ISSUES IN ISLAMIC CAPITAL MARKETS:
ISLAMIC BOND/ SUKUK

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Abstract

The purpose of this paper is to ascertain the prevailing Shariah issues in Islamic capital markets, particularly Sukuk. Common features of conventional bonds are replicated in Sukuk via late payment penalty upon default, trading of debt based Sukuk, purchase undertaking in equity based structures and ownership status in asset based transactions. These features posed Shariah concerns and are discussed in the paper from the perspective of current practices and views of scholars by compiling various references that reveals the unique diversity of Shariah. The four issues covered are not exhaustive and more are expected to creep up as Sukuk structures continue to mimic conventional bonds. The paper provides value by shedding light the named issues and also highlights the need for a balance between growing the Sukuk market and upholding Shariah in all aspects when structuring Sukuk.

Keywords: Sukuk, Shariah issues, late payment penalty, debt trading, purchase undertaking, asset backed, asset based.

1.0 Introduction

The Shariah issues surrounding Sukuk became notably apparent when Sheikh Taqi Usmani, in November 2007, commented that most of the Sukuk (about 85%) in the market (those using a Musharakah or Mudharabah structure) are not in line with the principles of Shariah. As the financial crisis spread into the GCC and some issuers began to default on Sukuk, it became clear to many investors that Sukuk carried additional risks due to the untested structures used to receive Shariah compliance. The restructuring process of landmark deals continues to highlight areas that have been overlooked by investors, particularly Shariah risk which may affect the investors’ protection.

In the first half (H1) of 2010, the Sukuk market has turned around with issuances up 99% on a year-ago levels at USD20.4 billion. Despite the rebound, global Sukuk issuances were still lower than the record set in H1 2007 at USD24.0 billion. Southeast Asia continues to dominate the Sukuk market with issuances worth USD17.35 billion in H1 2010 compared to $8.89 billion in H1 2009 and $4.5 billion in H1 2008. Malaysia topped the issuer countries in terms of the amount and the numbers of issuances with 310 issuances worth $15.4 billion, followed by Indonesia with 16 issuances amounting to $1.75 billion. The GCC Sukuk market recorded zero issuances on the
The sheer growth of Sukuk is enough to press upon the need to understand and resolve Shariah issues on controversial practices in the Sukuk market or risk dampening investors’ confidence and ultimately, the future of Sukuk market.

2.0 Sukuk in the Islamic Capital Markets: Behaving like Bonds
For the past 10 years, Sukuk have grown from being nonexistent to being the face of Islamic finance in many people’s eyes. The recent defaults faded from the limelight as quickly as the news did in 2007 and 2008 of revised AAOIFI guidance on Sukuk. The current situation faded from the headlines partly because new troubles in Greece and other parts of Europe have emerged, but the relative insignificance of Islamic finance in the global fixed income markets also contributed. The insignificance of Sukuk globally was in part caused because they are often structured exactly to mimic other bonds (sovereign, quasi-sovereign and corporate, both from developed and emerging markets). The insignificant of the Sukuk market and the reasons for it should lead to questions about the way Islamic finance in general, and the Sukuk market in particular, has developed. This leads us to the next question on whether Sukuk should retain the same features as conventional bonds and the Shariah issues arising from such structures.

3.0 Shariah Issues in Sukuk
AAOIFI’s Shariah Standards defines investment sukuk as certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, asset of particular projects or special investment activity. From this definition, it is clear that Sukuk is not a conventional bond in all aspects. In any circumstances, Sukuk should not have been referred to as an Islamic bond although it is structured to behave like one via current practices which may be disallowed by Shariah or disagreed amongst jurists and shall be discussed on its own in the ensuing sections:

- Issue 1: Imposition of late payment penalty on Sukuk issuer upon its default
- Issue 2: Trading at a discounted price for Sukuk representing debt
- Issue 3: Purchase undertaking in Musharakah and Mudharabah Structures
- Issue 4: Ownership of assets in asset based Sukuk

4.0 Sukuk: Late Payment Penalty upon Default

4.1 Introduction on Late Payment Penalty
Penalty on delayed payments or defaults is a common issue that affects almost all types of products in Islamic finance, including Sukuk because there is no universal consensus across jurisdictions in this. The penalty clause in the modern context is defined as an agreement between the two contracting parties on a pre-determined rate of compensation that the creditor or the obligor is entitled to if the obligated or the debtor has not fulfilled the obligation or delayed in performing it. The reason for this term is that it is normally put among the conditions of the main contract on the basis of which the creditor or the obligor deserves compensation. In general, the penalty rate on late payment is high. This payment charge is imposed to discourage late payment by customers as well as to prevent the creditor or the obligor from being exposed to losses due to opportunity loss.

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There are two kinds of penalty clause. The first kind is the penalty clause that comprises specific compensation for delay in completing the activity or failure to complete it completely. This kind of penalty clause is permissible and must be fulfilled because of the numerous evidences that support the fulfilment of contracts, promises and conditions. The second kind is the penalty clause for delay in settling debt. In fact, most of these are related to Murabahah, deferred sale and other deferred sale obligations.

Responding to this, there are two types of debtors who delay in settling debt. The jurists are unanimous in their view that an insolvent debtor, who is incapable of settling his debt, must be granted respite. The Islamic Fiqh Academy has produced a standard for insolvency, which stipulated granting respite to the insolvent is contingent upon the condition that he has no wealth in excess of his basic needs to pay for the debt in cash or in kind. For the defaulting solvent debtor, the jurists have agreed that delay of debt by a rich debtor is unjust, a sin and a transgression. However, the jurists have differed about imposing financial penalty on a solvent defaulter.3

4.2 Current Practice and Shariah Issues

In Malaysia, late payment or default by issuers of Islamic securities including Sukuk are required to compensate investors with late payment penalty that is stipulated upfront in the financing agreements. However, the practice in Middle East differs where the penalty proceeds are given to charity instead and cannot become a source of income for the investors.

