

Şukūk: A General Introduction*

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1. Introduction

When economic units in the conventional financial system require external financing, they resort to one of two methods: borrowing from financial intermediaries, with banks being at the forefront of these; or going directly to the financial markets, where they offer to savers – both individuals and institutions – underwriting of financial securities i.e., stocks and bonds. Except for the shares of companies, which are considered generally legitimate (Sharī‘ah-compliant)⁽¹⁾, rest of the conventional financing instruments do not comply with the provisions of Islamic Sharī‘ah due to their reliance on interest. Islamic finance has provided a successful Sharī‘ah-compliant alternative to conventional finance. One instrument in Islamic finance are *şukūk*; which have been presented as a Sharī‘ah-compliant alternative for conventional bonds.

2. Emergence of Şukūk

The idea of *şukūk*, albeit under a different name, dates back to 1977, when the late Dr. Sami Hamoud presented a study on “*Muqāradah* Bonds” as part of preparation for the issuance of a law for the Jordan Islamic Bank. The idea of these bonds was based upon their issuance on the basis of a Sharī‘ah-compliant *muqārabah* contract between the issuer and bondholders. Jordanian Awqāf Ministry adopted the idea. The first

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(1) It is noteworthy that some types of shares do contain in some of their details, elements which do not comply with the Islamic Sharī‘ah.

enactment aimed at the use of “*Muqāradah* Bonds” was issued for the development of *waqf* property in 1981. The Islamic Development Bank Group and the International Islamic Fiqh Academy, Jeddah⁽²⁾ each played an important role during that period in shaping and developing the initial idea which is now a commonly used term, “*ṣukūk*”. The International Islamic Fiqh Academy was the first to recommend replacing “bond” with “*ṣukūk*” in its resolution on “*muqāradah* bonds and investment bonds” issued in 1988⁽³⁾.

The last two decades of the twentieth century witnessed several experiments of the issuance of *ṣukūk* under different names in a number of countries. Perhaps the first of these were the *mushārah* bonds issued by the Turkish government in 1984, worth \$200 million, to finance the construction of Mohammed Al-Fatih bridge over the Bosphorus strait. The Malaysian experiment began in 1990, when it issued its first *ṣukūk* which was for the benefit of a multinational company, Shell. This was followed five years later by the issuance of a second *ṣukūk* to build an electric power plant worth \$350 million. In the Arab region, Sudan was the first to enter into the *ṣukūk* experiment by the government and the central bank issuing a number of investment certificates under the names of “*Shahāmah*”, “*Shahāb*” and “*Sarh*” between 1999 and 2003. Bahrain was the second Arab country to deal in *ṣukūk*, when the government of Bahrain issued *ṣukūk al-ijārah* in 2001 worth \$ 250 million. The year 2002 is considered an important milestone in the history of *ṣukūk*, as Malaysia issued for the first time a sovereign *ṣukūk* negotiable in the international market worth \$600 million.

3. Definition of *Ṣukūk*

Ṣukūk can be defined as “negotiable⁽⁴⁾ financial instruments, issued for a specified period, upholding its holder’s ownership of a common share in

(2) Previously known as the OIC Fiqh Academy.

(3) Resolution No. 30 (3/4) of the fourth session of the International Islamic Fiqh Academy 18-23 Jumada Al-Akhirah 1408, corresponding to 6-11 February 1988.

(4) Negotiability is not a necessary requirement. In theory, it can be visualized that *ṣukūk* issued are held by the subscribers until redemption. However, this requirement satisfies on the one hand the need of dealer liquidity by selling them in the secondary market, and on the other hand is consistent with the definition of financial securities and with the provisions of some *ṣukūk* laws including the Tunisian and Egyptian law.

income generating assets, and Sharī‘ah-compliant in their issuance, trading and redemption”. *Ṣukūk* are characterized by the features of financial securities such as equality in the value of each unit at the time of issuance and as its consequence, equality in the ensuing rights and obligations, their indivisibility at source, and their tradability. Other than *ṣukūk*, financial securities include equities and conventional bonds. For this reason, the definition includes restrictions to exclude bonds and securities from its scope. The restriction, “issued for a specified period”, excludes equities as they are issued for an indefinite time period. Bonds are excluded from the definition because they are debt certificates, not ownership certificates and are also based on prohibited interest and hence do not conform to the provisions Islamic Sharī‘ah.

