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CASE STUDY

Islamic Working Capital Finance through *Murābaḥah* for a Construction Company

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Abstract. This case study presents a narrative of how *murābaḥah*, a sale-based Islamic mode of financing, applies in the banking routine to create a real working capital finance service to a construction company. The construction company was looking to finance diesel, bitumen, and petrol to be used as working capital in its construction projects for the Government. The case presents interesting episodes of the client company and the bank as to how they reached the situation of applying *murābaḥah* and how that fits in within the broader Islamic banking regulatory framework of the country. A customised *murābaḥah* process flow is designed and applied with subsequent changes due to various market and external factors. The case shows how the bank purchases the goods from refineries and sells the same at a cost-plus to the construction company and how all settlements are made till the maturity of the case while maintaining Sharī'ah compliance. Many supporting parties such as *takāful* company, legal entities, credit information bureau, and suppliers provided supporting services to execute *murābaḥah* in the context of working capital finance. The roles of each party and issues in the application process are discussed.

KAUJIE Classification: K4
JEL Classification: G2

INTRODUCTION

Since 2002, the State Bank of Pakistan (SBP, the central bank), adopted an evolutionary framework to introduce Islamic banking in the country in parallel with the conventional banking. As part of the regulatory framework, SBP issued the model contracts and allowed

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the Islamic banks, Islamic banking subsidiaries, and stand-alone Islamic banking divisions of the conventional banks that jointly are termed as ‘Islamic Banking Institutions’ (IBIs) to come up with innovative financial services by applying the model contracts within multiple products and contexts. Freedom of product development is given to allow market-driven evolution within the Islamic financial products and hence within the Islamic finance market.

An IBI (hereafter called “the bank”) has adopted many of the model contracts of SBP and applied those for deposit raising and financing services, out of which *murābaḥah* has been the most frequently used. Ensuring Sharī‘ah compliance-providing the service according to the Islamic law, is a great concern for any Islamic bank in all operations including *murābaḥah*.

After attending the meeting on discussing the related issue of Sharī‘ah compliance, the Relationship Manager (RM) in the bank’s branch at Peshawar visited the managing director of a construction company and offered him different financing options. They discussed the possibilities of a finance facility in the context of the company’s requirements and the available Sharī‘ah-compliant alternatives including *mushārakah* and *murābaḥah*. The construction company was looking for working capital to finance their operations implying that *mushārakah* was not suitable for them. Specifically, it needed finance for fuel and construction material for which the relationship manager proposed the *murābaḥah*. The bank and company agreed to finance diesel, bitumen, and petrol, which are used by the company in road and bridge construction projects. It was clarified to the company that *murābaḥah* means selling the goods by the bank to the client on an agreed profit margin at the known cost of the goods and any Islamic bank would not be providing cash as a loan. The RM asked for specific documents to be submitted by the company to proceed further for *murābaḥah*-based finance.

DOCUMENTATION OF THE *MURĀBAḤAH* FINANCE

An administrator in the construction company obtained attested copies of the memorandum of association, article of association, and form 29 from the Company’s Registrar office. He also collected different documents from other banks, utility providers, and suppliers with whom the company was dealing. The finance manager of the company provided the required documents to the relationship manager in the Bank. The RM sent the company’s information to the regional coordinator of the bank. Based on the information provided, the coordinator at the bank got the credit information report of the company from the credit information bureau of SBP and provided the same to the relationship manager.

PREPARATION OF *MURĀBAḤAH*-BASED CREDIT PROPOSAL

Based on the documents and information obtained, the RM prepared a *murābaḥah* proposal for the company as the initial guideline to be sent to the branch by the head office. Different options related to the duration of the facility, the types of goods to be financed, and the sale consignments in the overall *murābaḥah* facility are selected according to the requirement of the company based on its normal working capital cycle. The current situation of the

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industry and the bank policy are also considered while developing the proposal. A master *murābaḥah* is proposed, regarding which the bank agreed to provide a facility of Rs. 10 million as working capital for the company in different phases in the coming year.

