

Islamic Finance as an Alternative for Supplementary Loans in Commercial Banks

A Descriptive and Analytical Study of Alternatives

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Abstract

This research aims at presenting the *Shari'a* rule on the supplementary loan in its original form and the new form of *murabaha*, , and *tawarruq*, using a descriptive and analytical approach. The research concluded that the traditional form of supplementary loan should be prohibited. However, providing the client with *murabaha*-based finance, which is separate from the original form of financing, to purchase commodities is permissible, if the conditions of the *Shari'a* are applied, since they depend on the legality of the sale. In addition, the research concluded that *tawarruq* is permitted by the *Shari'a* provided that it meets the conditions of a true sale as defined by the *Shari'a*. Finally, the research reached the conclusion that both organized and reverse *tawarruq in addition to inah* should be prohibited since they involve collusion between the client and the Islamic bank to collect an amount of cash currently and pay more than this amount in the future, which is considered to be usury, or *riba*.

Keywords: Islamic Finance, Alternative, Supplementary loans.

1. Introduction

thereof were the expansion of major and complementary financing, whether for real estate or consumption. This was in addition to the intensive use of organized *tawarruq* which is practiced by loan companies and institutions and low amount of finance designed for production. Therefore, some borrowers seek additional financing to meet their various needs. They ask the lending bank for additional financing and most commercial banks allow this type of loan which is called a "supplementary loan". While some banking institutions combine interest-based commercial transactions with contract-based on Islamic financing methods, the concept of the supplementary loan was applied to *murabaha* and a new *murabaha transaction* was advanced to the customer. Moreover, the banks provided financing through *tawarruq* and calculated profits in the same way that the original form of *murabaha* profit was calculated, and hence the *Shari'a* point of view in legality of these operations is required.

1.1 The Study Importance

The study is important because it deals with a matter that has been deliberated on from different perspectives in commercial banks and their alternatives in Islamic banks. This research will analyze whether Islamic banks are able to set non-interest-based alternatives for banking transactions or not.

1.2 Questions of the study

- 1-What is the *Shari'a* point of view on the supplementary loan in commercial banks and in Islamic finance in its original form and in the new *murabaha transaction* in addition, to *tawarruq financing methods*?
- 2- What is the impact of Islamic banks' application of Western solutions on their truthfulness before clients?

1.3 Challenges of the Study

In commercial banks, borrowers seek additional financing to meet their various needs, so they ask the lending bank for another loan. Most commercial banks allow this type of loan which is called a "supplementary loan". In addition, the Islamic banks applied the concept of supplementary loans to *murabaha* and gave the customer a new *murabaha separate from the original*. Moreover, profits in the second *murabaha* is calculated in the same way as the supplementary loan. Some Islamic banks use *tawarruq* to provide the client with the financing required, and therefore, it is necessary to explain the *Shari'a* point of view

2.1 Supplementary loan - Definition and Types:

Qard, or loan: it means to cut off a piece, from which the word lender is derived. Lending means giving a piece

of property to a needy person without expecting any profit (Al Azhari, 2001).

2.2. *The Term Loan in Shari'a:*

Qard al-hasan or benevolent loan (without charge): it is a name for every kind of voluntary giving to those in need to be appreciated or awarded whether it is for charity or for good works (Al Azhari, 2001).

What you give to others to be paid back in the future (Qalagy, 1988).

Borrowing: to receive a loan and the verb is "to borrow", as in "He lent me money" which means "I borrowed from him." (Al Razy, 1995, p. 218).

2.3: *Forms of Supplementary Loans*

In commercial banks, borrowers seek additional financing to meet their various needs, so they ask the lending bank for another loan. Most commercial banks allow this type of loan and set the following conditions:

1. At least six months must have elapsed on the first loan
2. Total installments for both loans should not exceed 33% of the borrowers' total income.

The second condition is more important than the first and other conditions. This type of loan is called the "supplementary loan".

