

Survey on Sharī'ah non-compliant events in Islamic banks in the practice of *tawarruq* financing in Malaysia

Practice of
tawarruq
financing in
Malaysia

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Abstract

Purpose – *Tawarruq* (Islamic commodity financing) has evolved as the most ubiquitous concept in Malaysia's Islamic banking industry. Nevertheless, the extensive use of *tawarruq* has invoked a number of Sharī'ah (Islamic law) concerns in its practice. This study aims to investigate the Sharī'ah non-compliant (SNC) phenomena in the practice of *tawarruq* financing in Malaysia.

Design/methodology/approach – This study adopts qualitative research methodology, combining both descriptive and content analysis. A self-administered questionnaire was distributed to 16 Malaysian Islamic commercial banks to unveil the Sharī'ah non-compliance issues in the application of *tawarruq* in Islamic banks (IBs) in Malaysia.

Findings – The study found that some practices of *tawarruq* in Malaysia might not comply with the Sharī'ah, mainly due to the improper sequencing of contracts. The study also discovered that IBs adopt different approaches in dealing with SNC events and the income derived therefrom. Finally, the study noted the influence of board of director/management on certain Sharī'ah decisions particularly on the treatment of non-*halāl* (impermissible) income.

Practical implications – The findings of the study serve as a reference to industry players and regulators in formulating a Sharī'ah non-compliance risk management framework for *tawarruq* practices.

Originality/value – The survey on SNC issues in *tawarruq* practice constitutes the first of its kind in the existing literature.

Keywords *Tawarruq*, Islamic banks, SNC events, Malaysia

Paper type Research paper

Introduction

Tawarruq, commonly known as commodity *murābahah*, is a financial instrument that has facilitated the launch of unprecedented and sophisticated Islamic commercial products, ranging from deposit and financing instruments to liquidity management and debt



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restructuring, structuring of sovereign and corporate *ṣukūk* (Islamic investment certificates), risk management and hedging instruments. It has gained full acceptance from industry players because of its built-in features and characteristics that can deliver a similar economic outcome to those of conventional products.

Tawarruq has over the past few years evolved as one of the most widely used concepts in the Malaysian Islamic banking system, responding quickly to the Bank Negara Malaysia's (BNM) circular on *bay' al-'īnah* (sale and buy-back), which substantially tightened the Sharī'ah (Islamic law) requirements of *bay' al-'īnah* products (BNM, 2012). A 2016 BNM Islamic Finance Development Report highlighted that *tawarruq* is the most significant contributor to the financing portfolios of Islamic banking in Malaysia, standing at 22.4%, a drastic increase of more than 100% in just two years (2014-2016). As at the end of 2019, *tawarruq* financing accounts for an even higher share at 46% of Islamic banks' (IBs) total financing in Malaysia (BNM, 2020b).

Nevertheless, the extensive use of *tawarruq* in Islamic financial institutions (IFIs) has stirred a plethora of contentious queries from both Sharī'ah scholars and Muslim economists. The fact that *tawarruq* is designed to merely mirror the characteristics of conventional products challenges a view that IFIs offer a genuine alternative to traditional finance. As a result, the prospects and solutions that IFIs can provide to the economic problems caused by conventional finance are dimming. On the operational side, *tawarruq* is prone to Sharī'ah non-compliance risk events, mainly because it involves a series of sale contracts conducted in succession.

A number of studies have discussed the jurisprudence and the application of *tawarruq* in IFIs (Al-Sāūs, 2004; Al-Shalhoob, 2005; Al-Rashīdī, 2005; Shubayr, 2009; Uthman, 2009; Hamad, 2009; Aleshaikh, 2011; Ahmed and Aleshaikh, 2014; Mahyudin and Seman, 2018; Sharaiyra and Haswa, 2019; Alkhan and Hassan, 2019). Some studies also discussed the Sharī'ah issues in the practice of *tawarruq* (Firoozye, 2009; Noor and Azli, 2009; Dusuki, 2010; Khnifer, 2010; Dusuki *et al.*, 2013; Mohamad, 2014; Mohamad and Ab Rahman, 2014; Ismail, *et al.*, 2016; Rahman, 2016; Ahmad *et al.*, 2020). Nevertheless, most of the previous studies on the subject in question remain embryonic and partial, confined to mostly fundamental theories and application aspects, and focusing on a single product in a particular bank. The present study, therefore, undertakes to fill the gap in the existing literature by empirically investigating the Sharī'ah non-compliant (SNC) issues in the practice of *tawarruq* financing in 16 Islamic commercial banks in Malaysia.

Following this brief introduction, the study is organised as follows: the next part reviews the literature related to the study; the research method and data used in the research are then discussed; it is followed by the survey findings and analysis section; and the last section concludes the study with a set of recommendations.

Literature review

The review of literature in this study is divided into two parts. The first part discusses the concept and application of *tawarruq* in IBs, while the second part highlights the previous studies on SNC issues in the modern practice of *tawarruq*.

Overview of *tawarruq*

The word *tawarruq* is derived from the Arabic root word *wariq*, which means minted silver (Qal'ajī, 1988). The word *tawarruq* and its verb are not directly traceable in *fiqh* (Islamic jurisprudence) terminology except in the Ḥanbalī School of jurisprudence (Al-Rashīdī, 2005). The technical definition of *tawarruq* is understood from its literal meaning, i.e. minted silver, signifying that the intention to enter into the contract is for the attainment of silver or

liquidity, and not for the commodity. Therefore, *tawarruq* is 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 to obtain liquidity (Dusuki *et al.*, 2013).

