

TECHNICAL NOTE

Tawarruq through PMEX using High Speed Diesel (HSD)

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The Background

On demand of some Islamic banks in Pakistan, the Pakistan Mercantile Exchange (PMEX) designed a structured product over the last some years to enable Islamic banks to do tawarruq using HSD as the underlying commodity. Keeping in view many Sharī'ah issues, the State Bank of Pakistan (SBP) allowed Islamic Banking Institutions (IBIs) on November 02, 2017 to undertake Commodity Murābahah (CM) transactions through the PMEX for a pilot phase till March 31, 2018, the period that has been extended till October 31, 2018. A good move to be seen in this regard was that in the pilot phase HSD based tawarruq could be done only with the Islamic Banking Institutions (IBIs) in Pakistan. However, as IBIs have other modes like murābahah and wakālah al-istithmār (investment agency) for intra-Islamic banks liquidity placement, use of PMEX platform for tawarruq remained minimal and only six transactions were undertaken by a few IBIs. Keeping in view that the 'Pilot Phase' is coming to an end and that some banks have been anxious to get regulatory permission for excessive use of tawarruq as a means of investment and financing, the Journal of Islamic Business and Management (JIBM) considered it appropriate to discuss the related Sharī'ah issues precisely enabling the Sharī'ah scholars, the regulator and the practitioners to decide the matter for long-term benefit of Islamic finance industry.

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Tawarruq and its Use as an Investment Tool

In jurisprudence, *tawarruq* is a tool that gives someone cash by way of trading activity while the objective is to get money, and not any commodity. As being practiced, *tawarruq* can be defined as getting cash or investing cash by way of trading as a contrivance while the subject of the exchange is not the objective. Almost all contemporary jurists allowed juristic/classical *tawarruq* in unavoidable cases where a person in serious need of cash may buy a commodity on deferred payment and sell it on spot (to any third party) to get (lesser) cash while fulfilling the conditions pertaining to transfer of ownership and possession. In case the commodity sold is bought/sold back by the seller buyer, it is '*inah* (buy-back), prohibited by the jurists. But, what Islamic banks do is '*organized tawarruq*' or '*commodity murābahah*', also called '*nominal tawarruq*' in which they buy and sell any commodities

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or instruments, serving as agent to investor or through broker(s) without fully observing ownership/possession related conditions.

The term, ‘*Commodity Murābahah*’ (CM) is organised *tawarruq* or reverse *tawarruq* conducted by Islamic banks - an Islamic bank purchases a commodity through brokers on spot and sells it for a deferred payment to any conventional bank on credit that again sells, also through broker, for the purpose of getting liquidity. It is basically a trick to circumvent the prohibition of earning money from money. Jeddah Based Islamic *Fiqh* Council prohibited organized *tawarruq* and reverse *tawarruq* in April 2009 [Resolution 179 (19/5)] on the ground that the conditions put for its valid use cannot be fulfilled by the banks properly - delivery of commodity involved to the buyers and transfer of ownership and related risk to them. AAOIFI allows *tawarruq* (SS. 30) subject to specific conditions. However, fulfillment of those conditions by the banks is almost impossible as indicated by many industry experts (Khan, 2010).

Dr. Ahmad Alhaddad, Chief of Muftis, Dubai Department of Endowment, and Member of Sharī‘ah Board of *Mawarid Finance PJSC*, indicated in an article on *tawarruq*, “.., *the Prophet (pbuh) said, "May Allah curse the Jews, for Allah made the fat (of animals) illegal for them, yet they melted the fat and sold it and ate its price" ... they tried to deceive the text and they thought that way of deceiving as useful". "In actuality, tawarruq is one of those confused matters, due to the element of cheating - -. This cheating removes tawarruq from its original rule, which is based on permissible trade into something else alike tricks, which are condemned by Allah. Moreover, those tricks lead to ribā, which is prohibited by the Sharī‘ah, he added"*. (Alhaddad, 2009¹).

