

Response to feedback received

Tawarruq

Introduction

Bank Negara Malaysia (“the Bank”) issued the Concept Paper on *Tawarruq* (CP) in April 2015 to seek feedback on the proposed operational requirements of *tawarruq*. The CP aims to complement and promote sound application of the Shariah principles and thus, enhance the integrity and sustainability of the Islamic financial transactions. The policy document on *Tawarruq* provides the basis for the Islamic financial institution (IFI) to develop necessary operational framework and infrastructure to ensure that the application and conduct of the *tawarruq* in Islamic financial transactions are Shariah compliant.

The Bank appreciates the constructive feedback and suggestions provided by the industry during the consultation period. These have been taken into account and incorporated in the final policy document where appropriate. Key comments received and the Bank’s responses are set out in this document.

Bank Negara Malaysia

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1 Criteria for qualifying asset

- 1.1 The objective of *tawarruq* is to facilitate the attainment of cash by the identified counterparty (which can either be the customer or the Islamic financial institutions (IFIs)). The Shariah requires the IFIs to satisfy the conditions of a valid sale and purchase transaction to ensure the *tawarruq* complies with Shariah requirement, which includes the condition of a valid asset.
- 1.2 In this regard, Shariah requires that the asset to be traded, either tangible or intangible, must be “valuable”. In view that the term “valuable” is subjective and the “value” of a particular asset may be derived based on various factors that may not be substantiated, it is important for the policy requirements to outline the qualifying criteria that facilitate an objective valuation of an asset in order to mitigate potential dispute and satisfy the condition of valid asset.
- 1.3 Majority of the respondents agreed with the proposed criteria that the asset shall be valued based on available market price or quoted price in an active market to enable efficient pricing mechanism and to mitigate potential market risk exposure. However, few respondents argued that the issue of price discovery of assets with no active markets may be resolved by using a third party valuation or mutually agreed pricing between the seller and buyer. The Bank has considered the feedback and decided to maintain the proposed qualifying criteria as to protect the integrity of the *tawarruq* transaction and mitigate potential dispute on the pricing of the asset.
- 1.4 The term “intangible” used by Shariah refers to assets without a physical form. For the avoidance of doubt, the CP has clarified that the definition of “intangible assets” under the Malaysian Financial Reporting Standards (MFRS) shall not be applicable under the CP.
- 1.5 The Bank maintains the proposed requirements in the final policy document.

2 Specification of selling price

- 2.1 From a Shariah perspective, another important condition of a valid sale contract is the certainty of selling price, which has to be determined at the inception of the contract. In this regard, the CP has provided the operational requirements that support the Shariah requirement on ensuring pricing certainty.

- 2.2 The respondents raised concerns that the CP appeared to allow the selling price to be determined based on the Shariah principle of *murabahah* (where breakdown of cost and profit is disclosed) only and excludes *musawamah* (where only the absolute amount of selling price is disclosed). The CP did not intend to restrict the application of permissible mechanisms to determine selling price. However, the operational requirements have considered the industry practice where the agreed selling price is always quoted in the form of principal and profit rate (reflecting the respective IFI's pricing) and calculated over the agreed deferred payment period, which essentially represents *murabahah*. The Bank agreed to remove the specification to facilitate the application of various pricing mechanisms, which are approved by Shariah.
- 2.3 The respondents also commented on the practicality of the proposed requirement to specify the selling price in absolute amount, especially in the case where additional profit is paid on term deposit that matures on an unexpected holiday. The operational requirement to specify the agreed selling price is practical and constitutes as an essential element of a sale and purchase contract. The practice of paying additional profit as compensation due to an unexpected event shall be treated as *hibah* (gift), and shall not affect the agreed selling price.
- 2.4 The Bank acknowledged that the policy requirement for the IFI to ensure the calculation of profit under *tawarruq* excludes the *hibah* payable under *amanah* (held in trust) or *qard* (loan) differs from the existing industry practice and hence, the industry is expected to affect necessary enhancements to comply with the requirement.
- 2.5 Except for removing the specification on selling price to be based only on *murabahah*, the Bank maintains other proposed requirements in the final policy document.

3 Operationalisation of dual agency arrangement

- 3.1 Following the Shariah ruling, the IFI is required to treat funds accepted from the customer as *amanah* (held in trust) prior to the execution of the *tawarruq*. This means the IFI is not allowed to use the funds for its Islamic banking business.
- 3.2 Notwithstanding, the IFI can treat the funds as *qard* (and hence utilise the funds) if the delay is due certain "unavoidable incidental circumstances". The CP has intended to specify the events that would warrant the treatment of *qard*.

- 3.3 The respondents informed the Bank that *tawarruq* transactions are currently conducted on a batch processing basis which is completed after 2-3 days depending on the respective IFI's internal policies and procedures. Furthermore, the execution of the batch processing is also dependent on the asset exchange's or asset broker's trading hours. In this regard, the respondents have proposed that due consideration should be accorded to the IFIs' operational capabilities. The Bank agreed to consider the time required to process the *tawarruq* transaction and provide additional guidance on the events that would warrant the treatment of *qard*. However, a reasonable period shall not be more than 3 working days from the transaction date i.e. T+2.
- 3.4 In addition, the respondents also highlighted that a longer implementation period of at least 6-months is required, due to the need to undertake significant enhancements on the IFIs internal system and processes in order to execute the *tawarruq* transaction on the same day.
- 3.5 The final policy will be effective on 1 July 2016, which the Bank deems to be sufficient period for the IFIs to enhance their operations.

4 Settlement of selling price

- 4.1 The *tawarruq* may be used in combination with another Shariah contract and/or arrangement (including *tawarruq*). From a Shariah perspective, each Shariah contract and arrangement accords the respective contracting parties specific rights and obligations and roles and responsibilities.
- 4.2 The respondents commented that certain Islamic financial products using *tawarruq* are structured in a manner (either in combination with another Shariah contract and/or arrangement) which allows the debt obligations of the contracting parties to be off-set or settled on a net basis. In this regard, the measurement of the ultimate debt obligation or the cash flows of such Islamic financial products may differ from a stand-alone *tawarruq*.
- 4.3 The Bank acknowledged that off-setting debt obligations may be conducted in a manner which is allowed by Shariah provided that the terms and conditions which reflect the rights and obligations of the contracting parties are adequately stipulated in the legal documentations. The final policy document has provided additional requirements on settlement to ensure consistency with Shariah and to provide effective legal basis.

5 Accounting records

- 5.1 The CP proposed that the accounting records shall reflect the different processes involved in the entire cycle of the *tawarruq*. The respondents in general were of the view that maintaining accounting records for each process was unnecessary since the different processes involved in *tawarruq* are typically executed sequentially in a short period of time. The respondents also argued that the present accounting records were consistent with MFRS.
- 5.2 The Bank acknowledged the requirements of MFRS and is of the view that the application of MFRS shall take into consideration the Shariah requirements (such as *amanah*, *qard*, *hamish jiddiyah*, *ibra'*) which are reflected in the terms and conditions. In this regard, the accounting records of the Islamic financial instrument may not be similar to an equivalent conventional financial instrument.
- 5.3 Notwithstanding, the Bank agreed to remove the proposed requirement in order to accord flexibility for the IFI to reflect the accounting records in its systems. Instead, the Bank has included in the final policy document a requirement on the IFI to ensure the accounting records are able to, if applicable, reflect the amount held in *amanah* and/or *qard* consistent with the application of Shariah and MFRS.