



The Premier Islamic Bank

## Murabaha Process, Documentation & Application of Murabaha



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## MURABAHA



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### Murabaha

- Murabaha is a particular kind of sale and not a financing in its origin.
- Since Murabaha is a sale transaction, rules of Shariah regarding sale should be understood.
- Where the transaction is done on a "cost plus profit" basis i.e. the seller discloses the cost to the buyer and adds a certain profit to it to arrive at the final selling price.



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### Murabaha

- The distinguishing feature of Murabaha from ordinary sale is:
  - The seller discloses the cost to the buyer.
  - And a known profit is added.



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## Murabaha

- Payment of Murabaha price may be:
  - 1) At spot
  - 2) In installments
  - 3) In lump sum after a certain time
- Hence, Murabaha does not necessarily imply the concept of deferred payment.



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## Murabaha

### Basic rules for Murabaha financing:

- Asset to be sold must exist.
- Sale price should be determined.
- Sale must be unconditional.
- Assets to be sold:
  - a) Should not be used for un-Islamic purpose.
  - b) Should be in ownership of the seller at the time of sale; physical or constructive.



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## Murabaha

### Basic rules for Murabaha financing:

- Re-negotiation of price and roll over of Murabaha are not permitted.
- Discounting of Murabaha instrument is not permitted.



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Step by step Murabaha financing



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## Murabaha

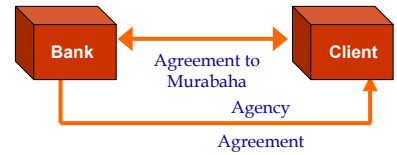
1. Client and bank sign an agreement to enter into Murabaha (MMFA).



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## Murabaha

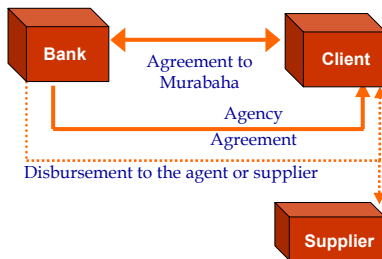
2. Client appointed as agent to purchase goods on bank's behalf



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## Murabaha

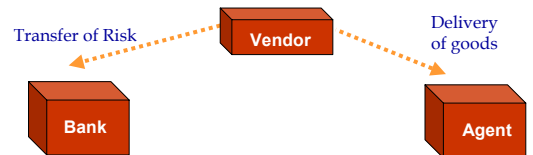
3. Bank gives money to agent/supplier for purchase of goods.



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## Murabaha

4. The agent takes possession of goods on bank's behalf.





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## Murabaha

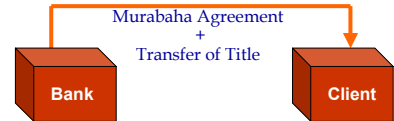
5(a). Client makes an offer to purchase the goods from bank through a declaration.



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## Murabaha

5(b). Bank accepts the offer and sale is concluded.



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## Murabaha

6. Client pays agreed price to bank according to an agreed schedule. Usually on a deferred payment basis (Bai Muajjal)



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## Part II

## Murabaha Documentation & Practical Issues





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## Murabaha Documentation

There are a number of documents involved in a Murabaha financing transaction. The most essential of these documents are:

- Master Murabaha Financing Agreement
- Agency Agreement
- Order Form / Draw Down Notice
- Declaration
- Purchase Evidences
- Demand Promissory Note
- Payment Schedule



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## Murabaha Documentation

### Master Murabaha Financing Agreement (MMFA)

- Its an agreement between the client and the Bank whereby the client agrees to purchase goods from the Bank from time to time as per the terms and conditions of this agreement.
- This is an over all facility agreement under which various Sub-Murabahas may be executed from time to time.
- Hence it needs to be signed once at the time the facility is sanctioned.



