INSTITUTIONAL TAWARRUQ: A PRODUCTS OF ILL REPUTE

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INTRODUCTION

Islamic finance has been introduced into a world of conventional finance. The allocation of financial resources is done in the conventional world of finance according the rate of interest. In addition, the volume of conventional finance is overwhelming and the use of the interest rate is prevalent. Islamic finance allocation introduces new criteria based on the use of financial resources to finance consumption and investment. On the one hand, it provides fund owners with a share in the profits of the financial process. On the other hand, it provides finance users with the goods and services they desire to obtain.

The criteria of allocating financial resources applied by Islamic finance introduce real benefits to the economy both at the macro level and at the level of the financial sector itself.

Tawarruq is a form of revisionism that replaces the Islamic allocation criteria with conventional ones, while maintaining a symbolic badge of Islamic finance attached to the whole process. It is unfortunate that the successful expansion of Islamic finance is accompanied with challenges that threaten to suffocate the whole process under the guise of financial innovation.

In this paper, we intend to show that institutional Tawarruq falls outside the paradigm of Islamic finance. Its use, if predominant, can be precipitous, leading to impose a conventional model onto Islamic finance and therefore could make it an exercise in futility.

The exposition relies on three previous publications by the author, which include a wider selection of references.

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SALIENT FEATURES OF ISLAMIC FINANCE

Islamic finance can be considered as the most important contribution to human civilization in the twentieth century, and the most important source of financial innovation in the twenty-first century. It has proven a sound and practical way to revive ancient and long forgotten Jewish, Christian as well as Hindu and Buddhist teachings[1]. However, Islamic finance has its subtleties. The reason is that it draws its logic from both Fiqh and monetary and financial economics. Fiqh is a discipline based on textual verification and analysis, while monetary and financial economics is a discipline based on deduction and induction. Both disciplines are quite different in methodology to the extent it takes a big effort from a scholar trained in one discipline to gain substantial expertise into the other.

Unfortunately, Shari'a scholars are at a great disadvantage in this regard, because they are not equipped to use economists' tools of analysis. Meanwhile, it is not an impossible task for economists to learn Fiqh methodology. However, sufficient care must be exercised.

Usually economists working in the field of Islamic finance, especially those well versed in Arabic are tempted to learn Fiqh, expecting to be able to play the role of both economics and Fiqh scholars. Undoubtedly, some economists have been able to write professional papers in Fiqh and could have a robust debate with Shari'a scholars. However, it would be difficult for Shari'a scholars to reciprocate. Economics is a much tougher discipline for outsiders than Fiqh. However, if economists are not well equipped in Arabic to the extent of being capable enough to handle classical texts, they are well advised to keep their distance. Anyone who does not have the right tools may end with a cloudy view of both disciplines. The unwary will face the fact that learning a methodology and practicing it influences one's way of thinking. Learning two

[1] Wayne and McIntosh (1998).

diagrammatically opposed methodologies, without taking extreme care could ultimately lead to one of them taking rein and the other setting back.

Some economists that venture into Fiqh may never become a Shari'a scholar while also loosing his economics panache, while others may survive in their own field. Shari'a scholars meanwhile would rarely be able to venture into the field of economics, due to their textual training. It may be safer for many economists to formulate their economist perspective of Shari'a. However, Shari'a scholars should contend with staying well within their own discipline, leaving the economic consequences of Fatwa to be determined by economists.

A. FULFILLMENT AND CHALLENGES

Taking interest is considered a grave transgression in Islam. The success of Islamic finance in a freely competitive market, where Islamic and conventional finance each has an equal chance was postulated by “Islamic economists.” Such equal chance has been hard to come by. However, wherever it is available, especially in most Gulf countries, Islamic finance enjoys higher growth than conventional finance. Islamic finance assets in the Gulf have grown at an average annual rate of 30 percent during 2001-2006. In the UAE alone, the average growth rate was 40 percent. The market share of Islamic finance in the total assets of the finance industry increased from 9 percent in 2001 to 17 percent in 2006. It is expected to reach at least one third by 2010.

Had Islamic finance been a fake hope or a backward ancient way of doing business, it would have failed right away. Then, believers would have withdrawn quietly.

However, Islamic finance faces serious challenges. One of such challenges is the products of ill repute. Such products can be attributed to the eagerness to provide finance products that can be good substitutes for conventional products. However, such eagerness to product substitution must be reined by the borderline that lies between Islamic and conventional finance. Such borderline can only be defined with the paradigm of Islamic finance.

B. SOURCES OF MISUNDERSTANDINGS

Certain misconceptions that may cloud the difference between Islamic and conventional finance must be pointed out. Some conventionally minded experts use the word "loan" to mean "finance." It must be stressed that Islamic banks provide *finance*, but they do not provide interest-based *loans*. They may provide a limited number of *interest-free loans* (Qard Hassan) as a social service or charitable activity. Only the Islamic Development Bank, IDB, provides sizable finance to its member governments as loans, against which it charges fees reflecting the actual administrative costs.

Some use the word "Islamic bonds" to mean "Sukuk." However, since bonds are interest-based debt claims, and since debt sale is generally against Shari'a, the term "Islamic bonds" would be self-contradictory.

Sukuk are asset-based financial instruments, where non-debt assets compose the majority. Debt assets in Islamic finance are claims resulting from Shari'a compliant sale finance.

