

Issues with the Use of Tawarruq in Malaysia

Habeebah Simisola Fa-Yusuf¹ & Ndeye Djiba Ndiaye²

Abstract

Tawarruq as one of the most commonly used financing products by Islamic banks has been faced with a lot of criticism. One of these criticisms is that it is used to circumvent interest. This paper assesses these criticisms in the light of current practices in Malaysia. Our methodology is qualitative and specifically involves explanatory design. Our findings reveal that the current practice of Tawarruq in Malaysia is faced with a lot Shari'ah compliance issues.

Keywords: Tawarruq, Commodity Murabahah, Malaysia, Shari'ah compliance

1. Introduction

On July 1, 2016, the IFSB released the result of its study on the composition of Islamic bank financing in 17 member countries including Malaysia. Of these, commodity *Murabahah/Tawarruq* took the second largest share (15.6%) second only to *Murabahah* which accounted for over 40% (IFSB, 2016). These statistics show the importance the Islamic finance industry places on *Tawarruq*. With the widespread usage of *Tawarruq* in countries such as Malaysia comes certain issues. *Ethica*, one of the Islamic Finance industry's leading training service providers, cites *Tawarruq* as one of the reasons that customers doubt the credibility of Islamic Finance (Globe Newswire, 2014). *Tawarruq* as currently practiced by Islamic banks is very controversial. Modern practices have evolved, diverting from acceptable conditions. Scholars against its use cite the many *Shari'ah* compliance issues associated with its modern application by some banks. We believe the OIC Fiqh Academy in its 19th session in April 2009 upheld its unlawfulness because of *Shari'ah* compliance issues. In this paper, we examine issues with the practice of *Tawarruq* in Malaysia. Before we look at the issues with *Tawarruq* as it is exercised in Malaysia, we critically examine the arguments put forward by the proponents of *Tawarruq*. The last part of this essay then concludes by driving home our view: the current practices in *Tawarruq* still have a lot of issues even after operational standards and guidelines have been issued by the monetary authority – BNM (Bank Negara Malaysia).

2. Justification for the use of *Tawarruq*

With the use of *Tawarruq* comes the debate regarding its permissibility. On one hand, some scholars are worried about the *Shari'ah* compliance issues with modern practices in *Tawarruq*. On the other hand, some contemporary scholars permit it noting that the majority of jurists from the schools of *Hanafi*, *Shafi'i* and *Hanbali* appear to have considered *Tawarruq* to be legally permissible (Lasasna, 2015).

¹ Corresponding Author: Habeebah Simisola Fa-Yusuf, Assistant Lecturer, Department of Finance, Faculty of Business Administration, University of Lagos, Nigeria and PhD student, International Centre for Education in Islamic Finance (INCEIF), Lorong Universiti A, 59100 Kuala Lumpur, Malaysia. Email: 1500241@student.inceif.org. Phone: +60109613020

² Ndeye Djiba Ndiaye, MSc student, International Centre for Education in Islamic Finance (INCEIF), Lorong Universiti A, 59100 Kuala Lumpur, Malaysia

The BNM's SAC (Shar'iah Advisory Committee) draws evidence from the Quran and the Sunnah legitimizing *Tawarruq*. Its Quranic evidence was an excerpt from Suratul Baqarah verse 275: "*Whereas Allah (SWT) has permitted sale and forbidden usury*"

To this, we say that Allah permits the sale when the purpose is right. Moreover, scholars have adopted *Tawarruq* considering it as an alternative to *Inah*. The involvement of a third party in the trading, even if is more appropriate to be ruled as permissible compared to *inah*, still doesn't make the transaction valid. As we explain later, there appears to be a **validity of purpose** issue with *Tawarruq* as is currently practiced in Malaysia. While we see the basis on which the regulator permits *Tawarruq*, we should examine the basis on which industry players justify its use. Practitioners in the banking industry see *Tawarruq* as a necessity. One reason is because with its current structure, it provides **liquidity management** solutions to Islamic Financial Institutions (IFIs). Another reason is because of the need to provide Muslim customers with "*Shari'ah-compliant*" working capital in the absence of collateral. Proponents say *Tawarruq* is very useful in situations when a bank customer needs cash but has no collateral to give his lender. They explain further that in the absence of an alternative Islamic finance structure that provides cash to the customer where he has no valuable asset, Islamic bankers should continue to offer *Tawarruq* products. Doing this, they say, will be better than diverting the customer to a conventional banking product which is clearly involved in *Riba* (Islamic Bankers, 2016). Practitioners do not only see *Tawarruq* as a necessity tool for the above-mentioned reasons but also as a useful tool to issue Islamic credit cards and provide Islamic home financing. Those in support of *Tawarruq* might deem it permissible based on *Maslahah Mursalah* (public interest). To this group, the use of *Tawarruq* might seem as *Hajiyat Masalih* which Kamali (2013) defines as an interest whose neglect leads to hardship in the life of the community. Our view of this line of reasoning is that any declaration based on *Maslahah Mursalah* of supposedly satisfying people's needs should not contradict the objectives of *Shar'iah*.