4.3 View of Scholars on the Shariah Issues

The jurists have differed in their views about considering financial penalty as a punishment. The opinions have converged into two schools: prohibition and permissibility. Abu Yusuf has permitted it for the Imam (ruler) if he finds in doing so, it is maslahah (public interest.). Abu Hanifah and Muhammad al-Shaybani have prohibited it due to lack of its Shariah validity. Whereas al-Zayla’i said, reporting from Abu Yusuf that enforcing ta’zir by taking money is permissible for the Imam. While al-Shafi’i in his previous view, not the recent, was quoted by al-Shibramulsi as saying, “It is not permissible, that is, to enforce al-ta’zir – based on the recent view – to take money.” On the other hand, the prominent Maliki scholars are of the view that al-Ijma (the general consensus) does not approve it. Thus, al-Dusuxqi said “based on the ijm a, there is no ta’zir in the form of money”. However, Ibn al-Qayyim mentioned that the popular opinion of Malik is to approve it in special situations. Meanwhile, the Hanbali scholars have differed in their opinions about its validity and invalidity. Al0Buhuti said “al-Ta’zir in the form of money is permissible by confiscating or seizing the wealth”. This is the view adopted by Ibn Taimiyah and his student Ibn Qayyim al-Jawziyah. However, Ibn Qudamah al-Maqdisi opposed this view saying it is invalid.

The Islamic Fiqh Academy (OIC) deliberated on this issue in its eleventh session and responded to the query, “Is it permissible for the bank to impose penalty on the debtor due to its delay in settling the debt within the specified time period between the two parties?” The Council responded saying, “If the creditor stipulates to the debtor or imposes on him to pay the creditor some money as a specific amount of financial penalty or a specific percentage if he delays in settling his debt within the specified period agreed upon between the two parties; this is an invalid condition or imposition and must not be fulfilled. Rather it is unlawful whether the person stipulating the condition is the bank or otherwise. This is because this condition or imposition is essentially the Jahiliyah Riba which

the Qur’an was revealed to prohibit”. Nevertheless, the Imam (ruler) has the right to declare al-Ta’zir punishment be it financial or otherwise, as a deterrent to the criminal and as a prevention to the offenders. This will preserve the stability and security of the people in their religion, honour and wealth.

However, the provision of penalty clauses that must be channelled to charity is permissible by the International Islamic Fiqh Academy and AAOIFI to maintain a balance between the severity of the problem and the important Shariah principles that prohibits riba. The penalty proceeds should be used for charity purposes and not become a source of income for the creditor. If not, it will tantamount to riba.

Resolution by the SAC of SC
The Shariah Advisory Council (“SAC”) of the Securities Commission (“SC”), at its 12th meeting on 14 July 1999, agreed to allow the imposition of ta’widh (compensation) on the late repayment of Islamic financing. Subsequently, the SAC at its 30th meeting on 8 November 2000, resolved that ta’widh payment for (i) arrears and (ii) failure to pay after the due date, is permissible for Islamic financing formulated based on `uqud mu`awadhat (exchange contracts) including Islamic debt securities. Ta’widh can be imposed after it is found that mumathil (deliberate delay in payment) is utilised on the part of the issuer to settle the payment of the principal or profit. The rate of ta’widh on late payment of profit is one per cent per annum of the arrears and it cannot be compounded. While ta’widh rate on failure to settle the payment of the principal is based on the current market rate in the Islamic interbank money market, it too cannot be compounded.

Recent Resolution by the SAC of BNM
The SAC of Bank Negara Malaysia (“BNM”) in its 95th meeting held on 28 January 2010 had decided that ta’widh (compensation) may be imposed on late payment of financial obligation arising from exchange contracts (such as buy and sell and hire purchase) and qard (loan). Nevertheless, ta’widh may only be imposed upon the lapse of the repayment period agreed by both contracting parties. The amount of ta’widh received may be recognised as income by the seller/financier/creditor on the basis that it is imposed as compensation for actual loss incurred by the seller/financier/creditor. The rate of ta’widh shall be determined by the authority namely BNM.

In addition, the SAC of BNM in its 101st meeting held on 20 May 2010 relating to late payment charge mechanism for Islamic Banking Institutions had arrived at the decision that as a deterrent mechanism against cases of default by customers in discharging their financial obligation arising from Islamic contracts, the imposition of late payment charge by Islamic banking institutions that comprises both concepts of gharamah (fine or penalty) and ta’widh (compensation) is allowable. Gharamah is not allowed to be recognised as income, and it must be channeled to specified charitable bodies. However, Islamic banking institutions may recognise ta’widh as income on the basis that it is imposed on the customers as compensation for the actual loss incurred by the Islamic banking institutions. The imposition of late payment charge by Islamic banking institutions should consider the customers’ financial capability. The maximum rate of gharamah and ta’widh that may be imposed by Islamic banking institutions will be determined by the authority namely BNM.

4.4 Industry Practices Based on Different Shariah Resolutions
The differing views and resolutions have resulted in clearly diversity in addressing the issues related to late payments or defaults on Islamic financing, including Sukuk. The author of this paper expects
that the SAC of the SC will subsequently endorse the recent resolution of the SAC of the BNM, hence impacting future Sukuk issuance originating from Malaysia.

