# ECONOMICS OF TAWARRUQ
## How its *Mafasid* overwhelm the *Masalih*

A position paper to be presented at the
Workshop on
Tawarruq: A Methodological issue in Sharī`a-Compliant Finance
February 1, 2007

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This paper examines the impact of *tawarruq* on the economy. It demonstrates through macroeconomic analysis that the harmful consequences of *tawarruq* are much greater than the benefits generally cited by its advocates. It concludes that a financial instrument whose *mafasid* (harms) are much greater than *masalih* (benefits) cannot be characterized as *sharī`a* - compliant.

**TAWARRUQ**

*Tawarruq* is the mode through which some Islamic Financial Institutions (IFI) are facilitating the supply of cash to their clients. The client— the *mutawarriq*—buys X on deferred payment from the IFI and sells X for a cash amount less than the deferred price to a third party. Also *tawarruq* enables IFI to guarantee a predetermined percentage rate of return to its term-depositor, buying XX from him/her on deferred payment then selling XX for cash, the deferred payment being larger than the cash price.

Every *tawarruq* transaction creates a debt. Furthermore, the debt a *tawarruq* transaction creates is invariably larger than the cash it transfers to the client---the *mutawarriq*, in the first case, and to the IFI in the second case (mediated in both cases by another transaction). In what follows, we trace the macroeconomic consequences of both: creation of new debts and the fact that the debt is larger than the cash received. But before doing so, let us examine the potentials of the new creation: the paper resulting from *tawarruq*. As it currently stands, both in the conventional and in the Islamic financial markets, debt documents, like those resulting from *tawarruq,* are subject to repeat financial and speculative transactions. At their limit, these transactions sever all links with the real assets with which they could have been associated with at the start (assuming the cash so acquired result in the production of wealth). This process leads to an inverted pyramid of financial instruments with a small asset base. The process also moves the transaction of *tawarruq* from that of the asset market to the money (debt) market, where the underlying signaling and equilibrating mechanisms no longer are linked to the real market.

**ROLE OF DEBT IN THE ECONOMY**

Mere debt creation does not increase the net wealth of society as every addition to social wealth through it is cancelled by deduction of a similar amount of wealth owed. Meanwhile the cash acquired through a debt can be put to uses that may or may not result in actual wealth creation. If wealth is in fact created, it may be equal to, larger than or less than the cash input. The economic consequences will be different in each case. If the additional wealth so created is larger than the cash invested, then society stands to gain in view of the net increase in social wealth after the debt is repaid. If the additional wealth is equal to the cash invested and, therefore, to the resources used, there is no net gain, as the social wealth remains what it was, after the debt is repaid. In case the cash invested results in wealth creation but by an amount less than the cash invested and the resources used, society is poorer to the extent of the loss, as the borrower must repay the debt by compensating for the loss out of existing wealth owned or acquired by him/her. The same applies to cases in which invested cash is totally lost, no wealth creation having taken place. In both cases a redistribution of wealth in favor of the creditors is involved.

[♣] I am grateful for the insightful inputs from Professor Mohammad Anas Zarqa and Dr. Abbas Mirakhor.

As a method of creating additional or new wealth, debt creation (or debt finance) is inefficient as well as inequitable. It is inefficient as the finance so provided goes not for the most promising projects for wealth production but to the most credit-worthy borrower. It is inequitable as it redistributes wealth in favor of suppliers of finance, irrespective of actual productivity of the finance supplied. Since both these points are well argued in Islamic economic literature, I will not repeat them in this paper.[1] One important point to note, to exchange money now for more money later is fundamentally unfair due to the uncertainty that accompanies the passage of time. Money needs to be converted into goods and services before it can enter into the process of production, the source of possible additional value creation. The results of such process of production have to be reconverted into money before money can be paid back to the one who gave it in the first instance.

