

Murabaha Financing in Pakistan: A Practical Islamic Banking Aspect

• Dr. Muhammad Farooq

•• Dr. Muhammad Mushtaq Ahmed

Abstract:

Modes of financing in Islamic banking system are generally categorized as Sharaiah based financing like Musharakah, Mudarabah and Shariah compliant financing like Murabaha, Ijarah etc. Islamic banks should have adopted and promoted Sharaiah based financial instruments but instead they have been predominantly using Sharaiah compliant modes especially Murabaha due to some valid reasons. The aim of this paper is to highlight and know the level of satisfaction of the clients, businessmen, entrepreneurs, professionals, academicians and Islamic banking experts of the prevalent structure and use of Murabaha by the Islamic banks in Pakistan.

Keywords: *Islamic Banking, Modes of Finance, Murabaha*

Introduction

Islamic banking is defined as banking practices in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by the Shariah of Islam.¹ It is in fact a banking system based on Islamically-ethical principles which are, in many ways, very different indeed from conventional banking and principles.² Islamic banking is more than interest free banking system. It is not only to avoid interest based banking transactions but also to avoid unethical practices and to actively strive to pursue the objectives and goals of an Islamic economy. Modes of financing in Islamic banking system can be broadly divided into two types—Shariah based financing like Musharakah, Mudarabah and Shariah compliant financing like Murabaha (sale purchase agreement), Ijarah etc.

• Associate Professor, Shaykh Zayed Islamic Centre, University of Peshawar.
drfarooqsm@gmail.com

•• Assistant Professor, Department of Law and Shariah, University of Swat.
dr.mmushtaqahmed@gmail.com.

Moreover, Islam is strictly against charging of interest on money, but allows earning of profit on sale of assets and commodities. Therefore, sale-based transaction is preferred to be used compared to loan-based transaction for financing the purchase of assets by Islamic banking cliental. Murabaha is the most common mode used by Islamic banking institutions (IBIs) all over the globe. It is a particular type of sale where the supplier of the asset/commodity reveals its cost and profit charged there on.³

Islamic banking industry (IBI) was set up in Pakistan in the decade of 2000 parallel to the conventional banking system. Since then, this industry has achieved tremendous growth and success in terms of assets, deposits, financing and investment. The following figure shows the growth of IBI in Pakistan during 2003 to 2014.

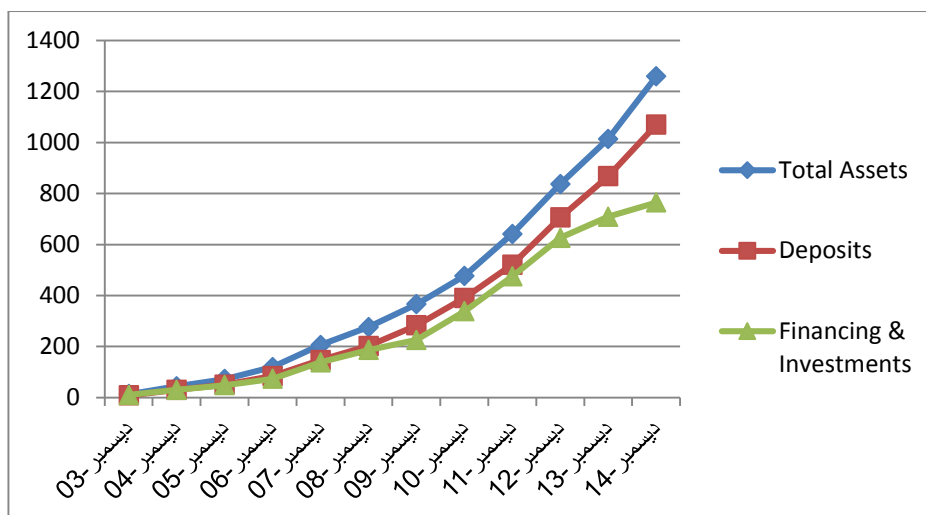


Figure 1 Progress of Islamic Banking Industry in Pakistan since 2003 to 2014
Total assets of the Islamic banking industry in Pakistan were only Rs. 13 billion in December 2003 which has increased to Rs. 1254 billion in Dec 2014 depicting a spectacular progress of the industry. Islamic banking attracted huge deposits in the same period. In December 2003, deposits with the Islamic banks in Pakistan were just Rs. 8 billion that has increased to Rs. 1070 billion in Dec 2014. The figure also shows an increase in net financing and investments from Rs. 10 billion in December 2003 to Rs. 765 billion in Dec 2014.

