SHARED RISK & REWARD

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Reading List

Organized Tawarruq in Practice: A Shari'ah Non-compliant and Unjustified Transaction (link)

An Islamic repo coming to market (Sharing Risk)

UAE Central Bank offering Islamic repo (Sharing Risk)

Shari'ah risks are not he only risks to Islamic repo (Sharing Risk)

Blog Posts This Week

New frontiers of replication in Islamic finance

Has Islamic banking stalled in Indonesia?

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Sharing Risk Blog

Replacing Tawarruq

A long-running theme in Islamic finance is debate about using 'organized' tawarruq for liquidity management. The OIC Fiqh Academy even released a fatwa that condemned the practice (as it is currently being done) as a 'deception'.

The specific criticism, as articulated in the article I linked to above, is that because tawarruq uses commodities that remain in warehouses throughout the transaction, and the different brokers are able to 'net' the purchases, there is not a genuine transfer of the asset and it returns back to the dealer at the end of the transaction.

The counter argument would be: legal title is transferred and there are more than two parties involved (so no bay' al-inah). It would just add cost to actually physically move the metals from one warehouse to another.

This is a valid point. Why would the product as it is currently used be any more legitimate if the metals were physically moved between warehouses? There would be no benefits, just costs. The alternative (moving back towards 'classical tawarruq) would lead to the introduction of price risk, which would make the contract more akin to the type preferred by the OIC Fiqh Academy because it would create a 'trading' operation where the parties involved are trying to profit by selling and re-selling an asset, and the profit would come from movements in the market price of the asset (rather than to LIBOR).

But that would lead to a different product than what tawarruq is used for now, and it would make it less useful, so the benefit from moving to a more 'authentic' structure would in practical use, render it almost worthless for short-term liquidity management.

So, what are the alternatives? The newest alternative is Shari'ah-compliant repo transactions, where a commodity murabaha is combined with collateral in the form of sukuk. This has its own risks, but for this discussion, it does not add much since it too relies on trade in metals to generate a financing contract (and in the case of the UAE Central Bank Islamic repo, uses Islamic CDs which themselves are based on commodity murabaha as collateral).

The remaining alternative is wakala, which doesn't rely on trading assets to generate a financing contract, but uses an agency agreement benchmarked to LIBOR instead. It is not ideal, but there are few other options for short-term liquidity management tools, so maybe the industry should be encouraged in this direction.

Until next week,
Blake Goud