

**Fikret Hadžić, PhD**

Sarajevo School of Economics and Business, University of Sarajevo, BiH

E-mail: fikret.hadzic@efsa.unsa.ba

**Aida Hanić, MA**

Institute of Economic Sciences, Belgrade, Serbia

E-mail: aida.hanic@ien.bg.ac.rs

## **SPECIFICS OF TAWARRUQ FINANCING MODELS IN ISLAMIC BANKING**

### **SPECIFIČNOSTI TAVARUK MODELA FINANSIRANJA U ISLAMSKOM BANKARSTVU**

#### **Abstract**

*Islamic banking defines money strictly as a medium of exchange; it has no value in itself and each note is the same as another banknote of the same denomination. Because Islamic banking has recent history, not all of their instruments are still fully created and one such model is tawarruq; model known as “reverse or commodity Murabahah that operates by borrowing cash based on two separate transactions. There are two basic types; the first type implies that an individual buys commodity from a bank, deferred, which later sold to another person or a bank for money in order to obtain the necessary liquidity. Another type is “organized tawarruq” that involves a transaction in which an individual buys commodity from Islamic bank on credit. It is a kind of standardized types such as metal or wheat. The bank purchased commodity sells to the client at a higher price with the term of payment in the future. The client hires the bank as its agent who sells commodity for cash. The result of this transactions means that the client gets the cash and bank owes funded amount plus the anticipated return. Many Islamic experts and economists express reservation under this model, considering that it achieves what Islamic banking seeks to avoid and it is the interest generated by activities of conventional banks. Although the model is acceptable from a legal point of Islamic economics, essentially in a spiritual way it isn't, since it opens the possibility of creating a multitude of transactions without creating real value and the possibility of creating interest. The aim of this paper is to introduce the basics of tawarruq model and its functioning, to examine its acceptability in terms of Islamic economics, and thereby contribute to further discussion on the admissibility and the purpose of its use.*

**Keywords:** Islamic banking, interest, Shari'ah, tawarruq

**JEL:** G21

## Sažetak

*Islamsko bankarstvo definiše novac isključivo kao sredstvo razmjene; nema vrijednost sam po sebi i svaka novčanica je jednaka drugoj novčanici iste denominacije. Zbog toga što islamsko bankarstvo ima relativno noviju historiju, svi njihovi instrumenti nisu u potpunosti kreirani a jedan od takvih modela jeste i tawarruq model poznatiji kao „obrnuti Mudarabah“ koji funkcioniše po principu posuđivanja gotovine ali uz dvije odvojene transakcije. Postoje dva osnovna tipa. Prvi tip podrazumijeva da pojedinac kupi robu od banke, na odloženo, koju kasnije prodaje drugoj osobi ili banci za novac u cilju dobivanja potrebnih likvidnih sredstava. Drugi tip tawarruq modela jeste „organizovani tawarruq“. Ovaj model podrazumijeva transakciju u kojoj pojedinac kupuje robu od islamske banke na kredit. Radi se o robi standardizovanog tipa poput metala ili pšenice. Banka kupljenu robu prodaje klijentu po cijeni većoj sa rokom plaćanja u budućnosti. Klijent angažuje banku kao svog agenta koja prodaje robu brokeru za gotovinu i depozite koju uplaćuje na svoj račun. Rezultat ovih transakcija znači da klijent dobiva gotovinu a banci duuguje finansirani iznos uvećan za predviđeni povrat. Mnogi islamski stručnjaci i ekonomisti izražavaju rezervu prema ovom modelu smatrajući da se njime postiže ono što islamsko bankarstvo nastoji da izbjegne a to je kamata koja se generiše aktivnostima konvencionalnih banaka. Iako je model prihvatljiv sa pravnog aspekta islamske ekonomije, suštinski i duhovno nije, budući da otvara mogućnost kreiranja mnoštva transakcija bez stvaranje realne vrijednosti kao i mogućnosti kreiranja kamate koja je u islamu strogo zabranjena. Cilj ovog rada jeste upoznati se osnovama tawarruq modela i njegovog funkcionisanja, ispitati njegovu prihvatljivostsa aspekta islamske ekonomije, te time doprinijeti daljoj diskusiji o prihvatljivosti i svrsi njegovog korištenja.*

