[1]

   With due consideration to the condition for valid Murabah that the commodity is purchased from third party, it is permissible for the customer to request the Financial Institution to purchase the item (commodity) from a particular source of supply. However, the Financial Institution is entitled to decline to carry out the transaction if the customer refuses offers from other sources of supply that are more suitable for the Financial Institution.[2]

2. The Financial Institution analyzes the credit worthiness, financial position, permissibility of the commodity to be financed in accordance with Shariah

[1] See Ausaf Ahmad, *Contemporary Practices of Islamic Financing Techniques*, Jeddah, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1993, pp. 34-36.
[2] Accounting and Auditing Organization For Islamic Financial Institutions's *Shariah Standard*, Manama, 2003, p. 113.

and repayment capacity of the customer in the light of its/his request in terms of the commodity and its price.[3] Consequently the Institution decides:

(i) limit of Murabaha facility to be provided to the customer;

(ii) security to be obtained from the customer against the facility to ensure the repayment;

(iii) period of facility;

(iv) profit margin/ratio over and above the cost of the commodity;

(v) modes of repayments with due dates and amount;

(vi) others terms and conditions.

3. The Financial Institution offers to the customer Murabaha facility against its/his request (mentioned in Step1 above) with all terms and conditions including but not limited to the terms and conditions mentioned in Step 2 above. The customer accepts the offer.

The offer and the acceptance between Financial Institution and the customer at this stage is merely an understanding to sign an overall agreement as mentioned in Step 4 below for the Murabaha facility to be granted by the Financial Institution to the customer.

4. The customer and the Financial Institution sign an overall agreement whereby the Financial Institution promises to sell and the customer promises to buy the commodity from time to time on an agreed ratio of profit added to the cost.[4] This agreement may specify the limit up-to which the facility may be availed.

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[3] See Ausaf Ahmad, pp. 34-36.

[4] See Muhammad Imran Ashraf Usmani, *MeezanBank's Guid to Islamic Banking*, Darul-Ishaat, Karachi, 2002, p. 127.

This agreement may also specify all terms and conditions of the facility, rights and duties of both the Parties in certain stages of the Murabaha facility, security required to be provided against the facility and repayment schedule.

If the overall agreement (Master Murabaha agreement) is signed for a certain limit to be availed by the customer from time to time under sub-Murabahas facility or facilities then at this stage the customer will provide a security if required by the Financial Institution as mentioned in Step 3 above required under sub-clause (ii) of Step 2 above.

At this stage, the Financial Institution and the customer promise to sell and purchase a commodity in future. This is not an actual sale. It is just a promise to affect a sale in future on Murabahah basis. Thus at this stage the relation between the Financial Institution and the customer is that of a promisor and a promisee.

5. An agency agreement is signed by both parties in which the Financial Institution appoints the customer as its agent for purchasing the commodity on its behalf.[5] At this stage, the relation between the Financial Institution and the customer is that of a principal and an agent. This Step can also be executed simultaneously with Step 4 by mutual consent. If the Financial Institution purchases the commodity directly from the supplier then it does not need any agency agreement.

6. The customer purchases the commodity on behalf of the Financial Institution and takes possession as the agent of the Financial Institution. At this stage, the relation between the Financial Institution and the supplier is that of a buyer and seller. The relation between the customer and the Financial Institution is that of a Principal and an Agent whereby the customer completes the purchase

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[5] Ibid.p.127.

of the commodity and takes possession of the commodity as an agent of the Financial Institution in terms of the Agency Agreement. In this capacity he (the customer) is only a trustee, while the ownership vests in the Financial Institution and the risk of the commodity is also borne by Financial Institution as a logical consequence of the ownership.

It is crystal clear that at this stage the commodity must remain in the risk of the Financial Institution.

In case the Financial Institution purchases the commodity directly from the supplier then it makes payment to the supplier and acquired ownership and possession of the commodity. At this stage the risk of the commodity is taken by the Financial Institution.

It is one of the requirement that the payment against commodity must be made by the Financial Institution to the Supplier directly whether the Financial Institution purchases the commodity itself from the Supplier or through the customer being an Agent of it.[6]

7. Consequent upon the purchase and taking possession of the commodity by the customer as the agent of the Financial Institution as explained above in Step 6, the customer informs the Financial Institution that it has purchased the commodity and taken the possession of the commodity on their behalf and simultaneously makes an offer to purchase it from the Financial Institution.

At this stage the relation between the Financial Institution and the customer is that the customer just informs the Financial Institution regarding completion of his/its job as its agent and also makes offer to purchase the commodity from the Financial Institution in terms of the

[6] See Shariah Standard, pp. 117-118.

understanding/promise/overall agreement signed between them as mentioned in Step 4 above.

In case the Financial Institution purchases the commodity itself then after acquiring ownership and possession, the Financial Institution informs the customer that it has purchased the commodity as requested by the customer and as explained in Step 1 above. The customer makes an offer to purchase it from the Financial Institution in terms of the understanding/promise/overall agreement signed between them as mentioned in Step 4 above.

8. The Financial Institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the customer and a particular Murabaha sale agreement (Murabaha Financing Agreement) is executed between the Financial Institution and the customer. All terms and conditions including but not limited to original cost plus profit margin and schedule of repayment is determined, agreed and fixed in terms of the overall agreement as mentioned in Step 4 above.

At this stage, the relation of buyer and seller comes into operation between the Financial Institution and the customer, and since the sale is effected on deferred payment basis, the relation of a debtor and creditor also emerges between them simultaneously. It is the stage whereby the Financial Institution may ask the customer to provide a specific security to its satisfaction to ensure prompt payment of the deferred price as per the agreed Schedule. The Financial Institution may also ask the customer to provide a promissory note or a bill of exchange or a post dated cheque(s) because at this stage, the actual sale takes place, i.e. at the Eighth stage as mentioned above. The reason is that the promissory note is signed by a debtor in favor of his creditor, but the relation of debtor and creditor between the Financial Institution and the customer begins only at the Eighth stage, whereupon the

actual sale takes place between them. In support, the following Fatwa of Shariah Board of Faisal Islamic Bank of Bahrain may be perused.

Fatwa: *"Promissory notes may not be taken until after a debt has been established as the result of a contract of murabaha between the bank and its client, or any other such contract in which a financial responsibility is initiated".*[7]

It is permissible for the Financial Institution to obtain cheques or promissory notes before the execution of the contract of Murabaha to the purchase orderer, as a guarantee of the indebtedness that will be created after the execution of the contract. This is possible on the written condition that the Financial Institution is not entitled to use these cheques or documents except on their due dates. The requirement to provide cheques as security is not permissible in countries where it could be presented for payment before their due date.[8]

It seems appropriate to explain that instead of the customer's offer to purchase the commodity as explained in Step 7 above, the Financial Institution can also make an offer to sell the commodity to the customer whereby then in that case the customer will accept the offer instead of the Financial Institution as stated in Step 8 above.

All the above Stepwise procedure with applicable rules/conditions are necessary to effect a valid Murabaha and this is the way by which the transaction of Murabaha Financing is distinguished from an ordinary interest-based transaction.

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[7] Yusuf Talal DeLorenzo , *A Compendium of Legal Opinions on the Operations of Islamic Banks*, , Institute of Islamic Banking and Insurance, London , 2001, p. 4.
[8] See Shariah Standard, p. 121.

3.2.1 Observations against the Procedure of Inland Transaction of Murabaha

There is no doubt that the procedure adopted for Inland Murabaha financing is permissible in Shariah. However I am of the view that there are many things which are permissible in Islam but are not preferable, therefore following points are objectionable which makes the Murabaha transactions similar to interest based transactions:

1. First of all banks do not operate as a trader in their normal course of business, therefore they are not involved in sale/purchase of the commodity to be sold to the customer on Murabaha basis. The banks purchase the commodity subject to the requirement of the customer. So we can say that the banks purchase the commodity for onward sale to the customer just to earn profit. Whereas the original concept was that traders whose usual business was the sale/purchase of the commodity were providing the commodity in Murabaha and in credit sale. These traders were not involved in the practices as the banks to become traders subject to the need of the customer keeping in view the profit.

2. The banks before purchasing the commodity obtained security along with other documents from the customer to ensure that after acquiring the commodity from the seller, the same commodity will be purchased by the customer from the banks. Further, the profit margin is also agreed between the customer and the bank. Therefore we can say that the profit of the bank is predetermined and fixed as in the case of interest based transaction.

3. The banks appoint the customer as its agent in every case to purchase the commodity actually required to the customer on behalf of the bank and subsequently sells the same to the customer. We understand that it is permissible but actually the bank shifts the burden and responsibility to the customer in connection of the purchase of the commodity and whereas the banks should undertake the responsibility and risk of acquiring ownership. The risk of ownership of the bank is mere documentary.

4. Under the procedure, the banks while purchasing the commodity through the customer being its agent, payment is made to the customer for onward payment to the seller. This procedure makes ways to un-Islamic transaction. For example the customer purchases the commodity in advance and even makes payment. Subsequently the banks execute agency agreement with the customer in prior date to cover the transaction between the seller and the customer and makes payment to the customer against already purchased commodity. This shows that Murabaha transaction is being engineered against already owned commodity.

5. The banks obtained a Promissory note for the total recoverable amount from the customer. We are of the view that Promissory note is a negotiable instrument which comes under the Negotiable Instrument Act which is interest based law. Therefore, it does not seem appropriate to obtain an instrument in a Islamic transaction which is the creation of the law of interest.

6. The underlying purpose of the entire procedure is to advance finance to the customer under the Umbrella of Murabaha sale. Therefore we are of the view that the procedure is permissible but the underlying objective is

to provide finance to the customer and earn net profit which is similar to the interest based transaction.

3.3 Procedure of Murabaha financing in case of Letter of Credit

Sometimes the customer needs to acquire commodity under Murabaha financing which is required to be imported. In such cases the customer (Importer) gets proforma invoice from the Seller (Exporter).[9] In proforma invoice the detail of the commodity, delivery and terms and conditions of payment is incorporated. Payment is usually required through letter of credit "L/C"[10] . The customer requests the bank to open L/C in favor of Exporter. In this regard the following stepwise procedure is adopted for import of the required commodity:

1. The customer requests the Bank to open L/C to import commodity from abroad through an application enclosing a proforma invoice and providing all the necessary details and information.

2. The Bank analyses the request of the customer and takes internal decisions regarding approval.

3. The Bank offers to the customer Murabaha facility (for import of the commodity) and the customer accepts the offer.

[9] See Ausaf Ahmad, pp. 37-38;
Fatwa of the Kuwait Finance House, no.286,p.278, Yusuf Talal DeLorenzo, pp. 87-89 and
Fatwa of the Kuwait Finance House, Question 23,p.50, Yusuf Talal DeLorenzo, pp. 60-62.

[10] A letter of credit is simply a promise by Buyer's Bank which runs directly to Seller that Buyer's Bank will pay the sales contract amount to Seller, if Seller produces the documents required by the sales contract which evidence that Seller has shipped the goods required by the sales contract (i.e., a negotiable bill of lading). Letters of credit may be revocable or irrevocable, but in a documentary sales transaction it is customarily understood that an irrevocable one required. Letter of credit may also be either confirmed or not. A confirmed letter of credit include a promise from Seller's Bank to Seller that Seller's Bank will pay the contract amount to Seller if Seller produces the required documents evidencing shipment of the goods. Thus, under confirmed letter of credit, Seller has a promise from a local bank, before shipment of the goods, of payment if the goods are shipped.(Ref:Ralph H.Folsom, University Professor of Law, University of San Diego and others, *International Business Transactions: A Problem-Oriented Course book,* West Group, USA, 2003 p.55.

4. The customer and the Institution sign an overall agreement. At this stage the customer promises to buy the commodity (to be imported through L/C of the Bank at the request of the customer) from time to time on an agreed ratio of profit added to the cost.

   At this stage the Bank obtains Security deposit (L/C Margin) and other security/collateral from the customer.

5. The Bank appoints the customer as its agent to negotiate and deal matters on behalf of the Bank with the Exporter (Supplier of the commodity in abroad) and also to handle other matters if required on behalf of the Bank. This Step can also be executed simultaneously with Step 4. The customer then places a Purchase order with the Seller.

