Tawarruq Potential Risks: The Practices of Islamic Financial Institutions in Qatar

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Abstract

Islamic Banking works in a very competitive market and fast moving international industry where mainstream banking is dominant and the needs of people for financial services are growing day by day. It faces serious challenges of exerting more endeavors to innovate competitive alternative unique Shari'ah-permissible diversified instruments that are quite distinguished from conventional cash-based ones to meet the rapidly growing needs of customers. This aggressive external environment of international banking industry forced Islamic financial institutions to find new profitable markets as competition forces profit-margins downward and to attempt to cut costs by any means. The need to avoid the risks that are linked, by nature, to some classical Islamic financing products such as Mudarabah, Musharakah and deferred sales products led many IFIs to deliberately expand their operations on Tawarruq as an alternative approach to deliver cash money to customers regardless of the objectives of the prohibition of Riba in Shari'ah, and the principle of realism in Islamic contracts. This paper argues that Tawarruq Instead of mitigating risks as thought at the first place seems to exposes IFIs to four potential types of risks that are: reputation, credit, legal, and compliance risks.

Keywords: *Tawarruq risks, Qatar IBs practices, cash-based instrument (Tawarruq), car-based Tawarruq, reputational risk, compliance risk, credit risk, legal risk.*

1. Introduction

Many IFIs claim that risk management, is one of the most important drivers that pushes them to shift from real structured Islamic contracts to cash-based instruments such

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as commodity Murabaha and other types of Tawarruq. This may be motivated by the loudly-heard idea that Islamic financial products are more risky than conventional banks' products. For example in Murabaha or Musawama contracts whereby the "Promise to buy" is not binding, the IFIs face price and liquidity risks if after buying the asset the customer rejects taking it or changed his/her mind for any possible variety of reasons while in conventional loans such risks do not exist because the bank gives cash to the customer, no asset involved. Habib Ahmed in his empirical work on product development in Islamic banks argued that there are *"risks related to product features"* (Ahmed, 2011, p. 153-154).

This paper tries to show that, the shift of IFIs from classical and real structured Islamic financial products to a cash-based instrument (Tawarruq) has exposed IFIs to a serious complexity of risks instead of mitigating risks as claimed. We take the Qatar IBs practices as a basis of this study. Four kinds of risks are associated with Tawarruq, namely, reputation, credit, legal and compliance risks. These will be discussed in the four sections of this paper and will be followed by our conclusion.

2. Reputation Risk in Tawarruq

The definition of Reputation Risk

(Reputational risk is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions. In general a reputational risk is any risk that can potentially damage the standing or esteem of an organization in the eyes of third-parties), (Perry, Jason, 2005, p. 4). It is also defined by Deloitte & Touché as *"when performance does not match expectations. Ultimately, how a company manages the expectations and performance related to its reputation determines whether value is created or destroyed* (Deloitte, 2014, p. 6).

Basel and IFSB operational risk framework, excludes reputation risk, however IFSB operational risk framework has mentioned reputation risk as a result of Shari'ah non-compliance and fiduciary risks. *"IIFS are exposed to risks relating to Shari'ah non-compliance and risks associated with the IIFSs' fiduciary responsibilities towards different fund providers. These risks expose IIFS to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities"* (IFSB, 2005, p.26).

Reputational risk can befall throughout a number of ways: it can result directly from the actions of the institution or industry itself. It can occur indirectly due to the actions of an employee or employees. It can also happen through system or product features.

Similarly it may occur through other tangential parties, such as partners, joint ventures or vendors. In Islamic finance industry reputation risk may arise from breaching Islamic finance Shari'ah principles and its moral and ethical values due to direct action of one or more IFIs or indirectly through employees particularly at the highest management levels; or through its product features. The most dangerous difficulty of reputation risk comes from being a hidden risk that can erupt unexpectedly. Although it is intangible in nature it can result in a serious tangible losses *(while reputation is intangible, damage to an institution's reputation and the resulting loss of customers' trust and confidence can have very tangible consequences – a stock price declining, a ruin on the bank, a rating downgrade, an evaporation of available credit, regulatory investigations, shareholders litigation…etc.)*, (Bayner, 2011, s.10). Because in most cases institutions do not see their mistakes until the disaster takes place, it can frequently cause losses of billions of dollars in seconds, *(It takes 20 years to build reputation and five minutes to ruin it. If you think about that, you will do things differently, said Warren Buffett)* (Ibid, s.1).

Tawarruq Downgrades the Image of Islamic Finance

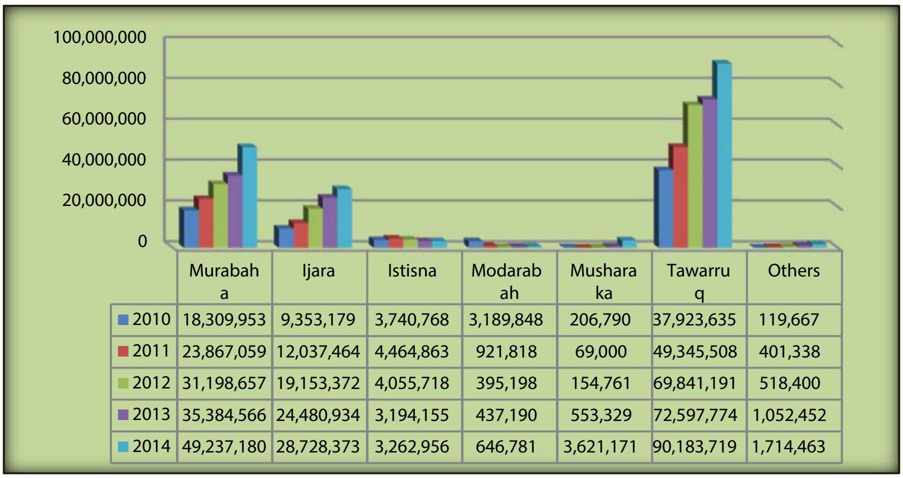
Although Islamic finance and banking industry has witnessed, to some extent, progress in respect of innovation of new hybrid and structured contracts such as Murabahah during the last four decades, still the practice of Tawarruq faces some Shari'ah issues and criticisms raised from respectful Islamic scholars, economists, and Fatwa-giving bodies like the OIC Fiqh Academy and the Fiqh Academy of the Muslim World League.

While conventional financing is based on interest and cash-based transactions, Islamic contracts are based on transferring assets through true sale transactions where riba or interest, whether de juré or de facto, is strictly avoided. Tawarruq operation breaches the Islamic Shari'ah principle of realism as one of the central conditions of Islamic finance contracts. Because the underlying asset is not meant for itself or considered as an end but rather a passage to deliver cash money to the customer. This situation brought sparked uproar and strong momentum of criticism within Islamic finance and its stakeholder's domain. It also brought criticisms from supporters of conventional banks, skeptics, and opponents of Islamic banking. A lot of frequent voices and literature criticize Islamic finance and claim that IFIs are interest-based finance in a hidden way and Tawarruq shown as the main instrument through which interest-based finance is done. *(You walk into the Islamic bank, sign some papers, "trade" in metal in some corner of the globe, and walk out with cash. Papers are pushed, money changes hands, and the metal just sits there, ready for the next customer to "trade" a few minutes later. Or can the same metal be bought and sold by different customers in the same minute? Who's counting anyway?)* (Hasan, 2014). These kinds of criticisms have very negative impacts on Islamic finance industry in the long-run. They spoil the image and the reputation of the whole industry. By expanding in the practices of Tawarruq, IFIs can attract customers and gain more profits. But they might lose them in the long-run, (*(Banks think they attract customers in the short term, but the reality is that they lose them in the long term. Ethica works with bankers and customers across multiple regions and we are seeing the same pattern: when Islamic finance's credibility is compromised, customers leave. And they usually don't come back.)* (Ibid.).

Reputation risk is quite linked to the compliance of IFIs with Shari'ah principles and its moral values. Shari'ah non-compliance in IFIs is one of the root causes of reputation risk. *(The reputation of an IFI and its profitability and market position could be at stake if there is negative publicity about its business practices, particularly relating to Shari'ah non-compliance in their products and services. Shari'ah non-compliance can be a reason for reputation risk that can trigger bank failure and cause systemic risk and instability)* (Paldi, 2014, s. 25, 26).

