

DETERMINANTS OF *SHARIAH* NON-COMPLIANT
EVENTS IN ISLAMIC BANKS IN MALAYSIA: WITH
SPECIAL REFERENCE TO *TAWARRUQ*-BASED
FINANCING

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Abstract

Tawarruq is a new phenomenon in the Islamic financial landscape. It has gained wide acceptance from the market due to its inherent characteristics that can offer similar features as the conventional structure. Nevertheless, tawarruq is exposed to a high degree of shari'ah non-compliant risk mainly because it involves a series of sale contracts in succession. The present study investigates the determinants of shari'ah non-compliant events (SNEs) in tawarruq-based financing as practiced by Islamic banks in Malaysia. The study adopts the Analytic Network Process (ANP) gathering different views of experts from practitioners, regulators, shari'ah scholars/advisors and researchers/academicians. The study found that lack of understanding and knowledge, inadequate control mechanism and reporting, ineffective functional structure, incompatibility of system to the execution of Islamic products, improper document execution and sequence, and inadequate internal policies and governing rules are the key determinants of SNEs in tawarruq-based financing in Islamic banks in Malaysia.

Keywords: *tawarruq*, Islamic banks, ANP, SNEs, Malaysia

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1. Introduction

Tawarruq is one of the most widely applied concepts in Islamic financial institutions (IFIs) today, ranging from deposit and financing activities, liquidity management and debt restructuring, government and debt sukuk structuring, to risk management and hedging purposes. The concept has gained wide acceptance from IFIs due to the embedded characteristics in the *tawarruq* concept which can offer various features similar to conventional products.

In the Islamic banking sector, *tawarruq* has been extensively used to structure both deposit and financing products. It is normally applied for the term deposit which offers depositors guarantee of principal as well as fixed returns. It is also employed to structure various financing products based on different clientele needs such as personal financing, asset financing, cash line facility, education financing, personal financing, revolving credit facility, working capital financing, home financing and project financing facilities.²

Nonetheless, the extensive use of *tawarruq* in Islamic banks has stirred high concerns mainly from regulators and *shari'ah* scholars. This is particularly true since *tawarruq* assumes a relatively high degree of *shari'ah* non-compliant risk as compared to other modes of financing³ due to the involvement of various processes and legs. Human error, as well as poor governance, business processes and supporting systems, in addition to lack of awareness and understanding of *shari'ah* matters, are the prominent factors which may trigger SNEs in *tawarruq*-based financing.⁴ SNEs may also originate from the product structure and the legal documentation.⁵ A proper review and due diligence is thus instrumental before the

² Dusuki (ed), *Islamic Financial System: Principles and Operations*, (Kuala Lumpur: Pearson, 2011), 232.

³ Nasrun Mohamad @ Ghazali, "Tawarruq in Malaysian Financing System: A Case Study on Commodity Murābahah Product at Maybank Islamic Berhad", (2013), 34.

⁴ Ibid., 122.

⁵ Nasrun Mohamad @ Ghazali and Asmak Ab Rahman, "Analysis of Tawarruq-Based Financing: From Shari'ah Risk Management Perspective" in *Islamic Economics, Banking and Finance Concepts and Critical Issues*, (2014), 34.

contract is executed.⁶ Extreme care should be observed to ensure that the arrangement does not reflect a mere exchange of papers.⁷

Against the above backdrop, the present study undertakes to investigate the determinants of *shari'ah* non-compliant financing in the *tawarruq*-based financing as practiced by Islamic banks in Malaysia; and to propose the mitigation mechanism for SNEs in *tawarruq*-based financing.

Following this introduction, the study is organized in accordance with the following: The next part reviews the literature. Part 3 expounds the research methodology for this study. The proceeding part presents the finding and analysis of the study. The last part concludes the study.

2. Literature Review

The literature review in this paper is divided into two parts. The first part discusses the concept and the application of *tawarruq* in Islamic banks; whilst the second part presents the previous studies on the subject of *shariah* non-compliant risk. The examination of the literature found that there is no empirical study made on the SNEs on *tawarruq*-based financing and thus the significance of this study.

2.1 Concept of *Tawarruq* and its Application in Islamic Banks

Linguistically, the word *tawarruq* is derived from an Arabic root word *wariq* which means coined silver.⁸ The first person who used the term *tawarruq* in treaties of Islamic law is attributed to Ali ibn Abu Thalib who said: "I would not abandon Hajj (pilgrimage) even if I had to do it through *tawarruq*."⁹ The technical definition of *tawarruq* can be understood from its literal meaning, coined silver, indicating that the intention to enter the contract is not for commodity

⁶ Nasrun Mohamad @ Ghazali, "*Tawarruq* in Malaysian Financing System...", 34.

⁷ Muhammad Ayub, *Understanding Islamic Finance*. (UK: Wiley, 2007), 351.

⁸ Muhammad Rawwas Qal'aji, *Mu'jam Luqhat al-Fuqahā'*, (Beirut: Dar al-Nafasi, 1988).

