Chapter 13

MURABAHA

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

Definition

Murabaha is a particular kind of sale where the seller expressly mentions the cost of the sold commodity, and sells it to the buyer by adding some profit thereon. Thus, Murabaha is not a loan given on interest; it is a sale of a commodity for hand to hand/deferred price.

The Bai’ Murabaha in banks involves the purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement, the bank discloses its cost and profit margin to the client. In other words, rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the Islamic bank will buy the goods from a third party and sell those goods to the customer at a pre-agreed price.

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

Difference between Murabaha and Sale

A simple sale in Arabic is called “Musawamah” - a bargaining sale without disclosing or referring to what the cost price is. However, when the cost price is disclosed to the client, it is called “Murabaha”. A simple Murabaha is one where there is cash payment i.e. payment is made at the time of sale. “Murabaha
Mua’jjal” is one on deferred payment basis i.e. payment is made after few days of sale.

**Differences between Murabaha and Conventional Financing**

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<th>Conventional Financing</th>
<th>Murabaha</th>
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<td>1. Qard based contract</td>
<td>A sale transaction</td>
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<td>2. Compensation in the form of interest, since any benefit over loan is interest</td>
<td>Compensation in the form of price of goods</td>
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<td>3. Bank does not assume the ownership and risk of the assets</td>
<td>The ownership and risk of the asset are borne by the bank</td>
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<td>4. Charges penalty in case of late payment</td>
<td>No penalty can be charged in case of late payment</td>
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**Basic Rules for Murabaha**

Following are the rules governing a Murabaha transaction:

1. The subject of sale must exist at the time of the sale. Thus, anything that does not exist at the time of sale cannot be sold and its non-existence makes the contract void.

2. The subject matter must be in the ownership of the seller at the time of sale. If the seller sells something that he himself has not acquired, then the sale becomes void.

3. The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity, yet it has come into his ownership and all rights and liabilities of the commodity are passed on to him, including the risk of its destruction.
4. The sale must be instant and absolute. Thus, a sale attributed to a future date or a sale contingent to a future event is void. For example, 'A' tells 'B' on 1st of January that he will sell his car on 1st of February to 'B', the sale is void because it is attributed to a future date.

5. The subject matter should be a property of value. Thus, a good having no value cannot be sold or purchased.

6. The subject of sale should not be a thing used for an un-Islamic purpose.

7. The subject of sale must be specifically known and identified to the buyer. For Example, 'A' the owner of an apartment building says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.

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

9. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.

10. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of the trade.

**Step by step Murabaha Financing**

Five steps needs to be followed in Murabaha Financing:

1. The client and the institution sign an overall agreement whereby the institution promises to sell the commodity and
the client promises to buy it from time to time at an agreed rate of profit added to the cost. This agreement may specify the limit up-to which the facility may be availed.

2. An agency agreement is signed by both the parties in which the institution appoints the client as his agent for purchasing the commodity on its behalf.

3. The client purchases the commodity on behalf of the institution and takes possession as the agent of the institution.

4. The client informs the institution that it has purchased the commodity and simultaneously makes an offer to purchase it from the institution.

5. The institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the client.

All the above conditions are necessary to affect a valid Murabaha. If the institution purchases the commodity directly from the supplier, it does not need any agency agreement.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage. The above step or transaction is the only way by which this transaction is distinguished from an ordinary interest-based transaction.

**Practical Example**

“ABC & Co” is a manufacturer and exporter of rice. The company purchases paddy rice from local suppliers and after processing the rice, the company exports it to different countries. The company has a working capital requirement of Rs. 100 Million
for purchase of paddy rice from the suppliers. The company approaches an Islamic Bank for granting finance facility of Rs 100 million.

