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Title "Tawarruq, its issues and its practical application in Islamic Banks"

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"Tawarruq, its issues and its practical application in Islamic Banks"

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Abstract:

Islamic banking system has gained good image and popularity since the last two decades and drew the attention of all banking and finance sector industry around the world and selected as a solution for the current economic problems, because every other system has failed in the solution of world's financial problems in the previous few decades. There are many new products being introduced as an alternative to conventional ones. One of them is "Tawarruq". The problem of liquidity risk management is very sensitive in the banking system. Tawarruq finance has been the most widely used form of liquidity management instrument to date. The following paper also discussed an important mode of finance which is named "Tawarruq" We have discussed its definition, approach, scope, its need in Islamic Banking, and its application in Islamic Banks. It will discuss also the similarities and differences between "Tawarruq" and "Inah". And application of Tawarruq for liquidity risk management and how it works. In this paper will be discussed the answers of objections which target Tawarruq in the light of sharia. Therefore, analysis about Tawarruq is very essential and many studies have been done on it. We have concluded that Tawarruq is a permissible mode of Finance.

Key Words: Tawarruq, liquidity risk management, scholars views, application models.etc.

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Introduction:

Now a days widely discussed topic of the Islamic banking is Tawarruq which became in practically field on 1421H. especially the banks of Saudi Arabia were advance in the use of Tawarruq. After it many other Islamic banks of the other countries for example, Qatar, Bahrain and United Arab Emirate followed the Saudi Arabia in the using of Tawarruq. Because they have used this financial instrument widely.

Sharia scholar's views about it are different. Some of them permit it and say that conditions of sale in the light of sharia founded in it and with the presence of a third party it is excluded from the form of "inah sale". While other scholars say that it is not permissible, it is a fraud and only trick for getting cash and Islamic banks provide legal sanction for interest. Islamic banks do not accomplish needfulness to sale and specially Tawarruq, consequently, we face many issue to implement the real Islamic finance in banking sector.

However, this paper will discuss how Islamic banking products, especially Tawarruq play its role in the real economy .it is very important that the base of Islamic banking is on asset based not on money. And there is real transfer of ownership between counterparty, while the product of conventional banks is only to play money with money and money is considered as a commodity.

Sharia rules don't permit it in the light of sharia. Money is only medium of exchange and cannot be exchanged with money when both money are same in value.

However, to getting stable value of money we have to change money with commodity and then sell it to another person or party so that we can take advantage differentiation of price between purchase and sale.

Therefore, objectives of this paper are provide the definition and forms of Tawarruq and provide the real concept of Tawarruq for liquidity risk management and its application in Islamic banks.

Dictionary definition of Tawarruq;

Tawarruq mean; اوراق الرجل، اى صارذا اوراق

The one owned money in "Zaad-ul-Maad", IbnulQayyam denotes it as

"سعى المرء بكلفة ومشقة فى الحصول على النقد" (T) "efforts done to receive Cash."¹

Idiomatic meaning of Tawarruq;

It is Hanabila specification and means that "A person who purchases something on a debt and sells it to a third party on a low cost". Selling at low cost it not essential but usually it is sold at low price. That, so in the definition low price is discussed.²

General example;

A Bank sells shares of 100000(one Lac) and he himself sells it to a client on 105000(one Lac five thousand Then the client Sells the shares by broker at 100000(one lac) then after three month the client will return 105000 (one Lac five thousand) to the bank.