6. The Bank opens L/C in favor of the Exporter after obtaining the security deposit and other security/collateral from the customer and sends copies to the correspondent Bank abroad and to the Exporter. The Exporter and its correspondent Bank accepts the L/C.

7. The Exporter makes arrangements to export the commodity and delivers the documents to the correspondent Bank abroad. The shipment of the commodity takes place and the correspondent Bank advises the Bank and sends the documents.

   The Exporter makes shipment of the commodity in the name of the Bank and the Bank is bound to make payment to the Exporter through the Correspondent Bank in any case. However, the Bank usually gets the acceptance of the import documents from the customer to make it clear that these documents are pertaining to that commodity being imported at the request of the customer.

8. Consequent upon the confirmation of the Bank's ownership of the commodity in question through the acquisition of related import documents, the Bank informs the customer in respect of the receipt of the import documents and makes an offer of sale to the customer and the customer accepts the offer. The Bank endorses the import documents in favor of the customer and an agreement of sale (Murabaha Financing agreement) is executed and signed with the customer. Repayment schedule and other required documents are also signed.

It is pertinent to clarify that the Bank makes payment to the correspondent Bank upon receipt of its Shipment documents and assume ownership and possession (that may be constructive possession). At this stage the commodity remains in the risk of the Bank. Thereafter the Bank offers and the customer accepts the sale/purchase of the commodity and the agreement of Murabaha sale is executed between the Bank and the customer and the documents are endorsed in favor of the customer. When the documents are endorsed in favor of the customer then the customer releases/clears the commodity from the relevant authorities (like customs, port and from airport in case of air shipment) and takes possession. The customer may also release and take possession of the commodity as an agent of the Bank.

3.3.1 Observations against the Procedure of Murabaha financing in case of Letter of Credit

Following are the Observations to be noted in case of L/C:

1. The bank open L/C at the request of the customer to import the commodity required to the customer. The bank before establishing L/C obtain cash margin and other security from the customer to ensure the payment of total price to be paid to the seller against the commodity. The bank and the

customer agreed on the profit margin to be paid to the bank before the import of the commodity. Therefore the bank import the commodity keeping in view the profit margin but at the same time does not undertake any real risk.

2. As a matter of principle the banks should import the commodity at its own risk and cost without involving the customer. Obtaining cash margin and other security from the customer means that the customer in any case is bound to make payment against the commodity. The banks actually do not perform an obligations of Purchaser/Owner and therefore do not assume any real risk in acquiring the ownership but merely become documentary owner to earn the agreed profit margin.

3. In case the customer refuses to purchase the commodity from the bank being imported at the request of the customer then the banks realize the security and recover all losses from the customer. It clearly shows that the banks do not assume any risk in real term.

4. The banks while making payment against the import documents to the bank's of Exporter usually gets acceptance against discrepancies if any in documents from the customer just to shift risk and responsibility to the customer. We are of the view that banks should avoid this practice and assume its own responsibility.

5. The appointment of customer as agent of the bank and promissory note has the same effect as in the case of in land transaction as discussed above.

6. Lastly the ultimate objective of the entire procedure is to provide finance to the customer against import of the commodity to earn the agreed profit margin.

3.4 Murabaha financing in case of Export

Murabaha as a mode of financing can be applied against the need of Export financing in various ways.

In cases where Exporter has orders in hand to export a commodity abroad against L/C from the Bank of the importer duly confirmed by in land Bank acceptable to Exporter, the Exporter may obtain Murabaha facility from the Bank/Financial Institution to fulfill its pre-shipment financing needs to prepare or arrange for the commodity in terms of the Orders to be exported as per the L/C.[11]

Many Islamic Banks use Murabaha for export financing whereby Banks purchases commodities that are to be exported at price that is less than the price agreed between the Exporter and the Importer. It then exports commodity at the original price and thus earns profit.

Murabaha financing requires Bank and Exporter to sign at least two agreements separately, one for the purchase of commodity and the other for appointing the Exporter as the agent of the Bank (that is agency agreement). Once these two agreements are signed, the Exporter can negotiate and finalize all the terms and conditions with the Importer on behalf of the Bank.[12]

The Exporter arranges the commodity in terms of the Orders of Importer and L/C. Further the Exporter ships the commodity and sells the same to the Bank. Once the Bank has legal possession (that may be constructive possession) of the commodity, it may sell these to the Importer by means of a legally valid sale; but on condition that the sale not in any way resemble an Inah sale.'[13]

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[11] See Imran Ashraf Usmani, p.197.
[12] Ibid.pp.196-198.
[13] Inah sale means to sell commodity on cash and then buy it back at a higher price to be paid on some specified time in future. It is called inah because the 'ayn (substance) sold by the seller returns to him. Malik and Ahmed Ibn Hanbal prohibited this transaction because it is a legal device for dealing in riba. (see Al-*Murabaha fi Bank*

3.5 Rules of Calculation for Determination of Cost in Murabaha

Murabaha takes place when the Seller declares the price for the buyer at which he had bought the Goods (commodities), and then stipulates some profit over and above the price.[14] Thus Murabahah can only be affected 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.

The opinion of Muslim jurists is divided as to what expenses can be added to the price and constitutes a basis for the calculation of profit.[15]

3.5.1 The Maliki School

The conclusion of Malik's school about that what has to be included in the price, is that whatever the seller is entitled to for the goods over and above the cost is divided into three categories: one of the category is that which is t be included in the cost and which also has a right to earn a profit; another may be included in the price, but has no share in the profit. Acts that are considered a part of the capital and have a share in the profit are factors that are effective in the essence of the goods, like tailoring and dyeing. Acts that are considered a part of the capital, but have no part of the profit, do not affect the essence of the goods and are those which the seller is not capable of undertaking himself, like transporting the goods from town to town and the renting of stores in which they are stocked. Those which do not fall under either case are acts that neither affect the essence of the goods nor is the seller able to undertake them himself, like brokerage, negotiation, and bargaining.[16]

Dubai al-Islami, p.15 and also see Muhammad Tahir Mansuri, *Islamic law of contracts and Business transactions*, Shariah Academy, International Islamic University, Islamabad, 2005, p. 224).

[14] See Ibn Rushd, Bidayat al-Mujtahid, vol.II translated by Imran Ahsan Khan Nyazee, p. 256.

[15] See Nabil Salib, Unlawful Gain and Legitimate Profit in Islamic Law, Graham & Trotman, 1992, P. 118.

[16] See Ibn Rushd, pp.256-257.

3.5.2. The Hanafi School

All the expenses which are accepted normally by commercial practices can be added to the cost price whether such expenses have affected the commodity itself (e.g. dying or tailoring) or were incurred on account of such commodity (e.g. transporting goods or paying commission to a middleman).[17]

3.5.3. The Hanbali and Shafi'i Schools

All actual expenses incurred as regards the commodity can be added to the capital provided that the Murabaha purchaser is made aware of the amount of these expenses and their origin.[18]

The basic principle in Murabaha financing is that the exact cost of the commodity must be ascertained and the profit must be fixed. Both cost and profit must be known to the Purchaser. The date for repayment of Murabaha cost (original cost plus profit) must fixed in clear terms and if it is payable in installments then schedule indicating date(s) and installment(s) must be fixed and it must be the integral part of the Murabaha agreement.

To ensure the principle to ascertain the exact cost, the Murabaha transaction should be based on the same currency in which the seller has purchased the commodity from the original supplier. If the seller has purchased it for Pakistani rupees, the onward sale to the ultimate purchaser should also be based on Pakistani rupees, and if the first purchase has occurred in U.S. dollars, the price of Murabaha should be based on dollars as well, so that the exact cost may be ascertained.[19]

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[17] See Kasani, Bada'i' al-Sana 'i', vol.5, p. 223.
[18] See Ibn Rushd, p. 257.
[19] See Muhammad Taqi Usmani, *An Introduction to Islamic Finance,* Idaratul Ma'Arif, Karachi, 1999, pp.143-145.

However, in the case of international trade, it may be difficult to base both purchases on the same currency. If the commodity intended to be sold to the customer is imported from a foreign country, while the ultimate purchaser is in Pakistan, the price of the original sale has to be paid in a foreign currency and the price of the second sale will be determined in Pak Rupees.

This situation may be met with in two ways.[20] Firstly, if the ultimate purchaser agrees and the laws of the country allow, the price of the second sale may also be determined in dollars. Secondly, if the seller has purchased the commodity by converting Pakistani Rupees into dollars, the exact amount of Pak rupees paid by the seller to convert them into dollars can be taken as the cost price and the profit of Murabahah can be added thereon.

In some cases, the bank purchases the commodity from abroad at a price payable after three months or in different installments, and sells the commodity to his client before he pays the full price to the supplier.[21] Since he pays the price in dollars, its equivalent in Pakistani Rupees are not known at the time when the commodity is sold to the client. Due to fluctuation in the price of dollars in Pak Rupees, the bank may have to pay more than it anticipated at the time of Murabahah sale. For example, the rate of U.S. dollars at the time of Murabahah was Rs. 40/- for one dollar. The price of Murabahah was settled according to this rate, but when the bank paid the price to the supplier, the dollar rate increased to Rs. 41/- for one dollar, meaning thereby that the cost of the bank increased by 2.5%. In order to meet this situation, some financial institutions put a condition in the Murabahah agreement that in case of such fluctuation in currency rates, the client shall bear the additional cost. According to the classical Muslim jurists, Murabahah based on this condition is not valid because it leads to uncertainty of the price at the time of sale. Such uncertainty continues upto a date after three months when the buyer actually pays the price to the

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[20] Ibid.
[21] Ibid.

supplier. Such uncertainty renders the transaction invalid. Therefore, there are following options open to the bank in this issue:

(a) The bank should purchase that commodity on the basis of L/C at sight and should pay the price to the supplier before effecting sale with the customer. In this case no question of fluctuation in currency rates will be involved. The Murabahah price can be determined on the basis of the market rate of dollars on the date when the bank has paid the price to the supplier.[22]

(b) The bank determines the Murabaha price in US dollars rather than in Pak rupees, so that the deferred Murabaha price is paid by the customer in dollars. In this case the bank will be entitled to receive dollars from the customer and the risk of the fluctuation in dollar's price will be borne by the purchaser.[23]

(c) Instead of Murabaha, the deal may be on the basis of musawamah (a sale without reference to the cost of the seller) and the price may be fixed as to cover the anticipated fluctuation in the currency rates.[24]

It would be pertinent to state that what expenses should be added and what should not be added to the cost/price of the goods (commodity). In this regard the following Fatwa (legal opinion) may be perused:[25]

"*Expenses which may lawfully be added to the price of goods sold by the bank by means of Murabaha include only those which are regularly incurred in accordance with customary practice, those which add value to the goods, and those which are incurred directly. The salaries of bank employees, however, are not to be added as they are a part of the (purchasing process and the) services offered by the bank in exchange for its right to make a profit. With respect to customs clearance, if those*

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[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] See Fatwa of the Kuwait Finance House, Question 143,pp.142-143, Yusuf Talal DeLorenzo, pp.12-13.

who undertake this work are not bank employees (but agents), then whatever is paid to them may be added to the price of the goods. If they are bank employees, however, their salaries may not be added; though the expenses they incur while clearing the goods may be added. Of course, it may be possible to cover all such expenses through increasing the percentage or amount of profit."

