

Shariah Views on the Components of Profit Rate in *Al-Murabahah* Asset Financing in Malaysian Islamic Bank

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Abstract—*Al-Murabahah* is an Islamic financing facility used in asset financing, the profit rate of the contract is determined by components which are also being used in the conventional banking. Such are cost of fund, overhead cost, risk premium cost and bank's profit margin. At the same time, the profit rate determined by Islamic banking system also refers to Inter-Bank Offered Rate (LIBOR) in London as a benchmark. This practice has risen arguments among Muslim scholars in term of its validity of the contract; whether the contract maintains the Shariah compliance or not. This paper aims to explore the view of Shariah towards the above components practiced by Islamic Banking in determining the profit rate of *al-murabahah* asset financing in Malaysia. This is a comparative research which applied the views of Muslim scholars from all major mazahibs in Islamic jurisprudence and examined the practices by Islamic banks in Malaysia for the above components. The study found that the shariah accepts all the components with conditions. The cost of fund is accepted as a portion of *al-mudarahah*'s profit, the overhead cost is accepted as a cost of product, risk premium cost consist of business risk and mitigation risk are accepted through the concept of *al-ta'awun* and bank's profit margin is accepted as a right of bank after venturing in risky investment.

Keywords—Islamic banking, Islamic finance, *al-murabahah* and asset financing

I. INTRODUCTION

THE concept of *al-murabahah* has been widely practiced in Malaysian Islamic banking since its inception. Asset financing of *al-murabahah* has reached more than 60 percent of funding compared to other financing concepts which are being practiced in Malaysia (BIMB, BMMB, RHB, CIMB, 2010).

To date, *al-murabahah* concept has been developed as a product that is used to obtain liquidity from other financing institution in Malaysia, it is known as the Commodity Murabahah Programme (CMP). This concept is commonly practiced in Inter Islamic Money Markets (IIMM). It is also being practiced for customer's financing of such as personal loans (BIMB, BMMB, 2010).

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The main problem of *al-murabahah* financing concept is the determinants of profit rate which is calculated by the Islamic banking, it is claimed to have some elements of *riba* and *Gharar* as being practiced in conventional banks.

Saed Abdullah explains that the rates of interest are taken into account when the mark-up on *al-murabahah* transaction is determined, as inflation is measured and rates of interest are compared to each other. Based on this statement, Abdullah Saed assumes that the determination of profit rate in the *al-murabahah* financing is based on the rate set by conventional banks [2]. Usmani meanwhile views that the determination of profit rate in the *al-murabahah* financing is referred to Inter-Bank Offered Rate (LIBOR) in London [23]. In other words, if LIBOR determines the interest rate by posed ten percent, the Islamic banking then would determine the same or more than LIBOR rate. He adds that the dependence on LIBOR shows the existence of *riba* in *al-murabahah* financing concept. The same view is given by Ahamed Kameel Mydin Meera and Dzuljastri Abdul Razak, who argue that the funding cost calculation of the formula, such as Bai' Bi Thaman Ajil (used *al-murabahah* concept) is similar to the calculation formula in the cost of conventional financing. Somehow, on contractual term, the panel of *Shariah* accepts it as a legal contract [3]. Yet the calculation is still bounded by the conventional formula. Hasrolefendy Hassan in his research on assets financing in Malaysia, he mentions the Islamic banks in Malaysia apply Base Financing Rate (BFR) as their base profit rate for asset financing. The rate is attributable to Base Lending Rate (BLR) is currently practiced in conventional banking throughout the world [12].

The same view is shared by ALM Abdul Gafoor, who believes the determinants of profit rate in *al-murabahah* financing are the intake and the dye from the conventional concept of profit which is based on *riba* [24]. The cost of borrowing in the conventional banking is called the Cost of Borrowing (COB), which is actually an interest, as the amount paid by the borrower is the additional amount other than the principal. According to ALM Abdul Gafoor, a conventional bank needs to take into account several components when making the determinants of profit rate, such of the cost of fund, risk premium cost, overhead cost and profit margin [24]. These components have been translated into a percentage which is called the interest rate. There are views from other scholars such as Ismail Shamsuddin, Hadenan Towpek and Joni Tamkin Borhan state that the determinants of profit rate for a conventional financing bank involve costs such as cost of fund, overhead cost, premium cost and profit margin of the bank [25],[26].

