Accounting treatment of Islamic products that require payment of full interest on prepayment

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Introduction

1) This paper discusses the classification and measurement of a specific Islamic-structured product under IFRS 9 *Financial Instruments* (2014). The financing product is commonly called *Murabaha* and has the characteristic of computing a fixed 'profit' on an asset sale with deferred payment. This form of financing is prevalent across many countries in the world where Islamic banks operate or where Islamic financing products are offered.

2) The financing transaction is normally structured as a deferred sale at a fixed profit. Appendix A has details of the structure. One distinguishing characteristic of this type of financing is that on prepayment of the amount due, the customer is contractually required to settle the entire 'profit' irrespective of the date of the prepayment. This is consistent with the Islamic principle of not recognizing the concept of the time value of money. At issue, is whether this Islamic-financing product will meet the requirement to be measured at amortised cost under IFRS 9 in respect of the Solely payments of principal and interest (SPPI) test. For completeness, the Amendments to IFRS 9: *Prepayment Features with Negative Compensation* issued in October 2017 have also been considered in this paper.

3) In a typical Islamic lending structure, as per the contractual terms, on prepayment of the debt, the obligor is liable for the entire interest that would be accrued over the contractual period had the debt not been repaid. It is established practice, and in some countries or jurisdictions legally required that the Islamic bank provide a 'discretionary refund' to the obligor so that the obligor would be (approximately) equal to the economic outcome of a conventional loan.

4) Historically, some Islamic banks that adopted IFRS have been considering these instruments as *Loans and Receivables* under International Accounting Standard (IAS) 39 Financial Instruments: Recognition and Measurement, and some early adopters earlier versions of IFRS 9 (2009 and 2010) have classified and measured these loans at amortised cost. The question under consideration is whether the measurement at amortised cost is justified under IFRS 9 (2014) and whether the practice of Islamic banks applying their 'discretion' to repay the interest can be considered within the purview of a contractual right as envisaged in IFRS 9 (2014).

Issue

5) The issue for consideration is whether these type of Islamic financing products meet the SPPI test.

6) For the purpose of this paper, we will not be considering the business model of the holder.

Example of issue

7) An example of the issue is provided below:

- A customer approaches a bank to purchase a vehicle. The retail price of the vehicle is CU 100,000 and the customer is required to provide a deposit of CU 20,000 (this could be done directly or through the bank). The bank will finance CU 80,000.
- The terms of the financing are as follows:
  - Principal financed: CU 80,000
  - Period of financing 48 months
  - Monthly interest rate is 1%
  - Calculated payments per month is CU 2,107 (rounded)
  - Total payments made over the period are CU 101,122 (rounded) (48 x CU 2,107) of which CU 21,122 is interest and CU 80,000 is principal.
  - The complete amortization schedule is provided in Appendix B.
  - At the end of T1, the table is as follows:

	Total payment	Interest	Principal	Balance
T0				80,000
T1	(2,106.71)	800	(1,307)	78,693

- In an Islamic-structured product, the commercial terms would be substantially the same, except that the form of the arrangement is that of a deferred sale and the ‘interest’ element is replaced with ‘profit’. Consequently, the legal form of the agreement represents a sale of an 80% share of the vehicle to an obligor at a fixed but deferred price rather than a financing transaction of CU 80,000 to the obligor. A diagram and explanation of an Islamic structure is provided in the Appendix A.
- An important characteristic of the Islamic-structured product is that since this is structured as a sale rather than a financing, when the customer settles the loan early, regardless of the settlement date, the entire ‘profit’ of CU 21,122 (See Appendix B) would still be payable to the bank by the obligor. Therefore, even if the obligor was to settle the loan at the end of T1, and the accrual of interest would only be CU 800 as per conventional banking computations, the Islamic-structured product would require the settlement of the entire CU 21,122.
- However, many Islamic funding structures with these characteristics allow the bank the ‘discretion’ to refund the customer the excess amount on early settlement.
- In more orthodox Islamic structures, no discretion will be allowed by the bank to refund, which entails that the customer would still be required to repay interest that has not yet accrued to date. In these structures it would be economically unviable for a customer to prepay his loan.

- In practice, depending on jurisdiction, practice and local laws, Islamic banks must or may apply this discretion so that the obligor is economically in the same position as he would be in the case of conventional banking and therefore the refund position may result in the net economic position (excluding penalties) being exactly equal to the conventional banking arrangement.

