CHAPTER - I

INTRODUCTION
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1.1 Background & Theoretical Framework:

As originally held by the theorists, the risk-sharing is the core principle of Islamic finance, upon which they produced the Islamic banking model in the form of *mudarabah* and *musharakah*. Thus, unlike conventional banks, Islamic banks were expected to engage in equity financing, sharing profit and losses with their clients. But it could no longer gain momentum and good footing into the market in the real world and proved to be too risky and difficult (due to obvious moral hazard problems and other reasons) to make it practical and viable in the prevailing environment where the Islamic banks were also to compete with conventional banks. Further, being the part of an infant industry, they had to prepare themselves to capture the market share so as to strengthen their base and get the good standing in the market. They turned to less risky operations rather than more risky ones, to generate the necessary profits for their depositors who wanted their funds to be invested in less risky assets than those targeted by venture capitalists.

*Murabahah* (mark-up) financing constitutes less risky, rather a safe operation on the part of financier, hence represented the most favoured form of finance used by Islamic banks as it accounts for 70 percent of their financial transaction.

Experts in Islamic finance generally advise the use of profit/loss sharing (PLS) modes and do not encourage extensive use of *Murabahah* or other trading modes. But, as its legitimacy from *shari'ah* position is accepted and almost all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional mode of credit, studying *Murabahah* from the point of view of Islamic banking is crucial and hence is the subject of the present study.
Several reasons are given for the popularity of *Murabahah* in Islamic banking investment operations:

1. *Murabahah* is a short-term investment mechanism and, compared with Profit and Loss Sharing (PLS), is convenient.

2. Mark-up in *Murabahah* can be stipulated in a manner which ensures that the Islamic banks are able to earn a return comparable to that of conventional banks with which they are in competition.

3. *Murabahah* avoids the uncertainty attached to earnings of businesses under a system of PLS;¹ and

4. It does not allow the Islamic banks to interfere with the management of the business since the bank is not a partner with the client but their relationship, instead, under *Murabahah*, is that of a creditor and a debtor respectively.

Originally *Murabahah* is a sale with the declared cost plus added profit. In present days it is typically used to facilitate short-term trade transactions and has been adopted as a financing mechanism. Thus, the *Murabahah*, presently being used in contemporary Islamic banking is something different from classical *Murabahah* sale contract used in normal trade. This modern *Murabahah* is concluded with a prior promise to buy or a request made by a person interested in acquiring goods on credit. As such, it is called “*Murabahah* to Purchase Orderer”. The AAOIFI²’s *Shari‘ah* Standard on *Murabahah* is also based on this arrangement. Under this technique, a customer wishing to buy goods requests the financial institution to purchase the items on his behalf and sell them to him at cost plus a declared profit on a deferred payment basis usually. It is thus a financing cum sale transaction. Buying the goods from the manufacturer and selling them to the borrower produces a period during which the bank owns the goods and so

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² Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
bears the risk.\(^3\) The bank, instead of sharing uncertain profit with the client, is to receive a fixed payment by a certain time. Thus, Murabahah, in economic consequence, outwardly resembles conventional consumer loan and therefore remained vulnerable to criticism since its very inception and regarded as less truly Islamic mode of finance.

*Murabahah* financing leaves the entire results of the use of the commodity financed in productive enterprise for the user. It is the one to bear losses, if any, and it is the one who owns all the profits. The financier has no share in the profit of *Murabahah*-financed enterprise. That sounds good for the incentive to work and manage the enterprise to the best of one's capacity. No agency problem and no moral hazard.\(^4\)

As it is believed that the original type of *Murabahah* arose as a result of a buyer wanting to buy certain goods but he did not have expertise and much knowledge about price, quality of the goods or markets etc. Hence he engaged the services of another person who was conversant with these aspects and offered him remuneration for his expertise as a mark-up on the goods. Here the aspect of credit does not enter into the relationship between the two at all. Hence present practice in respect of credit involved financing as such in contemporary *Murabahah* is completely at variance with that obtained in classical *Murabahah*.

The reason for emergence of this specific form of financing was to search for a *Shari'ah* compliant financial instrument capable of competing with conventional consumer-finance products and apply it in the area where *Mudarabah* or *Musharakah* etc. failed to operate.

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4 Siddiqi, M.Neajatullah (2004), 'Riba, Bank Interest and the Rationale of its Prohibition', Jeddah, KSA, IDB/IRTI, p. 73
Taking cognizance of real world problem, the practice of Murabahah changed over time owing to various reasons. Over the years, a number of additional alterations have been added. Some adaptations have made it more close to conventional loan. One of the main legal (fiqhi) point concerning the actual ownership of the goods by financial institutions seems in certain types of Murabahah deal (such as synthetic Murabahah) to be more symbolic than real. The duration theoretically is of merely a moment. The banks, therefore, is doubted to truly assume possession, even constructively. Further, the risks taken by the banks are most of them if not all of them, insurable. It is easy thus to pass on the cost involved to the customer as part of the mark-up. The introduction of tawarruq (commodity Murabahah) recently has aroused more controversy surrounding the shari‘ah acceptability of such financing method. Critics sternly disapprove this form and hold the view that it has significantly compromised its identity as Shari‘ah compliant method. As a result of criticism, many financial institutions have vowed to start phasing out certain types of Murabahah operation, though in practice this remains to be seen.