The early scholars' stand on the Sharī'ah ruling for *tawarruq* is mainly divided into two groups: those who approve it and those who disapprove. The vast majority of jurists (the Ḥanafī, Mālikī, Shāfi'ī and Ḥanbalī schools) held the view that *tawarruq* is permissible. Abū Maṣṣūr al-Azhārī claimed that all jurists are unanimous on the permissibility of *tawarruq*. Nevertheless, a prominent Ḥanbalī jurist, Ibn Taymiyyah, departed from the view of the majority of Ḥanbalīs, declaring that *tawarruq* is impermissible on the basis of blocking the means (*sadd al-dharī'ah*) to commit *ribā* (interest) and the statement of 'Umar ibn 'Abd al-'Azīz that *tawarruq* is the origin of *ribā* (Ibn Taymiyyah, 1987). He also argued that the main motive behind *tawarruq* transactions is to facilitate the attainment of liquidity based on a series of sale contracts where the substance is a mere loan with interest (Al-Uthaymīn, 1422/1428H). His disciple Ibn al-Qayyim al-Jawziyyah concurred, averring that *tawarruq* is a mere legal trick to circumvent the prohibition of *ribā* (Ibn al-Qayyim, 1991).

The modern practice of *tawarruq* has departed from the classical form of *tawarruq* approved by the overwhelming majority of jurists. The practice of *tawarruq* in its traditional way is done by an individual, involving three parties where the transaction among them is concluded naturally with no prior arrangement and promise involved. It reflects a genuine contract that establishes complete physical possession. On the other hand, the modern practice of *tawarruq* is normally arranged by institutions involving four parties whereby the contractual relationships are fully organised (Dusuki *et al.*, 2013). This leads to differing opinions among contemporary Sharī'ah scholars about the permissibility of the modern practice of *tawarruq*.

In 1998, Majma' Rābiṭah al-'Ālam al-Islāmī, in its 15th session in Makkah, resolved that traditional *tawarruq* is permissible based on the view of the majority of jurists and the original ruling on the legitimacy of a sale contract. In 2003, Majma' Rābiṭah, 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, Islamic Fiqh Academy of the Organisation of Islamic Cooperation in its 19th meeting – held in Sharjah, the United Arab Emirates – reiterated the decision made by Majma' Rābiṭah in 1998 and 2003 that the traditional *tawarruq* is permissible while the current practice of *tawarruq* is impermissible.

However, the Shariah Advisory Council of Bank Negara Malaysia (SAC-BNM), in its 51st meeting, 2005, resolved the permissibility of *tawarruq* for deposit and financing products in IBs. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2008) issued Shari'ah Standard no. 30 on *tawarruq* and resolved that organised *tawarruq* is permissible subject to specific rules and parameters. The Sharī'ah Advisory Board of Al-Rajhi Bank has also approved the practice of *tawarruq* as the customer has full liberty to deal with the purchased asset from the platform (Fatwa no. 125, 699 and 713). Kuwait Finance House (KFH, 1986) permitted modern *tawarruq* but suggested to remove the inclusion of the agency element in the *tawarruq* structure to avoid the resemblance to characteristics of *ribā* (Fatwa no. 131, 820 and 851). Dubai Islamic Bank shared the same view with KFH and Al-Rajhi in approving *tawarruq* provided that the arrangement is free from the element of prohibited *'mah* arising from the involvement of the third party in the financial agreement (Resolution no. 63). The National Sharia Board of Indonesia Ulama Council (DSN-MUI) also resolved the permissibility of *tawarruq* with certain conditions (Fatwa no. 82, 2011).

In 2015, BNM issued a policy document on *tawarruq* outlining specific requirements and parameters for the application of *tawarruq* in the Islamic financial context in Malaysia. These are as follows (BNM, 2015):

- Each sale and purchase contract in *tawarruq* shall satisfy all the necessary conditions of a valid sale and purchase contract under Sharī'ah.
- All sale and purchase contracts in *tawarruq* shall be executed by entering into separate and independent sale and purchase contracts.
- Execution of each sale and purchase contract in *tawarruq* must be respectively evidenced by appropriate documentation or record.
- The purchaser in each sale and purchase contract in *tawarruq* shall have the right to take delivery of the asset.
- The sale and purchase contract in *tawarruq* shall not contain any terms and conditions that restrict the purchaser from taking delivery of the asset or create an obligation for the purchaser to sell the underlying asset.
- Payment of any amount of the deferred selling price including profit shall not be paid to the seller before entering into the sale and purchase contract.

Currently, *tawarruq* is being used to structure different Islamic financial instruments and products. In the Islamic banking sector, it is used to structure both deposit and financing products. Under deposit products, *tawarruq* is typically used for term deposits that offer depositors a guarantee of the principal as well as fixed return. A term deposit is a type of deposit which has a specific fixed term, generally short-term, with maturity ranging from a month to a few years (Ismail *et al.*, 2016). A customer opening a term deposit account is bound to maintain his deposit up to maturity. Early notification is required if the customer wishes to withdraw his deposit earlier (Ismail *et al.*, 2016). As for financing products, *tawarruq* is designed to structure various 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 (Dusuki, 2011).

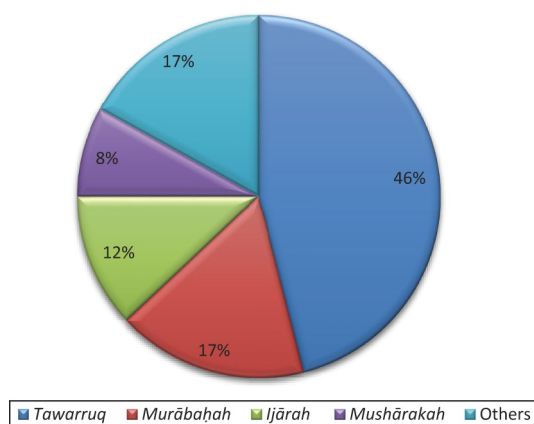
As highlighted above, *tawarruq* comprises the largest segment of the financing portfolio in Malaysia's Islamic banking industry, standing at 46% of total financing (BNM, 2020b). Figure 1 depicts the composition of financing by Sharī'ah contracts.