Tawarruq Drives out Good Islamic Finance Products

Tawarruq has become a dominant finance instrument in Islamic banks. For instance, its total exposure in assets side has reached QAR 90.2 billion in 2014 which represents 53% of the total financing assets of IFIs in Qatar. Figure (1) shows Tawarruq size in the assets side compared to other IFIs products in Qatar during the period 2010-2014:



	Murabaha	Ijara	Istisna	Modarabah	Musharaka	Tawarruq	Others
2010	18,309,953	9,353,179	3,740,768	3,189,848	206,790	37,923,635	119,667
2011	23,867,059	12,037,464	4,464,863	921,818	69,000	49,345,508	401,338
2012	31,198,657	19,153,372	4,055,718	395,198	154,761	69,841,191	518,400
2013	35,384,566	24,480,934	3,194,155	437,190	553,329	72,597,774	1,052,452
2014	49,237,180	28,728,373	3,262,956	646,781	3,621,171	90,183,719	1,714,463

Figure (1): Size of Tawarruq and other Islamic Finance Products in Qatar Islamic banks (2010-2014)

Source: (Habbani, 2015, p. 125)

It is clear that Tawarruq in assets side has got the lion share among other Islamic products. It increased from QR 37.9 billion in 2010 to QR 90.2 billion in 2014 which is almost 2.4 times. This is excluding Tawarruq between IBs for the purpose of liquidity management in the liabilities side and Sukuk-based Tawarruq. While Murabaha and Ijarah were quite lower compared to Tawarruq, Mudarabah, and Musharakah have almost disappeared from Islamic finance industry in Qatar. Tawarruq drives out classical and real structured Islamic financing products such as Mudarabah, Musharakah, Ijara, Istisna, and Murabaha, in the same way that bad money in Gresham's Law drives out the good money and replaces it in exchanging goods and services, (Kahf, Barakat, 2005).

This radical change in IFIs product mix towards imitating conventional banks might also lead to customers and depositors withdrawals, *(the same can happen if the perception of the stakeholders about the Islamic products becomes negative causing a serious loss of trust and credibility)*, (Paldi, 2014, p. 26). If this situation continues with the same trend it will damage the credibility in the long run, not only of IFIs in Qatar, but also of the whole Islamic finance industry. Islamic finance is quite distinct from conventional financing and should remain and continue to be distinct. Otherwise no need for its existence if it is imitating and replicating the same transactions of conventional banking.

Tawarruq and Lack of Governance

One of the most important sources of reputation risk is the lack of governance at both IFIs level and State level.

At IFIs level: the absence of one Shari'ah regulatory body in the State of Qatar that ensures binding authority over all IFIs represents one of the root causes of reputation risk. Although each IFI in Qatar has its own Shari'ah governance framework and Shari'ah Board, the same members are repeated in all Shari'ah boards of three Islamic banks in Qatar one member out of them is also a member of the Shari'ah board of the fourth Islamic banks. Some IFIs have the Shari'ah supervision activity within the organization structure of the IFI, but some others adopt outsourcing Shari'ah supervision Institutions. This situation in one industry that operates in one country creates confusion among stakeholders and triggers questions in their minds.

The absence of unified governance framework at the level of Islamic finance industry, at least at the level of Fatawa issuing is also considered as reputation risk. For example while AAOIFI validates a restrictive type of Tawarruq the OIC Fiqh Academy prohibits Organized Tawarruq all together. Although AAOIFI Shari'ah and accounting standards are not binding over IFIs QCB instructs IBs in Qatar to implement AAOIFI standards in accounting and reporting, and IAS in the areas that are not yet covered by AAOIFI, *(The Islamic banks should implement the accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as relevant to the accounting policies and treatments, preparing the financial statements and the related disclosures. Islamic banks should comply with the International Accounting Standards and disclosure for areas that are yet to be covered by AAOIF)* (QCB, 2013, p. 415).

At the level of the state: the lack of Shari'ah governance fosters Tawarruq transactions and makes its monitoring and control quite difficult. For example the IMF Country Report Number 08/322 reported that *(As other companies, precious metals dealers have to be registered in the commercial register held by the MEC. In addition, the Public Qatari Authority for Specifications and Criteria is in charge of the control of the quality of the metals sold, the MOI gives an authorization to sell gold. Exchange houses are permitted to engage in the purchase or sale of precious metals and gold bullions. They are licensed and supervised by the QCB and are subject to the QCB supervision (see section 3). There is no SRO for dealers in precious metals)* (IMF, 2008, p. 177). This lack of governance in one of the most related commodities to Tawarruq transactions might expose IFIs in Qatar to the exploitation by money launderers and terrorism financers, which negatively impacts IFIs reputation.

3. Credit Risk

The definition of Credit Risk

Credit risk is the risk of loss of principal or a financial payment due to the failure of debtor to pay back all or part of credit financed or meet a contractual obligation. It is defined by IFSB as *the potential that counterparty fails to meet its obligations in accordance with agreed terms… Credit risk includes the risk arising in the settlement and clearing transactions* (IFSB 2005, p. 6).

It occurs at any time a debtor is anticipating to employ future cash flow to pay an existing debt. *"The credit risk or risk of default always exists whenever a contract creates a debt and the moral hazard risk crops up in any inter-personal relationship"* (Kahf, 2006, p. 11). Credit risk is intimately attached to the prospective return of an investment and it is analyzed based on the customer's ability to repay. This includes, but not limited to, the customer's collateral, assets, and sources of repayment…etc.

Both Islamic and conventional financial institutions are exposed to credit risk.[3] In Murabahah contracts for example the IB transfers the asset to the customer with its ownership risk and the customer becomes the bearer of this risk while the IB bears the risk of customer's default. Tawarruq, when done with well-defined and guaranteed commodities in international exchanges, loses this kind of balance in risk bearing. Since there is no actual transfer of ownership of the asset in Tawarruq transactions and it is done only with prior arrangement of buy and sell the IB bears credit risk only.

Based on Basel II credit risk is associated with some risk factors that have to be computed before granting any credit finance. These are exposure at default (EAD), loss given default (LGD), and probability of default (PD). They are all used to estimate the credit risk capital requirement of financial institutions. PD is quite related to the possible credit risk caused by Tawarruq operations because the IFI does not know the final purpose of finance. The customer might spend the cash in an unproductive ways or with a sense of wastefulness which downgrade his normal source of repayment. In turn the PD will increase. LGD is also quite linked to Tawarruq operations because the IFI cannot take the underlying asset as collateral because it is immediately given up in order to deliver cash money to the customer. Also, EAD is linked to Tawarruq credit risk because the PD is too high in Tawarruq operations due to the ignorance of the final purpose of finance.

Based on the above mentioned three factors, accounting for credit risk should carefully assess different important credit risk elements that are linked to Tawarruq. The major elements relate to the purpose of finance, the segment of customer, the source of cash flow or payment, the type and value of collaterals, and the amount or the limit of finance. These elements are discussed in the following:

1- The Purpose of finance

The purpose of finance refers to the way in which the customer is going to use the credit financing. In conventional loans the case is quite serious because the bank in most cases does not know for which purposes the customer is going to spend the cash amount of the loan. While in IFIs where credit is asset-based the purpose of finance is very clear because the IFI has to own the asset at the first place then transfer it to the customer in a form of sale contract. Thus the purpose of finance element in

3 However IFIs are exposed to some additional unique ownership risk stemming from the very nature of Islamic finance contracts which are always asset-based. This asset-based nature of Islamic finance contracts requires the existence of a real asset in each transaction.

Islamic finance is quite maintained based on the principle of realism. Realism occupies central position in Islamic finance that completely distinguishes it from conventional finance. If IFIs lose this feature it becomes cash lenders just like conventional financial institutions.

The importance of knowing the purpose that lies behind any finance application can be summarized in the following points:

1.1. The bank will be confident that the credit facility will be used in a purpose that complies with the internal policies of the bank in terms of product line, customer segment targets, credit limits…etc.

1.2. The bank will make sure that the purpose of finance is quite complying with central bank regulations and all other external regulators. This includes the compliance with the anti-money laundry and terrorism prevention regulations.

1.3. In financing of income generating assets the bank will make sure that the credit finance is used in the same pre-disclosed purpose of the credit finance. Besides the bank will be aware that the credit finance will be repaid either from the cash flow generated by the business model of the customer or from the income generated by the financed asset. *(Furthermore, it has to be taken into account that, for certain finance transactions interest and principal repayments should be financed exclusively from the cash flow of the object to be financed without the possibility for recourse to further assets of the borrower. In this case, the credit review must address the viability of the underlying business model which means that the source of the cash flows required to meet interest and principal repayment obligations has to be included in the review)*, (OeNB, 2004, p.11). This is ascertained in Islamic finance by the nature of transaction while it requires extra research and evidence in cash-based transactions.

1.4. Finally, moral screening as one of the most unique elements related to IFIs can be reviewed since the purpose of finance becomes well-known. Otherwise IFIs can be exploited by money launderers and terrorism financers, or the money can be spent in any Shari'ah non-permissible uses.

