

Sustainable Sukuk Markets: The Role of Sovereign Sukuk

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Abstract

An essential driver of Sukuk markets is sovereign Sukuk. The prevailing mechanism for issuing sovereign Sukuk is complex and imposes severe limitations on the issuance of sovereign Sukuk. This paper presents an alternative model for a scalable, efficient and sustainable framework of sovereign Sukuk. The key to this framework is the establishment of the “Sovereign Finance Corporation” as an entity dedicated to financing the government’s activities using fixed-income Islamic modes of financing. The SFC acts as a financial intermediary between the government and capital markets and as a reserve builder for future financing of the government. The cash flow analysis and numerical simulations suggest the promising feasibility of the proposed framework.

Keywords: Sukuk, Simulation, Sovereign Finance Corporation, Fixed income, Islamic finance, Supply Chain Platform

Jel Codes: G00, G10

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Introduction

Sukuk markets are growing steadily worldwide. Sovereign Sukuk represents a major component and an instrumental factor behind the growth and resilient of the market. According to the International Islamic Financial Market (IIFM) Sukuk Report, total sovereign Sukuk issuance during 2001-2019 stands at USD 680.7 billion, or 54.58% of all global Sukuk issuances during that period. In 2019, sovereign Sukuk issuance represented 59% of domestic issuances, and 30% of international issuances. Sovereign Sukuk dominated the Sukuk market, both domestic and international, but they played a more important role domestically.

Despite the critical role of sovereign Sukuk, the prevailing Sukuk structures impose severe limitations on the scalability and sustainability of the market. For this reason, there is an increasing need for a flexible and sustainable mechanism for the issuance of sovereign Sukuk. Structured adequately, such a mechanism could serve the needs of liquidity management of the Islamic financial industry.

This paper presents a model that aims to meet these objectives based on Shari'ah resolutions of the OIC Fiqh Academy and AAOIFI Shari'ah standards. The proposal lays down a flexible framework for financing a wide range of government activities without the need to pledge physical sovereign assets. It also permits the use of various Islamic modes of finance without hindering the ability to trade Sukuk according to Shari'ah principles. The model is not intended to replace existing instruments for sovereign financing; rather, it acts to complement them and offer an opportunity to diversify sources of funding.²

1. Overview

1.1 Issues in the Prevailing Sukuk Model³

One of the currently common structures of Sukuk involves the sale of a tangible physical asset to a Special Purpose Vehicle (SPV), on the condition that the asset is leased back to the seller (who needs financing), with the undertaking to buy it back at maturity at nominal value. The certificates issued by the SPV represent the Sukuk, which pay regular income reflecting the rental payments of the leased asset. This model has the advantages of being simple and allows the issuance of tradable Sukuk due to ownership of the tangible asset. Being based on rental payments, these Sukuk are classified among fixed income instruments. From a practical perspective, however, a number of obstacles emerge.

Asset Ownership

² The proposed model is a cumulative outcome of collaboration among international lawyers, Shari'ah scholars, Islamic finance experts, as well as officials from IsDB Member Countries led by the author and the Financial Product Development team at the Islamic Research and Training Institute. A brief description of the model appeared in Al-Suwailem (2015). The current paper includes substantial improvements as well as cash flow analysis and numerical simulation.

³ This section is adopted from Al-Suwailem (2015).

First, there is the issue of transferability of the ownership of a sovereign asset to investors, particularly if they are non-citizens. This leads to complex legal procedures for Sukuk issuance in order to avoid the “true ownership” of such assets. Hence, Sukuk were transformed from being “asset-backed,” i.e., representing the true and legal ownership of the underlying assets, to being “asset-based,” whereby Sukuk holders do not fully and legally own the underlying asset. The underlying assets, therefore, become of marginal value in the structure. This can be seen from the clauses common in Sukuk documents stating that:

“No investigation or inquiry will be made, and no due diligence will be conducted in respect of any of the constituent assets” ...

“In particular, the precise terms of any of the constituent assets comprised in the Portfolio will not be known” ...

“No steps will be taken to perfect any transferor any of the relevant constituent assets comprised in the Portfolio”.

This obviously violates the basic Shari‘ah requirements of a valid sale transaction. As a result, such Sukuk are not fundamentally different from conventional bonds. They are explicitly described in the Sukuk documents as “unsecured”. This contradicts the claim of “purchase” and “ownership” of the underlying assets.

Haneef (2009) provides an overview of the developments of Sukuk since 2000, and concludes (p. 110):

Today, almost all Sukuk offerings are asset-based securities. The Sukuk will have Shari‘ah-compatible underlying assets, but the Sukuk holders will not have any security interest over the assets. The asset-based Sukuk are treated as senior unsecured securities similar to unsecured conventional bonds.

Limitations of Physical Assets

Second, Sukuk issuance is constrained by the existence of unencumbered, physical Shari‘ah-compliant assets with an aggregate value at least equal to the nominal amount of the Sukuk be used to support each issue of Sukuk. Such assets may not be possible in all cases, nor as regular as needed. Consequently, the structure does not allow sovereigns to issue Sukuk on a regular and predictable basis.

Accounting Issues

From an accounting perspective, the assets used to issue the Sukuk are not transferred from the balance sheet of the obligor or the seller because of the undertaking to buy them back at nominal value. This undertaking is a debt obligation on the obligor. With this debt on the balance sheet, the assets cannot be transferred from the seller’s balance sheet. But the presence of these assets on the obligor’s balance sheet is inconsistent with a true and genuine sale transaction.

Alignment of Finance and Economic Activities

Finally, the structure does not align Sukuk issuance with economic activities. The sale and lease transactions are applied to assets of no economic contribution. Hence, the financing and economic activities are disconnected. This might lead to an unproductive build-up of debt.

Shari'ah Rulings

Due to the Shari'ah-related problems facing this model of *ṣukūk*, the International Islamic Fiqh Academy, in its 20th conference in 2012, issued resolution no. 188 prohibiting stipulated sale-and-lease-back that ends up obtaining money spot in exchange for more money in the future. The resolution states:

"It is not permissible to sell an asset at a cash price on the condition that the seller leases back this asset with a promise to own, at a total price, including the rent and the price, that exceeds the cash price, regardless of whether this condition is expressed or implied, because this is a form of 'Einah that is prohibited by Shari'ah. Accordingly, it is not permissible to issue Sukuk based on this formula".

The *Ijārah* Standard issued by the Shari'ah Board of AAOIFI ruled that it is not permissible to stipulate the lease-back in the sale contract.

Paragraph 3/2 of Standard (9) states:

"It is permissible to acquire an asset from a party and then lease it to that party. It is not permissible, however, to stipulate the lease as a condition in the sale contract by which the institution acquired the asset."

Given these resolutions and the above-mentioned difficulties, there is a serious need for a sound and credible alternative that meets the needs of sovereigns in raising funds and complies with the principles of Islamic finance.

1.2 Objectives of the Proposed Framework

To meet the need of the OIC Member Countries for mobilizing resources, a Sukuk model should ideally satisfy the following characteristics:

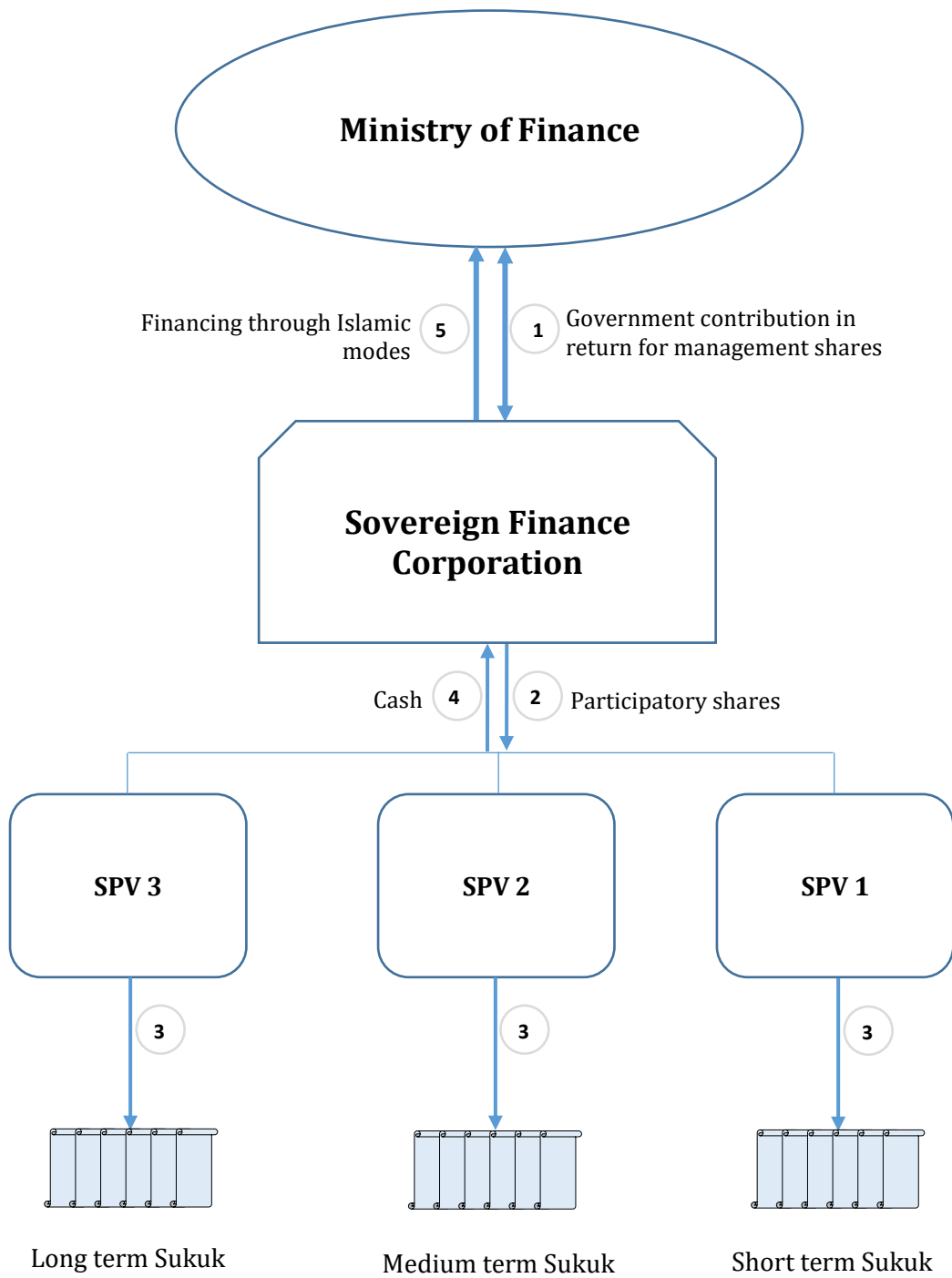
1. Sukuk issuance should not require using sovereign physical assets since such assets may not always be available. Moreover, the transfer of sovereign ownership of tangible assets might prove tremendously problematic.
2. The model should provide sufficient flexibility to select the most appropriate mode of financing and not be restricted to a single mode of financing.
3. The model should allow issuing Sukuk on a regular basis to meet the goals of the government's financial plans and to enable the financial market to manage liquidity in a robust manner.
4. The model should be scalable to allow Sukuk to grow as the financial capacity of the government grows in tandem with economic expansion.
5. The model should be structured efficiently to allow the sovereign to mobilize resources at competitive prices.

1.3 The Sovereign Finance Corporation

The proposed model can be summarized as follows:

1. The government establishes a financial institution, the Sovereign Finance Corporation (SFC) that will be responsible for financing the government's economic activities. Ideally, a law establishing the SFC and defining its duties and prerogatives shall be passed.
2. While it is not a commercial bank, the SFC plays the role of "the government's Islamic bank." It exclusively finances government economic activities through Shari'ah-compliant fixed income contracts such as Murabahah, Ijarah, and Istisna'a. By doing so, the assets of the SFC represent sovereign obligations.
3. The SFC issues two types of shares:
 - a. Management Shares (5-10% of the capital), to be owned by the government (Ministry of Finance). The government acquires these shares by providing cash or in-kind contributions.
 - b. Participatory (or Investment) Shares, to be owned by investors via Sukuk certificates as described below.

Figure 1: Participatory / Management Shares



1.4 Sukuk Issuance

- 1.The SFC establishes a Special Purpose Vehicle (SPV) and transfers the Participatory Shares to the SPV.
- 2.The SPV issues Certificates (Sukuk) to investors, backed by the Participatory Shares. The Sukuk represent ownership of SFC shares.
- 3.The Sukuk Certificates are redeemable over a defined period of time (say 5 years).
- 4.The SFC can create more than one SPV to issue Sukuk with various maturities.

1.5 Tradability

Since the SFC is a fully-fledged financial institution, its shares are treated the same way as the shares of any Islamic bank. According to OIC Fiqh Academy Rulings no. 180 and 196, these shares are tradable since they represent the ownership in the institution.

1.6 Redemption

The SFC promises to redeem the Sukuk at par subject to the performance of the underlying assets and the generated cash flows. From this perspective, the promise to redeem is not a debt obligation on the SFC, and thus no Shari'ah issue should arise in this regard. The involved risks nonetheless are still sovereign risks, as elaborated below.

1.7 Risks

Since the SFC is exclusively financing the government through fixed income contracts such as Murabahah, Ijarah, and Istisna'a, the SFC assets are carrying only sovereign risk. The SFC by construction has no debt obligations, and thus SFC shares reflect only the risk of the underlying assets, namely sovereign risk.

This risk is further reduced by the contributions from the government in the SFC's capital, which can be used as collateral government's obligations. In addition, the profits accumulated by the SFC above Sukuk returns (coupons) serve as reserves that enhance the creditworthiness of the SFC over time and thus reduce the cost of future funding.

Although the SFC does not guarantee the nominal value of Sukuk, redemption is subject to the performance of the underlying assets, which are sovereign obligations. Thus, risk is a sovereign credit risk. Furthermore, since the government owns the management shares, management risk is also sovereign. From Sukuk holders' point of view, therefore, the risks of the Sukuk are solely sovereign risks.

1.8 Sukuk with Different Tenors

As stated earlier, it is possible to create several SPVs to issue Sukuk with different tenors: short, medium and long term. Sukuk with different maturities will have different coupon payments. This can be structured by setting different sharing ratios between Sukuk holders and the SFC as the manager of the SPV issuing the Sukuk. The ratios will be in line with the maturity of the Sukuk.

Sukuk with various maturities can significantly facilitate the liquidity management of the Islamic financial industry. It also provides tools for monetary policy and lender of last resort to Islamic banks. Any profit potentially generated from this maturity mismatch is intended to be kept as reserves in the SFC, and as for all other non-distributed profits; it will over time enhance the creditworthiness of the SFC.

1.9 Waqf Sukuk

Waqf Sukuk are ordinary Sukuk whereby investors agree to donate their returns (coupons) to the SFC to support public projects. The Waqf Sukuk will have a separate SPV, as with other Sukuk classes, but the coupons will be reinvested with the SFC. Although the relative size of the Waqf Sukuk might not be substantial, they would play an essential role in enhancing the social responsibility message of the SFC and thus in gaining public confidence and support.