Forms of Tawarruq;

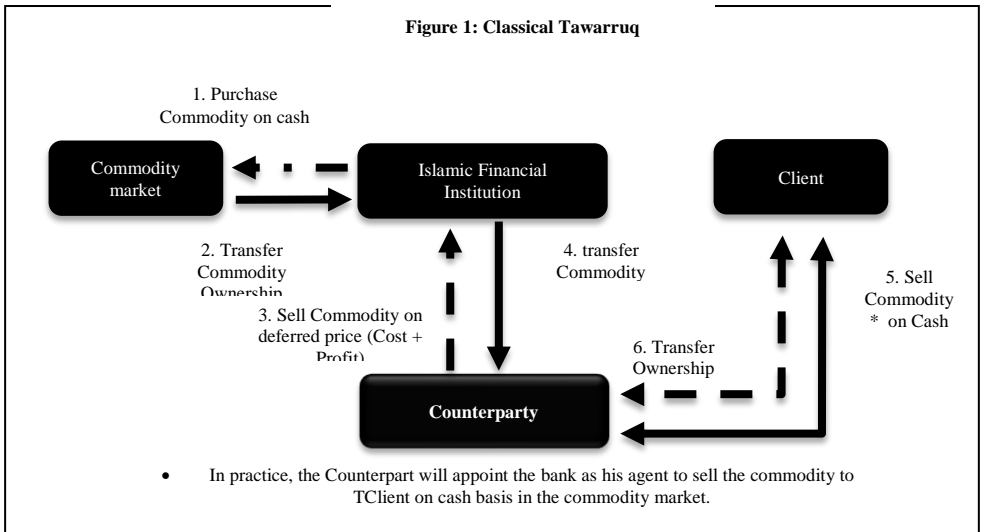
The kinds of Tawarruq are two. Those are classical Tawarruq (Al-Tawarruq al-Fardi) and organized Tawarruq (Al-Tawarruq al-Munazzam).

Classical Tawarruq: is defined as the purchase of a commodity possessed owned by the seller for a delayed payment, whereupon the buyer resell the commodity for cash to other than the original seller in order to acquire cash(al-wariq).³

Whereas, Fahmy et.all mentioned that the contemporary definition on organized Tawarruq is the transaction that a person (mustauriq) buys commodity from local or international market at a deferred price, Simultaneously, he (mustauriq) will ask the financier in his own capacity or through his agent or by special agreement with mustauriq to rearrange the sale transaction usually at a lower spot price. Classical Tawarruq is shown by the below model.

Modus Operandi of Tawarruq:⁴

Modus operandi of classical Tawarruq is shown as following picture;

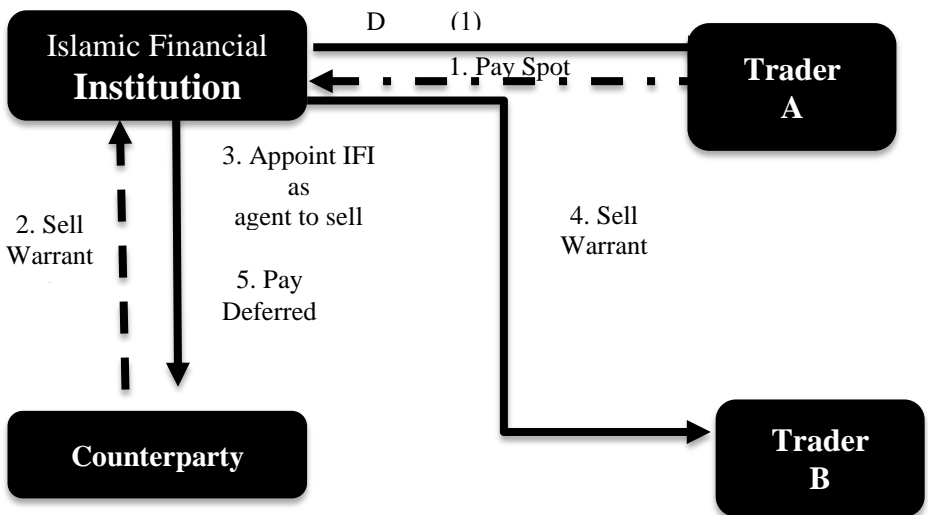


According to Fahmy et.all (2008), (5) the modus operandi of classical Tawarruq is;

1. The Islamic Financial Institution (IFI) purchases commodity from Commodity Market on cash basis;
2. Ownership of the identified commodity will then be transferred to IFI;
3. Thereafter ,the IFI sells the commodity to the Counterparty (e.g. Other Islamic financial institution, or client) on deferred price, i.e cost price plus profit margin);
4. The ownership of the commodity will be transferred to the counterparty;
5. The counterparty will then sell the commodity to Client on cash basis in the commodity market;
6. Finally, the ownership of the identified commodity will be transferred to Client.

