

# SHARIAH ISSUES IN SUKUK<sup>1</sup>

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## INTRODUCTION

This paper attempts to briefly discuss several selected Shariah issues that are contemporary and relevant to Sukuk. This paper will elaborate on the Shariah issues relating to Sukuk structures which covers issue on beneficial ownership, recourse to the underlying assets in Sukuk, purchase undertaking (*wa`ad*), foregoing of one's right (*tanazul*) in equity-based sukuk, rebate (*ibra`*) in sale-based Sukuk, liquidity facility, tradability of sale based Sukuk and portfolio of asset as Sukuk underlying asset. The discussion and analyses of most of the issues in this paper, however, are neither conclusive nor exhaustive.

## SHARIAH ISSUES IN SUKUK

In this section, the paper will attempt to elaborate on several Shariah issues that might arise in Sukuk structures which need further Shariah justifications and clarifications as follows.

### I. Beneficial Ownership in Asset Based Sukuk

Among the contentious issues in Sukuk structuring is the issue of ownership of the sukukholders in a particular asset or a business venture. Sukuk generally defined as “*certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a mudarabah). These assets may be in a specific project or investment activity in accordance with Shari`ah rules and principles.*”<sup>2</sup> Since the Sukuk represents its holders' ownership over certain underlying asset some Shariah scholars and practitioners debated whether the ownership status of the Sukukholder is in accordance to Shariah requirement.

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\* The views and opinions expressed herein are those of the authors. This write up does not necessarily represent the opinions of any particular institutions to which the authors are currently affiliated or were previously associated with.

<sup>2</sup> IFSB, Capital Adequacy Requirements For Sukuk, Securitisations and Real Estate Investment, p. 3.

From the Shariah perspective, ownership (*milkiyyah*) can be defined as “a legal right by a person over an asset, to the extent that he is free to transact with it, and exclude others from dealing with that asset”.<sup>3</sup> There are two basic types of ownership: complete ownership (*al milk al tam*) and incomplete ownership (*al milk al naqish*). Complete ownership refers to ownership that consists of both property and its usufruct. This type of ownership gives the owner all possible legal rights associated with the owned property, and it is unconditional and has no time limit as long as the property continues to exist. Moreover, ownership of such properties cannot be abolished (thus rendering the property ownerless). On the other hand, incomplete ownership refers to the ownership of the property but not of its usufruct, or vice versa. In this regard, ownership of usufruct may be a personal right tied to the individual rather than the property (e.g. if a person inherits the right to use a property for the rest of his life). On the other hand, ownership of usufruct may be attached perpetually to the property, regardless of the individual extracting the usufruct, such as easement rights that are established only for real estate and land.<sup>4</sup>

Some argue that beneficial ownership does not render the same effect as legal ownership due to a few reasons which include the restriction on Sukukholders (being the beneficial owner) from disposing the asset during the Sukuk tenure and upon the occurrence of Event of Default. According to this opinion, such discrepancies show that the beneficial ownership as practiced in asset-based Sukuk is not tantamount to a complete ownership (*milk at tam*) from the Shariah perspective.<sup>5</sup>

To have a macro perspective on the issue at hand, there is a need to understand the rationale that most Sukuk is structured on asset-based rather than asset-backed. In most countries including Malaysia, one of the main legal challenges is the restriction on foreign ownership of certain assets. This posed a question when structuring a Sukuk, can an offshore SPV own an asset in these jurisdictions?<sup>6</sup> In countries of the Gulf Cooperation Council (GCC), the regulatory framework for securitization is not well developed. However, in some countries like Malaysia, though the regulator has issued a guideline on Asset Backed Securities (ABS), the acceptance from the market are still low due to other reasons, including taxation issues.

The Islamic Financial Services Board (IFSB) elucidates the parameter of ownership in one of its standards where it states that the structure must transfer all ownership rights in the assets from the originator via the issuer to the investors. Depending on the applicable legal system, these ownership rights do not necessarily include registered title. The transfer could be a simple collection of ownership attributes that allow the investor (a) to step into the shoes of the

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<sup>3</sup> Nazih Hammad, *Mu'jam Mustalahat*, p 263

<sup>4</sup> Wahba al Zuhaily, *Financial Transactions in Islamic Jurisprudence* (trans by Mahmoud A El-Gamal), vol 2, p 421

<sup>5</sup> See Asyraf Wajdi Dusuki and Shabnam Mokhtar, *Critical Appraisal of Shari'ah Issues on Ownership in Asset based Sukuk as Implemented in the Islamic Debt Market* (Research Paper No. 8/2010), 2010 (Kuala Lumpur, Malaysia: 2010)

<sup>6</sup> Asyraf Wajdi Dusuki and Shabnam Mokhtar, p. 11

originator and (b) to perform (perhaps via a servicer) duties related to ownership. The transfer could also include rights granting access to the assets, subject to notice, and, in case of default, the right to take possession of the assets.<sup>7</sup>

The OIC Fiqh Academy has resolved that both legal and beneficial ownership are recognized from Shariah perspective. In this concern, the Shariah Advisory Council of Bank Negara Malaysia has taken the same opinion with the Academy.<sup>8</sup> These resolutions, however, come with a clear condition, i.e., the beneficial ownership must result in all rights and liabilities attached to the purchased asset be attained by the buyers.

To achieve the above condition set by the Shariah boards, Shariah scholars and practitioners together with the legal experts found a practical solution in the common law of trust. At the common law, when a person holds an asset in trust for another, the latter can be construed as the beneficial owner of the asset held by the former. The relationship between the trustee and the beneficiary is evidenced by a trust deed executed (often unilaterally) by the settlor. The trust deed can also be documented to allow the relationship between the trustee and the beneficiaries to be created through the issuance of a trust instrument by the trustee to the beneficiary or class of beneficiaries. For instance, a settlor can create a trust over say a house pursuant to a trust deed and appoint a trustee to issue trust instruments to a class of beneficiaries. The class of beneficiaries will be limited to the investors who purchase the trust instruments offered by the trustee for a certain consideration. The investors who purchase the trust instruments will automatically become the beneficiaries of the trust and be construed as pro-rata owners of the house held on trust by the trustee. The trust deed can also be structured to allow the holders of the trust instrument to transfer the trust instruments to others on a willing-buyer and willing-seller basis. If the trustee leases the house to a tenant for a fixed or variable rental term, the holders of the trust instrument will be entitled to a pro-rata share of the rental income derived from the house held on trust.<sup>9</sup>

The position under Malaysian law, which is quite similar to the position at common law, is that when the buyer pays the full consideration for a landed asset, the seller becomes a bare trustee and the buyer becomes the beneficial owner of the landed assets. As a bare trustee the seller cannot dispose the land to another without the consent of the beneficial owner. From the legal perspective, the law considers the beneficial owner as the true owner with the power to possess and dispose the landed assets. In order to protect the rights of the beneficial owner against any third party who may claim any interest on the landed assets held on trust, the bare trustee is

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<sup>7</sup> Islamic Financial Services Board (IFSB), Capital Adequacy Requirements For *Sukuk*, Securitisations And Real Estate Investment, p 9

<sup>8</sup> Cited from Shariah Resolutions in Islamic Finance of BNM, 2010, p.6, OIC Fiqh Academy, *Majallah Majma` al-Fiqh al-Islami*, 1990, no. 6, v. 1, p. 771.

