Modern Murabaha - a fiduciary sale or a misnomer?

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The use of the term infancy in reference to Islamic finance law - *murabaha* included - is somewhat revolting when the infant is over fourteen hundred years old. It gives rise to questioning the term used introducing old instruments in a new garb, embroidered with Islamic calligraphy that might or might not be shari’a compliant.

Notwithstanding the known prohibitions in Islamic law, business transactions are permissible by default. Absent necessities, when prohibitions are clearly expressed, the perfect tender rule applies where substantial compliance does not render an instrument permissible. Thus it seems the infancy label is used in the context of modern finance and adapting some Islamic principles to accommodate conventional financial instruments or banking practices. However, Islamic market ethics have existed throughout history protecting pecuniary, property and liberty interests of members of society. More specifically, money in Islamic law is to be circulated creating equitable economic opportunities with negative covenants safeguarding the exploitation of the weaker party. The modern use the *murabaha* contract is at the center of this debate.

Loitering on the use and definition of *murabaha* is necessary as there are significant implications: Today *murabaha* is far and wide the most popular and most common mode of Islamic financing. It is also known as mark up or cost plus financing (in fact the word *murabaha* is derived from the Arabic word Ribh that means profit). It is by far the instrument of choice in most Islamic finance houses minimizing risk for such institutions, with higher return in a short investment cycle. This is further evidenced by some of the largest Islamic funds trading vast amounts of *murabaha* contracts – often in the overnight or money markets (indeed some *murabaha* mutual funds in Saudi Arabia hold well over US$1 billion in assets under management).

Modern *murabaha* is as controversial an instrument as it is maligned by practitioners, mainly due to the fact that the bank plays a marginal role in the goods or commodities sold (where the bank is neither a merchant nor in the business of selling the goods - rather a basket of kaleidoscope goods being financed). Aside from being a financier, such practice will be held as a violation of the ultra vires doctrine in most common law jurisdictions. Recently though, there have been modest moves in Kuwait, Qatar and the UAE where banks have become merchants acquiring car dealerships and real estate properties, selling the products with a deferred mark-up margin, a move that is closely aligned with shari’a principles (for instance in Kuwait some car dealerships operate under the concept of musawama albeit the markup is not disclosed to the buyer but asset ownership is far more exact). Although AAOIFI has attempted to standardize *murabaha* contracts, the use of *murabaha* by IFIs is consistently inconsistent - at least a dozen definitions or methods for structuring such contracts exist.
In an article by Haider Ala Hamoudi on modern law murabaha titled “Chasing Chickens and the Murabaha” the author describes a debate on the issue of compliance of Murabaha contracts between him and Sheikh Yusuf Talal DeLorenzo, this specific anecdote comes to mind:

“I referred to a moment in my childhood when I complained to my grandfather respecting the Shi’a prohibitions on eating rabbit. Why was it, I wanted to know, that all the Sunni school kids could eat rabbit, but I could not? My grandfather, Allah bless him, was unfazed, and told me I wasn’t missing out on anything, because scientists had shown that if you chase a chicken around for 30 minutes and then slaughter it, it ends up tasting precisely like rabbit. (If he’s right, then I can confirm, rabbit tastes just like chicken.)”

Traditional murabaha is neither a chicken nor a rabbit, rather a fiduciary sale where the seller expressly mentions the cost he has incurred on the commodities to be sold with a mark-up known to the buyer conditioned by an honest declaration of cost. Plain and simple. Murabaha is rarely used by Islamic banks with the price paid immediately by the customer. In such cases, there would be no financing included and the Islamic bank would simply be a middle-man or broker-agent (simsar).

Modern day murabaha contracts arguably meet the requirements of the traditional definition under Islamic Law. Or do they? If we take a look at a generic modern murabaha definition (take for reference the recently issued Islamic banking guidelines of the Monetary Authority of Singapore, as shown in figure 1); it is a contract between the Bank (here Bank A) and a customer (here Bank B) under which the customer initiates the purchase of certain goods/commodities/assets as an Agent of the Bank, and after taking possession of the goods/commodities/assets (normally constructive) Bank A sells these to the same customer (Bank B) by adding a certain profit margin to its cost over a deferred period of time (here P + X). Finally Bank B, after purchasing the assets back, sells the assets to an external party (a commodity house or other third party).

Figure 1: Structure of a murabaha interbank placement

Source: Monetary Authority of Singapore

In most cases, the bank never takes actual or constructive possession of the goods sold (the ‘flow’ of the commodity is very much transient), the buyer does the shopping and price...
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negotiation. Once a deal is reached between the buyer and the seller, the buyer approaches several Islamic banks and gets approval on financing the product. The buyer signs an agreement with the bank for the scheduled payments and the bank in return communicates with the seller and obtains the relevant information to finalize the purchase and issues a check in the full amount for the goods purchased.

To begin with, we have two transactions: the first is a principal agent relationship which is in most laws acceptable absent an agreement if the principal ratifies this fiduciary relationship after the fact. However in most instances the buyer does the shopping prior to contacting a bank. It is acceptable to have an agency relationship without the knowledge of the principal once the relationship or acts by the agent are ratified by the principal. It is unusual to have an agent status without the knowledge by the agent himself, as intent cannot be retroactive. The accidental agency here is a stretch or a legal fiction of sorts but let’s assume that the buyer being an agent is implied in fact.

