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Islamic finance at a crossroads: the dominance of the asset-based sukuk

Feature

Habib Ahmed

is the Sharjah chair in Islamic Law & Finance at Durham University. Email: habib.ahmed@durham.ac.uk

In mimicking conventional finance, Islamic finance is focusing on the legalistic forms and ignoring the substance of Islamic law. Long-term growth of the industry will depend on the dominance of substance over the form.

KEY POINTS

- The principles of Islamic law governing financial transactions can bring about stability in the financial system.
- However, by replicating conventional financial products and focusing on the legalistic forms only, the practice of the Islamic financial industry is diluting the principles of Islamic law.
- In the *sukuk* market, the overwhelming majority of *sukuk* are asset-based with the primacy of form over substance.
- Moving to a more substance-based Islamic finance is needed to reduce the reputation risk and integrity of the industry.

INTRODUCTION

The introduction of Islamic finance initiated the use of Islamic commercial law in financial contracts. Shariah Supervisory Boards ('SSB') constituting of Islamic jurists and scholars create law in the private domain by endorsing contracts used in financial transactions. Most Islamic financial transactions, however, take place in jurisdictions that have variants of either the English common law or continental civil law. To minimise legal risks, the contracts sanctioned by SSB must comply with the laws of the country and also consider how disputes can be resolved in courts that apply non-Islamic commercial laws.

The current global financial crisis revealed both the strengths and weaknesses of Islamic finance. The strengths lie in Islamic principles that shielded the industry from factors that caused the crisis. Not only did the rules of Islamic commercial law prohibit the use of toxic products (such as credit-default swaps), its requirement of linking financing to the real sector would also have prevented the massive build-up of leverage. Although the Islamic financial sector was not directly affected by the crisis, the global recession and resulting downturn in economic activities in many Muslim countries affected the industry indirectly. The economic decline led to non-performance of several Islamic transactions and exposed some weaknesses in their structures. The predicament was highlighted in the non-performance of the Dubai based $3.5bn Nakheel *sukuk* (Islamic bond) in December 2009.

While debate on form over substance in Islamic finance has been going on for some time, the crisis brought the issue to the forefront. Critics claim that Islamic finance is primarily involved in replicating the practices of conventional finance. In doing so, Islamic financial transactions are conforming to Islamic law in form, but failing to meet its substance and spirit. One area in which this disparity is apparent is Islamic bonds or *sukuk*. The certificates issued appear to have diluted the Shariah requirements and are not fulfilling the substance of Islamic law. This article highlights the form/substance debate by examining a key legal issue in the case of *sukuk*.

SUKUK

The Accounting and Auditing Organization for Islamic Financial Institutions ('AAOIFI') defines *sukuk* as 'certificates of equal value representing after closing subscription, receipt of the values of certificates and putting it as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of special investment activity' (AAOIFI 2003, p 298). AAOIFI identifies 14 types of *sukuk* that can be classified based on assets, debt, equity and services. If the *sukuk* represent ownership of real assets or usufruct, they are negotiable and can be traded. However, if the instruments represent debt or money then they can be exchanged at par value only. For the purpose of this article, the widely used *ijarah*-based *sukuk* will be discussed.

Under an *ijarah sukuk*, the originator or obligor identifies a tangible asset, such as building or land, which forms the basis of the *sukuk*. A bankruptcy remote special purpose vehicle ('SPV') is established, usually in the form of a trust, to cater to the needs of the investors or *sukuk* holders. The asset is sold to the SPV which issues *sukuk* against it and the proceeds from the sale are passed on to the obligor. *Sukuk* certificates represent ownership of the asset which is held by the SPV in trust. The asset is leased to the obligor who pays periodic rent to the *sukuk* holders through the SPV. The rent paid can be fixed or variable linked to some benchmark rate. To repay the principal amount at maturity, a purchase undertaking is used by the originator to buy back the asset at par value.

To fulfil the Shariah requirements certain conditions of sale and ownership must be fulfilled. Ownership or propriety rights (*milk*) give the owner rights of possession and disposal. While ownership gives the owner the right to benefit from the property or its usufruct, the actual use of the benefits is possible with possession. The consequence of a valid sale is the exchange of ownership of an object and consideration. Thus, ownership and possession in sale contracts signifies complete transfer of the property and its associated risks from the seller to the buyer.

