

***Murābahah* financing revisited: The contemporary debate on its use in Islamic banks**

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Abstract: The *murābahah* contract, an ordinary contract in classical Islamic law, has played a significant role in the emergence and development of modern Islamic Banking and Finance. This contract which is basically a “resale with a stated profit” contract was introduced into the modern literature in the late 70’s in a totally redesigned form as an alternative to the conventional modes of credit. This modern financing tool has become the subject of intense debates since then and has been subject to criticism by some scholars. This paper aims at portraying the juristic discussion and debate on this modern contract and its application by Islamic banks. The first part of the paper introduces the subject and gives a summary of the Islamic injunctions on the *murābahah* contract in its original form based on the primary sources of Islamic law. The second part, which is the substantial part of the paper, portrays the profound transformation that the *murābahah* contract has undergone to make mark-up financing possible and summarizes the discussions related to the modern use of *murābahah* by Islamic banks.

Keywords: *Murābahah* financing; Islamic law; Islamic banks; Islamic finance; unilateral promises (*wa’d*).

Abstrak: Kontrak *murābahah*, kontrak biasa dalam undang-undang Islam klasik, telah memainkan peranannya yang penting dalam kemunculan dan perkembangan perbankan Islam moden dan Kewangan. Kontrak ini pada dasarnya adalah merupakan satu kontrak “penjualan semula dengan keuntungan yang dinyatakan”, telah diperkenalkan ke dalam literatur moden pada awal 70’an dalam satu rekabentuk baru secara total sebagai satu alternatif kepada

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bentuk konvensional kredit. Alat moden kewangan ini telah menjadi perkara yang didebatkan secara mendalam sejak itu. Ia telah menjadi bahan kritikan beberapa orang sarjana. Kertas kerja ini bertujuan untuk menggambarkan perbincangan perundangan dan perbahasan terhadap kontrak moden ini dan bagaimana ia digunakan oleh perbankan Islam. Pada bahagian pertama, kertas kerja ini memperkenalkan perkara yang memberikan ringkasan terhadap injuksi Islam ke atas kontrak *murābahah* dalam bentuk asalnya berdasarkan sumber-sumber utama perundangan Islam. Bahagian kedua pula, yang lebih didalami dalam kertas kerja ini, menggambarkan transformasi bahawa kontrak *murābahah* telah menjalani pembiayaan mark-up sepatutnya dan seterusnya meningkatkan perbincangannya dengan penggunaan *murābahah* secara moden oleh bank-bank Islam.

Kata Kunci: Bank Islam; kewangan Islam; perundangan Islam; pembiayaan *murābahah*; janji unilateral (*wa'd*).

Islamic banks (“Participation banks” in Turkey) utilize the money they have collected using various Islamic banking instruments. Although equity contracts and profit-and-loss sharing is encouraged in Islamic law, fixed return modes of financing rank highest in use by Islamic banks. According to Sairally (2002), *Murābahah* is the most common method used by Islamic banks to arrange financing.

The *murābahah* contract is a cost-plus-sale contract where an Islamic bank purchases a product for a client and sells the same goods to him at an agreed mark-up price that is paid in instalments. In Arabic Islamic finance literature, the phrase used for *murābahah* transactions is “*al-murābahah li al-āmir bi al-shirā*” (*Murābahah* to Purchase Orderer). Since a profit margin is added explicitly to the cost price, it is often referred to as “cost-plus financing” in English. In Malaysia the term “*Bay' bi thaman ājil*” (BBA) is used for long-term credit sales. In Turkey, it is also called either “production support (*üretim desteği*)” or “individual financing support (*bireysel finansman desteği*)”.

The contemporary application of *murābahah* is a product of modern conditions; hence, there are many different aspects that call for debate. Although modern *murābahah* is widely accepted by scholars of Islamic law, there are still several controversies around its application. On the other hand, since *murābahah* mimics the standard debt contract in conventional banking systems, its predominance represents a challenge to the idea that Islamic finance would provide an alternative to interest-

based conventional financial systems. Therefore, *murābahah*, as applied by Islamic banks today, has generated debate amongst Islamic scholars and Muslim finance specialists.

