RECOVERY PROCESS OF MURABAHAH FINANCING IN ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA

BY

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A scenario of recovery in Islamic banking industry is one of the vital sections in banking nowadays since it is actually to minimize the arrears and non-performing financing (NPF) as well as to generate profit to the banks. For this purpose of research, the writer examines the reality of recovery process in Islamic financial institutions by focusing on the *Murabahah* financing. Based on current practices, a major problem associated with *Murabahah* financing related to a possibility of default by customers. The longer it took the customer to pay the payment, the higher is the *Murabahah* price. If the customers pay the higher profit rate will have the larger probability of default. Therefore, the Islamic financial institutions will definitely use any possible ways to recover back the money from the defaulters. However, there are some issues with regards to the process of recovery from Shari'ah point of views including late payments fee or compensation (*ta'widh*), penalty (*gharamah*), early payment (*ibra'*) as well as the rescheduling and restructuring of the financing. This research attempts to discuss these issues based on the Guidelines issued by Central Bank of Malaysia (BNM) while comparing these to the practice in Islamic financial institutions in Malaysia. From the findings of the research and the analysis of the sample documents, it is concluded that the current recovery process of *Murabahah* financing in Islamic financial institutions in Malaysia is slightly same as per standard practice of recovery process in other financing in Malaysia. Additionally, this research finds that the impositions of *ta'widh* upon defaulters is relevant in the industry to compensate the actual costs incurred by Islamic financial institutions as well as the penalty (*gharamah*) as deterrent for defaulters against delays in payment. Both charges and penalty do not constitute riba' as compared to the conventional practice and considered as Shari'ah compliance practice. With respect to the issues of *ibra'* on early settlement due to default cases, the latest Guideline on *Ibra'* (Rebate) for Sale-Based Financing issued by BNM is a good initiative to eliminate uncertainties pertaining to customer's right in receiving *ibra'* from Islamic financial institutions and apply it in their claim in court. However, the writer hoped that the regulators will issue the Shari'ah parameter on recovery process of each products offered in Malaysia including the restructuring and rescheduling method to make it as a standard practices in the industry.

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

....
Rusni Hassan
Supervisor

This research paper was submitted to the Institute of Islamic Banking and Finance and is accepted as a partial fulfillment of the requirements for the degree of Master of Science in Islamic Banking and Finance.

....
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Dean, IIUM Institute of Islamic Banking and Finance

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature.................................... Date ....

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This study is dedicated to my beloved parents for their supports, advises, encouragement and prayers; my beloved husband Ahmad Firdaus Abdul Manaf who rendered me all the love, care and supports. It is also dedicated to my children; Ahmad Mukhlis and Siti Khadijah for their understanding and sacrifice and all who inspired intellectually and spiritually. May Allah s guidance and blessing be upon them all in this world and hereafter.

Praise be to Allah, the Most Beneficent and Most Merciful for the blessings, guidance, strength and mercy that He has given in completing this research. Without His guidance and help, I would not be able to complete this research. "Thank you, Allah!"

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AAOIFI	Accounting, Auditing and Governance Standards for Islamic Financial Institutions
AKPK	Agensi Kaunseling dan Pengurusan Kredit
BBA	*Bai'-Bithaman Ajil*
BNM	Bank Negara Malaysia
CPR	Ceiling/contracted Profit Rate
EPR	Effective Profit Rate
IBBM	Institute of Bank-Bank Malaysia
IECR	Islamic Export Credit Refinancing
IFI	Islamic Financial Institutions
ISRA	International Shari'ah Research Academy of Islamic Finance
LC	Letter of Credit
MPO	*Murabahah* to Purchase Orderer
MTR	*Murabahah* Trust Receipt
MWCF	*Murabahah* Working Capital Financing

1.0 RESEARCH BACKGROUND

Murabahah financing have been widely used and are considered the most preferred types of Islamic financing in most Islamic banks of Malaysia thus far. According to BNM Monthly Statistical Bulletin August 2013, total financing given by Islamic banks based on *Murabahah* remained dominant, constituting 49% of total financing. [1] Therefore, the tendency of non-performing financing contributes high. However, the ratio of non-performing financing have fallen recently and continued to improve through the reclassification of non-performing financing to performing status and recoveries, as well as rescheduling and restructuring of the financing. As a result, net non-performing financing ratios in the Malaysian banking system have gradually been in decline from a high of 29% in 2009 to 16% in 2012.[2]