Figure 2 shows percentage share of the Islamic banks in the whole banking industry of Pakistan. The percentage share of the Islamic banking out of the whole banking industry in Pakistan was only 0.5 percent in December 2003 that increased to 10.4 percent in Dec 2014, while the share of the deposits rose to 11.6 percent in Dec 2014 from just 0.4 percent in December 2003. Like-wise, the share of the financing and investment of the Islamic banking increased to 7.8 percent in Dec 2014 compared to only 0.5 percent in Dec 2003, as shown in figure 2.

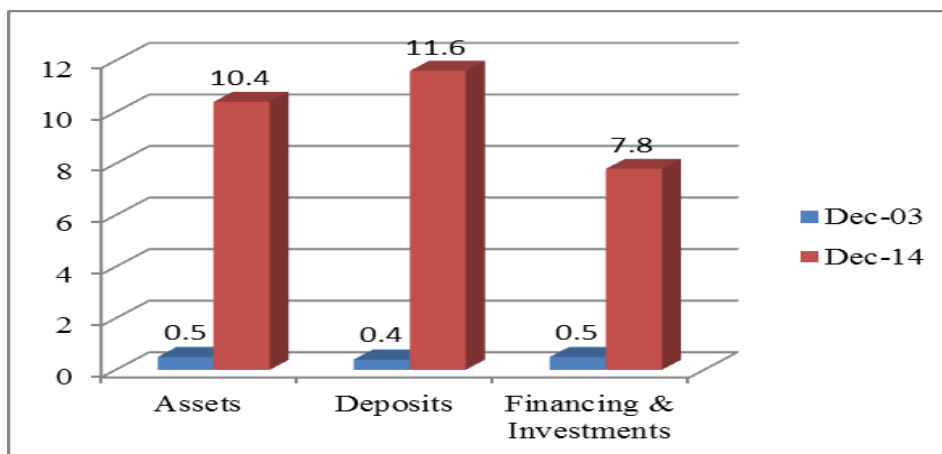


Figure 2 Share (percent) of Islamic Banks in Banking Industry of Pakistan

Definition of Murabaha:

As stated earlier that Islamic modes of financing have been broadly categorized into two groups called Shariah based financing and Shariah compliant financing modes. Data shows that the operation of Islamic banking sector in Pakistan is heavily dependent upon Murabaha as a mode of financing. However, it should be kept in mind that originally Murabaha is not a mode of financing; it is basically a sale-purchase transaction between two persons. The word Murabaha is derived from the word Riba which means gain or profit.⁴ It is a kind of sale-purchase transaction in which the seller has to reveal the total cost of the good(s) to the client/buyer plus the profit the seller wants to earn over and above the cost of the product. Murabaha is a type of sale contract in which the client/purchaser orders the seller to purchase the commodities and the seller then sells the commodities to the client with an additional amount as a profit paid at the same time.⁵ When a seller agrees with his client to provide him a specific good on a certain fixed amount of profit additional to the cost of the good is known as Murabaha contract.⁶ Murabaha is simply a sale transaction, therefore, all the basic rules of a valid sale must be duly observed to make it acceptable in Shariah of Islam.⁷ Therefore, it would be appropriate here to mention some of the important conditions of a valid sale.

