ISLAMIC FINANCE PROJECT
HARVARD LAW SCHOOL
ISLAMIC LEGAL STUDIES PROGRAM

HARVARD-LSE WORKSHOP
LONDON SCHOOL OF ECONOMICS, LONDON, UK - FEBRUARY 1, 2007

TAWARRUQ: A METHODOLOGICAL ISSUE IN SHARIA-COMPLIANT FINANCE: A SHORT REPORT

Purpose of the Workshop

Tawarruq is a debt instrument that many *shari'a* scholars have approved and that the Islamic finance industry has since used extensively. Yet, as its popularity has increased, so has criticism of it. In response to these developments, the Islamic Finance Project of the Harvard Law School's Islamic Legal Studies Program organized a one-day workshop on *tawarruq*. The Islamic Finance Project is proud that the London School of Economics (LSE) agreed to act as joint sponsor for this workshop on *tawarruq*, and to host the workshop at the LSE campus in London. The workshop thus has opened up the prospect of a formidable partnership between the two academic institutions in the area of Islamic finance and economics. While seeking to advance understanding of *tawarruq*, the workshop was framed also to carry on methodological debates opened up at an earlier workshop, "Select Ethical and Methodological Issues in S*hari'a*-Compliant Finance," held April 21, 2006 at Harvard.

Due to the success of the workshop, as attested unanimously by its attendees, both institutions look forward to holding a further event on a significant Islamic finance topic within the next year.

Overview

Although various definitions of *tawarruq* have been offered in Islamic finance literature, it is generally used to describe a transaction in which a financial institution sells a commodity to a customer on deferred payment at cost plus profit, and the customer then sells the commodity on a spot basis to a third party for cash. Critics have questioned whether use of this instrument is even permissible under the *shari'a*. Many cite the economic similarities of the transaction to other prohibited transactions and the potentially deleterious effects of *tawarruq* on society. Nevertheless, its proponents adamantly view the instrument as not only permissible but also helping to advance the growth of Islamic finance.

The goals of this workshop were to: (1) identify the issues and areas of concern about *tawarruq* in order to gain a better understanding of how it is currently used and applied in the market from the view of practitioners, economists, *shari'a* scholars, consumers, and society; (2) critically evaluate *tawarruq*'s performance; (3) consider whether *tawarruq* should be restricted or not; (4) consider whether there were alternatives that could fulfill the same purpose; (5) further the conversation among the various parties present by enhancing mutual understanding and furthering links between their methodologies and approaches; and (6) make specific proposals of channels and venues through which to continue this conversation, including workshops on the development of other products.

Guiding Questions

After a morning session highlighting participants' views, the following sets of questions were gatered from the various points raised and used as the basis for an informed and guided discussion. However, due to time constraints not all issues were discussed.

1. The role of debt in Islamic finance
    a. Criticism of debt: Is debt not linked to the "real" goods/services economy?
    b. Does debt cause instability?

2. What kind of debt is permissible
    a. *Tawarruq* within consumer debt versus within commercial debt.
    b. Does it make any difference if one mode is used as against the other from an economics perspective?
3. What should the role of a bank be in *tawarruq*
    a. Should a bank determine whether the need is genuine or is it just to provide product services?
    b. If not the bank, then who should decide?
    c. What should be the parameters to make that decision?
4. *Tawarruq*: its application as an Islamic finance product
    a. Is there a *tawarruq* on which all agree as to its permissibility and advisability?
    b. Is there a need for it? (i) Does it help convert non-*shari'a* practices to Islamic finance? (ii) Due to con straints on some Islamic transactions, does *tawarruq* help provide for these needs as an alternative? (iii) Does it help meet the immediate needs for hedging and liquidity relief?
    c. What conditions, if any, should be placed (i) as to contractual terms, (ii) as to its use/purpose, (iii) as to other limits?
    d. What are macro- and microeconomic consequences of it? Should these dictate that restrictions be placed on it? Or does such logic stifle innovation?
    e. Can *tawarruq* evolve to become more widely accepted?
    f. What alternatives are conceivable for *tawarruq* where it meets needs?
5. How would participants define intention, form, and substance in Islamic finance
    a. *Fiqh*'s concerns with both form and substance: which one(s) apply with *tawarruq*?
    b. *Hīlah/makhraj*: (i) How is *hīlah* defined? (ii) How is *makhraj* defined? (iii) Must either be avoided and to what degree and how? (iv) Is *tawarruq* either of these two?
6. Economics and *fiqh*
    a. What is the status of economic theories in Islamic finance?
    b. Relation of macro- and microeconomics in Islamic product development?
    c. Relation between contract, institution, government, economy and society?
    d. Turning to economic models, do economists in Islamic finance have a model that they could agree on?
    e. Would the proposed model be agreed to by other economists?
7. Participation of non-*ulama* voices
    a. Lay persons: in the market, education required versus government role
    b. *Siyasa shar`iyya*
    c. Specialists, in particular, economists
8. Role of *shari'a* committees
    a. Should *shari'a* committees analyze issues from both a micro and a macro perspective with the aid of rel evant experts?
    b. Is Islamic finance to support economic goals or rather something else?
    c. What role should *shari'a* scholars play in determining policy as well as law?