Some scholars and nonprofessionals find Islamic banking and *murābahah* arrangements artificial since they see banks as pure financial intermediaries and not traders. On the contrary, many scholars see *murābahah* financing as valid and suggest that Islamic banks are supposed to be “non-pure financial intermediaries” meaning that they have to assume some kind of commercial intermediation. Instead of providing funds directly to investors, Islamic banks are supposed to transfer assets they purchased to clients through credit sale during *murābahah* (Sairally, 2002, p. 80; Saadallah, 2007, pp. 174-175).

This paper offers a discussion about the main criticisms directed at modern *murābahah* financing from the perspective of Islamic law. The Islamic validity of modern *murābahah* as practiced by Islamic banks will be evaluated and any violations of the injunctions will be highlighted.

***Murābahah* in classical Islamic law**

In classical *fiqh* literature, sales (*bayʿ*; pl. *buyūʿ*) are categorized into two groups according to how the price is determined. If the price is determined between buyer and seller without referring to the original cost of the goods, it is called a *musāwamah* (bargain) which is the common form of trading. On the other hand, if the seller discloses his cost and his profit or loss, this is called a trust sale (*bayʿ al-amānah*). Depending on whether the seller discloses a profit or a loss, it is called *murābahah* or *wadīʿah*, not to be confused with *wadīah* which is a safekeeping agreement]. If the good is sold at its cost, it is a *tawliya* (Mawsili, 1937, vol. 2, p. 28).

The word *murābahah* is derived from the Arabic word *ribā* that means profit or gain. *Murābahah* literally means doing business on a cost-plus-profit basis. As mentioned above, *murābahah* is one of the “trust sale” categories. In *murābahah*, the seller explicitly reveals his cost and specifies his profit margin as percentage of the cost or in definite money terms (Abū Zayd, 2004, p. 37; Sairally, 2002, p. 74). This type of sale makes sense for customers who do not know the market price and would like to depend on the declaration of the seller.

The most important condition for this sale to be valid is that both parties know the cost and selling price of the goods. Additionally, according to most *fiqh* schools (except the Shāfi'īs), the goods must be *mithli* (standard) objects, and according to Hanafis the goods must be something exclusive of gold and silver. Since this is a trade based on trust, in case the seller is dishonest in his declaration of the cost, this is regarded as cheating and a compensation for this is dealt with in detail in classical *fiqh* works (Abū Zayd, 2004, p. 53).

***Murābahah* as a modern instrument**

Modern *murābahah* is based on a bank's purchase of some goods and reselling them to the customers who requested them. Eventually this is a sale with an agreed profit margin over the cost price along with deferred payment (Ayub, 2007, p. 219).

Murābahah, which is an ordinary type of sale in the classical period, seems to have undergone a significant change and transformation by evolving into a modern contract type and financing model that is increasingly located in the center of Islamic banking. *Murābahah* contracts as practiced today by Islamic finance institutions have highly differentiated shapes and terms compared to the classical *murābahah*. Modern *murābahah* is a complex and multi-stage process compared to its classical equivalent/counterpart. The point the modern *murābahah* has reached is quite different from the classic *murābahah* transaction in its nature and quality. That is why this new contract is also called "financial *murābahah*" (Saadallah, 2007, p. 174). We prefer the term "modern *murābahah*" in our paper.

The first introduction of this concept to Islamic banking is by Sami Hasan Hammoud in his PhD thesis "*Tatwīr al-'amal al-maṣrafiyyah bimā yattaḥiqqu ma' al-sharī'ah al-Islāmiyya*", meaning "Developing banking products that is in accordance/consistent with Islamic law" (Hammoud, 1976). He has based his model mainly on some examples mentioned by Imam al-Shāfi'ī. Modern *murābahah* helps banks assist clients to obtain commodities they need, and payments are subsequently made to the Islamic bank by installments. Modern *murābahah* consists of three components:

- i. Promise phase: the bank and the customer promise the buying and selling of goods or services.

- ii. First contract: The bank purchases the requested goods or services from a third party at the order of the client.
- iii. Second contract: The bank charges a mark-up to the cost and sells the goods or services to the customer at credit (Abū Zayd, 2004, pp. 239-243; Sairally, 2002, p. 74).

The first thing we can say about modern *murābaḥah* is that it is a compound contract and not directly related to the classical straightforward and simple *murābaḥah*. When we compare the two contracts, we see similarities in some aspects but many differences in other aspects. It is clear in this case that differences prevail. When we look more closely, it is not possible to mention a similarity in their natures but only a resemblance of names. In this sense, giving long lists of similarities and differences between the two contracts can be misleading. Hence, it is important to underline the difference between the two contracts in their nature.