MARKET AND CLIENT RESEARCH

For further information, the relationship manager and area manager of the bank visited the construction company's offices located at three construction sites. They met with the workers and checked the use of material they were looking to finance. This information further highlighted the actual service requirements and helped the relationship manager to tailor the agreed *murābaḥah* model further.

To get information related to the construction industry and supply of petrol, diesel, and bitumen in the country, the relationship manager contacted the chamber of commerce, suppliers, and contracting agencies of the customer. He also contacted different departments of the customer company to get detailed insights before the selection and specification of different options in the *murābaḥah* facility and also added new options to appropriately develop a robust *murābaḥah* proposal.

MULTIPLE STAGE EVALUATION PROCESS

The relationship manager developed the proposal based on the needs and situation of the customer and market and sent that to the branch manager for review and recommendations. The branch manager reviewed the case file and forwarded it to the area manager for an expert review. The area manager evaluated the case file and raised some queries, which were answered by the relationship manager. The dispatcher sent the file to the regional coordinator of the bank via courier.

COMPARATIVE EVALUATION AND COMMON MARKET EFFECT

From the credit information report and financial statements of the company, the regional coordinator of the bank found that the company is financially weak. She contacted the relationship manager and raised her concerns over the issue. The relationship manager contacted the finance manager of the customer's company and both developed answers to this query. The financial strength of the company was rationalised based on the construction contracts and projects agreed with the government agencies and expected positive cash flows shortly too. The finance manager of the company also sent copies of these contracts and projects to the regional coordinator of the Bank.

The regional coordinator again raised a query to the relationship manager about the contents of the credit information report, which shows some delayed payments in the customer's banking history. The relationship manager and the customer justified those delayed payments. The delayed payments were justified due to some financial crises in the whole economy. These delayed payments do not reflect an internal weakness of the company.

CULTURAL IMPACT

The regional coordinator raised another issue that the property offered by the company for the mortgage is not registered in the name of the construction company. This property was owned by the father of the company's director. The relationship manager contacted the director's father to confirm the mortgage of his property. The regional coordinator is informed about father's consent; however, it was still believed at different levels in the bank that this could be a weak point of the case. The case, however, was recommended and sent to the commercial department. The strong family bonds play an important role in the evaluation and development of financial feasibilities. Close relatives provide guarantees, and they are culturally bound to each other.

The regional coordinator sent the case to the commercial department for further evaluation and approval. They approved and sent the file to the Product Development and Sharī'ah Compliance (PDSC) Department. The PDSC department customized the *murābaḥah* finance process flow structure for this specific case as they do for every new case. This step is an important Sharī'ah compliance check. The PDSC's manager sent the customised process flow design to the relationship manager to check whether the customer agreed with the proposed design. The customisation process includes additions and specifications of the parties and subject goods of the sale transaction.

MURĀBAḤAH PROCESS FLOW AND CUSTOMISATION

The customer suggested some amendments in the goods supply chain. The relationship manager adapted the process flow design and sent it back to the PDSC manager for the final approval. The PDSC approved the amendments. The relationship manager and the customer signed the adapted process flow and sent that back to the head office. The customer's cash flow situation affects the standard *murābaḥah* process flow because every customer's situation varies, so does the service requirements.

ADOPTION OF *MURĀBAḤAH* CONTRACT

After mutually finalising the *murābaḥah* process flow design and other terms and conditions, both parties adopted the Master *Murābaḥah* Finance Agreement (MMFA). In an MMFA, the bank offered to sell the required working capital to the construction company at a mutually agreed cost plus profit price, whereas the construction company accepted the offer to buy the material as working capital. The bank also adopted an agency agreement with the construction company to appoint the latter as an agent to purchase supplies from the agreed list of suppliers on behalf of the bank, whenever the need for working capital would arise. Key steps in the working capital finance case are illustrated in Figure 1.

