FROM "ASSET-BACKED" TO "ASSET-LIGHT" STRUCTURES: THE INTRICATE HISTORY OF *ṢUKŪK*

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Abstract

This paper traces the development of the ṣukūk market through ṣukūk case studies. It discusses how ṣukūk has evolved from an asset-backed structure, where ṣukūk holders have ownership rights over the underlying asset, to an asset-based structure, where ṣukūk holders rank pari passu with unsecured creditors. This paper subsequently highlights the emergence of the asset-light structure, where the requirement of having tangible assets seems to be rather minimal. It also discusses the Sharīʿah concerns that arise in the asset-light structure.

Key words: Sharīʿah, ṣukūk, asset-backed, asset-based, asset-light.

I. INTRODUCTION

Ṣukūk can be generally defined as transferable certificates representing a share in the ownership of assets or business ventures that entitle the *ṣukūk* holders to receive periodic fixed returns and full redemption on maturity of the *ṣukūk*. Nonetheless, one needs to understand a distinction that is becoming increasingly popular

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in the market: asset-backed *ṣukūk* versus asset-based *ṣukūk*. Rating agencies[1] have published some research on this distinction and the following definition by Moody’s is worth highlighting:

“In asset-backed *ṣukūk*, investors enjoy asset-backing, they benefit over some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the note holders would be able to recover their exposure by taking control of and ultimately realising the value from the asset(s). It also requires the element of securitisations to be present – true sale, bankruptcy remoteness and enforceability of security...In asset-based *ṣukūk*, the originator undertakes to repurchase the assets from the issuer at maturity of the *ṣukūk*, or upon a pre-defined early termination event, for an amount equal to the principle repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the *ṣukūk* note holders, as the amount is defined to be equivalent to the notes. In this case, note holders have no special rights over the asset(s) and rely wholly on the originator’s creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable to honour its obligation to repurchase the assets, the note holders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor stressing the importance that the purchase undertaking ranks *pari passu* with any other of the originator’s senior unsecured obligations.” (Phillip Lotter et al, 2007, pp.5-6).

This paper attempts to trace the market development of *ṣukūk* structures from “asset-backed” to “asset-based” and “asset-light”. It highlights how over time the requirement of having tangible assets to support *ṣukūk* structures became diluted as the Sharīʿah standards became more liberal in their interpretation of these structures. This paper begins with a description of the asset-backed *ṣukūk* structures. Thereafter, it discusses the emergence of asset-based *ṣukūk* and

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1 Interestingly, the IFSB Standard on Capital Adequacy Requirement for *Ṣukūk*, Securitisations and Real Estate Investment (IFSB-7) issued in January 2009 defines asset-backed *ṣukūk* as an instrument that meets the requirement of rating bodies on asset-backed structures.

"blended assets" *ṣukūk*. It then discusses the birth of the "asset-light" *ṣukūk* and related Sharīʿah issues.

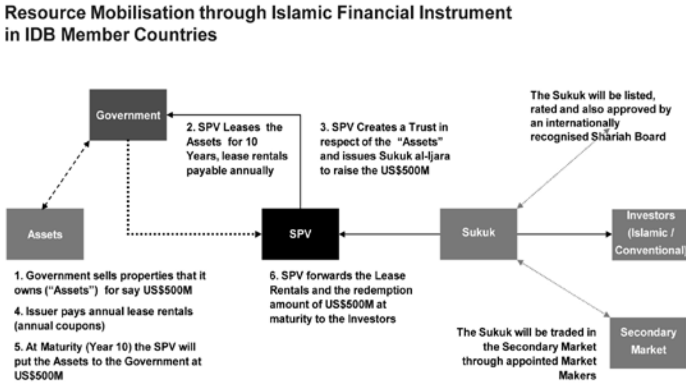
II. THE CONCEPT OF ṢUKŪK AS AN ASSET-BACKED SECURITY

Although the concept of *ṣukūk* has been discussed in the Islamic finance industry for more than a decade, the prototype of modern *ṣukūk* was first introduced in 2000 at the 11th Islamic Development Bank Annual Symposium[2]. The following structure was introduced to facilitate sovereigns and corporates to tap the Islamic capital markets through a *ṣukūk* issuance.[3]

2 Interestingly, *ṣukūk* or sakk is not a new invention of the Islamic finance industry. The concept of *ṣukūk* has been with the Islamic world since the early days of Islamic civilisation. Imam Malik has recorded the first historical account of *ṣukūk* in his famous treatise *al-Muwaṭṭa*. It is stated that in the 1st century AH (corresponding to the 7th Century CE) the Umayyad government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of *ṣukūk al-baḍā'iʿ*, which has been translated as "commodity coupons" or "grain permits". See, (Kamali, 2007; Malik ibn Anas, *al-Muwaṭṭa*, 2000, 296) The holders of the *ṣukūk* were entitled to present the *ṣukūk* on its maturity date at the treasury and receive a fixed amount of commodity, usually grains. Some of the holders used to sell their *ṣukūk* to others for cash before the maturity date. Although the validity of such trade has been questioned by scholars of that period, it shows that the concept of *ṣukūk al-baḍā'iʿ* as a tradable instrument has been known to the Islamic world for a very long time.

3 The *ṣukūk* structures were presented by Iqbal Khan, who was then the Managing Director of Amanah Finance, HSBC Investment Bank plc in London and the author was responsible for developing the *ṣukūk* business for HSBC. See (Khan 2000). For a more detailed discussion on *ṣukūk*, see (Haneef, Rafe 2005).

