

Sukuk: Issues and the Way Forward

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1. Introduction

Sukuk represents a new development in global capital market. It is one of the fastest growing sectors in Islamic finance and is considered by many as the most innovative product of Islamic finance.

As a relatively young asset class in the global capital market, the *sukuk* market inevitably faces problems typical of its early stage of development. In this relation, some Muslim scholars have questioned its level of compliance with the *Shariah* law, particularly on how they are structured. The main criticism was from Sheikh Muhammad Taqi Usmani¹, a prominent scholar who has taken the view that 85% of the current structures of Gulf *sukuk* do not comply with Islamic law², in particular *Sukuk Al Musharaka*, *Sukuk Al Mudaraba* and *Sukuk Al Istithmar*.

Following that, the *Shariah* Board of Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) had studied the subject of the issuance of *sukuk* in three sessions between 2007 and 2008. After considering the deliberations in these meetings and reviewing of the papers and studies presented therein, the *Shariah* Board of AAOIFI issued its resolutions in February 2008 to highlight the various areas in *sukuk* which were found to be non-*Shariah* compliant. Accordingly, Islamic financial institutions had been advised to adhere to the principles set out in the relevant AAOIFI Standards in *sukuk* issuance.

This paper attempts to explore the controversies or issues surrounding *sukuk*, in particular the observations and resolutions issued by the *Shariah* Board of AAOIFI.

¹ Sheikh Muhammad Taqi Usmani is the President of the AAOIFI *Shariah* Council. He is also on the *Shariah* Advisory Boards of HSBC, Dow Jones and Abu Dhabi Islamic Bank.

² As reported in the report by Reuters entitled “*Most sukuk ‘not Islamic’, body claims*” on 22 November 2007 at www.arabianbusiness.com.

2. **What is sukuk?**

Before getting into the details of *sukuk*, it is imperative to examine the meaning of *sukuk*. “*Sukuk*”³ is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond⁴. The AAOIFI defines “*sukuk*” as:

“... certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity”⁵.

In simple terms, *sukuk* are documents or certificates that represent ownership in an asset. It grants the investors a share of the asset along with profit and risks resulting from such ownership. *Sukuk* can be structured based on the principles of contract of exchange (e.g. *ijarah*, *murabahah*, *istisna'*) and contract of participation (e.g. *musyarakah* and *mudharabah*). In the early days, *sukuk* were basic contracts of sale premised on cost-plus sale or cost-plus production agreements but now, there has been a shift away from debt-based *sukuk* towards lease and partnership-based *sukuk*⁶.

At present, the Standard for Investment *Sukuk* issued by AAOIFI provides for 14 eligible asset classes and only 7 are being used – *ijarah*, *musharakah*, *mudarabah*, *murabahah*, *salam* and *manfa'a*.

3. **AAOIFI's ruling in relation to sukuk**

In 2008, the *Shariah* Board of AAOIFI has issued six recommendations on proper *sukuk* structures. These recommendations are as follows:-

- *Sukuk*, in order for them to be tradable, must be owned by the *sukuk* holders, together with all of the rights and obligations that accompany such ownership. The manager of a *sukuk* issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.
- *Sukuk* must not represent receivables or debt except in the case of a trading or financial entity selling all of its assets, or a portfolio with a standing financial obligation.
- It is not permissible for the manager of *sukuk* to undertake to offer loans to *sukuk* holders when actual earnings fall short of expected earnings. It is

³ “*Sukuk*” is the plural of “*sakk*” which means “legal instrument, deed, check”.

⁴ www.reference.com.

⁵ AAOIFI Standard 17.

⁶ “*The Malaysian Sukuk Market*” by RAM Ratings, published in *Islamic Finance News*, Vol. 5, Issue 45, 14 November 2008.

permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same is mentioned in the prospectus.

- It is not permissible for the investment manager, partner, or investment agent to agree to re-purchase assets from *sukuk* holders at nominal value when the *sukuk* are extinguished at the end of their maturity. It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase, in accordance with *Shariah* rules of partnership and modern partnerships, and on the subject of guarantees.
- It is permissible for the lessee in a *Sukuk Al-Ijarah* to agree to purchase the leased assets when the *sukuk* are extinguished for their nominal value, provided that the lessee is not also an investment partner, investment manager, or agent.
- *Shariah* supervisory boards should not limit their role to the issuance of *fatwa* on the structure of *sukuk*, but should also oversee its implementation and compliance at every stage of the operation.

4. Controversies or issues surrounding *sukuk*

I will now proceed to deal with the issues revolving the structures of *sukuk* and other incidental issues concerning *sukuk*.

A. *Sukuk* holders' ownership of enterprise asset

As mentioned above, *sukuk* are *Shariah*-compliant trust certificates and tradable financial instruments which reflect the value of a particular asset or assets. It represents ownership shares in assets that generate profits or returns to *sukuk* holder. Hence, from the *Shariah's* perspective, it is essential that *sukuk* are backed by a specific, tangible asset throughout its entire tenure and *sukuk* holders must have a proprietary interest in the assets which are being financed.