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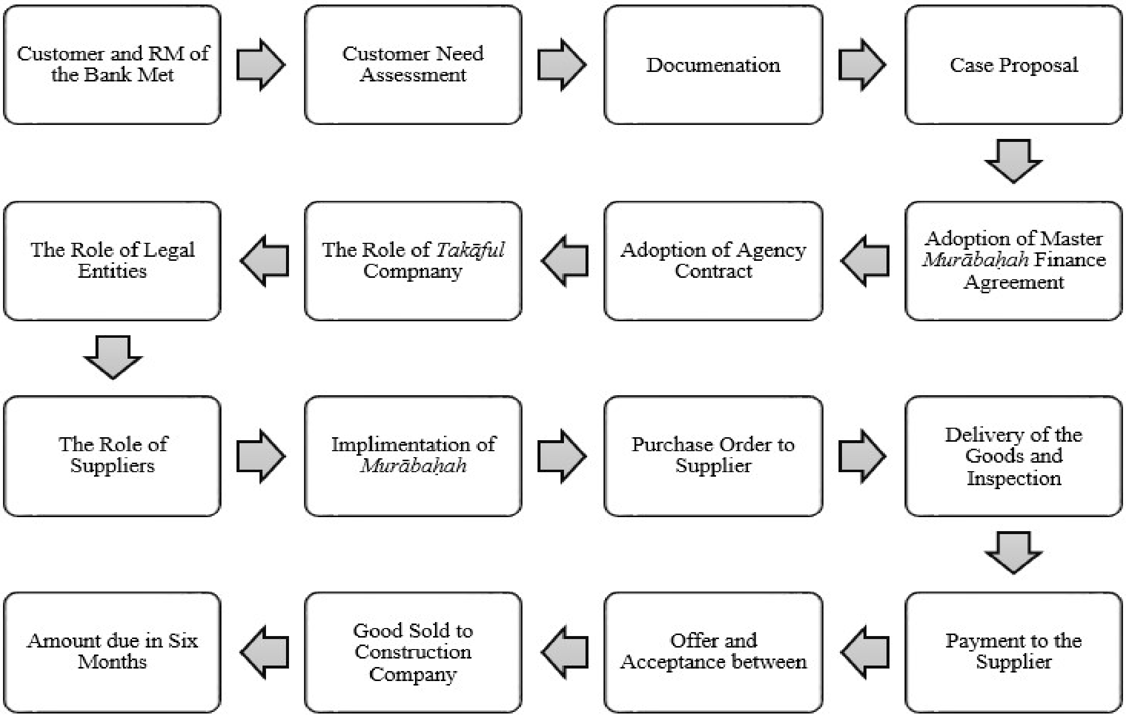

FIGURE 1. Key steps observed in the working capital finance process for the construction company

THE ROLE OF LEGAL ENTITIES

The PDSC department sent the case back to the relationship manager at the branch via courier. The Sharīʻah department listed the post-sanctioned formalities and legal requirements to be fulfilled. The relationship manager forwarded the file to the credit assessment manager to see that no rules are violated. The credit assessment manager called the external legal advisor to obtain his legal opinion on the ownership of property mortgaged against finance. The legal advisor also provided the legal documents for mortgaging the property with the registrar of mortgages. The director's father, the owner of the mortgaged property, visited the registrar of mortgages to show his consent for mortgaging his property with the bank.

Related to the Sharīʻah compliance, the role of PDSC is vital. They first developed a customised process flow for the case to ensure that the sales between the bank and the supplier occur before the execution of sale contract between the bank and the construction company. During the application, the process can be modified, and changes in the duration of the supply are made with the explicit consent of the Sharīʻah compliance department.

THE ROLE OF *TAKĀFUL* COMPANY

The credit assessment manager called the *takāful* company to arrange *takāful* (alternative to insurance) for the mortgaged property and the goods they aimed to trade in. *Takāful* models are applied as the risks attached to the location and goods are to be covered through the Blanket *Murābaḥah Takāful*. This activity generated another stream of actions, and new parties came into action as the evaluator of goods and surveyors provided their services.

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THE ROLE OF SUPPLIERS

The directors and finance manager of the company signed undertakings and personal guarantees against the finance. The company provided three suppliers' names, from whom they wanted to purchase petrol, diesel, and bitumen. These suppliers will now onwards work as vendors of the bank, and the bank will work as a vendor for the company. This extension in the supply chain sometimes proves to be very costly as well. Hence, due to the various steps in the *murābaḥah* model to meet the Sharī'ah compliance, the critics of Islamic finance sometime claim that the Islamic financial products are not efficient.

