

Ashurst briefing

Murabaha financing

Business highlights

Islamic finance has achieved rapid growth averaging 15–20 per cent over the last ten years¹:

- *At the end of 2008, the size of the Islamic finance market was estimated to be US\$1tn.*
- *Of this, the commodity murabaha market was alone estimated to be US\$100bn².*
- *The ratings agency Standard & Poor's has forecast that the Islamic finance industry could potentially control up to US\$4tn of assets.*

In an Islamic financial system, all transactions must be governed by norms of Islamic ethics as enunciated by the *Shari'ah* (Islamic law). While entering into commercial transactions is not prohibited, the freedom to contract is proscribed by other norms, such as the prohibition of *riba* and *gharar*.

The word *riba* literally means "increase". In the context of commercial transactions, however, *riba* refers to usury or interest. Prohibition of *riba* is central to Islamic financial ethics and law. All transactions and contracts must be free from elements of *riba*.

Gharar literally means "risk", "uncertainty" or "hazard". *Gharar* is considered to be of lesser significance than *riba*. While the prohibition of *riba* is absolute, some degree of *gharar* or uncertainty is acceptable in the Islamic commercial framework. Only conditions of excessive *gharar* need to be avoided.

The making of loans *per se* is not prohibited by the *Shari'ah* but the charging of interest is. Thus transactions which are debt-based and involve the payment of interest (e.g. the making of a loan which carries interest) are not *Shari'ah* compliant but transactions that create a debt (e.g. the sale and purchase of goods where the sale price is a debt owed by the purchaser to the seller) are permitted.

Other proscriptions include:

- prohibition of financing certain economic sectors: these include gambling, pornography, alcohol, pork, armaments, etc.;
- *al-kharaj bi-al-daman* which means "revenue goes with liability": the investor and financier must share the risk of all financial transactions; and
- financial transactions should be underpinned by an identifiable and tangible underlying asset.

Shari'ah board/committee

Transactions entered into by Islamic banks or conventional banks that have an Islamic division (i.e. banks which have capital committed to Islamic business) are scrutinised by a board/committee comprising a number of eminent Islamic scholars to ensure that they comply with *Shari'ah* principles. The *Shari'ah* board also informs the bank's lending policies. Different *Shari'ah* boards may have differing views on a given issue as a result of the various schools of thought within Islamic jurisprudence. Usually, however, there is convergence among the four main schools of thought within Islamic jurisprudence on the majority of issues. In addition, many modern-day scholars sit on the *Shari'ah* boards of a number of different Islamic institutions.

Before a transaction proceeds, the *Shari'ah* board of the relevant bank will issue its *fatwa* (opinion). There is usually no need for any subsequent review as to



Sky's the limit? Islamic finance has averaged growth of 15-20% over the last ten years

whether a particular financing remains *Shari'ah* compliant in the opinion of the relevant *Shari'ah* board.

General principles

A number of financing techniques have been developed to comply with *Shari'ah* principles. The *murabaha* is one of the most common methods of Islamic financing and is principally used in trade financing arrangements.

The Quran declares sales and purchases of *mal* (assets) for a profit to be lawful. A *murabaha* is a sale on a cost-plus basis where payment of the price (including the mark-up) is deferred to a later date.

The mechanism may be simply described as follows:

Person A is in need of commodity X. A approaches Bank B. B buys X from the vendor/supplier V at price P. This price is also known to A. Next, B sells X to A at a marked-up price, say P+M, where M is the agreed profit or mark-up taken by B. Typically, the mark-up charged will be based on a benchmark such as LIBOR plus a margin, so the economic effect is similar to an interest calculation under a conventional facility. The payment of price P+M is now deferred to a future date and is made in full or in parts. There are two distinct sale contracts that occur at different points in time. The first contract is between V and B and the second contract is between B and A.

It is worth noting the mutable nature of the relationship between the bank and its client. In the first phase, the relationship between them is that of a promisee and promisor. It then changes into a principal-agent relationship. In the third phase, it is a seller-buyer relationship. Finally, when the second sale is completed, it is a creditor-debtor relationship. Therefore, it is important that at each stage their roles, rights and obligations are understood.

