

# ***Marabaha* Contracts in Contemporary Islamic Banking: A Backdoor to Interest Based Financing?**

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## Abstract

*Islamic finance industry has grown rapidly from the last few decades in terms of size. Islamic banking is being practiced in more than fifty countries worldwide and Pakistan ranks fourth in the world according to the Islamic Finance Development Indicator. Marabaha is a widely used Islamic financial transaction everywhere, and the State Bank of Pakistan, in its 2018 Islamic Banking Bulletin, estimated that marabaha financing constitutes more or less 13% percent of the total Islamic modes of financing used nowadays in the country. The present article analyses whether marabaha transactions are legitimate financial instruments according to Islamic injunctions. The first part will be dedicated to defining marabaha and briefly describe the way it operates. The second part will be dedicated to the Islamic prohibition of riba (usury and interest). The third part will highlight similarities between interest based transactions in commercial banks and marabaha instruments. It will be finally argued that although differences exist between interest based transactions and marabaha, they are merely nominal in nature and therefore marabaha should not be considered a legitimate financial instrument in Islamic banking, as it flouts the prohibition of riba.*

## Introduction

Islamic finance industry has grown rapidly from the last few decades in terms of size and its overall size was estimated around US\$ 2.4 trillion worth of assets worldwide in 2017, with a growth of 11.5% over the previous financial year.<sup>1</sup> Islamic financing and banking are being practiced in more than 50 countries worldwide and Pakistan ranks fourth in the world according to the Islamic Finance Development Indicator which compares data relevant to 131 countries.<sup>2</sup> In spite of the fact that present-day Islamic scholars, including the Council of Islamic Ideology of Pakistan, only approve *marabaha* as a transitory financing technique (possibly under the law of necessity or *darura*) and do not recommend it as a regular and permanent feature of Islamic financing operations<sup>3</sup> – it is a widely used Islamic financial transaction.<sup>4</sup> The State Bank of Pakistan, in its 2018 Islamic Banking Bulletin, estimated that *marabaha* financing constitutes more or less 13% percent of the total Islamic modes of financing used nowadays in the country.<sup>5</sup> It is therefore a model of transaction that cannot be ignored when it comes to Islamic financial instruments. The present article analyses whether *marabaha* transactions are legitimate financial instruments according to Islamic injunctions. The first part will be dedicated to defining *marabaha* and briefly describe the way it operates. The second part will be dedicated to the Islamic prohibition of *riba* (usury and interest). The third part

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<sup>1</sup> Thomson Reuters, *Islamic Finance Development Report* (2018) 4 <<https://ceif.iba.edu.pk/pdf/Reuters-Islamic-finance-development-report2018.pdf>> accessed 10 April 2019.

<sup>2</sup> *Islamic Finance Development Report* (n 1) 7.

<sup>3</sup> Mehboob-ul-Hassan, *The Islamization of the Economy and the Development of Islamic Banking in Pakistan* (2007) 1-2 Kyoto Bulletin of Islamic Area Studies 92, 94.

<sup>4</sup> Mehboob-ul-Hassan (n 3) 97-98.

<sup>5</sup> State Bank of Pakistan, *Islamic Banking Bulletin* (September 2018) 4 <<http://www.sbp.org.pk/ibd/bulletin/2018/Sep.pdf>> accessed 11 April 2019.

will highlight similarities between interest based transactions in commercial banks and *marabaha* instruments. It will be finally argued that although differences exist between interest based transactions and *marabaha*, they are merely nominal in nature and therefore *marabaha* should not be considered a legitimate financial instrument in Islamic banking, as it flouts the prohibition of *riba*.

### A. What is *Marabaha*?

The word *marabaha* derives from the Arabic word *ribah* which carries the literal meaning of profit. The State bank of Pakistan defines it as a ‘agreed profit margin sale with cash or deferred payment of price’.<sup>6</sup> Basically, *marabaha* is not a loan but a sale of commodity for a deferred price which includes an agreed profit added to the cost and disclosed to the end customer.<sup>7</sup> Such cost will include all direct expenses incurred to acquire the commodity and to take over its possession like transportation, duties and insurance etc. however, indirect expenses such as utility bills, or staff salaries etc. cannot be included as those can only be added to profits.<sup>8</sup> *marabaha* financing is a widely used contract in contemporary Islamic banking and finance; and it is limited to cases where the customer actually needs to purchase some commodity. However, if a customer needs funds for commodities already purchased by him or any other purpose,

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<sup>6</sup> Guidelines for Islamic Mode of Finance, Press Release, *State Bank of Pakistan*, 15 April 2005 <<https://www.sbp.org.pk/press/Essentials/Essentials%20of%20Islamic.htm>> accessed 11 April 2019.

