



## **Reputation Risk and its Impact on the Islamic Banks: Case of the Murabaha**

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### **ABSTRACT**

Murabaha to the purchase orderer (MPO) is a rival product in the Islamic banking (IBs) system. It is implemented in the most of IBs. However, there is a controversy among contemporary jurists (Shari'ah Supervisory Board [SSBs]) in the mechanism of the implementation of this product. The objective of this study is to show the controversial issues related to the product of Murabaha and to identify its impact on the bank's reputation. This study is an exploratory study therefore, based on the literature review relating to the issues of MPO, reputation risk, and non-compliance risk. This study tries to describe and reveal the relationship between reputation and non-compliance risk. As well as revealing the impact of reputation risk on the IB stability and financial performance. It aims to brought the attention of decision-makers regarding consequences of these risks. At the end of this paper, concluded that the IBs like all other corporations, affected by the risks reputation, despite their principles that based on Islamic precepts.

**Keywords:** Murabaha to the Purchase Orderer, Reputational Risks, Non-compliance Risks, Islamic Bank

**JEL Classifications:** G21, G32, G33

### **1. INTRODUCTION**

The Murabaha played a key role in the development of the global Islamic finance market (Hart and Childs, 2011). Also, it is the most widely used instruments on it (Hart and Childs, 2011; Iqbal, 1997). According to some statistics and field studies, it is the most popular and attractive to customers in Islamic banking (IBs) in many of the countries (Al-'ane, 2012; Dawabah, 2007). It varies from one bank to another, in terms of the mechanism in some procedures such as the binding promise or the right of option (Al-Azeezy, 2004). The Murabaha has developed over the time from a classical Murabaha to composite, then become on the current form that called the banking Murabaha or Murabaha to the purchase orderer (MPO). This product has spread widely and become the most common model of Islamic financing. It adopted by the SSBs in many of the IBs.

The banking Murabaha still of more than two decades ago, issue of controversy among the contemporary scholars and Jurists ("Ulema

and Fuqaha"), despite the role of institutions that regulate the IBs policies such as accounting and auditing organization for Islamic financial institutions (AAOIFI) in the state of Bahrain, which is formulated the Standards of Murabaha in accordance with Shari'a principles. The MPO contract is still the issue to debate by some known contemporary jurists, through their conferences, books and journal or by the various social media. This controversy still rages among a large group of contemporary scholars whether they are supporters or rejectionists this kind of financing (Seraj, 2009). The present study was based on some of the previous studies, which proved the inconsistency among contemporary jurists on the contract of Murabaha that is currently applied in IBs, and the studies that have shown a relationship between reputation and non-compliance risk.

The controversy and criticism, which that apparent to the audience and to the customers of the IBs particularly among the contemporary scholars adversely affect the reputation of Murabaha

product. This controversy regardless of the right opinion for any party raises questions among the stakeholders of IBs on the validity of this type of financing and on the credibility of SSBs in the IBs, hence their real role in the monitoring of the implementation of Islamic transactions. This paper will discuss the reality of the controversy on the product of the MPO and their impact on the reputation risk, therefore its impact on the IBs stability and financial performance.

## 2. CONCEPT OF MURABAHA

Regarding the Murabaha transaction, the present study has adopted the definition of the AAOIFI for the Murabaha concepts. The Murabaha has two terms: The classical Murabaha, and banking or composite Murabaha, which is called the MPO.

Classical Murabaha is a cost plus profit sale. It refers to the sale of an item by the same price that is bought by the seller with an increase in the profit that is agreed upon with a percentage of the price or a sum of money without a prior promise and it's a kind of Bay' Amanah (AAOIFI, 2010, p. 103).

MPO, or as pronounced in Arabic: Al Murabaha lil aamer bil shiraa. Murabaha is selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy, in which case it is called an ordinary Murabaha, or with a prior promise to buy submitted by a person interested in acquiring goods through the institution, in which case it is called a "banking Murabaha," i.e., MPO. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses (AAOIFI, 2010, p. 120).

