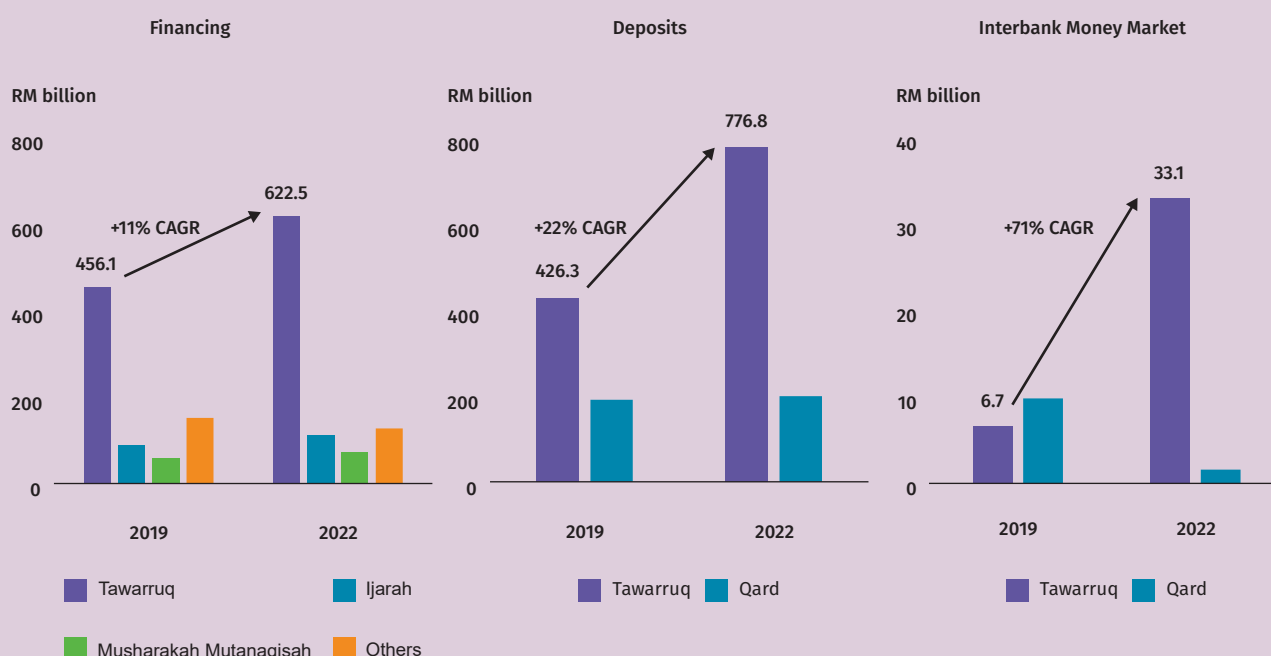


## Managing Transmission of Vulnerabilities in Commodity Markets Associated with the Application of *Tawarruq* in the Islamic Banking System

### Application of *Tawarruq* in Islamic Banking

A wide range of Shariah contracts<sup>1</sup> arrangements are currently applied to facilitate Islamic banking transactions. Of these, *tawarruq* is the most widely used contract in key product segments which include financing, deposits and interbank money market (Diagram 1).<sup>2</sup> This is largely due to its ability to facilitate placement of funds<sup>3</sup> and provide cash for different finance purposes such as working capital, trade financing and purchase of properties.

**Diagram 1: Trend and Composition of *Tawarruq* and Other Shariah Contracts by Key Products Segments of Islamic Banks as at 31 December 2022**



Note: Interbank Money Market data refers to fund placements only, excluding placement with Bank Negara Malaysia

Source: Bank Negara Malaysia, Islamic banks and DFIs

*Tawarruq* entails two separate sale and purchase transactions of commodities<sup>4</sup> involving four parties – an Islamic bank, its customer and two commodity suppliers. The combination of transactions serves to create a debt obligation on the part of the counterparty that purchases the commodity on a deferred basis at an agreed price (determined in reference to a specified profit rate) (Diagram 2). A wide range of commodities is used in *tawarruq* transactions. These include crude palm oil (CPO), plastic resin, metals, rubber, crude oil and digital commodities which are sourced domestically or globally (Diagram 3). The trading of these commodities is managed by Islamic banks through the use of commodity brokers and exchanges (CBEs).

