Regulatory and Financial Implications of Sukuk's Legal Challenges for Sustainable Sukuk Development in Islamic Capital Market[1]

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This discursive research paper is appraising issues pertaining to legal compatibility of sukuk in the heart of Islamic finance. Sukuk serve a powerful tool for Islamic financial institutions to mobilise funds from the Islamic capital market, and to extend financing through Islamic capital market operations. In Shari'a values, sukuk have to represent the ownership of either underlying assets or usufructs or services of the business entity based on asset securitisation concepts, where the return is justified by risk taking coupled with risk mitigation principles. Nevertheless, the present state of sukuk practises is detached from its ideal values because to some extent a western legal framework is not supportive enough for sukuk operations in the Islamic capital market to comply with Shari'a values. As a result, the structure of sukuk is heavily influenced by conventional bonds practises governed by the western legal framework. Due to that fact, in this research, sukuk structures are scrutinised to examine legal impediments inherent in sukuk contract. This research portrays that western legal system is not supportive enough for sukuk to protect the rights of sukuk holders in the event of sukuk defaults. Regulatory and financial implications are suggested as anticipations to any future sukuk defaults. The objective of this research paper is to sustain sukuk development in the Islamic capital market, where Shari'a and western legal framework can be in a harmony to govern sukuk operations.

Keywords: *sukuk*, Islamic capital market, legal challenges, *Shari'a*, western legal framework.

1. Introduction

1.1 Research Background

The development of the Islamic capital market ('ICM') is crucial for sustainable development of Islamic finance. ICM has a long term objective to mobilise and allocate resources in an effective and efficient manner. This long term objective can be achieved through a real sector development financing. In another dimension, ICM is the avenue for liquidity management of the Islamic financial industry through Islamic money market operations. Liquidity management is pivotal aspect for ICM in the short run because it is one of parameters for ensuring the long-run survival of Islamic financial institutions ('IFIs') in the financial market arena. Thus, the development of innovative, *shari'a* compliant ICM products is urgently needed for realising the existence of vibrant and efficient ICM. In this regard, *sukuk*, which are Islamic debt instruments in ICM, play an important role for smoothing liquidity and resource mobilisation in ICM. Besides, *sukuk* are potential financing instrument for contributing country's economic growth through real sector development initiatives. *Sukuk* plural; singular *sak* are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI') as "certificates of equal value representing undivided shares (in ownership of) tangible assets, usufruct, and services or (in

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the ownership of) the assets of particular projects or special investment activity" (AAOIFI 2008, p.307).

Sukuk are indeed promising as a *shari'a* compliant financing instrument. Total *sukuk* issuance amounts to US$ 236.75 billion as per June 2011 with Malaysia still champions the *sukuk* issuance[3]. This big number of *sukuk* issuance can be supported by the fact that western countries such as the United Kingdom and United States have jumped on the bandwagon for issuing *sukuk* as indicated by the UK's consideration of *sukuk* for government financing, and the issuance of *sukuk* by General Electric and East Cameron Gas in the US.

Based on Islamic Finance Information Services ('IIFS') statistic database of *sukuk*, *sukuk* issuance experienced an impressive growth from 2005 to 2006, increasing by 134% with the total *sukuk* issuance amounting US$ 26 million. *Sukuk* issuance peaked at US$46 million in 2007 but substantially declined by 64% to US$17 million in 2008. There are several factors that can explain the substantial decline of *sukuk* issuance, including global financial crisis, dry liquidity, widening credit spreads, and investor's wait--and--see attitude (Damak *et al*, 2009). Although *sukuk* were badly hit in 2008, they are indeed a promising ICM's instrument (IFIS, 2009). One reflection of this is the *sukuk* rebound throughout 2009 brought mainly by sovereign and quasi-sovereign *sukuk* issuances. These included the US$1.4 billion *sukuk* issuance of Terengganu Investment Authority in Malaysia, US$487.2 million retail *sukuk* issuance of government of Indonesia, plus *sukuk* from the Dubai government, the Islamic Development Bank (IDB), and so forth (Zawya *Sukuk* Intelligence, 2010).

Sukuk declined by 15% in 2010, which indicates that there was low confidence in *sukuk* market. This can be explained that there have been 21 *sukuk* defaults recently in Islamic capital market space as reported by Khnifer (2010), with Nakheel *sukuk* and East Cameron Gas *sukuk* are the most controversial one. These *sukuk* defaults pose severe legal risks of *sukuk* inherent in the *sukuk* contract. Specifically, the risk emanating from *sukuk* contract's enforceability whereby whether or not the *sukuk* can be enforced in order to protect the rights of *sukuk* holders in the event of *sukuk* defaults. As a matter of fact, legal conflicts are persistently occurring in the court due to *sukuk* defaults cases with the adverse impacts on legal rights, and even financial rights of the *sukuk* holders. Therefore, in this article, the issues surrounding enforceability of *sukuk* contract are discussed as an attempt to give possible legal and financial mitigations as solutions to the problem of *sukuk*'s legal challenges in Islamic capital market. At the end, it is expected that legal and financial rights of the *sukuk* holders can be fully protected.

