Ṣukūk in Various Jurisdictions: *Sharī´ah* and Legal Issues

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Abstract:

Ṣukūk are active Islamic finance instruments offered in various jurisdictions and have experienced various events in the recent years. Several *ṣukūk* defaults in 2009 highlighted a number of *Sharī´ah* and legal issues that are necessary to be discussed. As a part of the prerequisites to fulfil *Sharī´ah* requirements, compliance to the relevant laws is also a necessity. Among the issues that will be touched upon is ownership of the asset of the *ṣukūk* which will include discussion about *'al Qabd'* (taking possession). Next, rights of the *ṣukūk* holders will be discussed to see whether their interests are well protected and in this context the concept of asset backed will be differentiated from that of the asset based securities. Discussion on the contentious purchase undertaking in *ṣukūk* dealings will follow in order to highlight its status and effect on the *ṣukūk* and parties to the transactions. Then, the practice of tranching in *ṣukūk* issuance will be discussed followed by legal documentation of *ṣukūk* issues. In the end, the paper will present way forward for *ṣukūk*, so that these issues are further addressed for better *ṣukūk* issuance.

Key Words: *Ṣukūk*, *Ṣukūk* defaults, *Ṣukūk* trading; Islamic finance instruments, Purchase undertaking, Tranching in *Ṣukūk*, Islamic capital market, *Maqaṣid*.

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1. Introduction

Islam is a comprehensive way of life, which strikes the balance between the spiritual and the material need of human being. One of the important aspects in human life is the need for an all-inclusive system in order to govern their life and to ensure that the needs are catered adequately including the material needs such as the financial management. This aspect of life is closely related to the fast growing industry in the world nowadays, which is the Islamic financial services industry. At present, over two hundred and fifty Islamic financial institutions are operating worldwide and Islamic banking is estimated to be managing funds of up to the value of US $ 1 Trillion. The annual growth of Islamic financial institutions (IFIs) has been estimated at 15 to 20% worldwide over the past 10 years and is expected to accelerate in the near future.

One of the important sources of financing in the Islamic financial services is the fund generated from the capital markets. Over the last decade, the Islamic capital market has seen significant growth and efforts to further strengthen this area of funding are going on. In Malaysia, the creation of Islamic money market and capital market is no doubt a landmark development in the area of Islamic finance. A wide range of instruments was developed to facilitate the effective management of liquidity and funding by the IFIs. This has facilitated the smooth flow of funds in the Islamic financial system.

Ṣukūk are one of the important instruments in Islamic capital market. Since inception, *ṣukūk* were used as a tool that has assisted in raising capital inside the country as well as funds from international investors. Globally, *ṣukūk* issuance has increased over the last decade and it has grown tremendously, even though, there was slow down of issuance during the global financial crisis. Again, the global *ṣukūk* issuance for 2011 surpassed the USD34.2 billion peak recorded in 2007.[2]

However, the story of *ṣukūk* is not without critiques or blame. Since its issuance, *ṣukūk* have been accused to be identical to conventional bonds and not an alternative. This is because they posses some similar features and provide similar economic effects. As a matter of fact, such claims do not befall on *ṣukūk* only and many of Islamic finance products have

[2] See KFHR report on *ṣukūk* cited by Zawya, accessible at: http://www.zawya.com/story.cfm/sidZAWYA20101221101336; for updated data see: http://www.economist.com/blogs/graphicdetail/2012/04/focus-2?fsrc=gn_ep&goback=.gde_1794138_member_106916657

initially been developed as replication of the conventional finance products with some modification in order to make them '*Sharī´ah* compliant'. Thus, there was call for re-examination of *ṣukūk* structure particularly after the famous remarks made by the Chairman of the AAOIFI's *Sharī´ah* Board. Defaults in several *ṣukūk* in 2009 also triggered the need to re-examine the *ṣukūk* structures and the industry as a whole.

The above events prompted AAOIFI to reaffirm their *Sharī´ah* standard on *ṣukūk* and called for review of the current practices in *ṣukūk* and to move away from the conventional finance practices. The events also highlighted some flaws in *ṣukūk* and the hidden risks that certificate holders needed to bear as well as the disclosure of shocking results when *ṣukūk* undergo a legal test. Some unsettled *Sharī´ah* and legal issues within *ṣukūk* have been raised that need to be examined further and also to be acknowledge by parties in different jurisdictions who are already involved with *ṣukūk* or intend to associate with them in the future.

This paper will try to address some of the above concerns starting from definition of *ṣukūk* and their types as well as the arising *Sharī´ah* and legal issues. Among the important issues that will be discussed are issues of ownership on underlying asset, tranching, purchase undertaking, legal documentation, *ṣukūk* trading, credit enhancement facilities and guarantee to the *ṣukūk* holders.