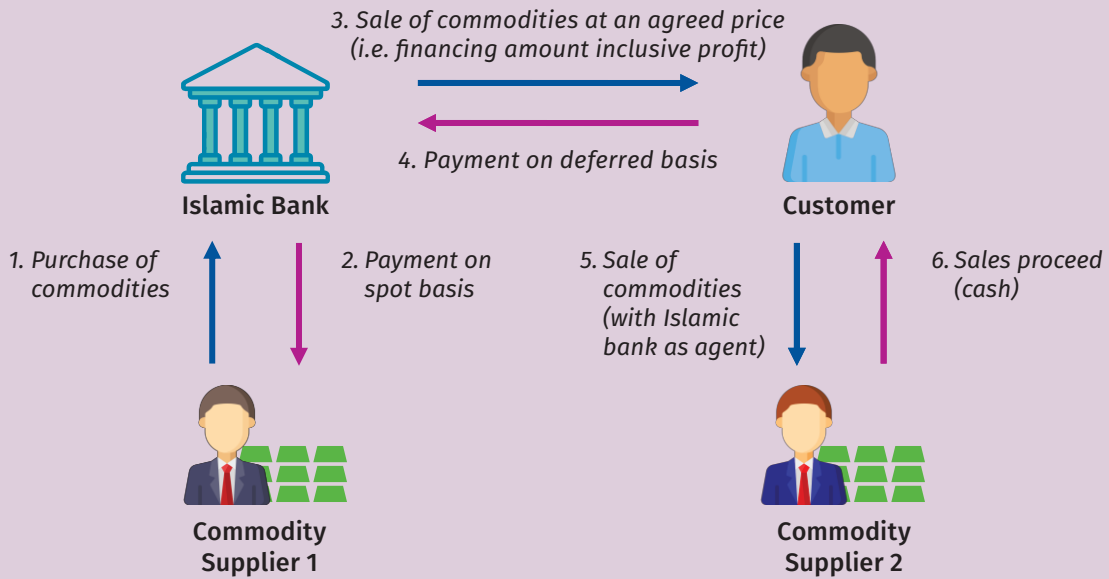
<sup>1</sup> The Shariah contracts consist of *murabahah*, *musharakah*, *mudarabah*, *istisna'*, *wakalah*, *wadi'ah*, *hibah*, *wa'd*, *kafalah*, *qard*, *bai' al-sarf*, *ijarah*, *rahn* and *tawarruq*

<sup>2</sup> Data excludes Islamic window

<sup>3</sup> Interbank money market, deposits, and cash management

<sup>4</sup> Except for gold and currencies

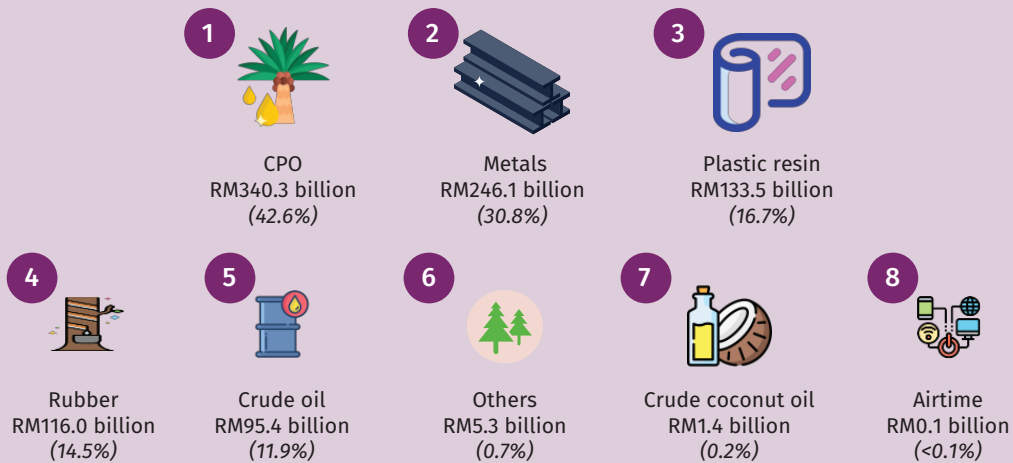
Diagram 2: Illustration on *Tawarruq* Mechanism (Financing)



Source: Bank Negara Malaysia

Diagram 3: Commodities Used for *Tawarruq*

Amount and composition of commodities used by trading volume (as at December 2022)



Note: "Others" include palm olein, palm stearin, refined palm oil as well as hardwood and softwood timber