**Ključne riječi:** islamsko bankarstvo, kamata, šerijatsko pravo, tawarruq

**JEL:** G21

## 1. Introduction

*“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand”.*

Imam Muslim, *Sahih*, Kitab al-muzara’a, h. 97

Islamic banking is not a new concept in the world economy but it became a fast growing financial services sector and a worldwide phenomenon in the last decade. Although the „western“ economists try to present Islamic banking as a subsystem of a conventional banking system, the facts

show that Islamic banking has his own history and path, his own rules and principles and ways of doing business. It is important to notice that, generally, Islamic banking is known as an interest-free business model because “*Allah has allowed trade and has prohibited riba*”(surah Al-Baqarah: 257).(Sami Ibrahim al-Suwaylim, n.d.) Shari’ah prohibited riba on both sides, the creditor and the debtor, because it is the result of their mutual consent. The history of Islam, as a basis of Islamic banking, teaches us that the prohibition of interest is not the only thing that is connected to Islamic banking, but also the whole set of ethical, moral and social principles that are important for, both, economic and social progress of every community and where (Chapra 1984, p. 1) socio-economic justice is one of the cherished goals of all societies. In that way, in Islamic banking there is importance in risk sharing, in terms that there could be no profit without taking the risk, where every financial activity should be backed by an underlying asset and, generally, every economic activity must be Halal (permitted) and not Haram (prohibited). In economic terms, Islamic banking products must be in accordance with Shari’ah<sup>1</sup> and must be approved by the Shari’ah Supervisory Board that every Islamic bank must have. „*The Shari’ah Supervisory Board is comprising of Shari’ah scholars and advisors that should be independent and qualified to give rulings that pass moral judgment on proposed contracts and transactions as well as to ensure that business conducted is according to the requirements of the Shari’ah.*“<sup>2</sup>

Islamic banking products can be divided into: a) sales based (Murabaha, Istisn’a, Ijarah, Tawarruq), b) equity based (Musharakah, Mudarabah), c) fee based (Wakalah, Kafalah, Rahn), d) Islamic deposits (Wadai’ah, Qard, Tawarruq), e) Investment Accounts (Mudarabah, Musharakah) and f) Investment Accounts (Wakalah). The history of Islamic banking instruments and models starts from 1970, so not all of the products are fully developed yet, including tawarruq, who is a relatively new product. It started to use in 2000 in Saudi Arabia and later in other countries, not just in the GCC region. Tawarruq is known as a “reverse or commodity Murabahah” operating by borrowing cash including two separate transactions. There are two basic types. The first type, “classical tawarruq”, implies that an individual buys goods from a bank, deferred, which later sold to another person or a bank for money in order to obtain the necessary liquidity. The second type is “organized tawarruq” that involves a transaction in which an individual buys goods from Islamic banks on credit. It is a kind of standardized types such as metal or wheat. In the case of metal it uses the platform of London Metal Exchange – LME. The bank purchased goods sold to the client at a price

higher with the term of payment in the future. The client hires the bank as its agent who sells goods for cash and broker deposits that paid to your account. The result of these transactions means that the client gets the cash and bank owes funded amount plus the anticipated return. The organized tawarruq is the subject of debate and some Islamic economist call it as a hybrid contract (Mihajat 2015, p. 90) because its mechanism is frowned as a form of *hilah* (legal trick). Although „*it has been widely used to structure various financial products and liquidity management instruments, such as attracting deposits, financing and structuring government and corporate sukuk*“<sup>3</sup>, every tawarruq transactions creates a debt (Siddiqi 2007, p. 1) which can lead to financial and speculative transactions. On the other hand the use and the acceptance of tawarruq model also depends on the point of view of school of thought in Islamic jurisprudence, because some Islamic scholars say tawarruq should be forbidden and others say it is in accordance with Shari’ah.

The aim of this paper is to explain the key elements of tawarruq financing model, as one of the most intriguing model in Islamic banking, and to examine its use in the Islamic banking system. This paper is organized as follows. The following section reviews the literature of the meaning of tawarruq and its use, the point of view of different School of Thoughts and the perspective of use of tawarruq model. The next section discusses the methodology being used in creating the classical and organized tawarruq what is followed by the analysis of the results that tawarruq brings to financial institution but also to the buyer. At the end of the paper there is conclusion and recommendation.