Conditions of a Valid Sale:

Ayub⁸; Mansoori⁹ and many others have nicely presented some basic conditions for a valid sale in their books and papers. Before going into the Murabaha contract, the two parties involved must take proper care of the following conditions required for a valid sale. In Islamic Fiqh, sale is defined as an exchange of a product having some value with another product of value with mutual approval.¹⁰

One of the essential conditions for a valid sale is that the two parties (offering and accepting) involved in a sale contract should be legally capable of making a contract between them; otherwise, the sale is invalid. Second, the sale

must not be imposed by force on the parties concerned. It should be based on free and mutual consent of the buyer and seller of the asset. The third condition states that this contract of sale must clearly show the actual price of the asset. Once the price is fixed cannot be altered. Fourth, the party who offers must be either the owner of the asset/product or an agent of the owner. Fifth, the commodity/asset should be present at the time of this sale agreement between the two parties; otherwise, it would be an invalid sale. Sixth, at the time of sale agreement, the commodity/asset for sale must be in the physical or constructive possession of the party who offers the commodity for sale to the accepting party and all rights and liabilities are borne by the seller. Seventh, the contract should clearly express the date, place of the delivery of the product and the time of payment of the price agreed upon in order to remove the uncertainty. Eighth, the sale must be on spot, immediate and complete in all respects. Any sale agreement attributed to a future date is an invalid sale according to Shariah of Islam. For instance, the seller utters to a purchaser on 30th June that he will sell his motorbike to him on 15th July; the sale is null and void.

Ninth, the subject of sale should be anything in which transactions are allowed by the Shariah of Islam. Similarly, the commodity of sale should be of value. Thus the commodities in which transactions are not allowed by the Shariah and goods having no value cannot be sold. Tenth, the commodity of sale must be explicitly known and identified to the purchaser by presenting detailed descriptions, specifications and characteristics of the subject of sale. Eleventh, the delivery of the sold asset to the purchaser must be certain and should not depend on chance. For instance, a seller sells his motorbike which has already been stolen by someone else, to a purchaser, the sale is invalid. Twelve, the sale must not be conditional; otherwise, it would be an invalid sale. A conditional sale is void unless the condition is a part of any normal practice of trade allowed by the Shariah of Islam. Last, the transactions which involve an element of uncertainty and risk with regard to the existence and acquisition of subject matter are not allowed by the Shariah, for instance, sale of fruit on a tree at the start of a season, sale of fish in water etc.

There is a common consensus among the Shariah experts that Islamic banks should focus their operations and transactions mainly on Shariah based financial instruments like Musharakah and Mudarabah, however, there is no denying fact that even after a couple of decades the financing operations of IBIs are based on Shariah compliant modes of financing like Murabaha and Ijarah. Because IBI prefers low risk categories of modes of financing which usually generate a fixed return.¹¹

Three Possible Structures of Murabaha Mode of Financing:

There are three different structures of Murabaha scheme of financing:

1. Two-Party Structure:

Two-party structure (buyer and seller or bank and client) is the simplest structure of Murabaha sale purchase transaction. In this structure, the

client approaches to a bank for the purchase of an asset/good assuming that he/she has already collected full information about the commodity/asset to be purchased from the bank (phase 1). The bank offers the desired asset/good to the client on cost plus profit basis, transfer the ownership as well of the product to the client (phase 2). Thereafter the client will pay the price on agreed dates in installments or in lump sum as decided between them (phase 3). This type of sale purchase agreement between the seller and the buyer is the most ideal one from the Islamic Shariah point of view.

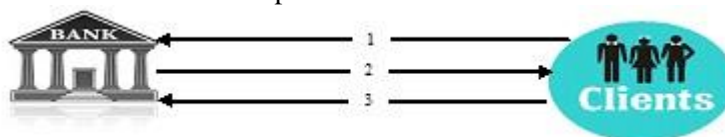


Figure 3 Two-party structure of Murabaha transaction

The profit so earned by the bank is fully justified by the risk it assumes before the asset is delivered to the customer. It is the most transparent, unambiguous and riba-free possible structure of Murabaha transaction. However, two-party structure of Murabaha is non-existent in the banking sector.

2. Three-Party Structure:

The second possible structure of Murabaha transaction is known as three-party structure. The three parties involved are: the bank, the client, and the supplier. In this structure, the customer approaches to a bank for a good/asset, with all relevant information, to be purchased on the basis of Murabaha mode of financing program (phase 1). The bank then purchases the good directly from the seller without involving the services of an agent (phase 2). The seller/supplier delivers the good to the bank and the bank takes the physical or constructive possession of the good delivered by the supplier and becomes the sole owner of the good and makes payment (phase 3). After the transfer of ownership of the good, the bank resells the same to the client on cost plus profit basis (phase 4). The client makes payment of the price to the bank in lump sum or in installments on agreed dates (phase 5).