<sup>9</sup> Rafe Haneef, Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities, p 5

required to procure a trust endorsement on the land title held at the land registry. The trust endorsement will give a clear notice to third parties of the beneficial owner's right in the landed assets and will prevent the bare trustee from inadvertently transferring the landed assets to any third party.<sup>10</sup>

These characteristics of the trust instrument squarely meet the requirements of *milkiyyah* from the Shariah perspective. The holders of the Sukuk will be construed under the Shariah as owners of an asset, although it is being held on trust by the seller who acts as bare trustee. Based on this arrangement, it can be argued that the Sukuk holders have a complete ownership (*al milk al tam*) over the asset though they are not the registered owners as far as the legal title is concerned.

Through this fresh interpretation, the contemporary Shariah scholars are able to extend the scope of ownership in Shariah to include the concept of beneficial ownership when, as illustrated in Malaysia, the true owner in the eyes of law is the beneficial owner and the seller remains only as a bare trustee. This solution, however, might not be a generic solution as legal framework varies from one country to another.

## **II. Recourse to the Underlying Assets in Sukuk**

Shariah scholars and practitioners raise their concern on the issue of recourse to the underlying asset in the Sukuk structure. In brief, recourse means a legal right to claim. As for the term 'without recourse' it refers to a phrase which means that one party has no legal claim against another party. It is often used in two contexts:<sup>11</sup>

1. In litigation, someone without recourse against another party cannot sue that party, or at least cannot obtain adequate relief even if a lawsuit moves forward. Someone completely without recourse cannot sue anyone for an alleged injury, or else cannot obtain any relief even if lawsuits are filed.
2. In financial transactions, the words "without recourse" disclaim any liability to the subsequent holder of a financial instrument. Thus, endorsing a check and adding "without recourse" to the signature means that the endorser takes no responsibility if the check bounces due to insufficient funds. If the bank accepts such a check and deposits the stated amount in the endorser's account, the bank will have no right to withdraw that amount from the endorser's account.

Generally, Sukuk can be classified into 2 categories, i.e., asset backed and asset based, in terms of the legal nature of the underlying assets involved in the Sukuk transactions, and its legal implications on the parties to the Sukuk transactions.

Under an asset backed structure, the investors or Sukukholders can only expect the returns from the cash flows of the underlying assets and there is no right of recourse to the originator or

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<sup>10</sup> Ibid, p. 6

<sup>11</sup> [http://www.law.cornell.edu/wex/without\\_recourse](http://www.law.cornell.edu/wex/without_recourse)

Issuer. This is because asset-backed Sukuk would require the originator or issuer to sell their asset to the Sukuk investors on a ‘True-Sale’ basis without having neither a purchase undertaking nor any right to recourse from the originator or issuer in the case the asset fails to generate the expected income to the Sukuk investors. In short, asset-backed Sukuk only allow recourse to the underlying assets which form the sole source of profit and principal payments.

According to Moody’s definition, asset-backed *Sukuk* 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 Sukukholders would be able to recover their exposure by taking control of and ultimately realizing the value from the asset(s). It also requires the element of securitisations to be present—true sale, bankruptcy remoteness and enforceability of security*”.<sup>12</sup>

On the other hand, Moody’s describes the features of asset-based Sukuk structure, “*the originator undertakes to repurchase the assets from the issuer at maturity of the Sukuk, or upon a predefined 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 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.*”<sup>13</sup>

Although the terms of ‘asset-based’ and ‘asset-backed’ may be seemingly identical, both have significant differences especially in term of credit risks. This can be seen in the case of Tamweel PJSC, where two types of *Sukuk* had been issued. In the Tamweel asset-backed Sukuk, the freehold titles to the properties were transferred to the Sukukholders along with the associated *ijarah* cash flows. The property/land titles are registered in the name of the investors. Any losses on those cash flows (that arise from the sale of distressed property) are passed on to the *Sukuk* holders, who are exposed to the asset risk. Nevertheless, upon the insolvency of Tamweel, the assets are legally isolated from Tamweel and will continue to pay the *Sukuk* investors. As for the unsecured or asset-based Sukuk issued by Tamweel, the Sukuk would not

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<sup>12</sup> As cited in Asyraf Wajdi Dusuki and Shabnam Mokhtar, *Critical Appraisal of Shari’ah Issues on Ownership in Asset based Sukuk as Implemented in the Islamic Debt Market* (Research Paper No. 8/2010), 2010, p.7.

<sup>13</sup> *Ibid*, pp 7-8.

survive the insolvency of Tamweel. Investors in these two sets of Sukuk are taking very different risks.<sup>14</sup>

According to Moody's, the international rating agency, they had in August 2009 lowered Tamweel's long-term issuer rating to Baa1 from A3. The ratings remain on review with the direction uncertain. Given the direct link between Tamweel and its asset-based Sukuk, the rating on Tamweel's \$300 million (AED1.1 billion) asset-'based' Sukuk trust certificates due 2013 was also lowered to Baa1 from A3, and also remains on review with the direction uncertain.<sup>15</sup>

Meanwhile, the asset-backed Sukuk continues to do well. The properties are legally registered to the investors and they have the first rights to the associated cash flows. Of the \$220 million raised, over half had been repaid. Critically, even if Tamweel should become insolvent or be liquidated (highly unlikely given its systemic importance), the investors retain the rights to the assets and Dubai Islamic Bank is on hand to look after the assets for investors. Hence, no rating downgrade from Aa2, Baa1 and Ba1 for the respective Class A, B and C notes.<sup>16</sup>

Many Shariah scholars are of the view that asset backed Sukuk is perfectly in adherence to the Shariah requirement on ownership in Sukuk origination. The central feature of asset backed Sukuk is a true sale which results in the transfer of ownership to the Sukuk holders as for asset based Sukuk, particularly the unsecured ones, Shariah scholars raise several concerns especially relating to the issue of sole recourse on the creditworthiness of the originator or obligor. Among the concerns include the Sukuk holders' ownership and interest in the underlying assets, whether it really complies with the requirement of ownership from the Shariah perspective.

