

Appeal of *Ṣukūk* as a New Type of Financial Instrument

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1. Introduction

This paper aims at stimulating a creative discussion on an emerging market for *ṣukūk*, which some writers consider to be a new way of debt-type contracting and others view as an equity-type instrument. This difference of opinion arises from various ways of structuring *ṣukūk*. The market is founded on a set of clear ethical financial principles found in Islam's teachings on financial trading⁽¹⁾. This topic attracts attention especially because the market is no more than two decades old, yet has chalked up an outstanding value of US\$ 1,200 billion in five financial centers: Saudi Arabia, Malaysia, Kuwait, Bahrain and United Arab Emirates. Together with these, there are 13 other financial centers with one or more *ṣukūk* instruments listed and traded in their financial markets⁽²⁾. London listed its first such instrument in August, 2014, and more has followed since, with the announced aim of making London a leading center for this form of contracting⁽³⁾. The term *ṣukūk* has been

(1) Some of these ethical principles are stated in the book Ariff, Iqbal and Shamsheer (2011).

(2) *Ṣukūk* with an outstanding value of US\$1,200 billion is the latest addition to Islamic finance. Much of the market is OTC while there are 18 market places in 2015 that have listed and traded *ṣukūk* instruments. For a quick description of Islamic financial markets, please see the Appendix. See also Viswanath and Azmi (2009).

(3) "Contractual structures for investment partnerships, agency and trust laws, the money transfer system, paper money, checks and letters of credit were just some of the concepts introduced into Europe by merchants from the Islamic world. These were the roots of modern capitalism, but somehow along the way the protection of the weak became forgotten and the concept of the unfettered free market dominated." source: Guardian newspaper article, 5 December, 2014.

defined succinctly by the Islamic Financial Services Board (IFSB) as: "... *ṣukūk* frequently referred to as "Islamic bonds" are certificates with each *ṣakk* representing a proportional, undivided ownership right in tangible assets or a pool of predominantly tangible assets, or a business venture...". Safari et al., (2014; p 14) define it as: "... *ṣukūk* structures are debt instruments that require the creation of assets in a separate entity, these assets being owned proportionally by lenders, the fund providers." This definition emphasizes the asset-backed nature as a fundamental structuring principle of these types of instruments. Thus, this definition considers the instrument as a debt instrument, and that investors would own tangible assets taken as security from the borrowers during the life of the loan for servicing the funding arrangements over the life of the project. This form of funding is mostly over a finite time period (exceptions being equity-like *mushārah* *ṣukūk*), and the transfer of ownership of assets to the borrowers provides not just security, but also income to pay back the initial investment. This appears to suggest that the loan book is fully backed by the tangible assets transferred to lenders and held in a special purpose firm jointly owned in the names of the lenders.

The lineup of countries which have initiated actions or have already passed laws to reform their financial regulations to facilitate the debut of *ṣukūk* markets is worth noting. *Ṣukūk* are making debuts in such unlikely places as China, Russia, Kazakhstan, and Australia. Soon more countries are poised to introduce this new instrument offering an alternative choice to investors long since wedded to traditional bond market instruments. International institutions, such as the World Bank, have raised financing using this new form of fund-raising, as has several governments and their agencies. Private corporations are keen to have *ṣukūk*, while some of them also having common bond and bank debt as well in their balance sheets. About half of the outstanding issues are by private firms, some of which are very large corporations, both listed and unlisted in Europe, the Middle East, and Southeast Asia. Even the Oxford English Dictionary has not yet included the word *ṣukūk* in its latest edition! The rapid acceptance of this new form of contracting by investors is widely commented upon in the financial press such as *Euromoney*, Bloomberg wire services and regulatory circles such as the IMF. The market for *ṣukūk* is growing at 17-24 per cent a year in 18 countries. Compared to this, the world has seen subdued growth, in fact, declining growth during 2008-10, in the conventional bond markets

because of the deleveraging trend that has started since the Global Financial Crisis in 2008.

This paper advances some ideas on this emerging market in an attempt to clarify what *ṣukūk* stands for, the various types of *ṣukūk* on offer, how they differ from traditional bonds, and highlighting the key issues about this new financial market. The paper is a modest attempt to offer a personal view on this worldwide phenomenon. Others are invited to contribute clarifications, elucidations, and even constructive criticisms on the following paper.

The rest of the paper is divided into four sections that cover: the main types of *ṣukūk*; scope of *ṣukūk* for fund mobilization by public and private sectors; and the challenge to product designers to fully exploit the potential of *ṣukūk*, while not limiting financial engineering by a restrictive interpretation of the Islamic laws on trade in financial instruments.

2. Common Types of *Ṣukūk* on Offer

There are six types of *ṣukūk* securities already in use both in the private and public sectors as issues for trading.⁽⁴⁾ They are: (i) *mushārahah ṣukūk*; (ii) *murābahah*-based treasury bills or commercial papers issued by governments in some countries. These are not yet issued by firms; (iii) *Ijārah ṣukūk*, which are leasing contracts mostly with fixed payments. This is the most common type on offer in all markets, especially in Malaysia; (iv) Variable payoff *muḍārabah ṣukūk* (partnership between financier and the entrepreneur). (v) *Istiṣnā' ṣukūk* to provide working capital or project financing, for an entrepreneur with experience to produce a product, with a loan without asset-backing at the time of issue; and (vi) *Salam ṣukūk*, which are advance-payment contracts to facilitate a temporary arrangement to secure funds ahead of the time to sell merchandise in the future, as in the sale of agricultural produce ahead of harvest.

These six types, with minor variations, are already being traded on exchanges or issued in the OTC markets. Sharī'ah scholars have identified and described more *ṣukūk* contracts, which are not yet issued.

(4) Safari, Ariff and Shamsher (2014a). *Ṣukūk Securities: New ways of Debt Contracting*. Wiley Islamic Finance Series. John Wiley & Sons, New Jersey, USA and Singapore. This won the best international publication research award in 2015.

