



SHARIAH ISSUES RELATING TO AN ISLAMIC SECURITY - SUKUK

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ABSTRACT

This paper aims to identify issues on Shariah regarding Islamic capital markets in particular Sukuk. Having aspects similar to that of conventional bond rise a matter of concern in Sukuk whereby the penalty for late payment, debt-based Sukuk trading, equity-based purchase structures and ownership in asset-based transactions are seen in Sukuk which bring about concerns in Shariah. Four of such issues that are being practiced currently are presented in this review. The methodology of this study is through document analysis on classical and modern literatures regarding to the topic of the issues in existing sukuk. While the mentioned issues have not been argued in a comprehensive manner, a fair explanation encompassing the main aspects of those has been provided. The need between Sukuk market and Shariah is felt thus the likelihood of being dealt with through the proposed position.

KEYWORDS: Shariah, Sukuk, investors, financial certificate, Musharakah, Mudharabah

INTRODUCTION

Numerous *Shariah* Scholars have viewed that *Sukuk* cannot satisfy the goal of *Maqasid-Al-Shariah*. In November 2007, the *Shariah* issues encompassing *Sukuk* became clear when *SheikTaqiUsmani* remarked that the vast majority of the *Sukuk* (around 85%) in the business sector (those utilizing a *Musharakah* or *Mudharabah* structure) are not in accordance with the standards of *Shariah*. When the financial crisis spread into the Gulf Cooperation Council (GCC) and some issuers started to default on *Sukuk*, it got to be clear to numerous investors that *Sukuk* conveyed extra risks because of the untested structures used to get *Shariah* compliance. The rebuilding process of landmark deals keeps on highlighting territories that have been neglected by investors, especially *Shariah* risk which may influence the investors' protection. In the first half of 2010, the *Sukuk* market has pivoted with issuances up 99% on a year-back levels at USD20.4 billion (Lahsasna & Lin, 2012).

Notwithstanding the bounce back, worldwide *Sukuk* issuances were still lower than the record set in the first half of 2007 at USD24.0 billion. South East Asia keeps on overwhelming the *Sukuk* market with issuances worth USD17.35 billion in the first half of 2010 contrasted with \$8.89 billion in 2009 and \$4.5 billion in 2008. It is obvious that Malaysia topped the issuer countries in terms of the amount and the numbers of issuances with 310 issuances worth \$15.4 billion, trailed by Indonesia with 16 issuances adding up to \$1.75 billion. The GCC *Sukuk* market recorded zero issuances on the corporate level, and only one Quasi Sovereign issuance for Saudi Electricity (Ernst & Young, 2009). The sheer development of *Sukuk* is sufficient to press upon the desire to comprehend and resolve *Shariah* issues on questionable practices in the *Sukuk* market or risk dampening investors' certainty and eventually, the eventual fate of *Sukuk* market.



What is *sukuk*?

Before diving into the details of *Sukuk*, it is basic to inspect the importance of *Sukuk*. In fact, *Sukuk*, is the plural of *Sakk* legal instrument, deed, check for a financial certificate but can be seen as an Islamic equivalent of bond (Debashish & Greg Man, 2009). The AAOIFI characterized “*Sukuk*” as:

“... certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as arranged, regular title to imparts and rights in tangible assets, usufructs and administration, or equity of a given project or equity of a special investment activity”.

In basic terms, it is clear that, *Sukuk* are papers or certificates that demonstrate ownership in an asset. It allows the investors to hold a share of the asset along with profit and risks resulting from such ownership. *Sukuk* can be organized taking into the principles of agreement of exchange (e.g. *ijarah, murabahah, istisna*) and contract of participation (e.g. *musyarakah and mudharabah*). In the early days, *Sukuk* were fundamental contracts of sale premised on cost-plus sale or cost-plus production contracts but now, there has been a shift far from debt-based *Sukuk* towards lease and partnership-based *sukuk* (Adawiah Engku, 2008).

