Challenges on Cost Plus (Murabahah*)* Based Financing: Zanzibar Experience

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Abstract. Islamic banking products has gained a significant momentum in recent years. *Murabahah* is known as a one of the key Islamic financial tools. However, it is a widely adopted and controversial tool in terms of its *Shariah* permissibility. Most of people argue about the resemblance with the conventional tool of finance. PBZ Islamic bank in Zanzibar uses *murabahah* as a mode of finance, the higher percentage in using the financial tool in PBZ Islamic bank. Murabahah is not a fully trusted tool in financing matters in Islamic banks at Zanzibar, the society believe that this tool is the same as used in conventional banks, the difference is only the names. This controversy kept the Islamic bank in Zanzibar at risk of getting new clients or losing its existing customers. This paper examined the problems faced by Islamic banks in Zanzibar through *murabahah* financing tool and discusses its key risks faced by PBZ. The methodology used in this study is in-depth interview with PBZ Islamic bank to interrogate deeply in the usage of *murabahah* as a financing mode. The findings reveal that most of the customers applied for the loan of the assets are money seekers whose main target is cash.
Key words: Murabahah, Islamic Banking Challenges, Zanzibar.

Introduction

Zanzibar is one of the most popular state of the United Republic of Tanzania which consists of two islands known as Unguja and Pemba. The estimated population of Zanzibar is 1,303,569 people, Male Population 630,677, Female Population 672,892 (2012 census) (Ministry of Finance, 2013). Zanzibar is located 40-60km from the Tanzanian mainland, the east coast in west part of the Indian Ocean, between latitudes 5 and 6 south of the equator and between 39 and 45 East of the Greenwich meridian. It covers a total area of approximately 26,243km^2.

Zanzibar's average population density is 496 people per square kilometres (President Office of Finance, 2012). The local community is blend of unique ethnic backgrounds which portrays the historic and colourful picture of this community. Additionally, Islam is a predominant religion across this state along with minor Hindu and Christian community.

Zanzibar is an Islamic state which has 99% of Muslims, these people deserves the Islamic financial services which fully comply Shariah. PBZ Islamic Bank is the only Islamic bank operating in Zanzibar. As what is being practicing in most Islamic banks all over the world (Arif, 2014: 62), PBZ Islamic Bank uses the sales and debt-based financing; to finance its customers. Even though *murabahah* is the dependent mode of finance in PBZ Islamic Bank but the population do not have faith in this tool. The large population of Muslims in Zanzibar do not accept *murabahah* as it said it's not riba free mode of finance, it's the same mode used by conventional banks.

Murabahah (mark-up sale) is an exchange transaction in which a buyer purchases an asset or any commodity from a seller at a cost plus a specified profit payable to the seller (Arif, 2014: 62). Both parties are aware of the commodity cost and the actual profit, payment of the *Murabahah* price may be in spot, instalment or can be made paid in full within a specified duration.

This paper aims to examine the problems faced by Islamic bank in Zanzibar through *Murabahah* financing tool and discuss key associated risks. The methodology used in this study is qualitative in-depth interview with (PBZ) Islamic bank to interrogate deeply in the usage of *Murabahah* as a financing mode. Recent studies of M.M. Mzee (2016: 161), H.S. Siddiqui (2001: 51-62), O. Azkanar (2016) were also used for broad and deep studying of situation with banks and challenges in their functioning.

The discussion will be continued with the principle of *Murabahah* mode of financing in the next section. Followed by hindrances of *Murabahah* contracts facing Islamic bank in Zanzibar and ended with conclusions.

Principles of Murabahah Mode of Financing

Modern day Islamic banks adopt Murabahah as an interest free financing tool to purchase commodities, goods, investment and real estate. It can also be utilised to fulfil financing and trade needs such as to purchase goods. The Mudarabaha transaction occurs during the sale of goods in a physical or constructive form; in addition, the subject matter must be of a value that is classified as property in shariah and should not involve forbidden commodities (Arif, 2014: 63).

Bank earns profit as a compensation for investing its time and money. However, bank is not liable to seek compensation beyond the contracted term. Moreover, bank does not impose penalties for the late payments and reserves the rights to retain the assets such as mortgage until the full payment is made.

Islamic banks buy commodities on behalf of the customers, and resell them to the customers on mutually agreed profit and the customers pay the sales price by instalments. The client made a prior promise to purchase a property or any goods on credit from bank; this is the modern way of Murabahah finance which is called murabahah to purchases order (Ayub, 2007: 222).

