CHAPTER - VIII

CONCLUSION

& SUGGESTIONS
CONCLUSION AND SUGGESTIONS

The appearance of Islamic banking and finance on the scene of global financial world and its rapid growth is an important development of the modern time. It has experienced tremendous growth not only in the Muslim world but also around the western world showing its viability and competitiveness as an arrangement of financial intermediation. The driving force behind the Islamic banking and finance movement was the prohibition of riba and permissibility of bay (trade) and the spirit of following the shari'ah (Islamic law) principles in undertaking commercial activities. Its theory was primarily developed on the basis of the PLS (Profit & Loss Sharing) principles i.e. participatory (Islamically acceptable) financial contracts, namely, Musharakah and Mudarabah. However, the practices of Islamic financial institutions failed to conform to the theory and greatly relied on the mark-up principle i.e. Murabahah. The PLS (equity based financial arrangement) is in stark contrast to the interest based financing mechanism, but the mark-up principle has not such degree of dissimilarity from the conventional method of lending and financing rather it seems to be similar to conventional financing mechanism.

So far as the operations of Islamic financial institutions are concerned, it is in plain sight that they concentrate on installment sale which is based on the mark-up mechanism. The Islamic banks has so far not heavily based their operations on participatory financing mechanism because of various reasons and practical problems and in place of equity based financing methods, they preferred fixed return or mark-up financing techniques due to its nature of being less risky and meeting the preference of risk averse depositors to give them profit without being bothered with the lurking fear of losses to suffer. Thus Islamic financial institutions seem to be satisfied with this state, but Islamic finance theorists who advocated the model of PLS based financing method as true mode to be
implemented to fully exploit the benefits of such principles, express dissenting views in connection with the extensive use of mark-up mechanism and worried about this state of affair and they (theorists and Shari’ah scholars) have shown concern in understanding the causes of such happening. While deliberating on the problems of Islamic banks, the theorists concentrate on the problems faced in the application of PLS modes, and try to propose the possible solution in its successful implementation but, on the other hand, the practitioners and bankers show their interest in discovering the ways to solve the problems related to mark-up based operations and they try to ignore the issues associated with the difficulties confronted in applying participatory financing mechanism. They do not find such operation viable and practically much workable due to noticeable moral hazard problems & agency problem and in view of the existing environment where the Islamic banks are to compete with conventional banks. Furthermore, the application of PLS modes intensively need a number of tedious jobs like extensive survey of the markets, assessment of credentials and credibility of partners, project evaluation and check & balance activities to monitor the business involved. A minor laxity on their part at times may lead them to be fallen prey to terrible predicament. In the case of liquidity problem, they may find themselves in trouble to come out from unpleasant situation. Moreover, they feel contended to simply play the role of financial intermediary like conventional banks and avoid being involved in trade like activities. On the contrary, Mark-up mechanism is free from such predicaments, rather in such mechanism there are far more options to mitigate the risk. But the main problem is that such method can not be used as a good profitable venture in long term projects and various business activities. Its uses are, to a large extent, limited to short term operations. Thus, there seems a dichotomy between the profitability and feasibility approach. Moreover, the need of the market demand many alteration in the structure of financing operations of Islamic banks that may affect and bypass the objectives of shari’ah (Islamic law) and compromise on the degree of compliance with Islamic law. The trade-off
between the need to preserve distinctive identity of shari‘ah compliant financing methods and the needs of the market place makes the practitioners to face a dilemma.

To be brief, the theorists and practitioners are not in harmony in connection with the solution of the problems. The former usually advises the use of profit/loss sharing (PLS) modes and do not support the idea of extensive use of Mark-up (Murabahah) or other trading modes. Whereas, the latter, on the contrary, concentrates to use fixed return trading modes because of its viability in present environment. An attempt is made in the present research to study the mechanism of Mark-up (Murabahah) and its critical examination from the perspective of theory and practice as it is of no dispute that this method is not only being widely used by Islamic financial institutions but also it dominates over the operations of Islamic banks catching a very large share in financing activities in comparison with other modes of finance irrespective of equity based such as Musharakah, Mudarabah or fixed return/sale based forms of financing such as Ijarah, Salam, Ististna etc. The experts esp. theorists has shown high concern on the prevailing dichotomy in the theory and practice of Islamic banking and are not satisfied about its implications for the future of Islamic financial service industry.