2- The Segment of Customer

The segment of customer is a very important element in credit risk review process. That is because each segment has its own risk profile that is completely distinguished from other segments' risks. In retail finance the bank looks at the character, age, marital status, education level, employer, and the legal identity…etc. While in corporate and

SME finance the bank will focus on the industry, the general economic situations, competition, comparative advantages, distribution channels, management capabilities, the market experience, etc. The most common segment classifications that banks use are: sovereigns, semi-government, corporates, and retail. In all segments, banks consider the minimum and maximum limits assigned for each segment in order to avoid concentration of risks. These limits are either decided by the board of directors or determined by central banks based on a macroeconomic considerations and overall risk management concerns.

3- The Source of Payment

The source of cash flow or payment is one of the major elements of credit risk assessment. Normally banks pay this element highest priority in the process of credit risk review because it constitutes the main source of assuring the bank about repayment. Although there are different kinds of sources of payment as much as customers' segments are different, the most preferable source of repayment is the income generated from the financed asset. *(The distinction of so-called specialized lending from other forms of corporate finance is based on the fact that the primary, if not the only source of reducing the exposure is the income from the asset being financed, and not so much the unrelated solvency of the company behind it, which operates on a broader basis. Therefore, the credit review has to focus on the asset to be financed and the expected cash flow),* (OeNB, 2004, p.12). This is because of the following justifications:

3.1. In business financing the income from the financed asset will add additional cash flow for the firm. But the normal cash inflow a firm makes from its normal operation activity will be negatively impacted by the cash outflow a firm pays for the purchase of unproductive asset. For example, if a company that works on heavy equipment leasing purchased new trucks through bank finance. This will increase its income due to the additional income that will be generated from the rent of the newly financed trucks. But if the same company purchased luxury cars for its non-executive board members through bank finance its normal cash flow from its main activity will decrease. The purchased asset in this case is not productive and cannot generate income and the company has to pay its installment from its normal cash flow.

3.2. Although in retail finance the asset an individual customer buys through a bank does not generate income, but it adds real utility and benefit to the customer. An individual who buys a car through a bank will utilize it during its useful life as well as he/she can get income when it is resold later at its salvage value.

4- The Type and Value of Collateral

Collaterals are considered as an alternative source of repayment a bank can liquidate if the customer fails to pay his/her obligation from his/her primary source of payment. It is also considered as an important tool for credit risk mitigation. The most common collaterals banks take against credit finance are real estate, heavy equipment, vehicles, deposits, letters of guarantee, and assignment of proceeds…etc. In most cases the financed asset is taken as preferred collateral by banks because it gives the bank an extensive degree of power over the financed asset.

5- The Limit of Finance

The limits of finance refer to the minimum and maximum ceilings a bank allocates for each customer segment or product. Normally credit limits are determined by central banks however financial institutions decide their own limits within the limits set by the central bank. For example the central bank might decide that the maximum limit for real estate finance should not exceed 100% of the capital base of the bank, but the board of directors of the bank may decide it should not exceed 75% as a matter of conservative stand. Credit limits are also considered as a main tool to mitigate concentration of risks.

Tawarruq Credit Risk in IFIs in Qatar

Based on the definition of credit risk and its elements the following paragraphs focus on how Tawarruq operations widely practiced in Qatar expose IFIs to serious credit risks.

1- Tawarruq Maximum Exposure

IFIs do not disclose the way in which PD, EAD, LGD have been calculated, but rather disclose the maximum exposure shown as growth before the effect of risk mitigation through the use of master netting and collateral agreements. Table (1) shows the maximum exposure to credit risk of the Qatari IBs during the period 2010-2014.

	2010	**2011**	**2012**	**2013**	**2014**
Balances with QCB	2,499,731	2,727,825	7,337,844	8,271,759	9,799,699
Due from banks	24,124,860	19,255,932	17,861,082	19,371,436	22,155,983
Financing assets	65,621,758	84,168,799	114,863,395	126,947,802	162,473,508
Investment securities	8,622,101	35,508,937	34,729,284	41,140,220	42,687,274
Other assets	3,254,098	3,958,470	1,679,556	1,559,611	1,766,544
Total	**104,122,548**	**145,619,963**	**176,471,161**	**197,290,828**	**238,883,008**
Financing assets / Total	63%	58%	65%	64%	68%

Table (1): IBs Maximum Exposure of Credit Risk– (Qr.000)
Source: IBs Annual reports 2010-2014

It is clear from the table that the financing assets have got the lion share among other exposures with average of 64% out of total exposure. Table (2) compares IBs total size of Tawarruq exposures with the total financing assets exposure in Qatar:

	2010	2011	2012	2013	2014
Financing assets exposure	72,843,840	91,107,050	125,317,297	137,700,400	177,394,643
Tawarruq exposure	37,923,635	49,345,508	69,841,191	72,597,774	90,183,719
Tawarruq / Financing assets	52%	54%	56%	53%	51%

Table (2) IBs Tawarruq Exposure to Total Financing Assets– (Qr.000)
Source: IBs Annual reports 2010-2014 and (Habbani, 2015, p. 124)

It is clear from the table that the size of maximum Tawarruq exposure represents an average of 53% out of the total financing assets. This high level of Tawarruq exposure might expose IFIs to serious losses in case of default.

2- Tawarruq Conceals the Final Purpose of Finance Application

From customer perspective the financed asset in any Tawarruq operation does not represent the final purpose of the finance application but rather a bridge to receive cash in order to achieve another purpose that is hidden in most cases. Although IFIs know that the customer seeks cash money but do not know the final purpose of finance. In other words the IFIs do not know for which purpose the customer will use the money. Consequently IFIs lose the following important elements:

2.1. The ability to know whether the final purpose is complying with the IFI internal policies or not because the final purpose in most cases is hidden.

2.2. The ability to know whether the final purpose is complying with the central bank regulations or not.

2.3. The ability to execute accurate moral screening.

IFIs ignorance of the final purpose will increase the chances of customer default due to the possibility of using the money in activities that may weaken the customer's sources and ability of repayment. This risk is true and serious in Tawarruq when compared with real Islamic finance practices; but when compared with conventional banks, it is similar to their practices. This also means that real practices of Islamic finance mitigate the credit risk, when compared with conventional banking, because the former confirms the final use of credit. Unfortunately, Tawarruq loses this advantage.

Although IFIs have achieved excellent performance with regards to the rate of Non-performing accounts (NPA) to total financing assets and provisions to NPA, it is reported that the NPA of individuals' exposure have sharply increased to reach more than 50% of the total NPA, (… At the same time, the share of NPLs of individuals rose substantially and accounted for more than half of the total NPL. While the NPL ratio of the private corporate sector declined to 1.6% by end-December 2013, that of individuals was around 5 %...), (QCB, 2013, p. 101). Given the IFIs total consumer financing amount of QR 38.6 billion which represents 41% out of the total consumer financing in 2014, as shown in table (3), the PD in the consumer financing exposure of IFIs seems to be very high bearing in mind that the defaulted percentage of consumer financing exposure in all Qatari banks exceeded 50% of the total NPA in the same period as reported by QCB earlier.

	Consumption	Real estate	Government
Qatari Banks	94,695	94,250	231,140
Conventional	56,084	67,882	184,005
% of Qatari Banks	59%	72%	80%
Islamic Banks	38,611	26,368	47,135
% of Qatari Banks	41%	28%	20%

Table (3) : Banks Groups (The largest Credit Facilities Dec. 2014), (Qr.000)
Source: QCB, Quarterly Statistical Bulletin-Dec 2014, table (25)

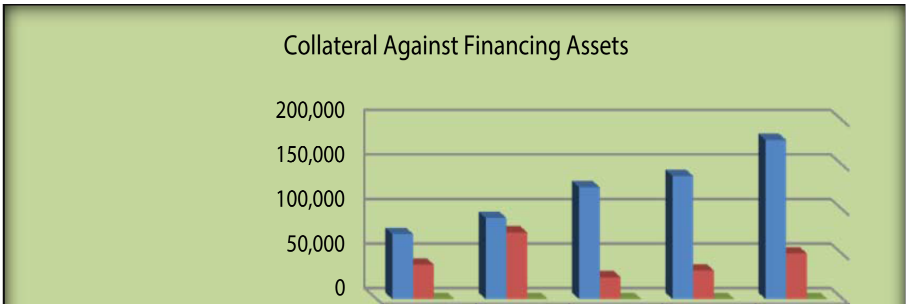
Since most of Tawarruq transactions within financing assets are retail financing transactions that mean the size of Tawarruq exposures during the period 2010-2014 bear the same credit risk that consumer financing bears. As individual NPA in all Qatari banks exceeded 50% of the total NPA as reported by QCB, it indicates that NPA in Tawarruq exposure also exceeds 50% of the total Tawarruq NPA.