Allowed exceptionally by some scholars for extreme and case-by-case situations, *tawarruq* has turned into a retail product used by Islamic banks all over the world. As such, it has taken the position of the ‘*Darling Kid*’ of Islamic finance industry used for taking deposits, financing and investments. The only exception is the Central Bank of Oman (CBO) that has declared that “*Commodity murābahah or tawarruq, by whatever name called, is not allowed for the licensees in the Sultanate as a general rule with the exception if the IFI’s survival is threatened, and no other mean to assist conventional conversion into Islamic*” (www.cbo-oman.org/news/IBRF.pdf).

Tawarruq is neither the spirit nor even the letter of Islamic finance. It runs against economic logic, because it employs artificial sales contract as a façade to camouflage the conventional nature of transactions (Al Jarhi, 2016). In many cases it may lead to ‘*inah* that is expressly prohibited (Alhaddad, 2009 cf Al-Suwailem). The Malaysia based well recognised researchers, Dusuki et al. (2013) summarised four major concerns raised by Sharī‘ah scholars on the practice of organised *tawarruq*:

- a) Many commodities used in the practice are junk and defective;
- b) The legal document of *tawarruq* is embedded with the clause that the customer is restricted from taking delivery of the commodity purchased as in the case of *tawarruq* trans-

¹Alhaddad, Ahmad bin Abdul Aziz. (2009). “*Tawarruq al Fiqhi and Organized or Financial Tawarruq-Features and Types*” prepared for 19th Session of Fiqh Council;. Retrieved June 25, 2018. <https://ifikr.isra.my/library/pub/302>

action conducted via the London Metal Exchange;

c) The commodity rarely gets physically transferred from the seller to the buyer; and

d) The inclusion of agency in the *tawarruq* arrangement makes the contract similar to the prohibited '*inah* (a fictitious, manipulative transaction for obtaining cash involving a commodity which is returned to the same seller for a lower price).

As *tawarruq* is generally done by involving the conventional (interest based) banks, the most serious outcome of this product is that resources mobilised by the Islamic banks for Islamic business are generally transferred to the conventional system for arbitrage by the latter.

PMEX as a Platform for *Tawarruq*

This is an organized '*tawarruq*' that serves as a means to generate return by Islamic banks from liquidity without any involvement in real business activities. Practically, the requisite conditions of valid *bai'*, i.e., delivery/possession of the subject matter and transfer of risk, are not properly fulfilled. As it is to take the form of a commercial practice ('*urf*') without any value addition for the economy or the clients, it turns out to be a fake process with ultimate objective of getting return on money.

What practically happens is that: i) surplus bank A purchases HSD from an OMC (oil marketing company) through PMEX by making advance payment of the purchase prices, say Rs 100 million. [Brokerage and other fees are charged separately]. The Diesel remains in the same container as a crucial provision of the contract is that the physical possession of the HSD is to remain with the OMC; ii) Broker/OMC/PMEX, as agent of A, sells the HSD to the deficit bank B on *murābahah* basis, say at 100+10=Rs 110 million, while Diesel still remains in the container and delivery given only on paper; and iii) Again, broker/OMC/PMEX, as agent of Bank B, sells the HSD to the OMC as its agent for Rs. 100 million (it is *tawarruq*, B's objective was to get cash). PMEX transfers 100 million to Bank B. Although on papers it is provided that the buyer has right to...get delivery or sell, but, as the actual/physical possession has to remain with the OMC, the subsequent buyer sells the HSD to the OMC as agent. The whole process takes only a few minutes. Thus, the HSD remains where it was while the investing bank earns profit on its cash, and the bank purchasing on *murābahah* basis uses cash for its business, mainly for arbitrage.

The above process does not fulfill the requisite conditions of transfer of ownership with risk and reward². When the HSD is to remain with the OMC, all subsequent process is mere a mock formality. According to the AAOIFI (SS. 30), in addition to other conditions, there should be real possession of the commodity, and must not be any obstacle that prevents the client to hold the commodity. There should not be any link between the contract of purchase at deferred price and the contract of sale at cash price, by a way that forbids the client to hold the commodity, either the link is stated in the contract or due to customary practices or

²According to Sheikh Taqi Usmani, "the commodity must be delivered to the buyer before he sells it to someone else., the broker cannot be the agent for the mustawriq (the one who seeks liquidity) to possess the commodity". Sheikh added that "the appearance of the name of a buyer on a computer screen does not transfer the ownership and liability to him". [Uthmani, Muhammad Taqi. (2009). *Ahkam al-Tawarruq wa Tatbiqatuhu al-Masrafiyah*; Munazammah alMuktamar Al-Islami. *Majma' Al-Fiqh Al-Islami Al-Duwali*. 26-30 April 2009]

by the nature of the procedures. Further, it is not permissible to appoint the Company or the investing bank as agent to hold the HSD because the both are seller and as such they are already holding the commodity.