Diagram 1: ***Resource Mobilisation through Islamic Financial Instruments in IDB Member Countries***



The *ṣukūk al-ijārah* structure essentially required the corporate to sell certain physical assets[4] to a special purpose vehicle or company and the physical assets were then leased-back by the special purpose company to the corporate for a certain number of years. The special purpose company issued *ṣukūk* to the investors to raise the funds required to pay the corporate for the sale of physical assets. The corporate received the sale price at the time of *ṣukūk* issuance and paid the periodic lease rentals, usually every six months, to the special purpose company for the duration of the lease. The special purpose company distributed the periodic lease rentals as coupon payments under the *ṣukūk*, comparable to bond coupon payments. At maturity the special purpose company sold the assets to the corporate at the original sale price, not at market or fair value, and the assets were returned to the corporate. The special purpose company then paid the sale price received from the corporate to the *ṣukūk* holders and the *ṣukūk* was redeemed. Given that the payment of rentals and sale price at maturity were the direct obligations of the corporate, the risk and reward profile of the *ṣukūk* was comparable to a conventional

4 Example of physical assets include buildings, plant & machineries, moveable assets like aircraft, ships, equipment, landed properties and also include certain intellectual properties.

bond profile. This then allowed the *ṣukūk* to be priced on par with conventional bond pricing.

Although the *ṣukūk* structure, risk and reward profile, and pricing rationale were quite straightforward and appealing, the sovereigns and corporates faced several major challenges in issuing *ṣukūk*. One of the major challenges was the lack of suitable assets for the underlying *ijārah* transaction. Most sovereigns were reluctant to part with public assets due to the apprehension that the disposal of public assets to foreign investors would create negative public sentiment. The sovereigns preferred the conventional bond route which did not require any disposal of assets from the sovereigns.[5] The corporates on the hand either did not have suitable assets, or the assets were not sufficient or already encumbered, or such disposal was subject to transfer taxes. Hence, although the *ṣukūk al-ijārah* was structurally viable and legally possible, the product did not receive much interest in the Muslim world in the beginning.

Finally in 2001, the State of Bahrain tested the *ṣukūk* waters by offering its inaugural *ṣukūk al-ijārah* issue in the domestic market.[6] The issue amount was USD250 million and had a tenure of five years. The *ṣukūk* carried six-monthly lease rentals which were fixed at the lease inception and paid in arrears during the lease term. The *ṣukūk* was backed by USD250 million worth of sovereign assets. The Bahrain *ṣukūk* issue was a major milestone in Islamic finance as it marked the dawn of the *ṣukūk* capital market. It also demonstrated to other Muslim sovereigns that the sale of sovereign assets for the purpose of *ṣukūk* issuance would not be perceived negatively by the public. However, the Bahrain *ṣukūk* documentation did not meet international bond standards and was not rated or listed or cleared through any clearing house. The Bahrain *ṣukūk* issue was hence mostly subscribed by domestic investors.

Subsequently in December 2001, Kumpulan Guthrie Berhad, a Malaysian public listed company involved in the plantation and construction sector, issued a *ṣukūk al-ijārah*. The company offered

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5 Many OIC member countries have issued conventional bonds, including the Islamic Republic of Pakistan and the Islamic Republic of Iran.

6 In 2000, the State of Bahrain was the first to issue the innovative *ṣukūk al-salam* but the securities were however non-tradable and not regarded as an Islamic alternative to a conventional bond issue.

a USD150 million *ṣukūk* issue with a floating rate return and the tenure was divided into three years (USD50 million) and five years (USD100 million). The *ṣukūk* was backed by underlying land parcels in Malaysia worth more than USD150 million. Unlike the Bahrain *ṣukūk*, the Guthrie *ṣukūk* was documented in accordance with the internationally recognised U.S. Regulation S format and was listed on the Labuan International Financial Exchange. However, the Guthrie *ṣukūk* was neither rated by the leading international rating agencies like Moody's, Standard & Poors or Fitch, nor cleared through any clearing house. Again, the Guthrie *ṣukūk* did not achieve a wide distribution in the international capital markets.

III. THE BIRTH OF ASSET-BASED ṢUKŪK

Malaysia, having successfully developed its domestic Islamic bond market, was eager to help create the international Islamic bond market. In 2002, the Federation of Malaysia created history by issuing the first Islamic global *ṣukūk* that complied with the U.S. Regulation S and Rule 144A formats that are used for conventional global bonds. The Malaysian *ṣukūk al-ijārah* was the first *ṣukūk* to be listed in the Luxembourg Stock Exchange and rated by Standard & Poor's and Moody's. The USD600 million *ṣukūk* was offered globally to Islamic and conventional investors including "Qualified Institutional Buyers" in the United States. The issue was hugely successful and was twice oversubscribed. The Malaysian *ṣukūk* was a significant development because it was able to successfully fuse the concept of *ṣukūk al-ijārah* with conventional bond practices such as listing, ratings, dematerialised scripts and centralised clearance.

The Malaysian *ṣukūk* was backed by USD600 million worth of sovereign assets such as government administrative buildings, hospitals and academic institutions. However, the asset-backed *ṣukūk* structure created a major legal constraint for the Federation of Malaysia. Unlike the State of Bahrain and Kumpulan Guthrie, the Federation of Malaysia had previously issued international bonds and some of them were still unredeemed in 2002. All international bonds have a standard negative pledge which restrains the bond issuers from issuing in future any bond that is not in *pari passu* with the

existing unsecured bonds.[7] Given that the Malaysian international bonds were all unsecured bonds, the proposed *ṣukūk* issuance was seen as a direct breach of the negative pledge clause given that the *ṣukūk* would be backed by the ownership of the underlying assets. The *ṣukūk* became effectively a secured bond and would be given priority over all unsecured bonds of the Federation of Malaysia. The Federation of Malaysia was advised not to proceed with the *ṣukūk* until all the outstanding bonds were redeemed. The development of the *ṣukūk* market almost came to a standstill.[8]

With the help of a few prominent Sharīʿah scholars, the Federation of Malaysia found a neat solution to avoid breaching the negative pledge. Under the revised structure, the *ṣukūk* holders would have beneficial ownership[9] of the assets held through the *ṣukūk* trustee during the life of the *ṣukūk*. This would meet the Sharīʿah requirements of asset ownership under *ijārah* principles. However, in the event of default by the Federation of Malaysia, the *ṣukūk* trustee's sole recourse to the assets would be to dispose of the assets only to the Federation of Malaysia and seek payment. The *ṣukūk*

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7 The standard negative pledge clause usually provides as follows: "So long as any of the Certificates remains outstanding, the Issuer has undertaken that it will not secure any of its present or future indebtedness for borrowed money by any lien, pledge, charge or other security interest upon any of its present or future assets, properties or revenues (other than those arising by operation of law)."