First, modern *murābaḥah* is a complex contract that consists of three stages. The first two steps have nothing to do with *murābaḥah*. In the first stage, the customer promises that if the bank purchases the property he needs, he/she will repurchase it from the bank; in the second stage, the Islamic bank acquires the good for the customer and in the third stage, the bank sells the property to the promising customer. Only the third stage of modern *murābaḥah* is identical to classical *murābaḥah*, since the price of goods in both sales is determined based on their original costs. Consequently, only the third stage is subject to classical rulings about classical *murābaḥah*.

The promise made by the customer to the bank turns this arrangement into a three party compound contract. While in classical *murābaḥah* there is neither a request from the customer nor a promise (*wa'd*) or prior agreement between the customer and the bank. This difference is a major one that changes the structure and validity of a contract and renders it impossible to see both contracts as identical. Another point is that, in classical *murābaḥah*, customers do not know the cost of the goods, so the vendor's false statement related to the cost seriously affects the authenticity of the contract. Whereas in modern *murābaḥah* the customer knows the price and the added mark-up exactly. Many times, the customer himself does all the arrangements related to the sale on behalf of the bank. Therefore, the core idea of classical *murābaḥah* ("a trust sale") seems no longer relevant in modern *murābaḥah*.

In contrast to classical *murābahah* in modern *murābahah*, the bank tries to sell the goods immediately to the requesting customer and tries to avoid damage liability. This also forms a major difference in the two contracts. Another difference is that theoretically, the payment of the price in both types can be either by cash or in installments. However, practically the payment in modern *murābahah* is always in installments. Lastly, modern *murābahah* utilizes views/rulings of different legal schools (*madhhabs*) to obtain a permissible contract while classical *murābahah* is deemed permissible by all schools of *fiqh*.

Although it is a common practice to spot similarities in this context, eventually it is very hard to find significant similarities between classic and modern *murābahah*. Depending on whether the initial promise is regarded binding or not, this difference would be more or less clear. Mostly, current Islamic banking practices are based on the premise that promises are binding. Therefore, it would make more sense to see modern *murābahah* as a new type of contract that needs to be evaluated according to the general principles of Islamic law. In light of this background, we see three different approaches to the permissibility of modern *murābahah* among scholars (Cebeci, 2010, pp. 215-219).

Proponents of modern *murābahah*: This approach constitutes the majority view. The scholars who adopt this view mostly base their ideas on practical concerns like economic needs of Muslims, competition with interest based banks and permissibility of producing new types of contracts in Islamic law.

Opponents of modern *murābahah*: These scholars see the large-scale use of *murābahah* as a deviation from Islamic banking principles and criticize the long-term tendency of Islamic banks to utilize debt-like instruments. They demand from Islamic banks to replace them with profit-and-loss based instruments.

Balanced approach to *murābahah*: These scholars accept this new instrument in a general manner but raise objections to some details of the theory and also to the practical application of modern *murābahah* by Islamic banks today. This approach constitutes our stand on this issue.

It seems that the arguments of the supporters of modern *murābahah* are more attractively presented in contemporary scholarship, since practical financing needs of the Muslims overrides many other concerns.

Consequently, when it comes to doing legal reasoning (*ijtihād*) regarding banking and finance, key terms like *ḍarurah* (necessity) and *maslahah* (social benefit) come up first. Another method utilized is recourse to combining views of different legal schools (*taḥfīq*) in validating modern *murābaḥah*. This eclectic method is highly problematic because whenever scholars face a problem, they choose a view from different legal schools that solves the problem. This is done without regard to academic integrity and consistency of the legal schools.

Problems and criticisms of modern *murābaḥah*

There have been debates among contemporary scholars concerning the modern *murābaḥah* contract and the conditions it is based on. The questions raised relate to such issues as the value of time, the binding promise, avoidance of Islamic banks of risks related to trading and whether modern *murābaḥah* is a disguised form of interest (Sairally, 2002, p. 75).

Time value of money: Murābaḥah vs. interest based loans

Modern *murābaḥah* has been criticized as being a roundabout way of charging interest by artificially transforming a financing transaction into a purchase and sale with deferred payment. The most important theoretical justification for this is the issue of compensation for value of time. It is maintained that the increase in the price vis-a-vis the selloff ordered goods on credit to the client is analogous to interest charged on a loan. This argument is fallacious since it equates reselling at a higher price and charging interest. We have to make it clear that Islamic law allows associating a value to time in case of a sale while it prohibits it in the case of a loan. Hence, time can be attributed value when there is a sale related to real commodities. Similarly, a modern *murābaḥah*, when carried out properly, involves a credit sale to the client and not a loan to finance his need. Therefore, its nature is that of a sale and not a conventional loan (Ayub, 2007; Sairally, 2002).