## 3. BANKING MURABAHA

The IBs have certainly been able to demonstrate their presence in the various branches of the economic activity (Shatnawi, 2009). These banks were and still evolving in a competitive environment that is fierce with the usurious banks. The conventional banks, which are based on interest system, always seek to provide the quality and competitive services to meet the unlimited needs of their customers. At the same time we began to see the major conventional banks and multinational banks have opened an Islamic finance window to provide Islamic financial products, like Citibank, HSBC, ABN-AMRO and Deutsche (Khorshid, 2012). On the other hand, IBs aimed to capture the maximum number of customers to compete with conventional banks by providing a large number of products as an alternative for interest based products (Ahmad et al., 2010). Therefore, they are trying to creating and developing a various services that suit their needs. The IBs are also considered as a strong competition among them, each IB is trying to reach the highest level of profits and a larger number of customers.

As the above mentioned, these promoted the main IBs for creativity and evolution by instructing to their relevant departments to find

more financial techniques that can meet the needs of the market within the principles of Shari'a. Among these services is the MPO, its way structures have developed over the last decades (Bälz, 2008). It has been shifted from a classical Murabaha that includes only two parties, to a composite Murabaha that involve more than two parties, whether the promise is binding or optional. The banking Murabaha or the MPO is considered one of the most funding formulas implemented in IBs, it's able to attract the largest number of customers because the easy to understand and implementation (Al-'ane, 2012). A field study was conducted in Egypt, Jordan and Gulf states showed that the MPO got a (60-90%) from the proportion of investment of those IBs in these countries (Dawabah, 2007). Another study showed that the MPO in the IBs got a (35-40%) of the financing granted to their customers in the UAE banking market during the period of the year 2008-2010 (Al-'ane, 2012). Thus, it was adopted in many IBs and no one can deny that it has achieved a great success and had its permanent customers and contributed to increase profit of IBs.

## 4. THE POLEMIC ON THE MPO

The Murabaha has shifted from a classical Murabaha to a composite or banking Murabaha. Therefore, the shift in the mechanism of its implementation has put the Murabaha in a circle of skepticism and suspicion by some contemporary scholars and critics, they argued that the Murabaha has become a contemporary Murabaha that has a lot of forbidden structure (Hiyal) (Seraj, 2009). The other group considered a Murabaha transaction as a successful product that should be developed in the financial institution that provide IBs facilities based on the Shari'a principles. They considered also the Murabaha of the binding promise that is applied currently in the IBs is within the principles of Shari'a compliance and it may not be challenged because it is within the legitimate guideline.

Accordingly, the researcher summarized the main opinions in the MPO contract; these opinions could be divided into two categories: First, permits the Murabaha that currently applied in the IBs system and its call MPO or banking Murabaha, the second objected and criticize its implementation mechanism. The polemic and controversy between the two groups that related to the mechanism of the implementation very critical, precisely in the case of a binding promise and possession of the commodity.

These are some literatures that show the controversy in the MPO contract included recognition of some of the jurists to the controversy in the MPO, which is currently applied in the IBs system:

Al-Qaradawi's (1998), in his study according to the MPO transaction, aimed to clarify the controversy and confusion about the MPO. He responds to the arguments of some scholars who outlaw this legitimate issue. He referred in his study to the existence of a real controversy emerged during the Conference of IBs in Kuwait in 1983. The study provided a clear vision about the MPO contract in terms of its definition, its legitimacy, evolution and its performance. The study showed the objections around it and the response to each objection clearly and separately. One of these objections is that this transaction is not a sale or purchase, and that

no one of the scholar issues a Fatwa about its legitimacy, and it's a kind of "Bai' al-'Inah." His opinion about binding promise was clear, he clarified its legitimacy and analyzes it in details based on the holy Quran and Sunnah. The study concluded at the end, to the legitimacy of the sale of Murabaha with a binding promise.