In such Sukuk structure, the originator typically transfers only the beneficial ownership or equitable interest in the assets to the SPV issuer. The Sukukholders generally have recourse to the Issuer/obligor. Even in the event of default, the Sukukholders being the beneficial owner cannot outrightly sell the asset to recover their capital but rather they have to exercise the purchase undertaking given by the obligor at the onset. Therefore, the transaction does not focus on asset risk, but rather on the credit worthiness of the originator/obligor of the Sukuk.

From the Shariah perspective, the Sukukholders should be able to deal freely with the underlying asset as they are the owners of the asset. This is to conform to the gist of (*milkiyyah*) ownership and (*qabadh*) possession from the Shariah perspective which comprises principles of *tamkin wa takhliyah*, which denotes that the buyer as owner must have full access to the object of sale without any encumbrances.<sup>17</sup> However, under the asset based Sukuk, Sukukholders do not have an outright right to dispose the asset especially upon the occurrence of event of default. This triggers a debate amongst Shariah scholars whether ownership is actually transferred to the

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<sup>14</sup> Tan Wan Yean, Sukuk: Issues and the Way Forward, pp 4-5.

<sup>15</sup> The rating difference between secured and unsecured Sukuk, Khalid Howladar in Zawya Sukuk Report 2009, p 32.

<sup>16</sup> Ibid

<sup>17</sup> Al Kasani, Al Bada'ie al Sana'ie, vol 5, p 244, Ali Haydar, Durar al Hukkam, vol. 1, 216

Sukukholders, or otherwise, the relationship between the Issuer/Obligor and the Sukukholders is merely that of creditor-debtor.

Among the alternative structures that are already in the market is a hybrid structure between the current unsecured asset-based Sukuk structures and the asset-backed transactions. This structure is called covered Sukuk which is comparable to the features of a covered bond. Such structures would provide investors with recourse to both the corporate credit of the obligor which they desire, as well as to the underlying assets to the extent that the obligor fails to fulfill its obligations under the purchase undertaking, making for a much safer investment as a result of the dual recourse.<sup>18</sup>

What is also interesting is that in such structures, additional security from the obligor would also be unnecessary as, following a default by the obligor, investors would have recourse to the assets which they would be able to realise in much the same way as any security to secure the obligations of such obligor in a secured asset-based structure.<sup>19</sup>

Among the notable issuance of this kind of Sukuk is Gatehouse Bank PLC Sukuk in 2012. The bank, via its special purpose company (SPC),<sup>20</sup> has issued its first real estate-backed Sukuk that comprises shares in a company which owns a property leased to Fujitsu Services Limited (the lessee).<sup>21</sup> Rental payments paid by the lessee will be applied to fund the periodic distributions to the Sukukholders. This structure allows investors to have recourse to the originator pursuant to the purchase undertaking but, in the event of a shortfall, the Sukukholders are entitled to enforce their rights against the underlying asset of the Sukuk, i.e., the property. However, there is no assurance that the proceeds from the underlying asset will be sufficient to make all payments due in respect of the Sukuk.

From the Shariah perspective, the features of the covered Sukuk are perfectly in consonance with the requirement of ownership (*milkiyyah*). The Sukukholders being the owners of the asset have the right to dispose the asset should the obligor fails to honour its obligation under the purchase undertaking. Unlike the asset based Sukuk Ijarah, the Sukukholders of the covered Sukuk or their agent should carefully examine the quality and the performance of the asset by conducting a proper due diligence to ensure that the income generated from the asset can meet the periodic distribution and in the event of disposal of the asset, the Sukukholders would be able to get back the principal and profit due from the originator/obligor. This means the Sukuk holders bear some risks associated to their holdings in the asset but yet they are entitled to the income generated by the asset. This is in line with the Shariah principles of “*Al-Ghunm bi al Ghurm*” (reward is to be accompanied with risk) and “*al-Kharaj bi al Daman*” (any benefit must be accompanied with liability).

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<sup>18</sup> [https://www.eurekahedge.com/news/10\\_sep\\_IFN\\_Sukuk\\_A\\_Secured\\_Investment.asp](https://www.eurekahedge.com/news/10_sep_IFN_Sukuk_A_Secured_Investment.asp)

<sup>19</sup> Ibid

<sup>20</sup> Milestone 002 PC

<sup>21</sup> Final Terms of Milestone Capital PCC Programme for the issuance of Sukuk Certificates, pp 15-17

### III. Purchase Undertaking (*Wa'ad*)

There are few issues relating to application of *wa'd* in Sukuk structure such as *wa'd* (unilateral undertaking) or *wa'dan* (two unilateral undertaking) vis-a-vis *muwa'adah*, bindingness of *wa'd* etc. However, the most controversial issue regarding *wa'd* is undertaking by the manager or partner in Sukuk Musharakah, Mudarabah and Wakalah bil-istithmar structures to purchase the underlying asset upon Event of Default or at Maturity date at a pre-determined formula.

Prior to 2008, in the most equity based Sukuk structures issued globally such as Sukuk Musharakah and Mudharabah, the manager undertakes to purchase the Sukuk assets from the Sukukholders at pre-agreed purchase price upon the dissolution of the Sukuk, regardless of actual market value of the shares on the date of dissolution. The agreed purchase or exercise price formula for the purchase undertaking ensures that the principal amount invested by the Sukukholders will be returned to them at the dissolution date. Thus, no matter how the venture goes, profitable or not, the return of investors' capital is assured.

In this circumstance, one may argue that the purchase undertaking is valid as it is a form of unilateral *wa'd* which is allowed under Shariah perspective and it can be binding and enforceable. However, the effect of such undertaking should be examined whether it contributes towards violation of the purpose or the essence of the underlying contract (*muqtada al-aqd*). In Mudharabah and Musharakah Sukuk, the undertaking applies in a way that the capital of the partnership is indirectly guaranteed where the return of capital to the investors is assured through the payment of the purchase price under the purchase undertaking mechanism.

However, the practice of Issuer granting such purchase undertaking has been heavily criticized by the scholars and perhaps the most notable one is by Shaykh Taqi Usmani, chairman of the AAOIFI Shariah Board. Later this had been the subject of scrutiny by the AAOIFI Shariah Board which led to the prohibition of such practices in February 2008. The AAOIFI Shariah Board ruled out that:

*It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation all the assets of the partnership as per their market value or as per the agreement at the date of buying. It is not permissible, however to promise to buy the assets of the partnership on the basis of face value.*<sup>22</sup>

Based on the above ruling, if the obligor undertakes to buy their partner (s)'s stakes in the venture, the purchase/exercise price must be based on the prevailing market value or any price agreed by the transacting parties at the point of purchase event. These recommendations aim at eliminating 'price fixing' element which render to guaranteeing the principal and the profit to the Sukukholders.

