Organised Tawarruq in Practice: A Shari’ah Non-Compliant and Unjustified Transaction

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Background
Organised tawarruq has been heavily used by institutions offering Islamic financial services (IIFSs) in substantial volumes for many years, largely for the purposes of liquidity management (often referred to as ‘commodity murabaha’) and the provision of cash-in-hand, i.e. ‘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 is left with a cash lump sum on one hand and a corresponding higher debt obligation on the other. The overall transaction will be arranged or ‘organised’ by an IIFS.

The OIC’s (Organisation of Islamic Conference) International Council of Fiqh Academy (ICFA) in Makkah ruled in April 2009 that organised tawarruq and reverse tawarruq were not permissible, since they were a ‘trick’ to get cash now for more cash paid later. 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. Among the various critics who have questioned the validity of the ICFA pronouncement, some have made the specific point that, inter alia, the judgement goes against the AAOIFI’s ruling on the permissibility of tawarruq, as laid out under AAOIFI Shari’ah Standard 30.

Tawarruq – ICFA’s Position

The ICFA’s Resolution 179 on organised tawarruq states:

‘It is not permissible to execute both organised and reverse tawarruq, because simultaneous transactions occur between the financier and the mustawriq (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 financial 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 IIFSs that purport to demonstrate the use of ‘brokers’ or ‘third parties’. This is ‘implicitly’ done via various ‘netting arrangements’.

To sum up, the ICFA prohibits tawarruq where any of the following occur: There are effectively only two parties, i.e. no real, unconnected third party There is concealed buy-back The transaction is a ‘trick’ with an embedded fixed return. Since the above three features typically characterise virtually all organised tawarruq transactions done by IIFSs, the ICFA holds that ‘organised’ tawarruq should be disallowed.

Tawarruq – AAOIFI’s Standard 30

What does AAOIFI Shari’ah Standard 30 say? The key clause in Shari’ah 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 a 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 organised 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. In summary, Articles 4/7 to 4/10 say the following:

- 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.
- Rather, the client should sell the commodity either himself or through his own agent. At the most, the bank should provide the client with the information needed to sell the commodity.

In reality, quite clearly, AAOIFI Shari’ah Standard 30 is therefore also implicitly saying that: ‘If your organised tawarruq cannot fulfil these stringent conditions, then you cannot do organised tawarruq.’

The key conditions laid out by AAOIFI Shari’ah Standard 30 are, therefore, that the transaction should not in essence be two party (ignoring the ‘cosmetic involvement’ of third parties); it should be real, i.e. 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 organised 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, it is correct to say that AAOIFI’s organised tawarruq is consistent with the ICFA’s implicit definition of unorganised tawarruq. The key lies in the separation of ‘how it is’ (therefore prohibited by ICFA) and ‘how it should be’ (if permitted by AAOIFI). Although everyone may not perceive it thus, in effect the ICFA has passed the recent resolution against organised tawarruq in light of the fact that the conditions for the permissibility of tawarruq (as laid out by AAOIFI) are virtually never followed.

Rather than there being a conflict, in reality the ICFA agrees with and reinforces AAOIFI Shari’ah Standard 30.

The joint stance of AAOIFI and the OIC Fiqh Academy is, ‘Do it properly, or don’t do it at 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

i) Customer A buys metal on deferred payment from Seller 1
ii) Customer A takes constructive/real possession of the metal

Sale-2

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

In fact, point (iv) in Sale-2 is what must happen, as a necessity, as implied by AAOIFI Shari’ah Standard 30, clause 4/5: 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.

So a key question relating to point (iv) is: Does the commodity bought by the customer in Sale 1 (on deferred payment) eventually definitely leave the warehouse of Seller 1, as Standard 30 clause 4/5 above clearly requires? The answer is, by and large, no. There are a number of 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.

Moreover, any necessity to physically move the ‘traded’ commodities in tawarruq from one location to another, as should be done, but is typically not done, would severely restrict the total volume and profitability of tawarruq transactions to the extent of eliminating the commercial feasibility of organised tawarruq altogether. As an added point, banks always organise the onward sale of the metal bought by the customer. This again is a violation of AAOIFI Shari’ah 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 at all’ is their combined implicit message to IIFSs.

