

# Why Tawarruq Needs To Go

## AAOIFI and the OIC Fiqh Academy: Divergence or agreement?

By Dr Salman H Khan

Organized Tawarruq is a transaction that has been heavily used by institutions offering Islamic financial services (IIFs) in substantial volumes for many years, largely for the purposes of liquidity management — often referred to as Commodity Murabahah — and the provision of cash-in-hand or “neutral” consumer finance.

Typically, 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 overall transaction will be arranged or “organized” by an IIFS.

The OIC’s International Council of Fiqh Academy (ICFA) in Mecca ruled in April 2009 that Organized Tawarruq and Reverse Tawarruq were not permissible, since they were a “trick” to get cash now for more cash paid later. Reverse Tawarruq is the mirror image of Tawarruq in which the individual in question — instead of needing liquidity has excess liquidity — buys on spot at price “A” and sells on deferred at price “A + B” to make a profit of “B”.

This pronouncement has stirred strong emotions. For some, it seemed to be rather hasty, not well-thought out and opposed to the needs of the Islamic finance industry. In the view of others, however, it was no less than a very welcome and long overdue breath of fresh air for the industry.

Some critics, who questioned the validity of the ICFA pronouncement, argued that the judgment goes against the ruling of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) on the permissibility of Tawarruq as laid down under its Shariah Standard 30.

The view expressed in this paper is that rather than contradicting each other, AAOIFI’s Shariah Standard 30 on Tawarruq and ICFA’s judgment on Tawarruq are actually both in agreement with each other, even though it may not have been explicitly stated.

A closer analysis reveals that the overall structure of Organized Tawarruq as permitted by AAOIFI is a theoretical model that is rarely or virtually never followed by the industry. Realizing this fact, the ICFA passed its recent Resolution No 179 which, in effect, implicitly agrees with and reinforces AAOIFI’s Shariah Standard 30. Thus, rather than there being any conflict, ICFA has simply put forward the same point of view, albeit expressed differently. In other words, the ICFA points out what *cannot* be done, while AAOIFI reaffirms this and completes the picture by explicitly outlining in AAOIFI Shariah Standard 30 what *should* be done.

### ICFA’s position on Tawarruq

The ICFA’s Resolution 179 on Organized Tawarruq states: “It is not permissible to execute both Organized and Reverse Tawarruq because simultaneous transactions occur between the financier and the Mustawriq (the party seeking finance), whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e. in order to get the

additional quick cash from the contract. Hence, the transaction is considered as containing the element of Riba.”

Clearly, the ICFA’s concern is with a concealed buy-back transaction where the metal (or other commodity) is used as a prop to justify a transaction in which the real purpose is to exchange money now for more money later.

Moreover, the phrase “simultaneous transactions between the financier and the Mustawriq, whether it is done implicitly or explicitly” deliberately highlights the reality that in today’s Islamic finance sphere, both transactions of purchase and sale of the Tawarruq commodity are, in effect, made between the same financier and the customer, notwithstanding cosmetic arrangements adopted by IIFs that purport to demonstrate the use of brokers or third parties. This is “implicitly” done via various “netting arrangements”.

The ICFA prohibits Tawarruq where any of the following occur:

- There are effectively only two parties and no real, unconnected third party
- There is a concealed buy-back
- The transaction is a “trick” with an embedded fixed return

Since the above three features typically characterize virtually all Organized Tawarruq transactions done by IIFs, the ICFA holds that Organized Tawarruq should be disallowed.

### AAOIFI Shariah Standard 30

The key clause in Shariah Standard 30 is Article 4/5: “The commodity (object of monetisation) must be sold to a party other than the one from whom it was purchased on deferred payment basis (third party), so as to avoid E’na which is strictly prohibited. Moreover, the commodity should not return back to the seller by virtue of prior agreement or collusion between the two parties, or according to tradition.”