Some use the expression of "personal finance" to mean personal loans. This only applies to conventional finance. In Islamic finance, it would not be possible to provide personal loans on commercial basis, as lending must be done without charging any interest (Qard Hassan). This may be carried out by Islamic banks on a limited scale as a philanthropic activity. Meanwhile Islamic banks can provide personal finance to fulfill certain personal requirements, like education, travel and health services. The bank purchases such services from their suppliers and sells them to customers against deferred installments under the "service-Ijarah contract."

Misunderstanding has not been limited to writings but they extended to practice as well. Islamic finance has its own share of self-claimed theorists as well as practitioners. On the theoretical side, there are those who claim scholarship in Shari'a without any academic training whatsoever. Some may have only a first or a second university degree in Shari'a.

A well-seasoned Shari'a scholar must be able to take a comparative view of all opinions involved in each subject he

would handle. This requires at least a Ph. D. degree in Shari'a from a well-known and highly accredited university. For this purpose, a ranking of universities that teach Shari'a must be made and regularly updated. This would make it possible to include Shari'a scholars with Ph D from one of the top ten or twenty universities in the field.

Such requirement is often ignored by shareholders who appoint members in their Shari'a boards. In addition, Shari'a scholars are not supposed to master the economic and financial side of the industry. Each Shari'a board should therefore have a monetary and financial economist as a nonvoting advisor who would explain things from his perspective.

Self-claimed experts as well as the absence of economists from most Shari'a scholars, have lead to the presence *products of ill repute* in Islamic finance. Such products start in narrow alleys, but spread rather quickly. They are structured outside the consensus of Shari'a scholars and are based on minority or maverick opinions signed by self-claimed but insufficiently qualified experts. They expose Islamic banks to grave reputation risk. They include debt based financial instruments circulating under the name of "Islamic bonds" and Sukuk, so called "hedge products" based on multiple promises, so called "Islamic hedge funds" that use dynamic strategies based on short sale and long purchase, as well as institutional Tawarruq.

C. THE BASIC STRUCTURE OF ISLAMIC FINANCE

Islamic finance is based on *both* equity and commodity trade. However, it does not deal in risk trading. In place of the conventional loan contract, Islamic finance has a collection of *modes of finance*. Such modes are contractual relationships that delineate the relationship between finance providers and users.

Equity-based modes of finance present funds to their users in order to provide for necessary factors of production, and/or working capital. Fund owners get in return a share in profit or in profit and management. No debt is created in this case.

In commodity finance, fund users obtain the commodities they require for production or consumption. Fund owners get mark-up, profit, or rental payments. Commodity finance results in debt, either monetary or in real commodities. Such debt is subject to strict rules regarding the prohibition of sale of debt, except at its nominal value. The value of debt is set at the outset of each transaction. Under no circumstances, it should be allowed to increase. This sets it apart from conventional debt.

D. THE PRODUCT MENU

Islamic finance uses about eleven modes of finance in place of the conventional loan contract. They include (1) Musharaka, (2) Diminishing Musharaka, (3) Non-Restricted Mudaraba, (4) restricted Mudaraba, (5) Wakala, (6) Ijarah, (7) Ijarah Muntahia Bittamleek, (8) Murabaha, (9) Deferred-Payment Sale, (10) Istisna', and (11) Salam[2].

Islamic finance has already passed the stage of "single mode transactions." A large number of transactions now involve multiple modes, e.g., Musharaka, Ijarah and Istisna' can all be packaged in one product. The art of product structuring has been evolving quickly. Compared to conventional finance, Islamic finance provides a much richer menu of products.

However, mixing modes of finance requires using multiple contracts. This must be done with great care in order to remain within Shari'a compliance. Shari'a scholars take a lot of care to keep certain contracts from becoming conditional on others and not to slip into the possibility of debt sale.

That is why it is important that Shari'a scholars working in the area of finance must be highly specialized. Academic training at least to the level of Ph. D. would be a minimum requirement. They would also need to work with a team of economics and financial experts, lawyers, and other documentation specialists.

Differences over Islamic financial products can arise from the relative incompetence of Fiqh scholars, especially of those who

[2] Appendix A gives a brief description of each mode of finance

lack academic credentials, ignorance of the economic consequences of fatwas; as such consequences must be taken into consideration[3]. Otherwise, formal legitimacy of contracts may be satisfied, while legitimacy of purpose may not. In addition, certain contracts may be singly lawful, but when mixed, they would compose a Shari'a non-compliant transaction.

E. THE BENEFITS

According to the theory of the optimum supply of money, developed in 1969 whose results gaining robustness overtime; a zero interest rate is a necessary and sufficient condition for the optimum allocation of resources (Pareto Optimality). By using the Islamic modes of finance, spot money is never sold against future money and the optimality conditions stands inviolate.

Islamic banking follows the pattern of universal banking, i.e., it mixes equity finance with commodity finance. This is known in economics to reduce both the risks of moral hazard and adverse selection.

Because investment deposits are not guaranteed, Islamic banking withstands the downturns of economic cycles much better than conventional banking, i.e., the former is more stable than the latter. This has been discussed in some IMF research papers.