5.0 Sukuk: Debt Trading at Discounted Price

5.1 Introduction on Debt Trading

Trading in debt has special regulations that differ from those of commodity trading, since it is an area in which the occurrence of riba is likely, either by an increase accompanying a delay in payment (debt rescheduling), which is the type of riba practiced during the period of Jahiliyyah, or by selling it for less than its worth for accelerated repayment (discount of promissory notes), etc., or by trading in debt, selling and buying them for less than their amount.\(^4\)

Bai al Dayn is defined as the sale of a debt arising from trade and services transactions in the form of a deferred payment sale. Shariah permits the selling of debt by its equivalent in quantity and time of maturity by way of hawalah. This form of debt trading is accepted by all schools of Islamic law provided it is paid in full and thus gives no benefit to the purchaser. According to most Hanafis, Hanbalis and Shafis jurists, it is not allowed to sell debt to non debtor or a third party at all. However Maliks, and some Hanafis and Shafie jurist allowed selling of debt to third party with some conditions, amongst which payment from the sale of debt should be at the same rate.\(^5\)

There are two schools of thought in contemporary Muslim jurisprudence. The first recognize current developments in financial transaction and seeks to interpret the law in keeping with these developments, thus allowing for most of the new financial product to be absorbed in the Islamic system. The second sees the Shariah as fixed on the form of transactions that prevailed at the time of the birth and development of the school of Shariah.\(^6\)

5.2 Current Practice and Shariah Issues

In general, a sukuk constitutes partial ownership in a debt (sukuk murabaha), asset (sukuk al ijara), project (sukuk al istisna), business (sukuk al musharaka), or investment (sukuk al istithmar). Since the sale of debt, except at its face value, is not generally acceptable by scholars, the use of sukuk where debt receivables are a noticeable proportion remains a Shariah issue.

Murabahah has been the workhorse of Islamic finance and its applications of Murabahah have been very distinct between Malaysia and the GCC. From the Malaysian perspective, Bai al Dayn generates an Islamic promissory note, which is an affirmation of debt and tradable instrument. The note is negotiable and when traded is understood to carry the underlying contract, and may be sold at either a discount or premium to par.\(^7\) Hence, secondary market trading of Malaysian-based Sukuk is conducted on the basis of Bai al Dayn.

\(^4\) Dr. Abdus Sattar Abu Ghuddah, Debt Issues: Zakah upon Debts and Trading in Debts - An Introduction to Juristic and Practical Issues (A paper presented to the 7th conference of the Shariah Boards of AAOIFI), May 27 - 28, 2008


\(^7\) Islamic Finance Asia, Debt-Based Sukuk (a co-published report, being an excerpt of Sukuk, which is the first volume in the Islamic Capital Market Series by the Securities Commission Malaysia), March 2010. Accessed on 1 October 2010 from the internet - http://www.islamicfinanceasia.com/11_co-sc.php
In contrast, a majority of opinions elsewhere views that a negotiable instrument must attach to the ownership of real assets based upon an underlying Shariah-permissible contract. Therefore, sukuk issued on Murabahah basis are only tradable before the sale of the goods to the end-buyer or if receivables (if inventory is maintained) are less than 50%; after sale of the goods and without inventory of more than 50%, tradable only at face value with recourse. Therefore, the difference of Shariah analysis turns on the view of what may be traded. If debt receivables are packaged together with other tangible assets, they may be securitised and sold subject to certain ratio. The ratio may differ from one Shariah board to another.

5.3 View of Scholars on the Shariah Issues

Resolution of the Islamic Fiqh Academy

Two resolutions on debts were issued. The first of them states that it is unlawful to sell a deferred debt to someone other than the debtor for a spot payment in the same or a different currency because it can lead to riba. Furthermore, there is no difference whether the debt originates from a loan or from a deferred payment sale.

The Council of the Academy issued Resolution No. 30 (4/5) on the issue of murabahah Sukuk and investment Sukuk which explains the criteria for trading them in three situations:

(a) If the constituents of the Sukuk remain cash, then the application of the rules of Sarf would apply.

(b) If the constituents of the Sukuk become debts, then the rules for transactions involving debts would apply.

(c) If the constituents of the Sukuk become “mixed assets that include cash, debts, tangible assets and usufruct, then trading of the murabahah Sukuk is permissible at a mutually agreed price, on the condition that the majority [of the assets] in this situation are tangible assets and usufruct.”

If the prevailing [assets] are either cash or debts, a majority of them on a subsequent seminar arrived at the following recommendations for formulation of Shariah parameters for trading of Sukuk and stocks, even if the majority of the assets of a company or institution are cash or debts. Firstly, it is permissible to trade the shares of companies, investment Sukuk and unit investment trusts at a mutually agreed price, whether spot or deferred on the condition that those shares, Sukuk and units are issued by institutions or companies whose objectives and core activities are lawful in Islam and that a majority of their transactions involve tangible assets (commodities), usufruct (services) or rights. That is based on the consideration that the cash and debts which form part of their present assets are subsidiary and not the primary focus of the activities of these companies or institutions. Their primary activities are trading of tangible assets or services or rights. The debts or cash ensuing from such business activities will not affect trade [in the shares], no matter what amount they are. If the company is new, then trading in [its shares] should only be after the announcement of its establishment and the beginning of its activities with its wealth.

Secondly, the evidence for the ruling of permissibility if the debts and cash are subsidiary, and that it is not a condition for the subsidiary to be less than the principal, can be found in certain Hadiths and legal principles which indicate that. Thirdly, it is not permissible to use the ruling of permissibility as a means or a stratagem for the securitization of debts and their trade; for instance, if the activity of a fund shifts to buying and selling debts which originated from [the sale of]

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8 Ayub, Muhammad. Understanding Islamic Finance. 2007 (England: John Wiley & Sons. Ltd.), p. 408
9 Dr. Abdus Sattar Abu Ghuddah, p.7-12.
commodities, and some commodities are then placed in the fund as a stratagem for allowing trade [of its shares].