The permissibility of unilateral promises (wa'd) to be binding

The problem of binding promises is actually the core point of the discussion around modern *murābaḥah* since this issue has a deep impact on the nature of an arrangement. When a client orders a commodity from an Islamic bank, the bank requests the client to sign a “promise to buy” to ensure that the client eventually buys what he/she ordered. The

bank also promises the client to sell him the good when it is purchased. This is because Islamic law does not allow the selling of a good that is not owned yet since ownership cannot be immediately transferred to the purchaser (Sairally, 2002, p. 84).

Islamic scholars are unanimous that promises are ethically binding. The discussion is whether they are also legally binding and whether law can enforce promises. There are differences of opinion on this subject. Only the Māliki School is of the idea that promises are also legally binding (Hattab, 2000, pp. 240-241). On the other hand, classical scholars have mentioned some arrangements similar to modern *murābahah*. These examples, which are equivalent to “*murābahah* to purchase orderer”, show that most of the classical legal schools see this practice valid since they regard promises as non-binding. According to the other three schools of law, unconditional promises that are not associated with a cause or condition is non-binding.

The dominant view in the Māliki School regards promises as legally binding if the promised person or entity has assumed an obligation based on this promise. However, the view of the Māliki School cannot be a justification for modern *murābahah*, since classical Māliki texts see examples similar to modern *murābahah* as impermissible since they consider promises as binding (Bājī, 1914, vol. 5, pp. 38-40; Mālik, 1985). Therefore, Imam al-Shāfi‘ī clearly mentions that if this arrangement is regarded binding, it will render the transaction invalid. On the other hand, the Ḥanafis suggest that the intermediary should buy the commodity with option (*khiyār*) in case the promising client changes his mind (al-Shāfi‘ī, 1990, vol. 3, p. 39; Sarakhsī, 1993, vol. 30, pp. 237-323).

If we consider the promise as non-binding, there is no problem from the view of Islamic contract law because this does not establish any link between the promise and the latter sales. However, regarding promises as unbinding today does not conform with the needs of Islamic banks and exposes them to commercial risk. Additional cost may be incurred for marketing goods that were initially acquired based on a promise by the customer to buy, but later refused without any reason. Therefore, for practical concerns, unilateral promises need to be regarded as binding. This is possible by either combining different views of schools (*tafīq*) or coining new terms like “contract(ual) promise” or “*ahd/taahhud* (a stronger promise with severe consequences)” (Cebeci, 2010; Saadallah, 2007, p. 175).

The Islamic Fiqh Academy of the OIC [Organization of Islamic Cooperation] regards unilateral (one-sided) promises in commercial dealings as binding if the promisor caused the promisee to meet with some liabilities or expenses. If the promisor breaks his promise, the court may force him either to purchase the commodity or pay actual damages to the seller but not the opportunity cost (Resolution 41 and 42 of the 5th Conference in 1988; Ayub, 2007; Hattab, 2000, p. 241).

Avoidance of banks of the risks related to ownership and possession

When the initial theory of Islamic banking was proposed, the bank was supposed to be active during the search for plausible goods, contacting the dealer, supplying and transferring it to the client, whereas in contemporary *murābaḥah* practices, we see that banks try to avoid all risks related to ownership and possession of the object before its final sale to the client. This attitude may comply with conventional banking principles but it is contrary to the legitimate gain theory of Islamic contract law. Islamic legal rulings on modern *murābaḥah* require Islamic banks to become involved in trade to some degree. In this point, the question arises whether Islamic banks shall stay as financial intermediaries or shall turn into traders. The answer to this question is that Islamic banks have to add the latter function to that of financial intermediation. Therefore, we can call Islamic banks' status during modern *murābaḥah* transactions as “non-pure financial intermediation” (Ayub, 2007, pp. 444-445; Saadallah, 2007, p. 174; Sairally, 2002, pp.80-81).

Since Islamic banks are not well equipped for the trader role and try to minimize all possible risks, they tend to avoid getting directly involved in trade transactions. Reflections of this problem can be observed in several practices of Islamic banks.