There are two methods used by interest-based banks for supplementary loans:

First method: This involves providing the client with additional financing separately from the first financing to meet his additional needs. The maturity date of the supplementary loan and its repayment installments are kept separate from the first one. Hence, the total installments for both loans must not exceed 33% of the client's total income. However, if the value of the total installments exceeds this level, banks use the second method to provide the client with the financing required.

Second method: This involves providing the client with financing at a level that covers the remainder of the principal loan as well as the additional funds required by the client. The bank settles the remainder of the previous loan and credits the client account with the remainder of the new loan. Hence, the client pays one installment to the bank but the duration of the repayments for the new loan is longer than for the previous one. The defect of this type of loan is that the cost to the client is high, as most of the installments paid by the client for the old loan would have been taken up by interest, and when a new loan is provided, new interest are added for the additional loan as well as the payments due on the old loan.

Supplementary loans are affected by some factors such as:

1. Loan objective
2. Payment methods and duration
3. Borrower's capacity to repay
4. Loan amount

Supplementary Finance in Islamic Banks:

When a person indebted to an Islamic bank needs additional financing to buy a commodity or pay a commitment, but he does not have enough money to do so and refuses interest-based loans as they are prohibited in Islam so he goes to some Islamic banks or companies to obtain the financing he needs. There are various ways in which Islamic banks provide additional financing, as follows:

First: Providing *murabaha* financing to the client, which is separate from the first financing, to buy the commodities he needs, subject to the following steps:

1. A commitment is required from the client to buy the commodity from the bank after the bank has purchased it, in order to avoid the consequences that may be incurred by the banks if the client does not buy the commodity after the bank has purchased it.
2. The bank or the company purchases this commodity.
3. The bank sells the commodity to the client who has applied for additional financing as a deferred purchase and at an installment payment price as agreed and in accordance with the client's financial capacities.
4. The client pays the price in installments on the previously agreed dates.

Thus, the Islamic bank or company gains a profit, which is the difference between the price of the commodity paid in cash on purchase and the total installment price paid by the buyer for the commodity, provided that the installments are paid on the due dates. The buyer also receives the cash required to buy the commodity he needs.

Similarly to interest-based banks, the total amount of the installment payments for both loans should not exceed a specific percentage of the client's income. However, if the value of the total payments exceeds this level, or the client fails to pay the installments for financing received previously from the Islamic bank, some Islamic banks use a second method, which is based on *tawarruq* to provide the client with the financing required.

Linguistic and Terminological Definition of Tawarruq

In Arabic language Tawarruq: is derived from *warruq*. Abu Ubaida said: The *warruq* is silver even if it used as money or metal (Ibn Mandhur, 1405)

Tawarruq in the terminology of scholars: a practice by which a person buys a commodity on credit then sells it to someone other than the seller for cash at an amount less than the purchasing price, in order to obtain cash. The use of such a term has been mentioned only by Hanbali Scholars, while others have spoken about it in connection with *inah sale* (Ibn Muflih, 1997). Whereas *inah* is similar to *tawarruq* and is sometimes confused with it by some scholars, *inah* shall be defined to show the difference between them. *Inah* in Arab language means (salaf) pay in advance (Al-Fayruzbadi, 817).

Inah: This is a contract to sell a commodity at a high price on credit which the seller repurchases in cash but at a much lower price (Al-Nawawi, 1997, p.163).

The difference between *inah* and *tawarruq* is that *inah* means to sell a commodity on credit, which is repurchased afterwards by the seller himself at a lower price, while *tawarruq* means that the buyer is not the seller, however the first buyer sells a commodity to a third party, who has no relationship to the first seller. In the practice of *inah*, a commodity is sold back by the buyer for cash to the seller, however this is not the case with *tawarruq*, i.e., the buyer has the freedom to dispose of his goods by selling them on the market at the current price to obtain liquidity. However, those who have assimilated *tawarruq* to *inah* have identified some common characteristics; the first is that, in both cases, the first seller sells the commodity on credit at a price that is higher than the current market price, the second is that the objective of this practice is to obtain liquidity, and the third is that both practices have adopted an artifice or a way to obtain liquidity and still avoid interest-based lending.