Previous studies

A number of past studies discussed the modern application of *tawarruq* and its SNC issues. Dusuki (2010) and Dusuki *et al.* (2013) concluded that the practice of organised *tawarruq* is exposed to four major Sharī'ah violations:

- (1) defective underlying commodity;
- (2) lack of possession and delivery;
- (3) pre-arrangement (*tawāṭu'*) via a netting facility arrangement between different storage facilities; and
- (4) inclusion of agency.

Radzi (2012) observed that the possible Sharī'ah violations in the practice of *tawarruq* emerge mainly in the possible redundancy of the underlying commodity used, the interdependency of one contract on another, the suitability of the commodity as the underlying



Source: BNM (2020b)

Figure 1.
Composition of
financing by Sharī'ah
contracts

asset and the ability to deliver the commodity. Meanwhile, [Firoozye \(2009\)](#) found that the designated commodity in the *tawarruq* transaction is merely used as an entry point to the brokers. The legal documentation might restrict the customer from taking delivery of the commodity.

[Mohamad and Ab Rahman \(2014\)](#) investigated the potential SNC incidents in IBs in the practice of *tawarruq* financing in Malaysia with special reference to Maybank Islamic Berhad. The authors concluded that SNC events in *tawarruq* financing may arise at various levels and in different processes, ranging from credit application, documentation, engagement with clients, disbursement, to credit monitoring and credit recovery (rescheduling and restructuring). In particular, [Mohamad \(2014\)](#) presented potential SNC incidents in *tawarruq* financing as follows:

- The *tawarruq* arrangement is used to grant financing facilities to an individual or to non-individual entities whose activities explicitly involve SNC elements, such as *ribā*-based transactions, liquor production, gambling and brothels.
- The bank's staff may engage in SNC activities with the clients in the bank's name.
- The commodity and collateral used for the *tawarruq* arrangement are not in compliance with Sharī'ah.
- The *tawarruq* contract is executed before the bank possesses the commodity.
- The series of sale transactions do not follow the sequential processes appropriately.
- The terms and conditions are not adequately stated, which may lead to misinterpretation during the contract process.
- The appointment of an agent before the commodity possession may lead to issues of fictitious transactions.
- The facility may be disbursed before contract execution.
- The compensation (*ta'wīd*) for late payment does not reflect actual losses.
- Debt rollover is executed in restructuring.

Noor and Azli (2009) studied the Sharī'ah issues in the practice of *tawarruq* in Islamic credit cards in Malaysia. The study found that the *tawarruq*-based credit card is prone to exposure to SNC issues, revolving around the fictitious transaction, prearrangement, the profit charge on the unpaid repayment of the credit limit, the appointment of the bank as an agent and resale of unowned merchandise.

Ismail *et al.* (2016) researched the potential Sharī'ah issues in the inclusion of dual agency (*wakālah*) in *tawarruq* time deposits as practised in Malaysia. The paper discovered that the application of dual agency via *bay' al-wakil li nafsīhi* (sale of the agent to himself) in the *modus operandi* of *tawarruq* deposit does not affect the validity of the *tawarruq* arrangement. However, extreme care should be taken at each step of the transaction to ensure it does not violate the Sharī'ah requirements of *tawarruq*, i.e. proper sequencing.

Mohamad (2014) argued that *tawarruq* financing involves a high degree of SNC incidents as compared to other modes of financing as it involves a series of processes and steps. Therefore, a proper review and due diligence are required before the contract execution so that the arrangement does not reflect a mere exchange of papers.

Rahman (2016) found that the practice of Islamic profit rate swap and options structured based on *tawarruq* triggers the issue of gambling in which one party may gain in the arrangement at the expense of another party.

Ahmad *et al.* (2020) discovered five main Sharī'ah issues in the application of interbank commodity *murābahah* for liquidity management in Malaysia. These include the issue of resemblance to interest, the nature of tradability of commodities, the structure of commodity *murābahah*, the duration of the completed *tawarruq* transaction and the real brokerage cost.

Despite the various past studies on the Sharī'ah issues in the modern practice of *tawarruq*, to the best of the researchers' knowledge, no study has been carried out to empirically survey the Sharī'ah non-compliance incidents in the practice of *tawarruq* financing in Malaysia. The present study, therefore, undertakes to fill the gap in the existing literature by investigating the SNC events in *tawarruq* financing.

Research methodology

The present study adopts a qualitative research methodology, combining both survey and content analysis. Accordingly, a structured questionnaire was prepared to collect the primary data on SNC phenomena in IBs in the practice of *tawarruq* financing in Malaysia. Questionnaire survey refers to "a pre-formulated written set of questions to which respondents record their answers, usually within rather closely defined alternatives" (Sekaran, 2003, p. 142).

Primary data is the most appropriate technique and possible source because of the lack of a database and public documents on the subject matter in the market.

Research population and respondents

The study surveys 16 Islamic commercial banks, comprising 5 stand-alone IBs, and 11 full-fledged Islamic subsidiaries. These represent the population of Islamic commercial banks in Malaysia. Table I depicts the details of the surveyed banks.

The study, however, had to exclude Public Islamic Bank from the survey absence of *tawarruq*-based product in its portfolio when the survey was conducted. The respective bank still heavily relies on other structures, such as *bay' al-īnah*. A total of 15 IBs were then surveyed, comprising 40% stand-alone IBs and 60% Islamic subsidiaries of conventional banks. The survey was conducted during December 2014 – March 2015.