**AAOIFI’s Shariah Standards**

Shariah Standard No. (17) on the issue of investment Sukuk has affirmed that decision by stating that Trading of Murabahah Sukuk is unlawful. In Shariah Standard No. (21) on the issue of financial papers (stocks and bonds) with regard to the ruling on trading of debt that is mixed with other things such as tangible assets, revenue sources in the form of rented or mortgaged items, cash and rights, states the following:

If the assets of the companies consist of tangible assets, usufruct, cash and debts, then the rule for trading their shares differs according to the basic criterion employed, i.e., the goal of company and its core activities. If its purpose and activities focus on transactions of tangible assets, usufruct and rights, then trading of its shares is permissible, without need to consider the regulations of īaraf or disposal of debts, on the condition that the market value of the tangible assets, usufruct and rights should not comprise less than 30% of the total assets of the company, which include tangible assets, usufruct, rights, cash on hand and whatever is equivalent to it (i.e. debts owed to the company, outstanding receivables, and bonds it owns, which represent loans). [This is] irrespective of the worth of the liquidity and the loans, as these are, in this case, secondary [to the main purpose and activities of the company].

But if the purpose and core activity of the company center upon transactions of gold or silver or currency (foreign exchange), consideration of the rules for Sarf is then compulsory when trading its shares. And if the purpose and core activity of the company focus on transactions involving debts (i.e.,[liquidity] facilities), then consideration of the rules for debts is compulsory in the trading of its stocks.

A condition for the application of what is in the above is that it not be taken as a means of securitizing debts and then trading them by adding tangible assets and usufruct to the debts as a stratagem for securitizing the debt.

**Resolution by SAC of SC**

At its 2nd meeting on 21 August 1996, the SAC unanimously agreed to accept the principle of bai`-dayni.e. debt trading as one of the concepts for developing Islamic capital market instruments. This was based on the views of some of the Islamic jurists who allowed this concept subject to certain conditions. In the context of the capital market, these conditions are met when there is a transparent regulatory system which can safeguard the maslahah (interest) of the market participants.

The SAC explained that in general, the majority of Islamic jurists are unanimous in allowing the activity of selling debts to the debtor. They only differ in opinion about selling the debt to a third party for the reason that the seller will not be able to deliver the sold item to the buyer. At its 8th meeting on 25 January 1996, the IISG identified the `illah (reason) for why some Islamic jurists do

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10 Dr. Abdus Sattar Abu Ghuddah, p.7-12.
not allow bai‘ dayn. The ‘illah generally touches on the risks to the buyer, gharar, absence of qabadh and riba. In the Malaysian context, the debt securities instruments based on the principle of bai` dayn are regulated by BNM and the SC to safeguard the rights of the parties involved in the contract. Therefore, the conditions set by the Maliki Mazhab and the fears of risks by the Hanafi Mazhab can be overcome by regulation and surveillance. Thus, it can thus be concluded that although there are differences in opinions on bai` dayn among the Hanafi and Maliki Mazhab, there is a convergence point which states that bai` dayn can be used if there is a regulatory system that protects the buyer’s maslahah in an economic system. The fifth condition set by Maliki Mazhab relates to the exchange of ribawi goods. In the context of the sale of securitised debt, the characteristics of securities differentiate it from currency, and hence, it is not bound by the conditions for exchanging goods.

5.4 Industry Practices Based on Different Shariah Resolutions

Based on the above resolutions, Sukuk originating from Sudan, Bahrain and other Middle Eastern countries are based on Shirkah, Ijarah, Salam, Istisna, Istisna cum Ijarah or a pool of mixed assets. Such Sukuk are acceptable to almost all of the Islamic scholars and banking experts, subject to the fulfilment of minimal Shariah essentials associated with the underlying contracts. On the other hand, Sukuk issues of Malaysia are mostly based on the concept of Bai al Inah and their trading in the secondary market takes place through Bai al Dayn. Having said so, the Malaysian Sukuk market has been issuing Ijarah Sukuk which is a healthy development.¹²

6.0 Sukuk: Purchase Undertaking in Musharakah and Mudharabah Structures

6.1 Introduction on Purchase Undertaking

Musharakah and Mudharabah Sukuk gained popularity over the last couple of years because they allowed Sukuk to be issued without being wholly reliant on the existence of underlying tangible assets (as in the case of Ijarah Sukuk) in order to generate a return for the Sukuk holders. Sukuk Musharakah and Mudharabah are commonly structured with purchase undertakings to assure that 100% of the invested capital is returned to investors. It may also be referred to as repurchase promises, put or call options that achieve the same purpose. In addition, it is often coupled with the profit tanazul by the investors.

Under the concept, one party guarantees the investors that the business venture is profitable and if there are any losses incurred, the former shall acquire the investors’ ownership in the venture for redemption at par (i.e. the investors’ initial capital) or pre-agreed formula (that effectively covers the investors’ initial capital and the expected profit for 6 months). In return, the investors reciprocate by tanazul or ‘rebate’ of profits in any 6 months of the venture by limiting their return to a conventional reference rate plus spread or any other benchmark they agree on. If their share of profit exceeds the benchmark, the excess profit goes to the other party as incentive fees.

In November 2007, Sheikh Taqi Usmani commented that most of the Sukuk (about 85%) in the market (those using a Musharakah or Mudharabah structure) are not in line with the principles of Shariah because of the purchase undertakings where a promise to pay back capital violates the principles of risk and profit sharing on which such Sukuk should be based.