The practice of *tawarruq* was not very common in past centuries, even if it was practiced by individuals. However, in the present era, and after the rapid expansion of Islamic banks and Islamic investment companies, most of these banks and companies have decided to offer *tawarruq* on a large scale; there are two methods of dealing with *tawarruq*.

Organized *tawarruq* involves the client's purchase of a commodity on the market for a deferred payment, for which the seller (financier) handles the sale on his own, through others with power of attorney, or through the client's complicity in agreeing to a current price that is less than the original price.

Reverse *tawarruq* is identical to organized *tawarruq*, where it is the client who has the money and is looking for a return on it. In this case, the client buys a commodity and sells it to the Islamic bank on a deferred basis and it is the bank that agrees to purchase the commodity in installments for a total price that is higher than the purchase price of the commodity. The client thus receives a fixed return on his investment.

The Process of Tawarruq in Islamic Institutions:

When a client needs an amount of money to buy a commodity or to start a project and does not have the funds to do so and further is not satisfied with interest-based loans owing to their prohibition, he falls back on the Islamic institutions that provide the Islamic *tawarruq* to obtain the liquidity he needs. He submits a request to the institution to obtain the required amount and after obtaining the institution's approval, the following steps are usually taken:

- The client pledges to purchase on credit the commodity that the institution purchases in cash.
- The institution then purchases a commodity on the market, equal to the value of the amount needed by the client, then it may or may not collect it
- The institution then sells this commodity by a registered contract to the client on a deferred basis and on installment payments as agreed
- Then it requests authorization from the client to sell this commodity to a third party in cash at a lower price than the sales price and promises to pay him the price of this commodity later. After this, the beneficiary (client) collects the cash price of the commodity, after selling it by delegating power of attorney. In this way, he obtains the funds required immediately and pays the price in installments as agreed between them in advance.

In this way, the Islamic institution makes a profit, which is the difference between the price of the commodity paid in cash and the price it agrees on with the client who pays for the commodity in installments and makes the payments on time. The client also obtains the funds necessary to meet his needs or to save or expand his business.

In this regard, we find that there are a number of Islamic banks and institutions that do not practice *tawarruq* at all, including the Jordan Islamic Bank and the Islamic International Arab Bank of Jordan, as a result of the advisory opinion of the International Islamic Fiqh Academy, that state the inadmissibility of both methods of *tawarruq* (both organized and reverse) (Bouheraous, 2009). On the other hand, it should be noted that most of the Saudi banks and companies depend heavily on *tawarruq* in their investments. For example, the investments of the National Bank of Saudi Arabia that practice *tawarruq* is approximately 80% of its investments,

documented under the name of facilitation "tayseer"

2.4: The Shari'a Rule of Supplementary Loans and Funding Applications

The Rule of the Traditional Method:

Prohibition (haram): Shehata, (u.d), is one of those who recommended its prohibition, which is inferred from the following: The fictitious *morabaha* and the point of prohibition is the form of the true sale contract has been imitated and its imitation is a way of circumventing *riba*, which is prohibited. AL-NAJAR, (1993) has already said, " *morabaha* is the worst method of the Islamic bank's work as it gives the opportunity to circumvent *riba* and shows the inability of the bankers to truly participate in the profit and loss of activities, which is the sound basis."

Permissibility: Scholars have inferred its permissibility by the general evidence on the permissibility of the sale and the peoples' dealings with it in different countries and ages and for their need of such a sale. Ahmed Bin Hanbal disapproved of it and his disapproval was recounted by Bin Umar, Bin Abbas, Masrouk, Al-Hasan, Ikrama, Said Bin Jubair, Atta Bin Yassar and others, as it indicates a form of ignorance and avoiding it is better; such dislike is correct but the sale should be approved as it has its main conditions (Ibn Qudama, 1978).