In practice, Article 4/5 is not followed in Organized Tawarruq. In addition to Article 4/5, Articles 4/7, 4/8, 4/9 and 4/10 (all in Standard 30) also highlight the divergence between AAOIFI’s permitted Tawarruq and the Tawarruq that is typically practiced. Articles 4/7 to 4/10 say the following:

- (i) The bank or its agent should not sell the commodity on the customer’s behalf if the customer initially bought that commodity from the bank; neither should the bank arrange a proxy third party to sell this commodity.
- (ii) Instead, the client should sell the commodity either himself or through his own agent. At the most, the bank should provide the client the information needed to sell the commodity.

In reality, AAOIFI Shariah Standard 30 is also really saying that: “Organized Tawarruq must fulfil these stringent conditions. If it doesn’t, it isn’t Shariah permissible and is therefore disallowed.”

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## Why Tawarruq Needs To Go (continued)

In short, Organized Tawarruq cannot be transacted if it does not fulfill these stringent conditions. Thus, the key conditions laid out by AAOIFI Shariah Standard 30 are that the transaction should not in essence be two-party (ignoring the “cosmetic involvement” of third parties).

It should be real, that is, the metal being traded should genuinely move from seller to buyer; there should be no “trick” or collusion involved; and hence, no fixed embedded return. These conditions actually describe a type of Tawarruq that by definition cannot be the Organized Tawarruq that is typically used in today’s Islamic finance industry.

All these conditions are based on concerns that are identical or very similar to those held by the ICFA. Therefore, in actual fact, AAOIFI’s Organized Tawarruq is consistent with the ICFA’s implicit definition of un-organised Tawarruq. The key lies in the separation of “how it is” (therefore prohibited by ICFA) and “how it should be” (if permitted by AAOIFI).

### Why Tawarruq must go

AAOIFI & ICFA’s joint message: “Either do it properly, or don’t do it all”

In the light of AAOIFI Standard 30, theoretically, the only way for Tawarruq to operate properly would be via three real and distinct parties, namely:

- Customer A
- Seller-1
- Buyer-1

And two distinct and unconnected sales:

- Sale-1
- Sale-2

i) Customer A buys metal on deferred payment from Seller 1 ii) Customer A takes constructive/real possession of the metal	Sale 1
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iii) Customer A sells same metal to Buyer 1 (a genuine third party other than Seller 1) iv) Metal actually moves from the warehouse of Seller 1 to Buyer 1, and Buyer 1 completes possession	Sale 2
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So, a key question relating to point (iv) above is: Does the commodity bought by the customer in Sale 1 (on deferred payment) eventually leave the warehouse of Seller 1, as Standard 30 clause 4/5 clearly requires?

The answer is, by and large, no. There are some reasons for this:

Firstly, the fact remains that the overall purpose of the seller in the transaction (who effectively provides the liquidity by selling on deferred payment) is:

- To advance liquidity
- To make a return on the money advanced, built into the price of Sale-1
- Not to trade, and therefore, certainly not to take on the kind of risk that is associated with normal and genuine commodity trading activities

Therefore, from the seller’s point of view:

- There is no purpose or intention to physically transport any of the commodities that he holds in his warehouse
- In fact, this activity would, in the seller’s view, incur unfeasibly high costs, and moreover, this is precisely not the purpose of their involvement with such liquidity provision mechanisms as Tawarruq
- Rather, this is much more similar to the provision of a loan on interest, where the metal from Sale-1 is stored as a security against the stream of receivables relating to the deferred price in Sale-2
- In case it becomes necessary to physically move the “traded” commodities in Tawarruq from one location to another, as should be done but is typically not done, this would severely restrict the total volume and profitability of Tawarruq transactions, and quite possibly may eliminate them altogether

As an added point, virtually all banks organize the onward sale of the metal bought by the customer. This again is a violation of AAOIFI Shariah Standard 30.

Thus, having defined and implicitly agreed upon what Tawarruq should and should not look like, AAOIFI and ICFA are well aware that the reduced profitability of doing this “reformed” version of Tawarruq may well render it economically unfeasible to do Tawarruq at all. Both institutions are quite comfortable with such an eventuality: “Either do it properly, or don’t do it all.”

### Movement of the commodity

What happens to the metal in reality? There are certain parties who are active in the Tawarruq sphere. These may be commodity trading companies who have the financial depth to hold reasonably large stocks of metal in their warehouses. Alternatively, brokers who have links with such trading companies also are active in this market.

