



## Tawarruq Application In Islamic Banking: A Comparative Study Between Malaysia And Indonesia

Muhamad Yusuf Abdillah<sup>1</sup>, Mighfari Elsha Rabi<sup>2</sup>, Nazarudin Firli<sup>3</sup>

<sup>1,2,3</sup>IUM Institute of Islamic Banking and Finance, Malaysia  
robbyelsha@gmail.com

### Abstract

**Purpose** - This paper aims to make comparative studies between Indonesia and Malaysia in the application of tawarruq contract which has been practised in Islamic banking.

**Method** - This research based on the qualitative data which will explore more on its back ground, view of Islamic scholars, and legal framework used by both countries i.e. Malaysia and Indonesia.

**Result** - The result of the research showed that Malaysia has been able to develop sophisticated tawarruq products in all aspect of banking and financing activities. On the other hand tawarruq applications are limited in other countries, also in Indonesia. Most countries only limit its usage to personal financing.

**Implication** - This study can provide a description of the differences in the application between Indonesia and Malaysia.

**Originality** - The paper looks into the comparative studies between Indonesia and Malaysia in the application of tawarruq contract. Previous studies only looked at the application of tawarruq in islamic banks without comparing with other country.

**Keywords:** tawarruq contract; shariah committees; comparative studies; dewan syariah nasional (DSN); and islamic bank .



## Introduction

Considered as a late comer, Indonesia started its Islamic banking industry in 1992, almost a decade behind Malaysia through the establishment of Bank Muamalat Indonesia (BMI). The growth has not been too bad since then and in 2015 the Islamic banking industry of Indonesia comprised of 12 general sharia banks, 22 shariah business units of conventional banks and 161 sharia people's credit banks (rural Islamic banks) with significant growth in capital as well (Sobol, I., 2016). Nevertheless, the product and the capital growth are somewhat slow moving when compared to Malaysian Islamic banking industry which indeed has been earlier - about one decade - building an Islamic banking system. It was almost 20 years after the emergence of the modern Islamic banking in the world that the Islamic bank was founded in this country. Until now the significance of Islamic banking in Indonesia, in comparison with Iran, Malaysia and the Middle East countries, is rather small.

Islamic banking in Malaysia was commenced in 1983 with a single fully fledged Islamic banking institution namely Bank Islam Malaysia. Since then Islamic banking industry in Malaysia has been growing tremendously well through four different phases and at this moment there are 16 fully fledged Islamic banking institutions in operation in Malaysia (Md Nor, M.Z. et al., 2016).

Islamic banking in Malaysia mostly uses *tawarruq* contract as their financing product. In the setting up of an Islamic banking system, an instrument is required to compete with conventional banking that deals with *riba*-based lending, which is prohibited by *shariah*. *Tawarruq* is introduced and as an alternative instead of using *bai' al Inah* contract.

This paper discusses comparisons between Malaysia and Indonesia about the current situation in the Islamic banking industry with a focus on the applicable or not applicable *tawarruq* contract in those both countries and initially this paper will present the true reality of point of view of Indonesia based on the available facts and figures separately. Next is followed by comparative discussion and analysis between the Islamic banking industries



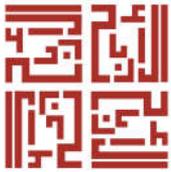
in both countries on the application tawarruq contract. In the end, a conclusion will be made to show the position of both countries in application of tawarruq by Islamic banking industry.

## Literature Review

### Islamic Banking in Indonesia

With the population of 257.5 million, Indonesia is the world's fourth most populous country (United Nation Department of Economic and Social Affairs, 2015). It is also the country which has the world's largest Muslim population. They constitute over 86% of the country's overall population. Most of them sunni and represent shafi'i school of law (Sobol, I., 2016).