## THE MARKET FOR DEBTS

Debt instruments can easily change hands. The economic consequences of this fact are independent of the terms on which debts change hands. These terms have their own consequences. The key aspect of this equation is what happens to a debt instrument between the time it is created and the time it is extinguished on repayment. Owners of debt instruments can benefit from these instruments in a number of ways. Financial innovations are providing them with newer and novel ways all the time. Debt instruments are substitutes for other forms of wealth, e.g. as securities can bring in some payment over and above their repayment. Insofar as they are substitutes for cash (generally but not necessarily at a discount) they can be characterized as near money. These uses of debt instruments create a demand for them that increases as the economy grows and the market expands. With ever-increasing supply and demand, we have a market for debt instruments. Like in every market, speculation plays a role in debt markets too.[2] But the special nature of debt instruments enhances the role of speculation in this market to a degree unmatched by any other market. Debt instruments are very heterogeneous.[3] The probability of a debt being repaid as promised varies from debt to debt, depending on the debtor, the guarantor if any, and the country of origin. There are no standard, uniform methods of evaluating the quality of debts with respect to their recoverability. Debt prices are also vulnerable to wide fluctuations in response to news, even rumors. Instances abound of manipulating debt prices by planting false news or manufacturing rumors. All these factors account for the observed reality of the market for debt instruments being much more vulnerable to gambling-like speculation than the markets for goods and services[4]. In short, it is better not to have a debt market. However, by allowing *tawarruq,* this leads to a debt market**.**

## THE DISCONNECT BETWEEN THE REAL MARKETS AND THE FINANCIAL MARKETS

The emergence of a market for trading in debts transforms the economy in a fundamental way. As compared to the situation in which all trade was focused on goods and services (or papers representing ownership rights over goods and services), this new economy has a new tier. This tier is a super economy focused on creation/production and trading/distribution of and benefiting from the consumption of debt

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[1] For detailed references and a summary of literature see, Siddiqi , Mohammad Nejatullah: Riba, Bank Interest and the Rationale of its Prohibition (2004) Jeddah, Islamic Research and Training Institute, Islamic Development Bank, chapter 4. Also, Khan, Mohsin S and Abbas Mirakhor (eds) [1987] Theoretical Studies in Islamic Banking and Finance, Houston Texas, The Institute for Research and Islamic Economics; Mirakhor, Abbas (1995) 'Theory of an Islamic Financial System", in Encyclopedia of Islamic Banking and Finance, London, pp. 31-49; Abbas Mirakhor: Globalaization and Islamic Finance, Paper presented at the Sixth International Conference on Islamic Economics and Finance, Jakarta, November 21-24, 2005.

[2] On speculative finance, see Minskey, Hyman P.: Stabilizing an Unstable Economy (1986) Yale University Press, New Haven and London, pages 43,117 and 177.

[3] Stiglitz, Joseph E. and Bruce Greenwald: Towards A New Paradigm in Monetary economics (2003),Cambridge University Press, page 271.

[4] Gambling inheres in creating a risk for the pleasure of betting on it. Normal business speculation inheres in expectations of price changes. Gambling-like speculation maneuvers expectations in order to profit thereby.

instruments. What is the relation between the two, the real market and a financial market dominated by debt instruments? In what ways are we human beings benefited or harmed by the ways in which the two interact? These are questions too big to be answered in this paper. But we can nevertheless hardly afford to ignore these questions.

Before we venture to offer some answers, let us note another development that naturally accompanies the emergence of a market for debts. Like all other markets, people can make money by also playing in the debt market, that is, by borrowing further to do this. The prospects of doing business in the debt markets tend to increase the volume of debt in the economy. The larger the volume of debt is the greater the scope for speculation. Furthermore, the debt market is, generally speaking, more speculative than the market for goods and services as debts extend way into the future. Expectations regarding future values could exercise greater influence on debt prices than on the prices of real assets. Also, it is in the nature of speculation to invite more speculation. Thus, the market for debt in a competitive economy tends to be increasingly speculative with the passage of time.

People enter the real market in order to profit from the enterprise of producing and selling goods and services that are in demand. When those seeking profits enter the debt market, there is a diversion of entrepreneurial talent and resources to an activity that does not increase the social wealth as we have seen earlier. Insofar as making money in the debt market results from gambling-like speculation, the distribution of income and wealth in the society tends to get distorted. Society suffers on both counts of efficiency and of equity.

The normal connect between the real and the financial market is a one to one correspondence between real and financial assets. Financial instruments representing ownership of real assets and deferred prices of real assets, conform to this rule. However, debts do not belong to this category. A debt instrument does not represent any real asset. As noted above *tawarruq* generates debts, adding to the hiatus between the real sector and the financial sector of the economy. This is at odds with the Islamic economy that claims a distinct advantage over the conventional debt based economy in effecting a closer integration between the real and the financial sectors.

