Islamic finance – financial institutions, products and services designed to comply with principles of Shari'ah (Islamic law) – is one of the most rapidly growing segments of the global finance industry. Starting with Dubai Islamic Bank in 1975 (and operations in the United Arab Emirates, Egypt, Sudan, Lebanon, Bahrain and Pakistan etc.), Islamic finance has grown by 15 -20 percent in each of the past three years, and since the inception of modern Islamic banking the number of Islamic financial institutions worldwide has risen from one institution (i.e. in Dubai), to more than 300 institutions with operations in 75 countries and with assets more than 500 billion US$ today. Islamic banking assets and assets under management now exceed US$1.7 trillion, and the Islamic finance sector is expected to reach US$2.7 trillion by 2010.

Though initially concentrated in the Middle East (especially Bahrain) and South-East Asia (particularly Malaysia), Islamic financial system is now increasingly found elsewhere. This includes developing economies where the financial sector is almost entirely Islamic (Iran and Sudan) or where Islamic and conventional financial systems coexist (Indonesia, Malaysia, Pakistan and the United Arab Emirates). It also includes developed economies where a few Islamic financial institutions have been established and where large conventional banks have opened Islamic financing windows (such as in Europe and the United States).

While the finance on Shari'ah principles has been practiced for many centuries, the concept of contemporary Islamic finance is a recent phenomenon that developed in the last three decade. In our days, the Islamic financial institutions offering Shari'ah based or Shari'ah compliant products and services have become more widespread and substantial. The emergence and rise of these institutions is an important academic and practical development of our times.
Theoretically, the main principles upon which Islamic finance is based are:

i. the prohibition of Riba (usually interpreted as usury or interest) and the removal of debt-based financing;

ii. the prohibition of gharar, encompassing the full disclosure of information, removal of asymmetric information in contracts and the avoidance of risk-taking;

iii. the exclusion of financing and dealing in activities and commodities regarded as sinful or socially irresponsible (such as gambling, alcohol and pork);

iv. an emphasis on risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for a pre-determined share of profits and losses;

v. the desirability of materiality, a financial transaction needs to have ‘material finality’, that is a direct or indirect link to a real economic transaction; and (vi) consideration of justice, a financial transaction should not lead to the exploitation of any party to the transaction.

In practical terms, these prohibitions and recommendations manifest themselves as the following commercial products and services offered by Islamic financial institutions:

1. *Mudarabah*, the provision of capital to a partial-equity partnership in return for a share of profits, but where the losses on funds lent are borne by the lender;

2. *Musharakah*, full equity partnerships where the provider of funds and the entrepreneur directly and wholly share in the business,
3. *Murabahah*, an instrument used for financing the purchase of goods and services where the financial institution purchases these on behalf of the customer;

4. *Bai muajjal*, deferred payments on products encompassed under *Murabaha*;

5. *Bai Salam*, advance or pre-paid sale contracts of goods and services;

6. *Istisna*, or manufacturing contracts to cover work in progress and paid by the financial institution on behalf of the customer;

7. *Ijarah*, lease financing in the form of operating leases only; (viii) *Takaful* or Islamic insurance in the form of cooperative self-help schemes, and

8. *Qard Hassan*, benevolent loans offered interest free. Thus, by using them, the Islamic banks, can also provide the products similar to the products and services offered by conventional banks with the exception that Islamic financing principles apply to the underlying bank assets and liabilities.

In brief, the Islamic law prohibits charging and paying of interest but allows earning profits by involving in trade and business activities. Therefore, the very prohibition of riba or interest is the core of Islamic finance which has led to the emergence of Islamic financial system. The theory of Islamic finance evolved on the basis of profit and loss sharing (PLS) principle underlying participatory Islamic financial contracts such as *Mudarabah* and *Musharakah*. However, the practice of Islamic finance does not conform to the theory and overwhelmingly relies on the *Murabahah* (mark-up) principle which motivates deferred trade. The PLS is in striking contrast to the interest mechanism, but the mark-up is not. It poses the interesting question as why the Islamic banks which, unlike conventional banks were expected to engage in equity financing, sharing profit and losses with
their clients, concentrated much on other than PLS principles. The answer can be sought in consideration with the real world situations i.e. the Islamic banks, because of obvious serious moral hazard problems, high risk and other practical problems, avoided to much engage in PLS principles and further to compete with conventional banks in the market, they needed less risky and fixed return financing techniques. Moreover, 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. For these reasons, 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* 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 about 70 percent of financial transaction.

It goes without saying that the theorists and 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.

The very purpose of this study is to provide a synoptic survey of Murabahah. The main objectives are:

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 survey the changing trend of Murabahah financing technique over the period of time and consequent causes.

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

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. 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 bears the risk. 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.

However, 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. Murabahah successfully meted the needs and proved to be a viable alternative to conventional consumer loan.

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. The introduction of tawarruq (commodity Murabahah) recently has aroused more controversy surrounding the shari’ah acceptability of such financing method.

To conclude, Murabahah, on the one hand, 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.

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. Therefore, theorists assert that Islamic banks’ heavy reliance on Murabahah may not be healthy in future.

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

Hence, this study on the present subject is, to an extent, theoretical and a bit empirical in nature. It makes an attempt to study the concept of Murabahah theoretically and investigate its use 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 the use of this form of financing vis-à-vis other modes over the course of the years. However, this study is limited to the commercial banks of the Gulf Cooperation Council (GCC) region for the period of 2000-2005 only. The study is exclusively based on secondary
data published by the General Council of Islamic Banks and Financial Institutions (CIBAFI), Bahrain. Trend analysis has been used as the main technique in the study and with the help of time series data, the growth and pattern of financing and investment activities of Islamic banks vis-à-vis various financing techniques have been analyzed. The relative share of each technique and method in the total investment and financing activities of Islamic financial institutions has been marked down.

The whole study has been divided into eight chapters. The first chapter introduces the main theme of the study, explaining about 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 reviews Islamic and conventional banking, and provides a comparative analysis of the two systems detailing about the fundamentals of Islamic finance, its distinguished features and advantages and various basic issues related to sale as Murabahah is originally a sale contract and thus requires meeting the necessary rules of sale. While highlighting the main features and pre-requisites of Islamic financial system we have tried to demonstrate as in what ways it differs from the contemporary interest based banking system and how it is a viable proposition that can result in efficient resource allocation and prove to be an alternative to modern interest based financial system and further what advantages, benefits and desirable effects it produces, if such system is implemented in true sense.

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.
Chapter four 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 and later on highlights the concept of contemporary Murabahah. As regards the concept of Murabahah, we have tried to analyze this specific form of contract investigating its traditional use as found in the discourse of classical Islamic jurists and its contemporary adapted structure which is particularly being used for financing. 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 discusses the basic features and conditions of Murabahah guiding its adoption, some important aspects and its applicability to meet the various needs of finance practiced by contemporary 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. The thesis ends with the relevant glossary of Arabic terms and bibliography.

The main 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.