

## ***Tawarruq, as a Product for Liquidity Risk Management, its Concept and Practical Approach***

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### ***Abstract:***

*The missions of Islamic shariah finance are to provide financial instruments and transactions for Muslim not to commit with usury, interest payment and gambling in their business life .the source of knowledge is taken from Quran, Sunnah, Ijma and Qiyas, and the main structure of the market is based on sharing the cost and benefit for simplicity, shariah means Islamic law, and Islamic finance is known as shariah compliant finance. Thereby Islamic banking and finance is secured by shariah and its interpretation.*

*The development of Islamic banking system in offering the products which is based on the shariah principles. There are many new products being introduced as alternatives to conventional ones. Other side the issue of liquidity risk management is very sensitive in the banking system to satisfy the need of asset and liability .since Islamic bank is free interest-based system which cannot use conventional product as their liquidity risk management. Thereby Islamic bank introduced Tawarruq as a solution for liquidity risk management. The main object of this paper is to introduce the real Tawarruq concept for Islamic bank to manage its liquidity.*

***Key words:*** *Tawarruq, Islamic finance, scholars view, liquidity risk management*

### ***Introduction:***

If we look to the conventional financial system, it's built upon the debtor-creditor relationship and there are normally two side.

Bank.

Borrower.

According modern commercial financial system usury (interest) is considered as a gain from the credit which is the profit for the bank.in addition, interest is taken into account as a price of credit which has got impact over the opportunity cost of money. However it is not allowed to make business based on interest earning in Islamic finance. The main distinguish point is that Islamic Finance is structured on Islamic Shariah and all financial

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transactions,dealings,businesses,investment portfolio and financial products are designed according to Islamic law that's opposite to most sectors procedures of conventional financial system.(Lewis and algaud,2001).

Islamic Finance is based on some modes of Finance, for example; Murabaha, Ijara, Mudharba, Musharka, Tawarruq, etc. These modes of Finance are used for different purposes. Tawarruq is used as alternate of qard (loan), because Islamic banks do not provide profit based loan. Instead of loan they use Tawarruq for liquidity.in this paper we analysis of Tawarruq ,its definition,forms,modals,application,scholars view and especially how to use Tawarruq for liquidity risk management.

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

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

### **Dictionary definition of Tawarruq;**

Tawarruq (التورق)is mentioned as an infinitive(مصدر)of the verb tawarraqa(تورَّق)<sup>i</sup>

Tawarruq mean;اورق الرجل،ای صار ذاورق;

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

"(ii)سعى المرء بكلفته ومشقة فى الحصول على النقد"