Expansion in Tawarruq operations leads to higher percentage of NPA. The hottest example for that is the case of Nayifat Finance Company which is an Islamic finance company operating in the Kingdom of Saudi Arabia under the supervision of Saudi Monetary Authority (SAMA). Its Tawarruq exposure has expanded to reach SR 1.6 billion in 2014 which represents 98.5% of gross financing assets. Consequently its NPA increased from SR 57.8 million in 2013 to 106.9 million in 2014, and the provision for NPA increased from SR 25.7 million in 2013 to SR 45.6 million in 2014. The NPA to Total financing assets was 9.4% and the provisions to total financing assets were 4% which are extremely higher than accepted standards, (Nayifat, 2014, p. 14).

3- Tawarruq Loses a Prime Collateral

The financed asset in Tawarruq instrument does not represents the final target of the customer. It is only a way to get cash money. The financed asset must be sold immediately either by the customer or through the bank in order to deliver cash money to the customer. If the asset remains in the hand of the customer then this transaction is not a Tawarruq transaction. Since the asset will be sold the bank cannot hold it as a pledge against the credit facility. The best practices of credit risk management tell that the best way is to take the financed asset as collateral against the newly issued credit exposure. The value of asset has to be fairly evaluated so that the bank decides the minimum advanced payment the customer has to pay. This will assure that, the market value of the asset in future will fully or partially cover the outstanding exposure in case of default.

The expansion of IFIs in Tawarruq operations without prime collaterals exposes them to serious losses in case of default bearing in mind that the total fair value of collaterals that all IBs in Qatar hold does not cover, neither Tawarruq exposure nor the total financing assets exposure. Figure (2) below compares the total fair value of collaterals IBs hold with the total financing assets exposure:



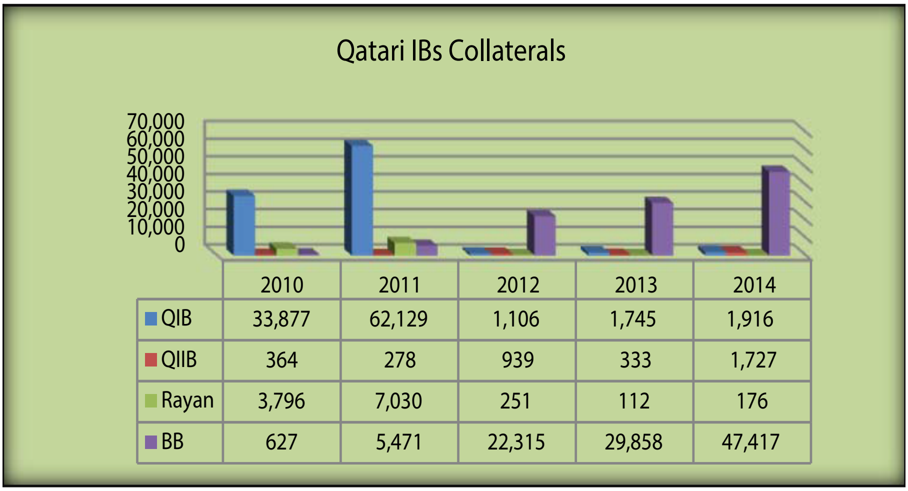
	2010	2011	2012	2013	2014
Financing assets	73,035	91,106	125,590	138,139	178,701
Collaterals	38,664	74,909	24,610	32,048	51,236
Collaterals / Financing assets	53%	82%	20%	23%	29%

Figure (2)

Source: Calculated from IBs Annual Reports 2010-2014

As shown in figure (2) the percentage of IBs total fair value of collaterals does not cover the total financing exposures during the five years. The recovery ratio has sharply decreased in 2012 and slightly increased in 2013 and 2014 respectively but did not exceed 29%. The maximum achieved recovery ratio was 82% in the year 2012. The sharp increasing of financed asset as shown in the figure should have been covered not only by an equal increasing trend in collaterals fair value, but even by more collateral. The best practices of credit risk management advise that collateral recovery ratio should always exceed the maximum exposure of credit financing assets.

Figure (3) shows the size of collaterals of the four IBs in Qatar individually:



	2010	2011	2012	2013	2014
QIB	33,877	62,129	1,106	1,745	1,916
QIIB	364	278	939	333	1,727
Rayan	3,796	7,030	251	112	176
BB	627	5,471	22,315	29,858	47,417

Figure (3)

Source: IBs Annual Reports 2010-2014

It is clear that while QIB held the highest value of collaterals in 2010 and 2011 respectively. Barwa Bank held the highest value of collaterals in the years 2012-2014. QIIB and Masraf Al-Rayan were the lowest during the five years.

Since IFIs lose collaterals in Tawarruq operations. The rapid expansion in Tawarruq exposure explains the shortfall of the collateral recovery ratios during the last five years. This situation will continue as long as IBs are wildly expanding in Tawarruq practices.

4- Tawarruq Creates Concentration Risk

Concentration risk normally arises from uneven distribution of exposure to certain type of product, customer's segment, region, or industry. It refers to an exposure with the possibility to cause great losses that can threaten the ability of the bank to perform its normal operations. Concentration risk may cause serious losses for banks and for the whole economy. For example the concentration of the national banks of Qatar including IFIs on real estate financing during the period 2005-2008 pushed Qatar government to buy the real estate portfolios of all local banks, including IFIs, at a cost of QR 14.4 billion in June 2009 to support the domestic financial sector against the fallout from the impacts of 2008 financial crisis, (QCBAR, 2009, p.81). Figure (4) reveals how real estate finance has sharply boomed during the period 2004-2008. It increased from QR 4 billion in 2004 to QR 33.3 billion in 2008.

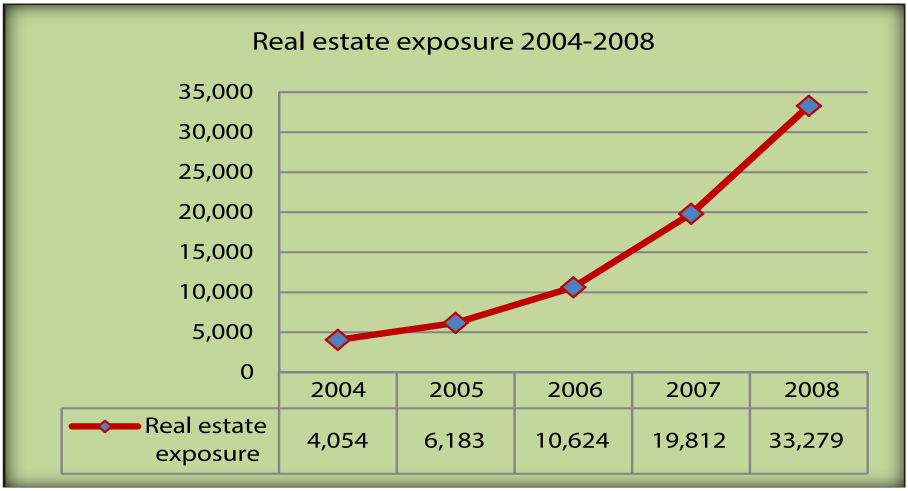


Figure (4)
Source: QCB, Quarterly Statistical Bulletin-Dec 2008, table (16) page 34

Table (4): Banks Groups (Assets Mix per Products Dec. 2014), (Qr.000)

	2010	2011	2012	2013	2014
Murabaha	18,309,953	23,867,059	31,198,657	35,384,566	49,237,180
Ijara	9,353,179	12,037,464	19,153,372	24,480,934	28,728,373
Istisna	3,740,768	4,464,863	4,055,718	3,194,155	3,262,956
Mudarabah	3,189,848	921,818	395,198	437,190	646,781
Musharaka	206,790	69,000	154,761	553,329	3,621,171
Tawarruq	37,923,635	49,345,508	69,841,191	72,597,774	90,183,719
Others	119,667	401,338	518,400	1,052,452	1,714,463
Total	**72,843,840**	**91,107,050**	**125,317,297**	**137,700,400**	**177,394,643**

Source: Collected from Table (2) and IBs Annual Reports 2010-2014

Tawarruq has gotten the biggest share among all types of Islamic products followed by Murabaha. Table 4 brings to light a serious lack of diversification and uneven distribution of exposures among Islamic products. It reveals apparent concentration risk in Tawarruq instruments during the period 2010-2014. It is also clear that Tawarruq has substantially increased during the period 2010-2014. While Ijarah and Istisna respectively occupy the third and fourth ranks in the product mix, Mudarabah and Musharaka were extremely minimal. This level of concentration risk in Tawarruq can lead to serious credit losses particularly if the economy is unexpectedly slowed down. This is caused by the following two unique credit risks of Tawarruq:

1. The final purpose of finance is unknown. Consequently the IB does not know the actual sector or segment it finances which will lead to procuring wrong and misleading data that do not help in managing credit risk portfolio. For example in car-based Tawarruq the IB records it as car finance while in fact it is not. The customer may use the money to complete his own house which is real estate finance, or he can use it for medical treatment which is also a different segment. The same applies to all other types of Tawarruq operations. The risk reports to the executive management or to the board of director may mislead to take wrong decisions. Conventional Banks disclose loans exposures in their financial reports while Tawarruq exposures in three IBs are mixed with Murabahah and Musawamah exposures, the exception is Barwa bank.