Islamic law distinguishes actual and constructive possession. In the former, moveable objects of sale are physically transferred to the buyer. In the latter case, physical transfer does not take place but possession is implied in the right to control and use the object. This would be the case for immovable objects (such as land) or financial transactions such as bank account transfers. The Islamic *Fiqh* Academy has ruled that constructive possession without physical possession in financial transactions is legally valid (Resolution No 53/4/6 in IRTI & IFA 2002, pp 107-08).

ASSET BACKED V ASSET-BASED

There are some contentious issues related to the contemporary *sukuk* from Shariah perspectives. One issue relates to the sale of assets and its implications to risks and returns for investors and issuers of *sukuk*. An asset-backed *sukuk* will involve a true sale and transfer the assets from the originator to the *sukuk*-holders. The transfer of ownership in the legal sense will involve 'effective registration of the property in the name of new owner(s)' and will be 'binding in any court process' (Howlader 2009). As a result of the sale, the asset would move from the balance-sheet of the obligor to the investors (through the SPV). In the case of bankruptcy of the obligor, the investors would have recourse to the asset and will have priority of claims over unsecured creditors.

Asset-based *sukuk* replicates a conventional unsecured bond, but uses an asset in the contract to fulfil the formal Shariah requirements. Th e requirement of transfer of ownership in the sale of the asset is allegedly fulfilled in its beneficial or constructive ownership by the investors. In reality, the sale of the underlying asset is not true either from accounting or legal (English law) perspectives (Dusuki and Mokhtar 2010). A key element in these types of *sukuk* is the use of a purchase undertaking whereby the originator promises to purchase the asset back at par value either at maturity or in the case of early termination (such as bankruptcy of the originator). Through the sale brought about by the undertaking, the credit exposure of the investors is transferred to the obligor and the investors do not have recourse to the asset. Thus, in the case of bankruptcy the asset is sold back to the obligor and the investors will rank *pari passu* with other unsecured debtors in terms of their claims. As ratings are based on the substance, Moody's considers the asset-based *sukuk* as a conventional unsecured bond with no recourse to the asset and rates the instruments according to the obligor's credit worthiness (Howlader 2009).

The *sukuk* market is dominated overwhelmingly by the asset-based *sukuk*. Dusuki and Mokhtar (2010) find that only 11 out of a total of 560 *sukuk* issues (or around 2 per cent of the total) qualify to be asset-backed as these fulfil the Shariah requirements of an actual sale of the underlying asset to the investors. Concerned about the incoherent practice in the market, the Shariah Board of AAOIFI issued a statement in February 2008 to stress that sale of the assets to the *sukuk* holders must be true with all associated rights and obligations of ownership and must be reflected in the accounting books.

The dominance of asset-based *sukuk* is sometimes blamed on the inconsistency of Islamic contracts with the prevailing non-Islamic legal framework and economic incentives of suppliers and demanders of *sukuk*. The fact that some asset-backed *sukuk* have been issued in Malaysia and the Gulf Cooperation Council region and that these resemble the widely prevalent asset-based securities in conventional markets indicate that the legal obstacles are not constraining factors. Yet the economic arguments of not using asset-backed *sukuk* are also weak. On the supply side, the originators can get relatively higher ratings compared to their asset-based counterparts which can substantially reduce the cost of funds. For instance, Moody's rated the Tamweel's asset-backed *sukuk* the maximum possible in the UAE of Aa2. An asset-based sukuk by the same company was four notches below at A3 during 2009 (Howlader 2009). On the demand side, the asset-backed *sukuk* provides a safer bankruptcy remote investment option to the investors.

CONCLUSION

While the principles of Islamic finance have much to offer to bring about stability in the financial system, the practice of the industry is drifting closer towards conventional finance. In the aftermath of the financial crisis, the Islamic finance industry needs to ponder on whether it should tread the current path of mimicking the practices of conventional finance and reproduce the associated inherent risks or move to a path that makes it distinct with its values and legal principles intact. Moving towards more substance-based Islamic finance is required for a more fundamental reason. Diluting the Shariah principles has a potential for creating reputation risk that can affect the long-term integrity and growth of the industry. In this regard, the Shariah governance has an important role to play. All Islamic products, including *sukuk,* coming to the market are approved by a SSB. Proliferation of products like asset-based *sukuk* indicates that the SSBs are not performing their roles as the gatekeepers of the industry. One way to bring discipline in Shariah governance may be to provide regulatory overview and guidelines that can help redirect the industry to more substance-based Islamic finance.

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