With regard to Tawarruq, the above parties act as buyers and/or sellers often in a large number of separate transactions, and typically, they operate a netting facility between their different storage facilities. So, in reality, the metal rarely gets physically transferred from Seller 1 to Buyer 1, as it should.

Typically, at any given point in time, these parties possess a certain stock or quantity of metal. Furthermore, these parties use and reuse this same stock many times during the same day as the subject matter in numerous consecutive sales.

Therefore, almost exactly like the concept of fractional reserve banking in conventional banking, these “commodity stockers” can, for instance, hold 100 tons of metal in their warehouse valued at say US\$2.5 million, and yet conduct Tawarruq transactions amounting to any multiple of that, for example US\$25 or US\$50 million or more. And throughout these transactions, the metal would not need to move an inch.

This is made possible because each Tawarruq transaction will normally have an implicit holding period after which it is “released” or “freed”. Thus, as an example, in a standard transaction:

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## Why Tawarruq Needs To Go (continued)

- 10.00am, 10<sup>th</sup> September 2009: Seller-1 books 4 tons of aluminium for a deferred sale @ US\$2,500 per ton to Customer, for a US\$10,000 sale
- 10.30am, 10<sup>th</sup> September 2009: Customer takes constructive possession (never sees the metal, and may at the most simply receive a certificate, usually indicating his consignment is placed in some named warehouse) and sells same aluminium to Buyer-1, for, say, an US\$8,000 spot price
- 11.00am, 10<sup>th</sup> September 2009: According to the netting facility, 4 tons of aluminium are netted off between the storage facilities of Seller-1 and Buyer-1, through some direct or indirect method, without the metal needing to physically move at all.

This example clearly illustrates that that AAOIFI Shariah Standard 30 is not being followed, since there exists prior agreement or collusion between the two parties Seller-1 and Buyer-1 for such deals, and effectively the metal does return back to the original seller as per the netting arrangement. So, the ownership of the metal returns back; the metal itself, in actuality, never really moves.

Incidentally, despite having collusion between the Seller-1 and Buyer-1, which in effect contravenes Clause 4/5 of Standard 30, the above example of the sample transaction is actually a good scenario case. By implication, Seller-1 properly demarcates the four tons of metal in his warehouse to denote the customer's constructive possession, until Seller-1's netting arrangement is finalized.

Conceivably, Seller-1 would do this by putting, say, a yellow sticker with the customer's details on the relevant metal consignment to confirm the customer's ownership of that metal. Alternatively, such demarcation can also be done through a robust electronic system. Moreover, it should be noted, that each and every transaction would have to be demarcated accurately, for the correct period of time.

In practice, however, it is doubtful, that even such proper demarcation of the subject commodity occurs in the warehouse for each and every transaction as it should, since that would involve labelling (physically by warehouse staff, or electronically) the exact stock of sold metal in every case, and then de-labelling it a bit later when the netting occurs.

Thus, if any certificate of ownership is issued to the customer, it should really say something like "X kilogrammes of aluminium, type y, grade z, located in Warehouse ABC, Aisle no 34, items 709 to 720".

However, based on available evidence, what typically happens is a daily or periodic netting, in which rather than specifically identifying and subsequently "releasing" the metal for each transaction, all the

transactions for a certain day are carried out without such specific demarcation, and hence even this minimal transfer of constructive ownership does not really happen in most cases.

Instead, daily net positions dictate the overall stock balances, that is, how much is encumbered and how much is free to be used for new Tawarruq transactions.

In the absence of any physical movement of the metal, it follows that Tawarruq "traders" would necessarily have to operate such a netting arrangement. It is either this, or that. No third avenue is apparent.