The study gathers information from 15 respondents representing 15 Islamic commercial banks, with one respondent from each bank. The respondents comprise head of Sharī'ah

No.	Name	Ownership	Type of banking structure
1	Affin Islamic Bank Berhad	Local	Islamic subsidiary
2	Al Rajhi Banking and Investment Corporation (Malaysia) Berhad	Foreign	Stand-alone Islamic bank
3	Alliance Islamic Bank Berhad	Local	Islamic subsidiary
4	AmIslamic Bank Berhad	Local	Islamic subsidiary
5	Asian Finance Bank Berhad	Foreign	Stand-alone Islamic bank
6	Bank Islam Malaysia Berhad	Local	Stand-alone Islamic bank
7	Bank Muamalat Malaysia Berhad	Local	Stand-alone Islamic bank
8	CIMB Islamic Bank Berhad	Local	Islamic subsidiary
9	HSBC Amanah Malaysia Berhad	Foreign	Islamic subsidiary
10	Hong Leong Islamic Bank Berhad	Local	Islamic subsidiary
11	Kuwait Finance House (Malaysia) Berhad	Foreign	Stand-alone Islamic bank
12	Maybank Islamic Bank Berhad	Local	Islamic subsidiary
13	OCBC Al-Amin Bank Berhad	Foreign	Islamic subsidiary
14	Public Islamic Bank Berhad	Local	Islamic subsidiary
15	RHB Islamic Bank Berhad	Local	Islamic subsidiary
16	Standard Chartered Saadiq Berhad	Foreign	Islamic subsidiary

Source: BNM (2020a)

Table I.
IBs and their types

review (constituting 40% of total respondents), head of Sharī'ah department (20%) and Sharī'ah advisory (20%). The remaining respondents are from the Sharī'ah risk management function (13%) and Sharī'ah research function (7%). The selection of respondents was on the basis that officers in the Sharī'ah departments, to the best of the authors' knowledge, are those who deal directly with the Sharī'ah non-compliance issues. Thus, we consider that they are the most suitable respondents to represent the bank.

In terms of working experience, the majority of respondents (60%) have been in the banking industry from one to five years while 33% of them have served the sector between six and nine years. The rest (7%) have been in the industry for more than 10 years. The experience of respondents is deemed satisfactory to understand the subject matter and thus provide the authors with reliable data and information.

As for the educational background of the respondents, 40% hold master's and PhD degrees, while 27% of respondents are equipped with Islamic finance-related professional qualifications, such as Chartered Islamic Financial Professional of International Centre for Education in Islamic Finance. The remaining 33% hold bachelor's degrees. Most of the respondents also possess Sharī'ah background. Some of them graduated from Al-Azhar University of Egypt and Al al-Bayt University of Jordan. The respondents' educational background substantiates that they are well-educated and well-versed in the subject matter, thus being able to provide the authors with reliable and consistent responses.

Data collection

This study adopts the self-administered questionnaire as the method of data collection. Initially, the questionnaire was distributed to 16 Islamic commercial banks. However, the authors managed to collect 15 completed questionnaires, with the exclusion of Public Islamic Bank.

A self-administered questionnaire has some advantages because the researcher has an opportunity to clarify any doubt that the respondent may have or any question related to the survey on the spot. It also enables the researcher to motivate respondents to give their

honest responses (Sekaran, 2003). Also, it allows the researcher to gather the completed responses within a short period (Sekaran, 2003).

Questionnaire content

The structured questionnaire used in this study included some close-ended questions to minimise the element of bias which may arise from the survey. The close-ended questions also allow the researcher to apply a descriptive statistical measure in explaining the findings from the study. They further ensure natural responses as well as consistency and uniformity of the responses (Hale et al., 1994).

The draft of the questionnaire was verified by some industry practitioners including head of the Shari’ah Department of Bank Muamalat, an internal auditor of CIMB Bank, a risk management officer of al-Rajhi Bank, the Shari’ah advisory officer of Maybank Islamic Bank and head of the Shari’ah Department of Affin Islamic Bank Berhad. In addition, the instruments have been checked by some International Shari’ah Research Academy for Islamic Finance (ISRA) researchers and representatives from the Shari’ah risk section of BNM to ensure practicality, relevance and reliability of the variables. Some adjustments to the variables were made based on the feedback.

The questionnaire is separated into three sections consisting of 18 primary questions. Section 1 aims to explore the extent of the use of *tawarruq* in IBs in Malaysia and to identify various forms of potential SNC events in IBs with particular reference to *tawarruq* financing. This section comprises eight closed-ended questions which include specific questions on the frequency level of SNC events in *tawarruq* financing. Both descriptive statistical analysis and content analysis were used to interpret the findings. The authors also measure the frequency level of SNC events in *tawarruq* financing using a simple weighting method: 1 is given the highest weight, and it signifies the most frequent occurrence, while 5 is assigned the lowest weight and it denotes the least recurring event. This is taking into consideration that some respondents gave the same response/degree for different variables/events. Table II draws the summary of weightage for different responses.

Afterwards, the weighting value for each SNC event is calculated based on the following formula:

$$Rs = \sum_{x=1}^n WxSx \tag{1}$$

where *Wx* is the weighting value for each response and *Sx* reflects the respondents’ feedback for each event.

Table II.
Weights given to the
responses

Response	Weightage (%)
1	33
2	27
3	20
4	13
5	7
	100

Source: Authors’ own

Section 2 of the questionnaire explores the approach adopted by IBs in dealing with various SNC events in *tawarruq* financing, consisting of two questions. A descriptive analysis is used to interpret the responses. Section 3 identifies the treatment of income resulting from SNC events in *tawarruq* financing. This section comprises five questions. Descriptive and evaluative analyses are used to analyse this section.

Findings and analysis

This part is the core of the paper, being devoted to presenting the survey findings on SNC events in IBs in the practice of *tawarruq* financing in Malaysia.