1.10 Support from the Central Bank

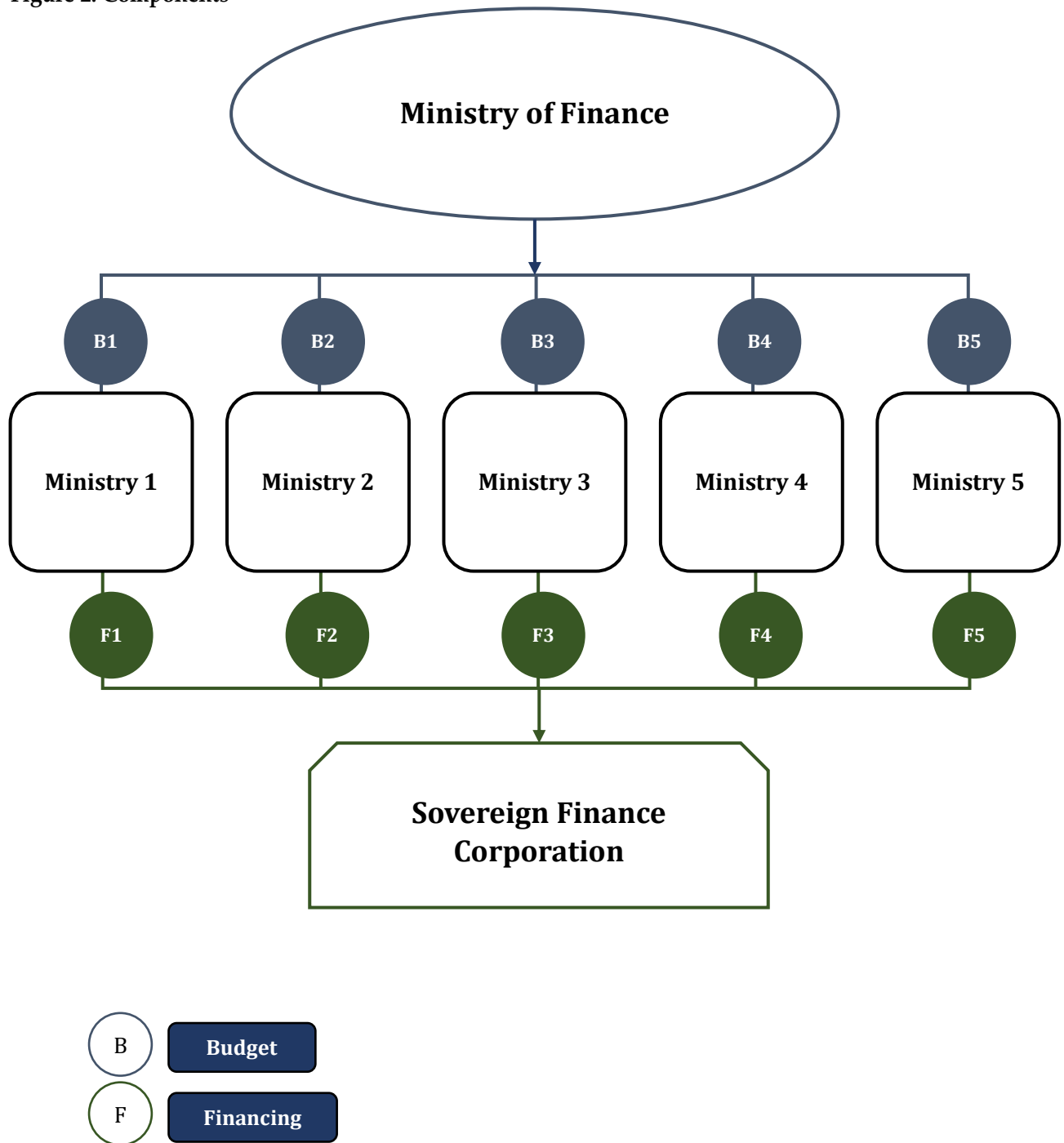
Since Sukuk can be issued with different maturities, Sukuk redemption may need liquidity support given the possible mismatch between the maturity of the Sukuk and that of government obligations. To mitigate any mismatch, the Central Bank may provide a line of financing to the SFC. The Central Bank may also provide currency exchange hedge in case the Sukuk are issued in a foreign currency so that this risk is still sovereign.

2. Organizational Relations

There are many ways to organize the relationship between the SFC and government entities, but we need to find the most efficient and effective. One approach is to consider the SFC as the “government’s Islamic bank,” as mentioned earlier. The SFC is a financial intermediary between government entities on one side, and capital markets on the other. This intermediation adds value by reducing the overall cost of financing for the government while providing investors competitive returns, as we shall see in subsequent sections.

The SFC will provide financing to government entities (or ministries) to supplement their budgets. Traditionally, ministries receive their allocated budgets from the Ministry of Finance (MoF). Through the SFC, ministries and government entities will be able to expand their activities beyond the budget, by obtaining financing from the SFC. The SFC will treat the approved budget as the “income” of the entity and will provide financing within the limits of this income, as banks usually do. Accordingly, repayment of the financing will be from the entity’s allocated budget. This allows the entities to plan and manage their financing according to their available resources with a reasonable degree of flexibility under the control and supervision of the Ministry of Finance.

Figure 2: Components



In addition, the above model allows for better harmony and synchronization between funding and spending at the ministry level. Since each ministry is able to interact directly with the source of financing, they are able to better align the two sides of the budget constraint, revenues, and expenditures. This alignment is expected to promote better coordination and information sharing (Welham et al., 2015).

2.1 Supply Chain Platform

The SFC model can capitalize on the recent developments in supply chain management. Properly managed supply chains are essential for the success of a business (Sarkar, 2017). Technological advancements in supply chain platforms make this even more important (Hofmann et al., 2018). The revolutions in platform economics prove that this is indispensable in the 21st century (Evans and Schmalensee, 2016).

Supply chain platforms for governments have been successfully applied in some OIC Member Countries. For example, Saudi Arabia developed its *Etimad* platform⁴ to manage its suppliers' relationships and processing government's procurements. The platform introduced financing by local Islamic banks.

Following a similar approach, the government can set up a supply chain platform to manage supplies for its entities. Financing these supplies using fixed-income Islamic contracts will be straightforward and actually more Shari'ah compliant than the traditional, manual approach. The OIC Fiqh Academy approved contracting through electronic means more than 30 years ago, in its ruling no. 52 issued in 1990.

Accordingly, we can think of the SFC as the entity holding and managing the government's supply chain platform. That is, the SFC will not be a traditional "brick and mortar" financing company. Instead, it will be primarily a platform coordinating the supplies of the government's entities and financing them. Put differently, the SFC Sukuk may be viewed, at least in part, as securitizing the supply chain platform. The SFC becomes a true model of integrating finance with real economic activities.

2.2 Sustainability

The SFC model is intended to be a sustainable source of financing. This can be achieved by *amortizing* debt through periodical installments. This allows available resources to be used for an indefinite period of time. When the government invests in the equity of the SFC, it provides resources for self-financing (or "renewable financing") of public spending. Since financing is for-profit (through the markup), the SFC will be able to pay for its expenses and to expand its operations in tandem with the expansion of the government and the economy. The government's equity in the SFC, therefore, serves as a reserve for future generations. From this perspective, the SFC complements the role of the Sovereign Wealth Fund in building up sustainable resources.

⁴ <https://www.mof.gov.sa/en/eservices/Pages/Eitimad.aspx>.

Amortization also provides an incentive mechanism to discipline financing and spending by the government entities. Compared with a bullet payment approach, installments are relatively larger in absolute value than the amount payable for the bullet payment financing (typically the coupon of the Sukuk). The higher installment incentivizes the entity planning to obtain financing to select only those activities or projects with sufficient value that justifies the periodical installments. This also helps to control the accumulation of debt, since unless the full installment is available in the entity's budget, the corresponding amount of financing will not be available. Put differently, the additional amount in the installment over the coupon acts as a "barrier to debt" that helps manage the level of debt and thus improve government's credit risk.

Moreover, each ministry or government entity needs to ensure that the installments are paid from the budgeted programs so that the budget suffers no additional burden. For example, suppose the budget allocates \$ x p.a. to the Ministry of Health, say, for establishing a certain number of primary care centers annually. Then, the Ministry of Health will be able to obtain financing that allows it to establish double or triple that number in year 1, such that the same allocated annual budget, \$ x , will be used to pay the periodical installments over the lifetime of the financing. Having more health care centers built in year 1 generates more social value in terms of public health than spreading them out over several years if no financing was available. In this manner, the Ministry of Health is able to achieve its developmental objectives without giving up its ability to pay for other programs.

On the spending side, higher installments, compared to the coupon payment only, impose discipline on spending by directing available cash to productive projects, thus controlling agency costs due to "free cash."⁵

Finally, amortization allows the SFC to allocate its capital efficiently among various ministries. When a ministry repays an installment, the funds become available for another round of financing to the same or other ministries, thus maximizing the utilization of resources. We shall see later in detail how amortization may help improve credit risk and reduce the cost of financing.

2.3 External Investors

Although it is conceivable that the SFC obtains funding completely from the government (through management shares), this might soften the incentives for debt repayment by ministries given that the SFC, in this case, will be an internal body within the government structure.

For the SFC to be fully independent, and thus its debt obligations are treated as "hard debt," external investors are invited to participate in the SFC through shares backed Sukuk, as explained in the Overview section. In this manner, the SFC becomes an independent financial

⁵ See: Michael C. Jensen (1986) "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review*, vol. 76, no. 2, pp. 323-329.

institution operating according to market standards and best practices. The SFC will be responsible for protecting the interests of the investors, resulting in better management of resources and thus lower costs of funding. By combining government's contribution with investors' contribution, the SFC is able, in principle, to achieve both objectives: (1) Self-sustainable financing and (2) efficient access to external finance.

3 Cash Flow

3.1 Reinvesting Installments

As outlined earlier, the SFC finances government's activities using Shari'ah-compliant fixed income modes of financing. To simplify the analysis, let us assume the SFC raises \$100 M in 5-year Sukuk, with the (expected) return of 5% p.a. For the time being, we assume the SFC has no equity from the government. We assume further that the SFC finances, say, a transaction by a particular ministry of \$100 M value at a markup rate of 5%.⁶ The ministry has to pay the deferred price in annual installments over 5 years. We assume for simplicity that there are no transaction or management costs. The following matrix summarizes the resulting cash flow.

The financing is executed in year 0, and it creates a debt obligation on the ministry of \$115.49 M, to be repaid in five installments, each = \$23.1 M. By the end of year 1, the ministry pays back \$23.1 M, of which \$5 M is deducted as returns (coupon) to Sukuk holders. The remaining \$18.1 M is reinvested in financing other activities of the ministry or other ministries. See Figure 1.

⁶ The rate applies to outstanding balance.

Figure 3: Cash Flow

Year	0	1	2	3	4	5
	100	23.1	23.1	23.1	23.1	23.1
		18.1	4.2	4.2	4.2	4.2
			22.3	5.1	5.1	5.1
				27.4	6.3	6.3
					33.8	7.8
						41.6
	Installments					
	Available cash for reinvestment					

The \$18.1 financing creates another 5-installment obligation, each of which is \$4.2. (Installments beyond year 5 are not shown here for brevity.) By the end of year 2, the SFC will receive two installments: \$23.1 for the 0-year \$100 financing and \$4.2 for the 1-year \$18.1 financing, for a total repayment of \$27.3. Again, \$5 coupon is deducted from the total repayment, and the resulting amount, \$22.3, is invested again, and so on. By the end of year 5, the SFC would redeem outstanding Sukuk and issue new ones to keep the process going. The financials of each, the government and the SFC, are presented in Table 1.

Table 1: Financials of Government and the SFC

Year	1	2	3	4	5
<u>Government</u>					
Deferred price (b. of year)	115.49	20.90	25.73	31.67	38.99
Paid-off debt (e. of year)	23.10	27.28	32.42	38.76	46.55
Total debt	92.39	86.01	79.32	72.23	64.66
Debt outstanding (PV)	81.90	77.72	72.58	66.24	58.45
<u>SFC</u>					
Cash	18.10	22.28	27.42	33.76	41.55
Investments	81.90	77.72	72.58	66.24	58.45
Total Assets	100.00	100.00	100.00	100.00	100.00

There is a possibility of “reinvestment risk,” i.e., a potential gap between repayment of installments and reinvesting these installments with the government, resulting possibly in a “negative carry”. This risk can be minimized by a (unilateral) commitment of the government (the MoF) to finance a certain portion of government’s budget through the SFC according to a pre-agreed financing plan. If the government in some years enjoys a surplus, part of the surplus could be invested in the equity of the SFC. As pointed out earlier, this investment serves as a reserve for the future. In addition, to minimize reinvestment risk, the SFC may invest surplus cash in higher-rated assets or Sukuk (e.g., IsDB AAA-Sukuk). This helps to diversify the portfolio of SFC assets and improve its returns.

The reinvestment risk is only a risk of generating less returns than desired, i.e., it is a risk related to the upside returns. But it offers protection on the downside risk. If, for example, the

credit rating of the government was downgraded, then the SFC may require additional collateral, raise the cost of financing, or finance only a portion of the requested funding, before deciding to reinvest with the government. Since the SFC is jointly owned by the government and outside investors, many of them might be international investors, and the SFC needs to protect the rights of those investors by preserving the credit quality of its assets. This protection results in a lower cost of funding for the government, so the government is the ultimate beneficiary of preserving the quality of SFC assets. The right of the SFC not to reinvest is obviously restricted to very special and unlikely events, but it does impact the cost of funding. This right shows how the SFC Sukuk differ from bullet payment bonds or Sukuk, as will be discussed shortly.

3.2 Asset Composition

If we assume the SFC is financing the government at the same rate it pays Sukuk holders, then it will not be making any net profits. Thus total assets will always be \$100 M, the same value of the principal raised through Sukuk (when we have no government equity contribution).

We also note that outstanding debt with the government (in present value) by the end of year 5 is \$58.45 M. Although the SFC raised \$100 M in Sukuk, due to amortization, outstanding government's debt is about 40% lower than if it raised a bullet-payment Sukuk. The difference is cash paid out in installments. This percentage drops in later years to about 30%. Table 2 shows the same financials for the years 10-15.

Table 2: Financials of Government and the SFC (years 10-15)

Year	10	11	12	13	14	15
<u>Government</u>						
Deferred price (b. of year)	38.49	38.38	36.15	37.02	37.48	37.54
Paid-off debt (e. of year)	38.23	36.31	37.06	37.45	37.50	37.31
Total debt	73.62	75.69	74.79	74.36	74.33	74.56
Debt outstanding (PV)	66.77	68.69	67.94	67.55	67.50	67.69
<u>SFC</u>						
Cash	33.23	31.31	32.06	32.45	32.50	32.31
Investments	66.77	68.69	67.94	67.55	67.50	67.69
Total Assets	100.00	100.00	100.00	100.00	100.00	100.00

The pattern for later years is roughly the same. That is, the level of government's debt stabilizes around 67.7%. The maturity of this debt is 1-4 years. The remaining 32.3% is cash received from installments paid by the end of the year. In other words, at any point in time during the year, about 32% of the Sukuk assets are either cash or receivables of less than one-year maturity, while 68% is of 1 year or more maturity.

From Sukuk holders' perspective, this composition of assets improves the maturity structure of their investment and thus makes it less risky. It is as if they are investing in a diversified portfolio of assets, some of which are short-term, and some are medium-term. Based on the above model, the average maturity of invested assets, for year 15, is about 2.3 years. At the beginning of any given year, all cash is supposed to be invested with the government. Assets of SFC at this point in time are only receivables from the government. The table below shows

the payable installments to the SFC over the coming 5 years, starting at beginning of year 15. Reinvestment is not reflected below since it occurs at the end of the year.

Table 3: Payable Installments to the SFC over the Coming 5 Years

Receivable Installments				
Beginning of Year 15				
15	16	17	18	19
7.68				
7.23	7.23			
7.40	7.40	7.40		
7.50	7.50	7.50	7.50	
7.51	7.51	7.51	7.51	7.51
Total	\$111.87			

The sum of payable installments equals total debt at the end of year 14, \$74.33, plus the deferred price created at the beginning of year 15, \$37.54 (see Table 2). The sum is $\$74.33 + \$37.54 = \$111.87$. Table 4 below summarizes the distribution of SFC assets according to their maturities. Average maturity is simply the sum of the percentage of each group of assets times its maturity.

Table 4: Distribution of SFC Assets According to Their Maturities

Distribution of Assets at the Beginning of Year 15	
Maturity (years)	Percentage
1	33.4%
2	26.5%
3	20.0%
4	13.4%
5	6.7%
Total	100.00%
Average Maturity	2.34 years

If the yield curve, or the term-structure of the interest rate, is positively sloped, then this should result in a lower overall rate for Sukuk. A positively sloped yield curve implies that the rate for short-term debt is less than that for the long-term.

Although the Sukuk term is 5 years, the SFC finances each transaction separately. Therefore, in the case of unexpected circumstances, the SFC shall take the necessary steps to protect the interests of investors according to the terms and conditions of the Sukuk certificates, as explained earlier. This means that, while investors are providing their capital for 5 years, their investment is managed in a manner that replicates the risk profile of a portfolio of short-term and medium-term assets. For a positively sloped yield curve, this implies that the coupon on the SFC Sukuk would likely be less than market rates of 5-year bullet-payment government debt. Thus, the cost of funding for the government is likely to be lower.

3.3 Costs

In addition to the maturity structure of the assets, the SFC model improves the cost of financing due to amortizing of debt. Amortization results in lower total cost compared to bullet-payment. If a \$100 M debt at 5% p.a. is amortized over 5 years, total paid-out costs = \$15.49 M. This translates into 3.1% p.a. of capital. For a bullet-payment structure (with an

annual coupon of \$5 M), the debtor has to repay \$100 M at the end of year 5. Total paid-out cost, therefore, becomes \$25 M, or 5% p.a. of capital.