THE ROLE OF *SUKUK* IN THE ISLAMIC CAPITAL MARKETS

For as long as 10 years, *Sukuk* have developed from being nonexistent to being the face of Islamic finance in numerous people’s eyes. The late defaults blurred from the spotlight as fast as the news performed in 2007 as well as 2008 of reconsidered AAOIFI direction on *Sukuk*. The present circumstance blurred from the headlines partly because, new inconveniences in Greece and different parts of Europe have developed, however the relative irrelevance of Islamic finance in the worldwide settled income markets also contributed. The unimportance of *Sukuk* comprehensively was in part caused because they are frequently organized precisely to mimic other bonds (sovereign, quasi-sovereign and corporate, both from created and developing markets). The immaterial of the *Sukuk* business sector and the explanations behind it ought to prompt inquiries concerning the way Islamic finance in general, and the *Sukuk* market in particular has developed (Media, 2010). This leads to the following inquiry on whether *Sukuk* ought to hold the same highlights as conventional bonds and the *Shariah* issues emerging from such structures. Thus, the following section will discuss on the *Shariah* issues in *Sukuk*.

SHARIAH ISSUES IN *SUKUK*

Investment *Sukuk* have defined by AAOIFI’s *Shariah* Standards as certificates of equal value representing undivided shares in ownership of tangible assets, usufructs administrations, as well as asset of specific activities or unique speculation action. In all view points by this definition, it is obvious that *Sukuk* is not a conventional bond. In any circumstances, *Sukuk* ought not have been alluded to as an Islamic bond despite the fact that it is organized to act like one by means of current practices which may be denied by *Shariah* or differ amongst legal scholars and should be examined on its own in the ensuing sections (Laahasna & Lin, 2012).

Imposition of late payment penalty on *Sukuk* issuer upon its default, trading at a discounted price for *Sukuk* representing debt, purchase undertaking in *Musharakah* and *Mudharabah* Structures, and ownership of assets in asset based *Sukuk* are amongst the main issues related to *Sukuk*.

LATE PAYMENT PENALTY ON *SUKUK* UPON ITS DEFAULT

Introduction on Late Payment Penalty:-

Penalty on postponed payments or defaults is a typical issue that influences a wide range of items in Islamic finance, including *Sukuk* in light of the fact that there is no consensus across jurisdictions in this. The penalty clause in the current connection is characterized as an agreement between the two contracting on a foreordained rate of remuneration that the lender or the obligor is qualified for if the committed or the indebted person has not satisfied the commitment or deferred in performing it. The purpose behind this term is that it is typically put among the states of the primary contract on the premise of which the leaser or the obligor merits remuneration. In general, the penalty rate on late payment is high. This payment charge is forced to demoralize late payment by clients and also to prevent the creditor or the obligor from being presented to losses due to opportunity loss (Laahasna & Lin, 2012).

There are two sorts of penalty clauses. The first type is the penalty clauses that include particular remuneration for postponement in finishing the movement or inability to finish it totally. This sort of penalty cause is passable and must be satisfied as a result of the various confirmations that backing the satisfaction of agreement, promises and conditions. The second kind is the penalty cause for deferral in settling obligation. Indeed, the vast majority of these are identified with *Murabahah*, conceded deal and other differed sale obligation. Reacting

to this, there are two sorts of borrowers who defer in settling obligation.

The Islamic *Fiqh* Academy has delivered a standard for indebtedness, which stipulated conceding rest to the ruined is dependent upon the condition that he has no wealth in excess of his fundamental needs to pay for the debt in cash. For the defaulting dissolvable borrower, the legal advisers have concurred that postpone of obligation by a rich debt holder is unjust and a transgression but, the jurists have contrasted about imposing financial penalty on a solvent defaulter (Akram Ladin, 2006).

View of Scholars on Late Payment Penalty:-

The legal scholars have contrasted in their perspective about considering financial penalty as a punishment. The view have converged into two schools, the prohibition and permissibility. Abu Yusuf has allowed it for the *Imam* (ruler) if he finds in doing so, it is *maslahah* (public interest.). Abu Hanifah and Muhammad Al-Shaybani have denied it because of the absence of its *Shariah* validity. Whereas Al-Zayla'i said, reporting from Abu Yusuf that upholding *Ta'zir* by taking money is permissible for the *Imam*. While al-Shafi'i in his previous view, not the recent, was quoted by Al-Shibramulsi as saying, "It is not permissible, that is, to enforce *Al-Ta'zir*- based on the recent view - to take money."