However, despite being the largest Muslim country in the world, Indonesia was relatively slow in introducing Islamic banking. It was almost 20 years after the emergence of the modern Islamic banking in the world that government of Indonesia decided that support for Islamic banking project was be an important gesture toward the Muslim community (Sobol, I., 2016). In August 1990 the idea to establish the first interest-free bank was explored by The Indonesia Council of Ulama (MUI) in a workshop held in Cisarua. Subsequently the MUI established a working grup, the task of which was to develop a concrete plan for establishing an interest-free bank. It should be note that the project received the backing of Soeharto, then President of Indonesia. He pushed a number of prominent figures, including several ex-minister and Muslim businessmen to participate in it. The Involvement of Association of Indonesia Muslim Intellectuals (Ikatan Cendekiawan Muslim se-Indonesia - ICMI), an organization largely controlled by the state, was important for the realization of the project. Backed by the government, the first Indonesian Islamic bank, Bank Muamalat Indonesia, was established in a relatively short time. It started operation in in 1 May 1992 (Saeed, 2008). In 1992, Banking Act No.7 was enacted which allowed Islamic banks operated in Indonesia alongside conventional institution (Bank Indonesia, 2002).



During its early years, Bank Muamalat Indonesia, as the only Islamic bank in Indonesia, faced some difficulties as the existing financial environment in the country then was not conducive enough for the operation and development of a new banking system. For example, there was no supporting network in the industry like market instrument, alternative for liquidity management and central bank facilities that comply with Islamic principles. In 1998, to overcome these problems and to encourage network expansion, the government amended the existing Banking Act no. 7 with a new act, called Act No. 10, to provide a wider opportunity and a stronger legal foundation for Islamic banking. Act No. 10 can be considered as the legal foundation for Islamic banks, as it provides assurance to investors, bankers, and the general public. This act does not only provide networking assistance to the existing Islamic banking institution but also open the door for conventional banks to establish Islamic banking units within the conventional banking institutions (Siregar M.E. and Ilyas N., 2011).

However, according to Lindsey (2012), the main aim of this legislation was to gather all the previous regulations in one act and to eliminate any existing inconsistencies. It has also provided a more adequate legal base to the development of Islamic banking in Indonesia and consequently be able to accelerate the growth of the industry. Since then there is no further development in the legal foundation of Islamic banking in Indonesia despite of the numerous changes and dynamism of the Islamic banking industry locally and internationally.

### **Islamic Banking in Malaysia**

The establishment of Islamic banking in Malaysia can be traced back to 1963 when Tabung Haji (the Pilgrims Management and Fund Board) was established by the government. The institution was established to invest the savings of the local Muslims in interest-free places, want to save up to perform Hajj. Tabung Haji utilizes Mudharabah (profit and loss sharing), Musharaka (joint venture) and Ijara (leasing) modes of financing for investment under the guidance of the National Fatwa Committee of Malaysia.



Based on the experiences of Tabung Haji, the government of Malaysia then introduced a well-coordinated and systematic process of implementing the Islamic financial system (Mokhtar et al., 2006). Furthermore, to this end, the first call for a separate Islamic bank was made in 1980, in a seminar held at the National University of Malaysia. The participants passed a resolution requesting the government to pass a special law for the setting up of an Islamic bank in the country. Responding to the request, the government had found a National Steering Committee in 1981 to study legal, religious and operational aspects of the setting up of an Islamic bank.

Islamic bank in Malaysia was commenced in 1983 with a single fully fledged Islamic banking institution namely Bank Islam Malaysia. Since then Islamic banking industry in Malaysia has been growing tremendously well through four different phases and at this moment there are 16 fully fledged Islamic banking institutions in operation in Malaysia (Md Nor, M.Z. et al., 2016). The development of Islamic Financial Industry in Malaysia is based on top-down approach or “government-driven” approach where both regulators and the players were initiated and backed by strong political will (Yussof, S.A., 2013).

The first Islamic bank to operate in Malaysia was Bank Islam Malaysia Berhad (BIMB), which was incorporated under the companies Act 1965 on March 1983 and which had commenced operations on 1st July of the same year. The important underlying force that led to the establishment of this Islamic bank in Malaysia was the elimination of interest-oriented *riba* (Abdul Hamid and Azmi, 2011). BIMB offers the products and services that have been available at conventional banks which are consistent with the Sharia principles. BIMB also has subsidiaries which operations are based on the Sharia principles. BIMB was listed on the Main Board of Kuala Lumpur Stock Exchange on 17th January 1992 (Haron and Azami, 2009).

The long-term objective of the Central Bank of Malaysia was to create Islamic banking system operations which are parallel to those of the conventional banking system. A single Islamic bank (BIMB) does not represent the whole financial system. It requires a large number of pro-active



players, a wide range of products and innovative instruments, and a vibrant Islamic money market. Realizing the situation, the Central Bank introduced the Interest Free Banking Scheme (now replaced with the Islamic Banking Scheme (IBS) in March (1993). The scheme allowed conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including their staff and branches.