<u>Summary</u>

The Islamic Finance Project (IFP) jointly with the London School of Economics hosted an all-day, closed-door workshop, "Tawarruq: A Methodological Issue in Sharī`a Compliant Finance," in the beautiful Box Room on the LSE London campus. Many leading economists, practitioners, and *shari'a* experts in the field attended and actively participated in the vibrant workshop discussion. The event began with a warm and inspiring opening by the LSE Deputy Director, Professor Sarah Worthington on behalf of the LSE and by Professor Frank Vogel on behalf of the Harvard Law School. They were immediately followed by presentations by *shari'a* scholar Dr. Mohammed Elgari and Islamic economist Professor Nejatullah Siddiqi, based on their written position papers, with additional co ments from others in their respective fields. A scholarly discussion of many of the issues raised then followed.

Summary of Dr. Mohammed Elgari's position paper
Contrary to twentieth century Islamic economic thought, Dr. Elgari believes that it is possible to fit an Islamic banking institution into an existing modern economic system, and this includes *tawarruq*. *Tawarruq*, he argued, does not violate the established principles of the *shari'a*; rather, *tawarruq* is permissible. A number of historical precedents were cited as evidence. Attempts to compare Islamic financial institutions with their conventional counterparts in terms of efficiency, he warned, is counterproductive since the majority of Muslim consumers will still avoid the conventional forms due to reasons of faith. As the intention of those who use *tawarruq* is to refrain from *ribā* transactions, not to engage in them, *shari'a* scholars largely agree that *tawarruq* cannot be considered a *hīlah*, or an artifice. A *hīlah* is present only if the intention of the parties involved is to secure the prohibited transaction by using a permissible arrangement as a conduit. Given the abundance and choice of interest-bearing transactions currently

available, there is no need for anyone to resort to deceit in order to engage in a lender-borrower transaction. Given the current advances in Islamic finance, he argued that *tawarruq* is actually a positive solution for a banking system that has adopted the *shari'a* as the guiding principle for its contracts and procedures. Though he did agree that in itself it is not ideal, the proliferation of *tawarruq* transactions in an economy will probably have a positive overall macroeconomic outcome.

Summary of Professor M. Nejatullah Siddiqi's position paper

Adopting a macroeconomic point of view, Professor Siddiqi argued that the impact of *tawarruq*, a debt product, on the economy was far more harmful than beneficial. For that reason, he contends *tawarruq* should unequivocally be banned. *Tawarruq* creates new debts and moreover debts far larger than the cash received. Tawarruq moves the economy from the asset market toward the money (debt) market, where the underlying signaling and equilibrating mechanisms are no longer linked to the real market. Debt creation does not increase the net wealth of a society because every addition to social wealth is cancelled by a similar amount of wealth owed in the future. Therefore, the compulsion for economic growth is created by the need to repay these larger amounts of debt owed. Debt proliferation also leads to gambling-like speculation and greater instability in the economy. Furthermore, debt leads to inequality in the distribution of income and wealth and inefficiencies in the allocation of resources, raises anxiety levels, and causes destruction of the environment. Though he acknowledged there are certain short-term benefits to it for the individual, the harmful effects on the society overall are far greater.