Tradability of *ṣukūk* means the possibility of buying and selling them in the secondary market at a price determined by supply and demand factors. Due to the fact that *ṣukūk* represent assets, their tradability depends on the nature of the assets they represent; tangible assets benefits, services, financial rights, cash, debt or a combination of these or some of these. This is because the provisions and conditions set by Islamic Sharī‘ah for the exchange of assets vary from one type to another. The provisions for the exchange of cash and debt, for example, differ from the provisions for the exchange of tangible assets⁽⁵⁾. Moreover, the underlying assets that *ṣukūk* represent, change between issuance and redemption. Hence, if an entity mobilizes resources from the market to buy tangible assets to be sold on a credit basis, and it issues *ṣukūk* for this purpose, then these *ṣukūk* will represent at the beginning ownership of cash and then turn to ownership of tangible assets and finally become ownership of debt. This means that such *ṣukūk* may be negotiable at some stage of its life and not be so at another stage.

4. Provisions of *Ṣukūk*

1. The Issuance is a contract which is convened by offer and acceptance and the issuance starts by offering it for public subscription after which investors subscribe for it. In case the demand is greater than the supply of *ṣukūk*, they are allocated to the subscribers as per the

(5) See, section below on “Provisions of *Ṣukūk*”.

process stipulated in the prospectus. As such the subscription in *ṣukūk* is the offer and its approval or allocation is the acceptance.

2. *Ṣukūk* are based on one or more of the contracts of Islamic finance like *ijārah*, *mushārah*, etc.
3. Cash cannot be traded except on like for like basis and hence, trading of *ṣukūk* whose proceeds have not been yet utilized to buy assets or benefits, is not permissible.
4. Debt may not be sold for less than its face value, and thus *ṣukūk* representing debt are non-negotiable, because any rational person will not accept to pay today one dinar and recover after a period one dinar or less.
5. *Ṣukūk* which represent cash or debt are not tradable.
6. It is permissible to trade *ṣukūk* that represent tangible assets, benefits or services or mixture of these or some of these, for a price mutually agreed upon between the buyer and seller or determined by the market.
7. Trading of *ṣukūk* that represent a mix of assets, benefits and services on the one part, and money and debt on the other, is permissible on the condition that, the first category is dominant. The criteria for this dominance are 51% as per the International Islamic *Fiqh* Academy and 30% according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
8. It is not permissible to trade *ṣukūk* that represent benefits of non-specific assets (assets whose specification is described but as yet to be acquired), until the particular asset, from which the benefit is to be extracted, is specified⁽⁶⁾.
9. It is not permissible to trade in *ṣukūk* representing ownership of such services which are a described debt to be recovered before specifying the entity from which the service is to be acquired⁽⁷⁾.
10. It is not permissible to trade *ṣukūk* which represent assets to be manufactured and then to be leased, based on description, before the actual manufacturing of the asset starts⁽⁸⁾.

(6) Resolution No. 196 (2/21) of International Islamic *Fiqh* Academy.

(7) Ibid.

(8) Ibid.

11. It is not permissible to sell an asset for a cash price with the condition that the seller leases the asset along with the promise to re-own the asset such that the total price and rent is greater than the original sale price. The ruling is the same whether such a condition is explicit or implicit, because this constitutes *bay‘ al-‘īnah* which is prohibited. Hence, it is not permissible to issue *ṣukūk* based on this basis⁽⁹⁾.
12. It is not permissible to combine contracts and promises such that they result in subterfuge for interest.

5. Characteristics of *Ṣukūk*

- *Ṣukūk* represent a common share in the ownership of assets, benefits or in a mix dominated by assets and benefits, and must not represent debt upon the issuer in favor of the bearer.
- *Ṣukūk* holders bear the consequences, responsibilities and risks that the ownership of the underlying assets of the *sukk* entails, including maintenance costs, administrative expenses and the risks of losing the asset or it becoming defective or depreciated.
- *Ṣukūk* are neither financial securities based on assets nor supported by assets. Rather, they are securities representing assets (assets-representing securities).

6. Issuing *Ṣukūk* and Securitization

The literature on *ṣukūk* in recent years has seen widespread usage of the term “securitization”, without a clear and accurate understanding of the commonalities and differences between it and *ṣukūk*”. Some researchers even went to the extent of considering them synonymous. In this section, we try to clarify both concepts and highlight what differentiates one from the other. In order to achieve this goal, we find it useful to refer to the term “securitization” in conventional finance and consider its definition and relationship with the issuance of conventional fixed-term securities i.e., bonds⁽¹⁰⁾.

(9) Resolution No. 188 (3/20) of International Islamic Fiqh Academy.

(10) Labeling these securities as bonds is a matter of naming all with the name of a part, because in fact they have a variety of names depending upon their maturities and the entities issuing them.