1.2 Research Objectives & Questions

This research has four main objectives, which are as follows:

1. Appraising legal issues at stake in present *sukuk* structures,
2. As precautionary measures for Islamic finance key players regarding the importance of legal protection for *sukuk* structuring,
3. Presenting regulatory and financial implications for the ideal *sukuk* development in the ICM given the legal issues of present state of *sukuk* structures, and
4. As a way to obtain holistic approaches from academia and practitioners point of views to tackle unresolved legal challenges of *sukuk*.

[3] The data is retrieved from combination 2 databases: Islamic Finance Information Services (IIFS) and Zawya Sukuk Monitor.

In order to achieve the stated research objectives, there are three important questions that need to be answered in this research, which are as follows:

1. What is the present state of *sukuk* structures?
2. What are the salient legal issues that come to bear on *sukuk* structures?
3. What are the regulatory and financial implications for ideal future *sukuk* development in the ICM?

1.3 Significance and Scope of Research

There have not been much discussions going on to appraise legal aspects of *sukuk* with the fact that there are *sukuk* legal default cases in ICM. So far, the legal aspect of *sukuk*, which are heavily discussed in literatures and conferences, only pertains to *Shari'a* compatibility of *sukuk* structures, but not taking consideration into *sukuk*'s legal issues. Amongst others, the research that discusses *Shari'a* compatibility of *sukuk* structure are Rosly and Sanusi (1999) with critical evaluation of the application of *bay al-inah* and *bay al-dayn* contracts for *sukuk* issuance in Malaysia, Al-Amine (2001) with critics for the interest rate benchmarking and guarantee features in *sukuk* operation, and Usmani (2008) with critics over current *sukuk* mechanism on asset ownership, guarantee, and *sukuk's* pricing benchmarks. For the recent research, Dusuki & Mokhtar (2010) criticise asset ownership in current *sukuk* mechanisms, and Al-Jarhi & Abozaid (2010) discuss *Shari'a* issues of current *sukuk* structure in a paper presented this year to the OIC *fiqh* academy conference.

However, in light of *sukuk* legal defaults occurring in ICM, so far there has been only one research paper discussed by Salah (2010) in reference to Nakheel's *sukuk* defaults. But, still more research paper is needed to find out solutions for *sukuk*'s legal challenges since legal aspect is one of important ingredients in *sukuk* issuance packaging that makes *sukuk* attractive to the investors. Hence, this research paper will contribute by scrutinising legal problems inherent in current *sukuk* structures with the expectation that there will be significant efforts in improving the status quo of western legal systems to cater the needs of *sukuk* operations in ICM.

The scope of this research is limited to theoretical research with secondary source data from relevant literatures or journals. Field work research to collect primary data, such as interviews, or questionnaires, cannot be conducted for this research due to time and resources constraints.

1.4 Research Outline

This research study is organised in a following manner. In the next section, the present state of *sukuk* will be scrutinised in light of recent debates and innovation of current *sukuk* structure. Section 3 is appraisal of the legal issues of *sukuk.* After appraising legal problems of *sukuk*, chapter 4 discusses regulatory and financial implications in the ICM arising from those legal issues. Finally, chapter 5 ends up this research paper with a conclusion.

2. *Sukuk* Practises in Islamic Capital Market

Sukuk structures have evolved from their basic structures through attempts to innovate on *sukuk* so as to gain popularity in financial markets. Nevertheless, not all *sukuk* innovation is positive, as signified by the failure of *sukuk* to become a *shari'a* compliant financing instrument and alternative to conventional bonds after being tested by the Islamic financial industry.

2.1 Types of *Sukuk*

Since *sukuk* can be structured in numerous ways, proper classification of *sukuk* is crucially important for issuers to determine the aim of *sukuk* structures, as well as the nature of *sukuk* structures. AAOIFI (2008) has classified *sukuk* investments in its *shari'a* standards, which are *ijarah* certificates (leased assets), *ijarah* certificates (ownership of usufructs of existing assets, described future assets, specified party, and described future services), *salam* (purchasing goods to be delivered in the future) certificates, *istisna'* (manufacturing/production of goods) certificates, *murabaha* (purchasing goods) certificates, *musharakah* certificates (participation, *mudharaba*, and investment agency *sukuk*), *muzara'a* (sharecropping) certificates, *musaqa* (irrigation) certificates, and *mugharasa* (agricultural) certificates. *Ijarah* and *musharakah sukuk* are predominant *sukuk* structures prevalent in the Islamic capital market. Other than the *sukuk* classified by AAOIFI, Tariq & Dar (2007) have a list of the modified types of *sukuk*, which is as follows:

1. **Hybrid/Pooled Certificates**
   These are certificates based on an underlying pool of assets, including *istisna'*, *murabahah* receivables, and *ijarah* with the condition that at least 51 percent of the pool comprises *ijarah* assets. The return on these certificates can only be a pre-determined fixed return.
2. **Variable Rate Redeemable Certificate**
   This type of *sukuk* can be called alternative *sukuk* due to its seniority to issuer's equity, their redeeming nature and their relative stable rate as compared to dividend payouts. The return on these *sukuk* is benchmarked to market references, such as LIBOR.
3. **Fixed-Rate-Zero-Coupon Certificate**
   These certificates are non-tradable certificates based on an underlying pool of assets, primarily *istisna'* or *salam* that would create debt obligations.

2.2 *Sukuk* versus Conventional Bonds

It is imperative to differentiate between the basic tenets of bond and *sukuk* operations. Bonds are financial obligations, in form of certificates, issued by borrowers to creditors. Bonds have guarantee features in which creditors guarantee capital repayment with capital charge to the borrowers. The prime objective of bonds is to gear up the issuer's leverage through a loan relationship. That loan relationship implies a contract with the characteristic of earning money on money, which is the practise known as *riba* and prohibited in Islam (Adam & Thomas, 2004). Bonds are very liquid in nature, as they can be easily traded in secondary markets in case the bondholders need liquidity. Bond's risks are highly concentrated on credit risk of the issuer.

In contrast, *sukuk* represents asset ownership passed from the issuer to *sukuk* holders in form of *shari'a* compliant contracts such as lease, partnership, or sale contract, which originate from trade and business activities. The return can be either derived from profits of real underlying assets attached to *sukuk* or from sales, lease or partnership of business ventures, which characterises *sukuk* as an asset-backed financing instrument. It is important to note that *sukuk* are not always debt instruments, but sometimes equity instruments, depending on how they are structured. The risks of *sukuk* are broader than conventional fixed income instruments in that they involve not only credit risk, but also market risk, asset-quality risk, regulatory risk, and so forth (Zaidi, 2009).

Under current practises, *sukuk* are aimed at having structure similar to conventional bonds in spite of different characteristics and modus operandi between *sukuk* and conventional bonds. According to Miller *et al* (2007), *su*kuk ensure returns similar to conventional bonds, while the difference is that the return of *sukuk* is generated from the underlying real asset ownership, not interest payments obligation as found in conventional bonds. This is similar to Wilson‘s (2008) argument that replicating *sukuk* to be identical to conventional bonds has been attempted by financiers because the financiers' aim is simplifying risk assessment for this new asset class of investments.

In the Malaysian experience, asset-backed *sukuk* have been structured in such a way that the receivables attached in the *sukuk*'s underlying assets can be traded in the market, as with the Time Engineering *musharakah* asset-backed *sukuk*. In that case, *sukuk* is structured to acquire the receivables generated by Time System Integrator (Mokhtar & Thomas, 2009). Furthermore, the rating proxies' treatment of *sukuk* is exactly the same as conventional bonds as shown by the research conducted by Siswantoro (2006). He finds that revenue income of the coupon payments stream is attached to the whole company (obligor), not the specific project undertaken by the company. Hence, those facts indicate that the current structure of *sukuk* show indifference of economic outcomes of conventional bonds and adjusts well to modern western capital market technique, which characterises asset-based *sukuk*.

2.3 Asset Backed *Sukuk* versus Asset Based *Sukuk*

According to IFSB guidelines (2005) No. 2, *sukuk* are ideally categorised as asset-based and equity-based instruments whereby the former offers fair and predictable return, such as in the case of *salam*, *istisna'*, and *ijarah* whilst the latter the return is derived from profit-loss sharing of joint venture business, which offers unpredictable return, based on *musharakah* or *mudharabah* contracts. Since there are deviations in the actual implementations of *sukuk* from ideal theoretical ground of *sukuk*, there has been a concern to categorise *sukuk* in order to differentiate genuine and non-genuine ones, particularly risk factors and sale execution. In this regard, the guidelines of *IFSB 7-Capital Adequacy Requirement for sukuk, Securitisations, and Real Estate Investments* (2009) distinguish three types of *sukuk* structures: Asset-Backed *sukuk* ('ABS') and two non-ABS structures, which are pay-through and pass-through structures.