‘Movement’ of the Commodity/Metal

Let us return to the question, ‘What does happen 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, they may be brokers, who have links with such trading companies and are also 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, whereby in reality metal either rarely or never really gets physically transferred from Seller 1 to Buyer 1, as it should. Typically, these parties possess a certain stock or quantity, e.g. ‘x’ tons of metal. Furthermore, these parties use and reuse this same stock many times during the same day in numerous consecutive sales. Almost exactly like the concept of fractional reserve banking in conventional banking, therefore these commodity stockers (for with regard to their tawarruq activities they are stockers more than traders) could hold one hundred tons of metal in their warehouse valued at $2.5 million and yet conduct tawarruq transactions amounting to any multiple of that, e.g. $25 or $50 million or even much more. 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 short holding period after which it is ‘released’ or ‘fused’. Thus, as an example, in a standard transaction: 10.00am, September 10, 2010: Seller-1 books four tons of aluminium for a deferred sale at $2,500 per ton to a customer for a $10,000 sale 10.30am, September 10, 2010: The customer takes constructive possession but never sees the metal and may simply receive a certificate, usually indicating his consignment is placed in some named warehouse. At this point, Seller-1 ‘holds’ the four tons for the customer 11.00am, September 10, 2010: The customer sells same aluminium to Buyer-1, for a spot price of $8,000; subsequently, according to the netting facility, four 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 should make it clear that AAOIFI Shari’ah Standard 30 is not being followed, since a prior agreement or collusion agrees 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 or rather, the ownership of the metal returns back; the metal itself, in actuality, never really moves. Incidentally, despite there being collusion between the Seller-1 and Buyer-1, which in effect contravenes Clause 4/5 of Standard 30, the example given is actually a good scenario case in which, 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 finalised.

In practice, however, it is doubtful whether such demarcation of the subject commodity occurs for each and every transaction, as it needs to do. Available evidence suggests that what typically happens is a daily or other 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. Daily net positions dictate the overall stock balances, i.e. how much is encumbered and how much is free to be used for new tawarruq transactions. The simple fact is that, in the absence of physical movement of the metal, it follows that tawarruq ‘traders’ would necessarily have to operate such a netting arrangement. It is one or the other; no third avenue is possible.

**Tawarruq: Quashing the ‘Justification’ Arguments**

The defenders of organised tawarruq have put forward various arguments to justify why tawarruq should be allowed.

**Claim 1:** Tawarruq traders often buy and sell metal with physical movement of the metal and hence that tawarruq is conducted by genuine traders.

**Reply:** Although some movement of metal may happen, let us be clear about the circumstances in which it happens. The likelihood is that there are most probably only two scenarios in which the commodity moves: a) Some traders apart from their tawarruq activities may conceivably also be genuine traders of the metal. The key point here, however, 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, their tawarruq transaction volume rises or falls, which may prompt them to buy or sell more metal from the market for the purposes of equalising the amount of metal stocked with the expected multiple of periodic tawarruq transactions. For example, if $1 million of stocks enables $20 million of transactions daily and daily ‘demand’ goes up to say $30 million, then proportionately the party would now stock $1.5 million worth 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; quite similar to the goldsmiths of the 17th century, who lent out the paper claims to gold against their gold stocks on which they received interest.

**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. Despite that, the fact is that typically: 1. A small stock of metal of a certain value will enable tawarruq sales of a large multiple of that value. 2. This will happen on a daily and repeated basis. 3. The metal does not move at all in relation to these tawarruq sales; this renders the metal virtually wholly irrelevant since it serves simply as a prop to ‘enable’ these monetisation deals to be transacted. For example, if a metal stock worth $1 million is used to perform tawarruq sales worth $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 it be realistically claimed that these are genuine ‘trade’ deals? This concern is even more valid given that they are in direct contravention of Shari’ah AAOIFI Standard 30 as well as the ICFA’s fatwa.

**Claim 3:** It is said that tawarruq is questionable because the metal is ‘unwanted’, ‘irrelevant’ or a ‘fake prop’. How is that so? After all, in real trade sellers buy their merchandise not because they want it per se, but because they want to sell it on and earn profit, so therefore, isn’t the merchandise also ‘irrelevant’, ‘unwanted’ and a ‘fake prop’ in real trade?

