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CRITICAL APPRAISAL OF SHARI‘AH ISSUES ON OWNERSHIP IN ASSET-BASED SUKUK AS IMPLEMENTED IN THE ISLAMIC DEBT MARKET

Assoc. Prof. Dr. Asyraf Wajdi Dusuki
Head of Research Affairs Department
International Shari‘ah Research Academy for Islamic Finance (ISRA)

Shabnam Mokhtar
Associate Researcher
International Shari‘ah Research Academy for Islamic Finance (ISRA)

Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based *Ṣukūk* as Implemented in the Islamic Debt Market

*Assoc. Prof. Dr. Asyraf Wajdi Dusuki**

Shabnam Mokhtar†*

1. INTRODUCTION

The development of an active capital market is vital to providing alternative funding avenues for individuals, corporate entities and the government. Tapping into the capital market allows a fundraising entity to reach a wider investor base, thus enjoying a larger funding amount at a competitive rate. Besides larger funding amount, capital market instruments also provide liquidity to investors, as they can trade them in the secondary market. Similarly, the Islamic capital market, as an integral part of the Islamic financial system, emerged and developed for efficient and effective mobilization and allocation of resources. Besides complementing the investment role of the Islamic banking sector, the Islamic capital market is deemed to be more relevant in an Islamic economy because the prohibition of interest entails a greater reliance on equity and asset-based finance.

In general, the Islamic capital market is comprised of two main components: the equity market and the debt market. The former involves active trading of Islamic securities, shares and other exchange-traded instruments, while the latter normally is represented by *ṣukūk*, which has been the most active Islamic debt market instrument. Indeed, *ṣukūk* is one of the fastest-growing segments of the Islamic financial market.

* Assoc. Prof. Dr Asyraf Wajdi Dusuki is currently the Head of Research Affairs, International Shari'ah Research Academy for Islamic Finance (ISRA). His email address is asyraf@isra.my.

* † Shabnam Mokhtar is currently an associate researcher at the International Shari'ah Research Academy for Islamic Finance (ISRA). Her email address is shabnam@isra.my.

Total *ṣukūk* issuance amounted to US\$133 billion as of 5th August, 2009,¹ making *ṣukūk* the most popular instrument in the global Islamic capital market.

Although the introduction of an enabling Islamic capital market is a considerable achievement, and although *ṣukūk* represent a leap in its development, some structures which attempt to achieve the same economic outcome as conventional bonds have distorted Sharī‘ah principles. This paper therefore aims to shed light on Sharī‘ah issues that arise in *ṣukūk* structure and operation. In particular, Sharī‘ah issues with regards to ownership (*qabd*) are identified and discussed. Three major issues have emerged in the structure and operation of asset-based *ṣukūk*. They are *ṣukūk*-holders’ interest in the underlying assets, restrictions on asset disposal, and due diligence regarding *ṣukūk* assets. Each of these issues is delineated in detail in order to build the case for a paradigm shift in *ṣukūk* structure and operation.

Our analysis of the above Sharī‘ah issues is based on detailed term sheet analysis from a sample of 43 *ṣukūk* deals. The sample was carefully selected and collected from IFIS Sukuk Database, which had listed 1191² *ṣukūk* as of 5th August, 2009. To further support the findings, the study also conducted semi-structured interviews with regulators, bankers, legal counsels, rating bodies and Sharī‘ah scholars.

The remainder of the paper proceeds as follows: the next section provides an overview of the concept of *ṣukūk*. The difference between asset-based and asset-backed *ṣukūk* is delineated in Section Three. Section Four analyses each of the four main Sharī‘ah issues related to asset-based *ṣukūk*, while the final section contains concluding thoughts.

2. THE CONCEPT OF *ṢUKŪK*

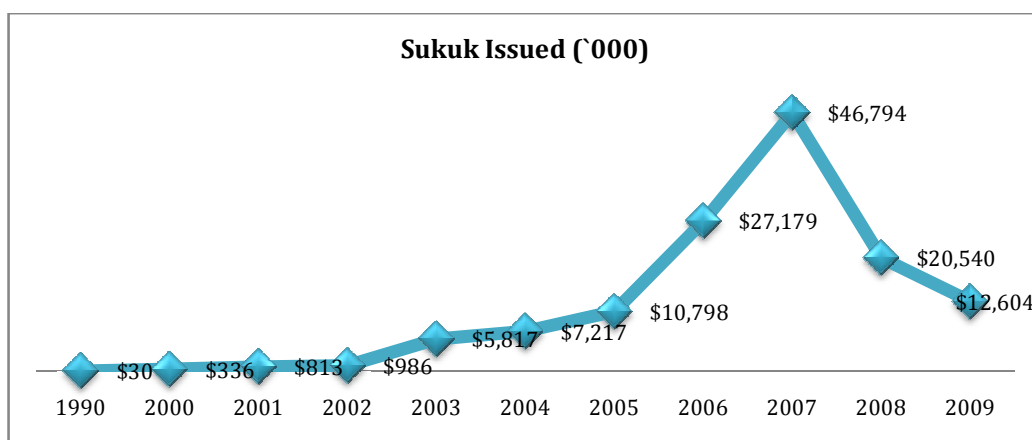
The last six years have witnessed rapid growth and development of the *ṣukūk* market. Chart 1 depicts that growth. The *ṣukūk* market is a fairly new development in the

¹ Based on Sukuk Database provided by IFIS, accessed on 5th August 2009.

² This number counts each tranche as a one. If we were to base the number of issuances according to the issuer, there were 560 issuances as of 5th August, 2009.

Islamic financial system. Based on data provided by IFIS, Shell MDS (Malaysia) issued a *ṣukūk* offering in 1990, but there were no active issuances by other players or countries until 2001, in which year a number of institutions issued *ṣukūk*. They included Majlis Ugama Islam Singapore (MUIS), Government of Bahrain and the first global corporate *ṣukūk* by Guthrie Malaysia. This marked the beginning of an active *ṣukūk* market. The *ṣukūk* issuance grew 145% in 2006, compared to 2005, to reach US\$27 million. The *ṣukūk* market peaked at US\$47 million in 2007 and dropped by 55% to US\$21million in 2008. The global market turmoil, drying up of liquidity, widening of credit spreads, and investors' wait-and-see attitude are some of the factors to which the sharp decline in 2008 has been attributed (Mohamed Damak et al, 2009).

Chart 1: Growth of the *Ṣukūk* Market³



Ṣukūk are frequently referred to as “Islamic bonds”. This term may mislead people to assume that *ṣukūk* are just like bonds; however, the two are diametrically opposed in nature. Before clarifying the distinction between the two concepts, let us first look at the definition of *ṣukūk*.

Literally, *ṣukūk* simply means ‘certificates’.⁴ Technically, *ṣukūk* refers to papers or certificates representing financial obligations arising due to trade and other

³ Source: ISRA Research based on IFIS Database – Mohamad Mokhtar & Abdullah, A Synthesis of Shariah Issues and Market Challenges in the Application of Wa`ad in Equity Based Sukuk

commercial activities (Kamil, 2008). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in its Sharī'ah Standard 17 (2), defines investment *ṣukūk* (*ṣukūk-al-istithmār*) as “*certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, assets of particular projects or special investment activity*”(AAOIFI, 2008). A similar definition is provided by the Islamic Financial Services Board (IFSB), another regulatory body for Islamic financial institutions. In its Capital Adequacy Standard (IFSB 2), *ṣukūk* is defined as “*certificates that represent the holder’s proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset*”(IFSB, 2005).

Based on the above definition, although the term *ṣukūk* is commonly translated as Islamic bond, a more accurate description of *ṣukūk* should be an investment certificate that represents ownership of an asset or business venture. In contrast, bonds are normally issued to evidence debts. Unlike *ṣukūk*, bonds do not represent ownership on the part of bondholders in the commercial or industrial enterprises for which the bonds were issued. Rather, they document the interest-bearing debt owed to the holders of the bonds by the issuer, who is actually the owner of the enterprise (Usmani, 2007).

