

Tawarruq in Islamic Finance

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Tawarruq means converting an asset into ‘*wareq*’ or money. It is a financial product structured to satisfy customer cash needs in accordance with Sharia’h. In this structure, the bank purchases certain goods on spot basis from local or international markets and sells them to the customer on credit on a cost plus basis. The customer in turn sells the goods to a third party for cash. Therefore, the customer has in effect turned an asset into cash using a bank as an intermediary and the bank has usually made a profit. In some instances, the bank will also act as agent in selling the asset for the customer.

In other words, the bank purchases commodity from a Trader (Trader A) in the commodity market on a cash basis. The bank then sells the commodity to the customer at a deferred price (cost price plus profit margin) payable in a lump sum or installment basis. The customer may appoint the bank as his agent to sell the commodity to another Trader (Trader B) on cash basis in the commodity market; and the bank then sells the commodity as agent of the customer to Trader B on a cash basis in the commodity market.

According to Mohammad Netajullah Siddiqi, in *Tawarruq*, ‘The client – the *mutawwarriq* – buys X on deferred payment from the International Financial Institution (IFI) and sells X for a cash amount less than the deferred price to a third party. Also *tawarruq* enables the IFI to guarantee a pre-determined percentage rate of return to its term-depositor, buying XX from him/her on deferred payment then selling XX for cash, the deferred payment being larger than the cash price.’ And therefore allowing the bank to make a profit. (Mohammad Netajullah Siddiqi, *The Economics Of Tawarruq*, 2007)

According to <http://finance.practicallaw.com/5-367-4016>, Tawarruq is “a method where the financial institution either directly or indirectly will buy an asset and immediately sell it to a customer on a deferred payment basis. The customer then sells the same asset to a third party for immediate delivery and payment, the end result being that the customer receives a cash amount and has a deferred payment obligation for the marked-up price to the financial institution. The asset is typically a freely tradable commodity such as platinum or copper. Gold and silver are treated by *Sharia’h* as currency and cannot be used.”

According to Salah Al-Shahoob, “the bank specifies the market, which is the international market, and the type of commodity which is, normally, a metal. Then, the bank indicates the contract which is offered to the client, which is a mark-up sales (*bay’ al-murabaha*). This means that they indicate the cost of commodities to the client and the amount of profit and the price must be paid within a certain period of time. This transaction might be under the concept of deferred sales (*al-bay’ al-mu’ajjal*) if the payment is a single transaction or installment sales (*bay’ al-taqsit*) if the payment is by more than one installment. The role of the institution may not end after selling the product to the client but the bank can also offer to the client their services as an agent to sell the commodity on his behalf and receive the price, which is credited to the client’s account.

Al-Mushaiqih defines the organized *tawarruq* as a contract where the financial institution arranges to sell a commodity to a client by deferred payment then becomes an agent on behalf of the client to sell the commodity to a third party whereupon the institution pays the price to the client. Then, al-Mushaiqih elaborates on the procedure. He says that the institutions buy commodities, normally minerals, specifically zinc, bronze, nickel, tin and copper, every week. They choose these minerals because they are common in daily exchange in the international market. In the contract, clients apply to buy a specific mineral which they specify and the contract is based on installment sales. The commodities are normally in another country, such as Bahrain. Then, the institutions sell the minerals in many units according to the wishes of the clients. After the client buys a unit, he empowers the institution to receive and sell his commodity in the international market and credits the price of it to his account. The clients have the power to change the price, so they might sell their commodities for the same price or a different one. The clients also have the right to receive their commodities in the place where they are normally delivered. In addition, Al-Mushaiqih also indicates that the financial institutions engage in an agreement with some brokers to obtain the metals.”

Al-Shaloob concludes that “organised *tawarruq* is a sales contract, the purpose of which is to finance people in accordance with Islamic law.” He says that, “The process begins in the international or local market where the financial institutions buy commodities for immediate payment and obtains a certificate which proves their ownership of the commodity. The financial institutions then offer the commodities to their clients and the clients buy the commodities as an installment sale. The financial institutions also often indicate the original price (*al-thaman*) which has been paid. The clients then enter into another agreement to empower the financial institutions or a third party to sell the commodities in the market,

although they normally avoid selling the commodities to the traders who originally sold them to the financial institutions. However, in some cases the financial institutions and clients enter into the contract before the financial institutions obtain the commodities. At the end, the financial institution credits the price to the account of the client.”