## 2. Literature review

To understand better tawarruq model and its components, it is necessary to define the meaning of the word itself. Tawarruq comes from the word *wariq* what means silver coin. It is important to emphasize the difference between the word *tawarruq* and *tawriq* because many researchers mix this terms. Dabu (n.d., p. 2) says that *tawriq* means documentation (*taskiik*); transferring existing commodities into *sukuk*, which are subject to circulation. The OIC Fiqh Academy defines *tawarruq* as: “*a person (mustawriq) who buys a commodity at a deferred price, in order to sell it in cash at a lower price. Usually, he sells the commodity to a third party, with the aim to obtain cash.*” The Islamic Fiqh Academy of Muslim World League defined *tawarruq* as: „*a contract to purchase a commodity from a seller on terms of spot delivery and deferred settlement and then the buyer sells the same*

*commodity to a third party other than the original seller on terms of spot deliver and spot settlements*“.<sup>4</sup> The parties involved in tawarruq contract are: the seller of the commodity or the creditor (Muwarriq), the buyer of the commodity (Mutawarriq) and the subject of the transaction (the commodity). Some islamic scholars consider tawarruq very close to the term inah<sup>5</sup> (credit sale) and in (Al-Zuhaili n.d., p. 3) *inah* is a fake sale, which is used as a means of usury (interest), and not to conclude a genuine sale. On the other hand some scholars say tawarruq is not inah and it is in the accordance with Shari’ah and there is no barrier in its use. In that way many Islamic bank use tawarruq very extensively (Bouheraoua 2009, p. 3) because they believe it ensures that depositors will continue to do business with them and because it provides the liquidity that is considered to be their lifeblood. (Ibrahim Fadhil Dabu n.d.,p.1) says that many Islamic banks use tawarruq because they believe that it aims to provide liquidity to banking customers, in which they will immediately receive an amount of money vis-à-vis their commitment to pay a deferred amount that is more than the cash that they have received. Generally, if we consider the definitions above, tawarruq model can become a three mechanisms (Hosen & Nahrawi, 2012, p. 126) because it includes a person that needs cash and buys an item, on a installment plan, and then sells the item to the third person, at a lower cost for cash. Also there could be a situation where person A needs the cash and tries to borrow it from the person B, but B may refuse such a transaction while offering A that an item that he needs is to be purchased by a person who needs money whereupon he can sell the item back at a low price, or a higher price, for cash.

There are two types of tawarruq, classical (Al-Tawarruq al-Fardi; tawarruq on an individual basis) and organized tawarruq (Al-Tawarruq al-Munazzam). OIC Fiqh Academy defines classical tawaruq as *“the purchase of a commodity possessed and owned by a seller on a deferred payment basis, whereupon the buyer then resell the commodity for cash to other than the original seller in order to acquire cash (al-wariq)”* and organized tawarruq as situation *“when a person (mutawarriq) buys a merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent. Simultaneously, the mutawarriq and the financier execute the transactions, usually at a lower spot price.”*<sup>6</sup> Habib and Aleshaikh (2014, p. 2) say that Islamic banks use this instrument to provide financing on the asset side and accept deposits on the liability side. Dr. Sami Ibrahim al-Suwaylimhas cited three differences between tawarruq on an individual basis and organized tawarruq:

- *“In organized tawarruq the original seller acts as an intermediary by selling the commodity for cash on behalf of the mutawarriq, whereas the original seller in individual tawarruq takes absolutely no role in the resale of the commodity and has no relation with the final buyer.*
- *In organized tawarruq the mutawarriq receives the cash from the original seller, to whom he owes the delayed price, whereas the cash in individual tawarruq will be taken by the mutawarriq directly from the final buyer without any involvement by the seller.*
- *In organized tawarruq the original seller might agree beforehand with the final buyer that he will purchase the commodity. This agreement will occur by the commitment of the final buyer to the purchase so as to avoid fluctuation of the price.”<sup>7</sup>*

(Mihajat n.d., p.8) says that organized tawarruq is usually practiced on the commodity murabahah which is the most commonly used in liquidity management instrument by IFI, because IFI can get a fix return from this instrument. Generally, this process is described in (Khan 2009, p. 17) as a model where Party A purchases a commodity on deferred payment and rapidly sells the same commodity on spot, where the seller in the first trade is supposedly a different party to the buyer in the second.