2. Understanding *Ṣukūk*

In order to understand *ṣukūk* from *Sharī´ah* perspective, it is significant to acknowledge that *ṣukūk* are different from conventional bonds. It is evident from *ṣukūk* definition as prescribed by AAOIFI, namely:

"Investment *ṣukūk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the *ṣukūk*, the closing of subscription and the employment of funds received for the purpose for which the *ṣukūk* were issued". [*Sharī´ah* Standard 17, Article 2 (Definition of Investment *ṣukūk*)]

So basically, *ṣukūk* are financial certificates that evidence ownership to underlying asset and the income or profit generated by it. From this definition, we understand that *ṣukūk* do not create indebtedness as the

certificates are not proof of investors' loan to *ṣukūk* issuers as in the case of bonds. In contrast, *ṣukūk* certificates are an evidence of *ṣukūk* holders' proportionate ownership of the underlying asset, usufruct or services in the *ṣukūk* and they shall receive return based on the performance of the underlying assets. Therefore, *ṣukūk* are considered as an investment facility and not a loan which shall not automatically guarantee return to the investors as it depends on asset's performance unlike return of interest on bonds. However, there are certain structures of *ṣukūk* that allow such guarantee and there are also certain parameters for allowable guarantee.

Ṣukūk are significant instruments in Islamic finance as they allow for global access to capital and provides cross border liquidity management capability. Apart from acces to capital, *ṣukūk* can be seen to facilitate securitization and allow for equitable wealth distribution as well as shared prosperity. Hence, *ṣukūk* are issued by various parties including corporate entities and government. Sovereign *ṣukūk* issuance by governments is also gaining popularity as they may facilitate major development projects at national and global levels.

3. Types of *Ṣukūk*

There are various ways for *ṣukūk* division. Among others are by way of the underlying contract and, therefore, *ṣukūk* can be divided as follows:

1. Sale based *ṣukūk* which include *ṣukūk* structures using the different sale based contracts including *Murabahah*, *Ba'i al'Inah*, *Salam* and *Istisna'a*;
2. Lease based *ṣukūk* which are based on *Ijarah* concept;
3. Partnership or equity based *ṣukūk* that are structured based on *Mudarabah* or *Musharakah* contracts;
4. Agency based *ṣukūk* that are based on *Wakalah al Istithmar* contract (agency for investment) contract; and
5. Hybrid *ṣukūk* which may combine more than two *Sharī´ah* contracts to structure the *ṣukūk*.

Other classifications are asset based *ṣukūk* which are based on deferred sale contracts or *Ijarah* contracts, or asset backed *ṣukūk* which include *ṣukūk* structured based on equity or partnership contracts, and this is among the most popular classification. Due to the significance of these

two types of *ṣukūk* (asset based and asset backed *ṣukūk*), we need to discuss them in detail:

Based on the Principle Guidelines in IFSB 7- Capital Adequacy Requirement for *ṣukūk*, Securitizations and Real Estate Investment[3], these *ṣukūk* categories were defined as the following:-

a) "An asset-backed *ṣukūk* structure that meets the requirements for being an asset backed structure as assessed by a recognised external credit assessment institution (ECAI): this structure would leave the holders of *ṣukūk* to bear any losses in case of the impairment of the assets. The applicable risks are those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI. (This is the category explicitly covered by IFSB-2.)"
b) An asset-based *ṣukūk* structure with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the *ṣukūk*. Normally, the assets are leased back to the originator in a sale-and-leaseback type of transaction. The applicable credit risk is that of the originator, subject to any *Sharī´ah*-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer (see paragraph 13). Such structures are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer.
c) A so-called "pass-through" asset-based *ṣukūk* structure: a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *ṣukūk*. This issuing entity requires the originator to give the holders recourse, but provides *Sharī´ah*-compliant credit enhancement by guaranteeing repayment in case of default by the originator."

In fact, when defining these two type of *ṣukūk*, IFSB-7 explained in its footnotes that " In Islamic finance, asset-backed structures involve ownership rights in the underlying assets ... Asset-based structures in Islamic finance are found in cases where, given the applicable legal environment, the ownership rights over the underlying asset may not

[3] See IFSB-7, p. 3-4

reliably result in an effective right of possession in case of default, and in consequence, the *ṣukūk* holders need to have a right of recourse to the originator in case of default" [4]

4. 2009 Major *Ṣukūk* Defaults

Major *ṣukūk* defaults in 2009 can be considered as the most recent adverse episode in *ṣukūk* industry that has called for scrutiny of *ṣukūk*. Various issues were highlighted and more clarity on *ṣukūk* transactions was required by all parties especially the investors. This was contributed by court cases revelation on some flaws in *ṣukūk* structures. Several issues were raised that entailed the examination of certain aspects which include among others, the ownership of underlying assets, purchase undertaking, tranching and legal documentation.

4.1 Asset Ownership

It is well understood that *ṣukūk* certificate is an evidence of investor's ownership of *ṣukūk* underlying. However, the definition of both asset-based and asset backed *ṣukūk*, as mentioned above, shows that the practice in both types of *ṣukūk* is different. In asset-backed *ṣukūk*, true sale is a requirement and thus, the ownership of the asset transfers to the certificate holders and in the event of default, they can dispose it to third party in order to obtain remedy for their losses. In the asset based *ṣukūk*, no true sale occurs and the asset is seen as a facility to enable the *ṣukūk* issuance and the only recourse the certificate holders have in the event of default is to exercise the purchase undertaking made by the issuer.