On the other hand, the prominent *Maliki* scholars are of the view that *al-Ijma* (the general consensus) does not approve it. Thus, al-Dusuqi said "based on the *ijma*, there is no *ta'zir* in the form of money". However, Ibn al-Qayyim mentioned that the popular opinion of Malik is to approve it in special situations. Meanwhile, the *Hanbali* scholars have differed in their opinions about its validity and invalidity. Al-Buhuti said "*al-Ta'zir* in the form of money is permissible by confiscating or seizing the wealth". This is the view adopted by Ibn Taimiyah and his student Ibn Qayyim al-Jawziyah. However, Ibn Qudamah al-Maqdisi opposed this view saying it is invalid. This is because this condition or imposition is essentially the *Jahiliyah Riba* which the *Qur'an* was revealed to prohibit." (Lahsasna and lin, 2012).

Nevertheless, the *Imam* (ruler) has the right to declare *al-Ta'zir* punishment be it financial or otherwise, as a deterrent to the criminal and as a prevention to the offenders. This will preserve the stability and security of the people in their religion, honor and wealth. In any case, the procurement of penalty provision that must be channeled to charity is permissible by the International Islamic *Fiqh* Academy and AAOIFI to maintain a balance

between the severity of the problem and the important *Shariah* principles that prohibits *Riba*. The penalty proceeds ought be utilized for charity purposes and not become a source of income for the creditor. If not, it will tantamount to *Riba*.

DEBT TRADING AT DISCOUNTED PRICE

Introduction on Debt Trading:-

Exchanging obligation has unique regulations that contrast from those of commodity exchanging, since it is an area in which the case of *Riba* is likely, either by an increase hand in hand with a delay in installment (debt rescheduling), which is the sort of *Riba* working on amid the time of *Jahiliyyah*, or by offering it for short of what it worth for accelerated repayment (rebate of promissory notes), etc., or by trading in debt, buying and selling them for not exactly their amount (Sattar Abu ghuddah, 2008).

Bai al Dayn is known as the sale of debt emerging from trade and services transactions as a deferred payment. *Shariah* allows the selling of debt by its proportional in amount and time of maturity by method for *hawalah*. This type of debt trading is approved by all schools of Islamic law if that type of trading paid in full and purchaser can't get any benefit. Depending on most *Hanafis*, *Hanbalis* and *Shafis* legal advisers, it is not permitted to sell debt to non -borrower or a third party ever never. On the other hands, *Malikis*, and some *Hanafis* and *Shafie* *Shariah* advisor permitted selling of debt to third party with some conditions, amongst which installment from the sale of debt ought to be at the same rate (Zaharuddin Hj Abd Rahman, 2006).

There are two schools of thought in contemporary Muslim law regarding this issue. The principal perceive current developments in financial transaction the law in keeping with these developments, consequently taking into account the majority of the new money related item to be invested in the Islamic framework. The second sees the *Shariah* as altered on the type of transactions that won at the time of the conception and development of the school of *Shariah* (Dr.Zaky Badawi, 2003).

AAOIFI's Shariah Standards:-

AAOIFI's *Shariah* Standard No. (17) on the issue of investment *Sukuk* has affirmed that decision by stating that trading of *Murabahah Sukuk* is unlawful. In AAOIFI's *Shariah* Standard No. (21) on the issue of financial papers (stocks and bonds) with regard to the ruling on trading of debt that is mixed with other things such as tangible assets, according to (Sattar Abu ghuddah ,2008) revenue sources in the form of rented or mortgaged items, cash and rights, states the following:

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

But if the goal and center movement of the organization heaps of gold or silver or currency (foreign exchange), consideration of the rules for *Sarf* is then compulsory when trading its shares. And if the purpose and core activity of the company focus on transactions involving debts (i.e., [liquidity] facilities), then consideration of the rules for debts is compulsory in the trading of its stocks. A condition for the utilization of what is in the above is that it not be taken as a method of securitizing debts and then trading them by adding tangible assets and usufruct to the debts as a stratagem for securitizing the debt.