Somehow, there is a different view from Saiful Azhar Rosly who includes some other components such as time value of money and opportunity cost. He also mentions other consequent costs like inflation cost and credit risk [27].

This paper aims to study on *shariah* views on the components of profit rate determined by Islamic banking such as cost of fund, inflation cost, overhead cost, risk premium cost and profit margin of the bank.

II. LITERATURE REVIEW

Numerous researches on legal and *al-murabahah* concepts have been done by many scholars in Middle East, the most distinguished study is carried out by al-Qaradawi. He postulates his theoretical arguments along with his different views of *fukaha* on *al-murabahah* [28]. Al-Qaradawi works on this research as it becomes a topic of discussion regarding the legal status of *bay 'al-murabahah li bi al-amir al-Shira'* whether the status is legitimate or null. He also answers some contemporary *fukaha* critics such as from al-Masri who regards *bay 'al-murabahah li bi al-amir al-Shira'* owns some elements of *gharar* and *hiyal*, which are prohibited by Islam especially it involves a "mandatory pledge" for sellers and buyers [28]. Researches on the determinants of profit in the Islamic banking are also conducted by several other scholars, including the study conducted by Nienhaus.

He relates the advantage of Islamic banks against conventional framework which again postulates the ratio of profits between Islamic banking and entrepreneurs that are relative to the interest rates by the conventional banking. He also claims that Islamic banking is not only computing the profit equally as being practiced by the conventional banking, but also yields the same rate of interest like the latter [29]. Hasan and Bashir studies the effects of controlled variables and uncontrolled variables towards the profits gained in Islamic banking. They relate some other factors such as capital cost, overhead, output in gross domestic product and interest rates, which have a direct relationship to the profitability in the Islamic banking [30].

While Haron examines three factors in determining the profitability of Islamic banking, namely the internal factors like cash flow, total expenditure, investment in Islamic securities and the ratio of profits between the bank and the entrepreneur. Apart from that, there are external factors such as interest rates, stock market and capital bank, while the last is the capital factor such as the capital of the depositors, the banks' capital, reserves and money supply, which also affect the profitability of Islamic banking. His findings also reveal that the three stated factors have an influence on the determinants of profit according to the Islamic banking. He also finds that that the greater the amounts of the deposit the bank receives, the greater amount of profit it will earn. He also states that the interest rate, inflation rate and the amount of bank capital have an impact on the determinants of profits in banking.

Abdullah Saed elaborates on the issue of deciding the *al-murabahah* financing. He claims the existence of *riba* in calculating the profit rate of *al-murabahah*.

His reason is that the Islamic banking compares the profit rate of *al-murabahah* financing with other conventional financings. He mentions that the interest rate is used in calculating *al-murabahah* profit is an undeniable fact [2]. Besides, inflation is also taken into account along with interest rate in the calculations. In addition, a research conducted by Muhd Ramadhan Fitri Bin Ellias has a direct relevance, and even becomes an important pillar of this paper. This master's degree study focuses on the pricing of Financing Fixed Rate (FFR) and Variable Rate Financing (VRF) [31]. In his study, he also discusses the factors that affect pricing in the *al-murabahah*, without focusing on each component of the determining prices. In his analysis, he discusses the BLR as a benchmark used by conventional banks and not to forget, concludes that the reference to the BLR is thus allowed. However, his study does not focus on components such as the cost of inflation; overhead cost, lower premiums and net profit which are the backbones to the calculation of prices and profitability in the financing of *al-murabahah*. Hasroleffendi in his research concludes that the BFR rate used by Islamic banking in Malaysia contaminated with *riba* and *gharar* as the rate will plunge and surge depending on the current economic performanc [12]. Then the rate will be determined by Central Bank of Malaysia (BNM).