Shari'a Rule for Tawarruq:

There are many differences among scholars concerning *tawarruq*, therefore we shall mention only the following: Al-Mokhtar Doctrine for the Hanbali School is that it is permissible according to the words of Mardaawi, may Allah be merciful to him: "In the case where money is needed, there is nothing wrong with buying the equal of one hundred with one hundred and fifty." stating his doctrine and that of his companions, on the subject of *tawarruq*. However Imam Ahmad expressed two opinions, one is repugnance and the other tended towards prohibition and the scholar Bin Taymiyyah and his student Bin Alqaeem Al Jawziyyah, may Allah be merciful to them, tended toward prohibition.(Al-Mardawi, 1979).

As for Imam Shafi'i, may Allah be merciful to him, he stated the permissibility of what is called *inah* by all scholars as he has for long approved its permissibility and has not stated any repugnance for it. Members of the Shafi'i School have applied this, mentioning its permissibility without repugnance. Baghawi, may Allah be merciful to him, stated: "In the case where something is sold on credit and then is purchased before the term of credit has expired, it is permissible to buy it at a price that is the same or less or more and also even after the expiry of the term." (Tahzib for Baghawi) Later members of the Shafi'i School mentioned their repugnance for the validity of such a contract, as evidenced by the words of the Judge Zakaria Al-Ansari, may Allah be merciful to him, who stated, "selling by *inah* is *makrouh* for the dignity of people in need; selling for cash at a low price and buying the same item on credit at a high price, this cannot be validated, even if it is widely practiced."

As for *tawarruq*, it was not mentioned by Shafi'i, whether independently or as a form of *inah*, yet they apparently permitted it as they gave permission to the first seller to buy the commodity at a lower cash price, and selling to other party is preferable.

Concerning Maliki School, their opinion is clear from the saying of Al Senhadji, (2010) that, "for he who sells a commodity on credit, then buys it back immediately at a lower price in cash from the buyer, this second sale is null and void as it is an excuse to practice usury, because by retaining the commodity in his hands, he has not sold it at all. Such a sale is therefore an excuse to obtain additional income through credit, which is called usury." He then said, "we say regarding the sale, that it is impossible to excuse the practice of usury if it were intentional, for these reasons: the first seller is the buyer and the second sale takes place soon after the first one, of the same commodity and the deferred price is higher than the price paid in cash and the reason behind this practice is usury under these conditions and it should be understood as such unlawful and these beliefs are the more restricted than most schools, where such a sale is permitted, as long as the commodity exists." (Ibn Rushd, u.d) However, Maliki School did not include the practice of *tawarruq* among such prohibited sales, so it seems that *tawarruq* was permissible for them without repugnance, but only Allah knows.

As for the Hanafi School, most of them have identified *tawarruq* as being *inah*, and while some of them admitted that it is repugnant, such as Imam Muhammad, may Allah's mercy be upon him, others maintain its permissibility, such as Imam Abu Yusuf and others. Al-Haskafy, (2000) may Allah's mercy be upon him, has said in the interpretation of the practice of *inah*", i.e. selling an object at a profit on credit to be resold to the lender at a lower price, in order to pay their debts, such a contract has been fabricated by those who practice usury, which is *makrouh* and is abhorred by the *Shari'a* as loans should be made only for good works or charities such as orphanages."

Bin Abidin (1407), in this context, said it is *makrouh*, for Muhammad as provided in hedayh. Al-Fateh and Abu Yusuf said, "This sale is not *makrouh*, as it has been carried out by most of the companions, not considering it to be usury." Muhammad further said, "This sale is like a mountain on my heart, it is abhorrent and has been fabricated by those who practice usury."

Discussion and Preference:

Financing through the new Morabaha

Discussion on the first saying:

The saying on the fictitious morabaha is notable and the justification for it is that the second morabaha shall be true and thus there is no place for this evidence.

Suspicion and reply: Calculating the morabaha with the same method used to calculate commercial loans shall not affect its legitimacy as it has been decided by the scholars who allow morabaha as applied by the Islamic banks.

Permissibility controls:

1. The second morabaha shall be true and not fictitious.
2. The second morabaha should be calculated independently from the old morabaha.