According to the ruling of the *Shariah* Board of AAOIFI, *sukuk* investors should have rights over the *sukuk* assets. Assets should be sold 'legally' and there must be a 'transfer' of assets from the originating company. As *Shariah* encourages financing through trading in specific and identifiable assets, *sukuk* risks and return should be linked to the *sukuk* assets. Even if the originator becomes insolvent, *sukuk* investors may still be able to recover their investment through the realisation of the assets.

In order to effect an actual transfer of assets, the *Shariah* Board of AAOIFI further ruled that the manager issuing *sukuk* must certify the transfer of ownership of such assets in its books and must not keep them as his own assets. There must be an agreement that is evidence of a binding sale transaction from the originator to the *sukuk* investors. Such contract should be legal, valid, binding and enforceable on all parties and the laws of the country which the assets and the company are based.

Following such ruling, it would mean that in the case of *ijarah sukuk* (for example), it is essential that the *ijarah* certificates are designed to represent real ownership of the leased assets, and not only a right to receive the rent. *Ijarah sukuk* holders have to jointly bear the risks of assets price and the ownership related costs and share its rents by leasing it to any user. In the case of destruction of the assets, each holder will suffer the loss to the extent of his ownership. This is in line with the *Shariah* principles of “*Al-Ghorm bil Ghonm*” (no reward without risk) and “*al-Kharaj bil Daman*” (any benefit must be accompanied with liability).

However, this *Shariah* requirement is merely complied with by a few *sukuk* issued to date, such as Tamweel and Sorouh PJSC, both UAE transactions where the underlying assets were sold to the investors and registered in favour of the investors. In most cases, the originator⁷ would actually intend to legally retain the asset in question and hence, the *sukuk* products have been structured to that effect. In some *sukuk* issuance, the assets concerned may be shares of companies which do not confer real ownership, although it offers a right to returns to *sukuk* holders⁸. Such arrangements would render the *sukuk* not lawful in the eyes of *Shariah*.

According to Moody’s report⁹, many *sukuk* structures applied have been effectively ‘reduced’ to a form that is identical to conventional unsecured bond. Most ‘asset-based’ *sukuk* may have the ‘form’ of ‘asset-backed’ *sukuk*, but not in substance¹⁰. In other words, while most *sukuk* have assets in their structures, they were only considered as ‘asset-backed’ or asset-secured if key securitization elements are present to ensure that holders enjoy beneficial title and realizable security over the assets and associated cash flows¹¹.

Although the concepts of ‘asset-based’ and ‘asset-backed’ may be identical in terminology, both have significant differences in credit risks. This can be seen in the case of Tamweel PJSC, where two types of *sukuk* had been issued. In the Tamweel asset-backed *sukuk*, the freehold titles to the properties were transferred to the *sukuk* holders along with the associated *ijarah* cash flows. The property/land titles are registered in the name of the investors. Any losses on those cash flows (that arise from the sale of distressed property) are passed on to *sukuk* holders, who are exposed to the asset risk. Nevertheless, upon the insolvency of Tamweel, the assets will continue to pay the *sukuk* investors. As for the unsecured or asset-based

⁷ Originator means the companies or banks that provide the assets.

⁸ Muhammad Taqi Usmani, “*Sukuk and their Contemporary Applications*”.

⁹ Khalid Howladar, “*The Future of Sukuk: Substance over Form? Understanding Islamic securitisation, Asset-Backed and AAOIFI principles*”, Moody’s Investors Service, 6 May 2009.

¹⁰ See Table 1 – Moody’s Sukuk Ratings. Moody’s Investors Service is the credit rating company and a subsidiary of Moody’s Corporation. Moody’s Investors Services was voted “Best Islamic Rating Agency”, i.e. best rating agency for Islamic finance ratings by the readers of Islamic Finance News in the publication’s 2008 Award poll. Most issuers of debt securities and preferred stocks rated by Moody’s have, prior to the assignment of any rating, agreed to pay a fee to Moody’s for the appraisal and rating services rendered by it.

¹¹ “*Asian Sukuk Market Faces New but Familiar Challenges*” by Islamic Finance News, published in *Islamic Finance News*, Vol. 6, Issue 16, 24 April 2009.

sukuk issued by Tamweel, the *sukuk* would not survive the insolvency of Tamweel. Investors in these two sets of *sukuk* are taking very different risks.

Following the sub prime crisis in the United States of America (“US”) which burst into a full-blown financial crisis affecting the rest of the world in 2008, the risk of defaults is just unfolding and it is believed that investors and market players will become more aware of the issue of credit risks attached to *sukuk*. In so far as existing *sukuk* are concerned, the nature of *sukuk* is being revealed by the parties themselves, as seen in the case of the *sukuk* issued by East Cameron Partners LP (“ECP *Sukuk*”).

The ECP *Sukuk* was launched in July 2006 in US to raise USD165.67 million, using the *Musharakah* structure¹². It was a multiple-award winning *sukuk* which was once the spotlight of the media. In October 2008, East Cameron Gas Co. (“East Cameron”) filed for bankruptcy protection after its offshore Louisiana oil and gas wells failed to yield the expected returns, partly because of hurricane damage¹³. The issue in this case was whether the *sukuk* holders actually own a portion of the company’s oil and gas. In this relation, East Cameron argued that there had been no real transfer of ownership of production revenues, known as royalties, into a “special-purpose vehicle” formed to issue the *sukuk*. Instead, the company claimed the transaction was merely a loan secured on those royalties, implying that *sukuk* holders would have to share the royalties with other creditors in the event of liquidation.