An example is *ṣukūk* based on a diminishing *mushārahah* contract, which has not yet been offered. This contract is liquidated by payments over the life of the contract to reduce the sum advanced at the time of contract to zero at maturity.

Another general classification, in which the above six contract types can be fitted, has been proposed in a recent text. The six generic types can be expanded within each by placing the *ṣukūk* in six classes⁽⁵⁾. Class I: *Mushārahah ṣukūk*, are share-like equity instruments, owners of which have full control of the firm either for an infinite period, in which case, risk and profit is shared; if the security has finite life, then too, there is some form of risk-sharing before profit is shared, although the profits are arranged to be paid in the lifetime of the contract or at the end;

Class II: Discount *ṣukūk* are when the amount to be paid back is discounted from the face value with provision normally for rewards to be paid at the end of the contract period with no servicing of the amount in the intermediate period by the special purpose company;

Class III: Fixed and constant growth payoff *ṣukūk* are of two types. If fixed, then the special purpose company services the investors with fixed payments at agreed regular intervals over the life of the instrument. If growing, then the periodic payments are increased at an agreed rate (say rents can go up by the amount of the inflation rate) as paid at agreed intervals by the special purpose company. This is a growing annuity paid in arrears. This class also accommodates short-term instruments over less than 1-year maturities;

Class IV: Variable payoff *ṣukūk* have outcome-based payoffs, and the outcome depends on the profits of the special purpose company, which decides on the amount based on actual cash streams. Sometimes there is a base payment to which a percentage is added as in LIBOR plus (international interest rate) or KLIBOR plus (in Malaysia);

Class V: *Istiṣnā' ṣukūk* are variously described as working capital funding or project funding arrangements. This type is ideal for large projects, where the assets of a firm are to be produced (some manufacturing is involved, as is clear by the Arabic word, *istiṣnā'*) in

(5) Safari et al. (2014).

future as in case of a toll road construction or an energy plant construction for government.

Class VI: These are futures contract, well suited for funding the production of items that will emerge in future, on evidence-already-in-place (example a blueprint, or flowers on a tree). A chart in the Appendix provides a fuller description of this classification.

These six structural types are suggested as sufficient classes to accommodate the variations in each of them as the market grows. Among the earliest *ṣukūk* on offer are the popular *ijārah ṣukūk* (lease-based contracts) which fall under Class III with a fixed payment at regular intervals based on some computation of the rental (or income producing) value of assets being leased. One could have a variation to this basic mode by adding a growth element, say for depreciation of the assets, if the lessee is arranging for a capital lease. Such a slightly-varied *ijārah* contract is called *ijārah manfaa ṣukūk*, which has a slight variation in the mode of payments from fixed to variable payments. Similarly, an *istiṣnā' ṣukūk* for leasing farmland with trees can be arranged as much as *istiṣnā'*. *Muqarasah* can be used just as the simple *istiṣnā' ṣukūk* is for funding a project for the production of special furniture by a firm to be fitted in a hotel. We believe this six-way classification is a useful way of grouping *ṣukūk* contracts in place in several markets. The BAB *ṣukūk* in Malaysia will fall under Class III whereas pure debt funding may fall under silent partnership under Class II.

Popular writings in the press and in some books refer to an easier and simpler classification. All *ṣukūk* instruments are divided into short-term or long-term instruments. For example, a government may raise finances through *muḍārabah ṣukūk* with a special purpose company that owns government buildings for rent. The income from rents will service this according to either fixed or a growing annuity over the life of the *ṣukūk*. In this case, normally it will be long-term financing. Short-term arrangements are usually based on asset-backed structures. The long-term funding is mostly equity-backed to provide incomes to service the financing over the life of the contract. This is a short-term versus long-term with asset-backing and equity-backing classification. This is not a fully consistent classification since there are overlaps among the three types in terms of asset backing.

Another favored method of classifying *şukūk* is to refer to the issuer type, as is also common practice in traditional bond markets. *Şukūk* issues with less than one year term are called bills (if issued by the government) or paper (if issued by companies). *Şukūk* issued by government agencies are called agency *şukūk* while those issued by private companies including financial institutions are called private *şukūk* certificates. Though widely in use in the market places, this method of referring to *şukūk* does not reveal the special nature of *şukūk*, which is that *şukūk* enables fund-raising for *different* purposes by having targeted financing.

Hence, the classification suggested earlier into six classes, in our view, provides enough room to include newer *şukūk* contracts as belonging to a specific class within the six, depending on the characteristic of a given *şukūk* contract. Therefore, we favor the six-class grouping of *şukūk* contracts, and would leave market participants to continue to refer to the simpler bills, bonds and equity as labels for specific *şukūk* contracts for comparison in-line with conventional bond market practices.

Asset-backing in *şukūk* markets is an important difference between the current practice in conventional bond markets under which loans are made based on implicit guarantee of ‘good name of the borrower’. Some would say that conventional bonds have broader appeal because of this, especially with general purpose borrowing. Under such conventional borrowing practices, at the time of a dispute that the loan is not being serviced as promised, a court of law must approve any action of investors to claim ownership of the assets of the firm. Under *şukūk* contracting, ownership is established right from the start of the contract by the process of setting up a special purpose company (SPC) to take over the assets, for the amount of funds, with proportionate ownership of investors in the firm.

3. How and Why Mobilize Funds via Şukūk Contracts

It used to be argued, (some scholars still do), that *şukūk* are basically equity-based, and that the idea of *Islamic debt* instruments is not defensible. There is some merit in this argument since *şukūk* span bills, bonds, and equity-type contracting, which is unlike the conventional bond instruments, all of which fall outside the equity-type instruments.

Yet, this reasoning is faulty in so far as the fact goes that in practice *ṣukūk* certificates are mostly based on debt-taking arrangements with the sole exclusion of *mushārahah ṣukūk*, which are seldom contracted as a loan agreement. Therefore, in our view, *ṣukūk* funding historically has been about debt-contracting, no doubt based on the Islamic idea of fairness, justice, society-first and non-exploitation of those who have no access to money.