<sup>7</sup> *M. Aslam Khaki v Muhammad Hashim* PLD 2000 SC 225 as per Mulana Taqi Usmani.

<sup>8</sup> Dr. Maulana Ijaz Ahmed Samdani, *Islamic Banking & Marabaha* (1<sup>st</sup> edn. Darul-Ishraat Karachi 2008) 20.

*marabaha* transactions are not applicable.

## 1. Governing Rules for *Marabaha*

*Marabaha* transactions are usually construed as a particular kind of sale; therefore all the Shariah rules and regulations that govern trading activities are vital for *marabaha* transaction.<sup>9</sup> The State Bank of Pakistan summarises the applicable rules as to include the following:

- The subject of sale must be specifically known and identified.
- The subject of sale must be in existence at the time of sale, and must be owned by the seller at time of sale.
- The subject of sale cannot be for *haram* use or forbidden commodities.
- The subject of sale must be something of value and classified as property according to Islamic jurisprudence (fiqh). This may raise several important jurisprudential issues, such as, whether rights qualify as property or not.
- The sale must be instant and must not be attributed to a future date
- The terms of delivery must be specified and certain.
- The sale must be unconditional and must not be contingent on a future event or fulfillment of a condition that is external to the transaction.
- A requirement of a valid sale is knowledge and specification of price and payment terms- spot or deferred. In case of deferred payment, the terms, such as, maturity, amount and timing of installments must be clearly specified at the time of

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<sup>9</sup> Bank Negara Malaysia (Central Bank of Malaysia), *Standards and Guidelines on Islamic Banking - Murabaha* (23 December 2013) 1-43, 4 <<https://mxae.digialliance.com/websites/stagingbnmgovmy/index.php?ch=57&pg=137&ac=191&bb=file>> accessed 11 April 2019.

contracting to avoid any gharar or uncertainty as a source of potential conflict between the parties.

- The deferred price may be more than the cash price, but it must be fixed at the time of sale. Once the price is fixed, it cannot be increased in case of default; nor can it be decreased in case of early payment.<sup>10</sup>

In procedural transaction of *marabaha* the client shows an interest in purchasing a particular asset from the bank for a certain price (a combination of cost price plus profit) at a certain time (the utilization date). The client identifies the vendor, selects the goods and advises its particulars, including the vendor's name and its cost price to the bank in writing and promises to purchase particular asset from the bank. Basically this theoretical transaction is impossible in practice without agency agreement in which bank appoints his agent (most often the person appointed as agent is the client themselves). After relying on the promise made by the client, the bank appoints the client as agent under agency agreement and sometimes funds the agent for the purchase of a particular asset from the vendor on the bank's behalf. After taking delivery from vendor, (delivery need not be in physical, it can also be constructive)<sup>11</sup> the agency agreement comes to an end. The client accepts the offer and the bank immediately sells the asset to the client, with payment due on the agreed date in the future.

Having defined *marabaha* and explained its functioning and the legal Islamic finance framework where it usually operates, the next chapter will move on to examine the prohibition of *riba* in Islam and its scope.

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<sup>10</sup> State Bank of Pakistan, Islamic Modes of Finance, Question 21: What are the basic rules for a valid Murabaha transaction? <<http://www.sbp.org.pk/IB/FAQ.asp>> accessed 9 April 2019.

<sup>11</sup> State Bank of Pakistan (n 10) Rule 3.

## B. What is *riba*?

The literal meaning of *riba* as it is used in the Arabic language means to excess or increase. A very concise and precise definition of it is given by Shah Wali Ullah Dehlvi<sup>12</sup> ‘*riba* is a loan with the condition that the borrower will return to the lender more than and better than the quantity borrowed’.<sup>13</sup> In the context of commercial transactions, however, *riba* refers to usury or interest.<sup>14</sup> In the Islamic terminology interest means effortless profit or that profit which comes free from compensation or that extra earning obtained that is free of exchange. Prohibition of *riba* is central to Islamic financial ethics and law.<sup>15</sup> All transactions and contracts must be free from elements of *riba*.

