Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

Introducing a new method of applying the Murabaha contract in the Iranian banking network with an emphasis on differentiating between repayment of principal and interest

Hossein Meisamy

Fereshteh Mollakarimi

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Monetary and Banking Research Institute

Central Bank of the Islamic Republic of Iran

No.10, Africa Ave., Argentina Sq.,

Tehran.Iran.P.O.box:16765-1654

www.mbri.ac.ir

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Hossein Meisamy, Fereshteh Mollakarimi

Introduction

In the Iranian financial system, financing the real sector of the economy is one of the main concerns of the country's economy in times of economic recession, and if done properly, it can increase the output of the whole economy and employment. Accordingly, at present, the design of tools and methods that facilitate the financing of production in the country's economy is of great importance.

Manufacturing companies, on the other hand, often face challenges in repaying bank loan installments, which can cause problems for banks and businesses, especially in times of recession; Disruption of the installment repayment program, on the one hand, increases the ratio of non-current receivables in the bank, and on the other hand, reduces the customer's credit rating with the banking network.

Diversification of tools, contracts, and solutions of the banking system to repay installments can meet customers' needs with different tastes and endogenously prevent the mentioned problems. Adapting the debt repayment schedule in banking tools and contracts to customers' needs reduces the risk of disrupting the customer repayment schedule.

In this regard, in conventional corporate financing, the types of loans are divided into three main groups in terms of repayment method, which are: "discounted loans," "amortized loans," and "segregated loans (separation between principal and interest repayment program)." While in discounted loans, the borrower repays the principal and interest of the loan together at maturity; in the case of amortized loans, the principal and interest are repaid gradually. Finally, in segregated loans, the loan's interest is gradually repaid, and the principal is repaid at maturity.

Considering that in usury-free banking, two methods of discounted and depreciable repayment have been used so far, but the segregation method has not received much attention, the purpose of this study is to present a new mechanism for using the Murabaha contract for granting facilities with the approach of short-term interest installment and long-term principal of the facility. It creates a trade-off between the firm's revenue stream and the installment repayment plan. According to what was raised, the questions that are answered in this research (analytical-descriptive method) are:

1. How will the new model of using the Murabaha contract with the different principal and interest installment approach be applicable in the banking network?
2. What is the need for the proposed model, and what problem does it solve for the banking network and facility recipients (especially producers)?
3. What are the new model's jurisprudential and legal bases and the important jurisprudence points in this regard?
4. How is the calculation of installments and interest paid by the customer in this mechanism compared to the methods available in the country's banking system, and what are the points?

The research structure is such that after the research's introduction and background, the theoretical foundations of the research are first examined. Then the jurisprudential foundations and the feasibility of using the Murabaha contract with a new approach are discussed. Then, the operational patterns of using the new facilities in the country's banking network are explained, and then, the method of calculating the amount of interest and installments in the new mechanism in comparison with the current methods (used in the banking network) is discussed. The concluding section summarizes the paper and offers policy recommendations and suggestions for future research.

Conclusions and policy recommendations

This study tried to explain the new mechanism of using the Murabaha contract with the feature of short-term installment of interest and the long-term principle of the facility. The most important finding of the research is that from the perspective of Islamic jurisprudence and the terms of the Murabaha contract, there are no restrictions on the method of debt repayment in this contract. Although with the conclusion of the Murabaha contract, a debt is formed between the bank and the customer, the method of debt repayment (including principal and interest) is among the main conditions of contract freedom and the condition rule (permission to include conditions in contracts) and there are no restrictions; Therefore, the bank and the customer can conditionally agree on the Murabaha contract that the interest on the facility will be paid in installments and the principal of the facility will be repaid at maturity. This idea can be considered in different and diverse operating models in the banking network as an option for all customers (or selected customers). In this research, two operating methods of"Installment repayment of interest and disposal of the principal at maturity" and "Installment of interest and installments of the principle of facilities after the breathing period" were emphasized. The research findings also show that:

A- Basically, the agreement between the customer and the bank regarding the debt repayment method is a rational issue that the Holy Shariah has not considered any restrictions for it in the Murabaha contract. Accordingly, banks can consider various repayment methods in the Murabaha facility to respect customers' tastes so that every customer (especially manufacturers) can choose the best option according to their needs and conditions. In this study, one of the most important repayment methods, namely installment repayment of interest and disposal of the facility's principal at maturity, was discussed.

B- The solution presented in this research is especially applicable for manufacturing firms that have entered into a long-term leverage relationship with the bank (evergreen firms); This is because these customers do not receive facilities from the bank only once, but the bank's resources are provided to them continuously up to a certain credit limit.

C- The new mechanism of the Murabaha facility has an advantage over the current method used in the banking network, i.e., depositing the original facility by the customer to the bank account for a very short time and considering a new facility with similar conditions (by changing the title) for the customer; Because using the current method requires re-going through the formalities of payment of facilities and spending transaction costs for the bank and the customer. In the new model, however, the repayment of interest after maturity is agreed upon from the outset, and there is no need to convert the contract into a new one and change the title.

D- Although the new Murabaha model can be useful for all real or legal customers, this method is especially important for producers (especially small and medium producers); Because in this model, there is a connection between the "debt repayment program" and the "income generation and liquidity program." Businesses usually do not generate much revenue in the early years of production, and it is time-consuming to reach the start-up and operation stage. In the new model, the bank considers the opportunity for the producer to reimburse only the facility's profit in the first years when the firm has not generated revenue and the facility's principal after the operation of the project (which means to generate revenue stream).

E- The new model can be considered as a model of "facilities with affordable installments"; Because in this method, the installments are determined in proportion to the customer's ability to repay and endogenously prevent repeated and suspicious delays in the banking network and the increased ratio of non-current receivables in the banking network.

Based on this study's findings, it is recommended that the Central Bank of the Islamic Republic of Iran amend the Murabaha contract's executive instructions and consider the possibility of providing different methods of repayment by banks to the general public or selected customers. Besides, it is recommended that banks and non-bank credit institutions in the country respect the tastes of customers and maximally meet their needs (especially manufacturers) and try to provide the necessary platforms to implement the new mechanism (including accounting platforms, software, etc.). Finally, it is recommended that banks and non-bank credit institutions, if using the new method, inform the customer of the number of installments and the total interest paid transparently from the beginning so that the customer decides on the best debt repayment option.

Due to the novelty of the idea presented in this research, other economic and financial issues can be raised in the continuation of this work, some of the most important of which are:

A- In this research, the research's focus was on the jurisprudential feasibility of using a new model. From an economic point of view, however, there may be concerns that delaying the principal's repayment after maturity may lead to the accumulation of bank receivables and their inflation. It will ultimately make it difficult to repay the installments and increase the risk of default and non-current receivables. Accordingly, considering the necessary measures to cover this risk can be an important topic for future research in this field.

B- The present study's focus was solely on the Murabaha contract and examined the pattern of separation between principal and interest repayment solely about this contract. Accordingly, future research can discuss the feasibility of using this idea about other exchange and partnership contracts.

C- In the conventional banking system, different types of loans are used, some of which (such as discounted loans, segregated loans, and amortized loans) are somehow related to the idea presented in this research. The subject matter and analysis of the jurisprudential-legal aspects of this type of loan can be considered as a topic for future research.

D- In this study, the discussions' focus was on the jurisprudential analysis of the new mechanism of using the Murabaha contract with the feature of short-term installment of interest and long-term disposal of the principle of facilities. However, using simulation and mathematical modeling methods, a complete explanation of this new method can be provided compared to the current methods common in the country's banking network. Paying attention to this issue can be a topic for future research in this field.

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