Purchase Undertaking in *Musharakah* and *Mudharabah* Structures:-

Introduction on Purchase Undertaking:-

Musharaka and *Mudarabah Sukuk* are very popular because it allows issuing *Sukuk* without depending on the underlying asset (*ijarah Sukuk*) in order to generate a return for *Sukuk* holders. *Musharaka* and *Mudarabah Sukuk* are structured to purchase undertakings to ensure that 100% invested capital will be returned to the Investor. Under the concept one party provide guarantee to the investor that the business will be profitable but if any loss occurs former shall acquire the investor's ownership at par value or pre agreed contract which will make the capital secured. In the case of return Investor will get by *Tanazul* or rebate of profit in every 6 months based on the benchmark rate which is predetermined and if the return is more, then excess profit will go to the other party as an

incentive fee. In November 2007, Sheikh TaqiUsmani commented that most of the *Sukuk* (about 85%) in the market (those using a *Musharakah* or *Mudharabah* structure) are not in line with the principles of Shariah because of the purchase undertakings where a promise to pay back capital violates the principles of risk and profit sharing on which such *Sukuk* should be based (Lahsasna & Lin, 2012).

View of Scholars on Purchase Undertaking:-

According to the *Malikis* and *Shafis*, the *mudarib* is not mindful to ensure the losses as regard the capital and any condition to do so will invalidate the *mudharabah* contract. The *Hanafis* and *Hanbalis* are of the opinion that the agreement is valid but the condition is esteemed to be void. On the other hand, it is reasonable for a third party, other than a *mudarib*, to undertake voluntarily that he will compensate the *mudharabah* losses, provided that this guarantee is not linked in any manner to the *mudharabah* contract (INCEIF, 2010).

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

Asset Backed versus Asset Based – Ownership of Assets:-

Introduction on Asset Backed and Asset Based Sukuk:-

In conventional financing, asset backed securities are issued pursuant to a securitization transaction involving the transfer of assets or risks to investors by satisfying certain criteria on the securitized assets, originator and true sale. For instance, the assets should generate cash flow and the originator has a valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitization transaction. There are no obstacles (contractual or otherwise) that prevent the effective transfer of the assets or the rights in connection to such assets from an originator to special purpose vehicle (SPV). The assets are transferred at a fair value (Abdul Aziz et al, 2007).

The originator should effectively transfer all rights and commitments in the underlying assets to the SPV which is adequately bankruptcy remote. The risk that a transfer of assets by an originator to an SPV might be re-characterized as a financing transaction rather than a sale of assets should be minimized as far as possible. Therefore, an originator must not hold any equity stake (directly or indirectly) nor able to exercise effective control over the decisions of the SPV. Similarly, the SPV must have no recourse to an originator for losses arising from those assets save for any credit enhancement provided by the originator at the outset of the securitizations transaction (Securities Commission, 2004).

Accordingly, *Sukuk* that is asset backed should ideally mirror the securitizations practice in the conventional space whereby *Sukuk* holders are the owners of the asset and the performance of the asset is the driver of the payment to *Sukuk* Holders. On the other hand, asset based *Sukuk* is said to behave more like a bond issuance whereby *Sukuk* holders may (or may not) have security interest (but not ownership interest that is mandatory for asset backed *Sukuk*) i.e. collateral over the assets only (Wajidi Dusuki & Mokhtar, 2010).

View of Scholars of Ownership in sukuk:-

Shariah scholars since recent times have talked about at incredible length the issue of *qabd* for buy and deal contracts specifically and additionally different contracts in general. There have been different perspectives about what constitutes *qabd* for different merchandise, for example, land and products sold by estimation and other merchandise, for example, clothes, animals and the like. The issue is, is it important that the products be approved by the purchaser's hand or is it adequate to concede the purchaser access to the merchandise without confinement (Lahsasna and Lin, 2012).

