

***Murabaha* Financing and Islamic Banking in Bangladesh: a case study**

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Abstract:

This article explores the use of *Murabaha* as one of the most common modes of operation used by Islamic Banks and references the Islami Bank Bangladesh Limited. It refers to a sale where the seller discloses the cost of the commodity and amount of profit charged. *Murabaha* is a sale of a commodity for profit, and its mechanism for operation is explained in simple terms as the bank purchasing the commodity at the level of the client's acquisition and selling it at a cost-plus-profit basis. *Murabaha* is a sales contract; whereas the conventional finance overdraft facility is an interest-based lending agreement and transaction. In case of *Murabaha*, the bank sells an asset and charges profit, which is a trade activity declared *halal* (valid) in the Islamic Shariah Laws¹.

Keywords: *Murabaha Contract, Cost plus sale, Sale, Debt, Musawamah, Asset Financing, Good Purchase, Trade Products*

Introduction

Islam is a natural religion with claims to recognise all basic needs of human beings and encourages a healthy trade and business activities that are both fruitful for individuals and society. According to the Holy Quran 'Allah has permitted trade and prohibited *riba* (Quran, Verse: 275- 279; Fadel, 2008). It is for this reason that Muslim people have become involved in trading. To undertake trade, people need to engage in financial activity, which involves lending and borrowing in terms of a loan with interest. Islamic banking is a relatively new experience for the investor in the banking sector. It was introduced in Egypt by Ahmad El Najjar in 1963, in the Egyptian town of Mit-Ghamar, in the form of savings accounts based on profit and loss sharing. In that iteration, it lasted no more than 10 years (Chong & Liu, 2009).

Following this period, there was a revolution in Islamic banking and finance necessitating the formation in 1974 of the Islamic Development Bank (IDB) by the Organisation of Islamic Countries (OIC). A number of Islamic banks were established including the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Sudan (1977) and the Bahrain Islamic bank (1979) (Ariff, 1988). The Islamic bank model has now spread worldwide to meet increased customer demand and to assist individuals and countries emerging from recessions. This article is based on criteria for Islamic banking and

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- 1 Islamic Shariah Laws: All aspects of a Muslim's life are governed by Sharia. Sharia law comes from a combination of sources including the Quran (the Muslim holy book), the Hadith (sayings and conduct of the prophet Muhammad) and fatwas (the rulings of Islamic scholars) (Hassan & Lewis, 2007).
 - 2 *Riba al-fadl*, which means adding to the amount when exchanging one item for another of the same type.
 - 3 Chapter 3 Sipara 'Tilkar Rosolui, Sura: 2 'Al Baqarah
 - 4 IDB. The Islamic Development Bank is an international Islamic financial institution. The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Islamic Shariah Laws (Islamic Development Bank, 2017).

finance and explores how Murabaha financing can benefit clients, rather than using the services of more conventional banks. This article also describes how the Islami Bank of Bangladesh Limited (IBBL) uses Murabaha financing. (Kettle, 2011).

Murabaha Contract

Review of selected literature suggests that *Murabaha* is a term of Islamic *fiqh* (Islamic jurisprudence) and one type of trust sale (*Bai al-amanah*). *Murabaha* refers to a seller disclosing his cost of goods and adds a certain amount of profit when arriving at a final selling price. The practice of Islamic banks is to provide finance. As a financing technique, if clients ask for or request the bank to buy a specific product, then the bank does this for a clear-cut profit. It is important that the seller must disclose of the cost price of goods and the addition of profit margin at the time of sale. If the cost is not disclosed, then it will be regarded as a normal sale known as *Bay al-musawamah* (Diwani, 2010) and will not qualify for *Murabaha* financing. It is important to note here that all activities must meet the terms of Shariah Laws.

Murabaha is a type of sale and not a type of financing in its origin. However, it is commonly used as an alternative to finance capital with certain limitations in the modern Islamic bank. *Murabaha* is also classified as a trustee sale. If the buyer trusts the seller, then the cost price of goods will be disclosed. The distinguishing characteristics of *Murabaha* from the ordinary sale are: the seller mentions the cost of goods to the buyer, and a lump sum profit is added. Since *Murabaha* is the sale, the payment system may be (1) at spot (2) on an instalment basis (3) as a lump sum after an agreed time.

Murabaha does not imply the concept of deferred payment, which is commonly misunderstood by people. *Murabaha* is a sale transaction and must be followed according to Shariah Laws.

There are some rules for a *Murabaha* sale. Assets to be sold must exist, the sale price must be determined, and the sale must be unconditional. However, the asset should only be used for purposes accepted under Islamic laws and be owned by the seller at the time of sale, physically or constructively⁵. Some important points about *Murabaha* transactions are made by the author in the following paragraphs..