As a result, Party A obtains the cash, as well as a higher debt obligation. The International Council of Fiqh Academy in 2009 declared organized tawarruq impermissible, reasoning that it contains elements of interest-based lending. In (Ahmed & Aleshaikh 2014, p. 1) in terms of organized tawarruq it says that the legalistic forms of contracts are fulfilled but the substance and spirit are not because (Dusuki 2007, p. 17) its mechanism resembles bay` al-`inah<sup>8</sup>; whereby the Islamic financial institution who is acting as an agent to the customer (mustawriq) who need cash sells the asset which was initially purchased from the same institution to the third party and at the end (Nagaoka n.d., p.11) the actual transactions of the real good tend to become just nominal on paper. In analyzing tawarruq, it is important to explain the point of view of school of thought in Islam, regarding tawarruq.

There are four well-known schools of thought; Maliki (founded by Imam Malik Ibn Anas), Hanafi (founded by Abu Hanifah Numan ibn Thabit), the Syafi'i School (known after Al-Shafi'i Mohammad ibn Idris) and the Hanbali School. In (Hosen & Nahrawi 2012, p. 126) the Hanafi, Syafi'i and Hambali schools of jurisprudence, view a tawarruq transaction as legal declaring that *„all trading transactions are halal, except for trading transactions*



*about whose haram-inducing qualities are disputed by the holy Qur'an or the Sunnah, while the Maliki school do not agree with the sale of goods at a price lower than that of the market, when this is done by someone who obtains profit on a loan by methods which is within the usury category.'*<sup>9</sup> In accordance with quote above, (Siddiqi 2007, p.6) lists some „harmful effects (mafasisd) of organized tawarruq“<sup>10</sup> such as:

- *It leads to creation of debt whose volume is likely to go on increasing.*
- *It results in exchange of money now with more money in future, which is unfair in view of the risk and uncertainty involved.*
- *It leads, through debt proliferation, to gambling like speculation.*
- *It leads, through debt finance, to greater instability in the economy.*
- *In a debt-based economy, the money supply is linked to debt with a tendency towards inflationary expansion.*
- *It results in inequity in the distribution of income and wealth.*
- *It results, through debt finance, in inefficient allocation of resources.*
- *It contributes, by consolidating debt financing, to raising anxiety levels and destruction of environment.*

As seen from above, classical tawarruq is permissible because it represent a classical way of trade. The organized tawarruq (Hosen & Nahrawi 2012, p. 140) is merely a word game in the contract, which in the end can cause suffering to and deceive the bank customer so as to obtain a profit what is not acceptable by Islam. Sheikh Mohammed Mukhtar Al Salami, Head of the Sharia (Islamic) Panel in the Jeddah-based IDB, said that „*tawarruq differs from usury in one thing; a usury deal is done through one window while tawarruq is done through two windows*“.<sup>11</sup>

### **3. Theoretical background**

Islamic banking has it core values, for entire financial system, and every Islamic financial institution must always have in consideration those values. But as we have seen from the previous section, there are differences in school of thoughts about tawarruq which directly affects its use in Islamic banking globally. The next table shows in which countries tawarruq is being used the most and where it has been restricted.

Table 1. *Key differences across jurisdictions*

	IRAN	SUDAN & SAUDI ARABIA	SOUTH ASIA	GCC & EUROPE	SOUTH EAST ASIA
MEZAHIB	Shiah	Sunni Maliki (Sudan), Hanbali (SA)	Sunni Hanafi	Sunni Hanbali	Sunni Shafi'i
BANKING SYSTEM	Single (Islamic) banking system	Single (Sudan) Dual (SA)	Dual banking system	Dual banking system	Dual banking system
SHARIAH GOVERNANCE	Centralized	Centralized (Sudan) and self governed (SA)	Hybrid (centralized & self governed)	Self governed except UAE (hybrid)	Centralized (Malaysia, Brunei & Indonesia) only
ISSUES ON SHARIAH CONTRACTS		Tawarruq restricted for liquidity instruments	Tawarruq restricted for liquidity instruments Salam on currency (Bill acceptance)	Tawarruq widely applied (except for banks supervised by Sheikh Husain Hamed Hassan – replaced by Salaam)	Bai' `Inah and Bai' Dayn Tawarruq widely applied

Source: Bank Islam

According to „*Islamic Financial Services Industry Stability Report 2015*“, the global Islamic finance industry's assets are estimated to be worth USD1.87 trillion as at 1H2014, having grown from USD1.79 trillion as at end of 2013.