Over centuries of bond market development, some of the ideas of fairness, non-exploitation, society-first and justice in financial contracting have been heavily watered down so much so that IF may look like having the vigor or doctrinaire-based restrictions broadly fulfilling the necessity for fairness, justice, society-first and non-exploitability as part of contracting principles. The *ṣukūk* contracting is establishing itself across the world. Islamic banking commenced 61 years ago and slowly evolved to have many products on offer by 2014.

We describe *ṣukūk* as Islamic debt market instruments (also see the Appendix for a fuller explanation of IF). As time goes on, more than the six generic types may be engineered by product designers and offered in the market place as Islamic debt instruments. Over the last 200 years, debt and equity have been twins in the capital make-up of modern-day firms, and there is no going back to equity-funding of ancient days. So there is a place in modern times for Islamic debt instruments called *ṣukūk*.

Consistent with this stand that we take in this paper, we now proceed to describe the funding arrangement for *ṣukūk* contracting. The first fact to keep in mind is that there are strict standards of compliance to a set of restrictions that must be in place for a *ṣukūk* structure to be approved for offer to the public. To be brief, these restrictions are supervised by especially-trained scholars (*fuqahā'*) who sit on the financial institutions' Supervisory Boards to oversee that full compliance is certifiable so that the offered product is made Sharī'ah-compliant.

The restrictions include:

- (a) Funding must have risk-sharing and by implication profit-sharing clauses so that reward to investors is not pre-agreed and fixed as in a conventional debt contract. This fulfills a need for a two-sided arrangement to bind both parties to a common purpose of production

of items useful to society since *şukūk* are targeted investment plans under a two-sided balanced contracting.

- (b) Rewards are obtained by fund providers for financing the entrepreneur with whom the financier shares the risk of business.
- (c) Full disclosure is required to ensure provision of symmetric information ahead of contracting so that the investors know the exact outcomes of the contract being signed. This ensures there are no hidden clauses, and that information that places the investment at high risk are fully understood, while gambling-type risks are not taken in financial transactions to make the funding safer.
- (d) Funding may only be made available to those production activities that will promote society's well-being. Production of intoxicants, tobacco, gambling, prostitution, weapons of mass destruction, etc., are denied funding under IF.
- (e) Funding is only made if the borrower is willing to transfer part of the borrower's income producing assets (if existing now and, if not, likely to exist in the future, when the asset becomes available through funding) to be held in the joint names of the lenders in a separate special purpose company (SPC) to service the debt out of the assets of the SPC. This is an important asset-backing principle – researchers have repeatedly called for this to be the cornerstone of IF debt contracting.

Asset-backing makes the lending more attractive and engenders the investors to *stick* to his end of the bargain much more doggedly than would an investor who is only interested in collecting rewards irrespective of the outcome to the entrepreneur. In a one-sided contract in this manner, investors are likely not to be interested in the outcome of the funding. Hence, *şukūk* not only target funding for a particular purpose, but also ensure that the finance provided is seen through to ensure the project is likely to be successful. Obviously this creates an agency problem, as well as moral hazard issue, which would increase the cost of monitoring IF contracts. The fact that part of the assets are already not under the control of the entrepreneur would mean that the entrepreneur would not want to waste his assets by shirking, which improves commitment to seeing the project to a successful end on the part of the entrepreneur.

Finally, *ṣukūk* funding has few other requirements (example, servicing of the loan is made through the SPC) in addition to the five basic requirements listed. Hence, observance of contracting parties to bind themselves to these conditions is applauded as making IF contracting fair, just, ensuring society-first goals and helping to avoid non-exploitation of weaker parties in financial contracts. Conventional debt contracting has evolved over centuries from some of these ethical principles. For instance, debt is made without asset-backing today whereas in the mid-sixteenth century banks used to back all lending by assets⁽⁶⁾.

Proponents of IF insist that all lending is asset-backed and that the assets must provide incomes to service debt. The assets could well be usufructs that have income producing character, if these are not tangible assets. Similarly requiring that the funds be used only for a pro-society production will lead to promoting stable social conditions since production and sale of avoided items are likely to endanger society's wellbeing. These are laudable ethical considerations, so IF harkens back to an important prevalent standard of lending that has been watered down, thus leading to the growth of institutions not inimical to society. IF is not a sinister plan to Islamize Western institutions, but it is a means to make markets stable, accountable to society at large, prevent use of money power to ensure non-exploitation by the rich. Hence, a rational argument underlies IF contracting.

Asset-backing also prevents profligate debt overhang. The world GDP is about US\$ 80 trillion, but the debt overload is US\$ 160 trillion (Ariff et. al., (2014)). Under an asset-backing principle, no borrower can borrow more than the total worth of assets in place. Imagine a firm with \$ 100 million in assets borrowing \$200 million! Naturally, the asset-backing principle would ensure that the firms and even governments do not borrow more than the asset value in place. The optimum debt will be under 100 percent of all assets if all debt is made via *ṣukūk* contracting.

(6) Beginning in 2015, US banks are required to have equity and debt capital together backing 8 cents in a dollar of loan book. Why? Some 160 years ago, UK banks had reserve backing of about 50 per cent. How did the sixteenth century 100 per cent loan book backing degenerate to 8 per cent by year 2000 is a well-kept secret! This degeneration of full asset backing of lending has evolved perhaps with the moneyed class working with the political class to ensure this lucrative practice of watering down loan book backing through increased leverage mostly benefitting the moneyed class.

This is a desirable aspect of IF debt market instruments, and is an answer to the current sovereign debt crisis in the EU nations, indeed for any indebted country.