Definition of Bonds

A bond is a document of indebtedness, used by companies and governments as a means of direct borrowing from investors. The issuer of the bond undertakes to pay the bearer a predetermined interest throughout the life of the bond and to repay its face value at maturity.

Definition of Securitization

Securitization is defined as a combining of financial assets i.e., a combination of debts mostly homogenous in nature, such as mortgages, auto loan, credit card debts, and then issuing bonds backed by such assets. This means that the principal of these debts and the interest due upon them are used to pay the bondholders' rights.

Differences between Securitization and Bonds

There are a number of differences between issuing bonds and securitization, the most prominent among these are:

- Securitization is the issuance of bonds backed by financial assets⁽¹¹⁾, i.e., it presupposes the existence of debt receivables with the one wishing to securitize⁽¹²⁾, which represents a guarantee in advance to bondholders. On the other hand, the simple issuance of bonds does not require the pre-existence of such assets.
- Asset-backed security holders cannot go back to the issuer for claims in case of insufficiency of those assets to meet the obligations of the issuer, whereas a bond holder can go back to the issuer.
- Securitization is a tool to refinance, for example where financial institutions that have a portfolio of illiquid debt want to gain liquidity, whereas a simple issue (of bonds) can be initiated in order to get financing in the first place.
- Securitization can only be done by financial institutions, while the simple bond can be issued by financial institutions and others, like industrial and commercial companies, as well as governmental and semi-governmental institutions.

(11) Asset-backed Securities.

(12) Known as the Originator.

- Securitization is a complex financial innovation compared to the simple issuance of bonds. In its most complex form it reaches to the extent of issuance of multiple slices of bonds backed by the same debt portfolio. This is known as structured financing.
- Securitization is a relatively recent innovation⁽¹³⁾, whereas the issuance of bonds goes back to distant eras. Securitization should not be thought of as an alternative to simple bond issues. In fact, bonds not backed by assets never ceased to exist in the global financial market.

6.1 Difference between Securitization and *Ṣukūk* Issuance

It can be inferred from the previous discussion on the issue of securitization in the conventional financial system, that it is necessary to distinguish between securitization and the issuance of *ṣukūk*, as not every issuance of *ṣukūk* is securitization. This distinction is based upon whether the issuer owns the assets to be securitized or not. If the issuer owns assets and wishes to sell them for a specified period to *ṣukūk* holders, and gain in return liquidity to be used for whatever purposes it deems fit, while the investors get the return from investing in those assets, then this will be securitization. If the intent behind the issuance of *ṣukūk* is to finance the acquisition of new assets for the benefit of the issuer, then it would be a simple issuance of *ṣukūk*.

It should be noted that securitization and issuing *ṣukūk* are similar in perceiving the presence of assets with the issuer. However they differ in two aspects: first, securitization is only carried out by financial institutions for the purpose of refinance, whereas issuing *ṣukūk* is open to financial institutions as well as others. Secondly, the underlying assets of securitization are debts, whereas *ṣukūk* are based upon tangible assets, or benefits and services or a mixture of tangible assets and benefits as well as cash and debt⁽¹⁴⁾.

(13) Securitization emerged in the US financial market in the early seventies of the last century, where two financial institutions specializing in mortgages, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), issued bonds supported by a portfolio of debt that they had on others, for the purpose of providing liquidity enabling them to grant additional funding for the housing sector.

(14) *Fuqahā'* stipulate that when there is a mixture of assets, tangible assets or benefits must be dominant, or that cash and debt are subservient.

7. Types of *Ṣukūk*

7.1. Types of *ṣukūk* from the perspective of their purpose

When an entity issues *ṣukūk*, it is one of two types:

- The first type is when the entity wants either to acquire some tangible assets or services, or they desire to start a new project or expand an existing one, and it desires to finance these from the proceeds of *ṣukūk* that they issue. In this case, the issuance of *ṣukūk* will generate wealth, promote accumulation of capital, spur economic development, and achieve the purposes of the Sharī‘ah. This is what the International Islamic Fiqh Academy called for when it stated in its Resolution No. 188 (3/20): “*Ṣukūk* must achieve the purposes of the Sharī‘ah in terms of promoting development, supporting real economic activity and the achievement of justice among the people”.
- The second type is that the entity desires simply to acquire liquidity, and thus the *ṣukūk* proceeds are utilized for purposes, chosen by the issuer, not directly related to the *ṣukūk*. The liquidity may be utilized to finance new projects or it may be used for consumption purposes that do not generate any wealth nor result in capital accumulation.