Fortunately, the bankruptcy judge, Robert Summerhays J. rejected the company’s contention and ruled that the *sukuk* holders “invested in the *sukuk* certificates in reliance of the characterization of the transfer of the royalty interest as a true sale”¹⁴. The judge then gave East Cameron leave to find further arguments to support its case.

In another recent case, Investment Dar, a Kuwaiti investment company that owns a 50% stake in luxury-car maker Aston Martin Lagonda Ltd., was reported of its failure to make payment on its USD100 million *Sukuk Al Musharaka*, which matures in 2010¹⁵. This is the first Gulf company to default on Islamic bond. As it is most likely an asset based or unsecured *sukuk*, the *sukuk* investors will have no priority over the assets of the defaulting company.

In these turbulent times, the recommendations by AAOIFI would certainly benefit *sukuk* investors in the long run as they would have a recourse over the assets in the event of insolvency of the originator. Indeed, the *Shariah* requirement of asset

¹² “Can Islamic Finance Help Ease US Woes?” posted at <http://muamalat.net/modules/AMS>. The article was originally from <http://www.islamicfinanceasia.com>.

¹³ Stephen Fidler, “Defaults Pose Latest Snag in Islamic-Bond Market”, Wall Street Journal, 16 June 2009, at <http://online.wsj.com/article/SB124510859262816907.html>.

¹⁴ *Ibid.*

¹⁵ Raphael Wong, “Kuwait - A dark day for Sukuk”, published in *Islamic Finance News*, Vol. 6, Issue 19, 15 May 2009.

ownership is compatible with the principles of asset-backed securitization which require a true and perfected sale of assets by the originator of such assets so as to ensure that these assets are isolated from the bankrupt estate of the seller.

On the other hand, it is to be noted that if the recommendations of the AAOIFI are followed by market players, *sukuk* holders must also be prepared to take true asset risk as the ownership transfer will entail in the transfer of control and risk in such assets. If the assets do not perform, *sukuk* holders must be prepared to incur the ensuing losses. This may not suit the appetite of certain group of investors who are used to the credit risk on the corporate credit of the obligor, rather than the risk in the assets concerned.

On another note, the recommendations of AAOIFI pertaining to asset ownership may not be easy to put into effect due to the certain restrictions that may be imposed by some jurisdictions.

For instance, in Indonesia, the general principles governing the transfer of state assets to third parties are as follows¹⁶:-

- (a) state assets needed for government operational activities cannot be transferred to third parties;
- (b) certain state assets may not be transferred to third parties without the prior approval of the governmental body. The transfer of state assets in the form of:
 - (i) land or buildings; or
 - (ii) other kinds of assets valued at more than IDR100 billion, requires the approval of the Indonesian Legislative Board;
- (c) sale of state assets must be conducted through a public auction generally.

Further, there is no concept of beneficiary ownership in Indonesia. As a result, the Indonesian government has on 7 May 2008 issued Law No. 19/2008 on State *Shariah* Commercial Papers (“State *Sukuk* Law”) to address the foregoing issues¹⁷.

By virtue of the State *Sukuk* Law, *usufruct* rights have been introduced to the Indonesian legal system and thus creating the legal possibility of transferring rights attached to certain assets without having to transfer the legal title of the assets. However, this will still not satisfy the requirements of the AAOIFI’s ruling if there is no actual transfer of ownership right in the state assets to *sukuk* holders.

As such, in order to fully implement the suggestions by AAOIFI, it is essential to have the full support and cooperation from the respective governments to introduce specific laws or amendments to existing legislation so as to avoid any possible conflict with the existing laws and regulations in the operation of *sukuk*.

Meanwhile, the enforcement of the *Shariah* law in different jurisdictions may pose certain problems to market participants as it depends on the degree to which

¹⁶ Indri P Guritno and Pramudya A Oktavinanda, “*Sukuk Law – An Indonesian Legal Perspective*”, published in *Islamic Finance News*, Vol. 5, Issue 31, 8 August 2008.

¹⁷ *Ibid.*

Shariah law has been incorporated into the laws of the relevant jurisdiction, in particular a purely secular jurisdiction. In the English case of *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC*¹⁸, one of the issues was whether the governing law clause in the relevant *Murabahah* Agreements required the consideration of the *Shariah*. Both the English High Court and the Court of Appeal ruled that the governing law clause did not require the consideration of the *Shariah*.

According to the English High Court, the reference to *Shariah* in the contract was no more than a reference to the fact that the bank purported to conduct its affairs according to the principles of *Shariah*. But this did not mean that *Shariah* law was applicable to the contract in an English court. On appeal, the Court of Appeal said that the statement as to the governing law was “*intended simply to reflect the Islamic religious principles according to which the bank holds itself out as doing business rather than a system of law intended to ‘trump’ the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement...*”. This means English courts will not apply Islamic law to the contract, although the disputed choice of law provision stated that English law was to be applied “*subject to the principles of the Glorious Shari’a*”.