Conventional finance has only one ingredient to use in structuring its financial products, viz., the conventional loan contract. Like a potato kitchen, it is a matter of how you would like your potatoes: boiled, baked, fried, mashed, curried, etc. Islamic finance in contrast has several modes of finance to use in product structuring. The room for financial innovation is almost limitless. With numerous modes of finance, Islamic finance is *haute cuisine*. Therefore, while you can eat almost anything in an Islamic finance kitchen, except for potatoes (which refers here to lending money at interest), the conventional finance kitchen serves only the potatoes of

[3] That can be attributed to the incompetence of economists advising Shari'a scholars.

your choice.

Islamic finance puts an accent on equity and ethical business (rejecting the finance of tobacco, narcotics, weapons activities that involve human trafficking as well production of distribution of material leading to social or individual harm).

We can therefore conclude that the economist view of Islamic finance is that it is a system that avoids trading money for money. Viewed as such, it has certain definite advantages when compared to conventional finance, in terms of efficiency, stability and risks.

THE PARADIGM OF ISLAMIC FINANCE

Islamic finance has a certain paradigm that can be deducted from the system as a whole. Such paradigm must be seriously considered by Shari'a scholars and Islamic economists alike as defining the boarders between Islamic and conventional finance. The paradigm serves as a yardstick for the avoidance of Reba. The main features of Islamic finance as a whole indicate that such features are all means to uphold the Qura'nic injunction against usury (Quran 2:279). The Prophetic injunctions not to sell cash (spot/forward) for cash (forward/spot), except for equal amounts and spot delivery supports and emphasizes the Qura'nic injunction.

A. THE CONCEPT OF MONEY

Monetary economists recognize that money is unlike other commodities. However, to stop treating money like any other commodity would require an ability to break old habits. It is true that all commodities can compete with money to different degrees in being useful as a unit of account and a store of value. Yet, only money can serve as a means of exchange. This should be taken as an indication that money should not be traded in the same way as other commodities. However, this is not recognized in conventional finance, where spot money is traded against future money.

It is interesting to note that Islamic finance does not treat money like other goods in the following manner.

1. The exchange of each good (including money) against itself (bartering) in unequal amounts is considered as a Reba transaction. When there is a quality differential, barter is discouraged and monetary exchange is encouraged. This stresses the importance of money as a medium of exchange.
2. The price of non-monetary commodities against deferred payment can be higher than its price against spot payment. This is considered trade, which is not only

accepted but also religiously encouraged with blessings.

3. The price of present money against deferred payment must be strictly equal to its price against spot payment. Any difference would be considered Reba.

B. PRESENT CASH IS NOT PROVIDED AGAINST FUTURE CASH

Islamic finance follows a certain paradigm whose most important feature is the prohibition of selling present against future cash, either directly or indirectly. This emanates from the insistence that money is unlike other commodities. It can be exchanged against other goods, but should not be exchanged (spot) against itself (forward). When traded against itself, the whole transaction must be made spot and in equal amounts. Obviously such trade would generally have no benefit.

When partnership finance is involved, cash is provided against equity rights, which include sharing of both profit and management. In Mudaraba finance, cash is provided against the right to share profits. Again, cash is not given against cash.

In commodity finance, present commodities are provided against future cash. Alternatively, present cash is paid against future goods. Goods here may include non-durables, durables and services usufruct.

C. BOTH FORMAL STRUCTURE AND PURPOSE ARE CRITICAL FOR CONTRACT VALIDITY.

Contracts should be formally legitimates, i.e., all formalities must be present. For example, formal legitimacy of a sale contract may include:

- The seller must own and possess the commodities.
- Both the buyer and the seller must have legal capacity and exchange offer and acceptance.
- The object of sale must be lawful.
- The sale contract itself must include the goods to be sold, the price, the quantity, delivery and payment conditions.

- One of the counter values (goods or price) can be postponed but not both.
- The act of sale must not be contingent.

Legitimacy of purpose is also central to the validity of contracts. Contracts which satisfy formal legitimacy conditions cannot be considered lawful if they are made for non-Shari'a compliant purposes. This is especially important when a transaction is structured form a multiplicity of contracts, each of which has formal legitimacy. However, in their total, they lead to illegitimate purpose, which is to sell money for money at a price that is not one-to-one.

When transactions are intended to lead to certain purposes, they are considered void, according to Shari'a. Some of such purposes include:

- Payment and/or receipt of Reba,
- Trading in non-lawful items,
- Harming someone
- Usurping people's wealth

Legitimacy of purpose must encompass all things that can realize or strengthen Maqassid al-Shari'a.

D. REVEALED INTENTIONS ARE CONSIDERED

As far as intentions are concerned, we can think of the following maxims:

1. Deeds are judged according to intentions.
2. Muslims are supposed to judge deeds not persons.
3. Intentions cannot be presumed, unless explicitly expressed.
4. When intentions are explicit or revealed, they must be considered.

Applying the above maxims to any transaction, we can say that a person involved in exchange would have explicit intentions to get cash in two cases:

- He sells commodities (goods or services) he owns

for cash.

- He has no goods to sell, but he engages in buying and selling to get cash and not goods at the end. This is the case of Tawarruq.

The first transaction involves getting cash in return for delivery of goods. Obviously this is legitimate.

The second case involves buying goods *which the person does not want* against deferred payment (for deferred cash) and then selling the same goods for spot cash. This is what is claimed here to be against Shari'a.