7.2. Types of *ṣukūk* from the perspective of the issuing entity

From this perspective, there are three types of *ṣukūk*:

- Sovereign *ṣukūk*; which are *ṣukūk* issued by governmental or quasi-governmental institutions, such as municipalities, in order to finance infrastructure projects that can produce cash flows, which can be distributed to *ṣukūk* holders, or to finance budget deficits.
- Corporate *ṣukūk*; which are issued by major companies and financial institutions, whether for the acquisition of new assets, funding a new project or expansion of an existing one, or to gain access to liquidity for purposes not directly related to the *ṣukūk*. These may also be issued to finance the accumulation of capital or may be utilized for consumption purposes or may be to pay off previous debts.
- *Ṣukūk* issued by the social sector or third sector bodies, most important among which are the *awqāf* (endowment) organizations.

7.3. Types of *şukūk* from the perspective of the Sharī‘ah contracts upon which they are based

Şukūk are of several types depending upon different modes of Islamic finance which are in turn based upon different Sharī‘ah contracts that govern financial transactions. The AAOIFI has counted fifteen types of *şukūk*; six are based upon the lease contract, another six are based upon sharing contracts like *muḍārabah*, *mushārahah*, *wakālah*, *muzāra‘ah*, *musāqah* and *mugharasah*, and three are based upon sale contracts like *murābahah*, *salam* and *istişnā‘*⁽¹⁵⁾.

Looking at what *şukūk* based upon sale contracts represent, we find that they are not tradable in most of their stages, and hence, do not come under the definition of *şukūk* which we have chosen at the beginning of this paper. This is clear with respect to *murābahah* and *salam şukūk*. “*murābahah şukūk*” do not represent assets except for a very short period between the use of *şukūk* proceeds to buy assets and their sale on installments spanning for the life of the issue. “*Salam şukūk*” represent debt of a specific asset upon the issuer from the subscription till the delivery date after which it may become debt in cash if the asset, the subject of the *salam*, is sold on credit. As for “*istişnā‘ şukūk*”, we need a more detailed description to explain what it represents. Let’s consider, a government organization that wants to construct a road, which will be constructed in three years, and its price is to be paid in installments over ten years after its construction. The organization offers investors subscription in the *şukūk*, the total price of which is equal to the cost of constructing the road. The relationship between the organization and the investors is based upon an *istişnā‘* contract: the organization requesting manufacture and the investors being the manufacturers. The price of the item being constructed (the road) is to be paid in installments over ten years, starting from the delivery date. The entity representing the investors will enter into an *istişnā‘* contract with a construction company and pay the construction costs from the proceeds of the *şukūk*. The entity representing the *şukūk* holders may also enter into a *wakālah* (agency) contract with the issuer to supervise the implementation of the project.

(15) Sharī‘ah Standard No. 17 on Investment *Şukūk*.

What do the *ṣukūk* holders own? From the day of subscription, till the day the project starts, they own cash. After which they own a debt upon the final manufacturer till the delivery date of the manufactured item. Then they own an asset after the manufactured item is delivered till it is handed over to the one that requested the manufacture in the first place, and finally they own a debt upon this latter party till the redemption of the *ṣukūk*. It is clear from this example that what are known as “*istiṣnā’ ṣukūk*” comprise either cash or debt during most stages of its life.

In short, the types upon which the definition of *ṣukūk* applies can be combined into two categories:

- *Ijārah ṣukūk*: These are of many types depending upon what subscribers to the *ṣukūk* own:
 - Specific assets.
 - Benefits of specific assets.
 - Benefits of described debt assets.
 - Described debt services (e.g., education or health services) to be received from a specified party.
 - Described debt services to be received from a described non-specific party.

The International Islamic Fiqh Academy has prohibited the trading of the last three types of “*ṣukūk*” prior to specifying the described debt⁽¹⁶⁾.

- *Mushārah ṣukūk*: These are all the same in essence but differ in some detail relating to the subject of the partnership; partnership in profit, or partnership in profit and loss, partnership in product; partnership in revenue; or depend on the relationship between the subscribers and the issuer like *muḍārabah*, *mushārah* or *mushārah* with *wakālah*.

We list below some types of *ijārah* and *mushārah ṣukūk* in both the case of simple issue and securitization:

(16) Resolution No. 196 (2/21) of International Islamic Fiqh Academy.

▪ *Ijārah şukūk*

We present three possible structures for the use of *ijārah şukūk*. The first two cases represent simple issue for the purpose of acquiring assets needed by the issuer in its activities. The last case represents securitization of leased assets, owned by the issuer, by selling them to the *şukūk* holders in order to obtain liquidity.

