Malaysian Journal of Syariah and Law
مجلة الشريعة والقانون بماليزيا
VOL 7 | JUNE 2018 (pp. 29-39)
ISSN: 1985-7454 | E-ISSN: 2590-4396
www.mjsl.usim.edu.my

THE APPLICATION OF TRUE SALE CONTRACT IN ASSET-BACKED *SUKUK*

[i*]Mohamad Zaharuddin Zakaria, [i]Ahmad Zaki Salleh, [i]Suraiya Osman, [i]Mushaddad Hasbullah, [i]Mohd Faisal Mohamed

[i]Faculty of Syariah and Law, Universiti Sains Islam Malaysia, Bandar Baru Nilai, 71800 Nilai, Negeri Sembilan, Malaysia

*(Corresponding author): zaharuddin@usim.edu.my

ABSTRACT

This article discusses the concept of true sale and its application in sukuk issuance whereby the existence of this concept is vital to ensure the permissibility of sukuk issuance especially for asset-backed sukuk. The purpose of this study is to differentiate the application of true sale contract in asset-based and asset-backed sukuk and to examine whether the concept of true sale involved therein is similar to the Shariah concept of sale. Thus the sukuk underlying contracts are analyzed in order to understand the concept and the practice of both asset-based and asset-backed sukuk. Finally, the study found that the true sale contract is really practiced in asset-backed sukuk but not in asset-based sukuk which make the previous comply with the shariah concept of sale whereby the later although did not apply the true sale contract but still the sukuk is comply with shariah rules.

Keywords: *True sale, asset-based sukuk, asset-backed sukuk, shariah*

Introduction

Sale-based sukuk means sukuk that are structured based on the contract of sales. Sale-based sukuk, which consist of BBA, Murabahah, Salam and Istisnaᶜ originated from the sale transaction that creates the debt obligation on the issuer, which later are being securitized as sukuk.

When discussing the sale-based sukuk as one of the asset-backed securities, it means the sukuk involve the sale transaction that constitutes a true sale contract, which requires the originator to transfer his asset to the sukuk holder. The asset will be removed from the balance sheet or known as Off balance sheet of the originator. Consequently, the sukuk-holder becomes an owner and apparently holds the legal title on the asset.

In contrast, asset-based *sukuk*, the sale transaction does not constitutes a true sale contract. The sukuk holder even though he buys the asset but he is not considered as the legal owner of the asset. According to the law, he only buys the beneficial title of the asset while the legal title remains with the originator. Meaning that, from the accounting point of view, the asset is still on the balance sheet of the originator even after the sale. This is the main difference between asset-backed and asset-based sukuk.

True Sale in Sukuk Issuance

One of the popular contracts used to issue sukuk especially in asset-based sukuk is the contract of BBA. It is a short form for "Bay^{c} bi thaman ajil", which has been defined by Securities Commission as a contract that refers to the sale and purchase transaction for the financing of an asset on a deferred and an installment basis with a pre-agreed payment period. The sale price will include a profit margin (SC Malaysia, 2004). Beside asset-based sukuk, an asset-backed sukuk may also be issued based on the BBA contract. As determined earlier, the true sale will differentiate between the two.

In BBA asset-backed sukuk, firstly, the originators sell their assets to the special purpose vehicle (SPV) at market value. The sale which is a true sale arrangement (according to law) is very crucial to ensure the legal ownership in the assets is really transferred to the buyer in order to meet the bankruptcy remoteness requirement. The transfer of ownership to the SPV also important to fulfill the Shari^{c}ah requirement for the SPV to acquire the ownership before it is allowed to make any transaction including to sell the assets to the investors. This is based on the hadith:

لا تبع ما ليس عندك

Do not sell something that you do not own (Abu Dawud,n.d)

The hadith clearly disallows us from selling anything that does not belong to us. Thus the transfer of ownership from the originator to the issuer or investors is very critical according to the Shari^{c}ah. This is also relevant according to the principle of "true sale" which is considered as an essence for the asset-backed sukuk. However, the "true sale" element is not crucial for the asset-based sukuk structure.

The true sale concept is derived from the securitization process of Asset-backed securities (ABS) in the conventional capital market. This concept provides the degree of separation that protects assets owned by the SPV from creditors of the company and the company from investors claims on its assets apart from the assets sold to the SPV (Goud, 2012).