Most majority Muslim countries are poor. Of the 57 such countries, forty have average per capita incomes of less than US\$ 5,000 in 2014 (Ariff and Safari, 2014c). That puts them as low-income (read it as poor) countries. These poor nations are the ones with large debt overhangs. If all their borrowing had been under IF terms, then they would have borrowed no more than what they could service, and the debt overhang of these countries would not have occurred. This is a normative behavior of managers, which if adhered to, would have resulted from *ṣukūk*. Further, as pointed out by the World Bank Group, *ṣukūk* borrowing would most likely be in local currencies, so the locals would have the assets in the SPC, and the loan will be serviced from incomes of the SPC, which would introduce caution in borrowing decisions. Iqbal (2011) points out that the nexus for debt overhangs is the lack of asset-backing in conventional debt contracting. He offers his idea that *ṣukūk* contracting is an attractive alternative to the long-run path to stable financing of new projects, if structured within Sharī'ah rules.

Finally, *ṣukūk* are designed to mobilize financing for specific purposes, and not for general purpose. General purpose debt-based funds can be used by top management to redirect the funds to whichever project they want to finance, thus providing incentives to mostly make personal benefits, given the agency problems on which much has been written. Some would say general purpose borrowing is flexible. Evidence exists that top management need to be restrained given their proclivity for pursuing personal interests.

An *istiṣnā'* *ṣukūk* fund cannot be diverted to pay lease payments, and vice versa; a *salam ṣukūk* cannot be diverted to fund a building. This ensures discipline in fund-raising by encouraging more focused modes of financing for specific purposes than in conventional debt markets. Islamic debt instruments fulfill fund needs that arise at different stages of a firm's development, and help limit borrowing to fix common fund needs of firms at different stages. The type of contract will determine the specific conditions for that specific purpose of a borrower. We term this aspect *targeted funding* under IF contracting. General purpose borrowing

encourages misdirecting resources by senior management: consider the leverage buyout debacle that rocketed the world's financial markets in the 1980s. So much failure in LBO-led bankruptcies would not have happened if *şukūk* type fund raising had been in place, which through asset-backing, would limit the borrowing from exploding and destroying so many firms (*The Economist*, 2007).

If we want to stretch this argument, we can also give evidence to show that credit binges that occur ahead of financial crises would not have been possible under IF funding. Promoting easy lending slowly led to the explosion of the credit binge that eventually led to the Global Financial Crisis (see Ariff et al., 2010). Great thinkers (Kindleberger and Goldsmith) have argued that all crises are preceded by credit binges or easy money policy of lenders promoting excessive borrowing which has been historically the major cause of financial crises (Kindleberger, 2007).

To summarize the discussion in this section, the IF requirements to promote fairness, justice, society-first goals and non-exploitation of borrowers have been advanced as strong arguments in favor of Islamic debt contracting. If all goes well – including agency problems and moral hazard behavior are controllable – then *şukūk* instruments are seen as promoting financial stability at the firm level by instituting moderate leverage, limiting unbounded credit explosion in an economy because of the asset-backing principle. Some of the five restrictions appear to promote society's wellbeing as well as the wellbeing of individuals. *Şukūk* markets appear to have some redeeming features by requiring – not just advocating – compliance to important ethical principles on how transactions in financial markets must be promoted.

4. Size of the *Şukūk* Markets

Şukūk-based contracting is growing at the rate of 17 to 24 percent a year since 2009: (in 2010, there was a 40% growth according to a source: Ariff et al. (2014)). As an emerging market, such growth is not surprising while the question is whether this market will grow to what size by what date. A recent estimate in the financial press (Reuters and Bloomberg) suggests that the outstanding value of *şukūk* securities is US\$ 1,340 billion. The market is found in the following countries, some of which have just started to issue *şukūk*: Saudi Arabia; Kuwait; UAE; Bahrian; Iran; Qatar; Turkey; Cayman Islands; Jersey (Channel Island); Bermuda;

Malaysia; Singapore; Indonesia; Pakistan; United Kingdom; Hong Kong; South Korea. Ten more countries have already announced their intention to create *ṣukūk* debt markets: among them are China, Russia, and Khazakhstan, in these cases, specifically to cater to the needs of sizeable Muslim populations in those countries.

The use of *ṣukūk* for public trading is increasing although some forms of *ṣukūk* instruments such as *muḍārabah ṣukūk* and *istiṣnā' ṣukūk* are more suited to be issued as OTC issues in the private market through financial institutions acting as the arranger (much as what goes on in large-scale lending in conventional finance). The first public *ṣukūk* issue, as far as we could confirm, was in 1998 in Malaysia for a mere US\$ 250 million by a multinational firm. More such issues are found in all but few of the countries mentioned in the last paragraph. For example, in February, 2015 a large issue in Indonesia was for US\$ 1.8 billion. The World Bank raised a large sum in 2012 through *ṣukūk* issue. With major financial centers entering this market especially to structure targeted funding for very large public and private companies in need of capital, the number of issues in 2014 increased. It is predicted also to be the case in 2015.

As of mid-2015, though reliable data are not available to the author, the private and public *ṣukūk* markets in Saudi Arabia and Iran are believed to be the largest, followed by Malaysia, then Kuwait, UAE and Bahrain. These six markets account for two-thirds of all outstanding issues. Indonesia has created a special body to promote IF-based *ṣukūk*, and is targeting private firms to increase their market size in the *ṣukūk* market. Currently private firms account for US\$ 1,800 million, which is less than 5 per cent of the total outstanding debt in that country. Indonesia's total *ṣukūk* issues are estimated to be US\$ 42 billion in 2015. The market is expected to grow much faster than in previous years. This is mainly due to the high growth in that capital-starved economy with a new government with a business-first philosophy bent on creating much needed jobs for the 4 million a year workers coming into the labor market. Firms need money, and *ṣukūk* are perhaps a good strategy to persuade the faithful to save more money in IF markets.

Another center that is expected to grow fast is London. British government have vowed to make London a major center for IF products. Thus, it appears there are widespread initiatives – think of the large

China market - in a significant number of countries to encourage pro-market rules to grow the *ṣukūk* industry to tap savings of potential investors in this market. In Malaysia, for example, non-Muslim investors have taken up 45 percent of the total issues. This is an aspect that must be noted. IF products are not just for the faithful, it is open to all investors, who decide to participate on the merits of the instruments in comparison with conventional securities on offer.