Current practice and implications related to these type of products

8) In many countries where Islamic products are offered, banks have provided empirical evidence to support the fact that refunds have been provided in all cases of prepayment and therefore argue that 'in substance' the arrangement is a normal prepayment term and that the SPPI criterion are met.

   - However, these banks acknowledge that in the absence of 'discretion' the SPPI requirement would not be met as the repayment of an entire period's interest on early settlement is inconsistent with the definition of 'interest' in IFRS 9 and as a result the cash flows do not meet the SPPI criterion.
   - It is also been acknowledged that the SPPI criterion would have been met if there was no option to prepay by the customer.
   - It is also argued that the prepayment function will never be applied in its contractual form as it will never be economical for a customer to prepay any amount outstanding.

9) The implications of a failure to qualify for SPPI will have wide reaching impact on Islamic-structured lending arrangements across the world, as it would result in the accounting for these products at fair value through profit and loss. This outcome is a concern for a broad range of users of financial statements in jurisdictions where Islamic-structured products exist as it creates massive disparity in the market and there is a view that this could, in fact, be misleading to users since it does not reflect the substance of the transaction – a lending arrangement.

10) The current accounting practice in the Middle East is to consider that the cash flows from these products qualify as SPPI based on the 'substance over form' argument, with the rationale provided that the both the bank and the obligor expect the economic outcome to be exactly the same as a conventional banking product. However, in the context of IFRS 9, behavior and empirical evidence (and the substance over form argument) does not drive the accounting treatment. Instead, the justification for the meeting of the criteria should be based on enforceable contractual terms of the instrument.

11) The objective of this paper is evaluate whether the cash flows of these Islamic structured products are SPPI. This paper cannot address all situations, and all Islamic and non-Islamic structures, each of which may have their own unique characteristics. We also note that the application of contract and other laws may differ between jurisdictions. Therefore, the analysis is limited to conceptually addressing the area of prepayment where discretion is applied to match the definition of interest.

12) The paper has not considered whether the Islamic transaction would be within the scope of IFRS 15 *Revenue from Contracts with Customers*, the paper focuses only on the receivable element, which in any event would be a '*financial Instrument'* as defined, and would be within the scope of IFRS 9.

Accounting requirements

13) There are two key requirements of accounting that are relevant for the analysis. The initial issue is qualification of the SPPI criterion and the second issue is the interpretation of the term 'contractual'.

SPPI

14) Paragraph 4.1.2 of IFRS 9 states that a financial asset shall be measured at amortised cost if it is held within a business model of which the objective is to hold to collect contractual cash flows, and those contractual cash flows represent solely payments of principal and interest. Paragraph 4.1.2 of IFRS 9 has been reproduced below:

> 4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:
> (a) the financial asset is held within a **business model** whose objective is to **hold financial assets in order to collect contractual cash flows** and
> (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are **solely payments of principal and interest** on the principal amount outstanding.

15) For the purpose of this paper, we have assumed that the requirement in paragraph 4.1.2(a) relating to business model has been met.

16) Paragraph B4.1.10 provides guidance on the contractual terms that could change the timing or amount of contractual cash flows. The prepayment terms could affect the timing and amount of contractual cash flows. The assessment of the contractual terms meeting SPPI must be over the life of the instrument. Paragraph B4.1.10 has been reproduced below:

> B4.1.10 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), **the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding**. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely

payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk.

17) In order to make the determination, paragraph B4.1.10 requires an assessment of the cash flows that could arise both before and after the change in contractual cash flows. The nature of the contingent event is not determinative.

18) Further, Paragraph B4.1.11 (b) provides an example of contractual terms that result in contractual cash flows that are solely payment of principle and interest on the principal amount outstanding.

B4.1.11(b) A contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract;

19) Paragraph B4.1.12 of IFRS 9 provides three conditions for a prepayment term that would affect the timing and amount of cash flows, to still meet the SPPI criterion. Paragraph B4.1.12 of IFRS 9 has been reproduced below:

B4.1.12 Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:

(a) **the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;**

(b) **the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable ~~additional~~ compensation for the early termination of the contract; and**

(c) **when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.**

The interpretation of the term 'contractual'

20) IAS 32 *Financial Instruments: Presentation* (IAS 32) addresses the issue of contract in its text. IAS 32 primarily addresses classification of financial liabilities and equity instruments. However, application of the contractual terms by analogy is considered appropriate in this context.