Murabahah to purchases order (*murabahah lil amri bil shira* or *murabahah lil wa'da bi shira*) is an arrangement of the bank to purchase the requested asset by a customer from a third party and sells the same to the customer on a differed payment basis (Ayub, 2007: 222). The customer requests the bank to purchase certain goods on the basis of *Murabahah* according to his specified supplier and promises to purchase goods from the bank on a cost-plus mode (Ayub, 2007: 222). It can be divided into two promises, the promise made by a customer to purchase the asset from the bank and the second promise is the promise by the bank to sell the assets to the customer by *Murabahah* basis.

In most cases the client is the one who made the promise to purchase the assets from bank, it should be noted that bilateral promises are not permissible if the promise is legally binding but if it is not legally binding it is allowable (Hasan, 2011: 296-297). The promise made on commercial dealings is obligatory since the other party has made some arrangements based on that promise and definitely any violation to this promise will bring harm to the promise. The fulfilling of the promise is mandatory not only in the eye of Allah (*Subhanahu Wata'ala*) but also enforceable by the court of law with the following conditions (Hasan, 2011: 298):

- it should be a unilateral promise;
- if the promisor has coursed the promise to incur some expenses, or undertake some labour or liabilities;

- if a promise is made to purchase something and actual transaction usually an offer and acceptance of an offer must occur within the specified time;

- if the promisor backs out his promise, the relevant court of law has an authority to force for the payment of commodity or the actual damage.

After the customer gives promises to purchase financing assets from bank, the first thing the bank starts with, is to make the customer its agent of the whole process of purchasing the specified assets by the customer. All the purchasing procedures are done by the customer and bring the purchasing documents to the bank for payments to be undertaken.

Before the bank makes the payments, it conducts a short survey to the supplier mentioned in the documents to make sure that is the legal supplier and the details of the documents are equivalent with the actual property (Arif, 2014: 62). The payment made by the bank after has been contented with the details provided by the agent (customer) and finally bank purchased the mentioned property. This is the first contract which is between bank and supplier and it ends after the execution of purchasing process, the supplier transferred the ownership of the property to the bank (Ayub, 2007: 224-225).

The customer offers to purchase the asset and the bank accepts the offer, bank gives the possession of the property to its customer, after the customer has delivered the asset to the bank, the *Murabahah* contract starts after the bank to own the property, in facts Islamic banks can't keep the stocks for the customer to be financed because Islamic banks are not really a trader and secondly every customer has its own specification on goods they want therefore it purchases the goods only when the customer propose to them.

Bank resell the goods to the customer (the one bank bought from the supplier) with a profit margin, this is called a *Murabahah* or *Baimuajjal* mode of finance, this mode allowes the customer to buy property from the bank and pays in lump sum or by instalments at the future time. Also the bank requires the customer to mortgage any valuable item as collateral. Islamic bank most of the times prefer house or land for a businessman to mortgage the debt, and those who are employed their salaries are used as mortgaged property.

The general structure of the *Murabahah* financing is listed below:

- the customer approaches and requests the bank to purchase a legally sellable commodity on a credit;
- the bank specifies the client as its agent to purchase the requested item;
- the bank purchases the item through the client as its agent;
- the bank pays the supplier on behalf of the customer;
- the client receives the delivered items on without any rollover, discount or rebate.

Baimuajjal is a credit sale or deferred payment contract. It is a contract in which the seller permits the buyer to pay commodity price on an agreed post-date in a lump sum or in instalments. The merchandise exists at the time of contract. The *Shariah* does not require that the cost price be known to the buyer.

The only different between the *Murabahah* and *Baimuajjal* modes of finance is that, the property already exist at the time of *Baimuajjal* contract while in *Murabahah* contract, bank made the client as its agent for the purchases of the property and secondly when the banks sells the property, profit margin are known by the customer at the time of sells in *Murabahah* mode of finance while in *Baimuajjal* mode of finance the customer does not know the profit added to the cost of the property (information received from the interview conducted with PBZ Islamic Bank).

Hindrances of *Murabahah* contracts facing Islamic banks in Zanzibar

Islamic banking financing products are *riba* free where customers repay the bank the exactly amount he/she is borrowing (principal amount). In PBZ Islamic Bank does not finance the money directly but almost they finance exactly what a customer wants to accomplish, like building a house, purchase of assets, leasing the assets, education and agricultural financing.

The most financing tools that almost all Islamic banks use for financing their customers *Murabahah*, *ijarah*, *tawarruq*, *bai bithamin ajil*, *mudharabah* and *musharakah*. These are the common financing instruments in Islamic banks which play a big role to increase the profit of the venture. As pointed out that Islamic banking relationship with its customers are seller and buyer and not debtor and creditor as we usually experienced in conventional banking loan application. PBZ Islamic bank confesses that they are confronted with challenges in financing products especially in *Murabahah*. *Murabahah* (mark-up sale) is a *shariah* contract where bank sells assets to his customer with a cost-plus profit, the buyer must know the cost of the assets and the added profit before he purchased the assets. The main challenges to the products are as follows:

- contrary to the contract;
- inadequate Information;
- market Risk;
- credit risk.