In the second case, exchange has no bearing on the real sector. The commodity needs not move from the supplier's storehouse, if resold to the same supplier. Even when sold to a different supplier, aggregate demand for the goods in question will not have increased.

The reason is that the first purchase against deferred payment registers an increase in quantity demanded and the second sale against spot payment registers an equal decrease in quantity demanded. The only net effect happens in the money market, where spot money has been exchanged against future money, leading to an increase in debt without an equivalent decrease in the aggregate inventory with the suppliers of the same goods.

When both contracts are placed in one transaction (purchase against deferred payment + sale against spot payment) we notice that the buyer in the first instance who is also the seller in the second instance has obtained spot cash against deferred cash. This is the Reba that Shari'a has explicitly prohibited.

In this case, the same person cannot hide his intention. The fact he sells right away what he had purchased exposes him as *cash and not commodity seeker*. When intentions cannot be ascertained, Muslims are supposed to judge things by appearance and not to speculate about intentions. However, when intentions are expressed in a certain way that makes them obvious, they must be considered in judging the

legitimacy of purpose of financial contracts.

TAWARRUQ AS A PRODUCT OF ILL REPUTE

I. INDIVIDUAL TAWARRUQ

A. ORDINARY TAWARRUQ

Tawarruq literally means obtaining cash or currency. When cash is obtained through the liquidation of ones property of goods and services, it pauses no problems. Such act can be termed *ordinary Tawarruq* which is considered lawful. In this case it makes no difference whether the commodities sold had been purchased or acquired through other means. The only requirement for ordinary Tawarruq is that it is done through one contract and not two or more contracts.

B. CONTRIVED TAWARRUQ (التورق التحيَلي)

In this type of Tawarruq, the person is interested in getting cash without selling anything. Therefore, he contrives a way through which he can fulfill his goals. The concerned individual purchases commodities against deferred payment. Then he sells those commodities to obtain cash. He may sell them back to the same supplier; in this case, it would be a two-party 'Einah Sale. Considering resale of commodities was done right after their purchase, to the same supplier and is admittedly done to obtain cash, such sale would be Shari'a non-compliant by consensus. The reason is that the intention to obtain cash is not hidden; it is made explicit through the act of buying and then selling back to the same supplier.

The individual may buy commodities from one supplier and then turns to sell them to another supplier. This is a three-party 'Einah sale. Since the *intention is to get cash for cash* and not commodities, and since such intention has been exposed explicitly by the act of buying then selling, it amounts to trading money for money and therefore involves Reba.

It is common to say that Tawarruq and 'Einah are not the same. This opinion claims that "Einah involves two parties but Tawarruq involves three parties. However, Dr. Sami Al-Suwailem stresses that the Hanafi School considers Tawarruq

within the definition of ‘Einah. In addition, the Malikis take the same position[4]. Another common but mistaken opinion is that the majority of Fiqh schools sanction Tawarruq. However, Dr. Ali Al-Salous provides strong evidence that the stronger view of the Hanafi scholars that it is not allowed, while the Malikis disallowed it. In addition, Imam Ahmad Ibn Hanbal considered Tawarruq as equivalent to prohibited ‘Einah[5].

Most importantly, a major figure of the Hanbali School, Imam Ibn Taymiyah and his well-known student, Ibn Al-Qayyem, have disallowed Tawarruq. In particular, Ibn Taymiyah considered Tawarruq to be a sale motivated by dire need, as the seller purchases the merchandize against deferred payment and sells it at a lower price against spot payment. Such sale is disallowed by Shari’a. In addition, Ibn Taymiyah considered Tawarruq as an artifice to use Reba, as it involves the sale of an amount of (deferred) cash for a lower amount of (spot) cash.

Other Fiqh scholars have also disallowed Tawarruq, including the Khalifa Omar Ibn Abdul-Aziz and the well-known Hanafi scholar, Muhammad Ibn Ibrahim Al-Hassan Al-Shaibani. Therefore, the common impression that Tawarruq is allowed by most Fiqh scholars is incorrect, as the Malikis, the stronger opinion of the Hanafis and the dominant figures in the Hanbali School have all disallowed Tawarruq.

II. INSTITUTIONAL TAWARRUQ

A. MECHANISM: BUSINESS TO CUSTOMER

Here we find an Islamic bank that notes the following:

1. There are customers who want to get present cash in return for debt. Such people may be concerned about Shari'a compliance, but they rely on or trust the opinion of the Shari'a board of that bank. They may also be totally unconcerned with Shari'a compliance.
2. Both the bank and the customer enter into an implicit

[4] Sami Al-Suwailem, “The position of old Shari'a schools from Tawarruq, “(in Arabic), 2004>
[5] Ali Al-Salous, “Tawarruq and Banking Tawarruq, “the Rabita Fiqh Academy, 2003.

contract through which the customer obtains an amount of present cash against a higher amount of future cash. Both the offer made by the bank and the acceptance made by the customer are made implicitly and not in writing. Such contract is invalid according to Shari'a, as it explicitly involves Reba or interest.

3. There is an opportunity to make money twice by the bank. The bank purchases commodities and then sells them through Murabaha or deferred-payment sale to the customer, gaining a markup. Then, it sells the commodities as an agent to the customer either to the same supplier or to a different supplier, gaining an agency fee.