Despite many improvements over the way Murabahah was practiced, there are a number of factors attracting the criticism and thereby it needs some fine-tuning to bring it nearer to the ethos of Islamic finance.

To sum up, on the one hand, Murabahah is the most preferred financing technique among Islamic banks due to its nature of being less risky but on the other, it is the most criticized mode of finance as well owing to its close proximity to interest based banking method.

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5 Warde, Ibrahim (2005), Corporate Governance and the Islamic Moral Hazard, op. cit. p. 19
6 Siddiqi, M.Nejetullah (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’ op. cit. p. 75
7 Vogel and Hayes (1998): 143, as cited by Ibrahim Warde, op. cit. p. 19
1.2 Statement of the Problem:

The trade-off between the need to preserve distinctive identity of Murabahah and the needs of the market place led the practitioners to be in dilemma. Recent adaptation made this technique more vulnerable to criticism on shari’ah ground. It is interesting to know what the real causes that resulted into mess are and what should be the measures to sort it out.

In Murabahah, debt obligation in the form of installments incurred by customers may be criticized for promoting debt transactions in the society and thereby giving rise to the ills of a debt driven financial system and jeopardizing the pro-stability of the Islamic financial system.

One then wonders whether the Islamic finance model based on predominantly debt-based solution will end up experiencing the same problems encountered in the conventional finance model.8

Murabahah is by its very nature focused on short-term financing. It is not capable of meeting the long-term needs of time taking industrial projects, for example. In practice Murabahah has been used mostly in financing trade. As a result of diverting most of its funds towards Murabahah Islamic banks may be failing in their expected role of mobilizing resources for development.9

In view of the above fact, it can be concluded that the Islamic banks’ too much reliance on Murabahah may not be healthy in future. Now the question arises:

Considering the economic consequences of using the Murabahah operation as well as its deficiency on shari’ah ground, to what extent, the Islamic financial institutions have tried to reduce or phase out this financing method over a period.

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9 Siddiqi, M.Nejatullah (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’, op. cit., p. 75
of time and increase the share of sharing or equity based modes of finance after experiencing the successful operation. The answer strongly calls for an empirical study.

While much discussion has taken place and some good literature has been produced, they are exhibited on theoretical plane concerning the various issues of contemporary Murabahah and controversy surrounding its latest practices. The practical and operational aspects with empirical study have not received as much attention. Thus, it can only be surmised that since its inception, Murabahah financing techniques remained as a leading method for providing finance by Islamic banks but how much Islamic banks used Murabahah as well as other modes of finance over the years and what are their relative share in IFIs’ financing activities, what is the incidence of use of various financing methods esp. Murabahah, which of these methods are more amenable for use in certain sectors, how much they are allocated to various sectors of the economy like manufacturing, trade, agriculture and what are their term structure etc., what are the economic repercussions in using sharing and non-sharing based modes. For example, in the absence of empirical evidence, it can only be surmised that the larger the ratio of demand deposits on the liabilities side and the more the ratio of debt finance (based on debt-generating modes like Murabahah and leasing) the more the vulnerability of the system to liquidity problems and threats of bankruptcy.10

It is also needed to set out to determine the significance of each of the Islamic financing techniques in the total operations of Islamic banks and whether

there have been any changes over a period of time in the composition of the financing techniques used by various Islamic banks.\(^\text{11}\)

These are basically empirical questions and can not be answered without reference to actual practices of Islamic banks. Though, of late, some studies on this line, has been made to attempt to focus on such issues but they are not significant. The detailed studies on various aspect of murabahah financing from this perspective are not good enough and it is difficult to even surmise its latest trend. Hence, this study on the present subject is, to an extent, theoretical as well as somewhat empirical in nature. It makes a little attempt to study the concept of Murabahah theoretically and investigate of its use and practice by Islamic banks as financing method in comparison with other techniques. The efforts have been made to know as whether some changes has taken place or not with regard to use of this form of financing \textit{vis-à-vis} other modes over the course of the years and as to what extent other instruments has been given place including the introduction of new methods to meet the need of finance in contemporary world. However, the researcher who is interested in such issues found himself confronted by a major difficulty i.e. the non-availability of relevant data. The annual reports of Islamic banks which mostly contain statements of balance sheets and profits & loss accounts cannot provide any information on these issues.\(^\text{12}\)

Experts in Islamic Economics and finance generally advise the use of profit/loss sharing (PLS) modes and do not encourage extensive use of Murabahah or other trading modes. But, as its permissibility is beyond doubt and all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional mode of credit, studying Murabahah from the point of view of Islamic banking is crucial and hence is the subject of the present study.