Therefore, asset-backed *ṣukūk* holders shall depend on performance of the asset for their return and must ensure that the assets generate good cash flow as well as of good value. This is because, if default occurs, their only recourse is on the asset. In contrast, asset-based *ṣukūk* holders will have more concern on the creditworthiness of the issuer or other guarantees or collaterals provided by them, rather than the asset. This is so because they shall have no claim on the asset but to enforce the undertaking made by issuer to repurchase the *ṣukūk* certificates. Such matter is evidenced in the documentation of *ṣukūk* whereby a clause on restriction to dispose the asset is found to be in existence.

Scrutiny and examination of term sheet of *ṣukūk* reveals that the above is the general practice in both types of *ṣukūk*. It implies that the asset-

[4] See IFSB -7, footnote no. 2 and 3.

based *ṣukūk* have departed from the *Sharī´ah* requirements as underlined by AAOIFI according to which *ṣukūk* holders are owners of the underlying asset. *Ṣukūk* documentations reveal that there is no such ownership –in asset-based *ṣukūk*, asset is only used as a facility to make the deal possible.[5] As a matter of fact, the asset remains in the issuer or the originator's book. It is important, therefore, to ascertain the status of such practice in Islam.

Scholars of all times have discussed the importance of ownership in sale and condition to qualify a valid transfer of ownership. A sale for issuance of *ṣukūk* certificate should give the effect of ownership transfer and taking possessing (*Qabd*) of underlying subject matter by the purchaser. Looking into the views of classic jurists reveals that most of them require *Qabd* to occur after sale agreement is executed. This is based on the narration of the Prophet (pbuh):-

"'Amr bin Syu'aib narrated from his father that ..... the Prophet has prohibited from [combining] a sale and a loan; to have conditions in a sale contract; to sell what you do not posses; or to get return without corresponding liability (for loss)"[6]

The hadith is considered by jurist as a basis for prohibition of sale of the non-existent subject matter or what cannot be delivered. However, al *Qabd* can take place explicitly or impliedly. Contemporary jurists have elaborated on the matters and as evident in OIC Fiqh Academy and AAOIFI standards,[7] transfer of ownership or possession can take place minimum via *Takhliah* and *Tamkin* (seller providing access without hindrance to the buyer to dispose the commodity as he/she pleases). Nevertheless, examination of *ṣukūk*'s term sheet shows that such right is not available to asset-based *ṣukūk* holders as normally there are clauses on restriction on disposal of asset although documentation states that *ṣukūk* holders are the beneficial owners of the asset. Therefore, there are inconsistencies or conflict of terms in the documentation.

4.2 Purchase undertaking

Purchase undertaking is a vital feature within *ṣukūk* because it gives the certificate holders some kind of protection against loss in the event of

[5] For example, see: Risk Factor relating to Mudaraba Asset, at p. 22 of the DP World Offering Circular

[6] Al Nasa'i, Sunan al Nasa'i bi Syarh al Suyuti, (Beirut: Dar al Ma'rif), 1999,vol. 7 , hadith no. 340

[7] See OIC Fiqh Academy (Resolution No. 53) and AAOIFI (Shari'ah Standard No.18).

default. This is true especially in asset-based *ṣukūk* as in the event of default, their sole recourse is the enforcement of purchase undertaking by the issuer or obligor. Although *Sharī´ah* recognizes *Wa'ad*, however, it is considered morally binding but not legally binding by majority of the jurist.[8] Only in certain events it is considered as legally binding from *Sharī´ah* perspective.

In relation to *ṣukūk*, *Wa'ad* becomes problematic when it is in the form of purchase undertaking of *ṣukūk* certificate at face value because at this state, it becomes somewhat like a guarantee of the capital and such is not possible where *ṣukūk* is an investment instrument. It must base on the principles of *Musharaka* / *Mudaraba*. This is based on the legal maxims "no return without risk". Thus, in all forms of investments, risks are involved and only by assuming higher risk will one deserve high return. If not, the certificate holders will not bear any liability and will be seen as advancing debt or capital to the issuer in return for protected principal plus interest. Thus, not different from bond that creates indebtedness on the part of the issuer towards the certificate holders. However, if undertaking is made to purchase the *ṣukūk* certificate at market value, *Sharī´ah* has no objection.

The other controversy of such undertaking was raised in the some *ṣukūk* defaults where questions were raised on the status of the undertaking from legal perspective. Does the law recognize it as a guarantee or not. It is significant because it determines the priority of *ṣukūk* holders in claims against the originator or issuer in event of default. It shall determine whether they rank as secured or unsecured creditors.

4.3 Tranching

Further scrutiny of *ṣukūk* aftermath with regard to the major *ṣukūk* defaults revealed another questionable practice in *ṣukūk* that required re-examination, namely the practice of tranching. This is because many scholars raised objection on similar practice that is done in issuance of shares. However, examination of various *ṣukūk* documentations revealed that it has not been practiced widely but rather found only in certain *ṣukūk*.

