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Shari'ah Precautionary Procedures in *Murabaha* and *Istisna'*

A Practical Perspective

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ABSTRACT

At this stage in the development of Islamic banks, the first priority is to ensure that the financial contracts that Islamic banks use do not contradict the *Shari'ah*. The contracts should be real and devoid of superficiality in application. Two widely used contracts in Islamic banks are *murabaha* and *istisna'*. *Murabaha* traditionally refers to an immediate sale contract, but in modern times is usually thought of as a deferred-payment and markup contract. The unique Hanafi position on *istisna'* distinguishes it from the *salam* contract. Since, for instance, *murabaha* and *istisna'* contracts can be used to sidestep the prohibition of interest/usury, *Shari'ah* boards should pay attention to the many ways that both types of contracts could run afoul of Islamic law. Most importantly, those involved in administering the contracts should be believers in Islamic finance.

I. THE *MURABAHA* CONTRACT FOR THE ISSUER OF A PURCHASING ORDER

The *murabaha* contract has two different meanings, one old, the other contemporary. According to the original *Shari'ah* meaning, *murabaha* is a kind of sale contract in which the buyer orders the seller to buy the goods, and the seller then sells the goods to the buyer, with an additional sum as a profit paid at the same time. It is an immediate contract in which the seller exchanges the price for the merchandise.

To Islamic banks, *murabaha* means selling for a deferred payment after adding a markup to the cost of the goods. The seller should inform the buyer of the cost price. The *murabaha* contract differs in its original *Shari'ah* form from its contemporary banking form in that it does not follow the immediate selling transaction with a disclosure of the price for which the merchandise was bought. There is also the addition of a defined amount of profit (there is no dispute among Islamic scholars as to the legitimacy of this type of *murabaha*). In contemporary banking *murabaha*, the merchandise is not initially in the custody of the bank/seller. It receives an order for purchasing, and the issuer of the purchasing order promises to buy it later for a price that exceeds the banking cost by a defined sum or percentage. This is the reason for keeping the word *murabaha* in the wording of the transaction title "*murabaha* for the issuer of the purchasing order."

There is a significant dispute in scholastic and banking circles about the value of the *murabaha* contract in practice, compared with the contemporary concept, and the effect of such a contract on the workings of an Islamic bank. The scholastic dispute began when Islamic banks started their activities in the 1970s. Since the executive officers of Islamic banks gained their experience through long careers in traditional banks, they designed *murabaha* to appear similar to the lending contracts they were accustomed to. They sought to convince some of *Shari'ah* boards to make the *murabaha* contract binding at the start of the operation and to make the purchasing order issuer's promise a commitment from him. Some *Shari'ah* boards agreed with this argument in order to cope with the position of Islamic banks in that phase. Since Islamic banks back then were still in the idea-formation stage, everyone sought to advance their ideas into reality. However, the commitment of a promise in the contemporary *murabaha* contract is not a matter on which contemporary *Shari'ah* scholars agree.

One of the most important points of the contemporary *murabaha* contract is the commitment to a promise by the purchasing order issuer before signing the *murabaha* contract. The original opinion states a non-commitment to a prior promise in the *murabaha* contract, and contemporary scholars who oppose this commitment justify their position on this stipulation by arguing that:

1. it is a continuance of a historic practice;

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2. the contract nowadays has been used as financial tool by the Islamic banks; and
3. the commitment promise makes it greatly resemble the lending contracts conventional banks use.

If, to the commitment to a prior promise, is added the requirement that one who delays payment must pay financial compensation (on top of the original sum due the bank), the *murabaha* contract is transformed into an interest contract similar to the one used by conventional banks.

In addition, some Islamic banks are lenient about the correct application under the *Shari'ah* of the *murabaha* contract. The bank does not itself buy the goods specified in the contract, and does not have it under its custody, but pays their price to the client. The client purchases the merchandise himself, if he really wants it. Sometimes, the client will deposit the money directly in his bank account because his aim from the beginning was to acquire solvent money (*al-tawarruq*). This turns the *murabaha* contract into a trick to acquire an interest-bearing loan. Acquiring usury deceptively offends the *Shari'ah* more than acquiring it openly.