\(^{11}\) Ahmad Ausaf (1987), Relative Significance of various Financing Technique of Islamic Banking: Evidence from Islamic Banks, \textit{Paper presented at} The Sixth Annual Conference of The Royal Academy For Islamic Civilization Research (Al al-Bait Foundation, Amman, Jordan

\(^{12}\) Ahmad Ausaf (1987) op. cit.
1.3 Objective of the Study:

The primary objective of this study is to analyse theoretical and practical aspects of the most favoured form of Islamic financing i.e. Murabahah (Mark-up). A comparative analysis between variable return and fixed return modes is made and the difference between Islamic and conventional banking is critically examined in this study. In other words, the main purpose of this study is to investigate the Murabahah financing technique and to analyze its increasing share in total financing operations of Islamic banks over time in comparison with other techniques.

In dealing with these issues, the study aims to achieve the following objectives:

(1) To give a brief historical background on the origin and growth of Islamic banking and finance with special reference to the Islamic financial intuitions of Gulf region on the basis of empirical evidences.

(2) To identify and evaluate the major modes of Islamic financing instruments in general and Murabahah in particular in the light of Islamic economics principles and suggest means to achieve the higher level of compliance.

(3) To survey the changing trend of Murabahah financing technique over the period of time and consequent causes.

(4) To ascertain the problems associated with the Murabahah transactions and to highlight its relevance as a mode of finance to the socio-economic problems of Muslims.

(5) To examine critically Murabahah mode of financing from legal (juristic), theoretical and practical point of view.

(6) To offer some tentative suggestions on the subject based on the findings of the research.
1.4 Methodology and Approach of the Study:

The methodology adopted for this study involves the following:

(1) The collection of material on Islamic banking and finance with focus on Murabahah, from various sources both within and outside India and survey of the available literature related to the subject.

(2) Examination of the secondary data on the subject through a study of dissertations, annual reports, balance sheets, brochures, journals, periodicals, bulletins, handouts, newspapers etc.

In an empirical study, it is possible to adopt either a country-based or an institution-based approach. However, on account of the limited nature of the available information, neither of these approaches has been fully adopted. Instead, an attempt has been made to use country-based approach to the possible extent.

1.5 Assumption of the Study:

Despite some deficiencies on Shari’ah ground Murabahah meets the preference of investors and depositors for risk free returns comparable to the market rate of interest. This is the reason for predominance of Murabahah in the Islamic financial market. However, as the Islamic Financial Institutions’ market share grows, investors desire higher returns and depositors listen to the critique of Murabahah, there is likely to be a decline in its market share, losing to profit sharing based modes of finance such as Mudarabah and Musharakah.

1.6 Scheme of the Study:

The thesis is divided into eight chapters. The first chapter is an introduction to the study. It explains statement of the problem, the objectives and purpose, methodology and approach and limitation of the study.

Second chapter starts with the literature review of the Islamic finance core concept, its practices and evolution in general and Murabahah in particular so as to
review Islamic financial system both in its theoretical and practical perspective. It also highlights the fundamentals of Islamic finance, its distinguished features and advantages. In particular, it reviews Islamic and conventional banking, and provides a comparative analysis of the two systems. It also discusses some basic issues regarding Islamic concept of sale & contract and business ethics.

The third chapter presents the background and overview of Islamic banking and finance as how its emergence and evolution took place and what was the background and main factor that led to its emergence and it being developed as viable alternative to interest based banking system. In this connection we have highlighted the recent trends and development of Islamic banking industry.

The fourth chapter is a broad introduction to original Murabahah contract as discussed by classical jurists. It elaborates the legitimacy and rationale, nature and classification of Murabahah contract under the legal opinions of four major school of Islamic jurisprudence viz Hanafi, Maliki, Shafi'i, and Hanbali. It also deals with different financing techniques used by Islamic banks so as to demonstrate the nature and function of these methods in contemporary Islamic banking.

Chapter five focuses on Murabahah as a mode of finance, its theoretical development, practical aspects and procedures. It deals with the basic features and conditions of contemporary Murabahah guiding its adoption, some important aspects and its applicability to meet the various needs of finance practiced by modern Islamic banking industry.

Chapter six focuses on empirical analysis of Murabahah operation, it shows the recent trends & growth rate of Murabahah financing during the period 2000-05 and analyses it on the basis of empirical evidences and explores the causes of rise in Murabahah financing and its decline. It also studies Murabahah financing with other modes of finance comparatively.
Chapter seven analyses the contemporary issues, practical aspects and problems arises in Murabahah financing such as increased price in credit sale, rebate in the case of early payment, use of interest rate as benchmark for mark-up determination, bindingness of promise on the part of clients, problem of defaulting and issue of imposing penalty in the case of unscrupulous defaulters etc.

Chapter eight of the thesis provides a summary and conclusion of the study and some suggestions.

1.7 Limitation of the Study:

Because of inadequacy, non-access and the lack of the relevant data, we have included the data of the Gulf Cooperation Council (GCC) countries’ commercial banks only. Thus, quality of data leaves something to be desired. However, one must not neglect the fact that the relevant data of the banks of GCC countries can not be underestimated as they constitute considerable share in Islamic banking industry. Further, our time series is not long enough as the study covers the period of 2000-05 only.