Tranching refers to the practice of slicing of capital structure in *ṣukūk* issuance and it is done via subordination where there is a prioritization process through which losses are allocated to different layers of investors. Tranching also involves the practice of time tranche where *ṣukūk* holder's

[8] OIC Fiqh Academy (Resolution No. 40 - 41)

certificates have different time of maturity. The former involves subordination where different investors are divided into different layers based on their capital contributions, the risk that they are willing to absorb and different return that they expect. Careful examination of *Sharī´ah* contracts shows that such practice is not allowed especially in equity. Long before tranching in *ṣukūk*, scholars have discussed the issue of subordination in shares and the majority had disallowed it.[9] Such ruling was made based on the legal maxim:

"Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment."

However, there are *ṣukūk* which have mentioned the term '*Tanazul'* in their tranching practices such as *Tamweel ṣukūk*.[10] This is a new concept that requires review on *Sharī´ah* view on the practice of subordination in *ṣukūk*. Notwithstanding, it is argued that '*Tanazul'* is only valid when one has actually received the return or seen the extent of loss that he has to suffer, then will only *Tanazul* shall take effect. One cannot waive something that he does not know or posses. It results into the unwanted uncertainty (*Gharar*) that makes the transaction invalid. Similarly *Ibra*', a concept that is said to be closely related with *Tanazul*, requires that the subject matter of waiver needs to be in existence before *Ibra'* can be executed.[11] Nevertheless, this issue needs in-depth study as deducing *Sharī´ah* ruling on tranching in *ṣukūk* will require its examination in the light of various types of *ṣukūk* and the underlying contracts.

4.4 Legal documentation

Apart from adhering to the *Sharī´ah* requirement, *ṣukūk* has to adhere to the legal requirements as well and thus it needs to be properly documented. As Islamic finance is still a nascent industry compared to the conventional system, the legal documentation follows much of the conventional practices. Thus, it is a requirement that *Sharī´ah* scholars have the capability and ample time to scrutinize *ṣukūk*'s legal documents as it shall evidence the rights and obligation of the parties as well as whether justice and *Sharī´ah* guidelines are followed. It has been said that

[9] See AAOIFI *Sharī´ah* Standard No. 12

[10] Refer p. 38 of Tamweel Offering Circular

[11] Refer Ahmad Basri bin Ibrahim (2010), *Islamic Preference Shares: An Analysis in light of the Principles of Musharakah and Tanazul,* paper presented in International Conference on Islamic Banking & Finance: Cross Border Practices & Litigations, held in 15-16 June 2010 at IIUM, Kuala Lumpur at p. 15

caution need to be exercised as complex transactions involve sophisticated documentation.

The default by major *ṣukūk* also caused disputes between parties and some cases were brought to courts. Legal examination revealed that there may be some legal flaws and issues as well. It is feared that courts are not familiar with *Sharī´ah* based transactions and may wrongly interpret the contract as the legal documentation will be the main reference in relation to the transaction. Notwithstanding that, there is also concern that legal documents do not match the *Sharī´ah* requirements thus allowing chances for the transaction to be declared as null and void. Among other issues that may come under court's examination are non clarity and conflict of terms in the contracts. An example of this is the conflicting terms in contract in relation to asset disposal clause and beneficial ownership on trust assets. Another issue is the legal status of purchase undertaking as to whether it amounts to a guarantee or not, thus determining the priority of asset-based *ṣukūk* holders' claim to the issuer or the obligor in comparison with their other creditors.

Apart from that, asset-based *ṣukūk* documentation reveals that underlying *ṣukūk* assets are not well elaborated in the documents. It causes injustice to the *ṣukūk* holders whereby they cannot ascertain the real asset nor can monitor its performance. Caution needs to be administered so that it does not result into ignorance of subject matter (*Jahalah fi Ma'qud 'alaih*) by the *ṣukūk* holders and the transaction becomes void due to existence of *Jahalah* and *Gharar*, the prohibited elements in Islam.

It is stressed, therefore, that *Sharī´ah* scholars need to examine *ṣukūk* legal documentation as well and not only *ṣukūk* structures as the documentation will be brought to court and is expected to explain the transaction and spell out the rights and obligations of the parties. Negligence in this regard may cause a fatal judgement by court and a ground to declare the transaction non *Sharī´ah* compliant and thus, invalid. In this regard, AAOIFI's pronouncement No. 6 cannot be taken lightly as it states:-

"**Sixth:** *Sharī´ah* Supervisory Boards should not limit their role to the issuance of *Fatwa* on the permissibility of the structure of *ṣukūk*. All relevant contracts and documents related to the actual transaction must be carefully reviewed {by them}, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with *Sharī´ah* guidelines and requirements as specified in

the *Sharī´ah* Standards. The investment of *ṣukūk* proceeds and the conversion of the proceeds into assets, using one of the *Sharī´ah* compliant methods of investments, must conform to Article (5/1/8/5)7 of the AAOIFI *Sharī´ah* Standard (17)."