The popularity of the *Murabahah* financing is due to the several risks associated to the contract which offer significant opportunities as well as liabilities to the Islamic banks and customers. Different products with the underlying mechanics of *Murabahah* are currently being offered by the Islamic bank in the areas of different types of financing like import, export, working capital and infrastructure, real state, machineries and equipments. In Malaysia, the implementation of *Murabahah* financing, no matter whether it is a long term financing (which is known as *al-Bai-*

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[1] Monthly Statistical Bulletin Bank Negara Malaysia, <http://www.bnm.gov.my/files/publication/msb/2013/8/ebook_8.pdf>

[2] Amirullah. Razli. Islamic Banking Recovery Process. IBFIM. Kuala Lumpur. 2011. p.3

of *al-'inah* and *tawarruq*. However, in this research, the *Murabahah* scope is meant only for the short term as well as intermediate financing purpose which normally for purchasing commodities / assets and other products on credit. *Murabahah* contracts which is meant for long term financing and purposely for cash financing or property financing will not cover in this research.

Apart from that, the writer will give a description of recovery process in practice, taking the case study of the Islamic banks in Malaysia as a sample. This will be followed by an evaluation of the practice of Islamic banks, which is guided by the Guidelines issued by Central Bank of Malaysia (BNM). Finally, the research will be concluded with the some recommendations to recover financing from non-performing financing (NPF).

1.1 STATEMENTS OF PROBLEM

Major problem in *Murabahah* financing for Islamic financial institutions is in the event of default by customers and the recovery process of the financing. In principle of *Murabahah*, if the customer defaults in payment of the price at the due date, the price cannot be increased. The price in the beginning of *Murabahah* contract is the final price fixed until the end of installment payment finished. Therefore the issue of *ta'widh*, *gharamah* and *ibra'* comes into the picture. The focus of the research is to investigate the practical application of those issues in Islamic financial institutions and provide some suggestions to keep continuing the *Murabahah* financing until the end of the agreed period.

1. What are the differences between the *Murabahah* in classical and modern *Murabahah* which has been practiced in Malaysia nowadays?
2. What are the Shari'ah issues during the recovery process of *Murabahah* financing in Islamic financial institutions?
3. How the Islamic financial institutions apply the concept of *ta'widh*, *gharamah* and *ibra'* in the event of defaults by the customers?
4. Do the rescheduling and restructuring methods are the effective solution to recover the *Murabahah* financing from default?

1.3 OBJECTIVES OF THE RESEARCH

This study aims to achieve the following objectives:

1. To evaluate the classical *Murabahah* and the modern *Murabahah* that has been practiced in the banking industry in Malaysia.
2. To examine the recovery process of *Murabahah* financing in the event of default in Islamic financial institutions in Malaysia.
3. To critically analyze the issues of *ta'widh* (late payment charges), *gharamah* (penalty), *ibra'* (rebate), rescheduling and restructuring in the process of recovery particularly in *Murabahah* financing.
4. To investigate the current effect and implementation on the recovery process of Murabahah financing.

them in order to produce an original and authentic piece of research. The writer using qualitative method and several methods, as listed below, are used:

1. Library Research, Textual Analysis and Internet Browsing

   This research engages in analyzing the relevant data in both electronic and non-electronic forms such as academic journals, websites, economic reports, conference proceedings, theses, the publications of Shari'ah scholars and textual references from the *Qur'an* and *Sunnah*. Materials about the operations of recovery process in Islamic banks as practiced today are taken from the seminar papers, workshop and other sources such as articles in current journals.

2. Interview

   This research is also conducted via interview with selected respondent in two different Islamic banks. Interview method is applied to find out detailed information on the current practices of recovery process through their special method and procedures set up in the banks. The information from these interviews is considered as a primary data. Some officers in particular department are very skilled in the issues of recovery and the mechanism of calculating *ta'widh*, *gharamah* and *ibra'*. Shari'ah advisors are also very experts to give their ideas and opinions to these issues from Shari'ah point of view and its implementation in the current practices.

inductive and comparative method. The descriptive and inductive method is used to explain the recovery process as implemented in Malaysia in general and *Murabahah* financing as a sample of analysis. It is including the legal effect on the implementation as well as how the contemporary Shari'ah scholars provide the solutions on these issues. As for comparative method, it involves analyzing the collected data by comparing them, draw conclusions and all these finding would then will be compared and reviewed in the legal and Shari'ah perspectives.