Finally, the followers of the scholars' rule on the morabaha which applied by Islamic banks and on the legitimacy of this wrongdoing should call on those who practice it to comply correctly with controls on permissibility.

2.5: Funding through Tawarruq

We shall deal in this part with the three forms of funding through *tawarruq*

1. *Inah*: in the practice of *inah*, we find that the first seller sells at a certain price and then becomes a debtor to the buyer at an agreed price, so if he repurchases it at a lower price than the first price, before the first price has been paid, he then becomes the creditor of the buyer for this amount, as if providing the first buyer with a loan and then receiving more than the amount of the loan, then we find here the clear demonstration of usury. Therefore, we conclude that *inah* is not permissible according to the *Shari'a*.
2. Individual *tawarruq*: After reviewing the views of individual scholars on individual *tawarruq* and their provisions and the evidence they relied on, we shall see that it is possible to permit it since it does not violate the absolute conditions for a sale, which is different from buying goods with the intention of using them, but using their value, similar to the work of the merchant, who buys goods for the purpose of their price and not for their use. Furthermore, none of the scholars have declared this to be blameworthy. Merchants buy goods only for the purpose of making a profit, but in this case the merchant buys for the purpose of using the price of his purchases after selling them in order to obtain cash, which is not an effective difference.
3. Organized and Reverse *Tawarruq*: For *tawarruq* transactions which scholars have permitted, the commodity is present for the seller and really is owned by him, therefore its ownership is transferred to the buyer according to the rule of the true sale, including all the conditions that define a true sale, but if this process takes place under other circumstances, the rule must change, because it is absolutely impermissible or blameworthy. The permissibility of such a sale is conditional on the first seller not selling the commodity at a lower price than the purchase price to the one who sold it to him, either directly or through an intermediary. If he should do so, his action shall be defined as *inah*, which is prohibited by the *Sharia* because it involves a ruse to circumvent interest or *riba*, and thus it becomes a prohibited contract.

In this regard, we note that organized *tawarruq* violates the one rule permissible by the public scholars, in two ways:

- a. The bank is in charge of selling the product, purchased by it and sold to whomever it wishes, while in individual *tawarruq* the client is in charge of selling the product and the bank has no connection with selling operation.
- b. The existence of a previous agreement between the bank and the final buyer includes purchasing the products presented by the bank by the price which paid by the bank, but in the individual *tawarruq*, the client is the seller of its commodity at the same price as the purchase price or more or less than it.

In sum, *tawarruq* is a legal artifice and a method for obtaining money, and despite its permissibility, it is still an artifice. Artifices and other methods are designed to resolve the problems of individuals in real need or sometimes of institutions. As for changing the main activity of Islamic funding institutions to *tawarruq*, this is a burden on the natural path of Islamic finance by reducing the funding methods recommended by the *Shari'a* that were designed to pave the way for the establishment of an integrated economic community. Therefore, we conclude that the two types of *tawarruq* (organized and reverse). Are prohibited according to the *Shari'a*.

Conclusion

1. The traditional image of the supplementary loan in commercial banks is blameworthy or *haram*.
2. Granting the client morabaha financing, separately from the initial financing, in order to buy

what he needs in the way of permissible goods, is permissible as long as it complies with the legal conditions, as it takes its legality from that of the sale; individual *tawarruq* is also permissible in the *Shari'a* if it fulfills the conditions of a sale as prescribed by the *Shari'a*.

3. Both organized and reverse *tawarruq* and also *inah* are blameworthy or *haram* owing to the collusion between the client and the financier by using credit to obtain cash currently at a higher value, which is considered to be *riba* or usury.

Recommendations

1. The necessity for Islamic banks to comply with the legal conditions in their transactions by activating the role of the *Shari'a* Board.
2. Islamic banks should reduce the emphasis on *morabaha* and *tawarruq* and concentrate on other methods of funding, that are devoid of all suspicion such as participation, *modarabah*, *salam*, infrastructure and leasing.
3. Islamic banks must develop Islamic funding products and tools, keeping pace with financial development and investment and with the Islamic *Shari'a*.

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