5. Other Concerns on *ṣukūk*

The above are the unsettled issues that were raised as a result of the major *ṣukūk* defaults. However, prior to that, the *ṣukūk* industry was shocked by a different revelation. In November 2007, Sheikh Taqi Usmani declared at AAOIFI Conference that 85% of *ṣukūk* issued globally were not compliant to the *Sharī´ah* rules. The reasons for his declaration were distributed to the public in his writing, namely "***Ṣ****ukūk* and their Contemporary Applications".[12] His condemnations were mainly on *ṣukūk Musharakah* and *Mudharabah* which are mostly known as equity *ṣukūk* as well as partly on *ṣukūk Ijarah*. Following that discussion erupted and *ṣukūk* went through strict scrutiny globally. Among the issues raised were *ṣukūk* trading, protection of face value, issues in *ṣukūk* redemption and emphasis on adoption of *Maqaṣid* approach. These issues shall be discussed briefly in the following.

5.1 *Ṣukūk* Trading

Pursuant to the pronouncement by Sheikh Taqi, AAOIFI conducted several meetings, consulted various scholars and made the following pronouncement in relation to *ṣukūk* trading:-

> "**First**: *ṣukūk*, to be tradable, must be owned by *ṣukūk* holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of *Sharī´ah*, in accordance with articles 2 and 5/1/2 of the AAOIFI *Sharī´ah* Standard (17) on Investment *ṣukūk*. The Manager issuing *ṣukūk* must certify the transfer of ownership of such assets in its (*ṣukūk*) books, and must not keep them as his own assets.
>
> **Second**: *ṣukūk*, to be tradable, 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

[12] See Usmani, M. Taqi (2008), "***Ṣ****ukūk* and their Contemporary Applications", accessible at: http://www.failaka.com/downloads/Usmani_*ṣukūk* Applications.pdf

included unintentionally, in accordance with the guidelines mentioned in AAOIFI *Sharī´ah* Standard (21) on Financial Papers".[13]

The statement affirms the provisions of AAOIFI standard on Investment *ṣukūk* especially on the conditions for *ṣukūk* trading and significance of ownership. At that moment, there were disputes on the status of ownership of *ṣukūk* holders as some *ṣukūk* appeared not to confer all rights and obligation to *ṣukūk* holder; for example, although *ṣukūk* holders are partners in the venture, but they are not entitled to dividends like the share holders. This refers to dispute on beneficial ownership that is being practiced overwhelmingly based on principle of equity and trust in common law due to difficulty to execute legal ownership transfer. In relation to this, some scholars adopted the opinion that difference of law between countries need to be recognized and what matters is an arrangement whereby the ownership by the *ṣukūk* holders may not be disputed following all the local law's requirement and procedures.

The other significance is to deal with condition to issue and trade the debts. AAOIFI and Middle East scholars are against *Ba'i al dayn* (sale of debt) and thus emphasise that *ṣukūk* with debt or receivables as underlying are not tradable.[14] It is the other condition to *ṣukūk* trading apart from ownership of *ṣukūk* underlying by the *ṣukūk* holders. However, because most of the financial institutions' assets comprise debts, hybrid *ṣukūk* have been innovated which include a mixture of asset, debt and equity as underlying asset so long as the debts do not exceed the tangible assets or equity. The renowned example is the 2003 IDB USD 400 million hybrid *ṣukūk* that were based on a combination of assets and receivables under *Ijara*, *Murabaha* and *Istisna* contracts (with minimum 51% *Ijara* asset). Nevertheless, a different practice is exercised in Malaysia because *Ba'i al dayn* is approved by its *Sharī´ah* committee and therefore, debt-based *ṣukūk* have been issued and exchanged within Malaysia. Nevertheless, most of the *ṣukūk* are held and redeemed upon maturity by the *ṣukūk* holders.

[13] See Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), accessible at: http://www.aaoifi.com/aaoifi/default.aspx, at p. 1

[14] See AAOIFI *Sharī´ah* standard and OIC Fiqh Academy Resolution on sale of debt prohibition.

5.2 Protection of Face Value (Principal)

It was observed that certain mechanism was installed into *ṣukūk* to allow for protection of the face value, namely the purchase undertaking based on *Wa'ad*. However, at that stage, only legitimacy of such *Wa'ad* was examined and in-depth legal scrutiny was not made. The aftermath discussion mainly stressed on its status from *Sharī´ah* perspectives as can be seen in the following.

This issue was pursuant to the finding that many equity-based *ṣukūk* guarantee return of capital by binding undertaking from manager or the issuers that they will buy the underlying assets or equities based on the purchase price. Such practices are not valid as it means that the issuer or manager is guaranteeing the return of capital by way that the underlying assets are loss proof. Thus, no matter how the venture goes, profitable or loss-giving, the investors' capital is seen as somewhat always safe. Of course, this suit the appetite and wishes of the investors but it is not *Sharī´ah* compliant as it impose unnecessary and invalid burden on the *ṣukūk* issuer or manager. In a partnership contract, the *Mudarib* or partner is not allowed to guarantee capital except in case of mala fide actions or negligence.[15] Nor the agency contract allows the combination of *Wakalah* (trust) contract and guarantee.