Role of debt in Islamic finance

The discussion session at first developed from Professor Siddiqi's points mentioned above. It revolved around how the institutionalization of modern-day debt and its application relates to the historical precedents commonly cited by scholars. Economists contend that due to financial and social advances, the two are diametrically different. Hence, any link between the two is tenuous. *Shari'a* scholars argued that the two were compatible and the precedents still relevant. Further questions evolved as to whether the acceptance and usage of debt-based products like *tawarruq* are changing the paradigm of Islamic finance from a development form of banking to a more debt-based banking system, mimicking that of conventional financial products. It was further feared that Islamic ideals of stability, efficiency, and economic equality would be jeopardized by the purported negative effects of debt products like *tawarruq*. However, arguments linking debt markets to inherent instability need further in-depth empirical evidence. Furthermore, participants demonstrated little unanimity as to what alternative products or models would successfully fill that debt gap.

The issue of form versus substance in relation to *tawarruq*

As with the previous workshop, the topic of form versus substance played a major role, this time in the debate pertaining to *tawarruq*, its application and its alternatives. In the context of this discussion, some *shari'a* scholars raised the Islamic Finance Project point that though *tawarruq* was mentioned only in the Hanbali school of thought, its substance under other names is found in all schools of thought. Moreover, some pointed out that practice of it could be found throughout history, including within Arabia (such as in Najd). Discussion on intention and the *maslaha* behind the prohibition of interest, in the context of *tawarruq*, were also critically addressed. Questions further developed as to who should be the ones to judge as to the *masalih* and the *maqasid* in the matter of *tawarruq*. Nevertheless, it was put forth that there is a need to minimize the intellectual tension between formalism and essentialism, as between the approaches that *shari'a* scholars and economists take to the subject of Islamic finance.

Advisability of *tawarruq*

Though many agreed that *tawarruq*'s permissibility from a *shari'a* point of view was not in dispute, most agreed that its advisability as to its scope of usage and its application should be revisited. Many argued that its usage was linked, in the case of individuals, to the immediate dire need for cash where *shari'a*-compliant alternatives were lacking. Some viewed *tawarruq* as allowed only in cases of dire necessity, whereas others viewed it less restrictively. The discussion led the participants to ask whether a distinction should be made between *tawarruq* for commercial consumption versus individual consumption. With the notable exceptions of a few economists who still felt *tawarruq* should not be permitted under any circumstances, most felt that *tawarruq* practiced at the individual level is acceptable. Most also agreed that it was acceptable if it would help convert conventional banks into *shari'a*-compliant ones.

Restrictions to *tawarruq*

Many felt that *tawarruq* practiced at the institutional systemic level is more of a problem. Some felt that placing restrictive conditions on its use, like that linking it to "real" goods and services transactions, are necessary. Some *shari'a* scholars argued against having different sets of rules according to levels of wealth. Other *shari'a* scholars feared that placing restrictions or prohibitions on its use would inadvertently prohibit something that is permitted and that leads to something "good," hence violating a major principle of Islam. Many felt strongly that government and regulatory policies placing limits on its usage would be best.

Banks' roles
Islamic financial institutions' responsibilities and duties were discussed within the context of selling *tawarruq*. One participant proposed that institutional consumers be required to use alternatives first before use of *tawarruq* is considered, and that for individual consumers, a more flexible, bespoke approach to each customer should be adopted, based on what is genuinely needed or desirable for them. It was unclear whether the burden of regulating *tawarruq* and informing customers of the risks should lie with the financial institutions that sell it, or rather with government and regulatory bodies. The role of banks in educating the public on *tawarruq* and the problems of debt was also raised. However, participants highlighted that though banks are able to help educate the public on the product itself, they could not take up the responsibility to provide guidance on *shari'a* matters.

Viable alternatives to *tawarruq*
Alternative products cited were *qard hasan, ijara, salam, istisna'*, service *ijara*, *bay' al-inah*, commodity *murabaha*, and even non-Islamic conventional loans. The participants examined and debated the merits of each product, though no consensus emerged and no alternative working models were proposed. Some continued to argue for banning *tawarruq*, while others argued that restricting it would stifle innovation and development of Islamic finance. It was nevertheless agreed that Islamic finance including *tawarruq* suffered from a perception and misrepresentation problem.