The bullet-payment structure might provide more flexibility to the debtor compared to amortized debt, since in the latter, the debtor has to pay \$23.1 M in annual installments, compared to only the coupon of \$5 M for the former. This gives the bullet-payment structure liquidity of \$18.1 M annually. However, to repay the principal, the debtor needs to invest the \$18.1 at 5% p.a. compounded in order to generate \$100 at maturity. This will be an advantage if the debtor is a profit-making entity, in which case it will invest the \$18.1 M in its operations (assuming it generates 5% p.a. or more). In this case, the debtor is able to invest the full \$100 M in its own business.

However, if the debtor is not a profit-making entity, like most government entities, the \$18.1 M must be invested with a third party; thus, the amount will not be available to support the operations of the entity. This makes the two structures, bullet, and amortized repayment, equivalent in terms of the available funds for spending. However, they are not equivalent in terms of risk. The bullet-payment generally poses higher risks to the debtor, and thus to investors, than amortized debt.

IMF researchers U. Das, M. Papaioannou, and M. Polan (2008), compare bullet-payment bonds to those with amortizing debt. They argue that bullet bonds tend to increase the rollover risk for the issuer as they create a 'hump' in the debt repayment profile. Further,

Amortizing bonds smoothen the repayment profile and decrease information asymmetry between the issuer and investors. Regular payments help investors monitor the issuer, and reassure them that the issuer is able to honor the payments. This can lead to a more rapid reduction in risk spreads. Also, amortizing bonds have a shorter duration than bullet bonds, thus making them less risky and, in turn, contributing to a lower cost of the issue (p. 16).

The two methods, bullet and amortized, may have equivalent risks only if the probability of default is assumed to be independent of size and maturity of the debt. Both assumptions are questionable, theoretically, and empirically. This is why we usually observe an upward sloping term-structure of the interest rate. Short-term debt usually pays lower rates than long-term debt, all other things equal.

In summary, in principle, the SFC model is able to integrate the flexibility of the bullet-payment with the efficiency of the amortized debt.

3.4 Building Reserves

As discussed earlier, the equity investment of the government in the SFC plays the role of reserves for future generations to support public projects. Equity also provides the returns needed to cover transaction costs and management expenses and thus making net profits. As

long as equity does not pay dividends, the SFC will be able to accumulate additional earnings to improve the risk profile of the SFC.

As pointed out in the Overview, government's equity can be used as collateral for its obligations towards Sukuk holders. The same is true for retained earnings. As these profits or earnings accumulate, the credit-risk of the SFC Sukuk improves, which may result in lower costs of funding compared to government's unsecured debt.

4 Simulation

In this section, we examine the performance of the SFC overtime given hypothetical assumptions about its capital and cost structure. As before, we assume the SFC finances government's purchases through Murabaha. For each transaction, the SFC charges 5% markup on amortized debt. The debt is to be repaid in 5 installments over 5 years, 1 installment per year. Collected installments will be used to finance other purchases by (other) government entities, and so on.

On the other hand, the SFC issues Sukuk backed by its shares, as explained earlier. To simplify, we assume the SFC issues \$100 M Sukuk. The government, meanwhile, invests \$8.5 M as equity in the SFC. The returns of these equities will be fully reinvested in the SFC operations. No dividends will be paid to the government. Total funds available to the SFC, therefore, is \$108.5 M.

Probably the most important factors are the coupon paid to Sukuk holders. Given that the average debt maturity of the SFC assets is 2.34 years (see Table 4), then the Sukuk coupon will depend on the yield curve. So, we assume that the yield curve is positively sloped, as normally is the case, with the following numbers.

Table 5: Yield Curve

Yield Curve	
Maturity (years)	Rate (p.a.)
1	1.00%
2	2.00%
3	3.00%
4	4.00%
5	5.00%

Given the distribution of maturity of the SFC portfolio, then the average rate of the portfolio should be close to 2.34% p.a. If we add management costs and reinvestment risk, we may consider the rate to be around 3% p.a. paid once a year.

To make our assumptions more realistic, we assume each parameter to be randomly distributed. The following table lists all input parameters and their distributions.

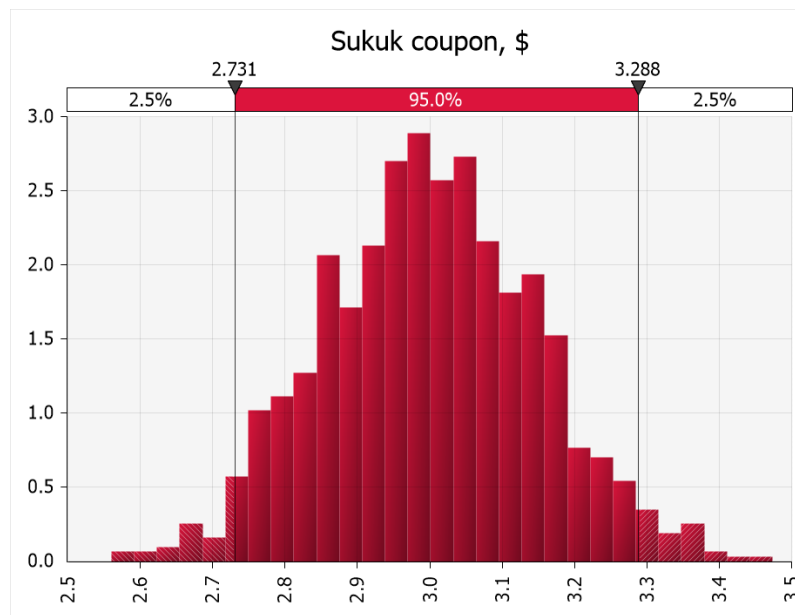
Table 6: Distribution of Input Parameters

Distribution of Input Parameters		
Parameter	Value	Distribution
1-year yield	1.00%	$N(.01, .001)$
2-year yield	2.00%	$N(.02, .002)$
3-year yield	3.00%	$N(.03, .003)$
4-year yield	4.00%	$N(.04, .004)$
5-year yield	5.00%	$N(.05, .005)$
Markup rate	5.00%	$N(.05, .005)$
Management fees	\$1 M	Uniform (1 M, 2 M)

The simulation was conducted using @Risk software, v.8.0, for 1000 iterations. The results are as follows.

4.1 Sukuk Coupon

Let us start with the Sukuk coupon paid to investors. As indicated previously, since Sukuk-holders own shares of the SFC, and therefore are directly exposed to its portfolio of assets, the Sukuk will reflect the risk profile of the portfolio. However, the distribution of the portfolio assets will change over time given the random distribution of input parameters. To simplify, therefore, we assume that the coupon rate is based on an equal distribution of different maturities, 20% each, resulting in 3% average rate. This distribution obviously is biased to the benefit of the investors. The point is that the coupon rate reflects market rates of the yield curve. The SFC shall pay investors this rate as the cost of Sukuk.

Figure 4: Sukuk Coupon \$

The graph above shows the distribution of the Sukuk coupon given the distribution of the yield curve. Investors were paid \$3 M or 3% on average, with a minimum of 2.56% and a maximum of 3.47%. These rates reflect market rates of the yield curve, as pointed out earlier. The rates are well-above the rates of the actual distribution of assets. The average distribution of asset maturities is presented in the following table.

Table 7: Average Distribution of Assets Maturities

Average Distribution of Assets Maturities	
Year (b.o.)	Distribution
5	2.24
10	2.35
15	2.35
b.o.: beginning of the year	

At the beginning of year 5, the average distribution is 2.24 years; while for years 10 and 15, it is 2.35. The corresponding rate on assets, therefore, should be around 2.4%; yet investors re paid on average 3% p.a.

4.2 Reserves

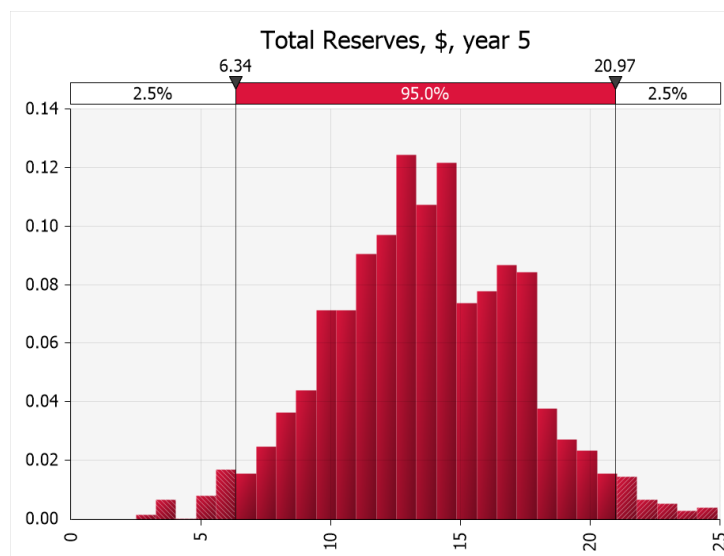
The SFC does not pay dividends to the government. It pays only the Sukuk coupon in addition to the management fees. All remaining income, therefore, is accumulated as retained earnings. Total reserves equal equity capital plus retained earnings. Total reserves, therefore, are an essential indicator of the performance of the SFC. They are also essential for its creditworthiness and, therefore, the cost of funding. The following table shows the average reserves for different years of the life of the simulation.

Table 8: Total Reserves, \$M

Total Reserves, \$M				
Year (e.o.)	Average	Minimum	Maximum	Std Deviation
5	16.37	2.48	24.9	3.6
10	26.42	-4.7	47.24	8.4
15	39.25	-13.3	77.65	14.7
e.o.: end of the year				

The distribution of reserves for year 5 is given below.

Figure 5: Total Reserves, \$, year 5



The probability of negative reserves is nil. This tells us that the \$8.5 M equity is sufficient to protect the SFC for the first 5 years. However, as the table shows, as time progresses, uncertainty builds up, and the SFC might incur losses by the end of year 10. However, the probability of negative reserves by year 10 is less than 1%, and about 2.1% for year 15.

Figure 6: Total Reserves, \$, year 10

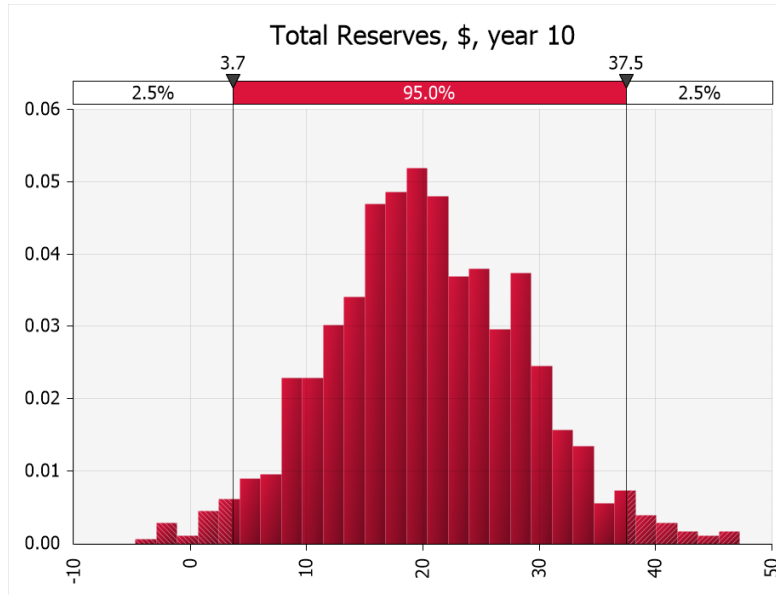
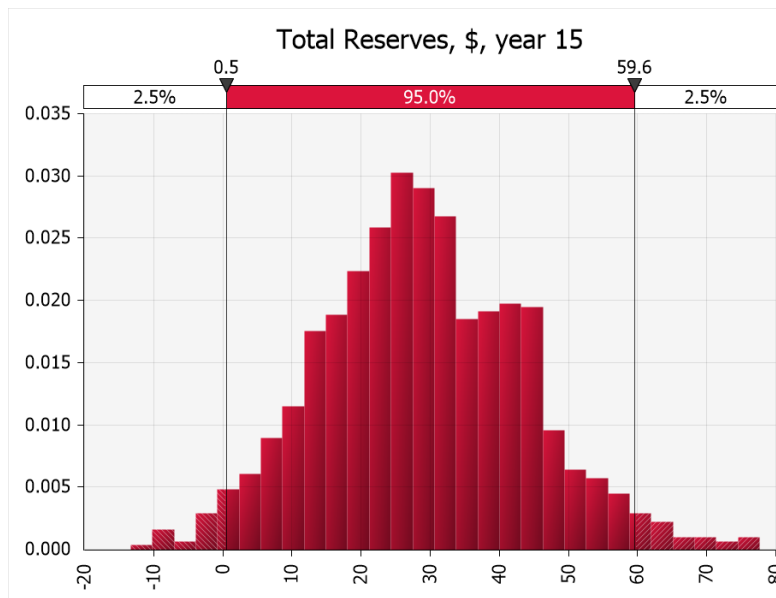


Figure 7: Total Reserves, \$, year 15



As the SFC accumulates reserves, its creditworthiness could be very well better than that of the (uncollateralized) government credit risk. In the long run, therefore, the SFC will be able

to mobilize resources at rates lower than those of the government. As pointed out earlier, the SFC could serve as a reserve building entity to serve future generations of the country.

Conclusions

A major player in the Sukuk market is governments. Sovereign Sukuk are essential not only for the depth and size of the market, but also for other sectors on the economy. Despite the critical role of sovereign Sukuk in supporting development, the prevalent model is very restrictive and apparently not sustainable.

This paper proposes an institutional framework for sustainable and efficient issuance of sovereign Sukuk to support the real economic needs of governments and government agencies. The Sovereign Finance Corporation model aims to meet these objectives. The SFC finances government activities through fixed income Islamic modes of finance and issues investment shares to back Sukuk issued to finance the government's activities.

The flexibility and sustainability of the model allow the government to plan its spending through scalable Sukuk programs to support economic activities. It also allows for improved risk profile resulting eventually in lower costs of funding.

The SFC model is not without costs or risks. But it has the potential to add value to sovereigns seeking Islamic modes of financing. The basic ingredients of the model are already applied and tested in the market, but the overall structure is apparently novel. The SFC, therefore, is not intended to replace the existing sources of sovereign finance. Rather, it helps to diversify and expand the available sources and strategies of funding in an efficient and sustainable manner.

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The Critical Shariah Issues of Sukuk

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Type: Research Article

Abstract

Purpose: The aim of the paper is to review some of the important Shariah issues of sukuk, especially in light of the controversies harboring some of them. The paper treats the three most critical Shariah issues of sukuk, which govern the legitimacy of sukuk from issuance to redemption. They relate basically to guaranteeing the capital invested and the return to the sukukholders, the sukuk being real representative of ownership of the underlying assets and the tradability of the sukuk.

Methodology: The paper employs a qualitative research methodology that adopts a textual and fiqh comparative analysis approach. The methodology also incorporates a macro perspective for treating the subject by analyzing the overall picture of sukuk in their current status.

Findings: The study primarily finds that certain controversies harbour the current standard structures of sukuk, which necessitates a revisit to sukuk engineering as it may have unnecessarily challenged the potential of sukuk on one hand and may have challenged some of the Shariah principles on the other.

Limitations: The study does not cover the accounting aspects of Sukuk nor does it cover their financial aspects.

Practical Implications: The study should help reconsider how sukuk should be structured to meet Shariah requirements.

Originality: Although the paper addresses some of the issues that have been addressed before, it acquires its significance and value from setting the basis for what constitutes Shariah compliant sukuk as an Islamic capital market instruments and showing the areas that need reform and reconsiderations.

Keywords: Sukuk, Guarantees of Sukuk, Tradability of Sukuk, Ownership of the Sukuk Assets

Jel Codes: G00, G10

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Introduction

Bonds are one of the most important financial and investment instruments. They enable the bond issuer to receive finance, and the bondholders to gain profit while having easy access to liquidity by reselling the bond when needed in the financial market (the capital market). However, bonds are based on the principle of a loan with interest, i.e. *riba*, as the buyer of the bond is considered a lender who earns interest from the issuer. The bond issuer promises to return the face value (i.e. the amount of the loan) upon the maturity of the bond, and pay an additional fixed amount on top of it. The issuer's guarantee of the face value of the bond makes it a loan, which renders the increment repaid on top of it *riba*. The trading of bonds is another problem from Shariah perspective, because it involves a sale of debt that does not fulfil its Shari'ah conditions, i.e. the maturity of the debt sold and the equality in the counter-values.