⁹ Ibn al-Athir, *The End of Strange Words in Hadith*, Vol. 2, (Islamic Library: Cairo: n.d), 301–302; Aleshaikh, Nourah, Mohammad, "Jurisprudence on *Tawarruq*: Contextual Evaluation on the Basis of Customs, Circumstances, Time and Place," (Durham Theses, Durham University). Accessed <http://etheses.dur.ac.uk/3188/>.

rather for the attainment of silver or liquidity. Thus, *tawarruq* can be defined as a series of sale contracts in succession whereby a person purchases a commodity from a seller on a deferred basis and subsequently sells it to a party other than the original seller on a cash basis for the purpose of obtaining liquidity.¹⁰

The early scholars' position of the *sharī'ah* ruling on *tawarruq* is mainly divided into two groups: those who approve it and those who view otherwise. The vast majority of jurists (Hanafi, Maliki, Shafi'i and Hanbali schools) held the view that *tawarruq* is permissible. Abu Manshur al-Azhari claimed that the permissibility of *tawarruq* is unanimously agreed to by all jurists. Nevertheless, a prominent Hanbali jurist, Ibn Taymiyyah, departed from the majority of the Hanbali school position in approving *tawarruq*. He upheld the view to outlaw the concept.¹¹ His stand was followed by his disciple, Ibn Qayyim al-Jawziyyah, considering it as a mere legal trick to justify *riba*.¹²

While the vast majority of early jurists have generally approved the classical *tawarruq*, the view of contemporary scholars and *fatwa* setting bodies over the current practice of *tawarruq* is diverse. In 1998, majma' rabitah al-alam al-islami in its 15th session in Makkah resolved that the traditional *tawarruq* is permissible based on the view of majority jurists and the original ruling on the legitimacy of a sale contract. In 2003, majma' rabitah al-alam al-islami in its 17th meeting held in Makkah clarified its previous stand and ended with the resolution that the modern practice of *tawarruq* is impermissible. In 2009, the Organisation of Islamic Cooperation (OIC) Fiqh Academy in its 19th meeting—held in Sharjah, the United Arab Emirates—reiterated the decision made by majma' rabithah in 1998 and 2003 that the traditional *tawarruq* is permissible while the current practice of *tawarruq* is impermissible.

¹⁰ Asyraf Wajdi Dusuki, M. Mahbubi Ali & Yulizar D. Sanrego, "The Application of Commodity Murabahah in Bursa Suq Sila' Malaysia vis-a-vis Jakarta Future Exchange Sharī'ah Indonesia: A Comparative Study." *ISRA Research Paper*, No. 49 (2013), 5.

¹¹ Ibn Qayyim al-Jauzi, *T'lamu al-Muwaqqi'in 'an Rabb al-'Alamin*, (Beirut: Dar al-Kutub al-'Ilmiyyah, 1991), 3/135.

¹² Muhammad Shalih Al-Uthaimin, *Al-Sharh al-Mumtī' 'Ala Zad al-Mustaqni'* (Dar Ibn al-Jauzi, 1422-1428H), 8/220.

However, the *Shari'ah* Advisory Council of Bank Negara Malaysia (SAC BNM) in its 51st meeting, 2005 resolved the permissibility of *tawarruq* for deposit and financing products in Islamic banks (IBs). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 2008 issued *Shari'ah* Standard No. 30 on *tawarruq* and resolved that the organised *tawarruq* is permissible subject to certain rules and parameters.¹³ The *Shari'ah* Advisory Board of Al-Rajhi Bank has also approved the practice of *tawarruq* since the customer has full liberty to deal with the purchased asset from the platform.¹⁴ The Kuwait Finance House (KFH) permitted the modern *tawarruq*, but suggested to remove the inclusion of the agency element in the *tawarruq* structure as to avoid the resemblant characteristics to *riba*.¹⁵ Dubai Islamic Bank (DIB) shared the same view with KFH and Al-Rajhi in approving *tawarruq*, provided that the arrangement is free from the element of prohibited *'inah* arising from the involvement of a third party in the financial arrangement.¹⁶ The National *Shari'ah* Board of Indonesia Ulema Council (DSN-MUI) also resolved the permissibility of *tawarruq* with certain conditions.¹⁷

Tawarruq is one of the most widely applied concepts in IFIs nowadays, ranging from deposit and financing activities, liquidity management and debt restructuring, government and debt *sukuk* structuring, to risk management and hedging purposes. In the Islamic banking sector, *tawarruq* has been used to structure both deposit and financing products. Under deposit products, *tawarruq* is normally used for term deposit which offers depositors with a guarantee of principal as well as fixed returns. Term deposit is a type of deposit which has certain fixed term, generally short term in nature, with maturity ranging from a month to a few years.¹⁸ A customer opening

¹³ AAOIFI, *Shari'ah Standards for Islamic Financial Institutions*, (Manama: AAOIFI, 2010), 525.

¹⁴ Al-Rajhi, Fatwa no. 125, 713 and 699.

¹⁵ KFH, Fatwa no. 131, 820 and 851.

¹⁶ DIB, Resolution no. 63.

¹⁷ DSN MUI, Fatwa no. 82.

¹⁸ Abdul Abdul Ghafar Ismail, Nik Abdul Rahim Nik Abdul Ghani, Mat Nor Mat Zain, *Tawarruq Deposit with Wakalah Principle: An Opinion that Triggers New Issues*, (IRTI Working Paper Series, 1435-02/2013), 4.