

**TAWARRUQ IN MALAYSIAN FINANCING SYSTEM:
A CASE STUDY ON COMMODITY MURABAHAH
PRODUCT AT MAYBANK ISLAMIC
BERHAD**

NASRUN BIN MOHAMAD @ GHAZALI

**DEPARTMENT OF SHARIAH AND ECONOMICS
ACADEMY OF ISLAMIC STUDIES
UNIVERSITY OF MALAYA
KUALA LUMPUR**

2014

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ON COMMODITY MURABAHAH PRODUCT AT MAYBANK ISLAMIC
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ABSTRAK

Tawarruq merupakan antara konsep *Sharī'ah* yang digunakan dalam sistem perbankan Islam untuk menyalurkan kecairan tunai. Konsep ini menjadi semakin popular di Malaysia sebagai alternatif kepada *bay' al-'īnah*. Walaubagaimanapun, konsep ini yang telah diubahsuai lalu dikenali sebagai *Tawarruq Munazzam* dan diaplikasikan ke dalam industri perbankan Islam, telah menjadi perdebatan di mana penggunaannya telah dilarang oleh *Majma' al-Fiqh al-Islāmī al-Duwalī* disebabkan wujudnya elemen yang meragukan. Selanjutnya, applikasi *tawarruq* dalam kewangan Islam ini berpotensi menghadapi risiko tidak patuh *Sharī'ah*. Oleh yang demikian, kajian ini bertujuan untuk menganalisa dan menilai aplikasi *tawarruq* dalam sistem pembiayaan di Malaysia menurut perspektif *Sharī'ah*. Untuk tujuan ini, kajian kualitatif telah dijalankan dengan menganalisa bahan-bahan fiqh dan perbankan termasuklah dokumentasi pengawalselia tempatan. Pengsampelan terhadap implementasi pembiayaan berasaskan *tawarruq* telah dijalankan di Maybank Islamic Berhad (MIB) ke atas produk Commodity Murabahah Term Financing-i (CMTF-i). Sesi temubual dengan pegawai-pegawai MIB dan penaksiran terhadap dokumentasi telah dijalankan untuk mengumpul maklumat. Kesimpulan yang dapat dibuat dari kajian ini ialah, pertama, inisiatif terhadap larangan ke atas *tawarruq munazzam* ialah wujudnya elemen yang meragukan di mana pengendalian rapi diperlukan bagi pemprosesan pembiayaan berasaskan *tawarruq* untuk mengelakkan sebarang risiko tidak patuh *Sharī'ah*. Kedua, potensi risiko wujud dalam beberapa peringkat pemprosesan pembiayaan berasaskan *tawarruq* di mana risiko ini boleh membawa implikasi terhadap aspek kewangan dan bukan kewangan. Ketiga, pemakaian *tawarruq* dalam sistem pembiayaan tempatan adalah selari dengan objektif *Sharī'ah* di atas dasar keperluan. Penulis mencadangkan supaya

pihak berautoriti menyelesaikan beberapa permasalahan seperti elemen *munazzam* dalam *tawarruq*, serta *qalb al-dayn* dalam penjadualan dan penstrukturan semula pembiayaan. Beberapa garis panduan teknikal harus dikeluarkan untuk menggariskan keperluan penting dalam pembiayaan berasaskan *tawarruq*. Bank-bank Islam pula perlu menambahbaik aspek pentadbiran dan pengawalan, di samping membudayakan kesedaran terhadap dasar patuh *Sharī'ah* dan meningkatkan kompetensi pengetahuan di kalangan pekerja-pekerja mereka. Dengan menjalankan peranan dan tanggungjawab masing-masing, pihak pengawal selia dan pihak bank dapat mengukuhkan asas perbankan Islam di masa hadapan.

ABSTRACT

Tawarruq is one of the *Sharī'ah* modes used in the Islamic banking system to aid cash liquidity. This concept has recently become popular in Malaysia as an alternative to *bay' al-īnah*. However, the evolved *tawarruq* concept or so-called Organized *Tawarruq* has become a debatable issue inasmuch as such a concept has been ruled as prohibited by *Majma' al-Fiqh al-Islāmī al-Duwalī* due to the fictitious elements. Hence, the application of *tawarruq* in Islamic financing potentially leads to a risk of *Sharī'ah* non-compliance. Based on those issues, this study intends to analyse and evaluate the application of *tawarruq* in the Malaysian financing system from the *Sharī'ah* perspective. To achieve this objective, qualitative research on the subject matter is conducted by analysing related *fiqh* treatise and banking materials. In addition, the sampling on the implementation of *tawarruq*-based financing is conducted at Maybank Islamic Berhad (MIB) focusing on the non-retail product, i.e. Commodity Murabahah Term Financing-i (CMTF-i). An interview session with MIB's expert on the subject matter and assessment of the relevant documentation has been conducted to gather the information. The main findings of the study are, first, the essence of *Sharī'ah* concern in organized *tawarruq* is the fictitious elements in which cautious handling is required to mitigate the *Sharī'ah* non-compliance risk. Second, the potential risk of *Sharī'ah* non-compliance does exist in several stages of *tawarruq*-based financing in which the risk might impact on the financial and non-financial aspects of the Islamic bank. Third, the adoption of *tawarruq* in the local financing system is aligned with *maqāsid al-Sharī'ah* on the basis of necessity. In order to enhance the *Sharī'ah* aspect in the application of *tawarruq*, the author would like to suggest to BNM to resolve several issues, i.e. organized element in *tawarruq* and debt rollover in rescheduling and restructuring, while several technical

guidelines pertaining to *tawarruq*-based financing should be established to outline the essential requirement. In addition, the Islamic banks should strengthen their governance aspects, while inculcating the awareness of *Sharī'ah* compliance and improving the knowledge competency on *Sharī'ah*-related matters among their employees. By carrying out the respective roles and responsibilities, regulators and players might refine the local Islamic banking system into a well-founded platform in future.

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الفقير إلى عفو ربه

نصر بن محمد الغزالي

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ABBREVIATION

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BAFIA	Banking and Financial Institution Act 1989
BIMB	Bank Islam Malaysia Berhad
BMIS	Bursa Malaysia Islamic Services Sdn Bhd
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BSAS	Bursa Suq al-Sila'
CGC	Credit Guarantee Corporation
CMH	Commodity Murabahah House
CMTF-i	Commodity Murabahah Term Financing-i
CMP	Commodity Murabahah Programme
CPO	Crude Palm Oil
ECM	Exchange Control Act
FAST	Fully Automated System for Issuing/Tendering
FCMD-i	Foreign Currency Commodity Murabahah Deposit-i
FCMP-i	Foreign Currency Commodity Murabahah Placement-i
FI	Financial Institution
FRS	Financial Reporting Standard
FSMI2-i	Fund for Small and Medium Industries 2
IBA	Islamic Banking Act 1983
IBS	Islamic Banking Scheme
IFSB	Islamic Financial Services Board
IBFIM	Islamic Banking and Finance Institute Malaysia Sdn. Bhd.
IFI	Islamic Financial Institution
IIFM	International Islamic Financial Market
IIFS	Institutions (other than Insurance Institutions) offering only Islamic Financial Services
IIMM	Islamic Interbank Money Market
IIUM	International Islamic University Malaysia
ISRA	International Shari'ah Research Academy for Islamic Finance
INCEIF	International Centre for Education in Islamic Finance

KLIFF	Kuala Lumpur Islamic Finance Forum
LGD	Loss Given Default
LMC	Liquidity Management Centre
MASB	Malaysian Accounting Standards Board
MBB	Malayan Banking Berhad
MIB	Maybank Islamic Berhad
MIFC	Malaysia International Islamic Financial Centre
MPOA	Malaysian Palm Oil Association
MPOB	Malaysian Palm Oil Board
MPOC	Malaysian Palm Oil Council
NEF2-i	New Entrepreneurs Fund 2
NSAC	National Shariah Advisory Council
OIC	Organization of the Islamic Conference
PARS	Product Approval and Repository System
SAC	Shariah Advisory Council
SC	Securities Commission Malaysia
SESRTCIC	Statistical, Economic and Social Research and Training Centre for Islamic Countries
SGF	<i>Sharī‘ah</i> Governance Framework
SPTF	Skim Perbankan Tanpa Faedah
UKM	Universiti Kebangsaan Malaysia
UM	University of Malaya
ed.	editor
eds.	editors
<i>et al.</i>	<i>et alia</i> (and others)
<i>ibid</i>	<i>ibidem</i> (in the same place)
n.d.	no date
<i>op. cit.</i>	<i>opere citato</i> (in the work cited)
pg.	page
pl.	plural
r.a.	<i>raḍīya Allah ‘anh/‘anhuma</i> (may Allah be pleased with him/them)
r.h.	<i>rahimah Allah</i> (may Allah have mercy on him)
s.a.w.	<i>ṣallā Allah ‘alayh wa sallam</i> (may the peace and blessings of Allah be upon him)
vol.	volume

TRANSLITERATION

Arabic Font	Transliteration	Arabic Font	Transliteration
ا, ء	a, ‘ (Hamzah)	ط	ṭ
ب	b	ظ	ẓ
ت	t	ع	‘
ث	th	غ	gh
ج	j	ف	f
ح	ḥ	ق	q
خ	kh	ك	k
د	d	ل	l
ذ	dh	م	m
ر	r	ن	n
ز	z	ه	h
س	s	و	w
ش	sh	ي	y
ص	ṣ	ة	h
ض	ḍ		

Short Vowels		Long Vowels	
Arabic Symbol	Transliteration	Arabic Symbol	Transliteration
َ (fatḥah)	a	آ / ا	ā
ِ (kasrah)	i	ي	ī
ُ (ḍammah)	u	و	ū

Diphthong	
Arabic Symbol	Transliteration
أَـ	aw
إِـ	ay
أُوـ	uww
أِيـ	iy / i

CHAPTER 1: INTRODUCTION

1.1 Introduction

In the capitalist financial system, money is used to generate more money. Therefore, such words as loan, lending or credit are commonly used in conventional banking to refer to money lending activities. However, with the different basis or principles being used in Islamic banking due to the impermissibility of interest, the word financing is frequently used, which refers to the activity of supplying funds by the bank to customers with specific underlying concepts.

Loans are the core domain in conventional banking, which are recorded as assets on the balance sheet. Together with other assets, they are balanced by liabilities including deposits from depositors, and shareholder equity. The same treatment is applied for Islamic banking in which financing becomes the core domain and is recorded as an asset of the bank.

Neither Islamic banks nor structured Islamic finance policies existed during the time of Prophet Muhammad s.a.w. However, the practice of Islamic finance was applied as proven by the sentences revealed in al-Quran concerning the permissibility of

business and impermissibility of *ribā*,¹ and also debt handling.² This is also supported by al-Hadith and al-Āthār, such as the statement of ‘Umar r.a.³

لا يبيع في سوقنا إلا من قد تفقه في الدين

Let no one trade in our market except for those who has acquired knowledge in the Deen (religion/Shari‘ah/mu‘āmalah).

Over the past few decades, the dominance of the West has ruined the Islamic finance practices, and, indeed, the Islamic economy itself. With the conventional or interest-based system as a solid anchor to the world’s financial system, the greatest challenge is to reform the financial system and institutions so that it complies with the regulations and philosophy of *Shari‘ah*.

Considerable initiative has been taken by Muslim scholars to empower the *Shari‘ah* rulings in the financial system. From the early twenty-first century, Islamic finance has been gradually developed from a nascent industry to a global market. Subsequently, its credibility has been recognized by the establishment of the international standard-setting bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM) and Liquidity Management Centre (LMC).⁴

¹ Surah al-Baqarah (2:275). The sentence is: "وأحل الله البيع وحرم الربوا".

² Surah al-Baqarah (2:282). The sentence is: "يأبىها للذين ءامنوا إذا تداينتم بدين إلى أجل مسمى فاكتبوه... الآية".

³ Sunan al-Tirmizī, chapter al-Witr, hadith no. 487. He said it is *ḥasan gharīb*. Al-Ghazālī also narrated that ‘Umar r.a. went around the market and hit some traders with his stick and he said: " لا يبيع في سوقنا إلا من يفقه وإلا أكل الربا شاء أم أبى " *Ihya’ ‘Ulūm al-Dīn, Dār al-Ma‘rifah, Beirut, 1982, part 2, pg. 64.* However, the *isnād* status of this *qawl* is not commented on by al-‘Irāqī who brought out the status of the Hadith in *Ihyā’*.

⁴ See Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons, UK, 2007, pg. 15.

This great momentum spread to Malaysia in the early 80s. The achievement can be seen through the Islamic Banking Act, which was enacted with effect from 7 April 1983⁵ and the first Islamic bank, i.e. Bank Islam Malaysia Berhad (BIMB), which was established on 1 July 1983.⁶ This was then followed by the introduction of “Skim Perbankan Tanpa Faedah (SPTF)” by Bank Negara Malaysia (BNM) on 4 March 1993,⁷ which is a window-based platform for conventional banks. On 1 May 1997, BNM established the National Shariah Advisory Council (NSAC), as the highest *Sharī’ah* authority in Islamic banking and Takaful.⁸ Then a second Islamic bank, i.e. Bank Muamalat Malaysia Berhad (BMMB), commenced operation in October 1999.⁹

Nowadays, most of the conventional banks have formed their own Islamic banking unit as a new legal entity or subsidiary including the biggest local bank, i.e. Maybank Berhad, which has subsequently become the largest Islamic banking player in the Asia Pacific region.¹⁰ Therefore, these banks have adopted a dual banking operation with a single platform sharing between conventional and Islamic banking. In addition, licences have also been given to a few foreign Islamic banks to operate their branches in Malaysia, such as Kuwait Finance House, al-Rajhi Bank and Asian Finance Bank.

⁵ Islamic Banking Act 1983, (Act 276, 1983), downloaded from <http://www.bnm.gov.my/index.php?ch=14&pg=17&ac=16&full=1>, accessed on 13/05/11.

⁶ Bank Islam Malaysia Berhad, Milestones, <http://www.bankislam.com.my/en/Pages/Milestones.aspx?tabs=1>, accessed on 13/05/11

⁷ Lee Mei Pheng (2007), *Islamic Banking & Finance Law*, Pearson, Kuala Lumpur, pg. 10. The term “Skim Perbankan Tanpa Faedah” was changed to “Skim Perbankan Islam” on 12 November 1998.

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ See <http://www.maybank.com/maybank-subsiidiaries/commercial-and-islamic-banking/maybank-islamic-berhad>, accessed on 09/05/2011.

Many guidelines and circulars have been developed by BNM to govern all the established Islamic banks in Malaysia. These include *Sharī'ah* parameters, governance, resolution, financial reporting, capital adequacy and some others. Some of the frameworks that are applied to conventional banks are also applied to Islamic banks, such as the provision (FRS 139) and introduction of new products.¹¹ Under *Sharī'ah* resolution, one of the recent concepts that have been endorsed is *tawarruq*.

Tawarruq is the sale and purchase transactions within the trading contract that have been widely used in the Gulf region. It has recently become popular in the local Islamic banking industry for financing or cash liquidity purposes. It can be considered as an alternative instrument to *bay' al-'īnah*, which was adopted in Malaysia a few years back. Nowadays, some of the local banks have started to move from *'īnah* to *tawarruq*.

In essence, *tawarruq* is a hybrid concept that consists of a credit and cash sale, which is similar to the concept of *'īnah*. The credit sale normally contains a profit margin, which is commonly executed under the basis of the *murābahah* concept. *Murābahah* is a cost plus sale, which refers to the sale and purchase of goods at a price with the profit margin agreed by both the seller and the buyer. This concept is widely used by Islamic banks and is globally accepted for financing products. The common purpose for this principle is for asset acquisition.

¹¹ See BNM, Laws, Policies & Guidelines, <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 12/05/11

Meanwhile, *tawarruq* can be briefly defined as someone who buys a commodity with deferred payment, and sells it to someone other than the seller for cash, with a lower price in order to get cash.¹² In other words, buying on credit and selling at cash using a third party. This concept is similar to *‘inah* except for the existence of a third party in between. In current banking practice, the upfront appointment of the bank as an agent to deal with the third party (*wakālah*) is termed organized *tawarruq* or *tawarruq munazzam*.

In some respects, its *modus operandi* is similar to *‘inah* with the difference being the involvement of a third party. The *‘inah* transaction only involves the seller and the buyer, whereas *tawarruq* involves a third party as another seller or buyer. These similarities and differences impact on the definitions given by previous scholars. In today’s banking, *‘inah* transactions only involve the customer and the bank, in which the commodity will go back to the bank or the customer as the initial seller. In addition, for *tawarruq*, the commodity broker is a third party who the bank deals with for commodity selling and buying.

Currently, the *tawarruq* concept has been approved by BNM for use for deposit, financing and *ṣukūk* products.¹³ Recently, various products have been developed using the concept of *tawarruq* by local Islamic banks especially for retail business. For

¹² Wizārah al-Awqāf wa al-Shu’ūn al-Islāmiyyah, *al-Mawsū’ah al-Fiqhiyyah*, vol. 14, Kuwait: Wizārah al-Awqāf wa al-Shu’ūn al-Islāmiyyah, pg.147.

¹³ See Resolution of Shariah Advisory Council of Bank Negara Malaysia, downloaded from http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/07_shariah_resolution.pdf, accessed on 14/5/2011.

example, credit cards offered by BIMB¹⁴ and personal financing by BMMB.¹⁵ Nevertheless, this study focuses on financing-based products only.

Commodity Murabahah is one of the products offered by Maybank Islamic Berhad (MIB) under its non-retail financing portfolio.¹⁶ This product uses a specific commodity as an underlying asset in the sale and purchase. The main purpose of this product is for working capital financing or cash liquidity.¹⁷ This is a pioneering product of non-retail financing that uses the *tawarruq* concept in MIB and even in Malaysia.

Since Malaysia has adopted dual banking, the financing practice for Islamic banking is similar to conventional banking in which the basis of the platform is the conventional system. The offered facility can be on the basis of short, medium or long term for various sectors, such as agriculture, construction, manufacturing, trading, real estate and others. The credit processing is also quite similar to the conventional in the way of credit proposal, appraisal, documentation, disbursement, administration, collection and recovery. Therefore, the application of the Commodity Murabahah product should go through this process with some *Shari'ah* elements also taken into consideration.

¹⁴ Bank Islam, Bank Islam Card,

<http://www.bankislam.com.my/en/pages/AboutBankIslamCard.aspx?tabs=2>, accessed on 14/03/11.

¹⁵ Bank Muamalat, Muamalat Personal Financing (Tawarruq-i), <http://www.muamalat.com.my/consumer-banking/financing/personal-financing/gratuity-financing-for-malaysian-armed-forces.html>, accessed on 14/03/11.

¹⁶ See Maybank Islamic, Commodity Murabahah Term Financing-i (CMTF-i), http://maybankislamic.com.my/b_cmtf-i.html, accessed on 14/03/11.

¹⁷ Commodity Murabahah is also used in the interbank money market for liquidity management, such as that provided by BNM Commodity Murabahah House. See http://iimm.bnm.gov.my/view.php?id=72&dbIndex=0&website_id=14&ex=1305409125&md=%E9%A5%7F%9D%CB%82aF%7Dio%B1%FA%26%7EY, accessed on 15/05/2011.

1.2 Problem Statement

Three main items can be highlighted from the research title, which are the *tawarruq* concept by itself, its adoption in the Malaysian financing framework, and the implementation and operation in local banks.

Contemporarily, the permissibility of *tawarruq* has been debated among *Shari'ah* scholars and different resolutions have been endorsed. For example, it is regarded impermissible by some authorized bodies like al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-'Ālam al-Islāmī, in its second *tawarruq* resolution,¹⁸ Majma' al-Fiqh al-Islāmī al-Duwalī,¹⁹ and other individual scholars like Rafīq Yūnus al-Miṣrī.²⁰ Conversely, it is regarded as permissible by al-Majma' al-Fiqhī al-Islāmī in its first resolution,²¹ Shariah Advisory Council of BNM²² and other personal opinions like Nizām Ya'qūbī.²³

¹⁸ al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-'Ālam al-Islāmī, 17th meeting, 17 December 2003, *al-Tawarruq kamā Tujrīh Ba'ḍ al-Maṣārif fī al-Waqt al-Ḥāḍir*, resolution no. 2, Majallah al-Majma' al-Fiqhī al-Islāmī, al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-'Ālam al-Islāmī, Makkah, pg.287, no. 17..

¹⁹ Majma' al-Fiqh al-Islāmī al-Duwalī, 19th meeting, *al-Tawarruq: Haqīqatuh, Anwā'uh (al-Fiqh al-Ma'rūf wa al-Misrī fī al-Munazzam)*, resolution no. 179 (19/5), downloaded at <http://www.fiqhacademy.org.sa>, accessed on 17/5/2011.

²⁰ Mawqī' Dr. Rafīq Yūnus al-Miṣrī, http://wailah.110mb.com/index.php?option=com_content&view=article&id=209:2008-09-24-20-38-46&catid=55:2008-09-23-10-40-11&Itemid=139, accessed on 17/5/2011.

²¹ al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-'Ālam al-Islāmī, 15th meeting, 31 October 1998, *Hukm al-Tawarruq*, resolution no. 5, <http://islamtoday.net/bohoorth/artshow-32-110801.htm>, accessed on 17/05/2011.

²² Bank Negara Malaysia, Shariah Advisory Council, 51th meeting on 28 July 2005, downloaded at http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/07_shariah_resolution.pdf, accessed on 17/05/2011.

²³ Organized Tawarruq valid under Shariah: Nizam <http://aibim.com/content/view/1626/144/http://aibim.com/content/view/1626/144/>, accessed on 17/05/2011.

However, the usage of the *tawarruq* concept in Islamic banking operation, especially in the local banking industry, which is the focus area of this research, is still questionable. Therefore, this study is conducted in order to provide a clear picture from the fundamental and implementation perspective of *fiqh al-mu'āmalāt*.

Extended from the first issue for those who agree that *tawarruq* is permissible, the study will be conducted to review the adoption of *tawarruq* in the local financing framework. Currently, the credit practice that is applied for conventional lending is also being applied for Islamic financing under the assumption that the credit consideration is the same. However, a few *Sharī'ah* elements need to be considered at certain points of the process within this credit framework.

The resolutions, guidelines and regulations of the highest authorized body, i.e. BNM,²⁴ which, in general, are being followed by the local banks, will be the baseline for this analysis. Therefore, the study will evaluate the structure of *Tawarruq*-based financing within the current credit framework in Malaysia.

In order to evaluate the operational process, a study will be conducted in Maybank Islamic Banking (MIB) as a sample case. A sample product of MIB will be picked, i.e. Commodity Murabahah, which is offered under the non-retail financing portfolio, as a focus of the study in order to review the potential exposure of *Sharī'ah*

²⁴ See BNM, Laws, Policies & Guidelines, <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 12/05/11.

non-compliance risk in the product implementation. This will be the baseline in conducting the study.

1.3 Objective

The objective of this study is as follows:

1. To analyse the nature of the *tawarruq* concept in the modern banking system.
2. To analyse the adoption of the *tawarruq* concept in the local financing or credit framework.
3. To analyse the implementation of the *tawarruq*-based financing product in the local Islamic banks using the sample case of the Commodity Murabahah product offered by MIB.
4. To evaluate the application of *tawarruq* in the local financing system from the *Shari'ah* perspective.

1.4 Significance of Research

A few benefits can be obtained from the study conducted. First, the analysis of the *tawarruq* concept will provide a clear understanding concerning the principle that has been applied both in the early days of Islam as well as in the current modern banking practices. Efforts to look for a common point between the two different thoughts can be achieved from analysis of the results.

Analysis on the adoption of *tawarruq* in Malaysia will provide a brief understanding of the application of *tawarruq* within the Islamic financing framework, which accepts the concept as permissible. In general, an understanding will be provided concerning how it is applied locally by either the full-fledged Islamic banks or Islamic banks that share the same platform with conventional banks within their own group.

Analysis on the implementation of *tawarruq* will provide a visualization of the real scenario concerning how it is operated in the current local Islamic banks. A detailed explanation of the entire process will provide some understanding of how the banking products that use *tawarruq* as the underlying concept work in the financing domain.

Lastly, the evaluation of the application of *tawarruq* in the financing system will explain to the reader the potential areas that risk non-compliance with *Sharī'ah* from what will be discussed in the fundamental theory and banking implementation chapters. It will also identify any issue or part that requires improvement.

1.5 Scope

The scope of the study can be broken down into three parts – fundamental theory of *tawarruq*, its adoption by the local financing system, and a Case Study of the MIB product.

In the fundamental theory of the *tawarruq* part, the concept of *tawarruq* from the *Shari'ah* perspective will be discussed, which is applied in modern Islamic banking. Analysis will be done to identify the common point between different thoughts. A conclusion concerning the *tawarruq* principle will be made as an outcome of this analysis.

Tawarruq in the local financing system will discuss the adoption of *tawarruq* in the Malaysian banking framework focusing on the financing domain. The BNM guideline is the basis to oversee the financing system run by the local banks. Therefore, a brief explanation concerning how *tawarruq* works under the current financing system, which, overall, is dual banking, will be an outcome of this part.

For the third part, i.e. the case study of the MIB product, an analysis will be conducted on the sample of the MIB product, which uses the *tawarruq* concept, i.e. Commodity Murabahah. Analysis against product characteristics – internal process, and control mechanisms, etc. – will be conducted in order to evaluate the implementation of *tawarruq* in the banking operation. The basis of the analysis will use the BNM framework as the main reference, and also certain other frameworks, such as AAOIFI, as a comparison.

MIB is chosen as a field work entity for this research for several reasons, as follows:

1. Maybank provides a dual banking system, which is running parallel on a single platform.

2. MIB is the largest Islamic bank in Malaysia and the Asia Pacific Region, in terms of funds and resources, and holds a high volume of customer accounts.
3. The Maybank financing system is more complex compared to other local banks.
4. Such a study has not been conducted on MIB before.

1.6 Literature Review

A review of previous studies is quite important to determine how far the research on the subject field has been done and to place the position of this research. There are two different ways to base *tawarruq* as the subject matter, either from the *Shari'ah*-based concept or as a banking product (or domain). From the perspective of *Shari'ah*-based concept, *tawarruq* can be applied to multiple types of banking product, whereas one type of product can have multiple concepts to be applied.

As it is difficult to implement such discipline, the rule has been set up to limit the search for information for this section as follows:

1. *Tawarruq*, as the primary subject matter (or from the concept perspective), is included in this review. It is restricted to the discussion of solely on *tawarruq* itself, and, also the application of *tawarruq* to the banking product or domain.
2. *Tawarruq*, as a secondary subject matter (or from product or domain perspective), is also included. It is restricted to the discussion on banking products or domain that use *tawarruq* as one of its main underlying concepts. It also includes the discussion of alternate solutions to the concept.

3. *Tawarruq*, as an accessory topic, which does not fall under either of the categories above, for example, research conducted on Islamic finance or banking but does mention *tawarruq* as part of the whole structure of the Islamic banking concept, is excluded from this review.

Consequently, following the defined rule, the search for document titles has been made via three modes – library catalogue, online database and other web resource. This search was based on three descriptors: “Tawarruq”, “Commodity Murabahah” and “Reverse Murabahah”. Additionally, the descriptor “تورق” is used for sites provided in Arabic.

The library catalogue is the tool that is used to locate the documents held by higher education institutional libraries. The institution is filtered by offering courses or faculties that relate to *Shari'ah*, economics, finance, accounting or business management. In this review, the search is done via accessing the Online Public Access Catalogue (OPAC) subject to its availability, which is provided for external networks. The filtered lists of the institutions that are used for this mode are as follows:

1. 33 out of the 65 Malaysian universities and universities colleges;
2. 61 of the 315 Organization of the Islamic Conference (OIC) universities, which are ranked based on published articles by the Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRTCIC); and
3. the 10 top world universities ranked by QS Top Universities.

Online databases provide access to journals or peer reviewed articles, conference papers, dissertations or other types of document. Accordingly, 16 online databases subscribed to by University of Malaya (UM) Library and 6 open access databases that are linked to the UM Library portal were used in this process.²⁵ The selected database also relates to *Sharī‘ah*, economics, finance, accounting or business management.

The third mode, i.e. other web resources, is the search within *fiqh al-mu‘āmalāt* related websites and also by random searches using Google search engine. The referred websites are as follows:

1. International Shari’ah Research Academy for Islamic Finance (ISRA)
2. Islamic Business Researches Center
3. Mawsū‘ah al-Iqtisād wa al-Tamwīl al-Islāmī
4. Mawqi‘ al-Fiqhī al-Islāmī

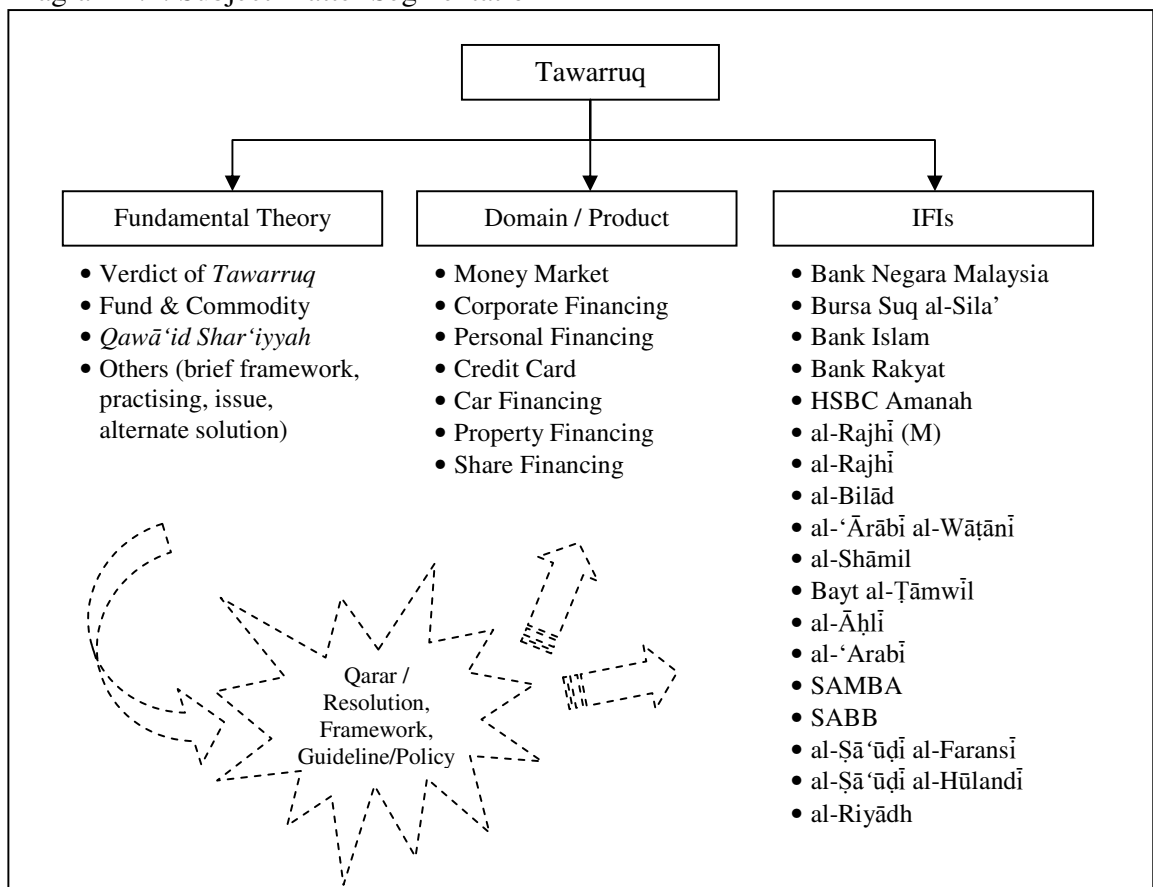
Each collected document was reviewed to eliminate the unrelated writing or any breach of the defined rules. It was retrieved either from the full text, partial text or abstract. The documents were subsequently divided into four categories – book, journal, article (includes working or conference paper that is written in such an academic format) and dissertation. The search results identified 6 books (including 2 chapters in books), 6 journals, 51 articles and 6 dissertations written in Arabic, English or Malay.

The filtered documents were blended and grouped together according to their subject heading. In this exercise it was divided into three segments, namely,

²⁵ See UM Library Interaktif Portal, <http://www.um.edu.my/library/>

Fundamental Theory, Banking Domain/Product and Field Work of Islamic Financial Institutions (IFIs). The majority of the writings fall within the first segment. For the third segment, most are from dissertations. The segmentation can be illustrated as per Diagram 1.1:

Diagram 1.1: Subject Matter Segmentation



Source: Illustrated based on literature review matrix.

Under the fundamental theory, most of the items discussed are the verdict or *Shari'ah* ruling of the concept. The discussion concerns more about what is or is not permissible in respect of the *tawarruq* concept in the earlier finance systems as well as the current banking applications. Some of it specifically mentions *tawarruq*, while some

of it also included *ṭinah* as having a similar *modus operandi*. Included in this coverage is the research that was conducted for the *Majma' al-Fiqh al-Islāmī al-Duwalī* as the highest authorized *fiqh* organization of Islamic countries.

The ruling of the Islamic fund and commodity transaction has also been discussed in *Muzakarah Cendekiawan Syariah Nusantara*. Other conducted studies discussed *Qawā'id al-Shar'īyyah*, and other topics, such as bank practice, issue and workaround solutions. The discussion concerning bank practice or implementation, which is classified under this category, only pertains to high level discussion with a general statement.

Under the second segment, the conducted study about banking implementation covers the money market and financing domain. The money market involves interbank fund transactions that use *tawarruq* as the underlying concept, namely, Commodity Murabahah Programme (CMP). Meanwhile, financing involves a few bank products that use *tawarruq*, such as corporate and personal financing, credit card, car financing, property financing, share financing and metal financing. Basically, all these types of financing are for cash liquidity.

The last part discusses the implementation of *tawarruq* at the specific IFIs. Some of the writings only discussed the policy endorsed by the bank, while some discussed the products or business process in more detail. Some of the listed banks are in Malaysia, while some are outside; mostly in the Kingdom of Saudi Arabia. In other words, this segment discusses how the field work operates.