3. Issues with the practice of *Tawarruq* by Islamic banks in Malaysia

Some of the issues raised with its use in Malaysia are:

3.1 Validity of Purpose Issue

To be valid from a *Shar'iah* perspective, a sale contract must be **valid in form and valid in purpose**. According to Al-Jarhi (2016), validity in form means that the contract must involve a buyer, a seller, a sold object that is lawful to trade and a price. The seller must own and possess the sale object, except for the sale of something that can be acquired in the market under Salam or Istisna. The sale must not be made conditional. The contract must be devoid of cheating, gharar (uncertainty), and *Riba* (interest rate). Validity in form also means that either the delivery of the good or its payment may be deferred; both aspects may be delivered on the spot but both aspects should not be deferred. Validity of purpose means that the contract must be for a valid purpose. For example, the purchase for grapes for liquor manufacturing has an invalid purpose that renders the sale contract void. The ultimate consequence of the contract must also be lawful which means that the sale contract must not ultimately lead to the exchange of money on the spot for **future money at a premium** (Al-Jarhi, 2016).

In our view, *Tawarruq* as is practiced in Malaysia **doesn't meet the validity of purpose requirement as a sale contract**. In fact, the ultimate goal of *Tawarruq* for whoever is providing the liquidity is to exchange spot money for a higher amount in the future, thus the financier is taking advantage of the need for liquidity of the client be it an individual or institutions to charge interest implicitly. If they were interested in a commodity then the mark-up would be justifiable, but clearly the goal is cash liquidity. Indeed according to (Ghazali, 2014) Umar 'Abd al-'Aziz stated that Allah permits the sale and purchase when the objective of the transaction is trading. However, if the intention of such trading is to gain more dirhams from dirhams, then there is no goodness in the deal (Ghazali, 2014).

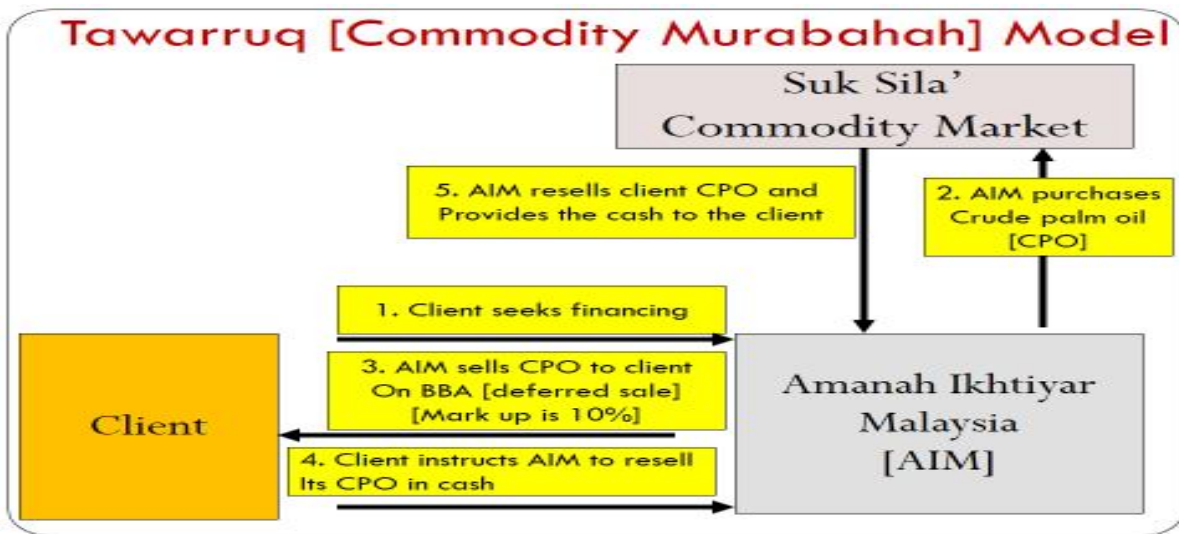
3.2 *Tawarruq* as *Hilah* to give a loan with interest