Application of tawarruq in Islamic banks in Malaysia

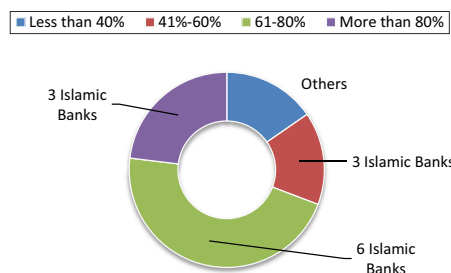
Tawarruq has gained full acceptance from the industry players because of its built-in features and characteristics that can deliver a similar economic outcome to conventional products. It has since the past few years evolved as one of the most widely used concepts in Islamic banking products in Malaysia. This is particularly after the issuance of BNM (2012) circular on *bay' al-'inah* (sale and buy-back), which substantially tightens the Shari'ah requirements of *bay' al-'inah*-based products. The circular has indirectly pushed IBs in Malaysia to explore alternatives to *bay' al-'inah* actively. Some Malaysian IBs have even phased out *bay' al-'inah*-based products from their portfolios (Ali and Muhammad, 2014).

The survey found that all of the 15 IBs surveyed have applied *tawarruq* for different types of deposit and financing products. A total of 11 out of the 15 IBs (73%) have also used the *tawarruq* concept for treasury products.

The survey also revealed that all the 15 Islamic commercial banks in Malaysia use the *tawarruq* concept for term deposit products. However, some IBs have also offered saving and current accounts based on *tawarruq*. These include, among others, Hong Leong Islamic Bank, CIMB Islamic Bank, Ambank Islamic, RHB Bank and Kuwait Finance House.

In terms of financing products, most of the IBs under the survey (80%) apply *tawarruq* for personal financing and term financing products while 60% also use *tawarruq* for home/property financing. Some banks further use *tawarruq* for vehicle financing, Islamic credit card facility and business financing.

Figure 2 explains that the *tawarruq* concept has dominated the financing portfolio of the 15 IBs in Malaysia, representing more than 80% of the total financing portfolio in 3 IBs. The concept also contributes between 61% and 80% to the entire financing portfolio in six IBs and between 41% and 60% in three IBs. The remaining three IBs apply *tawarruq* in a relatively small portion, notably, less than 40% of their total financing portfolio.



Source: Authors' own

Figure 2.
Composition of
tawarruq financing

The survey also queried about the subscription of the IBs to the commodity *murābahah* platform, Bursa Suq al-Sila' (BSAS). It revealed that all the 15 IBs have subscribed to BSAS to facilitate *tawarruq* transactions. In addition to BSAS, some IBs subscribe to the Sedania as-SIDQtm, Eiger Trading via the London Metal Exchange (LME) and AbleAce [1]. Five banks under the survey are registered members of LME while three banks also subscribe to AbleAce. Multiple subscriptions provide IBs with a wide array of choices and options in meeting the need for the high volume of the commodity. Based on the authors' interview with the Head of Sharī'ah, CIMB Islamic Bank, subscription to two platforms or more will offer flexibility to the bank in dealing with multiple and large quantities of transactions.

Sharī'ah non-compliant events in tawarruq financing

IBs in Malaysia apply different sets of Sharī'ah contracts for their financing products, ranging from sale-based to lease-based to equity-based contracts. Currently, sale-based contracts, such as *bay' bi thaman ājil* (BBA) and *tawarruq*, have dominated the financing products of IBs in Malaysia. It is perhaps for this reason that the degree of SNC events in sale-based contracts is relatively higher than that of other modes of financing. The survey discovered that 80% of SNC events in financing products originated from sale-based contracts. Only 13% of SNC events were found in equity-based contracts, such as *mushārakah*, while lease-based contracts accounted for 7% of SNC events (Figure 3).

In particular, the survey revealed that *tawarruq* contributes to a relatively higher portion of SNC events in IBs in Malaysia, making up 40% of SNC events in sale-based financing products thus representing the second most frequent SNC event after *bay' al-'inah*/BBA (46%) (Figure 4). *Murābahah* to the purchase orderer and *Istisnā'* (0%) and *Istisnā'* (0%) (7%) contributed the remaining SNC events in sale-based financing.

The main reason why *tawarruq* recorded the highest SNC events is because it involves a series of sale contracts. Failure to observe the Sharī'ah requirements of a valid sale contract in each leg may trigger a Sharī'ah non-compliance issue. This finding is consistent with the finding of Mohamad (2014) that *tawarruq* assumes a relatively high degree of SNC risk. Another reason may be that *tawarruq* contributes the largest portfolio in the financing composition of IBs in Malaysia.

The survey also identified potential SNC events in *tawarruq* financing in IBs in Malaysia as follows:

- improper sequence of sale contracts;
- improper facility disbursement;
- improper disclosure of price;

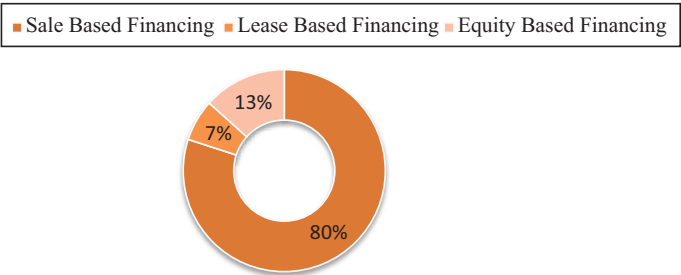


Figure 3.
SNC events in
financing

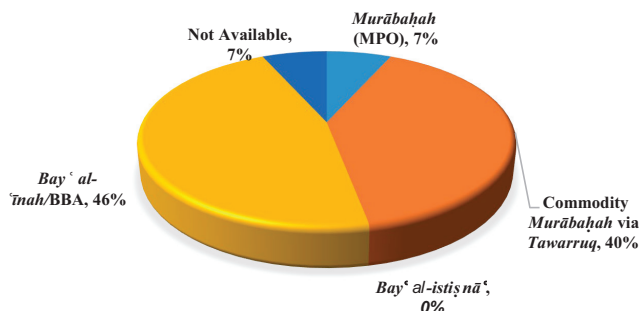
Source: Authors' own

- the absence of *wakālah* agreement;
- inappropriate imposition of *ta'wīd* (compensation);
- delivery restriction;
- the absence of new contract execution in facility renewal;
- improper disclosure of underlying contract;
- lack of proper asset specifications;
- SNC purpose;
- SNC commodity; and
- SNC collateral.