Overall, the scope of coverage for previous studies of *Tawarruq* that had been conducted can be summarized as per the following tables:

Table 1.1: Scope of Coverage – The Fundamental Theory

Fundamental Theory	Category	Author(s)
Verdict of Tawarruq	Book	Maḥmūd Muhammad Ḥanafī Maḥmūd (2010), Ibrāhīm `Abd al-Latīf Ibrāhīm al-`Ābīdī (2008), Ab Mukmin Ab Ghani (2006), Ahmad Fahd al-Rashīdi (2005), `Alī Aḥmad al-Sālūs (2005)
	Journal/Article	Asmak Ab Rahman et al. (2010), `Abd Allāh Sulaymān al-Bāhūth (2005), Aḥmad Muḥammad Khalīl al-Islāmbūlī (2005), Khalid `Ali al-Mashayqah (2004), Asyraf Wajdi Dusuki (2010), `Abd al-Raḥmān Yusrī Aḥmad (2010), `Abd al-Ḥamīd Maḥmūd al-Ba`lī (2006), `Abd Allāh Ḥasan al-Sa`īdī (2006), `Abd al-Raḥmān Ibrāhīm al-`Uthmān (2005), Sāmī Ibrāhīm al-Suwaylim (2004), `Iṣām `Abd al-Hādī Abu al-Naṣr (w.o.d), `Abd al-`Azīm Abu Zayd (w.o.d.), Azman Mohd Nor et al. (2010), Haytham Khaznah (2010), `Abd al-`Azīz al-Khayyāt (2009), `Abd al-Raḥmān Yusrī Aḥmad (2009), `Alī Ahmad al-Sālūs (2009), Aḥmad `Abd al-`Azīz al-Ḥaddād (2009), Ḥanā` Muhammad Hilāl al-Ḥanītī (2009), Ḥasan `Alī al-Shāzili (2009), Ḥusayn Kāmil Fahmī (2009), Ibrāhīm Aḥmad `Uthmān (2009), Ibrāhīm Fāḍil al-Dabū (2009), Muḥammad Taqī al-`Uthmānī (2009), Muḥammad `Uthmān Shabīr (2009), Nazīh Kamāl Ḥammād (2009), Sa`īd Buharāwah (2009), Sāmī Ibrāhīm al-Suwaylim (2009), Wahbah Mustafā al-Zuhaylī (2009), Muḥammad `Abd al-Laṭīf Maḥmūd al-Bannā (2009), Hishām Muḥammad al-Qāḍī (2007), `Abd al-Fattāḥ Maḥmūd Idrīs (2007), Muḥammad `Abd al-Ḥalīm `Umar (2007), Mundhir Qaḥf (2005), `Imād Barakāt (2005), `Abd Allāh Sulaymān al-Manī` (2003), Muḥammad Taqī al-`Uthmānī (2003), `Alī Aḥmad al-Sālūs (2003), Muḥammad al-Amīn al-Ḍarīr (2003), `Abd Allāh Muḥammad al-Sa`īdī (2003), Muḥammad al-`Alī al-Qarī (2003), `Abd Allāh Ibrāhīm al-Mūsā (1998);
	Dissertation	`Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007), Ṣālih Muḥammad al-Khuḍrī (2009), Mohd Irwan Kamil Mohd Isa (2009), Iman Saleh (2009), Rafidah Mohd Azli (2009), Aghim Matala (2006), Nur Farhah Mahadi (2010);
Fund & Commodity	Journal/Article	Azahari Abdul Kudus (2008), Engku Rabiah Adawiah Engku Ali (2008), Mohamad Akram Laldin (2008), Zaharuddin Abd Rahman (2008);
<i>Qawā'id Shar'īyyah</i>	Book	Maḥmūd Muḥammad Ḥanafī Maḥmūd (2010)

Others (including framework, practices, issue and alternative solution)	Book	Engku Rabiah Adawiah Engku Ali (2008), Ab Mukmin Ab Ghani (2006);
	Journal/Article	Omar Masood (2010), Mohammed Khnifer (2010), Rafe Haneef (2009), Monzer Kahf (2004);

Table 1.2: Scope of Coverage – Banking Domain / Product

Banking Domain / Product	Category	Authors
Money Market	Journal/Article	Asyraf Wajdi Dusuki (2007), Azman Mohd Nor et al.(2010);
	Dissertation	Nur Farhah Mahadi (2010);
Corporate Financing	Dissertation	Nur Farhah Mahadi (2010);
Personal Financing	Journal/Article	Asmak Ab Rahman et al.(2010);
	Dissertation	Irwan Kamil Mohd Isa (2009), Iman Saleh (2009);
Credit Card	Article	Sayd Farook (2009);
	Dissertation	Rafidah Mohd Azli (2009);
Car Financing	Dissertation	Şalih Muḥammad al-Khuḍrī (2009);
Property Financing	Dissertation	Şalih Muḥammad al-Khuḍrī (2009), Nur Farhah Mahadi (2010);
Share Financing	Dissertation	Şalih Muḥammad al-Khuḍrī (2009);

Table 1.3: Scope of Coverage – Institutions

Institutions	Category	Authors
Bank Negara Malaysia	Journal/Article	Asyraf Wajdi Dusuki (2007)
Bursa Suq al-Sila`	Dissertation	Nur Farhah Mahadi (2010)
Bank Islam Malaysia Berhad	Journal/Article	Asmak Ab Rahman et al. (2010)
	Dissertation	Iman Saleh (2009), Rafidah Mohd Azli (2009)
Bank Rakyat	Dissertation	Rafidah Mohd Azli (2009)
HSBC Amanah	Dissertation	Rafidah Mohd Azli (2009)
Al-Rajhi (M) Bank	Dissertation	Mohd Irwan Kamil Mohd Isa (2009)
Al-Rajhi Bank	Dissertation	Şalih Muḥammad al-Khuḍrī (2009)
al-Bilad Bank	Dissertation	Şalih Muḥammad al-Khuḍrī (2009);
al-Arabi al-Watani	Dissertation	Aghim Matala (2006);
al-Shamil Bank	Book	Ahmad Fahd al-Rashīdi (2005);
	Dissertation	Aghim Matala (2006);
Bait al-Tamwil	Dissertation	Aghim Matala (2006);
al-Ahli Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);

al-‘Arabi Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);
SAMBA Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);
SABB Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);
al-Sa'udi al-Faransi Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);
al-Sa'udi al-Hulandi Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);
al-Riyadh Bank	Dissertation	‘Abd al-Raḥmān Ḥāmid al-Ḥāmid (2007);

It can be concluded that most of the studies discussed the fundamentals, especially in the area of jurisprudence of the concept. A few of the studies wrote about the application of *tawarruq* in the banking product and the operational aspect of its implementation. Therefore, my contribution will be in the area of analysing the verdict and resolution, practices or framework in the Malaysian financing system, and the implementation of non-retail products for cash liquidity.

1.7 Data Collection Methodology

Data collection is an important element of this research. The quality of data input will form the basis of the accuracy of the results. The method that is used in this study can be divided into two methods – library research and field work.

1.7.1 Library Research

The purpose of this method is to analyse the subject matter theory by searching for related material in documentation form. This includes books, journals, articles, presentation papers and also unpublished material, i.e. dissertations or theses, which are in Malay, English or Arabic.

Overall, two types of source are considered, namely, the classic and contemporary jurisprudence materials and the banking-related materials. The first type is used as a reference for understanding the *mu'āmalah* theory, while the second part is to understand the financial operation and environment.

A few libraries and sources of information were identified, as listed below, to obtain such information:

1. Main Library, University of Malaya (UM)
2. Islamic Studies Library, University of Malaya (UM)
3. Tun Seri Lanang Library, Universiti Kebangsaan Malaysia (UKM)
4. Dar al-Hikmah Library, International Islamic University Malaysia (IIUM)
5. Knowledge Management Centre, International Centre for Education in Islamic Finance (INCEIF)
6. Knowledge Management Centre, Islamic Banking and Finance Institute Malaysia Sdn. Bhd. (IBFIM)
7. BNM LINK, Bank Negara Malaysia (BNM)

1.7.2 Field Work

This method analyses the selected object, which refers to the implementation of the study. The field work study was conducted at Maybank Islamic Berhad to gather the data and information directly.

Information collection at Maybank Islamic Berhad was conducted using several methods as follows:

i) Interviews

Interview sessions were conducted with the bank officers directly involved with the product implementation, i.e. Encik Amir Hamzah from Business IT & Operation, MIB; Hj. Ahmad Johor from Shariah Review, MIB; Ustaz Muhd Ramadhan Fitri from Shariah Management, MIB; and Encik Zamal Noor Iqma from Business Strategy and Transformation, MBB. The key areas covered in the interviews included product structure, business and operational process, *Shari'ah* governance and control mechanism.

ii) Documentation

This method was conducted to collect the relevant documents, which is treated as a baseline for MIB to operate this product. It includes policies or guidelines, specifications, manuals, legal documents, financial reporting standards and others.

1.8 Data Analysis Methodology

Since this research involves qualitative type of information, several methods have been determined for use in data analysis, which are the deductive approach, inductive approach and comparison approach.

The deductive approach is a theory building process, which commences with an established theory or generalization, and seeks to see if the theory applies to specific instances.²⁶ This approach works from general to specific, which is informally termed the “top-down” approach. For example, the *Shari’ah* parameters provided by BNM, shall be applied in the sample bank’s operation.

Conversely, the inductive approach works the other way round (“bottom-up”), starting with observations of specific instances, and seeking to establish generalizations

²⁶ Kenneth F. Hyde (2000), “Recognising Deductive Process in Qualitative Research”, *Qualitative Market Research*, Vol. 3 No.2, pg.82-89.

about the phenomenon under investigation.²⁷ The conclusion made, which is general in character, will be derived from the specific item. For example, in order to elaborate upon the *Shari'ah* concept applied, various and detailed views need to be scrutinized before developing a brief conclusion.

The comparison approach is used to establish patterns of similarities or differences across sets of cases.²⁸ This approach compares the collection of facts and data in order to arrive at a conclusion. For example, to identify the similarity or difference between conventional loans and Islamic financing, comparisons from several aspects are required.

1.9 Writing Structure

This dissertation consists of six chapters:

Chapter one is an introduction that provides an overview of the conducted study, which consists of the research background, problem statement, objective, scope, literature review, methodology and writing structure.

Chapter two discusses the fundamental theory of *tawarruq*. The items described in this chapter include the definition, form, type, verdict, tenet and elements. It tries to

²⁷ *Ibid.*

²⁸ Karl Henrik Sivesind (1999), "Structured, Qualitative Comparison", *Quality & Quantity*, Vol. 33, pg. 361-380.

identify a common point in respect of the two contradictory opinions of scholars in respect of jurisprudence and practice.

Chapter three discusses the Malaysian financing system and other related rules or regulations that have been enacted by BNM. It describes how *tawarruq* is adopted in the local banking industry in general.

Chapter four discusses the implementation of *tawarruq* in the local Islamic banks. It describes a case study of the Commodity Murabahah product, which is offered by MIB under its non-retail portfolio. The complete process relating to the implementation of the product is elaborated.

Chapter five is the analysis chapter, which analyses the fact finding that has been described in the three previous chapters. The analysis refers to the BNM framework as a basis, and also other frameworks, such as AAOIFI for a comparison. This two dimensional analysis is more comprehensive compared to a single viewpoint.

Chapter six is the last chapter, which concludes the analysis of the results of the study. Recommendations or possible solutions (if any) are provided to improve the components affected in the current financing system or practice.

CHAPTER 2: FUNDAMENTAL THEORY OF TAWARRUQ

2.1 Introduction

Islamic banking is built on the basis of free from *ribā*, which, nowadays, is known as interest, and is widely used in conventional banking. *Ribā* is one of the particular aspects to be avoided in *mu‘āmalah* deals. It is based on what is mentioned in al-Quran:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

And Allah permits trading and prohibits ribā

Surah al-Baqarah (2): 275

Therefore, Muslims are instructed to deal with *ribā*-free trading and commerce, and to abandon any transaction that leads to *ribā*. In addition, there are also some scenarios where the transaction is similar to permissible trading but the hidden objective is similar to what is provided by *ribā*, which is called *ḥīlah*¹ for *ribā*. This is a trick or technique to avoid such transactions being substantively seen as *ribā* transactions.

¹ *al-Ḥīlah* refers to a legal stratagem that makes use of a legal device to achieve the objective. There are a few definitions given to the term “*al-ḥīlah*” (pl. *al-ḥiyal*), either literally or technically. It can be summarized that the term encompasses the meaning of transforming the verdict of Islamic law so that it is accepted or prohibited by the law. *al-Ḥīlah* that demolishes the principle of *Sharī‘ah* and its *maṣlaḥah* (benefit or interest) is prohibited by *Sharī‘ah*. Meanwhile, if the principle of *Sharī‘ah* and its *maṣlaḥah* is not destroyed by *al-ḥīlah*, then it is accepted. Al-Shāṭibī divided *al-ḥīlah* into three types:

- i) No dispute on the invalidity, such as the *ḥīlah* by hypocrites
- ii) No dispute on the permissibility, such as saying the word of *al-kufr* (opposition to Islam) by force
- iii) The type that contains ambiguity and uncertainty due to the unavailability of clear and definite evidence as per the previous two types. The objective or intention is not clear, and the contradiction of *maṣlaḥah* is not visible. If the *ḥīlah* does not contradict *maṣlaḥah* then it is permitted, otherwise it is prohibited.

Currently, many products have been introduced by Islamic banks to fulfil the needs of customers. One of the demanding needs is cash liquidity. The most popular *Sharī'ah* concepts that have been used by Islamic banks to fulfil this need are *'inah* and *tawarruq*. However, there is some debate as to whether both these concepts are considered as *ḥīlah* for *ribā* or not.

This chapter will briefly discuss *tawarruq* from the theoretical perspective to provide a basic understanding of the concept, especially from the jurisprudence (*fiqh*) perspective. Indirectly, *tawarruq* is also related to *'inah* due to some similarity of the concept, which will be mentioned accordingly under its topic.

2.2 Definition

2.2.1 Literal Meaning

In al-Mawsū'ah al-Fiqhiyyah, *tawarruq* (التورق) is mentioned as an infinitive (مصدر) of the verb *tawarraqa* (تورق).² Based on Arabic morphology, the word is in a form or *wazn*

For more details, see al-Shāḥibī (1997), *al-Muwāfaqāt*, Abū 'Ubaydah Mashhūr (ed.), vol.3, al-Khubar: Dār Ibn 'Affān, pg.124-125; Ahmad Sa'īd Hawwā (2007), *Ṣuwar al-Taḥāyul 'alā al-Ribā*, Beirut: Dār Ibn Hazm, pg. 38-41. Moving forward, the term "*ḥīlah*" will refer to the type that is prohibited by *Sharī'ah*.

² Wizārah al-Awqāf wa al-Shu'ūn al-Islāmiyyah (1988), *al-Mawsū'ah al-Fiqhiyyah*, vol. 14, Kuwait: Wizārah al-Awqāf wa al-Shu'ūn al-Islāmiyyah, pg.147.

of *tafa‘‘ul* (تَفْعُلْ) which is an infinitive of *tafa‘‘ala* (تَفْعَلْ)³. If it is said *tawarraqa al-hayawān* (تَوَرَّقَ الْحَيَوَانَ), it means to eat the leave (أَكَلَ الْوَرَقَ),⁴ which is designated for animals. However, this meaning is not aligned with the technical meaning of *tawarruq*.

The term *tawarruq* is not found by the author in Arabic dictionaries, even in those that include the *fiqh* technical term or so-called *lughawī fiqhī* (لُغَوِي فَقْهِي) books, such as al-Miṣbāḥ al-Munīr⁵ and al-Mughrib.⁶ However a form of *tawarruq* is mentioned under the definition of *‘īnah*,⁷ as stated by al-Fayyūmī:

“..then if the buyer sold it (the commodity) to someone other than the initial buyer in the event, then it is also called *‘īnah* but it is permissible with *ittifāq*”⁸.

Perhaps this is the reason why the term is not widely known among the early period of *fiqh* scholars, although such a form was discussed under the rubric of *‘īnah*.

The root of the word is “و ر ق”.⁹ The original infinitive or noun¹⁰ of this word is *al-warq* (الْوَرَقُ),¹¹ which means minted dirham.¹² The phonation of *al-wariq* (الْوَرِيقُ), *al-*

³ See Ibn al-Qattā‘ al-Ṣaqlī (1999), *Abniyah al-Asmā‘ wa al-Af‘āl wa al-Maṣādir*, Aḥmad Muḥammad ‘Abd al-Dāyīm (ed.), Kaḥerah: Dār al-Kutub al-Miṣriyyah, pg 336 & 378. Taṣrīf: (تَفْعَلْ يَتَفَعَّلُ تَفْعَلًا فَهُوَ مَتَفَعِّلٌ (وذلك متفعِّلٌ تَفَعَّلَ لَاتَتَفَعَّلُ مَتَفَعِّلٌ مَتَفَعَّلٌ)).

⁴ Wizārah al-Awqāf wa al-Shu‘ūn al-Islāmiyyah, *op.cit.*

⁵ Written by al-Fayyūmī based on jurisprudence phonetics of the Shāfi‘ī school of law.

⁶ Written by al-Muṭarrizī based on jurisprudence phonetics of the Ḥanafī school of law.

⁷ *‘īnah* literally means *al-Salaf*, which means buying something with something that is deferred. Technically, *‘īnah* refers to someone who sells the commodity on a credit (deferment) basis and buys it back on a cash basis in order to avoid *ribā*. See al-Fayyūmī (1987), *al-Miṣbāḥ al-Munīr*, Khudhr al-Jawād, Beirut: Maktabah Lubnan, pg. 167.

⁸ al-Fayyūmī, *op.cit.*, pg. 167-168.

⁹ الواو والراء والقاف

¹⁰ al-Fal-masdar aṣl ṣadr-ene ḳl al-muṣṭafāt, min al-af‘āl wa al-ṣafāt al-tī tashbihā wāsmā al-zmān wa l-makān wā l-ālāh wa l-masdar al-mīmī al-Ghalāyaynī (2000), *Jāmi‘ al-Durūs al-‘Arabiyyah*, vol.1, Beirut: al-Maktabah al-‘Asriyyah, pg. 209.

¹¹ و"فَعْلٌ" هو المصدر الأصلي للأفعال الثلاثية المجردة، ثم عدل بكثير من مصادرها عن هذا الأصل، وبقي كثير منها على هذا الوزن.

al-Ghalāyaynī, *op.cit.*, pg. 162.

¹² al-Jawharī (1984), *al-Ṣihāh Taj al-Lughah wa Ṣihāh al-‘Arabiyyah*, Aḥmad ‘Abd al-Ghafūr (ed.), vol. 4, Dār al-‘Ilm al-Malāyīn, Beirut, pg. 1564. *Dirham* is silver money, which was widely used previously.

wirq (الورق) and *al-riqah* (الرقة) also refers to the same meaning, which is dirham.¹³ The term *al-wariq* (الورق) is also defined as silver either minted or not.¹⁴ *Al-waraq* (الورق) means leaf of the tree¹⁵. *Waraqa* (ورق) *yariqa* (يرق) means to sprout the leaf or produce the leaf perfectly.¹⁶ It is also defined as wealth of dirham, camel or others.¹⁷ *Al-Waraq* (الورق) is also defined as all the wealth, and also silver either minted like dirham or not.¹⁸ Therefore, perhaps we can say that the verb *waraqa* (ورق) *yariqa* (يرق) means an action taken to produce the wealth or dirham.

How *tawarruq* (تورق) is derived from the root word, which refers to dirham is not traceable. Based on Arabic morphology, the form of *tafa'ala* (تفعل) refers to an act of hardship, such as *ta'allama* (تعلم) or *taṣabbara* (تصبر).¹⁹ Therefore, *tawarraqa* (تورق) *yatawarraqa* (يتورق) might be conceived as a hardship act to acquire the wealth or dirham. Perhaps the term *tawarruq* (تورق) was invented to refer to the action of hardship undertaken by someone in order to acquire the wealth or dirham.

¹³ See Ibn Manẓūr (n.d.), *Lisan al-‘Arab*, ‘Abd Allāh ‘Alī al-Kabīr (ed.), vol. 53, Kaḥerah: Dār al-Ma‘ārif, pg. 4816. al-Zubaydī (1965), *Tāj al-‘Urūs min Jawāhir al-Qāmūs*, ‘Abd al-Sattār Aḥmad Firāj (ed.), vol. 26, Kuwait: al-Turāth al-‘Arabi, pg. 462. al-Fairūz Ābādī (2005), *al-Qāmūs al-Muḥīt*, Maktab Tahqiq al-Turāth fi Muassasah al-Risālah (eds.), Beirut: Muassasah al-Risalah, pg. 928

¹⁴ Majma‘ al-Lughah al-‘Arabiyyah (2004), *Mu‘jam al-Wasīt*, Kaḥerah: Maktabah al-Shurūq al-Dawliyyah, pg. 1026.

¹⁵ Ibn Manẓūr, *op. cit.*, pg. 4815.

¹⁶ Majma‘ al-Lughah al-‘Arabiyyah, *op. cit.* al-Zubaydī, *op.cit.*.

¹⁷ al-Jawhari, *op.cit.*, pg. 1565.

¹⁸ Ibn Manẓūr, *op.cit.*, pg. 4816. al-Zubaydī, *op.cit.*, pg. 461. There are also some other definitions for this term.

¹⁹ al-Ghalāyaynī, *op.cit.*, vol. 1, pg. 219.

2.2.2 Technical Meaning

The term *tawarruq* was not known in the early days of Islam, either during the era of Prophet Muhammad s.a.w., Khulafā' al-Rāshidīn, Tābi'īn or Tabi' al-Tābi'īn, except what was mentioned by Ibn Taymiyyah as a statement from Umar 'Abd al-'Azīz:

التورق آخية الربا²⁰

al-Tawarruq is a brotherhood of ribā

In addition, the statement from Iyās ibn Mu'āwiyah r.a., as was narrated by Ibn Abī Shaybah:

أَنَّهُ كَانَ يَرَى التورق يَعْنِي الْعَيْنَةَ²¹

Indeed he regards al-tawarruq as al-'īnah.

Furthermore, the term *tawarruq* was only commonly known during the later period after being used by the Ḥanbalī school of law. Perhaps Ibn Taymiyyah is the one who first popularized the term. However, based on some research, even this term had not been used, although a form of *tawarruq* had been mentioned before under the rubric of 'īnah. This is aligned with the statement of al-Fayyūmī, as mentioned earlier. It is also supported by what is mentioned by Ibn Qayyim under the discussion of 'īnah:

If the commodity doesn't return to the initial seller but goes to third party, do you name it as 'īnah?, This is the matter of tawarruq because the

²⁰ Ibn Taymiyyah (2004), *Majmu' al-Fatāwā*, 'Abd al-Raḥmān ibn Muḥammad et al. (eds.), vol. 29, Madinah: Wizārah al-Shuūn al-Islāmiyyah wa al-Awqāf wa al-Da'wah wa al-Irshād, pg. 303, 431, 442.

²¹ Ibn Abī Shaybah (2004), *Musannaf Ibn Abī Shaybah*, Ḥamad ibn 'Abd Allāh et al. (eds.), vol. 7, Riyadh: Maktabah al-Rush, pg. 171, Kitāb al-Buyū' wa al-Aqdīyyah, Bāb Man Kariha al-'īnah, hadith no. 20407.

*intention is money, and Ahmad specified, in the narration of Abī Dāwud, that it is part of ‘īnah and it is called as ‘īnah.*²²

According to al-Bahūtī, *tawarruq* is defined as someone who needs money, and then he buys something equivalent to one thousand (in currency) with a higher price to make use of the deferment.²³ Ibn Muflih mentioned in al-Mubdi’ that *tawarruq* transactions are, where someone needs money, and he buys something equivalent to one-hundred with eighty.²⁴ Al-Mardāwī also mentioned in al-Inṣāf that *tawarruq* is where someone needs money, and they buy something equivalent to one-hundred with hundred and fifty.²⁵ All these definitions mean that *tawarruq* is such a transaction of purchasing commodity with deferment either with a higher, equivalent or lower price than the actual value, in order to sell back the commodity to acquire cash.

Currently, most of the *fiqh* scholars also give similar or more detailed definitions for *tawarruq*. In al-Mawsū‘ah al-Fiqhiyyah it is defined as an act to buy the commodity on a credit (deferred) basis, and then sell it with a lower price on a cash basis, to someone else other than the initial seller, in order to acquire cash.²⁶ A similar definition was also provided by the council of al-Majma‘ al-Fiqhī al-Islāmī bi Rābitah al-‘Ālam al-Islāmī, in its first *tawarruq* resolution in 1998, which is the buying of a commodity that

²² Ibn Qayyim (1968), *‘Aun al-Ma‘bud Sharḥ Sunan Abī Dāwud ma’a Ḥāsiyah Ibn Qayyim*, ‘Abd al-Raḥmān Muḥammad ‘Uthmān (ed.), vol. 9, Madinah: al-Maktabah al-Salafiyyah, pg. 346.

²³ al-Bahūtī (2000), *Sharḥ Muntahā al-Irādāt*, ‘Abd Allāh ibn ‘Abd al-Muḥsin al-Turkī (ed.), vol. 3, Muassasah al-Risālah, Beirut, pg. 164.

²⁴ Ibn Muflih (1997), *al-Mubdi’ Sharḥ al-Muqni’*, Muḥammad Hasan (ed.), vol. 4, Dār al-Maktabah al-‘Ilmiyyah, Beirut, pg. 49.

²⁵ al-Mardāwī (2004), *al-Inṣāf fi Ma‘rifah al-Rājih min al-Khilāf*, Kitāb al-Buyū’, Riyadh: Bayt al-Afkar al-Dawliyyah, pg. 750. Later al-Mardāwī mentioned that if the buyer sells the commodity back to whom he bought from, then it is called ‘īnah.

²⁶ Wizārah al-Awqāf wa al-Shu‘ūn al-Islāmiyyah, *op.cit.*

is possessed and owned by a seller, with deferred price, and then the buyer sells the commodity for cash to someone else other than the initial seller, in order to acquire cash.²⁷

According to AAOIFI Shari'a Standard, *tawarruq* is defined as the process of purchasing a commodity for a deferred price determined through *musāwamah* (bargaining) or *murābahah* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash.²⁸ Generally, it can be said that the above given definitions are the basic definition for *tawarruq*, which, later, is also known as Classical *Tawarruq* or *al-Tawarruq al-Fiqhī* or *al-Tawarruq al-Fardī* or non-Organized *Tawarruq*.

Nowadays, due to the needs of financial products that comply with *Shari'ah* and also to consider the complexity of the current financial system, the *tawarruq* concept has been customized to make it feasible in the current landscape of Islamic banking. This branched out concept is also known as Organized *Tawarruq* or *al-Tawarruq al-Munazzam* or *al-Tawarruq al-Maṣrifī*. In addition, there is another subset level of *tawarruq*, which is known as Reverse *Tawarruq* or *Tawarruq al-'Aksī* that is also classified as organized *tawarruq*. The difference between organized *tawarruq* and classical *tawarruq* is that the bank will act as an agent to perform the commodity sale or purchase transaction with a third party on behalf of the customer.

²⁷ *Qararat al-Majma' al-Fiqhī al-Islāmī bi Makkati Mukarramah*, 15th seminar, resolution no. 5, downloaded from <http://www.themwl.org/publications/default.aspx?d=1&cid=20&cid=116&l=ar>, accessed on 01/03/12.

²⁸ Accounting and Auditing Organization for Islamic Financial Institution-AAOIFI (2010), *Shari'a Standards for Islamic Financial Institutions*, Bahrain: AAOIFI, pg. 525.

The council of al-Majma‘ al-Fiqhī al-Islāmī bi Rābitah al-‘Ālam al-Islāmī, in its second resolution for *tawarruq* in 2003, defined this type of *tawarruq* as the bank executing in a modern way to carry out the arrangement of commodity sale (not in a type of gold or silver) from international commodity market or others, to *al-mustawriq* with deferred price, and, subsequently, the bank sells the commodity – either bound in the contract or due to *al-‘urf* and *al-‘ādah* – on behalf of *al-mustawriq* to another buyer at a spot price, and then hands over the proceeds to *al-mustawriq*.²⁹

The council of Majma‘ al-Fiqh al-Islāmī al-Duwalī, in its resolution in 2009, classified *tawarruq* into three categories, as follows.³⁰

1. *al-Tawarruq* in respect of the technical meaning of *fiqh* exponents (*fuqahā‘*):

A commodity bought by a person (*al-mustawriq*) with deferred payment, who then, in most cases, sells it at a lower price to someone other than from whom it was bought, with the intention of acquiring cash.

2. *al-Tawarruq al-Munazzam* in respect of the contemporary technical meaning:

A commodity bought by the *mustawriq* from a local or international market or any of its kind with a deferred price, in which, later, the seller (*al-mumawwil*) occupies its sale arrangement either by himself or by his agent or by the cooperation of the *mustawriq* and the *mumawwil*, with a lower price in most cases.

²⁹ *Qararat al-Majma‘ al-Fiqhī al-Islāmī bi Makkati Mukarramah*, 17th seminar, resolution no. 2, downloaded from <http://www.themwl.org/publications/default.aspx?d=1&cid=20&cid=116&l=ar>, accessed on 01/03/12.

³⁰ Majma‘ al-Fiqh al-Islāmī al-Duwalī, resolution no. 179 (19/5), downloaded from <http://www.fiqhacademy.org.sa/>, accessed on 17/05/11.

3. *al-Tawarruq al-‘Aksī*:

This is a type of *tawarruq munazzam* with the scenario that the *mustawriq* is the institution and the *mumawwil* is the customer.

Concisely, the initial form of *tawarruq* is quite straightforward, whereby the *mustawriq* buys a commodity with a deferred price and sells it to a third party to acquire cash. Nowadays, this basic principle has been customized, namely, organized *tawarruq*, to suit the modern banking operation, where the *mustawriq* is either the bank or the customer who desires cash, and the bank is always an agent (on behalf of customer) to perform the sale or purchase transaction with a commodity broker. However, this evolutionary concept of *tawarruq* has a different impact from the perspective of jurisprudence as will be discussed next.

2.3 *Sharī‘ah Ruling on Tawarruq*

To have a better understanding on the *Sharī‘ah* ruling of *tawarruq*, first, we will analyse the classical jurisprudence view on the basic principle of *tawarruq*. Next, we will go through the contemporary jurisprudence view on *tawarruq*. This includes organized *tawarruq*, which is a branched out concept of the basic principle, by reviewing the authorized bodies’ resolutions and *fatwās*.

2.3.1 Classical View on *Tawarruq* Verdict

There are different views among the classical *fiqh* scholars regarding the *tawarruq* verdict. Some allowed or permitted this concept, and some did not. As discussed earlier, the term “*Tawarruq*” only became known in the later period of Ḥanbalī’s school of law (*madhhab*). Therefore, its verdict is clearly mentioned in the later period of the Ḥanbalī jurisprudence treatises. However, for the other schools of law and also the early period of Ḥanbalī’s school of law, the specific discussion on *tawarruq* is not available. Nevertheless, such a form of *tawarruq* was discussed in some of the treatises under the rubric of *‘īnah*.

Basically, the scholars view pertaining to this matter can be grouped into three types that sometimes used different Arabic terms, as follows:

1. Permissible, i.e. *al-Jawāz* (الجواز) or *al-Ibāhah* (الإباحة).
2. Reprehensible, i.e. *al-Karāhah* (الكراهة) or *al-Makrūh* (المكروه).
3. Prohibited outright, i.e. *al-Harām* (الحرام), *al-Manhiyy* (المنهي) or *al-Mamnū‘* (الممنوع).

2.3.1.1 Permissible

Most *fiqh* scholars allowed *tawarruq* to be practiced irrespective of whether it is directly stated in their treatise. Although *Tawarruq* was not directly discussed in the early period of Ḥanbalī’s exponents, a form of it was mentioned under the rubric of *‘īnah*. *‘īnah* was prohibited based on the statement of Nabi s.a.w:

إِذَا تَبَايَعْتُمْ بِالْعِينَةِ، وَأَخَذْتُمْ أَذْنَابَ الْبَقَرِ ، وَرَضِيتُمْ بِالزَّرْعِ ، وَتَرَكْتُمُ الْجِهَادَ، سَلَّطَ اللَّهُ عَلَيْكُمْ ذُلًّا لَا يَنْزِعُهُ حَتَّى تَرْجِعُوا إِلَى دِينِكُمْ³¹

If you execute sale and purchase contract of 'īnah, and you follow the tail of the cow, and you be pleased with the plantation, and you omit the holy war, Allah exert disgrace onto you which cannot be taken off until you back to your creed.

The threat of the statement shows that 'īnah is prohibited. According to the Ḥanbalī school of law, 'īnah refers to the act of selling a commodity on a cash basis, then buying³² it back from the buyer on a credit basis at a higher price.³³ Following the same principle, it also refers to buying the commodity on a credit basis with a higher price, and then selling it back on a cash basis. Supported by hadith, 'īnah transactions are prohibited as they lead to *ribā* transactions.

However, if such transactions involve a third party, i.e. the second buyer is not the initial seller, then it is allowed. This 'īnah concept can be described as someone who buys the commodity on a credit basis at a higher price from A, and then sells it on cash basis to B. This type of transaction is permitted as mentioned by Ibn Qudāmah:

*...and it is permitted for other people regardless the father or the son or others, because he is not the seller and he buy for himself, that similar to the third party...*³⁴

³¹ Abū Dāwud (2009), *Sunan Abī Dāwud*, Shu'ayb al-Arnaūṭ et al. (eds.) vol.5, Beirut: Dār al-Risālah al-ʿĀlamiyyah, pg. 332, Kitāb al-Ijārah, Bāb fī al-Nahyī ʿan al-ʿĪnah, hadith no. 3462.

³² Buying is performed by either the initial seller or their agent.

³³ See Ibn Qudamah (1997), *al-Mughnī*, ʿAbd Allāh ibn ʿAbd al-Muḥsin et. al (eds.) vol. 6, Riyādh: Dār ʿĀlam al-Kutub, pg.260-263, Kitāb al-Buyūʿ.

³⁴ *Ibid*, pg. 323.

The statement shows that if the buyer is not the initial seller then it is permitted. It can be understood that this is a form of *tawarruq* transaction, which is allowed by Hanbalī's exponents.

Consequently, the *tawarruq* concept was clearly discussed in the later period by Ḥanbalī exponents.³⁵ According to them, permissible is the selected view of *madhhab*³⁶ for the reason that it is not included in the *ḥīlah* for *ribā*. Al-Mardāwī mentioned:

*If someone needs cash, then he buys something equivalent to hundred in value with hundred and fifty, then it is allowed, and it is provisioned, and this is the selected view of madhhab, and the opinion of madhhab scholars, and it is the issue of tawarruq, that is regarded as reprehensible in one opinion and prohibited outright in another opinion which is chosen by Shaykh Taqi al-Din.*³⁷

The verdict on *tawarruq* is not clearly stated in the Ḥanafī school of law. However, a form of *tawarruq* was mentioned under the *'īnah* discussion. There are two views provided by Ḥanafī exponents regarding *'īnah*, that is, reprehensible and permissible. Reprehensible is the opinion of Muhammad al-Shaybānī r.h., as well as most of the Ḥanafī exponents, based on the statement of Nabi s.a.w.:

إِذَا تَبَايَعْتُمْ بِالْعَيْنَةِ وَتَبِعْتُمْ أَذْنَابَ الْبَقَرِ دَلَلْتُمْ وَظَهَرَ عَلَيْكُمْ عَدُوُّكُمْ³⁸

If you execute sale and purchase contract of 'īnah, and you follow the tail of the cow, He exert disgrace onto you and manifest your enmity.

³⁵ Such as Ibn Muflīḥ in *al-Furū'*, al-Bahūtī in *Sharḥ Muntahā al-Irādāt* and al-Mardāwī in *al-Inṣāf*.

³⁶ See al-Mardāwī, *op.cit.*, pg. 750-751.

³⁷ *Ibid*, pg. 750-751.

³⁸ Ibn Humam (2003), *Sharḥ Fath al-Qadir 'ala al-Hidāyah Sharḥ Bidayah al-Mubtadi*, Kitāb al-Kafālah, vol. 7, Beirut: Dar al-Kutub al-'Ilmiyyah, pg. 198. This Hadith phonetic is not found in Hadith books, except as narrated by Abū Dāwūd and others, as mentioned earlier.

Meanwhile, permissible is the opinion of Abū Yūsuf r.h. According to him, the sale is not reprehensible because it was practiced by many Prophet's companions, and they praised it and did not consider it as part of *ribā*.³⁹

This form of *tawarruq* was mentioned by the later period of Ḥanafī exponents, whereby the ruling was not prohibited, and also not considered as a part of *ʿinah* that is ruled as reprehensible by the majority of them.⁴⁰ Ibn ʿĀbidīn stated:

*“Then he said in al-Fatḥ...If it doesn't go back such as the debtor sold it at the market then it is not prohibited but khilāf al-awlā...and the object that doesn't go back to him which is initially from him, it is not named as Bayʿ al-ʿInah”.*⁴¹

He also mentioned that, according to al-Sayyid Abū al-Suʿūd, this is actually what is meant by Abū Yūsuf, as stated earlier.⁴²

Tawarruq is said to be permitted in the Shāfiʿī school of law. However, there is no clear statement mentioned about *tawarruq* among their treatises. Under the topic of *ʿinah*, there is a small argument concerning its verdict.⁴³ Overall, it is permitted for the reason that both executed contracts are independent of each other. This means that there are two separate transactions involved. For the first transaction, the commodity is sold on a credit basis and delivered to the buyer. For the second transaction, the commodity is bought back by the initial seller at a higher or lower or the same price, by either credit or

³⁹ *Ibid.*

⁴⁰ See *Ibid.*, pg.199 and Ibn ʿĀbidīn (2003), *Radd al-Mukhtār ʿala al-Darr al-Mukhtār Sharḥ Tanwīr al-Abṣār*, ʿĀdil Aḥmad ʿAbd al-Mawjūd et al.(eds.) vol.7, Riyādh: Dar ʿĀlam al-Kutub, pg.613, Kitāb al-Kafālah.