Conventionally, bonds are structured as debt instruments with fixed interest (commonly termed ‘coupon’). The amount of interest is determined as a percentage of the capital and not as a percentage of the actual profits. Bonds also guarantee the return of principal when redeemed at maturity, regardless of whether the enterprise was profitable or not. On the other hand, due to the Sharī'ah prohibition on interest, *ṣukūk* cannot be structured to represent a loan as a bond does. Thus, *ṣukūk* use assets and various Sharī'ah contracts to provide alternative instruments to the conventional bond. Consequently, *ṣukūk*-holders are entitled to share in revenues generated by the *ṣukūk* assets and may be entitled to share in the proceeds of the realization of the *ṣukūk* assets (Mohamad Mokhtar, Rahman, Kamal, & Thomas, 2009). This sharing in

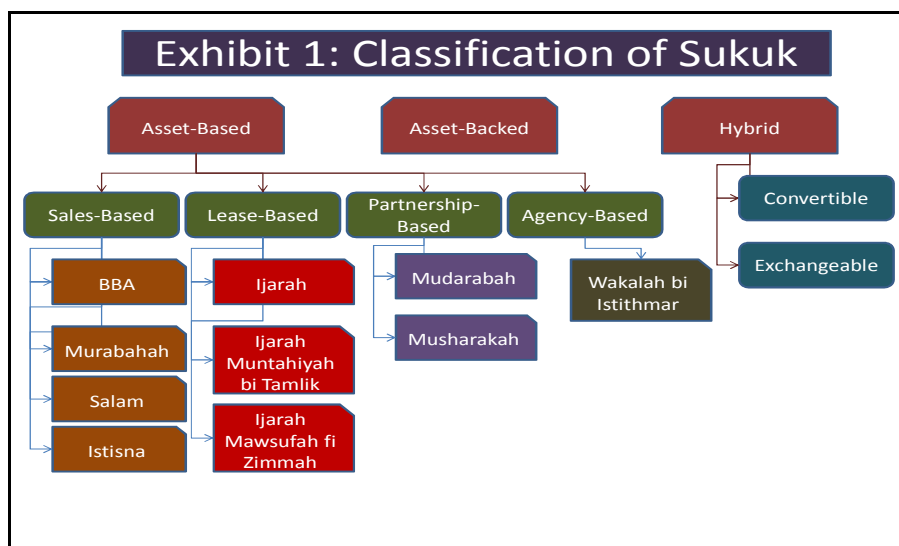
⁴ Although *ṣukūk* is a plural in Arabic, it will be treated in this paper like the English word ‘sheep’, which is used for both the singular and the plural.

the proceeds, however, is not fixed up-front; rather, it is based on the actual profit realized from the venture.

3. *ṢUKŪK* CLASSIFICATIONS

3.1 Asset-Backed and Asset-Based *Ṣukūk*

Ṣukūk can be classified in various manners. The bases for *ṣukūk* classification can either be the contracts underlying the *ṣukūk* structures, the nature and type of asset represented by the *ṣukūk*, or the *ṣukūk*'s technical and commercial features. The first method is to look into the underlying contracts used in transactions. They include some common Shari'ah contracts such as *bay' bi-thaman ājil* (BBA), *murābahah*,⁵ *salam*, *istiṣnā'*, *ijārah*, *mushārahah*, *muḍārabah* and *wakālah* (Kamil, 2008). AAOIFI identified 14 types of *ṣukūk*; however, the ones highlighted by Kamil (2008) are the most common *ṣukūk* issued in the market. Exhibit 1 depicts the various classifications of *ṣukūk*.



Source: (Securities Commission, 2009)

⁵ In Malaysia, BBA and *murābahah ṣukūk* utilize *bay' al-ṭinah* structures.

Islamic Financial Services Board, in its Guidelines No.2 (IFSB 2), issued in 2005, identifies two broad categories of *ṣukūk*; namely asset-based *ṣukūk* and equity-based *ṣukūk*. The former are defined as “*ṣukūk where the underlying assets offer fairly predictable returns to the sukūk holders, such as in the case of Salam, Istisnā‘ and Ijārah*”. Equity-based *ṣukūk*, on the other hand, are defined as “*ṣukūk where the returns are determined on a profit and loss sharing in the underlying investment, which does not offer fairly predictable returns (e.g. Mushārah or Mudārabah for trading purposes)*” (IFSB, 2005). This guideline clearly recognizes that *ṣukūk* represent ownership of the underlying asset and that the *ṣukūk*-holders assume all rights and obligation attached to the asset.

However, in reality, not all *ṣukūk* fulfill the criteria stipulated in IFSB 2. In fact, most of the *ṣukūk* structures in the market do not reflect true ownership by the *ṣukūk*-holders of the underlying asset. Therefore in 2009,⁶ an additional standard, *IFSB 7 – Capital Adequacy Requirement for Sukuk, Securitisations and Real Estate Investment*, was issued. This standard addresses, among other issues, the capital adequacy requirement for *ṣukūk* structures of non-Asset Backed Securities (ABS) and provides a clear guideline on the asset derecognition criteria for an ABS (Mohamad Mokhtar, True Sale and Bankruptcy Remoteness in Sukuk, 2008).

IFSB 7 distinguishes three types of *ṣukūk* structures – an Asset Backed Structure (ABS) and two non-ABS structures (pay-through and pass-through structures). According to IFSB 7, Asset-Backed *Ṣukūk* (ABS) are “*structures that meet the requirement for being an asset-backed structure as assessed by a recognized external credit assessment institution (i.e. rating bodies)*.” We will discuss below the requirements of two rating bodies for asset-backed *ṣukūk*. IFSB 7 also added that in asset-backed *ṣukūk* the *ṣukūk*-holders will bear any losses due to impairment of the assets. In other words, in asset-backed *ṣukūk*, the *ṣukūk*-holders have recourse to the asset and not the originator.

⁶ An exposure draft of IFSB 7 was issued in late 2007.

On the other hand, IFSB elaborates on two types of asset-based *ṣukūk*: firstly, *ṣukūk* that utilize a purchase undertaking from the originator (also termed pay-through *ṣukūk*), and secondly, *ṣukūk* with a guarantee from the issuer in case the originator defaults (also termed pass-through *ṣukūk*). Based on the IFSB definition above, it was made apparent that asset-based *ṣukūk* imply that the *ṣukūk*-holders have recourse to either the originator (via the purchase undertaking) or the issuer (via the guarantee). In other words, asset-backed *ṣukūk* involve full transfer of legal ownership of the underlying asset while asset-based *ṣukūk* involve recourse to the originator or the issuer (but not the asset).

Apparently IFSB's definition of asset-backed *ṣukūk* is very much influenced by the definition provided by rating agencies. For example, Moody, one of the most internationally recognized rating agencies, also makes a clear distinction between asset-backed and asset-based *ṣukūk*.⁷ According to Moody's definition, asset-backed *ṣukūk* are those whose "*investors enjoy asset-backing; they benefit over some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the noteholders would be able to recover their exposure by taking control of and ultimately realising the value from the asset(s). It also requires the element of securitisations to be present—true sale, bankruptcy remoteness and enforceability of security.*" (Lotter, Philipp; Howladar, Khalid; , 2007)

On the other hand, asset-based *ṣukūk* are those for which "*the originator undertakes to repurchase the assets from the issuer at maturity of the Sukuk, or upon a pre-defined early termination event, for an amount equal to the principle repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the Sukuk noteholders, as the amount is defined to be equivalent to the notes. In this case, noteholders have no special rights over the asset(s) and rely wholly on the originator's creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable*

⁷ In 2006 Moody's published a report titled Shariah and Sukuk: A Moody's Primer which briefly defined asset backed Sukuk as Sukuk that have key securitization elements in place. However the 2007 report provided a more detailed discussion on asset based and asset backed Sukuk.

to honour its obligation to repurchase the assets, the noteholders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor, stressing the importance that the purchase undertaking ranks pari passu with any other of the originator's senior unsecured obligations."(Lotter, Philipp; Howladar, Khalid; , 2007)

Besides Moody, Rating Agency Malaysia (RAM) has a similar definition of asset-backed and asset-based *ṣukūk*. According to RAM, asset-backed *ṣukūk* are "*characteristically non-recourse Sukuk, with the underlying assets forming the lone source of profit and capital payments*"(Mohd Noor, 2008). They further highlight the credit-risk characteristic of asset-backed *ṣukūk*, which is solely determined by the performance and credit quality of the underlying asset, i.e. the asset's cash flow and, in certain situations, expected value at maturity, given various stress situations and scenarios. Furthermore, RAM affirms the independence of *ṣukūk* investors from the originator by stating clearly that the *ṣukūk* investors "*do not have access to the asset owner (i.e. Originator), likewise they are safeguarded from the latter's financial plights, made certain by the transaction's structural and legal make-up*" (Mohd Noor, 2008). RAM also shares a similar concern to that of Moody with respect to the requirement on securitization elements, which establishes that the credit-risk profile of the *ṣukūk* is effectively delinked from that of the asset originator and is, instead, determined solely by the performance of the underlying asset.

