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# TAWARRUQ — THE 'NEW KID' IN ISLAMIC BANKING

The authorities, however, need to put certain parameters and limitations in the use of the concept

ISLAMIC financial products have evolved from simple and straightforward structures to highly sophisticated and multifaceted instruments. During the 1980s and 1990s, Islamic financial products were dominated by deposits and savings, syndicated project financing, syariah-compliant stocks and mutual funds.

The last decade has witnessed the unveiling of more complicated structures, including various sukuk models, derivatives, Islamic structured products, Islamic hedge funds, and others. Most, though not all, of them are reverse-engineered replications of conventional products, splicing together nominate contracts from the Islamic *fiqh* legacy with a few modifications to satisfy legal requirements and be "syariah-compliant".

*Tawarruq*, a financial instrument involving a series of sale contracts conducted in succession — a person purchases a commodity from a seller on deferred basis and subsequently sells it to a party other than the original seller on a cash basis for the purpose of obtaining liquidity — is "the new kid on the block".

It has facilitated the launch of unprecedented and sophisticated Islamic financial products, ranging from deposit and financing instruments, to liquidity management and debt restructuring, sovereign and private sukuk structuring, and risk management and hedging instruments. It is well accepted by market players due to its flexible nature that allows Islamic financial institutions (IFIs) to provide cash with predetermined fixed income, just like its conventional counterpart.

As a case in point, *tawarruq*, popularly known as commodity *murabahah*, has become a new phenomenon in the Malaysian Is-



'Tawarruq' has become a new phenomenon in the Malaysian Islamic banking system, particularly after the issuance of a 2012 Bank Negara Malaysia circular on *bay' inah* (sale and buy-back). FILE PIC



lamic banking system. This is particularly after the issuance of a 2012 Bank Negara Malaysia circular on *bay' inah* (sale and buy-back), which substantially tightens the syariah requirements for it. This, in turn, creates practical difficulties when applying *bay' inah* in the modern financial landscape. Since then, Malaysian Islamic banking system has started to actively use *tawarruq* as an alternative to *bay' inah*. Some have even phased out *bay' inah*-based products from their portfolios.

The result is obvious. *Tawarruq* has evolved as a dominating concept in Malaysian Islamic banks. A survey I conducted in 2015 revealed that *tawarruq* represented more than 80 per cent of the total financing portfolio in three Malaysian Islamic banks, between 61 per cent and 80 per cent in six Islamic banks; and between 40 and 60 per cent in two Islamic banks. The rest applied *tawarruq* in relatively smaller portions, constituting less than 40 per cent of their total financing portfolio.

Nevertheless, the extensive use of *tawarruq* in IFIs has stirred a plethora of contentious queries from both syariah scholars and Muslim economists. The fact that

*tawarruq* is designed to merely mimic the characteristics of conventional products challenges the claims of Islamic finance proponents that IFIs offer a genuine alternative to conventional finance. As a result, the prospects that IFIs can offer solutions to the economic problems caused by the conventional finance are dimming. The International Islamic Fiqh Academy, a subsidiary organ of the Organisation of Islamic Cooperation, in its 19th meeting — held in Sharjah, the United Arab Emirates in 2009 — resolved that the modern practice of *tawarruq* is impermissible.

This is mainly due to the absence of a true and genuine transaction — a series of transactions between the bank and the customer is executed simultaneously in exchange for a financial obligation. The arrangement has been designed to offer quick cash to the customer for a higher amount in the future, which is considered to contain the element of *riba*. The Accounting and Auditing Organisation for Islamic Financial Institutions, in its *Shariah Standard No. 30*, Paragraph 5/1, 2008, clearly states that *tawarruq* should only be employed as a last resort when an institution faces a liquidity shortage that could harm its sustainability. It should not be used as a mode of investment or financing for the purpose of profit making.

Dusuki et al. (2013) summarised four major concerns raised by syariah scholars on the

modern practice' of organised *tawarruq*.

**FIRSTLY**, many commodities used in the practice are junk and defective.

**SECONDLY**, the *tawarruq* legal document is embedded with the clause that the customer is restricted from taking delivery of the commodity purchased. This is particularly true in the case of *tawarruq* transaction conducted via the London Metal Exchange.

**THIRDLY**, the commodity rarely gets physically transferred from the seller to the buyer.

**FOURTHLY**, the inclusion of agency in the *tawarruq* arrangement makes the contract similar to the prohibited *inah* (a fictitious, manipulative transaction for obtaining cash involving a commodity which is returned to the same seller for a lower price).

On the operational side, *tawarruq* assumes a relatively high degree of syariah non-compliance risk as compared with other contracts mainly because it involves a series of sale contracts that are conducted in succession.

A proper review and due diligence is crucial before the contract execution. Extreme care should be taken to ensure that the arrangement does not reflect a mere exchange of papers.

As such, the Malaysian regulators and syariah committees have to put certain parameters and limitations in the use of *tawarruq*. This is for a number of reasons:

**FIRST**, the practice of *tawarruq* in IFIs is disputed among syariah scholars across jurisdictions. This in turn impedes the internationalisation of Islamic finance as promulgated by the Malaysian government;

**SECOND**, the overwhelming use of *tawarruq* does not substantially add to the IFI value proposition and economic growth due to debt nature inherent in the concept; and,

**THIRD**, *tawarruq* requires more prudent risk mitigation because it is prone to exposure to a large volume of syariah non-compliance events.

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