Some argue that the undertaking is a valid unilateral *Wa'ad* and thus binding and enforceable. Although this is agreed by many scholars and *Fatwa* institutions but it is not without cautious application and with certain conditions. For instance, an undertaking cannot be used to defeat the purpose or essence of the main contract. In *Mudraba* and *Musharaka ṣukūk*, the undertaking applies in a way that the capital of the partnership is guaranteed that defeats the maxim of 'no gain without risk' and 'profit comes with liability', thus the *ṣukūk* can no longer be called as investment *ṣukūk*. In addition, AAOIFI Standard No. 17 has prescribed that such undertaking (to purchase at the nominal value) is not valid except if the underlying assets are to be sold according to the market rate or at a rate mutually agreed upon at the date of redemption (Clause 5/2/5). It is also confirmed in AAOIFI *Sharī´ah* Standard No.12, clause 3/1/6/2 and Standard No.5, clause 2/2/1 and 2/2/2.

There may be an argument that such undertaking does not imply actual guarantee; in this respect, there is a need to emphasise that tools and

[15] Partners to *Musharakah* and *Mudarabah* (the investment manager) cannot guarantee, Sheikh Taqi p. 8

mechanisms in *Sharī´ah* based transactions cannot be observed from the form only but the substance is more pertinent. Apart from that, these instruments need to be assessed both from financial and *Sharī´ah* aspects. Thus, in this instance, one may argue that such undertaking is an issue only when at maturity, the underlying asset's value is less than the market price, but it is not an issue at all if it is above the market price or on equal value. But it would be a *Hilah* (trick to circumvent any prohibition). The current practice requires careful observation of *Hiyal* and *Makharij* that are being applied in Islamic finance. Hence, the above proposition needs to be reiterated.

5.3 Nature of Return

The other questionable issues included the nature of *ṣukūk* returns and reference to LIBOR or other interest based benchmarks to structure the returns. The former refers to any credit enhancement facility that is added to equity-based *ṣukūk* deal so that to ensure that *ṣukūk* holders receive the expected returns. This includes liquidity facility in the form of *Qarḍ al-ḥasan,* (benevolent loan) and prescription of incentive fee. These two mechanisms allow for fixed disbursement of expected returns on *ṣukūk*. The former refers to stipulation of loan by the issuer or investment manager for shortcomings in the periodic distributions of profits. Since it is stipulated in the contract, it obliges the manager with this additional burden and therefore the basic rule of the partnership or investment namely sharing of risk and reward is compromised. Certainly, this is not in accordance with the objectives of the *Sharī´ah* and it might fall under the prohibition of '*sale with credit'*.[16] In addition, such arrangement serves as a form of guarantee on specific return like in conventional debt whereby interest is guaranteed apart from capital. However, it may be said that there is not any issue if the lack is in the cash to be distributed and not the actual profit? However, for distribution, the issuer undertakes to pay investors from his money with the intent to reimburse once the profit is realised. Some scholars have indicated that giving such loan by the manager is fine so long as the manager can get back the amount from *ṣukūk* holder's return or their capital contribution. Nevertheless, most scholars are inclined towards another alternative remedy, a reserve fund to be created out of the periodic profits, or a third party financing may be utilized to cover the shortfalls of the distribution.

[16] Prohibition of sale side by side with credit as it may lead to implicit *Riba* and exploitation of any of the parties.

In addition, the incentive fee provision refers to the practice that if the actual profit is above the prescribed percentage, all the extra sum will go to the manager as incentive fee for good management or additional profit to the issuer. Majority of the classical jurists considered such offering of incentive to the manager (an investment agent) as *Makruh* as it generates uncertainty in profit distribution. However, there is *Sharī´ah* justification that supports the lawfulness of this arrangement.[17] Majority of contemporary scholars approves this provision. This was followed by AAOIFI Standard No. 13 article 8/5. However, such arrangement is not in line with the real purpose of *Shirkah* and the objectives of *Sharī´ah* as it fails to promote equitable distribution of profit to all investors. Apart from that, the percentage is not linked to the expected profit but to the interest rate in the market, without connection to the profitability of the venture. It is an awkward situation whereby the incentive for good management of a joint venture is given based on the prevalent interest rate and not actual performance.

Thus, there is a need for other benchmarking mechanism to be adopted other than interest based benchmark. Alternatively, actual profit calculation and apportionment should be used. The creation of an alternative benchmarking mechanism is extremely significant, not only for *ṣukūk* but also for other Islamic finance products.

5.4 *Maqāsid*

Some scholars also condemned the *ṣukūk* industry practices because they were of the opinion that although *ṣukūk* may satisfy most of *Sharī´ah* legal requirement but they are far away from the objectives of *Sharī´ah* which include promoting distributive justice and removing harm. The most of the *ṣukūk* posses some features similar to bond and various guarantee mechanisms negate the identity of *ṣukūk* as investment instrument. It is also because of *ṣukūk* return's linking with LIBOR. It is timely that Islamic financial institutions move forward towards genuine *Sharī´ah* operations and distance away from the conventional practices.

It is important for all Islamic finance stakeholders to comprehend that although *Sharī´ah* compliance is significant but consideration of the higher purpose of *Sharī´ah* is also not less significant. Thus, it is important to look into the products comprehensively, to include undertaking a study on their economic and social impact.

[17] See Sheikh Taqi, 2008; p. 5.