According to these particular guidelines, ABS are "structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies)" (p.3). Based on this guideline, there are two factors that constitute ABS. Firstly, in the case of any impairment of the *sukuk*'s assets, the *sukuk* holders have to face the loss. Secondly, the risk factor of ABS is the underlying assets of *sukuk*. Therefore, *sukuk* holders derive the risk and return from the cash flows of the *sukuk*'s underlying asset as well as have recourse to the *sukuk* asset, not the issuer, in case of default of *sukuk* issuer. True sale execution is another dimension of ABS in which there is a real transfer of assets from the originators to *sukuk* holders with the effect of releasing assets from the issuer's balance sheet to investors (Ahmed, 2010). Therefore, ABS issuance must be backed by real assets that represent the *sukuk*'s ownership as well as risks attached to the assets.

In contrast, with asset-based *sukuk*, there is no true sale transaction taking place, rather one sees just transfer of financial rights to the asset and the income is derived from the financial rights to obligations attached to the debt (Aziz & Gintzburger, 2010, p.276). True sale transaction is absent since the *sukuk* holders have recourse to the originator instead of the underlying assets in the event of defaults. This is based on pay-through and pass-through as defined in IFSB-7 (2009) guidelines, in which the former constitutes recourse to the originator via purchase undertaking whilst the latter constitutes recourse to the issuer via guarantee. Therefore, the risk and return of asset-based *sukuk* are derived from the obligor instead of the *sukuk*'s underlying assets, so that in case of defaults, investors have recourse to the obligor and secured creditors cannot recourse the asset. The risks are measured solely on the issuer or obligor's creditworthiness to pay back the capital. Thus, it is not surprising that investors are mainly focused on sovereign/corporate credit quality and less concerned on the actual underlying asset performance when they buy sovereign *sukuk* (Hales, 2005). In this regard, *sukuk* holders are guaranteed to get the capital back in the event of bankruptcy. Furthermore, in asset-based *sukuk*, the structures are merely fulfilling the form of a contract with much more complexity, which ultimately leads to Islamic equivalent of unsecured conventional bond (Howladar, 2009). Hence, *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked *pari passu* with other unsecured creditors (Haneef, 2009).

2.4 Islamic Securitisation vis-à-vis Asset Backed Sukuk

In a conventional framework, asset securitisation refers to "the process and the result of issuing certificates of ownership as a pledge against cash flow streams of diversified pool of assets (assets portfolio) to investors" (Jobst, 2007, p.14). This asset securitisation proposes an alternative for capital market-based refinancing mechanism to diversify external sources of asset funding instead of intermediated debt finance based with a special emphasis on the risk assessment of securitised assets (Jobst, 2006). True sale, bankruptcy remoteness, and enforceability of assets are essential prerequisites for asset securitisation. Effective risk management and capital enhancement are great advantages of asset securitisation, since there are lower costs and risks emanating from asset securitisation than contractual loan relationships (Shaenker & Colletta, 1991; Dvorak, 2002). Asset securitisation is highly exposed towards interest rate risks, since receivables associated to securitised assets are valued by interest rate discounting. Mortgage Backed Securities ('MBS') is one of examples of asset backed security, in which a pool of receivables of home buyers is securitised through intermediary institutions, such as Fannie Mae or Freddy Mac in US, and Cagamas in Malaysia. The risks of asset securitisation can be commoditised in a way that the risks can be detached from the assets to trade the risks in the market through irresponsible derivatives instruments, such as Credit Default Swaps ('CDS') instrument. CDS transfers the risk of default from the fixed income security holder to the swap seller.

To a certain extent, conventional asset securitisation is in line with Islamic securitisation. Both of these types of securitisation have similar prerequisites, processes, and advantages. Nevertheless, due to *shari'a* restrictions, Islamic securitisation has distinctive features that distinguish it from asset securitisation. Following the spirit of *shari'a*, Islamic securitisation must be free from three prohibited practises, which are *riba*, *gharar*, and *maysir*. Thus, anything leading to these practises is not tolerated such as debt and financial assets trading (*bai al-dayn*), *haram* activities, interest bearing collateral, and so forth. Furthermore, Islamic securitisation must involve the funding or the production of real assets rather than financial securities, which causes irresponsible leverage as well as speculation, through derivatives lending (Wilson, 2004). Jobst (2007) points out four important conditions for Islamic securitisation to take, which are as follows:

1. Investor's asset ownership conferment through direct business participation,
2. Real purpose for securitisation through identification of productive securitised assets,
3. Unconditional and unsecured payment obligation (non-guarantee promissory notes),
4. Risk-pooling spirit whereby the risks and rewards are shared among market participants in the Islamic financial market

Thus, based on those four conditions, Islamic securitisation has the risk-reward sharing spirit and places a paramount importance on the real economy through undertaking real project activities.