Afanah (2009), aimed on his study to show the controversy about the practical applications of Murabaha, with an evidence which is indicated for each scholar and the probability of one of them. The study highlighted the implementation mechanism of Murabaha in the IBs in the West Bank (Palestine). The researcher defines the MPO as the order to purchase a certain and descriptions commodity that is submitted by the client to an IB with commitment from the client to buy the requested item based on the price and profit agreed upon them and the payments shall be installments. Contemporary scholars have defined the MPO in various definitions. All of them agree that it's a demand by the client to purchase a certain commodity in a specific description submitted to the IB, in return the customer's commitment to purchase the requested commodity by the price and profit which are agreed upon them. The researcher acknowledged through his study to a significant difference between scholars and contemporary scholars in the judgment of Murabaha contract. He showed the different viewpoints in current Murabaha and the view of each team. He divides these differences into two groups; the first group: Allows the MPO with its condition of the binding promise, the second: Who does not allow this type of contract, which is based on the binding promise.

The study concludes to preference and adoption the "first school" that is based on the basics of legitimacy and jurisprudential, includes: "Contracts of Muamalat are permitted, unless there is evidence indicating otherwise." In addition, the past and present texts that are issued from some scholars approved this contract.

Seraj (2009), shown through his study to the most of the issues that are related to the Murabaha implementations and the MPO in terms of the definition, development, and Fatwas issued upon it and the response to them. The study considered that there was a difference and disagreement between scientists and scholar in many of its fractions and the permissibility. He aims to studying the mechanism of MPO in a way that is far from supporters and opponents of the Murabaha either party. It is based on the Quran, Sunnah and the books of Fiqh, until to reaches a clear view and critical decision about this type of financing. The study showed the definition of Murabaha in the Fiqh references and its evolution before going in specific to the Murabaha banking (MPO). The study describes the reality of the MPO in the IBs, and also showed the challenges faced by them such as the dispute and polemic over the legitimacy of this transaction. The study indicated the principles and rules for the Murabaha financing like the binding promise, this is due to the best for dealing, stability, and the interesting achievement. It removes the risk of the bank, which in turn invest supplier's money that represents a large group of people.

AbdulHallem (2006), clarifies the impact of the differences of jurisprudence at the Islamic finance industry. The author began his study by talking about Jurisprudential disagreement, he has

acknowledged of the variations since the time of the Sahabah, and he declares that this issue is not new. He lists some of the literature studies on the differences between the schools of jurisprudence and former scientists. In the study, the author refers to some practice in industries of Islamic institutions and banks to illustrate the difference, and disputed matters, including the issues of the MPO. In this regards, he defines the MPO as: Agreement between two parties which includes a promise by each party to the other party to obtain a subject matter in the future with the intention that the purchaser will buy what the seller of the commodity owns, and the commodity should meet the specification demand by the purchaser. The seller must sell the subject matter and the purchaser must buy it if it meets his demand. He indicated to the issue of controversy in the MPO between schools of jurisprudence and the financial institutions in the case of the binding promise. He cited the evidence of each party, and he considered that the majority of IBs allow the binding promise in the MPO product. The study concluded that the importance of taking all the cautious attitudes and tolerance on the controversial issues, as well as the IBs and financial issues are still new in our community. Therefore, the Ijtihad is a way to approximation disputed views and reduces the disagreements.