8 The following *ḥadīth* reported by Abu Hurayrah (r.a.) reminds us of the severity of the problems of *ribā* in our societies. According to Abu Hurayrah (r.a.), the Holy Prophet (s.a.w.) said: "A time will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him." This *ḥadīth* was recorded by Aḥmad, Abū Dāwūd, Nasā'ī and Ibn Mājah (2001). In the Malaysian context, the *ribā*-based bonds had almost shackled the hands of Malaysia from ever embarking on a Sharīʿah-compatible financing.

9 In common law jurisdictions, when the buyer pays the full consideration for a landed asset, the seller becomes a bare trustee and the buyer becomes the beneficial owner of the land. As a bare trustee the seller cannot dispose of the land to another without the consent of the beneficial owner. From a legal perspective, the law considers the beneficial owner as the true owner with the power to possess and dispose of the land. This is the same position under Sharīʿah where there was no system of land registration in place in the past. In jurisdictions with land registration systems, the buyer will procure the seller to register the land in the name of the buyer to protect the buyer's rights against any third party who may claim any interest on the landed assets held on trust by the seller. Such registration will also avoid the seller (as a bare trustee) from inadvertently or fraudulently transferring the land to any third party. Upon registration, the buyer (as a beneficial owner) becomes the legal owner.

trustee would not have the power to retain or sell the assets to any third party. Once the *ṣukūk* trustee had disposed of the assets to the Federation of Malaysia, the *ṣukūk* holders would in law be treated as unsecured creditors. The revised *ṣukūk* structure therefore was not seen as asset-backed securities although the *ṣukūk* had underlying assets. The Malaysian *ṣukūk* became known in the market as “asset-based” securities.[10] The *ṣukūk* was based on Sharīʿah-compatible assets but the *ṣukūk* holders would only be able to dispose of the assets to the lessee and no other. This was viewed by many as not an ideal solution but, given the prevailing circumstances, was the only possible solution.

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

IV. THE DAWN OF “BLENDED ASSETS” ṢUKŪK

When the *ṣukūk* concept was first conceived in November 2001, it was also envisaged that not all corporate issuers would have sufficient Sharīʿah-compatible physical assets for the *ijārah* transaction. The following structure was recommended for corporate issuers who had Sharīʿah-compatible receivables as well as physical assets.

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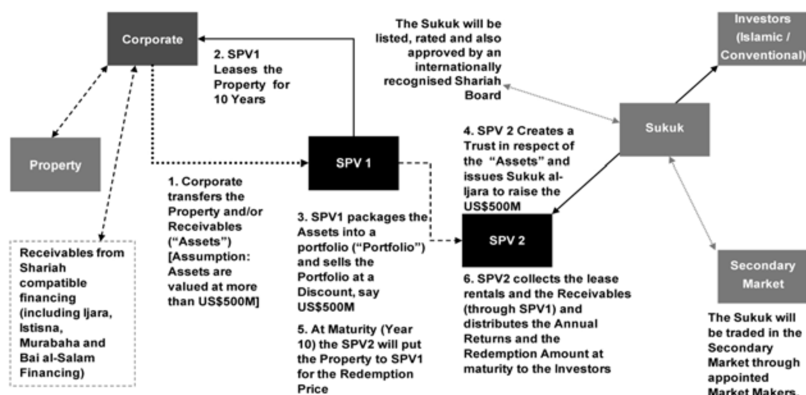
10 In the USD150 million Guthrie *ṣukūk*, the *ṣukūk* holders are entitled to have recourse to the *ṣukūk* assets including to liquidate the assets in the event of default by Guthrie. The USD250 million Bahrain *ṣukūk* also implicitly vests similar rights on the *ṣukūk* holders although the poorly drafted legal documentation is rather vague on this matter. These *ṣukūk* are therefore clearly asset-backed securities.

Diagram 2: ***Resource Mobilisation through Islamic Financial Instrument by Corporates in IDB Member Countries***



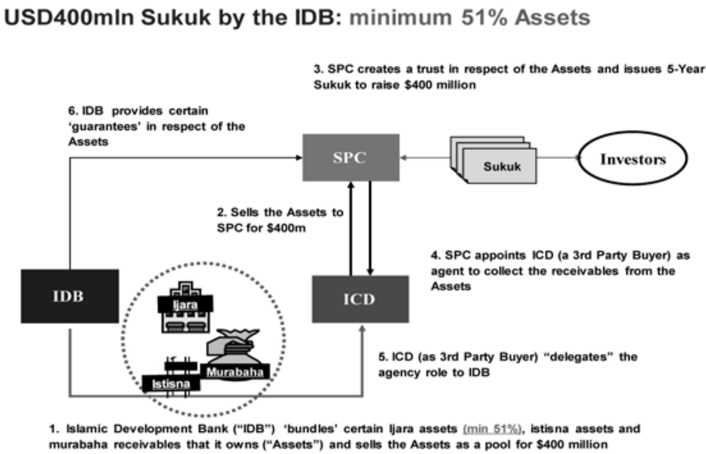
The above structure required the corporate to sell both physical assets and receivables to a special purpose company ("SPC 1") which in turn leased back the physical assets to the corporate. The SPC 1 then combined the receivables and physical assets (leased-back to the corporate) into a single portfolio and sold the entire portfolio to another special purpose vehicle ("SPC 2"). SPC 2 then held the portfolio on trust and issued *ṣukūk* to investors. The *ṣukūk* holders were treated in law as the beneficiaries of the trust portfolio and this met the Sharīʿah requirement of ownership. Although receivables and other forms of debt cannot be transferred except at par under Sharīʿah, if the receivables are combined with physical assets in a single portfolio then the entire portfolio can be sold at any price.[11] This

11 When an object consists of two substances and one of those is prohibited under Sharīʿah, the object can still be construed as Sharīʿah-compatible if the quantity of the non-compatible substance is insubstantial. For example, if a ring is made of gold and silver, it is permissible for a Muslim male to wear it if the quantity of the gold substance is insubstantial. There exists difference of opinions among scholars as to what amounts to "insubstantial" quantity. Most scholars have taken the view that the non-compatible substance will be regarded as insubstantial if the quantity of the Sharīʿah-compatible substance is at least 51%.

type of combination is structured based on the concept of *khulṭah*.[12] The main condition for such a portfolio is that the proportion of the physical assets has to be more than the receivables. Some Sharīʿah scholars require the majority portion to be at least 51%, and others insist that it should be at least $^{2}/_{3}$ of the portfolio.