In addition, the most important thing that must be underlined is that in the classical Tawarruq structure, each transaction shall be independence. Nevertheless, in practice, to achieve cost effectiveness, IFI will be appointed as an agent to sell the commodity to third party on behalf of the counterparty; that is called Classical Tawarruq.

Figure 2: Organized Tawarruq



Note:

Majority of commodity Murabaha transactions use London Metal Exchange (LME) base metals as an assets since they meet all criteria for commodity (i.e. no-perishable, freely available and can be uniquely identify) and are easily identifiable via warrants.

Figure 2: Organized Tawarruq

The organized Tawarruq is usually practiced on the commodity murabahah which is the most commonly used liquidity management instrument by IFI. This is because IFI can get a fix return from this instrument. Furthermore, following figure illustrates how organized Tawarruq works in the case of commodity Murabahah when an IFI provides funds to its counterparty to earn profit.

The description of organized Tawarruq is as following steps;

1. IFI purchases warrants from Trader A and pay spot.
2. IFI will then sell the warrants to the counterparty. The counterparty accepts the offer from the IFI to purchase warrants on a deferred payment basis, where the mark-up and the repayment date are pre-agreed.
3. The counterparty appoints IFI as an agent to sell warrants on its behalf. The IFI now acts as agent to sell the warrants at spot to another Trader Alternatively; the Counterparty could sell the warrants in the open market.
4. Payment made to the Counterparty; ownership of warrants transfer to the end buyer. In most of the case, whether the counterparty requests the IFI to sell the warrants on its behalf or arrange to sell to third party by itself, the counterparty will be paid the spot counter value of the warrants.
5. Deferred payment will be made by the counterparty to the IFI. This payment takes place at a pre-agreed time in the future and consists of the principal of the original purchase plus a pre-agreed mark-up.

The net result of the above movements of warrants and cash is that the counterparty now holds an amount of money against an offsetting payment to the IFI for a pre-agreed principal plus a mark-up at a pre-agreed future date, thus creating a synthetic deposit.

From that explanation, the Tawarruq process seems to be very simple.

However, extra care should be taken while undertaking such transaction, and it should be ensured that the transaction does not become a mere exchange of papers between two brokers, and one or two financial institutions. IFI needs to understand that Tawarruq arrangement should be used in extreme cases where no option is available to avoid interest. Widespread use of this Tawarruq is harmful to the industry in this long run. Therefore, Shariah Board needs to strictly monitor all Tawarruq based transaction which includes the commodity murabahah.

Scholar's view:

There are two views about Tawarruq;

First: view is that Tawarruq is permitted.

Second: view is that Tawarruq is prohibited.

Reasons of the scholars that permitted Tawarruq;

Firstly:

Allahtaala said in the Holy Quran(احل الله البيع وحرم الربوا)⁶

T: trade and sale is permitted by Allah and riba is prohibited .tawarruq is a form of sale and trade, which is permitted by shariah.it is clear that Tawarruq sale is legally permissible because there is no trace of a riba in this type of sale, and because it is the need that calls for that for refunding of debt, or marriage and so on.

Prophet (PBUH) appointed a man as his agent in Khyber. He brought some best quality dates to the prophet. Prophet (PBUH) asked him, "Are all the dates of Khyber like this? The man replied, "no" we exchange a sa,s of this kind of date for two sa,s of another, Prophet(PBUH)said, "do not do this! Sell your batch of dates for dirhams and then pay dirhams for good quality dates. (⁷)

Because something its format is not in line with the format endorsed by sharia, but if we make it in format approved by the sharia it becomes permissible.