5. *Ṣukūk* Instruments and Financial Engineering

In this section, we discuss the potential of the *ṣukūk* industry to innovate new products as the market develops over the next few decades to gain breadth *and* depth. There are six basic *ṣukūk* products that provide targeted funding under IF principles (fairness; justice; society-first in production funding; non-exploitation of the weak by the moneyed class).

If a silent partnership funding is sought by a firm, there is the *muḍārabah ṣukūk*, which dominates the private issues market. The funds raised are meant to be used to promote investment that produces profits. The profit is then shared with the *ṣukūk* holders under a risk-and-profit-sharing agreement. If the financier wishes to be active in the management of the firm, then one chooses *mushārah ṣukūk*, which can be for a finite (diminishing *mushārah ṣukūk*) or usually as a perpetual contract, again based on the principle of sharing risk and profits. If a firm wants to lease a productive capital asset (an oil tanker, for example) then an *ijārah ṣukūk* is used in different variations of the contract to raise money, in which case part of the income-producing assets are set aside in an SPC to service the loan arrangement. An entrepreneur wanting to build a toll road could raise *istiṣnā' ṣukūk* fund that would provide capital for the project in return and the debt is serviced via profit-and-risk-shared contracting terms (this could also be done via *muḍārabah ṣukūk*). A farmer wanting to raise money on the fruits already formed on the trees/vines could have his funds in advance through a *salām ṣukūk*.

Professionals in the industry have advanced new product development ideas through financially engineering new *ṣukūk* products (as well as other IF products). This is occurring mainly in the major financial centers. In a recent book, an author claims that this act of

engineering new products is dramatically altering the marketplace, by extending the breadth of the market into new areas: Irfan (2014)⁽⁷⁾.

In a chapter contributed to a book, Iqbal (2012) offers a set of guiding principles for product engineering. (i) *Principle of ease* is a guiding principle that mandates the spirit of Sharī‘ah to make things easy for people. He states that *among the permitted options*, the practice of the Prophet was always to choose the one which is easy for people. (ii) *Doctrine of maximizing human welfare*, which means seeking benefits and repelling harm for everyone⁽⁸⁾. (iii) *The doctrine of general permissibility* points to the obvious fact that things/contracts that are prohibited by Sharī‘ah are very few compared to those that are permitted in one’s dealing with others. (iv) *The doctrine of necessity*: permits *temporary* suspension of normal laws in case of dire need. This doctrine enables innovations when *extreme* circumstances occur. (v) *Prohibitions in IF* are enumerated as follows: no financial deals that can be described as usurious; extreme risk-taking (*gharar* as exposing oneself or one’s property to jeopardy due to assymetric information); gambling-type risk-taking is prohibited (*maysir*).

Based on a *Ḥadīth* of Prophet Muhammed (SAAW), he argues that financial products can be engineered as long as what is prohibited is not made permissible and what is permissible is not prohibited in a contract (except of course under the doctrine of extreme necessity).

Though product developments have been going along for a while, it is worth noting that much of the innovation is being led by conventional finance houses trying to duplicate their products by finding new ways to comply with a given set of IF principles. That is fine since a similar process in mainstream modern finance led to the birth of many new products that have come to stay with us. Some commentators have remarked that there is an attempt to overstep some of the principles in the zeal to produce new IF products, especially if such products are highly profitable. That is also the same in conventional finance: how else would you permit high risk CDS and other securitized products that were major

(7) **Harris Irfan** (2014) *Heaven’s Bankers: Inside the Hidden World of Islamic Finance*. Constable Publishing, London, UK.

(8) This is equivalent to the Greatest Happiness Principle of John Stuart Mills, a great political thinker, and philosopher.

contributors to the global crisis (CDS were financially engineered by a team of 4 people in 1994 by J.P. Morgan and the market for this new instrument referred to as the mass destruction instrument by Warren Buffet ballooned to about 4.5 trillion dollar, before it dragged the developed world to have the Global Financial Crisis (Ariff, et.al., 2010)).

Another example being cited in the literature is the case of Goldman Sachs introducing an Islamic Swap Contract. A swap is a two-way bet on a financial situation, though it is fair game, it resembles a gamble more than a financial service product. Since swaps of many kinds provide huge profits to financiers such as Goldman Sachs, it has been passed as permissible by some Sharī'ah Supervisory Board members. It certainly resembles a gamble (*maysir*) so it violates this doctrine that one should not put oneself in danger or one's property in jeopardy by taking a two-way bet.

Nonetheless, the industry is now mature enough, and there is much public debate among stakeholders regarding the development of new Sharī'ah-compliant products. One such example is that of the BAB *ṣukūk* in the Malaysian capital market, which until a change was made in 2013, violated some Sharī'ah provisions as pointed out by Taqī Usmani at that time. Hence, given the skills of large finance houses to innovate new products, ifoversight is vigilant, such new products as have been developingover last 20 years or so will continue to enrich the *ṣukūk* industry.

6. Some Key Issues in *Ṣukūk* Markets

In this section, we offer a summary of what are considered to be the major hurdles for the continued development of the *ṣukūk* industry. Financial products are like other products in that only the ones that are accepted by investors survive. *Ṣukūk* have survived, in fact thrived, relative to other IF markets, because, until the debut of *ṣukūk*, no one was looking at the radar for Islamic debt. Islamic debt was an anathema – at least as it was promoted then - though the fact of life has been that people, firms, and governments take debt right from ancient times. Islamic equity, mutual funds and *takāful* were the focus of the times before the debut of *ṣukūk*.

Firms have both equity and debt. Yet IF offered lots of equity-related products, but no systematic debt instruments until *ṣukūk* came to the marketplace. This is despite the fact that typically firms have 40 percent capital from debt and 60 percent from equity (cash starved economies such as Korea and India as well as high growth economies such as Japan at one time, had about 60 percent debt)⁽⁹⁾.