In 2003, the Islamic Development Bank seized the opportunity to test the viability of the "blended assets" *ṣukūk* structure and successfully issued a USD400 million *ṣukūk*. Like all financial institutions, the IDB had less of physical assets and more of Sharīʿah-compatible receivables on its books. The "blended assets" *ṣukūk* approach was the only viable solution to the IDB if it wanted to succeed in its resource mobilisation strategy. The IDB *ṣukūk* was structured as follows:

Diagram 3: ***IDB's "Blended-Assets" Approach to Ṣukūk***



In the IDB *ṣukūk*, the mixed portfolio consisted of *ijārah* assets comprising 65.8% of the portfolio (although the minimum requirement was set at 51%) and *murābaḥah* and *istiṣnāʿ* receivables comprising

12 Some Ḥanafī scholars have taken a more liberal view of the *khulṭah* principle. They have not allocated any fixed percentage or quantity but have left the matter to be decided on a case-by-case basis. Hence, there may be circumstances where even if the non-compatible component is more than 49%, the object can still be considered as wholly Sharīʿah-compatible.

34.2%.[13] The 65.8% of *ijārah* assets was comprised of certain physical assets owned by the IDB and which were leased out to various counter parties. Since the *ijārah* assets could be freely transferred at any price by the IDB, by mixing the *murābaḥah* and *istiṣnāʿ* receivables (*dayn*) with *ijārah* assets (*ʿayn*), the IDB was able to transfer the receivables as well.

The IDB *ṣukūk* issue was well received by the market and subscribed by both Islamic and conventional accounts. A few years later, the IDB went to the market again and this time the IDB appeared to have even less physical assets to inject into the mixed portfolio. The IDB wanted to reduce the proportion of *ijārah* assets from 65.8% down

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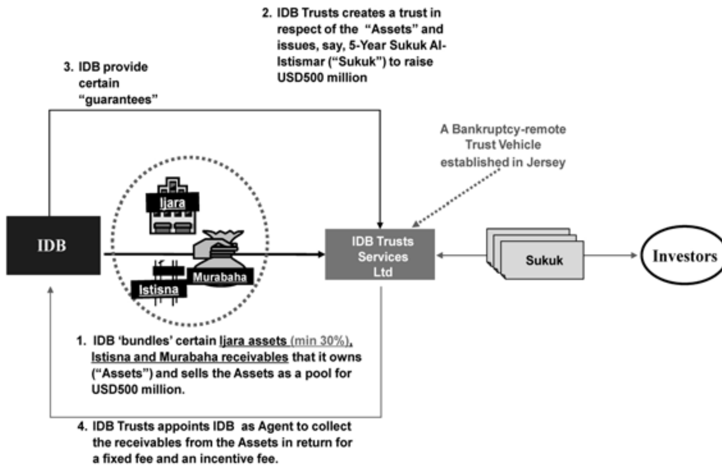
13 See, FINAL OFFERING CIRCULAR DATED 12 AUGUST 2003, p 11: "Whilst in general the transfer of interests in *murābaḥah* contracts and *istiṣnāʿ* contracts in themselves would not be permissible, the proposed pool will consist of at least 51% *ijara'a* contracts (and the related underlying assets). Therefore, the transfer of the entire pool consisting of such interests in *murābaḥah* contracts and *istiṣnāʿ* contracts is permitted. In addition, following the Closing Date, IDB must sell to ICD and ICD must sell to the Trustee sufficient new assets evidenced by *ijara'a* contracts and the Trustee has entered into arrangements to maintain at least 51% of the pool of Assets as ijara'a contracts (and the related underlying assets). However, in exceptional circumstances the proportion of ijara'a contracts (and the related underlying assets) may drop for a temporary period to a minimum proportion of 25% of the pool of Assets, and the Trustee will ensure that the assets evidenced by ijara'a contracts comprise not less than 25 per cent. of the outstanding Assets owned by the Trustee at any time. If at any time the proportion of Assets evidenced by ijara'a contracts falls below 25 per cent., a Dissolution Event will occur, and IDB by virtue of its separate undertaking will be obliged to purchase all of the Assets owned by the Trustee pursuant to the terms of the Purchase Undertaking Deed."

to 30%.[14] The scholars seem to have taken a more liberal view of the *khulṭah* principle. The IDB was permitted to sell a mixed portfolio consisting of only 30% physical assets. The subsequent IDB *ṣukūk* was hence structured as follows:

Diagram 4: *The IDB Ṣukūk Issuance Programme*



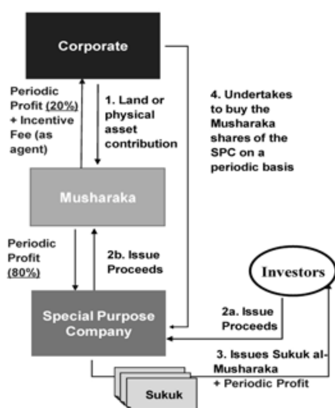
14 *See*, the FINAL OFFERING CIRCULAR DATED 23 MAY 2005, p 7: "By a decision of the President of IDB, IDB will establish a portfolio of assets (a "Portfolio") separate from any other assets of IDB in respect of each Series of Trust Certificates issued under the Programme. At least 30% of any Portfolio will be comprised of assets leased to certain clients of IDB under *ijārah* contracts (the ownership of such assets shall be transferred to the lessees at the end of the lease period) for a rental (the "Rental") consisting of the unamortised portion of the acquisition cost of leased assets (the "Principal – *Ijārah*") and a variable or fixed portion (the "Profit – *Ijārah*"), in addition to instalment payments ("Instalments") under *murābaḥah* and *istiṣnāʿ* contracts which IDB has entered into with certain of its clients. Each Instalment under a *murābaḥah* or *istiṣnāʿ* contract will consist of two parts: (i) the unamortised portion of the acquisition cost of the assets sold to clients under the *murābaḥah* contracts or the unamortised portion of the acquisition cost of the assets under the *istiṣnāʿ* contracts (the "Principal") and (ii) the profit ("Profit") which has been accrued exceeding the Principal under each *murābaḥah* and *istiṣnāʿ* included in such Portfolio. Accordingly, each Portfolio can be sold and purchased because it consists of (a) debts and (b) physical assets comprising not less than 30% of its total value, and because it is distinct and separate from any other assets of IDB."

V. THE INFLUX OF "ASSET-LIGHT" ṢUKŪK

Whilst the "blended assets" *ṣukūk* structure had been a tremendous boost for corporates like the IDB and other Islamic financial institutions to tap the *ṣukūk* capital markets, others found the prevailing *ṣukūk* structure too constraining and unviable. These corporates either could not meet the 30% physical assets requirement or they did not have any Sharīʿah-compatible receivables. Many of these corporates were in an expansion mode fueled by the massive economic boom in the Middle East. The corporates were keen to tap the ever-growing and liquid Islamic finance market and were severely constrained by the asset requirements for the *ṣukūk* issuance. With the help of a few Sharīʿah scholars, a new *ṣukūk* structure was conceived and launched out of Dubai. The new *ṣukūk* was called *ṣukūk al-mushārakah* and was structured as follows:

Diagram 5: ***The New Structure of Ṣukūk al-Mushārakah***

The USD300m Dubai Metals & Commodity Exchange Sukuk



- DMCE and the Special Purpose Company ("SPC") enter into a Musharaka arrangement for a period of 5 years – Profit-sharing ratio is between the SPC and the DMCE is 80:20
- DMCE (as Musharik) contributes to the Musharaka
- SPC (as Musharik) contributes cash (i.e.) the Issue Proceeds to the Musharaka
- The Musharaka appoints the DMCE as an agent to develop the land with the cash injected into the Musharaka and sell and/or lease the developed assets on behalf of the Musharaka
- In return the agent (i.e., DMCE) will get a fixed agency fee plus a variable incentive fee payable say, semi-annually. The Net Profit is divided in to 80:20 and from the 80% profit share, the agent will disburse to the SPC an amount equal to Issue Proceeds*Libor+Margin pa and the surplus (if any) would be kept by the agent as Incentive Fee
- DMCE irrevocably undertakes to buy **at a pre-agreed price** (i.e., the Issue Proceeds) Musharakah shares of the SPC on say semi-annual basis and at the end of 5 years, the SPC would no longer have any shares in the Musharakah

In the above *ṣukūk* structure, DMCE needed USD300 million to develop a land that it owned. DMCE and the special purpose company then formed a *mushārakah* where DMCE contributed

capital in kind in the form of land worth USD48 million.[15] The issuer contributed capital in cash equal to USD300 million and issued *ṣukūk al-mushārakah* to the investors to raise the required funding.

In return for the capital contributions, each *mushārik* was allocated a certain number of *mushārakah* units equal to the value of their capital contribution. The *mushārakah* units essentially represented shares in the *mushārakah*. The *mushārakah* then appointed DMCE to use the USD300 million cash contribution to develop three office and residential towers on the land in accordance with the *Mushārakah* Business Plan. The *Mushārakah* Business Plan stated that the various individual units in the three towers would be sold or leased by DMCE to potential customers on behalf of the *mushārakah*.[16] The proceeds of the lease rentals and sale considerations would be utilised to pay the six-monthly periodic distributions (viz. the coupon payments) and the final distribution at maturity (viz. the last coupon payment).

Unlike the Bahrain, Malaysian and IDB *ṣukūk* issues, there was no principal redemption feature (where the initial *ṣukūk* issue amount was repaid to redeem the *ṣukūk*) in the DMCE *ṣukūk* structure. Instead, the initial *ṣukūk* issue amount of USD300 million was amortised in 10 instalments of USD30 million which was paid as consideration for the purchase by DMCE of $^{1}/_{10}$[17] of the *mushārakah* units owned

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15 According to the PRELIMINARY OFFERING CIRCULAR (SUBJECT TO COMPLETION) DATED 8 APRIL 2005, p. 61, the market value of the land was AED139,833,856 and development costs incurred on it was AED 29,736,484 as at 27 March 2005. The USD equivalent of both the amounts was around USD48 million.

16 *Id. at 7:* "The purpose of the Musharaka will be to earn profit from the application of the Capital Contributions in the construction of Almas Tower, AU Tower and AG Tower, Jumeriah Lake Towers, Dubai, (together, the Towers), the sale of units in the Towers and lease of office and commercial premises in each Tower all in accordance with a business plan provided by DMCC."

17 *Id. at 9:* "On each Periodic Distribution Date, Certificate holders will receive, from moneys received in respect of the Trust Assets, a Periodic Distribution Amount equalling:
(a) the Amortisation Payment; plus
(b) the product of (i) LIBOR for such Return Accumulation Period plus the Margin, (ii) US$ 300 million (being the initial principal amount of the Certificates) less the aggregate of all Amortisation Payments previously paid by the Issuer and (iii) the number of days in such Return Accumulation Period divided by 360.
For the purpose of the foregoing: Amortisation Payment means US$30 million, being one-tenth of the initial principal amount of the Certificates."

by the Issuer every six months. DMCE provided a legal undertaking to the Issuer to buy the USD30 million worth of *mushārakah* units every six months until all the *mushārakah* units of the Issuer had been transferred to DMCE.