Islamic Bank offers the facility of Murabaha to the customer through which the Bank and the Customer signs a Master Murabaha Agreement to sell and purchase Paddy rice on Murabaha basis from time to time, as per the conditions of the Agreement. Upon requirement for the purchase of paddy rice, the customer gives an order to the bank to supply paddy rice worth of Rs. 10 million to the company on Murabaha basis. Upon receipt of the request from the Customer, the Bank authorizes the Customer to purchase the paddy rice as an agent of the Bank from the market. The Customer negotiates the deal with the Unique Rice Trader (a supplier) and intimate the Bank to make Pay Order in the name of Unique Rice Trader. Bank then issues a Pay Order in the name of Unique Rice Trader, which can either be paid directly by the bank to the supplier or the Bank may hand over the Pay Order to the Customer to provide it to Unique Rice Trader on behalf of the Bank.

Upon receipt of payment, Unique Rice Trader supply the rice to the Customer (the agent of the bank). Immediately upon the receipt of paddy rice, the agent (Customer) intimates the bank about the receipt of rice worth Rs. 10 million from the supplier and simultaneously offers to purchase the same rice from the Bank for Rs. 11 million with deferred payment of 6 months. The Bank, after verifying the genuineness of the transaction and ensuring that all the basic rules of sale are being fulfilled, accepts the offer of customer. With the acceptance of the Bank, the ownership and risk of the rice transfers to the customer and the same rice can now be used by the customer.
However, if the same customer would have approached some conventional Interest based bank for financing the same transaction, then the Conventional bank would have granted a loan of Rs. 10 million for a period of 6 months with an interest amount of Rs. 1 million.

Apparently, the end result of both the transactions look similar, where customer ends up paying same amount of money but the underlying transaction for the first transaction is a Sale based Contract, which is allowed in Islam, whereas the contract of Conventional Bank is a loan Contract for which any sort of compensation is impermissible in Islam.

**Issues in Murabaha**

Following are some of the issues in Murabaha financing:

1) **Securities against Murabaha**
   Payments accruing from the sale are receivables and for this, the client may be asked by the bank to furnish a security. The security may be in the form of a mortgage or hypothecation or some kind of lien or charge.

2) **Guaranteeing the Murabaha**
   The seller can ask the client to furnish a third party guarantee. In case of default on payment, the seller will have recourse to the guarantor who will be liable to pay the amount guaranteed to him. There are two issues relating to this:

   a) The guarantor cannot charge a fee from the original client.

   b) However, the guarantor can charge for any documentation expenses.
3) **Penalty for default**
Another issue with Murabaha is that if the client defaults in payment of the price on the due date, the additional price cannot be changed nor can penalty fees be charged. In order to avoid the adverse consequences, an alternative is that the client may be asked to undertake that if he fails to pay installment on its due date, he will pay certain amount to charity. For this purpose, the bank may maintain a charity fund and disburse charity from it under the directions of Shariah board of the bank.

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

5) **Rebate on Early Payments**
Sometimes the debtors want to pay earlier than maturity to get discounts. Majority of Muslim scholars including the major schools of thought consider this to be un-Islamic. However, if the Islamic bank or financial institution gives somebody a rebate on its own, without stipulating it in the contract of Murabaha, it is not objectionable especially if the client is needy. This should not be made a regular practice and in no way forms a part of the contract.
6) Calculation of cost in Murabaha
The Murabaha 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 Murabaha cannot take place. In this case, the sale will take place as Musawamah i.e. sale without reference to the cost.

7) Subject matter of the Murabaha
All commodities cannot be the subject matter of Murabaha because certain requirements needs to be fulfilled. For instance, the shares of a lawful company can be sold or purchased on Murabaha basis because according to the principles of Islam, the shares represent ownership into assets of the company provided all other basic conditions of the transaction are fulfilled. A buy back arrangement or selling without taking their possession is not allowed at all.

Murabaha is not permissible for items that cannot become the subject of sale.

Basic mistakes in Murabaha Financing
Some basic mistakes that can be made in practical implementation of the concept are as follows:

1. The most common mistake is to assume that Murabaha can be used for all types of transactions and financing. This mode can only be used when a commodity is to be purchased by the customer. If funds are required for some other purpose, Murabaha cannot be used.