It is important to point out that the common assertion that *tawarruq* does integrate between the real and the financial assets as it involves the sale and purchase of real assets as opposed to lending and borrowing with no real asset sale and purchase in between, is not sustainable. As noted by almost all scholars, a single car enables dozens of *tawarruq* deals without moving from its spot. Therefore, the financing facilitated by *tawarruq*, like its counterpart, lending in the conventional system, is free and unhinged from the real sector of the economy.

## IMPACT OF EASY AVAILABILITY OF LOANS

Borrowing is a serious business as it adds to one's obligations. Excepting cases of dire (consumer) needs, it would be irrational to venture into indebtedness unless one is fairly sure of using the command over resources so obtained for producing added value (or of future income from other sources). But uncertainty of future values makes this surety less than perfect. It is in the interest of all concerned, that indebtedness is incurred with due care so that failures causing pain and suffering are avoided. The social mechanisms developed over centuries to enforce due care include collaterals, penalties consequent upon failures to meet obligations and social ostracization. In earlier days, the same applied to governments and foreign nations. But the past few decades of aggressive debt financing have moved away from these earlier norms, a movement further accentuated by the flood of liquidity resulting from the oil booms in recent times. Borrowing made easy has resulted in mountains of credit card debts and other consumer debts, government borrowing has skyrocketed and loans have been thrust upon third world countries with little prospects of repayment.

The Islamic prohibition of interest serves as an effective check on the above trend as it shifts lending to the voluntary sector, as an act of charity rather than for business. The only exception is the traditional trade credit whose economics are entirely different from bank lending.[5]. *Tawarruq* sabotages this unique feature of Islamic finance by introducing lending as a means of doing business. It makes it easy to borrow. It puts IFIs on par with conventional financial institutions, both under competitive compulsion to lend in order to make use of surplus liquidity.

## MONEY AND ITS MANAGEMENT IN A DEBT-BASED ECONOMY

Money creation as well as monetary policy, including monetary expansion, in a debt based economy proceeds on the basis of debt. Money issued by the central bank, by derived bank deposits as well as money created by the commercial banks are based on debt. As the money supply increases to meet the increasing demand due to increases in population and rising incomes, so do the volume of debts. As we have seen, larger volumes of debt have been associated with enhanced speculative activity leading to greater inequities and instability. The larger the volume of debt, the more the gambling like speculation, and the greater the redistribution of wealth in favor of the rich. It has been rightly argued that monetary management in an Islamic economy will be free of this defect. Monetary expansion will mainly proceed on the basis of investment.[6] As regards the fiat money issued by the central monetary authority, a number of possibilities are being explored, but debt creation does not figure among these possibilities. Another common feature of all proposals about monetary management in an Islamic economy is to keep money supply linked to the needs of the real sector of the economy. This is seen as the most effective way of keeping inflation under control. The introduction of *tawarruq* into the body of Islamic economy is sure to act like a virus destroying its immune system that which would protect it from increasing indebtedness leading to speculation, monetary fluctuations, instability and inequity.

It is important to note, at this juncture, that there is nothing wrong about debt at the individual level. It is not *fasad.* Lending and borrowing at the individual level is harmless. What corrupts the financial system is debt proliferation in the economy and money creation through debt creation. It is a monetary system based on debt creation and speculative finance based on debt that amounts to *fasad.* The insight that distinguishes between the impact of an act at the micro level and its impact at the macro level was not available to us before the advent of macroeconomic analysis. From individual instances of debt here and there to an organized debt market is a qualitative change calling for a fresh assessment of its impact.

## THE PRICE OF MONEY

We noted above that the debt created by a *tawarruq* transaction is larger than the cash obtained through it. This disparity has its own consequences. One of these consequences is the compulsion to create additional wealth through the use of the cash so obtained. But the environment in which enterprise is conducted does not guarantee this. Insofar as the cash was obtained for non-productive uses, even the possibility of creating additional wealth does not exist. This creates a situation that cannot be handled except through transferring part of the existing wealth to the creditors and/or creating more debts in order to meet the contractual obligations of the debtors. The inequity of either "solutions" is obvious. In effect, it takes us back to an interest based lending system with all the ills associated with that regime. It is an unfair transfer

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[5] The far-reaching consequences of this change are too many to be assessed in this paper. As an example, consider this insightful remark: "The most important difference between investment model with debt and equity financing is that in the latter the firm is not in a position to exercise discretion in the determination of its level of investment. It can do nothing but passively adapt investment to what the market is willing to supply." Jan Mossin, Theory of Financial Markets (1973), Prentice Hall Inc. Englewood Cliff, N.J., page 160. The author further observes that, "the fact that the share prices and the allocation of investment capital among firms are determined in the market rather than in the firms themselves represents a kind of investor sovereignty which may have a certain appeal on ethical grounds (whatever it is)." Ibid, page 162. See also, Mills, Paul S. and John R. Presley. Islamic Finance, Theory and Practice. Macmillan Press, UK, St Martin Press, USA. 1999. pp.77-78.