First Structure

Suppose, an entity wants to acquire certain assets through ‘*ijārah Tamlikiyyah*’⁽¹⁷⁾, and offers subscription in *şukūk* to investors. The prospectus appoints a body to represent the *şukūk* holders and follow their interests, perhaps in cooperation with the secretary of the issue. After subscription and payment of the value of *şukūk*, the body representing the *şukūk* holders purchases the assets identified by the issuer and pays for it in cash from the proceeds of the issue. Then the body leases the assets and in turn transfers their ownership to the issuer, in the manner set out in the prospectus and in accordance with provisions of Sharī‘ah. Redemption of the *şukūk* occurs at the end of the lease period and when the complete ownership of the asset is transferred to the issuer.

Second Structure

This structure differs from the previous one only in the assumption that the issuer of the *şukūk* does not wish to acquire specific assets, but rather provides a complete description of them in the prospectus in a manner that leaves no ambiguity or room for any dispute. It is then the responsibility of the body representing the *şukūk* holders to acquire the assets which conform to the specifications set by the issuer.

Third Structure

Let’s suppose that an Islamic financial institution has provided a range of financing through lease ending in purchase (hire-purchase). Let’s also assume that the maximum remaining duration of these financings is five years. If such an institution wishes to liquidate its portfolio and mobilize

(17) ‘*ijārah Tamlikiyyah*’ is a lease, where ownership of the leased property is passed on to the lessee either at once at the end of the lease period, and is known as *ijārah* ending with ownership, or gradually throughout the duration of the lease.

additional resources to provide new financing, it can do so by securitizing its portfolio i.e., by issuing *şukūk* for ownership of the leased assets. This means that each ‘*sukk*’ holder will have a common share in the underlying assets of that portfolio and will be entitled to its gains and bear its losses. The *şukūk* are redeemed when ownership, of all the underlying assets of the portfolio, is transferred to the lessees.

Mushārahah Şukūk

Mushārahah şukūk entail partnership of the issuer with the *şukūk* holders in the financing of the project and sharing in its profits and losses according to the type of partnership chosen. We present three structures for *mushārahah şukūk*; two for the simple issue and one for securitization.

First Structure

Let’s assume that a big company wants to start a real estate project to be used later as its headquarters. They own the land and want to mobilize resources from the market to finance the cost of construction. In this case, the company can issue *şukūk* for the estimated cost of construction. The relationship between the issuer and investors is based upon three Sharī‘ah contracts:

- Partnership contract for the purpose of construction of the building and its utilization. The capital of this partnership would be the total proceeds of the issue and value of the land.
- An agency contract, authorizing the issuer, on behalf of the *şukūk* holders, to manage the partnership for an agreed fee.
- An *ijārah* contract based on description.

Comments:

- These *şukūk* are non-negotiable during the construction period as per the resolution of the International Islamic Fiqh Academy. However, they are freely tradable for the entire duration of the lease.
- It is possible for the issuer to pay the *şukūk* holders periodic installments during the construction period to be considered as down payments on account of the rent installments.
- The *şukūk* can be gradually redeemed through ‘*mushārahah mutanāqīşah*’ (reducing partnership).

Second Structure

Suppose that the government wants to construct an income generating expressway. It can offer investors to enter into a partnership, such that the state provides the land and investors provide the construction cost of the expressway. The partnership contract can be preceded by an investment agency contract. The *şukūk* holders get a return on their investment from the toll collected from the expressway users. The redemption occurs through the state gradually purchasing the stakes of the *şukūk* holders in the partnership.

Third Structure

This structure is based upon securitization of a *mushārah* finance portfolio owned by an Islamic financial institution, such that each *sukk* represents a common share in all underlying projects contained in the portfolio.

8. Mechanism of Issuing Şukūk

In this last section we present the practical process for the issuance of *şukūk*. We will begin with identifying the parties involved in the issuance process and the function assigned to each one of them. Then we will look into the matter of direct issuance by the beneficiary compared to issuance through an entity established by the beneficiary, known as a Special Purpose Vehicle (SPV)⁽¹⁸⁾. Finally, we will take *ijārah şukūk* as an example, and through it explain the practical steps involved in the issuance of *şukūk*.