According to Al-Azeezy (2004), the research aimed to illustrate the way in which the IBs deal with the practical application of the MPO regarding to the judgment of the binding promise and the forbidden structure (Al-hiyal). The researcher classification the MPO within three schools of judgment: The first school permits the binding promise for both parties (customer and the bank). The study showed through this school the importance of binding promise when conducting the Murabaha based on the arguments and the evidence of Shari'a, this school endorsed by some well-known scholars, such as Sami Hammoud, Yosuf Al-Qaradawi and Sheikh Abdul Hamid al-Sae'h. The second school based on the right of the option for both parties and the inadmissibility of the binding promise. The study refers to some well-known scholars who had authorized this way, like Rafiq Al-Masri and Sulaiman Al-Ashqar. The third School declares the inadmissibility of the mechanism of the MPO contract that is currently applied in the IBs, whether the way of the binding promise or the right of the option based on the legitimate evidences. This school admits that Murabaha with promise is considered as comprising two transactions in one transaction, and it could be considered as a person selling what he does not have, and it may not be allowed by Shari'a. The last argument is the procedures of the MPO are the same as Bai' al-'Inah, which were forbidden by the Prophet Muhammad (peace be upon him).

Al-Masri (1996), described the Murabaha mechanism based on the old Fiqh. He indicated the opinions for some of the jurists in forbidding the banking Murabaha. He defined the contemporary financing Murabaha (MPO) and he explained its advantages from the viewpoint of its supporters and the large facilities that offered to the audience of IBs. He discussed the naming of MPO and preferred to be called Murabaha for promising to buy, under the pretext, that It makes the bank committed to customer orders and leased him and both the bank and the client become committed and constrained to each other. He noticed in his study that the

MPO varies from one bank to another according to SSBs in this bank. The study showed that the binding promise in the MPO is forbidden and is not permissible according to scholarly consensus and the four Madhabs, he based on some of the provisions in these doctrines. His argument is; the MPO with binding promise has some kind of forbidden structures (Hiyal), and the supporters in this case have adopted the fabrication in their opinions. He showed some practical examples that show the absence of any difference between Murabaha with binding and usury. The study has found that Murabaha contract in the old Fiqh is permissible, and he recommended the adoption of the MPO as the right option for both parties.

According to Ghiryani (2003), there is controversial among contemporary scholars on the contract of the MPO. Some of them approved the case of binding promise and others did not accept this mechanism, he indicated that the most of the IBs used the binding promise in their transactions, but some of the IBs like Kuwait Finance House; Al-Rajhi bank imposed the right of the option in the MPO. The study aimed to investigate the views adopted by the Jurists who based on the binding promise in the MPO, and these include:

- Madhab (Maliki) permissible the binding promise
- Consideration the benefit of people after the worsened of their live.

The study concluded that all IBs that are based on the binding promise in their MPO transaction should replacement for the right of the option, to be a permissible contract, and does not infringe the principles set out in Sunah. It also recommended to be re-examined in the decisions of the councils and boards of jurisprudence in the binding promise in the MPO.

Al-'ane (2012), mentioned in his study the main financing methods, including Murabaha product and its definition in the four Madhabs, the study indicated that the MPO is the most applicable and the most common type in the Islamic financial market. The study discussed the important conditions for the MPO that is making the sale to be true and uncorrupted, as an example of these conditions: The first price should be known to the second buyer, the profit is known, and the capital consists of similarities such as weights and measures. The study recognized that there are criticisms to the MPO. It was classified criticism into three categories: The first category supports Murabaha, the second category is against Murabaha and the third one contains scholars that are neutrals. The study considered that there are some irregularities in the MPO contract like the binding promise, the approval and adoption of this way of mechanism is a violation of Shari'a principle. The study found that the MPO despite all the controversy, it is practically succeeded in comparison with the other methods and sales.

Dawabah (2007), based on his study to some of the provisions, which prohibits of this type of implementation, including the words of Ibn Hazm in his book (Al-Muhala) regarding the issue of requiring a certain profit in the MPO contract. He indicated in his study to the reality of MPO in the IBs. He showed that the IBs used the kind of ambiguity and the lack of transparency in the disclosure

of investments in the Murabaha ratios, and this seems like a kind of defect in which he refuses to show it. He acknowledged that the most of the implementations of this type of method are closer to the interest-based system than to the Islamic principles and methods, so the purpose of this type of product is only for funding, and not investment process in order to have the assets and take risks in order to gain profit. The study recommended for the adoption of the opinion of the International Islamic Fiqh Academy, Jeddah, which recommends the adoption of the right of the option during the sales process. It also emphasized the need to own the item and to take the risks until the buyer received the commodity.