Based on the data retrieved from IFIS's Sukuk Database, as of 5th August 2009 there have been only 11 deals that are considered to be asset-backed *ṣukūk*. Out of these *ṣukūk* issuances, seven were issued in Malaysia, while the remaining four are global issuances. Refer to Table 1 and Table 2 for details.

Table 1: Asset-Backed *Ṣukūk* in Malaysia

Concept	Issuer	Date issued	Amount (RM `000)	Underlying asset
BBA	ABS Plantation Asset	8/9/2005	175	Plantation asset
Ijarah	Golden Crop Return	22/11/2005	442	Plantation Asset
	Dura Palms	28/6/2006	284	Plantation Land
	ABS Logistic	8/5/2007	300	Warehouse
	Menara ABS	15/1/2008	1100	Office buildings
Musharakah	Musyarakah One Capital	4/4/2005	2500	Debt
	Cagamas MBS	8/8/2005	2050	Debt

Table 2: Asset-Backed *Ṣukūk* in the Global *Ṣukūk* Space

Concept	Issuer	Date	Amount (million)	Underlying Asset
Ijarah	Caravan I (Hanco)	15/2/2004	SAR98	Leased Vehicles
	Tamweel	July 2007	USD220	Leased Properties
Mudarabah	Sun Finance (Sorouh)	August 2008	AED 5,020	Land Plots
Musharakah	East Cameron Gas	July 2006	US\$166	Hydrocarbon

The following section further delineates the concept of securitization and the resemblance of its features to those of asset-backed *ṣukūk*.

3.2 Parallels between Asset-Backed *Ṣukūk* and Securitization

In the securitization market, the originators (owners of income-generating assets) do not raise loans in the capital market. Instead, they sell the assets they have on the balance sheet. In other words, the originator who wants to raise funding in the market sells the asset in order to get cash. Simply put, securitization is monetization of the originator's asset. In securitization, the asset will no longer reside on the book of the

originator. The repayment to the investors in securitization is derived solely from the cash flow generated by the asset. They will not have recourse against the originator (Kothari, 2008).

One of the most essential features of securitization is the 'true sale' requirement. It means the sale of the originator's asset must fulfill all accounting and legal requirements to remove the asset from the originator's books. In other words, the originator has to part with his asset for him to get funding. This is to ensure that the whole securitization process meets the bankruptcy-remoteness requirement, so that, in the event of bankruptcy, the creditors of the originator cannot claw back the asset from the investors (who have actually purchased the assets from the originator). Therefore, from the rating agencies' point of view, investors are the owners of the asset and remained protected if anything happens to the originator.

Similarly, in asset-backed *ṣukūk*, the *ṣukūk*-holders are the owners of the asset, and the actual performance of the underlying asset will determine the return to the *ṣukūk*-holders. If the underlying asset is performing while the originator is facing bankruptcy, the *ṣukūk*-holders' payment will be uninterrupted. If the underlying asset is not performing (i.e. impaired), the *ṣukūk*-holders must take the hit because they are the owners of the asset. In other words, as owners of the asset, the *ṣukūk*-holders will be exposed to market risk of the asset in addition to the credit risk.

In contrast, the asset present under asset-based *ṣukūk* is merely for the purpose of formal Shari'ah compliance rather than to serve as the source of profit and capital payments. Therefore, the credit risk assessment will typically be directed towards the entity with the obligation to redeem the *ṣukūk*. Usually, this will be the issuer; in some cases, however, the task may fall on the originator, sponsor or lessee via the existence of a purchase undertaking agreement. In this instance, an analysis of the asset will be inconsequential; rather, the credit quality of the obligor will be the key driver affecting the credit quality and rating of the *ṣukūk* (Mohd Noor, 2008).

To sum up, *ṣukūk* as currently practiced can be divided broadly into asset-backed and asset-based *ṣukūk*. Asset-backed *ṣukūk* mirror securitization practice in the conventional space, whereby the *ṣukūk*-holders are the owners of the asset and the

performance of the asset is the driver of the payment to the *ṣukūk*-holders. Asset-based *ṣukūk*, on the other hand, mirror bond issuance in the conventional space. Bondholders are creditors to the obligor. Holders of unsecured asset-based *ṣukūk* do not have any collateral, while holders of secured asset-based *ṣukūk* do have collateral on the asset of the obligor. However, their interest in the collateral is only security interest, not ownership interest.

Despite the fact that asset-backed *ṣukūk* are deemed closer to the spirit and principle of the Shari'ah compared to asset-based *ṣukūk*, to date only 11 asset-backed *ṣukūk* have been issued.⁸ The analysis would not be complete without understanding why asset-based *ṣukūk* are more popular in the market and knowing what challenges the asset-backed *ṣukūk* space faces.

First and foremost, there is a broader macro issue that needs to be addressed to understand the motivation behind the heightened interest in the asset-based *ṣukūk* structure. In countries of the Gulf Cooperation Council (GCC), the regulatory framework for securitization is not yet developed. One of the main legal challenges is the restriction on foreign ownership of certain assets in the GCC. This posed serious questions when structuring a *ṣukūk*; for example, can an offshore SPV own an asset in these jurisdictions? Moreover, what are the requirements for a true sale to take place in these countries? Malaysia has a clear guideline on true sale, but even then asset-backed *ṣukūk* have not taken off. The fact that insolvency law is still underdeveloped in the Middle East has further reduced the risk appetite of many *ṣukūk* issuers for structuring *ṣukūk* based on the ideal asset-backed structure.

⁸ Total number of issuance was 560. That means only about 2% of the current Sukuk are asset backed Sukuk.

4. SHARĪ‘AH ISSUES IN ASSET-BASED *ŞUKŪK*

4.1 Ownership Issues in Asset-Based *Şukūk*

The preceding section discussed in detail the differences in structure and operation between asset-backed and asset-based *şukūk*. Obviously, the structure and operation of asset-backed *şukūk* are deemed closer to the spirit and principles of the Sharī‘ah, whereas the practice of asset-based *şukūk* raises a number of Sharī‘ah issues. The next sections will analyse and discuss the various Sharī‘ah issues pertaining to asset-based *şukūk*. In that discussion, it is vital not only to discuss the relevant Sharī‘ah issues but also why the market is behaving as it is. This approach will facilitate the stakeholders’ deep investigation of the issue and help them decide how to chart a future path for the *şukūk* market and what necessary changes to systematically institute. Where needed, each issue will be discussed by comparing how asset-based and asset-backed *şukūk* approach it.

4.1.1 *The Meaning of Ownership (Qabd) in an Islamic Sale Contract*

One of the fundamental conditions of a sale contract is that the *maḥal al-‘aqd*⁹ (object of the sale) must exist and be owned by the seller at the time of the contract. This is important because the purpose of a sale contract is to transfer ownership of the object of the sale to the buyer and ownership of the price to the seller. If this condition is not fulfilled, the sale contract is deemed to be an invalid sale (*bay‘ fāsīd*). It is more specifically known as *bay‘ ma‘dūm* (selling something that does not exist), certain details of which have been a matter of longstanding contention amongst jurists. The issue of the buyer taking possession of the sold goods is known in Islamic jurisprudence as *qabd*.