The above *ṣukūk* structure raises the following Sharīʿah concerns:

A. Is the Sukūk Al-Mushārakah Tradable?

One of the Sharīʿah requirements for trading *ṣukūk* at premium or discount to face value is that the *ṣukūk* must represent substantial physical assets. What amounts to substantial assets has varied over the years from 100% in the Bahrain, Guthrie and Malaysian *ṣukūk* to 30% in the IDB "blended *ṣukūk*". If we compare the Sharīʿah standard used in the Islamic equity investments, the total receivables and cash in a company must not be more than 33% of the total assets.[18] If the company has more than 33% cash or 33% assets receivables, the equity of the company will be considered as non-Sharīʿah compatible. The rationale behind the standard is that if the company has more than 33% cash or accounts receivables, the shares of the company will essentially represent cash or debt (*dayn*) which, from a Sharīʿah perspective, cannot be traded except at par. This standard equally applies for *ṣukūk* which is also a tradable instrument.

In the DMCE *ṣukūk*, the *mushārakah* venture had USD48 million worth of physical assets and USD300 million worth of cash. The total assets of the venture was USD348 million and accordingly the ratio of cash to total assets was around 86% at the inception. In all likelihood, the cash would be utilised over a period of two to three years in line with the progress of the construction of the three towers.[19] Even in the most remote event, where DMCE

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18 *See*, http://www.djindexes.com/islamic/index.cfm?go=methodology. Although the DJIM standard provides for 33% of the trailing 12-month average market capitalisation of the company, this standard is used for public listed companies only. For privately held companies and *mushārakah* ventures, the appropriate standard is 33% of total assets of the company or venture.

19 The Preliminary Offering Circular (Subject to Completion) Dated 8 April 2005 is silent on the cash utilisation period. It will be highly unusual to utilise the cash in a very short period given the nature of the construction undertaken by the *mushārakah* venture.

(as agent of the *mushārakah*) had paid the entire USD300 million in one day to the contractors of the three towers, the *mushārakah* venture would still end up having assets receivables worth more than 33% of the total assets. According to the Offering Circular, more than 80% of the two towers had already been pre-sold by DMCE prior to the *ṣukūk* issuance. Given that all the rights over the three towers had been transferred to the *mushārakah* venture, the purchase price payable for the pre-sold units would become assets receivables of the *mushārakah* venture. A back-of-the-envelope calculation will show that the value of the receivables for the pre-sold units comprising more than 80% of the two towers will surely be more than 33% of the total assets.

Hence, the *ṣukūk al-mushārakah* should not be traded except at face value until the time when the three towers had been completed.[20] Unfortunately, this important aspect of Sharīʿah seemed to have been completely ignored and the *ṣukūk* was permitted to be traded at a premium or a discount to the face value.

B. Is it Permissible for DMCE to Undertake to Buy from the Issuer the Mushārakah Units at Par Value Every Six Months?

In *mushārakah* and *muḍārabah* arrangements, it is a well-established rule that one partner cannot guarantee the return of the principal or the share of profit of the other partner. The rationale behind this rule is that if say, partner A undertakes to buy the *mushārakah* share of partner B, the capital contributed by partner B will be regarded under Sharīʿah as a loan from partner B to partner A and if partner B receives any share in the *mushārakah* profits, such profit will be regarded as *ribā*. The Sharīʿah strictly requires that any loss suffered by the *mushārakah* venture to be shared by all partners in proportion to the capital contributed. Hence, if partner A contributes 14% and partner B contributes 86% of the capital of the *mushārakah* and there is a loss of say, USD100, partner A will

20 The Preliminary Offering Circular (Subject to Completion) Dated 8 April 2005 is completely silent on the tradability issue and the *ṣukūk* have been traded at a premium in the market.

be accountable for USD14 and partner B for the remaining USD86. The Sharīʿah does not allow the partners to mutually vary the loss-sharing ratio under any circumstances. For example, if partner A agrees with partner B to absorb say, 50% of the losses, such an arrangement will not be permissible under Sharīʿah.

In the DMCE *ṣukūk*, DMCE had irrevocably undertaken to buy USD30 million worth of *mushārakah* units of the Issuer at par value every six months. The undertaking was legally enforceable by the Issuer regardless of whether the *mushārakah* venture had suffered any losses or not. Let us assume that the construction of the three towers did not go as planned or DMCE was unable to sell or lease the end units of the three towers. In such an event, the *mushārakah* venture was likely to suffer significant losses. However, any such losses would be borne solely by one *mushārik*, DMCE. The Issuer would not suffer any losses given that it would be able to sell its share of *mushārakah* units to DMCE at the pre-agreed price of USD30 million every six months until its entire *mushārakah* units had been bought by DMCE. The irrevocable undertaking by DMCE effectively guaranteed the full principal repayment of the *mushārakah* investment made by the Issuer. This arrangement goes against the very grain of *mushārakah* contract as recognised by Sharīʿah.

The proponents of the DMCE-type of *ṣukūk* ("asset-light *ṣukūk*") contend that the irrevocable undertaking is permissible under Sharīʿah for the following reasons:

(i) DMCE had solicited the investment from the Issuer based on the business plan that it had submitted;
(ii) DMCE had represented that it had conducted adequate due diligence on the business plan and it was confident that the *mushārakah* venture would be successfully carried out as per the business plan;
(iii) If the *mushārakah* venture did not go as planned for whatever reason, the rebuttable presumption was that such failure was due to DMCE's own failure in conducting proper due diligence or in implementing the *mushārakah* venture as per the business plan; and

(iv) DMCE should be solely responsible for such failure or losses unless the presumption in paragraph (iii) above was rebutted by DMCE.

At first blush, the above reasoning appears rather convincing. Why shouldn’t DMCE be responsible for its own failure to conduct the *mushārakah* venture as per the business plan? The Sharīʿah does provide that if a *mushārakah* venture suffers a loss solely due to the negligence or willful default of say, partner A, it is perfectly lawful for partner B to seek full indemnity from partner A. However, if partner A can establish—usually in a court of law—that he was neither negligent nor was he in willful default, then there will be no indemnity from partner A to partner B. Both partners will bear the losses in proportion to the capital contributed.