2. The lack of prime collateral in most Tawarruq transactions exposes IFIs to severe credit risk. Although CBs focus exclusively on one or two finance contracts, loan and overdraft, which are not considered as concentration risk, they have a variety of risk mitigation tools. They can securitize their loans portfolio, or use any kind of derivatives to hedge loans and overdrafts commitments. In case of hedge ineffectiveness they go into a new hedge commitment to mitigate risk on a continuous basis, (QNB, 2014, p. 108). Since IBs do not have such hedging facilities and they have to stick to their credit risk exposure, the loss of prime collateral is a serious loss indeed.

5- Tawarruq Structure Risks

The structure and the process of Tawarruq transaction are quite complicated. This process-complication, in which more than two parties are involved, inherently has three types of risks which might slightly vary based on the type of Tawarruq. Car-based Tawarruq for instance might have only one car show room that sells the car to the bank at the first place and again buys it from the customer. Figure (5) shows the process of commodity Murabaha based on which the three types of risks are pinpointed as follows:

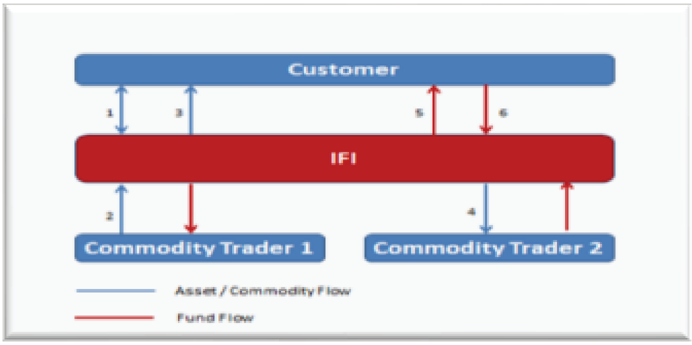


Figure (5): The Process of Commodity Murabahah

Source: Bank Islam, Credit Risk Management in IBs, IFSB, INCEIF Program, 2013

1. IFI is exposed to risk when the bank purchased the asset in step 2 based on the purchase orderer in step 1 and the customer changed his mind. This is a very high risk particularly when the "customer's promise to buy" is not binding. Although this type of risk exists also in true local Murabaha, but in Commodity Murabaha the case will be more risky because in local Murabaha normally IFI hedges for this risk by signing the purchase agreement on "Opt-Out condition for the buyer only". This agreement gives IFI the right to withdraw within two weeks if the customer changed his mind. But in commodity Murabaha where the purchase takes place in the international markets IFI loses this risk mitigation tool. Because in international markets there is no chance for the buyer to withdraw once the order is confirmed, and the payment in most cases has to be done immediately. Beside, in commodity Murabaha the IFI loses the purchase-brokerage commission that is paid to the broker at step 2.

2. The sequence of the purchasing and reselling of the asset and the fact that two brokers are involved might expose IFI to price risk. This will be terrible if the customer changed his mind after the IFI purchased the asset.

   This is of course in addition to normal credit risk if the customer failed to pay in future. Although this kind of risk is shared with all other financing products but in Tawarruq the bank does not know the final purpose of the credit application and also loses the chance to take the asset as collateral.

4. Legal Risk

The definition of Legal Risk

Legal risk can be defined as the possible loss that might arise to an investment or credit facility or any financial agreement as a result of inadequate and wrongly applied, or simply violating legal procedures in the country where the agreement being issued or the country in which the disputes have to be governed. It can also be defined as the loss that may occur due to legal uncertainty, *(There are two dominant approaches to defining legal risk. One is a broad definition of all business risks with legal consequences. This defines "legal" risk as significant legal consequences that flow from actions attributable to the business; The other is narrow, defining legal risk as risk originating in legal work product or legal uncertainty, which in turn has significant business consequences)*, (Moorhead, 2015, p. 4).

This definition has been supported also by Mahler who said: *(Legal risk is sometimes defined as the risk that is caused by, or which depends on, legal uncertainty. This can be illustrated by the following: "The risk that unexpected interpretation of the law or legal uncertainty will leave the payment system or members with unforeseen financial exposures and possible losses"* (Mahler, 2007, p.13).

Roots of Legal Risk Related to IFIs

Although most of Muslim countries have considered Shari'ah as one of the main sources of law, they have adopted mixture of Shari'ah law and different Western laws either due to colonization or imitation, such as English Common Law and French Continental Civil Law except very few Islamic countries like (Iran, Saudi Arabia, Sudan, and Pakistan) have developed, to some different extents, Islamic laws. So IFIs in most Muslims countries work in a mixed legal environment where their Islamic contracts have to comply with Shari'ah principles as well as with common or civil laws and regulations. Therefore disputes related to IFIs within Muslim countries where Shari'ah is the dominant law might not cause critical difficulties, but in countries that have mixed legal systems like Malaysia and Qatar or in countries that do not have Islamic laws like UK the case will be very complicated, *(As most Muslim countries have adopted either the common law or civil law frameworks, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products),* (Ahmed 2006, p. 16).

There are many disputes related to some Islamic structured contracts such as Tawarruq and Sukuk-based Tawarruq that caused great losses to IFIs. Such disputes occurred in some Muslim countries like Malaysia, Bahrain, UAE, as well as in cross-border transactions whereby different parties from different countries with different legal environments and cultural backgrounds are involved. Most of these disputes have been ruled in UK where Shari'ah law is not recognized or codified. Thus the lack of unified binding Islamic legal framework can be considered as one of the main root-causes of legal risk. The other root-cause of legal risk relates to the lack of reality of the Islamic hybrid instrument used particularly in cross-border investment and financial transactions. The main target behind these transactions is to deliver cash whether through a direct Tawarruq transaction or a Sukuk-based one. The utility of the underlying asset is not the final desired target of the buyer, *(Asset-based Sukuk, on the other hand, do not undertake true sale in the structure, but are rather more aligned with conventional bond structures. The Sukuk holders have a right that covers the underlying asset rather than ownership of the underlying asset; accordingly, they have recourse to the originator in case of default. In this regard, the investors'concerns will differ depending on whether they are focused on the asset value itself or on the creditworthiness of the obligor)*, (Khan, Elsiefy, Lee, 2014, p. 9).

IFIs have been struggling to muddle through the continuous aggressive evolution of the international banking industry which is moving very fast in terms of innovation of new products, financing practices, contracts, modern hedging tools, and new services…etc. This situation compelled most IFIs to go for the easier way of imitation or rationalization of conventional banking products. One of the main drawbacks of this choice is that IFIs have not been cautious towards the potential legal risks that might associate with these kinds of customized instruments particularly in cross-border transactions. The importance of both innovation rather than imitation, and formation of unified Islamic legal system stand as the real challenges before IFIs. The lack of both or one of them will continue causing harmful damages to Islamic finance industry bearing in mind the fast growing IFIs operations across the globe.

It is reported that the total global assets of Islamic banks reached US$1.54 trillion in 2012 and was estimated to touch US$1.7 trillion in 2013, the largest six Islamic markets QISMUT (Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, Turkey) are growing at 5-years CAGR of 16.4% for the period 2008-2012 and the average ROE of 12.6% for the top 20 Islamic banks, compared to similar conventional banks average of 15%, and they got hold of 38 million customers globally in the same period (E&Y 2013/2014, p. 8).

Within this robust growth of Islamic finance industry, cross-border Islamic transactions have also grown rapidly, the fact that can be realized from the growth of Islamic Sukuk Market which has significantly increased from US$ 5 billion in 2003 to a number of 750 new issues of a total amount of US$ 130 billion in 2012 (E&Y 2013/2014, p. 24). Most of these sukuk, as well as other types of Islamic financial instruments are cross-border transactions whereby English common law, in most of them, constitutes the governing law; *(The number of Sharia compliant products that are available has grown enormously over the past few years. Many Islamic finance transactions are governed by English law or the law of another country, instead of Sharia law)* (Lawrence, Khan, Morton, 2012, p.1). The expansion in cash-based transactions along with applying English law or any other Western laws whereby Islamic Shari'ah is not known, or even, applying some Muslim countries' laws where Shari'ah law may coexist with common or civil laws exposes IFIs to serious legal risks as indicated by the following few examples.