Based on the potential SNC events, the respondents were asked to rank the frequency level of SNC events in *tawarruq* financing based on their possible occurrence. The survey revealed that improper sequence of the sale contract – i.e. the asset is sold to the customer before the bank purchases it from a broker – represents the most frequent SNC event in *tawarruq* financing with a weight of 3.27. Practically, the whole intent of the customer entering into a *tawarruq* transaction is only to attain liquidity rather than to acquire the commodity. Therefore, some bank officers are not concerned with the contract's sequence as well as the ownership transfer of the commodity. A similar reason could also become the basis for the second most frequent SNC event: advance disbursement of the facility before complete execution of the *tawarruq* transaction (associated weight is 2.47).

From the Sharī'ah perspective, failure to observe proper sequence, i.e. sale of an asset by the bank to the customer before it actually purchases it from the trader, would lead to nullification of the contract. This is because the bank sells the asset which does not belong to it. The Shāfi'ī, Ḥanbalī and Zāhirī schools are of the view that ownership of the asset is a requirement for the conclusion of a contract (*in'iqād al-'aqd*) (Zuhaily, 2010). A contract executed by an unauthorised agent (*fuḍūlī*) is therefore null and void because of the absence of ownership (*milkiyyah*) and legal authority (*wilāyah*) (Zuhaily, 2010). The policy document on *tawarruq* stipulates the following:

The offer and acceptance must be executed in the following sequence: (a) the seller sells an asset to the purchaser by entering into a sale and purchase contract, and (b) subsequently, the purchaser from the first sale and purchase contract may enter into another sale and purchase contract to sell the same asset to a third party (BNM, 2015, p. 7).



Source: Authors' own

Figure 4.
SNC events in sale-
based financing

Improper disclosure of price constitutes the third most frequent SNC issue in *tawarruq* financing at 1.87 weightage. In Islamic law of contract, insufficient information (*jahalah*) may affect the validity of contract as it triggers potential dispute and prevents possession and delivery of the transacted commodity (Mun'im, 2007). According to the majority of jurists, insufficient information in the contract will make the contract null and void; thus, it cannot be rectified (Ibn 'Abidin, 1992). On the contrary, the Ḥanafī School regarded the contract containing insufficient information to be voidable (*fāsīd*), that is, rectifiable (Zuhaily, 2004). Accordingly, based on the Ḥanafī approach, if the price is mistakenly disclosed to the customer, the bank may notify the customer on the correction. Once the correction is made, the contract becomes valid and effective [2]. The policy document on *tawarruq* also stipulates that the price in each sale and purchase contract in *tawarruq* should be determined and mutually agreed by the contracting parties at the time of the execution of the contract (BNM, 2015).

Absence of a *wakālah* agreement represents the fourth most frequent SNC event in *tawarruq* financing at 1.57 weightage. The inclusion of the agency element constitutes an inseparable part of the modern practice of *tawarruq*. This is particularly true as the existing *tawarruq* platforms are designed in such a way that only a registered member can deal directly with the platform. From the Shari'ah perspective, the absence of a *wakālah* agreement would trigger the issue of unauthorised disposal (*taṣarruf fuḍūlī*) in which the bank acts on behalf of the customer to sell the commodity to the platform without authorisation. In Islamic jurisprudence, there are two diametrically opposing views pertaining to the legitimacy of *taṣarruf fuḍūlī*. The Ḥanafīs and Mālikīs are of the view that the status of contract entered into by a *fuḍūlī* is suspended (*mawqūf*) contingent upon the consent of the rightful owner (Al-Samarqandī, 1994). The Shāfi'īs and Ḥanbalīs, on the other hand, consider *taṣarruf fuḍūlī* null and void (Al-Dastūqī, 1980). AAOIFI (2010) in its Shari'ah Standard no. 23 resolves that *taṣarruf fuḍūlī* is a suspended subject to ratification by the rightful owner.

The fifth SNC issue based on the degree of its frequency is the excess of *ta'wīḍ* over the actual cost (with a weight of 1.33). The SAC-BNM (2010), in its 101th meeting, resolved that *ta'wīḍ* can be charged on late payment of financial obligations resulting from exchange contracts and *qarḍ* (loan). IFIs may recognise *ta'wīḍ* as income on the basis that it is charged as compensation for actual loss suffered by the institution. In 2012, BNM issued the "Guidelines on Late Payment Charges for Islamic Banking Institutions" to facilitate the industry in calculating the amount of *ta'wīḍ*. The guideline states that "The actual loss to be compensated from any default payment from the date of payment until the maturity date shall not be more than 1% per annum" (BNM, 2012, p. 4). Therefore, any excess over the actual cost charged to customers is illegitimate and requires purification.

The delivery restriction contributes the sixth most potential SNC issue in *tawarruq* financing (with a weight of 1.27). A Shari'ah contract is supposed to be free from any invalid condition which may impede the validity and effectiveness of a contract. Nevertheless, there is a possible instance where the *tawarruq* legal documentation might be embedded with a clause that the customer as a buyer at a stage of *murābahah* is restricted from taking delivery of the commodity. In Islamic law of contract, a sale contract is legislated mainly to affect the transfer of ownership of an asset from the seller to the buyer (Al-Nawawī, 1990). According to the Ḥanafī School, it is necessary for the seller to give the buyer full access to the object of sale without any hindrance so that the buyer can have full possession of the object (*takhliyah wa tamkīn*) (Al-Kāsānī, 1986). The policy document on *tawarruq* states that "The purchaser in each sale and purchase contract in a *tawarruq* shall have the right to take delivery of the asset" (BNM, 2015, p. 11).