Murabahah is a trading instrument in its original layout that has been adapted for financing purposes for providing a facility similar to credit facilities offered by interest based banks, while avoiding involvement in prohibited interest. When carried out correctly with due observance of all requirements, Murabahah provides a lawful means of fulfilling one’s immediate financing requirements at a premium, without being constrained to borrow on interest. However, due to the forced nature of the task Murabahah is required to perform which is not what it is originally designed for, financing on the basis of Murabahah involves numerous conditions, laxity in the observance of which may make the transaction invalid.
This would result in the failure of the basic purpose for which Murabahah was adopted in the first place, which is avoiding violation of Shari’ah.

Thus, the major positive aspect of Murabahah when carried out correctly is that it provides a lawful alternative to financing on the basis of interest, which is no meagre benefit. As far as those who avail Murabahah facilities are concerned, their benefit is principally in the form of avoiding entanglement in the curse of riba, thus ensuring their spiritual and material well being in this world as well as in the hereafter. Involvement in *riba* or interest, which is a heinous crime tantamount to waging war with Allah *Ta’ala* and his messenger (may peace be upon him), and which brings on the curse of Allah *Ta’ala* and his messenger (may peace be upon him) in addition to being the source of a host of economic evils, is replaced with a structure that is not unlawful in *Shari’ah*. This in itself is a major achievement of Murabahah based financing. Moreover, funds that were paid as interest to conventional banks previously and which served the purpose of furthering the interest based system are now channelled to Islamic banks and their depositors in the form of lawful profit, which is a tangible gain.

However, it should not be forgotten that enjoying the fruits of the economic system propounded by Islam requires more than only evading direct violations of Shari’ah. In fact, Islam has provided complete guidelines for establishing a just economic system that could eradicate social and economic oppression resulting from interest, monopoly, hoarding and speculation, ensuring an equitable distribution of wealth. A vital requirement in this system is the full-fledged adoption of the equity based financing mode of Musharakah and Mudarabah. Utilising a debt based trading tool such as Murabahah in financing could never bring about the real benefits of the Islamic economic system.

Therefore, employing modes such as Murabahah and Ijarah where the net result is not materially different from interest based transactions, should be restricted to instances where adopting *Musharakah* and *Mudarabaha* etc. is not
feasible. Widespread use of Murabahah in all spheres of financing should be curtailed and means for widening the scope of application of Musharakah actively sought, facilitating the gradual transition from Murabahah based structures to full-fledged implementation of equity based financing such as Musharakah & Mudarabah which executed on the principle of Profit and Loss Sharing (PLS).

As stated in the introductory chapter, the primary objective of the study is to analyze the present practices of Islamic banking with special reference to the most used form of financing method i.e. Mark-up (Murabahah). To achieve this objective, first, a methodological approach to understanding the concept of Islamic banking and finance was developed. Second, the study examined how the structure and practices of Islamic banking differ from those of conventional banking. In this connection the distinguishing features and advantages of Islamic financial system was highlighted. Since the Murabahah method is basically a sale contract, the perquisites of sale was analyzed in relation to Murabahah as how these rules could be fulfilled and fully applied if this sale contract is used for financing purposes.

Second, to evaluate the theoretical and practical development of the concept of mark-up (Mrabahah) in contemporary Islamic banking and finance. To achieve this objective the study investigated the past practices of classical Murabahah contract and its evaluation though the survey of classical fiqh literature as which forms of this specific contract was approved by classical jurist and how the concept of contemporary Murabahah financing was developed and adapted by modern jurists in order to use it as a financing mechanism in the operation of Islamic banks and financial institution.

Third, to see the change in the trend of Murabahah operation used by Islamic banks so as to find out as whether there happened any change in its use as a dominant operation or the use of other financing technique got increased in comparison with Murabahah operation. To this end, an empirical analysis was attempted to make the trend of different financing methods as compared to
Murabahah technique used by commercial Islamic banks of GCC countries during the period 2000-2005. The rest of study presented a comprehensive review on different issues related to the subject.