⁴¹ Ibn ʿĀbidīn, *op. cit.*, pg. 613.

⁴² *Ibid.*, pg.614.

⁴³ For a detailed discussion of *ʿinah* see al-Nawawī (n.d.), *Kitāb al-Majmuʿ Sharḥ al-Muhazzab li al-Shīrāzī*, Muḥammad Najīb al-Muṭīʿī (ed.), vol.10, Jeddah: Maktabah al-Irshad, pg.141-149.

cash. The first transaction is considered as one contract, and the second transaction is considered another contract, which is independent of the first contract even though the first contract has not reached the maturity date.⁴⁴

Some scholars judged it as reprehensible or prohibited outright if it becomes a common practice. In addition, if there is a condition stated in the contract for the second trading⁴⁵ then it is totally invalid. Consequently, *‘īnah* is regarded as reprehensible by some of the later Shāfi‘ī exponents due to the visibility of the intention of the needs, and it is disregarded as prohibitive or reprehensible if it is not a common practice.⁴⁶

Even though *tawarruq* was not being discussed, it can be said that the involvement of a third party in the trading is more appropriate to be ruled as permissible compared to *‘īnah*. This is supported by the statement of Imam al-Shāfi‘ī in the discussion of *bay‘ al-‘īnah*:

*Is it haram if someone sells his property, which he bought with credit, on cash basis? No. If he sells the property to someone else (other than initial seller), and then who prohibited it?*⁴⁷

Perhaps it is also what is meant by al-Fayyūmī in that a kind of *tawarruq* is also termed as *‘īnah*, as mentioned earlier.⁴⁸

⁴⁴ Date to complete the deferred price payment.

⁴⁵ Means pre-arranged.

⁴⁶ See al-Anṣārī (2001), *Asnā al-Maṭālib fī Sharḥ Rawdh al-Ṭālib*. vol. 4, Beirut: Dār al-Kutub al-‘Ilmiyyah, pg. 104.

⁴⁷ Al-Shāfi‘ī (2001), *al-Umm*, Iskandariyah: Dār al-Wafā‘, vol 3, pg. 79.

⁴⁸ See al-Fayyūmī, *op.cit.*, pg. 167-168. The fiqh technical term in the dictionary was based on *madhhab* al-Shāfi‘ī.

In the Mālikī school of law, there is also no clear statement mentioned about *tawarruq*. Meanwhile for ‘*īnah*,⁴⁹ there are three types, which are ruled as permissible, reprehensible and prohibited outright.⁵⁰ The first two are the deferred sale,⁵¹ while the third one is an ‘*īnah* transaction.⁵² Bay‘ al-‘*īnah*, as it is known in other *madhhab*, is prohibited by the Mālikī school of law due to the *ḥīlah* for *ribā*.

In addition, based on the substantive statements of Mālikī exponents, *tawarruq* was regarded as permissible. Imam Mālik forbade such ‘*īnah* transactions because the commodity goes back to the initial seller either directly transacted between the buyer and the seller or using an intermediary.⁵³ However, where the second contract goes to other than the initial seller was not discussed. Nevertheless, al-Qarāfī did mention in al-Furūq,⁵⁴ that if the second contract is from the initial seller then it is prohibited.⁵⁵ Therefore, it is a form of *tawarruq*, which is permitted, as was discussed under the topic of ‘*īnah*.

⁴⁹ ‘*īnah* is also discussed as a sub topic under deferred sale in the Mālikī treatise.

⁵⁰ For detail discussion on ‘*īnah*, see Ibn Rushd (1988), *al-Bayān wa al-Taḥṣīl wa al-Sharḥ wa al-Tawjīh wa al-Ta‘līl fī Masāil al-Mustakhrajah*, Muḥammad Ḥajjī (ed.), vol. 7, Beirut: Dār al-Gharab al-Islāmī, pg. 86.

⁵¹ i) A man approaches another man (the seller) and he says: Is there any commodity like this and this with you, and you sell it to me with credit? No. Then the seller walks away, buys the commodity, comes back and says to the man who asked: I have it. Then he sells it to the man. ii) The man says: Do you have any commodity like this and this, and then you sell it to me with credit? The seller says: No. Then the man says: Do you want to get and sell it and I buy it from you with credit plus profit. Then the seller buys it and sells it to him as promised.

⁵² There are six types of transaction. See Ibn Rushd, *op. cit.*, pg. 87-89.

⁵³ *Ibid.* pg. 89.

⁵⁴ Regarding deferred sale contract under topic al-Farq 194: “بين قاعدة ما يسد من الذرائع وبين قاعدة ما لا يسد منها”

⁵⁵ al-Qarāfī (2001), *Kitāb al-Furūq*, vol. 3, Kaherah: Dār al-Salām, pg. 1056.

2.3.1.2 Reprehensible

Reprehensible or disfavour is selected by Ibn Taymiyyah in most of his *fatwā*. According to him, it is also the ruling given by ‘Umar ‘Abd al-‘Azīz, one of the opinions of Imam Aḥmad and some of *Ahl al-Madīnah* including Imam Mālik.⁵⁶ This is also the view that is selected by some of the Ḥanbalī exponents.⁵⁷

The basis of the opinion of Ibn Taymiyyah is the element of *ribā*, that is, generating more money⁵⁸ from the money. This is based on the statement of ‘Umar ‘Abd al-‘Azīz:

التَّوَرُّقُ أَحْيَاةُ الرِّبَا⁵⁹

al-Tawarruq is a brotherhood of ribā

This means that *tawarruq* is the source or origin of *ribā*⁶⁰. In addition, the statement of Ibn ‘Abbās r.a.:

إِذَا اسْتَقَمَّتْ بِنَقْدٍ ثُمَّ بَعْتَ بِنَقْدٍ فَلَا بُاسَ بِهِ وَإِذَا اسْتَقَمَّتْ بِنَقْدٍ ثُمَّ بَعْتَ بِنَسِيئَةٍ فَتِلْكَ دَرَاهِمُ بِدَرَاهِمٍ⁶¹

If you price (the commodity) with cash then you buy it with cash, and then it is fine, but if you price (the commodity) with cash then you buy it with deferment, then it is classified as darāhim with darāhim.

⁵⁶ Ibn Taymiyyah (2001), *al-Qawā'id al-Nūrāniyyah al-Fiqhiyyah*, Aḥmad ibn Muḥammad al-Khalīl (ed.), vol. 1, Riyadh: Dār Ibn al-Jawzī, pg. 121; Ibn Taymiyyah (2004), *op. cit.*, vol. 29, pg. 30,302,303,431, 442,502

⁵⁷ al-Mardāwī, *op. cit.*, pg. 750; Ibn Muflih (2003), *al-Furū' wa Ma'ahu Taṣhīh al-Furū' li al-Mardāwī*, ‘Abd Allāh ibn ‘Abd al-Muḥsin al-Turkī (ed.), vol. 6, Beirut: Muassasah al-Risālah, pg. 316

⁵⁸ i.e. dirham had the function of money.

⁵⁹ Ibn Taymiyyah (2004), *op. cit.*, pg. 303, 431, 442.

⁶⁰ *Ibid*, pg. 431.

⁶¹ *Ibid*, *op. cit.*, pg. 442.

The statement means that the commodity is priced at a certain amount on the basis of a cash sale. However, if the intention of the trading is for generating money, then the commodity is bought on a credit basis with a higher price. Therefore, this is what is meant by *tawarruq*.

Ibn ‘Abbās r.a. also mentioned that perhaps there is a hint regarding such transactions as provided in the Hadith narrated by Usāmah from Nabi s.a.w.:⁶²

إِنَّمَا الرِّبَا فِي النَّسِيئَةِ⁶³

Indeed al-ribā is in the deferring

2.3.1.3 Prohibited Outright

Ibn Taymiyyah prohibited *tawarruq* in some of his *fatwās* due to the strong argument based on the meaning of the statement of ‘Umar ‘Abd al-‘Azīz:

أَنَّ التَّوَرُّقَ أَصْلُ الرِّبَا⁶⁴

Indeed, tawarruq is origination of ribā

He explained⁶⁵ that Allah prohibited generating more *dirhams* from *dirhams* due to deferment because it is considered as taking advantage against someone who is in need and eating his property with deception. In contrast, Allah permits the sale and

⁶² Ibn Taymiyyah (1987), *Fatāwā al-Kubrā*, Muḥammad ‘Abd al-Qādir ‘Aṭā et al. (eds.), vol. 9, Beirut: Dār al-Kutub al-‘Ilmiyyah, pg. 41.

⁶³ Muslim (2003), *Ṣaḥīḥ Muslim*, Beirut: Dār al-Fikr, Kitāb al-Musāqāh, hadith no. 3980 & 3982.

⁶⁴ Ibn Taymiyyah (2004), *op. cit.*, vol. 29, pg. 434

⁶⁵ See *Ibid*, pg. 434

purchase when the objective of the transaction is trading. However, if the intention of such trading is to gain more *dirhams* from *dirhams*, then there is no goodness in the deal.

Even though Ibn Taymiyyah chose prohibition, no such word as *al-ḥarām* was used. However, most of the later period of Ḥanbalī exponents mentioned in their writings that Ibn Taymiyyah's opinion against *tawarruq* is *al-tahrīm* (التحریم).⁶⁶

Concisely, the *tawarruq al-fiqhī*, or so considered as the basic principle of *tawarruq*, has three verdicts provided by classical *fiqh* scholars, i.e. permissible, reprehensible or disfavour, and prohibited outright. Now, the discussion about *tawarruq* is more in depth by contemporary *fiqh* scholars, especially concerning the branched-out-concept, namely, organized *tawarruq*, which is applied by Islamic banks today.

2.3.2 Contemporary Views on *Tawarruq*

Most of the contemporary *fiqh* scholars adhere to the view of the majority of classical scholars on the permissibility of *tawarruq* either in the form of an individual (*fardī*) *fatwā* or collective (*jamā'ī*) resolution. Subsequently, due to the evolution of the concept of *tawarruq* where the basic structure of the concept has been changed, some of the scholars provided an addendum to their *fatwās* or resolutions to address the organized elements in the modern *tawarruq* structure.

⁶⁶ See al-Mardāwī, *op.cit.*; Ibn Mufliḥ, *op.cit.*

In 1966,⁶⁷ the early grand mufti of Saudi Arabia, Shaykh Muḥammad ibn Ibrāhīm,⁶⁸ was asked about someone who wanted to obtain money by executing a *tawarruq* transaction.⁶⁹ He gave a *fatwā* that the well-known view in *madhhab*, i.e. Ḥanbalī, is permissible; even though the early scholars had different opinions concerning its permissibility, as mentioned by Ibn Taymiyyah. However, the view that permits *tawarruq* is more precise.

Subsequently, in 1977,⁷⁰ during the spread period of Islamic banking, the Saudi Arabia Council of Senior Scholars⁷¹ came out with a resolution that *tawarruq* trading of currency is prohibited since the intention is to sell money with more money. However, *tawarruq* trading of a commodity is permitted since it does not contain the element of *ribā* and it is not considered as two sales in a sale. The basis of the ruling is the saying of Allah Taala:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَى أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ

O ye who have believed, when ye contract a debt for a specified term, write it down

Surah al-Baqarah (2): 275

Also, on the basis of al-Hadith, which permits deferred sale and *bay‘ al-salam*.

⁶⁷ Corresponding to 1386H.

⁶⁸ He held the position from 1953 to 1969.

⁶⁹ Muḥammad ibn Ibrāhīm (n.d.), *Fatāwā wa Rasāil*, Muḥammad ibn ‘Abd al-Raḥmān (ed.), vol. 7, Mecca: Maṭba‘ah al-Hukūmah bi Makkah al-Mukarramah, pg. 6.

⁷⁰ 16 Shawal 1397H

⁷¹ The resolution was endorsed by members of council who are ‘Abd Allāh Khayyāt, ‘Abd al-Majīd Ḥasan, ‘Abd Allāh ibn Muḥammad ibn Ḥamīd, ‘Abd al-‘Azīz ibn Sāleh, Sulayman ibn ‘Abīd, ‘Abd al-Razāq ‘Afīfī, Ibrāhīm ibn Muḥammad Āli al-Shaykh, Rāshid ibn Khanīn, ‘Abd al-‘Azīz ibn Bāz, ‘Abd Allāh ibn Ghadyān, ‘Abd Allāh ibn Manī‘, Muḥammad al-Ḥarakān, Sāleh ibn al-Luḥaydān, ‘Abd Allāh ibn Qu‘ūd, Sāleh ibn Ghuṣūn, Muḥammad ibn Jabīr

Later, the individual *fatwā* given by the former mufti of Saudi Arabia, Shaykh ‘Abd al-‘Azīz ibn ‘Abd Allāh,⁷² when he was asked about someone who needed cash by executing a *tawarruq* transaction. According to him,⁷³ such a deferred sale of *tawarruq* with the intention to obtain money is permissible whereby the verdict of permissibility is more proper between two views of scholars. The basis of the ruling is the saying of Allah Taala:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

And Allah permits trading and prohibit ribā

Surah al-Baqarah (2): 275

And He says:

يَا أَيُّهَا الَّذِينَ ءَامَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَىٰ أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ

O you who believed, when you contract a debt for a specified term, write it down

Surah al-Baqarah (2): 282

The permissibility of *tawarruq* was also resolved by some *Sharī‘ah* committees of Arabian Islamic banks, such as the Kuwait Finance House, National Commercial Bank, Arab National Bank, Shamil Bank, al-Rajhi Bank, Abu Dhabi Islamic Bank, Investment Dar (Kuwait), Osoul Leasing and Finance Company, Saudi British Bank⁷⁴ and Saudi American Bank.⁷⁵

⁷² Known as Bin Baz. He held the position from 1993 to 1999. He also the council member of Hay‘ah Kibār al-‘Ulamā’

⁷³ Bin Baz (n.d.), *Majmu‘ Fatāwā wa Maqālāt Mutanawwi‘ah*, Muḥammad ibn Sa‘d, vol 19, Riyadh: Dār al-Qāsim, pg. 95-97

⁷⁴ Known as SABB.

⁷⁵ al-Rashīdī (2005), *‘Amaliyyāt al-Tawarruq wa Taḥqīqātuhā al-Iqtisādiyyah fī al-Maṣārif al-Islāmiyyah*, Amman: Dār al-Nafāis.

In 1998, the collective *tawarruq* ruling was resolved by one of the international authorized *fiqh* bodies, i.e. the council of al-Majma‘ al-Fiqhī al-Islāmī bi Rābitah al-‘Ālam al-Islāmī. The council,⁷⁶ in its 15th meeting,⁷⁷ resolved that the trade of *tawarruq* is permissible, as per the opinion of the majority of scholars, because the original ruling of trade is permissible, as mentioned in al-Quran:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

And Allah permits trading and prohibit ribā

Surah al-Baqarah (2): 275

In addition, there is no appearance of *ribā* in such trade, either implicitly or explicitly, and, also, because of the need for debt execution, marriage or others.⁷⁸

However, the permissibility of this trade is with condition, where the buyer cannot resell the commodity to the initial seller at the lower price, neither directly nor with an intermediary, and if it is executed in such a way, it will be classified as *bay‘ al-‘īnah*, which is prohibited, as it comprises the *hīlah* for *ribā*, which leads to a prohibited contract.⁷⁹

Subsequently, the application of *tawarruq* by Islamic banks was discussed in the seminar of al-Barakah li al-Iqtisād al-Islāmī in 2002. However, the resolution came out

⁷⁶ The council members who endorsed the resolution are ‘Abd al-‘Azīz ibn Bāz, Dr. ‘Abd Allāh ibn Sālih, Muḥammad ibn Jābir, ‘Abd Allāh al-‘Abd al-Raḥman al-Basam, Dr. ‘Abd Allāh Abū Zayd, Muḥammad ibn ‘Abd Allāh al-Sabīl, Muḥammad Sālim ibn ‘Abd al-Wadūd, Dr. Yūsuf al-Qarḍāwī, Dr. Muḥammad al-Ḥabīb ibn al-Khawjah, Abū al-Ḥasan ‘Alī al-Ḥusnī al-Nadwī, Dr. Aḥmad Muḥammad al-Muqrī

⁷⁷ Held in Makkah al-Mukarramah, starting from 11th Rejab 1419H, corresponding to 31st October 1998.

⁷⁸ *Qararāt al-Majma‘ al-Fiqhī al-Islāmī bi Makkati Mukarramah*, 15th seminar, resolution no. 5, downloaded from <http://www.themwl.org/publications/default.aspx?d=1&cid=20&cid=116&l=ar>, accessed on 01/03/12.

⁷⁹ *Ibid.*

after the second attempt of discussion⁸⁰ in the same year. The seminar resolved that the application of *tawarruq*, including the documentation, is not contradictory to *Sharī'ah* where there is no indication to prove a fictitious element.⁸¹ However, the permissibility was with the condition that the application of *tawarruq* needs to be observed, and that *tawarruq* is applied when there is no other solution, and due to necessity (*ḍarūrah*) and urgent needs. In addition, the accuracy of *tawarruq* must be improved to justify the independency of each contract.

Subsequently, in 2003, the council of al-Majma' al-Fiqhī al-Islāmī bi Rābiṭah al-Ālam al-Islāmī came out with a second resolution of *tawarruq* after conducting research and reviewing the bank's application and practices of the *tawarruq* concept. In its 17th meeting,⁸² the council⁸³ resolved that *tawarruq*, which is being practiced by the bank, or, namely, organized *tawarruq* is not permissible. The basis of the resolution is:⁸⁴

1. Enforcement of the seller in a *tawarruq* contract by using the *wakalah* concept to sell the commodity to another buyer or pre-arrange it makes it similar to *'inah*, that is,

⁸⁰ First discussion was conducted in 22nd Seminar on 8-9 Rabī' al-Ākhir 1423H, corresponding to 19-20 June 2002. Second discussion was conducted in 23rd Seminar on 6-7 Ramadhān 1423H, corresponding to 11-12 November 2002.

⁸¹ Resolution no. 23/3, *Nadwah al-Barakah al-Thālithah wa al-'Ishrūn li al-Iqtisād al-Islāmī*, <http://www.islamfeqh.com/Kshaf/KshafResource/List/ViewDecisionDetails.aspx?DecisionID=1650>, accessed on 24/01/12.

⁸² Held in Makkah al-Mukarramah, from 19th to 23rd Rejab 1419H, corresponding to 13th to 17th December 2003, resolution no. 2.

⁸³ The council members are Dr. Rashīd Rāghib, Dr. Muṣṭafā Sīrābnash, Dr. Naṣr Farīd Muḥammad Wāṣil, Dr. al-Ṣadīq Muḥammad al-Amīn al-Dharīr, Muḥammad Sālim ibn 'Abd al-Wadūd, Muḥammad ibn 'Abd Allāh al-Sabīl, Muḥammad Taqī 'Uthmānī (departed before signing), Dr. 'Abd al-Karīm Zaidan, Dr. Wahbah Muṣṭafā al-Zuhaylī, Dr. Yūsuf ibn 'Abd Allāh al-Qarḍāwī, Dr. 'Abd al-Satar Fath Allāh Sa'īd, Dr. Ṣālih ibn Zabin al-Marzūqī, Dr. 'Abd Allāh ibn 'Abd al-Muḥsin al-Turki, 'Abd al-'Azīz ibn 'Abd Allāh Āli al-Shaykh.

⁸⁴ See al-Majma' al-Fiqhī al-Islāmī bi Rābiṭah al-Ālam al-Islāmī (2003), *Majallah al-Majma' al-Fiqhī al-Islāmī, bi Rābiṭah al-Ālam al-Islāmī*, resolution no. 2, *al-Tawarruq kamā Tujrīh Ba'ḍ al-Maṣrif fī al-Waqt al-Ḥāḍir*, Makkah: al-Majma' al-Fiqhī al-Islāmī bi Rābiṭah al-Ālam al-Islāmī, pg.287.

prohibited by *Sharī'ah*, either the enforcement is clearly stipulated or follows the common practice.

2. This transaction in most cases fails to fulfil the condition of the commodity possession, as required by *Sharī'ah*.
3. The scenario of this transaction is built on the basis of granting the financing with some additional amount as a return. The sale and purchase transaction performed by the *mustawriq* is just fictitious in most cases, whereby the objective of the bank is to obtain some addition from the disbursed financing. Hence, this transaction is not a real *tawarruq*, as recognised among *fiqh* scholars, and as discussed in the previous resolution.

In 2005, the *tawarruq* concept was regarded as being permissible to apply by Islamic Financial Institutions (IFIs) in Malaysia. The Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM), in its 51st meeting,⁸⁵ resolved that deposit and financing products on the concept of *tawarruq* is permissible based on the following evidence:⁸⁶

1. al-Quran:

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

And Allah permits trading and prohibit ribā

Surah al-Baqarah (2): 275

Based on the general meaning of this statement, the scholars were of the opinion that *tawarruq* is permissible as part of trade. It may occur for the purpose of getting cash

⁸⁵ Held on 21st Jamādī al-Ākhir 1426H, corresponding to 28th July 2005.

⁸⁶ Resolusi Syariah dalam Kewangan Islam, pg. 94, BNM, downloaded from http://www.bnm.gov.my/microsites/financial/pdf/resolutions/shariah_resolutions_2nd_edition.pdf, accessed on 01/10/11.

either with or without knowing by all counterparties. It may also occur due to a critical situation of need or as a common activity by certain parties or institutions.

2. Legal Maxims:

الأصل في المعاملات الإباحة، إلا ما دل الدليل على حرمة

The original ruling in mu'āmalāt is permissibility, except the evidence shows the prohibition.

3. Views of contemporary scholars that permit the usage of *tawarruq* based on the opinions among *madhhab* Ḥanafī, Ḥanbalī and Shāfi'ī, which allow the usage of *tawarruq*.

Consequently, the council of Majma' al-Fiqh al-Islāmī al-Duwalī in its 19th meeting,⁸⁷ came out with a definition of *tawarruq* (as mentioned previously) and its verdicts. The resolution resolved that *tawarruq al-fiqhī* is permitted on the condition that it fulfils the conditions of sale and purchase in *Sharī'ah*.⁸⁸

However, neither *tawarruq al-munazzam* or *al-'aksī* are permitted inasmuch as there is cooperation between the *mumawwil* and *mustawriq*, either explicitly or implicitly or as a common practice, which is considered as deception to gain additional quick cash from the contract, which is classified as *ribā*.⁸⁹

⁸⁷ Held in Shārqah, United Arab Emirates, from 1st to 5th Jamādī al-Ūlā 1430H, corresponding to 26th to 30th April 2009.

⁸⁸ Majma' al-Fiqh al-Islāmī al-Duwalī (2009), *al-Tawarruq: Haqīqatuh, Anwā'uh (al-Fiqhī al-Ma'ruf wa al-Maṣrifī al-Munazzam)*, resolution no. 179 (19/5), downloaded at <http://www.fiqhacademy.org.sa>, accessed on 17/5/2011

⁸⁹ *Ibid.*

The resolution was presented at the council, under the auspices of al-Majma‘ al-Fiqhī al-Islāmī bi Rābitah al-‘Ālam al-Islāmī in Makkah, after reviewing the presented research papers regarding the topic of “*Tawarruq*, Its Meaning and Its Type”, for both classical and organized *tawarruq*.

Concisely, most of the scholars accepted the basic principle of the concept of *tawarruq*. However, the contemporary scholars have a different opinion concerning organized *tawarruq*, which is applied by Islamic banks. Nevertheless, *tawarruq* consists of a cash and credit sale and purchase. Therefore, generally, it should fulfil the essential elements that are required for sale and purchase, and also fulfil the specific elements required for deferred sale according to the concept of *murābahah* or *musāwamah*.

2.4 Essential Elements of *Tawarruq* Contract

Tawarruq is a hybrid concept that consists of a sale and purchase contract on a cash basis between the *mustawriq* and the *mumawwil*, and also a credit-based contract between the *mustawriq* and third party buyer. It may have another contract between the *mumawwil* and his vendor to obtain the commodity either by cash or credit contract. Therefore, *tawarruq* is a sale and purchase transaction that consists of a series of contracts.

Although, there are different definitions given by *fiqh* scholars for sale and purchase (*bay'*),⁹⁰ in summary, it refers to the exchange of wealth (*māl*) with wealth, whereby the wealth can be in the form of currency or commodity. Therefore, if there is no deferment from both contracting parties, it is a cash sale, while if there is deferment from either side, then it is a credit or deferred price sale.

A cash-based sale is a transaction where the commodity is sold by cash based on its value. This uses the general principle of sale and purchase, or, specifically, called by some *fiqh* scholars, as absolute sale (*al-bay' al-muṭlaq*),⁹¹ while a credit-based sale, namely, *bay' bithaman ajil* or *bay' mu'ajjal*, refers to the sale of goods or property, against deferred payment either in a lump sum or instalments.⁹² Normally, the price of a credit sale is higher than the cash price or prevailing market value due to the time value of money.⁹³

The higher price setting in a credit sale is normally underlain by either the contract of *murābahah* or *musāwamah*. The difference between the selling price and cost price will be the profit obtained by the seller. According to the AAOIFI standard, the

⁹⁰ See al-Jazīrī (2003), *Kitāb al-Fiqh 'alā al-Mazāhib al-Arba'ah*, vol. 2, Beirut: Dār al-Kutub al-‘Ilmiyyah, pg. 134-139.

⁹¹ According to the Ḥanafī School of Law, from the viewpoint of the trading object, the sale and purchase has four types, i.e. *Muqāyadhah*, *Ṣarf*, *Salam*, and *Bay' Muṭlak*. If the commodity is exchanged with a commodity then it is *Muqāyadhah*. If the currency is exchanged with currency then it is *Ṣarf*. If the currency is exchanged with a commodity then it is *Salam*. If the commodity is exchanged with currency then it is *al-Bay' al-Muṭlaq*. It is either on spot or deferred basis. See al-Jazīrī, *op. cit.*, pg 492.

⁹² Muhammad Ayub, *op. cit.*, pg. 219.

⁹³ The credit price of the commodity can be higher than the cash price provided it is settled before the separation of the parties.

credit basis or deferred price in a *tawarruq* transaction is determined through *musāwamah* or *murābahah*.⁹⁴

Bay' al-Murābahah is a cost-plus sale where the price is determined based on the cost price with an additional margin of profit bargained by both contracting parties.⁹⁵ Meanwhile, *bay' al-musāwamah* is a bargaining price sale where the price is agreed by both contracting parties without looking at the cost price.⁹⁶

The *murābahah* and *musāwamah* terms of payment are not necessary on a credit basis, whereby it could be either by cash or credit. However, in current banking practices, both *murābahah* and *musāwamah* contracts are being used for credit-based sales, i.e. *bay' mu'ajjal* or *bithaman ajil*. Therefore, from the payment perspective, *bay' mu'ajjal* or *bithaman ajil* contracts are normally embedded with the concept of either *murābahah* or *musāwamah*.

⁹⁴ AAOIFI, *op.cit.*

⁹⁵ See al-Zuhaylī, *al-Mu'āmalah al-Māliyyah al-Mu'āṣirah (Buhūth wa Fatāwā wa Ḥulūl)*, Damsyik: Dār al-Fikr, pg. 67. Muhammad Ayub, *op. cit.*, pg. 213.

⁹⁶ See al-Zuhaylī, *op.cit.*, pg. 66. Abdul Halim el-Muhammady, *Undang-undang Muamalat dan Aplikasinya Kepada Produk Perundangan Islam*, Kajang: Aras Mega, pg.132.

Concisely, to apply the *tawarruq* concept, the essential elements of the involving contract should be fulfilled. First, for a cash-based contract, the requirements of a sale and purchase or absolute sale (*al-bay‘ al-muṭlaq*) should be met. Second, the requirement of a cost-plus sale (*murābahah*) or bargaining sale (*musāwamah*) should be fulfilled for a credit-based contract.

2.4.1 Element and Condition of *al-Bay‘*

The sale and purchase (*al-bay‘*) consists of three main elements in which each of the elements consists of two sub-elements. Therefore, there are six essential elements for a sale and purchase contract. These elements are terms of agreement (*ṣīghah*), which consists of offer (*ījāb*) and acceptance (*qabūl*), contracting parties (*‘āqidayn*), which consists of seller (*bāi‘*) and buyer (*mushtarī*), and subject of contract (*ma‘qūd ‘alayh*), which consists of commodity (*muthamman*) and price (*thaman*).⁹⁷

Offer and acceptance refers to the agreement of both parties, i.e. the seller and the buyer, and is conducted either verbally or with a written document. However, the action of give and take without any words or writing is also effective, as it becomes the common practice to indicate the sale and purchase transaction.⁹⁸ It is required that the acceptance should conform to the offer in all the details, such as measurement,

⁹⁷ In the Ḥanafī school of law, the essential element for the contract only consists of offer and acceptance. However, the view is based on the core element of the existence of the contract, whereby the rest of the elements are embedded with offer and acceptance. For a detailed discussion on the elements and conditions, please refer to al-Jazīrī, *op. cit.*, pg. 141-153.

⁹⁸ Please refer to comparative *fiqh* treatise for detail discussion.

description, terms of payment, delivery, etc. and take place in the same session or meeting.

The parties who enter the agreement must be competent to make a sale and purchase. The seller and buyer should possess the intellectual maturity (*mumayyiz*).⁹⁹ However, although some *fiqh* scholars did not allow children¹⁰⁰ to enter into a contract, some allowed it with the permission of a guardian. Another condition is that neither the seller nor the buyer is in the position of being forced.

Lastly, the subject of the contract is provisioned to be pure and able to provide beneficial usufruct. Therefore, the subject matter cannot be unlawful or non-beneficial. In addition, the object of the trading should be able to be owned and measured, and the object and its price should be made known to both parties.

2.4.2 Elements and Conditions of *Bay' al- Murābaḥah*

Sale and purchase transactions under *murābaḥah* should meet all the elements and conditions applicable to an ordinary sale in terms of offer and acceptance, contracting parties and also subject matter. However, some additional requirements are needed. The original price or cost price paid by the seller to obtain the commodity should be stated and made known to the buyer. The additional expenses and margin of profit added to the

⁹⁹ Including insane people or those who do not possess the intellectual maturity.

¹⁰⁰ Yet to attain puberty (*bāligh*) age.

selling price should be declared precisely. Therefore, the determination of the selling price is transparent to the buyer where the cost price, additional expenses and margin of profit are stated clearly. As a result, the pricing for *murābahah* transaction can be mutually agreed upon between the seller and the buyer.

2.4.3 Elements and Conditions of Bay‘ al-Musāwamah

While in *murābahah* transaction, the contracting party bargains the price with reference to the original price, cost incurred and margin of profit, *musāwamah* transactions do not require such reference. It is different from *murābahah* in respect of the pricing formula inasmuch as the seller is not obliged to disclose the cost. However, both parties can negotiate on the price. All elements and conditions relevant to *murābahah* transactions are valid for *musāwamah* transactions except that the seller is not in the position to reveal the commodity cost that is offered to the buyer.

2.5 Conclusion

In summary, the discussion of classical *fiqh* scholars on *tawarruq* and *‘īnah*, encompasses the *hīlah* for *ribā*. The *madhhab* exponents debated whether such transactions are considered as a process of generating more money from the money, which leads to *ribā*. Most of the *fiqh* scholars ruled that the two-party *‘īnah* is ruled as *hīlah*. However, some of the Shāfi‘ī exponents permitted it due to the contract being

independent of each other. However, it is only permitted without pre-arrangement and where it fulfils the sale and purchase requirements.

In addition, the majority of classical *fiqh* scholars permitted *tawarruq* as it is not considered as *hīlah* due to the involvement of a third party as the end buyer. Therefore, it is considered as trading, which is permitted by *Shari'ah*. Conversely, *tawarruq* is disallowed by some Ḥanbalī exponents, i.e. Ibn Taymiyyah and his followers, either reprehensible (*karāhah*) or prohibited outright (*tahrīm*), for the reason that the objective is to gain money with money (*darāhim bi darāhim*), which is still classified as *hīlah*.

Nowadays, most of the contemporary *fiqh* scholars opine the same as previous scholars inasmuch as *tawarruq* is ruled as permissible. However, the customization of the *tawarruq* concept in current banking applications, i.e. organized *tawarruq*, causes disagreement between *fiqh* scholars inasmuch as the majority of them disallowed such a concept, as it is considered as *hīlah for ribā*. However, some scholars allowed it as the contract validity of each transaction is accepted.

In summary, the difference in the transactions and ruling between classical *tawarruq* or *tawarruq al-fiqhī* and organized *tawarruq* or *tawarruq al-munazzam* can be described, as per Table 2.1:

Table 2.1: *Tawarruq al-Fiqhī* vs. *Tawarruq al-Munazzam*

	<i>Tawarruq al-Fiqhī</i>	<i>Tawarruq al-Munazzam</i>
Modus Operandi	<ul style="list-style-type: none"> i. The <i>mustwariq</i> buys the commodity from someone on a credit basis where the price is higher than the cash price ii. The <i>mustawriq</i> sells the commodity to someone else (3rd party) on a cash basis where the cash price is lower than the credit price to acquire cash 	<ul style="list-style-type: none"> i. Customer (<i>mustwariq</i>) buys the commodity from bank (<i>mumawwil</i>) on credit basis with pre-arrangement of bank appointment as agent (<i>wakīl</i>) to resell the commodity ii. Bank sells the commodity on behalf of customer to 3rd party on cash basis iii. Bank gives cash proceeds from the sale to customer
Classical View	<ul style="list-style-type: none"> i. Permitted by the majority of scholars due to the involvement of a 3rd party, which makes the trading permissible and not considered as <i>hīlah</i>, regardless of the higher price in the deferred sale. ii. Prohibited (or reprehensible) by some scholars due to ‘<i>illah</i> of gaining money with money (<i>darāhim bi darāhim</i>), which is considered as <i>hīlah</i>, regardless of the involvement of a 3rd party 	<p>Not applicable (Evolution occurs in the modern age of Islamic banking)</p>
Contemporary View	Same view as the majority of classical <i>fiqh</i> scholars, i.e. permissible due to the involvement of a 3 rd party, which is not considered as <i>hīlah</i>	<ul style="list-style-type: none"> i. Prohibited by the majority of scholars due to the bank’s appointment as agent (<i>wakālah</i>) is considered as <i>hīlah</i>, whereby the trading transaction is fictitious and unable to fulfil the requirement of possession, and has a similarity with ‘<i>īnah</i>. ii. Permitted by some scholars under the basis of <i>Tawarruq al-Fiqhī</i> ruling, and each of the transactions including <i>wakālah</i> is valid and fulfils the requirements of <i>Sharī‘ah</i>

Source: Author’s summarization of chapter 2

CHAPTER 3: *TAWARRUQ* IN THE MALAYSIAN BANKING FRAMEWORK

3.1 Introduction

Malaysia has a unique financial system in that the Islamic banking and conventional banking run parallel. Since conventional banking was initiated earlier, it can be said that the conventional system has become the baseline of the local financial system, which includes the nature of banking products, standards and practices, and also laws and regulations. Having different principles from conventional banking, Islamic banking was developed under the basis of the requirements of *Shari'ah*. However, the development still refers to the existing conventional baseline.