Islamic Finance Dispute Cases and their Impact

We will review a few dispute cases related to Islamic financial transactions in UK, and US. The objective of this review is to show how the attitudes of courts in processing and rulings expose IFIs to legal risks.

Islamic Finance Disputes in UK:

Due to the absence of a unified Islamic legal system in most Muslim countries the governing law in cross-border financial transactions used to be the English common law. For IFIs, this is the best choice because of superiority or 'holiness' of contract in the common law framework. Most disputes related to international Islamic finance contracts are governed by English law. (*These typical practices indicate that numerous Islamic financial transactions are governed by English law in which the courts of England have exclusive jurisdiction to settle any Islamic finance disputes under such arrangements*), (Zulkifli, Asutay, 2011, p. 15).

But the practice of adopting English law has shown that the outcomes of most of disputes related to Islamic finance contracts exposed IFIs to legal risk in forms of direct financial losses or incidents of non-compliant with Shari'ah principles. This can be obviously noticed from the outcomes of the following case.

1- IICG and Symphony Gems (SG) case:

The case of Islamic Investment Company Of the Gulf (Bahamas) Limited, IICG, v Symphony Gems N.V. and Ors [2002] West Law 346969, QBD (Comm. Ct.)10 which was decided on 13 February, 2002 was the first case in the English courts pertaining to Islamic finance, (Zulkifli, Asutay, 2011, p. 15). The case tells that IICG registered under the law of Bahamas, and Symphony Gems (SG) signed an agreement in which IICG has to grant revolving Murabahah credit line to purchase precious stones from a third party (Precious Ltd). IICG paid the Precious Ltd immediately after receiving the order from SG. Precious Ltd failed to deliver the precious stones to SG. Since the precious stones were not delivered SG did not pay the rest of the amount. IICG brought the case to the London High Court (LHC) claiming for full payment of the balance amount. The defendant put the following arguments before the court:

- ✓ The Murabahah contract is an Islamic contract where delivery of the underlying asset is a prerequisite and since no delivery has taken place IICG has breached the contract and should be considered by the court;
- ✓ Since SG is registered also under Bahamas law the defendant claimed the common law principle of *ultra vires*;

The court decision was as follows:

- ✓ The contract was valid under English common law since the contract has included a very clear clause *(stating that the defendant was obligated unconditionally to purchase the gems from the plaintiff)*, (Ibid, p. 16).
- ✓ The delivery of precious stones is not a prerequisite in the contract. *(The court referred to the relevant clause provided in the contractual agreement which clearly stated that the plaintiff would not be liable for any failure of delivery or defects or any deficiency)*, (Ibid, p. 16).
- ✓ Regarding the argument of the contradiction with Shari'ah principles the judge consulted two Islamic scholars who asserted that the underlying contract was not complying with Islamic Murabahah contract therefore the judge dismissed this argument and decided that the contract is valid under English law. *In order to determine the validity of this Murabahah contract, two experts were called to testify, namely Dr. Yahya Al Samaan of the Saudi Law Firm of Salah Al Hejailan and Dr. Martin Lau of the School of Oriental and African Studies*, quoted , Zulkifli, Asutay, 2011, p. 16 (Balz, 2004: 124).
- ✓ The judge also rejected the argument of applying the principle of *ultra vires*, *(After analyzing the ultra vires law of the Bahamas, the court took the view that the plaintiff was not subject to the ultra vires doctrine (Moghul and Ahmed, 2003-2004, 188). The court ordered the defendant to pay the total amount of USD 10,060,354.28, inclusive of both principal and the compensation for late payments)*, (Zulkifli, Asutay, 2011, p. 16).

Although the case, seems to be like real Murabahah, but many remarks related to the structure of the transaction shows that it carries Tawarruq features rather than true

Murabahah. These remarks can be summarized as follows:

- ✓ The underlying asset was not possessed in reality by IICG. Because if IICG possessed the asset it could had been easier to transfer it to SG. Furthermore the court did not check whether IICG transferred the asset or not because simply the argument of the delivery of the asset as a prerequisite in the contract had been dismissed by the court.

Precious Ltd was not, in fact, a real supplier but rather a broker who was dealing with manufacturers and providers of precious stones. Consequently the involvement of a broker in any international commodity purchase transaction is an inherent feature of Tawarruq as practiced nowadays.

This risk was true, as Tawarruq had increased legal risk when compared with true Islamic finance transaction because there was no real delivery of asset and IICG in fact did not possess the underlying asset. But if it was a real Islamic Murabahah the delivery would be part of the transaction and legal risk declines. But when compared with the practices of conventional banks; it is similar to their unrealistic provision. In other words, true practices of Islamic finance reduce the legal risk, when compared with conventional banking, because they assure the delivery of the financed asset while Tawarruq loses this advantage edge.

Islamic Finance Disputes in USA:

There are three cases related to Islamic finance which have been brought to the US Courts. One of them relates to the bankruptcy of Arcapita which is taken in this section as a good example of typical legal risk of Tawarruq.

1- Arcapita Bankruptcy Case:

The bankruptcy case of Arcapita bank is considered as one of the most important cases that bring clear idea how Tawarruq can result in a serious legal risk and huge losses to IFIs. It tells how insolvency of any IFI can erupt all at once without any prior notice due to the lack of realism in Tawarruq transactions.

Arcapita was the first IFI to file a petition to restructure under Chapter 11 bankruptcy proceedings in the United States, (Goud, 2013). The bankruptcy was announced in a public press release held by the bank in 19th march 2012. *(Arcapita's Board of Directors has approved this course of action as the most effective way to protect their business and assets and implement a comprehensive restructuring that rationalizes Arcapita's capital structure and maximizes recoveries to creditors and other stakeholders)*, (Arcapita, 2012, p. 1).

Arcapita started business operations in 1997 under the name of First Islamic Investment Bank (FIIB). FIIB was Operating under an Islamic wholesale banking license issued by the Central Bank of Bahrain. It was privately owned by 360 shareholders. Arcapita Group is a subsidiary of FIIB which also provided Shari'ah compliant investment services and operated as an investment bank.

On March 19, 2012 Arcapita filed for protection under chapter 11 in the US Bankruptcy Court (USBC) after the group failure to convince a lender to reschedule a US$ 1.1 billion syndicated structured finance due on March 28, 2012.

It was reported that *(The global recession and the debt crisis in the Eurozone are the two primary factors leading to Arcapita's bankruptcy filing. Due to the recession, the company has seen its investment assets decline in value)* (Cornell, 2012).

Soon after filing for insolvency in the US, Arcapita Investment Holdings Limited (AIHL), a subsidiary of Arcapita incorporated in the Cayman Islands, hunted for protection from the Grand Court of the Cayman Islands. AIHL started procedures in the Cayman Islands in order to prevent another party from taking legal action in the Cayman Islands that might weaken the advantages given by the USBC, (Ibid.).

Arcapita started investment in the US market through its subsidiary in the US called Crescent Capital (CC) in Atlanta which has a branch in Europe. Its investment strategy aimed to *(to target a company with good, steady cash flows. It would typically be unlisted, but would be underpriced. Its initial targets would be family owned businesses that did not make a smooth transition into going national. And take it on an aggressive expansion plan and sell it for a profit within a year or two for a healthy return).* (Kureshi, 2013).

Through CC Arcapita acquired a number of well-known chains of retail stores in the US, (Bloomberg, 2015). It also acquired Bijoux Terner an international chain of fashion retail stores with more than 700 branches around the globe, (Wikipedia, 2015). The total investment including equity, real estate, and acquisitions that had been executed during the period 1997-2000 was around $ 1.5 billion, (Kureshi, 2013). During the period 2004-2006, Arcapita executed 7 investments of $ 2.393 billion. And it had conducted 8 investments of $ 13.2 billion in oil and gas, utilities, commercial cooling systems, electricity generation and warehousing and logistics during the period 2006 – 2008, (Kureshi, 2013).