Normally, the first step in sukuk issuance process shows the relationship between the originator and the issuer in a sale contract where the originator as a seller sells the asset to the issuer to initiate the first transaction in asset-backed securitization process. The element of true sale is vital in this transaction. In the absence of this element, it will change the type of sukuk from asset-backed to asset-based sukuk

In Asset-backed Securities (conventional), the company to raise fund will set up a legal entity called SPV to transfer the company's asset by selling it to that SPV via a true sale contract. For example, a company called Exceptional Dental Equipment Inc. has more than \$300 million of installment sales contract, then that company wants to raise \$300 million. To do so, Exceptional Dental Equipment will set up a legal entity referred to as a special purpose vehicle (SPV). The Exceptional Dental Equipment Inc.

will then sell to that SPV $300 million of the loans. Exceptional Dental Equipment Inc. will receive from the SPV $300 million in cash, the amount of funds it wanted to raise. The SPV obtains the $300 million by selling securities that are backed by the $300 million of loans. If the sale of loans is done properly,[1] the SPV then legally owns the receivables, not Exceptional Dental Equipment Inc. Consequently, if Exceptional Dental Equipment Inc. is ever forced into bankruptcy while the loans sold to the SPV are still outstanding, the creditors of Exceptional Dental Equipment Inc. cannot recover the loans because they are legally owned by the SPV (Fabozzi et. al. 2009)

The true sale provides the investors the legal rights over the receivables in a securitization. As a result, their rights are protected from the creditors of the seller of the securitized asset. Thus the bankruptcy court cannot penetrate the SPV to recover the collateral or cash flow from the collateral (Fabozzi et. al., 2009). In contrast, if the securitization is not a true sale transaction, the investors then will be at par with unsecured lenders (Khotari, 2012).

Shariah Principles on True Sale

It is clear now that the "true sale" in conventional Asset Backed Security (ABS) is actually a real sale involving two parties in a sale which is legally bound by a contract. Regarding the true sale transaction in Asset-backed sukuk as shown in the structure above, the term "true sale" also has been mentioned in its term sheet which gives the same meaning with the concept of true sale in the conventional ABS except in the conventional ABS, there is no restrictions with regards to the subject matter of the contract, whereas in Asset-backed sukuk, there are certain conditions to be met in order to make the contract permissible according to

[1] It has to be a sale of the loans at a fair market value.

Shari^c^ah principles. The conditions for the validity of subject matter are as follow (Khir, 2008):

i. Lawfulness: The object must be lawful and should be permissible to trade. It must be of legal value, which means its subject matter and underlying clause must be lawful and it must not be forbidden by Islamic law, neither an irritation to public order nor morality.
ii. Existence: The parties to a contract must legally own the subject. The issue of existence presupposes that the object of a contract must be in existence at the time of contract (selling fruit which are not ripe/ready for the market is illegal as it does not meet this criteria)
iii. Delivery: The object should be potentially capable of certain delivery to the buyer at the time of the contract.
iv. Determination: The object should be something known to the parties. It must be determined precisely as to its essence, its quantity and its value to avoid any kind of exploitation and future disputes.

Apparently in conventional ABS, all types of assets including loan receivables which are based on interest are allowed to be pooled as an underlying asset in securitization (Fabozzi et. al. 2009). Even though the contract is a "true sale" contract but it does not comply with the Shari^c^ah principles prescribed above especially in prohibiting interest.

However, the contract of "true sale" in the asset-backed sukuk above is permissible based on the verse:

وأحل الله البيع وحرم الربا

And Allah has permitted sale and forbidden usury (Al-Baqarah, 275)

The meaning of sale (*Bay^c^*) in the verse is defined as "the exchange of a thing of value by another thing with mutual consent" (Khir, 2008). Thus, sale in the market is a contract of exchange either an exchange of commodity for another commodity (barter trading) or of a commodity for money (sale) or money for money (*sarf*).