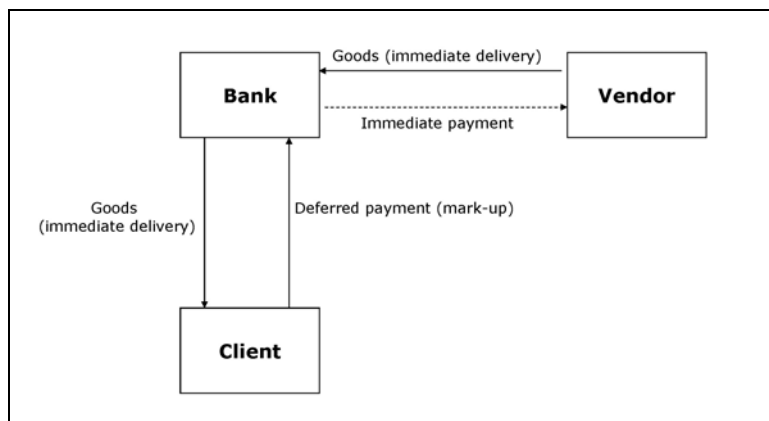
The principal steps of a *murabaha* transaction are as follows:

- The client indicates an interest in purchasing a particular asset from the bank for a certain price (a combination of cost price plus profit) at a certain time (the utilisation date).
- The client identifies the vendor, selects the goods and advises its particulars, including the vendor's name and its cost price to the bank in writing. Often the bank will appoint the client as its *wakil* (agent) to acquire the asset on the bank's behalf.
- The bank acquires the asset and offers to sell it to the client. The vendor will typically make delivery of the asset to the client (as the bank's agent). Delivery need not be physical, it can also be constructive (i.e. evidenced by delivery of documents of title).
- The agency contract comes to an end. The client accepts the offer and the bank immediately sells the asset to the client, with payment due on the agreed date in the future.

US\$4tn
Value of assets that the Islamic finance industry could potentially control (Standard & Poor's)

There are many variations of the above structure in the Islamic finance markets.

A *murabaha* facility may appear similar to conventional bank financing with the profit rate or mark-up being contemporaneous with the rate of interest. Indeed the distinction between the two may disappear if proper care is not exercised. *Shari'ah* therefore imposes several constraints and prescribes certain norms in order that a *murabaha* facility is free from *riba*. Conditions that aim to keep the product free from prohibited *gharar* are also prescribed. The more important of these are set out below.



Risk and return

The bank must bear a certain amount of risk associated with ownership, such as price risk or risk of destruction of assets etc. in order to legitimise its returns. Conventional banks providing interest-based loans are also exposed to these risks. Under the *Shari'ah*, however, such risk exposure is not enough to legitimise gains. In order to ensure that the bank's gains are above all suspicions of *riba*, the sequence of steps described above must be followed.

Murabaha may give rise to risks and liabilities for the bank or for the transaction that need to be assessed and, if appropriate, mitigated. However, many of these arise in conventional financing structures, such as traditional leasing, and are not unique to Islamic finance.

For example:

- the bank may incur liability as an owner of an asset (during the period before it transfers the asset to its client), such as liability for death or injury or environmental damage;
- there may be taxes payable on the acquisition or on-sale of an asset;
- warranties (e.g. fitness for purpose) may be implied in respect of the assets under the applicable laws;
- loss, destruction or delays in the production or construction of the asset may be an issue for the bank - if there is no "deliverable" asset, can the bank claim any payments from the client? In other words, can the bank pass on the asset risk to its client?

Subject of murabaha

The assets which are the subject of the sale must fulfil, among other things, the following requirements:

- The subject of sale must exist and be in the ownership (physical or constructive) of the bank at the time of sale. In other words, the second contract must "follow" the first contract. This risk-bearing by the bank - even if for a short or fleeting time period - legitimises banks' profits under *Shari'ah* as distinct from prohibited *riba*.
- They must be something of value that is classified as property in *fiqh* (Islamic jurisprudence) and must not be forbidden commodities, such as alcohol, pork etc.

Specification of price

The sale price and payment terms must be known. The price is fixed at the time of contracting, as is the mode of payment, e.g. frequency and quantum of instalment payments. This is to avoid any *gharar* or uncertainty. Where the sale price includes a known profit or mark-up, the profit rate can be determined or expressed in relation to the market interest rate such as LIBOR. The price may not always be specified in the main *murabaha* documentation but can often be the subject of side letters/agreements between the parties.

Default risk and its mitigation

A major risk for banks associated with *murabaha* financing is default by borrowers. Conventional lending usually has in-built disincentives against default and

often has incentives for voluntary prepayment. The borrower is required to pay default interest, which is deemed to be compensation for the delay or time value of money. Similarly, if the borrower decides to prepay, it does not have to pay interest for the remaining period although sometimes prepayment also carries a premium.