4. Taken individually, the Murabaha or deferred-sale contract, the Wakala or agency contract and the final spot sale contract are all valid. However, taken together, the contracts are made to implement an invalid contract whose object is to provide present for future money.

Such organized Tawarruq done through the intermediation of an individual or institution is a novelty. Ancient Fiqh scholars have known such contrivance and declared it impermissible. Dr. Sami Al-Suwailem shows that organized Tawarruq has been known to Saeed Ibn Al-Musayyab, Al-Hassan Al-Bassri, Imam Malik Ibn Anas, and Muhammad Ibn Hassan Al-Shaibani. Each of those old scholars has disallowed it.

We notice in our case above,

- The customer is committing a contrived Tawarruq, in which his *intention* is explicitly exposed by virtue of the contracts signed with the bank. His intention is to purchase an amount of present cash against a higher amount of future cash, in contrary to Shari'a explicit prohibition. In this case he is committing a serious transgression.

- The bank is helping and abetting a customer to commit a *haram* transaction. In addition, the bank is making money through such arrangement.

Two things can be noted in this regard. First, even if we were to believe that individual contrived Tawarruq is allowed, despite the *revealed* intention, it does not follow that institutional Tawarruq would be allowed[6]. What applies to individuals does not necessarily apply to society. Otherwise, we fall into the *fallacy of composition*. Such fallacy can be likened in fiqh to *Fard Kefayah*, like walking in a funeral procession, which once some people do this, it would absolve the whole society. However, this does not apply to the group. When no one walks in a funeral procession, every member of the society becomes a sinner, as this act becomes *Fard Ayin*. Therefore, if some opinions were to ignore explicitly expressed intentions and to consider contrived (individual) Tawarruq as permissible, this cannot be acceptable as a social act.

Second, *Ma'alaat*, or consequences cannot be the same for the individual and the society. This leads us to look into the consequences of the prevalence of Tawarruq.

B. MECHANISM: BUSINESS TO BUSINESS

Islamic banks use international commodity exchanges, and particularly the London Metal Exchange to place excess liquidity. Sometimes, the bank takes precautions that include:

- Dealing directly through brokers and not through banks
- Verification of purchase of *metal warrants* in their account
- Verification of ability to deliver

In such case the bank appears to be genuinely purchasing metal against spot payment and selling it against deferred payment. The resulting profit may be attributable to taking ownership of metal. However, we mentioned above that each of the sale, agency and purchase contracts might be valid by itself. Nonetheless, when combined together to implement an invalid Reba contract, they in themselves become invalid.

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[6] Individual Tawarruq is considered as a Reba-based transaction by Umer Ibn Abdul Aziz, Ibn Taymiah and Ibn Qayem Al-Jawziyah.

Meanwhile, Islamic banks find it more convenient to deal through conventional banks as agents. This may be more costly, as it involves extra bank commission in addition to broker's commission. However, the resulting debt may be guaranteed by the agent bank. However, the transaction in this case could be reduced to a mere formality, where the conventional bank receives funds from an Islamic bank through Wakala agreement and places them in conventional loans, while passing an interest-rate differential to an Islamic bank.

This reduces the transaction to a Tawarruq operation in which present money has been traded for future money.

C. CONSEQUENCES OF INSTITUTIONAL TAWARRUQ

Shari'a has ultimate objectives, *Maqassid*, that must be considered in making any judgement. All micro or macro consequences, (Ma'alaat) must be taken into consideration when judging something as Shari`ah compliant or not.

The prevalence of institutional Tawarruq has serious implications for the treatment of debt resulting form Islamic commodity finance. In addition, it has even more serious implications for the whole Islamic finance industry.

D. ISLAMIC FINANCE DEBT ACQUIRING CONVENTIONAL CHARACTERISTICS

One of the important distinguishing characteristics of debt resulting from Islamic finance is that at times of insolvency (as opposed to delinquency) the debtor is entitled to rescheduling the debt owed at no increase, not even for the administrative costs incurred in rescheduling. In contrast, conventional finance always results in debt and at times of insolvency; the customer must expect penalty interest rates to be slapped over the debt. Even if a conventional bank agrees to reschedule the debt, it would have to be done at cost, in addition to penalty.

If Tawarruq were to be universally practiced, an insolvent customer would be automatically advised to arrange settlement through Tawarruq, which means that the debt would increase in value, and the bank would also make an

extra buck. Islamic finance debt would then acquire some of the characteristics of conventional debt, like ability to increase over time.

Indeed this has been happening. In some instances, one Tawarruq transaction triggers another one and so on. Tawarruq over Tawarruq may please the financiers that abuse Islamic finance, as it would rid them from the obligation of providing free rescheduling to their insolvent customer. However it could become the nightmare of the whole Islamic finance industry.

E. THE BLACK HOLE EFFECT

Moreover, institutional Tawarruq is usually implemented through organized commodity markets, with standardized contracts and routine procedures. It is not done in the local market, where a Muslim would be subjected to social pressure not to commit religious *faut pas.* If it were to be considered lawful, Islamic financial institutions would find it much easier to provide their straight cash, along the pattern of conventional loans, rather than base their transactions upon Islamic modes of finance which may appear cumbersome and costly.