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<sup>22</sup> AAOIFI, 2010, Shariah standard No. 12, item 3/1/6/2, p.209

However, in the context of Malaysian market practice, SAC of Securities Commission accepted the purchase undertaking at a price representing the face value of the Sukuk at maturity or following an event of default. The common clause of purchase undertaking in principal and terms in Sukuk Musharakah as below stated;

*“Pursuant to the purchase undertaking for the IMTN Programme granted by the Obligor in favour of the Issuer (acting on behalf of the Sukukholders) (“Purchase Undertaking”), the Obligor shall irrevocably and unconditionally undertake to purchase the Sukukholders’ interest in the Musharakah Venture via a “Sale Agreement” at the Exercise Price on either the maturity date of the Sukuk Musharakah or the Mandatory Redemption Date or the Dissolution Date, whichever is the earlier. The Obligor will be entitled to set-off the Exercise Price with any Top-up payment(s) made.”*

The incorporation of the Purchase Undertaking in equity-based sukuk in Malaysia normally backed by the following justifications:

- i. Both parties (i.e. Obligor and the Sukukholders) have agreed to adopt a certain formula based on the concept of mutual consent (*al-Taradhi*) which has taken into consideration the performance of the Musharakah Venture (i.e. profit distribution) based on feasibility study conducted prior to the issuance of this Sukuk Programmes. The agreed formula for the Exercise Price for Purchase Undertaking is determined so as to avoid any future dispute or uncertainty in the computation of the Exercise Price.
- ii. The Sukukholders are not devoid of all risks as the performance of the Sukuk is still subject to the operation and performance of the Musharakah Venture and in case of dissolution event, to the credit standing of the Issuer; and
- iii. The principle of *‘Urf* or customary practice in the industry whereby Sukuk is deemed as fixed income instrument regardless of its underlying Shariah concept. In addition, the current investment rating parameter adopted by most of rating agencies stresses on the assurance/guarantee of principal and profit from the investment and this parameter applied to all types of Sukuk. Hence, the pre-determined formula of Exercise Price under Purchase Undertaking for this Sukuk is meant to satisfy such parameter.

#### **IV. Foregoing one’s Rights (Tanazul)**

*Tanazul* refers to an act to waive certain rights of claim in favour of the other party in a contract. In Islamic finance, *tanazul* is typically applied where the right to share some portion of the

profits is given to another party.<sup>23</sup> In classical fiqh literatures, the jurists used various terms which are equivalent to *tanazul* such as *al-isqat*, *al-ibra`*, *al-`afw*, *al-hibah* and other related terms. Therefore, the technical meaning of *tanazul* varies according to the different types and situations in which it is used. There are few Shariah issues regarding *tanazul* especially in equity based Sukuk such as Sukuk Musharakah, Mudarabah, and Wakalah. The concern becomes more apparent in the case of holders of such Sukuks are subordinated to the senior creditor or Sukukholders.

Among the key concerns on practice of *tanazul* in equity based structure such as Musharakah is that one or some of the partners waive certain rights up-front in favour of other partners for something that is yet to be known and to be realized in the future. As some quarters regard *tanazul* as similar to *ibra`*, it is a condition of *ibra`* that it must take place after the underlying right is established, because *ibra`* essentially involves waiving an established right.

Majority of contemporary Islamic jurists denounce this exercise as it is deemed to be not in line with the essence of partnership contract which is based on profit and loss sharing principle. Sheikh Taqi Usmani opined that it is unlawful to include any text or condition that leads to the possibility that the sharing of profits will be interrupted.<sup>24</sup> If this happens, the partnership contract is void as this is contrary to the concept of profit sharing in *Musharakah* which shall be based on an agreed portion; and losses shall be based on the ratio of capital contribution.<sup>25</sup>

This is in line with the AAOIFI Shariah Standard which states;

Item 3/1/5/7: “*It is unlawful for the conditions of partnership or for the basis of profit distribution to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void*”<sup>26</sup>

The concept of upfront *tanazul* has been discussed by SAC of SC with regard to permissibility of preference shares at its 20th meeting on 14 July 1999. The SAC of SC has, among others, ruled that non-cumulative preference shares are permissible based on *tanazul* where the right to profit of the ordinary shareholder is willingly given to a preference shareholder. *Tanazul* is agreed upon at an annual general meeting of a company which decides to issue preference shares in an effort to raise new capital. As it is agreed at the meeting to issue preference shares, this means that ordinary shareholders have also agreed to give priority to preference shareholders in dividing the profits, in accordance with *tanazul*.<sup>27</sup>

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<sup>23</sup> Chartered Institute of Management Accountant (CIMA). Islamic Finance: Glossary of terms and contracts (Arabic – English). Available at <<http://www.scribd.com/doc/50578092/Islamic-Finance-Glossary>>.

<sup>24</sup> Usmani, Taqi, *Sukuk and their Contemporary Applications*, p.9.

<sup>25</sup> Usmani, Taqi, *An Introduction to Islamic Finance*, p.38

<sup>26</sup> AAOIFI, 2008, Shariah Standard No 12, p.208.

<sup>27</sup> Resolutions of the Resolutions of the Securities Commission Shariah Advisory Council, 2<sup>nd</sup> Edition, pp. 92-93

In furtherance to the above discussion, there are three scenarios relating to the practice of *tanazul* in sukuk Musharakah, which are as follows:

1. *Tanazul* in the case where the realized profit is equal or less than the expected rate of profit. The issuer agrees to waive their right to a share of the profit until the Sukukholders get their expected rate of profit. This kind of *tanazul* arrangement is given upfront at the time of the contract in order to determine that it will have the intended effect if the actual profit is equal or less than the expected profit.

This practice of *tanazul* is contentious because it is considered by many scholars to be against the nature of *musharakah* that emphasizes on elements of profit sharing among the partners. In this type of *tanazul*, there is a possibility which is agreed upfront at the time of contract, that some of the partners (i.e. the junior Sukukholders) do not get any share of the profit, i.e. in the event that the realized profit is equal or less than the expected profit rate. In this scenario, all the profits will go to the senior Sukukholders only.

According to AAOIFI, it is not allowed to the issuers to waive their right to a share of the profit until the sukukholders get their expected rate of profit. The AAOIFI Shariah Standard as below; Item 3/1/5/3 : “ *It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contribution to the Sharika capital. It is not permitted therefore to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is however; valid that one partner takes without prior condition the responsibility of bearing the loss at the time of the loss*”<sup>28</sup>

However, the SAC of SC has ruled that in the case as the rule of Islamic Irredeemable Convertible Preference Share where the realized profit is the equal or less than an expected profit ratio, the waive of the right to the profit in this situation will probably cause the ordinary Sukukholders to bear all the losses while all the profit have been given away to the preference Sukukholders. The ordinary Sukukholder may be entitled to profit (if any) after the distribution of all the profit to the senior Sukukholders.<sup>29</sup>

2. *Tanazul* in the case where the realized profit exceeds the expected rate of profit. The Sukukholders agree to take their profit share at a rate that is fixed at an agreed cap (the expected profit rate) and any profit above the cap-rate will be waived and given to the issuer/obligor as an incentive payment. This principle of *tanazul* to waive such a right to the profit is specified as a condition of the contract. For example, in the case where the expected

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<sup>28</sup> AAOIFI, 2010, p.207.