The second reason for the attraction of *ṣukūk* is the fact that governments found it easier to promote *ṣukūk* lending because they were in need of funding for public projects. Given the generally declining currencies of countries promoting IF, would it not be saner to borrow from its citizens in local currency so that the currency risk of borrowing in foreign currency could be simply avoided? Would governments desire its citizens to have assets transferred to SPCs owned by their citizens rather than foreigners?

Some governments were, of course, pushing the religious agenda to make aware that they were promoting Islamic financial products. In the initial period, governments were the big users of *ṣukūk*-based funds. In recent years corporations have discovered that *ṣukūk*-based financing could be more suitable for a profit-and-risk-sharing method in large-scale projects. Contracting under IF prompts the financier and the financee to work for the interests of both parties through two-sided contracting with a focus to ensure that projects are successful (despite criticism by some writers that agency problems and moral hazard are greater in such contracts).

Costly to structure ṣukūk: Given this background, the *ṣukūk* industry is likely to experience growth from the private sector for fund raising. The first problem is whether the cost of contracting in this market can be reduced. Unlike traditional bond instruments, *ṣukūk* structures demand multiple embedded contracting, often with expensive Sharī'ah supervisors charging substantial expenses for their advice. In a typical week, three to five billion dollars can be raised in bond markets with standard terms while the time taken to structure a *ṣukūk* product is estimated to be anywhere from 6 to 10 months.

(9) See Islamic Finance News. This newsletter available on the Internet provides regular news on Islamic finance events.

First, there is this cost element; second, the lack of standard terms for each of the six *ṣukūk* types described in this paper makes structuring time-consuming. Third, though there is a worldwide clearinghouse for Sharī'ah advice (World Sharī'ah Council), each market operator has unique differences in the way the rules are framed and applied to respective places.

Some solutions have been suggested. One is that, for each contract type, a standard set of rules is agreed upon; so that the time to structure contracts can be reduced, and the high charges reduced⁽¹⁰⁾. Another solution is to have an institution of higher learning tasked to charter IF specialists. After all, the accounting profession has a super quality chartering name CA (Chartered Accountant), why not for IF? This latter idea has been taken by the central bank of Malaysia, and it has the chartering institution called INCEIF. Unfortunately, in my view, this institution has the pretense to become a seat of learning as a university, so its resources are wasted and its focus distracted in different directions than the sole purpose of chartering professionals.

The chartered IF specialists from this institution are now entering the marketplace in small numbers starting in 2013. Time will attest to their marketability and professionalism. It is also a fact of life that the huge financial institutions in major financial centers have the money and expertise embedded in the conventionally trained professionals to learn IF quickly and innovate new products. The small-sized Islamic financial institutions lack the in-house expertise to really do a good job even with well-trained IF chartered professionals. There is thus a symbiotic need for small IF institutions to make product design on a co-operative basis.

(10) Internet sources point to the small number of supervisory board members available across the world. The numbers suggested vary from 300 to 400. Some of them sit on about 20 or more boards! Does a person have time to travel and attend 20 Board meetings a month? There is a reluctance in Sharī'ah training schools to train specialists on IF so much so that religious teachers and prayer leaders have often entered this market to give advice. This is certainly unsatisfactory. I have spoken to deans of schools in different universities as to the feasibility of training IF specialists, and there is reluctance both in conventional and religious faculties to undertake this task.

Fatwá Shopping: The splintered nature of the Sharī‘ah advisory services (note also that the majority of them are not well-trained in financial transaction laws or in finance or economics) has hindered the fast development of the markets, especially as there is no common ground across all markets. This arises partly from human error in providing advice based on one or few persons’ views, especially, if the few are not fully trained to understand the issues⁽¹¹⁾. Further, this advice giving is not vetted by a larger body of professionals as it is in the case of other professions. The reason for the diversity of opinion in IF is also due to different interpretations from four main schools of Islamic jurisdiction (*fiqh*). What is acceptable to a particular school of law (say the more rationalist Ḥanafī School) would appear to be lax as viewed by another school (Ḥambalī School, a conservative one). While this problem may not be serious at country level, since country level experts will be mostly trained in one school of thought, it is a major problem internationally.

The solution for this is to identify the common ground that dominate on issues, and then treat the special provision of a different school at the local level. This is the way to arrive at a common set of rules for each of the six types of *sukūk* products, so that different interpretations or the slight shades of differences across schools do not become an impediment to creating standard templates for structuring contracts. This will circumvent the issue of different schools of thoughts interfering with the structuring of products. Because the International Sharī‘ah Academy is located in Saudi Arabia, there is unnecessary suspicion that the Academy or even a Council in the same place is not fit enough to spearhead the search for a common template. That is a wrong-footed approach.

Because no one has taken the initiative to arrive at a common stand, powerful finance houses shop around for scholars (usually the most expensive people) to give an opinion that such and such IF product may be permissible! This is unsatisfactory in the long run since this

(11) This is a major problem in managing any organization. I had the misfortune of working under a dean, a professor of sociology, who did not understand what was “return on investment”. This meant that the person was simply not capable of knowing how funding decisions must be made under strict rules of cost of capital and return to capital. In a similar manner, a theology trained bank supervisor will put all road blocks because the person is incapable of understanding what finance and economics is all about.

undermines the confidence of investors when criticism mounts later against such opinion (*fatwá*) of a scholar or a supervisory board as happened when swap contracts were offered three years ago as permissible, when some challenged that opinion of experts serving Goldman Sachs.

Liquidity Poor: Successful markets establish quickly a reputation for liquidity, which means that investors could transact securities speedily and avoid the cost of waiting (problem of immediacy). One study (Safari, 2013) suggests that *şukūk* certificates are traded only about 40 percent of the time, which would mean that there is trading once every 12 trading days. This is not acceptable, so steps are needed to be put in place to increase liquidity. Bond markets around the world suffered from this ailment for a long time.