Tawarruq is a format of trade. Some people characterized that its conditions and essential elements render it invalid.

Secondly:

there are many differences between Tawarruq and inah which leads to riba. Inah is not permissible (⁸) because the commodity is sold back to the person from whom it was purchased .thereby inah includes on two parties or persons, one is seller and second is buyer. Seller buys the commodity it certain price, and on deferredpayment. While Tawarruq includes on three parties or three persons. "A" buys the commodity from the "B"and then A sells it to "C" who is except of A.due to this differentiation all the schools of thought permit it and generally allow Tawarruq.(⁹)

The majority of jurists have allowed the Tawarruq because of free from riba, and it is not include any form of inah.

Thirdly:

Allama shatbi said in Al-muaqfat that it is enough for legality that is not founded a reason which is against to legality, because it is general rule of jurists that found legality in all contracts unless not found sharia issue in any contract. Tawarruq like this that have not any sharia issue... (¹⁰)

The scholars that do not permit Tawarruq;

Ibn Taymiyyah, Ibn Al-qayyam and some other scholars also forbid Tawarruq, due to some following reasons.

Firstly:

According to IbneTaymiyyah that there is no difference between inah and Tawarruq. Tawarruq contains all sharia virus such as inah, loan, and sale of debt transfer of debt, buying commodity at a cost price and selling commodity to the first seller at a price lower than the original purchase price.⁽¹¹⁾

The mother of the son of Zaid bin Arqam said to Aisha R.A, I bought from Zaid a slave at 800 dirham deferred price and I sold him to Zaid at 600 dirham cost price. Aisha said" what a bad you bought and sold! Tell Zaid that he has wasted his jihad with prophet (PBUH) unless he repents. ⁽¹²⁾

It knew that such type of sale is not allowed otherwise Aisha do not reject it.

Secondly:

Umer bin Abdul Aziz disapproved Tawarruq, and said that Tawarruq is the basis of riba.

Ibne Taymiyyah prohibited Tawarruq and said that Tawarruq is worse than riba, because Tawarruq entails a higher cost and losses .therefore the shariah does not forbid a lower haram(riba) and allows a higher haram(Tawarruq).⁽¹³⁾

Thirdly:

Tawarruq is a type of Bai-Al- Mud tar which is prohibited by prophet (PBUH).⁽¹⁴⁾ Because compelled person does buy back to get cash and this meaning also founded in Tawarruq.

Answers of the Afore mentioned objections:

Answer of the first objection: it is wrong that Tawarruq and inah have not any difference and both are same. Because the requester of inah will return the commodity back to the seller, whereas the mutawarruq in the individual form of Tawarruq will sell the commodity to a new buyer other than the first buyer with neither the arrangement nor the knowledge of the first seller. ⁽¹⁵⁾

Answer of the second objection:

To say that Tawarruq is the basis of riba is not correct, because definition of riba or forms of riba are not founded in Tawarruq concept. And also not explained in the mentioned objection. because the definition of Riba is that (فضل مال لايقابله عوض)

⁽¹⁶⁾ (في معاوضة مال بمال)

Answer of the third objection:

That Bai-AL-Mud tar is prohibited by prophet (PBUH) but it is not correct that Tawarruq is also a type of Bai-Al-Mud tar, because Mutawarruq is not compelled for doing Tawarruq. He can fulfil his needs by other way without Tawarruq.

Tawarruq in Practice: Case study of Bank Negara-Malaysi

To not compelled on Tawarruq and also not founded injustice, plunder and misappropriation in Tawarruq. It is also a sale and simple contract like other sales.