6.2 Current Practice and Shariah Issues

Most Musharakah and Mudharabah Sukuk in the Gulf have been structured and sold with a purchase undertaking, mirroring the fixed-income returns of a conventional bond. As a result of the

¹² Ayub, p. 396-397.
controversy caused by the statement made by Sheikh Taqi Usmani, the AAOIFI Shariah board convened a series of meetings in Bahrain on 13 and 14 of February 2008 after which a statement on Sukuk was produced which seeks to provide some guidance in relation to Sukuk structures. This pronouncement had an impact on global Sukuk issuance especially the issuance of Sukuk Musharakah.

The AAOIFI’s pronouncement that banned issuers from “purchase undertaking” to purchase the Sukuk asset back from the Sukuk holders at a nominal agreed value at the end of the tenure of the Sukuk or at the point of default has impacted the global Sukuk industry. The Sukuk structures directly affected by AAOIFI’s pronouncement are Sukuk Musharakah, Sukuk Mudharabah and Sukuk Istithmar. As a result, issuers have opted to issue Sukuk Ijarah which is seen as a viable alternative in the present situation.

This phenomenon can be clearly seen from the statistics of global Sukuk issuance using Musharakah and Ijarah structures at pre and post AAOIFI’s pronouncement. From March to June 2007, the issuance of Sukuk Ijarah recorded less than US$1 billion while Sukuk Musharakah recorded more than US$5 billion. In 2008, for the same period during post AAOIFI’s pronouncement i.e. from March to June, the value of Sukuk issuance using the Ijarah structures showed an increase to more than US$4 billion while the issuance of Sukuk Musharakah has sharply dropped to around US$1 billion.13

Sheikh Taqi Usmani’s criticism is fundamentally based on 2 critical points of Shari’ah analysis. First is that the common redemption features applied are meant always to assure that the investor recovers 100% of capital and related return; and, second, the redemption price and return are always structured in advance without consideration to any loss or risk which may be realised in the course of ordinary business. Hence, the redemption features run against the character of the traditional Musharakah and Mudharabah principles, prospectively invalidating them or creating a situation in which the redemption feature may not be enforceable in some courts.14 Generally, under most Musharakah and Mudharabah Sukuk, the provider of the purchase undertaking is also the investment agent.

6.3 View of Scholars on the Shariah Issues
Jurists unanimously agreed that the Mudarib under a Mudharabah structure is a trustee in respect of the capital that comes to his hand. The role of the mudarib is ultimately to use his best effort to make a profit for the Sukuk holders (i.e. rabumal), for which the investment agent is entitled to be paid an agreed proportion of the profit. It is not the role of the mudarib to guarantee the capital repayment of the Sukuk in the form of a purchase undertaking or otherwise. Likewise, the Mudarib cannot bear any losses from the venture unless upon his fault or negligence.

According to the Malikis and Shafiis, the mudarib is not responsible to guarantee the losses as regard the capital and any condition to do so will invalidate the mudharabah contract. The Hanafis and Hanbalis are of the opinion that the contract is valid but the condition is deemed to be void. However, it is permissible for a third party, other than a mudarib, to undertake voluntarily that

he will compensate the mudharabah losses, provided that this guarantee is not linked in any manner to the mudharabah contract.\textsuperscript{15}

Similarly, the nature of a musharakah partnership is that the partners agree to maintain the assets of the joint venture on a trust basis. Except in the case of wilful default, negligence or breach of contract, it is therefore not permissible to stipulate that a partner under a musharakah agreement will guarantee the capital of another partner in the same contract.

In general, AAOIFI’s Shariah Standards and resolutions issued by the International Fiqh Academy and the SAC of the SC generally permits the provision of a third party guarantee on the capital of the mudharabah and musharakah. However, there is no mention on the redemption price of the capital. AAOIFI that represents the consensus of leading scholars prefers that these redemption features are executed at a market price. Theoretically, the market price purchase removes the certainty of a guaranteed return of capital at a profit. There is significant discussion on the determination of market price that turns on to 3 factors: cost, regulation, and willingness to execute.

**AAOIFI’s Shariah Standards 2008 - Guarantees in a Sharika Contract (3/1/4)**

All partners in a Sharika contract maintain the assets of the Sharika on a trust basis. Therefore no one is liable except in cases of misconduct, negligence or breach of the contract. It is not permitted to stipulate that a partner in a Sharika contract guarantees the capital of another partner. (3/1/4/1)

It is permissible for a partner in a Sharika contract to stipulate that another party provides a personal guarantee or a pledge to cover cases of misconduct, negligence or breach of contract. (3/1/4/2)

A third party may provide a guarantee to make up the loss of capital of all or some of the partners. This is circumscribed with the conditions that: (a) The legal capacity and financial liability of such a third party as a guarantor are independent from the Sharika contract. (b) The guarantee should neither be provided for consideration nor linked in any manner to the Sharika contract. (c) The third party guarantor should not own more than a half of the capital in the entity to be guaranteed. (d) The guaranteed should not own more than a half of the capital in the entity that undertakes to provide the guarantee. In the case of a third party’s undertaking to guarantee, the partner benefiting from such an undertaking is not, however, entitled either to claim that the Sharika contract becomes null and void or to refuse to meet his obligations under the contract if the guarantor fails to meet his voluntary promise to cover the loss of his capital, on the grounds that he (the beneficiary) entered into the Sharika contract taking into account the state of such a third party’s undertaking to guarantee the loss of his capital. (3/1/4/3)

**International Fiqh Academy’s Resolution No. 30 (5/4) - Muqaradha Bonds and Investment Certificates**

The Council of the International Fiqh Academy resolved that neither the prospectus nor Muqaradha deeds should contain a guarantee from the manager of the funds for the capital nor a fixed profit based on the percentage of the capital. If such clause is implied implicitly or explicitly, the guarantee condition is voided and the mudharib is entitled to a profit equal to that of a similar mudharabah.