It has been alleged that most contemporary *Tawarruq* structures are a *hilah* (trick) to legitimize or circumvent interest-taking (Meera (2015) and Noor & Azli (2009)). In fact, the deception in the practice of modern *Tawarruq* was a major reason the OIC Fiqh Academy ruled it as impermissible. Ibn Taymiyyah prohibited *Tawarruq* in some of his fatwas due to the strong argument based on the meaning of the statement of Umar 'Abd al-'Aziz: "Indeed, *Tawarruq* is

origination of *Riba*". He explained that Allah prohibited generating more dirhams from dirhams due to deferment because it is considered as taking advantage against someone who is in need and eating his property with deception. In our view, *Tawarruq* as being practiced by Islamic banks in Malaysia seems to be to circumvent *hilah* indeed. The reason being that the assets traded in the *Tawarruq* contracts are usually not delivered to the purchaser. This means those assets are not needed for themselves but are merely used to form a complex model made to by-pass a conventional debt contract.

As an illustration we have included the *Tawarruq* financing model of *Amanah Ikhtiyar Malaysia* (AIM), the largest Islamic microfinance institution in Malaysia, which is supposed to help the poor in urban and rural parts of Malaysia. The model shows how AIM is using *Tawarruq* as an implicit way to charge interest. The microfinance client ends up getting cash for higher debt obligation payable in the future. The structure is therefore analogous to a loan with interest.

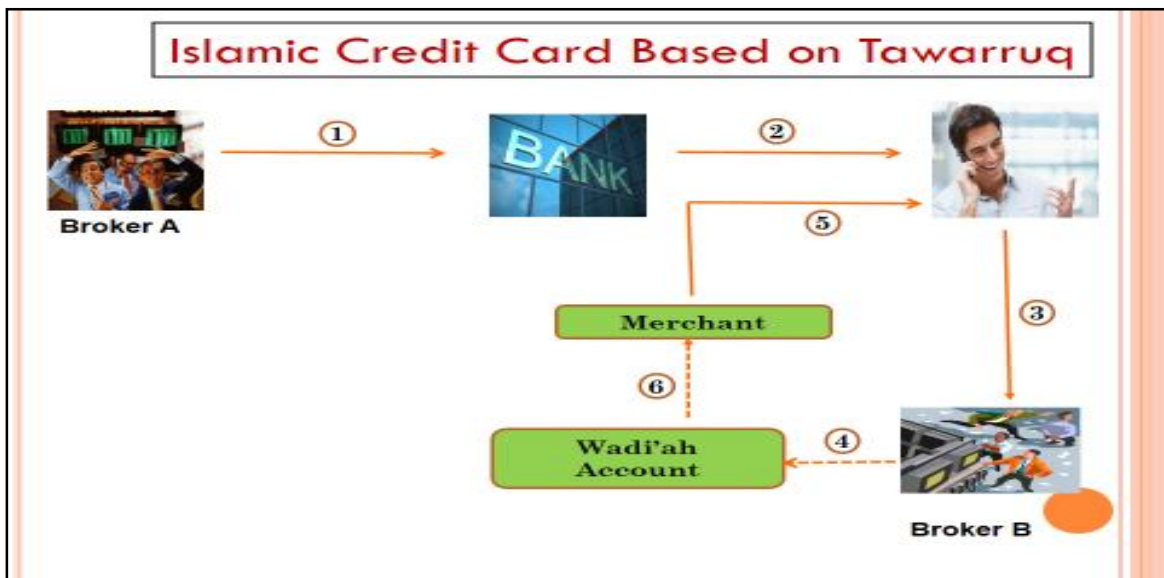
Figure 1: *Tawarruq* financing model of *Amanah Ikhtiyar Malaysia* (AIM)



Source: Mohammed (2016)

Another issue is the use of *Tawarruq* in Islamic credit card as illustrated below:

Figure 2: Islamic Credit card model based on *Tawarruq*



Source: Mohammed (2016)