In March 1993, Bank Negara Malaysia (BNM) launched a scheme known as “Interest-free Banking Scheme”. Through this scheme, financial institutions are allowed to offer Islamic banking products and services. The pilot phase of this scheme involved the three largest commercial banks in Malaysia and the second phase involved ten more financial institutions to join the scheme. In October 1996, the BNM issued a model of financial statement for the IBS banks requiring them to disclose their Islamic banking operations (balance sheet and profit and loss account) as an additional item under the notes to the accounts. In order to further strengthen the development of the Islamic banking system in Malaysia; the BNM established the National Sharia Advisory Council (NSAC) on Islamic Banking and Takaful on 1 May 1997. The council is regarded as the highest Sharia authority on Islamic banking and Takaful businesses in the country.

On 1st October 1999 the BNM issued a license for the second Malaysian Islamic bank namely Bank Muamalat Malaysia Berhad. This second full-fledged Islamic bank was established as a result of the merging between Bank Bumiputra Malaysia Berhad and Bank of Commerce (M) Berhad. In line with the aim to expand and liberate the Islamic banking industry in Malaysia, in 2004 the BNM approved the applications of three new full-fledged foreign Islamic banks that were given the licenses to operate in Malaysia, namely Kuwait Finance House, Al-Rajhi Banking & Investment Corporation and the consortium led by Qatar Islamic Bank (Mokhtar et al., 2006).

Concurrent with the progressive liberalization of the Islamic banking industry and the recommendations made under the Financial Sector Master Plan (FSMP) to further strengthen the institutional structure of the banking institutions participating in the Islamic banking system, the BNM had



approved the Islamic subsidiary structure to replace the Islamic windows scheme (IBS). Hence, the seven domestic banking groups were allowed to transform their current Islamic window into an Islamic subsidiary within their respective banking groups. However, this transformation was not made mandatory (Haron and Azmi, 2009).

Currently, the Islamic banks in Malaysia comprise of domestic full-fledged Islamic banks, foreign full-fledged Islamic banks and the Islamic banking subsidiary. There are currently two full-fledged domestic Islamic banks operating in Malaysia, Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad. There are also six foreign Islamic banks and nine Islamic subsidiary banks (BNM, 2010).

List of Islamic Banks in Malaysia Number Banks: 1.) Domestic Full-fledged Islamic banks: Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad; 2.) Domestic subsidiary Islamic banks: RHB Islamic Bank Berhad, Hong Leong Islamic Banking Berhad, CIMB Islamic Bank Berhad, AmIslamic Bank Berhad, Affin Islamic Bank Berhad, EONCAP Islamic Bank Berhad, Alliance Islamic Bank Berhad, Maybank Islamic Berhad, Public Islamic Bank Berhad; 3.) Foreign Full-fledged Islamic banks: Kuwait Finance House (Malaysia) Berhad, Al Rajhi Banking & Investment Corporation (Malaysia) Berhad; 4.) Foreign subsidiary Islamic banks: Asian Finance Bank Berhad, HSBC Amanah Malaysia Berhad, Standard Chartered Saadiq Berhad, OCBC Al-Amin Bank Berhad (Bank Negara Malaysia, 2012).

### **Understanding of Tawarruq Definition**

Tawarruq was a term originally introduced by Imam Hanbali in his book kitab Syarh Muntaha Al-Iradat, known as Daqaiq Awla An-Nahyu Li syarhi Al-Muntaha, to differentiate the concept of 'Inah from the classical tawarruq. 'Inah has been widely adopted in South East Asian countries as a means of cash liquidity (Mohamad and Rahman, 2014).

