Revisiting ISLAMIC BONDS

Are 85% of Sukuk Haram?

Part 2

By Michael Saleh Gassner

Throughout the regional Arab press, and even extending to the major financial mainstream media, doubts about the Shariah compliance of Sukuk, especially those issued in the Gulf, have been raised. In last month's column, we explored some of the current techniques that have been approved as compliant by contemporary Islamic scholars.

Now the Accounting and Auditing Organization for Islamic Financial Institutions is weighing in on the issue. In February, a major Arabian daily reported that the AAOIFI met on the issue and did not prohibit Gulf Sukuk, but the article revealed that key structuring elements had been abolished. A few days later, the AAOIFI itself published its decision in Arabic and English regarding the impermissibility of certain frequently used structuring elements in Sukuk, predominantly in Sukuk Al Musharaka, Sukuk Al Mudaraba and Sukuk Al Istithmar. This column explores the decision, why some scholars had dissenting opinions previously and the future of Sukuk.

Tightening Rules

First, the AAOIFI has explicitly demanded legal and lawful transfer of title (regarding both jurisdiction and permissibility under Shariah). This means that the compromise by some scholars to accept a transfer based on a sale contract that is not about to be properly legally registered is therefore not acceptable to the majority. This could raise substantial issues for Gulf Sukuk, where ownership on assets for foreigners is restricted, and the ultimate practice remains to be seen.

Second, the direct sales of receivables and revenues shall not be undertaken without the related business generating those returns, otherwise it is deemed unacceptable.

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Third, a coupon based on a cap of profits (max Libor plus margin) plus the undertaking by the issuer to grant interest-free credit for distribution in case of a shortfall in profits is no longer applicable. The interest-free credit needs to be replaced by another Shariah-compliant facility whereby the Sukuk holders are held liable. According to other jurists, distributions made based on interest-free credit just need to be made up properly in the end. From a practitioner's point of view, the coupon could still be generated via the highly criticised organised Tawarruq, a three-party sales arrangement leading to cash today against cash to be paid tomorrow, which resembles an interest-bearing loan.

Fourth, the method of capital protection has been that the issuer, as mudarib, sharik or agent, issues an undertaking to achieve the face value for the Sukuk issue. This practice is declared impermissible. A number of scholars allowed it previously in two cases:

1. When the purchase undertaking was meant for the underlying assets and not the units of the Sukuk being a sort of joint ownership and not a guarantee for monetary contribution.

2. When the assets would be destroyed, the purchase undertaking would not take place and could hence be differentiated from a general guarantee of the principal.

The majority of the AAOIFI scholars opined that obviously, the purchase undertaking had the character of a restricted guarantee of capital and is therefore impermissible.

Fifth, a lessee could purchase the leased asset at face value, meaning the Sukuk Al Ijara is exempt from any changes.

Sixth, the Sukuk should be supervised by the Shariah Board for the entire time to maturity, not only for review of the structure itself.

Last but not least, the Shariah Board of AAOIFI advised Islamic financial institutions to limit their dependence on lending and borrowing operations and to capitalize on real Musharaka transactions based on profit and loss sharing in a way that better achieves Shariah objectives. The Shariah Board in this way follows the view of many economists; however, a number of scholars do emphasize that debt-based modes of finance are permissible and that a general statement on the issue cannot be directly derived from Shariah.

Moving Forward

Summarizing the findings, decisions and different opinions, the Sukuk Al Ijara remains the most accepted structure from a Shariah perspective in the Gulf, while acceptance of the previous structures of Sukuk Al Musharaka, Al Mudaraba and Al Istithmar appear to be challenged. A major law firm has already announced that it has devised new structure elements for those Sukuk affected by AAOIFI's decision in order to once again create Sukuks that are more like bonds rather than equities, as the AAOIFI decision implies. The question is, Why is this bond-like behaviour is so sought-after?

A private investor can handle being exposed to asset price risk rather than to bond-like investments being paid back in USD or Euro with unknown future purchasing power. This covers the investor's future expenses in times when inflation knocks at the door; however, Islamic banks are much more in need of a variety of instruments improving asset and liability management. Sukuk based on Murabaha, Istisna or Salam are not very helpful, as Shariah does not allow trading of debt or liabilities at market value.

Is there a potential approach to bringing the objectives of Shariah and the nature of the contracts closer to the needs of contemporary regulation and banking infrastructure? Possibly yes. If capital protection shall no longer be achieved as before in Sukuk Al Musharaka & Co., then perhaps we can create a subordinated structure as a permissible technique.

This would move the industry a step closer to equity finance, while using the excellent technical infrastructure of the overly regulated and liquid debt markets. Structuring appears possible at first sight, and there will be appetite specifically for Islamic banks in the region for so-called Tier 2 capital, subordinated to debt, but preferred to shareholders' equity, as it would improve the debt-equity ratio for business expansion. This would follow the wisdom of gradual improvement, a well-established principle of Islam. If we achieve a liquid and significant market for subordinated Sukuk, it could increase the equity ratios and lead to a more stabilised economy. This could be a nice window of opportunity to give the region a lead in one financial market segment globally, while the major conventional debt markets are busy managing the credit crisis.