Sukuk (sing. *sakk*) have been proposed as a Shariah-compliant alternative to bonds. They help the sukuk issuer get the needed finance and the sukuk holders gain a profit with investment flexibility in terms of easy exit, similar to bonds, but in a Shariah-compliant fashion. It is natural that the Shariah legitimacy of this alternative arrangement necessitates the absence of guaranteed capital or return, as this is the main reason for the prohibition of bonds.

The common structure of sukuk is when the party that is in need of financing sells assets that it owns to the sukuk holders so that they become the owners of the assets. The same party then rents the assets from them. Hence, the sukuk holders earn from the rental amount. The sukuk issuer promises to buy the assets at a specified date in the future that is the maturity date of the sukuk. Through this sale contract, the sukuk holders get their capital back if the second sale price is the same as the first.

The paper treats different issues pertaining to the sukuk structure. These issues are ones that should distinguish sukuk from bonds. Basically, they relate to guaranteeing the face value and the 'projected' return of *sakk* to the sukukholders, the sukuk being real representative of ownership of the underlying assets and the tradability of the sukuk. While all these issues pose Shariah concerns, they are not of same importance. In fact, the first issue, i.e., guarantee of the *sakk* face value and return acquires special importance, as it is what practically distinguishes sukuk from bonds. This guarantee can be achieved by different means, and it varies according to the sukuk type. Some guarantees can be accepted, while others cannot. All this necessitates extensive study of the guarantee issue, and hence, it has been allocated a significant part of the paper.

After examining the detailed guarantee issues of sukuk, the paper proceeds to discuss how sukuk should represent common ownership of the sukuk underlying assets, and how failing to do so

may invalidate the very structure of the sukuk and thus undermine the very legitimacy of the sukuk. The paper, in this context, exposes certain market practices that may confirm the nature of some of the modern-day sukuk not being representative of real ownership, as those practices legitimately question the very sale of the sukuk assets to the sukuk holders. Finally, the paper tackles the last Shariah issue of sukuk; the tradability of the sukuk in view of the composition of their underlying assets, and it envisages four different scenarios in this regard. The paper then concludes with results and remarks.

In fact, the importance of the papers stems from tackling the above issues with the use of a critical scholarly methodology that subjects all relevant issues to careful Shariah scrutiny. The paper, unlike the most of the studies of sukuk, investigates sukuk in their real practices and not in their theory or ideal form. While comparing sukuk with bonds throughout the study, the paper implicitly draws the outlines of what constitutes genuinely Shariah compliant sukuk, so that their identity can be assured as Islamic and not just a replica of bonds.

The essential difference between a sakk and a bond is that a bond is a financial paper of a specified value representing a right to debt with interest, i.e., *riba*. The debt amount is made up of the original purchase price of the bond and the *riba* earned for its period. As for the sakk, it represents a right in the ownership of existing underlying assets that may include some cash and debt. In any case, a Shariah-compliant sakk does not guarantee the holder the amount invested (the face value of the sakk), or any return above that, unlike the bond, which guarantees to the holder its face-value and a fixed return on top of it. In addition, the circulation of sakk is not a circulation of debt, as a sakk represents underlying assets. If a debt is present in the sakk assets, it may only be part of it.

1. The Shariah Issues of Sukuk

It can be noticed that since their inception, Sukuk have been harboring some Shariah concerns. Most of the sukuk that have been issued so far have practically provided guarantees of the face value of the sakk, i.e. its original paid price, as well as its promised return. From a Shariah perspective, this removes any substantial difference between a sakk and a bond. It has also been noticed that the sukuk holders do not have actual ownership of the sukuk assets, as the sukuk holder does not actually own the sukuk underlying asset. This shall also affect the legitimacy of the sukuk and render their circulation a circulation of debt, and not the assets represented by the sukuk.

If the two concerns mentioned above occur in any sukuk issuance, they strip sukuk of their Shariah legitimacy and place them in the same basket of bonds. In fact, these two issues, in

addition to the tradability of sukuk, are the most serious Shariah issues of sukuk, and hence the need to discuss them in detail, as follows.

1.1 Firstly, Guaranteeing the Face Value and the Return of the Sukuk

Sukuk issuance includes various guarantees for the sukuk holders, some are problematic from Shariah perspective while others are acceptable². The types of guarantees are discussed as follows:

1.1.1 Types of Guarantees Presented to the Sukukholders

a. Guarantee from the Sukuk Manager Based on the Feasibility Study

It is an established rule of the Shariah that the fund manager is not liable for loss unless when caused by his negligence, misconduct, or breach of the investment terms and conditions. Thus, the fund manager cannot entice potential investors by providing them a guarantee of their funds or return. However, some contemporary *ijtihād* tends to permit the sukuk manager - whether as a partner (*sharīk*), or an entrepreneurial partner (*mudārib*) or an investment agent (*wakīl*) to guarantee the face value of the sukuk, i.e., the invested capital of the sukuk holders, or its projected return, on the basis of the feasibility study, which the sukuk manager submits prior to the investment.³ Usually, the sukuk manager conducts a feasibility study (on the feasibility of the investment project), showing the likely success of the project and its profitability. According to this opinion, the sukuk manager can be held liable for this study so that if afterward he claims the occurrence of loss and fails to prove that the loss occurred for a reason beyond his control, he becomes responsible for the loss. If, however, he proves that he is not to blame for the loss, then he bears no financial liability.

This *ijtihād* is predicated on the premise that the default position is the soundness of the feasibility study, i.e. that the project is profitable. If the manager claims loss for no obvious reason, the manager goes against this default position and is required to show proof that the loss was not caused by his misconduct or negligence. If he is unable to do so, he must bear the loss. The reasoning here is that the loss in the aforementioned case indicates the deception (*taghrir*) of the investors by the manager. This deception entails a guarantee/compensation⁴ (*damān* as is known

² It is worth noting that we see “Islamic” sukuk receiving an excellent credit rating by conventional international rating agencies, despite the fact that their rating is primarily based on guarantee of capital and return, which is inconsistent with the essence of Islamic investment. There would be no problem in rating the sukuk if the criteria used in the rating were Islamic, not based on the guarantee factor, but rather on matters such as the experience and solvency of the investment manager in the event he became liable due to mismanagement or violation of the investment terms and conditions.

³ Al-Fatawa Al-Shar’iyyah, Dubai Islamic Bank, 2/88.

⁴ For details on the effect of *taghrir* see Haidar, Ali, *Durar al-Hukkam Shareh Majllat al-Ahkam*, 1/312.

in fiqh). This ijtiḥad is also based on the ḥadīth: “The hand is responsible for what it takes until it return it back”⁵; so accordingly, the investment manager is responsible for the money until he proves his innocence.

Considering the reasoning of this ijtiḥad, and the general investment conditions and mechanisms in our time, this ijtiḥad seems acceptable but after qualifying it with certain conditions. The purport of ijtiḥad is shifting the burden of proof from the fund provider to the fund manager. Either way, the sukuk remains a trustee (amīn) and not liable for any loss so long as he can prove that there was no violation of trust or negligence on his behalf with regard to the management of the sukuk. This, in fact, involves a slight modification of the stand of the jurists regarding the liability of the fund manager. They consider him a trustee (amīn) and do not hold him responsible for proving that there was no shortcoming or misconduct on his part regarding his role as the fund manager, such that he would have to provide compensation. Instead, they consider him to have performed his duty and is free of such a responsibility until the fund provider proves the opposite.

In other words, the established Fiqhi stand would not hold the fund manager responsible for losses until the fund provider proves that the manager acted in a way that would necessitate compensation from a Shariah perspective. However, the novel ijtiḥad differs from the known Fiqh position on determining who is required to give proof with respect to the extent of the responsibility of the fund manager. In the established Fiqh it is the fund provider, while according to this new view, the burden of proof is on the fund manager.

In fact, this new opinion has its merit, especially that the investment manager is a claimant from one perspective as he has made a prior claim of the project’s feasibility and its profitability that is supported by a detailed study; therefore, he should stand behind his study (claim), defend and maintain his non-negligence. Furthermore, the investment conditions of the present-day differ from the past, as the fund manager could be an Islamic bank or an Islamic institution that invests the money of thousands of customers. It cannot afford to expose their money to unnecessary risk, especially in light of the proliferation of fraud and the weakness of the religious inner-conscience people, in general, have nowadays.

From another perspective, accepting and adopting this view that the investment manager is responsible until the otherwise is proven encourages Islamic financial institutions to enter into real investment activities through mudaraba or musharaka. Besides, it should reduce their

⁵ Ahmad, *Musnad*, No. 20086, 33/277; Abū Dāwūd, *Sunnan*, No. 3536, 3/321; al-Tirmidhī; *Sunnan*, No. 1266, 3/566.

reliance on securing profits through financing based on a formalistic sale of commodities, which may not differ in essence from conventional finance.

Nevertheless, the above has to be circumscribed with the following conditions:

- The prospectus clearly includes the liability of the sukuk manager in the way described above, and the sukuk manager agrees to it.
- The prospectus clearly states the reasons of loss for which the investment manager shall not deem liable, such as unpredictable market volatility, financial crises, or natural disasters.
- In case of loss, the parties must invoke an independent external arbitrator with Shariah credentials and necessary business experience to determine the extent of the sukuk manager's liability, if any.
- In case the sukuk manager is unable to prove non-responsibility for the loss, his liability must be limited to the capital invested only, i.e., the nominal value of the sukuk, so it does not go beyond that to include any profit or the market value of the sukuk prior to loss. This is because this Fiqhi opinion comes as an exception to treat a certain problem, so it cannot be expanded to include other than the amount actually invested (upon subscription).
- In case the sukuk manager is held liable for the loss, a distinction has to be made between what lies within his responsibility and what does not. This is because his infringement could be preceded by an event that he could not be considered responsible for, such as a sudden fall in the market value of the sukuk assets below their face value. Accordingly, in this case, the sukuk manager should not be held liable for the entire face value of the sukuk, but rather only for the market value of the sukuk before his infringement. In other words, his liability for loss should correspond to his fault only.

b. Promising to Buy the Sukuk Assets

Typically, the sukuk manager promises to buy the sukuk assets (redeem the sukuk) on their maturity date. However, the sukuk differ in the type of promise given. It could be a promise to buy the sukuk assets for the following values:

- The market price of the sukuk assets at the time of redemption
- A fair' price (a valuation of the assets by experts)
- A price agreed upon at the time of redemption

- The face value
- A price determined when giving the promise.

It is noticeable that there is no capital protection in the promises to buy the sukuk assets at the market price, at a fair price, or at a price agreed upon at the time of buying. This is because the price in all three cases is not predetermined, and it could be much lower than the face value, which negates the capital being guaranteed.

However, if a price is determined beforehand, or agreed beforehand, whether explicitly or implicitly, to be equivalent to the face value of the sukuk, then the prohibited capital protection materializes. In the first case, the sukuk issuer or manager guarantees a certain price for the sukuk holders. Even if this price is less than the face value, it is still unlawful because it involves a partial capital guarantee, while the capital, according to Shariah, must not be guaranteed at any magnitude. The same applies to promising to buy the sukuk assets at the face value, as it renders the capital fully guaranteed. Such a promise goes against the rules and principles of investment in Islamic financial law, which clearly define the relationship between the fund provider and the investment manager in terms of liability for loss and capital or profit protection, as discussed earlier.

It is also worth noting that the occurrence of this prohibited guarantee is not negated by the possibility that the promise is not effective or acted upon in case the sukuk assets are lost or destroyed, due to the absence of that which the promisor could buy in this case.⁶ This is because the mere issuance of such a promise is prohibited, not to mention the fact that the total loss or destruction of the sukuk assets is rare, and Shariah rules cannot be established on rarities.

I. The Position Permitting a Promise To Buy Sukuk at Their Face Value on the Basis That the Market Price of the Investment Sukuk Equals Their Face Value in Cases Where There Is No Loss

Some contemporary opinions deem it permissible to issue a promise to redeem the sukuk at their face value on the basis that the market price of the investment sukuk does not differ practically from the face value in cases where no losses occur.⁷ This is because the sukuk manager distributes the profit periodically, and the determination of the amount of profit to be distributed is done in reference to the capital, because profit is that which is in excess of the capital. Hence, if the profit

⁶ It has been argued that even with the purchase undertaking to redeem the sukuk at the face value, the capital protection is negated, since in case the sukuk underlying assets are totally lost or destroyed, no sale would take place, which would negate, in principle, guaranteeing the face value of the sukuk.

⁷ Al-Fatawa Al-Shar'iyyah, Dubai Islamic Bank, 4/89.

is all distributed upon maturity of the sukuk, then what remains is the capital (i.e. the value of the sukuk assets after profits are distributed is the same as the face value). The same occurs if there is no profit or loss - the face value will be the same as the market value. Hence, there would be no issue with giving a promise to buy the sukuk assets (redeem the sukuk) at the face value, because in practice, it is the same as the market value.

However, the argument above may apply only to cases when the sukuk proceeds are utilized in cash financing only. It does not apply to the cases where the sukuk proceeds are converted into assets, such as real estate properties or goods, for the sake of renting them out or trading them, and are not finally liquidated until the maturity of the sukuk. Such assets are supposed to be sold at the end of the investment in the market, i.e., for the market price. Most likely, their selling market price would not match their original purchase price.

Besides, even if we accept that the face value is equal to the market value in cases when profit is made, or at least no losses occur, this does not justify permitting the sukuk issuer to promise or undertake to redeem the sukuk at face value. This is because even if a loss is not expected to occur, it still could happen as long as we consider the whole process a real investment project and not a form of financing with a guaranteed profit, i.e., with hidden interest. The very existence of this promise/undertaking implies a guarantee that is prohibited by the Shariah, just like it is prohibited for a *mudārib* or a partner (*sharīk*) or investment agent to guarantee the capital even if the probability of the loss is next to nil.

II. Promise to Buy Ijarah Sukuk Assets

Ijarah sukuk are the most popular type of sukuk, as mentioned earlier, especially the structure which involves selling an asset by the sukuk issuer, then leasing it back from the buyer. This structure of sukuk corresponds to securitization in conventional finance, where an owner of an asset securitizes the asset; i.e., issues securities against it to obtain cash from the subscribers. These sukuk also achieve a reasonable risk-free return for their holders. Besides, there is no Shariah restriction on their tradability from issuance to redemption, which makes them more appealing to the Islamic capital market than the other types of sukuk.

Practically, the promise to buy the sukuk assets in ijarah sukuk is either at a price equivalent to the remaining unpaid installments in the case of sukuk of ijarah ending-in-ownership, or at their face value in the case of sukuk of operating ijarah, as follows.

III. Promising to Buy the Sukuk Assets in a Lease (Ijarah) Ending-In-Ownership

Ijarah ending-in-ownership is an ijarah contract that ends with transferring ownership of the leased asset either by a sale at a token price or by gifting. The lessor is not harmed by this, as he

covers the costs of ownership of the leased asset and achieves profit on top of that through the total rentals that the lessee has paid up until the end of the agreed rental period.

Some ijarah sukuk have been designed in accordance with this contract, whereby the sukuk issuer sells the assets to the sukuk holders and then returns to lease them in an ijarah ending-in-ownership. Some fatwas (e.g. AAOIFI) permit the sukuk manager to promise to buy the assets at the end of the ijarah period for the remaining unpaid rental installments (if the ijarah contract ended for any reason), on the basis that the remaining unpaid rentals represent the net value of these assets.⁸

However, this opinion sounds debatable because two scenarios are perceivable here. The first one when the sukuk manager is also the (original) seller of the assets and then is the lessee in an ijarah ending-in-ownership. The second scenario is when the sukuk manager is not the original seller of the rented assets, who then leases them from their new owners (the sukuk holders).

In the first case, a prohibited guarantee of the capital occurs in addition to a guarantee of the profit; the sukuk manager who is the seller of the assets promises in case of the ijarah contract being broken for any reason to pay an amount equal to the remaining amount of the rental installments. In this financial structure, the lessee/financed party guarantees - through the sukuk - for the financing party (i.e., the sukuk holders) the amount of finance (issuance amount) and a profit on top because the total amount of rent for the contracted rental period is more than the amount of the sukuk issuance, i.e., the amount of financing. This constitutes a prohibited guarantee of capital and return. There are also some potential problems surrounding this structure, where the seller himself leases what he sells through an ijarah ending-in-ownership.

As for the second scenario, the guarantee of capital and profit is also achieved for the sukuk holders from a non-independent party, i.e., the sukuk manager. The market value of the leased assets could be less than the total remaining rental instalments of the ijarah ending-in-ownership. The lease contract could also be nullified after a short period from its start, making the loss greater upon the sukuk manager, who is the guarantor.