Under Malaysian enactments, Islamic financial institution means a financial institution¹ carrying on Islamic financial business.² Islamic bank means any company that carries on Islamic banking business and holds a valid licence, and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank.³ Islamic banking business refers to banking business⁴ the aims and operations of which do not

¹ Financial institution is defined as a person carrying on a financial business regulated under the laws enforced by BNM and in addition includes any person who operates any payment system or issues any payment instrument, and any person carrying on any other financial business as the Minister may prescribe. Central Bank of Malaysia Act 2009, para 2(1), downloaded from <http://www.bnm.gov.my/index.php?ch=14>, accessed on 06/09/2011.

² *Ibid.*

³ Islamic Banking Act 1983, para 2, downloaded from <http://www.bnm.gov.my/index.php?ch=14>, accessed on 06/09/2011.

⁴ Banking business refers to the business of receiving deposits on current account, deposit account, savings account or other similar account, paying or collecting cheques drawn by or paid in by customers, provision of finance and such other business as BNM with the approval of the Minister may prescribe. Banking and Financial Act 2009, para 2(1), downloaded from <http://www.bnm.gov.my/index.php?ch=14>, accessed on 17/09/2011.

involve any element that is not approved by the religion of Islam.⁵ This means that Islamic banking still runs the same business as conventional banking, such as deposits, financing,⁶ and payments, but with the elimination of aspects that are non-*Sharī'ah* compliant.

Tawarruq is one of the underlying concepts that have been introduced recently in Islamic banking business for the purpose of cash liquidity in the domain of deposit, financing, treasury or others. Riding on the current landscape where the conventional system represents a baseline, the credit standards and practices for Islamic banking are treated the same as the conventional. However, there are some insertions and elimination of a few elements that are deemed as being required by *Sharī'ah*, of which the Islamic banks may not be aware, especially inasmuch as the conventional system is more dominant

3.2 Islamic Financial System

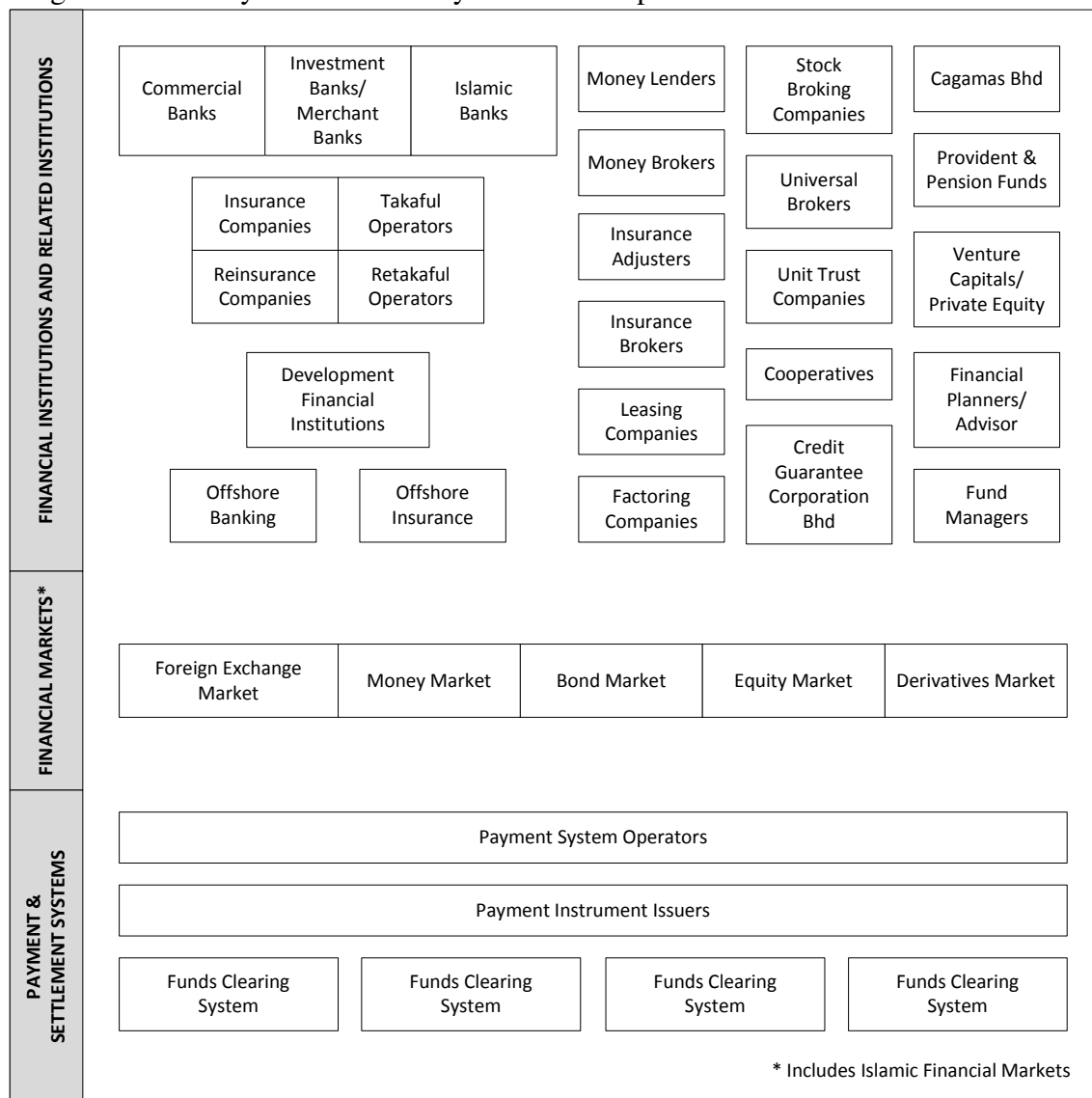
Malaysia has a comprehensive financial system inclusive of both Islamic and conventional systems that act as intermediaries for the resources in the economy. The system consists of two main components, i.e. financial intermediary and financial market. The financial intermediary is made up of bank and non-bank intermediaries, while the financial market comprises the money market, foreign exchange market,

⁵ *Ibid.*

⁶ The term “financing” is commonly used as a replacement for loan except for a benevolent loan to avoid the close relationship of loans with interest, which are legislated as *ribā*.

equity market, derivative market and bond market. The landscape of this financial system is illustrated in Diagram 3.2:

Diagram 3.1: Malaysian Financial System Landscape



Source: BNM Financial Stability and Payment Systems Report 2007

Based on the current landscape, the Islamic financial system encompasses the Islamic banking system, Islamic money market, Islamic capital market,⁷ Takaful and specialised financial institutions. The overall objective of Islamic finance development is to create an effective, progressive and comprehensive Islamic

⁷ Equity and bond market.

financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector, while meeting the economic needs of the nation.⁸

In order to achieve such an objective, BNM has taken a step-by-step approach. Starting with the establishment of full-fledged Islamic bank, other financial institutions were allowed to offer Islamic banking facilities, which later became a legal entity by using the existing infrastructure. Banking licences have also been given to foreign Islamic financial institutions to commence their operation in Malaysia. Malaysia's holistic approach to Islamic finance is as follows:

Table 3.1: Islamic Finance Approach in Malaysia

Duration	Event
Stage 1: (1983 – 1992) Instituting foundations	<ul style="list-style-type: none"> • Enactment of dedicated Acts for Islamic banking, takaful and government funding • Establishment of first full-fledged Islamic bank and takaful operator
Stage 2: (1993 – 2000) Institutional building, activity generation & market vibrancy	<ul style="list-style-type: none"> • Legislative amendment to allow window-concept • Establishment of National Shariah Advisory Council to expedite the expansion of products and services • Establishment of the Islamic Interbank Money Market
Stage 3: (2001 – 2010) Strategic positioning & international integration	<ul style="list-style-type: none"> • 4-pronged strategic approach <ul style="list-style-type: none"> i. Regulatory framework development ii. Legal & <i>Shari'ah</i> framework iii. Products and markets development iv. Enhancement of knowledge and expertise • Financial Sector Master Plan (FSMP) was launched • Establishment of Islamic Financial Services Board • Liberalise domestic Islamic finance sector <ul style="list-style-type: none"> i. Allow entry of foreign players ii. Islamic subsidiaries • Integrate with international Islamic finance sector • Establishment of Malaysia International Islamic Financial Centre (MIFC)

Source: Customized from MIFC document⁹

⁸ Nik Norzrul Thani et al. (2010), *Law & Practice of Islamic Banking and Finance*, Petaling Jaya: Sweet & Maxwell Asia, pg. 141.

⁹ MIFC document downloaded from http://www.mifc.com/?tpl=th010_search_result&qt=Islamic+finance+evolution+, accessed on 14/09/2011.

Numerous products using various concepts have been developed throughout the stages. *Tawarruq* is one of the products that have been developed for cash liquidity as an alternative to *‘īnah* where *‘īnah* was previously used for that purpose. Some resolutions have been endorsed by BNM for deposit and financing products, *ṣukūk* and interbank money market to use *tawarruq* as the underlying concept for all these products.

3.3 BNM Framework for *Tawarruq*-based Products

The BNM resolution permitted the *tawarruq* concept to be implemented by Islamic banks in Malaysia as an alternative to *‘īnah*. The concept is also known as commodity *murābahah* and widely used in deposit products, financing, asset and liability management as well as risk management.¹⁰ However, no specific framework or detailed guideline has been introduced by BNM except in the SAC resolution or so-called Shariah Resolution in Islamic Finance,¹¹ which gives a brief explanation of the *tawarruq* verdict and *tawarrud*-based products.

The *tawarruq* concept in Malaysia has been applied in deposit products, financing products, *ṣukūk* and the interbank money market. *Ṣukūk*,¹² deposit¹³ and financing¹⁴ products, which were proposed by Islamic banks to be underlain by the

¹⁰ Bank Negara Malaysia-BNM (2010), *Shariah Resolution in Islamic Finance*, Second Edition, Kuala Lumpur: BNM, pg. 94.

¹¹ As replied by BNM via email on 08/12/2011.

¹² Endorsed by SAC in 67th meeting on 03/05/2007

¹³ Endorsed by SAC in 51th meeting on 28/07/2005

¹⁴ Endorsed by SAC in 51th meeting on 28/07/2005GBR3

tawarruq concept, were later approved by the SAC of BNM in the resolution. In addition, the *tawarruq* concept is also being used in the interbank money market, which is managed by BNM under the Commodity Murabahah Programme (CMP). Consequently, Bursa Malaysia Berhad (Bursa Malaysia) under the MIFC umbrella set up the Commodity Murabahah House (CMH) as the world's first fully-*Sharī'ah* compliant commodity trading platform, which is now known as Bursa Suq al-Sila'.

3.3.1 Alternative Concept to *ʿĪnah*

As mentioned in the BNM resolution,¹⁵ the *tawarruq* concept is regarded as an alternative concept to *bayʿ al-ʿĪnah*, which was used earlier as the underlying concept to obtain cash liquidity from financial products or instruments. *ʿĪnah* has been implemented in financing products, deposits and financial liquidity management. The reason to introduce the *tawarruq* concept is due to the need to address the contemporary issues and subscribe to the majority opinion of *Sharī'ah* scholars.¹⁶

Previously, *ʿĪnah* was regarded as being prohibited by the majority of *fiqh* scholars, but permitted by some *Shāfiʿī* exponents, as long as the intention of the needs, such as upfront condition in the contract is invisible. Otherwise, it will be regarded as disfavoured or prohibited.¹⁷ Nowadays, although most of the *Sharī'ah*

¹⁵ BNM (n.d.), *Resolution of Shariah Advisory Council of the Bank*, pg. 12, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584#shariah>, accessed on 06/09/2011

¹⁶ *Ibid.*

¹⁷ See al-Anṣārī (2001), *Asnā al-Maṭālib fī Sharḥ Rawḍ al-Tālib*. vol. 4, Beirut: Dār al-Kutub al-ʿIlmiyyah, pg. 104..

scholars also prohibit *‘īnah*, it is permitted by some scholars, mostly in the South East Asia region by using the view of *Shāfi‘ī* exponents.

However, according to the BNM resolution,¹⁸ a valid *‘īnah* contract should fulfil the following conditions¹⁹:

1. Consisting of two clear and separate contracts, namely, a purchase contract and a sale contract.
2. No stipulated condition in the contract to repurchase the asset.
3. Both contracts are concluded at different times.
4. The sequence of each contract is correct, whereby the first sale contract shall be completely executed before the conclusion of the second sale contract.
5. Transfer of ownership of the asset and a valid possession (*qabḍ*) of the asset in accordance with *Shari‘ah* and current business practice (*‘urf tijārī*).

The *‘īnah* contract is facing a major issue due to its operation. The main condition given by the *Shāfi‘ī* school of law is to avoid pre-arrangement. Therefore, the BNM requirement to have two separate contracts in different interval time, for transacting the sale and for purchasing the commodity between the bank and the customer, can only be adapted with strict controls. In addition, to have a valid possession of a commodity and to transfer its ownership, from the bank to the customer and back to the bank, is quite challenging to implement via those contracts.

In the real scenario,²⁰ the document of offer and acceptance for both contracts is agreed and signed upfront. In some cases, the contract is done verbally, i.e. via

¹⁸ SAC 16th meeting dated 11 November 2000 and 82th meeting dated 17 February 2009.

¹⁹ BNM (2010), *op. cit.*, pg. 113.

phone telecommunication, for both contracts upfront. In addition, the commodity is not clearly specified and movement of the ownership is questionable. Therefore, such a scenario can be considered as failure to comply with the BNM resolution and also what is legislated in the *Shāfi'ī* school of law.²¹

Consequently, *īnah* contract execution is considered as invalid, thereby leading to a *ribā*-based transaction. Therefore, it will have a high impact on the financial aspect of the bank whereby purification of the financing account needs to be conducted. Inability to comply with *Sharī'ah* requirements will cause a loss to the bank in which the profit cannot be earned and the cost of purification needs to be borne by the bank.

In comparison, the fundamentals of *tawarruq* are permitted by the majority of *fiqh* scholars, while *īnah* is only allowed by the *Shāfi'ī* school of law with certain conditions. Therefore, *īnah*-based products, which are mostly applied in South East Asia, are hardly likely to penetrate the global market where the *tawarruq*-based products are preferred. The following table shows the difference between *īnah* and *tawarruq* from the banking operational perspective:

²⁰ Author's view based on observation of personal financing and credit card products of several local banks.

²¹ Please refer to Chapter 2 for the view of the *Shāfi'ī* school of law on *īnah*.

Table 3.2: Operational Comparison of *‘Īnah* and *Tawarruq*

<i>‘Īnah</i>	<i>Tawarruq</i>
The commodity will go back to the seller. In banking operations, financing for example, the bank will be the seller in the <i>‘Īnah</i> deal. The commodity or property that is sold to the customer will be sold back to the bank.	The commodity will not go back to the seller. The commodity, which is bought by the bank from the vendor, and sold to the customer, will be sold back by customer to another vendor. The commodity cannot be sold back to the same vendor by the customer. ²² Otherwise it becomes tripartite <i>‘Īnah</i> or four parties and so on.
There are only two contracting parties, i.e. the bank and the customer.	There are more than two contracting parties (normally four), i.e. the bank, the customer and the vendors or brokers.
Legal documentation content consists of agreement between two parties, i.e. the bank and the customer.	Legal documentation has more content that consists of the agreement of two parties, i.e. between the bank and customer, and also the clause for trading with a third party, i.e. vendors or brokers.
<i>‘Aqd</i> execution only between the bank and the customer	<i>‘Aqd</i> execution will involve the bank, the customer and a third party i.e. vendor and broker for commodity sale and purchase.
Has two separate contracts and the movement of commodity or property between the bank and the customer is the potential risk of <i>Shari‘ah</i> non-compliance.	The risk exposure is more on legal documentation (for organized element), <i>‘aqd</i> execution and commodity movement within vendors and market.

Source: Summarized from several sources including the BNM resolution, Bursa Suq al-Sila’ documents and author’s observation.

Therefore, due to market forces and the dynamism of the Islamic finance industry,²³ the Malaysian market started to diversify the type of *Shari‘ah* contract and product structure including providing *tawarruq* as an alternative to *‘Īnah* for cash liquidity. Moving forward, the products of the local Islamic banks will be able to cater for sophisticated customer demand, especially from countries in the Middle East.

²² In the Bursa Suq al-Sila’ case, the commodity selling to vendors by Bursa Malaysia Islamic Services (BMIS) is executed randomly, which means that the control of commodity flow will not be fixed either to the initial seller or other vendors.

²³ As replied by BNM via email on 08/12/2011

3.3.2 *Tawarruq* in Deposit Product

Deposit refers to the sum of money kept or deposited in a bank. According to Banking and Financial Institution Act (BAFIA), 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.²⁴ In simple words, it refers to the savings in the form of a savings account, current account, investment account, etc.

The same deposit concept is applied by Islamic banks except for the involvement of prohibited elements, such as interest. The customer or account holder who deposits the money in the bank is called a depositor. The depositor can be defined as a person who has an account at an Islamic bank, whether the account is a current account, a savings account, an investment account or any other deposit account.²⁵

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. Referring to the BNM resolution, the proposed mechanism for *tawarruq*-based deposits is as follows.²⁶

²⁴ Banking and Financial Institution Act 1989, para 2(1), *op.cit.*

²⁵ Islamic Banking Act 1983, para 2, *op. cit.*

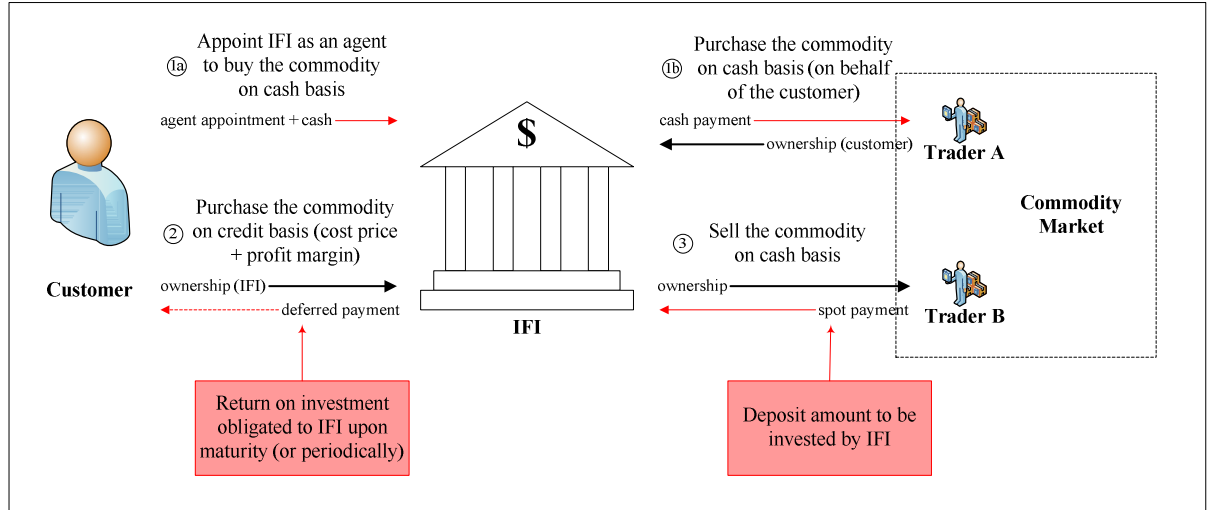
²⁶ BNM (2010), *op. cit.*, pg. 94. The resolution stated on metal commodity whereby the commodity trading is not limited to metal only as long as it has value. Perhaps it refers to metal trading at the London Metal Exchange (LME), which was widely used earlier as a commodity trading platform.

1. The customer (depositor) appoints the IFI as an agent to purchase a metal commodity from metal trader A on a cash basis in a recognized metal commodity market.
2. The IFI will thereafter purchase the metal commodity from the customer on a deferred sale at a cost price plus profit margin.
3. Next, the Islamic financial institution will sell back the metal commodity to metal trader B on a cash basis in the metal commodity market.

The cash received by IFI from trader B will be the deposit amount of the customer to be invested by the bank. The deferred price (cost price plus profit margin) of the deal between the IFI and the customer becomes the obligation or liability to the IFI that needs to be paid to the customer upon maturity. This is the return of investment expected by the customer.

In summary, the customer will deposit such amount into the IFI's investment portfolio in a mode of commodity trading, while the IFI will pay the return on investment to the customer upon maturity as an outcome of the credit purchase by the IFI. The modus operandi for this type of deposit is illustrated as follows:

Diagram 3.2: Modus Operandi for *Tawarruq*-based Deposit



Source: Illustrated based on BNM resolution for *tawarruq*-based deposit

3.3.3 *Tawarruq* in Financing Product

Financing refers to the money supply by the bank for the customer's needs. According to the Central Bank Act, financing is defined as the giving of any advance, loan, credit or other facility in whatever form or by whatever name called, including the giving of a guarantee or undertaking of any surety obligations for another person and where such financing is extended in accordance with *Shari'ah* it shall include, and may be in the form of, without limitation, any sale or purchase arrangement, joint venture arrangement, deferred payment sale, return sharing arrangement or any other financing arrangement made in accordance with *Shari'ah*.²⁷

Financing in Islamic banking and loans in conventional banking have a similarity as a core domain in banking business. In conventional banking, loans refer to the money lent on condition that they are repaid, either in instalments or all at

²⁷ Central Bank of Malaysia Act 2009, para 2(1), *op. cit.*

once, on agreed dates and usually that the borrower pays the lenders an agreed rate of interest.²⁸ Therefore, it can be said that a loan is money capital that gains profit from interest and charges via borrowing or lending activities.

Even financing has a similar intention to that of lending in conventional banking, i.e. for money supply, albeit with the elimination of the prohibited elements like interest to comply with Islamic law. Therefore, the *Sharī'ah*-based concept plays a role in a deal between the bank and the customer. The financing contract or so-called '*aqd* agreement relies on this underlying concept, which reflects the financing operation. In addition, the applied concept is also based on financing type, such as housing, hire purchase, trade or cash line. *Tawarruq* is one of the *Sharī'ah* modes used for financing, especially for cash based financing.

Referring to the BNM resolution, the proposed mechanism for *tawarruq*-based financing is as follows:²⁹

1. The IFI purchases a metal commodity from metal trader A on a cash basis in a recognized metal commodity market.
2. The IFI sells the metal commodity to the customer on a credit basis at a cost price plus profit margin.
3. The customer appoints the IFI as his agent to sell the metal commodity to metal trader B on a cash basis in the metal commodity market.

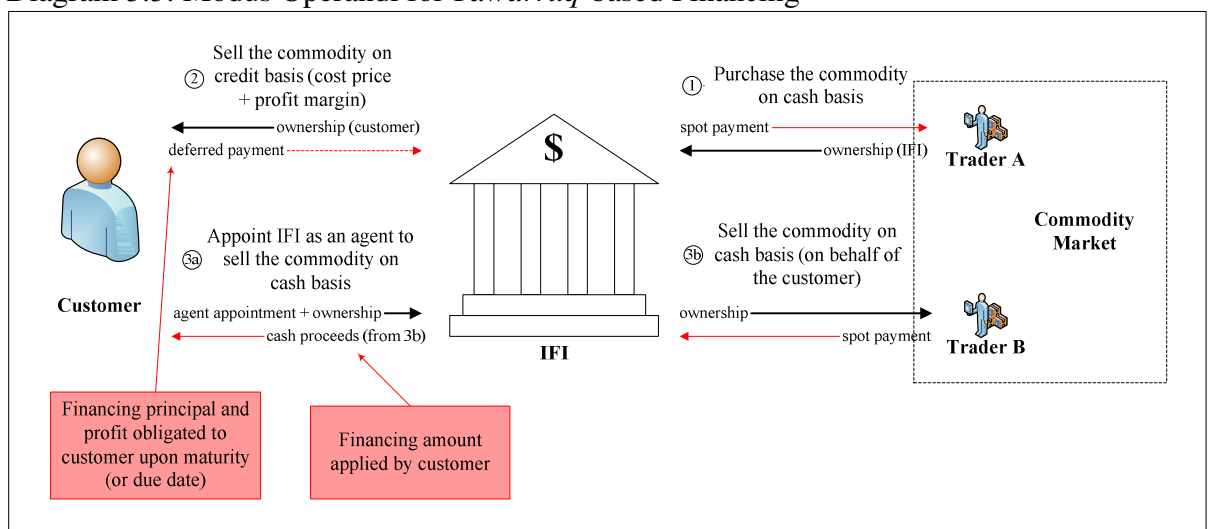
²⁸ Oxford University (2008), *Oxford Dictionary of Banking and Finance (4th Edition)*, Oxford: Oxford University Press, pg. 265.

²⁹ BNM (2010), *op. cit.*, pg. 96.

The proceeds received from the cash sale by the IFI on behalf of the customer to trader B will be the financing amount given to the customer. Meanwhile the deferred sale will create the financial obligation for the customer that must be paid to the IFI subject to the agreed terms and condition. This is the instalment or deferred payment from financing inclusive of the profit margin expected by the bank.

In summary, the bank will provide financing to the customer for their purpose or needs via a mode of commodity trading, while the customer will pay the instalment or deferred payment upon the due date as an outcome of the credit sale by the bank. The modus operandi for this type of financing is illustrated as follows:

Diagram 3.3: Modus Operandi for *Tawarruq*-based Financing



Source: Illustrated based on BNM resolution for *tawarruq*-based deposit

3.3.4 *Tawarruq in Şukūk*

Şukūk or investment *şukūk* is a document or certificate that represents the value of an asset.³⁰ It can also be defined as a certificate of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity. However, this is only true after the receipt of the value of the *şukūk*, the closing of the subscription and employment of funds received for the purpose for which the *şukūk* was issued.³¹

There are several *Shari‘ah* modes being used as the underlying concept in *şukūk* products, such as *muḍārabah*, *mushārah*, *ijārah*, *salam*, *istiṣnā‘* and *tawarruq*. *Tawarruq*-based *şukūk* is also known as *şukūk* commodity *murābahah*, which was introduced as an alternative instrument to the existing money market product that is based on *‘īnah*. The *şukūk* product structure may vary between each other, but the element of *tawarruq* is the same, i.e. to provide cash for the *şukūk* issuer.

Şukūk commodity *murābahah* was approved by the SAC of BNM with the condition that the sale transactions involve three or more contracting parties.³² The cash received by the *şukūk* issuer from a commodity cash sale will be the subscribed amount of the investor. The deferred price (cost price plus profit margin) of the deal

³⁰ Nik Norzrul Thani et al., *op.cit.*, pg. 92.

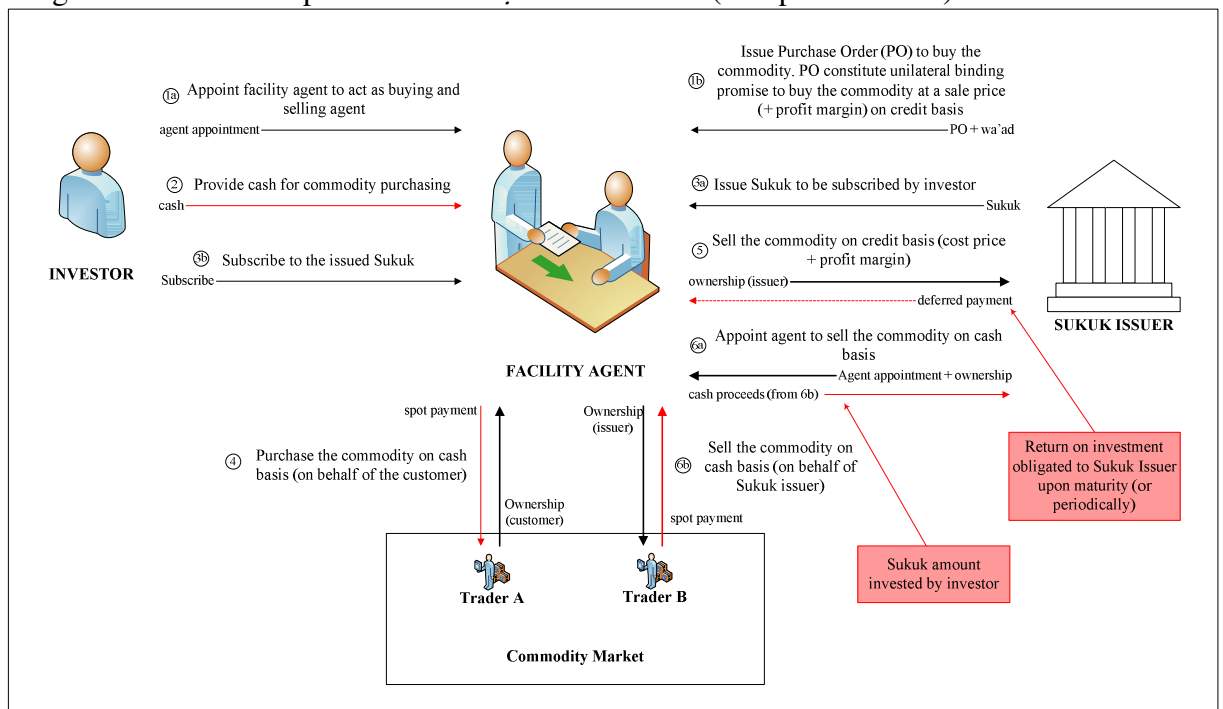
³¹ AAOIFI (2010), *Shari‘a Standards for Islamic Financial Institutions*, Bahrain: AAOIFI, Standard no. 17, Article 2, pg. 307.

³² BNM (2010), *op. cit.*, pg. 98.

between the *ṣukūk* issuer and the investor via the facility agent³³ becomes the obligation or liability to the *ṣukūk* issuer that needs to be paid to the investor upon maturity. This is the return of investment expected by the investor. In addition, this *ṣukūk* is tradable in the secondary market for financial institutions that apply the concept of *bay‘ al-dayn*.³⁴

In summary, the investor will invest such amount via the facility agent into the issued *ṣukūk* in a mode of commodity trading, while the issuer will pay the return on investment to the investor upon maturity as an outcome of credit purchase by the issuer. The modus operandi for the *ṣukūk* structure is illustrated as follows:

Diagram 3.4: Modus Operandi for the *Ṣukuk* Structure (Sample Structure)



Source: Illustrated based on interview with AmInvestment Bank personnel³⁵

³³ Normally an investment bank is appointed as a facility agent to act as the intermediary between the investor and the issuer.

³⁴ BNM (2010), *op. cit.*

³⁵ Mohd Imran Mustapha, Associate Director of Islamic Banking, AmInvestment Bank Bhd.

3.3.5 *Tawarruq* in Interbank Money Market

The money market refers to the market for short-term loans and debt instruments.³⁶

The common players are banks, discount houses, institutional investors and money dealers that deal among themselves for borrowing and lending. It can also be in the form of liquid financial instruments, such as banker's acceptance, commercial papers or securities.

The Islamic Interbank Money Market (IIMM) was introduced in Malaysia on 3 January 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on *Shari'ah* principles. Through the IIMM, the Islamic banks and banks participating in the Islamic Banking Scheme (IBS) are able to match the funding requirements effectively and efficiently.³⁷

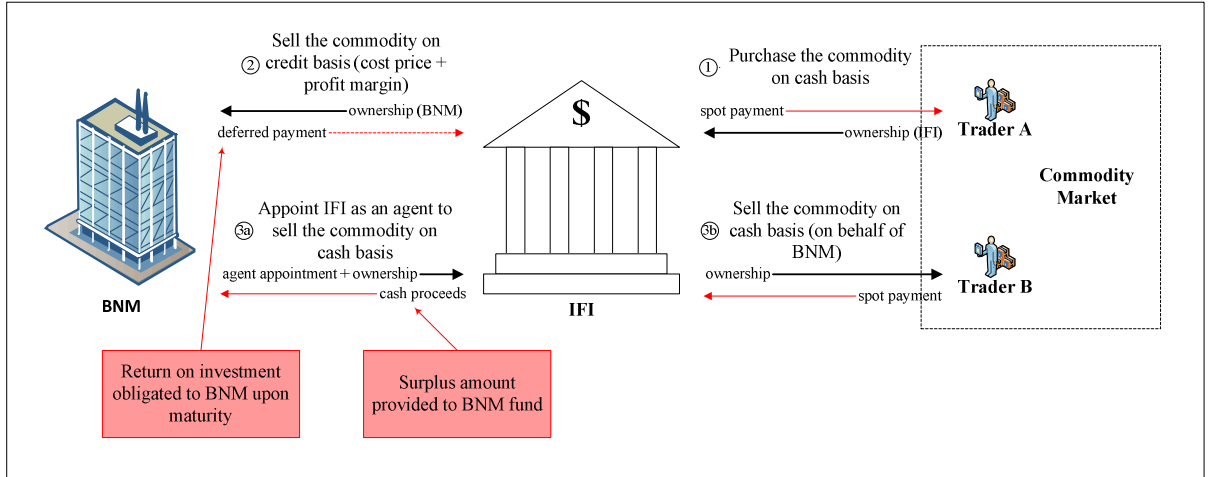
In March 2007, BNM introduced the Commodity Murabahah Programme (CMP) to facilitate liquidity management and investment purposes. It is a liquidity management tool to mobilize funds between surplus and deficit units. Using the *tawarruq* concept, the Crude Palm Oil based contracts are utilized as the underlying concept. The CMP transactions with BNM were first auctioned competitively in IIMM via the Fully Automated System for Issuing/Tendering (FAST) on 14 March 2007.³⁸ The setup mechanism is described as per the following diagram:

³⁶ Oxford University, *op. cit.*, pg. 291.

³⁷ About IIMM, BNM, <http://iimm.bnm.gov.my/index.php?ch=4&pg=4&ac=22>, accessed on 19/09/11.

³⁸ BNM (n.d.), *Commodity Murabahah Programme*, downloaded from <http://iimm.bnm.gov.my/index.php?ch=4>, access on 19/09/11.