Islamic securitisation is in line with asset-backed *sukuk* structures whereby the true sale transaction is taking place between the *sukuk* holders and the *sukuk* issuer. Besides, the return of securitised assets is derived from real activities, and the *sukuk* holders can legally enforce the securitised assets in the event of defaults. But, under current practises the *sukuk* structures, as asset-based *sukuk* is dominant structures in the ICM, unfortunately there is no such an Islamic securitisation in *sukuk* structuring. Thus, this poses major legal problems in the event of *sukuk*'s legal defaults where the *sukuk* holders cannot recourse to the securitised assets.

3. Legal Challenges of Sukuk Development in Islamic Capital Market

3.1 Legal Infrastructure of *Sukuk* in Various Jurisdictions

Sukuk legal development is varied across countries operating Islamic finance, but the status of development is a major determinant of the success of *sukuk*. From an Indonesian perspective, the legal basis for *sukuk* development is not sufficient, because the legal basis for Islamic financial development as a whole still relies on conventional banking laws and regulations. With regard to *sukuk* development, the existence of the asset securitisation law in Indonesia is not in line with *shari'a* dictates, wherein the draft of the asset securitisation law clearly states that securitisation can only be structured through debt (Djojosugito, 2007). Meanwhile, in Malaysia, which is the most active Islamic capital market, has robust regulatory standards as framed by their Securities Commission ('SC').

From a British legal perspective, *sukuk* instruments apparently fall under the definition of a Collective Investment Scheme ('CIS') as pursuant to the Financial Services and Markets Act (FSMA 2000). If *sukuk* were treated in the same way as CIS, *sukuk* issuers would be subject to a wider range of controls, and may need to be authorised. Such authorisation would entail limits on the range of assets eligible for investments, gearing and marketing purposes. Hence, this would arguably put *sukuk* issuers at a disadvantage compared to issuers of conventional debt securities.

The legal perspective of the US, however, is very helpful for facilitating *sukuk* issuance by upholding its true value as project financing for real activities. *Sukuk* are regulated in such a way that *sukuk* are structured through U.S traditional private-placement.[4] The Securities Act, Section 4 (2) exempts "transactions by an issuer not involving any public offering," which indicates that the investors in the private placement market are not typical investors who need the protection of the registration provisions of the Securities Act, since the investors have the ability to make an informed decision and bear the economic risk of the specified investment (Khaleq &Young, 2007). This Securities Act is supported by Rule 144A in which full due-

[4] Private placement refers to secured long-term financing provided directly by a limited number of big investors such as big investment banks, insurance companies, and mutual funds (Ross et al, 2008).

diligence over the issuer must be conducted and receive disclosure on the prospectus from the US Securities Council within US disclosure standards and Management's Discussion and Analysis, Financial Condition Results of Operation ('MD&A').

Furthermore, Regulation S and Regulation D are interrelated to facilitate international secured financing through private placement in US (Shenker & Colletta, 1991). This can be seen in the *sukuk* issued by East Cameron Gas in the US through private placement, whereby there was a proper due-diligence conducted over the project—oil drilling— along with risk management mechanisms for project's anticipated risks. Hence, US federal securities law provides an impetus for *sukuk* development towards the true value, even though US federal securities law treats *sukuk* in similar fashion with conventional bonds.

3.2 Enforceability of *Sukuk* Contracts

3.2.1 Dispute between Western Law and *Shari'a*

Before assessing issues surrounding the enforceability of *sukuk*, it is imperative to portray the kind of conflicts happening in the sphere of Islamic finance due to dual law system that governs transactions.

English common law and civil law each present distinctive problems when they collide with *shari'a*. The problem in using *shari'a* finance under common law jurisdiction is the conflict that emerges between *shari'a* law and common law; the national law/common law always prevails over *shari'a* law when there are disputes. As a consequence, the contract is interpreted solely based on what is written in the contract in respect to *shari'a* regulations. This can be seen in the case of Shamil Islamic Bank of Bahrain VS Pharmaceutical Company, as explained by Potter (2004). In that case, the defendant was not able to make payment for his financing to the bank, and the court judged based on English law instead of Islamic law. The defendants argued that the contract was so worded with *Shari'a* principles as not to clash with English law. However, the judge ruled that there cannot be two separate law systems governing a contract, and that the national system is the valid law to govern the contract based on Roman conventions which have force in the British law system. The conflict between common law and *shari'a* leads to idiosyncrasies, such as that verdict which was decided based on sale contract law, while the substance of the contract was actually a conventional debt contract. Therefore, confusion emerged as to the legal basis of the verdict.