IV. Promising to Buy the Sukuk Assets in An Operating Ijarah at Their Face Value

According to AAOIFI Shariah standards⁹, it is permitted that the lessee in ijarah sukuk, where the Ijarah is a normal operating ijarah, to promise to buy the leased assets at the maturity of the sukuk for the face value of the sukuk, as long as the lessee is not as a partner, a mudarib or agent of the investment in this sukuk structure.

⁸ The fatwa by AAOIFI Fatwa Council related to Sukuk as appendix to it.

⁹ The fatwa by AAOIFI Fatwa Council related to Sukuk as appendix to it.

However, in the practical application of this type of sukuk, the lessee in the operating ijarah is normally the seller of the leased assets. He pays the rentals throughout the rental period and then buys the leased assets for the face value of the sukuk, i.e. for the price that he originally sold the asset. The net rentals that the lessor/buyer (sukuk holders) gains during the rental period is an increment over the money (finance) he has paid as a price of the assets. This price (finance amount) is going to be repaid to him when he sells back the asset to the same lessee. This practice resembles what is known in Fiqh literature as bay' al-istighlal',¹⁰ which is a legal-tick to riba if the lessor does not practically assume the liabilities of the leased corpus.¹¹

Thus, it is necessary not to view this undertaking as a promise from a party that is independent of the party managing the sukuk, but rather to look at the structure in its most common practical application.

1.1.2 Various Issues Related to Sukuk Guarantees

a. Provision of Implicit Capital Guarantee through the Inclusion of Incentive Clause Combined with the Auction Sale

Incentive and auction sale have been used as a trick in some sukuk structures to provide face value protection to the sukuk holders.

Since the undertaking by the sukuk manager/issuer to redeem the sukuk at their face value (repurchase of the assets sold at the same original selling price) is unlawful, in view of the capital protection such undertaking achieves, some Sukuk issuances involved a contrivance to this basic rule. In the prospectus, it is stipulated that the sukuk holders waive to the sukuk manager/issuer upon redemption whatever amount exceeds the face value of the sukuk. Upon maturity of the sukuk, the sukuk underlying assets are offered for sale at auction, whereby the sukuk manager/issuer is one of the bidders. Therefore, no one can compete with or overbid the sukuk manager/issuer as the amount in excess of the face value of the assets eventually reverts to him by virtue of the incentive. Thus, although such prospectus does not involve an undertaking to redeem the sukuk at face value, but implicitly it does.

¹⁰ Ibn Abdeen, *Al-Hashiyat*, 4/248; Ibn Taimiyah, *Al-Fatawa*, 30/333-335.

¹¹ In practice, the sukukholders are absolved of all the liabilities that are associated with ownership. After signing the lease contract with the sukukholders, the lessee assumes the owner-type liabilities on behalf of the owner (sukukholders), and then whenever he pays some expenses on the lessor's behalf, an equivalent amount will be added up to rental payable in the subsequent lease period. Thus, the owner/lessor does not bear effectively the ownership liabilities, but rather the lessee does.

Effectively, the auction in the above structure is useless, as it is only meant to justify providing the sukuk holders with capital protection. On the other hand, it does not give them the chance to make any capital gain, thanks to that incentive.

b. Guaranteeing the Face Value of the Sukuk by a Third Party

If the guarantee to the face value of the sukuk or their return is issued by a third party that is truly independent of both sukuk parties, such that it can be considered a pure donation, then the guarantee can be deemed permissible. This is because it is a donation (hiba) in essence, even though it is called 'guarantee'. Effectively, it is a gift to the beneficiaries (sukuk holders) but conditional on their losing the invested money or failure to achieve the expected rate of return. The gharar (uncertainty) befalling the gift, due to being conditional on an uncertain event, is unobjectionable in the Shariah, because gharar can be tolerated in contracts of donation.¹² Therefore, such a third-party guarantee may be accepted as long as it can be regarded as a pure gift and so long as it is independent of the contract that governs the relationship between the sukuk parties, as stated in the resolution issued by the OIC Fiqh Academy.¹³

c. The Sukuk Manager Guaranteeing a Particular Party He Deals with

If the sukuk manager selects a particular party to deal with despite the risk or doubts surrounding him, such as an a particular construction company or a particular supplier of commodities, then guaranteeing this party by the sukuk manager in favor of the sukuk holders is acceptable from Shariah perspective. However, the guarantee has to be through a separate contract and without compensation, i.e. it has to be free of charge. Such kafāla (guarantee) does not involve the protection of profit or capital to the sukuk holders. At most, it implies a voluntary commitment from the sukuk manager towards the sukuk holders that the party he selects to deal with stand up to its agreements, such as executing projects or repayment of the debts that result from contracts. Executing such agreements may not necessarily produce a profit to the sukuk holders or prevent a loss. Hence, such kafala does not involve a guarantee of the sukuk face value or their expected return, which makes the matter acceptable.

d. Provision of Guarantees through SPV

When the SPV (Special Purpose Vehicle) is established by the sukuk issuer/manager, the guarantees of the sukuk face value or return become unacceptable, simply because the SPV is not, from a Shariah perspective, an entity that is independent from the sukuk issuer/manager. Companies that have the same owners or shareholders (sister or parent companies) should be

¹² Al-Dasuqi, Al-Hashiyat, 3/22; Al-Hattab, Muwahib Al-Jaleel, 4/37.

¹³ OIC Fiqh Academy resolution No. 30 (4/5).

treated like one company according to the Shariah. This makes the guarantee given by the SPV a guarantee given by the party that established the SPV, and hence the invalidity of guarantee. In fact, if such guarantee were permissible, it would constitute a legal device to circumvent the prohibition of guaranteeing the capital or the return.

e. Distributing Prizes to the Sukuk Holders

The sukuk sponsors may announce prizes through a raffle that is aimed at attracting people to subscribe to the sukuk. Here we have different scenarios:

One: The cost of such prizes are ultimately born by the sukuk holders, i.e. the cost of prizes affect their distributable profit. In this case, the sukuk holders unknowingly enter the draw with their own money. This involves deception and makes the matter akin to gambling (*qimār*).

Two: The cost of the prizes is not ultimately paid by the sukuk holders. In this case, if the prizes are significant in value there is a suspicion (*shubha*) of gambling because the chance of winning prizes could be the reason why some people subscribe, meaning that they pay the price for entering the raffle, which is prohibited. If, however, the prizes are insignificant in value, such that they do not constitute a real motivating factor leading people to subscribe, then they could be undoubtedly acceptable.

Likewise, if the prizes are given to all the subscribers and paid by the sukuk manager, then in order to be permissible, they should not be of high value, because if they are of high value, the process then involves guaranteeing part of the capital that the subscribers contribute towards. This part of the capital is the value of this prize that the sukuk holders receive, i.e., they are guaranteed some money in an investment where no money should be guaranteed. If the sukuk manager deducts the value of the prizes from the anticipated profits of the sukuk holders, then the process involves deception (*taghrīr*), since there are no real prizes in this case.

f. Forming a Reserve from the Sukuk Returns to Cover Possible Future Losses or Unstable Income

OIC Fiqh Academy¹⁴ ruled that it is permissible to deduct a certain percentage of the sukuk profits at the end of every investment period, whether paid from actual profit achieved or on account of revenue expected and to place it in a special reserve to meet the various risks that may face the investment.

¹⁴ Resolution No. 30 (4/5) regarding *Muqarada* and investment sukuk.

However, such fatwa should be qualified by enabling the sukuk holder to regain what has been deducted from his profit to form this fund when he withdraws from the investment because he does not consent to deduct it as a donation. Rather, he consents in order to benefit from it himself afterwards in order to achieve a regular return. He does not leave it to others but leaves it for himself in order to receive it at a future period, given that the whole undertaking is an investment with the aim of increasing wealth. This process differs from Islamic takāful insurance, which does not aim to be an investment or gain an investment return but to overcome life hardships. Therefore, it should be the right of the sukuk holder who exits to regain that which was deducted from him when forming the reserve, if not utilized.

g. Reclaiming the Sukuk Face Value After Subscription Ends and Before the Investment Commences

If the sukuk holder is allowed to regain the face value of the sukuk before the investment commences, this is not a prohibited guarantee but a decision not to invest, which is permissible. This is because the investment, which is prone to loss, has not yet commenced. As such, by giving the sukuk holder the right to regaining the face value no prohibited guarantee occurs.

1.2 Secondly, the Issue of Sukuk Holders Owning the Sukuk Assets

With respect to the sukuk being representative of their underlying assets, sukuk can be classified into two types, the asset-based sukuk and the asset-backed sukuk.

The difference between the two is that from a technical legal perspective the sukuk assets of the first type (the asset-based sukuk) are a security (rahn) against the value of the sukuk. These sukuk do not actually represent ownership of the assets. In addition, the sukuk owners are not given any specific rights over these assets, but rather they are treated as normal debtors in case the issuer goes bankrupt. As for the second type, the sukuk holders have specific rights over these assets, and are not treated *pari passu* with the other debtors in case the issuer goes bankrupt. Rather, when the sukuk assets are sold, they are the first to receive their claim from the proceeds of the sale. However, from a legal perspective, the holders of those sukuk are not considered owners of the assets. Rather, the assets are a mortgage (rahn) against the money that they paid when buying the sukuk, and they have priority rights over the remaining creditors if any, but they do not own the balance of the sale proceeds, if there is a balance. Furthermore, they are not legally allowed to act upon the assets as an owner does. In many sukuk structure of this type, ownership is transferred to an SPV that the sukuk issuer establishes and owns so that the SPV acts as an agent representing the sukuk holders in the ownership of the assets. However, the sukuk holders remain unable to dispose of or act upon these assets, and they are not considered legal owners of the assets.

This is the difference between these two types of sukuk. It relates to having a specific claim right over the underlying assets, but it has nothing to do with the real or legal ownership of the underlying assets, as both are the same in this regard. This difference, in fact, is not unique to sukuk, but rather a common difference in bonds and other types of debt documents, as known in the literature related to debt securities.

If this is the case, then sukuk of both types do not, from a Shariah perspective, represent ownership of the underlying assets. Rather, these assets are simply security (rahn) provided by the sukuk issuer against the value of the sukuk, i.e., the sukuk proceeds. This undermines the legitimacy of the sukuk and turns them into debt. Consequently, the profit that is distributed to sukuk holders cannot, therefore, be justified from Shariah perspective, as debt is not supposed to generate any income to the creditor, and the very circulation of sukuk becomes problematic due to their being debt securities in essence.¹⁵

Therefore, sukuk have to represent ownership of the underlying assets, and this is the basis of their validity and legitimacy from the Shariah perspective. If this core requirement were compromised, sukuk would effectively be nothing but bonds.

The following facts harboring most of the issuances of sukuk confirm the nature of modern-day sukuk not being representative of real ownership, as these practices question the very sale of the sukuk assets to the sukuk holders:

- It is possible, that the sukuk underlying assets are not valid for sale in the first place, such as some government properties. The laws of a country may not allow the government to transfer its properties to the private sector, or the government may not be willing effectively to sell them. Yet, we may witness in such countries sovereign sukuk where the underlying assets are ports, airports or some essential public services! The structure of the sukuk necessitates that the government has sold the underlying assets to the sukuk holder. However, in reality, the sukuk holders do not own these assets and cannot own them, and if the sukuk are Ijarah sukuk, as in most cases, then there is no real lease that justifies receiving the rentals, rendering thus the whole process as financing with a guaranteed interest return.
- In most cases the sukuk assets selling price does not reflect their market price, but rather the required financing amount. This amount could be significantly more or less than the market

¹⁵ Sale of debt is subject to strict Shariah rules, the breach of which leads to Riba. Trading sukuk, if deemed debt securities, in the secondary market breaches these rules. Al-Dasuqi, Al-Hashiya, 3/63; Al-Sherbini, Mughni Al-Muhajj, 2/71; Al-Hattab, Muwahib Al-Jaleel, 4/368; Al-Bahuti, Kashaf al-Qinah, 3/307; Ibn Abedeen, Al-Hashiya, 4/160.

value of these assets. Neither the issuer nor the sukuk holders would care, because the 'selling' party would 'repurchase' them afterwards for the same price that he 'sold' them for, and not the market price. This matter confirms that the sale of assets is a mere formality. If the sale was real and the ownership would actually be transferred to the sukuk holders, they would be cautious not to own them for a value above the market price, and the seller would be cautious not to sell them for less than the market price. However, in practice none of the parties, the issuer or the sukuk holders, could be aware of the sale thing, but they appreciate that they have to formulate the contracts in a 'peculiar' manner to fulfill the requirements of 'Shariah compliance'.

- The sukuk holders do not benefit from any appreciation in the market value of the underlying sukuk assets. Practically, the sukuk issuer 'buys' back the sukuk assets for the same amount that he 'sold' them for, and they have no option but to 'sell' them to the issuer, and for the same price. If the sukuk owners were the real owners of the underlying assets, they would be able to possibly gain from the selling price of these assets (achieve capital gain), or even have the option to sell them to a third party, in case they could not reach an agreement with sukuk issuer.

1.3 Thirdly, the Tradability of the Sukuk

Trading of securities representing different types of assets, such as sukuk and shares, could be problematic from the Shariah point of view. It is established in the Shariah that the sale of cash money or debt is subject to certain Shariah restrictions. The Shariah requires that when money is sold for money, the two counter values must be equal in amount, and the transaction must be executed on the spot, such that none of the two counters value can be delayed.¹⁶ Similarly, debt is subject to the same rules as long as the debt is money, and since the debt is a liability in the description and not payable on the spot, its sale for cash money or counter debt becomes impermissible.

In the context of sukuk, they typically represent different types of assets, which most likely include debt or cash. While cash and debts are not tradable in essence, the sukuk other typical assets, such as real estate properties, commodities, and services, are tradable.

However, there are some considerations that relate to the sale of securities in general and sukuk in particular, on the basis of which we may tolerate trading the debt or the cash included in those securities.

¹⁶ Al-Dasuqi, Al-Hashiya, 3/63; Al-Sherbini, Mughni Al-Muhajj, 2/71; Al-Hattab, Muwahib Al-Jaleel, 4/368; Al-Bahuti, Kashaf al-Qinah, 3/307; Ibn Abedeen, Al-Hashiya, 4/160.

In this regard, we can distinguish between four cases:

1. The first case: The case where the entity that owns the assets has a name (a registered trademark) that has a market value, so that its name has an impact on the price of the security that represents those assets. This applies to shares of companies and shares of commercial and financial institutions.

Undoubtedly, the trademark value of a company is taken into account when pricing its stocks since the value of the stock is affected by the performance of the company and the people's confidence in it. Very often, the market value of the stocks varies from time to time, regardless of the changing value of their underlying tangible assets.

In truth, the trademark (the name of the company) is the main reason that attracts people to the stocks of a particular company, whether for investment or trading and not the value of its tangible assets, although the value of the trademark could also be affected by the value of those assets. This makes the trademark an integral part of the stock when acquired or traded. Accordingly, the name of a company should not be overlooked when considering the company assets.

In fact, the trademark has a monetary value that is recognizable by the Shariah, and it is a valid subject matter of sale on its own.¹⁷ Besides, its trading admits no restriction from the Shariah perspective, as it is neither cash nor debt.

Thus, if the trademark is the core factor for subscribing to stocks, then it has to play the major role in determining the tradability of the company stocks, because when people trade stocks, they buy and sell the trademark before anything else and hence, there is room to tolerate the composition of the company's other assets when being untradeable.

This also includes the stocks of the financial institutions that primarily deal with money and debt, such as Islamic banks and money exchange companies, as long as their trademark value is significant and plays the primary role in attracting stockholders.

2. The second case: The case where the entity that owns the assets is an entity that does not have its own trademark, but the activity in which those assets are invested is one that normally generates debts and cash. That is, the underlying assets are in constant change from cash to debts, commodities, benefits, services, and the like. Here, the components of the assets should be overlooked due to their constant change and the inability to maintain a particular ratio of the tradable assets.

¹⁷ OIC Fiqh Academy resolution 32 (7/4).

For example, the real investment sukuk would normally involve the investment of the sukuk proceeds in various and renewable investment activities that may include buying, selling, leasing, etc. Those investment activities would normally yield tangible assets, cash, and debt throughout the investment period. Maintaining a specific minimum ratio of the assets composition is extremely difficult and impractical, given the volatility of the investment underlying assets. Besides, the performance of the sukuk is also a consideration that potential buyers take into account when buying sukuk, similar to stocks of company, where the trademark of the company becomes part of the company assets and is tradable without any restriction.