2. The document in Murabaha signed for obtaining funds is for a specific commodity and therefore it is important to certify
(ensure) the subject matter of the Murabaha.

3. In some cases, the sale of the commodity to the client is affected before the commodity is acquired from the supplier. This occurs when the various stages of the Murabaha are skipped and the documents are signed altogether. It is important to remember that Murabaha is a package of different contracts and they come into play one after another at their respective stages.

4. It has been observed in some financial institutions that Murabaha is applied on already purchased commodities. This is not permitted in Shariah and can only be affected on commodities that have not yet been purchased.

5. Both the customer and the Bank staff must be properly educated. Lack of awareness about Islamic financing modes may cause Shariah non-compliance issues.

**Risk Management of Murabaha Financing**

Some of the major risk and their mitigants are as follows:

1) **Product Specific Risk**

In Murabaha Financing, an Islamic Bank should assume the risk of destruction or loss of the assets prior to its sale to the Customer.

**Mitigant**

i) Takaful coverage for the Murabaha assets.

ii) Another tool for managing this risk is to minimize the time of ownership by selling the asset to the customer immediately after acquiring the assets.
2) **Credit Risk**
   It is the risk pertaining to the default or delay of customer in paying its obligations.

**Mitigant**
   i) Any Shariah Compliant security can be taken to cover the risk of non-payment or delay in payment.
   ii) Robust evaluation of customer’s business performance and Industry outlook.
   iii) Matching the Murabaha financing with the cash cycle of the customer. For example, if a customer sells its goods in the market for a credit of 90 days, then tenure for Murabaha financing must be kept around 90 days.

3) **Shariah Non-Compliance Risk**
   This is the risk of Non-compliance of basic Shariah requirements for a Murabaha transaction, which results in the reduction of the income of the bank as non-compliant income may lead to loss of bank’s income as banks cannot accept or recognize income from a non shariah compliant transactions.

**Mitigant**
   i) Proper Training of Bank employees and the customer.
   ii) Implementing strong control measures in the bank through policy making.
   iii) Implementing a system of Shariah Audit and Compliance.
   iv) Development of easy to understand process flow for each Murabaha financing.

**Variants of Murabaha Financing**
   On the basis of requirements of customer, numerous variants of Murabaha can be developed. Some of them are as follows:
1) **Advance Payment Murabaha**
   In this type of Murabaha structure, bank makes an advance payment to the supplier of assets and sells these assets to customer upon receiving its delivery.

2) **Credit Payment Murabaha**
   In this type of Murabaha structure, bank sells the assets to its customer which the bank has purchased on credit from the supplier i.e. outflow of funds is made by the bank after certain time of execution of Murabaha sale with the customer and financing is booked prior to the disbursement of funds by bank.

3) **Murabaha Pledge**
   In this type of Murabaha structure, bank keeps the same goods as pledge which the bank has sold to the customer through a Murabaha transaction.

4) **Murabaha Spot**
   In this type of Murabaha structure, the bank does not immediately sell the asset to the customer but keeps the asset in its inventory. The assets held in the inventory of the bank are sold to the customer, as per his requirement against spot payment.

**Uses of Murabaha**
Murabaha is being used in following scenarios globally for Short / Medium / Long Term Finance:

- Raw material
- Inventory
- Equipment
- Asset financing
• Import financing
• Export financing (Pre-shipment)
• Consumer goods financing
• House financing
• Vehicle financing
• Land financing
• Shop financing
• PC financing
• Tour package financing
• Education package financing
• All other services that can be sold in the form of package (i.e. services like education, medical etc. as a package).