In addition, there is nothing in Shari’a preventing the inclusion of a statement in the prospectus or the Muqaradha certificates, about a promise made by a third party, totally unrelated

to the two parties to the contract, in terms of legal personality or financial status, to donate a specific amount, without any counter benefit, to meet losses in a given project, provided such a commitment is an independent one, not related to the Mudharaba contract, in the sense that the enforcement of the contract is not conditional to the fulfilment of the promise, or that the promise underlines the terms of the contract. Neither the shareholders nor the Mudharib may invoke this clause to avoid the contract or renge on his commitment, alleging that the said commitment made by the third party had been duly taken into consideration in the contract.

**Resolutions by the SAC of SC**

Sukuk issuers are allowed to apply third-party guarantee on the capital invested under the principles of Mudharabah (35th meeting on 7 November 2001) and Musyarakah. It was agreed that a fee (ujrah) is allowed to be paid to the guarantor on the condition that the guarantee should not be on a recourse basis, which means the investors cannot go after the issuers in the event of business failure since the guarantee will be provided by the guarantor. The investors are also allowed to ask for collaterals from the issuers in view of possible gross negligence by the issuers.

The SAC’s arguments that support the permissibility of kafalah on mudharabah capital are as follows:

(a) The original law on guarantees for Mudharabah capital: According to the arguments of past Islamic jurisprudence, the jurists were unanimous in their opinion that when losses occur in a mudharabah contract, the loss is to be borne by the rabb mal and not the mudharib as the latter’s status is only amin (trustee). However, if it could be proven that the loss was clearly due to the mudharib’s negligence or intentional, then the mudharrib is to make good the capital to the investor. Past Islamic jurists were unanimously of the opinion that in a situation where a loss occurs on a mudharabah, a capital guarantee by the mudharib is not permissible. However, they have different opinions on the status of the contract. The Hanafi and Hanbali Mazhab were of the opinion that the contract is valid and the conditional guarantee should be nullified. The Maliki and Syafi’i Mazhab, however, were of the opinion that the mudharabah contract is immediately nullified if there is such a guarantee.

(b) Contemporary Islamic jurists have made studies on the acceptable level of capital in mudharabah contracts that can be guaranteed according to the perspective of Islamic jurisprudence. The main issue of concern in relation to capital guarantee is whether the guarantee given will cause the mudharabah contract to be nullified since it violates the muqtadha `aqd (the main objective of a contract). For third-party guarantee Based on Tabarru’, the OIC Fiqh Academy discussed on the matter of issuance of Sanadat Muqaradhah and summarised that mudharib guarantee on capital and mudharabah profits are not permissible. However, the guarantee may be issued by a third party who has no connection whatsoever with the mudharib if it is done by way of tabarru’ and is not included as a condition in the actual mudharabah contract sealed and signed by both parties. The Shariah Council for Accounting and Auditing Organization for Islamic Institutions (AAOIFI) allowed for third-party guarantees other than by mudharib or investment agent or business partner towards the liability of investment losses. However, this is on the provison that the guarantee given is not tied to the original mudharabah contract. The basis of their decision is tabarru’ which is allowed by Shariah. Husain Hamid Hassan summarised the basis of the permissibility of third party guarantees based on the views of the Maliki Mazhab which allow wa’d mulzim (promises that must be kept). It is further strengthened by maqasid Shariah (Shariah’s objective) which allows for such action.
6.4 Industry Practices Based on Different Shariah Resolutions

Thus far, it seems that Shariah standards and resolutions are aligned on the “rightful” application of purchase undertaking to reflect the risk and profit sharing principles of Musharakah and Mudharabah structures. Nevertheless, the industry is still witnessing the issuance of such Sukuk contracts, although at far lower level post-AAOIFI announcement but the purchase undertaking covers the Sukuk face value although it is provided by a third party that fulfils the required conditions. Instead, there has been an increasing momentum for the issuance of Sukuk Ijarah where it is permissible for the lessee to undertake acquiring the leased asset at a fixed price, hence delivering the fixed returns profile that are demanded by current investors.

7.0 Sukuk: Asset Backed versus Asset Based – Ownership of Assets

7.1 Introduction on Asset Backed and Asset Based Sukuk

In conventional financing, asset backed securities are issued pursuant to a securitisation transaction involving the transfer of assets or risks to investors by fulfilling certain criteria on the securitised assets, originator and true sale. For example, the assets must generate cash flow and the originator has a valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitisation transaction. There are no impediments (contractual or otherwise) that prevent the effective transfer of the assets or the rights in relation to such assets from an originator to an SPV. The assets are transferred at a fair value.

More importantly, any transfer of assets by an originator to an SPV must comply with the true sale criteria where the underlying assets must have been isolated from an originator i.e. put beyond the reach of the originator and its creditors even in receivership or bankruptcy as far as possible. The originator must effectively transfer all rights and obligations in the underlying assets to the SPV which is sufficiently bankruptcy remote. The risk that a transfer of assets by an originator to an SPV might be re-characterised as a financing transaction rather than a sale of assets should be minimised as far as possible. Therefore, an originator must not hold any equity stake (directly or indirectly) nor able to exercise effective control over the decisions of the SPV. Similarly, the SPV must have no recourse to an originator for losses arising from those assets save for any credit enhancement provided by the originator at the outset of the securitisation transaction.\(^\text{16}\)

Therefore, Sukuk that is asset backed should ideally mirror the securitisation practice in the conventional space whereby Sukuk holders are the owners of the asset and the performance of the asset is the driver of the payment to Sukuk Holders. However, asset based Sukuk is said to behave more like a bond issuance whereby Sukuk holders may (or may not) have security interest (but not ownership interest that is mandatory for asset backed Sukuk) i.e collateral over the assets only.\(^\text{17}\)

7.2 Current Practice and Shariah Issues

The majority of recent Sukuk structures have been Sukuk Ijara where the party seeking financing i.e. the originator transfers certain of its assets to a SPV. There is typically a requirement that on maturity of the Sukuk or upon an event of default, the originator has a purchase obligation to repurchase the assets enabling the SPV to redeem the outstanding certificates and repay the Sukuk holder.