**Reply:** It is true that traders do not want their merchandise per se; they aim to sell it on. The crucial difference is that, in genuine trade, there will always be an ultimate genuine user of the sold commodity. In contrast, in tawarruq, two spurious sales (with no movement of metal) are always followed by an accounting netting-off that is done only in the books of the brokers. There is no ultimate user, and absolutely no one will ever want that metal for genuine end use.
Claim 4: The bank does a favour to the client by arranging the second sale, giving the client the best price possible, i.e. the market price. The customer thereby avoids potential loss.

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, i.e. buying and selling with the hope of making a profit, an activity that will always involve risk 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 could be higher than the liability of the deferred price of Sale-1. Moreover, banks can hardly be credited with organising tawarruq because they want to help their clients ‘avoid extra loss’ by helping them secure a ‘good price for their metal’ in Sale-2. In reality IIFIs favour organised tawarruq because: \(\square\) The transactions are virtually ‘riskless’ with ‘secured returns’; \(\square\) Transaction costs are very low; \(\square\) IIF斯s are able to carry out a huge volume of transactions specifically because this tawarruq is organised and they therefore enjoy huge profitability in such deals. It is no coincidence that all of the above three features are also the key characteristics of the regular conventional products of an interest-bearing loan. This, then, is also an additional source of unease for those not in favour of organised tawarruq.

Claim 5: Organised tawarruq transactions are sound, with proper constructive possession and transfer of ownership at the right time.

Reply: Another sobering point is well worth mentioning here. The clearing system used for organised tawarruq by major brokers in the metal trade is such that it is logistically impossible to transfer ownership following Sale-1 prior to executing Sale-2, i.e. the brokers’ system physically does not allow it. This clearly renders all their intended tawarruq transactions as fundamentally invalid, even within the highly generous and flexible space being afforded to tawarruq in the current financial framework of constructive possession, use of agency, etc. Moreover, if major players are doing this, quite naturally the smaller players are also incapable and unwilling to make sure that tawarruq is followed even vis-à-vis Sale-1. AAOIFI’s Shari’ah Standard 30 is but a distant mirage and there is little attraction to pursuing it, given that institutions ignoring the AAOIFI standards or any others do not face any effective penalties. Until a regulatory system is meaningfully enforced where penalties for non-compliance are real and they hurt, it is rather futile to expect IIF斯s to change any of their past patterns of behaviour. Such enforcement, again, is largely dependent on both political will and vision. In the present set-up, these are rare commodities in the industry.

Claim 6: If the metal price rises after the customer buys the metal from us, he is free to benefit by selling it in the market to get a higher price.

Reply: Effectively, this is merely a theoretical possibility, which never happens in practice. Tawarruq brokers and banks are hardly likely to provide a ‘sell in the market by yourself’ option to the customer, since, if it were really a genuine option, this would eliminate their own profit from the transaction. All parties are well aware that the customer has neither the contacts nor the ability to effect Sale-2, so this is a redundant option, which is ‘cosmetically’ offered to ‘boost’ the justification for tawarruq. It’s like offering to buy lunch for your guest (which you cannot afford to buy) in the full knowledge that he is unable to accept the offer due to other factors – and then proclaiming how ‘generous’ you are for making the offer.

Claim 7: The ICFA’s viewpoint on tawarruq on an individual level 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 that, where the bank organises 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 Shari’ah permissibility, if the deal, especially the second sale, is organised by the IIF斯s, since the metal by design is not 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 such that real delivery occurs. Unassisted tawarruq, therefore, 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 for cash, with the hope of making more money from his sales to earn a profit.
Agreeing Why Organised Tawarruq Must Go

Organised tawarruq as it is currently practised in the Islamic finance industry is clearly not in compliance with basic Shari’ah principles. The metal is explicitly nothing more than a prop, which virtually never moves due to the netting-off process. No genuine trade really occurs; only stocking of metal takes place, similar to retaining collateral against an interest-based loan thus reducing the transaction to little than money now for more money later. In addition, the involvement of the IIFs in organising the second sale is a key component in the process, which helps to undermine the genuineness of the overall transaction as highlighted by the ICFA and AAOIFI. For all these reasons, the ICFA (directly) and AAOIFI (indirectly) have disallowed it. Moreover, these very concerns held by ICFA and AAOIFI are also shared by a large number of industry practitioners, Islamic economists and other stakeholders.