21) Paragraph 15 of IAS 32 states that when determining classification of a financial instrument, an entity should assess the substance of the arrangement rather than its legal form. Paragraph 15 of IAS 32 has been reproduced below

    15 The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument **in accordance with the substance of the contractual arrangement** and the definitions of a financial liability, a financial asset and an equity instrument.

22) In assessing 'the substance of a contractual arrangement the entity, needs to consider all of the terms and conditions of the instrument, including local laws, regulations and the entity's governing charter in effect at the date of classification.

23) Central to the classification of Islamic-structured products is the consideration of what is meant by the term "contractual". The IFRS Interpretations Committee (IFRIC) noted in IFRIC Update 11-06 that a contractual obligation could be established explicitly or indirectly, but it needs to be established through the terms and conditions of the instrument.

24) IFRIC Update 11-06 and 01-14 discussed the issues of 'contract" and noted that in assessing the substance of the contractual arrangement, an entity needs to exclude a contractual term that lacks substance.

25) Paragraph AG28 of IAS 32, when dealing with contingent settlement provisions, requires the exclusion of contractual terms that are 'not genuine'. It states:

    AG28 Paragraph 25 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is **not genuine**, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

26) Further, paragraph B4.1.18 of IFRS 9 further enunciates the treatment of contractual features that are not genuine. It states:

B4.1.18 A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

27) IFRIC also noted that IAS 32 does not require or permit factors not within the contractual arrangement to be taken into consideration in classification of an instrument. Therefore, for example, economic compulsion; should not be used as a basis for classification. Similarly, we believe that a past practice of settling an Islamic-structured product does not create a contractual obligation or right.

Conclusion

28) Based on the discussion above, Islamic products could qualify for SPPI if the return from contractual cash flows represents payments that are solely payments of principal and interest. This test would be the same as would be for any financial instrument and there is no need in IFRS for a unique or a different test for Islamic-structured products with these prepayment options.

29) The contractual right by banks for full repayment of principal and interest on any prepayment, will on its own, exceed the boundaries of "reasonable compensation" as envisaged in B4.1.12(b) and as such the SPPI criteria will not be met.

30) It is noted that that orthodox Islamic structures where no prepayment option is possible could qualify for SPPI.

31) The past practice of Islamic Banks providing a refund cannot be considered as contractually binding in the context of IFRS 9.

32) The 'substance over form argument' does not override the enforceability of the contractual terms, rather the substance over form requirement entails a consideration of explicit and indirect terms, including local laws, regulations and the entity's governing charter. However, a mere past practice (without enforceability) would not qualify as binding.

33) An argument has been put forward that when a customer does prepay an Islamic loan, there is always an expectation of a refund or else there would be no incentive for the customer to ever prepay an Islamic structure. This argument lays question to whether the discretionary feature is in fact 'genuine'.

34) In some jurisdictions, laws and regulations, specifically pricing laws would require that Islamic Banks refund the customer and therefore the 'discretionary refund' is actually implied and expected, and for all purposes enforceable through law. Therefore, in these cases, the instrument will de facto be providing a return of principal and interest, and consequently the SPPI criterion is met.

35) We anticipate that outcomes would differ between countries and jurisdictions depending to the extent of enforceability of the prepayment option. Similar to IFRS 15 paragraph 35C assessments, we believe that individual banks should assess whether the prepayment terms under these structures are in fact, enforceable or not under the applicable laws and regulations. It is noted that the conclusions for some of the aforementioned assessments will involve the exercise of judgment. These should be disclosed under the appropriate IFRSs.

Way forward

36) We believe that some interpretative guidance could be provided that would provide better amalgamation of the guidance in IFRS 9, IAS 32 and the IFRIC update papers (11-06, 14-01) specifically the matters around the boundaries around the concept of what is considered "contractual".

37) The guidance included in the IFRIC updates as well as IAS 32 were applied by analogy in the assessment above. It may be helpful to link the concepts that assist in determining contractual in IAS 32 to IFRS 9 assessments of SPPI.