Absence of a new contract in the renewal of the *tawarruq* facility constitutes the seventh most frequent SNC event in *tawarruq* financing. In Islam, if the debtor is in difficulty, the creditor has to grant him a reasonable period of extension. The common mechanism used by IBs for this purpose is rescheduling or restructuring. Rescheduling is an adjustment of financing payment term without significantly changing the principal terms and conditions. This is done by simply lengthening the financing tenure and revision of the monthly instalment (Mohamad, 2014). Restructuring is the modification of the principal terms and conditions of contract, which includes changes in types or structures or change in its terms (Mohamad, 2014). On this basis, restructuring normally involves a new facility by terminating the earlier facility to justify the new price and additional cost. The increase in price for restructuring without a new contract execution to justify the profit triggers the issue of *ribā al-jāhiliyyah*. *Ribā al-jāhiliyyah* refers to an increase in the debt principal because of late payment or an increase imposed on the debtor as a result of extension of credit. In view of this, the SAC-BNM on 26 June 2016 resolved the permissibility of restructuring provided that any change in price to the first facility is reflected in a new contract to avoid the issue of *ribā* and uncertainty.

The subsequent SNC issue based on its frequency is the presence of SNC purpose. As a business entity established within the ambit of Sharī'ah, IBs have to ensure that their products and services are for Sharī'ah-compliant purposes. Nevertheless, the survey by the authors revealed that there are instances where customers use the financing facility for SNC purposes. This is despite the fact that the prevailing market practice puts a standard clause in the legal document that requires customers to use the financing facility for Sharī'ah-compliant purposes only. The SAC-BNM in its 58th meeting dated 27 April 2006 resolved that IFIs are prohibited from granting financing to companies, bodies or individuals whose activities explicitly involve non-compliant elements such as gambling, liquor industry and brothels (BNM, 2010).

SNC commodity constitutes the second-to-last issue based on the level of its frequency. It is worth noting that this issue is unlikely to arise in the commodity *murābahah* platform available in Malaysia. It might be possible if the bank subscribes to international commodity *murābahah* platforms. Al-Qaradaghi (2009) revealed that he came across one *tawarruq* transaction using the international commodity market in which the underlying commodity was actually defective aluminium from Russia that had been in storage for more than 10 years. The commodity is used because it cannot be sold in the market. The policy document on *tawarruq* states that the asset to be traded in the *tawarruq* arrangement has to be an asset recognised by the Sharī'ah as valuable, identifiable and deliverable (BNM, 2015).

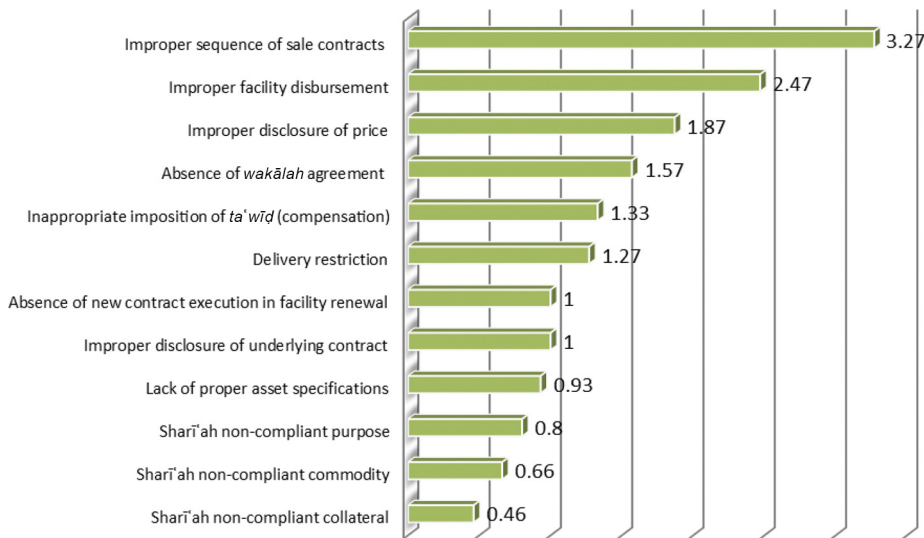
The last potential SNC issue in the *tawarruq* financing is the use of SNC collateral. From the Sharī'ah perspective, the requirements of collateral share the same requirements as subject matter in a sale contract: the subject matter should be in existence, be valuable and be recognised by the Sharī'ah. The policy document on *tawarruq* states that the collateral (*marhūn*) to secure debt in a sale and purchase contract in the *tawarruq* arrangement shall be a Sharī'ah-compliant asset (BNM, 2015).

Figure 5 draws a list of potential SNC events in *tawarruq* financing based on their frequency.

Treatment of Sharī'ah non-compliant events in tawarruq financing

On 15 March 2013, BNM issued a circular on SNC reporting which detailed out the regulatory requirements for IBs to submit a report to BNM on any actual and potential SNC events, as well as their rectification plan approved by their respective board. The new Sharī'ah Governance Policy Document issued on 20 September 2019 also mandates senior

Figure 5.
Frequency of SNC
events in *tawarruq*
financing



Source: Authors' own

management of IFIs to report to the board and Shari'ah committee (SC) on any potential and actual SNC event in a timely manner.

In particular, the BNM circular on SNC reporting requires banks to submit the report on SNC events to BNM within 14 days from the realisation of the fact and its rectification plan within 30 days (BNM, 2013).