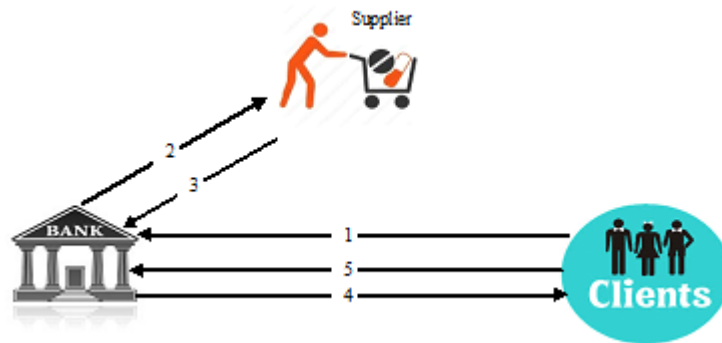


Figure 4 Three-party possible structure of Murabaha transaction

This type of Murabaha transaction involves two sales contracts/agreements. The first sale purchase contract takes place between the bank and the supplier of the product, while the second sale purchase agreement takes place between the bank and its client. In Murabaha mode of financing, it is obligatory on the bank to disclose the total cost which it incurs on the good and reveals profit earns from the client.

3. Three – Party Structure with Customer as Agent:

Another possible structure of Murabaha transaction also involves three parties, the bank, the client and the supplier, but the client now works as an agent appointed by the bank for the purchase of the good from the supplier on behalf of the bank. In this possible structure, the bank does not deal directly with the supplier/seller of the good. The bank appoints its client as its agent for the purchase of good. So, the first sale purchase contract takes place between the supplier and the bank through its client as its agent. The agency agreement between client and the bank ceases once the bank takes the physical or constructive possession of the good. After taking the ownership, the bank sells the commodity to its client on the basis of cost plus profit and the second sale purchase contract concludes.

This type of structure where the bank appoints its client for the purchase of good from the supplier/seller, may be ideal one where the client of the bank is better informed about the specialized good and its source of supply too. The bank usually uses this type of structure for recurring trade financing transactions.

If we look carefully at the structure of Murabaha financing facility, more than one relationship between the bank and its client emerges. At the start where customer approaches the bank for this mode of financing, the relationship between the bank and its client becomes that of a promisor and promise;

however, when bank appoints the customer as its agent, the relationship between the two changes into master-agent relationship. Another relationship which emerges between the bank and its customer is that of a seller (bank) and purchaser (customer) when the bank sells an asset to its customer, and finally when the sale purchase agreement concludes on a deferred payment basis, relationship between the two becomes that of a creditor (bank) and debtor (customer).¹² Therefore, management must be vigilant about the various stages involved in the Murabaha mode of financing and their implications for both the parties—the bank and the customer.

Material and Method:

The objective of this paper is to highlight and know the level of satisfaction of the professionals, clients, academicians, Islamic banking experts, businessmen of the prevalent structure and execution of Murabaha as a mode of financing by the Islamic banking industry in Pakistan. For this purpose, opinion survey was prepared and distributed among the relevant professionals, banking experts, clients, and academicians. The questionnaire contains both close ended and open ended questions. Part A of the questionnaire is about the personal information of the respondents while part B contains some important questions about the present structure and practice of Murabaha mode of financing in Pakistan. The data and information is collected from the respondents through this questionnaire were converted into averages and percentages. The paper used MS-Excel to compile and examine the main findings of the survey. The number of persons on whom the survey distributed was sixty (60). However, only 49 people, including 15 professionals, 5 clients, 22 Islamic banking experts, and 7 professors/teachers and academicians duly filled the questionnaires and sent back their responses.

Discussion:

Islamic banks have been predominantly relying on Shariah compliant modes of financing such as Murabaha in Pakistan. The percentage share of Murabaha financing out of total financing mix in Pakistan was 30.1 percent in Dec 2014 while it was 40.6 percent in Dec 2013,¹³ clearly shows tilt of the IFIs towards this mode of financing. This paper is so structured to make an effort to highlight the level of contentment of the clients of Islamic banks, banking professionals and academia related to the field of Islamic banking, of the prevalent structure, risks related to Murabaha and the use of Murabaha as a mode of financing in Pakistan. For this purpose, a questionnaire was prepared for taking the opinions of these people.