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holders. In this regard, the rights of Sukuk holders in the event of default will vary depending on whether the Sukuk structure is an asset-backed or an asset-based structure. It is established earlier that in an asset backed Sukuk, legal title to the underlying assets will typically pass by way of a true sale from the originator to the SPV so that Sukuk holders are able to exercise certain rights of ownership and control over such assets, with no recourse to the originator and therefore, credit risk performance is determined solely by the underlying asset.

In an asset based Sukuk, the originator typically transfers only the beneficial ownership or equitable interest in the assets to the SPV issuer. There is no true sale and as a result, Sukuk holders have no recourse to the assets. Therefore, the transaction does not focus on asset risk, but rather on the credit worthiness of the sponsors/promoters of the Sukuk. These types of Sukuk usually do not grant the Sukuk holders the right to cause the sale or other disposition of any of the trust assets on default. Typically, they can cause the trustee to call a meeting of the Sukuk holders and exercise their rights under the transaction documents including issuing notice to the originator pursuant to its undertaking to repurchase the assets on maturity or default of the Sukuk. In structuring the sukuk, additional security could also be granted by the originator including share charges, mortgages, and guarantees provided by related parties in the originator group. Alternatively, upon a default, the parties may agree to restructure the debt and related obligations including an agreement to reduce the principal sums outstanding or granting standstills on exercising any rights under the transaction documents. Ultimately, asset based Sukuk are based upon the credit of the originator, guarantor or other co-obligors.18

The majority of Sukuk issued are asset based. There is a need to understand the reason for this practice. In countries of the GCC, the regulatory framework for securitisation is not yet developed. One of the main legal challenges is the restriction on foreign ownership of certain assets in the GCC and whether an offshore SPV can own an asset in these jurisdictions. In Malaysia where clear guidelines on true sale are clarified, asset backed sukuk have not taken off as well.19 One of the possible reasons could be the originator’s reluctance to incur additional statutory costs to perfect the asset’s legal ownership transfer to the SPV and more importantly, relinquish its control over the assets to the SPV. In addition, the due diligence and rating methodology conducted on asset backed securities are typically more detailed and stringent which may result in a lower rating for the financing amount required, hence defeating the originator’s ultimate purpose for cost efficient financing.

In unsecured asset based Sukuk, the Sukuk holders do not have any interest or control whatsoever in the underlying asset. In secured asset backed Sukuk, the Sukuk holders have security interest i.e. collateral in the asset but are not owners of the asset. A charge over the asset does not make them the asset owners. They can only claim the total amount due to them and any surplus arising from the asset disposal must be returned to the obligor. If the disposal proceeds are insufficient, the Sukuk holders rank together with other unsecured creditor.20 Therefore, the Shariah issues in asset based Sukuk is on the ownership status and as a result, the restricted rights (if not, none at all) over the underlying assets.

19 Assoc. Prof. Dr. Asyraf Wajdi Dusuki and Shabnam Mokhtar, p. 11
7.3 View of Scholars on the Shariah Issues

Jurists since early times have discussed at great length the issue of qabd for purchase and sale contracts in particular as well as other contracts in general. There have been different views about what constitutes qabd for different goods, such as real estate and goods sold by measurement and other portable goods, such as clothes, animals and the like. The issue is, is it necessary that the goods be accepted by the buyer’s hand or is it sufficient to grant the buyer access to the goods without restriction.

A number of Hadiths mention the necessity of qabd. In general, the scholars of Islamic jurisprudence have divided qabd into two forms: physical possession (qabd hissi or haqiqi) and legal possession (qabd hukmi). Physical possession refers to explicitly taking possession or when the buyer is observed taking the goods sold to him. It is normally evidenced in transactions involving two types of assets. First, in the case of immovable assets such as land and buildings, qabd is said to have taken place when the original owner gives permission to the buyer to take control of the land and carry out whatever activity he wishes without hindrance. Qabd is completed for such assets when the new owner’s name appears on the grant title or the ownership certificate. The second type of asset to which qabd haqiqi applies is moveable property such as commodities, food, vehicles etc. Qabd haqiqi is effective for this category when the buyer collects or receives the goods upon paying the price.

Qabd hukmi refers to taking possession implicitly or not in a physical form. However, the legal status of qabd hukmi is the same as that of qabd haqiqi, provided that it fulfills one of the following conditions: First, the seller must grant the buyer full access to the object of sale without any encumbrances. Second, legal ownership can also take effect by means of a contra-debt by which debt between two parties is implicitly settled, the result being that neither party owes debt to the other. Third, qabd hukmi can also take place due to an earlier action which implies that ownership has already taken place, although the earlier form of qabd is different from the new form. Finally, qabd hukmi or legal ownership also takes place due to spoiling.