A valid sale according to Shari[c]ah must comply with the following principles of contract:

i. Offer and acceptance – a contract requires an offer (*ijab*) and acceptance (*qabul*) (Musa, 1952). The contract can be oral or in writing, made by signs or gestures, by conduct or through an agent.
ii. Contracting parties – the parties entering into a contract must fulfill the capacity as he or she must be legally competent (*mumayyiz*) (Musa, 1952). A minor, a person of unsound mind, an insolvent person, a person legally declared a prodigal, an intoxicated person or a person suffering from illness which leads to his or her death (*marad al-maut*) cannot enter into a binding contract (Venardos, 2006).
iii. Mahal al-[c]aqd or Object of the contract which must exist and be owned by the seller at the time of the contract and it must not involve materials or acts which are prohibited according to Islamic law (Kuwait: 2006). The object of the contract could be in tangible form such as an object in the contract of sale, the object of the contract could also be intangible in form of service and usufruct like in the contract of lease (As-Salami, 2008).
iv. The price must be determined explicitly in absolute amount when the contract takes place (Sultan, 2009).
v. Legality, the purpose of the contract must be legal from the perspective of Shari[c]ah. A contract would be illegal if the purpose of the contract contradicts with the Shari[c]ah principles, for instance, a sale with interest is considered illegal (Khir, 2008).
vi. Absence of duress – the parties must enter into the contract of their own free will. A contract concluded under duress is null and void (Musa, 1952).

Thus, it seems that in conventional ABS even though the contract is a "true sale" contract but it does not comply with the Shari[c]ah principles prescribed above especially in prohibiting interest. However, the contract of "true sale" in the asset-backed sukuk above is permissible because it fulfills the conditions of valid sale under the Shariah law.

Securities Commission Malaysia (SC) Guidelines on the Offering of Asset-backed Securities 2004

The concept of true sale in conventional practice will be determined by the law itself whereby the requirement of "true sale" according to the practice may (Khotari, 2012):

i. Be laid down by the law of the land
ii. Be laid down by Courts
iii. Be implied from judicial history/ legal tradition
iv. Be inferred from international practice of securitization industry

Thus, for that purpose, Securities Commission Malaysia (SC) has laid down several criterias of true sale to be achieved in order to issue an asset-backed sukuk in Malaysia. These criteria has been put in the Guidelines on the Offering of Asset-backed Securities 2004. Among the criterias requires the isolation of the asset from the originator i.e. put beyond the originator and its creditors even in bankruptcy as far as possible (SC Malaysia, 2004). This conforms to the concept of *qabd* or capable of taking possession i.e. in order to ensure the validity of a contract, the subject matter of the contract should be capable of being delivered and can be easily possessed plus the ownership of the subject matter can be transferred to buyer (Khir, 2008). Thus, a transfer of ownership in a contract is very paramount in every contract especially between the originator and the SPV in this sukuk transaction. Otherwise, the transaction will not become a true sale from either the legal point of view or Shari[c]ah point of view and subsequently will be invalid.

The isolation of the asset from the originator can be explained as a mode of transfer of ownership from the originator to the SPV. This can be understood from para 6.03 of the same guidelines that further describe that the originator cannot hold any equity stake, directly or indirectly in an SPV, whereby the originator has no power to control that SPV in making any decisions with regards to the securitization transaction. Consequently, in the next para. 6.04, mentioned clearly that the SPV cannot recourse to the originator for the losses arising from the asset because there has no more relationship between the originator and the asset since the ownership has been legally transferred to the SPV. The ABS's term sheet also clearly mentioned that under the sale and purchase agreement, the assets will be transferred from the originator to the SPV issuer at market value (SC Malaysia, n.d). This complies exactly with the Shari^{c}ah principles.

Ownership

It should be noted that the transfer of ownership in the true sale transaction involves a transfer of both legal rights and beneficial rights of the assets at the same time to the SPV issuer (SC Malaysia, n.d). This creates another issue in Shari^{c}ah that is also important because the division of ownership into beneficial ownership and legal ownership is seem to be different between conventional law and Islamic law especially in term of beneficial ownership.

According to Islamic law, there are two types of ownership namely complete ownership (milkiyyah tammah) where the owner has a full right over the assets including the physical (corpus) and the usufruct (manfa^{c}ah) and partial ownership where the owner owns either the physical (corpus) features or the benefit (usufruct) (Khafif, 1990).