The above diagram is explained thus: In step 1, the bank purchases a commodity from Broker A on the spot. In step 2, the bank sells the commodity to the customer on deferment. The selling price is equivalent to the credit limit and inclusive of the bank's profit. In step 3, the customer sells the commodity to Broker B. In step 4, Broker B deposits the cash into the customer's balance in the Wadi'ah account. In step 5, the customer buys goods from the merchants using the balance in the Wadi'ah account. In step 6, the purchase price is transferred to the merchants. One of the conflicting juristic views that have emerged in contemporary Islamic Banking is that there is no need to reinvent products offered by conventional banks in a globally competitive banking industry. Instead, Islamic banks should adopt the minimal necessary modifications to these conventional products to ensure *Shari'ah* compliance. This tendency to emphasize 'form over substance' is symptomatic of 'big businesses' driven by the profit-making maxim (Mallin, Farag and Ow-Yong, 2014). *Tawarruq* seems to fall into this category of products. In our view the use of *Tawarruq* in Islamic credit card is tantamount to a loan with interest. One can observe from the above that the client doesn't take delivery of the asset. The client is barely involved, he/she needs money on spot which he/she will get in return for a debt, higher than the cash he/she, to be repaid on deferment. The structure ultimately is analogous to a loan with interest, like any conventional credit card. *Tawarruq* is only used as a way to circumvent Riba.

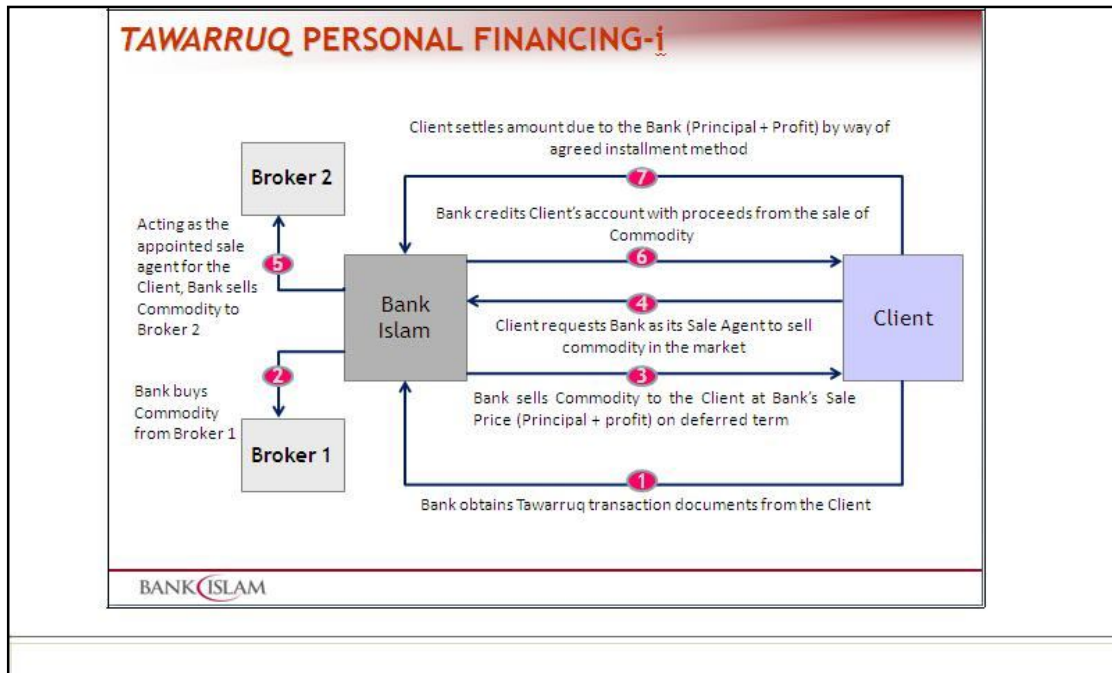
3.3 Resembling *Inah*

The Hanbali scholar, ibn Taymiyyah, and his student ibn al-Qayyim had strongly disapproved of *Tawarruq* and included it in the same category as the *Inah* sale. Before modifications were made to the structures commonly used by Malaysian Islamic banks for personal finance, the common practice was for the bank to make a pre-arrangement with the customer to sell the commodity back to them. This is clearly *Inah*. Bowing to a lot of criticism, BNM disallowed this sort of structure. This structure has been replaced mainly by banks acting as an agent to sell a commodity under a *Tawarruq* structure to a third party. However, this is still just a way to get around lending the customer money making him return more money in future. The current *Tawarruq* practices still closely resemble *Inah*.