This would turn institutional Tawarruq into a black hole in the in which all Islamic finance would be sucked in. Islamic finance would therefore cease to exist. Instead, we would have Tawarruq institutions. Muslims would therefore engage in Reba-based transactions, as they would sell future cash for present cash. Meanwhile, they may be lead to believe that the Tawarruq procedures, which amounts to using commodities as a camouflage and not as an object in itself, used would save them from the wrath of God. This would introduce to our economic behavior a substantial measure of hypocrisy.

F. MACROECONOMIC EFFICIENCY

Islamic finance being based on provision of goods and services rather than money has certain benefits. The most significant in this regard can be two categories of benefits:

1. The first benefits relate to the economy at the macro level,

where the practical closure of the integrated debt/money market and the cancellation of the role of the interest rate as an allocation mechanism of financial resources[7]. In such case, the allocation of resources would be based on investment and production criteria rather than debt criteria. People will have no incentive to economize on the use of money (which happens because the rate of interest is above zero)[8]. The economy would reach optimal equilibrium without contriving policies to reduce the rate of interest to zero.

By bringing back the money market, Tawarruq returns the economy to the dilemma of having a positive return on cash, regardless of its use. People would have an incentive to economize on the use of cash in transactions and economic equilibrium would fall back to suboptimal.

2. The second benefits relate to the efficiency of the finance sector itself. Conventional finance is practiced through the money market where spot money is traded against future money. This process is subject to two major risks: *adverse selection and moral hazard.* Such risks arise from information asymmetry between the more informed fund user and the less informed fund provider. Information asymmetry can be significantly reduced through two means. First participation in the management of the fund using enterprise, through *Musharaka* would provide the fund provider with inside information at low cost. Second, tying finance to specific uses would provide more information to fund providers about how funds are used.

Islamic banking, unlike commercial but very much like universal banking, opens the door for partnership with fund

[7] Notice that the debt market in Islamic finance is segmented by commodities. Each commodity has its own separate debt market in which the demand for such goods against deferred payment, whether through Murabaha or deferred-payment sale, and its supply determine the equilibrium mark-up on Murabaha or the equilibrium price differential on deferred-payment sale. Such mark-up or price differential is not determined by the demand and supply of debt, as debt is non-negotiable. It is rather determined by the demand and supply of the goods concerned against future payment.

[8] Notice here again that the premium paid is not on present against future money, but it is on goods for deferred payment against goods for spot payment.

users through Musharaka. Moreover, Islamic finance involves itself in the provision of goods and services and hence in the use of financial resources by consumers and investors. By its nature, it should be devoid of adverse selection and moral hazard[9].

G. THE BRIDGE BETWEEN THE REAL AND FINANCIAL SECTORS

A major consequence of practicing mainstream Shari'a-compatible financing modes is to tie the financial and real sectors together and to reduce the financial sector to size relative to the real sector. Tawarruq seriously undermines this. Tawarruq is just trading present for future money. We can have a storehouse of goods that would never be used, except only as a conduit to make conventional financial transaction concluded through Tawarruq look Islamic.

Tawarruq, meanwhile, removes the financial process from the goods market and places it back to the center of the money market. It brings back the risks of adverse selection and moral hazard to the financial sector, thereby reducing its efficiency. In addition, the little tale of the economy would grow back to exceed the size of the dog, exactly like what is happening in a conventional economy. Now the tail can have fun wagging its own dog.

Western bankers realize this dilemma and sometimes complain about it. Consider Lamfalussy's remark on this phenomenon during his term in the Bank of International Settlements, *"…Our financial revolution has been accompanied by an accelerated growth in financial transactions without any detectable link with the needs of the non-financial economy.*[10]"

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[9] Risks of adverse selection and moral hazard result in conventional finance from the information asymmetry resulting from that the bank knows much less about the use of funds, while the customer is well informed, as he himself spends the loaned money. Conventional banks would have to continuously monitor their customers in order to avoid such risks. However, monitoring is usually resisted or dodged by customers and is rather costly to banks. Universal banks that practice equity finance (Musharaka) side-by-side with lending are better equipped to monitor their corporate customers by setting on their boards. In Islamic finance, cash is given to customers only in cases of partnership finance, when full monitoring is available. In sale finance, the bank directly provides goods and services to its customer, thereby leaving no room to use the funds for other purposes.

[10] Alexandre Lamfalussy, general manager, BIS, "The Restructuring of the Financial Industry: A central Banking Perspective", SUERF Lecture, City University, London, 5 March 1992.

We can therefore conclude that Tawarruq effectively removes one of the major benefits of Islamic finance, which is to have a strong, two-way, bridge between the real and financial sector.

III. SOME SIDE ISSUES

A. PARALLELISM BETWEEN MURABAHA AND TAWARRUQ

The claim of parallelism between Murabaha and Tawarruq lacks reasoned justification. Murabaha is a legitimate mode of Islamic finance. It places goods and services (not cash) in the hands of banks' customers. It was criticized as bearing similitude to the classical loan. In addition, it requires a number of legal actions that must be taken in the proper order. If not, it loses Shari'a compliance. The practice of Murabaha has helped the Islamic finance industry to survive for some time until innovation has brought forward a large number of products that helped Islamic banks to diversify their assets. Now, the justification of predominance of Murabaha is getting weaker.

In addition, if an intention to use Murabaha is revealed by a particular customer, the Islamic bank should refuse to provide him with such finance. Such intention can be discovered through repeated use of goods Murabaha, or blowing the whistle by someone else in the market.