THE BANK'S CLIENT AND SUPPLIERS INTERACTIONS AND ISSUES IN IMPLEMENTATION

The purchase manager of the company, as an agent of the bank, requested bitumen from supplier A and forwarded the order form to the bank. The relationship manager after receiving the order form in the bank forwarded the request for the payment to the operations manager. The operations manager prepared a demand draft for the amount of purchase. The draft was made in the name of supplier A. The purchase officer of the company took the demand draft and sent that to supplier A. A copy of the demand draft was also given to the carriage company that supplied the goods to the customer.

On one occasion, the supply was suspended due to a shortage of the oil supply in the country and the damage of one of the carriage company's oil tankers. The purchase manager of the client company requested amendments in the *murābaḥah* process flow design to increase the duration of supply. The relationship manager amended the process flow design and increased the supply duration from 17 days to 25 days, which was approved by the Sharī'ah compliance department. The relationship manager sent the amended *murābaḥah* process flow design to the purchase manager of the company. The carriage company picked the goods from the supplier and supplied these to the company's construction sites.

Since the goods are purchased by the banks, therefore, the supplier A has drawn the invoice against the bank that made the payment to the supplier through a payment order, delivered by the construction company as an agent of the bank. Consequently, these goods are delivered to the construction company. After receiving the goods, the bank's relationship manager went to the construction sites and checked that the goods are supplied as specified. The company made an offer to purchase the goods from the bank through a declaration at an agreed payment schedule. The relationship management accepted the offer on behalf of the bank and sold these goods to the construction company at a marked-up price.

At one of the sites, the relationship manager noticed that the supplies were mixed with the stock of the client before an actual sale agreement between the bank and the client. This situation raised serious Sharī'ah compliance issues. As per discussion and guidance from the Sharī'ah compliance department, the bank then reversed back the transaction of those goods, which were mixed before the sale of the goods to the client company. A transaction of Rs. 500,000 was paid back to the bank whereas the transaction was classified as a direct sale between the client and the supplier. In the rest of the supplies, the sale between the

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bank and the construction company occurred before mixing of the goods with the existing stocks. It was also the responsibility of the construction company as an agent of the bank to check the quality of goods and ensure quality control at different levels.

After five months, the relationship manager sent a letter of maturity to the customer reminding the repayment date of finance. The customer paid the due amount at the end of the sixth month by depositing a cheque with the Bank.

TEACHING NOTES

a) Learning Objectives:

The case is aimed to achieve the following in-class objectives:

- Understanding the application of *murābaḥah*
- Understanding the *murābaḥah* process flow and related problems faced while applying *murābaḥah* in practice
- Understanding the management of various roles in *murābaḥah*-based working capital finance practice.

b) Suitability of the Case

The case is suitable for:

- Undergraduate and graduate students taking courses in Islamic banking and finance
- Research students with particular focus on theory and practice of Islamic finance
- Trainees interested in understanding how Islamic working capital finance is utilised in Pakistan.

c) Assignment Questions

1) Identify and discuss the roles of various stakeholders, who were involved in the *murābaḥah* case. Do the current theoretical *murābaḥah* models well define the roles of these stakeholders?
2) What is the actual need of the company in the case study? What should the bank look for regarding the Sharī‘ah compliance of the need?
3) What alternative the Islamic finance model, in your opinion, could the bank and the company use to fulfill the same need of the company? Make a comparative viability analysis of the *murābaḥah* and your proposed model.
4) Identify and discuss the supporting services that are considered essential for the actual implementation of the *murābaḥah* service.
5) Discuss the role of client and market research in the successful management of the application of *murābaḥah* finance.

d) Analysis

1) Identify and discuss the role of various stakeholders who were involved in the *murābaḥah* case. Do the current theoretical *murābaḥah* models well define the roles of these Stakeholders?

Answer: In the case study, we see the roles of bank, customer: A construction company,

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takāful provider, evaluation company, supplier, and shipment company. The theoretical model of *murābaḥah*, however, only defines the role of the bank, the customer, and the supplier.

2) What is the actual need of the company in the case? What should the bank look for related to the Sharī'ah compliance of the need?