According to Bouheraoua (2013) classical tawarruq is defined as the purchase of commodity possessed and owned by the seller on deferred basis, and then the buyer resells it to a third party (other than the original seller) to

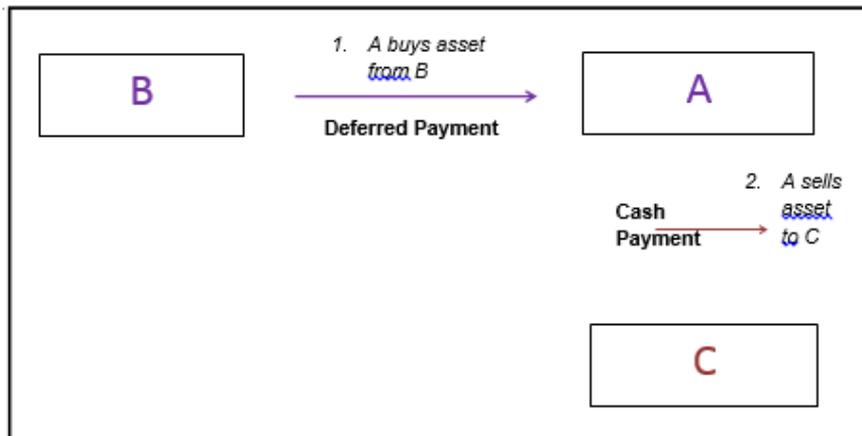


acquire cash (al-wariq). Tawarruqin explained in figure 1, its original form is a process of purchasing a commodity on credit by Mutawarriq (seeker of cash) and selling it to a third party at a lower price on spot basis for the purpose of liquidity management (Dusuki, 2008).

In terms of language, tawarruq comes from the words in Arabic namely warq or wariq which means silver, dirham or silver metal coins (Fatwa in Islamic Finance, ISRA). It is called tawarruq because when buying the item for a fee, the buyer does not intend to use it or use it, but only wants to make it pass to get cash (Noor, F.B & Nuzul A.B., 2014). Tawarruq contract involves two business entities, which initially involves the purchase of credit between the buyer and seller of an asset and then ranked second where the buyer then sells cash to a third party. (Resolusi Syariah dalam Kewangan Islam, BNM 2005).

Technically the OIC Fiqh Academy fatwa no. 179 defines tawarruqas "someone (mustawriq) who buys an item on a payment basis with the aim of selling the item at a low price to get cash" (Noor, F.B & Nuzul A.B., 2014).

**Figure1. Tawarruqin its Original Form**





Accounting and Auditing Organization of Islamic Financial Institutions Shariah Standard (AAOIFI) concludes by defining tawarruqis a commodity purchase contract by credit payment either through direct selling or murabahah contracts. The commodity is then sold initially in cash to parties other than the original seller (Noor, F.B & Nuzul A.B., 2014).

## Methods

### Types of Research

This research based on the qualitative data which will explore more on its back ground, view of Islamic scholars, and legal framework used by both countries i.e. Malaysia and Indonesia.

## Discussion

### Classical Tawarruq /Tawarruq al-Fardi

Concept where the first buyer buys the goods in a manner installments from the first seller and sell them to third parties in cash with Low prices with the aim to get cash immediately or fulfil the need for liquidity. In this formation, the third party has no direct connection with the first seller. In such cases, the first seller of goods must not be linked with cash sales made by the buyer of goods after that. This situation termed as al -awarruq al-fardi by a half-time mualamat scholar (Asmak Ab Rahman, 2010).

The views of the Hanafi scholars, Syafie and Hambali see this tawarruq transaction is legal and based on sharia principles. This form of tawarruq transaction was also accepted by a number of sharia bodies such as the Shariah Supervisory Council of the Al Rajhi Bank, Saudi Arabia, Kuwait Finance House and the Malaysian Shariah Agency itself in Shariah Resolution in Islamic Finance 2005.

### Classical Tawarruq /Tawarruq Al-Fardi

A buyer (mutawarriq) buys goods with credit on the market in the country or outside the country and the financial institution acts to manage or regulate the agreement either by financial institutions themselves or through



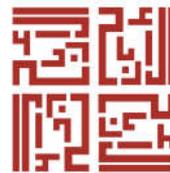
agents and directly between buyers and financial institutions at lower prices. (Ibraheem Musa Tijani, 2013).