3. The third case is the case where the sukuk represent the assets whose investment involves a single activity that generates debts, so that the assets do not fluctuate between what is tradable and what is untradeable, i.e., debt and cash. Examples include Murabaha Sukuk and Salam sukuk, where the sukuk proceeds are used to purchase commodities to be sold on Murabaha or Salam basis in one deal. Once sold, the sukuk will represent the receivables, which are debts. Tradability of such sukuk must be governed by the nature of their underlying assets. The criterion (ratio) that should be used here is the criterion of preponderance¹⁸ so that the debt and/or cash must constitute less than 50% of the total underlying assets in order for the sukuk to be tradable. This is unlike the sukuk under the second case, where the underlying assets are in constant change, which makes it impractical and almost impossible to maintain a certain ratio.

4. The fourth case relates to the sukuk of the first and second type, but with debts being intentionally brought and added to sukuk assets for the purpose of justifying their trading by making them ancillary to the tradable assets. Such sukuk should be ruled as unlawful to trade regardless of the ratio of the debt to the total assets, in view of the purposeful and the unnecessary inclusion of the debts. This corresponds to the resolution of the OIC Fiqh Academy No. 188, which states that it is not permissible to add debts that are independent of the sukuk assets to those assets, in order to justify their circulation.¹⁹

¹⁸ Fiqh Academy (Resolution No. 30 (5/4) decides in the issue of sukuk that includes money and debt that majority preponderates; if money or debts constitute the majority of the sukuk assets then they cannot be traded. According to some standards like AAOIFI Shariah standards (No. 21 (3/19), it is only 30%, which means that sukuk are tradable as long as their underlying cash or debt components do not exceed 70% of the sukuk total assets. However, the Fiqh literature support the majority or the preponderance criterion. For example, in Fiqh, counterfeit gold - i.e. gold that is mixed with brass or another metal - is treated as pure gold if the gold constitutes the majority, while it is no longer gold if the other metal constitutes the majority. If the gold and the counterfeit metal are equal in amount, both are treated as gold by way of caution. The same applies to silver and all *ribawi* money. Ibn Al-Humam, *Fateh Al-Qadeer*, 6/275; Al-Dasuqi, *Al-Hashiya*, 3/47; Al-Sherbini, *Mughni Al-Muhajj*, 2/22; Al-Hattab, *Muwahib Al-Jaleel*, 4/346; Al-Soyoti, *Al-Ashbah wal Nazair*, 1/107-120-121.

¹⁹ OIC Fiqh Academy resolution No. 188.

Conclusion

In conclusion, the occurrence of the above Shariah concerns combined in one sukuk issuance makes it a mistake to find a separate exist (makhraj) for each partial Shariah issue in sukuk. Even if we find partial Shariah exits (solutions) to the individual sukuk issues, the sukuk eventually become in their final outlook a strange structure that is not harmonious with the spirit of the Shariah, or its principles and rules, and probably closer to the prohibited bonds than to a Shariah-compliant crowd investment.

Indeed, if the sukuk were really investment sukuk, structured on an actual profit and loss basis, and being representative of real ownership of the underlying assets, it would then be possible to overlook some partial issues harboring them. This includes obliging the sukuk manager to provide a loan if the actual profits fall below the expected rate of return and the sukuk holders waiving any actual profits in excess of the expected return. However, with the sukuk being structured in way that guaranties to their holders their capital and return, and with sukuk failing to represent real ownership of the underlying assets, the sukuk in their totality become nothing but debt securities similar to bonds, denying thus any room for rectification.

The paper also records the following primary results:

- Providing a capital or return protection to the sukuk holders invalidates the sukuk, unless the guarantee to the capital or the return is provided by a third party that is genuinely independent from all sukuk parties, such that it can be regarded as pure donation from the provider.
- The sukuk have to represent real ownership of the underlying assets, so that the assets legally belong to the sukuk holders and they are not just a security (rahn). If this does not materialize, the very legitimacy of the sukuk is undermined.
- The tradability of the sukuk in view of the nature of its underlying assets should not be treated as a major Shariah issue, as long as the nature of the underlying investment necessitates constant change of the assets types and no independent debts are purposefully inserted to justify their trading.
- Finally, and in light of the above, both Shariah scholars and sukuk market players should really revisit and reconsider the current structures of sukuk and attempt to amend them; otherwise sukuk will fail to play their perceived role as a capital market instrument that achieves the purpose of bonds but without leading to the evils and harms of riba.

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Commentary on Research Paper entitled "The Critical Shariah Issues of Sukuk"

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Comments

The author successfully highlighted wrong practices in Sukuk issuance, ownership, and tradability. Unfortunately, such wrong practices are backed by tricky fiqh justifications. The author discussed justifications (or so-called fatwas sometimes) and pointed out their loopholes. He analyzed every deviation from Shariah in the Sukuk businesses separately and made reference to how the right position ought to be, depending on authentic Shariah sources. He is quite right in asserting in his conclusions that "even if we find partial Shariah exits (solutions) to the (undesirable) individual Sukuk issues, the Sukuk eventually become in their final outlook a strange structure that is not harmonious with the spirit of the Shariah, or its principles and rules, and probably closer to the prohibited bonds than to a Shariah-compliant crowd investment."

However, I have a few comments that do not run in the opposite direction to the article's main theme. I hope to empower the author's analysis. All my remarks are based on Islamic economics philosophy, which would never neglect Fiqh, but it takes classic fiqh rules to contemporary financial transactions as guidable but not necessarily submissive. It is the job of Islamic economists to go deeply into our today's problems and distinguish haram and halal based on the exact principles of the Quran and Sunnah. This is important for understanding my comments.

1- In discussing Types of guarantees presented to the Sukuk holders, the author in P. 4 takes the case of (Guarantee from the Sukuk manager based on the feasibility study). Firstly, on purely economic grounds, Sukuk is business, and we have to adopt the right procedures to make sure such business is economically and financially viable. Secondly, we have to ensure that everything concerning Sukuk is straight forward run in compliance with Shariah, i.e., that Sukuk is genuinely profit-loss sharing securities without any tricks or backdoors devices. The author analyzed the guarantee offered by the Sukuk manager, "based on the feasibility study."

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In fact, it should not be treated as a guarantee if the Sukuk contract is designed from the beginning on the basis of Restricted Mudaraba. The Sukuk manager (the Mudareb) should submit a well-prepared feasibility study based on a sound economic criterion and consider all changes that can be expected in the financial market during the Sukuk tenure. If accepted by the buyers of Sukuk, such a study should be taken as obligatory to the manager as he voluntarily submitted and accepted. If profits that the manager has expected are achieved under such Restricted Mudaraba contract, there will be no problem. If a loss happens or gains are not realized, though the market has not been subject to any failure or extraordinary shocks, i.e., nothing happened against the factors and figures that the feasibility study was built upon. The manager immediately would be responsible to compensate the Sukuk holders. We do not have to find if the manager was negligent or had observed market rules and standard practices. Gharar could have been involved deliberately or unconsciously in his feasibility, but this would be taken simultaneously against him. It is a Restricted Mudaraba Contract. The Sukuk holders will need only in such a contract a third party to guarantee that the Sukuk manager will fulfill the contract's compensation condition in case of loss. In an efficient Sukuk market, the expected buyers of Sukuk will surely give preference to those projects promising higher profit on the basis of Restricted Mudaraba. The Sukuk market will grow more competitive and efficient over time.

2-I have to emphasize that a promise to buy Sukuk at their face value on any basis is incorrect. The author managed successfully to discuss different cases in detail. I would agree with him. But, in my opinion, we don't need to involve ourselves in a lengthy debate or dialogue about this matter! Let us be straight forward. Islamic Sukuk is a loss/profit business once it is arranged through Mudaraba or Musharaka contracts. Thus, even if the investment Sukuk market price would be equal to their face value (in cases where there is no loss, as the author argued), why give a promise? As the author attained. Secondly, if the Sukuk are involved in non- Shariah-compliant transactions, we better don't discuss promises to give back the face value. In general, if Sukuk are rightly issued and committed to the holders' ownership of real assets, such assets may be subject to an increase or decrease in price at the end of their tenure. We should not exclude any possibility. In my opinion, if we desire to exclude any suspicious action, we have to exclude any proposition or guarantees to pay the face value at the end and let free-market forces determine the value. If the market is not competitive, then we need to arrange for a neutral, independent, and efficient arbitration.

3-Suppose Sukuk is issued based on an investment Wakalah contract. Unlike the Mudaraba contract, the Wakalah contract allows the manager to agree with the Sukuk holders (Principal) that it would be his right to maintain for himself any extra profit above a given rate of profit (if this has actually been realized). However, the agent is a trustee (Amin) and is not responsible for loss if this happened. Thus, he cannot guarantee to maintain the invested capital's face value, except if negligence or misconduct is proved. "It is permissible to stipulate that the agent, in addition to his fee, is entitled to all or part of any amount over and above the

expected profit as a performance incentive." (AAOIFI, Shariah Standard Rules- No. 46). It would be better, however, if the agent, "6/6: with the principal's consent, to set aside a portion of the profit to create a profit equalization reserve for the benefit of the principal. 6/7 Upon liquidation, the balance of the profit equalization reserve is returned to the principal without affecting the agent's entitlement to the fixed fee or performance incentive for the period in which the reserve was set aside". The face value of the invested capital can be realized in the case of continuous profit without promise.

4-In page 13 under the subtitle "Guaranteeing the face value of the Sukuk by a third party. My comment is: It is Important is to answer; Why gives a gift to Sukuk holders who are, in fact, doing business? Moreover, may they be rich people? And who is the donor? Wherefrom does he get the resources of his gifts? In fact, in several important cases, the guarantee of Sukuk's nominal value and their rate of return was supported by sovereign entities (e.g., the governments of Malaysia, Bahrain, and Qatar, etc.). Guarantees given by sovereigns are claimed to be Shariah permissible because governments were considered (through the tricky Sukuk mechanism) to be a third party, which is not valid. In principle, the government, in many cases, was the actual originator and beneficiary. Guarantees given by sovereigns to Sukuk's capital or its returns are unacceptable when Shariah tenets (Maqasid) are considered. This is because, in case of loss, public revenues would be used in favor of Sukuk holders who are, nevertheless, represent only one section (probably a tiny one) of the society. This issue calls for new Shariah treatment since it unfairly affects national income distribution. Besides, State in an Islamic system should not be involved in projects which the private sector is capable of carrying (Yousri, "A Critique of Sukuk Experience, and their Possible Role in Muslim Countries Development, International Journal of Islamic Economics and Finance Studies, October 2018) 5- Comments on "the tradability of the Sukuk" PP.19-21

5-The author argued that "In truth, the trademark (the name of the company) is the main reason that attracts people to the stocks of a particular company, whether for investment or trading *and not the value of its tangible assets*"! This is a very sweeping statement and, in fact, is misleading. First, The terminology "Trade Mark" is a name, symbol, or other devices that are generally used to identify and promote a company's product or service, but not that company. When talking about corporations or companies, we talk about their "reputation" and not "trade mark". The author maintains that "the trademark has a monetary value that is recognizable by the Shariah, and it is a valid subject matter of sale on its own! We need to know and discuss: in what way the so-called "trademark" is recognizable by Shariah? In fact, the market reputation or position of any corporation or company that is issuing common stock or other securities is dependent on its "Net Worth," i.e., the value of the assets the corporation or company owns, minus the liabilities they owe. Buyers of common stock or other financial securities issued by a corporation or a big company are indeed affected by its Net Worth, which has a definite impact on its market fame or reputation. But there are other factors In practice, that also influence market reputation and the value of its assets and securities. Most

important among these factors are recent and current realized profits (distributed dividends) and expected ones. And, more accurately, in comparison to other competitive businesses. Famous credit rating houses such as Standard and Poor's, Moody's, and Fitch Group plays a significant role in rating the financial position of all different players in the financial market. They have no concern with Islamic Shariah. Would the author explain how the rating is done on a Shariah basis? Or how would this compare with what the famous credit rating houses do? I think it is too hasty and somewhat inaccurate to say that "the trademark has a monetary value that is recognizable by the Shariah, and it is a valid subject matter of sale on its own." I think that we have to work hard before we reach a definite conclusion here.

6-Thereupon, I would raise my objection to statement such as "its trading admits no restriction from Shariah perspective, as it is neither cash nor debt."! ... adding "because when people trade stocks, they buy and sell the trademark before anything else." The author emphasizes the point by stating that "This also includes the stocks of the financial institutions that primarily deal with money and debt, such as Islamic banks and money exchange companies, as long as their trademark value is significant and plays the primary role attracting stockholders."

I would say that "Common Muslims" for practical reasons have to trust their Islamic financial Institutions and their products as long as they have Shariah boards and claim to be Shariah-compliant! But nothing more specific can be said on halal and haram. Under present circumstances, we have to examine case by case to know whether or not tradability of Sukuk is Shariah permissible. If Sukuk are backed by real assets and run on genuine Shariah grounds, i.e., by avoiding all wrong practices which the author highlighted and discussed, why deny permissibility of their tradability?

Sukuk Standard

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Editor's Note: This standard has been suggested to be used in Borsa Istanbul. It contains essential improvements over previous standards and allows for further development, especially in the values of the relevant indicators, as the Islamic finance industry evolves. Readers are invited to send their comments to the journal editor to pass them to the author.

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Introduction

This introduction provides a general perception of the securitization process.

A *Sukuk originator* would like to carry out some projects, business ventures, and other profitable economic activities, through which he/she/it offers some assets to be used. In contrast, some other assets would be created in the process. Such an undertaking requires more resources than available. The originator wishes to mobilize funds through securitization. He/she/it issues financial instruments (Sukuk) in order to mobilize the required funds. The originator establishes a special purpose vehicle, SPV, to issue the Sukuk. The SPV would be so structured to allow Sukuk holders to share (with or without the originator) the newly created assets, venture, and the results of planned economic activities. The SPV would work as a corporation, in which Sukuk holders are also its shareholders. The SPV issues the Sukuk collects proceeds and carries out the venture/activities while owning the underlying assets created on the way. When the originator intends to acquire the Sukuk assets after a pre-agreed period, the underlying contracts have special provisions to transfer asset titles from the SPV to the originator.

In carrying out its investment activities through some finance and investment contracts, the SPV would appoint managers for specific undertakings. For example, when the SPV wishes to construct some real estate, it contracts with a construction company under the *Istisna'* contract. The SPV may have an investment department headed by an investment manager. Alternatively, it may appoint an investment manager for each undertaking, e.g., manufacturing machinery and equipment, residential housing construction, and the like. Each manager can be appointed based on investment *Wakala* or *Mudaraba*. The relationship between the SPV and such investment managers could be pivotal and treated in some of this standard's articles.

This standard avoids issuing Sukuk as fixed income conventional financial assets or bonds. It, therefore, contains provisions that ensure the issuance of Sukuk as Islamic financial instruments. The standard prohibits selling assets to Sukuk holders by the originator and then lease/purchase them back. It disallows synthetic securitization and avoids strenuous structuring and disingenuous ruses, which would deprive the economy of the real benefits of Islamic finance. Furthermore, rules have been included in this standard to ensure the broadest possible subscription, including small investors.

The following standard details the rules of this securitization process.

Article 1: The Scope of the Standard

1. This standard sets out the terms, conditions, and characteristics to ensure that Sukuk are used to finance the economic activities that support a healthy, equitable, and sustainable economy.
2. In particular, investment is encouraged wherever its feasibility is proven, based on adequately exercised due diligence.

3. The standard applies to all Sukuk issued in the Turkish Republic, under the Capital Market Board jurisdiction, CMB.
4. The standard applies to all Sukuk listed in Borsa Istanbul and continues to be a listing requirement.

Article 2: Securitization Partners

A. The Originator

1. The originator is a public or a private institution that wishes to carry out a project, business venture, and other profitable economic activities. It wishes to mobilize resources fully or partially that cover their finance. Such function is referred to the finance providers or Sukuk holders for a time period equal to the lifetime of Sukuk, after which, the project is transferred to the originator.
2. The originator provides some initial assets to be used in the project, e.g., franchises, land, waterways, and the like.
3. Initial assets remain in the originator's property (with permission to the Sukuk holders to build on it and recognition of the separation of ownership of land from buildings) during the lifetime of Sukuk.
4. The originator may wish to subscribe to some of the issued Sukuk and become a shareholder of the SPV and comanage it with Sukuk holders.

B. The Special Purpose Vehicle, SPV

1. A corporate body, created by the originator, whose capital is equal to the proceeds of Sukuk subscription plus any physical or monetary capital advanced by the originator, in return for its equivalence of Sukuk.
2. It is wholly owned and controlled by Sukuk holders and manages the Sukuk lifetime's investment processes on their behalf.