⁹ Also known as the *ma‘qūd ‘alaih* in Arabic.

In Arabic, *qabḍ* (قبض) means 'to take possession'. Literally, it means 'to grip with the hand' or 'to take or catch' something. *Taqābud* (تقاييد) adds a bilateral connotation of mutual taking of possession.¹⁰ Jurists since early times have discussed at great length the issue of *qabḍ* for purchase and sale contracts in particular as well as other contracts in general. There have been different views about what constitutes *qabḍ* for different goods, such as real estate and goods sold by measurement and other portable goods, such as clothes, animals and the like. The issue is, is it necessary that the goods be accepted by the buyer's hand or is it sufficient to grant the buyer access to the goods without restriction (التمكين والتخليه). These issues will be deliberated in detail in the following discussion.

4.1.2 The Status of Ownership (*Qabḍ*) in the Shari'ah

A number of *hadīths* mention the necessity of *qabḍ*:

عَنْ ابْنِ عَبَّاسٍ رَضِيَ اللَّهُ عَنْهُمَا أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ نَهَى أَنْ يَبِيعَ الرَّجُلُ طَعَامًا حَتَّى يَسْتَوْفِيَهُ . قُلْتُ لِابْنِ عَبَّاسٍ : كَيْفَ ذَلِكَ ؟ قَالَ : ذَلِكَ دَرَاهِمٌ بِدَرَاهِمٍ ، وَالطَّعَامُ مُرَجَأٌ .

Ibn 'Abbās narrated that the Prophet (peace be upon him) prohibited that a man sell food he has not yet received. Ibn 'Abbās was asked as to its form. He answered, "Dirhams for dirhams, with [delivery of] the food delayed"¹¹ (Bukhārī, Muslim and Tirmidhī).

¹⁰ Al-Fayyumi (770H), *al-Miṣbāḥ al-munīr fī gharīb sharḥ al-kabīr*, Cairo: Wizārat al-Ma'ārif al-'Umūmiyyah (1922, 5th ed.) vol. 2, p. 936.

¹¹ Al-'Aynī explained the meaning of "Dirhams for dirhams, with [delivery of] the food delayed" thus: "One buys grain from someone for a *dirham* with delayed delivery and then sells it back to him or to someone else, before taking possession of it, for two *dirhams*, for example. This is not permissible because it is, by implication, sale of *dirhams* for *dirhams* while the grain is not present; it is as if he sold the *dirham* with which he purchased the grain for two *dirhams*, which is *ribā*, for it is the sale of something absent for something present." Badr al-Dīn al-'Aynī, 'Umdat al-Qārī', *Sharḥ Ṣaḥīḥ al-Bukhārī*, 17:439, in *al-Maktabah al-Shāmilah*, Version 3.28.

In another *hadīth*,

عَنْ عَبْدِ اللَّهِ بْنِ دِينَارٍ قَالَ : سَمِعْتُ ابْنَ عُمَرَ رَضِيَ اللَّهُ عَنْهُمَا يَقُولُ : قَالَ النَّبِيُّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ : مَنْ ابْتَاعَ طَعَامًا

فَلَا يَبِعُهُ حَتَّى يَتَقَبَّضَهُ

Ibn ‘Umar stated that the Prophet (peace be upon him) said: “*Whoever buys food, he should not resell it before he has received it*” (Bukhārī and Mālik).

In general, the scholars of Islamic jurisprudence have divided *qabḍ* into two forms: physical possession (*qabḍ ḥissī* or *ḥaqīqī*) and legal possession (*qabḍ ḥukmī*).

4.1.2.1 *Qabḍ Ḥissī* or *Ḥaqīqī*

This type of *qabḍ* refers to explicitly taking possession or when the buyer is observed taking the goods sold to him. It is normally evidenced in transactions involving two types of assets. First, in the case of immovable assets (*‘aqār*) such as land and buildings, *qabḍ* is said to have taken place when the original owner gives permission to the buyer to take control of the land and carry out whatever activity he wishes without hindrance. *Qabḍ* is completed for such assets when the new owner’s name appears on the grant title or the ownership certificate. The second type of asset to which *qabḍḥaqīqī* applies is moveable (*manqūl*) property such as commodities, food, vehicles etc. *Qabḍḥaqīqī* is effective for this category when the buyer collects or receives the goods upon paying the price (Al-Zarqa, 1968).

4.1.2.2 *Qabḍ Ḥukmī* or *Qabḍ Ma‘nawī*

In contrast to *qabḍḥaqīqī*, *qabḍ ḥukmī* refers to taking possession implicitly or not in a physical form. However, the legal status of *qabḍ ḥukmī* is the same as that of *qabḍḥaqīqī*, provided that it fulfills one of the following conditions: First, the seller must grant the buyer full access to the object of sale without any encumbrances (*al-tamkīn wa al-takhliyah* والتحكين والتخليه); for example, if a person purchases furniture in a

house, and then the seller gives him the key to the house saying: “*I have given you full access and permission to take the object of sale.*” By so doing, the seller has given consent for the buyer to take possession of the goods bought without hindrance.¹²

Second, legal ownership can also take effect by means of a contra-debt (*muqāṣṣah*) by which debt between two parties is implicitly settled, the result being that neither party owes debt to the other. For example, Ahmad owes Ali RM2000. Then Ali incurs a debt of the same amount to Ahmad. This means the two parties are no longer in debt to each other. In this context, *qabḍ hukmī* of the amount of the debt has taken place in the form of the contra-debt.¹³

Third, *qabḍ hukmī* can also take place due to an earlier action which implies that ownership has already taken place, although the earlier form of *qabḍ* is different from the new form. For example, in the case of an Islamic hire-purchase contract (*al-ijārah thumma al-bay'*), a rental *qabḍ* occurs first when the tenant occupies the rented premises. Then, when the premise is sold to the tenant, *qabḍ hukmī* takes place, although the *qabḍḥaqīqī* occurs after the sale and purchase contract.¹⁴

Finally, *qabḍ hukmī* or legal ownership also takes place due to spoiling (*itlāf*). If the buyer spoils purchased goods while they are in the possession of the seller, then he is considered a recipient of the goods, i.e. *qabḍ* has taken place, and he is liable for the price. This is because giving access and permission also implies giving the ability to affect the objects, and spoiling the goods certainly affects them.¹⁵

4.1.3 Ownership (*Qabḍ*) in Sales Contracts

After highlighting the basic concept of *qabḍ* and its various forms, it is time to examine the various schools of thought regarding its status in a sale contract. According to the Ḥanafīs, *qabḍ* is not an essential requirement (*rukṅ*) of a sale, but

¹² OIC, Majallah Majma' al-Fiqh, No.6, vol.4, p.562; Haidar, Ali (1991)Durr al-Hukkam, Dar al-Jil, Beirut p.251.

¹³ OIC, Majallah Majma' al-Fiqh, No. 6, vol. 4, pp.726-727.

¹⁴ OIC, Majallah Majma' al-Fiqh, No.6, vol.4, p.729/

¹⁵ OIC, Majallah Majma' al-Fiqh, No. 6, vol. 4, pp.731-732; Wahbah Az-Zuhaily, Al-Fiqh Al-Islami Adillatuh, vol. 5, pp.3388-3393.

rather, a subsidiary condition (*shart al-nifādh*). They clearly validate a bona fide sale by an unauthorized person (*fuḍūlī*) who does not own the object but sells it nevertheless. In this case, the sale is deemed to be valid but not effective. It becomes effective only upon obtaining the owner's consent.¹⁶ Thus, *qabḍ* is not a prerequisite of a valid contract, and it is perfectly lawful to postpone it to a later date. Only in the case of transactions of *ribawī* items (e.g. sale of gold for gold) is *qabḍ* elevated to a prerequisite of a valid contract. AbūḤanīfah exempted what is movable and transferable from what is immovable and non-transferable, for transfer of possession, according to him, is still possible by making the property available.