According to Kureshi Arcapita's exits were doing well. It achieved exceptional above all expectations ROE ranging between 40% and 100% during the period 2005 until 2009 in spite of the great collapse in 2008 (Ibid.). This may indicate that one of the reasons of Arcapita's insolvency was the products structure and lack of realism particularly during the years 2006 until the Company went for filling under chapter 11 in 2012. The lack of realism is apparent in Arcapita's acquisition and exit of Veridian Group (VG). Arcapita acquired VG at a price of $ 3 billion in 2006 while exited at a $ 2 billion loss, which represents 67% out of the total capital invested, (Ibid.). The first quarter financial report of VG at the end of March 2009/2010 revealed £ 45.2/40 million losses and £ 251/291 million accumulated retained losses in the same years respectively. It also revealed that the ratio of total loans to total equity was (7.8:1) and (9.3:1) in 2009 and 2010 respectively which are very high leverage ratios. This means, for each single pound paid from the shareholder's equity, VG borrow 7.8 and 9.3 pounds.

These continuous losses and high leverage ratios proved that the value of VG was overestimated when it had been acquired in 2006. Since it was purchased at £ 3 billion and sold at a loss of £ 2 billion that means its value was twice doubled. In fact the £ 2 billion huge loss of Arcapita's from the sale of VG was the actual start point of the collapse story, (Kureshi, 2013).

Sukuk-based Tawarruq was one of the Root Causes of the Collapse

The expansion of Arcapita in cross-border Sukuk-based Tawarruq transactions in fact was one of the major factors that exposed Arcapita to serious legal risks. Loyens & Loeff a well-known attorney, tax lawyers, and civil notaries, has given the evidence that prove how Arcapita deals with cross-border Sukuk-based Tawarruq transactions. They published their profile on their website and mentioned under the category (Highlights of our Islamic finance practice) that *(We advised Arcapita in the Shari'ah-compliant USD 400 million acquisition of the Tensar Corporation (by means of a Tawarruq structure), a global leader in providing technology driven soil stabilization, erosion control and foundation support products),* (Loyens & Loeff, 2015).

Most of Arcapita Sukuk-based Tawarruq transactions were cross-border contracts that were governed by Western laws whereby no room for Shari'ah principles. This situation exposes IFIs to legal risk. Arcapita deliberately filing under chapter 11 of the USBC stands also as another real example of typical legal risk happening.

The first noted legal risk in the filing under chapter 11 document is that, USBC had classified each single creditor's claim as "bank loan" while all Arcapita's contracts were Islamic. Despite that, the authorized signatory of Arcapita "Henry A. Thompson" had signed a "Declaration Under Penalty of Perjury" (DUPP). That means Arcapita under the signed (DUPP) declares that it has gone through the consolidated list of creditors holding the 50 largest unsecured claims" and that it is true and correct to the best of its information and belief (USBCMD, 2012, p. 17). USBC classified all claims as "bank loans" simply because of the Tawarruq nature of these contracts. Had these contracts been classified as profit and Loss sharing contracts, such as Mudarabah, Arcapita would have a solid legal argument that as a Mudarib it does not share loss except in the case of negligence. Accordingly, Arcapita could have incurred no risk since the 2008 and euro-zone financial crises were identified as the major causes of the collapse. While in loans there is no place for such argument.

In June 11th 2013 the USBC has approved the reorganization plan of Arcapita. The plan stated that only secured debtors will be paid in full and the unsecured debtors will receive 7.7% out of the $1.9 billion, (Reuters, 2013). The total liabilities of the largest unsecured 50 creditors were $ 2.1 billion, while Standard Chartered PLs (SCB) was the only secured creditor with the amount of approximately $96.6 million, *(SCB extended two $50 million Murabahah facilities to Arcapita in 2011. Under the agreement, SCB's $96.6 million in principal amount of claims will be paid in cash, subject to a $2 million reduction of its adequate protection claims, with the proceeds of its exit facility)*, (Leveragedloan.com, 2013). This ruling revealed that most of Arcapita investments transactions were not asset backed based transactions. Most of creditors were left either without clear entitlements over real assets or with just only ownership certificates that can never be translated on a real possession of the assets. This is apparent from the proceeding which mentioned that Standard Chartered PLs (SCB) was the only secured creditor with the amount of approximately $96.6 million.

5. Compliance Risk

The definition of Compliance Risk

Compliance risk is part of operational risk. Several definitions of compliance risk have been provided by different institutional or individual stakeholders who are involved in Operational Risk, governance, supervision, and compliance. Although there are no major differences or conflicts between most definitions, the definition of Michael D. Kelsey and Michael Matossian may be the most comprehensive one. They define compliance risk as *(The adverse consequences that can arise from systemic, unforeseen, or isolated violations of applicable laws and regulations, internal standards and policies, and expectations of key stakeholders including customers, employees, and* *the community, which can result in financial losses, reputation damage, regulatory sanctions, and, in severe cases, loss of franchise or rejected mergers and acquisitions)*, (Kelsey, Matossian, 2004, p. 6).

This definition gives a broader meaning of compliance risk for both conventional financial institutions (CFIs) and IFIs. However IFIs have additional unique piece of compliance risk that is not applicable in CFIs. Beside the compliance with internal standards and external laws, regulations, and expectations of major stakeholders, IFIs have to comply with Shari'ah moral values and its principles as determined by internal or external Shari'ah regulatory bodies.

The Shari'ah non-compliance risk can be defined as *(the risk that arises from the Bank's failure to comply with the Shari'ah rules and principles determined by the relevant Shari'ah regulatory councils)*, (Chik, 2013, p. 13). It is also defined by IFSB as a *(the risk that arises from IIFSs' failure to comply with the Shari'ah rules and principles determined by the Shari'ah Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate)*, (IFSB, 2005, p. 26).

Potential Areas of Compliance Risk in IFIs

Compliance risk in IFIs normally arises from the following five areas:

1. Non-compliance with the laws or regulations forced by the local regulator such as central banks. This includes credit and investment maximum limits, supervisory ratios, management approach, governance, BOD election, reporting and disclosure…etc. Both IFIs and CFIs are exposed to this type of risk.

2. Non-compliance with Anti-Money laundering and Combating Terrorism Financing (AML & CFT) standards and regulations. QCB regulates and supervises local and foreign financial institutions in Qatar with regards to AML & CFT based on (the Law Number (4) of the Year 2010 "Combating Money Laundering and Terrorism Financing Law" that has been developed by the National Money Laundering & Terrorism Financing Committee. Both IFIs and CFIs are required to comply with these laws and regulations in terms of internal policies and procedures formulation, implementation, monitoring and controlling, information technology systems implementation, and reporting.

3. Non-compliance with some of the State government department laws and regulations such as the commercial law, property law, criminal law, tort law, labor law…etc. Both IFIs and CFIs are equally required to comply with these laws.

4. Non-compliance with the expectations of major stakeholders such as customers in terms of service quality and customer protection…etc. which are also valid for all financial institutions.

5. Non-compliance with Shari'ah rules determined by relevant reputed Shari'ah bodies such as internal or external Shari'ah boards, Fiqh Academies…etc. This type of compliance risk is related only to IFIs.

Cost of Non-compliance Risk

An empirical research on the economic effect of compliance measures named "The True Cost of Compliance" was conducted by The Ponemon Institute Tripwire, Inc. on a representative sample of 46 multinational organizations. It was found that the average cost of compliance is $ 3.5 million while the average cost of non-compliance was $ 9.4 million. The survey concluded that investing in compliance activities helps avoid business disruption, reduced productivity, reputation damage, fees, fines and penalties, (Ponemon, 2011, p. 2). Not-surprisingly PNP Paribas Bank pleaded guilty to the New York County District Attorney on 30th June 2014 for $ 8.8 billion penalties for illegal transactions for violating US sanctions, HSBC Bank pleaded guilty with $375 million in forfeiture and penalties in 2012, Standard Chartered Bank for $327 million in forfeiture and penalties in 2012, ING Bank, with a penalty of $619 million in 2012, Barclays Bank for $298 million in 2010, Credit Suisse AG for $536 million in 2009, and Lloyds TSB Bank, with a penalty of $350 million in 2009, (NYCDAO, 2012).

The cost of non-compliance can also occur due to lack of truth-in-lending regulations and AML. In addition to direct cost of implementation of new systems, employing permanent or outsourcing consultants and lawyers…etc. (Kelsey, Matossian, 2004).

The cost of non-compliance is too high for IFIs as well as for CFIs. However IFIs are expected to be exposed to higher cost compared to CFIs because IFIs have singularly an added Shari'ah non-compliance risk.