38) We recommend the following stepped approach to be taken for Islamic products classified as financial assets:

   a. Identify the contractual terms that are enforceable by considering the explicit and implicit terms of the contract, local laws and regulations, entity's governance charter, Central Bank requirements? This process may involve an assessment of the enforceability of the laws and regulations of the jurisdiction.
   b. Consider whether any of the terms of the Islamic contracts are 'not genuine'. We believe a test for whether a contractual term is genuine could be whether the term has economic substance. This can be assessed by responding to the following questions:
      i. Will the contract economics be impacted in any way if the term/s was removed?
      ii. Will the removal of the terms affect the fair value of the instrument?
      iii. Are there limitations or barriers to the exercise of the terms for example, penalties, legal restrictions, etc
   c. Assess whether the contractual terms (in the absence of a prepayment) meet the criterion of repayments of principal i.e. the initial fair value of the asset?
   d. Assess whether the contract terms (in the absence of a prepayment) meet the criterion of interest as defined being a return for time value, credit risk associated with the principal amount outstanding during the period of time, and other basis lending risks such as liquidity risk?

e. Assess whether the instrument contain prepayment terms, and do the prepayment terms result in the prepayment amount representing the contractual par amount and unpaid contractual interest, plus a reasonable compensation (It is noted that that an entire repayment of future interest would not represent a “reasonable” compensation)?

Practical Considerations

39) For orthodox Islamic products where there is no prepayment option, we believe that the SPPI criterion can be met if the returns on the product meet the definition of ‘interest’ as per IFRS 9.

40) For products with prepayment features, our initial investigation has demonstrated that in the United Arab Emirates, Bahrain and some other Gulf countries, the local laws would override the discretionary nature of the refund by the Islamic bank and force the bank to refund. In these cases, we believe that the SPPI criterion could be met.

41) It is noted that in certain jurisdictions, the prepayment options are discretionary and not enforceable by law. In these cases, even if there was a past practice of refunding the customer to make the customer whole, we do not believe the SPPI criterion can be met.

Appendix A - Notes on Murabaha

The general form of the Islamic structure is in the form of a "Murabaha". Quoted below is an excerpt off the internet that succinctly explains Murabaha financing.

Murabaha is the most common structure used for financing and notes some of the structural and legal issues surrounding these structures.

Source: http://www.financialislam.com/murabahah.html

Murabaha is a form of sale where the cost of the goods to be sold as well as the profit on the sale is known to both parties. The purchase and selling price and the profit margin must be clearly stated at the time of the sale agreement. Payment of the Murabaha price may be in spot, in instalments or in lump sum after a certain period of time.

Murabaha has been adopted as a mode of interest-free financing by a large number of Islamic banks to finance the purchase of the consumer goods, intermediary or capital goods, real estate, raw materials, machinery and equipment. It may also be used for trade financing needs such as import of goods or pre-shipment export finance. However, the subject of Murabaha must exist and be in the ownership of the bank at the time of sale in a physical or constructive possession form; and these assets must be something of value that is classified as property in Islamic jurisprudence and must not be forbidden commodities. Debt instruments and monetary units that are subject to the rules of Bai´ al Sarf cannot be sold through Murabaha.

The diagram below explains the concept of the Murabaha:

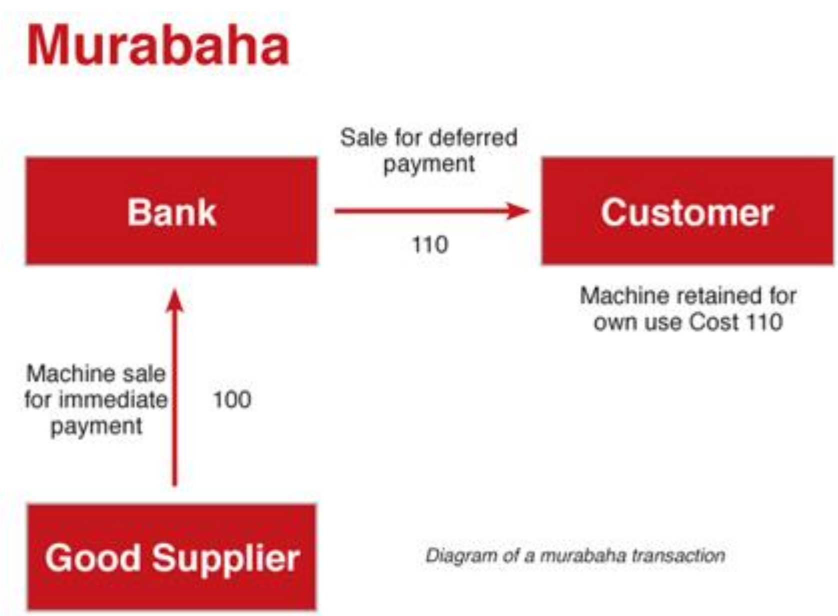

Diagram of a murabaha transaction

Islamic banks are required to take the genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods. The bank is compensated for the time value of its money in the form of the profit margin. However, it is not compensated for the time value of money outside of the contracted term. In fact, the bank cannot charge additional profit on late payments; the asset remains as a mortgage with the bank until the Murabaha is paid in full; and there must not be any reference to the time of payment by the buyer to keep the transaction free from interest.

In addition, Islamic Banks should not simply provide funds through Murabaha; they have also to be involved in the trading process of their client's business. They also need to ensure that the transaction is genuine and avoid the possibility of misuse of the funds by the client. In fact, the purchase price is paid directly by the bank to the seller or supplier, even though, the client may serve as the agent of the bank for onward. The purchase by the bank should be evidenced by invoices or other documents provided by the supplier to ensure that all conditions of a valid Murabaha have been fulfilled. Also the bank should arbitrarily inspect the purchased goods at their place of storage to ensure that the supplier and the client do not do any under-hand dealing, in fact, the client should not be a dual agent undertaking both the purchase and sale in a transaction.

Murabaha is not a loan given on interest. It is a credit sale that enables banks' clients to make a purchase without having to take out an interest-bearing loan. The parties negotiate the profit margin to be paid on the cost of the original purchase, and not the cost price. If payment of the sale price is deferred, Murabaha becomes Muajjal, which is legal from the point of view of the Shari'ah. This one of the features that makes Murabaha attractive as a mode of financing in modern financing transactions: It is a sale transaction effected on the basis of deferred payment. The price should be fixed at the time of the original contract of sale and the due date of payment must be explicitly set. It has to be a fixed sum including the cost of goods to the seller and an agreed amount of profit over the cost that can also be based on a percentage of the cost price to the seller. The Murabaha selling price includes a mark-up agreed upon and added to the actual cost incurred by the seller; No additional profit can be paid over and above the contract price.

To determine the amount of profit on the purchase of the goods and onward sale to the client, the bank may take into consideration different factors such as the period for deferred payment. The difference in price is not meant as a reward for time to reflect sale In fact, the jurists agree that a seller can indicate two prices, one for cash and the other for a credit transaction, since it a genuine market practice ruled by supply and demand; but one of the two prices must be settled on at the time of contract. In fact, the credit price of a commodity may be more than its cash price at any one point of time, while, in a forward purchase, the price for future delivery of the goods may be less than the cash price. This practice is quite different from a loan or debt, on which any addition is prohibited.

A Murabaha transaction, as used by Islamic Banks is quite different from a traditional Murabaha. In fact, Islamic banks do not normally maintain an inventory of goods; rather they purchase the goods on the specific request of their clients. They take a binding promise to purchase from the client that he would purchase the goods when the same are acquired by the bank. This promise can be incorporated into the purchase request of the client to enable the bank to purchase the goods for the client, either directly or through an agent. The bank can keep an option to rescind the purchase for return of the goods within a specified period (Khiyar-e-Shart) as a risk management measure in the event that the client fails to purchase the goods from the bank. Khiyar can be used as a risk mitigation tool for the goods acquired at the risk and cost of the bank until the goods are sold to the client or returned to the supplier. In addition, Islamic banks can use different structures to provide financing by way of credit sales to their clients. The bank may purchase the goods direct from the supplier for sale onwards to the clients. Islamic banks can also conduct their trading activities either through the client acting as an agent of the bank or through third party agents appointed by the bank. Islamic banks may appoint qualified suppliers as third party agents to undertake the purchases as and when required. They may establish specific purpose companies, a limited number of the bank's employees with relevant specialised expertise may be entrusted to trade in the goods required by their clients.