There was another reason why the English courts could not apply *Shariah* law in the case of *Beximco*. This is due to the fact that England was a party to the Rome Convention (“the Convention”), which has the force of law in England by virtue of section 2 (1) of the Contracts (Applicable Law) Act 1990. Article 1.1 of the Convention only made provision for the choice of law of a country but it did not provide for the choice of law of a non-national system of law, such as *Shariah* law, *lex mercatoria*, etc.

The ruling in *Beximco* has far-reaching significance in the field of Islamic finance and may influence courts in other countries. Hence, parties who wish to apply *Shariah* law to their contracts have to choose a jurisdiction that will apply such law; otherwise, their intention will not be carried out. Market participants will have to be wary of the choice of law, the legal system of the jurisdictions involved and the degree to which *Shariah* law has been incorporated into the laws of these jurisdictions so as to ensure that the contract is not merely legal and valid, but enforceable under the laws of the country which the assets and the company are based.

The issue in *Beximco* is unlikely to arise in Malaysia as Malaysia has developed a dual financial system, whereby the Islamic financial system operates in parallel with the conventional system. Although disputes in relation to Islamic banking and financial transactions in Malaysia fall within the jurisdiction of civil courts, a *muamalat* division has been established within the High Court in 2003 with a designated judge to hear Islamic banking and takaful cases. At present, in proceedings relating to Islamic banking business, Islamic financial business or any other business which is based on *Shariah* principles, the Malaysian courts may take into consideration any written directives and the ruling of the *Shariah* Advisory Council of the Central Bank of Malaysia (“SAC”) (where any such matter is

¹⁸ [2004] APP. L.R. 01/28, at <http://www.nadr.co.uk/articles/published/ArbitLawReports>.

referred to the SAC). In the near future, however, the SAC will assume a more authoritative role in the determination of *Shariah* matters. According to the Central Bank of Malaysia Bill 2009¹⁹, if any question concerning a *Shariah* matter arises in any proceedings relating to Islamic financial business, the courts or arbitrator shall take into consideration any published rulings of the SAC or refer such question to the SAC for a ruling. The SAC's ruling pursuant to such reference made thereto will be binding on the courts. This will create more certainty in the legal frameworks of Islamic finance in Malaysia.

The other alternative that the market players may consider is to refer their disputes to arbitration or other alternative dispute resolution procedures. A good example is the machinery set up by the Kuala Lumpur Regional Center for Arbitration ("KLRCA") in 2007 for the arbitration of Islamic financial business disputes. In order to facilitate the resolution of disputes arising from *Shariah* aspect of Islamic banking and Islamic financial services, the KLRCA has also introduced the Rules for Islamic Banking and Financial Services Arbitration in March 2007. In the long run, arbitration could be a more preferred form of dispute settlement as it allows parties to determine their own procedure for settling their dispute. This is a method which is encouraged by the *Shariah*.

B. Prohibition of selling of receivables or debts

The second point raised by AAOIFI was that *sukuk* must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally. This recommendation is related to the first point raised by AAOIFI above where *sukuk* holders should stand in the line of owners of underlying assets and not in the line of creditors.

As such, in order to be tradable, *sukuk* should not be backed purely by receivables. In *sukuk* securitisation²⁰, the underlying assets should be sold to the investors. If the originator were to become insolvent, the legal ownership of the properties would reside with the investors, thus providing the necessary protection to them.

C. Stipulation of incentive for the manager & stipulation of loans to investors

As pointed by Taqi Usmani, most *sukuk* issued are similar to conventional bonds in relation to the distribution of profits from their enterprises at fixed percentages based on interest rate (LIBOR)²¹. There is usually a clause in the relevant contract stating that if the actual profits from the enterprise exceed the percentage based on interest rates, the entire excess amount shall be paid to the manager (whether a

¹⁹ The said bill is pending the Royal Assent and will come into operation upon notification in the Gazette.

²⁰ The term "securitisation" means transforming one type of financial exposure into another.

²¹ *loc. cit. n.8.*

mudarib, or a partner, or an investment agent) as an incentive for good management. If the actual profits are less than the prescribed percentage based on interest rates, the manager may take it upon himself to pay out the difference to *sukuk* holders, as an interest free loan to them. The loan will be recovered by the manager either from the amounts in excess of the interest rate during subsequent periods or from lowering the cost of repurchasing assets upon redeeming the *sukuk*.