3.6 Rules of Calculation for Fixation of Profit

Murabaha is the resale at fixed rate of profit on the stated original cost. One of the basic principle in Murabaha financing is that the profit to be charged over and above the original cost must be fixed and known to the Purchaser. Thus it is a condition in a Murabaha sales contract that all elements of the sale be known to both parties. In this regard the following Fatwa (legal opinion) may be perused:

"It is a well-established fiqh principle that in a Murabaha sale the original purchase price and all the expenses incurred by the purchaser in order to take possession of the commodity must be known by the client (the purchase pledger). It is for this reason that fiqh scholars define Murabaha as the sale of a commodity, as is, plus an agreed upon margin of profit." [26]

It is an obligation that both the price of the item (commodity) and the Financial Institution's profit on the Murabaha to the purchase orderer transaction be fixed and known to both parties on the signature of the contract of sale. It is not permitted under any circumstances to subject the determination of the price or the profit to unknown variations or variations that are determinable in the future, such as by concluding the sale and making the profit dependent on the rate of LIBOR (London inter-bank offered rate) that will prevail in the future. There is no objection

[26] See Meeting of the Shariah Council of the Faisal Islamic Bank of Egyp: June 1, 1981, Yusuf Talal DeLorenzo, pp.28-29.

to referring to any other known indicators during the promise stage as a comfort indicator to determine the rate of profit, provided that the determination of the Financial Institution profit at the time of concluding the Murabaha to the purchase orderer is based on a certain percentage of the cost and is not tied up with LIBOR or a time factor.[27]

The Financial Institution's profit mark-up in Murabaha to the purchase orderer must be known, and the mere mention of the total selling price is not sufficient. It is permissible that the profit be determined based on a lump sum amount or a certain percentage of the cost price only or of the cost price plus the expenses. This determination is completed by the agreement and mutual consent of the two parties.[28]

It has been observed that most of the Financial Institutions in Pakistan while financing by way of Murabaha determine their profit or mark-up on the basis of the current interest rate, using KIBOR[29] (Karachi Inter-bank offered rate) as the criterion. Outside Pakistan instead of KIBOR, LIBOR is used and applied to calculate and determine the profit. For example, if KIBOR/LIBOR is 10%, they determine their mark-up on Murabahah equal to KIBOR/ LIBOR or some percentage above KIBOR/LIBOR. Although this way of calculation is resemble to the interest based financing but it does not seem prohibited. The obvious reason is that the Original cost plus the profit is disclosed and known to the Purchaser. Furthermore the rules and formulas adopted for calculation is also disclosed to the Purchaser. For example if the Original cost is Rs. 100/- and profit is 10% per annum being payable after one year. In this case after one year Rs. 100/- being original cost plus Rs. 10/- being profit will be payable. But if the Original cost is Rs. 100/- and profit is 10% per annum with the condition that 50% original cost with profit will be paid six monthly. In this situation, Rs. 50/- being original cost with Rs. 5/- being profit will be paid after six months and

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[27] Shariah Standard, p.120
[28] Ibid.
[29] KIBOR stands for Karachi Inter-bank offered rate.

after next six months (on completion of one year) Rs. 50/- on account of original cost plus Rs 2/50- will be paid. In this case original cost is paid Rs. 100/- but total profit is paid Rs. 7/50- as against Rs. 10/- in the first example.

The conclusion is that Original cost with detail and profit must be known, disclosed and fixed at the time of the Murabaha financing agreement. Both Original cost plus profit must be agreed by both the parties. Whichever formula and rule is adopted for calculation and fixation of profit should preferable be disclosed to the Purchaser. Once the profit is fixed, it cannot be changed. It can neither be increased nor decreased in any circumstances. The Repayment schedule of Murabaha price (cost plus profit) must be attached to the Murabaha agreement as an integral part.

3.7 Security Deposit (Hamish Jiddiyyah)

It is the amount paid by the purchase orderer upon request of the purchaser to make sure that the orderer is serious in his order of the asset. However, if the promise is binding and the purchase orderer declines to purchase the asset, the actual loss incurred to the purchaser shall be made good from this amount.[30]

3.8 Urboun (Earnest Money)

It is the amount paid by the customer (orderer) to the seller (i.e., the original purchaser) when the former purchases an asset from the seller. If the customer proceeds with the sale and takes the asset, then the urboun will be part of the price; otherwise, the urboun be for the seller.[31]

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[30] Shariah Standard, p.116.
[31] Ibid p.134.

3.9 No Roll Over in Murabaha Transaction

Murabaha transaction is the sale of the Commodity on deferred payment mutually agreed by the Seller and Purchaser. If a customer of the Financial Institution/Bank cannot pay the price of the Murabaha at the due date for any reason it cannot be rolled over for a further period as the old contract ends.

The concept of roll over of the financial facility is the extension of the maturity date for further period of the already matured facility on new terms and conditions. Roll over is a common practice in an interest-based financing where a customer of the Financial Institution/Bank cannot pay at the due date for any reason, it/ he may request the Financial Institution/Bank to extend the facility for another term. If the Financial Institution/Bank agrees, the facility is rolled over on the terms and conditions mutually agreed at that point of time, whereby the newly agreed rate of interest is applied to the new term. It actually means that another loan of the same amount is re-advanced to the borrower. The important point is that the re-advance is shown under the loan documents only and actually no fresh disbursement is made to the borrower. The re-advance under the name of roll over is in fact the extension of the period of maturity date under the new terms and conditions of the already matured loan. Generally fresh documents for roll over facility are executed to secure the loan.

As explained in the foregoing Chapter that Murabaha is not a loan rather it is a sale of a commodity, which is deferred to a specific date. Once this commodity is sold, its ownership transfers from the Financial Institution /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.

The gist of the above explanation is that Murabaha transaction cannot be rolled over for a further period as practiced in conventional banking in interest based transaction.

3.10 Rescheduling of Installments (Payments) in Murabaha Transaction

If the Purchaser/Customer in Murabaha financing is not able to pay according to the date(s) agreed upon in the Murabaha agreement, it/he sometimes requests the seller/the Financial Institution/Bank for rescheduling the installments. In conventional Banks, the loans are normally rescheduled on the basis of additional interest and some token payment. This is not possible in Murabaha payments. If the installments are rescheduled, no additional amount can be charged for rescheduling. The amount of the Murabaha price will remain the same in the same currency.

It is not permissible to extend the date of payment of the debt in exchange for an additional payment in case of rescheduling, irrespectively of whether the debtor is solvent or insolvent.[32]

The conclusion is that Rescheduling is permissible provided the amount remains the same and no additional amount is charged against the rescheduling. In this regard the following Fatwa (legal opinion)[33] may be perused

"*Rescheduling the remaining installments is permissible provided that the amount due to the Creditor (the bank) remains the same, with no further increase.*"

3.11 Rebate or Discount in Case of Earlier Payment

It has been noticed in the banking system that on certain occasions due to number of reasons the Debtors use to pay back earlier to the Creditors than the specified date(s) to get discounts. This issue is known in the Islamic legal literature as "Give discount

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[32] Ibid, pp.115-116.
[33] Shariah Council of the Islamic Finance House, meeting of August 20-21, 1987 at Geneva, Yusuf Talal DeLorenzo, p. 18.

and receive soon." The majority of the Muslim Jurists hold that if the earlier payment is conditioned with discount, it is not permissible and is un-Islamic. However, if this is not taken to be a condition for earlier payment, and the Creditor gives a rebate or discount voluntarily on its/his own, it is permissible especially if the customer is needy.

The perusal of the following Fatwa may clarify the issue of rebate or discount in case of early payment:

Question: Stipulating Yearly Review of Profit Margins

In regard to long term Murabaha sales, is it lawful for the bank to agree with the buyer on the inclusion of a clause in the contract for the Murabaha sale which states that the profit will be subject to review each year?

Fatwa:[34]

"*Once the Sale has been completed, and the price plus costs and the profit have been specified, it will not be lawful to increase or decrease anything unless it be to decrease the amount of an installment in return for its early repayment. This will be in accordance with the principle "pay now and pay less," which was derived from the Prophet's ruling in regard to the Jews of Banu Nadir when they were banished. For they said to him, "We are owed debts which have not yet fallen due." And he, upon him be peace, told the debtors, "Pay now, but pay less." For this reason, there is nothing wrong legally with decreasing the installment amount in return for its early repayment, but on condition that this not be made a condition for the client (customer) by the bank.*"

[34] Fatwa of the Shariah Board, Faisal Islamic Bank of Bahrain.p.16, Yusuf Talal DeLorenzo, pp.34-35.

The conclusion of the above explanation is that no clause in respect of rebate can be stipulated in the agreement of Murabaha transaction effected by Financial Institution/Bank, nor can the Customer claim it as its/his right. However, if the Financial Institution/Bank gives it/him a rebate on its own, it is not objectionable, especially where the customer is a needy person.

3.12 No Extra Charges in Case of Earlier Payment or Termination of Facility

It is pertinent to state that in conventional banking if the Customer wants to pay earlier than the specified date(s) or to settle the facility before maturity whereby the facility is terminated for settlement, the Bank/Financial Institution allows the early payment with the condition to pay some additional amount known as "termination charges or charges against pre-mature payment or settlement. Such charges in case of Murabaha's early repayment can not be claimed as it is totally against the principle of Shariah.

3.13. All Installments may become Due before their Due Dates

It is permissible for the Financial Institution to incorporate a clause stipulating a condition in the Murabaha agreement that all Installments may become due before their originally agreed due dates in case of the Customer's refusal to perform or delay in paying any Installment without any good reason. [35] This may take place in one of the following ways:

(a) the Installments automatically become due as a result of a mere delay in a payment, no matter how short the period of delay is.

[35] See Shariah Standard, p.121.

(b) The Installments become due after a delay in payment exceeding a specified time period.

(c) The Installments become due after the sending of a reminder notice by the Financial Institution to the seller giving a specified time period for payment.

The Financial Institution is entitled, in these circumstances, to waive a portion of its dues.

3.14 Commission And Expense

It is not permissible for the Financial Institution to receive a commitment fee from the customer.[36] It is also not permissible for the Financial Fnstitution to receive a fee for providing a credit facility. The expense of preparing the documents of the contract between the institution and the customer are to be divided between the two parties (the institution and the customer), provided they do not agree that the expenses are to be borne by one of the parties, and provided those expenses are fair, that is, they reflect the amount of work involved, so that they do not implicitly include a commitment fee or a facility fee.

If the Murabaha to the purchase order carried out by means if syndicated financing, the institution which acts as the arranger of the syndicate is entitled to claim an arrangement fee to be paid by the participants in the syndicate.

It is permissible for the institution to take a fee for a feasibility study that it undertakes, if the study is based on the request by the customer and is for his benefit, and he agreed to pay the fee from the outset.

[36] Ibid,pp.115-116.

3.15 Difference between Murabaha based financing and Conventional Bank lending

1. We understand that in conventional banking, the borrower (customer) approached to the Bank for loan and gets cash (interest bearing loan) from the (bank) lender. In case of Murabaha, the customer gets commodity, not cash. Once the Bank advanced the loan then thereafter it has no concern as to how the money is used by the Borrower. The reason is that the concern of the Bank is just with the interest to be paid by the borrower along with the return of principle loan amount not with application, use and purpose of the loan.

   In case of Murabaha based financing, no money is advanced by the Bank to the Customer because the Bank sells the Commodity to Customer usually on Credit. In Murabaha transaction, the Customer approached to the Bank and provide the detail description and specification of the Commodity required to the Customer. The Bank analyses the request and offers to the Customer the Murabaha facility in general. The Customer accepts the offer and promises to buy the specified Commodity at an agreed rate inclusive of Bank's profit. The Bank then purchases the Commodity and sell out the same to the Customer at an agreed terms and conditions in the light of the Shariah rules and Murabaha sale agreement is executed between the Bank and the Customer. It is crystal clear that in case of Murabaha the Bank sells the Commodity to the Customer usually on credit against which the Customer pays the original cost plus agreed profit. The cost and profit both are known to the Customer well in advance. Therefore it is clear that in case of Murabaha there is no question of loan in cash form to be given to the Customer against which interest is paid.

2. The rate of interest has become a policy-determined variable. But the rate of mark-up in Murabaha is determined by the demand and supply of goods and

services like all other prices. Murabaha financing is therefore more compatible with free market economy.

3. In the conventional financing system, loans may be advanced for any profitable purpose wither permissible or not under the Shariah. A gambling casino can borrow money from a bank to develop its gambling business. A pornographic magazine or a company making nude films are as good customers of a conventional bank as a house-builder. Thus, conventional financing is not bound by any divine or religious restrictions. Whereas the first important principle of Islamic Banking is that it must be governed by the Shariah, so the Islamic Banks and Financial Institutions must be operating in accordance with the teaching of religion. Therefore, Islamic banks would be conducting those businesses that are permitted and must be avoiding those activities that are forbidden to Muslims and also to avoid unethical practices. This is the reason that the Islamic Banks do not finance gambling, liquor, hoarding and usury based lending which are strictly prohibited. The gist of this explanation is that Islamic Banks cannot remain indifferent about the nature of the activity for which the facility is required. They cannot effect Murabahah for any purpose which is either prohibited in Shari'ah or is harmful to the moral health of the society.