Mālikīs confined the application of the *ḥadīth* on *qabḍ* to food grains, which means that non-food-grain items (e.g. cotton, palm oil etc.) may be sold prior to taking possession. Ibn Rushd confirmed this, stating, “*There is no dispute in Mālik’s school about the permissibility of selling something, other than food, before taking possession, and there is also no dispute in his school regarding ribawī food (wheat, barley, dates and salt) that possession is a condition for its sale.*”¹⁷ As for non-*ribawī* food, Mālikīs have two opinions: first, that it is disallowed (without prior possession). This is the more famous position and is also the opinion of Aḥmad and Abū Thawr, though these two authorities stipulated that the prohibition applies to food that is sold by volume or weight. The second Mālikī opinion is that it is permitted to sell non-*ribawī* food prior to taking possession.

For the Shāfi‘īs, possession is a condition for all kinds of property. Al-Shāfi‘ī deduces his opinion based on the *ḥadīth* of the Prophet (peace be upon him),

¹⁶ Al-Kasani, *Bada’ al-Sana*, 5/148, Al-Dardeer. *Al-Sharh Al-Kabir*, (Published with Hashiyat al-Dasuqi), 3/12, Al-Shirazi. *al-Muhathab*, 1/262-263; Ibn Qudamah, *Al-Mughni* 6/295.

¹⁷ Muhammad ibn Ahmad ibn Rusyd al-Qurtubi, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, translated by Imran Ahsan Khan Nyazee, vol. 2, pp.175-176.

عَنْ عَمْرٍو بْنِ شُعَيْبٍ عَنْ أَبِيهِ عَنْ جَدِّهِ قَالَ: تَخَضَى رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ عَنْ سَلْفٍ وَبَيْعٍ وَعَنْ شَرْطَيْنِ فِي بَيْعٍ وَاحِدٍ وَعَنْ بَيْعٍ مَا لَيْسَ عِنْدَكَ وَعَنْ رِبْحٍ مَا لَمْ يُضْمَنْ "

"It is not permitted to [combine] a sale and a loan; to have two conditions in a sale contract; to sell what you do not possess; or to profit without corresponding liability (for loss)."¹⁸ Shāfi'īs strictly adhere to the literal meaning of the *ḥadīth* "Do not sell anything until you receive it", to the extent that even the sale of immovable objects must satisfy the possession requirement prior to resale. However, his view is not shared by the other schools, which do not require *qabḍ* prior to resale in the case of immovable objects like land.

Ibn al-Qayyim and his teacher Ibn Taymiyyah departed from the majority position by expanding the concept of *qabḍ* through consideration of custom or *'urf* (the common practices of the local community). They based their opinion on the principle that no form of sale is prohibited unless it is stated as such in the Qur'an, the Sunnah or the *fatwās* of the companions. As for the Prophet's prohibition of resale before possession, they interpreted it as being directed at sales with excessive uncertainty and risk (*gharar wa mukhāṭarah*), where the object may be undeliverable, whether it exists or not (e.g. a runaway horse or camel). Thus the wisdom in the prohibition is not linked to existence or the lack thereof.¹⁹

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

¹⁸ Al-Nasā'ī, *Sunan al-Nasā'ī bi Sharḥ al-Suyūṭī*, (Beirut: Dār al-Ma'rifah), 1999, vol. 7, *ḥadīth* no. 340.

¹⁹ Wahbah Az-Zuhaili, *al-Fiqh al-Islami wa Adillatuh*, vol. 5, pp. 3340-3398.

The International Islamic Fiqh Academy (OIC) in its *fatwā* on *qabḍ* in 1990:

"أولاً: قبض الأموال كما يكون حسيًا في حاله الأخذ باليد أو الكيل أو الوزن في الطعام ، أو النقل والتحويل إلى حوزة القابض ، يتحقق اعتبارًا و حكمًا بالتخلية مع التمكين من التصرف ، ولو لم يوجد القبض حسًا. وتختلف كيفية قبض الأشياء بحسب حالها واختلاف الأعراف فيما يكون قبضًا لها ."²⁰

Qabḍ (taking possession) of assets may occur physically, e.g. when taking by one's hands, or by measurement or weight for food, or transfer from the custody of one party to that of another. It can also be considered to have occurred in a legal (ḥukmī) sense by providing access without hindrance in allowing [the buyer] to dispose of [the commodity] as he or she pleases, despite the absence of any physical ownership. The way in which ownership or control of sold goods occurs differs according to the state of the goods, and it differs according to customary practice as to what constitutes qabḍ."

Based on the above, *qabḍ ḥukmī*, with regard to its ruling, is similar to *qabḍ ḥissī*, even though there is no physical possession. Some other contemporary *fatwā* to that effect are as follows:

The *fatwā* of the Islamic Fiqh Academy of the Muslim World League in February 1989²¹ and of the International Islamic Fiqh Academy (OIC) in 1990 regarding *qabḍ*, both of which considered all forms of credit into customers' accounts as *qabḍ ḥukmī*. That includes cash deposits and money transfers (remittances, intra- or inter-bank account transfers).

These *fatwās* of the Islamic Fiqh Academies have also been accepted by AAI OFI in its Sharī'ah standard on currency trading.²²

²⁰ *Majallat Majma' al-Fiqh al-Islāmī*, Session 6, vol. no. 4, p. 770.

²¹ Extracted from Nazih Hammad, al-Qabḍ al-ḥukmī wa al-ḥaqīqī, in *Majallat Majma' al-Fiqh al-Islāmī*, session 6, vol.1, p. 709.

²² The original AAI OFI Standard no 1, related to currency trading:-

2/6/5 يتحقق القبض الحكمي اعتبارًا و حكمًا بالتخلية مع تمكين من التصرف ولو لم يوجد القبض حسًا، ومن صور القبض الحكمي المعتبرة شرعًا و عرفًا ما يأتي:

(أ) القيد المصرفي المبلغ من المال في حساب العميل في الحالات الآتية:
- 1 - إذا أودع المال في حساب العميل المبلغ من المال مباشرة أو بحوالة مصرفية.

Meanwhile, AAIOfI has explained *qabd* in detail in its Sharī'ah Standard No. 18. It considers the delivery of guaranteed individual cheques, bank drafts, credit- and debit-card payments as *qabd ḥukmī*,²³ even though the account will be credited or debited in the future.

4.1.4 The Paradox of Ownership in the Asset-Based *Ṣukūk* Structure

From the above analysis, it is clear that ownership or *qabd* is very essential in determining the validity of a sale contract. The following discussion evaluates the issue of ownership in the contemporary practice of Islamic finance. In particular, some case studies of the asset-based structure which dominates the *ṣukūk* issuance in the market today shall be thoroughly reviewed. This is done by conducting a detailed analysis on the term sheets of various *ṣukūk* issuances.

4.2 *Ṣukūk*-holders' Interest in the Underlying Asset

Based on our study, in most asset-based *ṣukūk* structures, the *ṣukūk*-holders who are supposed to own the underlying assets do not have any interest in the underlying asset. This is particularly true for unsecured asset-based *ṣukūk*, which form a majority of the *ṣukūk* market. Even for secured asset-based *ṣukūk*, the *ṣukūk*-holders will only

2- إذا عقد العميل عقد صرف تاجر بينه وبين المؤسسة في حال شراء عملة بعملة أخرى لحساب العميل.
3- إذا اقتطعت المؤسسة - بأمر العميل- مبلغاً من حساب له لتضمه إلى حساب آخر بعملة أخرى في المؤسسة نفسها للعميل أو لمستفيد آخر. وعلى المؤسسة مراعاة قواعد عقد الصرف في الشريعة الإسلامية.