Various *Hadiths* say the need of *qabd*. All in all, the researchers of Islamic law have divided *qabd* into two structures: physical ownership (*qabdhissior haqiqi*) and legitimate ownership (*qabdhukmi*). Physical ownership alludes to unequivocally taking ownership or when the purchaser is watched taking the products sold to him. It is ordinarily prove in exchanges including two sorts of benefits. To begin with, on account of undaunted resources, for example, land and building, *qabd* is said to have occurred when the first proprietor offers consent to the purchaser to take control of the land and complete whatever movement he wishes without impediment. *Qabd* is finished for such resources when the new proprietor's name shows up on the grant title or the ownership

certificate. The second kind of advantage for which *qabdhahqiqi* applies is moveable property, for example, items, foods, vehicles and so on. *qabdhahqiqi* is viable for this classification when the purchaser gathers or gets the products after paying the cost.

Qabdhukmi refers to taking ownership verifiably or not in a physical structure. Then again, the lawful status of *qabdhukmi* is the same as that of *qabdhahqiqi*, gave that it fulfills one of the taking after conditions: First, the dealer must concede the purchaser full access to the object of sale without any encumbrances. Second, lawful possession can likewise produce results by method for a contra-debt by which debt between two parties is certainly settled, the result being that neither one of the party owes debt to the other. Third, *qabdhukmi* can likewise occur because of a prior activity which infers that possession has officially occurred, despite the fact that the prior manifestation of *qabd* is unique in relation to the new frame. At the last, *qabdhukmi* or lawful possession likewise happens because of spoiling. The majority of *Shariah* scholars hold the reason of prohibiting sale former to taking ownership (*qabd*) to be mostly because of the vicinity of *gharar* (excessive risk and uncertainty), which may prompt question among the transactions parties. This was a result of the worry that the products may not be conveyed because of harm or different factors.

OPINIONS AND RECOMMENDATIONS

At present, *Sukuk* is organized in such a way to reflect the payout arrangement of action and financial specialists insurance that settled wage speculators are well known as well. Consequently, *Sukuk* is frequently used to supplant conventional bonds, competing for financing from the same pool of bond financial specialists. The advertising brochures are loaded with terms and conditions conspicuous to bond investors to give an identical result inside the limits of *Shariah* compliance. As a result, *Shariah* issues have surfaced on debatable practices which have raised general concerns on whether these structures are genuinely *Shariah* compliant or not.

Some argue that *Sukuk* is still in its incipient phase of development and ought to be "indulged" to permit future development for the purpose of *maslahah*. On the hindsight, the surprising growth of *Sukuk* market in based on approach will need to stop in the long run on the grounds that it is pass that the *Sukuk* market's validity is at present being addressed by investor when *Sukuk* arrangements are being tried in the financial crisis. The industry's improvement has come to a point that it might be inadmissible to hazard the reputation of Islamic

finance, especially *Sukuk* that has been developed over the previous years, to push for “innovation” emulating conventional bonds when such “innovations” are being marked as *Shariah* issues. The industry clearly understands this issue yet pushing ahead, how would they resolve the issue between the longing to develop and catch significant against the perfect necessity to maintain *Shariah* in all aspects?

Sukuk is inevitably another asset class however will miss the mark regarding being one in the event that it keeps on being overworked and installed with highlights features conventional bonds. Since *Sukuk* is skipping back, the industry ought to grab this window of chance to instruct the contributing open furthermore, organizations. More effort should be focused on the unique features of *Sukuk* and the investors’ rights ought to an occasion of default happen. In addition, the straightforwardness of *Shariah* decisions furthermore, its process is similarly imperative to widen the believability of the choice to the entire world, both Muslim and non-Muslim (Vicary, 2010).

CONCLUSION

Sukuk was established to replicate the conventional bonds with some *Shariah* rulings. From the above discussion we have identified that however *Sukuk* are known as Islamic bond but there are many issues related with existing *Sukuk* structure which is not under the line of *Shariah*. The innovation of *Sukuk* was very much challenging. Now a days *Sukuk* are very well known Islamic instrument, as a result many new challenges are coming towards the *Sukuk* regarding Islamic *Shariah*. Many *Shari’h* scholars have given different views with different issues. Lastly we can conclude that according to their views the Structure of the *Sukuk* need to be developed more which will able to really fulfill the line of *Maqasid-Al-Shariah*.

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