However, a deeper analysis of the asset-light *ṣukūk* documentation clearly evinces the following:

(i) The *ṣukūk* investors were not privy to the business plan and in reality, hardly paid any attention to the business plan.

(ii) Whilst the undertaking by DMCE to buy the Issuer’s *mushārakah* venture was irrevocable and invoked the presumption of negligence or willful default on the part of DMCE should there be any losses in the *mushārakah* venture, the documentation is completely silent on how such a presumption could be rebutted by DMCE. For example, if say, DMCE had completed the three towers fully in accordance with the business plan but, due to the ongoing global financial crisis, failed to sell or lease the end units as set out in the business plan. In such an event, the presumption would be that DMCE had been negligent in selling or leasing the units and hence should be responsible for the losses suffered by the *mushārakah*.

(iii) The documentation does not provide any opportunity for DMCE to rebut the presumption and avoid being responsible for the losses. This type of irrefutable presumption is clearly not permissible under Sharīʿah. The Sharīʿah would have allowed DMCE to rebut the presumption by, for example, establishing that the failure to sell or lease the end units was solely caused by the global financial meltdown which was unprecedented

and completely unexpected at the time the business plan was prepared.

(iv) Any attempt by DMCE to refute this presumption on the basis of Sharīʿah in the English courts will likely fail given that the documentation is totally silent on this matter. The English courts have emphatically stated in relation to Islamic finance contracts that they would only look within the four walls of the documentation to evince the intention of the contracting parties. The English courts refuse to apply Sharīʿah given that the Sharīʿah is not the recognised law of a state and there are different interpretations of the Sharīʿah by the various schools of jurisprudence.[21]

Based on the analysis of the DMCE *ṣukūk* documentation, it appears that the rationale proffered by the proponents of the asset-light *ṣukūk* does not however apply to the DMCE *ṣukūk* itself. But, what if the *ṣukūk* documentation were to provide that DMCE shall be entitled to rebut the presumption of negligence or willful default and be released from the irrevocable undertaking to buy the *mushārakah* units from the Issuer? In theory, this is clearly possible. But in reality, such a clause will cause serious concerns among the *ṣukūk* investors who only want to assume the credit risk of DMCE. Any potential risk linked to the viability of the business plan will mean that the *ṣukūk* investors are assuming quasi-equity type of risk in addition to the credit risk of DMCE. Such additional risk will not be attractive to *ṣukūk* investors who are mostly fixed-income investors. Such risks may appeal to equity investors but in return for such risks they will demand a higher return on the *ṣukūk* which in turn will not be attractive to DMCE. Hence, from a practical perspective, it is extremely remote for any *ṣukūk al-mushārakah* documentation to contain any such provision. It is therefore not surprising for the DMCE *ṣukūk* documentation to be totally silent on such a critical Sharīʿah provision.

21 See Islamic Investment Co of the Gulf (Bahamas) Ltd v Symphony Gems NV and Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd (No.1) as discussed by Balz, Kilian (2005).

C. What Happens if the Mushārakah Venture Fails to Generate Sufficient Profit to Meet the Periodic Distribution Amount?

Another critical Sharīʿah issue was the ability of the *mushārakah* venture to generate sufficient profit. One of the cornerstones of *muḍārabah* and *mushārakah* contracts is that, whilst the partners are at liberty to agree on any profit-sharing ratio among themselves, no partner can guarantee the profit share of another partner. Any such guarantee will be tantamount to *ribā*. In the DMCE *ṣukūk*, DMCE and the Issuer agreed to share the profit generated by the *mushārakah* venture based on an 80:20 ratio.[22] However, if the Issuer's share of profit was greater than the pre-agreed benchmark rate, DMCE would be entitled to the surplus as a form of incentive fee.[23] Through the incentive fee mechanism, the DMCE *ṣukūk* was able to cap the profit share of the Issuer and transfer any potential upside to DMCE.

If the *mushārakah* venture was unable to generate any profit, the DMCE *ṣukūk* provided that DMCE would seek Sharīʿah-compliant funding, at its own account and without any recourse to the *mushārakah* partners or *mushārakah* assets, to ensure that there was sufficient liquidity to make the six-monthly periodic

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22 *Supra* note 14, at 8: "Eighty per cent. (80%) of all Net Cash Profit will be distributed to the Issuer, and twenty per cent. (20%) of all Net Cash Profit shall be distributed to DMCC (having first deducted Incentive Fees (as defined below), if any). If the *Musharaka* incurs a Net Loss for any accounting period, such Net Loss shall constitute a Change in Circumstances thereby entitling the Issuer to early exercise of the Purchase Undertaking."

23 *Id*. at 8: "If the Issuer's profit share, is in excess of the product of (a) LIBOR for such Return Accumulation Period plus the Margin, (b) the number of Units then held by the Issuer at the beginning of the Return Accumulation Period multiplied by US$30 million, being one-tenth of the initial principal amount of the Certificates and (c) the number of days to elapse in such Return Accumulation Period and a year of 360 days, the surplus distributable profit is payable to the Management Agent as incentive fees (the Incentive Fees) for acting as manager under the Management Agreement."

distributions.[24] Although its permissibility under Sharīʿah is debatable, the liquidity facility mechanism appears to be a neat solution that protected the downside risk of the Issuer. Further, if DMCE failed to pay any of the six-monthly periodic distributions. this would trigger an early dissolution of the *mushārakah* and DMCE would be obliged to immediately buy all the remaining *mushārakah* units of the Issuer.[25] This mechanism also further reduced the *mushārakah* downside risks of the Issuer. All these new features put together had ingeniously transformed an equity-type *mushārakah* investment into a debt-type fixed income investment.