Contrary to the contract

The main objective of this contract is to finance the assets to needed customers by sells agreement. In contrast with the customer’s main objective is to get cash not a property. Islamic banks before entering in sales agreement with its customer, firstly made the customer as its agent to buy the recommended asset on behalf of the bank. Customer use this opportunity to make a plan with the supplier whose bank is going to pay for the assets it has been purchased to him, banks receives the invoice from the supplier detailed about the assets and its price.

After the bank has been satisfied with the details given by the supplier, prepared for the payment of the asset and finally customer takes the assets on behalf of the bank. However, at this point, the customer does not take an asset instead he took the money paid by the bank from the supplier. This challenge has been practiced a long time ago since they started to finance by using *Murabahah* instrument and still remained as a challenge in Islamic bank of Zanzibar.

PBZ Islamic bank does not have a contract to finance cash directly to a customer like *tawarruq* contract instead it can finance the project directly as customers agreed upon like building a house or house improvement, financing a business projects, education, purchasing an asset and leasing.

Inadequate Information

Another challenge is the awareness and knowledge of society about the alternatives offered by Islamic banking. The conventional system gains a foothold in industry for a long time, so that the customers are used to their products and services.

Murabahah contract has much resembles with interest loan provided by conventional banks. Hence, this gap of knowledge left the *Murabahah* products inevitable to escape from the shadow of conventional banking products.

The main point is that many Muslims complain about *Murabahah* is not really a *shariah* complied product due to the fact that cost of *Murabahah* are much bigger or sometime equal to interest-based loan, in addition, sells contract it's just a document writes the sells procedures but in practice there is no such a thing happened.

Islamic banking products faced the challenges such as lack of knowledge and awareness of the objectives, principles, and advantages of Islamic banking products among people. There is a dearth of information about Islamic banking products even among Muslims. Majority of Muslim users perceive that Islamic banking as an interest free and ambiguous banking which is replicated from conventional banking. This is a serious drawback to the growth of Islamic banking products thereby leading to unnecessary oppositions and increasing lower public acceptance.

Market Risk

Market risk is a risk faced by the bank due to hostile and unexpected forces in the market price. Market risks mainly arise from within arrangements under the Sales-based Modes. Such risks are like mark-up Risk within *Murabaha* (cost plus sale). Islamic *shariah* requires that the mark-up rate under *murabaha* and other trade-financing instruments be fixed at the time of contracting. This means if the rate agreed say 20% of the cost of the asset is pre-fixed at the time of making the contract for the entire length of the contract.

The Islamic banks are exposed to the risk of upward movement of the continuously rising mark ups whereby, it cannot generate any specific benfit from such incrementals. Inflation risks are said to be the most important market risk facing Islamic banks especially when the currency used to finance is weak or weakens against the US dollar. A good example is the Tanzanian shilling. The risk is the Tshs may be strong when the bank pays for the asset but may be weak when some or all installments from the customer are due.

Credit risk

Credit risk exists in almost all of the instruments or products offered by the Islamic banks. The only difference is the degrees of the exposure and how the banks mitigate it. Credit risk management in Islamic banks is more complicated not only due to the nature of the contract but also due to some additional externalities. Islamic banks cannot charge a penalty due to default in payment by the counterparty as traditional banks can charge penalty or overdue interest. This limitation can be misused by the counterparty and they may purposely default in payment since they know Islamic banks will not charge anything to them.

In *Murabahah* transactions for instance, risks are pertinent especially where the bank makes prompt delivery of assets but client fails to make timely payment. The bank is in no position to take immediate effective measures to cover its dues nor can it charge interest or impose penalty on the outstanding balance. The bank stands to lose not only its funds but also funds of its depositors. Thus both the bank and the customer may sustain the risk of loss (Rasem and Kassim, 2009: 25).

Conclusion

Murabahah contracts is the most financial tool used by Islamic banks around the globe to finance its client and has been successful in catering the need of the investors and credit seekers, though there is a counting challenge Islamic banks face in the catering of this services. Islamic banks bear the inflation risks especially when the currency used to finance is weak or weakens against the US dollar. A good example is the Tanzanian shilling. In *Murabahah* transactions Islamic bank takes the loss of the client that he purposely does not pay its dues in time. Customers manipulate the contract by taking the money instead of the goods. These challenges drag PBZ Islamic banks backward in the market as the successfulness of this contract depends on both two parties (bank and its clients). Islamic banks should conduct the seminars, roadshows and other awareness programs to educate the people about the difference between *murabahah* and the conventional bank mode of finance. This will assist to increase the understanding of the people in Zanzibar about Islamic bank with *Murabaha* mode of finance.

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