Since the 1980s, regulators have introduced reforms whereby investors can trade via Internet-based portals in bond exchanges, and small investors are encouraged to participate in issues without leaving the comforts of their homes. Small investors may even make advanced booking to buy new issues through a booking system in the web as in Belgium or Austria. The liquidity in conventional bond markets has since improved because of active promotion of trading and uptake.

Other measures are also needed. Designating a set of investment bankers to act as market makers (example of which have been done successfully in the money market through establishing discount houses) would increase liquidity. This method has been widely used in stock exchanges and in recent years in bond markets to increase liquidity. Public participation in *şukūk* could lead to liquidity improvement if closed-end *şukūk* mutual funds are established and listed for trading on stock exchanges in countries where there are *şukūk* issues. Close-end mutual funds offer good returns and can be targeted to earn the average of different risk classes of *şukūk*. The public would then take part, and the interest in such *şukūk* funds will add to liquidity across *şukūk* markets.

Applied software development and databases: Markets have unique differences, as do *şukūk* contracts compared with conventional bonds. Some of the software used in the industry needs to be examined *carefully* – I would say *meticulously* – as to whether the system incorporates the

requirements of *ṣukūk* funds (in fact IF requirements). For example, simply using the mortgage table designed for conventional bank mortgages is unlikely to give correct numbers for an IF *muḍārabah* mortgage. There are important differences in the way payments must be made, and the capital to be treated, etc. This task has to be done by the regulators since leaving this to the private sector would lead to different interpretations, so wrong applications will be made.

A related issue on how to price *ṣukūk* is the lack/absence of pricing models for *ṣukūk* securities. This is important because basing investment advice on market-clearing prices is fraught with danger since markets could under- or overprice a security. In conventional markets, there are theoretical models which provide a method to estimate fair-value for securities being issued independent of the market prices⁽¹²⁾. Such is possible only if the pricing models are carefully developed from first principles as occurs in conventional finance markets for all finance products ranging from bills to swaps. This aspect requires funding research activities in higher learning institutions, where there are people with the skills needed to develop valuations models. This is completely absent at present (see Safar, 2013).

Databases for analysis are important these days to provide reliable investment advisory services. While there are many points at which data are produced and are available, it is not as easy as in the conventional finance industry to have access to trading data. This is likely to evolve slowly in IF, yet the methodology for doing so has vastly improved so a *ṣukūk* database can be compiled with much lower cost today compared to some decades ago. There has been no initiative in the market to get this done. Once such databases are available, the industry will develop analyst interest to provide carefully evaluated advice to investors in this market. The analysts are actually the market makers, and the present situation without the *ṣukūk* industry analysts resemble monopolies.

(12) See Safari (2013).

7. Conclusion

The development of *şukūk* instruments has helped to complete the market landscape in IF (see the Appendix). This is particularly noteworthy when one considers that the world of equity-only domination has disappeared centuries ago with the modern fractional reserve banking helping to create money to lend as debt. Debt with no optimum limit has grown simply as an uncontrolled behavior of market participants to multiply returns to equity holders in the private sector while the governments have relied on debt to go on budget-busting development programs and spending binges. *Şukūk* funding based on asset-backing in some form would help tame this appetite for debt. Thus, in the long run, debt cannot go beyond the ability to service the debt. That would bring stability to financial affairs of companies, banks, and governments.

There are some serious developmental issues that require speedy attention. These range from the lack of common standards for structuring products in different regulatory centers to simple stuff such as creating software designed to ensure the terms of a *şukūk* are not based on conventional securities with different meaning of terms. The *şukūk* market has to address the serious problem of liquidity shortage by introducing easier trading for the public and also creating new *şukūk* funds aimed at the mass market involving the public. Finally, given the interest of the private sector in funding via *şukūk*, it is very likely that growth in the future will come from private issues, which over the years will reduce the proportion of government-linked issues dominating *şukūk* markets. Hence, *şukūk* as an alternative to conventional debt-contracting is gaining global attention, which is good news for sustainable financial system to develop.

Appendix: An Overview of Islamic Financial Markets

Ṣukūk with an outstanding value of US\$1,350 billion is the latest addition to Islamic Finance (IF). Islamic banking is the first innovation in IF, which started in 1963 and has since grown to US\$ 4,700 billion in banking assets mostly in the Gulf Region. Islamic insurance companies (*takāful*) soon developed, and there are some 67 such insurance corporations. There is little information on the size of this market. Islamic mutual funds sprouted in many countries in the 1980s prompted by the absence of instruments to invest under IF principles, and these invest in IF approved equities. There are some 600 mutual funds with a total sum under management estimated to be between US\$ 240 to US\$ 400 billion, a very small market compared with the conventional mutual fund market estimated to be worth US\$ 44,600 billion worldwide in 2014: Ariff et al. (2014b).

Since not all listed firms are likely to be acceptable for Islamic financial investment, attempts were made in the 1990s to identify listed companies in the stock indices that would be consistent with IF principles. This led to the so-called Islamic counters identified in some 24 stock markets: roughly about 40% of firms in such indices are deemed Islamic equities and are approved as being compliant with Islamic financing rules. The worldwide size of the listed stock markets is US\$ 82,000 billion. There is no way of knowing how much investment money has been placed in such securities after the Islamic indices were put in place. So, we do not know how much increase in IF funding is taking place in these markets.

Ṣukūk is the latest market to develop, starting in 1998, with one listing in Malaysia, by a private firm⁽¹³⁾. It should also be mentioned that a substantial sum of money is saved by Muslims who intend to perform their pilgrimage and are placed in what are called Hajj Funds in almost all countries where Muslims live. This vast sum of money has been managed as per Islamic Finance principles for some 1450 years. This is

(13) Recent writers (including Murat Çizakça) trace the use of *ṣukūk* to ancient time right up to the twelfth Century in the Ottoman Empire. However, the idea of *ṣukūk* as debt instrument was advanced in modern times by a scholar in the *Journal of Islamic Economics* in 1978. Since then, the idea has taken root, with six products on offer and a further six are already described although not yet issued for trading.

perhaps the largest amount of money (no estimates exist on how much is involved) that has been managed under Islam-stipulated financial principles. Similarly, bequests (*waqf*) is as old as Islam, and the physical-cum-money assets in *waqf* (bequests for charitable purposes, religious learning and maintenance of mosques) are managed by millions of committees in countries where rich people made assets and/or money available as bequests. No data are available, although the value of assets under this is likely to be the biggest part of IF. Islamic Finance is about financial trades involved in these six sectors.