According to survey, hundred percent of the respondents knew the meaning as well as relevant conditions of Murabaha as a mode of financing. Out of total respondents only 12 percent have availed Murabaha facility while 88 percent have no such practical experience. Sixteen percent of the respondents are of the opinion that Islamic banks do follow the conditions relevant to Murabaha mode of financing while the rest of the respondents did not answer this question.

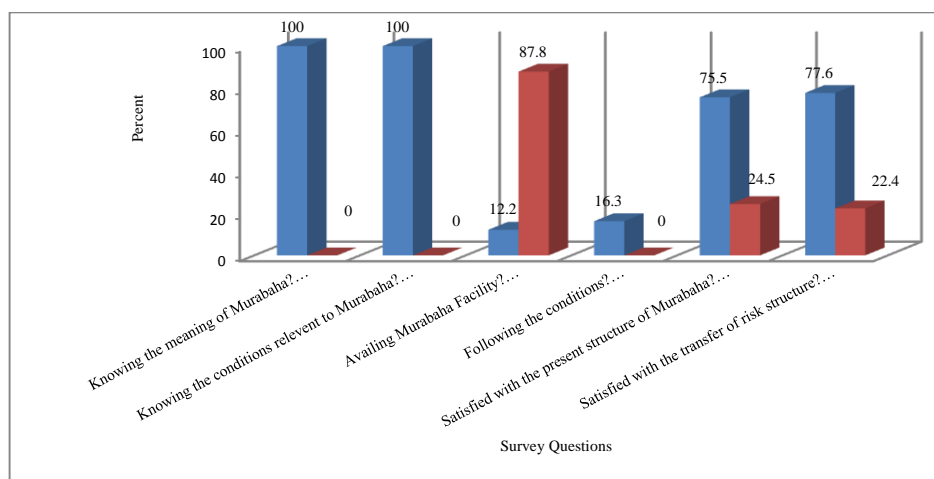


Figure 5 Survey opinions of the respondents

Answering the question that whether you are satisfied with the present structure of Murabaha, 75 percent says yes, while 24.5 percent says no to this question. Moreover, 77.6 percent of the respondents showed satisfaction about the transfer of risk structure of Murabaha while 22.4 percent were unsatisfied. According to the opinion survey, there are some basic mistakes/misuses which normally occur during the Murabaha financing process. The first one of these mistakes is, the customers, in most of the cases, come to banks for acquiring funds only through Murabaha mode of financing having no intention to use the funds for the purchase of an asset/product. They just sign the documents to obtain money from the bank. After receiving the money, the customers use the money for some other purposes, according to the survey opinions. Second misuse, according to the survey opinions, is that sometimes the customer is already having a product in its possession and tries to acquire funds from Islamic bank through Murabaha facility for the same product. If Islamic bank purchases the product from its customer and sells the same again to the same customer, it is a buy-back agreement which is totally against the Shariah of Islam. In this case too, the customer wants to secure funds from the bank and uses the same for some other purposes.

The third mistake which may occur during Murabaha financing process, is signing of all the Murabaha facility documents at one time in one go. Murabaha financing process consists of numerous stages. When the requirements of first stage/phase are fulfilled the second stage begins and so on. One cannot jump to the next stage without fulfilling the pre-requisites of the preceding stage. For example, a product cannot be sold to the client until and unless the bank holds physical or constructive possession of the product. Therefore, the management of the bank must take care of these various stages of Murabaha transaction otherwise, the transaction would be void.

Most of the managements in IFIs find it easy to use Murabaha facility for every type of financing activity due to their ignorance of the various stages and basic principles of Murabaha mode of financing. They serve customers who need funds for financing their overhead expenditures, which is totally against the spirit of Murabaha financing facility allowed by Shariah.