III. SHARIAH VIEWS ON THE DETERMINATION OF PROFIT RATE

A discussion on the determinants of the profit rate is made in line with the pricing. According to *shariah*, the price is not determined by any party including the government. Indeed, the price is determined by supply and demand in the market. It takes many aspects such as quality, types, production, quantity and the purchasers' desires to acquire goods. The main elements that determine pricing and profitability are the supply of goods by the manufacturer and demand from customers that wish to have the goods. This subject can be understood from the *hadiths* of which amongst is:

Meaning:

from Anas, he who said that price increases have occurred in the era of the Prophet (peace be upon him), then few friends said to the Prophet (peace be upon him), "set the price for us", the Prophet (peace be upon him) answered, "Allah determines the price, the holder (sustenance) the giver (sustenance), the provider (sustenance), I am hoping that until I meet with my Lord, no one among you can claim, I 'm cruel either in the blood or treasure".

(hadith no. 1235)

Imam Shawkânî states that the purpose of the above *hadith* is to tell that there should not be any determinants on prices and profits upon any goods by the government because it is regarded as cruel, whereby people are not free to manage their assets [22]. The *fukaha* do not make any determinants on the price and the amount of profit that should be taken by a dealer.

Shamsiah Mohamad mentions in her study that no one among the *fukaha* should make the determinants of the price and the rate of profit [21], except for Imam Ibn Qayyim, who says,

"...the dealers shall set the rate of profit among themselves and avoid the raise after the determinant is made" [15].

He does set prices and rate of profit to be taken by traders in their business. Al-Imam Shawkânî and al-San'ani mentions that the majority of the *fukaha* do not set the prices and rates of profit in the business whether it is large or small [38][41]. It depends on the pleasure of the involved parties. The *fukaha*, however state that it is contradictory from each to another if any of the buyers or sellers are ignorant about the price and profit in the market rate. Majority of *fukaha* like Imam al-Ghazali, Ibn Hayyan, Ibn 'Arabi and Ibn Qudamah view that ignorance does not affect the contract because profit does not have its limitation, although it is not known by a buyer or a seller [32][33][34]. However a reprehensible fraud and abuse is sinful and against Allah (swt), Ibn Hazm on the contrary, he considers profits that are not known by either of them as ignorant and thus are not valid [35]. Based on the above discussion the majority of *fukaha* view the determination of profit will freely be decided by market with the agreement from both side (buyer and seller).

IV. THE IMPLEMENTATION OF AL-MURABAHAH IN ISLAMIC BANKING IN MALAYSIA

Al-murabahah was among the earliest of financing concept being implemented in Bank Islam Malaysia Berhad since its founding. In its first financial report in 1984, products which are based on *al-murabahah* concept are used to finance trades such as letters of credit and working capital financing. According to BNM records in 2008, there are nine generic concepts of *al-murabahah* (including BBA and Comoditi Murabahah) offered by Islamic bank in Malaysia. These products include various categories such as property financing, commodity financing, credit facilities and others.

The study found that the implementation of the *al-murabahah* financing in Malaysia, no matter whether it is a long-term financing or a short-term financing have been applied along the *bay' al-'inah* and *bay' al-tawarruq*. The concept of *al-'inah* and *al-murabahah* are practiced in products such as Cash Line facility-i, Credit Revolving facility-i, Refinancing Credit-i Export-i, Letter of Credit-i and Capital Working Financing-i. However the concept of *al-murabahah* and *bay' al-Tawarruq* is practiced in commodity murabahah and Personal financing-i products.

The components of profit rate applied in Islamic banking in Malaysia are similar to one another, in which cost of fund, overhead, risk premium and profit margin are included in the cost of *al-murabahah* financing, yet the rate of inflation is not included in these components. At the same time Islamic banks will refer to the OPR issued by Central Bank of Malaysia.

Most Islamic banks in Malaysia adopt two types of profit rate which are in accordance to fixed rate and variable rate.

For variable rate, the bank will set the ceiling price in the contract of *akad* (solemn) with the customers, in which this *akad* will be made at the highest price, while the rate of profit under the contract is considered as a form of *ibra'* from the Islamic banks to customers.

