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Islamic Finance: Issues in *Şukūk* and Proposals for Reform

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Islamic Finance: Issues in Şukūk and Proposals for Reform is a jointly edited volume by Mohammad Hashim Kamali and Abdul Karim Abdullah. The book is jointly published by the International Institute of Advanced Islamic Studies, Kuala Lumpur, Malaysia (IAIS) and the Islamic Foundation, U.K. Professor Kamali is the founding chairman and CEO of IAIS. He is an expert of Islamic jurisprudence, Islamic finance, and human rights in Islam. Abdul Karim Abdullah is a rising star in IAIS and working as a research fellow. This publication on an important current topic of Islamic economics and finance by the Islamic Foundation, which has been a leading publisher on the subject since long should be welcomed.

The book may be divided into three parts - an introduction, seven articles, and two interviews. It consists of the following papers:

1. The ‘Ping-Pong’ of the Asset-Backed/Asset-based *Şukūk*-Debate and the Way Forward by Faizal Ahmad Manjoo,
2. Unresolved Sharī‘ah Issues in *Şukūk* Structuring by Muhammad al-Bashir Muhammad al-Amine,
3. *Şukūk*: Perception, Innovation and Challenges by Muhammad Imad Ali,
4. *Şukūk* and Bonds: A Comparison by Abdul Karim Abdullah,

5. Measuring Sharī‘ah-compliance in *Ṣukūk* Ratings: A Survey of Existing Methodologies by Sheila Ainan Yussof,
6. Concession Rights as Underlying Assets for *Ṣukūk* by Sirajulhaq Hilal Yasini and Nermin Klopic,
7. The Case for Receivables–Based *Ṣukūk*: A Convergence between Malaysian and Global Sharī‘ah Standards on *Bay‘ al-Dayn* by Rafe Haneef.

The editors in their “Introduction” present an overview of the *ṣukūk* industry and provide a concise introduction of the papers. They also give summary of two interviews: one with Abbas Mirakhor entitled “*Ṣukūk*: Issues and Reforms” conducted by Sheila Ainon Yussof, and the other with Raja Teh Maimunah on “Issues in the Prevailing Financial Architecture with Special Reference to *Ṣukūk*” conducted by Zarina Nalla.

In the wake of recent financial crises and default of some *ṣukūk*, questions were raised about the authenticity of Islamic finance and proper development of *ṣukūk*. This was the main reason why the International Institute of Advanced Islamic Studies (IAIS) Malaysia took the initiative to solicit the views of a number of scholars and practitioners in the industry to present their stance in this volume. Except one article by Rafe Haneef, reproduced from ISRA, the rest of papers have been specially written for this book. They identify and analyze various issues related to *ṣukūk* and make some proposals for reform.

Faizal Ahmad Manjoo in his article “The ‘Ping-Pong’ of the Asset-Backed/Asset-Based *Ṣukūk* - Debate and the Way Forward” draws a picture of the debate about asset-backed and asset-based *ṣukūk* structure and the legal uncertainties surrounding them. He distinguishes the two terms: ‘In an asset-based transaction, the *ṣukūk* holder technically pays money to receive money without a real estate changing hands between the counterparties. In an asset-backed transaction, by contrast, the deal is premised on an underlying asset itself which generates the cash flow to investors’ (p. 15). The author has collected data to study various types of *ṣukūk* issuance. He carries out a qualitative analysis to understand the underlying problems of a True-sale and purchase undertaking. He has skillfully examined the related *fiqhī* issues like the question of true-sale with an asset-based *ṣukūk* and purchase guarantee of the investors’

capital at the end of *şukūk* life. This makes the *şukūk* debt instruments. He emphasizes the need to move towards proper asset-back securities.

Muhammad al-Bashir Muhammad al-Amine, in his article “Unresolved Sharī‘ah Issues in *Şukūk* Structuring” considers the ownership of *şukūk* assets as an unresolved issue that can have a negative impact on the industry. He thinks that the current practice of *şukūk* replicating debt-based conventional bond structures has to be changed, and asset-backed securitization model has to be adopted, because such *şukūk* are closer to an equity position. In this case, the *şukūk*-holders own the underlying asset, and they will have no recourse to the originator in the event of a payment shortfall. Rather, they will be granted direct recourse to the *şukūk* assets. In case of asset-based *şukūk* the investors (*şukūk*-holders) have no real ownership over the asset and therefore, have no right to sell the asset to a third party or dispose of it (p. 38). He asserts that “the returns of *şukūk* will be based on the performance of the underlying assets and not on the creditworthiness of the originator.” (p.48).

Muhammad Imad Ali in his article “*Şukūk*: Perception, Innovation and Challenges” also starts with distinguishing between asset-linked *şukūk* and conventional bonds. In the case of *şukūk*, the specific underlying assets generate the income to *şukūk*-holders, whereas conventional bonds are not linked to any assets that serve as a source of non-interest income to bondholders. He stresses that “a clear consensus exists among the Sharī‘ah scholars that the risks and rewards in the underlying *şukūk* assets need to be shared by the *şukūk*-holders and that only this sharing justifies the return to the *şukūk*-holders on other investment” (p. 57). He considers the recourse to the *şukūk* assets by the *şukūk*-holders in case of default still an issue that needs to be addressed (p. 64).