The study critically analyses the main functioning and features of the conventional and Islamic banking system and demonstrates as how Islamic banking system is a viable proposition that can result in efficient resource allocation and prove to be an alternative to contemporary interest based financial system. They can be summed up as follows:

1. It is argued that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope.

2. Unlike conventional banking, Islamic bank is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis and thus can play a catalytic role in stimulating economic development.

3. Conventional finance typically focuses on profit-maximization within a given regulatory framework, whereas Islamic finance is also guided by other Islamic principles that have certain social objectives for the benefit of human beings and society. It strictly prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.
4. Unlike conventional banking, commercial banking in an Islamic framework is not based on the debtor-creditor relationship. Islamic banks have more stringent Know-Your-Customer requirements than conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients and therefore less concerned about the character and credibility of their clients or the moral implications of the business venture for which money is lent.

5. Under Islamic financial system, the underlying principle which is applicable to both labor and capital is that there should not be any reward without taking a risk. i.e. no payment is allowed for labor, unless it is applied to work, or there is no reward for capital unless it is exposed to business risk.

6. The Islamic financial system is based on equity whereas the conventional banking system is loan based and interest is considered to be the price of credit, reflecting the opportunity cost of money. They are often, more pre-occupied with the underlying securities and assets. whereas, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of funding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks.

The study has also dilated upon the essentials of Islamic finance concept, that must be fulfilled, otherwise the operation could no more be sharia‘h compliant or shari‘ah based. These can be summarized as:

a) Any predetermined payment over and above the actual amount of principal is prohibited.
b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.

c) Making money from money is not Islamically acceptable.

d) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.

e) Gharar (Uncertainty, Risk or Speculation) is also prohibited.

f) Investments should only support practices or products that are not forbidden (i.e. Transactions in unethical goods and services; Earning returns from a loan contract \( \text{(Riba/Interest)} \); Compensation-based restructuring of debts; Excessive uncertainty in contracts \( \text{(Gharar)} \); Gambling and chance-based games \( \text{(Qimar)} \); Trading in debt contracts at discount, and; Forward foreign exchange transactions etc.).

Our analysis also highlighted the resultant benefit and advantages that could be emerged from adopting such interest free financial system from the perspective of efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability etc.

Since the Mark-up (Murabahah) is originally a sale contract which was later adapted for financing purpose and got developed as the most used method of finance in contemporary Islamic banking operation, we have dealt with the concept of sale contract discussing its type, ethics and basic rules that are necessary for the execution of a sale. There are mainly two types of sale with respect to structure i.e. the common or generally widespread sale and specific which constitute the form of 'Trust (amanah) sales. Murabahah falls under the latter category. These different types of sale are known as Musawamah, Tawliyah, Wadiah and Murabahah. The last three ones are categorized as trust sales. The musawamah (Negotiation or bargaining sale) can be defined as a sale at the agreed upon price without reference to the original price of the commodity. This forms
the most common type of sale. *Tawliyah* (At-cost sale or investiture) is a sale in which the object is resold to the buyer for the same price at which the seller obtained it, whereas *wadijah* (sale at a loss), on the contrary, is a kind of sale in which seller sells the commodity (with a known discount) at a price below the original price. *Murabahah*, just quite reverse, is a sale of the commodity at original price plus a stated agreed upon profit margin. It is called as cost-plus sale or Mark-up. As for the basic rules of sale, the main purpose of discussing them is from the viewpoint that if Murabahah is adapted for financing purposes, these rules too would be applied to such Mark-up mechanism and could not be ignored. However, there may be further stipulated some specific conditions to its proper execution so that its compliance with shari’ah principle may not be compromised while accepting it as a financing method. The principal conditions that primarily concern in connection with mark-up financing mechanism are taking the real ownership/possession avoiding any sort of ambiguity in fixing the price of the commodity that must exist. In addition to this, an important issue which may occur in such sale contract, was also discussed under the head ‘options of sale’ which in connotation of Islamic law (*jurisprudence*) are termed as ‘*Khiyar*’. They refer to a specific type of right of either or both parties to the contract to confirm or rescind the contract so as to avoid the potential disputes that may arise due to some sort of uncertainty (*jahalah*) or absence of relevant information (*gharar*).