8.1 Parties involved in the Issuance Process

In essence, the issuance of *şukūk* is a relationship between two parties, the seller and the buyer or between the party wishing to obtain cash resources from the sale of *şukūk* and investors who accept the subscription of *şukūk* and pay for it, waiting for a return. However, the

(18) Other names are also used for this intermediary, such as Special Purpose Entity (SPE) and Structured Investment Vehicle (SIV). In Tunisian law, it is known as Common Fund for *Şukūk*, which is derived from what is known in the French law as, the Common Fund for Securitization. The French law merely considers it as common ownership and does not recognize it as a corporate body and it does not have its own management.

practical reality is more complex and diverse, as many parties are involved in the issuance process to carry out specific functions. It should be noted that it is not necessary that each issuance includes all the parties. In fact, it is possible that a particular issuance is limited to some parties and not the other. It is also possible that more than one function is combined in a single party.

1. **Originator:** Is the beneficiary from the proceeds of the issuance of *ṣukūk*.
2. **Issuer:** A counterparty to investors in the issuance contract. In the case of direct issuance, the originator and issuer are the same party. However, the originator may choose to assign the issuance to a second party, which it establishes especially for this purpose, known as an SPV.
3. **Management Company**, which undertakes the management of the SPV, when it takes a legal form whereby it is not allowed to have its own management, as is the case for mutual funds for financial rights (securitization funds), known in French law.
4. **Investors** who are the *ṣukūk* holders, i.e., subscribers at the time of offer or buyers of *ṣukūk* from the secondary market thereafter.
5. **Arranger**, the one who arranges the issuance process, creates an SPV, chooses the assets that support the issuance in case of securitization, and coordinates in this regard with rating agencies. When the originator is a financial institution, the arranging of the issuance process is often entrusted to a team, specializing in financial engineering, from within the institution.
6. **Underwriter**, whose job is to promote the offered *ṣukūk* to investors and guarantee its underwriting in its entirety, by pledging to subscribe to any *ṣukūk* not subscribed for by investors.
7. **Trustee or Secretary of the Issue**, who represents the *ṣukūk* holders and takes care of their rights and receives their entitlements from the one tending to the *ṣukūk* and then delivers these to them. Monitoring the performance of the management company, if any, is also among its duties.

8. **Issue Manager**, the one who manages and invests the assets owned by the *ṣukūk* holders, usually based upon *muḍārabah* or *wakālah*. Often the issuer is also the issue manager.
9. **Servicer**, whose function is the collection of cash flows relating to the *ṣukūk* and delivering them to the body representing the investors, could be the originator itself.
10. **Paying Agent**, whose function is the implementation of payment orders.
11. **Rating agencies**, whose job is to evaluate the risks the *ṣukūk* holders may be exposed too. In the conventional financial system, the work of rating agencies is often limited to credit risk assessment. Following the financial crisis of 2008, the rating agencies came under severe criticism due to their negligence of liquidity risk. They have been asked to change their methodology to suit the distinctive characteristics of *ṣukūk* that are exposed to risks of a special nature as compared to conventional securities.

In addition to the parties mentioned, a number of other experts, advisors and regulatory agencies are involved in the process of *ṣukūk* issuance. We mention from among them, legal and accounting experts, auditors, the capital market authority and the Sharī‘ah supervisory board, among whose functions is to certify the underlying contracts of the *ṣukūk* and to ensure that the issuance mechanism and the documents conform to the provisions of the Sharī‘ah.

8.2 Direct and Indirect Issue

Most of the academic and practical studies on the subject of *ṣukūk* assume that they are issued indirectly, specifically through an SPV established at the initiative of the beneficiary from the issue. Tunisian law also requires the issue to be through the Common Fund for *Ṣukūk*, except if the Sharī‘ah supervisory board sees otherwise. Egyptian law requires that the issue, in all cases, must be through an SPV. Jordanian law is perhaps one of the few cases in which the door is open for a direct issue without passing through an SPV. What is the purpose to create such an entity and what is the role played by it and can it be dispensed with? To answer these questions we will revert to the writings on SPVs in the

conventional financial system, in order to know their nature, legal form and function.

Nature of SPV

It is a legal entity, accounts of which are not shown on the bank's balance sheet. It is created on the initiative of the originator or the beneficiary to achieve a temporary need of the beneficiary. First, it should be noted that, a simple issue of bonds, i.e., outside the securitization mechanism, is direct, as there is no need for mediation from an SPV. As for the issues that are within the securitization mechanism, an SPV has been considered a key element of such a mechanism until recently, but the financial crisis of 2008 shook the confidence in securitization in general and raised questions about the usefulness of indirect issues. Critics of indirect issue believe that exclusion of debt from the balance sheet by transferring it to an SPV weakens its incentive to ensure the quality of loans granted. They conclude that restoring transparency to the balance sheet of banks by returning the assets transferred to the SPV back into the balance sheet of banks will raise the efficiency of the financial system.