Tawarruq Compliance Risk

Compliance risk may exist in all financing products. However conventional loans, overdraft, Murabahah, Ijarah, and all retail or consumer finance products are regarded as potential areas of compliance risk, *(Compliance risks are present in every product offered by a bank. Even though the ramifications for missing flood insurance may be greater for a single commercial loan, consumer loans generally provide more opportunity for compliance exceptions and, in most banks, would be considered a* *higher compliance risk product)*, (Ibid. p. 7). So the product structure in terms of the process, subject matter of contract, parties involved, payment, and maturity are the main determinant of the weight of compliance risk. In overdraft, and personal loan the bank is completely ignorant of the final purpose of finance. While in real Murabahah where the purchased asset is the target of the buyer there is no place for any degree of ignorance.

Non-knowing the final purpose of finance while it increases credit risk because the customer can spend the cash on anything, it may also create compliance risk because the cash may be spent on purchases that violate Shari'ah.

Since the main target in Tawarruq is the cash and the purchased asset is only a bridge to deliver cash to the customer. The final purpose of finance is quite unknown to the IFI which violates the realism principle. Unreality together with the complexity of the process of Tawarruq transaction due to the involvement of more than two parties, and more than two contracts create a generative environment for compliance risk. The fragile structure of Tawarruq exposes IFIs to potential compliance risk that can be identified through the following three types:

1- Tawarruq Shari'ah Non-compliance Risk:

Shari'ah non-compliance risk takes place once transactions executed by IFIs are ruled impermissible. Since in IFIs normally cleanse profits from prohibited sources by transfer all profits to charity. The IFIs could bear big losses if the profit from such impermissible transactions is channeled to charity.

Islamic finance industry nowadays is exerting serious efforts to focus on innovation rather on imitation. The need to link Islamic finance with the objectives of Islamic Shari'ah has got loud voices. OIC Fiqh Academy has clearly prohibited Tawarruq as practiced in IFIs, (OICFA, 2009) *(Recently, with various well regarded Shaykhs, openly questioning practices of other IFIs. Recent events include Sh. Taqi Usmani's stating that 85% of all sukuk were non-compliant and subsequent AAOIFI statement clarifying sukuk structures and their validity: the Malaysian High Court Ruling that BBA was not compliant and the subsequent Malaysian Supreme Court overturning this decision)*, (Firoozye, 2009, p. 6). These efforts might lead to rule IFIs contemporary Tawarruq practices as non-permissible. Thus the profit of total Tawarruq exposure of all IFIs must go for charity. The case will be absorbable if Tawarruq exposure represents not more than 5% or even 10%. But the current situation, at least in Qatar where Tawarruq exposure at the assets side only represents an average of 53% out of the total financing assets, will be a real catastrophe. The total exposure of Tawarruq including commodity Murabahah between IBs in Qatar at the end of 2014 was QR 94.7 billion, (Habbani, 2015). If we assume that the IBs profit percentage was only 5%,[4] the expected losses in case of Shari'ah non-compliance occurrence will be QR 4.7 billion which is very huge.

2- Tawarruq AML and CFT Non-compliance Risk:

The CBs and IBs are exposed to the risk of Money Laundering and Financing of Terrorism and can be exploited by money launderers and terrorism financiers. *"It could not be denied that money launderers commonly use Islamic financial institutions as a place to legitimize their ill-gotten gains through utilization of various financial instruments"*, (Zulkifli, 2003, p. 1). The difference between IBs and CBs in terms of methodology, products, process does not mean that IBs are not exposed to ML and FT or they are in a better situation than conventional financial institutions, *"there is no evidence that Money Laundering and Financing of Terrorism (ML/FT) risks in Islamic finance are materially different than those posed by conventional finance. Moreover, the choice of whether to launder the proceeds of crimes or finance terrorism through conventional or Islamic finance institutions would appear to be dictated by convenience and opportunity rather than by inherent differences between them"* (Kammer, Norat, Piñón, Prasad, Towe, Zeidane, and an IMF Staff Team, 2015, p. 23). But it does not mean that there are no differences between the two as far as products and most of banking services are quite different. *"Nonetheless, while the risks associated with conventional finance are generally well-identified and understood (albeit to varying degrees) by the relevant national authorities, there may be ML/FT risks that are specific to Islamic finance, including those specifically related to: (i) the complexity of some Islamic finance products; (ii) the nature of the relationship between the institutions and their clients; and (iii) the limited experience in the supervision of Islamic finance, especially in jurisdictions that face multiple risk factor,* (Ibid.). Since ML and FT concern cash and trading high liquid assets that can be quickly converted to cash, Tawarruq as cash-based instrument can be one of the product through which money launderers and terrorism financiers exploit IFIs.

Since IFIs do not know the final destination of funds in Tawarruq transactions because the real purpose of the finance application is hidden, customers may use the fund they receive in the way they like regardless of morality and ethical screen. The nature of Tawarruq as a cash-based financial transaction may render IFIs exposed to exploitation

4 Estimated as QCB Lending Rate (QCBLR + 0.5). QCBLR is fixed at 4.5%, (QCBMMB, 2015, t. 28).

by money launderers and terrorism financiers who may use smart techniques to hide both the root sources and the final destinations of fund.

The international financial network has widely expanded during the last five decades due to globalization and the expansion of international trade and exchange of goods and services. Accordingly, *"as the international financial system has expanded, so too has the abuse of the system. One of the abuses that have gained ground, due to the free trade of goods and services and the contemporary need for easy capital mobility, is the increase and spread of money laundering"* (Sanusi, Kulliyah, 2008, p. 251).

Although Qatar is classified among the less corrupted countries the IMF 2008 detailed assessment report on AML & CFT has raised a few negative remarks on Qatar AML & CFT regulation system that may allow room for ML and FT to grow. Some of the remarks mentioned by the IMF may be considered as gaps through which money launderers and terrorism financiers can exploit IFIs through Tawarruq.

6. Conclusion

The conclusion of this paper is that credit, legal, and compliance risks are quite linked, by nature, to Tawarruq operations. The absence of realism in Tawarruq contracts constitutes the root cause of all four risks because of the following:

1. The study concludes that the total exposure of Tawarruq in Qatar IBs is estimated at 53% of their total financing assets and it has been rising over the past 5 years. The majority of IBs financing activities have become cash-based activities. If this trend continues, it may damage the credibility of IFIs in the long run. IBs were established in the first place to be quite distinct from conventional finance and should continue to be distinct. Otherwise their existence may become questionable.

   IBs are exposed to reputation risk as Tawarruq sparked noise and strong criticism within Islamic finance stakeholders as well as from supporters of CBs, skeptics, and opponents of IBs. A lot of literature and frequent voices including reputed scholarly Organizations such as the OIC Fiqh Academy criticize IBs as becoming interest-based in a hidden way. These kinds of blames may have very negative impact on Islamic finance industry in the long-run. It spoils the reputation of the whole industry and might lead to strategic risk in the future which might threaten its existence. Expansion of Tawarruq may make large profits to IBs but might also lose in the long-run.

2. The expansion of Tawarruq operations drives out the good Islamic products such as genuine Murabahah, Istisna', Ijarah, Mudarabah, and Musharakah in the same way that bad money in Gresham's Law drives the good money out of the market.

   The absence of realism in Tawarruq transactions is also a root cause of higher credit risk. Since the underlying asset does not stay in hands of Mustawriq the IB loses prime collateral. The percentages of Qatari IBs collaterals compared to total financing assets represented only 29% in 2014. Also since in Tawarruq the customer receives cash rather than the asset which is not the final purpose of finance the chances of customer default increase due to the possibility of using the money in activities that may weaken the customer's sources and ability of repayment. High exposure of Tawarruq creates concentration of credit risk. The cost of this risk will be very difficult bearing in mind that the final purpose of finance is hidden and the potential recovery ratio is only 29% of the total financing assets.

3. Increased legal risk is also a result from the absence of realism in Tawarruq particularly in cross-border transactions. The cases of Gulf (IICG) versus Symphony Gems (SG), and Arcapita bankruptcy revealed that lack of realism in the 'Islamic' hybrid instruments used particularly in cross-border investments and financial transactions is the main root-cause of legal risk. The target behind these transactions was to deliver cash whether through direct Tawarruq transactions or Tawarruq-based Sukuk.

4. IFIs are also exposed to compliance risk due to the lack of realism in Tawarruq operations. Islamic finance is asset-based and in real Murabahah where the purchased asset is the target of the buyer there is no place for any degree of ignorance. In contrast, CBs are kept completely ignorant of the final purpose of finance when they offer overdrafts and personal loans. Tawarruq is similar to conventional overdraft and personal loans in that it loses this kind of realism. Not-knowing the final purpose of finance exposes IBs to compliance risk because the cash may be spent on purchases that may violate not only Shari'ah requirement but also central bank regulations as well as AML & CFT financing laws. Should Tawarruq is ruled non-permissible the estimated cost of Shari'ah compliance risk for the Qatari IFIs may be as high as QAR 4.7 billion.

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