Firoozy (2009) ⁽¹⁷⁾ mentions that Tawarruq in practice has become an institution and as in many institutional frameworks, has been streamlined and risk managed. The actual goal of securing finance for a fixed term is emphasized over all else, since classical Tawarruq has too many moving parts and risk managers the world over could complain. The result is that the bank plays the intermediary in all transactions, the client having essentially no ownership (nor interest in actual or legal sense) in the underlying asset. The end result is called organized Tawarruq.

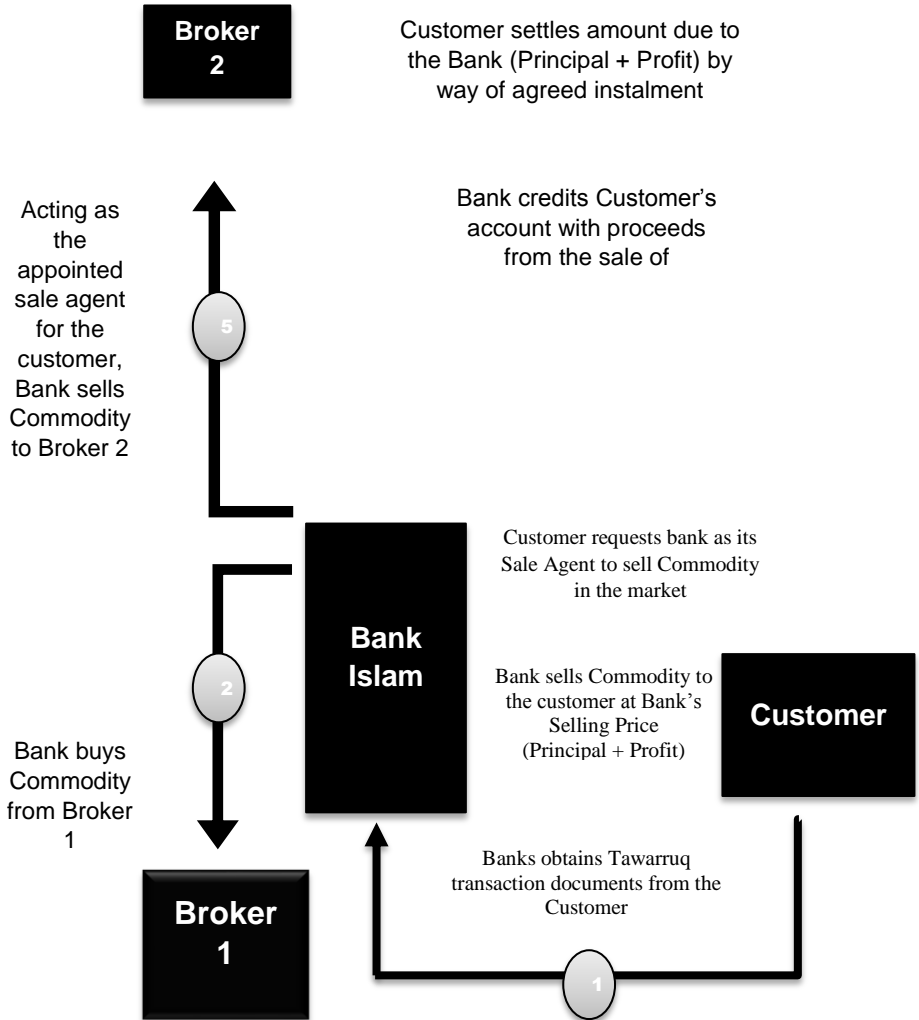
Moreover, Dabu (2008)⁽¹⁸⁾ stresses that the goal of Tawarruq actually is to get cash which is clearly stated in the notices of Islamic Banks and their brochures. The major reason that prompts the said banks and financial institutions to practice Tawarruq is that in most cases, is to free from the constraints of the balance sheet, as the financial accounting rules take into account the principle of capital adequacy, and provision for managing bad debts (doubtful debts), which would hinder the activities of finance in general, slow down the circulation for capital and reduce the profitability of the bank. In this case, Tawarruq is considered an appropriate substitute, due to the fact that it can rotate part of the liquid assets for Tawarruq for non-liquid assets that guarantee the bank's debts to the other person, without an increase of risks to the bank that is without any need for a special supervision in the general budget.