ويغتفر تأخير القيد المصرفي- بالصورة التي يتمكن المستفيد بها من التسلم الفعلي- إلى المدة المتعارف عليها في أسواق التعامل، على أنه لا يجوز للمستفيد أن يتصرف في العملة خلال المدة المعتقده إلا بعد أن يحصل أثر القيد المصرفي بإمكان التسليم الفعلي.

(ب) تسلم الشيك إذا كان له رصيد قابل للسحب بالعملة المكتوب بها عند استيفائه، وتم حجز المؤسسة له.
(ج) تسلم البائع قسيمة الدفع المتوقعة من حامل بطاقة الائتمان (المشتري) في الحالة التي يمكن فيها للمؤسسة المصدر للبطاقة أن تدفع المبلغ إلى قابل البطاقة بدون أجل.

²³ The original text AAIOfI Shariah Standard no. 18 related to *qabd*, paragraph 5:

5- أهم تطبيقات القبض المعاصرة
1/5 يعد من القبض الحكمي قبض المستفيد للشيك المصرفي (Bank Draft) أو الشخصي (Personal Cheque) المضمون السداد من البنك المسحوب عليه. وبعد ذلك قبضاً لمضمونه ولو تأخر التحصيل الفعلي لمبلغه، مع مراعاة ما جاء في المعيار الشرعي رقم (1) بشأن المتاجرة في العملات، البند (5/6/2) ب، وما جاء في المعيار الشرعي رقم (12) بشأن الأوراق التجارية، البند (2/6,1/6).
2/5 يعد من القبض الحكمي الدفع ببطاقة الائتمان. وينظر المعيار رقم (2) بشأن بطاقة الحسم ببطاقة الائتمان، البند (4/4).
3/5 يعد من القبض الحكمي إيداع شخص مبلغاً من المال في الحساب المصرفي بطلبه أو رضاه. سواء تم نقداً أم بحوالة المصرفية أم بشيك مضمون السداد من البنك المسحوب عليه، وتبراً ذمة المودع إذا كان مديناً بذلك المبلغ.

have security interest in the asset.²⁴ This means the *ṣukūk*-holders are merely creditors and not owners of the asset. Even if they have a charge on the asset, legally, they are not the owners of the asset. Security interest means the *ṣukūk*-holders can only claim total amount of debt due (capital plus accrued profit). In case of foreclosure, *ṣukūk*-holders enjoy only what is due to them, and any surplus out of the asset disposal must be returned to the obligor. If the amount is still insufficient after the asset disposal, the *ṣukūk*-holders shall wait in line with other unsecured creditor to get back any balance due.

In contrast, for asset-backed *ṣukūk*, *ṣukūk*-holders cannot ask for recourse to the originator since the asset is deemed to be owned by them. There is no indebtedness between the originator and the *ṣukūk*-holders since the former has already sold the asset to the *ṣukūk*-holders (normally done through a Special Purpose Vehicle). Hence, full ownership is evidenced in asset-backed *ṣukūk*.

As a case in point, Box 1 illustrates an example from DP World Sukuk Mudarabah's offering circular regarding *ṣukūk*-holders' interest in the asset.

Box 1: No Interest in *Mudārabah* Asset from an English Law Perspective

Pursuant to the Declaration of Trust, the Issuer will declare a trust, *inter alia*, of its interest under Shari'a in the Mudaraba Assets and certain of its rights, benefits and entitlements, present and future, under each of the Transaction Documents. On any Redemption Date, pursuant to the Purchase Undertaking or the Sale Undertaking, the Obligor will be obliged to purchase all (or in the case of a Change of Control Put Date, the relevant pro-rata part) of the Trustee's interest under Shari'a in the Mudaraba Assets.

Each of the Mudaraba Agreement, the Purchase Undertaking and the Sale Undertaking are governed by English law under which the interest under Shari'a in the Mudaraba Assets of either the Issuer and/or the Trustee **may not be recognised**.

Neither the Issuer nor the Trustee has any interest in the Mudaraba assets under English law.

(Source: Risk Factor Relating to *Mudārabah* Asset, p. 22 of the DP World Offering Circular)

²⁴ In unsecured asset-based *ṣukūk*, the *ṣukūk*-holders do not create any claim or charge on the underlying asset. Thus they are normally ranked *pari passu* with other unsecured creditors of the obligor. However, in secured asset-based *ṣukūk*, the *ṣukūk*-holders create charge or claim (either fixed or floating) on the asset.

Note that usually the trust asset section will say that the *ṣukūk*-holders are the beneficial owners of the trust asset; however, in other parts of the offering circular, usually the risk section, there will be one or more of the following provisos: restriction on the disposal of the asset, clarification that the *ṣukūk*-holders will not have interest in the asset from a legal (English law) perspective and/or clarification that transfer of the ownership has not been perfected. Last but not least, it is also common to find in the risk section that no detailed due diligence will be conducted on the asset. This due diligence would include legal due diligence and financial due diligence. We will discuss only legal due diligence in this section and save financial due diligence for the next section.

With regards to legal due diligence in an asset-based *ṣukūk*, it does not require a true sale (from a legal and accounting perspective) to take place. Thus the transfer of the asset to the SPV will not be perfected. Therefore, the assets utilized in the *ṣukūk* will remain on the balance sheet of the obligor.²⁵ If there is no additional charge created on the asset, then the *ṣukūk*-holders will rank *pari passu* with unsecured creditors of the obligor. This means they will not have priority in claiming the asset if there is default.

See Box 2, for example, on ADIB Sukuk Musharakah which was issued in 2006. It is clearly stated that the transfer will not be perfected and that it is not clear if the law allows such transfer. Also, the *ṣukūk*-holders cannot dispose of the asset and can only enforce the purchase undertaking.²⁶ Simply put, no detailed legal due diligence means one is not sure whether one can legally buy the underlying asset or not. That brings up a pertinent Sharī'ah issue: with this approach of no due diligence on the asset, how will one satisfy the very basic requirement in Sharī'ah that a seller is able to legally transfer title to the buyer?²⁷ One must wonder if it is possible to actually perfect the transfer of ownership. Hanco (an asset-backed *ṣukūk*) provided evidence that the transfer can be perfected from a legal perspective.²⁸ Nonetheless, it also provided a

²⁵ With the exception of certain deals in UAE—Emirates Islamic Sukuk Musharakah is one example—where the assets were taken off the balance sheet although the full route of securitization was not taken.

²⁶ We will discuss the issue of restriction in disposal in the next analysis.

²⁷ Discussion with Rafe Haneef, the Managing Director of Fajr Capital on 23rd Oct, 2009.

²⁸ All asset-backed *ṣukūk* must perfect the transfer of ownership to qualify for true sale.

reminder that the bankruptcy regime in the GCC market needs improvements because the current rules are not clear. Refer to Box 3 for details of Hanco's approach.

Box 2: Non-Perfection of Transfer in ADIB *Şukūk* Musharakah

No investigation has been or will be made as to whether any interest in any Co-ownership Assets **may be transferred as a matter of the law governing the contracts**, the law of the jurisdiction where such assets are located or any other relevant law. No investigation will be made to determine if the Master Purchase Agreement, together with the relevant supplemental Purchase Contract, will have the effect of transferring a co-ownership interest in the Co-ownership Assets of the relevant Series of Trust Certificates. There are doubts whether, under UAE law, a co-ownership interest in certain assets (in particular those assets which are real estate based) can be effectively transferred. Accordingly, no assurance is given that any co-ownership interest in the relevant Co-ownership Assets has been or will be transferred to the Issuer.

Nevertheless, as indicated earlier, the **Certificateholders will not have any rights of enforcement as against the Trust Assets and their rights are limited to enforcement against ADIB** of its obligation to purchase the Issuer's co-ownership interest in the Co-ownership Assets pursuant to the terms of the **Purchase Undertaking Deed**. Accordingly, any such restriction on the ability of ADIB to make a "true sale" of the co-ownership interest in the Co-ownership Assets to the Issuer is likely to be of limited consequence to the rights of the Certificateholders.