In this regard, the survey discovered that any SNC finding is tabled and deliberated during the SC meeting. The respective SC will confirm whether the issue is an actual SNC or not, and if it is, present its rectification plan. If the SC decision on the finding is pending, it will become a potential SNC event for reporting to BNM within 30 days. The bank will then notify BNM of the decision made by the SC on any Shari'ah non-compliance issue based on the timeline given. Nonetheless, the survey revealed that there are instances where the respective Shari'ah department rectifies the finding on the SNC matter immediately before the SC's deliberation.

Despite the BNM policy that a report is to be submitted to BNM on any SNC finding, potential or actual, the fact remains that not all IBs are adhering to such requirement. Based on supplementary interviews with some respondents during the survey, some of them are reluctant to do so as it may tarnish the reputation and image of IBs. They also raised concerns about the administrative action the BNM may take for the reported events. Under [Islamic Financial Services Act \(IFSA\) \(2013\)](#), BNM may enforce financial liability and/or criminal proceeding towards IFIs for any breach or failure to comply with the Shari'ah principles. Section 28(1) of [IFSA \(2013, p. 60\)](#) vividly states:

Any person who contravenes subsection (1) or (3) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.

The survey also found that IBs adopt different approaches and treatments in dealing with SNC events in *tawarruq* financing. Some incidents involve re-execution of the contract or a rectification process. Some even require IBs to terminate the facility with an immediate effect. Other SNC incidents oblige the bank to notify the customer on the corrective measure or to change the underlying contract. There are also instances where the respective SCs do not deem specific events as a SNC issue. In fact, the same incident may have different treatments and approaches in different banks as it all depends on the SC's decision. This is true as the regulator does not provide the industry with a dedicated guideline and framework to deal with SNC events, particularly for *tawarruq* transactions. There are also different treatments in regard to the income resulting from SNC events in *tawarruq* financing. Some incidents require the bank to refund the income to customers or to channel it to charity. There are also incidents which permit the bank to recognise the income as profit after necessary rectification or re-execution.

The survey further revealed that the approach used in dealing with SNC issues and the income derived therefrom follows the direction of the respective SCs. In particular, when the study asked the respondents on the treatment of non-*halāl* (non-permissible) income, in particular, channelling the income to charity, it was found that most of the IBs (40%) in the survey rely heavily upon the direction of their respective SCs. Some IBs (23%) consider the difficulty in refunding the tainted income to customers as a basis of the treatment while others (10%) believe that reputational risk is the key consideration in dealing with non-*halāl* income. Among the interesting findings in the survey was the influence of board of directors/management as the judgement for the treatment of non-*halāl* income (7%).

The survey found that most of the non-*halāl* income is channelled to the poor, underserved, *da'wah* (Islamic propagation) and school-related activities. Some banks also allocate non-*halāl* income for charitable food, scholarships and building of mosques. A few banks use the non-*halāl* income for the bank staff's welfare.

Conclusion

The study presented the survey findings on the application of *tawarruq* financing in IBs in Malaysia and its common forms of potential SNC incidents which may emerge in the use of the *tawarruq* concept in financing products. It is not, however, an exhaustive list. Other potential events may not be captured in the survey.

The survey found that *tawarruq* has become a new phenomenon in the development of the Islamic banking industry in Malaysia as the industry has recently started to actively use the *tawarruq* concept as an alternative to products based on *bay' al-'inah*. This is because of strict regulatory and Shari'ah requirements for the application of *bay' al-'inah* in IBs in Malaysia.

The study revealed that most of the SNC events in financing products originated from sale-based contracts. In particular, *tawarruq* financing represented the second largest SNC event after *bay' al-inah*/BBA. The survey also suggested that improper sequence is the most frequent SNC event in *tawarruq* financing. This finding calls for IBs to institute more prudent and clear standard operational procedures for *tawarruq*-based products.

The study further discovered that IBs adopt different approaches in dealing with SNC events and the income derived therefrom. Most IBs do not have a clear guideline and specific methodology to deal with SNC events. Any SNC finding relies mainly on the direction and decision of their respective SCs. Finally, the survey noted the influence of board of directors/

management on certain Shari'ah decisions, particularly about the treatment of non-*halal* income.

The research suggests the active role of the regulator to mitigate the issue of SNC events in the *tawarruq* practice. Specifically, the study proposes that BNM and SCs establish controls and parameters in the application of the *tawarruq* concept in IBs in Malaysia. The restriction on the use of the *tawarruq* concept is important as organised *tawarruq* is not internationally acceptable. The overuse of *tawarruq* may impede the internationalisation of Islamic finance as aspired by Malaysia.

The present study has attempted to provide an empirical finding on the application of *tawarruq* in Malaysia with respect to potential SNC issues. Nevertheless, the study acknowledges the following limitations that provide more room for future research:

- The study focuses on SNC phenomena in *tawarruq* financing. Further research may explore SNC events in other types of contracts or products.
- The study investigates SNC issues in the Islamic banking sector in Malaysia. Future research may explore the SNC phenomena in different sectors and other jurisdictions.
- Further research may examine the implication of failure to comply with the BNM Shari'ah Standards on the Shari'ah-compliant status of the transaction.
- The study admits that the list of identified events is not exhaustive. Other potential incidents may not be captured in the survey findings. Some of them might not be relevant to the current development. Future research may use different research methodology and approaches to arrive at more objective and comprehensive findings.

Notes

1. Sedania as-SIDQtm is a Shari'ah-compliant product offering automated Islamic banking *tawarruq* platform using telco-airtimes. LME is the world-centre for industrial metals trading, serving as the global reference price. This platform is used to facilitate derivatives, such as futures and options, and *tawarruq* transactions using metal/aluminum. AbleAce is a *tawarruq* platform and the first Malaysian local company using palm oil and its related commodities as the underlying *tawarruq* assets.
2. This ruling is also applicable to another two identified issues, namely, improper disclosure of underlying contract and insufficient information on asset specification.

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