<sup>29</sup> As cited from Shariah Rulings and Opinions on Ijarah, Musharakah and Mudharabah, Islamic Capital Market, Securities Commission, p. 159, Resolutions of the Securities Commission Shariah Advisory Council, at its 20<sup>th</sup> meeting, 2006, p.92.

profit rate is 6% and the actual return (based on the profit sharing ratio) is 10%, the Sukukholders will take 6% and forego the excess 4% to the obligor as incentive for good performance. The *tanazul* arrangement for distribution of the excess profit above the expected profit rate is provided upfront in the *musharakah* agreement.

This could be in the form of granting him part of or the entire premium above a certain benchmark profit. This has been supported by the AAOIFI that allows such stipulation in the contract of *musharakah*. This is evident in the AAOIFI resolution in *Shariah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations*, regarding the outcome of *Sharikah* investments (profit and loss):

*“3/1/5/9 It is permissible to agree that if the profit realized is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner.”<sup>30</sup>*

This arrangement is considered a valid condition because it is still consistent with the notion of profit sharing and in line with *muqtadha al-aqad* of the contract, which is based on profit sharing.

In most of Sukuk Musharakah issued in Malaysia, the arrangement of *tanazul* on excess return/profit will be stated as follows:

“The Issuer shall be appointed as the manager to manage the Musharakah Venture. The Sukukholders agree that any excess of the profits from the Periodic Distribution Amount (as defined herein) shall be retained by the Issuer as an incentive fee”.

3. Priority in the return of capital in the event of liquidation (winding up) is given to senior Sukukholders over junior Sukukholders.

Generally, this priority is not permissible since the loss must be divided between the partners and shareholders exactly in accordance with the ratio of investment as discussed earlier in relation to the maxim. It is not permitted for the partners to agree on holding one partner or a group of partners liable for the entire loss or liable for certain parts of the loss that are not proportionate to their ratio of capital contribution. However, any of the partners can agree to absorb all the losses after they have been realized. This is reflected in the *Shariah Standard* issued by AAOIFI that reads:

*3/1/5/4 ‘It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the Sharikah capital. It is not permitted therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is valid that*

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<sup>30</sup> AAOIFI,2008, *Shariah Standard No 12*, p.207.

*one partner takes without any prior condition, the responsibility of bearing the loss at the time of the loss.”*

However in Malaysia, there is a clause stating the Sukukholders declaration to waive their right in receiving the proceeds upon liquidation of the collateral security. The generic provision on the declaration is as follows:

“For avoidance of doubt, pursuant to the Shariah concept of tanazul (waiver), the Junior Sukukholders shall up front agree to waive their rights to receive claims and entitlement in the Junior Sukuk in favour of the Senior Sukukholders until the Issuer has fully paid the Senior Sukukholders their claims, rights and entitlement in the Senior Sukuk”.

Out of three scenarios stated above, the scenario 1 and 3 seems to be violating the *muqtadha al aqad* of Musharakah which is profit and loss sharing. It is recommended that a detailed and comprehensive research to be conducted to discuss how far the concept of *hurriyat al taaqud wa tasyarrut* including agreement on tanazul of certain rights by the transacting parties can undermine the *muqtadha al aqad* of a particular contract. This research is not only significant to determine the Shariah stance on subordination feature in Sukuk structuring but also significant to address Shariah concerns on the features of preference shares.

## **V. Rebate (Ibra’) in Sale-based Sukuk**

The common issue that was raised in Islamic capital market is the offering of rebate (*ibra’*) in the event of early settlement. Linguistically, *ibra’* denotes liberation (*al-takhlis*), purification (*al-tanqiyah*), elimination (*al-izalah*), dropping (*al-isqat*) and isolation from certain things (*al-muba’adah ‘an al-shay*).<sup>31</sup> As a term of Islamic Jurisprudence, *ibra’*, means “surrendering one’s claims and rights on a certain thing. That right is other people’s obligation (*zimmah*) to him which needs to be fulfilled”.<sup>32</sup> Meanwhile, according to the Securities Commission (SC), *ibra’* refers to the act of surrendering one’s claims and rights, such as a creditor writing off the debts of a debtor. *Ibra’* falls under *uqud tabarru’at*.<sup>33</sup>

The issue of *ibra’* may exist in Sukuk Murabahah or any other sale based sukuk such as Istisna and Tawarruq upon early settlement or event of default whereby the Sukuk is redeemed before its maturity date. In this case, the Sukukholders may or shall give *ibra’* on the outstanding amount due and payable to the seller or the debtor. The main issue of *ibra’* is whether the stipulation of the *ibra*

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<sup>31</sup> Ismail bin Hammad al Jauhari, *al Sahhah taj al lughah wa sighat al Arabiah (vol 1)*, (Beirut: Dar al Ilm lil Malayin, 1984), p.14.

<sup>32</sup> Ministry of Waqf and Islamic Affairs of Kuwait, as cited from Bank Negara Malaysia, *Shariah resolutions in Islamic Finance*, (Kuala Lumpur: Bank Negara Malaysia, 2007), p.94.

<sup>33</sup> Securities Commission’s Shariah Advisory Council (SAC) Resolution 2<sup>nd</sup> Edition, pp. 46-47.

clause in the agreement is allowable or not from Shariah perspective. This is because the inclusion of *ibra`* may affect the contract itself as it seems the contract is uncertain in term of price.

The Shariah Advisory Council of Central Bank of Malaysia<sup>34</sup> and Securities Commission Malaysia (SC) resolved that Islamic banking institutions/Sukukholders may incorporate the clause on undertaking to provide *ibra`* to customers who make early settlement in the Islamic facility agreement. With regard to application of *ibra`* in Sukuk, SAC of SC at its 30th meeting on 8 November 2000 and its 45th meeting on 7 March 2003, resolved that:<sup>35</sup>

- a. Holders of Islamic securities may offer *ibra`* to the issuer based on the application made by the issuer of the securities concerned;
- b. The formula for the computation of early settlement may be stated as a guide to the issuer; and
- c. The *ibra`* (rebate) clause and the formula for the computation of early settlement may be stated in the main agreement of the Islamic securities contract which is based on *`uqud mu`awadhat*. However, the *ibra`* clause in the main agreement shall be separated from the part related to the price of the transacted asset. The *ibra`* clause shall only be stated under the section for mode of payment or settlement in the said agreement.