On the side of civil law, one sees a lack of predictability, transparency, and consistency. Full codification of law, which is needed for predictability, is not implemented in the countries under civil law regimes. The problems posed by civil law can be witnessed in the recent *Nakheel Sukuk* case, in which there was confusion over which law should be adopted when *Nakheel* declared itself in a state of default. Because the *Nakheel* offering circular was governed with English common law while the *sukuk* transactions took place in a civil law jurisdiction, there was a conflict when the investors sued *Nakheel* for capital repayment in Dubai's civil court. The investors could sue in English courts as well as in the United Arab Emirates, the seven-member federation that includes Dubai. Nevertheless, even if they win and the court orders seizure of the assets, the foreign law ownership as well as *sukuk* agreement cast doubts over whether the law is enforceable in the UAE (Kasolowsky & Abocar, December 2009). Consequently, the investors' rights are restricted from what was promised in the offering circular. Therefore, this indicates that civil law is not yet predictable and flexible enough to be enforced in governing jurisdiction.

With respect to *sukuk* structures in jurisdictions where *shari'a* concepts are followed, this is, to a certain degree, more straightforward from a legal perspective, although the process does compose more layers since it requires compliance with *shari'a* as well as local law (Khaleq & Richardson, 2007). Realising that in most of *sukuk* issuances that there are cross-border transactions, there is a problem with which law would be enforced. This enforceability issue causes legal impediments due to the inability to obtain satisfactory legal opinions, which emanate from the sales of assets between the originator and investors through the SPV, and also due to various bankruptcy law matters (McMillen, 2007). Hence, there is a confusion about which law can be enforced and to what extent that law can be enforced in *sukuk* issuance.

3.2.2 True Sale Execution

Executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV. Nevertheless, some *sukuk* issuances do not execute a true sale, as with asset-based *sukuk* issuance, due to the absence of property law and bankruptcy law under civil law regimes. This again was reflected in the *Nakheel Sukuk* case wherein leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE as applicable in the Emirate of Dubai (Salah, 2010, p.10). Instead, the rights were viewed as unregistered personal contractual rights binding the parties as opposed to rights to the land in question (Silkenet *et al*, 2009). Similarly, in Indonesia, the concept of beneficiary rights has not been recognised for sovereign *sukuk* issuance, as state assets needed for government operational activities cannot be transferred to third parties and must be subject to the approval of a government body (Guritno & Oktavinanda, August, 2008). This indicates that the civil law indeed impedes the undertaking of true sales that would be enforceable in *sukuk* issuance.

3.2.3 Bankruptcy

Bankruptcy law is crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed securities, even in cases of the originator's bankruptcy (Schwarchz, 1995, p.151). So far in some countries under civil law regime, especially Middle East region, there has not yet emerged a proper bankruptcy law to protect *sukuk* holders from bankruptcy on the part of the *sukuk* originator. Taking example of the bankruptcy law of UAE, bankruptcy governed in Commercial Companies Law, Federal Law No.8 of 1994 does not have a specific definition of bankruptcy. The Law only shows the situation where a 'Trader' will be regarded as a bankrupt in the event of insolvency, as governed in Article 645 of the Law. In pursuant to Article 4 of the Law a trader is defined as being an individual or company that carries out commercial activities. The Law unfortunately does not have specific recognition of the term that describes the situation where shareholders have limited liability, as in the case of common law jurisdiction (Gulf News Report, January 2009). On the side of common law jurisdiction and some countries under civil law jurisdiction such as Indonesia and Netherlands, the bankruptcy law is codified in the specific law. Besides, the law has clearer administrative procedures to deal with bankruptcy entity.

Due to lack of codification of bankruptcy law under civil law regime in Middle East region, the transaction is not a true sale, but a secured disguised loan in a true sale. This originates from the suspicious type of financing occurring persistently between the originator and the trustee. Thus, in case of bankruptcy, the court follows the legal precedent that the financing is a transfer of collateral because of the presence of recourse to the originator (Lupica, 1998). Nakheel *sukuk* default is precisely the example of legal uncertainties in UAE where the *sukuk* holders' rights to claw back the assets are not protected when Nakheel declared its bankruptcy. Due to that fact, this is a warning for asset-based *sukuk* issuance in which the *sukuk* are issued in reflection of a secured collateralised loan. Hence, this means that the enforceability of the law in the court will be exactly the same between *sukuk* and secured collateralised loan.

3.2.4 SPV

An SPV is a bankruptcy remote firm, which is independent from the obligor. The SPV is established based on the trust law in which the *sukuk*'s originator as the transferor transfers the assets to the *sukuk* holders as beneficiaries via the SPV as a trustee with a good faith. Therefore, trust law plays an important role in governing the SPV's establishment. Trust law has been well incorporated into both common and civil law jurisdictions; Dubai and Bahrain have already incorporated trust law in their legal systems. This trust law recognises the equity for remedies and rights in which beneficiaries are provided with equitable treatment remedies against unfaithful acts. Within common law treatment, the legal rights of the trustee are bounded by the legal rights of beneficiaries. In contrast, under civil law treatment, the beneficiaries have no rights or control towards the assets managed by trustee (Hansmann & Mattei, 1998). Hence, civil law treatment entails a problem for *sukuk* issuance that originates from civil law jurisdiction countries. In those cases, in the event of default, the *sukuk* holders do not have recourse to the asset due to civil law restrictions, and therefore those *sukuk* are characterised as asset-based *sukuk*.