By way of further assurance, ADIB has covenanted in the Purchase Undertaking Deed that to the extent that any transfer of a co-ownership interest in any of the Co-ownership Assets is not effective in any jurisdiction for any reason, it will make restitution in respect of those Co-ownership Assets.

(Source: Risk Factors, p9-10 of the ADIB Offering Circular)

Box 3: Perfection of Transfer in Hanco *Şukūk* Al-Istithmar

(i) Perfection of legal interest.

So long as the Vehicles purchased by Al-Karam pursuant to the Agreement for the Purchase and Sale of Assets are (i) registered in the name of Al-Karam and (ii) not pledged or encumbered in favour of any of Hanco's creditors, **there is a sufficient basis under Saudi Arabian law for a Saudi Arabian court or other adjudicatory authority to conclude that upon the transfer to Al-Karam of ownership of the Vehicles, the Vehicles ceased to be assets of Hanco and therefore are unavailable to Hanco's creditors in the event of Hanco's insolvency or liquidation.** However, prospective investors should be aware that in the absence of a clear Bankruptcy regime, or system of case reporting or binding precedent, it is not possible to rule out the possibility that a Saudi Arabian court or other adjudicatory authority, exercising its discretion, might take a different view and conclude that the transfer of the Vehicles to Al-Karam was effected as a security for a financing provided to Hanco, in which case the court or other adjudicatory authority could conclude that the Vehicles are still Hanco's assets and therefore are available to Hanco's creditors in the event of Hanco's insolvency or liquidation.

(Source: Risk Factors, p. 13 of Hanco Offering Circular)

Sharī'ah scholars usually allow the non-perfection of the interest in the asset because of the additional encumbrances that must be faced in order to complete it. We believe it is time to look deeper into the consequences of this approach and consider what will happen in default cases.

4.3 Restriction on *Ṣukūk*-holders Regarding Asset Disposal

From a Sharī'ah perspective, as highlighted in our discussion earlier, as the owners of the underlying asset, the *ṣukūk*-holders should be able to deal freely with the asset. This is to conform with the principle of *takhliyah* or *taslīm*, which denotes detaching the seller's claims to the object of sale, thus enabling the buyer to take the asset and use it without hindrance.²⁹

However, in practice, this is not always the case. In most unsecured asset-based *ṣukūk*, the *ṣukūk*-holders cannot dispose of the asset to third parties. This restriction is not mentioned in the Sharī'ah document or agreement (i.e. *ijārah*, *mushārahah*, *muḍārahah*, etc.), but is mentioned in the purchase undertaking, risk section and enforcement clause.

On the other hand, for secured asset-based *ṣukūk*, they can dispose of the asset due to the charge that they created. However, they only have security interest in the asset that assures them of getting back the debt amount due to them. In asset-backed, the *ṣukūk*-holders have the right to dispose of the asset because they are the owners of the asset. This restriction in disposal raises crucial Sharī'ah issues in asset-based *ṣukūk*. If the *ṣukūk*-holders cannot dispose of the asset, what, then, is their interest in the asset? We also need to evaluate if mere security interest in the asset (as in secured asset-based *ṣukūk*) satisfies the Sharī'ah requirement.

The accounting rules on true sale (FAS140 in the US and Exposure Draft on Securitization – IFRS 39 in the UK) include right of disposal as one of the criteria for testing whether sale has taken place or not. If the buyer cannot pledge or resell the

²⁹ OIC, *Majallat Majma' al-Fiqh al-Islāmī*, Session 6, vol. 4, p. 562; Haidar, Ali (1991) *Durr al-Hukkām*, Beirut: Dār al-Jil, p. 251.

asset, then the seller is deemed to maintain control, and the whole arrangement is deemed to be a financing arrangement (i.e. undertaking debt) and not sale of an asset.

This right of disposal is a very critical point that warrants the attention of Sharī'ah scholars. *Ṣukūk* have always been said to provide added protection to investors. This is not always true. The restriction in right of disposal shows that unsecured asset-based *ṣukūk* do not provide added protection to *ṣukūk*-holders. A number of *ṣukūk* that have been in trouble lately (Investment Dar, Golden Belt, Nakheel) are unsecured asset-based *ṣukūk*. As a result of this non-added protection, we can see how they have affected the reputation of the Islamic finance industry as a whole.

In order to identify the true role of the asset (from Sharī'ah and legal perspectives), we only need to ask these two simple questions:³⁰

If there is default, can the *ṣukūk*-holders dispose of the asset?

If something goes wrong with the asset itself, will the investors' return be interrupted?

If the answer to both questions above is no, then it is an asset-based *ṣukūk*. This is a practical approach that Sharī'ah scholars can take to ensure that the documents accurately define the role of the asset. They can ask why the *ṣukūk*-holders cannot dispose of the asset and why the return will not be affected if the asset is impaired. The reasoning can then be captured in the *fatwā* so there is added transparency in the deal.

Table 3 provides comparison of disposal right by asset-based *ṣukūk*-holders (unsecured and secured) and asset-backed *ṣukūk*-holders.

³⁰ Discussion with Khalid Howladar, Senior Credit Officer for Asset backed and Sukuk Finance at Moody's Dubai on 10th Nov 2009.

Table 3: Right of Disposal in Pre-AAOIFI *Ṣukūk*³¹

Pre-AAOIFI Deals	Use PU	Source of payment include PU?	Sole right upon dissolution	Due Diligence on <i>Ṣukūk</i> Asset	Enforcement	Other security
1 IDB2003	Y	Y	pay exercise price (PU)	N	PU & Guarantee	NIL
2 Hanco	N	N	NA	Y	Reserve acc & disposal	PoA to sell vehicles and charge on collection accounts
3 PG Municipal	N	N	NA	Y	Security	Charge on collection account
4 Gold Sukuk DMCC	Y	Y	Exercise PU	Silent. No stress test	PU, not dispose asset	NIL
5 IDB 2005	Y	Y	pay exercise price (PU)	N	PU & Liquidity facility	NIL
6 PCFC	Y	Y	Exercise PU & share pledge	Silent	PU & Share Pledge	Share Pledge
7 Rantau Abang	Y	No info	SU had restriction on disposal to third party	No info	All sums under PU are immediately due and payable in full	NIL
8 East Cameron	N	N	NA	Y	sell hydrocarbon and enforce security	Lien over asset, security interest in leasehold estate
9 ADIB	Y	Y	Exercise price and cannot dispose asset	N	PU	NIL
10 KL Sentral	Y	No info	Nothing specific	No info	Enforce security (include charge on land)	charge on project land, designated account and put option
11 DP World	Y	Y	Exercise price and cannot dispose asset	Silent	PU, not dispose asset	NIL

³¹ Source: (Mohamad Mokhtar & Abdullah, 2010 (forthcoming)).

4.4 No Due Diligence on Asset

There is usually no detailed due diligence conducted on the *şukūk* asset itself. We have discussed legal due diligence in the earlier section, so let us now focus on financial due diligence. To facilitate the discussion on this point, reference is made again to Table 3 above. The deals highlighted in red are actually deals that utilize purchase undertaking (PU) as part of the sources of payment to *şukūk*-holders. Furthermore, PU is the sole right upon occurrence of dissolution event, thus restricting the right of disposal over the *şukūk* asset.

As the PU takes away the asset risk (i.e. fluctuation in price of the asset) from the *şukūk*-holders, no detailed stress testing will be done on the asset to examine if the cash flow generated by the asset (or venture) will be sufficient to pay the *şukūk*-holders. Why is this so? The main reason for this is that the *şukūk*-holders will rely on the PU to sell the asset (or interest in the venture) back to the obligor at par. So whether the asset is sufficient to pay the *şukūk*-holders will become irrelevant.

This is the total opposite of the approach applied in the asset-backed *şukūk* (highlighted in blue). In these deals, PU was not used and the source of payment is limited to cash flow generated by the asset or venture. In other words, the recourse for the *şukūk*-holders is the asset itself and not the Originator. Also, there was right of disposal over the *şukūk* asset. Now the asset becomes really vital, as the *şukūk*-holders can only rely on this in case of default. Therefore, a very detailed due diligence was conducted on both aspects: the legal transferability of the asset and financial capacity of the asset to pay the *şukūk*-holders.