With regard to the stipulation of an incentive for the manager, if the fees of the manager is not specified in the contract (save for the incentive), such arrangement is considered as *makruh* (undesirable) by the majority jurists, other than *Hanbali* scholars as it will lead to uncertainty. In this relation, the Standard for Mudarabah as approved by the *Shariah* Council of AAOIFI reads as follows:-

“If one of the two parties should stipulate for itself a specific amount (of profit), the mudarabah will be void. This prohibition, however, is not inclusive of an agreement by the two parties that if the profits exceed a certain percentage then one of those parties will receive the excess exclusively such that the distribution will be according to what the two have agreed.”²²

However, in practice, such an incentive has been operated on the basis of interest rates or with a view to maintain the status quo of the conventional, *riba*-based market. The prescribed percentage in some *sukuk* is not linked to the expected profits from the enterprise, but to the cost of financing or to the prevalent rates of interest in the market. There is no connection between prevailing interest rates and the actual profit / returns from an enterprise. Hence, it has been commented by Taqi Usmani that the so-called “incentive” in these *sukuk* “*is not truly an incentive but rather a method for marketing these sukuk on the basis of interest rates.*”²³ As such, it has been recommended that *sukuk* should be free of such “incentives” or it should be based on the enterprise’s expected profits.

In relation to the stipulation of loans when profits fall below the prescribed percentages, the *Shariah* Board of AAOIFI has disallowed such practice as it is not justifiable from the *Shariah*’s perspective. According to Taqi Usmani, such arrangement would amount to a sale with a credit, which is prohibited by the Prophet and the entire community of *Shariah* scholars.

However, the *Shariah* Board of AAOIFI permits the setting up of a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus.

D. Manager’s promise to repurchase assets at face value

It is well established rule under the *Shariah* that the return of investors’ capital cannot be guaranteed as reward always follows the risk. However, most *sukuk* issued today contain a guarantee of *sukuk* holders’ principal by indirect means,

²² AAOIFI Standard 13, para. 8.5.

²³ *loc. cit.* n. 8.

where the manager undertakes to purchase *sukuk* assets at par value upon maturity, regardless of their true value on that day. Such arrangement is rather similar to conventional bonds – if the enterprise is making a loss, such losses will be borne by the manager; if it is profitable, the profits will accrue to the manager, regardless of the amount. The *sukuk* investors have no right other than the return of their principal.

The above practice is a departure from the *Shariah* principles which prohibit any guarantee of capital to *sukuk* investors. Instead, *sukuk* holders should have a right to the true value of the *sukuk* assets, whether their value exceeds that of their face value or otherwise.

In exploring the lawfulness of the above arrangement, Taqi Usmani has considered the manager of *sukuk* may act in the capacity of a *mudarib* (investment manager), a *sharik* (partner) or a *wakil* (investment agent) for the investors.

(a) where the manager acts as a *mudarib* (investment manager)

If the manager makes the commitment to the investors in the capacity of a *mudarib*, such commitment is void. According to the Standard on Mudarabah approved by the *Shariah* Council of AAOIFI, if the loss is greater than the earnings, the losses should be deducted from the capital provided that there is no negligence or *mala fides* on the part of the manager²⁴. If the costs are equal to the earnings, the investors will receive their capital back and the manager will earn nothing²⁵. If there is profit, it will be distributed among the investors and the manager according to the pre-agreed ratio²⁶.

(b) where the manager acts as a *sharik* (partner)

In the case where the manager acts as a partner of the *sukuk* holders, it is also unlawful for him to guarantee the return of capital to the *sukuk* holders as it would interrupt the partnership in the event of losses / in the sharing of profits²⁷.

Whilst it is not permissible for a partner to issue a binding promise to purchase the assets at face value (as it amounts to a capital guarantee), it is lawful for him to promise to purchase the assets of the partnership during the period of partnership or at the time of dissolution at market value or at an agreed price at the time of purchase²⁸.

²⁴ AAOIFI Standard 13, para. 7.8.

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ AAOIFI Standard 12, para. 3.1.5.7.

²⁸ AAOIFI Standard 12, para. 3.1.6.2.

(c) where the manager acts as a *wakil* (investment agent)

In the case where the manager acts as an investment agent, it is also unlawful for him to make such a commitment because agency or *wakalah* is a contract of trust and there can be no guarantees except in cases of negligence or *mala fides*²⁹. This is because the stipulation of a guarantee by an investment agent will transform the operation into a loan with *ribawi* interest³⁰.

In view of the foregoing, the *Shariah* Board of AAOIFI disallows managers of *sukuk* to undertake [now] to repurchase the assets from *sukuk* holders for its nominal value when the *sukuk* are redeemed at the end of its maturity. However, it is permissible for the manager to undertake to purchase on the basis of the net value of the assets, its market value, fair value or a price to be agreed, at the time of actual purchase. The guarantee of capital only occurs in the case of negligence or omission on the part of *sukuk* manager, or his non-compliance with the investors' conditions.

E. The role of *Shariah* Supervisory Boards

Islamic banks and financial institutions have been set up with an aim to achieve the objectives of an Islamic economic system and to move away from interest-based banking system. In this relation, the *Shariah* Supervisory Boards have given permission to the Islamic banks to introduce *Shariah* compliant products to the investors with the hope that the banks will gradually distance themselves from interest-based enterprises, thereby creating a *Shariah*-compliant investment environment for the investors.

However, the operations of the majority Islamic financial institutions show that many institutions have moved backwards to interest-based system through the introduction of products which are not *Shariah* compliant, in the strive to compete with conventional banks and financial institutions.