### **Idiomatic meaning of Tawarruq;**

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

### **Forms of Tawarruq;**

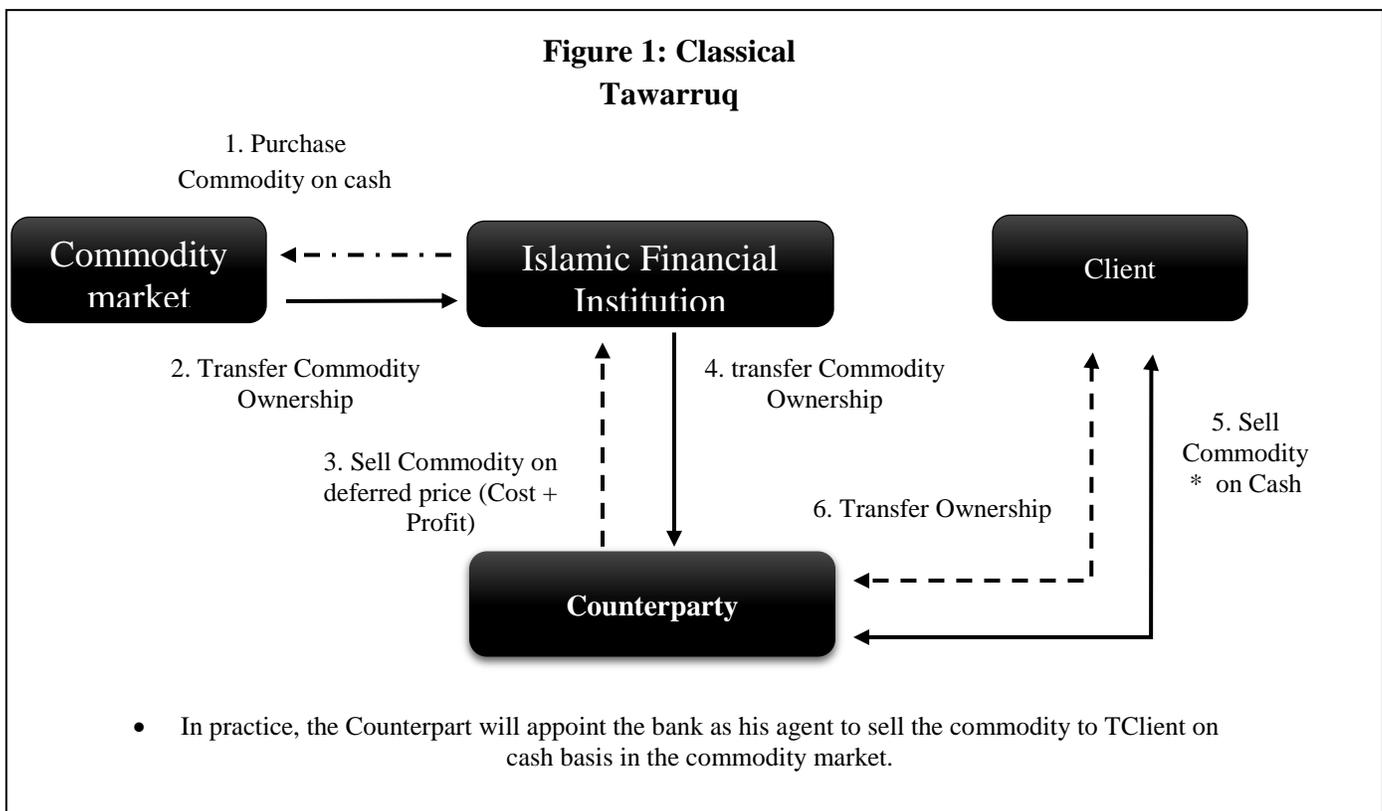
The kinds of Tawarruq are two. Those are classical Tawarruq (Al-Tawarruq al-Fardi) and organized Tawarruq (Al-Tawarruq al-Munazzam).

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

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

**Modus Operandi of Tawarruq:**<sup>v</sup>

Modus operandi of classical Tawarruq is shown as following picture;