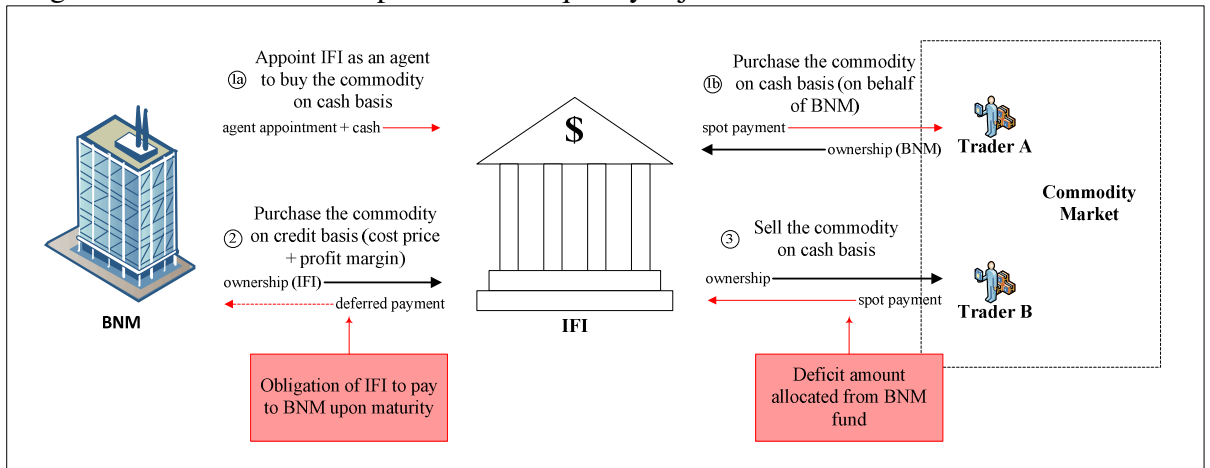
Diagram 3.5: CMP Modus Operandi for Liquidity Absorption



Source: Customized from BNM Commodity Murabahah Programme document

In summary, the IFI (surplus unit) will provide such amount into the BNM fund in the mode of commodity trading, while BNM will pay the return on investment to the IFI upon maturity as an outcome of the credit purchase by the bank. Although the CMP document does not provide the modus operandi for the deficit unit transaction, it works vice versa. BNM will provide such amount to the IFI (deficit unit) via commodity trading, and the IFI will pay to BNM on a deferred basis. This can be illustrated as follows:

Diagram 3.6: CMP Modus Operandi for Liquidity Injection



Source: Illustrated based on *tawarruq*-based deposit concept

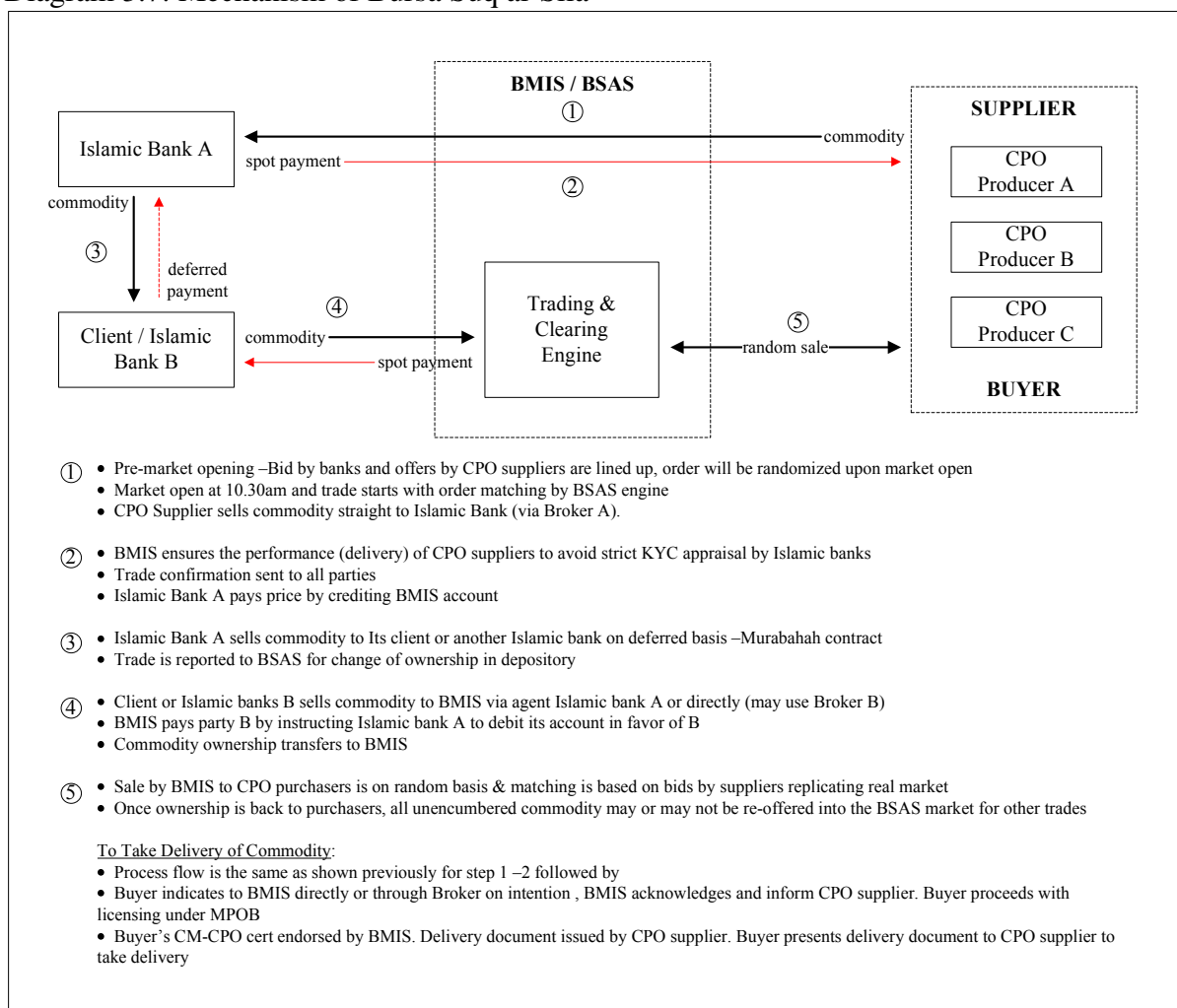
3.3.6 Bursa Suq al-Sila' as a Commodity Market

Bursa Suq al-Sila' (BSAS) is a commodity platform specifically dedicated to facilitate Islamic liquidity management and financing by Islamic banks.³⁹ It was formerly known as Commodity Murabahah House or CMH, which was officially launched on 17 August 2009. It was established from the collaboration of BNM, Securities Commission Malaysia (SC), Bursa Malaysia and Islamic financial industry players in support of the MIFC initiative. It also receives co-operation and support from the Ministry of Plantation Industries and Commodities through the Malaysian Palm Oil Board (MPOB), Malaysian Palm Oil Association (MPOA) and Malaysian Palm Oil Council (MPOC). The business activity is managed by Bursa Malaysia Islamic Services Sdn Bhd (BMIS), a wholly-owned subsidiary of Bursa Malaysia.

With a fully electronic web-based platform, BSAS provides the international avenue to undertake multi commodities and currencies under the principle of *tawarruq*, *murābahah* or *musāwamah*. Initially, crude palm oil (CPO) was supplied by several vendors to be purchased for *tawarruq*-based trading. Now another commodity, i.e. plastic resin is available for trading. The workflow of BSAS is illustrated as per the following diagram:

³⁹ Bursa Suq al-Sila', http://www.bursamalaysia.com/website/bm/products_and_services/islamic_capital_market/BMIS/, accessed on 02/12/11.

Diagram 3.7: Mechanism of Bursa Suq al-Sila'



Source: Customized from BSAS presentation slide⁴⁰

In the proposed structure of CMH, the seller is required to own the CPO prior to any sales transaction. CMH allows the buyer to receive delivery of the commodity if the buying position is above the commodity sale and the trading accounts are not squared off on the same day. Prior to delivery, the CPO buyer must first obtain a licence from the Malaysian Palm Oil Board and will be charged a delivery fee determined by the CMH as well as other costs relating to the delivery and storage.⁴¹

⁴⁰ Downloaded from <http://www.oicexchanges.org/presentations/thirdmeeting>, accessed on 08/01/12.

⁴¹ BNM (2010), *op. cit.*, pg. 99.

The SAC of BNM⁴² resolved that the proposed operational structure of CMH is permissible on the condition that the traded CPO shall be identifiable and precisely determinable in terms of its location, quantity and quality in order to meet the features of a real transaction. In addition, it is also recommended that the transaction shall be executed randomly so that the CMH operation is able to better meet the original features of *tawarruq*.⁴³

The council viewed that the underlying assets of CPO fulfil the requirements of the subject matter of a sales transaction because it exists and is physically identifiable, is able to be received before the sale, and its quality is determinable based on the given specifications in terms of its essence, standard and value. In addition, the traded CPO is deliverable to the buyer and is free from any binding terms.⁴⁴

3.4 Product Implementation for *Tawarruq*-based Financing

Based on the approval of the BNM resolution, Islamic banks in Malaysia started to introduce *tawarruq*-based products, especially for financing to fulfil the customer's needs and the requirements of *Sharī'ah*. However, the introduction of this new developed product still needs to follow the existing BNM guideline and financing practices where applicable. In addition, the internal control should be in place to ensure compliance with *Sharī'ah* for this concept.

⁴² SAC 78th meeting dated 30 July 2008.

⁴³ BNM (2010), *op. cit.*

⁴⁴ *Ibid*

The introduction of new *tawarruq*-based products on the market regardless of whether for financing or deposit is similar to other Islamic banking products, which are governed by the Guideline on Introduction of New Products.⁴⁵ The aims of the Guideline are to:⁴⁶

1. Improve the time-to-market for financial institutions to introduce new products, or to effect changes to existing products.
2. Promote sound risk management practices in managing and controlling product risk by ensuring the appropriate assessment and mitigation of risk during the product development and marketing stages.
3. Further strengthen the duty of care owed to consumers to ensure that the products developed and marketed are appropriate to the needs, resources and financial capability of the targeted consumer segments.

Each Islamic bank has its own product development process. Specifically, for *Shari'ah* related matters, it should follow the provision of the Compliance with *Shari'ah* Principles in the Guideline, which is about ensuring the *Shari'ah* review processes during the pre and post stages of product launching. In particular, it should ensure:⁴⁷

1. Appropriate processes have been established to ensure proper *Shari'ah* governance and compliance with all *Shari'ah* requirements, as described under the “Guidelines on the Governance of Shariah Committee for Islamic Financial

⁴⁵ There is some exception to certain products, which is not really related and not mentioned hereafter. Please refer to the Guideline for details.

⁴⁶ BNM (n.d.), *Guideline on Introduction of New Products*, para 3.1, pg. 1, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 24/09/11.

⁴⁷ *Ibid*, para 6.12, pg. 13.

Institutions”⁴⁸ issued by BNM. Specifically, all product proposals should be endorsed and validated by all members of the *Sharī‘ah* Committee, including the terms and conditions contained in the proposal forms, offer letters, agreements and other legal documents used in the transaction. Similarly, all product manuals, advertisements or marketing materials, product illustrations and brochures used to describe the product shall be endorsed by the *Sharī‘ah* Committee.

2. All *Sharī‘ah* issues are thoroughly researched prior to the deliberation of the *Sharī‘ah* Committee
3. There is an effective process in place to monitor *Sharī‘ah* compliance of products on an on-going basis. This includes ensuring that all operational decisions concerning the product are conducted in a *Sharī‘ah*-compliant manner, for instance, only accepting collaterals that are *Sharī‘ah*-compliant for Islamic financing products.

At the final stage, it should submit the required information to BNM via Product Approval and Repository System (PARS). The *Sharī‘ah* Information required to be submitted is as follows:⁴⁹

1. product description, including name and features;
2. product structure, including diagrams/transaction flows;
3. type of *Sharī‘ah* contract used;
4. *Sharī‘ah* Committee’s deliberation, including:
 - i. *Sharī‘ah* issues arising from the proposed structures
 - ii. issued on *takyīf fiqhī* (*fiqh* confirmation)

⁴⁸ BNM (n.d.), *Shariah Governance Framework for Islamic Financial Institutions*, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 24/09/11.

⁴⁹ BNM (n.d.), *Guideline on Introduction of New Products*, *op. cit.*, appendix 6, pg. 26.

- iii. the appropriate current *Shari'ah* ruling and/or recognized *Shari'ah* standard (if any);
- 5. validation by all *Shari'ah* Committee members; and
- 6. other relevant supporting documents.

The following is a snapshot of the range of generic financing products and services provided by Islamic banks in Malaysia published by the MIFC:⁵⁰

Table 3.3: *Tawarruq* Product Range and Services

Concept Used	Product Category	Product Line	Generic Name
<i>Tawarruq</i>	Financing	Fund Based	Asset Financing-i Commodity Murabahah Financing-i Project Financing-i Working Capital Financing-i

Source: MIFC Product Range and Services

Asset Financing-i is a financing for asset acquisition, such as landed properties, plant and machinery, etc. Project Financing-i is to finance those projects that are awarded to customers, such as development projects. Working Capital Financing-i is a financing for day-to-day business operations. Meanwhile, Commodity Murabahah Financing-i is meant for cash-based financing for customer needs.

Practically, in today's local financing system, *tawarruq* is implemented in three types of facility, i.e. Credit Card, Personal Financing and Business Financing. Credit cards are plastic cards issued by a bank or finance organization to enable

⁵⁰ Range of Products, MIFC, downloaded from http://www.mifc.com/?tpl=th010_search_result&qt=Islamic+finance+evolution±, accessed on 14/09/2011. "i" indicates Islamic product.

holders to obtain credit in shops, hotels, restaurants, petrol stations, etc.⁵¹ Personal financing is financing given to retail or individual customers for consumer related purposes in the form of cash.⁵² Meanwhile business financing is financing given to non-retail or non-individual customers for their business activity purposes. Generally, it is a type of term financing, which is meant for working capital or other cash acquiring. Table 3.3 shows the availability of *tawarruq*-based products in the Malaysian local market:

Table 3.4: *Tawarruq*-based Financing Products of Islamic Banks in Malaysia

Bank Name	Credit Card	Personal Financing	Auto Financing	Home Financing	Business Financing*
Al Rajhi Banking & Investment Corporation (Malaysia) Berhad		✓	✓	✓	✓
AmIslamic Bank Berhad					✓
Asian Finance Bank Berhad					✓
Bank Islam Malaysia Berhad	✓	✓			
Bank Kerjasama Rakyat Malaysia Berhad	✓				
Bank Muamalat Malaysia Berhad		✓			✓
Hong Leong Islamic Bank Berhad		✓			
HSBC Amanah Malaysia Berhad		✓			✓
Kuwait Finance House (Malaysia) Berhad		✓			✓
Maybank Islamic Berhad					✓
RHB Islamic Bank Berhad		✓			
Standard Chartered Saadiq Berhad					✓

*For term financing, working capital, asset acquisition, cash line or others

Source: Websites of respective banks⁵³

Based on the table, the total number of retail products being applied by Islamic banks using the *tawarruq* concept is more than for non-retail products. For non-retail, *tawarruq* is mostly used for cash-based financing for working capital. In addition, the number of banks that provide the *tawarruq* concept for business

⁵¹ Oxford University, *op.cit.*, pg. 107.

⁵² See *Ibid*, pg. 339. Author customized the definition to suit the Islamic and local banking environment.

⁵³ As at 02/01/2012. There is no information on certain products of a few banks, therefore it is left blank.

financing is more from foreign banks compared to local banks, while for retail products, most of the products that use *tawarruq* are for personal financing, which is cash-based financing. Concisely, *tawarruq* is used for cash liquidity, and most of the foreign banks use *tawarruq* for that purpose due to global acceptance. Although some local banks have also started using *tawarruq* for that purpose, many local banks continue to use *ʿinah* for financing.

3.5 *Tawarruq* Element in the Credit Framework

Any financing facility that is applied by the customer should go through some credit process or workflow. Regardless of whether or not it is a *tawarruq*-based product, Islamic or conventional banking, the credit consideration is treated the same. However, there are some specific elements to be catered for *Shariʿah* requirements, or, specifically, for *tawarruq*-based financing throughout the process.

Details of the process of the credit workflow depend on the internal credit structure of the bank and also the nature of the credit application.⁵⁴ However, based on the BNM guideline on best practices of credit risk management, a typical credit process involves several components, as follows:⁵⁵

1. business origination
2. credit administration and monitoring
3. credit collection and recovery

⁵⁴ Credit application is a request for bank facility from the customer.

⁵⁵ BNM (2001), *Guideline on Best Practices for the Management of Credit Risk for Development Financial Institutions*, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 21/09/11. A similar practice applies to both the commercial and Islamic banks.

4. credit controls, review and analysis

In addition, the specific accounting treatment for *tawarruq*-based financing should be taken into consideration, which contains a series of transactions. The series of transactions involve cash and credit transactions that have their own sequence that needs to be followed. A proper book keeping entry will manage the monetary tracking and monitoring purposes.

3.5.1 Business Origination

Business origination is the first stage of credit workflow. It is the stage where the credit application is prepared and submitted for approval. It consists of several processes – credit origination, credit review, and credit approval. As a result, if successful, the letter of offer to the customer will be generated.

Credit origination is the stage where, normally, the marketing section identifies the target market, priority sector, product or account portfolio, and key individuals or business customers.⁵⁶ This is also the stage where engagement with prospective or existing customers is made, whereby the goal of the marketing section is to generate as many as possible for what are not deemed as high-risk credit applications. Therefore, a preliminary analysis of the customer's needs and acceptance criteria will be conducted.

⁵⁶ Tang Kean Onn et al. (2007), *Certified Credit Professional: Financial System and Principles of Credit*, Kuala Lumpur: Institut Bank-Bank Malaysia, pg.7-4.

The credit assessment for business can be based on various criteria, such as minimum sales, profitability, net worth or conduct of account, while for retail customers it can be based on customer profile, qualification, employment, income, financing amount and credit history etc. Normally, this exercise involves credit verification⁵⁷ with internal⁵⁸ or external⁵⁹ sources to validate the quality of the information. During this process, a credit memorandum or proposal may be written for the applied facility.

Finally, the credit application will go for the approval process. Analysis of the document contents and sound decision making are essential for the success of the application. The decision by the authorized approver will result in approval, amendment or rejection. If amendment is required, the application will go back to the originator, however, if it is rejected, the application will be terminated. If approved, the letter of offer and other related documents will be prepared accordingly.

Like other Islamic financing assessments, the *Sharī'ah* element in *tawarruq*-based financing at this stage is more focussed on customer business activities. From the *Sharī'ah* perspective, financing is not allowed to be granted for non-compliant activities, such as *ribā*-based transactions, liquor industry, gambling and brothels. Such activities can be verified either from the customer profile and nature of business, or from the purpose of facility and other credit checking. It may involve internal or external sources and reports.

⁵⁷ The process of verifying the customer's information and to determine the risk of financing for the bank.

⁵⁸ Bank's internal database, such as customer exposure, blacklist etc.

⁵⁹ External database, such as CCRIS, DCHEQS, CTOS, etc.

According to BNM, the SAC has resolved⁶⁰ that Islamic financial institutions are prohibited from granting financing to companies, bodies or individuals whose activities explicitly involve non-*Sharī'ah* compliant elements, such as gambling, liquor industry and brothels.⁶¹ The basis of the ruling is that such financing would result in the revenue of IFIs being generated by non-*Sharī'ah* compliant activities, as consistent with the saying of Allah SWT as follows:⁶²

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ، وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

...help one another in furthering virtue and God consciousness, and not in what is wicked and sinful...

Surah al-Mā'idah (5): 2

In addition, there are also some concerns regarding the bank and the customer relationship. The personnel of Islamic banks are prohibited from being involved with non-*Sharī'ah* compliant activities with their customer, such as misconduct of authority, fraud activity and corruption. Such incidents can be prevented by the sincerity of the bank's employees themselves and also by applying internal control and monitoring throughout the credit process.

3.5.2 Credit Administration

Credit administration manages several processes of post approval financing, i.e. documentation, disbursement and monitoring. Documentation or security documentation is perfected in this stage by the credit administration unit together

⁶⁰ SAC 58th meeting dated 27 April 2006.

⁶¹ BNM (2010), *op. cit.*, pg.199.

⁶² *Ibid*, pg. 200.

with the solicitor.⁶³ It refers to the process of preparing legal and other relevant documents required to secure the financing, obtaining the signatures of the customer and related parties, examining the accuracy of the document, and stamping the document.⁶⁴ For Islamic financing, the contract or '*aqd*' agreement is prepared based on the underlying concept used, such as sale and purchase or partnership.

Disbursement is a payment by a bank under a facility or other agreement.⁶⁵ It refers to the process of money paid out by the bank to the customer. It means that the funds are ready to be utilised. Most of the time, a financing account is created for the funded type, but it is rarely created for the non-funded, especially for trade financing. The credit administration needs to ensure that the funds are meant for the prescribed purpose as agreed in the contract. After the disbursement process, the financing payment will become the customer's obligation.

Once the funds have been distributed to the customer, the financing will be monitored either periodically or on an ad-hoc basis by the credit administration until settlement. Monitoring is important to the bank to identify early symptoms of problems or delinquency, in order to protect the bank's assets and minimize the loss. The control mechanism of the Islamic banks will be discussed in the subsequent topic, i.e. collection and recovery.

⁶³ Either panel or non-panel, or security may not require for unsecured facility, subject to the bank's policy.

⁶⁴ See Tang Kean Onn et al. (2008), *Certified Credit Professional: Consumer Credit*, Kuala Lumpur: Institut Bank-Bank Malaysia, pg.7-4., pg. 6-2.

⁶⁵ Oxford University, *op. cit.*, pg. 127.

The most crucial part at this stage for *tawarruq*-based products is the execution of the *'aqd* or contract agreement and commodity trading. Unlike the lending process in conventional banking, the bank personnel, i.e. customer relationship or credit officer and bank commodity trader should have a sound knowledge of the trading transaction. Meanwhile, the customer should be briefed accordingly on what type of dealing they are entering into, especially concerning the trading process and legal documentation.

Since contract agreements are very important in any deal from a *Sharī'ah* perspective, any misconduct, such as selling price is wrongly written, in the offer or acceptance, will lead to the potential risk of *Sharī'ah* non-compliance. The risk will potentially cause severe loss to the bank, either in terms of financial or non-financial, such as image or reputation. The potential impact can be either the contract is null or void, loss of principal amount or cost price, or inability to recognize the expected profit.

The offer and acceptance can be performed either by face-to-face or via tele-conversation. If either the face-to-face or tele-conversation method is undertaken, the transaction should follow the correct sequence, which is:

1. Bank trader purchases the commodity from commodity supplier for cash.

Practically, it can be performed via the system, email, telephone or any other medium of communication.

2. Bank trader will sell the commodity to the customer on a credit basis using the *murābahah*⁶⁶ principle (cost plus profit). The bank will provide the offer that

⁶⁶ Or *musāwamah*. Most of the banks use *murābahah*.

includes all the commodity details required, such as type of commodity, quantity, cost price, selling price, date and location. In addition, the bank should have the ability to deliver the commodity to the customer.

3. The customer should be given the option either to possess the commodity or to resell it. If the customer decides to possess the commodity, then the bank should be able to deliver it as agreed. Otherwise, the customer can resell it to the buyer in the market to obtain cash. In situations where the customer does not have any means to resell the commodity, due to *maṣlahah*, the bank can be appointed as an agent to resell it on behalf of the customer. However, this condition should be agreed up front to avoid organized elements in *tawarruq* (*tawarruq munazzam*).⁶⁷

The legal documentation should spell out precisely the terms and conditions for trading transactions including the offer and acceptance statement. This contract agreement should be written following the trading sequence, as mentioned earlier. For tele-conversation, the communication should be clear and understandable for offer and acceptance, which follows the same sequence. In addition, both contracting parties should be aware concerning the dealing, i.e. trading⁶⁸ that they are entering into.

⁶⁷ BNM resolution does not mention clearly about *tawarruq munazzam* or provide details of the requirements of *tawarruq*-based deals.

⁶⁸ For *tawarruq*-based financing, the bank and the customer are dealing with commodity trading. However, for conventional minded thinking, such trading is just similar to conventional lending whereby the result is to obtain cash. Therefore, this critical aspect may not be executed properly and may not be controlled nor monitored seriously by Islamic banks.

3.5.3 Credit Collection and Recovery

Collection or debt collection is a process of collecting payments from those who are delinquent, i.e. those who make payments later than their contractual due date.⁶⁹ Meanwhile the recovery process is to collect money still owed on the account after the bank has classified the account as non-performing or has written off the account as a loss.⁷⁰ In simple terms, both processes are performed by the bank to get back its assets from problematic customers or accounts.

The collection and recovery process is an acquired skill that involves counselling, persuasiveness and negotiating skills of the financier to get back their asset from the customer.⁷¹ The effort taken will result in either bringing back the financing into the regular or current status, considering rescheduling or restructuring, or proceeding to the litigation process. Irrespective of the path that needs to be taken, it will proceed until settlement either with or without legal enforcement.

In conventional banking, any late payment after the due date or default account will be charged with interest-based charge, which is classified as *ribā*. However, since *Shari'ah* prohibits *ribā*, this mechanism cannot be applied to Islamic financing. Therefore, there is an issue concerning how to address the cases of customer default in settling their obligation under Islamic contracts.

⁶⁹ Tang Kean Onn et al. (2008), *op. cit.*, pg. 9-2.

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

In Islamic financing operations, both the financier and customer have their own obligation. The financier is obliged to provide financing as stipulated in the contract and the customer is obliged to settle the financing within the period as agreed in the contract. However, if settlement is not made within the time frame, the financiers business activity will be impacted. Therefore, there is a requirement to address the compensation for losses encountered by the financier.

There are two methods available to claim the compensation for losses of Islamic financing activities, i.e. *ta'wīḍ* and *gharāmah*. *Ta'wīḍ* refers to claims for compensation arising from actual losses suffered by the financier due to the delay in payment of financing or debt amount by the customer. Whilst *gharāmah* refers to penalty charges imposed for delays in financing or debt settlement, without the need to prove the actual loss suffered.

The SAC of BNM resolved⁷² that both concepts are permissible to be applied as a control mechanism for late payment. However, it is subject to the following conditions:⁷³

1. *Ta'wīḍ* may be charged on late payment of financial obligations resulting from exchange contracts (such as sale and lease) and *qarḍ*;
2. *Ta'wīḍ* may only be imposed after the settlement date of the financing became due, as agreed between both contracting parties;
3. Islamic financial institutions may recognise *ta'wīḍ* as income on the basis that it is charged as compensation for the actual loss suffered by the institution

⁷² 4th meeting dated 14/02/98, 95th meeting dated 28/01/10 and 101st meeting dated 20/05/10.

⁷³ BNM, *op. cit.*, pg. 130.

4. *Gharāmah* shall not be recognised as income. Instead, it has to be channelled to certain charitable bodies.

The permissibility of imposing *ta'wīḍ* on defaulting customers and being recognized as income is based on the following evidence and argument:⁷⁴

1. Hadith Nabi s.a.w. narrated by Abū Hurayrah r.a:

مطل الغني ظلم⁷⁵
Delay by a rich person (in payment of debt) is a tyranny

2. A *fiqh* maxim extracted from hadith:

لا ضرر ولا ضرار⁷⁶
Neither harming nor reciprocating harm (in Islam)

Based on this maxim, the delay in payment by the customer will create harm to the Islamic financial institution as the financier whereby the Islamic financial institution will suffer actual loss in terms of incurring additional expenditure, such as cost for issuing notices and letters, legal fees and other related costs. These issues should be avoided in order to ensure that business transactions are conducted according to the principle of market efficiency (*istiqrār ta'āmul*).

3. Late payment of debt is analogous to usurpation (*ghasb*). Both share the same '*illah*', which is tyrannically obstructing the use of the property and exploiting it. In the case of *ghasb*, *Imam al-Shāfi'ī* and *Ahmad* are of the view that the benefit of the seized property is guaranteed and shall be compensated. In the case of delayed payment

⁷⁴ *Ibid*, pg. 130-131.

⁷⁵ al-Bukhārī (2003), *Ṣaḥīḥ al-Bukhārī*, Beirut: Dār al-Fikr, Kitāb fī al-Istiqrāḍ wa Adā' al-Duyūn wa al-Hajr wa al-Ṭāflīs, hadith no. 2400.

⁷⁶ Ibn Mājah (2006), *Sunan Ibn Mājah*, Beirut: al-Maktabah al-'Aṣriyyah, Kitāb al-Ahkām, hadith no. 2340 & 2341.

of financing amount, the financier is also unable to utilise the fund for other business purposes that should be settled within the stipulated period. Therefore, the customer should pay compensation for the losses suffered by the financier.

4. *Fiqh* maxim:

⁷⁷ الضرر يزال

Whatever harm should be removed

Based on the aforesaid *fiqh* maxim, imposition of *ta'wīḍ* and *gharāmah* on delayed payment of debt is an appropriate approach to mitigate the harm suffered by the financier, and, at the same time, instil discipline on the customer to make payment according to the stipulated schedule.

A similar approach is also provided by BNM for settling judgment debt⁷⁸ for Islamic finance cases. The SAC of BNM has resolved that *ta'wīḍ* and *gharāmah*⁷⁹ on actual cost may be imposed on judgment debt as decided by the court ruling on cases of Islamic banking according to the following mechanism:⁸⁰

1. Court may impose late payment charge at the rate as stipulated by the procedures of the court.⁸¹ However, from this rate, the judgment creditor (Islamic financial institution) is only allowed to receive the compensation rate for actual loss (*ta'widh*).

⁷⁷ al-Suyūṭī (2006), *al-Ashbāh wa al-Naẓā'ir*, Muḥammad Muḥammad Tāmir et al. (eds.), Kaheerah: Dār al-Salām, pg. 210.

⁷⁸ Judgment debt is a court order to pay such costs obliged by the judgment debtor (customer) to the judgment creditor (bank).

⁷⁹ Compensation using *gharāmah* needs to be channelled to a charity fund.

⁸⁰ BNM (2010), *op. cit.*, pg. 133-134.

⁸¹ SAC has resolved that the rate is 8%.

2. To determine the compensation rate for actual loss (*ta'wīd*) that may be applied by the judgment creditor, the SAC agreed to adopt the “weighted average overnight rate” of Islamic money market as a reference.
3. The total compensation charge shall not exceed the principal amount of debt. If the actual loss is less than the applicable rate for judgment in current practice, the balance shall be channelled by the judgment creditor to a charitable organisation as may be determined by Bank Negara Malaysia.

As mentioned earlier, another common mechanism in conventional banking for problematic accounts is rescheduling and restructuring. However, it cannot be applied one-hundred per cent to Islamic financing, specifically for *tawarruq*-based financing. Rescheduling is allowed for customers in default by granting an extension to the existing tenure for them to settle the debt, providing no additional charges on the financing amount are imposed. For this purpose, the bank may request additional security.

For restructuring, in terms of re-pricing, the existing deferred sale or receivables is not allowed. Further mark-up on receivables in default is classified as *ribā* due to the reason that the ownership of the commodity had already been transferred to the customer. Therefore, the bank is not entitled to add any additional amount to debt created in such *murābahah*⁸² transaction. However, the risk of this situation is commonly exposed to the Islamic bank operation, whereby the transaction can be executed due to ignorance (*jahālah*). This scenario is termed

⁸² As mentioned previously, deferred sale in *Tawarruq* can be either in a form of *Murābahah* or *Musāwamah*, whereby most of the banks in Malaysia apply the *Murābahah* concept for the pricing mark-up.

“Rollover in *Murābahah*”, which means executing a new *murābahah* transaction against existing receivables in respect of a payment that has not been made by the customer.

According to the BNM resolution, any changes to the price require a new agreement in order to avoid *ribā* and *gharār*.⁸³ Therefore, in restructuring sale-based financing, which involves sale agreement, the original sale must first be terminated (*fasakh*) before concluding the new agreement.⁸⁴ However, the new agreement will incur additional cost to the customer in terms of new legal fees and stamp duty charges, unlike in conventional banking where a supplementary agreement is all that is needed.

The SAC of BNM⁸⁵ resolved that the rescheduling and restructuring agreement can be cross-referenced to the original agreement for the purpose of stamp duty exemption provided that it is done after termination of the original agreement.⁸⁶ The basis of ruling is due to *maṣlaḥah*, which is to avoid double payment of stamp duty. In addition, the SAC also resolved⁸⁷ that based on mutual agreement, the financing period for the customer might be extended without the need for a new contract, providing that both parties satisfy all concluded promises and the price imposed on the customer does not exceed the original sale price.⁸⁸

⁸³ BNM (2010), *op. cit.*, pg. 207.

⁸⁴ BNM (2010), *op. cit.*, pg. 206.

⁸⁵ 26th meeting dated 26 June 2002

⁸⁶ BNM (2010), *op. cit.*, pg. 206.

⁸⁷ 32nd meeting dated 27 February 2003

⁸⁸ BNM (2010), *op. cit.*, pg. 206.

3.5.4 Credit Control, Review and Analysis

This stage is not part of credit processing as discussed earlier. However, some sort of mechanism is required to monitor the exposure to mitigate the risk and minimize the loss. Referring to the BNM guideline of credit risk best practice, the components involved are internal controls and audit, independent credit review and audit, portfolio review and trend analysis, and credit policy and process review.⁸⁹ It is sound management monitoring and reporting to manage and protect the main asset of the bank.

In terms of *Sharī'ah* governance, the BNM has released the Shariah Governance Framework⁹⁰ as a guideline for IFIs to ensure their operations and business activities are in accordance with *Sharī'ah*. The framework emphasizes the requirements for *Sharī'ah* governance and the role and responsibility of the IFIs board and management and their *Sharī'ah* Committee. It also outlines the functions of the internal *Sharī'ah* review, *Sharī'ah* audit, *Sharī'ah* risk management and *Sharī'ah* research.

The board is accountable for the *Sharī'ah* governance framework and overall compliance. The board is expected to rely on the Shariah Committee, which is accountable for *Sharī'ah*-related decisions, views and opinions pertaining to the operations of the IFI. Meanwhile, the management is responsible for implementing

⁸⁹ BNM (2001), *op. cit.*, pg. 10.

⁹⁰ See BNM (n.d.), *Shariah Governance Framework for Islamic Financial Institutions*, *op. cit.*

the *Sharī'ah* ruling made by the SAC and *Sharī'ah* Committee, and refer any *Sharī'ah* issue to the *Sharī'ah* Committee for decisions or views.

For internal IFI control, *Sharī'ah* review is responsible for regular assessment concerning *Sharī'ah* compliance in the activities and operations of the IFI. Meanwhile, the *Sharī'ah* audit is responsible for independent and periodical assessment of the IFI operations. *Sharī'ah* risk management is accountable to systematically identify, measure, monitor and control *Sharī'ah* non-compliance risks. In addition, *Sharī'ah* research is accountable for conducting pre-product approval process, research, vetting of issues for submission, and undertaking administrative and secretarial matters relating to the *Sharī'ah* Committee.

3.5.5 Accounting Treatment

The Malaysian Accounting Standards Board (MASB) released the supplementary guidance⁹¹ of accounting treatment for sale-based contract, i.e. Technical Release i-4: Shariah Compliance Sale Contracts. This issuance is meant to provide guidance concerning the application of the MASB approved accounting standards to transactions and events based on a *Sharī'ah* compliant sale contracts except the contract for sale of usufruct.⁹²

⁹¹ Apart from the main issuance of the Statement of Principle i-1 (SOP i-1): Financial Reporting from an Islamic Perspective, which was issued on 15/09/09 for Islamic Accounting.

⁹² MASB (2010), Technical Release i-4, *Shariah Compliance Sale Contracts*, pg. 6, downloaded from http://www.masb.org.my/index.php?option=com_content&view=article&id=1617&Itemid=87, accessed on 05/12/11.

According to the appendix of that guidance,⁹³ the term “*Tawarruq*” refers to an arrangement where an item is sold and repurchased through various parties.⁹⁴ Similar to *‘inah*, the term indicates a sale arranged with a view to obtaining cash financing.⁹⁵ Therefore, it is classified under the Contracts of Exchange⁹⁶ - exchange for goods.

Tawarruq transactions contain a series of transactions that involve two contracts of sale and purchase. According to MASB, the series of transactions is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole.⁹⁷ This is the case when the series are interrelated, negotiated as a single transaction, and take place concurrently or in a continuous sequence.⁹⁸

The MASB is aware that based on *Sharī‘ah*, this type of transaction has more than one contract, which is separate and independent of each other. However, the accounting principles may require that the series be accounted for as one transaction if their economic effects are deemed to be linked.⁹⁹ This view is from economic decision making with a basis that accounting is just for recording, which will not revoke the *Sharī‘ah* validity of the transactions.

⁹³ *Ibid*, Appendix A. The appendix does not form part of the Technical Release, but should be read as background material to the Technical Release (as per issuance note).

⁹⁴ *Ibid*, pg. 15.

⁹⁵ *Ibid*.

⁹⁶ *‘Uqūd al-Mu’āwadāt*

⁹⁷ MASB (2010), *op. cit.*, pg. 9.

⁹⁸ *Ibid*.

⁹⁹ *Ibid*.

This type of recording is also termed as “Substance over form”, which means an accounting principle that emphasizes the financial reality of a particular transaction rather than its legal form.¹⁰⁰ The SAC of BNM resolved¹⁰¹ that, in principle, “substance” and “form” are equally important and taken into consideration by *Shari’ah*. In this respect, *Shari’ah* emphasises that “substance” and “form” must be consistent and shall not contradict one another. In the event of inconsistency between “substance” and “form” due to certain factors, *Shari’ah* places greater importance on “substance” rather than “form”.¹⁰² Therefore, recording of *tawarruq* transactions based on financing transactions and not according to the contract is allowed.

3.6 Conclusion

Financing is the core banking business of every bank irrespective of whether it follows the conventional or Islamic system. It is deemed as an investment portfolio funded from the customers’ deposits and shareholders’ equity. In respect of the unique landscape of the Malaysian dual banking system, Islamic banking needs to make use of the existing platform to promote its operation, as it would appear that the conventional system is more dominant.