As such, the AAOIFI has resolved that the *Shariah* Supervisory Boards should go beyond the role of advising and approving the structures. In this relation, it is believed that *Shariah* scholars and the *Shariah* Supervisory Boards have a more significant role to play. They should structure, assist in the drafting of, review and approve the documentation for *Shariah*-compliant transactions in order to ensure the adequacy of compliance and to enhance the certainty, consistency and transparency of enforcement of such transactions. The relevant *Shariah* provisions should be precisely and adequately incorporated in the relevant contracts so that such contracts may be enforceable in a purely secular jurisdiction. Further, *Shariah* Supervisory Boards should continue to oversee the implementation and operation of the relevant product so as to ensure that it complies with all respects of the *Shariah* principles up to its maturity.

²⁹ *loc. cit. n. 8.*

³⁰ AAOIFI Standard for Guarantees, para. 1.2.3.

F. Other related issues

In addition to the above issues highlighted by Taqi Usmani and AAOIFI, the other issues which are related to *sukuk* are as follows:-

a. High costs of financing

Sukuk are extremely difficult instrument to structure as they require extensive and costly legal and religious advice and a lot of different skills and resources to make it work³¹. The development of new products and financial engineering are resource-intensive activities as it involves the conduct of market research, product development and analytical modeling³². These activities demand financial and human resources which are costly. On the other hand, Islamic financial institutions are generally of small size and may not have the budget for research and development. Further, there is uncertainty with regards to the perceived risk associated with the instruments³³. This is why many corporations and banks shy away from this instrument.

It has been suggested that Islamic financial institutions should seriously consider joining efforts to develop the basic infrastructure for new products, given the importance of financial engineering³⁴.

b. Lack of trading at the secondary market

Although *sukuk* can be negotiated and traded freely in the market, it remains active merely at the primary market. This is because most holders keep *sukuk* to maturity and many *sukuk* are held by large institutions so that the assets are unavailable for the average private investors³⁵. The lack of active trading at the secondary market is also due to the limited number of issuances and the lack of alternative instruments in this asset class³⁶. Moreover, *sukuk* are out of reach for the average investors and its holders are normally the wealthiest Muslim investors due its huge trading size. This may defeat the higher purpose that Islamic finance aims to achieve – fair and equal distribution of wealth among the people.

³¹ Elwaleed M. Ahmed, “*Sukuk “Islamic Bond” The Fastest Growing Sector in Islamic Finance: Its Unique Feature & The Challenges Facing Its Growth*” at <http://sukukislamicbond.blogspot.com>.

³² Hossein Askari, Zamir Iqbal and Abbas Mirakhor, “*Expanding Financial Frontiers – Part I*”, published in *Islamic Finance News*, Vol. 6, Issue 21, 29 May 2009.

³³ “*Sukuk Comes of Age in Infrastructure and Project Finance (Part 1)*” by Standard & Poor’s, published in *Islamic Finance News*, Vol. 6, Issue 17, 1 May 2009.

³⁴ *loc. cit.* n. 32.

³⁵ *Ibid.*

³⁶ *Ibid.*

As such, in order for *sukuk* to achieve their macroeconomic and microeconomic benefits, it is important that asset securitization *sukuk* be issued and traded on a large scale basis³⁷.

In addition to the above, the lack of trading at the secondary market is also due to the issues revolving *bay' al dayn*³⁸, or sale of debt. It is generally accepted that debt is an asset and financial right. Debt and *sukuk* are similar in this respect as both represent rights which are subject to performance or exercise by the relevant contracting party. In this relation, Muslim scholars have different views as to whether debt can be traded, i.e. bought and sold, in particular when the sale involves the creditor and a third party. Some jurists have disallowed the practice of sale of debt between the creditor and a third party contenting that there is uncertainty (*gharar*) in the ability of the seller to deliver the subject matter of the contract³⁹. As for some jurists, such practice is allowed subject to certain conditions which must be fulfilled before the sale may be carried out⁴⁰.

According to the contemporary scholars and the Organisation of the Islamic Conference (“OIC”) Islamic Fiqh Academy’s ruling, sale of debt is permissible so long as it is free from any element of *riba* and *gharar*⁴¹. Following such ruling, it is pertinent to determine the nature and status of the debt⁴². If the receivables of the debt are in the monetary form, the debt is considered as similar to money and the rules in the exchange of money will apply. This means the transaction will have to adhere to the rule of parity and it must be carried out on the spot. If the receivables are in the forms of non-*ribawi* goods, it is considered as a non-monetary financial right and the rules in the exchange of money or *ribawi* items will not apply⁴³.

Notwithstanding the above ruling by OIC Islamic Fiqh Academy, the *Shariah* Advisory Council of the Malaysian Securities Commission (“SACSC”) has departed from the rule of parity in allowing sale of debt with a discount. This is because the nature of the debt has changed after it has been securitised. Therefore, it is no longer governed by the rule on

³⁷ This is the view of McMillen, Michael J T in his article: “*Contractual Enforceability Issues: Sukuk and Capital Markets Development*”, published in Chicago Journal of International Law dated 1 January 2007, source from <http://www.highbeam.com>.

³⁸ “*Dayn*” is the Arabic term for debt.

³⁹ This is the view of the *Hanafis*, *Hanbalis* and some of the *Shafi'i* jurists.