1.5 SCOPE AND LIMITATION OF RESEARCH

This research is believed to be essential as the issue of recovery in Islamic financial institutions is rarely discussed and analyzed academically, particularly in very specific product; *Murabahah* financing. The research is intended to focus on the implementation of *ta'widh*, *gharamah* and *ibra'* in the current practices in two samples Malaysian Islamic financial institutions, local bank and international foreign Islamic bank. The limited time and space in conducting the research also render the final research produced far from perfect.

2.0 INTRODUCTION

This chapter examines the concepts of *Murabahah* in a classical literature as well as in a modern practice. This chapter looks at *Murabahah* contract and the model of modern *Murabahah* structure which is known as "*Murabahah* to the Purchase Orderer", its legality, Shari'ah issues on the operational perspectives and the risk associated in *Murabahah* financing. At the end of chapter, the writer concludes that *Murabahah* financing in modern practice is Shari'ah compliant provided that certain terms and conditions should be duly observed.

2.1 *MURABAHAH IN* CLASSICAL LITERATURE

Literally, the word *Murabahah* is derived from "*ribh*" which means gains, profit or addition. In English this word is often translated as mark up or cost-plus financing. As a technical form, different Shari'ah scholars define *Murabahah* differently based on their understanding of the terms. Al-Marghinani, a Hanafi jurist has defined *Murabahah* as "the sale of anything for the price at which it was purchased by the Seller and an addition of fixed sum by way of profit"[3]. Ibn Qudamah, a Hanbali jurist,

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[3] Al-Marghinani, (1957), *Al-Hidaya*, translated into English by Charles Hamilton, Premier Book House, Lahore,p 282

describes *Murabahah*, "When someone sells the items with a contract, for instance for every ten products the profit is one, the buyer thus, must pay the cost price, that is 90 dirham, plus the profit if 1 *dirham* for every ten, hence 9 dirham, and therefore eventually the total financing is 99 *dirham*."[5] According to Imam Malik, "*Murabahah* is conducted and completed by exchanging goods and price including a mutually agreed profit margin"[6]. It is important to observe that to him, no credit is involved in *Murabahah*. Malikis as a whole do not like this sale as it requires so many conditions, the fulfillment of which is very difficult. However, they do not prohibit it.[7]

As for contemporary Shari'ah scholars such as Mansoori (2006)[8], explains that *Murabahah* is a contract of sale in which cost plus profit for selling commodity is mutually decided by both the parties. Nyazee (2005)[9] views *Murabahah* as a contract where the cost plus profit is clearly determined for the knowledge of the buying party. Siddiqui (2008) [10] states that it is a contract of sale where profit is decided on the basis of mutual agreement and only when the cost of selling good is reasonably known to the buyer.[11]

By definition, therefore, it is basic for a valid *Murabahah* that the buyer must know the original price, additional expenses if any and the amount of profit.

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[4] Ibn Qudamah, *Al-Mughni*. Beirut. Dar Al-Kutub Al-'Ilmiyyah, vol.4, p199.
[5] Abu Ishaq Al-Shirazi (Shafi'i). *Al-Muhadhhdab*. Egypt. Matba'at Al-Babi Al-Halabi. Vol.1. p.382
[6] Ibn Juzayy (Maliki), *Al-Qawanin Al-Fiqhiyyah*. Matba'at Al-Nahdah. p.283
[7] Muhammad Ayyub, (2007). *Understanding Islamic Finance,* John Wiley & Sons Ltd. England. p.216.
[8] Mansoori Muhammad Tahir, *Islamic Law of Contracts and Business Transactions*,3rd Edition, Shariah Academy International Islamic University Islamabad Pakistan.p.214
[9] Nyazee Imran Ahsan Khan, 3rd Edition. "*Outlines of Islamic Jurisprudence*", published by Advance Legal Studies Institute, p. 278
[10] Samdani Mulana Ejaz Ahmad, (2008) *Islamic Banking and Murabaha (*Translated by Dr Sajidur Rahman Siddiqui), Maktabah Maariful Quran Karachi Pakistan Edition, p.73
[11] Lutfullah Saqib and et al, "*Application of Islamic banking Instrument (Murabaha) for Sugarcane Industry in Developing Countries*", Journal of Islamic Economics, Banking and Finance, Vol. 9 No. 1, (Jan - Mar 2013):p. 91

correctly reveal the initial price at which he acquires the goods without any proof or oath.