As discussed earlier, Hanco, as a case in point, has actually perfected the transfer to achieve true sale. The same approach was also used in the East Cameron Şukūk structure. Another example is PG Municipal Şukūk, which was structured in a slightly different way. The structure looks similar to a covered bond, as developed in the European market. Instead of true sale and perfecting the transfer, the cash flow to be generated from the venture (which manages and collects assessment tax in an industrial area in Johor) remained on the balance sheet of the obligor, but it was ring fenced for the purpose of paying the *şukūk*-holders. PG Municipal followed the due

diligence standard for asset-backed *ṣukūk* (i.e. securitization), with the exception that the asset remained on the balance sheet of the obligor. On the issue of financial capacity due diligence for the asset-backed *ṣukūk* deals, there was detailed tracking of how much cash flow could be generated. They would rely on collection history in the past and stress test these data. The information on the asset that is available in the term sheet ranges from about 10 pages (Hanco) to about 60 pages (East Cameron). Detailed information on cash flow generated, expenses and other relevant information will be available. The cash flow then will be subjected to stress testing (various assumptions on decline in revenue and increase in costs) to ensure that the cash flow is sufficient to pay the *ṣukūk*-holders. Compare this to Gold Sukuk DMCC, which had three pages of investment plan; a stark difference in the approach between asset-backed and asset-based *ṣukūk*.

Furthermore, based on our analysis (refer to Table 3), the asset-based *ṣukūk* (red category) did not create additional security for the *ṣukūk*-holders except PCFC. PCFC had in place a share pledge which the investors could enforce in cases of default. That is why for PCFC in the sole-right section and the enforcement section, the right was to exercise PU and enforce share pledge. Table 3 highlights the security in green. KL Sentral Sukuk Musharakah also created additional security on the land. One should note that the security gives the *ṣukūk*-holders the status of secured creditor. Why creditor? This is because PU creates indebtedness on the obligor if they fail to purchase the *ṣukūk*-holder's interest in the venture. To secure this indebtedness, the *ṣukūk*-holders can enforce the security (i.e. sell the shares or land) to get back the indebted amount. Nothing more will be taken if the collateral was worth more than the debt amount. On the other hand, if the proceeds from the collateral sales are not sufficient to pay the *ṣukūk*-holders, they have to wait in line with the unsecured creditors of the obligor, if there is a bankruptcy proceeding. Thus the deals highlighted in green represent the secured asset-based *ṣukūk*.

Asset-based *ṣukūk* are popular for one reason: they allow the obligor to raise unsecured funding; they don't have to part with their asset to get money. They can use the money raised for any purpose they want. The proceeds from *ṣukūk* don't necessarily go into any specific project. On each periodic distribution, the obligor

pays *sukūk*-holders using money from any of its operations (not necessarily from cash flow generated by the asset). If cash flow and periodic payment don't match, the obligor provides liquidity facility. At maturity, the obligor pays back the investor's capital. The obligor (in *sukūkijārah*) needs to provide an asset to facilitate the Sharī'ah requirement, but the asset never leaves their books.

On the contrary, in asset-backed *sukūk*, true sale from a legal perspective must take place, which will lead to an accounting de-recognition of the asset from the originator's books. In layman terms, this de-recognition means that the originator is no longer the asset owner; the *sukūk*-holders are. If we relate this to the capital adequacy requirement for banks, for example, Basel II says if a bank securitizes a pool of assets (and meets all the condition outlined) they do not have to provide capital against this asset. Why? Because they are not the owner of the asset anymore, and they are not exposed to the risks of the underlying asset once de-recognition takes place. The question is, are the issuers willing to part with their asset? Or do they still want to sit on their asset and raise unsecured funding?

Next, let's look into investors' demand. Let's be mature and ask: are investors truly willing to take asset risk, or are they actually looking for purely credit risk? The reality of the current market is that *sukūk*-holders do not want asset risk. They want to be like bondholders and have purely credit risk. They provide capital, and at maturity they expect to get back their capital with their periodic return. However, when problems arise, they demand to seize the asset. Related to this point, we need to see if the court will agree in their judgements with what the documents say, i.e. asset-based *sukūk*-holders are unsecured creditors, or if they will declare *sukūk*-holders to be the owners of the asset. Why is this important? If *sukūk*-holders are the owners of the asset, they are exposed to asset risk. This means if the asset that they repossess from the obligor is not sufficient to repay their investment, they cannot chase the obligor for "unpaid investments". Are the investors ready for this, and is this what they want? Recall that, in asset-based *sukūk*, no detailed due diligence is conducted on the capability of the asset value to repay the *sukūk*-holders. Thus, if the court rules that the *sukūk*-holders are the owners of the asset, and the value is not sufficient, they will be surprised by the hit they will be required to take.

By contrast, financial due diligence is critical in asset-backed *ṣukūk*. That is why detailed due diligence is conducted on the asset prior to entering into the deal. The asset (and all reserves) will be the only recourse in defaults. If the trustee sold the asset (in asset-backed *ṣukūk*) and does not have enough money to repay the investors, they cannot chase the originator because the recourse is to the asset and to the originator. If the asset is not sufficient, then the investors must take the hit. Besides investor protection, we see asset-backed *ṣukūk* giving more transparency. Investors understand what risks they are taking and make an informed decision. However not all investors will want this risk. Let's take an example: the aircraft business. Can all corporations understand the risks that arise in that business? Since they don't, some investors will be reluctant to buy into these instruments.

5. CONCLUSION

In conclusion, we can see from the analysis above that there are many contentious Sharī'ah issues arising in asset-based *ṣukūk*. Restriction of the right of disposal poses a serious doubt whether asset-based *ṣukūk* structures truly comply with Sharī'ah principles. Furthermore, the coupling of this restriction of disposal with the purchase undertaking at par effectively turns *ṣukūk* into a debt instrument. With the exception of sale-based *ṣukūk*, the lease-based and equity-based *ṣukūk*-holders should be the owners of the underlying asset. However PU at par takes away any risk of loss to these *ṣukūk*-holders. It allows the *ṣukūk*-holders to enjoy guaranteed capital and guaranteed return.

We can therefore say that asset-backed *ṣukūk* clearly fulfill the Sharī'ah requirement and dispel all the contentious fundamental issues above. Hence, there is a need to move towards more asset-backed *ṣukūk* in the market. In our opinion, the Sharī'ah scholars will be the main driving factor that will determine the growth of asset-backed *ṣukūk*. If the scholars say that the Sharī'ah requirement and the legal status of the *ṣukūk*-holders must match, it will drive more issuance of asset-backed *ṣukūk*, simply because it is the rule of the game in the Islamic space. Issuers who want to raise funding must be ready to part with their asset, and investors who want to invest in

ṣukūk must be ready to take asset risk. However, this approach will have the effect of focusing only on a niche market. Bankers would say this is restricting their business, and it's a point that the scholars will need to consider. Issuers will complain that they are not able to raise unsecured funding. How to manage this issue? We believe all the stakeholders in the *ṣukūk* market need to come together and thoroughly discuss the future of the *ṣukūk* market. If we want to move away from asset-based to asset-backed *ṣukūk*, we have to analyze the legal framework in markets where *ṣukūk* are active and develop it. We have to figure out collectively how to make this transition in a systematic manner. There are no easy answers to all these questions. What is needed is a consultative processes and continuous improvement on the regulatory framework for securitization.

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ISRA الأkademya العالمyة للبحوث الشرعyة
International Shari'ah Research Academy for Islamic Finance

International Shari'ah Research Academy for Islamic Finance
ISRA @INCEIF (718736-K)
2nd Floor Annexe Block,
Menara Tun Razak,
Jalan Raja Laut,
50350 Kuala Lumpur,
Malaysia

Tel : +603 2781 4000
Fax : +603 2692 4092
Email : info@isra.my