With regards to the "true sale" in the *sukuk* transaction, it involves the sale and purchase of asset between the originator as a seller and the issuer as a buyer on behalf of the investors. The transaction transfers the complete ownership of the assets (milkiyyah tammah) from the originator to the SPV. This is permissible based on the conditions of a valid contract described above. Among the characteristics of full ownership are (Rasban, 2006):

i. The ownership is permanent and there is no time frame
ii. The owner has full rights to the assets. Meaning that, he can give away the assets or lend them to others or keep the assets or use them as he pleases as long as it is not in conflict with Shari^{c}ah.
iii. The owner is not liable for the damages or losses but he can be penalized if he damages the assets or misused the assets in activities that are in conflict with Shari^{c}ah (Al-Zuhayli, 1997).

This type of ownership of assets can be acquired via (Rasban, 2006):

i. Working where a person get remuneration of services offered by an individual to others.
ii. Gift given by others as long it is permissible
iii. The purchasing of the asset
iv. The inheritance
v. Compensation received due to damages or injury or death caused by another party, *diat* or blood money.

Conclusion

As a conclusion, a true sale fulfils one of the requirements of complete ownership as prescribed above via a sale and purchase deal. It confers the owner a right of full ownership and as a result, he would finally gain full control over the assets. Hence, based on this fact, there is no conflict between a true sale in the legal practice and true sale in Shari^{c}ah perspective. Thus, a true sale transaction as practised in the asset-backed sukuk issuance is permissible and should be applied to all issuances either in asset-backed *sukuk* or asset-based *sukuk*. In the case of asset-backed *sukuk*, it was determined that the full ownership of the assets was transferred to the SPV issuer actually. The SPV issuer then becomes the legal owner of the assets on behalf of the *sukuk* holders. With regards to the contract of sales in asset-based sukuk, which is not a true sale according to law, the researcher is in view that this issue needs further study in order to ensure the practice would not jeopardy the shariah concept of sale.

REFERENCE

Angelo M Venardos. (2006). Islamic *Banking & Finance in South-East Asia: Its Development & Future*, (Singapore: World Scientific, 2nd. Ed.) 51

The Ministry of Auqaf and Islamic Affairs Kuwait, *al-Mausucah al-Fiqhiyyah al-Kuwaitiyyah*, (Kuwait: Dar al-Salasil, 2nd. Ed. 1404 H – 1427 H, vol.9, 10

Al-Salami, Nasr Muhammad. (2008). *Al-Dawabit al-Sharciyyah li al-Istithmar*, (Alexzendria: Dar al-Iman, 1st ed) 102

Syed Alwi Mohamed Sultan. (2009). *AMini Guide to Sharicah Audit for Islamic Financial Institution – A Primer* (Kuala Lumpur: CERT, 2nd ed.) 41

APAB-Revised PTC.pdf, 11

APAB-Revised PTC.pdf, 9

cAli al-Khafif. (1990). *Al-Milkiyyah fi al-Sharicah al-Islamiyyah*, (Beirut: Dar al-Nahdah al-cArabiyyah), 30. Musa, *Al-amwal wa nazariyyah al-caqdi fi al-fiqh al-Islami*, 167

Al-Zuhayli, *al-Fiqh al-Islami wa Adillatuh*, vol. 4, 415

Abu Dawud, *Sunan*, Hadith no. 3503, Maktabah 'Asriyyah: Beirut, vol. 3, 283

Blake Goud, *Sukuk, SPVs and the 'true sale*', http://investhalal.blogspot.com/2009/05/sukuk-spvs-and-true-sale.html (accessed on 4th January 2012)

Frank J. Fabozzi & Franco Modigliani. (2009). Capital Markets, *Institutions and Instruments*, (New Jercy: Prentice Hall, 4th ed.) 545-557

Kamal Khir others. (2008). *Islamic Banking, A Practical Perspective*, (Petaling Jaya: Pearson Malaysia Sdn. Bhd., 1st ed.) 44

Muhammad Yusuf Musa. (1952). *Al-amwal wa nazariyyah al-ᶜaqdi fi al-fiqh al-Islami*, (Qairo: Dar al-kitab al-ᶜarabi, 1st. ed. 254.

Sadali Rasban. (2006). *Personal Wealth Management For Muslims*, (Singapore: HTHT Advisory Services Pte Ltd., 1st ed.) 20-22

SC Malaysia. (*2004). Guidelines on the Offering of Islamic Securities*, A-1.

Vinod Khotari, *True sale question*. http://www.vinodkothari.com/truesale.htm (accessed on 4 January 2012)