The three key points here, therefore, are:

- Even if full and proper demarcation of commodities for the correct period of ownership were to happen for all Tawarruq transactions with regard to Sale-1, this would only help towards securing Shariah compliance of Sale-1; the fact that eventually in Sale-2 the metal effectively returns to Seller-1 contravenes AAOIFI Shariah Standard 30 in any case
- However, the evidence is that in the majority of cases even this initial demarcation does not happen as it should; if this is also the case, then such Tawarruq transactions are rendered doubly invalid
- Although the bank is not allowed to organize the onward sale of the metal/commodity as per AAOIFI Shariah Standard 30, this happens in virtually all cases in practice

### Life without Tawarruq: Points to ponder

A majority of Islamic banks conduct a large volume of Tawarruq transactions on a regular basis with regard to their treasury operations. This, in the opinion of their Shariah boards, is permitted on the basis of daroora (need), since the view is that there is no other option available.

### Phasing out

As such, even if an intention were made to follow the opinion of the ICFA and AAOIFI, in practice it is doubtful that IIFSs would be in a position to stop doing their existing Tawarruq transactions immediately. Instead, even under a best-case scenario, Tawarruq would most likely need to be phased out.

However, even if Islamic banks make the intention of bringing their dealings in Tawarruq to a gradual halt, they have to demonstrate some tangible commitment and willingness to move in this direction.

The present reality of the Islamic finance industry is that levels of regulation, adherence to any kind of standards, and penalties for non-compliance are poor or non-existent, all of which suppress the incentive for IIFSs to eliminate Tawarruq (and in fact all questionable products) since it is so profitable.

### Liquidity management alternatives

Since Tawarruq is extensively used by most Islamic financial institutions for liquidity management purposes, an alternative workable solution must be available in case Tawarruq is phased out. The best way out is to return to the "honesty" of a 100% cash reserve ratio, and shift *continued...*

## Why Tawarruq Needs To Go (continued)

the focus to genuine investment-based and profit-loss sharing products. These will rule out the need for the fractional banking system that is based on liquidity management.

However, such a move represents a paradigm shift that challenges the very basis of the existing banking structure, and would require strong political will to institute – and could quite likely occur only in conjunction with an overall philosophical review and revision of the basis and practice of the Islamic commercial industry – and while there appears to be increasing demand for such a revision (particularly in the aftermath of the recent economic crash), it is difficult to predict when this may happen.

In the more immediate future, as a parallel move, other helpful steps to assist liquidity management include improving financial markets' infrastructure to enhance the tradability of Sukuk, and using Mudarabah-, Musharakah- and Wakalah-based inter-bank deposits.

### “Cash-in-hand” consumer liquidity

If Tawarruq is to be made redundant, there would be a heightened need to provide genuine Shariah-based product solutions that offer neutral liquidity or “cash-in-hand” to the client.

For such needs, Salam is probably the most genuine product that was specifically sanctioned by the Prophet precisely for meeting the liquidity needs of agricultural producers. It should be noted that Salam can comfortably be utilized outside the agricultural sector as well.

However, Salam remains grossly underused and is disliked by banks because of the perceived “price risk” associated with this product. This apprehension in using Salam persists despite the existence of various risk-mitigating tools, some of which include negotiating an initial tough Salam price, the use of Parallel Salam, and obtaining a foreign exchange promise-based currency hedge, where the good is paid for in foreign currency.

However, it remains that the very first step towards any improvement must begin with a frank, unqualified and meaningful appraisal and

acknowledgement of the situation. Any corrective measures taken must necessarily be a subsequent step. This acknowledgement, it seems, cannot be readily observed at present in the Islamic finance industry.

### Moving forward

Despite the perceived conflict between AAOIFI's Shariah Standard 30, which permits Tawarruq, and ICFA's ruling forbidding Organized Tawarruq, in actual fact there is no real disagreement between the two.

The key point to note is that AAOIFI permits a reformed version of Tawarruq, which is currently not practiced in the industry. By implication, therefore, AAOIFI clearly forbids the existing form of Tawarruq, as does the ICFA. So, in effect, the ICFA says, “The prevalent form of Tawarruq is impermissible”, to which AAOIFI implicitly nods and adds, “If you must do Tawarruq, Shariah Standard 30 will show you how.”