Abdul Karim Abdullah in his article “*Şukūk* and Bonds: A Comparison” gives basic information related to Islamic finance and in particular *şukūk* which is very significant for those unaware readers who want to understand the industry. Therefore, in the opinion of this reviewer it should have been placed at the beginning of the volume. The author elaborates advantages of trading and investment carried out on partnerships basis and disadvantages of speculation and interest-based project financing, defines *şukūk* and bonds, gives brief history of *şukūk*, shows similarities and differences between fixed income securities and

risk-sharing securities, conventional bonds and *ṣukūk*, distinguishes between interest and profit, sale-based *ṣukūk* to finance trade and participatory *ṣukūk* issued to finance investment, etc. He rightly points out that the prohibition of trading in debt (bonds) reduces unproductive speculation financed by interest-based debt significantly, and speculation in financial markets only redistributes existing wealth and contributes little to the generation of new wealth. The elimination of excessive speculation in the financial sector, implied by the prohibition of interest-based loans, will free resources for utilization in the real sector. While showing the advantages of trading and investment carried out by partnerships he significantly notes that European and Japanese banks, unlike their UK and US counterparts, often take equity interest in the enterprise they finance. For these reasons, it is in the public interest (*maṣlahah*) to avoid indebtedness.

The author traces the history of *ṣukūk* back to the period of second caliph Umar b. al-Khattab (d. 23/644). Another incident of selling *ṣukūk* is reported during the caliphate of Marwan b. al-Hakam (d. 65/683) which he prohibited when objection was raised by some Companions. The author missed to report it. However, it needs to be discussed how far these two episodes could be related to the present form of *ṣukūk*.

The author's statement "the *ribā* prohibited in the Qur'ān is known as *ribā al-nasī'ah*; *ribā* mentioned in the prophetic tradition is known as *ribā al-faḍl*" is not very precise and satisfactory statement (pp. 80-81). Even according to the Prophetic tradition if a gold *dīnār* is exchanged with another gold *dīnār* with the difference of time, it is *ribā al-nasī'ah* or *ribā al-nasā'* to use a little different term. A better expression is to say that *ribā* al-Qur'ān occurs in loans (*qurūd*), and *ribā al-ḥadīth* occurs in exchange (*buyū'* or *ṣarf*).

Sheila Ainan Yussof in her article "Measuring Sharī'ah-Compliance in *Ṣukūk* Ratings; A survey of Existing Methodologies" deals with an important issue related to *ṣukūk*, that is, Sharī'ah-compliance in *ṣukūk* rating. *Ṣukūk* have to satisfy two sets of legal criteria: Sharī'ah and commercial. Compliance from the Sharī'ah perspective and enforceability of an obligation strictly from the standpoint of contract and commercial law. In addition, they must fulfill Sharī'ah objectives of justice, equity and fair play. The article is not a

theoretical exercise. Rather, it surveys existing methodologies applied by regional and international rating agencies. The author discovers that the existing agencies mainly pay attention to credit quality and default risk rating. Similar attention is not paid to Sharī'ah-compliance of the *sukūk*. The author recommends development of a rating methodology to cover both financial performance and Sharī'ah-compliance. Only then, can they win the confidence of Muslim investors.

Sirajulhaq Hilal Yasini and Nermin Kloplic, in their article “Concession Rights as Underlying Assets for *Şukūk*” examine the Sharī'ah stand on concession rights, as an underlying asset for the issuance of *sukūk*. They think that this will be helpful to issuers who do not have sufficient tangible assets for the purpose of securitization (*taşķik*). The authors discuss four types of concessions – utilization, origination, management and franchise and license – and possibility of using them as underlying assets in the securitization process. *Taşķik* or securitization of concession rights may take two forms: “*taşķik* of rights directly by the source which originally owns these rights such as the issuance of *sukūk* by a state directly granting a concession to *sukūk*-holders and *taşķik* of concession by the concessionaire after receiving the concession from the grantor” (p. 126). After going through case studies of two Saudi companies, the Saudi Electricity (SEC) and the Saudi Basic Industries Corporation (SABIC), they show how these companies successfully issued *sukūk* of 2007 using the concession rights as underlying assets.

Rafe Haneef in his paper “the Case for Receivables–Based *Şukūk*: A Convergence between Malaysian and Global Sharī'ah Standards on *Bay' al-Dayn*” addresses the issue of the sale of blended assets which comprise both physical assets and Sharī'ah-compliant receivables. Majority of scholars, especially from Middle East, holds that for sale of *sukūk*, at least 51% or 33% of the blended asset *sukūk* must be in the form of physical assets to avoid blame of *ribā*. He critically examines the maxim of one-third and concludes that “the physical asset threshold requirement (either 51% or 33%) is not particularly relevant within the context of blended-assets *sukūk* that satisfy the minimum price requirement” (p. 155). He argues that they can be traded in the secondary market at less than 33% or 51% physical assets, provided the price at which they are sold is equal or greater than the value of the cash and/or