4. As explained in the forgoing Chapter-2 that originally, Murabaha was not conceived of as a mode of finance rather it was sale but Islamic Banks/Financial Institutions joint the rules of the Murabaha sale with Credit sale and now Murabaha is used as mode of financing. One of the basic rule for the validity of Murabaha is that the commodity is purchased by the Bank/financier which means that the Bank/Financier assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he/it assumes. No such risk is assumed in an

interest-based loan. It is also worth noting that in case of Murabaha sale, the Seller (Banks/Financial Institutions) can not demand from the Purchaser (customer) the price of the commodity before it owned, possessed and deliver the same to the customer as against in the case of conventional financing the Bank/Financial Institutions can receive the prices/ rentals against the asset yet not owned, possessed and deliver to the customer.

5. In case of conventional Banking when the repayment is due, a regular loan can be rolled over with the customer paying interest for the extended time (often at a rate higher than the initial). This is not possible in Murabaha. What the customer owes is a price agreed against the Commodity in the beginning, which can not be increased because of delay in payment. Therefore it shows that in case of an interest bearing loan, the amount to be repaid by the borrower keeps on increasing with the passage of time whereas in case of Murabahah, on the other hand, a selling price once agreed becomes and remains fixed. As a result, even if the purchaser (Customer of the Bank) does not pay on time, the seller (Bank) cannot ask for a higher price, due to delay in settlement of dues. This is because in Shari'ah , there is no concept of time due of money.

6. At the macro level, Murabaha keeps the financing tied to real economic activity conducted through acquisition of goods and services, which is not the case with debt financing. Debt-financing contributes to higher inflation, and the availability of huge quantities of debt instruments in the market opens the door for speculative games that do not contribute to the real economy.

Chapter-4

Some Issues and Problems in Operation of Murabaha Financing

Murabaha is basically a sale and Islamic banks operate it as a mode of financing by providing commodity on deferred payment to the customers. When Murabaha is applied as financing technique then the credit risks are involve and several issues i.e. (securities, guaranteeing Murabaha price and sale of debts) arise to secure the repayment of the Murabaha price. In addition to these issues, there are some serious objections against Murabaha financing which are addressed to understand the true sense of Murabaha financing.

4.1 Securities against Murabaha Price

In Murabaha financing, the customer pays the Murabaha price in installments in a future fixed date(s). It is the credit risk of the Financial Institution because the customer may default in payment of Murabaha price. Therefore to secure this credit risk, the Financial Institution should ask the customer to provide lawful security in the contract of Murabaha to ensure repayment of the Murabaha price on due date(s). The security may be in the form of third party guarantee or the pledge of the investment account of the customer or the pledge and lien, charge, hypothecation or mortgage of any real (immovable) or moveable property or the pledge of the subject matter or the Murabaha contract as a fiduciary pledge (or a registered charge), either without taking possession of the pledged asset, or by taking possession of the pledged

asset and then releasing the pledge progressively according to the percentage of the total payment received.[1]

The basis for demanding collateral to secure payment is because such a requirement does not effect the contract, rather it consolidates performance and such guarantee are relevant to contracts involving credit.[2]

Basic Rules about the Security:

Following are the basic rules about the security;

1. The security can be claimed rightfully where the transaction has created a liability or a debt. No security can be asked from a person who has not incurred a liability or debt. However, it is also permissible that the client furnishes a security at earlier stages, but after the Murabaha price is determined.

2. It is also permissible that the sold commodity itself is given to the seller as a security. It is not necessary that the purchaser takes the delivery of the sold property before he surrenders it as mortgage to the seller. The only requirement would be that the point of time whereby the property is held to be mortgaged should necessarily be specified, because from that point of time, the property will be held by the seller in a different capacity which should be clearly earmarked.

[1] See Accounting and Auditing Organization For Islamic Financial Institutions's *Shariah Standard*, Manama, 2003, P. 121.
[2] Ibid, p.132.

4.2 Guaranteeing the Murabaha Price

The Financier in Murabaha financing (sale) can ask the customer to provide a third party guarantee that may be personal guarantee, corporate guarantee or even bank guarantee to ensure payment as per the agreed schedule. Such guarantee can be invoked if the customer fails to make payment on due date(s). Therefore in case of default, the Financier may have recourse to the guarantor who will be liable to pay the amount guaranteed to him. However, following are the two issues relating to this:

1. The guarantor cannot charge a fee from the original customer. The reason being that a person charging a fee for issuing a guarantee comes under the definition of riba.

2. The guarantor can only charge a documentation expenses.

4.3 Sale of Debts : Securitization of Murabaha

There is a general agreement among the Muslim Jurists that the sale of debts is not allowed except at their face value. The rationale usually given for this position is that the sale of debts involves riba (interest) as well as gharar (excessive uncertainty) both of which are prohibited by the Shariah.[3]

It is impermissible to issue negotiable instruments where the underlying asset consists of Murabaha receivables or other receivables. Likewise, it is not permitted to conclude a Murabaha contract on a commodity that was the subject matter of a

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[3] See M.Umer Chapra and Tariqullah Khan, *Regulation and Supervision of Islamic Banks*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 2000, p. 77.

previous Murabaha contract with the same customer, i.e. to refinance the transaction.[4] The basis for the prohibition of Murabaha tradable securities or refinancing of a Murabaha transaction is because these fail under the heading of sale of debt that is prohibited by Shariah.[5]

We are of the view that in case of Murabaha financing, the customer pays the Murabaha price in installments in a future fixed date(s). It shows the customer's debts payable against the Murabaha price to the Financial Institution. In conventional banking such debts can be securitized but in Murabaha being an Islamic mode of financing it can not be securitized. The procedure of securitization (the sale of debts or receivables) is that at the instruction of the Financial Institution, the customer signs a document (generally bills of exchange or it can be a demand promissory note) which evidences its/his indebtedness towards the Financial Institution. Further the customer accepts the document for payment of debts (receivables) to be paid to third party (usually a discount house or it may be a bank from where the Financial Institution gets discounting of receivables) nominated by the Financial Institution. Such acceptance is the transfer of debts whereby the customer will now pay its debts to the third party instead of the Financial Institution. Against the transfer of such debts, the third party pays the whole debts (receivables) of the customer to the Financial Institution at once. This procedure clearly shows a transfer of money. In Shariah, where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price as generally practiced by the conventional banks/Financial Institutions in discounting of bills of exchange. Therefore, the document representing a monetary obligation arising out of a Murabaha transaction cannot create a negotiable instrument. If the document is transferred, it must be at par value.

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[4] *Shariah Standard*, p .114.
[5] Ibid, p. 128.

4.4 Objections against Murabaha Finanicng

There are some Objections against Murabaha financing on the basis of which the net result is often considered the same as the net result of an interest-based loans. Apparently these objections seem to be logical to some extent but are based on a misunderstanding and misconception about the principles of Shari'ah regarding the prohibition of riba. When Murabaha financing is explained in its true sense of sale on deferred payment then it becomes clear that it is not in any case similar to interest based borrowing. Therefore it is necessary to address these objections/issues in the light of the principles of Shariah with regard to the Murabaha sale when used as a mode of financing. Following are the main three critical objections and its true answers with correct understanding.

4.4.1 Different pricing for cash and credit sales

The first Objection/Issue and question about Murabahah is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The Bank purchases the commodity on cash payment and sells it to the customer on credit. Here the important point is that while selling the commodity on credit, the Bank takes into account the period in which the price is to be paid by the customer and increases the price accordingly. The longer the maturity of the Murabaha payment, the higher the price. Therefore the price in a Murabaha transaction, as practiced by the Islamic banks, is always higher than the market price. If the customer is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a Murabahah transaction on deferred payment basis. The question arises as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. Some people argue that the increase of price

in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the Murabaha transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by the conventional banks.

This argument, which seems to be logical in appearance, is based on a misunderstanding about the principles of Shari'ah regarding the prohibition of riba. For the correct comprehension of the concept, the following points must be kept in view:[6]

The modern capitalist

The modern capitalist theory does not differentiate between money and commodity in so far as commercial transactions are concerned. In the matter of exchange, money and commodity both are treated at par. Both can be traded in. Both can be sold at whatever price the parties agree upon. One can sell one dollar for two dollars on the spot as well as on credit, just as he can sell a commodity valuing one dollar for two dollars. The only condition is that it should be with mutual consent.

Islamic principles, however, do not subscribe to this theory. According to Islamic principles, money and commodity have different characteristics and therefore, they are treated differently. The basic points of difference between money and commodity are follows:[7]

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[6] See Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idaratul Ma'Arif, Karachi, 1999, pp. 111-118.

[7] See Dr. M. Aslam Khaki and others versus Syed Muhammad Hashim and others, *PLD 2000, Supreme Court of Pakistan*, pp.716-717.(It is the famous Judgment on Riba decided on 23rd December, 1999 by Supreme Court of Pakistan).

(a) Money has no intrinsic utility. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring some goods or services. The commodities, on the other hand, have intrinsic utility. They can be utilized directly without exchanging them for some other thing.[8]

(b) The commodities can be of different qualities, while money has no quality except that it is a measure of value or a medium of exchange. Therefore, all the units of money, of same denomination, are 100% equal to each other. An old and dirty note of Rs. 1000/- has the same value as a brand new note of Rs. 1000/-, unlike the commodities which may have different qualities, and obviously an old and used car may be much less in value than a brand new car.

(c) In commodities, the transaction of sale and purchase is effected on a particular individual commodity or, at least, on the commodities having particular specifications. If A has purchased a particular car by pin-pointing it and seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the delivery of another car, though of the same type or quality. This can only be done if the purchaser agrees to it which implies that the earlier transaction is cancelled and a new transaction on the new car is effected by mutual consent. Money, on the contrary, cannot be pin-pointed in a transaction of exchange. If A has purchased a commodity from B by showing him a particular note of Rs. 1000/- he can still pay him another note of the same denomination, while B cannot insist that he will take the same note as was shown to him.

Keeping these differences in view, Islam has treated money and commodities differently.[9] Since money has no intrinsic utility, but is only a medium of exchange which has no different qualities, the exchange of a unit of money for another unit of the same denomination cannot be effected except at par value. If a currency note of

[8] Ibid.
[9] See Taqi Usmani, pp. 111-118.

Rs. 1000/- is exchanged for another note of Pakistani Rupees, it must be of the value of Rs. 1000/- The price of the former note can neither be increased nor decreased from Rs. 1000/- even in a spot transaction, because the currency note has no intrinsic utility nor a different quality (recognized legally), therefore any excess on either side is without consideration, hence not allowed in Shari'ah. As this is true in a spot exchange transaction, it is also true in a credit transaction where there is money on both sides, because if some excess is claimed in a credit transaction (where money is exchanged for money) it will be against nothing but time.

The case of the normal commodities is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of the purchaser. If the purchaser accepts to buy it at that increased price, the excess charged from him is quite permissible for the seller. When he can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will.

It is sometimes argued that the increase of price in a cash transaction is not based on the deferred payment, therefore it is permissible while in a sale based on deferred payment, the increase is purely against time which makes it analogous to interest. This argument is again based on the misconception that whenever price is increased taking the time of payment into consideration, the transaction comes within the ambit of interest. This presumption is not correct. Any excess amount charged against late payment is riba only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price,

may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity which has intrinsic utility may charge a higher price and the purchaser may agree to pay it due to various reasons, for example: (a) his shop is nearer to the buyer who does not want to go to the market which is not so near.

(b) The seller is more trust-worthy for the purchaser than others, and the purchaser has more confidence in him that he will give him the required thing without any defect.

(c) The seller gives him priority in selling commodities having more demand.

(d) The atmosphere of the shop of the seller is cleaner and more comfortable than other shops.