### **The Similarities Tawarruq and Bai' Al Inah**

1.) The same objective, despite the differences, tawarruq is still considered as form of Bai' al Inah. This is where the opponents disapprove tawarruq, since both contains element of riba. Ibn al-Qayyim pointed out that the objective of the contract is not to affect sale but exchange money for money (Dusuki et al, 2013). IbnQayyim is also of the view that tawarruqis impermissible and he strongly believes that it is as a fraudulent practice against Allah (SWT) and Shari'ah (Ahmed et al, 2012); 2.) Containing Usury (Riba), Contemporary scholars who dismiss tawarruqin the banking system also argue that the use of tawarruqin the banking industry is somewhat similar to Inah which clearly involves an essence of riba in its purpose behind the transaction, which is to acquire cash and the payment of a greater amount of immediate cash in consideration of the delay (Bouheraoua, 2013); 3.) There is a forced Element, Classical Scholars such as Hanafi School and Ibn al-Qayyim believe tawarruqand Inah to be of a forced sale and such an exploitative nature is prohibited in Islam. According to ibn al-Qayyim, this is due to the fact that the contract is done by someone who is forced to seek liquidity, and the counterparty is not willing to give loan, instead, sell commodity with profit (Dusuki, 2010).

### **The Difference Tawarruq and Bai' Al Inah**

1.) Tawarruq was an alternative to bai' al inah, tawarruq was a term originally introduced by Imam Hanbali in his book kitab Syarh Muntaha Al-Iradat, known as Daqaiq Awla An-Nahyu Li syarhi Al-Muntaha, to differentiate the concept of 'Inah from the classical tawarruq. 'Inah has been widely adopted in South East Asian countries as a means of cash liquidity (Mohamad and Rahman, 2014). However, the application of 'Inah has become debatable due to its legal stratagem. Following to that, tawarruq was introduced as an alternative to Inah (Bilal and Meera, 2015); 2.) Involved



Third Party, the main difference between the two is that in 'Inah the commodity returns to its original seller, whereas in tawarruq the commodity is sold to a third party, this main difference is one of the reasons why some of the proponents view tawarruq was permissible (Dabu, 2007).

### **Legal Framework in Indonesia**

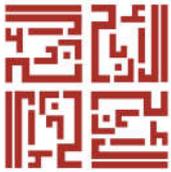
In 1992 the government of Indonesia through parliament has enacted and passed the Banking Act No.7 which recognizes the existence of two banking systems namely the conventional banking system and the Islamic banking system together to serve the economy. By virtue of this act, the first Islamic bank in Indonesia, Bank Muamalat Indonesia was established in 1992 (Sobol, I., 2016).

In 1998, to overcome problems of there was no supporting network in the industry like market instrument, alternative for liquidity management and central bank facilities that comply with Islamic principles and to encourage network expansion, the government amended the existing Banking Act no. 7 with a new act, called Act No. 10.

Act No. 10 provide a wider opportunity and a stronger legal foundation for Islamic banking. Act No. 10 can be considered as the legal foundation for Islamic banks, as it provides assurance to investors, bankers, and the general public. This act does not only provide networking assistance to the existing Islamic banking institution but it also open the door for conventional banks to establish Islamic banking units within the conventional banking institutions (Siregar M.E. and Ilyas N., 2011).

In 2004 the parliament amended Central Bank Act 1999 (Act No.23) that resulted in the birth of Act No.3. Through this amendment, the central bank allowed monetary control with instruments based on Islamic principles. Since then the industry has steadily progressed and expanded. The Act No.3 also strengthens the legal foundations for Islamic banking industry further.

In 2008 the Islamic banking Act (Act No.21) was passed. In the beginning, this act mentions some of the reasons for its existence such as to achieve



justice and virtue in society based on economic democracy, to develop an economic system based on values of justice, equality and well-being in accordance with the principles of shariah, to meet the needs of Indonesian society to Islamic banking services, to comply the rules of the Islamic banking system and to have a more specific legislation relating to Islamic banking than what has been provided in Act No 7 of 1992 and Act Number 10 of 1998. It has also provided a more adequate legal base to the development of Islamic banking in Indonesia and consequently accelerated the growth of the industry. Since then, there is no further development in the legal foundation of Islamic banking in Indonesia, despite of the numerous changes and dynamism of the Islamic banking industry locally and internationally.

#### **Legal Framework in Malaysia**

In Malaysia, separate Islamic legislation and banking regulations exists side-by-side with those of the conventional banking system 10 years later, BNM introduced "Skim Perbankan Tanpa Faedah" (Interest-free Banking Scheme) for conventional banks to offer Islamic banking products through its windows and for that purpose, section 124 (7) of the Banking and Financial Institutions Act 1989 (Act 372) was introduced. (Hasan,Z., 2008).