One example of bank that practice Tawarruq in Malaysia is Bank Islam.

According to Bank Islam (2009)⁽¹⁹⁾, in regards to Murabaha commodity, Bank Islam is executed to serve house and fixed asset financing, vehicle financing and personal financing.

Moreover, step by process flows of Tawarruq practiced in Bank Islam are explained step on this following picture;

Figure 3: Tawarruq Structure Diagram of Bank Islam



Descriptions:

1. The customer applies financing product based on Tawarruq concept from the bank. Bank obtains Tawarruq transaction documents from the customer.
2. Bank will buy the commodity at LME through broker 1.
3. Under the Murabahah contract, bank then sells the commodity to the customer at bank's selling price (principal profit) on deferred payment term.
4. Under the wakalah contract, customer requests bank to sell the commodity in the market.
5. Acting as the appointed sale agent for the customer, bank sells the commodity to broker 2.
6. Bank then credits wariq (proceed) from the sale of commodity to the customer's account.
7. Finally, customer pays amount due to the bank (principal + profit) by way of agreed instalment method.

Furthermore, to ensure the product is in line with shariah, Alhadad (2003) ⁽²⁰⁾ mentions that there are some conditions that must be met by Bank Negara in carrying out the above transaction:

1. The contract for deferred sale should be shariah compliant, either by negotiation or Murabaha and make sure that the commodity exists and possessed by the seller before he sells it. In case of binding promise, the promise should only be from one party. Moreover, the subject matter should not be gold, silver or currencies;
2. The commodity must be precisely determined, either by possessing or by serial number of its documentation, such as the serial numbers of where houses certificates;
3. If at the time of concluding the contract, the commodity does not exist, then the seller must provide full information regarding the description, quantity and the place the commodity is stored to the client, in order to ensure that the sale is genuine not fraud. Preferably, the transaction should use local commodities;
4. There should be real possession of the commodity, and there should not be any obstacle that prevents the client to hold the commodity;
5. The commodity should be sold to a third party, and not to the first sellers. Because it will become sale of 'inah" . Additionally, the first seller should not get the commodity by any condition, collusion or through customary practices;
6. There should not be any link between the contract for purchase at deferred price and the contract of sale at cash price.
7. The client should not appoint the company(which deals with the international markets of commodities) or its agent to sell the commodity that the client has bought, However, if the system in the market does not allow the client to sell the commodity by himself, the client can assign the company as his agent to sell the commodity, on condition that the sale should be done after the client has held the commodity;
8. The company should not appoint another to sell the commodity(which was sold by the company-first seller)on behalf of the client;

9. By taking other provision into account, the client should sell the commodity himself or through another agent(not the company):and
10. The company should provide full information, in order to enable the client to sell the commodity, either by himself or through his agent.

Conclusion and Recommendation:

Many scholars permit and allow the Tawarruq, because in the light of sharia, it has no any sharia problem, but some Economist says that Tawarruq is harmful for Economy.

Now the problem is that Tawarruq should be allowed or prohibited?

If we do not allow the Tawarruq, many people will be divert to conventional bank, and will be involve in interest base transaction which is haram by sharia.

So we should to allow Tawarruq, so as the people do not involve in interest based transaction.

On the other hand, it is necessary to super induce legitimately the IFIs and Islamic Banks. Especially during the process of sale, Purchas and wakalah agreements, sharia Adviser should to see the specification and conditions of sale, purchase and wakalah, i.e. commodity which is being selling, should be exist and after purchasing should be possession on commodity by agent or by buyer. If all needs of this transaction are fulfil, then it is best alternate for interest based loan.

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