(e) The seller is more courteous in his dealings than others.

These and similar other considerations play their role in charging a higher price from the customer. In the same way, if a seller increases the price because he allows credit to his client, it is not prohibited by Shari'ah if there is no cheating and the purchaser accepts it with open eyes, because whatever the reason of increase, the whole price is against a commodity and not against money. It is true that, while increasing the price of the commodity, the seller has kept in view the time of its payment, but once the price is fixed, it relates to the commodity, and not to the time. That is why if the purchaser fails to pay at the stipulated time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.

To put it in another way, since money can only be traded in at par value, as explained earlier, any excess claimed in a credit transaction (of money in exchange of money) is against nothing but time. That is why if the debtor is allowed more time at maturity, some more money is claimed from him. Conversely, in a credit sale of a

commodity, time is not the exclusive consideration while fixing the price. The price is fixed for commodity, not for time. However, time may act as an ancillary factor to determine the price of the commodity, like any other factor from those mentioned above, but once this factor has played its role, every part of the price is attributed to the commodity.

The conclusion of the above discussion is that when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and credit transactions. Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money.

This position is accepted unanimously by all the four schools of Islamic law and the majority of the Muslim jurists. They say that if a seller determines two different prices for cash and credit sales, the price of the credit sale being higher than the cash price, it is allowed in Shari'ah. The only condition is that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of the transaction. For example, it is allowed for the seller, at the time of bargaining, to say to purchaser, "If you purchase the commodity on cash payment, the price would be Rs. 100/- and if you purchase it on a credit of six months, the price would be Rs. 110/-" But the purchaser shall have to select either of the two options. He should say that he would purchase it on credit for Rs. 110/- Thus, at the time of actual sale, the price will be known to both parties. However, if either of the two options is not determined in specific terms, the sale will not be valid.

Another point must be noted here. What has been allowed above is that the price of the commodity in a credit sale is fixed at more than the cash price. But if the sale has taken place at cash price, and the seller has imposed a condition that in case

of late payment, he will charge 10% per annum as a penalty or as interest, this is totally prohibited; because what is being charged is not a part of the price; it is an interest charged on a debt.

The practical difference between the two situations is that where the additional amount is a part of the price, it may be charged on a one time basis only. If the purchaser fails to pay it on time, the seller cannot charge another additional amount. The price will remain the same without any addition. Conversely, where the additional amount is not a part of the price it will keep increasing with the period of default.

We are of the view that so for this objection and question is concern as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. As stated above that some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated like the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. This argument and understanding is based on a misconception and misunderstanding about the principles of Shari'ah regarding the prohibition of riba. It may be recalled that Murabaha is asset backed financing. In a Murabaha transaction, the Financial Institution acquires the commodity at the order of the customer and after getting ownership and possession the same commodity is sold to the customer at the original cost plus agreed profit margin on deferment of payment. The most important point here is that the cost and profit must be known and agreed to both the parties and all other basic rules/principles of Murabaha financing as explained in the previous chapter should must be fulfilled to make the transaction Shariah compliant. When the cost and profit margin is known to the customer and there is no ambiguity in the Murabaha Sale then the transaction is valid even the price is high than the present market. We understand that commodities have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a

fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of the purchaser. If the purchaser accepts to buy it at that increased price, the excess charged from him is quite permissible for the seller. Now the most important point is that when seller can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will as also necessary in ordinary sale.

In support of the above statement, the following Fatwas (legal opinions) may be perused:

Fatwa[10]:

"According to the Shariah, it is lawful to apply a scale of direct proportion on profits that is based on the payment period and the nature of the goods to be sold. This, however, is provided that the "purchase pledger" [11] knows how much profit he will have to pay for.

This Fatwa is based on the following considerations:

1. A fundamental requirement in any Murabahah sale is that the profit be known by both seller and purchaser.

2. It is not a condition in Murabahah sales that the price be paid in cash. In an other than cash sales, the transaction will be subject to the rulings regarding credit sales.

[10] Fatawa of the Jordan Islamic Bank: vol.1.pp.28-30, Yusuf Talal DeLorenzo, *A Compendium of Legal Opinions on the Operations of Islamic Banks*, 2001, Institute of Islamic Banking and Insurance, London, p. 4.
[11] Purchase Pledger means the Customer who is the Purchaser of the Commodities (goods) from the Bank/Financial Institution.

3. It is the opinion of the jurists that if a seller says to purchaser, "I will sell you this commodity right now for either ten in cash or fifteen on credit, whichever you choose," the sale will be valid.

4. Scholars have noted that in Murabaha sales the profit is considered in respect of the capital, and in credit sales profit is considered in respect of the return for the commodity and credit period.

5. In his fatwa, Ibn Taymiyah stated that customary practices (in the marketplace) are prima facie lawful; and that sales, gifts, leases, and the like, where people need to deal with one another, are customary practices and that nothing in these dealings is prohibited unless specifically mentioned as unlawful by the Shari'ah."

Fatwa:[12]

"Murabaha sales are well known in the Shariah and are lawful by consensus, whether they are conducted for cash or credit. Moreover, the misgiving that Murabaha involves interest, as a sale on credit, is without basis, and the same is true of misgivings concerning credit sales on terms.

A usurious transaction of exchange in a loan on interest takes place when like commodities are exchanged. A lender, for example, will loan a hundred dollars for a certain period of time and will receive in exchange a hundred and ten dollars. In a Murabaha sale on credit, however, the exchange is between unlike commodities, like goods and cash. Therefore, how can a Murabaha sale be compared to a usurious transaction? It should further be noted that in a Murabaha sale, even though the profit is fixed, the seller may still suffer a loss if market prices rise; and if market

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[12] The first Albarakah Seminar, Fatwa no.8, al Fatwa al Shar'iyah li Majmu'a al Barakah:Fatawa 73, pp.98-101, Jordan Islamic Bank, al Fatawa al Shar'iyah, Yusuf Talal DeLorenzo, pp.99-103.

prices go down, the buyer may suffer a loss. All of this is a function of supply and demand in regard to the commodity, rather than the supply of and demand on cash".

It may also be recalled that any excess amount charged against late payment is riba only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity which has intrinsic utility may charge a higher price and the purchaser may agree to pay it due to various reasons.

At the end we clarify the position of Murabaha financing transaction that it is not an interest based transaction. It is asset based financing and is Shariah Compliant. However the rules/principles required to be adopted in Murabaha financing must be complied in sequence.

4.4.2 The use of Interest-Rate as Benchmark

The second objection and question most oftently raised against Murabaha financing is that interest rate is used as bench mark for determining and calculating the profit margin being charged over and above the original cost.[13]

We know that in conventional banking the interest rate is being used to calculate the interest amount to be charged over and above the principal amount of loan. If in case of Murabaha financing, the interest rate is applied to calculate the profit to be charged over and above the original cost of the commodity (asset), apparently that really makes the transaction resemble to the interest based financing. No doubt interest rate is used as bench mark in both the transaction to calculate the amount of interest in case of interest based transaction and to calculate the amount of

[13] See M. Umer Chapra and Tariqullah Khan, pp..55-56.

profit in case of Murabaha financing but it is crystal clear that Money is advanced as loan in case of interest based transaction whereas commodity is sold to the customer on deferment of payment in case of Murabaha financing.

Murabaha is the resale at fixed rate of profit on the stated original cost. When the Murabaha is being used as a mode of financing in Islamic banking, the banks or Financial Institutions hereinafter referred to as the "Financial Institution" must know the original cost of the commodity as it needs to be disclosed to the Purchaser (customer) and must fixed the profit to be charged over and above the original cost as it needs to be known and agreed by the customer. Therefore most of the Financial Institutions in Pakistan while financing by way of Murabaha determine their profit or mark-up on the basis of the current interest rate, using KIBOR (Karachi Inter-bank offered rate) as the criterion. Outside Pakistan instead of KIBOR, LIBOR (London inter-bank offered rate) is used and applied to calculate and determine the profit. For example, if KIBOR/LIBOR is 10%, they determine their mark-up on murabahah equal to KIBOR/ LIBOR or some percentage above KIBOR/LIBOR. This practice is often criticized on the ground that profit based on a rate of interest should be as prohibited as interest itself.

As a matter of fact there is no doubt that the use of the rate of interest for determining a halal profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of interest, even this apparent resemblance should be avoided as far a possible. But one should not ignore the fact that the most important requirement for validity of Murabaha is that it is a genuine sale with all its ingredients and necessary consequences. If a Murabaha transaction is based on Islamic principles and fulfils all the conditions enumerated in the previous chapter, merely using the interest rate as a benchmark for determining the profit of Murabaha does not render the transaction as invalid, haram or prohibited, because the deal itself

Solution to this problem is sought in the Murabaha arrangement by asking the client to sign a promise to purchase the commodity when it is acquired by the financier. Instead of being a bilateral contract of forward sale, it is a unilateral promise from the client which binds himself and not the financier. Being a one-sided promise, it is distinguishable from the bilateral forward contract.

This solution is subjected to the objection that a unilateral promise creates a moral obligation but it cannot be enforced, according to Shari'ah, by the courts of law. This leads us to the question whether or not a one-sided promise is enforceable in Shari'ah. The detail examination of this question in the light of the original sources of Shariah is as follows:

4.4.3.1 Status of Promise in the light of the Holy Quran and the Sunnah

It is worth mentioning that the Holy Qur'an and the Sunnah of the Prophet (PBUH) are very clear and particular about fulfilling promises.

The Holy Quran says:

"And fulfill the covenant. Surely the covenant will be asked about (in the hereafter)".

(Bani Isra'il : 34)

"O those who believe, why do you say what you not do. It invites Allah's anger that you say
what you not do". (al-Saf:2 to 3)

Imam Abu Bakr al-Jassas has said that this verse of the Holy Qur'an indicates that if one undertakes to do something, no matter whether it is a worship or a contract, it is obligatory on him to do it.[15]

[15] See Al-Jassas, Ahkamul Quran 3:420 as quoted by Taqi Usmani, p.124.

The Holy Prophet (PBUH) is reported to have said:

"There are three distinguishing features of a hypocrite: when he speaks, tells a lie, when he promises, he backs out and when he is given something in trust, he breaches the trust."[16]

There is a large number of injunctions in the ahadith of the Holy Prophet (PBUH) where it is ordained to fulfill the promises and it is clearly prohibited to back out, except for a valid reason.

Therefore, it is evident from these injunctions that fulfilling promise is obligatory. However, the question whether or not a promise is enforceable in courts depends on the nature of the promise. There are certainly some sorts of promises which cannot be enforced through courts. For example, at the time of engagement the parties promise to go through the marriage. These promises create a moral obligation, but obviously they cannot be enforced through courts of law. But in commercial dealings, where a party has given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced. Therefore, on the basis of the clear injunctions of Islam, if the parties have agreed that this particular promise will be binding on the promisor, it will be enforceable.

This is not a question pertaining to Murabaha alone. If promises are not enforceable in the commercial transactions, it may seriously jeopardize commercial activities. If somebody orders a trader to bring for him a certain commodity and promises to purchase it from him, on the basis of which the trader imports it from abroad by incurring huge expenses, how can it be allowed for the former to refuse to purchase it? There is nothing in the Holy Qur'an or Sunnah which prohibits the making of such promises enforceable.

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[16] See Sahih-al-Bukhari, Kitab al-iman as quoted by Taqi Usmani, p.124.

4.4.3.2 Status of Promise in Classical Islamic Jurisprudence

1. Shafi'i and Hanbali Jurists are of the view that promises are not mandatory. They represent just a moral obligation on promisor to fulfill his promise.[17]

   Some Jurists are of the opinion that fulfilling a promise is noble quality and it is advisable for the promisor to observe it and its violation is reproachable, but it is neither mandatory (wajib), nor enforceable through courts. This view is attributed to Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and to some Maliki jurists.[18]

2. A number of the Muslim jurists are of the view that fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfill his promise. According to them, promise can be enforced through courts of law. This view is ascribed to Samurah b. Jundub (RATA) the well known companion of the Holy Prophet (PBUH), Umar b. Abdul Aziz, Hasan al-Basri, Sa'id b. al-Ashwa', Ishaq b. Rahwaih and Imam al-Bukhari. The same is the view of some Maliki jurists[19], and it is preferred by Ibn-al-'Arabi and Ibn-al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah.