Regarding the status of qabd in a sale contract, the Hanafis is of the opinion that qabd is not an essential requirement of a sale but rather a subsidiary condition. It is perfectly lawful to postpone it to a later date. Only except in the case of transactions of ribawi items, qabd is elevated to a prerequisite of a valid contract. However, Malikis confined the application of the Hadith on qabd to food grains, which means that non-food-grain items (e.g. cotton, palm oil etc.) may be sold prior to taking possession. There is also no dispute that for ribawi food (wheat, barley, dates and salt), possession is a condition for its sale. As for non-ribawi food, Malikis have two opinions: first that it is disallowed (without prior possession) and second, it is permitted to sell non-ribawi food prior to taking possession. For the Shafiis, possession is a condition for all kinds of property. The Shafies strictly adhere to the literal meaning of the Hadith “Do not sell anything until you receive it”, to the extent that even the sale of immovable objects must satisfy the possession requirement prior to resale. However, the view of al-Shafiie is not shared by the other schools, which do not require qabl prior to resale in the case of immovable objects like land.

The majority of scholars of Islamic jurisprudence hold the rationale of prohibiting sale prior to taking possession (qabd) to be mainly due to the presence of gharar (excessive risk and uncertainty), which may lead to dispute among the transacting parties. This was because of the concern that the goods might not be delivered due to damage or other factors. Thus, Islam prohibits
any transactions involving bay ma dum, since the delivery of the subject matter cannot be affected, and this brings about the prohibited element of gharar.21

International Fiqh Academy’s Resolution No. 53 (4/6) – Possession: Its different forms, especially the modern forms and their rules
The Council of the International Fiqh Academy resolved that just as the possession of commodities may be physical, by taking the commodity in one’s hand or measuring or weighing the eatables, or by transferring or delivering the commodity to the premises of the possessor, similarly the possession may also be an implied or constructive possession which takes place by leaving the commodity at one’s disposal and enabling him to deal with it as he wills. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf.

Based on the ruling above, qabd hukmi is similar to qabd hissi, even though there is no physical possession.22

AAOIFI’s Shariah Standards (No. 18)
AAOIFI has explained qabd in detail in this standard. (Paragraph 5)
The approved new guidelines will require investors to become the legal, rather than nominal, owners of sukuk assets. Shari’ah boards are to review all relevant contracts/documentation related to the transaction to ensure comprehensive compliance with Shari’ah and oversee that implementation and operation complies with Shari’ah. AAOIFI’s new guidelines have resulted in heightened investor awareness of sukuk structures. These guidelines appear to conclude that the sukuk must reflect an equity-type instrument that cannot represent a debt owed to the holder. It is believed that this will likely result in increased investor preference for “asset-backed” sukuk.

Resolution by SAC of the SC
The Islamic Instrument Study Group (“IISG”), at its 8th meeting on 25 January 1996, resolved that the local `urf be made the basis and guideline to determine the qabadh status in any transaction. Subsequently, whatever is accepted by the `urf as qabadh can be used as a guideline for transactions conducted in the Malaysian capital market.

7.4 Industry Practices Based on Different Shariah Resolutions
Although asset backed Sukuk are more consistent with the ideal of granting the investor an ownership share of the asset, asset based sukuk may be more suitable where legal title to assets cannot be transferred investors, especially where there are restrictions on foreign ownership of certain asset classes such as real property. In addition, asset-backed sukuk may not be adequate in circumstances where the enforceability against the assets may be challenging, example sovereign-related assets.

8.0 Opinions and Recommendations
At present, Sukuk is structured in such a manner to mirror the payout arrangement and investors protection that fixed income investors are familiar too. Therefore, Sukuk is often used to replace conventional bonds, competing for financing from the same pool of bond investors. The offering circulars are replete with terms and conditions recognizable to bond investors to provide an equivalent outcome within the bounds of Shariah compliance. As a consequence, Shariah issues

21 Ibid, p. 14-17
22 Ibid, p. 18
have surfaced on controversial practices which have raised general concerns on whether these structures are truly Shariah compliant or not.

Some argue that Sukuk is still in its nascent stage of development and should be “indulged” to allow future innovations for the sake of maslahah. On the hindsight, the remarkable growth of Sukuk market based on this approach will have to cease eventually because it is clear that the Sukuk market’s credibility is currently being questioned by investors when Sukuk deals are being tested in the financial crisis. The industry’s development has reached a juncture that it may be unacceptable to risk the reputation of Islamic finance, particularly Sukuk that has been built up over the past years, to push for “innovations” mimicking conventional bonds when such “innovations” are being labeled as Shariah issues. The industry obviously realizes this problem but moving forward, how do they resolve the dilemma between the desire to grow and capture significant market share against the ideal requirement to uphold Shariah in all aspects?

Sukuk is inevitably a new asset class but will fall short of being one if it continues to be overworked and embedded with features replicating conventional bonds. Now that Sukuk is bouncing back, the industry should seize this window of opportunity to educate the investing public and corporations. More effort should be concentrated on the unique features of Sukuk and the investors’ rights should an event of default occurs. In addition, the transparency of Shariah rulings and its process is equally important to broaden the credibility of the decision to the whole world, both Muslim and non-Muslim.

9.0 Conclusion

The Shariah issues highlighted in this paper are not unique to Sukuk only, but may also prevail in the financing practices of Islamic banking. Some of these issues have been debated since the early days of Islamic jurisprudence but have crept up again in the practice of modern Islamic financing, including Sukuk because the present structuring of Sukuk mimics the features of conventional bonds. By referencing the views of different schools and mainstream scholars, such issues are attempted to be resolved by established and respected fiqh academies, Shariah boards of international and regulatory bodies governing the practices of Islamic financial institutions, which eventually influences the current practices in Sukuk.

So long as Sukuk continue to be associated as Islamic bonds and are not able to establish itself as a new class of asset, there will be a never ending process of sorting out “new” Shariah issues as and when “innovations” are overworked to replicate conventional bonds. A more holistic and long term solution is required to ensure that Islamic finance, particularly Sukuk, is able to flourish within the ambit of Shariah and yet still being accepted and demanded by investors and corporations.

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