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## Murabaha Documentation

### Agency Agreement

- Through this agreement, the Bank appoints customer its agent to select and procure specified goods for the Bank.
- This agreement needs to be signed once between the client and the bank to cover the specified agency period. The disbursement of funds is done under this agreement.
- The customer should define a comprehensive list of assets and commodities that he may procure during the course of business from time to time.



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## Murabaha Documentation

### Order Form

- This document is executed at the time of each sub-Murabaha request i.e. each time when the customer requires Murabaha for purchase of assets.
- Through this document customer requests the bank to purchase the assets from the supplier and undertakes that it will purchase the assets from the bank once the bank acquires them from the market.
- The customer also undertakes to compensate for the actual loss the bank may suffer in case that he fails to purchase the assets from the bank.



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## Murabaha Documentation

### Declaration

- This is the most important part of the Murabaha process.
- Declaration is to be signed by the customer immediately after the purchase of goods as Bank's agent but before the actual consumption.
- This document establishes the actual sale transaction, i.e. transfer of ownership of goods from the Bank to the customer
- At this stage the specific details of the assets must be known i.e. quantity, quality, cost etc.



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## Murabaha Documentation

### Declaration

- Purchase Evidences in the form of bills, sale invoice, sales tax invoice must be furnished along with the Declaration specifying the full details of the goods purchased.
- The cost of goods must be inclusive of all cost including sales tax, transportation and handling etc.
- Proper timing of declaration is extremely important especially in cases of perishable or immediately consumable commodities.
- Murabaha price (Cost of Goods + Profit) should be determined at this stage and stated clearly in the Declaration.



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## Murabaha Documentation

### Payment Schedule

- The Payment Schedule specifies the amount that the Client will make from time to time or at once towards the payment of Murabaha price.
- This shall be executed after the execution of Declaration.
- The dates mentioned in the schedule corresponds to the day when the payment becomes due on the client.



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### Practical Issues in Murabaha



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## Issues in Murabaha

1. Timing of 'Offer & Acceptance'
2. Rollover in Murabaha
3. Rebate on Early payment
4. Penalty in Late payment
5. Subject Matter
6. Purchase Evidence
7. Direct Payment
8. Profit recognition
9. Training of Customer & Bank staff
10. Process of Murabaha differ from product to products



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## Issues in Murabaha

### 1. Timing of 'Offer & Acceptance'

- A Murabaha financing arrangement consists of a series of documents to be executed at various stages, the sequence and timing of which is extremely important.
- Through this, client and the bank execute an important step of a valid Murabaha sale i.e. Offer & Acceptance.
- This is to be signed by the customer when it has purchased and taken possession of the goods as the Bank's agent.
- Offer & Acceptance must be signed while the goods are still in existence and have not been used in the production process or sold to some other entity.



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## Issues in Murabaha

### 2. Rollover in Murabaha

- Rollover in Murabaha is not allowed since each Murabaha transaction is for the purchase of a particular asset. A new Murabaha can only be executed for the purchase of new assets.
- It is advisable that whenever practicable there must be a gap of 1-2 days between maturity of the previous Murabaha and disbursement of the new one.



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## Issues in Murabaha

### 3. Rebate on early payments

- If the customer makes early payment and there is no commitment from the institution in respect of any discount in the price of Murabaha, then the institution has the sole discretion in allowing them the rebate.
- It is not recommended to make it a practice and must be avoided in normal course of business. Such issue, if arises, should be brought in the knowledge of Shariah advisor



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## Issues in Murabaha

### 4. Penalty on late payments

- As soon as the Murabaha is executed, the Murabaha price becomes a receivable (Dayn) for the Bank. Hence, any amount charged over and above the "dayn" amount will be Riba.
- However, it is permissible to have an undertaking from the customer to pay an amount of money or a percentage of the debt to be donated to charitable causes in the event of delay in payment/installments.