The second transaction is Bai’ Bithaman Ajil (BBA) or modern murabaha, a contract of deferred payment sale (i.e. the sale of goods on deferred payment basis at an agreed selling price), which includes a profit margin agreed by both parties. The profit margin in this context is justified since it is derived from the buying and selling transaction as opposed to interests accruing from the principal lent out.

As for the profit margin being a fixed rate, the opinion of the permissibility of such contract is best articulated by Dr. Mahmoud Amin El-Gamal, a well-known Islamic economist, in an article titled “Permissible Financing Methods” where he cites Islamic jurists such as ‘Ibn Rushd (Maliky) and the likes:

“The contemporary confusion is hardly new. In ‘Ibn Al-‘Arabiy’s ‘Akhkam Al-Qur’an, he reports a specific argument given by the Arabs during the time of Prophet Muhammad (pbuh) to support their statement that “trade is like Riba” [2:275]. They argued as follows: Consider a credit sale, with a price of 10 payable in a month. After a month, the buyer and seller agree to postpone for one more month, and increase the price to 11. The latter is forbidden Riba. They then argued: is this not the same as an initial sale with the price of 11 deferred for two months? The answer in [2:275] was a decisive “but Allah has permitted trade and forbidden Riba”. The legal difference between the two is very clear: one is a sale in which price is increased for deferment, and the other is an increase in the amount of a debt for deferment. The first is permitted, and meets almost all the financing needs, which can be met through forbidden Riba-based lending. The second, however, is strictly forbidden. The permissibility of the first and the prohibition of the second are both quite clear and unequivocal. Therefore, we may use credit sales as a form of finance, and we must categorically avoid interest-bearing loans.”

In the context above it is presumed that the transaction takes place directly between the seller and the buyer. In most cases the bank is not a merchant nor does it deal with the products sold. The role of the bank is less than marginal and only as a financier.

In addition, the problem does not arise from the profit margin being fixed rather the way it is calculated. Most Islamic banks today simply use LIBOR (a Riba-based lending index for conventional banks) as a reference or a measuring stick for the profit margin. Permissible? Yes. Ideal? No.

It is preposterous to assume that the need to finance a product is a Novus concept in Islamic society, the need has existed throughout history. The two major distinctions between traditional BBA and modern BBA is that currently most Islamic banks take no risk in the transaction and the role is simply limited financing. The commodity is often secured by filing a financing statement securing the bank’s interest. And for an added measure
some banks ask for two co-signers who hold deposit accounts in the lending bank for the transaction to be approved.

The disclaimer of all warranties by the bank poses another problem, where the risk of loss is on the buyer dealing with latent defects or the destruction of the subject matter without fault leaving the customer to incur the hardship and the expenses of litigation. The bank must take actual risk for the sale to be a real bona fide shari’a compliant transaction.

Another contentious issue with the current modus operandi is having two sales in one, a sale and a condition in one contract are not permissible in Islam, although some Islamic jurists endorsed such practices if the sale is divided into phases or separate transactions; however, the problem remains where the ultimate buyer is normally unaware of such distinctions when the two transactions take place contemporaneously.

Finally, the use of liquidated damages on non defaulting customers, where the bank imposes a liquidated sum even in cases of an early repayment of the financed amount is simply unconscionable. The liquidated damages provision thus operates as a penalty and should not be enforced because it does not fix damages in light of anticipated or actual harm that never happens. Damages should thus be limited to any harm the bank suffers, if any not as punitive measures.

A fiduciary sale that lacks trust, covenants of good faith and fair dealing or equal bargaining positions is nothing but a misnomer. It is time for banks and fatwa incorporated to reconsider such practices and stop the chase, let that proverbial chicken rest, it will never become a rabbit.

ASIDE: Market signals & side-effects.

The debate over Murabaha is significant because it presents the industry with a slippery slope. In their “Guidelines on the Application of Banking Regulations to Islamic Banking”, the Monetary Authorily of Singapore clearly states that it “does not expect the risk profile of an Islamic bank to be fundamentally different from its conventional banking counterparts.” The MAS is not at fault of equating participatory banking with fractional banking (which could not be more different), it is simply stating the facts of current market practice.

The MAS goes on to state quite succinctly that “the payoffs and risks in making a murabaha deposit are similar to that of a deposit placed in the conventional banking system”, it is no surprise that commodity murabaha is often branded as ‘comedy murabaha’ by practitioners. In that sense, murabaha is just one more example of the divergence we observe: what practitioners are clamoring for and what the industry is delivering to them in practice.

When a regulatory body states that “throughout the transaction, the bank is expected to minimise the holding period of the assets so as to avoid being exposed to the price movements of the assets” one must wonder where are the risk-sharing and asset-ownership principles that form the basis of Islamic banking.

The MAS directive to the industry is clear: “The bank can also choose to take security over the underlying asset in a murabaha to enforce the repayment of the amount owed.” Never mind that foreclosure and forced-sale are not exactly ideals of Islamic banking.

These are signals that are allowing the industry to move closer and closer to conventional banking, when that model is suffering the worst crisis it has seen in the last sixty years.