The study also highlights the unprecedented growth of Islamic banking and finance in the contemporary finance world. Our analysis captures the advancements of Islamic banking and finance industry across the globe from South-East Asia to Middle-East and Europe. Our study has found that the Middle East countries contribute the highest share in respect to geographical distribution i.e. 53% followed by Indian sub-continent, South-East Asia, Africa and the rest of the world as 16%, 13%, 9% and 9% respectively. We have mainly presented a general review that bears facts and figures over the recent developments of Islamic
banking and finance across the globe. It takes stock of the growing institutional and infrastructure support for the Islamic banking and finance system in Muslim countries and Western financial markets.

The findings of our analysis hold that Islamic banking and finance industry has been making breakthrough improvements to become a truly viable and competitive alternative to conventional systems at the global level. Islamic banking and finance institutions have acquired booming grounds in the Middle East, South-East and South-East Asia. After leading conventional bank such as Citibank, HSBC, BNP Paribas, Barclays and USB started offering Islamic financing products on a basic level through dedicated Islamic banking windows or divisions, other leading conventional banks too began to follow the suit which further fueled its mounting growth. These growing Islamic hubs have been acting as a launching pad to promote Islamic banking in Western business and financial markets. Experts attribute to various core factors contributing to the recent success of Islamic banking and finance, such as high liquidity in GCC because of oil production, prolonged boom in the Middle-Eastern economies, product innovation and sophistication, increasingly receptive attitude of conventional regulators and information technology advancements that have been acting as a catalyst for the Islamic banking and finance industry to go global. Given all growth patterns, Islamic banking may be able to win over the majority of customers from the Muslim world that constitutes almost 24 per cent of the world's population (over 1.3 billion), and other ethical groups across the globe in times ahead. Our study has mostly born a subjective outlook taking the stock of on-going developments in Islamic banking and finance industry worldwide and dealt with some latest information, facts and figures, which however do not amount to a substantive volume and not meant to make analysis to figure out the main factors and their actual contributions in making Islamic banking and finance emerge as the fastest growing industry of the global finance. This overview suggests that Islamic
banking industry has been increasingly growing at the rate of 15%-20% over the past many years.

In Murabahah contract, theorists always implicitly stress the sale aspect whereas a transaction has normally two aspects purchase and sale. However, our findings hold that the original type of Murabahah arose as a result of a buyer wanting to buy certain goods either for own use or to participate in his trade, but about the nature as details of which (i.e. price, quality, markets etc.) he/ she does not have expertise. Hence he/ she engaged the services of another person who is conversant with these aspects. The remuneration he offered the consultant is not for per diem (as an employee) but as a mark-up on the goods stressing his/her independent status. In this case the aspect of credit did not enter into the relationship between the two parties at all and the mark-up would be clearly only for the expertise if the finance for the purchase was provided by the ultimate buyer. We, thus find that what sort of situation actually prevailed in the past is different from contemporary state of affairs widespread in modern Islamic banking system. The present practice in respect of credit involved financing as such in Murabahah is completely at variance with that obtained in classical Murabahah.

The discourse on Murabahah is found in almost all main schools of Islamic jurisprudence, however, it was not much discussed or touched upon by the earliest jurists but the later jurists of these schools tried to discuss in rather detail the different form of Murabahah sale and its aspect in the light of shari’ah principles. All are unanimous that Murabahah is special kind of sale with the original price (capital cost) and an added on profit and for validity of this contract, it is compulsory on the seller to fully disclose the original cost to the buyer and the surcharge, extra amount of profit must be known and mutually agreed upon. However, the classical jurists have some degree of difference with respect to different forms of Murabahah. Particularly in relation to specific variety of Murabahah sale, some has disapproved or regarded as makruh while others
thought otherwise. The opposing opinion mainly occurred on the form of Murabahah on purchase order and what way of determining the profit should be allowed. The later jurists of Hanbali School have provided many grounds to argue for the approval of different aspect of Murabahah.