C. Sukuk Holders and Shareholders Association

1. Those who subscribe to Sukuk
2. They act in the capacity of SPV shareholders in proportion to their subscription.
3. They may exercise full property rights on the assets owned by the SPV.
4. In its capacity as the financial-market authority, the CMB shall issue a decree to compose the Sukuk holders Association, which acts as the general assembly of Sukuk holders.

5. The CMB shall appoint for each Sukuk issue a Sukuk holders Board that takes decisions on behalf of Sukuk holders, with at least five members with the highest Sukuk subscriptions: three from institutional subscribers and two individual subscribers.
6. The total subscription of Sukuk Board members must be above 10 percent. If the top five members (3 institutional and two individual) total share is lower than that, CMB shall add more members until 10 percent is reached.
7. The CMB can call the Sukuk holders to meetings when necessary at the CMB headquarters or virtually through videoconferencing. They shall participate at their own expense. Email/SMS texts circulate their decisions to all Sukuk holders. Decisions are considered confirmed after five working days unless a simple majority of Sukuk holders object.

Article 3: General Requirements

In order that securitization fulfills its economic objective on the one hand and satisfy Shariah rules, on the other hand, the following conditions must be met:

1. Real ownership transfer:
 - 1.1. Since the SPV carries out investment and creates assets in the process, the SPV continues to be the owner of all underlying assets during its lifetime, except for those temporarily provided by the originator.
 - 1.2. It is not allowed to tie Sukuk return to a distant bundle of assets through what is similar to interest/income swaps or to anchor return to some index.
 - 1.3. Sukuk holders shall maintain the authority to exercise property rights on the underlying assets during the Sukuk lifetime.
 - 1.4. To ensure the real transfer of the ownership of the underlying assets, they should not represent liabilities to the seller or any other concern, nor should they carry seniority over other creditors. Such underlying assets must not appear on or off any party's balance sheet other than the SPV on behalf of Sukuk holders.
- 1.5. Proper asset composition:
 - 1.6. Real and non-debt Shariah-compliant financial assets should always dominate the underlying assets.
 - 1.7. They should include at least 51 percent of real assets. The ratio should be raised by .025 percent every year until it reaches 75 percent.
 - 1.8. Sukuk shall not be used in any manner as a means to trade present for future money.
 - 1.9. The underlying assets should be productive. Based on due diligence, they should earn a rate of return that is satisfactory to Sukuk holders.

Article 4: General Rules

1. Sukuk Issuance

1.1. No Sukuk may be issued to buy assets that will be sold in any manner and on any future date to the seller.

2. Sukuk with Wakala:

2.1. Sukuk may be issued for financing new projects or expanding new ones. The prospectus may include an agency to the originator given by the Sukuk holders to construct the project or its expansion and manage it on behalf of the Sukuk holders,

2.2. Wakala Sukuk may contain a commitment from the originator to buy the Sukuk assets at a future date (s) to redeem the Sukuk value.

2.3. Sukuk must be issued based on an underlying contract which must:

2.3.1. Satisfy its pillars and conditions,

2.3.2. Produce its legal effects and consequences,

2.3.3. Be implemented in a way that fulfills its Shariah objective and;

2.3.4. Be void of conditions that contradict its essence and Shariah objectives.

2.4. The scale of Sukuk sale and distribution

2.4.1. The SPV must open the door for subscription to all investors, regardless of subscription size or subscriber's nature (whether they are natural or legal entities).

2.4.2. Subscription should be available through bank branches, PTT offices, and similar outlets, without minimum limits.

2.4.3. When Sukuk subscriptions are allocated, and in cases of oversubscription, preference should be given to small investors. Their subscription applications should be given priority to large-size and institutional investors.

2.5. The activities:

2.5.1. Issuance and trading of Sukuk are not allowed if their proceeds are meant to be used in unlawful activities or if some of the Sukuk assets were unlawful.

2.5.2. Issuance, trading, or redemption of Sukuk must not involve or boil down to the sale of spot money against deferred more money; consequently,

2.5.2.1. It is not permitted for the asset title transfer from the seller to be fictitious, i.e., it does not involve a real and legal transfer of ownership.

- 2.5.2.2. It is not permitted for the assets sold to Sukuk holders in Sukuk of ownership of leased, or to be leased tangible assets to be unsalable according to the official laws, or to remain as the property of the seller, appearing in accounting terms on or off the seller's balance sheet.
- 2.5.3. It is not permitted that the investment Sukuk documents stipulate that the Sukuk originator (as Mudareb, managing partner or investment agent) owes the Sukuk sale proceeds or the Sukuk assets value to the Sukuk holders and not managing the Sukuk assets on a trust basis.
- 2.5.4. It is not permitted that the Sukuk prospectus or contracts state that the Sukuk holders shall not have the right of recourse to the Sukuk assets or to legitimately or legally dispose of them off as regular asset owners do. Such ownership rights must be clearly stated for the Sukuk holders in the prospectus.
- 2.6. The return on Sukuk must be the actual and compelling return on investing the Sukuk underlying assets. It is neither a financial liability nor a commitment upon the Sukuk originator.
- 2.7. Shariah rules and precepts stipulate Sukuk proceeds are to be utilized throughout the investment for the purpose for which the Sukuk have been issued.
- 2.8. Sukuk may be nominal, i.e., each carries the Sukuk holder's name, with their title transferrable by registration in a special record kept by the SPV. Alternatively, title transfer can be effected by writing on Sukuk the name of every new holder. Sukuk may also be for their bearer, so their title is transferred then by changing hands.
- 2.9. When Sukuk proceeds are intended to finance project development, care must be taken to ensure that:
 - 2.9.1. Purposes and activities for each project must be legitimate and in line with the Shariah precepts, considering Article IV, (para 5.21) of this standard, which prohibits investment activities that harm the environment.
 - 2.9.2. The SPV shall provide a financial account for each project that is both distinguishable and independent of the accounts of other projects, which constitute liability on the Sukuk originator, who is the beneficiary of the Sukuk issuance proceeds.
 - 2.9.3. A financial statement is issued for each project per AAOIFI Accounting Standards.
 - 2.9.4. Project accounts are controlled by a qualified financial controller(s) appointed by the SPV.
 - 2.9.5. Each project is audited by the internal Shariah auditor, under the SPV-SB supervision, to ensure its activities, profit distribution, and loss sharing comply with the Shariah rules. The CMB shall vet the audit report.
3. For the protection of the Sukuk holders' rights,

- 3.1. The Sukuk originator is responsible for the validity, accuracy, and comprehensiveness of all data, information, documents, and declarations in the Sukuk prospectus. Intentional concealment or misrepresentation shall trigger the liability of the Sukuk originator.
- 3.2. Investment Sukuk shall place no liability on the Mudareb, the partner, or the investment agent for any taxes imposed on the Sukuk returns or for any currency-exchange price differences except in negligence or contract violation cases.
- 3.3. The International Fiqh Academy, IFA, resolutions, the Islamic Financial Services Board, IFSB, and the AAOIFI Shariah and Accounting Standards shall be the binding reference for whatever general rules and principles not covered in this Sukuk standard. The IFA resolutions shall take precedence to AAOIFI and IFSB standards.
4. securitization rules
 - 4.1. All assets not owned by the originator are permissible to securitize, except for prohibited financial products, debt transactions, and gambling assets, irrespective of whether the asset manager is involved in their production, marketing, transporting, selling, and buying or is acting as an intermediary in these activities.
 - 4.2. While Sukuk must be based on a genuine Islamic finance and investment contract, contracts converting Sukuk to common shares in money (except during Sukuk liquidation), debt or gambling payoffs, are prohibited. Furthermore, assets purchased from third parties cannot be securitized if they will be resold to their original seller or his/her/its proxy.
5. Activities resulting in non-securitizable assets:
 - 5.1. Interest-based lending and borrowing.
 - 5.2. Conventional financing,
 - 5.3. Conventional investment,
 - 5.4. Conventional insurance,
 - 5.5. Credit cards receivables,
 - 5.6. Receivables of Murabaha and other debts regardless of their origin,
 - 5.7. Deferred transactions in gold, silver, or currencies,
 - 5.8. Trade in pork or its by-products,
 - 5.9. Trade in all kinds of liquors and alcohol,
 - 5.10. Trade in narcotics for a non-medical purpose,
 - 5.11. Trade in tobacco or its products,

- 5.12. Trade in pipes, shisha, and other smoking tools and material,
- 5.13. Trade in vaping tools and material,
- 5.14. Gambling, and all pure-risk trading,
- 5.15. Dealing in pornography, permissive and other materials that contravene Islamic ethics and values in any manner, such as by publication or distribution of acts of obscene nature through any means,
- 5.16. Transactions involving ghabn, gharar, or Reba or contradicting Shari'ah and its Maqassed (the ultimate consequences of transactions as determined by economists)
- 5.17. Entering into impermissible debt-based transactions, such as discounting debt instruments and taking a commission on the mere act of guarantee,
- 5.18. Inhuman and unethical dealing in human-related objects, such as human trafficking, trading in human organs and prostitution,
- 5.19. Producing or trading in weapons against the law of the land,
- 5.20. Hotels, tourist resorts, and similar establishments that provide or deal in prohibited products and services; or market them or act as agents in such deals,
- 5.21. Activities which are harmful to the environment,
- 5.22. Materials which jeopardize, whether alone or when mixed with other elements, the health of living beings (humans, animals, and plants),
- 5.23. Biological research projects which conflict with principles and fundamentals of Shariah, such as human cloning or setting embryo's sex through non-Shariah means,
- 5.24. Hereditary or genetic engineering to change humans' nature or physique, unless it is meant for medical purposes such as treating disabled organs to restore their original function.

Article 5: Special Purpose Vehicle, SPV

1. The Sukuk originator shall define/establish a particular purpose vehicle, SPV, with legal and financial independence (from the Sukuk originator).
2. The property and control of the SPV shall be transferred to Sukuk holders, following closing and allocation of subscription.

Article 6: The SPV Founding Stage

1. The SPV performs the following functions:
 - 1.1. Acts for Sukuk holders as trustee as well as investment agent,
 - 1.2. Carry out or review the underlying Sukuk feasibility study

- 1.3. Appoints a transitory Sukuk management, to be later confirmed by Sukuk holders,
- 1.4. Issues the Sukuk prospectus,
- 1.5. The prospectus must include the SPV articles of association,
- 1.6. Receives the subscription proceeds
2. The SPV shall contract with trustees/agents to perform the following functions as described in the prospectus
 - 2.1. Acquires the initial underlying assets from the originator,
 - 2.2. Makes and implements plans for project/venture implementation and asset creation,
 - 2.3. Collects investment returns,
 - 2.4. Issues at quarterly audited financial statements, to be reviewed and approved by its board of directors,
 - 2.5. Distributes returns to Sukuk holders,
 - 2.6. May appoint experienced staff to help discharge some of its responsibilities,

Article 7: Shariah Supervision

1. A Shariah Committee shall supervise the SPV: its own SPV Shariah Board, SPV-SB, or the financial-market regulator's (Capital Markets Board, CMB) level, CMB-SB.
2. An SPV-SB/CMB-SB shall be composed of a minimum of 3 members, two-third of which are Islamic economics scholars and one third are Shariah scholars.
3. Scholarship of members require the following qualifications:
 - 3.1. A Ph.D. in their subject (Shariah /Fiqh Almuamalat; economics /Islamic economics),
 - 3.2. Occupying the position of a professor,
 - 3.3. Teaching at the graduate level in accredited universities,
 - 3.4. Publishing in peer-refereed journals,
 - 3.5. Knowledge and honesty, without subscribing to opinions justifying ruses and non-Shariah compliant products (like tawarruq, 'Eina, and debt-sale).
 - 3.6. CMB shall make a list of Islamic economics and Shariah scholars who fulfill the above conditions through public announcements or contact with relevant institutions. CMB shall exclude those who occupy more than one appointment. Both lists must be ordered by academic seniority and updated quarterly.

- 3.7. The CMB-SB members shall be appointed by the CMB from the most senior members on its lists for four years renewable once.
- 3.8. Each member shall serve only in his/her original position and his/her CMB-SB membership only.
- 3.9. The CMB-SB shall appoint the SPV-SB members. Each member shall serve in one SPV only.
- 3.10. No one shall occupy membership in both CMB-SB and SPV-SB simultaneously.
4. The CMB-SB shall oversee all decisions made by the SPV-SB's and maintain the right to final judgment. The former shall have absolute seniority over the latter.
5. The CMB-SB/SPV-SB functions:
 - 5.1. All Sukuk issuers in Turkey must send their Sukuk proposals and the necessary documentation to the CMB-SB for the required endorsement of their structure, contracts, and prospectus.
 - 5.2. The SPV-SB shall, under the supervision of the CMB-SB, shall
 - 5.2.1. ensure that Sukuk issuance, trading, and redemption have all been in line with the Shariah rules and this standard.
 - 5.2.2. Ensure that Sukuk proceeds use to comply with the purpose of issuance and that the distribution of the Sukuk returns from issuance to redemption has been in line with the Shariah rules.
 - 5.2.3. Monitor and audit the SPV and all involved in Sukuk issuance. All activities, projects, and deals financed by the Sukuk issuance proceeds must comply with the Shariah rules as confirmed by periodical reports to the Sukuk holders' association.
 - 5.3. To act as a mediator in cases of conflict between Sukuk holders, management, and any other parties involved. Its decisions are final and subject to appeal at the CMB-SB only. The CMB-SB shall set rules of appeal.
6. The SPV-SB shall appoint one or more Shariah auditors to carry out the auditing and submit its reports to the Sukuk Association Board of Directors through the CMB.
7. The Sukuk Shariah Committee shall notify the Capital Markets Board, CMB, in the Country of any violations (of Shariah or otherwise).

Article 8: Sukuk Prospectus

1. The Sukuk Prospectus shall be prepared in coordination with the Shariah Committee and all relevant parties and shall include the following:
 - 1.1. The articles of association of the SPV,

- 1.2. A proper feasibility study of the project or the venture to be financed by the Sukuk proceeds, which should include:
 - 1.2.1. Ample description of the project, venture, or economic activities to be financed by Sukuk proceeds,
 - 1.2.2. A summary of the feasibility study that includes
 - 1.2.2.1. The cost of setting up or developing projects, ventures, economic activities, management phases, potential risks hedging instruments, Shari'ah-compliant guarantees, and expected profits specified under relevant scenarios,
- 1.3. An endorsement and technical review of the feasibility study by an independent financial adviser, certified by CMB,
2. A sustainability report that attests that all projects, ventures, and activities financed by Sukuk proceeds are:
 - 2.1. Environment-friendly,
 - 2.2. Equity, growth, and stability-enhancing,
 - 2.3. Defining the underlying Shariah contracts, their rules, conditions, and legal consequences. In particular, all parties' rights and obligations, including Sukuk holders, originator, Sukuk holders Association Board and SPV management, must be identified, and the role of ISB/HSB as an arbiter in cases of conflicts.
 - 2.4. The legal procedures, contracts, and other evidence underlying asset titles would be transferred effectively to Sukuk holders.
3. An expert opinion to be issued/approved by the SPV-SB/CMB-SB endorsing the Sukuk structure and documents.
4. The SPV-SB members and their scholarly qualifications, unless Shariah matters are referred to the CMB-SB,
5. An undertaking of the SPV-SB to discharge its responsibilities in:
 - 5.1.1. supervising and auditing the projects, ventures, and activities where the Sukuk proceeds are invested,
 - 5.1.2. Submitting periodical reports every quarter to Sukuk holders and publishing them on an open-access website.
6. A stipulation that Sukuk holders must be summoned to consider appropriate actions. It would be mandatory in cases of a flagrant infringement of Shariah rules, procrastination, or refusal of

the project, venture and activities manager(s) to follow the Shariah committee's instructions or to remedy any violations.

7. A clear explanation of Sukuk holders' participation in profit and loss per the underlying finance/investment contract, in proportion with the number of Sukuk each holds.

8. The nominal value per Sakk, its subscription value, and term to maturity

8.1. A report on the fair value of the Sukuk assets by one of the chartered financial advisers of the CMB, in the Country, in case the Sukuk were issued against existing assets.