[6]see fn. 5 above

of wealth; it is inefficient as it penalizes entrepreneurs and rewards rentiers; it leads to instability as it creates obligations irrespective of whether they can be met or not.

On the level of the economy as a whole, the compulsion for economic grow is created by the fact that the total amount to be repaid is invariably larger than the total amount obtained through loans and this has devastating consequences. It leads to overuse of natural resources and is very destructive of the environment. Since the increased payment must also follow a timetable, it increases anxiety levels by enforcing rigid timetables all round. It is also one of the factors leading to commercialization of almost all spheres of life, including family relations, education and health care as these spheres too come under debt-financing with its compulsions of repayment with an addition at an appointed time.

## CURRENT SITUATION

The history of *tawarruq* in Islamic finance has hardly completed its first decade. Yet its practice has been expanding due to its endorsement by a section of *sharī`a* scholars. Juristic discussion has been focused primarily on the contractual aspects and little attention has been paid to the *masalih-mafasid* calculus, which is so important in public policy and financial transactions. Even the recently issued AAOIFI "standards" are blissfully oblivious to this essential dimension of Islamic Law, with its considerations of largely the *masalih*. Other than the two pure forms mentioned in the opening paragraph of this paper, hybrids of *tawarruq* in *sukuk* and leasing instruments are becoming popular everyday. All efforts to block sale and purchase of debt *(bay'al-Dayn*) have come to naught, as effective ways have been found to circumvent the prohibition This is often through making debts a minority part of a large pack of assets. The market has enthusiastically welcomed this development mainly because it takes us back to familiar grounds long trodden under conventional finance.[7]

As a result, several scholars who approved *tawarruq* in the first instance are raising their voices against its indiscriminate widespread use. But profit-maximizers have rarely been amenable to moral exhortations. The Islamic debt market in Malaysia is leading the way[8], with the Gulf following. The *sharī`a* scholars in Malaysia have allowed sale of debt[9]. Those in the Gulf area who disallowed it, permitted inclusion of amounts receivable as a minority component in a larger package of securities. The end result is no different: all debt-obligations are now sellable. An effective check on the spreading virus needs treating *tawarruq* as a matter of public policy, focusing on the harms (*mafasid* ) associated with it and declaring it not suitable for a modern Islamic economy.

## HARMFUL EFEECTS *(MAFASID*) OF *TAWARRUQ*

The calculus of *masalih* and *mafasid* has been an essential tool of Islamic jurisprudence since the earliest days.[10] Behind that calculus stands the Islamic view on life, the purpose of honoring humankind by laying the resources of the universe at their disposal so that life is sustained for all, and the command from Allah that wealth be shared equitably. Measures that increase inequality in the distribution of wealth and lead to its concentration do not qualify in that framework. The same applies to the strategy of risk-shifting, i.e. debt finance, as compared to risk-sharing involved in other Islamic modes of finance.

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[7] The Islamic debt market is currently estimated to be $10 billion in size. Vide, Gulf Times, 8 March 2006.
[8] According to the Star online, December 11, 2006:" In the debt market for instance, Islamic bonds account for 66% of total new corporate bond issued to date. Islamic bonds are expected to trend higher to 88% of total corporate bonds issued by end 2006."
[9]. Securities and Exchange Commission (2002) Resolutions of the Securities Commission, Syariah Advisory Council, Kuala Lumpur, March 2002
[10] Some good readings on the subject are : Abdul Wahab Khallaf (1955) Masadir al-Tashri' al-Islami fi ma la Nassa fih, Egypt, Matabi' Dar al-Kitab al-Arabi.; Husain Hamid Hassan, Fiqh al-Maslaha wa Tatbiqatuha al-Muasirah (1993) Jeddah, Islamic Research and Training Institute, Islamic Development Bank, especially pp.39-48.

It will be useful at this stage briefly to recount the harmful effects (*mafasid*) of *tawarruq*.