3. The third view is presented by some Maliki jurists. They say that in normal conditions, promise is not binding, but if the promisor has caused the promise

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[17] See Muhammad Tahir Mansuri, *Islamic law of contracts and Business transactions*, :Shariah Academy, International Islamic University, Islamabad, 2005, p.189.
[18] See Ibid and Taqi Usmani, pp. 121-122.
[19] See Tahir Mansuri, p.219.

to incur some expenses or undertake some labor or liability on the basis of promise, it is mandatory on him to fulfill his promise for which he may be compelled by the courts.[20]

4. The Hanafi and Maliki Jurists acknowledge the validity of bay'al-wafa which establishes the fact that the Hanafis and Maliki also favor the concept of the binding nature of promises. Bai' bil wafa' is a special kind of sale whereby the purchaser of an immovable property undertakes that whenever the seller will give him the price back, he will resell the house to him.[21]

4.4.3.3 Status of Promise in Modern Islamic Jurisprudence

The Islamic Fiqh Academy, Jeddha has made the promises in commercial dealings binding on the promisor with the following conditions:[22]

(a) it should be one-sided promise.

(b) the promise must have caused the promisee to incur some liabilities.

(c) If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the concluded sale.

(d) If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by him, but will not include the opportunity

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[20] See Taqi Usmani, p. 122.

[21] See Ibn Juzy, al-Qawanin al-Fiqhiyyah, p.258, Ibn Qudamah, al-Mughni, vol.4,pp.17-195, as quoted by Tahir Mansuri, p. 219;
Taqi Usmani, p. 123.

[22] Resolution No.2 and 3, Islamic Fiqh Academy, See Academy's Journal No.5, vol.2, p. 1509.

cost.

Keeping in view the status of Promise in the light of (i) the Quran and the Sunnah (ii) in view of Muslim Jurists (iii) in accordance with the Resolution No.2 and 3 of the Islamic Fiqh Academy (iv) the procedure and nature of financing under Murabaha sale, we are of the view that promises are binding on the promisor specially in the commercial transactions. Here the Promisor is the customer and the Promisee or in whose favor the promise or undertaking is executed is the Financial Institution.

We are of the view that when Murabaha sale is being used as method of financing in Islamic Banks/Financial Institutions, the customer first approached to the Financial Institution to provide Murabaha facility under Murabaha sale and provide the description of the commodity. Under the basic rules of Murabaha, the Financial Institution is required to first acquire the commodity from the Supplier and then sell out the same to the customer because prior to the ownership and possession of the commodity, the Financial Institution can not enter into an agreement of Murabaha sale of the commodity. For this reason, the Financial Institution first purchases the commodity and after getting ownership and possession then sells the same to the customer under the Murabaha sale. Now the question arises that in case the Financial Institution purchases the commodity at the order of the customer and the customer refuses to purchase the same commodity from the Financial Institution then in such a circumstances who will bear the losses to be incurred to the Financial Institution because due to a number of reasons, the Financial Institution will not get its total cost incurred into the purchasing of the commodity. To avoid losses in such a circumstances, it is necessary for the Financial Institution to obtain from the customer

an undertaking (Promise) that as and when the Financial Institution acquired the required commodity, the same will be purchased from the Financial Institution failing which the customer will be liable for all the losses incurred in this connection. The reason is crystal clear that it is not the business of the Financial Institution to purchase and own the commodity for itself but in fact the business of the Financial Institution is to purchase the commodity at the order of the customer and then sells the same to the customer at original cost and already agreed and decided profit margin. Therefore it seems appropriate that the promise must be binding on the customer otherwise a lot of problems will be created in the trade and banking sector.

As explained above, it is allowed that the customer promises to the Financial Institution that he will purchase the commodity after the latter acquires it from the supplier. This promise will be binding on him and may be enforced through courts. This promise does not amount to actual sale. It will be simply a promise and the actual sale will take place after the commodity is acquired by the Financial Institution for which exchange of offer and acceptance will be necessary.

4.5 Applications of Murabaha financing

Murabaha has become one of the most popular techniques among Islamic banks. It has been estimated that 70-80 percent of the total finance provided by Islamic banks is through Murabaha. Hence, the technique is widely used by Islamic banks to satisfy different financing requirements of such various sectors of the economy as: industry, agriculture, domestic trade, construction and real estate, transportation, international trade.[23] Therefore the applications of Murabaha financing can be made in the following areas and sectors: [24]

[23] See Ausaf Ahmad, *Contemporary Practices of Islamic Financing Techniques*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1993, pp. 38.
[24] www.bankalbilad.com

- Financing of purchasing commodities and goods from the local markets
- Financing import and export transactions
- Financing fixed assets (machines and equipments)
- Financing of working capital (purchasing feedstock used for production and raw material for factories)
- Financing construction and installations material purchases
- Financing purchasing of real estate (land and building)
- Financing agriculture sector

4.6 Penalty in case of Default or Late Payment

In conventional Banking where an interest-based loans are advanced to the customer, the amount of loan keeps on increasing according to the period of default or to the period of late payment. But in Murabaha financing, once the price is fixed, it cannot be increased. This restriction is sometimes exploited by dishonest customer who deliberately avoid to pay the price at its due date, because they know that they will not have to pay any additional amount on account of default or late payment.

In order to resolve this issue, some contemporary scholars have suggested that the dishonest customers who default in payment deliberately should be made liable to pay compensation/penal charges to the Financial Institution for the loss it may have suffered on account of default.[25]

[25] See Taqi Usmani, p. 132.

It is argued in favor of charging compensation that the Holy Prophet (PBUH) has condemned the person who delays the payment of his dues without a valid cause. According to the well-known hadith he has said,

"*The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace.*"[26]

It is important to know the actual reasons of the default. If it appears that the default of the customer is due to poverty, no penalty or compensation can be charged or claimed from it/him. Indeed, he must be given respite until he is able to pay[27], because the Holy Qur'an has expressly said,

"*And if he (the debtor) is short of funds, then he must be given respite until he is well off.*" (2:280)

But again the question arises that how it can be judged that the default is genuine and there is no willful and deliberately default. To answer such question, the customer may have to provide sufficient evidences in its/his defense to prove that the default is due to poverty and is due to financial crises beyond his/its control. In case the Financial Institution disagrees to the evidences then it can be judged by the Competent Court of Law.

However to resolve and understand this issue, the following important points may be noted:

1. it is permissible that the contract of Murabaha consist of an undertaking from the customer to pay an amount of money or a percentage of the debt, to be donated

[26] Sahih al-Bukhari, hadith No.2400, with fath al-Bari, V.5, p.62. as quoted by Taqi Usmani, pp. 134-135.
[27] Taqi Usmani, p. 133.

to charitable causes in the event of a delay on his part in paying installments on their due date. The Shariah supervisory board of the Financial Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Financial Institution itself.[28]

This rule is based on a ruling given by some Maliki jurists who say that if a debtor is asked to pay an additional amount in case of default, it is not allowed by Shari'ah, because it amounts to charging interest. However, in order to assure the creditor of prompt payment, the debtor may undertake to give some amount in charity in case of default.[29] The proper wording of the penalty clause would be on the following pattern:

"The customer hereby undertakes that if he/it defaults in payment of any of his/its dues under this agreement, he/it shall pay to the charitable account/fund maintained by the Bank/Financial Institution a sum calculated on the basis of ...% per annum for each day of default unless he/it establishes through the evidence satisfactory to the Bank/ Financial Institution that his/its non-payment at the due date was caused due to poverty or some other factors beyond his/its control."[30]

2. when there is default in payment by the Customer with regard to installments of the selling price that are due, the amount due is just the amount of the unpaid selling price. It is not permissible for the Financial Institution to impose any additional payment on the Customer for the Financial Institution's benefit. This provision is, however, subject to the above stated point 1.[31]

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[28] *Shariah Standard*, p 122.
[29] See Taqui Usmani, p.138.
[30] Ibid,p.139.
[31] Shariah Standard, p.122.

It is permissible to agree on the payment of the price of the item under Murabaha to the purchase orderer either by short or long term installments, and the selling price of the asset becomes a debt that the customer is obligated to pay at the time agreed upon. It is not permitted subsequently to demand any extra payment either in consideration of extra time given for payment or for delay in payment that may be for a reason or no reason.

In short we can say that in Murabaha transaction, there is no provision of extra charges to be charged from the customer for the benefit of the Financial Institution in case of its/his default in payment of the price at the due date(s). Hence the price cannot be changed nor can penalty fees be charged.

Chapter- 5

Murabaha Financing Practices in Pakistan

5.1 Brief background

The process of economy-wide Islamization of the banking system in Pakistan started in Pakistan after the then President of Pakistan specifically asked the Council of Islamic Ideology on 29-9-1977 to prepare a blue-print of an interest-free economic system and later on declare that the government planned to remove interest from the economy within a period of three years.[1] To assist the Council[2] in the delicate task of finding the ways and means to eliminate Interest (riba) from the country's economy, and to re-model the economic and financial system of the country in accordance with the injunctions of Islam, the Council appointed a Panel of Economists and Bankers in November, 1977. The Panel submitted its Report to the Council in February, 1980, which was considered by the Council in several meetings. While considering the Report, the Council modified or substituted some of the recommendations so as to bring them in conformity with the Shariah and finally adopted a consolidated Report in its meeting held at Karachi on 15th June, 1980. In this Report the Council pointed out and recommended (i) equitable sharing of risks and gains encouraged by Islam (ii) practical considerations in applying the profit/loss sharing system and (iii) a number of other possible devices[3] to replace the fixed interest system which may be in conformity with Shariah.[4] It may be noted that on the Council's Report,[5] a decision had been

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[1] Report of the Council of Islamic Ideology on the *"Elimination of Interest from the Economy"*, June, 1980, Council of Islamic Ideology, Government of Pakistan, Islamabad, p. (xi) Preface.
[2] Council means Council of Islamic Ideology.
[3] Other possible devices include Service charge, Indexation of bank deposits and advances, Leasing, Investment auctioning, Bai Muajjal, Hire-purchase, Financing on the basis of normal rate of return, Time multiple counter-loans and Special loans facility.
[4] Report of the Council of Islamic Ideology, pp. 7-31.
[5] Ibid. p.(xi) Preface.

taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and the Investment Corporation of Pakistan. Within a few months of this announcement, these specialized financial institutions took the necessary steps to reorient their activities on a non-interest basis. In January 1981, separate counters for accepting deposits on a profit/loss sharing (PLS) basis in all the domestic branches of the five nationalized commercial banks were set up. This parallel system, in which savers had the option to keep their money with the banks either in interest-bearing deposits or PLS deposits, continues to operate till the end of June 1985.

In this process of Islamization of banking, State Bank of Pakistan "SBP" issued a Circular[6] No.13 regarding Elimination of Riba from the Banking System. Under this Circular, As from Ist July 1985, no banking company was allowed to accept any interest-bearing deposits except foreign currency deposits, which continued to earn interest. As from that date, all deposits accepted by banks share in the profit and loss of the bank, except deposits in current accounts on which no interest or profit is given and whose capital sum is guaranteed. On the asset side under the same Circular, the SBP introduced 12 permissible modes of financing.

Keeping in view the gradual Islamization process, Murabaha financing Practices in Pakistan can be divided into the following two periods:

5.1.1 Murabaha Financing Practices in Pakistan (1980-1998)

Under the said Circular No.13 of the SBP, a time frame[7] was given to the banks to shift over to the prescribed 12 Islamic modes of financing in which funds mobilized by the banks could

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[6] BCD Circular No.13 dated 20th June, 1984, titled *Elimination of Riba from the Banking System* issued by State Bank of Pakistan, Banking Control Department, Central Directorate, Karachi.