The largest segment of the global Islamic finance industry is the Islamic banking sector, with assets in full-fledged Islamic banks, subsidiaries and windows amounting to approximately USD1.48 trillion as at 1H2014. The sector has grown by 16% in 2013. When we speak about the use of all Islamic banking instruments, on the next figure there is a representation of the use of Islamic banking instruments.



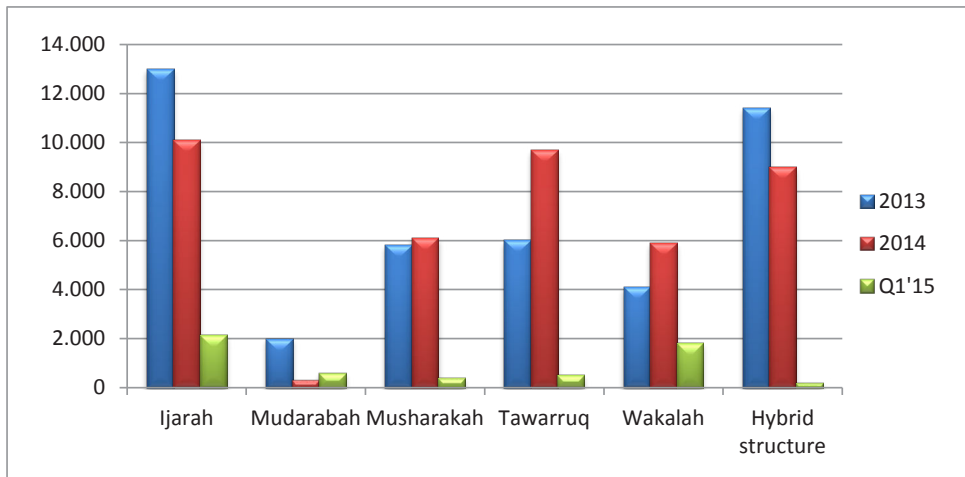


Figure 1. *The use of Islamic banking products widely*

Source: IFIS, Ideal Ratings

As seen from the figure, tawarruq is being used very actively. Before analyzing the reasons for such trend, it is important to explain the differences between the classical and organized tawarruq.

Table 2. *Differences between the classical and organized tawarruq*

<i>Classical tawarruq (Al-Tawarruq al-Fardi)</i>	<i>Organized tawarruq (Al-Tawarruq al-Munazzam)</i>
The original seller (Muwarriq) of the commodity doesn't play any role in the resale of the commodity and also has no relation with the final buyer.	The original seller (Muwarriq) acts as an agent of Mutawarriq by selling the commodity for cash on behalf of the Mutawarriq.
The buyer (Mutawarriq) will receive the cash directly from the final buyer without the involment of the seller.	The buyer (Mutawarriq) will receive the cash from the original seller and owe him a delayed price
The original seller has no relation with the final buyer.	The original seller might have a pre-arrangement with the final buyer of purchasing the commodity.

Source: Authors

Classical tawarruq is accepted by the majority of jurists but to be valid, the following requirements must be fulfilled:<sup>12</sup>

- a) Each transaction in the tawarruq arrangement must be in a accordance with the Shari'ah conditions.

- b) The tawarruq arrangement means two transactions a) between the client and a bank and 2) between the client and third party. To avoid *inah* it is not allowed that these transactions are between the two same persons or institutions. The subject of the sale can't be returned to the original seller.
- c) The subject of the sale must be commodity or tangible assets.
- d) The subject of the sale must be clearly defined and distinctive as compared to other assets and commodity owned by the bank.
- e) The subject of the sale must be taken from the buyer before it can be sold to the third party.
- f) Transactions of buying and selling must be separated and independent from each other. The contract is not valid if it consist the condition of sales purchase or vice versa.
- g) Selling the item can be made only after the customer takes over the goods.