There is one more which involves money. Individual that are faithful are required to pay a sum equal to 2.5 percent of new wealth in a year to charity (*zakāh*), which is a religious tithe mandated to be spent voluntarily to be disbursed to eight categories of needs, most of which relate to alleviating poverty and destitution. Since this is voluntary, there is no market for this aspect of money spent. Payments to this *charity* purpose may be offset against personal and corporate taxes in several countries, to ensure a level playing field in taxation. The Prophet of Islam has consistently refrained from making this compulsorily collected by governments. We will exclude this from IF.

Understandably, IF is young compared to the two-and-a-half centuries that led modern banking institutions to reach the stage where they are today. The future path of this 50-year experiment is uncharted. It is essentially an attempt to bring Islamic ethics (call it human ethics since most world religion advocate similar ethics for financial transaction) to financial transactions as interpreted by theologians, who currently consider a set of standards as requirements to certify what are to be permissible Islamic financial instruments. There are worldwide academies with learned theologians, who have systematically compiled what are called opinions (*fatwas*) that are used to test if an instrument is compatible with the strict requirements of these opinions. Opinions are promulgated in open discussion, and debated, commented upon, and then a consensus is reached for the time being until at a future date when consensus on some of these may be challenged. This is similar to the Catholic Church that interpreted the prohibition of usury for centuries and made the historic turnaround in the mid-seventeenth century to permit usury as another form of permissible activity.

Recent writers, noting the stability of lending and borrowing under IF during market turmoil, advanced an idea that funding under IF is sticky, meaning that investors do not exit markets quickly when a firm experiences temporary problems. Lending under IF promotes stable banking and less volatile financial markets for securities, so it is claimed. But these claims have been systematically challenged. There are voices from some scholars to the effect that the imposition of extra rules necessarily contributes to greater transactions costs in IF.

There is market acceptance of new instruments, nevertheless, the field is likely to experience growth while facing challenges about not just the efficiency and cost of IF transactions but also about the longer-term attractiveness of IF. Financial press information suggests that *ṣukūk* attracts non-Muslim clientele simply because of its slightly more attractive returns, no doubt also prompted by government promotion of this form of fund-raising in Muslim majority countries and major financial centers, where promotion of IF is heavily egged on by the state.

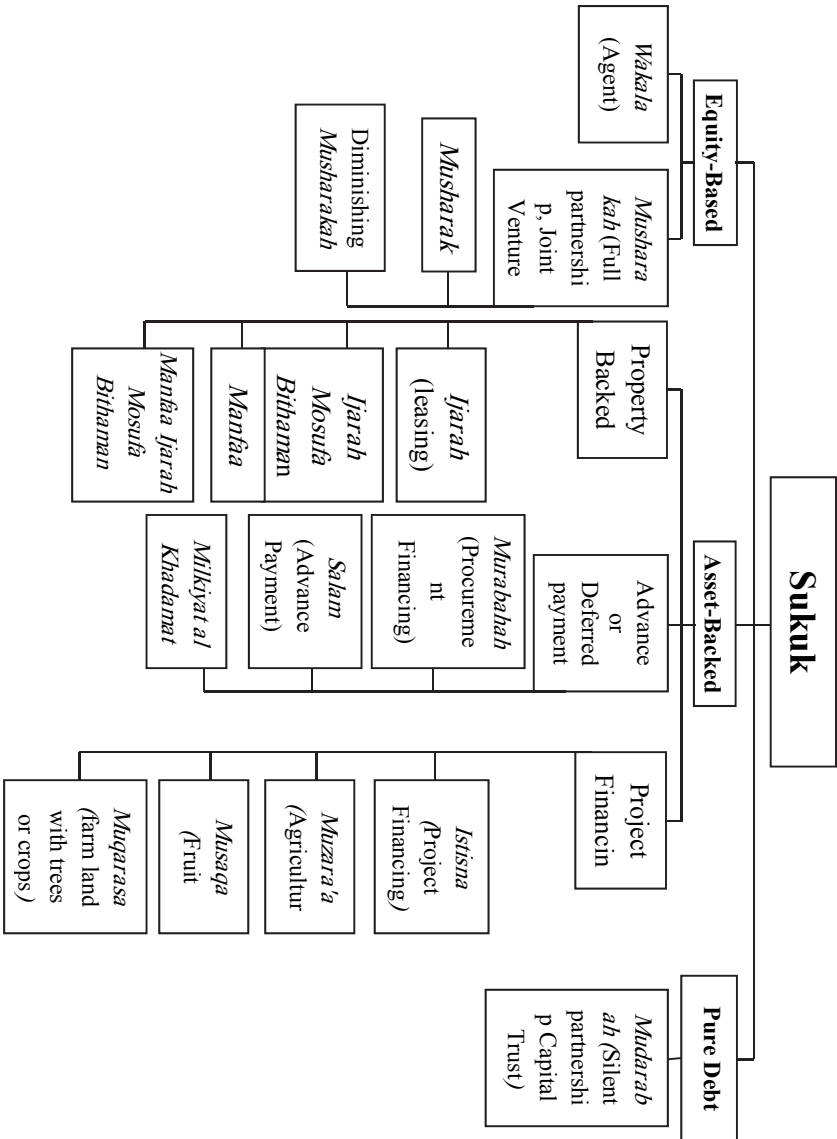


Figure A1: A Classification of *Ṣukūk* Contracts in Detail (Source: Safari, Arif and Shamsher, 2014: p 27)

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