Although the DMCE *ṣukūk* had serious Sharīʿah issues, the simplicity of the structure and the easing of the Sharīʿah requirement for physical assets created a lot of excitement in the nascent *ṣukūk* market. Corporates seeking to tap the liquid Islamic market suddenly found an easy way to issue a *ṣukūk*. All they required was a good credit rating and a business plan. It was almost too good to be true for both the issuers and the investors. The *ṣukūk* market suddenly saw an exponential growth with the issuance of multi-billion dollar *ṣukūk* offerings. Many jumbo-sized *ṣukūk*, including the following notable issues, have all been made possible by adopting the asset-light *ṣukūk* structure:

- USD1.4 billion *muḍārabah ṣukūk* by DP World, UAE
- USD2 billion *mushārakah ṣukūk* by JAFZ, UAE
- USD2.5 billion exchangeable *muḍārabah ṣukūk* by Aldar Properties, UAE
- USD3.5 billion convertible *mushārakah ṣukūk* by PCFC, UAE
- USD4.5 billion *mushārakah ṣukūk* by Binariang GSM, Malaysia.

24 *Id.* at 63: “Business Plan: it shall do, and not omit to be done, all other reasonable acts and things (including implementation of cash management, debt collection practices and provision of Sharia compliant funding (solely for the Agent’s own account and expressly without recourse to the *Musharaka* or the *Musharaka* Assets, except that, for the avoidance of doubt, the Agent shall be entitled to apply all or any of the Incentive Fees received by it towards repayment of such Sharia compliant funding) to ensure that the cash liquidity set out in the *Musharaka* Business Plan is at all times achieved) for the execution of the Business Plan.”

25 *Id.* at 8: “Additionally, DMCC undertakes to purchase all of the Units then held by the Issuer at the Exercise Price on the second Business Day after the date of the Exercise Notice given following the occurrence of a Dissolution Event.” See also Condition 11 thereof.

VI. THE BACKLASH FROM AAOIFI

In February 2008, the Sharīʿah Board of the Accounting and Auditing Organisation for Islamic Financial Institutions (“AAOIFI”), having deliberated on the various Sharīʿah issues raised by the asset-light *ṣukūk*, issued a ruling which effectively banned the asset-light *ṣukūk*. Unfortunately, the AAOIFI ruling, due to poor drafting, lacks clarity and fails to shed sufficient light on the rationale for the ban. (Usmani n.d).

The AAOIFI ruling is summarised as follows:

i) in order to be tradable, *ṣukūk* must evidence the ownership in Sharīʿah-compliant tangible assets (like real estate) and/or intangible assets like usufruct (e.g., leasehold rights) or services (e.g., toll road concessions);
ii) in order to be tradable, *ṣukūk* must not represent any receivables or debt unless the *ṣukūk* represents (i) the entire business of a Sharīʿah compliant trading company or an Islamic financial institution, or (ii) the portfolio of existing Sharīʿah-compatible tangible and/or intangible assets which incidentally also includes some Sharīʿah-compatible receivables;
iii) the *ṣukūk* agent cannot offer or procure any liquidity facility if the profits generated are insufficient to service the periodic distributions payable to the *ṣukūk* holders;
iv) neither the agent nor the partner in *wakālah*, *muḍārabah* or *mushārakah ṣukūk* is permitted to undertake, at maturity or upon an early dissolution of the *ṣukūk*, to buy the shares (or the shares’ underlying assets) of the other partner(s) at the initial face value. Such undertaking is however permissible if the price is based on the prevailing market value or fair value (if there is no market value) or at a price to be mutually agreed at that time; and
v) in *ṣukūk al-ijārah* however, the lessee is permitted to undertake to buy at the initial face value the leased assets from the lessor at maturity or upon an early termination of the lease provided the lessee is not acting as a partner, *muḍārib* or an investment agent of the lessor.

The above ruling has effectively put an end to the dramatic growth of asset-light *ṣukūk* issuances. Without an undertaking to

buy the shares of the *ṣukūk* holders at par value, it is impossible to issue an asset-light *ṣukūk*. Since the AAOIFI ruling in February 2008, there have not been any asset-light *ṣukūk* offerings in the market. It is however not quite obvious whether the lack of such offerings is due to the AAOIFI ban or the unprecedented credit crunch caused by the global financial crisis. It is hoped that the dearth of asset-light *ṣukūk* is due to the AAOIFI ban. The *ṣukūk* market was rather quiet in 2008 with hardly any significant *ṣukūk* offerings either in the Middle East or the Far East.[26]

VII. BACK TO BASICS

In the first half of 2009, the *ṣukūk* market witnessed some green shoots emerging. The Republic of Indonesia successfully issued its inaugural USD500 million *ṣukūk al-ijārah* which was oversubscribed to the tune of USD3 billion. The Kingdom of Bahrain also returned to the market to successfully issue another *ṣukūk al-ijārah* which closed at USD650 million. And in August 2009, Petronas, the Malaysian national oil company, also successfully issued its debut benchmark *ṣukūk al-ijārah* issue. The Petronas *ṣukūk* was launched at USD1.5 billion and was five times oversubscribed. Interestingly, all the three *ṣukūk* issues were structured as asset-based *ṣukūk al-ijārah* and carried fixed rental rates. Hopefully, the AAOIFI ban has played a key role in shifting the market away from asset-light *ṣukūk*. It is however still too early to declare the demise of the asset-light *ṣukūk* and only time will tell whether the market has taken the AAOFI ruling seriously. The success of the Indonesian, Bahrain and Petronas *ṣukūk* issues clearly demonstrates that the asset-based *ṣukūk* is still the most viable and attractive option to issuers. The shift to asset-based *ṣukūk* will certainly add more credibility to the *ṣukūk* market and help the industry to gradually progress towards a Sharīʿah-based financial system. The *ṣukūk* industry is still at its early stages and has a long way to go. Hopefully, its future path will be clear of asset-light *ṣukūk* issues.

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26 The total volume of new *ṣukūk* issues plummeted to USD14 billion in 2008 compared to USD50 billion in 2007. There were 11 mega-sized *ṣukūk* issues (in excess of USD1 billion per issue) in 2007 compared to only two in 2008.

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