Organized tawarruq can be represented as the following:

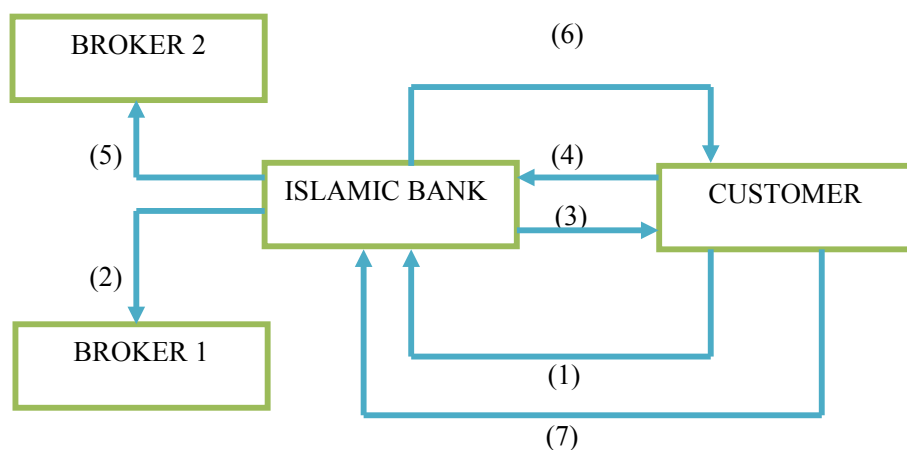


Figure 1. Organized tawarruq structure

Source: Bank Islam

1. "The customer applies financing product based on Tawarruq concept from the Bank and the bank obtains Tawarruq transaction documents from the customer.
2. Bank buys the commodity at London Metal Exchange (LME) through Broker 1.
3. Under the Murabahah contract, Bank then sells the commodity to the customer at Bank's Selling Price (Principle + 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 the *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 installment method."

One form of the organized *tawarruq* is banking *tawarruq* (***Al-Tawarruq Al-Masrafi***). The bank sells the commodity from the market to the buyer with deferred payment. In selling the commodity, the bank will represent the buyer to third party for cash, and it will deliver the payment to the buyer (*Mutawarruq*). One of the most used concept of organized *tawarruq* is a form of commodity *Murabahah* (Mihajat, n.d., p. 8) because IFI can get a fix return from this instrument. Although they are similar, there are differences between these two instruments because *tawarruq* includes three parties while commodity *Murabahah* includes four parties.

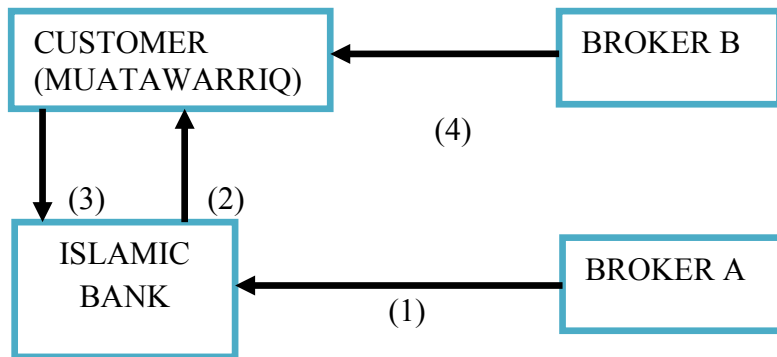


Figure 2. *Commodity Murabahah structure*

Source: Bank Islam

1. The client and the bank agree on the details of the transaction and the amount of money that is required. The bank buys certain commodity on the market from the broker A worth 100.000 euros for cash.
2. Purchased commodity the bank sells to the client for the price increased for the profit margin, for example 110.000 euros.
3. The client commits to pay the purchased commodity within a specified time and in installments.
4. He sells the purchased commodity to the broker B for 100.000 euros in cash.

#### 4. Methodology

Tawarruq as a model can be used to manage liquidity risk that plays an important role in the banking sector. Generally, liquidity risk incurs because of a mismatch of the asset side and a liability side in a balance sheet of a financial institution. Liquidity risk in Islamic banks can happen because of the nature of the Islamic banking products and also because of the influence of the other types of risks, depending on the phase of the realization of the contract. Therefore liquidity risk management lies at the heart of confidence in the banking system. Failure to address liquidity problems not only can cause an insolvent bank to runs but may also have contagious effects (Dusuki 2007, p. 5) banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments such as deposits at the point at which they become due. Thus, liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost. For Islamic banks, liquidity risk is a significant risk owing to the limited availability of Shariah-compatible money market instruments and lender-of-last-resort (LOLR). The importance of managing the liquidity risk in Islamic banking confirms the founding of International Islamic Financial Market (IIFM) and Liquidity Management Center (LMC) with the goal to “*enable IFI to manage their liquidity mismatch through short and medium term liquid investments structured in accordance with the Shari’ah principles.*”<sup>12</sup> In managing the liquidity risk, Central Bank of Malaysia (Bank Negara Malaysia) developed Islamic Inter – bank Money Market (IIMM)<sup>13</sup> in 1994. In March 2007, Bank Negara Malaysia introduced the Commodity Murabahah Programme (CMP), a liquidity management tool in order to connect surplus and deficit units. CMP uses the tawarruq model that utilizes the Crude Palm Oil (CPO) as the underlying concept. The structure of CMP for liquidity management (both to absorb and inject liquidity) can be represented in the next few steps (Dusuki 2007, p. 13) banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments such as deposits at the point at which they