[7] Under Clause (iii) of the Circular, As from the Ist April, 1985 (this was the last date in the time frame), all finances provided by a banking company to all entities including individuals shall be only in any one of the 12 modes as mentioned above.

be employed. These included: (i) loans not carrying any interest on which the banks may recover a service charge not exceeding the proportionate cost of the operation, excluding the cost of funds and provision for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the State Bank from time to time; (ii) qard-e- hasana[8]; (iii) *purchase of goods by banks and their sale to clients at an appropriate mark up in price on a deferred payment basis*; (iv) purchase of trade bills; (v) *purchase of moveable or immovable property by the banks from their clients with buy-back agreements or otherwise*; (vi) leasing; (vii) hire-purchase; (viii) financing for development of property on the basis of a development charge; (ix) musharakah or profit and loss sharing; (x) equity participation and purchase of shares; (xi) purchase of Participation Term Certificates; and mudarabah certificates, and (xii) rent sharing.an Islamic modes of Financing were introduced and all Banks were asked to adopt the mark-up based technique for financing with or with out buy-back arrangement.

5.1.1.1 Modes of Murabaha

In the above prescribed 12 modes of Islamic financing, although the word "Murabaha" was not clearly mentioned, however modes of financing mentioned at (iii) and (v) were considered as Murabaha and the banks started its practices in Pakistan.

5.1.1.2 First Mode

Purchase of goods by banks and their sale to clients at appropriate mark-up in price on deferred payment basis. Under the technique of mark-up, a sale transaction is arranged at price mutually agreed upon between the buyer and seller. The sale price consists of the cost of goods plus margin of profit and the same is payable by the buyer on deferred basis either in lump sum or in installments. While extending the facility, the banks takes into consideration the credit worthiness, dealings, securities offered and cash flow of the

[8] Qard-e-Hasana loans given on compassionate ground free of any interest or service charge and repayable if and when borrower is able to pay.

customer. It also analysis the resale of the goods and other credit risks. Following procedure was use to be adopted in this mode of financing:

1. The customer approaches to the bank requesting for certain amount of finance on Murabaha base.

2. The customer purchases the commodity from the supplier and obtains invoices in the name of the bank to show that it has been purchased by the bank.

3. The bank provides finance to the customer against a sale transaction. The sale price consist of the cost of goods plus margin of profit and the same is payable by the buyer (customer) on deferred basis either in lump sum or in installments.

5.1.1.3 Objections against the above Mode

The above mode of Murabaha was totally against the Shariah in the light of the following objections:

1. The bank does not purchase the commodity needed by the customer as required in Murabaha sale. It only provides finance to the customer to purchase the commodity.

2. The bank charges a predetermined increase over the amount of finance, which makes Murabaha similar to charging increase over and above the amount of loan.

3. The bank only introduces the word mark-up instead of interest.

4. It does not bear any risk.

5. The bank shows documentary purchase and sale in the Murabaha financing, there was no actual purchase and sale transaction.

5.1.1.4 Second Mode

Purchase of movable and immovable property by the banks from their customers with buy-back agreement or otherwise:

Under this transaction of mark-up based financing with buy-backed arrangement, simultaneous transactions of purchase and re-purchase of movable and immovable property are made between the bank and customer at a mutually agreed price for a specified period. The bank purchases an asset, movable or immovable at an agreed price, which the party agrees to re-purchase at a marked-up price payable on deferred basis either in lump sum or in installment with following procedure;

1. The word mark-up was used instead of interest.

2. The customer approached the bank requesting that he needs certain amount say Rs. 5,000/- financing facility to be based on Murabaha.

3. The bank purchased commodity (without any description and specification as required in the case of Murabaha sale) from the customer up to the value of Rs. 5,000/- and at the same time sold the same commodity to the customer on Rs.5,500/- payable to the Bank on a later date i.e. after the period of one year. The Bank in fact paid to the customer Rs. 5,000/- against which it received from the customer Rs. 5,500/- after one year. These purchases and sales were fictitious and documentary. No actual purchase/sale had taken place.

4. Generally the bank obtained collateral in the shape of mortgages and charges etc. as in the case of loan.

5.1.1.5 Objections against the above Mode:

1. There is no real purchase and sale of commodity involve in the transaction. It is only documentary and artificial sale and purchase of commodity.
2. It is a fictitious deal that ensures a predetermined profit to the bank without actually dealing in goods.
3. There is no risk of the bank.
4. It is interest based transaction.
5. Buy-back is in fact a form of prohibited sale called bay'Inah[9] in Islamic law.

In short the banks were providing interest based loans to the customers in the name of Murabaha financing. The loan transactions did not even resemble the Murabaha. Rescheduling on mark-up over mark-up and on extra charges and rollover were a common practices of the Banks as in the case of other interest based loans. All the terms and conditions and procedure of interest based loan were applied in the Murabaha transaction.

The above practices of Murabaha financing has now become past and as such no such interest based financing in the name of Murabaha are providing by the Islamic Banks in Pakistan. Furthermore the Federal Shariat Court declared the above procedure adopted by banks in Pakistan since April 1, 1985 based on Mark up technique un-Islamic in November 1991.

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[9] Inah sale means to sell commodity on cash and then buy it back at a higher price to be paid on some specified time in future. It is called inah because the 'ayn (substance) sold by the seller returns to him. Malik and Ahmed Ibn Hanbal prohibited this transaction because it is a legal device for dealing in riba. (see Al-*Murabaha fi Bank Dubai al-Islami*, p.15, as quoted by Muhammad Tahir Mansuri, *Islamic law of contracts and Business transactions*, Shariah Academy, International Islamic University, Islamabad p. 224).

5.2 Murabaha Financing Practices in Pakistan (1999-2007)

Islamic banks started Islamic financing including Murabaha as a major financing technique after Islamization movement in Pakistan. Islamization movement started pursuant to the compliance of the famous Judgment of the Supreme Court of Pakistan on Riba passed on December 23, 1999[10]. Consequently the present progressive Islamic banking started in January 2003, when SBP[11] issued criteria for establishment of Islamic banks in private sector. A full fledged Islamic Banking department was set up in SPB in September 2003 to supervise the sector, review and process applications, issue guidelines along with a Shariah Board on December 2003 that advises the SBP on modes, procedure, laws and regulations for Islamic banking. All Islamic Banks are regulated by the Islamic Banking department of SBP and are bound to comply with the Essentials of Murabaha financing duly approved by the SBP's Sharia Board.

At present, Al Baraka Islamic Bank Limited, Meezan Bank Limited, Dubai Islamic Bank Limited and now BankIslami Pakistan Limited are full fledged Islamic Banks of Pakistan providing finance facility under Islamic modes of financing including Murabaha[12]. MCB, Standard Chartered Bank, Bank of Khyber, Bank Al Falah, Habib Bank A.G.Zurich, Bank Al Habib, Metropolitan Bank, Soneri Bank, Askari Commercial Bank Limited and Habib Bank Limited were allowed to open Islamic banking branches. These Banks have as many as 62 Islamic banking branches operating in 13 cities all over the country as on September 20, 2006. This data is available on the websites of SBP and BankIslami.

The significant feature of Murabaha financing of Islamic banks in Pakistan is that Murabaha to the purchase orderer is being practiced which is the modern and devised form of Murabaha sale. In fact the banks have added the concept of deferred payment to the

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[10] See Dr. M. Aslam Khaki and others versus Syed Muhammad Hashim and others, PLD 2000, Supreme Court of Pakistan. (It is the famous Judgment on Riba decided on 23rd December, 1999 by Supreme Court of Pakistan).
[11] SBP stands for State Bank of Pakistan.
[12] www.bankislami.com.pk

concept of sale and the combination of both is developed as Murabaha to the purchase orderer. Under this scheme, the customer approaches the bank and provides description, quality, quantity of the required commodity with the request to purchase it and then sell the same commodity to him. If the bank acceded to the request of the customer then it executes overall agreement incorporating all terms and conditions of the Murabaha facility with the customer. Generally the banks appoint the customer its agent to purchase the commodity for and on behalf of the bank. The customer purchases the commodity and takes possession on behalf of the bank and informs the bank accordingly. The customer then offers to purchase the same commodity from the bank and the bank accepts the offer and sale of Murabaha is concluded.

The period of Murabaha financing varies from bank to bank. Some banks provide it up to the maximum period of one year whereas some banks extend it up to two or three years. All banks prefer to apply Murabaha financing for short term period.

The Profit is determined and calculated on the basis of the current interest rate, i.e. KIBOR (Karachi Inter-banks offered rate). For example, if KIBOR is 10%, they determine their mark-up on Murabahah equal to KIBOR or some percentage above KIBOR. However it is fixed and known to both the parties before Murabaha transaction.

The Murabaha financing is applied against various commodities like raw materials, machinery, equipment, construction machinery and machinery of agriculture sector. Some banks provide Murabaha facility against import and export also. Some banks provide Murabaha financing against real estate where some provide only the material used in construction and do not provide financing against purchase of land.

It has been observed that all the banks appoint the customers its agent in almost all the Murabaha transaction who purchases the commodity for and on behalf of the bank and then subsequently purchases the same from the bank.

It has also been noted that in most of the transactions the banks make the payment to the supplier through its agent (customer) and obtain evidence that the same payment is made to the supplier. However some banks do not allow payment to the supplier through its agent or any third Party and make payment to the supplier directly in any case.

5.3 Shariah Compliance in Murabaha Financing

The present practices of Murabaha financing apparently seem in accordance with Shariah. The Islamic banks are bound to comply with Shariah rulings of the SBP. The internal procedure of Islamic banks and documents being obtained in Murabaha financing vary from bank to bank. However the basic documents to achieve the required purpose are almost the same in all the banks without any substantial difference. There are, however, some small difference in practice and procedure. For example some Islamic banks execute the agreement with the customer title of which is Murabaha financing agreement and some banks titled the same agreement as Murabaha sale agreement. Like wise some banks sign with the customer Master Murabaha agreement in initial stage and thereafter execute sub-Murabaha(s) whereas some banks do not use this terminology. They even do not execute such agreement because they simply obtain an undertaking (promise) from the customer and purchase the commodity. Consequently the bank sells the commodity and execute Murabaha sale agreement at the actual stage of Murabaha financing.

In short all the Islamic banks follow Shariah Compliant procedure to advance Murabaha financing which is permissible. After the request of the customer, all the banks purchase the commodity and take possession. When the bank becomes the owner and takes possession then it sells the same commodity to the customer on deferred payment on cost plus profit which is determined before the Murabaha transaction.

Beside the above information being collected from various banks, it is pertinent to highlight that the internal procedure and documentations of Islamic banks cannot be checked

to know its compliances with Shariah rules. Therefore it seems necessary that each bank/financial institution should have its Shariah Advisor and Shariah Compliance Officer to certify every Murabaha financing transaction to ensure Shariah Compliances. Furthermore there must be Shariah Advisor and Shariah Compliance Officer of State Bank of Pakistan and Securities and Exchange Commission of Pakistan to ensure that Murabaha financing transaction of all banks/financial institutions are in compliance with Shariah.

5.4 Some Violations in Murabaha Financing

Although Islamic banks have developed their Shariah Compliant procedures under the supervision of its Shariah Advisors for extending Murabaha financing and are also complying with the Shariah essentials of State Bank of Pakistan. However, it has been observed that some basic violations are usually committed in Murabaha transactions by the Banks/Financial Institutions. These are as follows:

1. In some cases it has been reported that commodity is purchased at the request of the customer and then sold to the customer under Murabaha financing whereby Murabaha price was payable through monthly installments. Subsequently the monthly installments were increased giving reason that the rate of mark-up has been increased. This is totally against the basic principles of Murabaha because in Murabaha, price is fixed once for all and no subsequent increase or decrease is allowed. The reason is that Murabaha is the sale of a commodity and once the price is fixed, it can not be changed in any case.

2. It has also been observed that in some cases, sale of commodity to the customer is effected before the commodity is acquired by the bank from the supplier. This mistake is invariably committed in transactions where all the documents of Murabaha are signed at one time without taking into account various stepwise procedure of the Murabaha. In fact the banks/financial institutions can not sell the

commodity unless and until it acquires the same. Once the bank acquires the commodity then it can sell the same. The banks/financial institutions are supposed to observe and follow all the required stepwise procedure to make the Murabaha Shariah Compliant failing which the whole transaction turns into an interest-bearing loan. Merely changing the nomenclature does not make it lawful in the eyes of Shariah.