Legal form of the SPV

- Legal adaptation of SPVs differs across legal systems. The most notable legal forms include:
 - Charitable trust, as is the case in Canada.
 - Limited liability company as is the case in the USA.
 - Company with a limited purpose owned by a charitable trust.
 - Company owned by the originator.
 - Semi-endowment foundation as is the case in Holland.
 - Common fund not having a legal personality, as is the case in France and Tunisia⁽¹⁹⁾.

Function of the SPV

We have already mentioned that securitization involves compilation of financial assets, or debts, owned by a financial institution and then issuing bonds backed by those assets. To protect bondholders from the credit risk of the originator and especially to protect them from creditors'

(19) These different legal forms show the inaccuracy of translating SPV as “شركة ذات الغرض الخاص” in Arabic.

claims in the event of bankruptcy, those assets must be excluded from the balance sheet and transferred to an independent party, the SPV. In order to enhance protection of *ṣukūk* holders, the SPV is not allowed to incur any debt except what it owes the *ṣukūk* holders. In this way, it is unlikely that the SPV runs into bankruptcy.

The basic function of the SPV is to protect *ṣukūk* holders from the risk of bankruptcy of the originator and the issuer. This is referred to by the statement that the SPV is bankruptcy-remote (free from bankruptcy).

However, an SPV does not actually perform this function except under certain conditions which basically require the isolation of the SPV from the originator in terms of ownership and in terms of influence in administration. International standards of financial disclosure stipulate that it is necessary to combine the assets of an SPV with the originator's assets if the latter controls the first.

Is it necessary to resort to an SPV for Issuance of *ṣukūk*?

We can conclude from the foregoing that an indirect issue through an SPV is unnecessary in the case of issuing *ṣukūk* for the acquisition of new assets not available with the originator. However, in the case of securitization, i.e., issuing *ṣukūk* to transfer the ownership of existing assets from the originator to the *ṣukūk* holders, the question that should be posed is: does the securitization process require the primary function for which the SPV is established; which is isolating the transferred assets from the risk of bankruptcy of the originator? The answer is that securitization entails transferring complete ownership to the *ṣukūk* holders, and therefore it is taken out of the balance sheet of the originator whether an SPV is present or not.

Some may argue that an SPV represents *ṣukūk* holders and takes care of their rights. This argument can be refuted from two aspects: Firstly, the relationship between the originator and the SPV is unsteady and changes along with the changes in the legal systems. At best, the originator has some, even if little, influence over the SPV, which it created itself. Therefore, even if the SPV was designed to represent the interests of investors, it is impossible to exclude it from the suspicion of conflict of interest. Secondly, most of the practical arrangements for the

issuance of *ṣukūk* as well as bonds include a party other than the SPV, which performs the functions of representing investors and protecting their rights, that is the trustee. So what is the purpose of multiplicity of representation of *ṣukūk* holders?

In the end, I do not see any reason to copy the SPV mechanism in the domain of *ṣukūk* issuance. I propose replacing it by creating a body to represent the *ṣukūk* holders and protect their rights. However, its creation should be entrusted to a public entity, such as the Capital Market Authority, and not to the originator, in order to prevent suspicions of conflicts of interest.

8.3 Practical steps for the Issuance of *ṣukūk*: *ijārah ṣukūk* as a Sample

We will provide a description of the practical steps of a direct issue of *ijārah ṣukūk* by an airline company seeking to expand its activities. In order to achieve this, it desires to acquire 10 aircrafts with particular specifications worth \$500 million.

▪ Assumptions:

1. The desired delivery time from the aircraft manufacturer is six months.
2. The planned number of *ṣukūk* to be issued is 500 thousand, with each *ṣukk* having a face value of \$1,000.
3. The price of the aircrafts is to be paid in monthly installments from the date of the manufacture request till delivery date.
4. Excess liquidity during the manufacturing period is to be invested on behalf of the *ṣukūk* holders in short-term investments.
5. The aircraft are leased to the airline company with fixed semi-annual installments for five years.
6. The entity representing the *ṣukūk* holders carries out the maintenance work since this responsibility falls upon the *ṣukūk* holders as owners of the aircraft. The entity also takes out necessary insurance, ensuring its conformity with the provisions of the Sharī‘ah.

7. The relationship between *ṣukūk* holders and the aircraft manufacturing company is adapted on the basis of an *istiṣnā'* contract, and the relationship between them and the airline company is based upon the contract of lease of a described asset. The ownership of the aircraft is transferred at the end of the lease period on the basis of a gift conditional to the payment of all rental installments.