According to Mohammaad Netajullah Siddiqi, “the harmful effects (*mafasid*) of *Tawarruq* include:

- It leads to creation of debt the volume of which is likely to keep increasing.
- It results in exchange of money now with more money in the future, which is unfair in view of the risk and uncertainty involved.
- Through debt proliferation, it leads to gambling like speculation.
- Through debt finance, it leads to greater instability in the economy.
- In a debt-based economy, as the money supply is linked to debt, there will be a tendency towards inflationary expansion.
- It results in inequity in the distribution of income and wealth.
- Through debt finance, it results in the inefficient allocation of resources.
- By consolidating debt financing, it leads to the raising of anxiety levels and destruction of the environment.”

(Mohammaad Netajullay Siddiqi – Economics of *Tawarruq*)

According to Saleh – Shaloob, “*Tawarruq* is not accepted by the *Maliki* School, however, is more accepted with the *Hanbali*, *Hanafi*, and *Shafi* Schools. According to Islamic Finance WIKI, the 5th decision of the Muslim World League on *Tawarruq* considered it permissible as the technique is derived on two sales contracts with the ultimate buyer being not the same as the initial seller. However, the OIC Fiqh Academy Ruled Organized *Tawarruq* Impermissible in 2009. Other Scholars believe that permission should be granted on a case-by-case basis.”

Saleh Al-Shaloob states that “The Islamic *Fiqh* Academy, which belongs to the Islamic World League, has issued two separate and different resolutions on the contract of *tawarruq* in the traditional form and the contract of organized *tawarruq*. According to the Islamic *fiqh* academy, the traditional form of *tawarruq* is permissible (In the Circle 15th, Makka,1998) whereas the new form of *tawarruq*, which is called banking *tawarruq* (*al-tawarruq al-masrafi*) or organised *tawarruq* (*al-tawarruq al-munazam*) is prohibited (In the Circle 19th, Makka, 2003).

According to proponents of this view, there are three differences between the two forms;

The first difference is that the role of agency which is played by the financial institutions changes the nature of the contract, bringing it close to the form of *inasales*, which is prohibited in Islamic law according to the majority scholars, whether the agency of the financial institution is indicated as a condition of the contract or is very common in this type of contract.

Secondly, this kind of contract, in many cases, does not reflect the concept of possession in Islamic law.

Thirdly, the reality of this type of contract is to finance the client (*al-mustawriq*) who applies for some money and to charge him extra;

The financial institute arranges the procedure of the contract by obtaining the commodity and selling it in the market on behalf of the client in order to achieve this purpose. However, that is not the real form of *tawarruq* which has been indicated in the traditional *fiqh* and previously premised by the Islamic *fiqh* academy. The traditional form of *tawarruq* is a contract in which the seller sells a commodity, which is normally under his ownership and belongs to his business, to the buyer for deferred payment and the seller delivers the commodity to the buyer to be under his full possession and responsibility. Then, after the

commodity is received by the buyer, he sells it to a third party who is not the seller for immediate payment.” (Salah Al- Shahoob)

“Conditions of Organized Tawarruq

1- Ownership of the commodities.

The seller must own the commodity before selling it to the buyer.

2- Commodity is specified.

The seller has to explain the details of the commodity to the buyer.

3- Possession of commodities.

The commodities which are normally used in the contract of organised *tawarruq* can be transferred from place to place and this kind of commodity is called a transferable commodity (*manqulat*). Examples include metals, cement, rice and cars.

4-Avoiding ‘*ina* sales.

As has been mentioned, the majority of jurists consider that ‘*ina* sales are prohibited according to Islamic law. Therefore, financial institutions avoid buying the commodities again from the client because they have already sold them to the client by installment payments for more than what they normally pay to acquire the commodities. Consequently, if they were to buy the commodities from the clients for less than what the client had paid, the contract would be an ‘*ina* sale.

5- Details of the time of payments.

The contract between the financial institution as the seller and the client as the buyer is based on the contract of installment sales or deferred sales in general and one of the conditions of the both contracts is that it must explain in detail the manner of payment.

6- Avoiding usury.

The contracting parties have to be careful not to deal with commodities, which it is not permissible to exchange for deferment, otherwise, they would be involved in the usury by way of deferment (*riba al-nasi'a*).

7- Delivery is immediate.

As indicated previously, the contract of organized *tawarruq* is based on deferred or installment payment so if the delivery is deferred, the contract would then be a sale of debt –for- debt and this kind of sale is prohibited in Islamic law. “(Salah Al-Shaloob)

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