There were at least ten pieces of legislations which form the legal framework for the establishment and operation of Islamic banking system in Malaysia. These were Islamic Banking Act 1983 (IBA), Banking and Financial Institution Act (BAFIA 1989), Takaful Act 1984, Central Bank of Malaysia Act (CBMA 1958), National Land Code 1965, Hire Purchase Act 1967, Stamp Duty Act 1949, Property Gains Tax Act 1979 and Islamic Financial Services Act (IFSA 2013).

The earliest legal foundation for the Islamic banking industry in Malaysia was Islamic Banking Act 1983(IBA). This act paved the way for the establishment of the first Islamic banking institution in Malaysia and it also authorized the central bank or Bank Negara Malaysia (BNM) to supervise and regulate Islamic banks, similar to the existing licensed banks. Although the IBA is considered as too general and non-comprehensive consist of 60



sections, it is acknowledged though that it creates healthy flexibility to Islamic financial institutions (Hasan, Z., 2008). Six years later in 1989 Section 124(7) of the existing Banking and Financial Institution Act 1989 (BAFIA) was then introduced. The introduction of this section allows conventional banks to open Islamic counter to offer Islamic banking products (Hassan, R., 2006). This section also required them to establish the Shariah Committee in order to advise them any matter related to Islamic banking business or Islamic financial business. Initially this scheme is known as Interest Free Scheme Banks or Skim Perbankan Tanpa Faedah (SPTF) and later on changed to the Islamic Scheme Banks or Skim Perbankan Islam (SPI) until now. Arguably the introduction of section 124 (7) of BAFIA promotes healthy competition amongst Islamic banking players (Hasan, Z., 2008). Apart from the IBA and the BAFIA, the Central Banks Act 1958 (CBA) also plays a crucial role in term of regulating the aspects of supervision and monitoring of the implementation and operation of Islamic banking. This can be seen in the case of the amendment of section 16B of the CBA in 2003. This amendment was made in order to enhance the role of the Shariah Advisory Council of BNM in supervising the operations of every individual Islamic banking institution in this country (Hassan, R., 2006).

## Conclusion

From the above description, it could be seen that the contemporary scholars approved the classical tawarruq. Problem arises from the practice of organized tawarruq world wide. In Malaysia, tawarruq is being applied in almost all areas of Islamic Banking activities, including deposit, financing, investment, and in capital market. Malaysia deemed tawarruq is different with bai al inah; tawarruq is an alternative of bai' al Inah.

Malaysia follows the Fatwa from the Bank Negara's Shari'ah Advisory Council which authorised the practice of organised and reversed tawarruq. As a result, Malaysia has been able to develop sophisticated tawarruq products in all aspect of banking and financing activities. On the other hand tawarruq applications are limited in other countries. Most countries only limit its usage



to personal financing. It is evident in the paper that the modern scholars do not dismiss the application of tawarruq out rightly; rather, the dismissal is due to the many violations of Shari'ah principles in its modern application.

Indonesia did not promote the implementation of bai' al Inah in Islamic banking transactions and also confirmed tawarruq practices may be applied as one of the latest alternatives in Islamic banking products but need to comply and meet the requirements of transactions and trade that stated in the Alquran and as-Sunnah.

Another reason why Indonesia do not implement tawarruq because AAOIFI never detested tawarruq as an Islamic Product.

It was also revealed that due to the divergent view with regard to the application of tawarruq around the globe, it is necessary for Islamic financial Institution to understand that tawarruq arrangement should be used in accordance with guiding principles of shariah while the industry should continue to fine a lasting solution for the liquidity management. Widespread use of organized tawarruq could be harmful to the industry in the long run due to Shari'ah issues in it. Some of the issues which include no physical transfer of ownership of the underline asset in the transaction, two separate prices in one transaction i.e. for the delivery and non-delivery of the commodity are few to be mentioned. Therefore, Shari'ah Board needs to strictly monitor all tawarruq based transaction which includes the commodity Murābahah.

In conclusion, Islamic financial institutions should strive hard for better alternatives and adhere strictly to the Shari'ah guidelines and the resolutions by both the OIC Fiqh Academy and AAOIFI on the application of tawarruq. Otherwise, IFIs will appear as practitioners of merely copying the conventional system, their functions and operations essentially no different from the conventional space, except in their use of Islamic terms to disguise riba and avoid other Shari'ah prohibitions.



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