Answer: It seems prominent that the company is looking for Sharī'ah-compliant funds to finance its working capital needs (para 3). The Sharī'ah compliance, as part of the need, is interested to know as it requires different strategies for analysis. For instance, the interpretation with regard to Sharī'ah compliance by the bank and the customer might vary.

3) What alternative theoretical Islamic finance models, in your opinion, could the bank and company use to fulfill the same need of the company? Make a comparative viability analysis of the *murābaḥah* and your proposed model.

Answer: The bank could use any of the partnerships, e.g., *mushārakah* or *murābaḥah*. However, firstly, in that case, it will assume more risk. Secondly, they will face problem in the identification of the joint assets and in determining to share the profits in the project. In *mushārakah*, the benefit will be that the customer will feel more Sharī'ah compliance in the service, as the Bank will be a partner in the project till the actualisation of the profit from the project and will share the earned profits with the company. Many scholars prefer the banks to use the partnership contracts and urge the banks to take the risk of the business for longer to be entitled to the actual business profits. However, the banks remained reluctant to take the risk. Some banks now try an adapted version of *mushārakah*, termed as the running *mushārakah* for working capital finance that practically involves a fixed charge to the client as in the case of the conventional Over Draft (OD). Note: Students may be assigned a task to review the running *mushārakah* and make a comparative analysis of that with the *murābaḥah* presented in this case.

4) Identify and discuss the supporting services that are considered essential for the actual implementation of the *murābaḥah* service.

Answer: Once a *murābaḥah* model is adopted in the bank based on its business strategy, one could analyse the existing *murābaḥah* service. A process flow diagram should be drawn to the existing service showing the stakeholders involved at each stage and then in the light of the proposed *murābaḥah* model, a revised process flow diagram can be drawn. Here the objectives of the service design would be two-fold: (i) to align it with the proposed *murābaḥah* model, and (ii) to simplify the process flow for operational efficiency purpose.

5) Discuss the role of client and market research in the successful management of the application of *murābaḥah* finance.

Answer: Of course, this is very important for at least two reasons: (i) initial need assessment of the client, and (ii) designing of a customized service. However, the way the clients' needs assessment is being carried out needs to be critically examined. Currently,

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the relationship managers and area managers might not be the right people for making an assessment of the financing needs given the technical complexity of the construction business. So, a technical individual having construction industry know-how should accompany the team.

6) What happens when the client is unable to make the payment to the bank?

Answer: If the client in the *murābaḥah* financing is unable to make payments according to the dates agreed upon in the *murābaḥah* contract, he/she can request the bank for rescheduling the payments. However, it is the discretion of the bank to approve the request. Further, it is not possible in the *murābaḥah* contract to charge an additional amount for rescheduling. If the banks impose any penalty due to default in the payment by the client, in the case agreed in the Master *murābaḥah* Agreement, the penalty amount will be credited to the charity account maintained at the bank. As the scholars agree, such a penalty amount cannot be a source of income for the bank. The charity is managed by the bank and is (should be) used for the Sharīʻah-compliant social causes under the supervision of the Sharīʻah scholars. This imposed charity is to discipline the clients and to ensure on-time payment against the goods supplied by the banks.

e) Readings to be Assigned to the Case

For developing discussion and answering the questions, the readers are expected to have knowledge of the Islamic finance models. Some suggested readings are:

Ayub, M. (2007). *Understanding Islamic finance.* New York, NY: John Wiley & Sons.

Ayub, M. (2016). 'Running *mushārakah*' by Islamic Banks in Pakistan: Running from *mushārakah* or moving back to square one. *Journal of Islamic Business and Management (JIBM), 6*(1), 7-18.

SBP. (2008). *Strategic plan for Islamic banking industry of Pakistan.* Retrieved from https://goo.gl/RD2eg1

Ullah, K., & Al-Karaghouli, W. (2017). *Understanding Islamic financial service: Theory and practice.* London, UK: Koganpage.

Usmani I. A. (2015). *Meezan banks guide to Islamic banking.* Retrieved from https://goo.gl/KK14BG

Usmani, T. (2002). *Introduction to Islamic finance.* The Hague, Netherlands: Kluwer Law International.

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