- a. Most of the banks appoint third party agents (many times the client himself) to act on their behalf while purchasing goods, taking delivery and reselling them. The bank appoints the client as his agent: i) to buy the goods on behalf of the bank, ii) to take delivery of the goods and iii) to sell it to himself (the client) on behalf of the bank. This procedure cuts off operational costs and minimizes for the Islamic bank the risk of buying goods that would be later refused

by the customer. However, this is problematic from Islamic viewpoint because the bank does not take delivery of goods, bears any commodity risk at all and all risks are associated with the client acting as agent. Unfortunately, these types of practices make modern *murābahah* contract seem very similar to bank loans and remove the essential difference between Islamic banking and conventional banking loans. We can say that using agents can only be permissible, so long as the bank bears the commodity risk (*damān*) of the good from the time of the bank's possession until it is resold to the client (Cebeci, 2010, pp. 149-151; Sairally, 2002, p. 81).

- b. Some banks stipulate in the contract that even if the commodity cannot be delivered due to external reasons, the client has the obligation to pay the installments to the bank. This stipulation is unacceptable in Islamic terms because the bank has to deliver the goods specified in the order.
- c. Possible defects ('ayb) in the object of sale are also a similar problem. Banks do not accept the responsibility for any defects in the goods. This is justified with the help of the Ḥanafī view that accepts total irresponsibility of the seller for defects if it is stipulated during the purchase. (Abū Zayd, 2004, p. 225; Cebeci, 2010, pp. 164-165).
- d. Some banks stipulate charging earnest money during the promise stage. Money paid as security is a matter of debate in Islamic contract law. Those who see it permissible see it only permissible related to a contract and there is no contract during the promise stage.
- e. Some banks stipulate that the client has to pay the insurance premium although the burden for these costs has to be on the bank during this stage (Abū Zayd, 2004, p. 226).

Conclusions

The discussion that took place on modern *murābahah* is perhaps one of the most detailed and complex debates in Islamic contract law and Islamic economic thought. Therefore, modern *murābahah* is a typical sample that can help us to understand modern Muslim scholars' approach to contemporary economic issues and the reasoning they apply to come up with solutions.

Modern *murābaḥah* has two faces: the theoretical face and the practical face. While Muslim scholars represent the theoretical aspect, Islamic banks across the Muslim world represent the practical aspect. Those who are against the practice of modern *murābaḥah* have problems in explaining why it is theoretically impermissible and those who are pro-modern *murābaḥah* find difficulties in justifying its practical application by many Islamic banks today.

Our study showed us that, unlike the similarity in their names, modern *murābaḥah* is completely different from its classical namesake. Therefore, it is not possible to render modern *murābaḥah* permissible using classical madhhab-based *fiqh* methodology. However, we do not want to say that modern *murābaḥah* should be considered impermissible. Adopting a strict interpretation that regards debt-finance as prohibited is neither realistic nor viable. According to empirical research in the developed countries, the best possible lowest result in external finance in the form of debt is 35 per cent (Yousef, 2004, p. 76). The point we want to highlight is that we should not try to base its permissibility on classical *fiqh* principles or its resemblance to previously known contracts in Islamic law. Combining views of different legal schools for this aim is also not a consistent approach. The best approach is to regard modern *murābaḥah* as a new nameless (non-nominal) contract and judge/evaluate it based on the main principles and prohibitions of Islamic contract law.

Although modern *murābaḥah* is a credit solution for those clients in need of a specific commodity who cannot afford to make cash payment, at the same time, its dominance represents the failure of Islamic banks to respond to the full range of financing needs of those seeking external finance that is in accordance with Islamic values. Another shortcoming is in the field of development. The tendency of Islamic banks to utilize debt-like instruments took them away from the goal of contributing to the development of their countries. There is a clear need for the adoption of other less debated modes of financing that also encourages long-term investments.

In conclusion, we can say that modern *murābaḥah* transactions that are carried out in conformity with its initial theory are in accordance with Islamic principles and do not violate Islamic law. It is clear that Islamic banks cannot act as pure financial intermediaries and have to

assume a commercial function to some extent. There tends to show up more problems during the practice of modern *murābahah*. Therefore, Islamic banks should put in a great deal of effort towards the proper implementation of modern *murābahah* and take the necessary precautions to correct any deviations in the practice of it.

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