This resolution is in line with the opinion of some of Shariah scholars such as Aznan Hassan that permitted for the inclusion of prior agreement between the creditor and debtor and the debtor is discharged if he makes prompt payment. This deduction takes into account the principle of “*isti`nas`*” as practiced in the Hanafites school about the time limit in *murabahah* in cases where the buyer makes a complete payment or dies during the duration (*ajal*), in a situation where the seller accepts only the previous rate. Therefore, based on this it is permissible to implement of policy which agreed upon and observed by the creditor and its debtor based on the debtor`s prompt payment of his debt.<sup>36</sup>

The common disclosure on *ibra`* (rebate) in the Sukuk`s Terms and Conditions is as follows:

*“The Rebate (Ibra`) shall be the unearned profit due to the Sukukholders from the Profit Payment date following the declaration of the Event of Default/Early Settlement up to the maturity date of the Sukuk Murabahah”.*

With the inclusion of *ibra`* clauses in the facility agreement, the creditor is bound to honour the promise. This approach mirrors the concept of giving discount on a price or reducing the debt of the

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<sup>34</sup> Its meeting on 24th April 2002/ 11th Safar 1423.

<sup>35</sup> Securities Commission, Resolutions of the Securities Commission`s Shariah Advisory Council, (Kuala Lumpur: Securities Commission. 2006), p.47.

<sup>36</sup> Hasan, Aznan, *The Principle of Ibra` in Islamic Financial System : Adaptation and Application*, International Shariah Scholars Dialogu, 2006, p.376.

customers who make early settlement based on the concept of *da' wa ta'ajjal*, which is acceptable in the *Shari'ah*. The confusion on the issue of uncertainty in price (*gharar*) does not arise if the clause on the promise to give *ibra'* is stated clearly in the facility agreement.<sup>37</sup>

The practice of including rebate clause and its formula, however, is not in line with the relevant resolution of the OIC Islamic Fiqh Academy. While the Academy in its resolution no. 66/2/7 resolves that a rebate on a debt for early payment, whether it is requested by the creditor or the debtor is legal and is not a kind of *riba*, the Academy asserts that there should be no prior agreement between the contracting parties and the deal should involve only two parties i.e., the seller and buyer.<sup>38</sup>

## **VI. Liquidity Facility in the event of shortfall in Sukuk Musharakah**

Another issue to be discussed is liquidity facility in equity based Sukuk such as Sukuk Musharakah. In this regard, the manager who is also a partner in the Musharakah venture undertakes to make good the difference between the actual income generated and the indicative/expected return based on Shariah principle of *qardh*. Thereafter such an amount will be reimbursed or set-off against the subsequent actual income generated (if there is excess over the indicative return) or the exercise price to be paid to the Sukukholders upon dissolution of Sukuk Musharakah.

Many Shariah scholars criticise this practice, including Sheikh Taqi Uthmani who opines that that such commitment and obligation by the issuer/manager in covering shortfalls in the expected return for periodic distribution of profit will come under the heading of a sale with credit which was prohibited by the Prophet (peace be upon him).<sup>39</sup>

The AAOIFI Shariah Board disapproves the practice of giving loan by the manager to Sukukholders to cover the shortfall. They argue that this act is equivalent to guaranteeing the expected return which violates the nature of Musharakah which is based profit-loss sharing. Alternatively, in order to address this concern, AAOIFI is suggesting an alternative solution by way of the establishment of a 'reserve account' for the purpose of covering such shortfalls and the establishment should be mentioned in the prospectus. The pronouncement issued by AAOIFI in this matter as below stated;<sup>40</sup>

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<sup>37</sup> Gharar defined by Ibn Qayyim (1991) as "being the subject matter that the vendor is not in a position to hand over to the buyer, whether this subject-matter is in existence or not." (see, Ibn Qayyim, *I'lam al muwaqqi'in...*, 1:pp.357-361)

<sup>38</sup> Cited from , Muhammad al Bashir Muhammad al Amine, *Istisna' (manufacturing contract) in Islamic banking and finance*, (Kuala Lumpur: A.S. Noordeen, 2006), 114

<sup>39</sup> Taqi Uthmani, *Sukuk and its Contemporary Applications*, p.7.

<sup>40</sup> AAOIFI, Pronouncement, Shariah Ruling no 3.

*“It is not permissible for the manager of Sukuk, regardless of whether the manager acts as a mudarib (investment manager), or a sharik (partner), or a wakil (an investment agent), to undertake to offer loans to Sukuk holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus.”*

The operationalization of the reserve account is different from loan top-up. The reserve account contains the excess amount over the expected return which has been waived by the Sukukholders. Hence, in the case of shortfall, the reserve amount will be used to cover such difference. Based on this practice, one may argue that this is not a pure guarantee as the amount in the reserve account is the ‘real’ return from the business venture to begin with.

On the other hand, the Shariah Advisory Council of Securities Commission is of the view that the issuer is allowed to make advance payment to meet the expected return since there is no guarantee issue because the payment will be deducted or set off from the Exercise Price.<sup>41</sup> Furthermore, to deduction/set off does not entail any additional amount, which is tantamount to *riba*.

In some of Sukuk structures, it combines both approaches. It means, if there is any shortfall, the difference will be covered by the reserve account. If the reserve account is insufficient to make good the difference, the manager undertakes to advance its own money to top-up the shortfall on the qardh basis.

## **VII. Tradability of Sale -Based Sukuk**

Among the disputed issues regarding the sale-based Sukuk is the tradability of the Sukuk at the secondary market. Based on the practice in Malaysian capital market, the Sukukholders can trade the sale-based Sukuk and the norm is that the Sukuk is traded at discounted price. This practice however is subject to criticism as it involves the issue of *bay’ al dayn*. Unlike equity-based or Ijarah Sukuk where the sukuk represents the undivided ownership in the business venture or asset, in sale-based sukuk such as Murabahah, the sukuk is evidencing the Sukukholders’ right to receive the payment of Murabahah sale price which is debt in nature.

The SAC of SC in its 2nd meeting on 21 August 1996, has unanimously agreed to accept the principle of *bai` dayn* i.e. debt trading as one of the concepts for developing Islamic capital market instruments.<sup>42</sup> This was based on the views of some of the Islamic jurists who allowed

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<sup>41</sup> As cited from Shariah Rulings and Opinions on Ijarah, Musharakah and Mudharabah, Islamic Capital Market, Securities Commission, p. 157.

<sup>42</sup> Resolutions of SAC SC (2<sup>nd</sup> edition), p. 16.

this concept subject to certain conditions. In the context of the capital market, these conditions are met when there is a transparent regulatory system which can safeguard the *maslahah* (interest) of the market participants.