6. The Way Forward

Looking into all the arising issues in *ṣukūk*, it can be said that reform is needed and the *ṣukūk* industry cannot be left at the current state of affairs. However, it shall not involve reform in the *Sharī´ah* scrutiny only as has been highlighted in previous discussions. Emphasis is required onto the following matters as well:-

6.1 Legal Practice Reforms

It is said that in all sophisticated transaction, like *ṣukūk*, documentation risks require paramount consideration or else it could result in substantial litigation risk. It is essential, therefore, that the legal documents are clear and the parties understand it fully and, if required, are able to present it well to the court. Lawyers and contracting parties need to clearly draw the terms and conditions of the documents and understand their implications financially, legally and from *Sharī´ah* perspective. Therefore, lawyers need to have sufficient *Sharī´ah* knowledge so that the legal documentation is in-check. Above all, it is hoped that the judiciary and the courts will get orientation on the principles of Islamic finance and recognize the essentials of *Sharī´ah* based transactions and acquire all the help needed to understand it and decide the cases accordingly.

Islamic finance has experienced many incidents where courts failed to appreciate and understand *Sharī´ah* based transactions and decided according to the English or civil laws.[18] This has happened in the international sphere as well as in countries like Malaysia where the court looked into the transaction as similar to any conventional transaction. It is feared that parties may take the advantage of annulling the transaction by saying that it is not *Sharī´ah* compliant as declared by the court, not knowing the real deal or intention of parties. It is also suggested that a clause is included in the legal documents on alternative dispute resolution whereby parties shall opt for this type of dispute resolution before approaching the courts. This is because parties shall have better opportunity to enforce their will in conducting *Sharī´ah* transaction and the process can be facilitated by a *Sharī´ah* expert who may act as mediator or adjudicator. Moreover, the facility is in existence as there are already two regional alternative dispute resolution centres based in Dubai

[18] See cases like Beximco Pharmaceuticals Ltd, Bangladesh Export Import Co. Ltd., Mr. Ahmad Solail Fasiuhur Rahman, Beximco (Holdings) Ltd. v. Shamil Bank of Bahrain E.C. [2004] EWCA Civ 19; Arab Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn Berhad & Ors [2008] 5 MLJ 631.

and Malaysia.[19] Therefore, alternative dispute resolution is a fair arrangement to the parties with the option to pursue the case in court if the former fail to resolve the matter.

The other measures that can be taken as practiced in Malaysia is by providing facility to court to become specialized or expert in handling Islamic finance cases as Commercial Division in High Court which handles Islamic business cases. According to Practice Direction No.1/2003, paragraph 2, all cases under the code 22A (Islamic banking) filed in the High Court of Malaya will be registered and heard in the High Court Commercial Division 4 and this special high Court will only hear cases on Islamic banking. Another pleasing development is that in certain cases, court calls *Sharī´ah* scholars as expert witness to clarify the transaction to the court.

As a matter of fact, Malaysia has crossed over another milestone by amending the Central Bank of Malaysia Act to include provisions to make the national *Sharī´ah* Advisory Council's ruling compulsory upon courts and binding upon the parties.[20] Such move is seen generally to be positive in order to complete the chain of *Sharī´ah* compliance of Islamic finance products, but some also considered negatively as to negate the independence of court. National *Sharī´ah* Advisory Council is considered as a unit of the executive and under the concept of separation of power; it should not in any way have influence on the court.

Apart from that, Islamic finance industry in every national jurisdiction should strive for initiation of a specialized court in Islamic finance which comprises a number of judges who include expert in law, expert in finance and expert on *Sharī´ah*. Only then, justice is served to the parties and the industry and the chain of compliance to the *Sharī´ah* is not broken.

6.2 Other *Ṣukūk* Default Ramedy

Looking into the substantial legal risk and financial uncertainty faced by the parties, considering other remedies than litigation in the event of default is worthwhile. Those remedies may include considering restructuring or refinancing *ṣukūk* as may be applied to bond in similar situation. Debt restructuring refers to "the process of a person or business negotiating and agreeing with its creditors to reduce its debt or to revise a

[19] It refers to Kuala Lumpur Regional Centre for Arbitration (KLRCA) and (IICRA) which can deal with Islamic finance dispute cases and give award.

[20] See section 51 till section 58 of the new Central Bank of Malaysia Act 2009.

repayment plan"[21]. This is applicable if the issuer or the originator and the assets are still viable and sustainable from the financial viewpoint but only facing some temporary difficulties, thus, there is no need to invoke insolvency law and risk the interests of all parties. Like debt restructuring, it is hoped that *ṣukūk* restructuring will assist the issuers or the originators who are facing troubles due to liquidity or financial distress. In fact, this alternative remedy is said to be more cost efficient. Actually the Almighty has prescribed in the holy Qur'an, clear guidelines to deal with such event whereby it is stated: "If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit if by way of charity, that is best for you if ye only knew" [2: 280].