In *sukuk* issuance, usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). This can be seen in the *Tamweel sukuk* issuance in which the SPV was located in the Cayman Islands—far from Dubai, the originator's country. However, this typical offshore SPV leads to a problem whereby there is no uniform law, insofar as the off-shore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs (Frankell, 1998). Indeed, there is a significant legal unpredictability governing *sukuk* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the United Kingdom, there can be additional impediments arising from those foreign judgements' enforceability in those foreign jurisdictions where there is an absence of bilateral treaties for reciprocal enforcement of judgments (Ryan & Elmalki, January, 2010). Therefore, this issue leads to weakness on the part of the local court or legislation as well as legal confusion with respect to certain laws' enforceability in case the issuer defaults.

4. Regulatory and Financial Implications of Sukuk's Legal Challenges

4.1 Regulatory Implications

4.1.1 Role of Rating Agency

It is an inevitable fact that when investors purchase *sukuk*, they are interested in the risk related to the issuer instead of the underlying assets or project undertaken due to prevalence of asset-based *sukuk*. This is happening because the methodology used by rating agencies for *sukuk* rating is similar with conventional bond ratings, since no independent *sukuk* rating agency has yet formed. In this regard, since the very essence of *sukuk* is project financing backed by real assets, rating agencies should shift the paradigm of *sukuk* rating whereby the risk's proxy is based on the feasibility and prudential evaluation of the assets instead of the originator's risks. Furthermore, compliance with *shari'a* as well as legal uncertainties are important proxies to be incorporated in *sukuk* rating methodology, particularly regarding how the *sukuk* issuance can protect the investors and also resolve the legal conflicts in the event of bankruptcy. It is important also for rating agencies to give assurances to investors through information notification regarding the underlying asset's quality, so that they can make informed decisions (Zaidi, 2009).

4.1.2 Standardisation of *Sukuk*

Since there are legal uncertainties and conflicts arising from *sukuk* transactions as well as *Shari'a* divergences, *sukuk* need to be standardised and streamlined in terms of legal documentation and *shari'a* standards. AAOIFI *shari'a* standards for *sukuk* have been set properly, but the problem is that the standards are not binding among key players in the Islamic financial industry. Therefore, enforcement of the standards is critical at the moment for having *shari'a* compliant *sukuk* in the market. Besides, there should be uniformity of law for offshore jurisdiction as well as the methods to resolve the conflict of legal systems that applies to all *sukuk* issuance across all jurisdictions. The goal would be that, in a case of default, the case could be resolved in pursuant to a standardised legal documentation. Hence, there would be predictability, certainties and *shari'a* convergence through *sukuk* standardisation.

4.2 Financial Implications

4.2.1 *Sukuk* Feasibility Analysis

Since one must undertake a true sale undertaking as well as have full ownership of the assets, usufructs, or projects in a *sukuk* transaction, it is important that *sukuk* are structured in a manner backed by an identified of portfolio of high quality assets, which is in line with asset securitisation, and prospective projects (Dusuki & Mokhtar, 2010). Hence, the value of the identified portfolio of assets and project must represent the market value of the *sukuk* issuance in order to ensure that there are genuine interests over the portfolio of assets or a project. In this regard, at the initial *sukuk* structuring stage, it is vital for the *sukuk*'s lead arrangers, which are Islamic investment banks in most cases of *sukuk* issuance, to exercise careful due diligence over identified assets through scenario analysis (both best and worst scenarios), as well as stress-testing analysis where the asset performances in different financial situations over the *sukuk*'s tenure are evaluated. In addition, an on-site visit is required to look over the identified portfolio of assets and whether or not the assets are in existence and productive enough to generate positive cash flows. If, after thorough due diligence analysis over asset and an on-site visit, the identified of portfolio of assets are deemed to be high quality and productive assets, then the *sukuk* issuance can proceed. Consequently, positive cash flows are ensured for the investors along with the risks arising from a portfolio of underlying assets.