## 5. THE CONTROVERSY IN THE (MPO) AND ITS IMPACT ON THE (IBs) REPUTATION AND IMAGE

Through the previous literatures, this study becomes able to prove the clear difference between the scholars regarding to the Murabaha mechanism in terms of the implementation. A number of researchers acknowledged of disagreements among contemporary scholars on the Murabaha contract (AbdulHallem, 2006; Al-'alayt, 2006; Al-Azeezy, 2004; Ghiryani, 2003; Seraj, 2009). These controversies between the various schools of jurisprudence, and some of the SSBs in the same country (Al-Salami, 2011), lead to strong polemic and challenged on the validity of this product, and hence led to a kind of suspicion. The acknowledging the legitimacy of juristic differences as an inherent feature of Islamic law, such differences could jeopardize a nascent Islamic finance industry, leading to what has come to be arbitrarily termed "Shari'ah risk" in Islamic finance (Soualhi, 2012).

Ignition the controversy and disagreement on the Murabaha transaction that appeared to the audience through the various media or by related books and journals, undoubtedly affects the image of IBs and their products. Some contemporary jurists criticized the Murabaha contract explicitly in their books such as; (Murabaha sale is a forbidden structure (Hila) to the writer Yousef Kamal), and (uncover of the MPO to the writer Raffeq Al-masri). Not all customers have a legitimate and jurisprudential interest and awareness. The challenge of the validity and legitimacy of Murabaha contract which is one of the most important types of financing in the IBs cause uncertainty towards the products and threatens the image of the these banks. Skepticism in Murabaha contract by some contemporary jurists leads to a non-compliance risks that strong impact on IB's performance, a particularly in the presence of a SSBs and legitimate committees specialized in this field. Reputational risk is closely interrelated Shari'a non-compliance risk (Abdullah et al., 2011). Non-compliance risks defined as a failure to comply with the Shari'a rules and principles, which are determined by the Shari'a boards or relevant body in the jurisdiction (Shahrizal, 2013).

The controversy between the various scholars who support or against the Murabaha transaction (MPO) has adverse effects on the reputation and the image of IBs. The reason for this is that the largest proportion customers of these banks are adopted on the IBs principles that is based on the prohibition of interest and to stay

away from the suspicions. At the same time, the differences between SSBs in the same country also affect to the customer loyalty (Zaman, 2010). The difference in the Fatwa between each SSBs in the same country, lead to dispersion and confusion, specifically, according to the IB customers, the binding promise in the MPO is an example of this, some of them considered the binding promise is permissible and others prohibit dealing with it (Al-'Iyat, 2006).

Some previous studies have shown the importance of reputation risks and non-compliance risk by their strong impact on the banks and companies. A damaged reputation can lose companies their customers, destroy profit potential and may lead to bankruptcy (DeRose, 2007). Many cases of companies that declared their bankruptcy or face financial problem as a result of reputational damage like: Budget clothing retailers – collapse of the Rana Plaza garment factory in Savar, Bangladesh (2013), BP – Oil spill (2010) (Smith-Bingham, 2014). Institutions Islamic financial Services (IIFS) are also exposed to reputational risk arising from failures in governance, business strategy and process (IFSB, 2005). Hence the IBs like other institutions and companies in the financial system affected in case of a fraud or corruption or defect in the particular product effect on their image and reputation among their audience, regardless of their principles. The Islamic financial services industry is a relatively young industry, and a single failed institution could give a bad name to other banks that do not engage in irresponsible behavior. Nevertheless, all IBs in a given market are exposed to such risk (Van Greuning and Iqbal, 2008). Failure to manage Shari'a risks effectively will lead to significant financial losses and regulatory damage (Shahrizal, 2013). The risk of reputation does not discriminate between conventional and IBs. Any failure in this aspect, the IB will bear the negative consequences for that.