Source: Islamic banks and DFIs

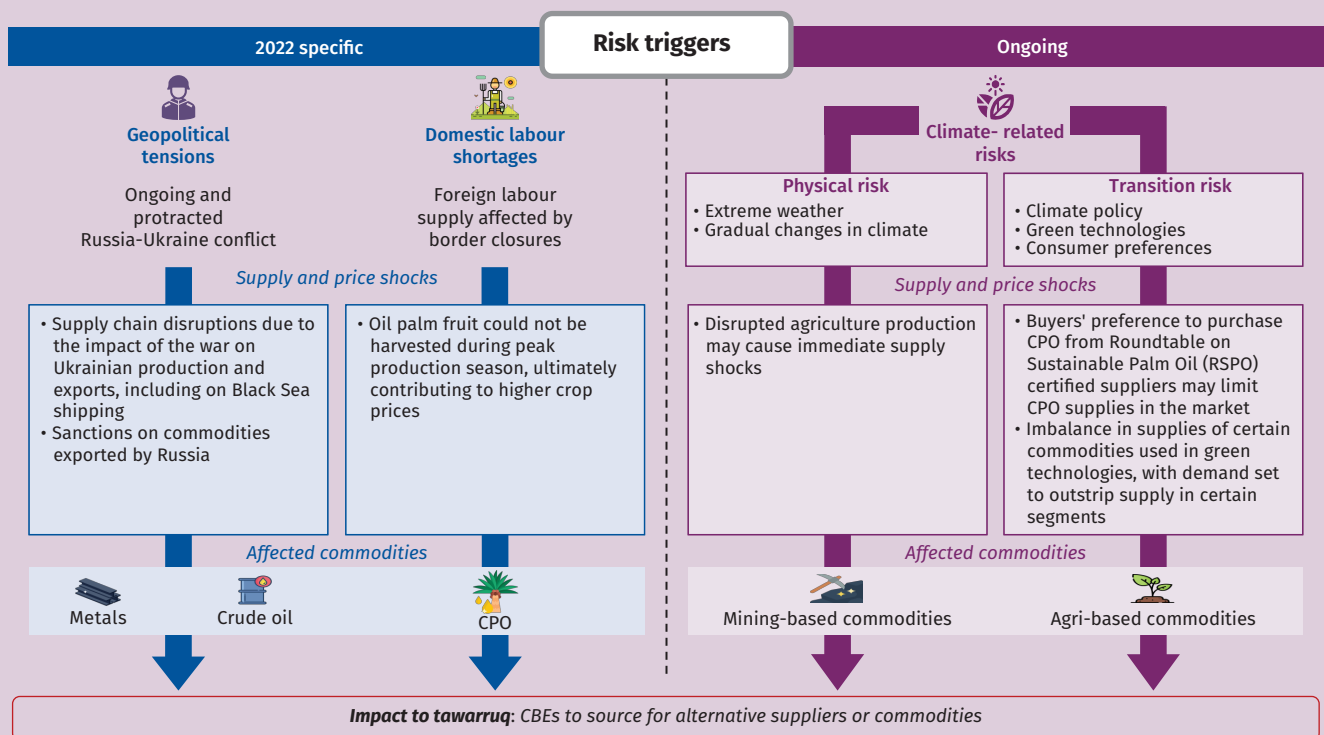
## Key Vulnerabilities Observed in Commodity Markets and Their Transmission to *Tawarruq* Transactions

The year 2022 saw increased volatility in commodity markets. Ongoing geopolitical tensions, particularly the military conflict in Ukraine and the subsequent imposition of sanctions on Russia, have affected the supply of metals such as aluminium and nickel. Meanwhile, domestic CPO production was also affected by disruptions in harvesting activity due to prolonged labour shortages during the year.<sup>5</sup> These developments led to significant volatility in the global commodity markets which saw global commodity prices reaching record highs before moderating since the third quarter of 2022.<sup>6</sup>

While the impact of supply disruptions on the commodity markets have been manageable thus far, risks of a further worsening in supply disruptions remain should geopolitical tensions intensify. Over the medium to longer term, physical and transition risks from climate change impacts will also have an important bearing on the outlook for commodity markets.

The volatility in global commodity prices affect *tawarruq* transactions in a number of ways (Diagram 4).