Islamic banks in Malaysia do not use the inflation rate as a component in calculating the price of *al-murabahah* financing. However, they use the cost of fund which is determined by Islamic banks respectively. The cost of fund for Islamic banking is about the amount of profit should be considered to funder, the amount of profit is not guaranteed in the contract, the cost which is used by Islamic banks in financing either through the *al-mudarabah* saving account or other shareholders fund and the Islamic Inter-Bank Money Market (IIMM). The amount of profit is calculated as a cost of fund which later being used by Islamic banks as a component of profit rate in *al-murabahah* financing. As for conventional banks, the cost of fund is the interest rate issued by the bank for loan. Islamic banks in Malaysia also include risk premium cost as a component for calculation of profit rate. The cost appears when the assumption of repayment to the bank is uncertain or may not be settled within an agreed period, the bank will avoid any risk incurred, as responsibility of the bank to secure depositor's fund. There are two types of risk in property financing, business risk (genuine risk) and mitigation risk. The business risk associates with the original business, where the bank must take precaution of any possibility of loss in their business. The higher risk leads to the higher profit of the bank. For the mitigation risk, Islamic bank in Malaysia acquires assistance from the third party (insurance company) in protecting the customer's default and natural disaster of the property during the financing tenor. The cost for mitigation risk will be borne by customer. There are two premiums of mitigation risk which are Mortgage Takaful (MRTA) and Owner Takaful (Householder Takaful). The premium amount depends on the amount of funding, customer's age and period of payment.

Overhead cost (indirect cost) is the cost that contributes to the *al-murabahah* product indirectly. The existence of these costs is essential for a successful business. All expenses for the Islamic banks in Malaysia is reported in annual bank reports.

The bank records total amount and the detailed expenditure as a reference for the bank itself and its customers. Items of overhead cost for each Islamic bank in Malaysia are almost the same, namely the promotion cost, establishment cost and general expenses. The cost of salaries, bonuses, allowances, and social contributions are included in the personal cost, in which the cost is borne entirely by the bank. However direct cost such as attorney's fees, photocopies, etc. are charged to the customer whenever the financing is handled. In this paper, the authors will discuss overhead cost from Islamic point of view.

TABLE I
 INDIRECT COST IN ISLAMIC BANKS MALAYSIA

No	Personal Cost	Overhead Cost and expenses
1	Salary	Promotion: advertising, publicity and commissions and others

2	Allowance and Bonus	Establishment: Office rental, depreciation of fixed assets, rental equipment, maintenance, <i>Takaful</i> , electricity and water bills, maintenance.
3	Other related costs	Staff management and public expenditure: allowances of auditors, professional fees and others.

Source: Adapted from the Annual Report of Islamic Banks in Malaysia, 2008

Profit margin is a profit earned by the Islamic bank for every one ringgit used in financing in certain period of time. It is also called the rate of return on sale. The profit margin is calculated based on the amount of financing, and bank will produce the exact amount of profit margin together with other amount for the purpose of signing the contract. In this stage the customer will aware on the amount of profit taken by the bank throughout the period of financing. The implementation of *al-murabahah* asset financing in Islamic bank in Malaysia includes all the above components of profit rate, the banks will refer the OPR which produced by BNM as a benchmark.

V. ISLAMIC POINT OF VIEW ON COMPONENTS OF PROFIT RATE PRACTICED IN MALAYSIA

As mentioned earlier, Islamic banking in Malaysia includes several components in the computation of profit rate for *al-murabahah* asset financing. These components are cost of fund, risk premium cost, overhead and profit margin. In this paper, the authors will discuss the above components from the *shariah* point of view as it represents the total profit rate. Interestingly, certain quarters claim that the profit rate practices in Islamic banking in Malaysia contains an element of *riba*. The objective of such discussion is to clear the doubt and retain the product on the right path.

Firstly, in term of cost of fund, this is a cost of acquiring fund. The use of cost of fund in Islamic bank is to set the gain of depositors and investors (*rabb al-mal*). It is the ratio of profit by depositors and investors, in which those benefits must be calculated in the calculation of price. Determining the ratio of profit by investors at the beginning of the calculation does not mean that the depositors are free from any losses, because the condition of depositor's fund in Islamic bank must bear the risk of loss. According to 'Abd al-Barr al-Namri profit follows the agreed contract and risk shared between parties involved. In the case of a loss, the owner of the capital will bear a portion of risk as agreed in a contract [1]. The use of cost of fund for the computation purpose is allowed according to Islamic law as long as investors are still responsible to the risk. However, if cost of fund invested with guaranty of profit, then the contract becoming null and against the principle of *al-mudarahah* contract [6].