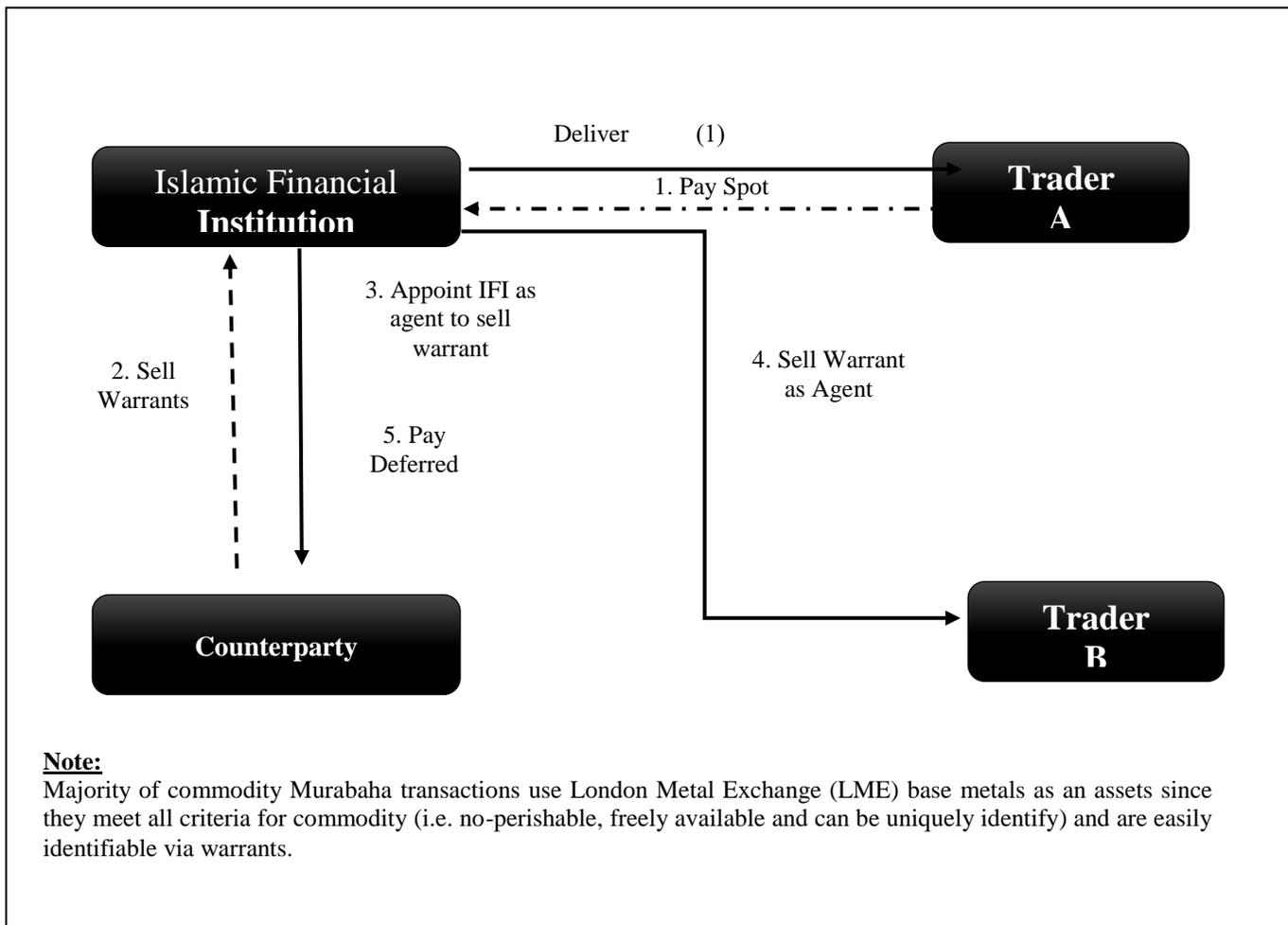
According to Fahmy et.all (2008), <sup>(vi)</sup> the modus operandi of classical Tawarruq is;

1. The Islamic Financial Institution(IFI) purchases commodity from Commodity Market on cash basis;
2. Ownership of the identified commodity will then be transferred to IFI;

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

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

**Figure 2: Organized Tawarruq**



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

The description of organized Tawarruq is as following steps;

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

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

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

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

#### **Scholar's view:**

There are two views about Tawarruq;

**First:** view is that Tawarruq is permitted.

**Second:** view is that Tawarruq is prohibited.

#### **Reasons of the scholars that permitted Tawarruq;**

**Firstly:** Allahtaala said in the Holy Quran (احل الله البيع وحرم الربوا) <sup>vii</sup>

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

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

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

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

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

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

**Thirdly:** A llamashatbi said in Al-muafqat that it is enough for legality that is not founded a reason which is against to legality, because it is general rule of jurists that found legality in all contracts unless not found sharia issue in any contract. Tawarruq like this that have not any sharia issue... (xi)

### **The scholars that do not permit Tawarruq;**

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

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

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

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

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

IbneTaymiyyah prohibited Tawarruq and said that Tawarruq is worse than riba, because Tawarruq entails a higher cost and losses. therefore the shariah does not forbid a lower haram (riba) and allows a higher haram (Tawarruq).<sup>(xiv)</sup>

**Thirdly:** Tawarruq is a type of Bai-Al- Mud tar which is prohibited by prophet (PBUH).<sup>(xv)</sup> Because compelled person does buy back to get cash and this meaning also founded in Tawarruq.