And by further implication, both ICFA and AAOIFI add the comment: “...although it's quite possible that if you do Tawarruq according to Standard 30, you may not want to do it at all, due to dramatically reduced profitability and feasibility concerns. This is fine too.” Thus, both institutions are quite comfortable with the eradication of Organized Tawarruq as it exists presently. This sentiment is also shared by a large number of industry practitioners, Islamic economists and other stakeholders in Islamic commerce. (2)

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## Tawarruq: Quashing the “justification” arguments

**The defenders of Tawarruq (as it is now practiced) have put forward various arguments to justify why Tawarruq should be allowed. Some of the leading justifications are critically analyzed.**

### Claim 1:

Tawarruq traders often buy and sell metal with physical movement of the metal and hence Tawarruq is conducted by genuine traders.

### Reply:

Although some movement of metal may happen, the likelihood is that there are only two probable scenarios in which the commodity moves:

- a) Some traders, apart from their Tawarruq activities, may also be genuine traders of the metal. However, the key point here is that while they may physically receive, transport, and trade metal in their other sales, *with regard to their Tawarruq transaction, the metal rarely or never moves.*

- b) Alternatively, what may happen from time to time is that for a certain party, the volume of their Tawarruq transactions rises or falls, which may prompt them to buy or sell, respectively, more metal from the market for the purposes of equalizing the amount of metal stocked with the expected multiple of periodic Tawarruq transactions. So, for example, if US\$1 million of stocks enables US\$20 million of transactions daily, and daily “demand” goes up to US\$30 million, the party would then proportionately stock US\$1.5 million of metal.

However, this is hardly trade. Rather, it is stocking of sorts, where the inventory effectively acts as a security against the liquidity transactions undertaken over the relevant period. This is quite similar to the goldsmiths of the 17<sup>th</sup> century who lent out the paper claims to gold (against their gold stocks) on which they received interest.

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**Why Tawarruq Needs To Go (continued)**

**Tawarruq: Quashing the “justification” arguments (continued)**

**Claim 2:**

Commodities are genuinely being bought and sold, and this is trade. How can trade be forbidden?

**Reply:**

Assume that Tawarruq happens with correct demarcation of the subject commodity vis-à-vis Sale-1 in all cases. Nevertheless, the fact remains that

- A small stock of metal of a certain value will enable Tawarruq sales of a large multiple of that value
- This will happen on a daily and repeated basis, and
- The metal does not move at all in relation to these Tawarruq sales; this renders the metal virtually irrelevant since it mainly serves as a prop to enable these monetization deals to go through

Thus, as an example, if a metal stock worth US\$1 million is used to perform such Tawarruq sales worth US\$30 million on a daily basis, it effectively means that the same physical stock of metal is “sold” and “resold” 30 times per day, without moving an inch.

Can anyone realistically claim that these are genuine “trade” deals?

This concern is even more valid given that they are in direct contravention of Shariah AAOIFI Standard 30 as well as the ICFA’s fatwa.

**Claim 3:**

The criticisms of Tawarruq that “nobody wants or needs the metal”, “the commodity is rendered irrelevant”, and is a “fake prop” are unfair. After all, in real trade as well, all sellers buy their merchandise, not because they want it per se but, because they want to sell it and earn a profit. So, isn’t their merchandise also “irrelevant”, “unwanted” and a “fake prop”?

**Reply:**

No one claims that regular trade is “real” because genuine traders buy their merchandise for their own needs. Rather, it is real because the buyers to whom the traders sell their goods do actually need these goods for genuine consumption and usage.

Even if we assume a chain of buying and selling in real trade, the point here is that the “end” buyers will always consume or use that good. This is, by design, not the purpose in Organized Tawarruq, where the purchased commodities are stocked to facilitate the transactions without ever being delivered. To make the point clearer, if following Sale-2, Buyer-1 wants to take actual physical possession of the commodity, the Organized Tawarruq infrastructure will largely cease to be viable or profitable.

**Claim 4:**

The ICFA’s viewpoint on Tawarruq is contradictory. Firstly, the ICFA agrees that Tawarruq on an individual level is permitted; thus, if “A” buys a commodity in the market on deferred payment and sells the same on spot, by his own efforts, then that is allowed. At the same

time, the ICFA also says where the bank organizes the full Tawarruq transaction, in particular the second sale, such transactions should not be permitted. How does this represent a consistent viewpoint?