Historically, most of the developed Islamic products, including financing products, mirror the conventional products to provide an alternative to the customer.

¹⁰⁰ BNM (2010), *op. cit.* pg. 192.

¹⁰¹ 57th meeting date 30 March 2006 and 71st meeting dated 26-27 October 2007.

¹⁰² *Ibid.*

Various products have been developed using the *Shari'ah* concept. However, the most equivalent feature of Islamic products compared to conventional lending is for cash liquidity purposes, which charts the highest demand and supply in the local market.

The most common *Shari'ah* concepts that are being used for cash liquidity are *qard*, *'inah* and *tawarruq*. *Qard* is not popular due to the benevolent element, which is not of commercial importance to the bank. *'inah* is the most popular concept used for financing products. However, due to the arising issue of *'inah* and market forces, the alternative concept, i.e. *tawarruq* is more preferable. *Tawarruq* has been implemented in deposit, financing, *ṣukūk* and interbank money market, as approved by BNM, and also in some treasury products.

In addition, *tawarruq*-based financing still follows the existing credit standard and practices except for some areas, such as customer relationship and credit administration in which *Shari'ah* elements need to be addressed. The riskiest part of a *tawarruq* deal is at the stage of commodity trading whereby any misleading will cause a loss to the bank in terms of invalidity of the contract, profit is not entitled for recognition, loss of principle or expected profit.

In addition, due to the nature of the *tawarruq* concept, which consists of a series of transactions, accounting treatment triggers a debate on how to address the issue. Even knowing the *Shari'ah* concern that all the transactions are independent of each other, the MASB resolved that it is accounted as one since the economic effect

is deemed to be linked. On the basis of accounting being just for recording, the decision is supported by the BNM resolution on substance over form matter.¹⁰³

¹⁰³ BNM, *op. cit.*, pg. 192.

CHAPTER 4: A CASE STUDY ON COMMODITY MURABAHAH PRODUCT AT MAYBANK ISLAMIC BERHAD

4.1 Introduction

Maybank Islamic Berhad (MIB), the Islamic finance arm of the Maybank Group, is the largest Islamic bank in Malaysia (by assets), and in the Asia Pacific region. As an entity operating on a dual-banking platform, MIB is regarded as the most successful Islamic subsidiary bank leveraging on its parent bank's infrastructure and resources, and continues to lead the industry through the development of new, innovative and internationally accepted propositions.¹

MIB's strong financial standings, large contributions to the public and industry have been acknowledged with various internationally recognized awards and accolades, such as the Asset Triple A Award for Islamic Retail Bank of the Year, KLIFF Islamic Finance Awards 2010 for Most Outstanding Retail Banking, Reader's Digest Trusted Brands Awards for Islamic Financial Services – Gold Awards, and KLIFF Islamic Finance Awards 2009 for Best Outstanding Islamic Bank.²

MIB provides a wide range of banking facilities under the consumer and business banking portfolio. The facilities offered are quite similar to the conventional

¹ Maybank Islamic, Corporate Info, <http://www.maybankislamic.com.my/info.html>, accessed on 26/04/2012.

² *Ibid.*

banking that is provided by Malayan Banking Berhad (MBB). Commodity Murabahah Term Financing-i (CMTF-i) is one of the products offered by MIB under its business banking portfolio. This Islamic term financing facility was officially launched on 1 July 2009.³

The CMTF-i product is underlain with the *Shari'ah*-based concept of *tawarruq*.⁴ Therefore, the *'aqd* or contract execution relies on commodity trading. The *tawarruq* concept has been applied by Maybank Islamic since it commenced operation as a separate legal entity. The concept has been used since 28 February 2008 with the official launching of two treasury products, namely, Foreign Currency Commodity Murabahah Deposit-i (FCMD-i) and Foreign Currency Commodity Murabahah Placement-i (FCMP-i).⁵

4.2 Company Information

Maybank Islamic Berhad (MIB) was incorporated in Kuala Lumpur, Malaysia, on 5 September 2007 as a public company (Co. no. 787435-M) under the Companies Act 1965. It commenced operation as a legal entity on 1 January 2008. The registered office

³ Maybank Islamic Launches Commodity Murabahah Term Financing-i and Murabahah Term Financing-I, http://maybankislamic.com.my/news_launch-commodity.html, accessed on 01/05/2012.

⁴ MIB describes the underlying concept for this product as murābahah.

⁵ Maybank Islamic Launches Foreign Currency Commodity Murabahah Products, http://www.maybank2u.com.my/mbb_info/m2u/public/personalDetail04.do?channelId=Personal&cntTypeId=0&cntKey=AU08.02.28&programId=AU02.02-ArchiveNews&newsCatId=/mbb/AU-AboutUs/AU02-Newsroom/2008/02&chCatId=/mbb/Personal, accessed on 26/04/2012.

of MIB is at Menara Maybank, Jalan Tun Perak, and the head office is at Dataran Maybank, Bangsar.⁶

The parent holding company of MIB is MBB (Co. no. 3813-K) or so-called Maybank, which was incorporated on 31 May 1960, and commenced operation in Kuala Lumpur on 12 September of the same year. Listed on the main board of Bursa Malaysia, MBB is the largest local bank today⁷ with total assets of USD135 billion, a net profit of USD1.5 billion and market capitalization of USD22 billion. Having a large network of over 2,100 offices in 17 countries worldwide, its operation is supported by around 42,000 employees to serve over 21 million customers.⁸

MIB is principally engaged in Islamic banking and the provision of related financial services, which are regulated under the Islamic Banking Act 1983. Starting as a windows-based concept in 1993, MBB offered Islamic financial services under Skim Perbankan Tanpa Faedah (later Skim Perbankan Islam), which was introduced by Bank Negara Malaysia (BNM) in the same year to allow conventional banks to offer Islamic banking products and services.

Towards supporting the government's effort to position Malaysia as an international Islamic financial centre and reaffirming the Maybank Group focus on key strategic objectives – offering Islamic foreign currency business, development of new

⁶ See Maybank Islamic Annual Report 2009, downloaded from <http://www.maybankislamic.com.my/news.html> accessed on 02/11/2011.

⁷ By asset as at September 2011

⁸ See Maybank Annual Report 2011, downloaded from <http://www.maybank.com/newsroom/financial-reports>, accessed on 02/11/2011.

business of Islamic wealth management and *Mushārah*, and the expansion of domestic business leadership – MIB was incorporated as a separate Islamic banking subsidiary.⁹

As at June 2008, with paid-up capital of RM100 million and using the existing Maybank Group platform, the newly set-up MIB became the largest Islamic commercial banking provider in the Asia Pacific region with total Islamic assets of close to RM28 billion and a dominant domestic market share of Islamic financing and customer deposits of 23% and 18%, respectively.¹⁰

MIB products are diversified into three portfolios – consumer banking, business banking and wealth management. Consumer banking provides deposits, financing and credit card facilities to retail customers. The deposit facilities offered to retail customers are savings account, current account and term deposits, while the financing facilities are for mortgage or property financing, cash line or overdraft, personal financing, hire purchase, share margin financing and ASB financing.¹¹

The business banking portfolio, which is targeted for non-retail customers, provides deposit and financing facilities. The deposit facilities offered are current account, fixed term deposit, investment account and fixed deposit. In addition, the financing facilities offered are term financing, working capital and trade financing, such as letter of credit, trust receipt and bills for collection. This portfolio also provides

⁹ See Maybank Annual Report 2008, downloaded from <http://www.maybank.com/newsroom/financial-reports>, accessed on 02/11/2011.

¹⁰ *Ibid*, pg. 73.

¹¹ See Consumer Banking, Maybank Islamic, <http://www.maybankislamic.com.my/consumer.html>, accessed on 04/05/2012. Some facilities consist of multiple products where each product has its own specific feature.

financing facilities for the government fund, i.e. Fund for Small and Medium Industries 2 (FSMI2-i) and New Entrepreneurs Fund 2 (NEF2-i).¹²

The wealth management portfolio provides investment products and wealth management services for both retail and non-retail customers. The provided product range by wealth management is based on the investment theme, i.e. equities, commodities, and currencies. This portfolio becomes the avenue for customers to place their excess funds while increasing the yield or profit.¹³

Today,¹⁴ MIB is still the largest Islamic bank in the Asia Pacific region with total assets of RM66 billion, and is ranked 17th among the world's Islamic financial institutions in terms of *Shari'ah*-compliant assets. Locally, it dominates the Islamic banking industry with a leading market share in the retail financing and deposits segment. Meanwhile, on the global front, the Group's Global Wholesale Banking is recognized as the largest global *ṣukūk* manager both of *ṣukūk* in all currencies and RM-denominated *ṣukūk*.¹⁵

Presently, the consumer product and services are distributed primarily at 12 sales and service centres known as Cawangan Perbankan Islam, as well as at over 400 Maybank branches, automobile financing centres and private banking centres. In

¹² See Business Banking, Maybank Islamic, <http://www.maybankislamic.com.my/business.html>, accessed on 04/05/2012.

¹³ See Wealth Management, Maybank Islamic, <http://www.maybankislamic.com.my/wealth.html>, accessed on 04/05/2012

¹⁴ As at 30 June 2011

¹⁵ Maybank Annual Report 2010, pg. 138, downloaded from <http://www.maybank.com/newsroom/financial-reports>, accessed on 02/11/2011.

addition, the business products and services are distributed through the Group's business centres, trade finance centres and at the head office Business and Corporate Investment Banking divisions. It also leverages on the strength of Maybank's existing electronic channels for customer interaction.¹⁶

4.3 Commodity Murabahah Product

Commodity Murabahah Term Financing-i (CMTF-i) is a facility offered by MIB for non-retail customers. It was introduced for the purpose of working capital or asset expansion. In other words, it provides cash to operate the business. The product was developed under the framework of introducing new products, as guided by BNM.¹⁷

4.3.1 CMTF-i Product Feature

The CMTF-i product is a type of Islamic term financing.¹⁸ The purpose of the facility is for the purchase of completed or under construction assets or properties, such as landed property, plant and machinery, and commercial vehicles. It is also for the purpose of refinancing assets or property, working capital, contract financing and other viable

¹⁶ See Maybank Annual Report 2008, pg. 73, *op. cit.*

¹⁷ Details are available in BNM (n.d.), *Guideline on Introduction of New Products*, downloaded at <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 24/09/11.

¹⁸ Term financing is a fixed-period financing that is paid back by the customer with an agreed payment mode and tenor. It is equivalent to term loan in conventional banking, which calculates and charges interest together with loan principle repayment. Therefore, in Islamic banking, the underlying concept mostly being used to obtain the profit for this type of facility is sale and purchase.

business venture.¹⁹ The product is packaged together with takaful coverage against fire or burglary on the asset or property that is charged, assigned or pledged to the bank.

The product is targeted for new and existing corporate and commercial customers either local or foreign. The financing amount and tenor are dependent on the customer capability. The product is subject to at least yearly credit review. It will operate within the parameters set by the Islamic Banking Act, Exchange Control Notices (ECM), Maybank Group's policy and procedures and other guidelines issued by BNM.

The pricing for the CMTF-i product is based on either a fixed rate or variable rate. For fixed rate pricing, the rate is used to calculate the selling price and profit. For variable or floating rate pricing, there are two rates used for calculation, i.e. selling price rate and effective rate. The selling price rate, or commonly known as the cap rate, is used to calculate the selling price. Meanwhile, the effective rate, which is the variable rate, is the actual rate charge to the customer based on the Base Financing Rate (BFR). The difference between the selling price rate and effective rate will be the *ibrā'* or waiver given to the customer. There is also a combination of fixed and variable rate used as the effective rate.

The profit computation for CMTF-i financing is based on the daily and monthly rest. The financing debt can be paid by the customer either in a lump-sum or through

¹⁹ Commodity Murabahah Term Financing-i (CMTF-i), Maybank Islamic, http://www.maybankislamic.com.my/b_cmtf-i.html, accessed on 07/11/11

periodical payment, i.e. monthly, quarterly, half-yearly and yearly. For early payment, no prepayment fee will be charged by MIB to the customer except for actual cost.

For defaulted accounts, MIB applies *ta'wīḍ* as a control mechanism where two types of rate are being used. For the debt that has yet to reach the full tenor date, then the cost rate of 1% is charged on the monthly instalment, while for a debt that has already passed the full tenor date, the money market rate is charged on the total amount due. The income from this late payment charge is earned by the bank.

For customers with multiple facilities, MIB applies cross default, where if one account or facility defaults, then all the facilities are considered defaulted. For example, if the customer has CMTF-i and other facilities, such as cash line and multiple trade finance facilities with MIB, then if one of the facilities defaults, then all the facilities are tagged as having defaulted. However, the *Sharī'ah* treatment for each contract is still valid due to the independence of these contracts from the one that is in default. Therefore, cross default is a tagging on the customer default status as part of credit control and monitoring.

4.3.2 *Sharī'ah* Concept and Mechanism

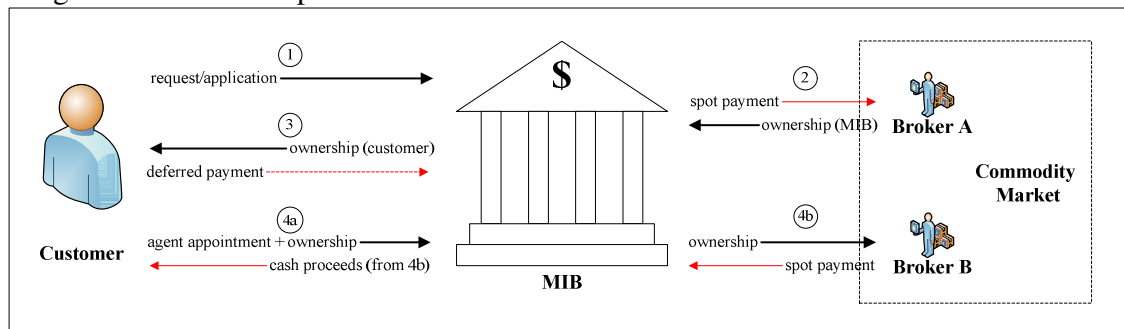
CMTF-i is based on the *tawarruq* concept. The deferred sale and purchase between the bank and the customer is using the contract of *murābahah* (cost-plus sale). Under this contract, a specific commodity that complies with *Sharī'ah*, such as zinc, copper, lead,

palm oil or wheat, will be used as an underlying asset for the sale and purchase transactions between the bank and the customer. The underlying asset will be sourced from the authorized commodity brokers.²⁰ However, practically, crude palm oil (CPO) is being used most of the time, either provided by Bursa Suq al-Sila' or another vendor.

The bank buys the commodity from the commodity broker or vendor at cost price, and then sells it to the customer at an agreed selling price, i.e. cost plus profit. The customer will pay the selling price (which comprises the financing amount and the profit) to the bank on a deferred payment basis.

There are four parties involved in the trading process. The modus operandi can be illustrated as follows:

Diagram 4.1: Modus Operandi for CMTF-i



Source: Based on interview with MIB personnel

Step 1 : The customer requests financing via the CMTF-i product

²⁰ Commodity Murabahah Term Financing-i (CMTF-i), Maybank Islamic, http://www.maybankislamic.com.my/b_cmtf-i.html, accessed on 06/11/11

- Step 2 : MIB purchases the commodity on a spot basis from Broker A (commodity market)
- Step 3 : MIB sells the commodity to the customer on deferred payment basis (cost + profit)
- Step 4a : The customer appoints MIB as agent to sell the commodity on a spot basis to Broker B (commodity market)
- Step 4b : MIB as an agent sells the commodity to Commodity Broker B on a spot basis, and delivers the sale proceeds to the customer

The process will occur during the disbursement stage. Prior to the commodity trading, legal documentation will be signed by both contracting parties.

4.3.3 Legal Document

Legal documents are the bound documents of agreement between the contracting parties including *'aqd* agreement for *Sharī'ah*-based product. For CMTF-i product, the legal documents that are required for stamping are as follows:

1. Letter of Offer
2. Master Commodity Murabahah Financing Agreement
3. Security documents (if applicable)

The letter of offer is a document that describes the offer of MIB to grant financing, i.e. CMTF-i to customer. The letter of offer will be issued to the customer

upon the bank's approval of the financing application. The letter contains brief information concerning the offered facility and general terms and conditions. Subsequently, other documents will be contracted upon the acceptance of the offer by the customer.

The Master Commodity Murabahah Financing Agreement is the main agreement between the contracting parties, i.e. the bank and the customer. This document lays out the agreement clauses, which includes facility information and details of the terms and conditions. The document also states the provision of the *Sharī'ah*-compliant facility and late payment charges (*ta'wīd*). The schedules for commodity trading are attached together with the document, which includes the purchase request, offer and acceptance, and agent appointment.

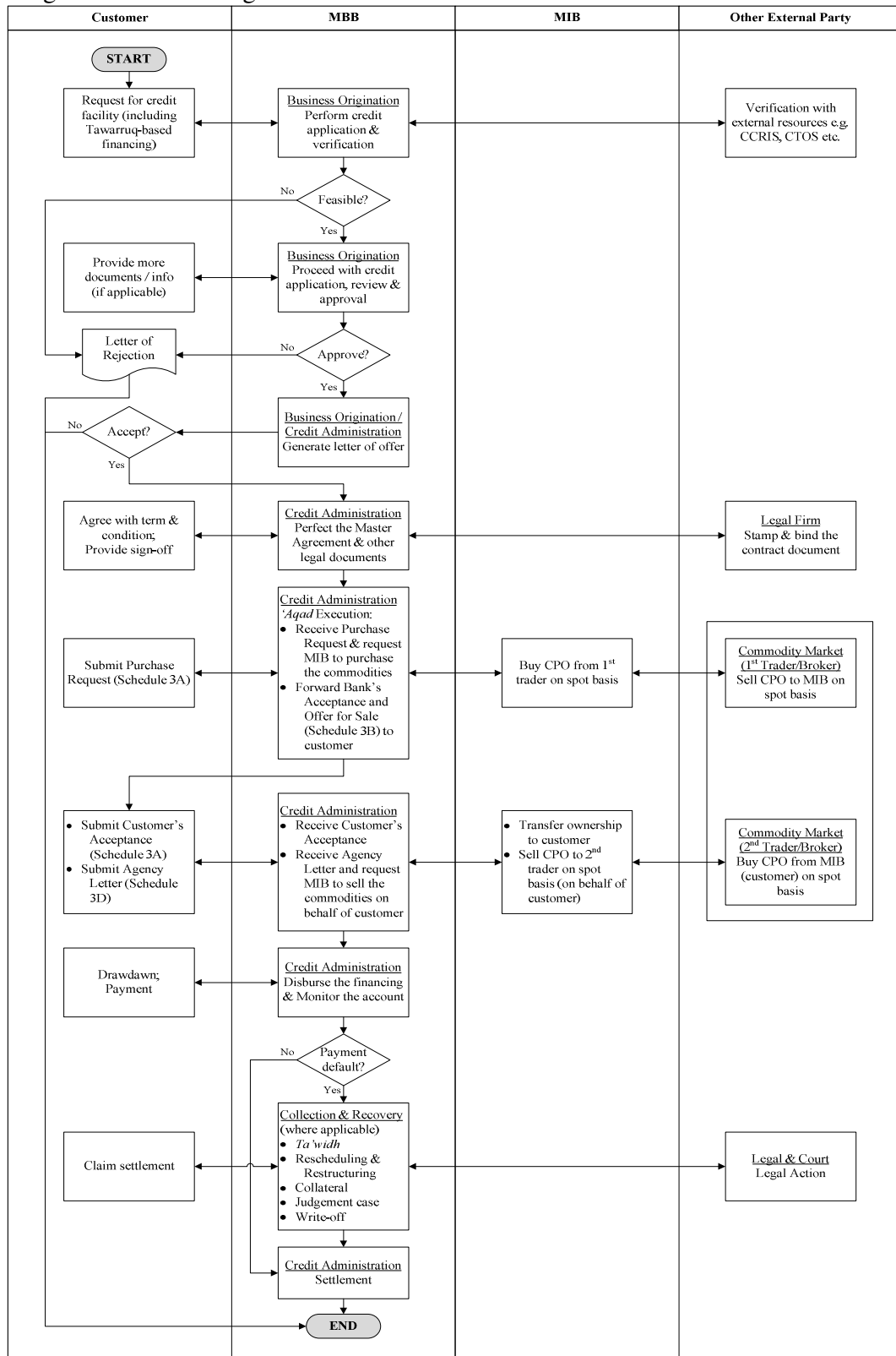
The security document is the document that is required to secure the financing or sale debt of CMTF-i. If the financing is required to be pledged by security or collateral, then this security document is applicable. The document is dependent on what type of security, such as charge annexure and deed of assignment for property. The content of the security document also differs in some aspects depending on state regulation (where applicable).

All these documents need to be prepared by the credit administrator at the documentation stage. The documents are the binding contract, which is stamped by the authorized party and is executed prior to commodity trading and disbursement in the credit processing.

4.3.4 Credit Process

The Islamic financing product of MIB is operated on the same platform as the MBB conventional products within the Maybank Group. Most of the credit functions in the financing process for Islamic banking are handled by the same units that handle the conventional loans. The credit consideration for conventional or Islamic banking is deemed to be the same, except for some *Shari'ah* considerations in approving the financing. The CMTF-i process flow can be described as per the following diagram:

Diagram 4.2: Financing Process for CMTF-i



Source: Illustrated based on interviews with MIB personnel

MIB runs the Islamic banking business on the same platform as the conventional banking provided by MBB. Therefore, the business origination, credit administration, collection and recovery, etc., are handled by the same parties in MBB. However, the *Sharī'ah* non-compliance aspect is monitored by MIB.

The first step of the processing will be the request for credit facilities or financing, which includes the CMTF-i product as one of the facilities.²¹ The request can be approached either by the customer or by the bank. Upon receiving the request, the bank personnel, i.e. credit or marketing officer will verify the feasibility of granting credit facilities to the respective customer including *Sharī'ah* consideration in recommending the facility to the customer.

The customer screening or verification will involve internal or external resources. After passing through, the credit application will be forwarded to a higher level for evaluation and subsequent approval. Any amendment requested by the reviewing or approving party will be attended to by the credit officer. For rejected applications, the customer will be informed accordingly.

Upon credit application processing, the *Sharī'ah* consideration on customer activities and purpose of financing need to be monitored by business originators where any involvement with *Sharī'ah*-prohibited activities must be avoided. Any uncertainty will be referred to the related personnel in MIB.

²¹ For business financing, each credit application can have multiple facilities.

For collateral assets that are pledged to secure the financing, the business originators and credit administrators need to monitor and control the acceptance of those collaterals where the non-compliance assets type must be avoided. Any uncertainty is referred to the related personnel in MIB.

Upon approval of the credit application, the letter of offer will be issued to the customer. Once the offer is accepted by the customer, further legal documentation will be processed by the credit administrator. Some additional documents may be requested from the customer. The legal documents, including the master agreement, will be signed by the customer at this stage.

After documentation has been completed by the credit administrator, MIB will inform the customer to submit the form of Purchase Request (Schedule 3A of Master Agreement) to undertake the purchase of the commodity after it has been purchased from the vendor. Upon receiving the form, credit admin will request MIB to purchase the commodity from the vendor. MIB will locate the commodity, most of the time using crude palm oil (CPO), from the commodity market. Currently, there are several vendors that are preferred by MIB. Once the commodity is determined, MIB will purchase the commodity on a spot basis from the commodity trader whilst the commodity ownership is transferred to MIB.

MIB will inform the credit admin to proceed with the commodity sale to the customer. Credit admin will then forward the form of Bank's Acceptance and Offer for Sale (Schedule 3B) to the customer. The customer will reply with the form of

Customer's Acceptance (Schedule 3C) to credit admin and the commodity ownership will be transferred to the customer by MIB. The sale is executed on a credit basis and under the concept of *murābahah* in which the cost and profit are disclosed upfront. The deferred price will be the obligation amount of the customer to be settled upon maturity either by instalment or lump sum.

Subsequently, the commodity will be sold to another trader in the commodity market by MIB that acts as an agent of the customer after the form of Agency Letter (Schedule 3D) is received by credit admin. The sale is executed on a cash basis, which is normally at the price of the commodity cost that was purchased by MIB earlier. The sale proceeds will be the financing amount granted to the customer, which is disbursed by either crediting into the customer's account or by cheque.

If the facility is granted with multiple drawdowns, especially for business financing, then the commodity trading will be executed multiple times as and when it is required. The disbursement process will be executed after the trading for each tranche subject to the limit balance where the facility limit will be the capping limit for utilization.

For customer payment that is in arrears, *ta'wīd* will be charged on the default account where it is earned by the bank. Furthermore, rescheduling or restructuring might be considered by the recovery unit. Restructuring involves structural changes in the facility, and also the terms and conditions. Therefore, a new '*aqd*' process will be

executed for the restructuring facility, which follows the same '*aqd*' process, as mentioned before.

However, if rescheduling and restructuring cannot work or are not deemed applicable to execute, then a summons will be served on the customer. Normally, this situation is applicable after the account status turns into non-performing financing (NPF). Furthermore, the recovery unit may proceed to execute the foreclosure process and/or legal proceedings where applicable.

4.3.5 Monitoring and Tracking

The *Shari'ah* organs in MIB consist of Shariah Management, Shariah Review and Shariah Risk. Shariah Management governs the pre-implementation of the product including the function of advisory, research and secretariat to the Shariah Committee. Shariah Review will govern the compliance aspect of the post-implementation. Both Shariah Management and Shariah Review will report to the Shariah Committee,

Meanwhile, Shariah Risk is responsible for *Shari'ah* non-compliance risk tracking and monitoring, and obliged to the Risk Committee. In addition, the Shariah Audit function, which performs a periodical audit on *Shari'ah* matters, resides within the Maybank group audit and is responsible to the Audit Committee.

Shari'ah compliance review will be periodically conducted by the respective personnel. Assessment of the operational aspects, product, documentation, etc., will be handled manually by having a sampling of the cases. The review exercise will go through the operational process and provides a report for any potential or actual *Shari'ah* non-compliance events.

4.4 Conclusion

MIB is the biggest Islamic bank in Malaysia and Asia Pacific as measured by the value of the assets. It is the arm of Maybank Group for Islamic banking business, which operates as a legal entity under the provision of the Islamic Banking Act 1983. However, MIB shares the same infrastructure as MBB under the basis of dual banking on the same platform.

By sharing the same platform, the financing or credit processing is handled by MBB units except for the process of commodity trading. However, overall monitoring for *Shari'ah* non-compliance is still under the obligation of MIB. Therefore, MIB is accountable for executing *Shari'ah* non-compliance review and risk control.

The CMTF-i product of MIB, which is underlain with the *tawarruq* concept, is the cash-based financing provided for non-individual customers or business purposes. *Tawarruq* contains a series of sale and purchase transactions in which the end result is to obtain cash proceeds from commodity sales to third party traders. Hence, the trading

transaction is exposed to a high degree of *Sharī'ah* non-compliance risk where any misconduct may trigger a *Sharī'ah* non-compliance event.

There are a few other areas that are also vulnerably exposed to *Sharī'ah* non-compliance risk, such as engagement with customer, collateralizing, rescheduling and restructuring (These *Sharī'ah* non-compliance risk will be further discussed in the next chapter). Hence, MIB may need to ensure that the control mechanism is in place for those areas in order to avoid *Sharī'ah* non-compliance events and mitigate the risk accordingly.

CHAPTER 5: ANALYSIS OF *TAWARUQ*-BASED FINANCING FROM *SHARĪ'AH* PERSPECTIVE

5.1 Introduction

Islamic financing, which is constructed using the permissible contracts according to Islamic law, has a similar intention or function with a conventional loan, i.e. for money supply. However, some *Sharī'ah*-prohibited elements, such as *ribā*, *gharar*, and *qimār*, must be eliminated in the financial transaction.

Tawarruq is one of the *Sharī'ah* concepts used for cash-based financing due to the nature of the concept, that is, to provide cash. Cash proceeds that result from the commodity sale to a third party provides liquidity to the *mustawriq*, i.e. the customer. Therefore, the liquidity provided by *tawarruq*-based financing is equivalent to the liquidity provided by a conventional loan. Hence, the concept alternates most of the conventional facilities, such as personal financing, property financing, corporate financing and others.

Sharī'ah allows any mechanism, tool, practice or procedure of conventional banking that does not contravene the principles of *Sharī'ah* to be adopted in the Islamic banking system. This is aligned with the legal maxim that states:

الأصل في الأشياء الإباحة، حتى يدل الدليل على التحريم¹

¹Al-Suyūṭī (2006), *al-Ashbāh wa al-Naẓā'ir*, Muḥammad Muḥammad Tāmīr et al. (eds.), Kaheerah: Dār al-Salām, pg. 166. There is some debate concerning the maxim, inasmuch as according to al-Shāfi'ī, Abū Hanīfah opined that the origin is haram till evidence indicates permissibility. However, according to some Hanafī exponents, the origin is permissible.

The basis (origin) of the things is permissible till evidence indicates prohibition

Therefore, the credit practices in conventional banking can be applied to Islamic financing subject to a few *Sharī'ah* elements that need to be taken into consideration, especially for *tawarruq*-based financing. Since *Sharī'ah* is the foundation for the Islamic banking system, any violation of the *Sharī'ah* requirement will lead to possible exposure to *Sharī'ah* non-compliance risk, which might cause a loss to the Islamic bank. In addition, any matter that leads to misperception of *Sharī'ah* principles should be avoided.

5.2 *Sharī'ah* Non-Compliance Risk

Sharī'ah non-compliance risk is the risk arising from the Islamic financial institution's (IFI) or Islamic bank's failure to comply with *Sharī'ah* ruling, as defined by the IFI *Sharī'ah* committee or authorized body, which may result in IFI loss either financial or non-financial, such as reputation or image. The *Sharī'ah* Governance Framework (SGF) of Bank Negara Malaysia (BNM) defines *Sharī'ah* non-compliance risk as possible failure to meet the obligation to *Sharī'ah* principles or possible incidences of *Sharī'ah* non-compliance.² According to the Islamic Financial Services Board (IFSB), *Sharī'ah* non-compliance risk is the risk that arises from the failure of IIFSs³ to comply with the *Sharī'ah* rules and principles determined by the

² BNM (n.d.), *Shariah Governance Framework for Islamic Financial Institutions*, pg. 5, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 24/09/11.

³ Institutions (other than Insurance Institutions) offering only Islamic Financial Services, which refer to IFIs or Islamic banks.

Shari'ah Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate.⁴

The failure to comply with *Shari'ah* requirements may arise in every aspect of Islamic bank operations. It can be due to the lack of quality in respect of governance, business process, supporting system or awareness among the Islamic banking staff. A *Shari'ah* non-compliance event either in financing, deposit, investment, treasury, gold trading and other segments may be executed from the product structure or the legal documentation where it should be properly developed by a product specialist and endorsed by the *Shari'ah* committee.

Breaching of *Shari'ah* compliance in *tawarruq*-based financing might have implications for the financial and/or non-financial aspects of the Islamic bank. The implications may lead to the undesired result of actual loss, unentitled for profit, or reputation of the Islamic bank.

5.2.1 Financial Impact

Tawarruq is a form of sale and purchase contract. Therefore, any breach of *Shari'ah* compliance with regard to contract documentation and execution of sale and purchase will cause the deal between the Bank and the customer or other external party to become invalid. Hence, any income or profit generated from the invalid contract and transaction is deemed illegitimate or non-halal.

⁴ IFSB (2005), *Guiding Principles of Risk Management for Institution (Other than Insurance Institution) Offering only Financial Services*, Principle 7.2 (121), pg. 26, downloaded from <http://www.ifsb.org/published.php>, accessed on 24/09/11.,.

In addition, the Bank may not be entitled for the expected profit that is gained from improper contract execution even if the contract is valid. For example, if the deferred sale of a commodity is accidentally executed by the bank to the customer based on cost price, then the bank is not entitled to recognize the expected profit of the trading, which is the deferred income to the bank.

Improper contract executions may also cause the derecognition of the bank's assets. For example, the commodity selling price in the offer and acceptance is lower than the cost price of the commodity, which is the principal amount of financing granted to the customer. In this situation, the contract is still valid. However, the variance between the commodity selling price and cost price (where the cost price is higher) will derecognize the bank's financing asset, and, subsequently, impact on the capital.

In credit standard practice, which is also applied to *tawarruq*-based financing (especially for business financing), collateralizing is one of the mechanisms used to secure the credit exposure. However, any negligence concerning the control of collateral pledging will impact the bank's recovery when an account is in default if the bank is not entitled to claim or to recover the credit exposure from *Sharī'ah* non-compliant collateral assets in which the asset is sourced from non-*halal* activities.⁵

⁵BNM only allows acceptance of collateral that is *Sharī'ah*-compliant for Islamic financing products, as stated in Guideline on Introduction of New Products, pg. 14. However, BNM allows conventional fixed deposits to be pledged by excluding the amount of interest, as resolved by SAC. See BNM (2010), *Shariah Resolution in Islamic Finance*, Second Edition, Kuala Lumpur: BNM, pg. 57.

Hence, it also impacts on the ratio of loss given default (LGD),⁶ which is one of the main components in the credit risk model.

A violation of *Shari'ah* compliance will contravene the provisions of the Islamic Banking Act (IBA) 1983 where consequent incidents of *Shari'ah* non-compliance will lead to the severe loss of the Islamic bank. The bank, upon conviction is liable to a fine and/or revoking of licence. Section 3(5) states:⁷

The Central Bank shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless the Central Bank or the Minister, as the case may be, is satisfied-

(a) that the aims and operations of the banking business which it is desired to carry on will not involve any element which is not approved by the Religion of Islam;

Section 4 states⁸:

(1) The Minister may at any time, on the recommendation of the Central Bank, vary or revoke any existing condition of a licence or impose conditions or additional conditions.

(2) The Minister shall, prior to any action under subsection (1), notify his intention in writing to take such action to the Islamic bank concerned and shall give the bank an opportunity to submit within such period, being not less than fourteen days, as may be specified in the notification reasons why the condition of the licence should not be varied or revoked or conditions or additional conditions should not be imposed.

(3) Where a licence is subject to conditions, the Islamic bank shall comply with those conditions.

(4) Any Islamic bank which fails to comply with any condition of its licence shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit.

⁶ LGD is the magnitude of likely loss or estimated percentage of loss over the total exposure when the bank's counterparty defaults. LGD is facility-specific because such losses are generally understood to be influenced by key transaction characteristics, such as the presence of collateral and the degree of subordination. For more details please refer to Basel II definition, e.g. url <http://www.basel-ii-risk.com/Basel-II/Basel-II-Glossary/Loss-Given-Default.htm>, accessed on 16/08/2012.

⁷ Islamic Banking Act 1983, section 3(5), downloaded from <http://www.bnm.gov.my/index.php?ch=14>, accessed on 06/09/2011.

⁸ *Ibid*, section 4.

5.2.2 Non-Financial Impact

Sharī'ah refers to divine law that originates from Allah s.w.t. The law founds the Islamic banking system in which all banking operations and activities should comply with the *Sharī'ah* precepts. Therefore, Islamic banking is not just about banking business, but, in essence, obedience to the divine law that underlies the banking system.

Any violation of *Sharī'ah* compliance will be against the commandment of Allah s.w.t. and answerable to Him. Allah mentioned in the Quran:

وَأَنْزَلْنَا إِلَيْكَ الْكِتَابَ بِالْحَقِّ مُصَدِّقًا لِّمَا بَيْنَ يَدَيْهِ مِنَ الْكِتَابِ وَمُهَيِّمًا عَلَيْهِ فَاحْكُم بَيْنَهُم بِمَا أَنْزَلَ اللَّهُ وَلَا تَتَّبِعْ أَهْوَاءَهُمْ عَمَّا جَاءَكَ مِنَ الْحَقِّ لِكُلِّ جَعَلْنَا مِنْكُمْ شِرْعَةً وَمِنْهَاجًا

And We have sent down to you (O Muhammad saw), the Book (this Quran) in truth, confirming the Scripture that came before it and Muhaymin (trustworthy in highness and a witness) over it (old Scriptures). So judge among them by what Allah has revealed, and follow not their vain desires, diverging away from the truth that has come to you. To each among you, We have prescribed a law and a clear way.