become due. Thus, liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost. For Islamic banks, liquidity risk is a significant risk owing to the limited availability of Shariah-compatible money market instruments and lender-of-last-resort (LOLR):

1. *“Bank A that faces excess liquidity can manage their liquidity by purchasing commodities from Broker A on cash basis. For example, one million USD.*
2. *The bank sells the commodities to Central Bank of Malaysia on deferred price (cost price plus profit margin). For example, one million USD (cost) plus 7.5 profit margin for a duration of six months ( $7.5\% \times 6/12 \times 1 \text{ million USD} = \text{USD } 1,037,500$ ).*
3. *Central Bank of Malaysia sells the commodity to Broker B in on spot at the original price to net off the commodity position that it holds when it purchased from Bank A. The Central Bank of Malaysia may appoint the bank as his agent to sell the commodities in the commodity market.*
4. *On maturity date, Bank A will be receiving the amount equivalent to the principal plus the net yield as agreed beforehand.* “<sup>14</sup>

In the case of temporary liquidity problems, the use of CMP instrument would look as the following:

1. *„Central Bank of Malaysia purchases the commodities from Broker A on cash basis. For example, 1 million USD. Alternatively, the Central Bank of Malaysia can appoint Bank B (that faces temporary liquidity problem) as its agent to buy the commodities from commodity market. Bank B will receive the funds for the purchase of commodities on spot basis. The ownership of the commodities is then transferred to the Central Bank of Malaysia.*
2. *The Central Bank of Malaysia sells the commodities to Bank B on deferred price (cost price plus profit margin). Hence, the ownership of the commodities is now transferred to Bank B.*

3. *Bank B sells the commodities to Broker B in on spot at the original cost price to net off the commodity position that it holds when it purchased from Central Bank.*
4. *On maturity date, Bank B will have to pay Central Bank for the funds equivalent to the principal plus profits. In the final analysis, Bank B obtains funds on spot which is required to manage its liquidity effectively and efficiently.*<sup>15</sup>

Bank Negara Malaysia also developed a concept of using tawarruq called *Bursa Suq Al-Sila* (BSAS), “a commodity trading platform specifically dedicated to facilitate Islamic liquidity management and financing by Islamic banks.”<sup>16</sup> It is a fully electronic webbased platform that enables participants to undertake multi-commodity and multicurrency trades. It offers commodity Murabahah, tawarruq, wakala and wadiah for short-term money market. On the other hand, Islamic banks widely use tawarruq for mobilization of needed capital by the investor and the public. This is mainly considered in terms of deposit where on the previous platform there is a Commodity Murabahah Deposits. In this case, (Dusuki, 2010, p. 4) since the client has the money and is looking for avenues to place the fund and earn return, he would first buy the metal (using the bank as his agent) and then sell it to the Islamic bank on a deferred basis. That can be explained in following:

- a) *The client buys the commodity from broker A on a spot basis, using BSAS.*
- b) *The client then sells the commodity to bank on a deferred basis at Cost + Profit model.*
- c) *Bank sells the commodity to Broker B using BSAS, on a spot basis and obtains cash.*
- d) *The Islamic bank makes payment of the selling price upon maturity.*