⁴⁰ Jurists who allow the sale of debt include the *Malikis* and some *Shafi'i* jurists. The *Malikis* allow the sale with eight conditions while the *Shafi'is* impose less conditions to such sale.

⁴¹ Dr. Engku Rabiah Adawiah Engku Ali, “*Islamic Law Compliance Issues in Sale-based Financing Structures as Practised in Malaysia*”, [2003] 3 MLJ lviii, at p. lxxvii.

⁴² According to the classical jurists, this would be dependable on its receivables.

⁴³ *loc.cit. n. 41*, at p. lxxviii.

currency exchange and the practice of discounting in the sale of debt is allowed⁴⁴.

Having said so, it has to be noted that the SACSC's ruling merely represents the minority view in the market. Although the sale of debt with a discount is allowed in Malaysia, such practice may not pass the more stringent requirements of such sale as imposed by the classical and majority of the contemporary jurists⁴⁵. This is one of the reasons why *sukuk* or debt is not actively traded in the secondary market.

5. Conclusion and the Way Forward

As seen above, the problems faced by the *sukuk* industry include the legal constraints under the existing legal framework of certain jurisdictions, the issue of enforceability of the contracts, cross-boarder issues, the lack of well-structured and well-regulated secondary market for *sukuk* etc. Further, in order to compete with conventional bond market, most *sukuk* offered partial or total guarantees of repayment of capital and/or periodical distributions. This is contrary to the *Shariah* principle that parties to a financial transaction must share in the risks and rewards attached to it. Hence, *sukuk* structure needs to be revised and this would require the joint efforts of the states, market providers, market players, investors, regulators, legal expertise as well as the *Shariah* scholars. This is an on-going process which may take years or even decades to achieve.

Although the views of Taqi Usmani and the AAOIFI's ruling has caused a stir within the industry, it constituted a positive move towards improving transparency and bringing the substance of *sukuk* products closer to the basic principles of *Shariah*.

Considering the noble objective of Islamic finance, the market has to move away from *ribawi* elements or interest-based products in order to achieve equitable distribution among the partners. Given the various weaknesses in the structure of *sukuk* today, one cannot help but to seriously ponder over the higher purposes and objectives of Islamic economics - whether the goal of Islamic finance is to essentially replicate in its entirety the conventional financial system, or how much emphasis should be placed on innovation that encourages and favours investments and funding that adheres to *Shariah* principles.

On the other hand, given the diversity of rulings of the various *Shariah* advisory boards from various jurisdictions, it is important for the *Shariah* scholars to have more discussions or sessions of meetings in order to come out with standards and practices which are more acceptable at the global level. As commented by Sheikh Nizam Yaquby, a prominent *Shariah* scholar: "*for the purpose of standardization, it is important to have certain prudential rules and basic contracts, especially repetitive*

⁴⁴ *Ibid.*.

⁴⁵ *loc.cit. n. 41*, at p. lxxix.

ones, to be accepted among a group”⁴⁶. This statement highlights the importance of standardization so as to reduce the number of “repetitive” contracts that are placed in front of *Shariah* boards for review. Given the shortage of qualified and widely recognised *Shariah* scholars, *Shariah* scholars should be asked to focus efforts on reviewing more innovative or controversial products⁴⁷.

In this relation, it is suggested that reputable Islamic organisations such as the Islamic Financial Services Board (“IFSB”)⁴⁸ and the International Islamic Financial Market (“IIFM”)⁴⁹ may undertake the role of developing unified documentation frameworks which are essential for the growth of Islamic capital market. For instance, model acts may be developed for each primary area or subject of *sukuk*, e.g. the area of *ijarah* and transactions using the *ijara* (such as *sukuk*), etc. These model acts would embody codifications of the principles of the nominate contracts and widely accepted transactional forms, which would serve as basic guidelines and would be amenable to modification for different purposes and jurisdictions. This is crucial as the Muslim community consists of diversity of peoples and cultures and this diversity will affect the implementation of any model compilation. The compilation of model acts is a long-term effort which requires the involvement of a broad range of participants. A number of working groups will have to be set up for the preparation of working drafts, which would be discussed by different sections and various levels of participants. Although this is an uphill task, the production of unified documentation frameworks and product development, the sharing of expertise will certainly create cost reduction for the Islamic financial institutions and thus benefiting the entire industry in the long run.

Moving forward, market participants should be wary of the following:-

- (a) *Sukuk* holders must have complete ownership in the real assets throughout the tenure, which is evidenced by proper book entries and the relevant

⁴⁶ Quoted by Blake Goud (Executive Director of Institute of Halal Investing, Portland, the US) in IFN Forum – “*Shariah* scholars claim that standardization would limit the diversity in Islamic banking products, hence challenging the Islamic concept of *Ijtihad* (reasoning). However, regulators and industry practitioners suggest that such standardization is necessary to further develop and improve investment certainty. Can there be an equilibrium? Discuss.”, published in *Islamic Finance News*, Vol. 5, Issue 47, 28 November 2008.