Surah al-Maidah (5) : 48

The verse cited in *khiṭāb* (ordinance) from Allah Taala that was revealed to His Prophet Muhammad s.a.w., and His commandment to give judgement based on *Sharī'ah*, which is the right and clear way to be practiced.⁹ As narrated from Qatadah, there is a *Sharī'ah* for the Tawrah, a *Shari'ah* for the Injil, and a *Sharī'ah*

⁹ See al-Ṭabārī (n.d.), *Tafsīr al-Ṭabārī*, Maḥmūd Muḥammad Shākir et al. (eds.), vol. 10, Kaheerah: Maktabah Ibn Taymiyyah, pg. 376-389

for the Quran where Allah permits what He wants and prohibits what He wants, to know who obeys and who disobeys.¹⁰

He mentioned in another verse:

ثُمَّ جَعَلْنَاكَ عَلَىٰ شَرِيعَةٍ مِّنَ الْأَمْرِ فَاتَّبِعْهَا وَلَا تَتَّبِعْ أَهْوَاءَ الَّذِينَ لَا يَعْلَمُونَ

Then We put you, (O Muhammad saw), on a (plain) way (Shari‘ah) of (Our) commandment, so follow you that, and follow not the desires of those who know not.

Surah al-Jathiyah (45) : 18

The above verse cited on Allah’s command to Prophet Muhammad s.a.w. prescribed following what is revealed to him from his God, no God except Him, and to ignore the *mushrikīn* (polytheists).¹¹ The meaning of the verse is that Allah prescribes a clear way of religious matter to the righteous to His Prophet s.a.w.¹² Since *Shari‘ah* is the foundation of the Islamic banks, all banking operations and activities should comply therewith.

It is also mentioned in other verse:

وَأَنِ احْكُم بَيْنَهُم بِمَا أَنزَلَ اللَّهُ وَلَا تَتَّبِعْ أَهْوَاءَهُمْ وَاحْذَرْهُمْ أَنْ يَفْتِنُوكَ عَنْ بَعْضِ مَا أَنزَلَ اللَّهُ إِلَيْكَ فَإِنْ تَوَلَّوْا فَاعْلَمُوا أَنَّمَا يُرِيدُ اللَّهُ أَنْ يُصِيبَهُمْ بِبَعْضِ ذُنُوبِهِمْ وَإِنَّ كَثِيرًا مِّنَ النَّاسِ لَفَاسِقُونَ

And so judge (you O Muhammad saw) among them by what Allah has revealed and follow not their vain desires, but beware of them lest they turn you (O Muhammad saw) far away from some of that which Allah has sent down to you. And if they turn away, then know that Allah’s Will is to punish them for some sins of theirs. And truly, most of men are Fasiqun (rebellious and disobedient to Allah).

Surah al-Maidah (5) : 49

¹⁰ *Ibid*, pg. 385.

¹¹ Ibn Kathīr (2004), *Tafsīr al-Qurān al-‘Azīm*, Beirut: Dār al-Ma‘rifah, pg. 1444.

¹² al-Qurṭubī (2006), *al-Jāmi‘ li Ahkām al-Qurān*, ‘Abd Allāh ibn ‘Abd al-Muḥsin al-Turkī (ed.), vol. 19, Beirut: Muassasah al-Risalah, pg. 154.

The verse cited on Allah's command to His Prophet s.a.w. prescribed judging based on what was revealed to him, and to beware of the enemy, i.e. Jews, who tried to turn him from the righteous path. Allah emphasized that upon their choice, He is capable to turn them from His guidance and be in their sin which deserves punishment. He also mentions that a lot of people disobey their God, which is a non-righteous act.¹³

In addition, any breach of *Sharī'ah* compliance may impede the Bank or the Bank's personnel from His *barakah* (blessing). Allah mentioned in the Quran:

وَلَوْ أَنَّ أَهْلَ الْقُرَىٰ آمَنُوا وَاتَّقَوْا لَفَتَحْنَا عَلَيْهِم بَرَكَاتٍ مِّنَ السَّمَاءِ وَالْأَرْضِ وَلَٰكِن كَذَّبُوا
فَأَخَذْنَا هُمْ بِمَا كَانُوا يَكْسِبُونَ

And if the people of the towns had believed and had the Taqwa (piety), certainly, We should have opened for them blessings from the heaven and the earth, but they belied (the Messengers). So We took them (with punishment) for what they used to earn (polytheism and crimes).

Surah al-A'raf (7) : 96

The verse cited on Allah's blessing of the dropping from the sky and the planting on the earth rewarded to the *muttaqīn* while promising to the believers the destruction of their earnings that are sourced from sinful and prohibited activities.¹⁴ In Islamic banking operations and activities, purposely violating the *Sharī'ah* compliance might deserve the withholding of Allah's blessing.

Sharī'ah is the foundation for Islamic banking in which a bank is required to manage the stakeholders' expectation in providing Islamic banking services.

¹³ See Ibn Kathīr, *op. cit.*, pg. 507. Even most *tafsīrs* describe the manner of the Jews; morally, such situation is applicable to Muslims as well. This is supported by methodology of Quranic science, i.e. العبرة بعموم اللفظ لا بخصوص السبب (the lesson by general pronunciation not by specific reason) where the lesson of the Quranic verse is to be understood generically.

¹⁴ See Ibn Kathīr, *op. cit.*, pg. 633.

Therefore, any breach of *Sharī'ah* compliance will lead to a lack of trust in the expectation and create negative publicity, and, consequently, will jeopardize the Islamic bank's reputation and image.

5.3 Risk Exposure in Credit Framework

According to IFSB, *Sharī'ah* non-compliance risk is classified under operational risk of Islamic banks.¹⁵ Nevertheless, how the risk factor originates from credit processing or financial instrument portfolio is not being addressed. Henceforward, *Sharī'ah* non-compliance risk is deemed to be associated with credit risk.

Based on fiqh methodology,¹⁶ by default, whatever is created by Allah Taala is *halal* and permissible providing no *ṣaḥīḥ* (sound) and *ṣarīḥ* (explicit) evidence proves otherwise.¹⁷ This provision is applicable to *‘ādāt* (custom) and *mu‘āmalāt* (mutual relation) only, and not to *‘ibādāt* (worship).¹⁸ Therefore, *Sharī'ah* allows the credit practice and procedure of conventional banks to be applied by Islamic banks subject to the elimination of *Sharī'ah* -prohibited matters.

Accordingly, there are a few elements that need to be considered throughout the credit process that might lead to exposure to *Sharī'ah* non-compliance risk. The

¹⁵ Guiding Principles of Risk Management, IFSB, pg.26, *op.cit.*,

¹⁶ Refer to legal maxim that has been mentioned earlier i.e. *الأصل في الأشياء الإباحة، حتى يدل الدليل على التحريم*

¹⁷ al-Qardāwī (1985), *al-Halāl wa al-Harām fī al-Islām*, Beirut: Dār al-Ma‘rifah, pg. 20.

¹⁸ *‘Ibādah* is treated oppositely based on hadīth narrated by al-Bukhārī and Muslim “من أحدث في أمرنا هذا “ما ليس فيه فهو رد” means whoever creates a new thing in worshipping, which is not from us then it is not accepted.

risk exposure exists in a few areas of credit processing¹⁹ for *tawarruq*-based financing as follows:

Table 5.1: *Shari'ah* Consideration in Credit Components

No	Credit Component	Processing Stage
1	Customer Engagement	Business Origination
2	Collateral Pledging	Business Origination and Credit Admin
3	Contract Execution	Credit Admin
4	Default Payment	Credit Admin and Credit Recovery
5	Rescheduling and Restructuring	Credit Recovery

Source: Several references.²⁰

Generally, the contract execution, i.e. component 3, is the risk exposure area for all *Shari'ah*-based financing. However, the contract execution of commodity trading is specifically exposed to *tawarruq*-based financing. Moreover, the risk in rescheduling and restructuring is exposed to debt-based financing, while other components are exposed to any *Shari'ah*-based financing.

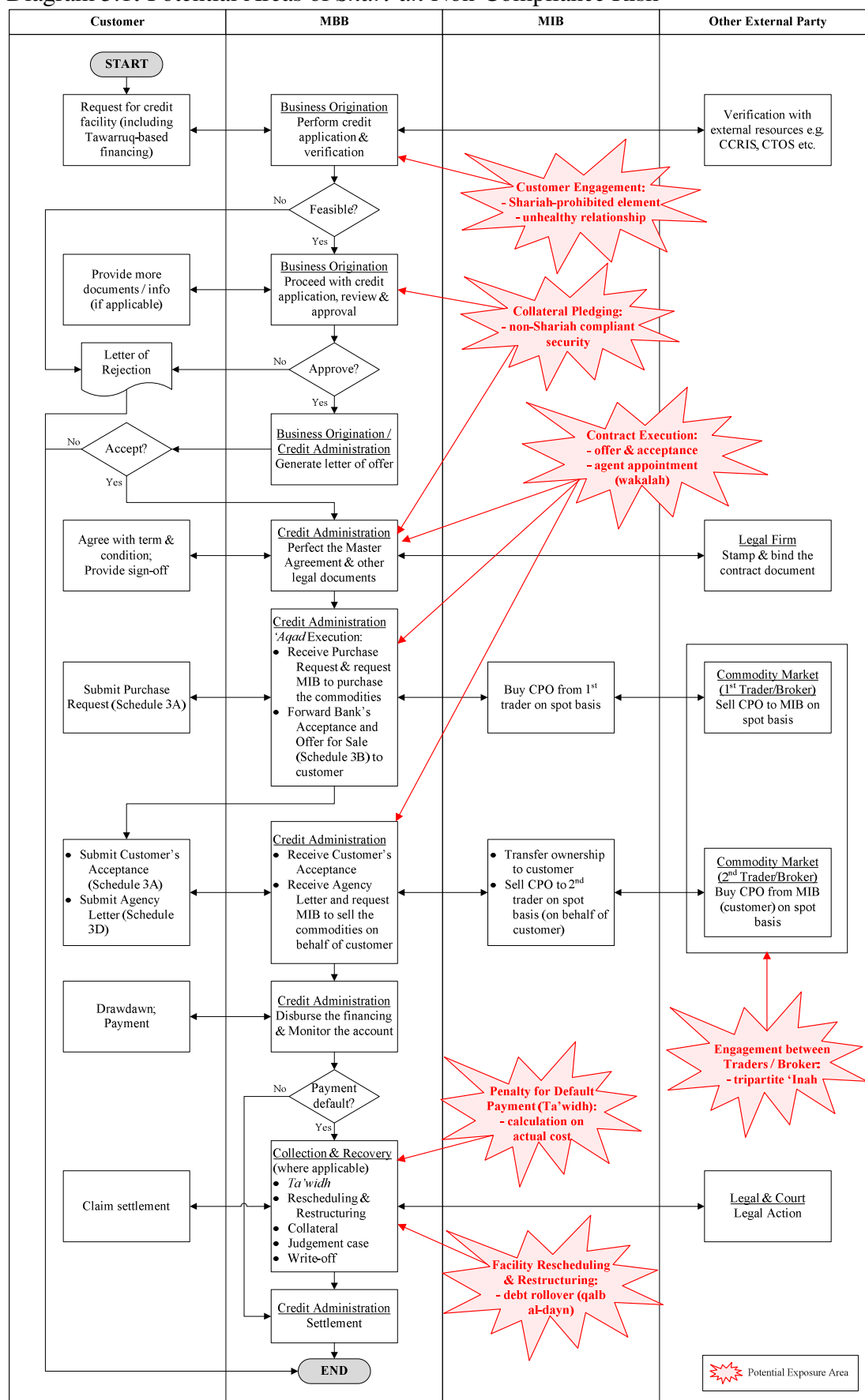
By mapping such exposure areas onto the MIB process flow, the potential risk of *Shari'ah* non-compliance that might arise in *tawarruq*-based financing can be illustrated as per Diagram 5.1:

¹⁹ Please refer to chapter 3 (Best Practices for the Management of Credit Risk by BNM). The typical credit process involves:

- Business origination – Credit origination, credit appraisal and review, credit approval
- Credit administration and monitoring – documentation and security, disbursement and receipt
- Credit recovery
- Credit control, review and analysis – internal controls and audit, independent credit review and audit, portfolio review and trend analysis and credit policy and process review

²⁰ Such as CCP, CRM BNM, BNM resolution, AAOIFI Shari'a Standard

Diagram 5.1: Potential Areas of *Shari'ah* Non-Compliance Risk



Source: Illustrated based on credit process and interview with MIB personnel

5.3.1 Potential Risk in Customer Engagement

In the early stage of business origination, *Sharī'ah* consideration in financing focuses on the customer or counterparty's business activities and purpose of financing. The financing is not allowed to be granted to individual or non-individual entities whose activities explicitly involve *Sharī'ah* non-compliant elements, such as *ribā*-based transactions, liquor production, gambling and brothels.

As discussed in chapter three, the BNM resolution disallows such financing on the basis that it would result in the revenue of Islamic financial institutions being generated by non-*Sharī'ah* compliant activities, which is consistent with the saying of Allah s.w.t.:²¹

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

“...help one another in furthering virtue and God consciousness, and not in what is wicked and sinful...”

Surah al-Maidah (5) : 2

However, no detailed guideline has been provided to identify the requirement, especially when different types of contract are being used to underlie the financing, or the counterparty's business activities are a mix of halal and non-halal elements. Neither has the standard been defined by AAOIFI, as in the current standard.²²

²¹ BNM (2010), *Shariah Resolution in Islamic Finance*, Kuala Lumpur: BNM, pg. 200, downloaded from

http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en
accessed on 06/09/2011

²² As in AAOIFI Shari'a Standard 2010

Nevertheless, there is no explicit evidence to disallow *tawarruq*-based financing being granted to any counterparty in which the cash proceeds will be used for prohibited activities. However in *fiqh* treatises, an analogical case was discussed concerning the commodity selling to a counterparty that uses the commodity for the prohibited activities, such as selling grapes to the producer of alcoholic beverages.

The majority of scholars²³ ruled such a sale as *harām*,²⁴ *makrūh*²⁵ or *makrūh tahrīm*²⁶ on the basis that it supports or assists in opposing Allah Taala²⁷ as Allah says in al-Quran:²⁸

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

“...help one another in furthering virtue and God consciousness, and not in what is wicked and sinful...”

Surah al-Maidah (5) : 2

In the context of business financing, conducting assessment on the customer profile, business activities and purpose of financing is a standard credit practice. Hence, the Bank knows the details of the customer’s activities prior to credit approval. Based on the argument that has been discussed, *tawarruq*-based financing for prohibited activities shall not be granted on the basis of aiding funds for activities

²³ Those who allow such sale argue on the basis of the general statement of evidence “وأحل الله البيع وحرم الربا” (and Allah permits trading and prohibits *ribā*).

²⁴ By most of the *fiqh* scholars

²⁵ By some Shāfi‘ī exponents

²⁶ By some Hanafī exponents

²⁷ See al-Nawawī (n.d.), *al-Majmū‘*, vol. 9, Muḥammad Najīb al-Muḥī‘ī (ed.), Jeddah: Maktabah al-Irshād, pg.431-432. There is also a subsequent argument on the validity of the contract. See al-Zuhaylī, *Fiqh al-Islāmī wa Adillatuh*. Vol. 1.

²⁸ Another evidence used by *fuqahā’* is based on hadith Abī Burdah r.a.: “من حبس العنب أيام القطاف، حتى ” narrated by al-Tabrānī in *al-Awsāt* and hadith “من حبس العنب ” narrated by al-Bayhaqī in *Sha‘b al-Imān*. There are different views on the *isnād* of the hadith inasmuch as it is classified as *hasan* by al-Hāfiẓ Ibn Hajar and some other scholars, while it is classified as either *dha‘īf*, *dha‘īf jiddan* or *mawdū‘* by others including al-Albānī. However, the evidence supporting *ma’siah* is very concrete to support the argument, as mentioned by Ibn Taymiyah in *Majmū‘ Fatāwā* where such trading is prohibited and not deemed as *ḍarūrah*.

that opposes Allah Taala. In addition, under the *sadd dharāi'* method, such financing should not be allowed as it might bring *mafsadah* to the economic system and society overall.

In the case study of MIB, *Sharī'ah* consideration on customer engagement is controlled by the business originator while internal *Sharī'ah* units will be referred to for advisory purposes. Therefore, if the guideline is not available for reference while the staff's knowledge is not competent enough, then the involvement of MIB in prohibited activities might be overlooked.

In addition, undefined policies or guidelines to outline the moral of the bank's personnel while engaging with the customer might cause exposure to some *Sharī'ah* issues that lead to negative publicity, e.g. bribery, fraud or involving prohibited entertainment. However, the implementation of the policy or guideline, if available, seems difficult whereby the same personnel serve for both the conventional and Islamic system of Maybank when the requirement is only meant for the Islamic system.

5.3.2 Potential Risk in Security or Collateral Pledging

Similar to conventional banking practice in mitigating credit risk, security or collateral pledging is often requested by the Islamic bank to secure the facility granted to the non-individual customer. In the modern system, security that is accepted by the bank is normally in the form of a tangible or non-financial asset, e.g.

real estate, vehicle etc., intangible or financial asset, e.g. fixed investment, shares etc. or in the form of guarantee.

Generally, accepting a non-*Sharī'ah* compliant collateral asset by an Islamic bank is disallowed as mentioned in BNM guideline on new products:

*...This includes ensuring that all operational decisions concerning the product are conducted in a Shariah-compliant manner, for instance, only accepting collaterals that are Shariah-compliant for Islamic financing products.*²⁹

According to the BNM resolution, basically the pledged collateral should be a tangible asset. However, receivables, cash and any acceptable assets are permitted to be charged as collateral on the basis of being valuable and deliverable. Permissible assets also include conventional fixed deposit certificates by excluding the amount of interest or *ribā*, which is deemed to meet the required features of a chargeable asset.³⁰ BNM also resolved that a credit guarantee facility with fee (*kafālah bi al-ujr*) offered by the Credit Guarantee Corporation (CGC) is permissible.³¹ However, no specific parameter or guideline is provided by BNM to outline the detailed requirements for collateralizing.

Nevertheless, AAOIFI has come out with a standard for collateralizing under Sharia Standard 39 with the title “Mortgage and Its Application”.³² The standard outlines the *Sharī'ah* requirement for collateralizing using the *rahn* principle. Regarding the collateral asset, the standard disallows accepting the pledging of non-

²⁹ Guidelines on Introduction of New Products, BNM, pg. 14, downloaded from <http://www.bnm.gov.my/index.php?ch=18&pg=55&ac=584>, accessed on 24/09/11

³⁰ See BNM (2010), *op. cit.*, pg. 57-58

³¹ See *Ibid*, pg. 165-166.

³² The title of the standard in Arabic version: “الرهن وتطبيقاته المعاصرة”

Shari'ah compliant collateral, as mentioned in the article of rulings related to the Mortgaged Asset:

*The mortgaged asset should be a Shari'a-permissible property. It should also be well specified (through pointing, naming or description) and can possibly be delivered.*³³

Included in this provision is financial or intangible asset on the basis that it provides value, it can be identified and is able to be delivered, as mentioned in the subsequent article:

*In principle, the mortgaged object should be a tangible asset, yet it can be a debt, a cash amount, a fungible asset or a consumable commodity. Perishable objects can also be mortgaged as they can be sold and replaced by their value. Moreover, a mortgaged object can be a share of common property which can be identified and sold separately.*³⁴

AAOIFI also provides a standard for guarantee that can be used to secure the debt including modern applications of guarantee, such as letter of guarantee, documentary notes and promissory notes under the principle of *ḍaman* or *kafālah*.³⁵ The pledging collateral should be based on the fact that the objective of the pledge is to facilitate recovery of the debt.³⁶

In short, the collateralizing transaction should be guided using the main principle of *rahn* for tangible assets, as guided by legal maxim:

ما جاز بيعه جاز رهنه، وما لا فلا

*What is permitted with its trading (sale and purchase), its collateralizing is permitted, and what is not then it is not.*³⁷

³³ AAOIFI (2010), *Shari'a Standards for Islamic Financial Institutions*, Bahrain: AAOIFI, Standard 39, Article 3/2/1, pg. 698.

³⁴ *Ibid*, Article 3/2/2.

³⁵ See *Ibid*, Shari'a Standard No. 5, pg 59-78.

³⁶ *Ibid*.

³⁷ Al-Suyuti, *op. cit.*, pg. 788.

In addition, if the security is the guarantee-based security, then the principle of *ḍaman* or *kafālah* applies.

Basically, the pledged collateral should be free from *Sharī'ah* prohibited elements, such as *ribā*-based financial instrument like deposit or investment account or any relevant instrument from conventional bank. As mentioned earlier, even though BNM resolved that a conventional fixed deposit is allowed to be pledged as collateral by excluding *ribā* or the interest amount, without any necessity such approach should be avoided by Islamic banks. Under the current situation where the fixed investment is offered by most of the Islamic banks in Malaysia, accepting such an instrument will position the respective Islamic bank into indirectly participating with *ribā*-based transactions and contributing to the economic growth of conventional instruments overall.

In the case study of MIB, *Sharī'ah* consideration on security or collateral pledging is controlled by the business originator and credit administrator, and internal *Sharī'ah* units will be referred to for advice. However, if no proper guideline is established to outline the requirement, the collateral pledging might lead to exposure to the risk of *Sharī'ah* non-compliance.

Disability to filter the collateral pledging may impact the entitlement to claim on the collateral asset for recovery if the financing account is in default. In addition, the acceptance of an immovable asset that is consumed for *Sharī'ah*-prohibited

activities must be discouraged since the reputation or image of the Islamic bank will be impacted, especially at the foreclosure³⁸ stage.

For example, if the granted financing is pledged by private property that is used for prohibited activities, such as brothel activities or alcoholic beverage warehouse, if the account defaults, one of the Bank's options is to foreclose the property. Hence, auctioning such property will give negative publicity to the image of the bank. Therefore, the technical guideline on collateralizing should be developed either by BNM or the Islamic bank itself.

5.3.3 Potential Risk in Contract ('Aqd) Execution

The most critical part in *tawarruq*-based financing is the process of contract execution. In a situation where classical *tawarruq* seems difficult to apply for Islamic financing, organized *tawarruq* causes exposure to the risk of fictitious elements, which leads to the *ribā* issue. Hence, the exposed area shall be appropriately mitigated to avoid losses to the bank.

The *tawarruq* concept is allowed to be applied by the SAC of BNM on the basis of *tawarruq* permissibility, which refers to classical *tawarruq*. The proposed mechanism mentioned in the BNM resolution does not describe the existence of any pre-arrangement, issue on commodity possession and enforcement of agent appointment to resell the commodity. However, there is no technical guideline or

³⁸ Foreclosure is the stage where the Bank will recover the debt from mortgaged property normally in a way of auctioning the property to the public.

parameter to describe the detailed requirement of all transactions hybridized in the *tawarruq* concept.

Meanwhile, as discussed in chapter three, organized *tawarruq* was prohibited by the Council of al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-‘Ālam al-Islāmī as it was deemed to contravene various elements pertaining to pre-arrangement, commodity possession and fictitious elements. Under the auspices of this resolution, organized *tawarruq* is deemed as *hīlah* for *ribā* by Majma' al-Fiqh al-Islāmī al-Duwalī. Hence, organized *tawarruq* is prohibited by this world authorized council.

To harmonize both arguments, the exposure in execution of the contract of *tawarruq*-based financing needs to be determined in order to mitigate the *Sharī'ah* non-compliance risk. Hence, *tawarruq* can be used as an exit for *ribā*-based borrowing, as highlighted by the AAOIFI *Sharī'ah* ruling.³⁹ The exposed area can be segmented as follows:

1. Documentation
2. Offer and Acceptance (sale '*aqd* execution)
3. Agent Appointment (*wakālah*)
4. Commodity Trading with third Party
5. Disbursement

In addition, if any purification is required from the arising issue, then it will impact on the cost bearing of the exercise.

³⁹ See AAOIFI (2010), *op.cit.*, pg. 530.

Based on the case study of MIB, the above exposure areas are mapped to the CMTF-i process where a brief analysis is described as follows:⁴⁰

1. Documentation

The schedule of the bank's offer clearly defines the details of the commodity, and the terms and conditions for trading transactions. Hence, it meets the requirements of the AAOIFI Shari'a Standard for Controls on Monetization (*Tawarruq*) Transactions, as stated in the standard are as follows:

*The commodity sold should be well identified so as to become distinct from the other assets of the seller...*⁴¹

However, it will be better if the document schedules of customer acceptance and purchase request provide the same description, which is currently not available in the documents.

The master agreement, which contains the contracted clause, is signed prior to the commodity trading, and then all the schedules (attachments) including agent appointment will be signed during the trading prior to the disbursement. Therefore, the documentation process meets the *Sharī'ah* requirement of a sale and purchase (*bay'*) contract. However, if the schedules are not executed properly upon the trading process, then it leads to *Sharī'ah* non-compliance risk.

Basically the *tawarruq* concept contains a series of transactions. Without counterparty involvement in activity sequences, the '*aqd*' is deemed to be executed before the commodity is possessed by the bank. Hence, it breaches the AAOIFI

⁴⁰ Since no technical guideline is provided by BNM, the AAOIFI standard and other parameters will be used as a comparison.

Shari'a Standard in which the standard requires the seller, i.e. the bank, to possess the commodity before selling it. Article 4/4 states:

*...There should also be a real commodity that the seller owns before selling it...*⁴²

Therefore, there is a potential risk in the invalidity of the contract if the contract is executed before possession of the commodity.

2. Offer and Acceptance ('aqd execution)

Conceptually, the credit admin of MBB will liaise with the customer with regard to the schedules, i.e. purchase request of the commodity, sale offer and acceptance. On the other hand, the credit admin will liaise with the MIB team to perform commodity trading with the vendors. Hence, the concept meets the *Shari'ah* requirement of a sale and purchase (*bay'*) contract.

Operationally, the series of transactions should follow the sequential process appropriately. Otherwise it will lead to a *Shari'ah* issue on commodity possession, as stated in the AAOIFI Shari'a Standard:

*The commodity should be actually or impliedly received by the buyer, and there remains no further condition or procedure for receiving it.*⁴³

Therefore, any failure to abide by the rule may lead to the risk of contract invalidity and unentitled expected profit.

A similar requirement was also provisioned by the civil code of the Ottoman Caliphate, i.e. The *Mejelle*,⁴⁴ where the thing to be sold should exist:

⁴¹AAOIFI (2010), *op. cit.*, Shari'a Standard No. 30, Article 4/2, pg. 525.

⁴²*Ibid*, Article 4/1, pg. 525.

⁴³*Ibid*, Article 4/4, pg. 526.

*The existence of the thing sold is necessary.*⁴⁵

And also:

*The sale of a non-existing thing is invalid.*⁴⁶

Selling a possessed commodity is a tenet of sale and purchase. *Fiqh* scholars agree that selling a commodity that is not possessed or owned by the seller is not permissible,⁴⁷ as supported by the hadith from Hakim ibn Hizam in which he said:⁴⁸

يا رسول الله، يأتيني الرجل فيريد مني البيع ليس عندي، أفأبتاعه له من السوق؟
فقال: لا تبع ما ليس عندك

O Messenger of Allah! A man came to me to buy something that I don't have. Shall I purchase (the goods) from the market for him? Then he (Nabi s.a.w.) said: Don't sell what you do not own.

3. Agent Appointment (wakālah)

The schedule of agent appointment is signed and submitted to the credit admin after the Bank's offer is accepted by the customer. Therefore, the process is deemed able to mitigate the issue of organized elements in *tawarruq* where the agency should not be appointed prior to the commodity possession. Operationally, any negligence might lead to *Sharī'ah* non-compliance risk where the agent appointment is not supposed to be assigned if the commodity is yet to be possessed by the customer.

Appointing the bank as an agent before commodity possession leads to the fictitious issue, which is addressed by the *Sharī'ah* ruling that prohibits organized

⁴⁴ The code originally established in Turkish. The Arabic translation is known as *al-Majallah al-Ahkām al-Adliyyah*.

⁴⁵ *The Mejelle* (2007), (trans.) C.R. Tyser et al., Kuala Lumpur: The Other Press, Article 197.

⁴⁶ *Ibid*, Article 205.

⁴⁷ This provision excludes *bay' al-salam*.

⁴⁸ Abū Dawūd (2009), *Sunan Abī Dāwūd*, Shu'ayb al-Arnaūṭ et al. (eds.), Beirut: Dar al-Risalah al-'Alamiyah, Kitāb al-Buyū', hadith no 3503. According to editor, the isnad of the hadith is said to be *munqati'*. However, it is supported by another hadith, which makes it *sahih li ghairih*.

tawarruq. In fact, the agent appointment should be performed after the customer purchases the commodity from the bank where the tenet of *wakālah* requires that the matter being commissioned should first be possessed by *muwakkil* (constituent).⁴⁹ In addition, the agent appointment should not be a binding clause in the master agreement.

In addition to the *wakālah* clause, AAOIFI Shari'a Standard mentioned that the bank should not sell the commodity on behalf of the customer except by virtue of regulation, as stated in Article 4/7:

*The client should not delegate the institution or its agent to sell, on his behalf, a commodity that he purchased from the same institution and, similarly, the institution should not accept such delegation. If, however, the regulations do not permit the client to sell the commodity except through the same institution, he may delegate the institution to do so after he, actually or impliedly, receives the commodity.*⁵⁰

The requirement of the standard intends to avoid the organizing (*munaẓẓam*) element in *tawarruq*.⁵¹ There is no clause stated in the contract agreement regarding this matter. Hence, the potential risk may arise in the validity of the contract. The issue and risk exposure arising in this matter aligns with the *Sharī'ah* concern of who prohibits organized *tawarruq*.

In order to harmonize the *Sharī'ah* ruling by contemporary scholars and the practice of Islamic banks, the agent appointment should be restricted to the customer that is legally incapable of reselling the commodity to the third party buyer on the

⁴⁹ See al-Zuhaylī (1985), *Fiqh al-Islāmī wa Adillatuh*, Damascus: Dār al-Fikr, vol. 5, pg. 76. AAOIFI (2010), *op. cit.*, Article 4/7, pg. 526.

⁵⁰ *Ibid*, Article 4/7, pg. 526. It is also mentioned in some classical *fiqh* treatises.

⁵¹ As mentioned earlier, no clear guideline on organized *tawarruq* is provided by BNM as at now (05/06/2012).

basis of *maṣlahah*.⁵² This requirement shall be provisioned accordingly in the master agreement.

4. Trading with Third Party

Trading with third party is another potential risk in *tawarruq* transactions. The bank needs to monitor the integrity of the commodity traders where the commodity selling by the customer should be to the third party who does not have any association with the first commodity supplier. Otherwise, it leads to the issue of tripartite *‘īnah*.

Tripartite *‘īnah* (or more parties) occurs when the traded commodity flows back to the initial seller where such transaction is prohibited by most scholars due to the fictitious element, as stated by AAOIFI Shari’a Standard of Tawarruq:

*The commodity (object of Monetization) must be sold to a party other than the one 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.*⁵³

Upon occurrence, the arrangement is deemed to be fictitious. However, any transaction between traders is beyond the bank’s control. Although, the Bank may need to request and ensure that the traders comply with the requirement since their role is part of the transaction chains. In addition, the bank may need to monitor and track the performance of the traders as affordable.

⁵² Customers from other IFIs or Islamic banks that participate in Bursa Suq al-Sila’ (BSAS) have the capability to access the BSAS system and resell the commodity by themselves.

⁵³ AAOIFI, *op. cit.*, Article 4/5, pg. 526.

5. Disbursement

The bank disburses the financing amount (cash proceeds) to the customer after the sale of the commodity to the end buyer is completed, which fulfils the *Shari'ah* requirement. However, if the disbursement occurs prior to the transaction without any basis, then it is deemed invalid and fictitious. The AAOIFI standard states:

*...and sells it to a third party to obtain liquidity...*⁵⁴

In addition, if the disbursement is executed in tranches,⁵⁵ then the bank will perform the new *'aqd* for each tranche. The *'aqd* execution will follow the same process, as mentioned earlier. Hence, the issue will be exposed to each tranche as discussed before.

5.3.4 Potential Risk in Charge of Default Payment

As a control mechanism of the late payment, two methods have been introduced to claim the compensation for losses of Islamic financing activities, i.e. *ta'wīd* and *gharāmah*. *Ta'wīd* refers to a claim for compensation arising from actual loss suffered by the financier due to the delay in payment of financing or debt amount by the customer. Whilst *gharāmah* refers to the penalty charges imposed for a delay in financing or debt settlement, without the need to prove the actual loss suffered.

⁵⁴ *Ibid*, Article 3/1, pg. 525.

⁵⁵ Subject to time interval where normally business customers require funds to be utilized at different points of time.

Based on arguments, as discussed in chapter three, BNM resolved that *ta'wīḍ* is permissible to be charged on the actual cost after the due date, while *gharāmah* is permissible to be charged but not to be recognised as income and has to be channelled to charity.⁵⁶ The permissibility of this mechanism is intended to mitigate the harm suffered, and, at the same time, instil discipline on the customer to make payment according to the stipulated schedule.⁵⁷

Meanwhile, of al-Majma' al-Fiqhī al-Islāmī bi Rābitah al-Ālam al-Islāmī resolved that the penalty for default payment either has to be agreed upfront or it is not permissible where it is classified as *Ribā al-Jāhiliyyah*, the prohibition of which is mentioned in al-Quran.⁵⁸ Subsequently, a similar resolution was decided by Majma' al-Fiqh al-Islāmī al-Duwalī where the penalty is deemed as *ribā*.⁵⁹

According to the AAOIFI Shari'a Standard, such penalty is disallowed where it constitutes *ribā* as stated:

*It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt.*⁶⁰

⁵⁶ See BNM (2010), *op.cit.*, pg. 129-130

⁵⁷ *Ibid*, pg. 131.

⁵⁸ See al-Majma', Meeting no. 11, resolution no. 8. 1989. Al-Quran, chapter Ali Imran, verse 130 says: ((يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفَةً وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ)) *O you believe! Eat not Ribā doubled and multiplied, but fear Allah that you may be successful.* Based on this verse, some *mufasssin* said, during the pre-Islamic period, lenders who charged interest or *ribā* used to say to their debtors: "Do you want to settle now or to pay an additional amount for further period of credit?" It is a common practice during that time where money is used to generate money, and it is known as *Ribā al-Jāhiliyyah*.

⁵⁹ See Majma', meeting no.6, 1990, qarar 51 (6/2).

⁶⁰ AAOIFI (2010), *op. cit.*, Shari'a Standard 3, Article 2/1(b).

The basis of the *Sharī'ah* ruling for this standard is based on several narrations about contractual conditions and granted loans with payment in excess of the amount lent, and also by referring to the resolution of Majma' al-Fiqh al-Islāmī al-Duwalī.⁶¹

In the case study of MIB, *ta'wīd* is charged at the rate of 1% against monthly instalments with a condition that the debt is yet to reach the full tenure date. Otherwise, the money market rate is calculated against the total amount due. *Ta'wīd* is supposedly to be calculated based on the actual cost incurred due to default of payment of the debt. Therefore, the charge should be calculated consciously to avoid an additional amount that leads to *ribā*. Nevertheless, *Sharī'ah* non-compliance risk may arise in the implementation of *ta'wīd* where a high integrity of internal control is required.