In comparison, Murabaha finance, where goods are sought for themselves and not cash, reduces suppliers' inventories and increases the quantity demanded of the same goods. When such trend persists (people tend to purchase the same goods using Murabaha finance, an increase in the price of goods (in the real sector) and markup (in the finance sector) thereupon would rise.

In the case of Tawarruq, no effects on the real sector, while the financial sector would charge higher price differential on deferred-payment sale. This is a purely monetary change with no real counterpart. This makes it a disguised rise in the rate of interest.

B. TAWARRUQ AS AN ARTIFICE:

An artifice is a pretense or ploy. Institutional Tawarruq is an artifice in that sense. An artifice could imply deception, deceit or cunning. However, institutional tawarruq may not involve that, unless we mean self-deception. It involves the deceit of others to the extent that the majority of people are laymen when it comes to Fiqh. In addition, many would assume that everything practiced by an Islamic financial institution must be legitimate, especially if Tawarruq is provided under a nice name.

C. ISLAMIC BANKS OPERATING AT SECOND LEVEL

Some people may justify Tawarruq and other products of ill repute as transitory. The argument starts with postulating that Islamic finance is a new industry. It cannot therefore apply fully its paradigm from the very beginning. It must start at second level (perhaps what is meant is the basement) before moving higher.

Transitory modes of operations can be temporarily tolerated, provided that:

- The transaction itself should not be declared Shari'a-compliant. Shari'a non-compliance should be admitted at the outset. Justification could follow for reasons of dire necessity or *darura.*
- Permission to carry out such transactions should be obtained from the Shari'a board on a case-by-case basis.
- The use of such transaction should be considered temporary, which would make it subject to review periodically.

Second-level operations (or rather basement products) should never be declared Shari'a compatible. Only temporary tolerance is allowed as an exemption. In addition, in order to ascertain dire necessity, there must not be any viable alternative to the exempted unlawful transaction.

The case of institutional tawarruq does not involve the admission of some Shari`ah incompatible aspects while working on their gradual removal. It rather involves claiming

that tawarruq is lawful and the practicing bank is already using first-best solutions. In addition, almost all Islamic modes of finance can be used in place of Tawarruq. When lawful alternatives are present, exemptions become unjustified.

CONCLUSIONS

We can conclude from above the following:

First, Islamic finance has an approach that is uniquely different from the conventional approach. In addition, Islamic finance leads to real gains both to the economy as a whole and to the financial sector in particular.

Second, the Islamic finance industry has come of age and is capable of competition if a plain-level field is assured. This is what is happening gradually in the Gulf area.

Third, the Islamic finance industry is suffering from lack of human resources with the right knowledge and experience. It is also suffering from self-claimed yet hardly qualified Shari'a experts who have no credentials to deserve to be called Shari'a scholars. The existence of this group, coupled with the negligence of some Shari'a scholars of the economic consequences of their Fatwa, has lead to sneaking some products of ill repute into the Islamic finance industry.

Fourth, Tawarruq is one of the most dangerous among the products of ill repute, for it threatens the future of Islamic finance.

Fifth, the common impression that individual Tawarruq has been sanctioned by a majority of Fiqh scholars is a common mistake that has been perpetuated by one of the rate careless passages of the Kuwaiti Fiqh Encyclopedia. The fact is that Fiqh consensus has been to consider Tawarruq as 'Einah, which is strongly prohibited.

Sixth, contrary to the common impression, organized Tawarruq was known to old scholars and was considered by them as "Einah, which they disallowed.

Seventh, the banking regulatory authorities are strongly invited to set standards for the corporate governance of Fatwa and Shari'a Supervisory Boards in Islamic banks. In particular, such standards must require a Ph D in Shari'a from a well-known university for Shari'a scholars to qualify for board membership. In addition, the standards must envisage

at least one monetary and financial economist with a Ph D in his field as a none-voting member of such boards.

Eighth, a ranking of universities teaching Shari'a must be done and updated regularly as a guide to ascertain the qualifications of Shari'a scholars.

APPENDIX A: A BRIEF LIST OF ISLAMIC FINANCIAL PRODUCTS

Islamic financial products can be simple or complex. Simple products are based on a single mode of finance, while complex products are structured using multiple modes of finance.

The following list does not intend to provide the reader with a comprehensive menu of Islamic financial products, but merely intend to give the reader a taste of the variety and multiplicity of such menu.

I. SIMPLE PRODUCTS OF ISLAMIC FINANCE

A. PARTNERSHIP PRODUCTS

1. MUSHARAKA

1.1 In Musharaka**,** both parties share in capital and management.

1.2 Permanent Musharaka is exactly similar to equity finance.

1.3 Diminishing Musharaka stipulates providing funds for a limited number of years, during which a part of the partner's profit is used to buy out the share of the finance provider.

1.4 Equity finance can make the bank a permanent shareholder, to exit only through the sale of its share in the stock market or OTC.

2. DIMINISHING MUSHARAKA

2.1 In diminishing Musharaka, the bank exits within a specified number of years.

3. MUDARABA

3.1 In Mudaraba, the bank provides capital and the entrepreneur provides management. Profit is shared in a preagreed formula. It is usually used to finance working capital requirements for medium-term periods. It requires monitoring, whose cost is reduced when both

Musharaka and Mudaraba are used simultaneously.