3. It has been observed in some cases where the banks extend Murabaha financing against commodities already purchased by their customers from a third party. This is again a practice never warranted by the Shariah. Once the commodity is purchased by the customer himself, it cannot be purchased again from the same supplier. If it is purchased by the bank from the customer itself and is sold to him, it is a buy-back technique which is not allowed in Shariah, especially in Murabahah. In fact, if the customer has already purchased a commodity, and he approaches the bank for funds, he either wants to set-off his liability towards his supplier, or he wants to use the funds for some other purpose. In both cases an Islamic bank cannot finance him on the basis of Murabahah. Murabahah can be effected only on commodities not yet purchased by the client.

4. It has also been learnt that in some cases arranged and engineered rollover has taken place. For example Murabaha sale is effected and the price is payable after one year. If the customer is not able to pay the price on due date then the Price is received from the Customer and fresh Murabaha is extended and shown against the Customer. It is against the Shariah principles because once the commodity is sold and price is fixed then the same commodity can not be sold again to the same customer.

5.5 AlBaraka Islamic Bank B.S.C.(E.C.) Pakistan

AlBaraka Islamic Bank B.S.C.(E.C.) Pakistan "AlBarka" has been operating as an Islamic Bank in Pakistan since 1991 and at present its network is existing in all major cities of Pakistan. It is providing all range of various Islamic financing which are Shariah compliant and free of interest. It has also been facilitating its customers by extending Murabaha financing facility. It is operating both Murabaha on spot and Murabaha on deferred payment. Generally it is extending Murabaha to the Purchase orderer whereby the customer requests and provide the detail and descriptions of the commodity and AlBarka purchases the commodity and then sells the same to the customer. Both the transactions of purchase by the AlBarka and then the sale to the customer are completed in Compliance with Shariah rules.

The silent features of AlBarka's Murabaha financing is as under:

- Flexible repayment terms
- Competitive pricing
- Fixed/Reducing balance basis
- Minimum Murabaha finance: USD 50,000/-
- Variable tenors

AlBarka provides under Murabaha sale all kinds of commodities i.e. raw materials, construction materials, machinery, equipments and all other assets which are permissible under Shariah. However it has been learnt that it does not deal in land and also does not deal to import commodity through letter of credit and then sells the same under Murabaha.

The AlBarka prefers short term Murabaha and maximum period of Murabaha financing is up to three years. The calculation of profit over the original cost is based on the relevant KIBOR (Karachi Inter Bank Offer Rate) plus agreed spread and the price is fixed before the agreement of Murabaha sale. Following is the detail of advances for the year 2004 and 2005:

Rupees in '000

Year	Total Advances	Total Murabaha Financing	Percentage
2004	6,991,361	4,104,573	59%
2005	7,204,665	4,397, 072	61%

The above table shows that Murabaha financing is 60% of the total advances which signifies that Murabaha is a major mode of financing of the AlBarka.

5.6 MEEZAN BANK LIMITED

Meezan Bank Limited "MBL" is dedicated to establishing Riba free banking as the banking of first choice. The first Islamic banking license is issued to MBL by State Bank of Pakistan. It has its four members at Shariah Board. The members of the Shariah Board of MBL are internationally renowned scholars serving on the boards of many Islamic banks operating in different countries. The Chairman of the Board is Justice (Retd) Muhammad Taqi Usmani.

MBL has started its operation since 2002 and is providing various mode of Islamic financing. Murabaha is one of the major modes of financing being provided for raw material, industrial machinery, equipment and commodity, construction material and all other permissible commodities. MBL also provides Murabaha facility against properties and housing. Furthermore it provides Murabaha facility against import and export. In case of import letter of credit is established and commodity is imported then sold to the customer.

MBL deals in both, spot and deferred payment Murabaha. KIBOR is applied to calculate the profit over and above the original cost. It prefers short term Murabaha and as a

matter of policy it provides Murabaha facility for the maximum period of two years. Following is the detail of advances for the year 2004 and 2005:

Rupees in ' 000

Year	Total Advances	Murabaha Financings (A)	Financings against bills-Murabaha (B)	Total Murabaha Financing (A+B)	Percentage
2004	12,418,567	4,856,083	87,779	4,943,862	40%
2005	19,857,560	8,117,096	353,433	8,470,529	43%

The above table shows that Murabaha financing is 40-43% of the total advances which signifies that Murabaha is a major mode of financing of MBL. However, it may be noted that this percentage is on lower side as against the Murabaha financing of other Islamic banks which is around 60-70%.

5.7 Bank AlFalah Limited

Bank AlFalah Limited "BAL" has its Islamic banking branches and providing Murabaha financing to its customer in various sector i.e. agriculture, industry, construction, real estate and other permissible assets. BAL has the same procedure of purchasing the commodity at the request of the customer and then sell the same to the customer at agreed cost plus profit. KIBOR is used to calculate the profit. It provides Murabaha facility up to maximum of two years. BAL also provides Murabaha financing in case of letter of credit. It has been learnt that one of the basic condition of BAL's Murabaha financing is that it makes payment to the supplier directly. It does not allow payment through third party. Some banks appoints the customer its agent to purchase the commodity on its behalf and releases payment to the

agent to be paid to the supplier but BAL also allows to release payment to the customer even being its agent and makes payment to the supplier directly against the commodity.

5.8 Governing Law and Regulators

Islamic banking including Murabaha financing is governed by the laws of conventional banking because *Islamic banking law does not exist in Pakistan.* Islamic banking started pursuant to the compliance of the famous Judgment of the Supreme Court of Pakistan on Riba passed on December 23, 1999[13]. In this Judgment, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. Therefore laws for Islamic banking were supposed to be made and implemented but meanwhile the Judgment was referred to Federal Shariat Court for its review. Hence at present there is no Islamic banking law to govern Islamic banking specifically. However the *State Bank of Pakistan has approved Essentials of Islamic modes of financing including Murabaha as guidelines to form the basis of Prudential Regulations for Islamic banking.*

All Islamic Banks are regulated by the *Islamic Banking department of State Bank of Pakistan* and all Financial Institutions including all other Companies are regulated by the *Securities and Exchange Commission of Pakistan.*

5.9 State Bank of Pakistan's Shariah Board Approved Essentials of Murabaha Financing

The Commission for Transformation of Financial System set up in the State Bank of Pakistan in pursuant to the Supreme Court Judgment on Riba dated December 23, 1999 approved essentials of Islamic modes of financing including Musharaka, Mudaraba, Murabaha, Musawama, Leasing, Salam and Istisna. The State Bank of Pakistan's Shariah

[13] See Dr. M. Aslam Khaki and others versus Syed Muhammad Hashim and others, PLD 2000.

Board has reviewed and approved these essentials of Islamic modes of financing and recommended that the same may be circulated to the banks conducting Islamic banking business in Pakistan as guidelines that would form the basis for Prudential Regulations on Islamic banking in due course. It does not preclude the possibility of developing new modes or instruments of financing, modifications or variants of the modes provided they are Shariah compliant.

In these essentials Murabaha as a sale has been defined with reference to the goods to be traded. Murabaha like any other sale requires an offer and acceptance which will include certainty of price and other terms and conditions in respect of the transaction. Price once fixed cannot be changed and Murabaha contract cannot be rolled over. Buy-back arrangement is prohibited. Therefore commodities already owned by the customer cannot become the subject of a Murabaha transactions.

5.10 Securities and Exchange Commission of Pakistan's Islamic Financial Accounting Standard 1 for Murabaha Financing

Securities and Exchange Commission of Pakistan (SECP) is the Regulator of Non Banking Companies in Pakistan. State Bank of Pakistan regulates Commercial Banks whereas SECP regulates Non Banking Companies and other Private and Public limited Companies.

The Institute of Chartered Accountants of Pakistan has issued the Islamic Financial Accounting Standard 1 which has been adopted by SECP through its Notification dated August 24, 2005 vide S.R.O. 865(I)/2005 to be followed in regard to the Financial Statements prepared in the context of historical cost convention while accounting for Murabaha transactions undertaken by a bank as defined by the said Standard:

Provided that the Commission may, of its own motion or upon an application made to it, grant exemption to any company or any class of companies from compliance with all or any of the requirements of the aforesaid Standard.

Bank(s) means banks and similar financial institutions as defined in the Standard.

In the said Standard, background of Standard and Murabaha, Murabaha definition, Basic Shariah Principles and Features of Murabaha, Modalities of Murabaha and Standard Accounting Practice has been explained. At the end the Shariah Essentials issued by Shariah Board of the State Bank of Pakistan has also been made the integral part of the Standard.[14]

5.11 Conclusion

Murabaha in its *origin is a sale which is known as Cost-Plus Sales*. In this sale, the buyer knows the price at which the seller obtained the object, and agrees to pay a premium over that initial price. Islamic banks have added to this sale the concept of *deferred payment and developed the modern form of Murabaha* to use it as a mode of financing which can be called *Murabaha to the Purchase orderer*. In conventional banking, *cash is given in form of loan but in Murabaha, commodity is purchased by the bank at the request of the customer and then the same is sold to the customer on original cost plus agreed profit.*

Murabaha in its origin was not a *mode of financing* but Islamic banks have developed it as a *mode of financing by adding the concept of deferred payment* to the Murabaha sale. The Islamic banks have developed this modern form of Murabaha to meet the requirements of trade finance and in some cases working capital of its customers.

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[14] www.secp.gov.pk

It is crystal clear that *banks do not operate as a trader in their normal course of business,* therefore they are not involved *in sale/purchase of the commodity to be sold to the customer on Murabaha basis.* The banks purchase the commodity *subject to the requirement of the customer.* So we can say that the banks purchase the commodity for onward sale to *the customer just to earn profit.* Whereas the original concept was that traders whose usual *business was the sale/purchase of the commodity were providing the commodity in Murabaha and in credit sale.* These traders were not involved in the practices as the banks to become traders subject to the need of the customer keeping in view the profit.

It is understood that *if the customer had fund he would have purchased the commodity himself, he would not have requested the bank to purchase the commodity and sold the same to him on cost plus profit on deferred paym*ent. Basically the Islamic banks meet the financial need of its customers by acquiring and then selling the commodity on deferred payment instead of providing cash in form of loan. *Selling commodity on deferred payment under Murabaha transaction is permissible if it is Shariah compliant and advancing cash in the form of loan is strictly prohibited. It is pertinent to highlight that although Murabaha financing is permissible but it is not preferable.*

It is strange that major mode of financing of the Islamic banks is based on Murabaha despite the fact that Murabaha is not the original mode of financing. The reason behind this approach of Islamic banks seems to be that in Murabaha financing, the chances of losses are remote as against other mode of financing.

Despite its permissibility in Shariah, we think that the Islamic banks should avoid frequent and excessive use of this mode. *It should be used only in extraordinary circumstances where no other real Islamic mode can be applied. The reason is that Murabaha in many respects resembles interest based transaction.*

5.12 RECOMMENDATIONS

We recommend that:

(i) there must be law to govern Islamic banking in Pakistan.

(ii) Murabaha was originally a sale. It was not conceived as a mode of financing as adopted by Islamic banks/financial institutions, hence it should be used only in extraordinary circumstances where no other real Islamic mode can be applied. However even if it is used as financing mode then it should be restricted to 25-30% of the total financing of the banks/financial institutions.

(iii) the present practices to appoint customer as agent of the bank/financial institution in every case of Murabaha transaction should be avoided and this option should be exercised in a situation of dire need.

(iv) Banks/Financial Institutions should make payment directly to the supplier while acquiring commodity to avoid any violation of Shariah rules.

(v) every bank and financial institution should have Shariah Advisor and Shariah Compliance Officer to ensure the compliances of the applicable rules in Murabaha financing in the present operation of Islamic banking. Shariah compliance certification should be mandatory in each transaction of Murabaha.

(vi) Regulators i.e. State Bank of Pakistan and Securities and Exchange Commission of Pakistan must have its Shariah Advisor and Shariah Compliance Officer to ensure the compliances of Shariah rules in every Bank and Financial Institution.

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