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## Issues in Murabaha

### 5. Subject matter of Murabaha

- Goods must exist at the time of execution of Murabaha.
- Murabaha cannot be done in all commodities, e.g. such as currencies, gold, silver.
- Murabaha cannot be used for paying utility bills, wages, overhead expenses, etc.
- General rules of sale related to subject matter must be followed



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## Issues in Murabaha

### 6. Purchase Evidence

- In order to ensure that the customer actually purchased the assets as claimed, the customer is required to submit asset purchase evidence along with Offer & Acceptance.
- The purchase evidence must confirm that the asset purchase took place after the agency agreement.
- Asset purchase may be in the form of Invoices, delivery orders, truck receipts etc.



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## Issues in Murabaha

### 6. Purchase Evidence.....(Contd)

- In some cases, however, it may be too burdensome for the client to submit all the invoices as the number of invoices may run into hundreds.
- For example, cotton purchases are generally in small quantities from various sources and hence for each Sub-Murabaha there may be too many invoices to submit. It is suggested to furnish considerable sample of invoices along with summary of all purchases.





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## Issues in Murabaha

### 7. Direct Payment in Murabaha

- In many cases, the disbursement is made to the customer as an agent of the bank.
- In order to ensure transparency of the Murabaha, it is preferable that disbursement / payment be made directly to the supplier.



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## Issues in Murabaha

### 8. Profit Recognition in Murabaha

- Generally in Murabaha transaction there are in two stages:
  - Investment Stage (Agency to Purchase)
  - Financing Stage (Declaration to payment)
- The profit for the Murabaha transaction can be recognized after the goods are sold by the bank to the customer.



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## Issues in Murabaha

### 9. Training of Customers & Bank staff

- Proper training & understanding of is very important for
  - Bank staff dealing with the Murabaha
  - Customers purchase officers & accounts staff.



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## Issues in Murabaha

### 10. Process of Murabaha differ from product to product

- Application of Murabaha is not simple for all products
- Its application differs from products to products like
  - ✓ Sugar cane
  - ✓ Shares
  - ✓ Leather
  - ✓ Cotton
  - ✓ Gas
  - ✓ Petrol

Therefore the RM/RO dealing with the customer needs to understand and define step wise process flow along with the credit approval for each new customer/industry



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## Implementation of Murabaha Process flow



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### Murabaha Process Flow

- Key points to check
  - Customer Purchasing Cycle
  - Inventory holding period
  - Inventory holding method
  - Payment terms to supplier
  - Mode of Payment
  - Storage / warehousing facility
  - Physical Inspection
  - Timing of Offer/Acceptance
  - Other industry/goods specific parameters



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### Case 1- Murabaha for Vehicles

- ABC Suzuki Autos is a proprietorship concern, running a vehicle showroom. The proprietor purchases cars of different models for Suzuki directly from the manufacturer for further resale in the market. The delivery time varies from 3 months to 5 months and 100% payment is advance.
- The client has approached MBL branch for Murabaha Facility amounting to Rs. 25 million for purchase of vehicle. The Murabaha facility will be for one year at a rate of KIBOR + 3% p.a.
- You have been asked to suggest the step wise process flow, documentation & calculation involved in the above case.



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### Case 1 – Process Flow

- Execution of MMFA and Agency with ABC Suzuki Autos after approval of Limit.
- ABC Suzuki Autos requests (via Order Form) for booking/purchase of vehicles from Suzuki Co worth Rs. 25 mln
- MBL issue Purchase order along with Pay Order in favor of Suzuki Co for booking of vehicles.
- Upon completion of the Order after 5 months, Suzuki will intimate MBL along with asset description (engine/Chassis No. etc)



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## Case 1 – Process Flow

- MBL will intimate ABC Autos about availability of vehicles. ABC autos will submit Declaration (after 5 months) along with Summary Payment Schedule.
- MBL will accept Declaration and will issue Delivery Order along with Transfer Letter in favor of ABC Autos.
- On the due date (one year from the date of disbursement), ABC Autos will pay the Contract Price of Murabaha to MBL.

$$\text{Contract Price} = 25 \text{ mln} * (1 + (k + 3\%))$$