4. UNRESTRICTED MUDARABA

4.1 Mudaraba can be either restricted or non-restricted.

4.2 Unrestricted Mudaraba allows the bank to provide the customer with working capital that can be used in all aspects of the customer's business. Profit is shared in pre-agreed ratios, but loss must be shared proportionately.

5. RESTRICTED MUDARABA

5.1 The bank provides funds to invest under certain restrictions, which can be positive or negative.

5.2 Positive restrictions would list all allowable investment outlets in which the funds provided can be used.

5.3 Negative restrictions would list all the investment outlets in which the customer is prohibited from using the funds.

B. PRODUCTS BASED ON SALE FINANCE

6. DEFERRED-PAYMENT SALE

6.1 In deferred-payment sale, the bank already owns the goods.

6.2 A price is negotiated without reference to cost that would entail deferred payment in lump sum or installments

7. Murabaha

7.1 In Murabaha, the customer signs a promise to buy the goods on installments at cost plus markup. The bank acquires the goods and sells them to the customer as promised

7.2 Murabaha can be used to finance raw materials, consumer goods or fixed assets, although it is used more often in car finance.

8. SALAM

8.1 Salam can be used to finance working capital. The bank purchases a quantity of future output and pays spot. The customer delivers later. The bank can sell the same products through parallel Istisna', or appoint the customer as its agent to sell them at time of delivery.

8.2 In Salam, the buyer finances the seller which is just the opposite of Murabaha and deferred-payment sale. It can also be used as a means to secure future commodity/raw material requirements for business enterprises at given prices (product finance). This provides a hedge against future price changes.

9. ISTISNA'

9.1 In Istisna', the assets are not existent at the time. The bank signs an Istisna' contract. Such contract commands the bank to build or manufacture the asset according to detailed specifications. In order to fulfill its obligations, the bank signs a parallel Istisna' contract with the manufacturer to do the same.

9.2 Payment in Istisna' contract (by the customer) could range between 5 and 15 years. Payment to manufacturer or builder is done at specified stages and upon the completion of each stage.

9.3 While in Murabaha and deferred-payment sale, the seller finances the buyer. Meanwhile, in ISTISNA' either party may finance the other (according to Intl Fiqh Academy ruling and some schools of jurists).

C. IJARAH FINANCE

10. REGULAR IJARAH

10.1 This is used to finance the use of durable assets, as in home finance, and in the finance of plant, equipment and means of transport (airplanes, ships, etc.)

10.2 The bank leases the assets with a permission to sublease. The bank then leases the assets to its customer against regular rental payments.

10.3 In this case, the customer is interested only in the usufruct and not in title transfer.

11. IJARAH MUNTAHIA BITTAMLEEK

11.1 The bank acquires the assets and then leases them to the customer with a promise to transfer full ownership to customer by way of gift or selling them to customer at a

token price, provided he fulfills all obligations.

11.2 Ijarah Muntahia Bittamleek is typically an intermediate to long-term finance. It could go up to 15 or 20 years. Ordinary Ijarah that does not involve title transfer is typically a short-term finance that ranges from one to five years.

12. WAKALA

12.1 The bank can provide the customer funds to be used in a specific investment outlet.

12.2 The customer would be acting as an agent of the bank.

12.3 The bank obtains all the profit and bears all the losses.

12.4 The customer gets a fixed commission to compensate for his efforts.

II. COMPLEX (STRUCTURED) ISLAMIC FINANCE PRODUCTS

The number of complex Islamic finance product enormous and cannot be listed. With 12 modes of finance to use as raw material, which would be mixed in different ways and different proportions, combinations can amount to hundreds. However, using multiple modes of finance in one transaction is tantamount to using multiple contracts. This requires acumen in both Shari'a and law. The art of product structuring has been made less tedious by using multi-disciplinary teams of Shari'a, finance and law experts to do the job.

III. OTHER PRODUCTS

13. MUTUAL FUNDS SHARES

13.1 Islamic banks and finance institutions structure funds for purposes similar to those of conventional funds. The mixture of liquidity, security and return is measured to suit the requirements of fund shareholders. However, the fund must be structured to be Shari’a compatible.

13.2 Islamic funds based on Ijarah dealing in high growth sectors like real estate earn high rates of return, but the

risk is also high.

13.3 Funds based on shares can become victims of stock markets idiosyncrasies. Each Islamic bank in the UAE has some high-profile funds in addition to marketing funds structured by conventional and/or Islamic banks and financial institutions.

13.4 Like conventional funds. An SPV is constructed to mange the fund. The brochure, prospectus and other documents must be approved by the bank's Shari'a Board. It is also subjected to Shari'a auditing.

13.5 Most funds created are managed by SPV's located in tax havens. Bahrain and the International Financial Market in Dubai are increasingly attracting fund managers. Fund assets must be evaluated regularly (usually quarterly) for profit distribution. Islamic banks in the UAE have become quite familiar with the process of distributing roles related to fund establishment and management among themselves.

14. SUKUK

Sukuk are created through several steps. First banks acquire real assets and bunch them in a Shari'a compatible fashion. They are sold in a bunch to an SPV. Credit enhancement, promotion, underwriting and marketing is done in a fashion similar to conventional securities. The SPV manages the underlying assets for the interest of shareholders. It distributes its net profit to Sukuk holders in proportion to their holding.

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