3.4 The Bank as a dual agent

The most recent *Shar'iah* Standards and Operational guidelines on *Tawarruq* issued by the BNM's SAC permit the implementation of dual-agency in *Tawarruq* contracts. Dual agency here means that a bank is acting as an agent to buy the underlying asset on behalf of the customer while at the same time, being the agent to sell that asset on behalf of the customer or in term deposit accounts to sell it to him. We see this in the following illustration of the model used by Bank Islam for one of its products:

Figure 3: Bank Islam *Tawarruq* Structure for Personal financing-i



Source: Bank Islam (2012)

The bank is performing the role of a dual agent in the above model if the client instructs the bank at stage 1 to buy the commodity on its behalf. This bank will be the same agent that sells the commodity on behalf of the client. Here, it is very conducive for the bank to take advantage of the client by generating a huge mark-up. We believe the client is being taken advantage of with this process.

3.5 Charging a delivery process fee

Upon examining the product disclosure sheet of Standard Chartered Saadiq's Personal Financing-i based on commodity *Murabahah*, we observed that the customer is to solely bear the cost of physical delivery of the commodity (plastic resins). The situation is not different in the current practices at the BSaS (Bursa Suk al-Sila). The question is: Why should there be a separate charge for delivering the sold commodity to the buyer? We believe this element is what gives the incentive of purchasers not wanting the commodity delivered. This widespread practice of non-delivery of traded commodities in most of the *Tawarruq* structures in Malaysia give further backing to the view that most *Tawarruq* as practised nowadays is not a true trade and its goal is to get cash. Is constructive possession enough? How do you make sure that the sale is not just in papers? To address this criticism, we believe that the commodity's selling price should take care of the delivery charge.

3.6 Encouraging the proliferation of debt

The wide usage of Islamic debt instruments such as *Tawarruq* increases the proliferation of debt according to some (Dusuki, 2010). This is because private debt accumulation in a supposedly *Shari'ah*-compliant way has been made easy by instruments such as *Tawarruq*. In Malaysia, the increasing usage of *Tawarruq* by banks to finance private debt such as home loans and credit card debt has contributed to the country's worrying high rate of private debt growth. In our view, this rapid growth of private debt is unsustainable and points to a crisis waiting to happen.

3.7 Accounting risk

Bacha & Mirakhor (2013) note that Islamic Money Market instruments, of which the *Tawarruq* structure used by BSaS belongs face accounting risk. By accounting risk, we mean that as the underlying commodity is traded from one party to another, the right monetary values may not be reflected in the books of the parties concerned. However, with appropriate audit of the books of the IFI, this problem can be addressed.

3.8 The use of Base Financing Rate (BFR) in profit as benchmark

In cases of variable rate financing for products based on *Tawarruq* in Malaysia, most times a benchmark is used in deciding the issuer's profit. An example of this is can be seen in Bank Islam Malaysia's Islamic home financing. Here, the bank's EPR (Effective Profit Rate) is based on the BFR which is a conventional interest rate. Some say benchmarking in Islamic banking should be a non-issue saying that if a transaction fulfils the necessary conditions, merely using the interest rate as a benchmark for determining profits does not render the transaction as haram. To us, determining profits based on what is happening in the conventional banking sector will mean that the Islamic finance industry and the conventional will move in tandem with one another. An issue can then be raised that the two are not so different after all.

3.9 *Tawarruq* as a barrier to true risk-sharing

We are of the view that *Tawarruq* discourages the widespread use of products based on true risk-sharing like Mudharabah and Musharakah. In *Tawarruq*-based transactions like fixed deposit accounts and commodity Murabahah the capital and return are guaranteed. In contrast, in Musharakah and Mudarabah the capital and profits are not guaranteed. Being risk averse, banks and other IFIs would likely favour *Tawarruq* in lieu of equity-based contracts. Furthermore, modern *Tawarruq* structures drives investment from moneybags to end-users who may or may not be capable of repaying. Of what good is Islamic Finance when it becomes elitist due to contracts like *Tawarruq*? Islamic Finance is supposed to be based on the values of benevolence, justice and fairness. They reflect the true essence of Islam. Those values are achievable through risk-sharing between parties as opposed to conventional finance where the risk is shifted to another party.