An important question asked in the questionnaire was that are you satisfied with the transfer of risk structure in Murabaha mode of financing? Most of the respondents are in affirmative. However, few have recorded some reservations about the risk structure. Murabaha mode of financing consists of various stages, each stage has its own implications, and therefore, proper care should be given to the sequence and order of all these stages. Moreover, there are a couple of risks associated with Murabaha facility. These are credit risk, market risk and liquidity risk.

Islamic banks are usually exposed to credit risk especially in the case of Murabaha mode of financing. The bank buys a product for a client on the basis of the Murabaha facility and then hands over the possession of the product to the client. If the client will not pay the due installments in time, the bank will face a risk which is called credit risk. Credit risk means inability of the debtor to make payment at the time agreed upon for repayment and in accordance with the conditions stipulated in the contract.¹⁴ Another risk to which Islamic banks are exposed to is known as market risk or price risk. Market risk is the risk of losses in on balance sheet and off balance sheet positions arising from fluctuations in market prices.¹⁵ Perhaps, it is the price risk which opens a chance for entrepreneur to gain profit by pretending to be default.¹⁶ The customer promises to buy the ordered product from the bank, but he/she may breach his/her promise and refuses to purchase from the bank. The bank has to sell commodity in the open market and may incur losses due to fluctuations in market prices. Market and credit risks both results into liquidity risk. Liquidity of an asset means its easy convertibility into cash or cash equivalent asset.¹⁷ If the customer refuses to purchase the ordered commodity from the bank and if the client will not pay the due installments in time, both will lead to liquidity risk for the bank concerned.

It is true that Shariah Scholars have allowed the use of Murabaha mode of financing in situations where Shariah based financing techniques like Musharakah and Mudarabah cannot be used and that they have allowed it on temporary basis only. However, the ratio of Murabaha cannot be decreased unilaterally by the management of Islamic banking sector. It also depends upon the nature and needs of the clients. Perhaps, majority of people in our society use Murabaha because their economic conditions do not allow them to opt for other financing products. Secondly, they have no expertise in trade and business, therefore, Murabaha mode protects such people from the guiles and deceits of the cunning traders (Ayub, and Mansoori).¹⁸ The endeavor to reduce the ratio of Murabaha financing is directly or indirectly also depends upon the ratio of Musharakah and Mudarabah out of the total financing mix. The percentage share of both Musharakah and Mudarabah has been very negligible since 2003 in Pakistan due to various valid reasons. So, before reduction in the ratio of

Murabaha, efforts must be made for removing the causes which compel Islamic banks to restrict the growth of Shariah based financing modes.¹⁹ Therefore, most of the respondents do not recommend reduction in the ratio of Murabaha. Instead they stress upon the need of awareness, education, training, and knowledge of the customers and bankers. They want innovation and creation of new products to replace Murabaha. Furthermore, respondents lay more emphasis on further strengthening the present structure of Murabaha instead of reducing its ratio in the financing mix of Islamic banking.

Most of the respondents are of the view that a number of steps may be taken to strengthen the Murabaha structure. For instance, first of all banking officials must make sure at the approving stage of Murabaha that the customer really intends to purchase good(s) and not deceiving the management of the bank. Secondly, Islamic banks should introduce effective mechanism of inspections for each customer in order to block ways of misuse of this mode of finance. Awareness and training sessions should regularly be conducted for bankers and clients. Ideally Islamic banks should purchase the good(s) directly from the vendors if possible. Agency agreement may be made with third party instead with the client and payment may be made directly to the vendor. Banking officials must take physical delivery of the good(s) before selling it to the client. Islamic banking should also introduce a program of rewards to staff upon good and efficient work while penalty for staff in case of Shariah non-compliance and negligence. Moreover, structure of Murabaha may be more strengthened if we reduce and make the documentation process simple.

Conclusion

Modes of financing in Islamic banking are broadly categorized into two groups—Shariah based financing and Shariah compliant financing. No doubt that Islamic banking industry in Pakistan has achieved tremendous success and growth in terms of assets, deposits, financings, and investment; however, it is heavily relying on Shariah compliant financing modes especially on Murabaha due to some valid reasons. Therefore, instead of trying to minimize the ratio of Murabaha mode of financing out of total financing mix in Pakistan, efforts may be focused on the strengthening the present structure of this mode of financing.

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