

The Fate of Tawarruq Going Forward

By Oliver Ali Agha

The Islamic finance industry is evolving. A decade or more ago, Islamic structures were unabashedly conventional replications in Shariah form but not in substance. To render a conventional instrument “compliant” required merely removing the word “interest” and substituting it with “profit.”

As the market developed, evolving structures continued to create controversy since at their core they remained conventional in nature, relying heavily on hiyal or legal fiction in order to give them a Shariah compliant packaging.

However, the use of hiyal is in direct contravention to the Islamic doctrine of *Sadd adh-Dharai*, accepted by an overwhelming majority of the schools of thought, that states that actions that lead to an impermissible result are prohibited.

Thus, as scrutiny has turned to the substance rather than the form of Islamic finance transactions, debate is now centered on many products carrying a “Shariah compliant” label but which are in fact conventional finance deals.

For example, Muhammad Taqi Usmani in his Fatwa entitled “Sukuk and their Contemporary Applications” drew attention to some of the more “creative” Sukuk structures, expressing concerns that these were, in fact, conventional bonds involving *riba* despite the wording of the underlying documentation.

Now, with the issuance of the fatwa by the International Council of Fiqh Academy (ICFA), the debate has enveloped Tawarruq transactions and in particular the more complex reverse commodity Tawarruq arrangements. The above-mentioned Fatwa has provided a review of the various Tawarruq structures and then issued its views on their legitimacy (or lack thereof).

In its Fatwa, the (ICFA) specifically stated that the original manifestation of a Tawarruq (where a person buys merchandise at a deferred price in order to sell it in cash at a lower price, usually to a third party, to obtain cash) is a Shariah compliant transaction provided that the sale agreements are themselves Shariah compliant.

However, the (ICFA) then went on to state that more complex transactions known as reverse commodity Tawarruq, or simultaneous organized and reverse Tawarruq, are not Shariah compliant. Such arrangements have been commonly used to raise finance on the back of real or fictional commodity trading.

Under this arrangement the borrower approaches a lender and asks for a loan. The lender then “sells” commodities to the borrower on behalf of a supplier for an agreed amount plus profit on a deferred basis.

The borrower then immediately “re-sells” the commodity to the original seller, usually for the original amount paid by the lender (often with the lender acting as the agent for the borrower).

The concerns expressed by the (ICFA) primarily revolved around the fact that the above-mentioned structure is, in effect, a conventional finance transaction involving a fixed and largely risk free return (*riba*).

It used the term “deception” to describe the use of the fictional commodities trades in circumstances where the parties never had any real intention of purchasing commodities, such commodity transactions simply being a means to execute the credit agreements.

While used in the Islamic finance industry, the reverse commodity Tawarruq is of concern to those looking to steer the development of Shariah finance away from conventional structures. Firstly, as pointed out by the (ICFA), it contains a hidden element of *riba*.

In addition, the complex web of simultaneous commodities trades (many of which may never actually take place) obfuscates the real nature of the transaction and undermines the requirement in Shariah compliant financing of transparency on the part of both parties and the nature of the transactions reflecting the real intentions of the parties.

Without the underlying commodity entering/remaining in the deal, the debt obligation has no underlying asset or commodity to attach itself to and therefore may undermine the stability of the financial system in the same way that toxic bonds and excessive gearing did in conventional finance.

The ruling of the (ICFA) should be welcomed as a move towards the development of genuine and substantive Islamic finance and away from disingenuous and replicated transactions.

Such a development will buttress the Islamic finance industry as an autonomous viable alternative to conventional finance, particularly when conventional finance has been ravaged by the excesses of leverage, speculation (hedge funds), derivatives and bifurcation of assets from debt and on-sale (collateralized debt obligations), each of which is prohibited/problematic in Islamic jurisprudence.

In the short term there is likely to be some disruption in relation to financings that are undertaken using the reverse commodity Tawarruq structures. However, some commentators have suggested that their use in the Middle East is already in decline and there has been a palpable discomfort among scholars on such structures in any event. The pronouncement of the (ICFA) will be the final nail in the coffin of the reverse commodity Tawarruq.

Meanwhile, Islamic finance will continue. In Islam, we believe that in the application of the principle, profit takes a subordinated role: As coined at our firm: “Principle before Profit” must be the mantra, not the other way around. ☺



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