8.2. The prospectus should include:

8.2.1. the text of any agreements that places any commitments on the Sukuk holders and the SPV,

8.2.2. The mechanism for profit distribution and loss sharing,

8.2.3. Dates of subscription offering and closing, and rules governing the case of failing to meet the subscription percentage specified in the prospectus, without prejudice to the CMB instructions, in the Country,

8.2.4. How Sukuk are allocated among subscribers in the case of oversubscription while giving priority to small investors,

8.2.5. The Sukuk tradability and redemption of each type of the Sukuk, as permitted by the Shariah principles, based on the underlying assets and contracts,

8.2.6. Reasons that trigger early maturity of the Sukuk, treatment of cases of default and settlement of Sukuk holders' rights,

8.2.7. Any other data required by the CMB, in the Country or by the Sukuk Shariah Committee,

8.3. The prospectus may not include any clause that violates the issuance contract's provisions or its Shariah legal consequences.

8.4. The SPV shall verify the accuracy of all data and information included in the issuance prospectus, either directly or through commissioning an expert.

Article 9: Sukuk Tradability

1. Sukuk with underlying assets that are dominated (51 percent or more of total assets) by cash balances, debt, or monetary assets cannot be traded.

2. Once the composition of securitized assets reaches that state, they must be reconstituted into an asset collection dominated by real assets.

Article 10: Credit Rating

1. When the Sukuk underlying assets include financial assets (like debt resulting from Shariah-compliant transactions) and their returns partially hinge upon some parties' creditworthiness, the credit rating would be required.

1.1. Credit rating would measure the possibilities of recovering the finance principal and returns. It must reflect, at least, the minimum ability to meet the commitments contained in the public prospectus.

Article 11: Investment Rating

1. Sukuk management may also involve investment actions, which would require due diligence in order to ensure profitability.

2. Investment rating would be based on the original feasibility study review and the update of information and the projections until the Sukuk maturity.

3. It must reflect the ability to provide a rate of return that is competitive with what is available in the market.

Article 12: Subscription Coverage

1. Underwriting:

1.1. The SPV may itself undertake the function of underwriting. Alternatively, it may appoint a Turkish Sukuk underwriter certified by the CMB to guarantee the subscription.

1.2. Sukuk proceeds must be used for the same purpose for which the Sukuk were issued and per the underlying contracts.

1.3. In cases of insufficient subscription and suspension of issuance, all amounts paid by the subscribers must be repaid to them during the period determined by the prospectus.

1.4. The SPV must appoint the necessary qualified staff to handle its administrative and financial matters, including the distribution of returns and the payment of the redemption value upon the maturity of Sukuk, as per the provisions contained in the prospectus.

Article 13: Listing and Trading

1. Listing

1.1. Sukuk put to an initial public offering. IPO must be listed and traded in the stock market; however, they can be listed and traded in other markets, with the CMB's permission, defining the listing regulations and procedures, in conformity with Shariah rules.

1.2. The Sukuk listing request must be submitted with the necessary data and documentation by the SPV. According to the CMB regulations, in the case of non-listing, they shall be sold over the counter.

1.3. In all cases, the listening and trading of Sukuk shall be subject to the rules and resolutions issued by SPV-SB/CMB-SB.

1.4. The Sukuk originator may redeem the Sukuk upon their maturity and pay their value to their holders by purchasing the then-existing Sukuk assets. He may also purchase these assets before the Sukuk's maturity at a value defined according to the Shariah guidelines outlined in the prospectus.

Article 14: Sukuk Holders Rights

1. Sukuk holders in their capacity as SPV shareholders and through their Sukuk holders Association and its Board, shall:

1.1. Work together to protect their shared interests, including:

1.1.1. Litigation against the Sukuk originator, or any other parties, in cases that are not resolvable by the ISB/HSB,

2. The SPV Articles of Association shall determine the guidelines and procedures of convening the Sukuk holders Association general meeting, including the call for convening, the eligibility criteria for attendance, the arrangements, and venue of the meeting, the voting process as well as the SPV's relationship with the beneficiary from Sukuk issuance.

3. The SPV must establish a cumulative reserve to protect Sukuk holders from the investment risks. The reserve shall be financed through the deduction of a certain percentage of the SPV's realized profits, after deduction of the Mudareb's or the investment agent's profit share, until the reserve reaches a specific limit during the term of the Sukuk.

3.1. The prospectus shall define how to form the reserve, utilize it, and distribute the remaining balance among Sukuk holders upon the Sukuk's maturity.

Article 15: Issuance Rules

1. The SPV shall handle Sukuk issuance and control their underlying assets in the name of Sukuk holders.

2. The SPV financial liability must be independent of the liability of the Sukuk originator. It shall act as the Sukuk holders' trustee in holding the Sukuk assets' title, invests the Sukuk proceeds in designated outlets, and contracts with investors for this purpose.

2.1. The Sukuk originator may become a shareholder in the SPV, against his/her holding of some Sukuk.

3. The originator may not wholly own the SPV. His/her share of the SPV capital (the total value of Sukuk) should not exceed 5 percent.

3.1. The SPV may be managed by the Sukuk originator, under the supervision of the Sukuk Association Board.

Article 16: Sukuk Guarantees

A. General

1. Sukuk holding is an investment in real ownership. Sukuk holders bear the risk of the Sukuk underlying assets. Sukuk do not represent debt liability upon their issuer towards their holders. As a consequence,

1.1. Sukuk holders bear the risk and gain the returns of the underlying assets.

1.2. A guarantee is taken to cover the value of the underlying assets against destruction, damage, or loss of value; without any misconduct, negligence, or breach of the issuance conditions on the guarantor's part.

B. Investment Sukuk Guarantee

1. Neither the SPV nor the investment managers are permitted to guarantee Sukuk holders the face value of their Sukuk or a return on their investment under one of the following investment contracts

1.1.1. Mudaraba,

1.1.2. Musharaka or

1.1.3. Investment Wakala,

1.2. Such guarantees render the Sukuk as well as their underlying contracts null and void.

1.3. Investment managers shall be liable to Sukuk holders for any loss in the Sukuk assets' value unless they prove that the loss was due to reasons beyond their control and which they could neither anticipate nor avoid. In such cases, the burden of proof rests on the manager.

1.4. Investment Sukuk holders may accept a binding promise, documented from an independent third party to purchase the Sukuk assets at a specific time or upon Sukuk maturity. The investment manager may also undertake to buy the Sukuk assets at:

1.4.1. The market value,

1.4.2. The value agreed upon at the time of executing the purchase,

1.4.3. The net assets value,

1.4.4. A fair value or the value determined by agreed market experts at the time of sale.

1.4.5. At the value paid by the Sukuk holders for purchasing them in leased asset Sukuk

C. Finance and Ijarah Sukuk Guarantee

1. It is not permissible to issue Sukuk based on Murabaha, Istisna' or Salam

2. Ijarah Sukuk's originator cannot guarantee the assets or usufructs he has sold to the Sukuk holders. Furthermore, he cannot assume responsibility for their total loss, damage, or value depreciation after delivering them to the Sukuk holders or their representative because of liability shifts with ownership transfer.

3. It is permitted to appoint the seller of the assets or the usufructs as a service agent for the Sukuk holders against a fixed fee plus an incentive. It is permissible if assets are bought from a third party or constructed on Wakala

D. Guarantees by Investment Managers

Investment managers guarantee the value of the Sukuk assets under their management. In cases of breach of the agreement (breach of the requirements of trust, negligence, or misconduct in respect to making the appropriate investment decisions which should typically be expected of an investment expert) or the investment rules stipulated by the Sukuk holders. The guarantee shall be of the capital alone and per the general rules of guarantees.

Article 17: Sukuk Companies

1. Trade-finance Sukuk companies

1.1. The SPV contracts to purchase local or foreign merchandise on Istisna' and to sell on Salam,

1.2. Deliveries of Istisna' merchandise are synchronized with deliveries of Salam merchandise,

1.3. Proceeds are used to pay for Istisna' installments,

1.4. Salam payments replenish cash balances,

1.5. Cash balances can be minimized through synchronization,

1.6. Hopefully, the SPV reaches a high rate of cash turnover on the asset side, in addition to merchandise stocks kept for short periods until delivery dates,

1.7. Useful in domestic and foreign trade finance,

1.8. The attainment of low cash balances could make trade Sukuk negotiable and attract more liquidity by issuing more Sukuk.

1.9. Suppliers' credit (selling on Salam and buying on Istisna') in addition to volume discounts offer chances for higher profitability.

2. High-Value Assets Finance

- 2.1. SPV's can be established to specialize in obtaining high-value assets from construction and manufacturing companies and selling them to ultimate users.
- 2.2. Examples of such assets include office buildings, residential compounds, passenger planes, cargo ships, tankers, railroad trains, wagons, and similar assets.
- 2.3. The SPV contracts with construction and manufacturing companies to supply the high-value assets,
- 2.4. Based on Istisna' or Ijarah or forward ijarah contracts,
- 2.5. The SPV issues Sukuk to finance the purchase of assets to be supplied,
- 2.6. The SPV would have already obtained orders for such assets from real-estate, transport, and shipping companies,
- 2.7. The SPV can distribute the net return on Sukuk holders and continue its activities, with more Sukuk issued as needed,
- 2.8. The assets of the SPV would include real assets under construction and manufacturing. Their real liabilities would include the same to be delivered, the ratio of cash and monetary obligations would be sufficiently limited to allow Sukuk tradability,
- 2.9. Since Sukuk are tradable, Sukuk holders can opt to continue holding Sukuk or opt-out through their sale,

3. Infrastructure Sukuk Companies

- 3.1. A government department or an Islamic financial institution can establish an SPV to mobilize resources to finance infrastructure through Sukuk issuing.
- 3.2. The government provides the SPV with a franchise to build the infrastructure, operate it for a certain period, and then transfer the title to it to the government, under a BOT arrangement.
- 3.3. The infrastructure's net earnings would be the fees (the value of infrastructure services sold minus the total fixed and variable cost amortized over the franchise's lifetime).
- 3.4. Net earnings would be distributed to shareholders up to Sukuk maturity.
- 3.5. It is important to stress that environmental considerations must be observed in such undertakings.

4. Agricultural Sukuk companies

- 4.1. To expand agriculture by land reclamation, increase gardening and forestry areas producing fruit, nuts, and lumber,

4.2. The government can provide pieces of unexploited public land to SPV's for a nominal rent, on a permanent or a temporary basis, provided it is cultivated with crops or fruit/lumber trees within a specific time limit,

4.3. The government may add an incentive to grant a percentage of the land offered after reclamation is complete,

4.4. The SPV issues Sukuk to mobilize sufficient resources for land reclamation, gardening, and forestry,

4.5. The Sukuk holders would gain the annual net return, plus the land's capital appreciation when offering partial title transfer.

4.6. In the end, more forestation, in particular, should help the environment.

5. Wakala Investment Sukuk Companies

5.1. Based on the investment Wakala contract,

5.2. Their proceeds used as capital, paid to the investment agent to invest it against a commission,

5.3. Sukuk holders are

5.4. Entitled to the investment return

5.5. Liable for investment risks, in proportion to their Sukuk number,

5.6. The investment agent is entitled to:

5.7. A guaranteed fixed commission payable,

5.8. An agreed incentive set in relationship to the profit exceeding a certain threshold,

6. Musharaka Sukuk

6.1. Based on the Musharaka contract,

6.2. Proceeds used as the Sukuk holders' share in the Musharaka capital, whose other partners,

6.3. Sukuk holders are:

6.4. Entitled to a common share in the investment return

6.5. Liable for investment risks in proportion to their Sukuk number,

Article 18: Conflict Resolution

1. In cases of conflicts among Sukuk holders, manager, investors, and other parties, the CMB-SB is the sole arbiter between all parties,

2. CMB shall set the rules of litigation and appeals to the CMB-SB,

3. Parties can refer their conflicts to Turkish courts only when such referrals are instructed or permitted by the CMB.

Article 19: Definitions

1. Islamic Shariah Rules

Shari'ah rules are derived from the Quran, the Sunnah, and other Shariah sources whose authority is derived from the Quran and the Sunnah.

2. Sukuk

2.1. Sukuk: Plural of 'Sakk,' lexically means a certificate, a deed, or security².

2.2. In Islamic Finance terminology, 'Sukuk' refers to certificates or legal instruments (securities) of equal value, nominal or for-the-bearer certificates.

2.3. They represent undivided shares in ownership of assets (the Sukuk assets): tangible assets, usufructs, debts, money, services, financial rights, or a mixture of some or all of these kinds, but subject to certain conditions upon issuance and after subscription.

3. Sukuk distinguished from bonds

3.1. Sukuk are tradable instruments so long as they do not represent debt or money alone.

3.2. They cannot be deemed as debt for their owners on their issuer at the issuance stage;

3.3. They are issued based on one of the Shariah contracts, and the rights and obligations of all contractual parties are well defined in the prospectus and the Sukuk contracts.

3.4. Moreover, Sukuk have the following features:

3.5. They provide management rights to their holders,

3.6. Their holders share the profit and the liquidation value of the assets they represent. In case of loss, he is also liable for loss to the proportion of the Sukuk he holds based on the Fiqh maxim "liability is an obligation accompanying gain."

3.7. Sukuk's ability for redemption and trading is subject to the conditions of the tradability of the assets they represent.

3.8. Sukuk can either be issued for a limited period during or after which they can be redeemed.

4. Sukuk distinguished from shares

² From the word 'Sakk' were developed later the English word (check) and the French word (cheque) and their likes.

4.1. While a Sakk is a common undivided right in a collection of underlying (securitized) assets, a share is a common right in the ownership of a specific legal company's assets.

4.2. The latter right remains effective as long as the company itself remains in existence.

4.3. In contrast, Sukuk can be issued for specific periods after which they can be redeemed or without specifying a duration for redemption.

5. Green Sukuk or Climate Sukuk;

5.1. All Shariah-compliant investments must not harm the environment,

5.2. Sukuk, whose proceeds finance further environmental improvements, like clean air, forestation, recycling of waste, renewable energy, and the like, may be named green Sukuk.

6. Equity (social justice) Sukuk;

6.1. All Shariah-compliant finance should not be involved in actions that disadvantage the poor,

6.2. Sukuk, whose proceeds contribute to narrowing the differences between the rich and the poor, are considered equity Sukuk. Examples include providing low-cost housing, food sustenance, unskilled employment, and the like.

7. Bonds (as compared to Sukuk)

7.1. A Bond is a certificate or a deed (security) that represents a guaranteed interest-bearing debt owed by its issuer (the debtor /borrower) to its bearer (the creditor /lender). A bond thus represents a financial right for its bearer (the lender). Its amount is guaranteed by the bond issuer (the borrower) to be repaid at a specific future time.

7.2. It is the reality of the financial papers that matters and not their terminology. Therefore, terming bonds as 'investment certificates' does not change the prohibition of their acquisition and trading.

7.3. Similarly, terming Sukuk that have fulfilled all Shariah conditions as 'Islamic bonds' does not render them prohibited,

7.4. The name (Islamic bonds) itself is not accurate in economic terms as it is self-contradictory.

8. CMB,

CMB is the governmental unit responsible for supervising financial markets in Turkey. It consequently supervises the issuance of Sukuk.

9. Issuance Prospectus

The issuance prospectus is the information document, which includes all of the data, terms, conditions, and the Sukuk issuance and redemption provisions.

10. Sukuk underlying Assets

They are the Sukuk issuance proceeds and what they may be converted into tangible assets, usufructs, services, cash, debts, or other financial rights.

11. Issuance (underlying) Contract

The Shariah contract is based on which Sukuk is issued.

12. Trading Sukuk

It is the sale of Sukuk to parties other than their issuer at the agreed price.ⁱ This sale is subject to the Shariah rules of the tradability of Sukuk underlying assets as outlined in the prospectus.

13. Redemption

It is the sale of the Sukuk underlying assets to the Sukuk originator, subject to the rules and conditions of Sukuk's tradability as outlined in the prospectus.

14. The Market

It is the authorized securities and commodities exchange in the Country.

15. Underwriting

It is the undertaking by some party to promote Sukuk subscription and subscribe at a determined price to the Sukuk not subscribed to, which binds the underwriter alone and not the Sukuk originator.

16. Sukuk Originator

It is the party seeking finance from the Sukuk subscription proceeds to establish a project, a venture, or an economic activity.

17. The Issuer:

The same as the SPV.

18. Sukuk Owners (Sukuk holders)

They are the Sukuk subscribers and buyers who own the Sukuk assets and reap their gains and bear their losses in proportion to the number of Sukuk held by every one of them. They represent the seller in Murabaha or Istisna, the buyer in Salam, the buyer of the leasable assets or services or usufructs, the capital provider in Mudaraba, Musharaka, or Wakala in investment.

Article 20: Date Of The Standard Issuance

This standard was issued in ----, reviewed, and revised in ----.