With regard to project identification, *sukuk* must be structured in a way that *sukuk* structures provide linkage of the identified project's risks to the *sukuk* holders. This can be seen in *Tamweel Sukuk* where there were risks borne by the *sukuk* holders over the property development project since the periodic rental payment is from a third party lessee. There must be a proper feasibility analysis over the investment project's plan, wherein the location of the project is identified. A scale model of project is also needed for conducting feasibility analysis. Realising that there are different sectors of industry, such as oil and gas, property development, pharmaceuticals, and so forth, industry analysis over the investment project plan is also required to assess the position of the sector in comparison with other sectors as well as the industry's risk assessment within current and projected economic conditions. If the project is deemed to have bright prospects in which the project would generate positive returns in the future, then the investment project should be undertaken. This project *sukuk* financing is actually a long-term investment asset class. Therefore, the investors are no longer interested in the issuers' risks rather than the asset's risks, with the consequence of no guarantee and the investors easily have recourse over the assets in the event of default since the investors have legal ownership. There must be a proper and simple disclosure of the risk assessment and the nature of assets and project risk profile to the investors at the first *sukuk* offering, so that investors can make an informed investment decision based on the underlying risks in the *sukuk* issuance.

This actually has a good implication for looking at alternatives for s*ukuk* pricing, as *sukuk* are currently priced at LIBOR. Due to the fact that the *sukuk* holders bear the risks of the identified portfolio of assets and the projects, the periodic payment of *sukuk* to the *sukuk* holders is positive cash flow derived from the underlying assets in proportion with the number of *sukuk* holders. So, for *sukuk ijarah*, the cash flows are derived from rental payment of underlying assets leased to the third party lessee. For the project financing, the payment is from rental proceeds once the project is developed in a case of *sukuk ijarah mausuf bi al-zimmah*. Hence, the ideal pricing for a given *sukuk* is derived from the real underlying assets or projects rather than current interest rates, and this pricing mechanism is actually in line with Islamic economic objectives.

4.2.2 *Shari'a* Compliant Financial Innovations of Sukuk

Possible *Shari'a* compliant financial innovations can be suggested in order to give the financial protection to the *sukuk* holders from the legal uncertainties. As suggested by Khnifer (2010), there are three ways for suggesting so. Firstly, *sukuk* maturity extension whereby the *sukuk* contract is extended until the issuer's legal dispute is resolved by imposing legal compensations in *sukuk* documentation, which can be reflected in higher rental payments to the *sukuk* holders in the case of *ijarah sukuk*, and higher agreed profit sharing ratio in the case of *musharakah sukuk*. Secondly, *sukuk* refinancing in which *sukuk* are refinanced with another *sukuk*, which have lower financing costs, in order to settle the *sukuk* holders' residual payments. These two suggestions can be done only if the *sukuk* position had a strong financial position. Lastly, convertible equity *sukuk* in which *sukuk*'s assets values are converted into the issuer's equity value based on pre-determined formula in the event of defaults. These innovations are expected to give assurances to the *sukuk* holders before the purchase undertaking is executed, and hence their financial rights are fully protected from legal uncertainties.

5.0 Conclusion

In this discursive research paper, current *sukuk* practises and legal compatibility issues of *sukuk* have been extensively discussed in the wake of *sukuk* defaults occurring in Islamic financing space. Regulatory treatments and also practical *shari'a* compliant financing innovations have been suggested to mitigate future *sukuk* defaults.

With the current structure of *sukuk*, the problems still revolve around form over substance of the *sukuk* structures whereby asset based *sukuk* structures are prevalent in the Islamic capital market. In line with Islamic securitisation concepts, asset-based *sukuk* do not fall under Islamic securitisation concepts because of the absence of a true sale in the operation, whilst asset-backed *sukuk* falls under Islamic securitisation due to the presence of a true sale. The absence of true sales in current *sukuk* operations poses legal uncertainties to all *sukuk* parties, especially the *sukuk* holders. Based on an analysis of the legal issues discussed in this research, the legal infrastructure under various jurisdictions is not supportive enough for *sukuk* operations taking place. Each legal system entails different problems in governing *sukuk* operations as a true *Shari'a* compliant financing.

Due to that reason, at the bottom line, current *sukuk* structure fails to protect the legal rights of *sukuk* holders to the securitised assets. For the way forward, closer engagement between key players, regulators, Shari'a advisers, and scholars in the industry are urgently needed to discuss and improve the feasibility of these regulatory and financial implications as discussed in this research paper.

This research paper only covers salient features of legal issues facing *sukuk* development. There are still rooms for improvements and more detailed analysis of this research topic, such as detailed legal analysis of trust law and bankruptcy law vis-à-vis SPVs, the regulatory issues pertaining to law development for *sukuk* issuance—just to name a few. It is expected that more works on this research topic will create awareness among regulators and key players in the Islamic financial industry, particularly the lawyers who do *sukuk* legal documentation. This is to ensure that *sukuk* can further progress through eliminating legal challenges with a step-by-step approach, which indeed requires concerted and synergised efforts from all key players in the Islamic financial industry.

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