We can conclude, therefore, that as the actual/physical possession is to remain with the OMC, the requisite conditions for valid sales cannot be practically fulfilled. Hence, PMEX *tawarruq* may not be allowed even among Islamic banks. It is pertinent to mention here that as other modes/structures like *mushārah*, *muḍārah*, and *wakālah* are available for the purpose of placing funds with other Islamic banks; then why to do PMEX related *tawarruq* and pay fees to the brokers. The stakeholders should be witnessing that sanity prevails. So, doing such *tawarruq* even with other Islamic banks has to be avoided.

Tawarruq deals of any kind with the conventional banks may be prohibited altogether. The Bank of Oman is a thoughtful example in this context to be followed by the SBP. Accordingly, *tawarruq*, on any commodity like HSD, any metals or commodities like sugar or instruments like GOP *Ijārah Ṣukūk*, may be prohibited except in situation when any IBI's survival is threatened and no other source exists to get liquidity. In such unavoidable situation, following conditions must be met while doing *tawarruq* with IBIs, for conformity to the principles of the Sharī'ah, at least in letter:

1. The PMEX must ensure compliance of the relevant provisions of AAOIFI's Sharī'ah Standards No.8 (*Murābahah*) and No. 20 (Commodities trading in organized markets) regarding ownership, possession and delivery of the commodities; and SS No. 30 (*tawarruq*), especially:

- i) Clause 5/1 of SS 30: *Tawarruq* is not a mode of investment or financing - it has to be used only when there is danger of liquidity shortage;
- ii) Clause 3/2 of SS 30 prohibits *tawarruq* with conventional institutions;
- iii) Clause 4/1 of SS 30 - commodity should not be gold or silver;
- iv) Clause 4/5 of SS 30: it should not be organized - collusion between the two parties, or according to the *'urf* (common practice);
- v) Clause 4/6 of SS 30: the 2 contracts of purchasing and selling must not be linked together through stipulation or through *'urf*; It means that all the contracts must be stand-alone and not be conditional on any other contract;
- vi) Clauses 4/7- 4/10 of SS 30 with regard to agency; brokers of both transactions (buying and selling) must not be same; and
- vii) The compliance of clause 3/3 of AAOIFI' Sharī'ah Standard No. 20 that prohibits 'Futures' contracts in commodities.

2. The Commodity must be specifically known, quantified and identified to the buyer.

3. The delivery of the Commodity to the buyer must be certain and it should not be based on chance or contingency; HSD in present case, purchased by investing bank must move from the Container of seller (OMC, or *mustawriq*), and must be in physical or constructive possession of any purchasing bank at time of onward sale.

4. The sale must be instant and absolute and it must not be attributed to a future date or a sale contingent on a future event, as such sale is void.

5. The PMEX must ensure that the re-sale of the Commodity is done without any prior

agreement with the first seller and ultimate buyer.

6. The PMEX must ensure that no netting off of transaction between first seller and the subsequent buyers is carried out.

7. There has to be a minimum time for holding the commodity by a buyer bank before onward selling it to the other bank; preferably be at least one day; the second bank may sell to the PMEX or the third bank after another day.

As per clause 5/1 of AAOIFI's SS 30, *tawarruq* is not a regular mode of investment or financing; it has to be used only when there is danger of liquidity shortage. We expect that the Sharī'ah scholars associated with the Islamic banks and the Sharī'ah boards/committees would be helping the State Bank of Pakistan in making the right decision of allowing *tawarruq* for unavoidable situations of liquidity shortage only, that too with Islamic banking institutions. Such historic decision will go a long way in enhancing credibility of Islamic banking in the country and obliging the IBIs to finance micro, SMEs, agricultural and other commodity producing sectors, enhancing thereby financial and social inclusion.