**Reply:**

The very basis of the opposition to Organised Tawarruq is that it is very difficult to maintain overall Shariah permissibility if the deal (especially the second sale) is organized by the IIFS, since the metal, by design, isn’t meant to move, and effectively it becomes a “money now for more money later” transaction, with no real economic activity in between.

In unassisted Tawarruq, the commodity is individually bought by “A” in step 1, physically possessed by “A”, and then genuinely sold to Buyer-1 so that real delivery occurs. Therefore, unassisted Tawarruq is simply a form of real trade, similar to the fruit seller buying his daily inventory in the morning from the fruit wholesale market on credit, and selling this stock during the day on cash, with the hope of making more money from his sales to earn a profit.

**Claim 5:**

The bank does a favour to the client by arranging the second sale in a smooth manner, which helps the client to sell his metal for the best market price possible. The customer thereby avoids potential loss that he might have faced had he executed the same deal on a personal and unassisted basis, as the bank with its strong links to the brokers, its infrastructure, and its knowledge of the market enjoys economies of operation not available to individual customers, and can pass on these lower costs to its customers.

**Reply:**

If the customer ends up making a loss because he engages in unassisted Tawarruq, let it occur. Unassisted Tawarruq is precisely similar to the genuine concept of trading, that is, buying and selling with the hope of making a profit.

This is an activity that will always involve risks, just as it will always provide an opportunity to profit as well. How might profit accrue? Even in unassisted Tawarruq, the liquidity achieved via Sale-2 is often used for investment or business purposes. If invested shrewdly, the returns on that investment would be higher than the liability of the deferred price of Sale-1.

Moreover, banks can hardly be credited with organizing Tawarruq because they want to help their clients avoid extra loss by enabling them to find a good price for their metal in Sale-2. In any case, even if these noble intentions existed, the avoidance of such a loss by the customer is hardly a good enough reason to permit Organized Tawarruq, which entails substantial Shariah concerns.

Instead, IIFSs in reality favor Organized Tawarruq because:

- The transactions are virtually “riskless” with “secured returns”
- Transaction costs are very low
- IIFSs are able to carry out a huge volume of transactions

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**Why Tawarruq Needs To Go (continued)**

**Tawarruq: Quashing the “justification” arguments (continued)**

specifically because this Tawarruq is organized, and therefore enjoy huge profitability in such deals

It is no coincidence that the three features mentioned are also the key characteristics of the regular conventional product of a loan on interest. This, then, is also an additional source of unease for those not in favor of Organized Tawarruq.

**Claim 6:**

Organized Tawarruq transactions are sound, with proper constructive possession and transfer of ownership at the right time.

**Reply:**

There are a few select brokers who carry out very large volumes of Tawarruq transactions to service the liquidity management needs of many major Islamic banks. A little-known fact relates to perhaps the most well-known broker/player in the Tawarruq market.

The clearing system used by this major broker is such that it is logistically impossible to transfer ownership following Sale-1 prior to executing Sale-2 (that is, the broker’s system physically does not

allow it). This clearly renders all intended Tawarruq transactions carried out by this major broker as fundamentally invalid, even within the highly generous and flexible space being afforded to Tawarruq in the current financial framework.

It follows, therefore, that if a leading player is doing this, it should be of little surprise if the smaller players are also unable and unwilling to make sure that Tawarruq is followed even vis-à-vis Sale-1. Indeed, AAOIFI’s Shariah Standard 30 would seem to be a distant mirage that carries little attraction of pursuing it.

The current financial, regulatory and legal infrastructure for Islamic financial institutions is more or less largely voluntary, such that very few penalties apply to institutions that do not follow the AAOIFI Standards, or any other set of Shariah-related rules or standards.

Until a regulatory system is meaningfully enforced where penalties of non-compliance actually hurt, it is rather futile to expect IIFSs to change any of their past patterns of behavior. Such enforcement, again, is largely dependent on both political will and vision. In the present set-up, these are rare commodities in the industry. ☹

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