The contemporary *murabaha* contract, as applied by some Islamic banks, requires a commitment to a prior promise and requires the customer to perform all the transactions as an agent of the bank. The bank's role is limited to paying money in return for collateral. At the end, it receives the deposit plus the profit when it matures. The whole process is a superficial one; the entire operation is merely dealing in papers and money with no effort, responsibility, or risk on the bank's part.

The contemporary *murabaha* contract—in the form and application mentioned—has obstructed the work of Islamic banks. This is a circumstance that has induced one of the most famous Islamic bankers, Shaykh Saleh Kamel, to wish that Islamic banks escape the "*murabaha* bottleneck." Despite all that, most officers of Islamic banks rely on *murabaha* to invest the bank's resources. Much evidence shows that the focus of some Islamic banks on *murabaha* has obstructed the application of other *Shari'ah*-based financial products, and creates a distorted picture of the *Shari'ah* and Islamic banks for non-specialists.

Shari'ah boards should focus on the following important points respecting *murabaha* to ensure that the contract is consistent with the *Shari'ah*.

First, the contract at the promise phase should not be committing. This means that the client has the right, after the promise phase and after the bank acquires the requested goods, to change his mind for any reason he sees fit. He is not committed to buy the goods, except when he signs the selling contract with the bank and before the bank is in custody of the goods. The experiment of Al Rajhi Banking and Investment Company is a good example. Its *Shari'ah* board ruled that clients are not committed to a prior promise. In practice, the number of customers who breach the promise in *murabaha* contracts was negligible, had no effect on the bank's work in this field, and posed none of the risk that traditional bankers had expected when they rejected the form of the *murabaha* contract lacking a prior promise commitment.

Second, the bank must have bought the goods required by the client, and the goods must be in the bank's custody before the sale contract is signed with the client. This is to adhere to what the Prophet Muhammad (PBUH) said: "It is forbidden for one to sell what he does not own, and to profit from what he does not have in his custody."

Third, the bank should not have acquired from the client, before signing the contract, any collateral that may make the client committed in any way toward the bank. If the bank acquires any type of collateral, it should be recorded in a collateral contract. The bank does not have the right to use this collateral unless the client has signed the sale contract with the bank, and the client becomes committed by a contract to the bank.

Fourth, the *murabaha* contract may not include any delay fines or in any way compensate the bank for such a delay in case a client fails to pay on time.

Fifth, it must be ensured that the goods in the *murabaha* contract are not forbidden by the *Shari'ah*, or will not be used for forbidden purpose, such as selling grapes to a person known to be a winemaker or selling weapons to rioters or terrorists.

Sixth, no supplements or side-correspondence may have occurred between the bank and the client in a way that contradicts any of the contract provisions and turns it into a contract that violates the *Shari'ah*. The managers of some banks do not reveal such correspondence to their *Shari'ah* boards and seek to apply the *murabaha* contract superficially.

Seventh, if there is a conflict between the bank and its client, it ought to be solved according to the *Shari'ah*, either by resorting to a *Shari'ah* court or by arbitration according to *Shari'ah* rules.

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II. THE *ISTISNA'* CONTRACT

The *istisna'* contract lets one buy a described manufactured item that the seller does not own at the time of contracting, whether the item is made by the seller or another manufacturer. The *istisna'* contract is a unique feature of the Hanafi school, for the other three schools (Maliki, Shafi'i, and Hanbali) consider it a *salam* sale and apply to it the *salam* rules. Because a *salam* sale is a sale of a described item the not in the seller's custody, the three schools besides the Hanafi attach to the *istisna'* contract a condition of paying the entire price at the contracting time. The Hanafi school says that the *istisna'* contract has its own ruling, and is not considered as a *salam* sale would be. On the basis of the Hanafi opinion, contemporary scholars have ruled that the *istisna'* contract is valid; that the payment of the full price at the contracting time is not obligatory; and that the price can be paid in installments. Furthermore, *istisna'* is a committing contract based on fulfillment of the purchase specifications by the manufacturer.

The *istisna'* contract is misused by some Islamic banks. It has been turned into a form of contemporary *murabaha* on the basis that an item is sold for deferred payment and at a profit included. The *istisna'* contract has been used in a way similar to *murabaha*: as a financial tool by Islamic banks. Therefore, the following important points should be observed for the *istisna'* contract to ensure accordance with the *Shari'ah*.