In its justification, the SAC explained that in general, the majority of Islamic jurists are unanimous in allowing the activity of selling debts to the debtor. However they disputed about the permissibility of selling the debt to a third party for the reason that the seller will not be able to deliver the sold item to the buyer. At its 8<sup>th</sup> meeting on 25 January 1996, the SAC clarified that the underlying reason for the prohibition of *bai` dayn* is due to the risks to the buyer, *gharar*, absence of *qabadh* and *riba*.<sup>43</sup>

The SAC of SC resolution on *bay' al dayn* is not in consonance with AAOIFI Shariah Board ruling on the Sukuk in which the latter highlighted in its resolution, among others include:

*“Sukuk, to be tradable, must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally, in accordance with the guidelines mentioned in AAOIFI Shari'ah Standard (21) on Financial Papers”.*<sup>44</sup>

AAOIFI Standard (21) on Financial Papers;

Item 3/18 *“It is not permitted to undertake trading in the shares of a corporation if the entire assets of the corporation are composed of debts, unless the rules for dealing in debts are observed”.*<sup>45</sup>

AAOIFI stated in Shariah Standard no 17 Investment Sukuk;

Item 5/2/15; *“It is not permissible to trade in Murabahah certificates after delivery of the Murabahah commodity to the buyer. However, trading of Murabahah certificates is permissible after purchasing the Murabahah commodity and before selling it to the buyer.”*<sup>46</sup>

The International Fiqh Academy has resolved two resolutions on trading of debts.<sup>47</sup> The first of them states that it is unlawful to sell a deferred debt to someone other than the debtor for a spot

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<sup>43</sup> Ibid, p. 17.

<sup>44</sup> [http://www.aaofii.com/aaofii\\_sb\\_sukuk\\_Feb2008\\_Eng.pdf](http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf).

<sup>45</sup> AAOIFI, Shariah Standard, 2010, p.382.

<sup>46</sup> AAOIFI, Shariah Standard, 2010, p.316.

<sup>47</sup> Ahcene Lahsasna, Issues In Islamic Capital Markets: Islamic Bond/ Sukuk In 3rd International Conference on Business and Economic Research (3rd ICBER 2012) Proceeding.

payment in the same or a different [currency] because it can lead to *riba*. Furthermore, there is no difference whether the debt originates from a loan or from a deferred payment sale.<sup>48</sup>

The Academy has also issued a resolution on the issue of Islamic Sukuk and its Tradability in the Contemporary Practices which explains the criteria for trading them in three situations:<sup>49</sup>

- (a) If the constituents of the Sukuk remain cash, then the application of the rules of *Sarf* would apply.
- (b) If the constituents of the Sukuk become debts, then the rules for transactions involving debts would apply.
- (c) If the constituents of the Sukuk become “mixed assets that include cash, debts, tangible assets and usufruct, then trading of the Sukuk Murabahah is permissible at a mutually agreed price, on the condition that the majority [of the assets] in this situation are tangible assets and usufruct.”

With regards to the practice of trading of Sukuk Murabahah in Malaysia, there are at least three main issues which trigger concerns;

- i. It represents monetary receivables i.e., resulting from Murabahah sale between the Issuer as the seller and the Sukukholders as the buyer;
- ii. The price paid for the debt is in monetary terms; and
- iii. The trading of Sukuk Murabahah at a discounted price.

As such, the trading of Sukuk Murabahah at secondary market in Malaysia does not comply with the resolution of International Fiqh Academy and AAOIFI Shariah Standard. Even some of quarters argue that there is a resemblance of *riba* in such practice as the sukuk is traded at discounted basis.

<sup>48</sup> Resolution No. 101(11/4) from the verdicts of the International Islamic Fiqh Academy, p. 350.

Full resolution of Majma fatwa :

إن مجلس مجمع الفقه الإسلامي الدولي المنبثق عن منظمة المؤتمر الإسلامي في دورة انعقاد مؤتمره الحادي عشر بالمنامة في مملكة البحرين، من 25-30 رجب 1419هـ، الموافق 14-19 تشرين الأول (نوفمبر) 1998م. بعد اطلاعه على الأبحاث المقدمة إلى المجمع بخصوص موضوع "بيع الدين وسندات القرض وبدائلها الشرعية في مجال القطاع العام والخاص"، وفي ضوء المناقشات التي وجهت الأنظار إلى أن هذا الموضوع من المواضيع المهمة المطروحة في ساحة المعاملات المالية المعاصرة. **قرر ما يلي:**  
أولاً: أنه لا يجوز بيع الدين المؤجل من غير المدين بنقد معجل من جنسه أو من غير جنسه لإفضائه إلى الربا، كما لا يجوز بيعه بنقد مؤجل من جنسه أو غير جنسه لأنه من بيع الكالء بالكالء المنهي عنه شرعاً. ولا فرق في ذلك بين كون الدين ناشئاً عن قرض أو بيع أجل.

<sup>49</sup> International Fiqh Academy Conference, Putrajaya, 2009, No. 178 (4/19), full resolution of Majma fatwa;

إن مجلس مجمع الفقه الإسلامي الدولي المنبثق عن منظمة المؤتمر الإسلامي المنعقد في دورته التاسعة عشرة في إمارة الشارقة دولة الإمارات العربية 41 نيسان (إبريل 6112 م)، - المتحدة من 1 إلى 5 جمادى الأولى 1341 هـ، الموافق 62 بعد اطلاعه على البحوث الواردة إلى المجمع بخصوص موضوع الصكوك الإسلامية (التوريق) وتطبيقاتها المعاصرة وتداولها، وبعد استماعه إلى المناقشات التي دارت حوله، قرر ما يأتي:  
(أ) إذا كانت مكونات الصكوك لا تزال نقوداً فتطبق أحكام الصرف.  
(ب) إذا انقلبت الموجودات لتصبح ديوناً كما هو الحال في بيع المرابحة فيطبق على تداول الصكوك أحكام الدين، من حيث المنع إلا بالمثل على سبيل الحوالة.  
(ج) إذا صار مال القراض موجودات مختلطة من النقود والديون والأعيان والمنافع فإنه يجوز تداول صكوك المقارضة وفقاً للسعر المتراضى عليه، على أن يكون الغالب في هذه الحالة أعياناً ومنافع. أما إذا كان الغالب نقوداً أو ديوناً فتراعى في التداول الأحكام الشرعية التي سببها لائحة تفسيرية توضع وتعرض على المجمع في الدورة القادمة.