In the case of default by the client in the payment on the due date, the price selling price cannot be increased. However, contemporary Muslim jurists agreed that banks can impose a late payment penalty on delinquent clients. It may be a percentage on the overdue amount which cannot compounded. The penalty amounts must only be used for charitable purposes. Islamic banks can also ask for liquidated damages from the client through the courts, in case of default; and they can sell any held collateral without the intervention of the court.

Concerns

Shari´ah scholars generally consider Murabaha to be a border-line technique because its transactions may give the appearance of a fixed-income loan with a fixed rate of profit determined by the profit margin agreed by the parties. However, the fixing of a profit margin per se is not a problem, as prices have to be fixed in all valid trade bargains and at no point money is treated as a commodity in the Murabaha transaction, as it is in a conventional loan. In fact, in Murabaha, the Islamic bank buys an item at one price and sells it to someone at a higher price, allowing them to pay the client for it over time. While in Riba, conventional banks lend someone some money and require them to pay back a greater value of money than what they borrowed.

Moreover, the exchange in respect of a loan, wherein any excess is prohibited, occurs between a commodity and its like, while in a Murabaha transaction, exchange takes place between two different commodities: money is first exchanged for goods purchased and then goods are sold for money. Therefore, the difference between the purchase price and the sale price does not amount to Riba and legitimizes the profit derived from trading. Goods traded in Murabaha should be real, they must exist at the time of the sale and in the ownership of the seller when selling to another party. Further, interest charged on a loan is payable to the lender unlike in a sale contract where the price is liable to change; if it rises, the purchaser gains on purchasing goods on deferred payment basis, but if the price declines, it is the seller who gains on selling the goods on deferred payment basis at a higher price.

In addition, the use of Murabaha implies a risk of destruction or loss of goods occurring during a period where the bank owns the goods acquired for their clients. Thus the mark-up could be justified by the liability for the goods assumed by the bank until the client purchases them at a higher price on a future date. Besides, the promise from the client to buy the commodity from the bank is not a legal binding; therefore, the client may go back on his promise and the bank risks the loss of the amount it has spent. The goods are also subjected to no acceptance by the client if there is any hidden defect.

Another concern in the light of the Shari´ah for using Murabaha is the pre-payment rebate. In fact, Shari´ah scholars may consider it similar to interest-based instalments sale techniques, where the rebate allowed for early settlement of a financing is intended to reflect a refund of unearned interest. In Murabaha, the rebate shouldn't be already stipulated in the contract. Therefore, there is no commitment from the bank in respect of any discount in the price of a Murabaha transaction, the bank has discretion on whether to allow a rebate or not if the client makes an early payment. In any case, the profit on a Murabaha sale on a deferred payment basis is not based on a monetary value of time.

Risk Management techniques

Murabaha mode of financing is adopted by the Islamic banks to satisfy a variety of financing requirements of their clients in various and diverse sectors. It can be used to provide finance for the purchase of consumer durable or to finance the purchase of machinery, equipment and raw material for manufacture, etc. This mode is highly suitable for providing short-term working capital in financing projects. It can also be used for import and export trade as well as for local trade.

However, Murabaha may not be suitable for housing or other long term investments in economies with a high rate of inflation. The reason for that is that the bank might face a greater risk in the possible return if the general rate in the market increases owing to inflationary pressures. Murabaha can still be used for mortgage financing for longer periods ranging in economies where inflation is not a major issue. Also, Murabaha is not the right mode to provide financing for the purchase of easily perishable items.

Nevertheless, Islamic banks must bear a certain amount of risk associated with Murabaha transactions in order to legitimize their returns. They use some techniques to manage and mitigate each type of the common risks. In order to ensure that the bank's gains are above all suspicions of Riba, the bank reduces Shari´ah non-compliance risk by making direct payment to the supplier, it requires the invoice from the seller for the goods purchased, the date of which not before the offer and acceptance is carried out and not later than the declaration and it also arranges for the random physical inspection of the goods. This technique seeks to avoid that the client has already purchased the goods and subsequently wants the financing to make payment to the supplier. The bank can also obtain Takaful Insurance to reduce in-transit risk of destruction or loss of goods occurring without the agent’s negligence. The bank may ask the client to provide security through any assets of the client and stipulates a penalty payment clause in the contract that in the event of payment defaults. Murabaha does not allow additional charges in case of instalments. The amount of the Murabaha price remains unchanged. Long-term Murabaha may be avoided to guard against rate of return risk.