In a *murabaha* transaction, the price is fixed so any savings on prepayment of the deferred sale price may not be possible. There is, however, a difference of opinion among scholars in relation to rebates on voluntary prepayment.

There may not be any objection to the bank granting a rebate on a voluntary prepayment by the borrower (as an act of kindness and virtue!) if the rebate is voluntary and at the discretion of the bank. The rate of the rebate cannot be specified in the *murabaha* contract. However, most Islamic banks do provide for a rebate in case of voluntary prepayments. So far as delays and defaults are concerned, various methods have been suggested to mitigate these risks:

- Require the borrower in default to donate a specified amount for a charitable purpose. The bank collects such donation and uses the same for a charitable purpose on behalf of the borrower. Needless to say, such a penalty does not form part of the income of the bank and hence, does not compensate the bank either partially or fully for its cash flow problems caused by delays and delinquencies. It merely acts as a disincentive.
- Require the borrower to pay compensation to the bank for the actual loss it suffers due to delays and delinquencies. Arguably, the payment of such compensation may be contrary to *Shari'ah* principles.
- Stipulate a condition in the contract that in the event of payment default of a single instalment that is due, the remaining instalments will become due immediately. However, this alternative may cause undesirable hardship for the borrower and may (arguably) be contrary to *Shari'ah* principles.
- Seek security from the borrower either in the form of (among others):
 - a mortgage, lien or charge on any of the borrower's assets;
 - a guarantee from a third party; or
 - a promissory note or a bill of exchange.

"given its exponential growth over the past few years, murabaha continues to offer significant opportunities to both financiers and borrowers"

- Reschedule instalments. In conventional banking, loan rescheduling is often accompanied by additional interest charges for the timing differences. *Murabaha* does not allow such rescheduling as no additional amount can be charged for the same. The amount of the *murabaha* price remains unchanged. Some banks attempt to circumvent this by changing the unit of currency. This is not, however, permitted.

Conclusion

As described above, *murabaha* financing is not without its issues. However, given the exponential growth this sector has experienced over the past few years, it continues to offer significant opportunities to both financiers and borrowers.

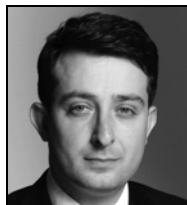
Notes:

- 1 Islamic Finance Review July 2008
- 2 Middle Eastern Insurance Review December 2008

Ashurst's Islamic finance group

Ashurst's award-winning Islamic finance practice is a dedicated team consisting of prominent Islamic finance lawyers qualified under English, German, French, UAE, Indian and other law. The team advises in relation to the full range of *Shari'ah* compliant products including *sukuk*, *murabaha*, *musharaka*, structured products including securitisation, *Shari'ah* funds and *Shari'ah* project finance transactions. Our Islamic finance practice covers our clients' Islamic finance needs in Europe, the Middle East and Asia.

Our lawyers' work in the field of Islamic finance has been recognised with awards including *UAE Regulatory Team of the Year 2008* and the *Euromoney Project Finance Award for Middle East Transport Deal of the Year 2007*.



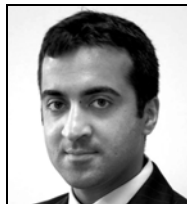
London

Abradat Kamalpour
Partner
T: +44 (0)20 7859 1578
E: abradat.kamalpour@ashurst.com



Tokyo

Matthias Schemuth
Partner
T: +81 3 5405 6200
E: matthias.schemuth@ashurst.com



Dubai

Tahir Ahmed
Partner
T: +971 (0)4 365 2000
E: tahir.ahmed@ashurst.com



Singapore

Shri Maski
Senior associate
T: +65 6221 2214
E: shri.maski@ashurst.com

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Ashurst LLP, Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112 www.ashurst.com

Ashurst LLP and its affiliated undertakings trade under the name Ashurst. Ashurst LLP is a limited liability partnership registered in England and Wales under number OC330252. It is regulated by the Solicitors Regulation Authority of England and Wales. The term "partner" is used to refer to a member of Ashurst LLP or to an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Ashurst LLP's affiliated undertakings. Further details about Ashurst LLP and its affiliated undertakings can be found at www.ashurst.com.
© Ashurst LLP 2009 Ref: 11822825 12 January 2009