In terms of classical practice, *Murabahah* is a form of a trust sale in which only two parties involves. The buyer orders the seller to buy the goods without depending on a prior promise of purchase and the seller then sells the goods to the buyer, with an additional sum as a profit paid at the same time. Initially, the goods have already been owned by the seller before the seller sells the goods to the buyer. In other words, it is an immediate contract in which the seller exchanges the price for the goods. No financial intermediary was involved on that time.

2.2 *MURABAHAH* FINANCING IN MODERN PRACTICE

In modern Islamic banking, *Murabahah* is conducted by Islamic financial institutions was transformed from the sale transaction to a mode of financing which based on the deferred payment basis. It has been adopted by many Islamic financial institutions in Malaysia and considered as the safest way for banks to avoid commodity-based risks and related problems. It involves a bunch of contracts; promise (*wa'd*), agency (*wakalah*) and actual *Murabahah* at the end of contract. As such, nowadays, this transaction is popularized with the term "*Murabahah* to Purchase Orderer" (MPO). According to Shari'ah Standard on *Murabahah* issued recently by Central Bank of Malaysia (BNM) recently on 20 December 2013, MPO is refers to an arrangement whereby the purchase orderer (purchaser) promises (*wa'd*) to purchase an identified and specified asset from a seller on *Murabahah* terms upon the latter's acquisition of more negotiate and promise each other to execute an agreement according to which the orderer asks the purchaser to purchase an asset of which the latter will take legal possession. The orderer promise the purchaser to purchase the asset from him and give the ordered a profit thereon. The two parties would conclude a sale after the possession of the ordered to the asset. However, the purchase orderer may or may not be obliged to conclude the sale.[13]

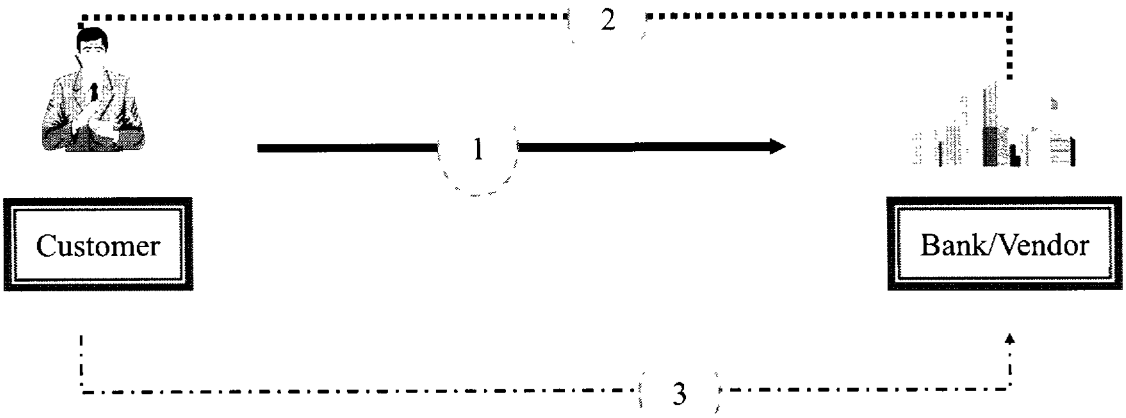
The idea of MPO appears to be originated for several reasons which will be increased in credit purchases in the current industry nowadays. Normally, Islamic financial institutions do not undertake business where there might be maintaining inventories of various goods. They do not want to become grocers or traders because inventory storage, space and holding cost might be expensive. In a meanwhile, BNM do not allow the banks undertake trading as their core business, with the dual purpose of keeping them liquid/saving them from the asset and market risks related to goods and to avoid cartels and monopolies in the commodity market. It also may not possible for Islamic banks to purchase all items in advance for *Murabahah* to their clients because the lists of goods could be very long and there could be continuous additions to the lists. As such, most of Islamic banks purchase only those goods for which they receive requisitions from the customers. From the customer's perspective, they might be in need of specific quality goods and the banks might not be even aware of the source of availability. If banks keep items in inventory, these might be not

[12] Bank Negara Malaysia, Shari'ah Standard on *Murabahah* issued on 23 December 2013.
[13] Accounting, Auditing and Governance Standards for Islamic Financial Institutions, 1425-6H/2004-5M, June 2004, Bahrain, AAOIFI,p. 130

Generally, there are three model of *Murabahah* structure that has been practiced in the industry. But only two models are being practiced in Malaysia, which is model two and three as explain below.