Phased Withdrawal from Organised Tawarruq

Let us not forget the realities. First of all, a significant majority of Islamic banks conduct a large volume of tawarruq transactions on a regular basis in relation to their treasury operations. This, in the opinion of their Shari’ah boards, is permitted on the basis of need or ‘daroraa’, since the view is that there is no other option available. Even if a decision were made to follow the opinion of the ICFA and AAOIFI, in practice it is doubtful that IIFs would be in a position to cease their existing tawarruq transactions immediately. Even under a best-case scenario tawarruq would most probably need to be phased out. If Islamic banks, however, decide to bring 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 factors which suppress the incentive for IIFs to eliminate tawarruq (and in fact all questionable products) since it is so profitable.

Alternatives for Liquidity Management

Since tawarruq is heavily used by most Islamic financial institutions for liquidity management purposes, an alternative workable solution must be available in the event that tawarruq is phased out. The best solution is to return to the ‘honesty’ of a 100% cash reserve ratio and shift the focus to genuine investment-based and profit/loss-sharing products, which rule out the need for the fractional banking system that is based on liquidity management. Such a move, however, represents a paradigm shift that challenges the very basis of the existing banking structure and would require strong political will to institute. It would, moreover, be most likely to happen in conjunction with an overall philosophical review and revision of the basis and practice of the Islamic commercial industry. While there appears to be an 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, steps to assist liquidity management include improving financial markets’ infrastructure to enhance the tradability of sukuk, and using mudaraba, musharaka and wakala-based, inter-bank deposits.

Alternatives for ‘Cash-in-Hand’ Consumer Liquidity Needs

If tawarruq is to be made redundant, there would be a heightened need to provide genuine Shari’ah-based product solutions that offer neutral liquidity, i.e. ‘cash-in-hand’ to the client. For such needs, the product of salam (a sale with full payment upfront at T0 and delivery deferred to T1) is one genuine alternative product that was specifically sanctioned by the Prophet (SAWS) precisely for meeting the liquidity needs of agricultural producers. Salam can comfortably be utilised beyond the agricultural sector, although it remains grossly underused and disliked by banks because of the perceived ‘price risk’ associated with this product. The reluctance to use salam, however, persists despite the existence of various risk-mitigating tools such as the use of parallel salam, and obtaining a foreign exchange, promise-based currency hedge, where goods are paid for in foreign currency, etc. Salam, moreover, needs to be used with care and in conjunction with in-built checks and controls to prevent banks from obtaining extortionately low prices from indebted and under-duress customers. Another alternative is mudaraba and musharaka mini-investment projects, which may be specific or general in scope, where liquid funds are advanced to the customers. There are various methods for reducing the usual moral hazard in such transactions, but to elaborate on these would be beyond the scope of this article.
Frank and Meaningful Acknowledgement

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.

Conclusions

This article has sought to demonstrate that despite the perceived conflict between AAOIFI’s Shari’ah Standard 30, which permits tawarruq and the ICFA’s ruling forbidding organised tawarruq that, in actual fact, there is no real disagreement between the views held by these two organisations.

The key point to note is that AAOIFI permits a reformed version of tawarruq, which is not practised virtually anywhere in the industry at the moment. As a necessary accompaniment, AAOIFI by implication clearly forbids the existing form of tawarruq, as does the ICFA. In effect the ICFA says ‘the prevalent form of tawarruq is not permissible, to which AAOIFI implicitly nods and adds ‘if you must do tawarruq, Shari’ah Standard 30 will show you how.’ By further implication, both ICFA and AAOIFI add the comment: ‘...although it is 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, which is fine.’ Both institutions, therefore, are quite comfortable with eradication of organised tawarruq as it exists presently, a sentiment shared by many other stakeholders in Islamic commerce.