Bai’ Muajjal

Bai’ Muajjal is the Arabic acronym for "sale on deferred payment basis". The deferred payment becomes a loan payable by the buyer in a lump sum or installment (as agreed between the two parties). In Bai’ Muajjal, all those items can be sold on deferred payment basis which come under the definition of capital where quality does not make a difference but the intrinsic value does. Those assets do not come under the definition of capital where quality can be compensated for by the price and Shariah scholars have an 'Ijmah' (consensus) that demanding a high price in deferred payment in such a case is permissible.

Conditions for Bai’ Muajjal

The Conditions for Bai’ Muajjal are as follows:

1. The price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without any qualms about riba.

2. Complete/total possession of the subject in question must be given to the buyer, while the deferred price is to be treated
as debt against the buyer.

3. Once the price is fixed, it cannot be decreased in case of early payment, nor can it be increased in case of default.

4. In order to secure the payment of price, the seller may ask the buyer to furnish a security either in the form of mortgage or in the form of a tangible item.

5. If the commodity is sold in installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately.

**Accounting Treatment of Murabaha Transactions**

Since Murabaha is a Sale transaction and not a loan transaction therefore, the accounting treatment of Murabaha must also be different from the loan transaction. Following are the major points which should be considered while devising accounting treatment of Murabaha transactions.

1) **Profit Recognition**
In a loan transaction, interest income is accrued and recognized by the banks from the date of loan disbursement, but in case of Murabaha transactions, the income can be recognized by the bank only after the asset has been sold to the customer, even though the bank has made advance payment to the supplier or to his agent.

2) **Inventory**
The goods purchased by Islamic Banks, before being sold to the customer, must be recorded in the balance sheet of the bank as inventory of the bank. Cost of inventories should comprise all
costs of purchases and other costs incurred in bringing the inventories to their present location and condition.

3) Murabaha Receivables
Unlike a loan transaction, the Murabaha receivable shall be disclosed as Trade debts. A sample of accounting entries that can be used to record Murabaha transactions are as follows:

1. At the time of payment to the client for the purchase of goods on behalf of bank or directly to the supplier by the bank, the transaction will be accounted for as follows:

   January 01, 2011:
   Dr Advance Against Murabaha xxxx
   Cr Pay Order / Party Account xxxx

2. When bank receives the possession of the goods, the following entries would be passed:

   Dr Inventory xxxx
   Cr Advance against Murabaha xxxx

3. When the purchased goods are sold by the bank to the customer on Murabaha basis, the following entries would be passed:

   Dr Murabaha Financing xxxx
   Dr Murabaha Profit Receivable xxxx
   Cr Inventory xxxx
   Cr Deferred Murabaha Income xxxx

4. If the bank has sold the goods on 12 months deferred period, then at the end of each month, bank may recognize 1/12th
of the income as Income on Murabaha financing. At this stage, following entries would be passed:

\[\begin{align*}
\text{Dr} & \quad \text{Deferred Murabaha Income} & xxxx \\
\text{Cr} & \quad \text{Income on Murabaha Financing} & xxxx \\
\end{align*}\]

And so on. This entry will be passed at the end of EACH month till maturity.

In case, the bank does not receive the possession of the goods by the month end and therefore could not execute Murabaha sale with the customer, the bank will not accrue income for the month and the above mentioned entry # 4 would NOT be passed.

Apart from this, entries number 2, 3 and 4 will also not be passed since bank has not yet possessed the goods.

If the bank receives the goods in the next month, then the entries from 1 to 3, as mentioned above will be passed. At the month end, accrual for the two months would be booked by the bank as per entry number 4, since bank did not book income for the preceding month.

5. On maturity of Murabaha transaction i.e. at the time of receiving of final payment, following entry would be passed:

\[\begin{align*}
\text{January 01, 2012:} \\
\text{Dr Party Bank A/c} & \quad xxxx \\
\text{Cr Murabaha Financing} & \quad xxxx \\
\text{Cr Murabaha Profit Receivable} & \quad xxxx \\
\end{align*}\]

Note: The Accounting entries are based upon the usual practice of Meezan Bank Limited and may vary from bank to bank.