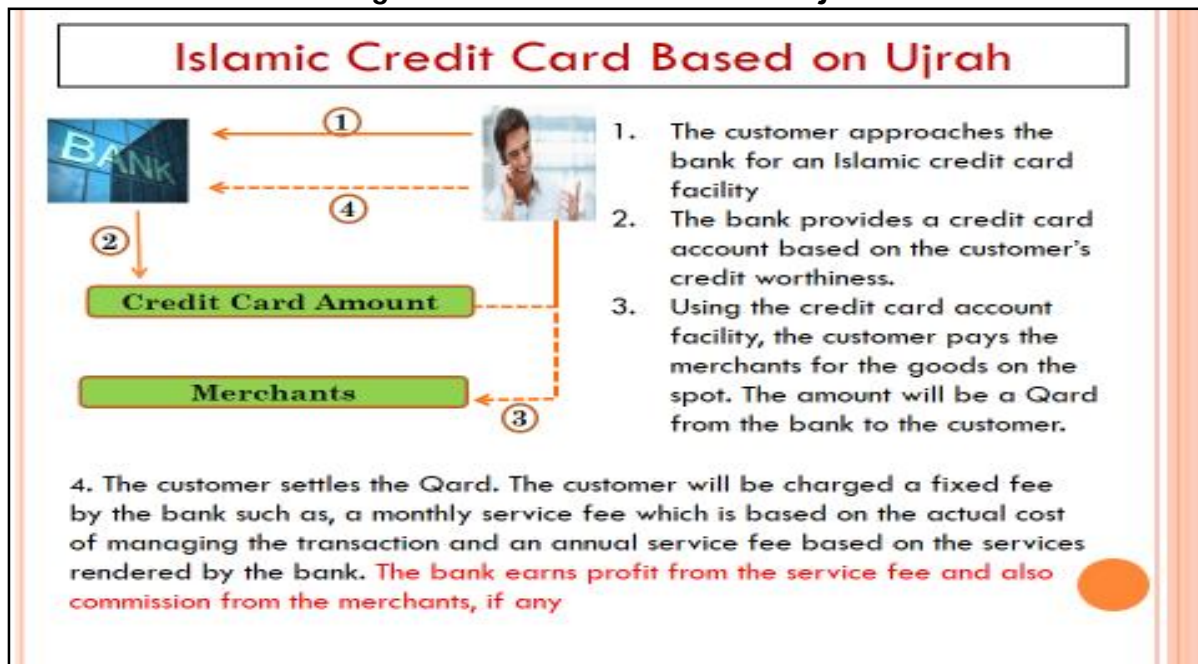
4. Conclusion

Islamic Finance or Banking should not only be different from the conventional finance in theory. It should also be different in practice. Islamic Banking from a theoretical perspective is based on the principle of Profit and Loss sharing in place of the interest based deposit/lending found in conventional banks (Mallin *et al.*, 2014). Contracts like *Tawarruq* defeat the essence of Islamic Banking/Finance as we explained earlier. It is difficult to prove that *Tawarruq* as is practised in Malaysia is very different from a loan involving *Riba*. The use of *Tawarruq* seems to reflect the tendency of modern IFIs, and in this case, Malaysian ones, to emphasize form over substance. This tendency to choose 'form over substance' is symptomatic of big businesses driven by profit making (Mallin *et al.*, 2014). Islamic banks are business entities indeed but they have the moral responsibility of being truly based on the *Shari'ah*. Tacitly charging interest ought to be given up. If not, the Islamic Finance industry would be analogous to the case of someone who calls himself Muslim but does not want to give up alcohol under the delusion that he must consume alcohol to be alive and well. Such a person would need to find another drink pleasing to his creator and beneficial to his soul. The opportunity cost of loan (*Qardh*) in Islam is non-market non-material. As evidenced in the Holy Quran in Suratul Baqarah: 245:

"Who is he that will lend to Allah a goodly loan so that He may multiply it to him many times? And it is Allah that decreases or increases (your provisions), and unto Him you shall return."

We suggest some measures to address the current problems with *Tawarruq*. Firstly, *Tawarruq* as is currently practised in Malaysia should be deemed impermissible by the BNM as a way of blocking the means to *Riba*. Secondly, its current operations should be modified to ensure strict Shar'iah compliance. Thirdly, bearing in mind that going after *Maslahah Mursalah* should not contradict the *Shar'iah*, efforts need to be intensified in substituting *Tawarruq* with products that will serve the public interest and at the same time be *Shar'iah*-compliant in every sense. One of such products for personal financing in the absence of collateral, for instance, is Islamic credit card based on *Ujrah* as it is less controversial.

Figure 3: Islamic credit based on Ujrah



Source: Mohammed (2016)

Another suggestion is to employ equity-based instruments issued by BNM to enable banks manage liquidity effectively will be useful. This is because one of the arguments often put forward by proponents of *Tawarruq* is the necessity for liquidity management by IFIs. However, as we have seen, *Tawarruq* as currently practice in personal financing is a mean for IFIs to charge interest implicitly.

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