**Diagram 4: Key Vulnerabilities in the Global and Domestic Commodity Markets and Impact on *Tawarruq* Transactions**

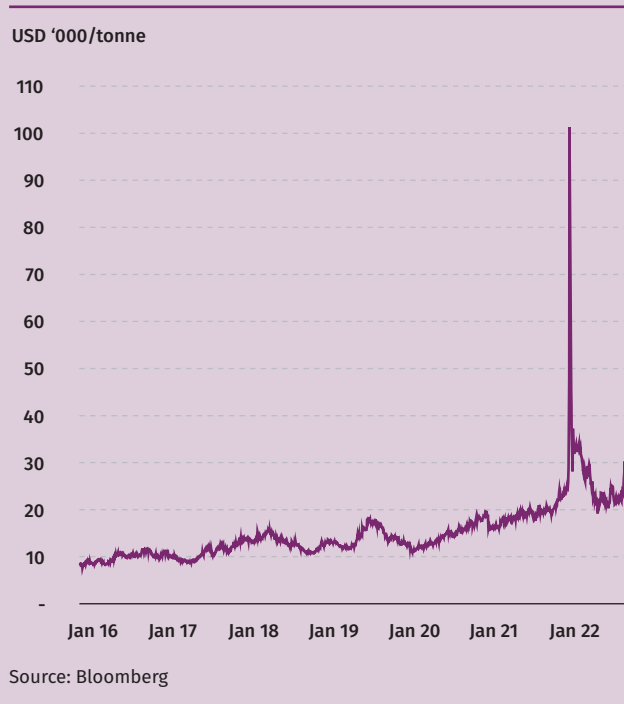


<sup>5</sup> Source: BNM Q2 2022 Quarterly Bulletin  
<sup>6</sup> Source: World Bank

The imposition of sanctions on Russia resulted in extreme volatility in nickel prices in early 2022 as Russia is the producer of 17% of the world’s top-grade nickel. On 8 March 2022, nickel futures prices surged by an unprecedented 250% in two days to trade above USD100,000 a tonne (Diagram 5). This caused severe mark-to-market losses for counterparties with short positions in futures contracts on the London Metal Exchange (LME). Consequently, LME had to suspend nickel trading to restore order and enable settlement due on transactions.<sup>7</sup> As the LME sets the global benchmark price for many metals including nickel, the suspension caused a temporary absence of a global benchmark price for nickel. This in turn halted *tawarruq* transactions based on nickel in Malaysia, although its overall impact was limited given the small share of *tawarruq* transactions based on nickel (RM56.0 billion, 6.1% of total commodities used for *tawarruq* transactions).

In such event, Islamic banks will need to find alternative commodities as substitutes. In an extreme scenario where substitution cannot be made, Islamic banks may not be able to enter into new *tawarruq* transactions, disrupting day-to-day *tawarruq* based banking operations.

**Diagram 5: Extreme Price Volatility in Nickel in 2022, Particularly in March**



<sup>7</sup> Source: Reuters

## Risk Mitigation to Promote Ecosystem Resilience

The Islamic finance industry has implemented several risk management strategies to manage these risks. For example, Islamic banks have, over the years, taken steps to diversify underlying commodities used in trades. Islamic banks are also using multiple CBEs to execute trades. These risk management strategies are further complemented by additional measures taken by CBEs to contain spillover risks. For instance, CBEs typically lock-in prices with commodity suppliers and hedge against intra-day price movements (Diagram 6). These measures have helped Islamic banks navigate the recent shocks in commodity markets, thus preserving orderly intermediation in the domestic Islamic banking system.

Diagram 6: Two Lines of Defence: Risk Management and Controls At Islamic Banks and CBEs



Source: Islamic banks, DFIs and CBEs

## Measures moving forward

At a system wide level, reducing *tawarruq* concentrations through diversification into non-commodity based Shariah contracts will further enhance the resilience of Islamic banking activities to the risk of extreme supply shocks in global commodity markets. The industry is taking concerted efforts to grow alternative Shariah contracts, as evidenced by an encouraging CAGR of 6.2%<sup>8</sup> in such contracts for the past three years. In addition, various product innovations are taking place, albeit to different degrees across Islamic banks. For example, diminishing partnership (*musharakah mutanaqisah*) has been adopted by a number of Islamic banks as an alternative Shariah contract to facilitate the financing of both completed and under construction properties. Investment account products based on agency contract (*wakalah*) and profit and loss sharing contract (*mudarabah*) are also gaining traction as alternatives to *tawarruq* based deposits. The industry is also advancing initiatives to explore *wakalah* as the Shariah contract for interbank placements between Islamic banks. Moving forward, these innovations are expected to continue to gain traction and further reduce the concentration in *tawarruq*.

<sup>8</sup> Includes only financing activities based on alternative Shariah contracts