The goods subject to the contract are manufactured and are not in their raw state (i.e., as God has created them). Therefore, *istisna'* is not applicable to grain, millet, crude oil, and such goods, since they are only to be sold through the *salam* contract because they have not been subjected to the process of manufacturing and have not changed from their God-made nature.

The manufactured item should itself be acceptable in Islamic law. Therefore, no contracts could be made for goods that the manufacture, sale, purchase, and use of which the *Shari'ah* forbids, such as liquor, pork, materials harmful to humans or damaging to environment, and other goods forbidden by Islam.

The *istisna'* contract may not state that the manufacturer will sell goods made by a certain company. The contract should mention only the technical specifications of the manufactured items and not connect them to a certain factory or certain party. Indeed, the Prophet Muhammad (PBUH) forbade such a clause in the *salam* contract, which is the basis of the *istisna'* contract. If this occurs, the contract will be a trading contract because it will involve selling manufactured goods that the seller does not own: an act the *Shari'ah* forbids.

The common procedure to protect the bank from price fluctuations is for the Islamic bank to sign an *istisna'* contract parallel to and with the same specifications as the contract it has signed with its client. The separation between the two contracts should be insured. The *istisna'* contract that the bank signs with its client should not refer to the other contract that the bank will sign with the factory or the party from which the bank will purchase the goods. The bank is committed to deliver to its client, at the time specified in the contract between them, the manufactured goods according to specifications. That is, the bank commits to meeting that contract's provisions, whether or not the factory delivers the goods at the time specified in the second contract between the bank and the factory.

It must be ensured that the Islamic bank does not absolve itself from its responsibility toward its client regarding manufacturing defects. The bank should commit to delivering quality goods that conform to specifications. It can limit the warranty period for the manufactured goods to a few months after delivery of the goods to the client in order to minimize the risk involved. If, during the warranty period, no defects are found, the bank is not responsible for defects that occur later. The contract can state that the original manufacturer of the goods must compensate the client in case any defects emerge. If the original manufacturer does not respond positively during the warranty period, the client has the right to charge the Islamic bank in its capacity as an original guarantor. (The name of the original manufacturer and its address should not be mentioned in the contract between the bank and the client, but should be supplied by the manufacturer in a separate letter, at a later date, and after delivery).

Further, the contract ought to commit all parties to resort to *Shari'ah* courts or Islamic arbitration in case of conflict between the contracting parties. This should be applied if the two parties of the contract are both Muslim. If one is non-Muslim, the two parties should agree to an arbitration procedure. The arbitration procedure and the decision of a court of law may not rule that an interest payment is required.

The *istisna'* contract may impose a fine, payable to the client, on the manufacturer in case it delays delivery. The client can obtain collateral from the manufacturer for the fulfillment of his responsibilities in

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the manufacturing contract. The client has no right to obtain and receive all the rights from this collateral unless the manufacturer fails to fulfill all the obligations stated in the manufacturing contract.

These are the most important points that should be noted to ensure the correctness of the contemporary *istisna'* contract from the *Shari'ah* point of view.

III. CONCLUSION

The best way to ensure that Islamic finance contracts follow the *Shari'ah* is to involve owners and senior management who believe in the cause and principles of Islamic finance, and to train staff accordingly.

Shaykh Saleh Kamel, on the occasion of the award offered him by the Islamic Development Bank, said:

> "I say to you in all sincerity that if I'm to turn back to what I have done, I would not choose the framework of a bank to achieve the teachings of Islam in fields of investment and economics. I would have chosen a different framework that is consistent with the *Shari'ah* rules that govern investment. This is because we have not only chosen the name of the bank but its basic concept as a financial intermediary. We have therefore failed to find for our financial institutions a concept that will bypass financial intermediation. What became widespread in Islamic banks is a hybrid between debt and investment. It is a hybrid that carries all the characteristics of debt and the weaknesses of capitalism. It does not reflect the elimination of interest, which is not possible without detaching ourselves from the realities and effects of the interest-based banking system."

This statement is based on the long experience of one of the leading authorities on Islamic banking. There is a need to define the philosophy of the Islamic banking system and enhance its activities and performance by developing the appropriate financial tools to achieve the goals of Islamic banks and to compete with conventional ones.

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