⁴⁷ *Ibid.*

⁴⁸ IFSB is an international body comprised of regulatory and supervisory agencies of governments. It was inaugurated in 2002, opened in 2003, and has been granted the immunities and privileges of an international organisation and diplomatic mission by the Government of Malaysia pursuant to the Financial Services Board Act 2002. Among the objectives of IFSB include establishing various standards pertaining to the soundness and stability of the Islamic financial sector and recommending these standards for adoption by governments and other appropriate agencies and entities.

⁴⁹ IIFM was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank. Its primary focus lies in the advancement and standardisation of Islamic financial instrument structures, contracts, product development and infrastructure and the issuance of guidelines and recommendations for the enhancement -of Islamic Capital and Money Market globally. In October 2008, IIFM launched its first-ever standardized treasury *Murabahah* documentation - the Master Agreement for Islamic Treasury *Murabaha* Contracts.

documents. This is to give reasonable assurance to investors that they will be able to recover a major part of their investment if the issuer defaults. Eventually, Islamic capital market is to move away from the bulk of unsecured structures towards secured, asset-backed *sukuk*;

- (b) The returns of enterprises should accrue to *sukuk* holders after deducting all relevant expenses, such as the manager's fees, or the share of the *mudarib* in profits. If there is to be an incentive for the manager, it should be based on the profits expected from the enterprise and not on the basis of an interest rate;
- (c) If actual profits are less than expected, it is unlawful for the manager to offer a loan to *sukuk* investors;
- (d) It is unlawful for *sukuk* manager to furnish an undertaking to repurchase the assets at face value. The repurchase must be carried out on the basis of the net value of the assets, or at a price agreed upon by the parties at the time of purchase.
- (e) *Shariah* Supervisory Boards of the Islamic financial institutions to play a more pro-active role in ensuring that *sukuk* products adhere to the *Shariah* principles. Apart from reviewing the relevant contract and documents related to the actual transaction, the *Shariah* Supervisory Boards should oversee the actual means of implementation and make sure that the operation complies with *Shariah* principles and requirements at all stages.

NOTE: This article is intended to provide our clients and the members of ILN with an update on the Islamic capital market. It is intended for general information only and is not a substitute for legal advice. The author reserves all rights pertaining to this article.

Table 1 – Moody’s Sukuk Ratings

SECURED SUKUK (Asset-Backed)

Country	Issuer	Originator Name	Amount (USD mm)	Issue Rating
UAE	Tamweel Sukuk Ltd. Class A	Tamweel PJSC	185.90	Aa2
UAE	Tamweel Sukuk Ltd. Class B	Tamweel PJSC	16.10	Baa1
UAE	Tamweel Sukuk Ltd. Class C	Tamweel PJSC	10.30	Ba3
UAE	Tamweel Sukuk Ltd. Class D	Tamweel PJSC	7.70	NR
UAE	Sun Finance Ltd. Class A	Sorouh Real Estate PJSC	750.68	Aa3
UAE	Sun Finance Ltd. Class B	Sorouh Real Estate PJSC	68.24	A3
UAE	Sun Finance Ltd. Class C	Sorouh Real Estate PJSC	272.97	Baa3

UNSECURED SUKUK (Asset-Based)

Country	Issuer	Originator Name	Amount (USD mm)	Issue Rating
Saudi Arabia	Golden Belt 1 B.S.C.	Saad Trading Contracting & Financial Services Co	650	Baa1
Indonesia	Indonesia Global Sukuk	Republic of Indonesia	650	Ba3
UAE	ADIB Sukuk Co. Ltd.	Abu Dhabi Islamic Bank	5,000	A2
UAE	DIB Sukuk Co. Ltd.	Dubai Islamic Bank PJSC	750	A1
UAE	DP World Sukuk Ltd.	DP World	1,500	A1
UAE	Dubai Sukuk Center Ltd.	DIFC Investments LLC	1,250	A1
UAE	EIB Sukuk Co. Ltd. Programme	Emirates Islamic Bank PJSC	1,000	A1
UAE	JAFZ Sukuk Ltd.	Jebel Ali Free Zone FZE	2,043	A1
UAE	Tamweel Sukuk Ltd	Tamweel PJSC	272	A3
UAE	DB Sukuk Ltd.	Dubai Bank PJSC	5,000	A3
UAE	Sukuk Funding (No. 2) Limited*	Aldar Properties PJSC	1,021	A3
UAE	Dewa Funding Ltd.*	DUBAI Electricity & Water Authority	872	A1
Malaysia	Malaysia Global Sukuk Inc.	Government of Malaysia	600	A3
Malaysia	MBB Sukuk Inc. (Subordinated)	Maybank	300	A3
Malaysia	Sarawak Corporate Sukuk Inc.	State of Sarak	350	Baa1
Kuwait	NIG Sukuk Ltd.	National Industries Group Holding S.A.K.	475	Ba3
Qatar	Qatar Alaqaria Sukuk Co.	Qatar Real Estate Investment Co	300	A2

Total amount of issuance rated by Moody’s: USD 22,033 mm

*Actual Issuance in AED, USD Equivalent listed

Source: “The Future of Sukuk: Substance over Form? Understanding Islamic securitisation, Asset-Backed and AAOIFI principles”, Moody’s Investors Service, 6 May 2009.

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