The primary sources of Islamic law expressly talk about its prohibition in society. The Quran, states:

*‘That which you give in usury for increase through the property of people will have no increase with Allah: but that which you give for charity seeking the countenance of Allah, it is these who will get a recompense multiplied.’*<sup>16</sup>

On the same line,

*‘O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey Allah and the prophet*

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<sup>12</sup> Great Hanafi scholar.

<sup>13</sup> Interest (Riba’) <<http://www.inter-islam.org/Prohibitions/intrst.htm>>

<sup>14</sup> State Bank of Pakistan (n 10) Question 2.

<sup>15</sup> State Bank of Pakistan (n 10) Question 1.

<sup>16</sup> *The Holy Quran*, Surah al-Rum, verse 39.

*so that you may receive mercy.*<sup>17</sup>

The relevant *hadiths* which are in line with Quranic verses are narrated by Hazrat Umar Ibn al-Khattab<sup>18</sup>

*'The last verse to be revealed was on Riba and the Prophet, peace be on him, was taken without elaborating it to us; so give up not only Riba but also what is in doubt.'*<sup>19</sup>

Another scholar, Hazrat Abu Huraira, reports that

*'A tie will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him respectively.'*<sup>20</sup>

The principal reason why the Qur'an has delivered such a harsh verdict against interest is that Islam wishes to establish an economic system where all forms of exploitation<sup>21</sup> are eliminated, and particularly the injustice perpetuated in the form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return.<sup>22</sup> Islam wishes to

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<sup>17</sup> The Holy Quran, Surah Al-Imran, verse 130-2.

<sup>18</sup> Ibn Majah 2267 quoted by Ahmad Shafaat, Riba in the Quran, *Islamic Perspectives* (March 2005) <<http://www.islamicperspectives.com/Riba1.htm>> accessed 8 April 2019.

<sup>19</sup> That is: 'whatever raises doubts in the mind about its rightfulness'.

<sup>20</sup> Abu Dawood, Nisai quoted by Mohammad Zakir Hossain, *Why is interest prohibited in Islam? A statistical justification* (2009) 25:4 Humanomics 241-253.

<sup>21</sup> Muhammad Nejatullah Siddiqi, *Muslim Economic Thinking – A survey of Contemporary Literature* (The Islamic Foundation, Leicester 1981) 6.

<sup>22</sup> Ozsoy I., *Islamic Banking: Conceptual Fundamentals and Basic Features* (2010) 22(4) *Economical Herald of Donbas Quarterly* 140, 144.



establish justice between the financier and the entrepreneur. From this perspective, interest is perceived as the allocation, to the capital owner, of an unearned, undeserved, unborn, unavailable and imaginary income that might be attained without producing anything and without contributing any value to the revenue of the society.<sup>23</sup> Moreover, lenders would usually not provide loans to those they believe are unable to repay so such wealth would be restricted to those able to service the debt. This is something forbidden categorically by the Quran as the effects on society result in the accumulation of wealth amongst those who have it and increase the divide between the rich and the poor.

Ibn Rushd argued the rationale relates to the possibilities of cheating that exists in *riba*, which is clearly visible in *riba-al-fadl*.<sup>24</sup> Interest mechanism prevents the fair distribution of positive or negative outcomes of economic activities among the lender and borrower and worsens the resulting income distribution.<sup>25</sup> Injustice and unequal distribution of income is perceived by Islamic law as an inevitable consequence of applying interest and therefore it is forbidden as being contrary to the essential goals of *shariah*. A long term effect of *riba* is that it contributes and strengthens the divide of people into classes like upper, middle and lower class. This generates envy and hatred among the poor toward the rich, resulting in social disorders, conflicts and at times breeds revolutions & movements.<sup>26</sup>

It is clear from the above mentioned discussion that *riba* surely includes all forms of interest given at usurious rates. It remains to be established if it applies to all forms of interest based loans and

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<sup>23</sup> Ozsoy I. (n 22) 144.

<sup>24</sup> Ibn Rushd, *The Distinguished Jurist's Primer* (Garnet Publishing Ltd, Lebanon Sept 2000).

<sup>25</sup> Ozsoy I. (n 22) 146.

<sup>26</sup> Ozsoy I. (n 22) 146.

transactions.

The Supreme Court of Pakistan in a Shariat Review Jurisdiction case, *United Bank Ltd. V M/S Farooq Brothers etc.* (2002),<sup>27</sup> set aside the previous judgment where the Federal Shariat Court<sup>28</sup> had declared that *riba* in all its forms and manifestations was prohibited by the Holy Quran and Sunnah, and the subsequent Supreme Court's (Shariat Appellate Jurisdiction) judgement<sup>29</sup> that had approved it. The cases were remitted to the Federal Shariat Court for determination and never decided since. While a final judicial determination on the point is pending, banks and financial institutions follow the guidelines issued by their respective central banks on the matter.