- It leads to creation of debt whose volume is likely to go on increasing.
- It results in exchange of money now with more money in future, which is unfair in view of the risk and uncertainty involved.
- It leads, through debt proliferation, to gambling like speculation.
- It leads, through debt finance, to greater instability in the economy.
- In a debt-based economy, the money supply is linked to debt with a tendency towards inflationary expansion.
- It results in inequity in the distribution of income and wealth.
- It results, through debt finance, in inefficient allocation of resources.
- It contributes, by consolidating debt financing, to raising anxiety levels and destruction of environment.

It is worth noting that giving priority to public interest over individual interests has been an accepted principle in Islamic jurisprudence. The benefits of *tawarruq* to individuals in certain circumstances must be over ruled in view of the huge public benefits of not allowing it. It will, however, be necessary to make some social arrangements for taking care of the individual problems sought to be solved through *tawarruq.*

The subject we are considering is not the permissibility of a certain activity. Rather it is a matter of public policy on which hinges the welfare of society as a whole. We are duty-bound to examine whether *tawarruq* leads to *fasad* or *salah.* In verse after verse the Quran tells us that Allah does not like *fasad* or those who perpetrate *fasad.*[11] The great jurists all emphasized examining *maslaha* and *mafsadh* as measures under consideration not specifically mandated by text.[12]

**WHY THE FUQAHA DID NOT SAY NO TO TAWARRUQ?**

The above raises a tricky question: How has a whole array of Islamic jurists in the past, starting as early as the second century *hijri*, have allowed *tawarruq*?

Two facts explain the apparently puzzling situation: The *Fuqaha* in the past were dealing with a different world, and the tools of macroeconomic analysis, required to find out the harmful effects of *tawarruq*, were not available to them. The harmful impact (*mafasid*) of *tawarruq* on the economy as a whole, to the extent present, were not visible at the time, whereas its benefits (*masalih*) in certain individual cases were easy to see.

Let me first elaborate, though briefly, the first point. Debt did not play as big a role in the economy during the times our *fuqaha* as it plays today. Money was not based on debt. Debt instruments hardly existed, much less traded. There was nothing even remotely resembling the debt markets of today. Traders' speculation focused on prices of real goods and services rather than that of debt instruments. Economic fluctuations originated in droughts, famines and crop failures or in big changes in population rather than in the financial sector. Debt financing of business was secondary. Trade, industry and agriculture were largely financed by self-owned wealth, trade credit, partnership and sharing. Loans (based on interest) did exist but their role was not dominant.

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[11] Al-Quran (2:204-05; 28:4; 30:41; 26:150-52; 7:74).

[12]. As Ibn al-Qayyim put it: "Everything that lapses out from justice into injustice, and from mercy into its opposite, and from *maslahah* to *mafsadah*, and from wisdom into the frivolous, does not belong to *sharī`a*, even if it is inducted into it by interpretation *(ta'wil* )." Ibn al-Qayyim (n.d) I'lam al- Muwaqqiín.., Egypt, Matbaah Muniriyah, vol.3,page 1,also see vol. 4,pp 309-11. Earlier, Izzuddin Ibn Abdussalam had noted that*: sharī`a* is focused on what is good for human beings. (Izzuddin Ibn Abdussalam (1955).Qawaid al-Ahkam,Cairo, Maktabah Husainiyah, pages 65-66.

Macroeconomic analysis that deals with rates, ratios and entities related to totals or large numbers was not feasible without empirical studies yielding data—numbers and statistics. The early social scientists, which our great jurists no doubt were, had to make do with direct observation and reports about the past. Projection of current tendencies into the future was a matter of conjecture at best. Juristic thinking was dominated by analogical reasoning. Empiricism played a little role, though through the familiar categories of *istihsan, istislah, urf* , *sadd zara.,* These speak volumes about the pragmatic approach of the great jurists with whom these categories are associated. But for reasons that can hardly be elaborated in this paper, later day developments leaned heavily on systemized analogical methodology and avoided the nebulous methods based on intuition and empiricism.

**CONCLUSION**

Islamic economic movement was launched to usher in a financial system that would help remove the *zulm* and *fasad*, inequity and inefficiency, perpetrated by the currently dominant system based on debt. It is our duty not to endorse a process that could someday take us back to the same system. That this should happen at a time when globalization, financial innovation and the spread of information technology is generating a move towards greater reliance on equity participation and asset based financing at the world level, is ironic indeed. An innovative recourse to sharing based modes and asset based financing may get a boost from closing the door to *tawarruq*.