Notwithstanding the abovementioned, it is worth to highlight that the Sukuk Murabahah can still be traded based on the International Fiqh Academy and AAOIFI Shariah Standard under the following situations.<sup>50</sup>

1. If the Sukuk issued prior to the sale of the *murabahah* commodities from the Originator to the underlying purchaser. This is because the Shariah analysis turns on whether there is some ongoing ownership stake between the Investor and the Sukuk asset following a transfer of the Sukuk certificate (which is permitted) or whether the transfer shifts ownership and creates a debt obligation on a third party (not permitted). As such, Sukuk certificates issued prior to a *murabahah* commodity sale would represent ownership in those commodities rather than the right to the receivables generated by their sale (which have yet to be created);
2. If they are issued after the sale of commodities under the underlying *murabahah*, so long as they are traded at face value (rather than sold at a discount or a profit); and
3. If the *murabahah* receivables form a small proportion (exact percentages may vary depending on the transaction and the analysis of each Shariah scholar) of a larger portfolio of Sukuk assets comprising mostly other negotiable instruments such as Sukuk Ijarah, Sukuk -Musharakah, and/or Sukuk Mudarabah.

#### **VIII. Portfolio of Asset as Sukuk Underlying Asset.**

Sukuk Wakalah or Wakalah bil Istithmar is very fast becoming one of the most favourable structure globally. A few reasons can be identified as contributing factors to this trend. One of them is less dependency on tangible asset as compared to Sukuk Ijarah and Musharakah. Most sovereigns were reluctant to allocate the public asset to sukukholders due to the apprehension that such asset is transferred to foreign investors and this might create negative public sentiment. The corporates on the other hand, either did not have suitable assets, or the assets were not sufficient or already encumbered.

Under Sukuk Wakalah, instead of 100% of the asset must be in tangible form, Sukuk Wakalah as issued in the global market, including ones issued in Malaysia, combines tangible asset and receivables in one portfolio of asset. Hence the originator or issuer of the sukuk does not necessarily allocated huge asset to backed the entire transaction value. The requirement imposed by the Shariah board with regards to ratio of tangible asset vis-à-vis the receivables varies from one jurisdiction to another.

In the first IDB Sukuk Wakalah bil Istithmar issued in 2003, the mixed portfolio consisted of *Ijarah* assets comprising 65.8% of the portfolio (although the minimum requirement was set at 51%) and *Murabahah* and *Istisna* receivables comprising 34.2%.<sup>51</sup> The 65.8% of *Ijarah* assets

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<sup>50</sup> DIFC Sukuk Guide, pp. 49-50

<sup>51</sup> Rafe Haneef, From “Asset-backed” to “Asset-light” Structures: The Intricate History of Sukuk in ISRA International Journal of Islamic Finance • Vol. 1 • Issue 1 • 2009, pp. 112-114

was comprised of certain physical assets owned by the IDB and which were leased out to various counter parties. Since the Ijarah assets could be freely transferred at any price by the IDB, by mixing the *Murabahah* and *Istisna* receivables (*dayn*) with *Ijarah* assets (*Ñayn*), the IDB was able to transfer the receivables as well. A few years later, the IDB went to the market again and this time the IDB appeared to have even less physical assets to inject into the mixed portfolio. The IDB wanted to reduce the proportion of *Ijarah* assets from 65.8% down to 30%.<sup>52</sup>

In case of Government of Malaysia's Global Sukuk Wakalah (GSW), the tangible asset comprised 51% of the portfolio, and the tangible asset consists of leasable asset and unlisted shares and the receivables is created via *tawarruq/murabahah* transaction. One of the differences between the GSW and IDB Sukuk is: Under the GSW, the receivables is created after the issuance of the Sukuk while in IDB Sukuk, the receivable is created prior to issuance of the Sukuk.

AAOIFI Shariah Standard No. (21) on the issue of financial papers (stocks and bonds), in Article 3/19, with regard to the ruling on trading of debt that is mixed with other things such as tangible assets, revenue sources in the form of rented or mortgaged items (*mustaghallat*), cash and rights, states the following:<sup>53</sup>

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

*But if the purpose and core activity of the company centre upon transactions of gold or silver or currency (foreign exchange), consideration of the rules for sarf is then compulsory when trading its shares. And if the purpose and core activity of the company focus on transactions involving debts (i.e., [liquidity] facilities), then consideration of the rules for debts is compulsory in the trading of its stocks”.*

Some of the scholars argued that the permissibility of *khultah* (portfolio of mixed assets) is derived a legal maxim which says:

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<sup>52</sup> Ibid.

<sup>53</sup> AAOIFI, *Al Ma'ayir al Shar'iyah*, 2010, p. 299

## التابع تابع

“The subsidiary is subsidiary.”<sup>54</sup>

It means the debt when it has been mixed with the tangible asset, it is then becomes a subsidiary to the tangible asset and thus it should follow the ruling of tangible asset rather than ruling on *bay' al dayn* or *bay' al sarf*. The discussion on the ratio of tangible asset vis-à-vis liquid asset including cash and receivables is further elucidated by the jurists and can be summarised into three views:

- i. Some mentioned that the illiquid asset should be 51% and above based on the juristic principle:

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*The majority deserves to be treated as the whole of a thing.*<sup>55</sup>

- ii. Some other scholars have opined that the tolerance level of illiquid asset for the shares of a company to be acceptable for general trading is 33% or more of its total asset. This is based on a hadith where the Prophet advised his Companion, Sa'ad ibn Waqas in the case of wasiyah that, “1/3 (33.33%) is enough”,<sup>56</sup>
- iii. The third view is based on the *Hanafi* jurisprudence. The principle of the *Hanafi* school is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:<sup>57</sup>
  - a. The illiquid part of the combination must not be at ignorable quantity. It means that it should be at a considerable proportion.
  - b. The price of the combination should be more than the value of the liquid amount contained.

Looking at the recent Sukuk Wakalah issuances, there is Sukuk Wakalah which consists as low as 10% of tangible asset out of the entire portfolio value. The question is whether this 10% can be considered as substantial in order to comply with Hanafi's view as stated earlier.

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<sup>54</sup> Al-Zarqa, Mustafa, Al-Madkhal Al Fiqhi Al-Am, Dar al-Qalam: Damshik, v2, pp.1022-1023,

<sup>55</sup> Al-Zaidan, Abd Karim, Al-Wajiz, v.1, p.214.

<sup>56</sup> Hadith narrated by al-Bukhari and Muslim.

<sup>57</sup> Taqi Usmani, Principles of Shari'ah Governing Islamic Investment Funds, An online publication by accountancy.com.pk

## **CONCLUSION**

Considering Malaysia is the biggest Sukuk market in the world and leading innovator in developing capital market instruments, there is an urgent need to address the highlighted Shariah issues especially those issues which are highly contentious such as Tanazul in equity-based sukuk, purchase undertaking and bay' al dayn in trading the sukuk at secondary market. However, these issues can only be resolved with a concerted effort, not only from the Shariah scholars but require involvement and commitment of all stakeholders including the regulators, industry players and investors.