The State Bank of Pakistan seems to have made a clear choice in favour of considering all forms of interest as *riba*, when it states that:

*'riba implies any excess compensation without due consideration (consideration does not include time value of money)'*<sup>30</sup>

and that

*'There is consensus among the Muslim scholars of all the fiqhs [sic] that interest is riba in all its forms and manifestations'*.<sup>31</sup>

The State Bank of Malaysia adopts a similar approach, stating that only if the extra amount given by the borrower to the lender is

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<sup>27</sup> *United Bank Ltd. v M/S Farooq Brothers etc.* PLD 2002 SC 800.

<sup>28</sup> *Dr. Mahmood-Dr-Rahman Faisal and others v Secretary, Ministry of Law, Justice and Parliamentary Affairs, Government of Pakistan and others* PLD 1992 Federal Shariat Court 1.

<sup>29</sup> *Dr. M.A. Khaki v Hashim and others* PLD 2000 SC 225.

<sup>30</sup> State Bank of Pakistan (n 10) Question 1.

<sup>31</sup> State Bank of Pakistan (n 10) Question 2.

not based on, or equivalent to a stipulated condition a loan transaction can be considered interest free.<sup>32</sup>

Interestingly both the Pakistani and the Malaysian Central Banks accept and advise *murabaha* as one of the essential instruments of Islamic Financing approved by their respective *Shariah* Boards.<sup>33</sup>

The next chapter will be dedicated to compare and contrast *murabaha* with interest based commercial loans to challenge the easy insertion of *murabaha* within the family of acceptable Islamic financial instruments. If it can be proved that *murabaha* do not substantially differ from interest based financial schemes, then it should be unacceptable in Islamic banking.

### **C. Similarities and Differences between Interest-Based Financing in Commercial Banks & *Marabaha* Transactions in Islamic Banks**

A *marabaha* transactions carry similar appearance to interest based financing in conventional banking. This demands an analysis of the basic differences between the two and whether these differences are of substantial or mere nominal value.

The first difference is that *marabaha* is a sale and not a loan, because in *marabaha* transactions a real commodity is involved rather

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<sup>32</sup> Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance* (2<sup>nd</sup> edn, 2010) 51 <[http://www.bnm.gov.my/microsite/fs/sac/shariah\\_resolutions\\_2nd\\_edition\\_EN.pdf](http://www.bnm.gov.my/microsite/fs/sac/shariah_resolutions_2nd_edition_EN.pdf)> accessed 11 April 2019.

<sup>33</sup> Bank Negara Malaysia (n 9); State Bank of Pakistan (n 6).

than money like in interest based financing.<sup>34</sup> As *marabaha* contract involves the transfer of a real commodity, the commodity must be in ownership of bank; this differentiates it from interest based financing. In the standard procedural transaction of *marabaha*, as soon as the agent (client) takes delivery of the commodity from the vendor on behalf of the bank, the agency agreement comes to an end. The client, at the same moment, accepts an offer to purchase the specific asset from the bank. So practically the ownership of goods in *marabaha* transaction rests with bank for few seconds only. It can be argued that ownership of the commodity for a mere few seconds is not sufficient to establish real ownership of the commodity by the bank and therefore it is submitted that, in this respect, *marabaha* are sales only in a fictitious sense.

The second difference is linked with the previous one. For *marabaha* transactions to be *Shariah* compliant the bank must bear a certain amount of risk associated with ownership, such as price risk or risk of destruction of assets, in order to legitimize its returns until delivery to the relevant customer.<sup>35</sup> In actual procedural transactions as practiced in Pakistan the real burden lies on the customer. As explained before, in real terms the bank bears risk just for a few seconds, and if during agency agreement commodity is destroyed due to negligence of the customer, the bank can have recourse to security of agent (client) as bank is the beneficial owner of commodity.<sup>36</sup> Conventional banks providing interest based loans are also exposed to these risks. So the difference in terms of risk-bearing is only nominal in nature.

A similarity between conventional interest based financial

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<sup>34</sup> State Bank of Pakistan (n 6).

<sup>35</sup> Bhatti M., *Taxation Treatment of Islamic Finance Products in Australia* (2015) 20(2) Deakin Law Review 263, 277.