Collateral provisions for *Murabaha* payment

For successful *Murabaha* financing, the seller has to ensure that the *Murabaha* payment will be repaid on a due date. For this reason, the seller stipulates an acceptable security to recover the payment in case the buyer is unable to pay (Kettle, 2011). In terms of Shariah Law restrictions, the seller cannot ask for security until the buyer has incurred the liability or the debt. However, it is permissible when the buyer incurs a debt.

⁵ As an example: an unborn animal cannot be sold under *Murabaha* because it does not exist at the time of sale

The Penalty for default

If a buyer defaults on one or more instalments, it is not permitted for the seller to increase the selling price or increase the instalment as a financial punishment for the buyer. Modern scholars have approved the rights of sellers to charge a certain amount of penalty, but it should be separate from the principal amount and the fee will be used for charity purposes (Diwani, 2010).

No 'rollover' in *Murabaha*

In a conventional Westernised bank, if a customer defaults for any reason, the bank can be approached to extend the facility. The extension of time is called 'rollover'. In *Murabaha* financing, transactions cannot include an extension of time because it is not a loan. It is trading between a buyer and a seller. Any roll-over in *Murabaha* is not permitted by Shariah Laws (Kettle, 2011).

Rebate on earlier payment

Sometimes a client may wish to pay early before financing maturity and apply for a discount for early payment. In such cases, the question arises as to whether or not it is permissible to provide a discount on early repayments made under *Murabaha* transactions. The question has been discussed by Islamic scholars, and two opposing opinions have been mooted: (1) a discount is permissible and (2) a discount is not allowed when agreements do not include early repayment discount options. A middle line seems to have been taken, in that in the case of needy sellers, some consideration can be given as a *Murabaha* voluntary discount (Kettle, 2011).

Misapplication of *Murabaha* financing

Murabaha can be used only for trading. It is not allowed in Shariah Laws for *Murabaha* to be implemented for financing the overhead expenses of a firm or salaries, wages, factory rent, etcetera. Therefore, Islamic banks must ensure that the client intends to purchase the goods (Diwani, 2010).

Comparisons between conventional banks and Islamic banks in the context of *Murabaha* financing

In the modern economic world, there are two types of banking systems: conventional banking which is based on interest and Islamic banking, which is interest-free banking under the rules of Shariah Laws. The main difference between Islamic banking and conventional banking is that Islamic scholars state that money has no fundamental value and, therefore, do not allow Muslim people to profit by lending it without taking any sort of risk and interest (*riba*) cannot be charged. To make money from money is prohibited in Islam (Kettle, 2011). Wealth can only be generated by engaging in genuine trade and investment. Any profit achieved relating to trading is shared between the capital providers and the person who provides the expertise. The two basic difference between conventional and Islamic banking are (1) conventional banking is concerned with the removal of risk and Islamic banking takes the risk (2) conventional banks do not assume any liability involved in a transaction with the consumer; they only take benefit from interest. Islamic banks accept the liability involved. Taking any benefit without bearing any risk is not allowed in Islam.

There is a vast difference between *Murabaha* transactions and conventional interest-related loans. A conventional bank advances cash in the name of loanee, which gains interest. When conventional banks give a loan to the customer or client to purchase goods or machinery and any risk or loss occurs, conventional banks will not bear any of the risk. On the other hand, Islamic banks first purchase the goods or machinery and, in taking ownership, assumes the risk for that item. The Islamic bank will sell it at a particular profit without disclosing the cost of goods to the customer. Islamic banks disclose the cost of goods and profit in *Murabaha*.

According to Holy Quran “*trading is permissible and interest is prohibited*”. The logical reasoning for the permissibility of *Murabaha* is that the Islamic banking system assumes the risk of the subject matter of the sale and, according to Islamic scholars, ‘*whoever assumes the risk is eligible to earn a profit from such goods*’. Therefore, the difference is clear: conventional banks deal only with money, while Islamic banks deal only with trading and investment.

Islami Bank Bangladesh Limited (IBBL) using *Murabaha* as a mode of financing

Bangladesh is a third largest Muslim country in the world with around 160 million inhabitants. Most of the population are Muslim, and, in 1983, the first Shariah Laws-based banking system was introduced in Bangladesh to provide opportunities for banking in accordance with Shariah Laws. IBBL was formed as a public limited company under the 1913 Company Act and became the first

Islamic bank in Bangladesh, Initial operations commenced on March 30, 1983. IBBL currently has 251 branches in Bangladesh, taking deposits and investing in deposits under Shariah Laws, which are monitored by the Central Shariah Laws Board for Islamic Banking in Bangladesh.