▪ **Pre-Issuance Stage**

1. Feasibility study of the project in cooperation with accounting experts and the arranger.
2. Certification of the feasibility study from a reliable source.
3. Rating of the *ṣukūk* in the light of the certified feasibility study, the creditworthiness of the Airline Company and guarantees presented, if any.
4. Drafting of contracts in collaboration with legal and Sharī'ah advisers.
5. Appointing the underwriter and, if required, the paying agent.
6. Drafting the prospectus.
7. Certification of the contracts and issuance mechanism by the Sharī'ah supervisory board.
8. Creating an independent body to represent the *ṣukūk* holders to protect their rights (trustee) according to the terms and conditions set in advance by the concerned regulatory authorities.
9. Obtaining the necessary approvals for the issuance of *ṣukūk* in accordance with the laws in force.
10. Advertising the prospectus.

▪ **Issuance Stage**

1. Subscription of investors in the *ṣukūk*, and if any part is left unsubscribed, the underwriter subscribes what remains.
2. Payment of the subscription proceeds to the paying agent.
3. Transfer of the subscription proceeds to the account of the trustee.

4. Conclusion of the lease contract based upon description between the trustee, the representative of the *ṣukūk* holders, and the originator.
5. Issuance of promise to gift from the trustee in favor of the originator conditional to the payment of all rental installments.
6. Conclusion of *istiṣnā'* contract between the trustee and the aircraft manufacturing company.
7. Payment of *istiṣnā'* installments through the paying agent.
8. Investing excess liquidity.
9. Receipt of aircraft by the trustee on behalf of the *ṣukūk* holders after confirming compliance with the specifications by a team representing the originator. From this stage the *ṣukūk* become tradable.
10. The trustee concludes maintenance and *takāful* insurance contracts.
11. Handing over the aircraft to the airline company for utilization in accordance with the lease contract.
12. Payment of lease installments by the originator to the trustee at contractual time intervals.
13. Payment by the trustee of periodic or emergency maintenance costs and *takāful* insurance contributions.
14. Transferring periodic returns to the *ṣukūk* holders.

▪ **Redemption Stage**

This phase is limited to the conclusion of the gift contract, through which the ownership of aircrafts is transferred from the *ṣukūk* holders to the airline company.

9. Conclusion

As indicated above, *ṣukūk* are an Islamic market-financing mechanism that is supposed to provide a Sharī'ah compliant alternative to bonds. Contrary to the latter, which are an interest-bearing debt certificates, Islamic *ṣukūk* represent certificates of ownership of the assets acquired with the proceeds of the *ṣukūk* issue.

The paper showed that *ṣukūk* may constitute an effective developmental tool, provided they are issued to create additional productive assets. If, on the contrary they are issued for the purpose of getting liquidities through the sale of existing assets to the *ṣukūk* holders, there is no guarantee that the proceeds of the issue are not used for purposes which do not create wealth and expand capital accumulation.

The paper also showed the importance of distinguishing between securitization of *ṣukūk* (*taṣkik*) and the mere issue of *ṣukūk*. securitization supposes that the issuer holds assets that he is willing to transfer temporarily to the *ṣukūk* holders, while the purpose of the simple issue of *ṣukūk* may be to acquire assets which are not in the hands of the issuer.

Finally it was shown in the paper that the widespread use of the Special Purpose Vehicle device in the field of *ṣukūk* is baseless. SPVs are associated with the securitization of conventional debt assets; their core function is to serve as a bankruptcy-remote device; i.e. as a means to transfer the assets from the balance sheet of the issuer to the SPV in order to protect the securities holders in case the originator goes bankrupt. Therefore there is no rationale for going through an SPV when the issue of *ṣukūk* does not involve a transfer of assets, i.e. in the case of the simple issue of *ṣukūk*. In case *ṣukūk* are issued in the framework of a securitization process, the Sharī'ah rules require a full and unrestricted transfer of the ownership of the securitized assets. Thus the assets exit the balance sheet of the originator, with or without the SPV. SPVs have no role to play in the issuance process of *ṣukūk*. As for the protection of the rights of the *ṣukūk* holders, it is of a vital importance to create a body to specifically fulfill this function. The paper suggests the establishment of a body where the *ṣukūk* holders are represented and which is entrusted with the protection of their rights and interests. The responsibility of creating such a body should be entrusted to a public authority, such as the capital market authority, and not to the issuer, as it is the case of the SPVs. This is to avoid any possible conflict of interests.

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