Degree of consensus
Despite all the points made, at the conclusion of the workshop, participants' views remained largely divergent. Most agreed that though *tawarruq* is not ideal, it is on the other hand not *haram*. Most also agreed that *tawarruq* should have some form of policy parameters. Some continue to believe that *tawarruq* presents risks to the Islamic banking paradigm while others felt that *tawarruq* has helped to expand and further Islamic finance, citing the example of Saudi Arabia's growth in this area. Almost everyone agreed that the objection to *tawarruq* was more to its advisability rather than its permissibility. Further research is needed on the role of debt, its risks, and the extent to which it is causing a negative paradigm shift for Islamic finance as a whole. Differences remain as to whether different rules apply to individual consumers compared to commercial players.

All participants agreed that there was a need for enhancing the discussions between *shari'a* advisers and economists and offered several solutions and proposals: (1) continued work on a journal on the *fiqh* of Islamic finance; (2) further research into the role of debt as well as on how to implement ideal Islamic economic models; (3) increased empirical data from all independent sources; and (4) holding future workshops, including sessions with the London School of Economics, to discuss related issues and specific products and instruments, with the goal of achieving unified recommendations or decisions.

In Attendance

Opening:
Sarah Worthington, LSE Deputy Director and Professor of Law, London School of Economics
Moderator:
Frank E. Vogel, Founding Director, Islamic Legal Studies Program, Harvard Law School

Attendees:
Khurshid Ahmad, Member State of Pakistan, Islamabad, Pakistan
Manazir Ahsan, Director, Islamic Foundation, Markfield, Leicestershire, U.K.
S. Nazim Ali, Director, Islamic Finance Project, Harvard Law School, Cambridge, MA, USA
Iqbal Asaria, Consultant, Lloyd Bank and Bank of England Committee, London, U.K.
M. Muhammed Al-Awan, Professor, INCEIF, Kuala Lumpur, Malaysia
AbdulKadir Barkatulla, Sharī`a Supervisor; London, U.K.
Gohar Bilal, BNP Paribas, London, United Kingdom
M.A. Mohaimin Chowdhury, European Islamic Investment Bank Plc, London, U.K.
Stella Cox, Managing Director, DDGI Limited, London, U.K.
Ross Cranston, Centennial Professor of Law, London School of Economics, London, U.K.
Humayon Dar, Managing Director, Dar Al Istithmaar; London, U.K.
Majid Dawood, Chief Executive Officer, Yassar Limited, London, U.K.
Mohammed Elgari, Sharī`a Supervisor & Professor, King Abdulaziz University, Jeddah, Saudi Arabia
Essam M. Ishaq, Sharī`a Supervisor; Manama, Bahrain
Husam El-Khatib, DentonWildeSapte, London, U.K.
Rafe Haneef, Islamic Banking Division, Citigroup, Kuala Lumpur, Malaysia
Michael R. Hanlon, Former Managing Director, Islamic Bank of Britain, London, U.K.

Hussain Hamed Hassan, Sharī`a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates
Mabid Al-Jarhi, President, IAIE and Financial Expert, Emirates Islamic Bank, Dubai, UAE
Iqbal A. Khan, Founding CEO, HSBC Amanah, London, U.K.
Zuhaib Khan, Student, London School of Economics, London, U.K.
Mohammad Akram Laldin, Sharī`a Supervisor, HSBC Amanah, Kuala Lumpur, Malaysia
Kamal Mian, Head, Islamic Finance, Bank Saudi Hollandi, Riyadh, Saudi Arabia
Mansoor Shakil, Associate Director, Global Sharī`a Compliance, HSBC Amanah, Dubai, UAE
M. Nejatullah Siddiqi, Independent Researcher and Consultant; Milpitas, California, USA
Seif el-Din Tag el-Din, Associate Professor, Markfield Institute of Higher Education, Leicestershire, U.K.
M. Imran Usmani, Sharī`a Supervisor; Karachi, Pakistan
Rodney Wilson, Professor of Economics, University of Durham, Durham, U.K.
Nizam Yaquby, Sharī`a Supervisor; Manama, Bahrain
Anas Zarqa, Advisor, The International Investor, Kuwait