The second component is risk premium cost, it is a part of the revolution in finance management of credit risk, as it aims to avoid big losses that may occur to the financier (bank).

There are two types of risk in financing mainly business risk and risk mitigation. The business risk is a genuine risk where the bank accumulates a possible risk that may occur on their fund, and the bank will take into account the customers financial ability, position, monthly salary, other income and others in order to charge a profit for the customer. The Muslim scholars such as Ibn Khaldun, Imam Ibn Qayyim, Imam al-Qurtubi, al-Masri and Shawqi Ismail Shihatah state that the business risk as an element of for the seller to consider an amount of profit either high or low, the more risk face by seller the profit could be considered [14][15][18][5][22].

The risk mitigation is about bank's effort to mitigate a possible risk occurs to the customer such as default and disability. The bank will consult customer to get assistance from insurance company in managing the risk on behalf of the customer. The company has commercial value and sought to gain profit. To avoid any conflict with Islamic law in practice, the Islamic banking scheme also provides Islamic insurance or better known as *takaful* scheme, by providing facilities to the Muslim to get protection via *tabarru'* (charity) and *ta'awun* (mutual assistance). Risk premium is the cost to be borne by customers and non-bank financiers. This it is based on a *hadith* which is issued by Imam al-Tarmidhi,

Meaning:

From Abu Hurayrah (ra), that the Prophet (saw) said, "The soul of a Mukmin is hanging until he settles his debts"
(hadith no. 998)

Imam al-San'ani states that this hadith explains that there is an urgent need for one to settle his debt before death as it is a major requirement [41].

The third component is overhead cost; it is the expenses of Islamic bank in a business process. The Muslim scholars Al-Rafi'i, Ibn Al-Murtada, al-'Amili Shafi and Al-Bahuti view that the cost should be charged to the customer, This is because the business involves with various costs such as office equipment, computers, photocopy machines, etc., [36][37][38][39][these costs either directly or indirectly contribute to the success of any funding. Therefore, taking into account the overhead cost of *al-murabahah* financing is important in Islamic business.

However, the period cost such as marketing cost, maintenance, security and others are not directly involved. This opinion is leaned to the view of the majority of *fukaha* that the costs which are not related to the product, whether direct or indirect can not be transferred to the customer. Besides, al-Bahuti assumes that the cost of losses such as being robbed and others cannot be transferred to other businesses [39].

Loss is a separate incident and does not involve with other businesses. It thus should not be charged to other parties that have nothing to do with the business.

The fourth component is profit margin, where a bank's profit for every ringgit used by bank in their financing which is normally presented in a form of percentage. However Islamic bank will apply an exact amount during the *akad* session.

In previous *fiqh* discussion, the Muslim scholars used the term *dah wa yazdah* to indicate for every ten Dirham of sale is one Dirham's profit. On the other hand the majority of Muslim scholars such as Ibn 'Abidin, al-Kasani and al-Rafi'i disagree with the this system [13][4][36].

In Islamic banking practice in Malaysia, the bank will apply the exact amount for the contract during akad session, while the percentage of profit margin is just merely a calculation. It has cleared the doubt of invalidity of the contract.

VI. CONCLUSION

The determinants of profit rate in *al-murabahah* asset financing in Malaysia involved several components such as cost of fund, overhead cost, risk premium cost and profit margin. The *fukaha* collectively agree that these components are not perverting the Islamic law. Acquisition of cost of fund is understood as a profit for the depositors and investors. For overhead cost, the *fukaha* agree with the cost which contributes to products but not with the period cost. Likewise, the risk premium cost is also accepted, where the cost is aimed to compensate of any losses and risks involved in business. *Shariah* also accepts the innovation of risk mitigation but it is only limited to the *ta'awuni* takaful risk premium concept, and thus the premium cost will be borne by the customer. The profit margin of Islamic bank in Malaysia features an exact amount in their contract which clears the doubt of unknown profit in contract session.

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