## **5. Conclusion and recommendation**

Islamic banking became a way of doing business around the world. Because of the prohibition of interest, Islamic banks have developed many products as an alternative to the conventional banking, with the aim to satisfy their clients financial needs but on a more ethical and moral way. On the other hand, some of the newly developed products are the subject of debate among the Islamic scholars because every Islamic banking product must be in accordance with Shari’ah. One of these instruments is a tawarruq model, developed on a base for a client to get cash by reselling the commodity that

he (the client) purchased from the seller. There are two basic types; classical tawarruq (*Al-Tawarruq al-Fardi*) and organized tawarruq (*Al-Tawarruq al-Munazzam*). Classical tawarruq implies that an individual buys commodity from a bank, deferred, which later sold to another person or a bank for money in order to obtain the necessary liquidity. Organized tawarruq involves a transaction that allows the bank to act as an agent for repurchasing the commodity that has been sold. The result of these transactions is that the client gets the cash and bank owes funded amount plus the anticipated return. Although the tawarruq is being used as liquidity management tool, especially in a form of a Commodity Murabahah Programme with the aim of solving problems with lack of liquidity, there is a debate in terms of organized tawarruq because some Islamic scholars believe that this model contains interest. One of the reasons for the existence of differences, in the concept of the eligibility of an instrument, is the conditions and regulatory regimes under which Islamic banks operate. The Hanafi, Syafi'i and Hambali schools of jurisprudence view tawarruq transaction as legal while the Maliki school do not agree with the sale of goods at a price lower than that of the market. Because every Islamic banking product must be approved by the Shari'ah board, it is important to notice that the decision on acceptance or rejection of a product will depend exclusively on to which mezahib belongs the members of the Shari'ah Board. For example, we have a situation where in Iran tawarruq is completely banned while in Malaysia or Saudi Arabia, it's been used widely. This can lead to a situation where a bank develops new products but during the time they also become a subject of debate among Islamic scholars, which raises the question whether Islamic banking is really a different way of doing business or yet a conventional banking just called with a different name? Also it is a good opportunity for critics of Islamic banking to confirm their thesis that Islamic banking is not ethical as claimed. Although the scholars still debate on tawarruq, the fact is that this instrument is being used in many Islamic banks, not only in GCC region but around the world, which raises the question for further studies whether should tawarruq be used only as an exception or as a rule in the Islamic financial institutions?



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## Endnotes

- 1 Islamic law that defines every aspect of human life and according to which every Muslim seek to live.
- 2 [http://www.islamic-banking.com/glossary\\_I.aspx](http://www.islamic-banking.com/glossary_I.aspx) (Accessed: August 20, 2015).
- 3 ISRA Monthly Publication (2013). *A snapshot of tawarruq in contemporary islamic finance*. Available at: <http://ifikr.isra.my/documents/10180/16168/blp-isra%20sep%20bulletin%20Tawarruq.pdf> (Accessed: August 25, 2015).
- 4 ISRA Monthly Publication (2013). *A snapshot of tawarruq in contemporary islamic finance*. Available at: <http://ifikr.isra.my/documents/10180/16168/blp-isra%20sep%20bulletin%20Tawarruq.pdf> (Accessed: August 25, 2015).
- 5 *Inah* is defined as the sale of commodity on credit and repurchasing it for a lesser amount in cash
- 6 ISRA Monthly Publication (2013). *A snapshot of tawarruq in contemporary islamic finance*. Available at: <http://ifikr.isra.my/documents/10180/16168/blp-isra%20sep%20bulletin%20Tawarruq.pdf> (Accessed: August 25, 2015).
- 7 (Sami Ibrahim al-Suwaylim, n.d.) Tawarruq banking products. *Organization of the islamic conference the international islamic fiqh academy*. p. 21
- 8 Buying an object for cash then selling it to the same party for a higher price whose payment is deferred so that the purchase and sale of the object serves as a ruse for lending on interest. Bay al Inah comprises two agreements; in the first agreement, the bank sells an identified asset to the customer at an agreed price and the customer can complete the purchase of bank's asset by payment in installments over an agreed period; in the second agreement, the bank re-purchases the same asset from the customer at a lower price and on completion of the second transaction, the bank will pay the lump sum amount in immediate cash at the price agreed between them. The difference in the price is the bank's profit, which is determined in advance. Available at: [http://www.islamic-banking.com/glossary\\_B.aspx](http://www.islamic-banking.com/glossary_B.aspx) (Accessed: August 31, 2015).
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- 12 See more in: Smolo, E. (2013). *Uvodu i islamsku ekonomiju i finansije*. Sarajevo: Dobra knjiga, pp. 421-422
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- 15 Ibid, p. 15.
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