Reputational risk is defined as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors or regulators that can adversely affect an IIFS's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (IFSB, 2014).

The reputational damage as a result of the fraud in the product or the financial and administrative corruption within the company that leads to a significant loss of revenue and a significant reduction in customer loyalty, and therefore to a reduction in the value of the stock and bankruptcy (Zaman, 2010). The promoting reputation it has a role in building customer loyalty and increase revenue (Mahmood, 2008). This happens with the IB, when it is deceiving in their products and introducing to market in a fraudulent way. Therefore, it aims to raise profits that are not based on the principles of Islamic precepts as a priority, and this has gravely damaged the image of the bank and effects on the loyalty of customers and forcing them to withdraw their deposits and to go to other IBs. On the other hand the image of bank shaking when there is a difference in a Fatwa between SSBs of the IBs in the same country (Al-'Iyat, 2006; Al-Salami, 2011).

Reputation risk is one of the important risks that affect the companies and banks, and it is causing a lot of anxiety for managers, investors and decision-makers, and if the reputation

risk materializes, it will inevitably impact on the income statement and on the confidence of investors (Zaman, 2010). The risk of reputation is difficult to measure and to identify, and it has clearly emerged after the global crisis in 2008 (Zaman, 2010).

The bank's reputation and image are the most important risk which strongly affects the customer satisfaction (Hamzah et al., 2015). The collapse of IB's reputation as a result of the fiduciary risks which are resulting from failure to comply with the Shari'a rules and principles which determine with the Shari'a board (Dar et al., 2013). It is called Shari'a of non-compliance risk, thus consequent negative impacts, including the withdrawal of deposits of clients which lead to the crises liquidity (Hamzah et al., 2015).

Foregoing makes clear that the debates and the skepticism of the validity of the Murabaha contract leads to negative consequences for the Islamic financial industry. Accordingly, the present study addressed the significant literatures that showed the in the MPO among the contemporary jurists, also the relationship between the reputational risk and Shari'a non-compliance risk. Therefore, the continuing controversy between contemporary jurists according to the contract of Murabaha and the objections on the way of implementations has adverse effects on the Shari'a non-compliance. The reputation damage of IBS could expose them to the many of the financial problems, and it also effect on the stability of the IBs.

## 6. CONCLUSION

The IBs are still in a phase of evolution, and that development needs more work and effort by the decision-makers, bodies and the institutions of regulatory organization of the IBs. If we exclude the basic principles, the IBs like other conventional banks and companies in the financial system, are affected by any reputation damaged in their departments or products. The MPO in IBs is one of the most important types of financing. This product is exposed to a question regarding its implementation mechanism. It is an issue of controversy among the various contemporary scholars, this did not stop, and it is still going on in a closed circle. It is opening the way for further questioning regarding the case of MPO. These controversies and skepticism in this product may affect the IBs reputation and thus on their stability. The risk of reputation is considered as other risks in the IBs in terms of its impact on their financial performance; on the other hand, the reputation has a positive impact on the bank if the bank has a strong image for the customers (Hamzah et al., 2015; Tang, 2010).

What distinguishes reputation as other risks it is difficult to measure and identify. Therefore, the solution of this problem needs a long time, which may extend for some years. This paper is significant because of the weakness of reputation risk management in the IBs, and this study is complementary to the practical side in the IBs, which already suffers from deficiencies in this field. Accordingly, the researcher through this paper finds that the institutions and the regulators must put an end to the controversy in the case of the MPO contract.

The IBs have to create particular departments, which are part of the risk management to moderate the risk of reputation, monitoring

and alert the management of the causes. The IBs should establish a supreme supervisory body that characterized in mandatory in decisions, include all the IBs and Islamic financial institutions. Finally, the Islamic financial institutions have to increase the awareness of its customers with its products to increase their confidence and maintain their loyalty to avoid non-compliance risk.

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