Due to the difficulties to determine the actual loss in calculating *ta'wīd*, BNM resolved that the Islamic bank can refer to the method of BNM as an authorized body by using the daily overnight Islamic interbank rate based on daily rest.⁶² Albeit such method is allowed, the dispute still surrounds the charge of non-actual loss, which is deemed as *ribā*. In addition, the risk also exposes to the mechanism of *gharāmah*. For those who apply this type of mechanism, a proper handling process should be put in place to mitigate the exposure of non-halal income.

⁶¹ See *Ibid*, Appendix B: Basis of the Shari'a Rulings.

⁶² See BNM (2012), *Resolusi Syariah dalam Kewangan Islam 2010-2011*, Kuala Lumpur: BNM, pg. 5, downloaded from http://www.bnm.gov.my/guidelines/05_shariah/cir_012_3.pdf, accessed on 10/10/12

5.3.5 Potential Risk in Rescheduling and Restructuring

Another applied mechanism for financing recovery or remediation in local Islamic banking is rescheduling and restructuring.⁶³ Rescheduling refers to the modification of financing payment terms where the principal terms and conditions of the contract are not changed significantly, i.e. lengthening the financing tenure and revision of monthly installments.⁶⁴ Instead, the price amount of the debt cannot be increased.

There is no issue in *Shari'ah* to extend the debt tenure as defined in the rescheduling. Even the debt extension is encouraged for the debtor who is incapable of making payment on time. However, if there is an additional charge of non-actual cost incurred for this exercise, then that additional amount is exposed to the risk of debt rollover, which leads to *ribā* even if a separate contract is entered into between the bank and the customer.

Meanwhile, restructuring refers to the modification of the principal terms and conditions of the facility, which includes change in the type or structure of the facilities or change to its terms, e.g. conversion of Overdraft to Term Financing.⁶⁵ This will require the termination of the existing facility and entering into new documentation for the new facility will be initiated. Additional costs will be involved here.⁶⁶

In restructuring, the existing debt or facility is normally restructured into a new facility or new terms where some additional amount of non-actual cost will be

⁶³ These mechanisms are adopted from conventional banking system.

⁶⁴ IBBM (2010), Islamic Banking Handbook, Kuala Lumpur: IBBM, pg. 137, downloaded at <http://www.iefpedia.com/english/wp-content/uploads/2010/11/Islamic-Banking-Handbook-FINANCIAL-SECTOR-TALENT-ENRICHMENT-PROGRAMME.pdf>, accessed on 10/10/12.

⁶⁵ *Ibid*, pg. 137.

⁶⁶ *Ibid*.

calculated into a new price for the bank to earn the profit from this exercise. Hence, this addition being charged to the debtor or customer in the new price leads to the risk of exposure to debt rollover.

No specific topic on debt rollover has been resolved by BNM except for the related resolution on the Restructuring and Rescheduling in Islamic Financing Agreement and Financing Settlement through New Financing. In the first resolution, it is mentioned that any changes to the price of the sale contract that were fixed during inception of the contract, require a new agreement in order to avoid *ribā* and *gharar*.⁶⁷ In the second resolution, it is mentioned that the existing debt can be settled by issuing the Islamic debt securities to the original financier on the basis that it is a separate and independent contract.⁶⁸

Based on such resolutions, it can be literally said that restructuring is allowed by terminating the existing contract and concluding the new contract. However, the addition that is priced for the new debt while terminating the old debt is not discussed clearly. Therefore, the permissibility to execute the rescheduling, which is normally exposed to the debt rollover issue is still questionable.

Neither is the topic resolved by AAOIFI. Instead, of al-Majma' al-Fiqh al-Islāmī bi Rābitah al-'Ālam al-Islāmī and Majma' al-Fiqh al-Islāmī al-Duwalī resolved that debt rollover (*qalb al-dayn*) or terminating debt with debt (*fasakh al-dayn fī al-dayn*) is

⁶⁷ BNM (2010), *op.cit.*, 206-207. Based on resolution, the new agreement can be cross referred to the original document to avoid double payment of stamp duty.

⁶⁸ *Ibid.* pg. 208.

prohibited, as it is deemed as *ribā*.⁶⁹ *Ribā* arises in this transaction when the addition is earned from the debtor due to the extension of the debt tenure. The rollover occurs where the creditor and debtor execute a new debt (with addition) on deferred basis to settle all the existing debt or part of it regardless the debtor is solvent or insolvent.⁷⁰ For example, new *tawarruq*-based financing (with higher price than existing debt receivable) is executed to settle the existing financing.

Based on resolution by both fiqh academies, the debt rollover is an inherent risk in the restructuring or even rescheduling transaction. The new debt from a new financing transaction with a new price (higher than the existing receivable) cannot be used to settle the existing debt as included in the *ribā al-jāhiliyyah* definition either the customer is solvent or insolvent. However, executing a new transaction for the purpose of other working capital is not included in this definition.

The term *qalb al-dayn* was unknown in the early period of Islamic jurisprudence history.⁷¹ It was later introduced after being used by Ibn Taymiyyah and the later period of Hanbali exponents, whilst similar connotation had been discussed in Maliki treatises where it is known as *Fasakh al-Dayn bi al-Dayn*.⁷² In short, the discussion surrounds the debt rollover scenarios that are deemed as *ribā al-jāhiliyyah*.

Ribā al-jāhiliyyah is being described as a person who gives an option to his counterparty to extend the debt tenure upon the due date with a condition that there

⁶⁹ See al-Majma' al-Fiqhī al-Islāmī, meeting no. 18, 2006, resolution no 3; Majma' al-Fiqh al-Islāmī al-Duwalī, meeting no. 17, 2006, resolution no. 158 (17/7).

⁷⁰ See *Ibid*.

⁷¹ Nazīh Kamāl Ḥamād, *Qalb al-Dayn wa al-Ahkām al-Fiqhiyyah al-Muta'alliqah bihi fī al-fiqh al-Islāmī*, Majallah al-'Adl, vol. 31, pg. 48.

⁷² See *Ibid*.

will be an addition to the existing debt in terms of amount, other quantitative or right. If the counterparty agrees, the new debt with new price, terms and conditions will be executed. Hence, the new executed transaction is called *qalb al-dayn* or *fasakh al-dayn bi al-dayn*. This is a common scenario that was widely practiced during the *jāhiliyyah* (pre-Islam) period.

Regardless of the name given, the essence of the prohibition is due to addition being charged onto the existing debt (in a way of creating a new debt), in a situation to give extension to the debt tenure. Hence, this addition is classified as *ribā al-jāhiliyyah*, which is prohibited by *Sharī‘ah*, as mentioned in al-Quran.

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفَةً وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ

O you who believe! Eat not Ribā (usury) doubled and multiplied, but fear Allah that you may be successful

Surah Ali Imran (3) : 130

According to al-Ṭabarī: The verse prohibits Muslims from eating *ribā* after accepting Islam as was practiced in *Jāhiliyyah* (pre-Islam era). During *Jāhiliyyah*, a man lends a *māl* (wealth/property) to another man on a deferred basis. When the time is due, he comes for collection while saying: Do you want to extend your debt and I place addition onto the *māl*? Then they do that.⁷³ This type of *ribā* is named as *Ribā al-Jāhiliyyah*.

In the case study of MIB, the facility restructuring is managed by the remediation unit of MBB. If the facility is restructured, a new *‘aqd* will be executed, while MIB will receive instruction to perform commodity trading for this restructuring facility. Although BNM has not clearly defined the issue of debt

⁷³ Al-Ṭabarī, *op. cit.*, vol 7, pg. 204.

rollover, such practice potentially leads to the risk of exposure to debt rollover as has been resolved by international *fiqh* academies.

Nevertheless, restructuring is still a grey area in local Islamic banks inasmuch as it causes vulnerability to the issue of debt rollover and needs to be resolved. Indeed, the risk impact of debt rollover is deemed high in Islamic bank with either a financial or non-financial impact. For financial impact, the risk is exposed to invalidation of the contract and unentitled to the profit generated from the transaction in which the non-halal income needs to be purified. In addition, the debt rollover is deemed as *ribā al- jāhiliyyah*, which is strictly prohibited where whoever is involved in *ribā* declares war against Allah Taala and His Messenger, as mentioned in al-Quran:

فَإِنْ لَّمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِّنَ اللَّهِ وَرَسُولِهِ

And if you do not do it, then take a notice of war from Allah and His Messenger

Surah al-Baqarah (2) : 279

5.4 Risk Mitigation in Credit Processing

As discussed earlier, the credit practice of conventional banking can be adopted by the Islamic banking system with the condition that any element that contradicts the requirements of *Shari'ah* be eliminated. Based on the case study of MIB, the potential areas that are vulnerable to *Shari'ah* non-compliance risk are summarized as follows:

Table 5.2: Potential Exposure of *Sharī'ah* Non-Compliance Risk in CMTF-i Financing

No	Stage	Risk Description	Exposure
1	Business Origination:	Customer Engagement:	
	• Credit Origination	- Screen credit profile and financial health	✗
	• Credit Review	- Involved with <i>Sharī'ah</i> -prohibited activities	✓✗
	• Credit Approval	- Involved with unhealthy customer relationship	✓✗
		Collateral Pledging:	
		- Screen collateral asset and value	✗
		- Accept non- <i>Sharī'ah</i> compliant collateral	✓✗
2	Credit Administration:	Collateral Pledging (as above)	
	• Documentation	Contract Document:	
	• 'Aqd Execution	- Prepare documentation based on regulatory standard	✗
	• Agent Appointment	- Document and sign-off the offer and acceptance agreement based on supposedly process	✓✗
	• Disbursement	- Indicate <i>wakālah</i> concept is adopted by virtue of law (to mitigate <i>munaẓẓam</i> element)	✓
		Contract Execution:	
		- Execute 'aqd based on correct sequence between Bank, commodity traders and customer	✓✗
		- Appoint Bank as an agent to resell the commodity after the possession by customer	✓✗
		Traders Relationship:	
		- Monitor transaction between traders (to avoid tripartite 'inah)	☑
		Disbursement:	
		- Credit cash proceeds into customer's account	✗
		Penalty for Default Payment:	
		- Calculate the actual cost or loss (<i>ta'wīd</i>)	✓
		- Impose non-actual cost (<i>gharāmah</i>)	✗
		- Impose other actual fee, e.g. legal, mail, etc.	✗
3	Credit Recovery	Penalty for Default Payment (as above)	
		Rescheduling and Restructuring:	
		- Execute debt rollover in rescheduling	✗
		- Execute debt rollover in restructuring	✓

Note:

- ✗ : No exposure to *Sharī'ah* non-compliance risk
- ✓ : Exposure to *Sharī'ah* non-compliance risk does exist
- ✓✗ : Exposure is in between (risk will arise if no adequate control in place)
- ☑ : Exposure does indirectly exist (beyond the Bank's control subject to monitoring)

Source: Summarization of earlier analysis.

In order to mitigate the potential risk, the financing must be structured in such a *Sharī'ah*-compliant manner, and each transaction must be executed appropriately and sequentially. The proposed mitigation approach can be described as follows:

Table 5.3: Mitigation Steps for *Tawarruq*-based Financing

No	Stage / Process	Mitigation
1	Credit Application (Engagement with Customer)	<p>Guidelines on customer engagement should be established to control the breaches of <i>Sharī'ah</i> compliance while the credit officer should be made aware of the compliance. For counterparties that have a mix of prohibited and permissible activities, a proper mechanism is required to be defined to identify the permissibility of the financing.</p> <p>In addition, customer screening at the early stage of credit processing should accommodate the elements of <i>Sharī'ah</i> non-compliance, which can be verified via customer profile, such as nature of business and purpose of financing.</p> <p>In order to mitigate the <i>Sharī'ah</i> non-compliance activities in the relationship between the Islamic bank's personnel and the customer, an education and awareness culture of <i>Sharī'ah</i> compliance should be adopted. The <i>Sharī'ah</i> compliance policy should make provision for the enactment for staffing matters and conduct of business.</p>
2	Credit Application/ Documentation (Collateral Pledging)	<p>Guidelines on collateralizing (<i>rahn</i> and <i>ḍaman</i> principle) should be established to control the breaches of <i>Sharī'ah</i> non-compliance. The accepted collateral asset should be filtered where business origination will be the first stage of control and credit administration will be the second stage.</p>
3	Documentation and ' <i>Aqd</i> Execution	<p>Guideline on Sale and Purchase principle, which includes deferred sale or <i>bay' bithaman ajil</i>, <i>murābahah</i>, <i>musāwamah</i> and <i>tawarruq</i> contract shall be established to improve the understanding of trading execution.</p> <p>In addition, an appropriate process of '<i>aqd</i> execution should be in place to ensure that the trading operation is adequate. The sequential process (as conducted by some of the Islamic banks for some processes) is as follows:</p> <ol style="list-style-type: none"> 1. The customer provides a purchase order for the commodity to the bank. Hence, the inventory risk can be mitigated. 2. The bank's trader purchases the commodity from the

		<p>commodity supplier on cash. Practically, it can be performed via the system, email, telephone or any other medium of communication.</p> <ol style="list-style-type: none"> 3. The bank's trader will sell the commodity to the customer on a deferred basis (<i>bay' bithaman ajil</i>) either using the <i>murābahah</i> or <i>musāwamah</i> principle. 4. The customer should be given an option to take possession of the commodity in the contract agreement. If the customer decides to take possession of the commodity, then the commodity should be able to be delivered as agreed. In this regard, the customer can resell the commodity themselves to the buyer in the market to obtain cash. Only in a situation where the customer does not have any means to resell the commodity, then due to <i>maṣlaḥah</i>, the bank can be appointed as an agent under the <i>wakālah</i> principle to resell it on behalf of the customer with the condition that the commodity is already possessed by the customer. This condition should be stated clearly in the contract. However, the appointment should not be bound upfront to avoid the risk of organized element (<i>munazzam</i>) in <i>tawarruq</i> according to the AAOIFI standard. <p>Based on the readiness of the platform of the commodity market provided by BSAS, this sequence can be managed and conducted properly.</p>
5	Credit Monitoring/ Recovery (Late Payment)	For the <i>ta'wīḍ</i> mechanism, the calculation of actual cost must be justified based on the actual cost and not the assumption. If <i>gharāmah</i> is applied, the handling process and purification account should be monitored, especially concerning the distribution procedure to charitable bodies. The implementation document must be defined and maintained properly.
6	Credit Recovery (Rescheduling & Restructuring)	The local fatwa or resolution pertaining to this matter should be made clear. While detailed guidelines on debt rollover should be established as a business guide to address the rescheduling and restructuring mechanism.

Source: Based on earlier analysis

5.5 *Maqāsid al-Sharī'ah* Perspective of *Tawarruq*-based Financing

Tawarruq is not a primary financing mode in the Islamic banking system where it is introduced to fulfil the needs for cash liquidity. AAOIFI's Shari'a Standard states:

Monetization is not a mode of investment or financing. It has been permitted when there is a need for it, subject to specific terms and conditions.

In the same standard, the basis of the *Sharī'ah* Rulings stated:

Principally, institutions have to show strict commitment towards using modes of investment and financing such as the various forms of Musharakah (Partnership) and exchange of goods, usufructs and services that conform to the very nature and basic activities of Islamic banking. Hence, imposition of controls and restrictions on monetization would curb any tendency for expanding monetization to the extent that jeopardizes the extensive use of the original modes of investment and financing. Therefore, institutions should not use monetization except in the limited scope defined in this Standard. They should also restrict the use of monetization to the cases of clients whose transactions cannot be disposed of through other-modes of financing and investment such as Musharakah, Mudharabah, Ijarah, Istisna and the like. Monetization may also be used as a means for helping the clients to dispose of their previous interest-based debts, after ensuring that they have developed genuine intention not to deal in usurious transactions any more.

The standard aligns with what is mentioned in the later period of Hanbali's fiqh treatises, where *tawarruq* transactions are allowed to be executed in situations of necessity or need (حاجيات) for money, as mentioned by al-Bahūtī:

*And who needs money, and then he buys something that equivalent to thousand with higher price to make use of the deferment, then there is no issue. It is provisioned, and named as the *tawarruq*.*⁷⁴

⁷⁴ Al-Bahūtī (2000), *Sharḥ Muntahā al-ʿIrādāt*, . 'Abd Allāh ibn 'Abd al-Muḥsin al-Turkī (ed.), vol. 3, Beirut: Muassasah al-Risālah, pg. 164. Statement in Arabic is as follows: (ومن احتاج لنقدٍ، فاشترى ما يساوي ألفاً، ليتوسع بثمنه، فلا بأس. نصاً، ويسمى: التورق)

However, in the current landscape of the financial system where conventional banking is dominant, the aspect of *maṣlaḥah* (benefits and interests) should be considered. Hence, *tawarruq* has become one of the main financing modes to address the needs of the public.

5.5.1 Meaning of *Maqāsid al-Sharī'ah*

Maqāsid (مقاصد) is the plural of the term *maqsid* (مقصد),⁷⁵ which means intention, purpose, objective, aim or goal, etc.⁷⁶ The term *Sharī'ah* refers to the verdicts that were revealed by Allah s.w.t. to His servants (mankind) either via al-Quran or al-Sunnah,⁷⁷ which consists of three components, i.e. *'aqidah*, *ahkām 'amaliyyah* (*'ibādah* and *mu'āmalah*) and *akhlāq*. Therefore, *Maqāsid al-Sharī'ah*⁷⁸ refers to the objective, purpose or outcome that is required by *Sharī'ah* where the *Sharī'ah* itself encompasses all disciplines, segments and aspects of life.

Basically, the objective and essence of *Sharī'ah* is to predicate on the *maṣlaḥah* (interests) and the *manfa'ah* (benefit) and to eliminate the *maḍarrah* or *mafsadah* (harmful/damage) of mankind in this world and the Hereafter. According to Ibn 'Āshūr:

The general objective of Sharī'ah is to preserve the social order of the community and insure its healthy progress by promoting the well-being and righteousness (ṣalaḥ) of that which prevails in it, namely,

⁷⁵ Al-Munazzamah al-'Arabiyyah (1998), *al-Mu'jam al-'Arabī al-Asāsī*, Tunisia: Al-Munazzamah al-'Arabiyyah, pg. 989.

⁷⁶ Hens Wehr (1976), *A Dictionary of Modern Written Arabic*, New York: Spoken Language Services Inc., pg. 767.

⁷⁷ Abd al-Karīm Zaydan (1998), *al-Madkhal li Dirāsah al-Sharī'ah al-Islāmiyyah*, Beirut: Muassasah al-Risālah.

⁷⁸ Also known as *Maqāsid al-Shar'i* or *al-Maqāsid al-Shar'iyyah*

*the human species, where the righteousness comprises the righteousness of intellectual, action and environment.*⁷⁹

Maṣlaḥah safeguards the objective of *Sharī'ah*, which consists of five elements, i.e. religion, life, intellect, lineage, and wealth (known as *al-Ḍarūriyyāt al-Khams*)⁸⁰ that are meant to be preserved, as mentioned by al-Ghazālī:

*As we concern on maṣlaḥah, that it is the safeguarding on the objective of Shara'. And the objective of Shara' of the mankind is five, and it meant to preserve them, i.e. their religion, their life, their intellect, their lineage, and their wealth. Whatever ensures the protection of these five fundamentals is Maṣlaḥah. And whatever vanish these fundamentals is Maḥsadah (damage).*⁸¹

The range of *maṣlaḥah* can be classified according to three levels in a descending order of importance, as follows:

1. *Ḍarūriyyāt* – the essential interests to normal order in society as well as to the survival and spiritual well-being of individuals, so much so that their destruction and collapse will precipitate chaos and collapse of normal order in society.⁸² It is the basis of all *maqāsid*, which consists of five components, namely, *al-Ḍaruriyyāt al-Khams*.
2. *Ḥajiyyāt* – the complementary interests and not an independent category as they also seek to protect and promote the essential interests, albeit in a secondary capacity. These are defined as benefits, which seek to remove severity and hardship that do not pose a threat to the very survival of normal order.⁸³

⁷⁹ Ibn 'Āshūr (2001), *Maqāsid al-Sharī'ah al-Islāmiyyah*, Amman: Dar al-Nafāis, pg. 148.

⁸⁰ Some scholars add another element, i.e. dignity.

⁸¹ Al-Ghazālī, *al-Mustasfā min 'ilm al-Uṣūl*, Ḥamzah ibn Zahīr (ed.), vol. 2, Madinah: Sharikah al-Madīnah al-Munawwarah li al-Ṭabā'ah, wa al-Nashr, pg. 482.

⁸² Hashim Kamali (2009), *Maqasid al-Shariah Made Simple*, Kuala Lumpur: The International Institute of Islamic Thought (IIIT), pg. 4.

⁸³ *Ibid.*

3. *Tahṣīniyyāt* – the nature of desirability as they seek to attain refinement and perfection in the customs and conduct of people at all levels of achievement.⁸⁴

We might say that *tawarruq*-based financing, which is being discussed as a subject matter, resides in between the first level, *ḍaruriyyāt*, and the second level, *ḥajiyyāt*. The position is due to the current situation where lending activities of the conventional system is strongly dominant in the financial and economic system, whilst *tawarruq*-based financing provides mechanism for cash liquidity, which is equivalent to conventional lending.

5.5.2 Necessity of *Tawarruq* in Malaysian Financing

Based on BNM statistics,⁸⁵ the total loans and advances of the conventional banking system as at July 2012 was RM1,069,414.4 mil. The figure refers to conventional loans, which is certainly higher than Islamic financing, which was reckoned at RM217,082.0 mil. Therefore, the size of Islamic financing in Malaysia, as at July 2012, was just 20.3% of the conventional figure in trillion, which is relatively small.

Based on the economic statistics for 2006, the percentage of *Bumiputera* equity is 19.4% from the total of RM612,833.5 mil.⁸⁶ Although the percentage is still small compared to the Chinese and foreign equity, the portion value of RM120,387.6

⁸⁴ *Ibid.*

⁸⁵ See BNM (2012), Monthly Statistical Bulletin July 2012, Kuala Lumpur: BNM, pg. 23-24.

⁸⁶ Unit Perancang Ekonomi Jabatan Perdana Menteri Malaysia, Menangani Ketidaksamaan Sosioekonomi yang Berterusan secara Membina dan Produktif, pg. 61, downloaded from <http://www.epu.gov.my/html/themes/epu/html/mtr-rm9/bahasa/teras3.pdf>, accessed on 07/10/12. Estimation of ownership surrounds 680,000 active companies provided by Suruhanjaya Syarikat Malaysia (SSM).

mil is still considered large. Furthermore, the percentage had increased to 23% in 2010⁸⁷ albeit the initial target was 30% in 1990 under the New Economic Policy.⁸⁸

This argument does not represent the concrete facts of the necessity, but it does show the growth of economic or business activities among Muslims.⁸⁹ In addition, the population of the Muslim community in Malaysia is considered as the majority,⁹⁰ which shows the potential growth in equity and economic activities. Indeed, the majority population represents a potential market for consumer financing for those in need.

Based on the size of conventional portfolio, it can be said that conventional banking is still strongly dominant in the local financial system. Hence, there is a need to promote the Islamic financing mechanism vis-à-vis to that aided by conventional loans, thus upholding the Islamic banking portfolio in the local financial system.

Conventional loans or lending capitalises money to generate more money where the addition is classified as *ribā*, which is prohibited by *Sharī'ah*. Cash liquidity facilitated by conventional loan is required by society to fund their economic activities. For example, cash liquidity is needed by business organizations

⁸⁷ Kementerian Kewangan Malaysia, Ucapan Bajet Tahun 2013, pg. 19, downloaded from <http://www.treasury.gov.my/pdf/bajet/ub13.pdf>, accessed on 07/10/12.

⁸⁸ Dasar Ekonomi Baru, Unit Perancangan Ekonomi Jabatan Perdana Menteri Malaysia, <http://www.epu.gov.my/neweconomicpolicy>, accessed on 07/10/12.

⁸⁹ *Bumiputera* is not one-hundred percent Muslim. With the assumption that the majority of them are Muslim and a minority of other races are also Muslim, where the statistic for Muslim equity is not available, the estimated amount is approximately as per the above-said figure.

⁹⁰ With the assumption that most Malays are Muslim and a minority of other ethnicities are also Muslim. The statistics show that Malays constitute the majority in 2012 with 54.76% from 26,974.1 mil population. See Jabatan Perangkaan Malaysia, Penduduk dan Perangkaan Penting, pg. 10, downloaded from http://www.statistics.gov.my/portal/download_Buletin_Bulanan/files/BPBM/2012/JUL/05_Population.pdf, accessed on 07/10/12.

for their working capital, while also being needed by individuals for their personal use.

As discussed in previous chapters, in keeping with the current landscape, the only solution available to overcome this issue is to use *‘īnah* or *tawarruq* as the underlying concept for Islamic financing. Nevertheless, *‘īnah* has a fundamental problem inasmuch as it is prohibited by the majority of scholars while being allowable by some Shāfi‘ī exponents with strict conditions. Henceforward, the application of *‘īnah* in the banking environment causes the risk of *Sharī‘ah* non-compliance, which leads to non-halal income. Therefore, *tawarruq* offers an alternative solution.

Even though *tawarruq* is deemed not to be a primary mode in Islamic financing, in the current situation, it might be positioned at the *ḍaruriyyāt* level to fulfil the needs of the Muslim society. From a macro perspective, there is a necessity to uplift the Islamic financing and overtake the conventional lending while maintaining economic activities, especially for the Muslim community. Otherwise, *ribā*-based activities will continue to found the economic system, which brings *mafsadah* to the society.

Instead, if *tawarruq* is positioned at the *ḥajiyyāt* level, by looking at the level definition, due to the general needs and the importance of such *mu‘āmalah*, the level is uplifted to *ḍarūriyyah*, as defined by legal maxim:

الحاجة تنزل منزلة الضرورة، عامة كانت أو خاصة
al-Ḥājah descends to the degree of al-Ḍarūrah, generally or specifically

Therefore, by having *tawarruq* as the underlying concept to Islamic financing it will temporarily resolve the issue, bring *maṣlaḥah* to the society and eliminate the *mafsadah*. Hence, the objective of *Sharī‘ah* is able to be fulfilled while efforts are required to find a permanent solution and shift the Islamic financial system to a better position.

5.6 Conclusion

In considering various research and resolutions, the *tawarruq* concept provides an appropriate solution for Islamic financing. By mitigating the risk factor that potentially arises, *tawarruq*-based financing outfits a prudent *Sharī‘ah*-compliant instrument that is able to compete with conventional loans. Although it is not a primary mode of financing, under the basis of necessity, the *ijtihād* that has been made by contemporary scholars does bring *maṣlaḥah* to the Islamic financial system.

Rasulullah s.a.w. said in hadith Amrū ibn al-‘Aṣ⁹¹:

إِذَا حَكَمَ الْحَاكِمُ فَاجْتَهَدَ ثُمَّ أَصَابَ فَلَهُ أَجْرَانِ، وَإِذَا حَكَمَ فَاجْتَهَدَ ثُمَّ أَخْطَأَ فَلَهُ أَجْرٌ

If a Judge gives a verdict according to the best of his knowledge and his verdict is correct, he will receive a double reward, and if he gives a verdict according to the best of his knowledge and his verdict is wrong, even then he will get a reward

Adopting the mechanism and procedure of conventional lending in *tawarruq*-based financing is allowed by *Sharī‘ah* subject to eliminating the *Sharī‘ah*-prohibited elements. Any violation of this requirement will lead to the risk of exposure to

⁹¹ Al-Bukhārī, *Ṣaḥīḥ Bukhari*, Kitāb al-I‘tiṣām bi al-Kitāb wa al-Sunnah, Bāb Ajr al-Ḥākim idhā Ijtahada faAṣāba aw Akhṭa’, hadith no. 7352, Beirut: Dār al-Fikr

Sharī'ah non-compliance. The exposed risk may also lead to the financial loss of the Islamic banks and non-financial loss.

The credit standard practice that is applied to *tawarruq*-based financing should consider the potential risk of *Sharī'ah* non-compliance throughout the financing process. The risk exposure does exist in the process starting from origination until the recovery stage, especially in the critical area of contract execution, restructuring and charges of default payment.

Customization of the conventional approach to suit the *Sharī'ah* requirement is a must and shall be cautiously applied. Hence, *tawarruq*-based financing can be smoothly applied in Islamic banking without any critical concern. Moreover, awareness of *Sharī'ah* non-compliance risk should be cultured in Islamic banks in order to reduce the degree of risk.

CHAPTER 6: CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

6.1.1 Resolution on *Tawarruq*-based Financing

Financing is a core banking business that supplies money for customer needs. Similar to conventional lending, the substance of financing is to supply cash. *Tawarruq* is one of the *Sharī'ah* modes that have been used by Islamic financing to provide cash liquidity. Hence, cash supplying of *tawarruq*-based financing is able to fulfil the needs of business capital or personal consumption.

Generally, *tawarruq* can be categorized into two types – Classical *Tawarruq* and Organized *Tawarruq* (*Tawarruq Munazzam*). There are two different *Sharī'ah* views regarding the verdict of *tawarruq*. Classical *tawarruq* is permissible according to the majority of classical and contemporary *Sharī'ah* scholars where it is classified as a type of trading that is permissible in *Sharī'ah*. However, the permissibility should be on the basis of *al-ḥājjah* (needs). Meanwhile, a minority of classical *Sharī'ah* scholars have ruled that *tawarruq* is prohibited due to *ḥīlah* for *ribā* on the basis of generating money with money.

The issue of organized *tawarruq* arises in the modern age of Islamic banking in which the principle of classical *tawarruq* is customized to suit the landscape of the current financial system. The organized element is not explicitly discussed by BNM

even though the mechanism has been approved to be implemented by local Islamic banks based on the permissibility of classical *tawarruq*. Neither a *Sharī'ah* standard or parameter has been issued to outline the requirement. Conversely, the structure of organized *tawarruq* is prohibited by most of the international *fiqh* bodies and *Sharī'ah* scholars where it is deemed fictitious and considered as *hīlah* for *ribā*.

The essence of the *Sharī'ah* concern in respect of organized *tawarruq* is the fictitious elements, especially on the commodity possession. Therefore, by handling those elements appropriately will avoid the fictitious elements and make *tawarruq* permissible to be used as the underlying concept expressly for financing. Hence, this mitigation is able to harmonize the views between the fundamental and the operational perspective.

6.1.2 Credit Practice and Processes

Sharī'ah allows any mechanism or practice of the conventional system to be adopted by Islamic banks as formulated by *fiqh* methodology. However, the adoption is subject to the elimination of *Sharī'ah*-prohibited elements (if any). Hence, the credit practices of the conventional system can be applied in *tawarruq*-based financing where *Sharī'ah* considerations of a few processes need to be addressed properly in order to mitigate the *Sharī'ah* non-compliance risk.

The potential exposure to *Sharī'ah* non-compliance risk exists in a few stages of credit processing, starting from origination until the recovery stage, especially in

the critical area of contract execution, restructuring and charges of default payment. The risk of commodity trading is only exposed to *tawarruq*-based financing while other potential risks are also applicable to other financing.

The risk of *Shari'ah* non-compliance is able to severely impact the financial and non-financial loss of the Islamic banks. The severe loss of financial and non-financial aspects can lead to the insolvency of the banks. Hence, the proper handling of *Shari'ah* -related issues is required to ensure the strong governance and control of the Islamic banks with regard to *Shari'ah* as a foundation to the Islamic banking system.

As a sampling of this study, the CMTF-i product of MIB has been analysed to identify and measure the potential risk of *Shari'ah* non-compliance in *tawarruq*-based financing. Based on this analysis, it can be generalized that the risk exposure might arise in other local Islamic banks where *tawarruq* is applied in their financing products. However, the scenario might be similar or different. Perhaps, a standardized approach might be needed to outline the essential requirement.

6.1.3 Need for *Shari'ah*-compliant Financing Instrument

In the modern economic system, financial support is necessary to generate business activities. For local Islamic financing, the *'inah* concept has been widely used since the early days to provide cash liquidity for business working capital and asset acquisition, etc. However, due to market forces and dynamism in the local Islamic

banking system, the concept of cash-based financing started to shift to *tawarruq* as *‘īnah* is facing considerable fundamental and operational issues compared to *tawarruq*.

Indeed, *tawarruq* in Islamic banking is potentially facing the *Sharī‘ah* issues whereby operationalizing the fundamental theory requires cautiousness and expertise. However, by mitigating the related risk of *Sharī‘ah* non-compliance, *tawarruq*-based financing can be a prudent instrument that supplies the market demand. Hence, *tawarruq*-based financing can be deemed as a truly *Sharī‘ah*-compliant instrument that provides balancing between *Sharī‘ah* and economic requirement.

Although *tawarruq* is not considered as a primary mode of Islamic financing, in the current situation of Malaysia’s 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 *Sharī‘ah* while waiting for a proper Islamic financing framework to be developed.

6.2 Recommendations

Based on the conducted study, the author opines that several items need to be addressed in order to improve the aspects of *Sharī‘ah* compliance for *tawarruq*-based financing. The recommendations are as follows:

1. The authorized body, i.e. BNM, should 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. BNM should develop and issue a *Sharī'ah* standard or parameter for the *tawarruq* concept as guidance for the local Islamic banks. Overall, *Tawarruq* contains a series of transactions in which the practical treatment seems complicated. Hence, preferably, a guiding principle is required. In addition, the standard will be able to set the requirement that should be adhered to by the banking operation in executing the transaction.
3. BNM should establish an addendum guideline to the existing guideline of credit risk management to cater for *Sharī'ah* consideration in Islamic financing. This should outline the proper treatment to address all issues pertaining to *Sharī'ah* in credit processing, which might otherwise be exposed to the risk of *Sharī'ah* non-compliance.
4. BNM should develop and issue a *Sharī'ah* standard or parameter for collateralizing as guidance to the local Islamic banks. Collateralizing may comprise the *rahn* and *ḍaman* principle for which a standard is yet to be established. The standard should set the requirement that should be adhered to by the banking operation in executing the transaction.

5. BNM should resolve the *Sharī'ah* issue on debt rollover in rescheduling and restructuring to make clear what is permissible and what is prohibited. This resolution would be the main reference for local Islamic banks in developing their related policies and guidelines pertaining to rescheduling and restructuring.
6. The local Islamic banks should strengthen their governance aspects by improving the internal policies, guidelines and procedures. These documentations should play a role as an enactment to outline the consideration of *Sharī'ah* in executing related transactions and other *Sharī'ah* requirements to be fulfilled.
7. The local Islamic banks should review their internal controls and methodologies from time to time in order to improve the mitigation of *Sharī'ah* non-compliance risk. The existing mechanism should be robust enough to handle any arising issue on *Sharī'ah* non-compliance.
8. The local Islamic banks should conduct systematic training to improve the knowledge competency among the bank staff. Staff or people are one of the risk factors that contribute to the *Sharī'ah* non-compliance risk where competency in handling the critical areas, such as contract execution, is a must. In addition, the banks also need to inculcate the culture of risk awareness at both the corporate and working level for the staff to understand and be aware of the risk of *Sharī'ah* non-compliance that they are facing in their day-to-day work.

9. Bursa Suq al-Sila' might need to take another step in providing an open platform to resell the commodity. By having such a platform, a *wakālah* contract for selling the commodity to a third party is no longer required. Hence, dispensing with the *wakālah* contract preserves the fictitious elements in *tawarruq*-based financing. However, the solution requires further detailed study.

6.3 Recommendations for Future Research

The author opines that further research is required in certain matters with regard to this study in order to strengthen the governance aspects of the Islamic financing system. The suggested topics are as follows:

1. Research pertaining to debt rollover in rescheduling and restructuring.
2. Research pertaining to the application of the principles of *rahn* and *ḍaman* in the collateralizing of credit practices.
3. Research pertaining to customer engagement and external parties in Islamic banking activities.
4. Research pertaining to mitigating *Sharī'ah* non-compliance risk within commodity traders.
5. Research pertaining to mitigating the reputational risk of Islamic banks in respect of *Sharī'ah* compliance issues, which might lead to severe impact on financial or non-financial aspects.

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