Moreover, the bank may obtain a performance bond from the supplier to prevent from non-performance risk by the supplier where he may not perform an obligation to supply the goods. The client can undertake to guarantee the performance of the supplier. Similarly, for the non-performance risk by the client where the he may refuse to purchase the goods when acquired by the bank at the client’s request, the bank should secure a promise from the client to purchase the goods. Furthermore, the bank can ask for Hamish Jiddiyah to recover its possible loss. Hamish Jiddiyah can also be used to prevent from a legal risk in case the client does not purchase the goods, as the initial agreement is only a promise by the client to buy and for the bank to sell; the bank who purchases the goods required by the client, may have to be involved in litigation.

In addition, there is a greater fiduciary risk where the client is appointed as agent to purchase and take possession of the goods on behalf of the bank; this could result in the client failing to administer the trust and agency accounts. To guard against such risk, bank may provide in the Murabaha contract that the client would be liable for any such loss. There is also a liquidity risk, since Murabaha receivables are debts payable on maturity. Therefore, they cannot be sold at a price different from the face value in a secondary market if the repayment date has to be extended. Similarly, if the client is unable to pay the amount on time, which is essentially a credit risk, it can give also rise to a liquidity risk for the bank until the payment is made by the client.

Appendix B - Amortisation schedule (all amounts in CU)

	Total payment	**Interest**	**Principal**	**Balance**
T0				80,000
T1	(2106.71)	800	(1,307)	78,693
T2	(2106.71)	787	(1,320)	77,374
T3	(2106.71)	774	(1,333)	76,041
T4	(2106.71)	760	(1,346)	74,694
T5	(2106.71)	747	(1,360)	73,334
T6	(2106.71)	733	(1,373)	71,961
T7	(2106.71)	720	(1,387)	70,574
T8	(2106.71)	706	(1,401)	69,173
T9	(2106.71)	692	(1,415)	67,758
T10	(2106.71)	678	(1,429)	66,329
T11	(2106.71)	663	(1,443)	64,886
T12	(2106.71)	649	(1,458)	63,428
T13	(2106.71)	634	(1,472)	61,955
T14	(2106.71)	620	(1,487)	60,468
T15	(2106.71)	605	(1,502)	58,966
T16	(2106.71)	590	(1,517)	57,449
T17	(2106.71)	574	(1,532)	55,917
T18	(2106.71)	559	(1,548)	54,369
T19	(2106.71)	544	(1,563)	52,806
T20	(2106.71)	528	(1,579)	51,228
T21	(2106.71)	512	(1,594)	49,633
T22	(2106.71)	496	(1,610)	48,023
T23	(2106.71)	480	(1,626)	46,396
T24	(2106.71)	464	(1,643)	44,754
T25	(2106.71)	448	(1,659)	43,094
T26	(2106.71)	431	(1,676)	41,419
T27	(2106.71)	414	(1,693)	39,726
T28	(2106.71)	397	(1,709)	38,017
T29	(2106.71)	380	(1,727)	36,290
T30	(2106.71)	363	(1,744)	34,546
T31	(2106.71)	345	(1,761)	32,785
T32	(2106.71)	328	(1,779)	31,006
T33	(2106.71)	310	(1,797)	29,210
T34	(2106.71)	292	(1,815)	27,395
T35	(2106.71)	274	(1,833)	25,562
T36	(2106.71)	256	(1,851)	23,711
T37	(2106.71)	237	(1,870)	21,842
T38	(2106.71)	218	(1,888)	19,953
T39	(2106.71)	200	(1,907)	18,046
T40	(2106.71)	180	(1,926)	16,120
T41	(2106.71)	161	(1,946)	14,174
T42	(2106.71)	142	(1,965)	12,209
T43	(2106.71)	122	(1,985)	10,225
T44	(2106.71)	102	(2,004)	8,220
T45	(2106.71)	82	(2,025)	6,196
T46	(2106.71)	62	(2,045)	4,151
T47	(2106.71)	42	(2,065)	2,086
T48	(2106.71)	21	(2,086)	0
	(101,122.08)	**21,122**	**(80,001)**	