Modes of finance

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Modes of finance are forms of contract developed by Islamic banks to substitute the "loan" as a means of financial intermediation.

The process is to take a form of contract that is already Shari'ah acceptable and apply the principles of financial engineering to produce a new model of the same which is both Shari'ah compatible and fitting the function of financial intermediation.

The Murabaha mode of finance.

Originally Murabaha is a simple sale contract in which the two parties negotiate the rate of profit (mark-up) not the sale price. Sale price is arrived at by adding the agreed upon mark-up to the cost of acquiring the goods by the seller.

To fit the function of financial intermediation Islamic banks introduced many modifications which are essential from risk point of view. These are:

- Unlike merchants, the bank will not buy anything unless it has been ordered to do so by a customer who identifies what is to be purchased.

- The customer who made the order must also undertake to buy the same from bank once title is held by the bank. Such purchase will be on Murabaha basis which means cost of purchase (plus other expenses) plus agreed upon mark-up.

- If the customer fails to meet its commitment, bank will dispose of the already purchased goods by selling the same to another purchaser, or return them to supplier. It would not be Shari'ah acceptable to assume that the commitments (promise) to purchase given by the customer are evidence of purchase. The legal consequence of the commitment is to bear the damages inflicted upon the bank by the fact that it was promised and the promise was not honored. Effectively the damage is the actual loss made by the bank as it disposes of the goods to another purchaser.

- To get compensated for these damages the bank can sue the client. Such litigation will result in court ordering the customer to pay for the concept is Shari'ah compatible. Because litigation is very costly and may take longer time Islamic banks have also introduced what is called "earnest margin" in the Murabaha mode of finance. This is a sum of money deposited in an account at the outset so bank can directly debit to cover damages if customer fails to meet its purchase commitment and the bank increases actual loss in same to a new purchaser. Earnest margin is not a down payment for no sale contract has been effected.

- People who come to the bank do so because they need credit. Hence, another modification is introduced into the Murabaha and that is paying the sale price on installment basis. But it remains that the sale price must be expressed as a one amount that doesn’t change for any reason once contract is concluded.

- Although mark-up can be set on the basis of an index (like LIBOR), no variability is allowed in sale prices once they become a receivable (i.e. concluding a Murabaha contract).

- Delinquency and even default will not justify any increase in the total amount of the sale price. Even if term was extended willingly by the bank or due to not meeting due dates, such extension will not result in any more payments than originally set by the Murabaha sale contract.

- While this is the Shari'ah requirements for any increase is considered Riba, such procedure is not acceptable from risk point of view. If debtors are permitted to delay payment as they desire without such delay resulting in possible damages, chances are no payment will be made on time. This goes against the general principles of Shari'ah which requires that people are to live up to their promise and honor their contracts. Another innovation was introduced in the Murabaha structure and this is what is called "the stipulated *Sadaqah*". Based on this, penalties will be imposed but they will not constitute an income to the bank but will be paid to charity. It serves the purpose without falling in the definition of Riba.

- Once a Murabaha sale is concluded, a receivable is created in the books of the bank that is not dissimilar to a receivable created by conventional lending. This is one of the reasons why Murabaha gained wide acceptability because assets created by Murabaha sale contracts can fit easily into an already existing accounting and auditing standards. It remains nevertheless that there are important differences between a receivable created loan (lending money to customer) and that created by Murabaha. They are:

- Once Murabaha contract is effected, price can't change for any reason.
- Murabaha sale mark-up can only be fixed.
- Murabaha receivables can't be securitized. (i.e. _____ in the form of negotiable securities).

- A Murabaha debt can be secured by collaterals or other securities that are Shari'ah permissible. Since the purpose of security is for possible sale in the market to cover due debt amounts, only securities that are Shari'ah acceptable should be used. Otherwise it will not be permitted to be sold and hence will not serve the purpose.

- Anything that can be sold on deferred payment basis can be the subject of a Murabaha contract. This includes both goods and services. Gold and silver cant be the subject of a Murabaha contract for they are only sold for cash (spot) in Islamic system

- Murabaha can be short term, medium term or long term. However, once you go beyond the medium term, a bank would need certain arrangement to hedge interest and market risks such techniques may not be readily available in Islamic finance.
- Because Murabaha is simple and straight forward (buy cash and sell on deferred payment basis) it is so widely used that it can be considered the back bone of Islamic banking. One of the major uses for Murabaha model is as part of the process of documentary credit. The bank can purchase the goods from the exporter for cash and sell to importer on deferred payment basis.

- For this purpose another risk needs to be mitigated. That is the risk of the goods not meeting the agreed up specification. Conventionally documentary credit is a paper transaction where bank deal in documents not goods. This will not be acceptable from Shari'ah point of view since the subject of the Murabaha is goods not documents. Islamic banks introduced what is called "Daman Al-Ohdah" to transfer that risk to the customer. Since the customer is the one who actually ordered the bank to purchase from a supplier identified by that customer, and because in most cases of fraud is the quality of goods involve both exporter and customer, Islamic bank assumed that it would be just to revert this risk back to that customer.