Model 1: Two Party Relationships (Bank- Customer)

Figure 1.1
Two Party Relationships (Bank- Customer)



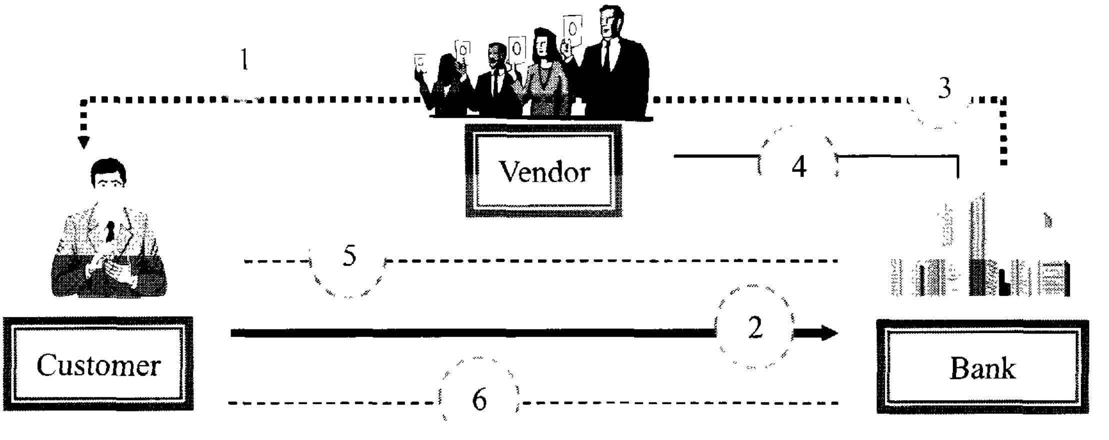
1. The customer approaches bank (also act as vendor) and identifies goods and collect relevant information including cost and profit.
2. The bank enters into *Murabahah* contract with the customer and delivers the goods.
3. The customer pays the bank in installment over the contract period.

[14] Muhammad Ayyub, (2007). *Understanding Islamic Finance,* John Wiley & Sons Ltd. England, p. 222

are fully justified because bank assumes all risks as vendor. However, Islamic banks in Malaysia are not preferable to use this model. Only Kuwait Finance House practices this model in case of car financing. The bank has warehouses, where it keeps its cars which it has bought from manufacturers or dealers. The customer will select the car from the warehouse and sign the *Murabahah* contract with the bank. The customer will pay later in installment basis. [15]

Model 2: Three Party Relationship (Bank-Vendor) And Customer (MPO with Wa'd)

Figure 1.2
Three Party Relationship (Bank-Vendor) And Customer (MPO with *Wa'd*)



1. Customer identifies and approaches the vendor or supplier of the goods and collects all relevant information.

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[15] Reporting of Islamic Financial Institutions, Chartered Islamic Finance Professional (CIFP), INCEIF. 2013, Unit 7

3. The bank makes payment to vendor directly.
4. Vendor delivers the goods and transfers the ownership of goods to the Bank.
5. Bank sells the goods to customer on cost plus basis and transfers ownership.
6. Customer pays *Murabahah* price in lump sum or in installments on agreed dates.

In most cases in Islamic financial institution in Malaysia, *Murabahah* transaction involves a third party (i.e. vendor) because bank is not expected to engage in sale of variety of products required for variety of customers. The bank directly deals with the vendor and purchases the goods. The important element is this model is the concept of *wa'd*. The *wa'd* to purchase the asset is binding on the customer when the bank has taken an action to acquire the asset. However, if the customer take delivery and refused to enter the *Murabahah* contract upon the bank's purchase of the asset as per agreed, it considered as breach of *wa'd* and must compensate for related actual costs incurred by the bank for disposal of the asset to a third party and the shortfall in the disposal price compared to the purchase price.

It is important to highlight that *Murabahah* contract can only take place on assets not yet purchased by the customer. In case that customer has purchased the asset from the supplier, the earlier contract should be terminated and the bank must enter the new contract with the supplier. At the stage of *wa'd* also, the customer may