receivables component of the underlying shares. To him, this would satisfy the requirement that debt could not be sold at less than the par value. His argument is based on an opinion in the Hanafite School which allows sale of assets with mixed items – *ribawī* and non-*ribawī* – if the parties can verify the value of the *ribawī* item and exchange equal value for it. Any extra payment will be considered in lieu of the non-*ribawī* item. He also supports his stand by the case of *mudd ‘ajwah*. That is an exchange of a *mudd* (a unit of measure) of ‘*ajwah* (a good quality date) with ‘*ajwah* mixed with an inferior quality of date measuring more than a *mudd*. No doubt, the author’s suggestion is innovative and deserves attention by the jurists in Sharī‘ah supervisory boards. However, it may be noted that Malaysian jurists allow the sale of *ṣukūk* having 100% receivables, known as *bay‘ al-dayn*, whilst jurists in the rest of world permit the sale of *ṣukūk* only when they have substantial physical assets. The author does not discuss the first case. So the divergence persists between the Malaysian and global ‘Sharī‘ah standards on *bay‘ al-dayn*.

The two interviews at the end of the book provide two opposite stands on *ṣukūk* structuring. Mirakhor is with those who campaign for the reform and restructuring of *ṣukūk* to genuinely reflect true-sale and complete legal transfer of ownership of the underlying asset to the investors. In his opinion, its absence was the main reason behind default or near default of a few *ṣukūk* in the past. He strongly advocates the adoption of profit-and-loss-sharing structure for *ṣukūk* in which guarantee cannot be provided to the investors for fixed periodic return and repurchase of their assets at full price. He emphasizes that a level playing field between debt and equity is a must to encourage the growth of *bona fide* profit and loss sharing *ṣukūk* which is not available at present. Efforts should be made to change the existing unfair situation.

Raja Teh Maimunah has completely different view about *ṣukūk*. In her interview, she disagrees that *ṣukūk* need to be asset-backed in order to comply with Sharī‘ah and to provide genuine protection to investors. She reiterates that the Islamic finance differs from conventional finance in that it funds the real economy which is fulfilled under asset-based *ṣukūk* as well. She maintains that a suitable legal framework can ensure investors’ protection. So the difference between asset-backed and asset-based *ṣukūk* will become irrelevant. She has personal experience that 50% supporters of asset-backed are unable to justify them fully. In her

opinion, insistence on asset-backed *ṣukūk* will only increase the cost of issuance without any benefit to the industry. She says that, if you insist on asset-backed *ṣukūk*, “you would have to pay high taxes; it becomes expensive and this dissuades people from doing it” (p. 173). However, she does not present any proper empirical evidence in support of her stand. It may be mere apprehension. It has yet to be established empirically that people will, in fact, abandon *ṣukūk* in favor of conventional bonds if *ṣukūk* are asset-backed to represent true-sale and structured on profit and loss sharing basis. Most probably the belief in Islamic legitimacy will influence peoples’ choices. They may still prefer clean *ṣukūk* to doubtful ones.

To put it in a nutshell, the book provides a lot of food for thought. The concepts of true-sale, beneficial ownership, income and capital guarantee, *ṣukūk* returns and the use of LIBOR, credit risk of the originator, Shari‘ah-compliance and rating agencies, regulatory challenges, risk-sharing *ṣukūk*, use of concession rights as underlying asset in securitization, Shari‘ah standard on *bay‘ al-dayn*, etc. But in the opinion of this reviewer the most basic question, dominating the whole book, and touched by almost all the writers, but still remains unresolved is the issue of asset-based and asset-backed *ṣukūk*. The introduction section clearly defines and differentiates between the two. *Ṣukūk* where investors have merely beneficial ownership of the underlying asset are known as asset-based. On the other hand, *ṣukūk* structured on the basis of true-sales are known as asset-backed (p.5).

The editors in their preface strongly advocate the issuance of *ṣukūk* as asset-backed. In their opinion this will have many advantages: True-sale by the originators to the investors makes the deed Shari‘ah-compliant; question will not arise regarding beneficial ownership from Shari‘ah viewpoint; this will provide stronger investors’ protection as they are the legal owner of the asset; and risk-sharing is realized as investors face asset-risk rather than originator risk (p. ix). However, the two interviews at the end of the book are the proof that the issue is still unsettled and needs further debate. The question of asset-based and asset-backed seems to be an appropriate topic to be discussed at a suitable forum. In this connection legal protection, regulation, transparency, and the role and legitimacy of the legal person – Special Purpose Vehicle (SPV) – should also be fully examined.

In sum, *ṣukūk* are one of the most important innovations of Islamic finance. In terms of volume, they represent the largest amount by any single product. They have been utilized not only by Muslim countries, but also by advanced non-Muslim countries. *Ṣukūk* have facilitated implementation of many projects in private and public sectors. With the increasing currency of *ṣukūk* products, there has been increasing volume of literature on the subject. But still there is dearth of works in English by writers simultaneously having expertise in Sharī'ah and practical experience in the industry. In this sense, the present work is a significant addition. It is hoped that it will spur further research in this area.

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