***Murabaha* financing in IBBL**

To earn a positive return for the owner and depositors at IBBL, investments are used to utilise the funds in a systematic manner, while abiding by the principles of Shariah Laws. *Murabaha* is one of the modes of financing in the Islamic banking system. As stated previously in respect of general practices, *Murabaha* in IBBL constitutes a contract between a seller and the bank, and sellers are bound to disclose the cost of product and profit on the product. Payment could be on the spot or in the future, based on the agreement (Sarkar, 2009).

There are two types of *Murabaha* recognised:

(1) *Ordinary bai Murabaha*, which is a normal transaction between a buyer and a seller and there is no involvement of third party; and (2) *Bai Murabaha order on and promise*, where there are three parties involved, the buyer, the seller, and the bank. In the second type, the bank is an intermediary trader between the buyer and seller. The Bank receives a promise from the buyer, and, under this agreement, the bank purchases the product from the seller in order to fulfil the sale (Kayed and Kassim, 2009).

To achieve the sale, the IBBL follows certain stages for financing under the *Murabaha* system. As a first stage the seller submits a proposal in accordance with the Bank's

requirements. This covers the sale specifications, which include detailed features of products, date, time, place of delivery and payment method. After that, IBBL makes another proposal, either accepting the price or making a counter offer. The second step involves the client's promise to buy the product from the bank under the *bai Murabaha* basis at the agreed price. The Bank accepts the promise or order and formulates the terms and condition of the transaction. At the third stage, the IBBL informs the client to gain approval of the agreement to purchase. The Bank may pay now or at a later stage. It is at the fourth stage that IBBL and the client sign the contract, which will be in accordance with an agreement to purchase on the basis of *Murabaha* financing. At the fifth stage the bank gives permission to the client or its nominee to receive the goods. During the final stage, the seller delivers the goods, which the client receives as the representative of the legal owner, and notifies IBBL that the transaction has been completed by proxy (IBBL, 2017).

IBBL operational mantra for *Murabaha* financing:

1. Before procurement, the Bank ensures profitability by researching the marketability of goods, the integrity of the client and the expected profit.
2. The Bank itself purchases the goods for the clients.
3. The Bank requires advance deposits as security, usually from 25% to 30% of the sale price, in the form of cash or goods and on completion the bank will return the deposit.
4. If deemed appropriate, the Bank will demand collateral or securities prior to confirming the payment.
5. In the event of payment failure or in case of failure to receive goods, the Bank retains the right to sell the goods at a higher price

anywhere and adjust the investment account by any additional amount.

6. The Bank can surcharge if there is any damage to goods and seek compensation without challenge.

7. The ownership transfers to the client only after completion of the sale, prior to which the Bank retains ownership.

8. The duration of *Murabaha* financing is 2 months to 12 months.

9. All types of trading can be undertaken by *Murabaha* finance.

10. *Bai Munjal*, similar to *Murabaha* finance, allows for immediate ownership transfer to the client, with the Bank taking collateral. This form of transaction is used particularly for Government or Municipal business involving building, transport and or valuable items where default risk is minimal (Alam, 2011).

Conclusion

The principles of Islamic finance emphasise the market-based risk-sharing of financing that promotes asset and enterprise, deploys finance in the service of the real economy, and facilitates the redistribution of wealth and opportunity (Hayat & Malik, 2014). To protect from *riba*, Islamic practices propose an alternative called 'trading'. The Quran states trading is 'halal' or permissible and *riba* is 'haram' or prohibited. *Murabaha* is one type of financing as a mode of investment (Al Baraka, 2017). Under Shariah Laws, Islamic banks are not permitted to use any debt-based instrument to mitigate credit risk, nor any speculative methods. Islamic banks can share their losses with the depositors through the Profit-and-Loss mode of financing on the liabilities side, an option not available to conventional banks (Kabir et al, 2015). *Murabaha* is a trading operation, under which the bank is bound to disclose the cost of goods to the client. IBBL is the top ranking commercial bank among others. It has the

highest number of branches compared to other commercial banks and executes all investments under the principles of Shariah Laws.

There is always a credit risk in business. According to Golin (2001), credit risk in general term means the loss in which risk occurs on the financial obligation, with a tendency for default; and thus it is the degree of potential loss. Traditionally, the bank places great emphasis on the relationship with its customers; however, nowadays they must be able to assume and predict the behaviour of customers in terms of payment obligations. Therefore, having several borrowers, banks

must apply methodologies and techniques for implementing sophisticated models in order to enhance their credit risk management systems, especially when undertaking Murabahah financing contracts (Akkizidis and Khandelwal, 2008). There are five (5) steps to minimise the risk of vulnerable borrowers in Murabahah, which include the identification of credit risk exposure, the application of credit risk assessment models, an valuation of credit risk, risk mitigation and lastly having the validation of credit rating systems (Mousavi and Mahdavi, 2008).

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