#### **Answers of the Afore mentioned objections:**

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

#### **Answer of the second objection:**

To say that Tawarruq is the basis of riba is not correct, because definition of riba or forms of riba are not founded in Tawarruq concept. And also not explained in the mentioned objection. because the definition of Riba is that (فضل مال لا يقابلُه عوض في معاوضة مال بمال)<sup>(xvii)</sup>

#### **Answer of the third objection:**

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

#### **Tawarruq in deposit product:**

Deposit means a sum of money received or paid on terms under which it will be repaid with or without interest or at a premium or discount or under which it is repayable, either wholly or in part, with any consideration in money or money's worth.<sup>xviii</sup>

The same deposit concept is applied by Islamic banks except for the involvement of prohibited elements, such as interest. The customer who deposits the money in the bank is called a depositor.

Normally the Tawarruq concept is used for investment accounts, since the purpose of Tawarruq is for cash liquidity, and then the cash that is obtained from the commodity transaction will be deposited into an investment account.<sup>xix</sup>

**Tawarruq for liquidity risk management:**

Liquidity risk management is play important role in the banking sector. Since the bank play with others people money, managing the liquidity to satisfy the demand of asset and liability is the key of survive of the bank and ensure that the bank always has liquidity to pay the depositors money. Otherwise, the depositors will rush to the bank to take their money back namely bank run. If let say one bank collapse it will lead other banks will collapse (system risk) as happened in Asian crisis 1997-1998. therefore, the role of treasury department in the banking like heart. If they cannot manage in appropriate way, automatically the bank will collapse.

The concept of Tawarruq is basically to propose Islamic bank to use this

'aqd' in managing their liquidity.<sup>xx</sup>

**Tawarruq for interbank money market:**

Modus Operandi of Tawarruq for interbank money market is shown as following figure:

**Figure 1: Tawarruq concept for liquidity management interbank money market:**

1. the surplus Islamic Financial institution purchases commodity from the market on the price that the deficit bank wants to borrow, letsay, deficit bank wants to borrow 1 million Rupees, so the surplus bank purchase an asset such land equal to 1 million Rupees on cash basis.
2. Ownership of the identified commodity will then be transferred to IFI.
3. Thereafter, the surplus bank sells the commodity to the deficit bank at cost price plus profit margin on deferred price.
4. The ownership of commodity will transfer to the deficit bank and it will be paid let say after 6 month or 1 year.
5. The deficit bank will sell the commodity to the market at the market price.

Finally, from the last transaction deficit bank will get cash money and can use it for satisfying the needs of depositors etc.

In addition, the most important point in this structure is there is no relationship between the surplus bank and the market which will lead in to fictitious contract and will place "hila" that organizing riba with the name of Islamic name of contract. Another point in this structure is that whereby the two banks are involved in the real economic whereas transfer of commodity plus its ownership to real buyer and seller which will create well economic growth in the economic system.

**Conclusion and recommendation:**

Tawarruq based financing can be deemed as a truly sharia compliant instrument that provide balancing between sharia and economic requirement.

Although *Tawarruq* is not considered as a primary mode of Islamic financing, in the current situation in financial and banking system, where

Conventional lending is strongly dominant; *Tawarruq* brings a great benefit and is of public interest. Its capability and function of aiding the fund in the current economic system meets the objective of *Shari'ah* while waiting for a proper Islamic financing.

### Recommendations

The recommendations are as follows:

1. The authorized body should i.e. State Bank explicitly resolve the debatable issue of organized elements in the *Tawarruq* mechanism to make clear what is permissible and what is prohibited. This will solve the application issue of organized *Tawarruq* in the local financial system, which has struck the industry in the last couple of years.
2. State Bank should develop and issue a Shariah standard for the *Tawarruq* concept as guidance for the local Islamic banks.
3. State bank should establish an addendum guideline to the existing guideline of credit risk management to cater for *Shari'ah* consideration in Islamic financing.
4. The local Islamic banks should conduct systematic training to improve the Knowledge competency among the bank staff.
5. Although, *Tawarruq* is not core mode of finance, but is enough for fulfill the needs of customer or institutions.

If we do not use this mode of finance then the customer will go to conventional banks and will fulfill their needs via interest.

So that we should adopt *Tawarruq* as a mod of finance and avoid their weakness and should try to make it better according to sharia rules.

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