As far as the legitimacy of Murabahah is concerned, our analysis finds that the legal evidences or indicators variously adduced by the classical jurists for the legitimacy of Murabahah contract are mainly general in nature and not at all specific to Murabahah. Hence, later classical jurists had recourse to legal principle when explaining the legitimacy of Murabahah: ‘It is lawful owing to its meeting all the conditions for validity’. They conclude that the basic principle is the permissibility of things, and no clear text exists prohibiting such a transaction. As regards the rationale of Murabahah, they hold that there is a great need for this sort of dealing because one inexperienced in the ways of business will have to depend on those more experienced, and be satisfied with paying as much as the more experienced one has paid.

As for our empirical analysis made to know the concentration and growth of Murabahah in financing activities of GCC commercial banks, we find that Murabahah is the most dominating financing technique used by Islamic banks in GCC countries. At times it seems that some banks use Murabahah as their sole financing technique. Its average percentage share stayed at (56.13%) over the period 2000-05. The second most popular form of financing used by GCC Islamic banks is Muajjal followed by Ijarah which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.

We also observe from Murabahah financing growth rate that there is U-shape change. During 2000-01, the percentage increase was (14.28%) and then (8.04%), (-2.40%), (9.07%) during 2001-02, 2002-03 & 2003-04 respectively. During 2004-06, the growth rate unexpectedly reached as high as (16.13%) which was the ever high increase over the period. One may conclude from this U-shape
change in Murabahah operation that the use of this form of financing has gradual decline as its share has been reduced over the past years (i.e. 2000-04) which means that the Islamic banks is swiftly increasing the shares of other financing operations, but abruptly or phenomenal high percentage increase of (16.13%) during 2004-05 demonstrate otherwise and thus indicating that the banks still have heavy reliance on Murabahah operation (a fixed return mode of finance).

However, as we assumed that Islamic banks would rise to the challenge of normative Islamic economists and scholars to increase profit sharing and decrease Murabahah based financing. This somewhat plays down the economic rationale behind the prevalence of Murabahah, which we predict will remain the predominant mode of financing for Islamic banks, as a result of moral hazard concerns. For us to assume that profit sharing will increase just as a result of pressure or whatever reasons is somewhat superficial. Also, a number of Islamic banks particularly in the gulf have a number of restricted investment accounts which invest on a profit sharing basis on equity based projects whether companies or development projects or other. However, the AAOIFI standards require these to be reported off-balance sheet in a separate statement and as a result we will not see these on the balance sheet analysis that we are conducting.

There is also another theory that suggests that Islamic banks will move to profit sharing modes when the moral hazard concerns in their economies alleviate and financial instruments and investments diversify. This will happen when the financial system and wealth of individuals develops more and therefore people have more wealth to diversify. When they don’t have wealth to diversify, investors will prefer low risk deposit returns and therefore Islamic banks will engage in low risk Murabahah investments rather than equity based projects.

The major findings of the study can be summarized as follows:

1. Murabahah is still a dominant and widely used financing technique in comparison with other Islamic methods of finance.
2. The present practice in respect of credit involved financing as such in Murabahah is completely at variance with that obtained in classical Murabahah.

3. Murabahah has played the major role in the growth of Islamic banking and finance industry.

4. The attitude of Islamic banks while practicing Murabahah is largely focused on to mitigate the risk as much as possible and make it a close competitive alternative to conventional loans as it is evident from the introduction of commodity Murabahah/ dealing in synthetic Murabahah in which the essentials of Murabahah esp. the actual ownership of goods is rather symbolic than real.

5. Murabahah is the most dominating financing technique used by Islamic banks in GCC countries, staying its average percentage share at (56.13%) over the period 2000-05 followed by Muajjal and Ijarah which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.

We suggest that:

a) Future prospects of Murabahah depend on the extent to which Murabahah receivables repackaged as sukuk are considered tradable.

b) The issue of penalty for default in case of Murabahah has still to be resolved in a manner which compensates the banks for any loss suffered because of the delay in payment.

Thus, to our mind, the recent upsurge in Murabahah seems particularly due to practical resolution of the two issues noted above.

Nevertheless, this still leaves out the main objectives against Murabahah i.e. it is geared towards short-term financing. The present trend is to take recourse to equity.