<sup>36</sup> State Bank of Pakistan (n 10).

system and *marabaha* can be seen in the discount for early repayment of the loan. Interest based commercial transactions grant the borrower a discount or rebate if the customer decides to pay earlier than the scheduled time. In *marabaha* transactions the rate of discount must not be pre-specified as a condition, as it is not a right that debtor can claim – lest the operation as a whole become contrary to *Shariah* dictates.<sup>37</sup> However, several Islamic banks<sup>38</sup> do provide for a pre-determined rebate in case of early repayment, which is the same procedural aspect of interest based financing.

Another similarity between the two systems, is that in case of default or delinquency, the conventional financial system penalizes the borrower with additional interest, which is deemed as a compensation for the delay or time value of money. In case of default of payment in *marabaha* transactions, Islamic banks have multiple options to secure their transactions. They usually choose to take an undertaking from the customer at the time of entering into *marabaha* that the customer will pay a certain amount for *sadqa* to be used for charity purposes only. This is deemed to be in line with *Shariah*. But

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<sup>37</sup> ‘The majority of the jurists hold that if the earlier payment is conditioned with discount, it is not permissible. However, if this is not taken to be a condition for earlier payment, and the creditor gives a rebate voluntarily on his own, it is permissible. It means that in a *murabahah* transaction effected by an Islamic bank or financial institution, no such rebate can be stipulated in the agreement, nor can the client claim it as his right. However, if the bank or a financial institution gives him a rebate on its own, it is not objectionable, especially where the client is a needy person. For example, if a poor farmer has purchased a tractor or agricultural inputs on the basis of *murabaha*, the bank should give him a voluntary discount.’ Muhammad Taqi Usmani, *Islamic Banking: Conceptual Fundamentals and Basic Features: Rebate on Earlier Payment*, quoted in Islamic Markets <<https://islamicmarkets.com/education/rebate-on-earlier-payment>> accessed 11 April 2019.

<sup>38</sup> Islamic Bankers Resource Centre, *Islamic Banking Products are Expensive?* <<https://islamicbankers.me/tag/early-settlement-rebate/>> accessed 9 April 2019.

other ways may not differ much from the ones used in conventional banking like when the customer is made liable to pay compensation to bank for the loss, or when the bank can have recourse to the security or guarantor who will be liable to pay amount guaranteed by him, or when the defamation of borrower is employed.

As far as issue of security is concerned it is used for the same purposes in both *murahaba* and interest based financing and calculation of profit in *murahaba* transaction by KIBOR (Karachi Interbank Offered Rate) also makes *murahaba* transaction a dubious one, although it may be argued that KIBOR is used only as a benchmark to avoid the need to determine prices afresh every time.

From the point of view of philosophical understanding of *marabaha*'s acceptability, we have to look into the reason why *riba* has been prohibited in Islam and find out whether *marabaha* fares any better in that respect.<sup>39</sup> The apparent reason why the Almighty has prohibited *riba* is that the lender demands from the borrower that he should pay back the principal amount to him plus a pre-determined interest even if he is in no position to do it. This is quite clearly showing lender's complete lack of concern for the plight of the borrower. If during the period of the loan, the borrower gets bankrupt, the lender would still demand not just the principal amount but interest as well. The same seems to apply to *marabaha* transactions: in case of bankruptcy of the Customer the bank demands the price of its commodity as agreed at the time of entering into *marabaha*, which include both the cost and the profit of the commodity. Therefore, even in *marabaha* the bank does not show any concern for the plight of the client.

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<sup>39</sup> Zaheer K., *Is charging more on credit sales (marabaha) permissible?* Islamic Banking <<http://www.khalidzaheer.com/is-charging-more-on-credit-sales-murabaha-permissible/>> accessed 8 April 2019.

## Conclusion

It has been shown in the previous chapter that both the theoretical and practical differences between *marabaha* and *riba* are of mere nominal value. Even from a moral point of view, *marabaha* may also be against the Islamic concept of business transaction because the bank has no concern for the plight of borrowers, which is the basic Islamic ideological rationale of interest based financing's prohibition. It may be deduced that the use of *marabaha* in Islamic banking is not very different from conventional banking use of interest based loans. It is submitted that *marabaha* transactions are simply a camouflage for interest based loans and it is high time that they are expelled from the list of *Shariah* compliant financial instruments by the Central Banks of the major Islamic states.

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