In fact, prior to global financial crisis, *ṣukūk* experienced high rise in demand and issuance. Most of *ṣukūk* performed well and provided the expected returns to its certificate holders. Although shaken in 2007 by AAOIFI *Sharī´ah* Board Chairman, Sheikh Taqi Usmani's pronouncement on the invalidity of major *ṣukūk* issues, the *ṣukūk* market continued to operate. Global financial crisis however brought about difficulty to some issuers that have caused them to experience bankruptcy or to fail in making the expected periodical payments, and it involved prominent *ṣukūk* such as East Cameron and Nakheel *ṣukūk*. Some of the defaults were taken to court for settlements and it was disclosed that investor's rights are not well protected and they may be in great danger to suffer major losses. Such was not anticipated by the investors as they presumed that their rights were well protected in existence of purchase undertaking from issuer or obligor to purchase the *ṣukūk* certificates if default occurs. Thus, it brought about uncertainty into the interest and claim of the *ṣukūk* holders and, as mentioned above, there are many questions of law that need to be answered first. For example, when the issuer or the originator falls into bankruptcy, what will be the position of the *ṣukūk* /certificate holders, secured or unsecured creditors and does the purchase undertaking entitle them to get priority or become secured creditors? Some *Sharī´ah* scholars have covered this issue into discussion.[22] They observe whether such practice as available for bonds can be made available to *ṣukūk* as well but they need to analyze and understand the phenomenon in *ṣukūk* default first. Dr. Engku Rabiah observed that actually, if compared to the

[21] Farflex, (2009), "Farflex Financial Dictionary", accessible at: http://financial-dictionary.thefreedictionary.com/Debt+Restructuring.

[22] Among others were Dr. Mohd Daud Bakar and Assoc.Prof. Dr. Engku Rabiah Adawiah Engku Ali.

total *ṣukūk* market value, only 1% of the total *ṣukūk* has defaulted.[23] However, it is undeniable that the default occurred globally as it involved *ṣukūk* default in Kingdom of Saudi Arabia, Kuwait, Malaysia, United States of America and Pakistan.[24] In fact they involve various types of *ṣukūk* with different underlying contracts. Therefore, scholars are of the opinion that the matter is not uncomplicated. The *Sharī´ah* rulings will differ depending on the type of *ṣukūk* and the underlying contract.

Detailed studies need to be made; however, preliminary studies have brought some lights onto the issues. For instance, preliminary studies on debt based-*ṣukūk* show that it is possible for restructuring it as it involves indebtedness like the practice of restructuring bond. Apart from that, *Ijarah ṣukūk* also can be easily restructured because of the clarity of the obligations and rights of parties. In fact in Malaysia, Ingress and Talam *ṣukūk* have been restructured with various measures. Equity-based *ṣukūk* appear to be more difficult to undergo *ṣukūk* restructuring because it does not involve real indebtedness and therefore suitable *Sharī´ah* compliant restructuring measure need to be explored. However, attempt to restructure asset-backed *ṣukūk* is found to be more questionable because of the execution of true sale which makes the *ṣukūk* holders having no recourse to the obligor or issuer but rather recourse to the asset only. Thus, it may be easier if the investors sell the assets and retain back their capital. However, the matter may need rethinking when the assets value in the market is not sufficient to cover for all losses or there are other claims on the asset.

Although *ṣukūk* restructuring could be the preferable choice to the parties, in-depth studies need to be conduct on the best restructuring measures that not only satisfy the parties but also all *Sharī´ah* requirements.

6.3 *Maqāsid* Approach

The concern regarding steps for achieving the 'higher objective or purpose of *Sharī´ah* by some scholars is very valid. However, the objectives of *Sharī´ah* will not be achieved if transactions are conducted without parties

[23] It was based on the data obtained from IFIS as of April 29, 2010 where only 16 *ṣukūk* defaulted.

[24] See Engku Rabiah Adawiah Engku Ali (2010), "*ṣukūk* and Isu-isu Syariah: Penstrukturan Semula (Restructuring) *ṣukūk* dalam Kes Kemungkiran Pembayaran", Paper presented in KLIFF's Muzakarah Penasihat Syariah Kewangan Islam, Agust 2, 2010, at p. 4.

having clear overview of what they are getting into. In addition, it is impossible to achieve the *Maqāsid* if relevant *Sharī´ah* requirement are not fulfilled. It particularly includes the issue of ownership where issuers do not want to depart from their assets but design artificial transfer in order to get liquidity. *Ṣukūk* issuance should not be made only to get liquidity facility for some corporation, but real economic impact needs to be obtained as well. It is important that *Sharī´ah* compliance as well as the higher purpose of the *Sharī´ah* become the main consideration for issuing *ṣukūk* and profitability is the second. Investors need to understand the unique features of Islamic finance and absorb all risks related to their investments if they wish to gain return. It is timely that genuine *Sharī´ah* transactions are executed and *Sharī´ah* requisites are not compromised or diluted.

7. Conclusion

Various unsettled legal and *Sharī´ah* issues surrounding *ṣukūk* may have not made bad impact so far to the current market but it will surely cause trouble to Islamic finance industry in the future, if they are not correctly responded to. Strict *Sharī´ah* and legal scrutiny from times to times need to be carried out so that the unsettled issues in relation to different *ṣukūk* deals are unveiled and corrected. Therefore, the two events that took place in 2007 and 2009 should be considered as a blessing in disguise. Nevertheless, the suggested solutions, as outlined in the way forward section, should not be neglected as they can provide immediate solution to the current problem and are believed to have the potential of lasting effect.

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