



A STUDY OF THE UNDERLYING ASSETS IN DEBT-
BASED *ŞUKŪK* STRUCTURE FROM THE *SHARĪ'AH*
PERSPECTIVE

BY

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ABSTRACT

Ṣukūk market has witnessed massive development in recent years, many governments and financial institutions expressed interest in *ṣukūk* and its unique Islamic principles. However, the securitization activities and the evolution of financial engineering process of fixed income *ṣukūk* have become very challenging in terms of its conformity with the principles of *sharī'ah* law. Asset based *ṣukūk* which includes debt securitization that evidences indebtedness originating from the contract of exchange of *bay' bi thaman ājil*, *murābahah*, *istiṣnā'*, *salam* and *ijārah ṣukūk* are seen by many scholars as controversial products. This is due to many issues surrounding the securitization process of the underlying assets used in debt based *ṣukūk* structures such as non-existent assets and future assets (*ma'dūm*), tangible and intangible assets usufruct and rights. *Bay' al-'īnah* and *dayn* are also among the controversial issues analyzed in this study. The evolution of *ṣukūk* structures still remain active and continue to grow despite all the challenges. The meaning of tangible and intangible assets according to their linguistic origin and their various applications in Islamic law are explained and contrasted with the contemporary applications and *ṣukūk* practices. Special attention is given to understanding the concept of futures assets and *'ayn ma'dūm* to ascertain whether or not they are acceptable asset for *ṣukūk* transaction. Several forms of Islamic contracts are analyzed in details; couple with their various components in order to assess their validity based on the various opinions of the four main schools of Islamic thought. In this, the differences between schools are identified along with the sources of these differences. The finding of the research shows that asset in debt based *ṣukūk* should be legally owned by the originator and should be free from any encumbrances. Debt based *ṣukūk* certificates may only be negotiable in the secondary market if they form a small part of a larger portfolio comprising mostly of other negotiable instruments such as *mushārahah*, and *muḍārabah ṣukūk*. *Ijārah asset* should be legally transferred to investors and the issuer should not in any circumstance include the asset in his balance-sheet.

خلاصة البحث

إن الصكوك الإسلامية شهدت ولازالت تشهد تطورا كبيرا في السنوات الأخيرة، فالكثير من البنوك والدول العظمى تتحدث اليوم عن إنشاء الصكوك الحديثة تحت قواعد وضوابط الشريعة الإسلامية الغراء. ومع ذلك فإن تقدم عملية التصكيك وبالأخص الصكوك المبنية على أرباح ثابتة أو المبنية على الديون لاتزال تواجه مشاكل فيما يتعلق بمطابقتها بالتعاليم والقواعد الشرعية. إن الصكوك المبنية على الأصول المتعلقة بالديون التي تجني ثمارها عبر عقود المعاوضات مثل البيع بثمن آجل، مراحة، إستصناع، سلم وإجارة، تعتبر عرقلة على رأي كثير من المتخصصين، وذلك لأجل القضايا المتعلقة بالأصول المستخدمة في عملية التصكيك. فالأصول المستخدمة تتكون من الأصول المعدومة، الأصول المستقبلية، الأصول المستقرة، الأصول غير مستقرة، المنافع، والحقوق. وكذلك بيع العينة والديون. كل هذه الموضوعات تمت مناقشتها في هذا البحث. ولا تزال هيكله الصكوك في تطور رغم كل المعوقات والتحديات. وقد تناول البحث معاني الأصول المستقرة وغير مستقرة وتطبيقاتها في هياكل الصكوك الإسلامية. كذا الأصول المستقبلية والمعدومة لمعرفة ما إذا كانت مقبولة كأصل من أصول الصكوك أم لا. كما تفحص البحث العديد من العقود التجارية الإسلامية للتأكد من صحتها من خلال النظر إلى آراء المذاهب الأربعة، مع إيضاح ماورد من إختلافات فقهية فيها وأسبابها. وهذا يوضح جليا الإختلافات الأساسية بين المذاهب للوصول إلى نتائج مهمة في عقود المعاملات التجارية الإسلامية. ونتائج البحث تشير إلى أن الأصول المستخدمة لإنشاء الصكوك المبنية على الديون لابد أن تكون مملوكة شرعا لدى مصدر للصكوك. وأن الصكوك المبنية على الديون لايمكن أن تباع في الأسواق الثانوية إلا إذا تضمنت جزءا من الأصول الأخرى من الصكوك التي ليست مبنية على الديون، مثل صكوك المضاربة، أو المشاركة. الأصول المستخدمة في صكوك الإجارة لابد أن تنقل إلى مشتريها من المستثمرين، وأن المصدر لاينبغي له أن يضم الأصول إلى ممتلكاته الشخصية بعد عقد البيع.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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**UNDERLYING ASSETS IN DEBT-BASED *ŞUKŪK* STRUCTURE
FROM *SHARĪ'AH* PERSPECTIVE**

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*This thesis is dedicated to my mother **Balkisu Harun** whose endless compassion and care continues to restore positive in fact in my life. And to my humble Father **Alhaji Adam Sa'ad**, whom I enjoyed his full support toward my entire School life. And to my wife **Aishatu Aliyu Ahmad**, for her eternal love and patience during this study. And also to my lovely children **Fatima, Abdur-Rahman** and **Zainab** whose presence made the life during this study a beautiful and memorable one. I ask the Almighty Allah to reward and guide them all in their future endeavours and grant them Jannah in the hereafter.*

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BBA	<i>Bay' bi thaman ājil</i>
ABS	Asset-Backed Securities
SPV	Special Purpose Vehicle
ICM	Islamic Capital Markets
IDB	Islamic Development Bank
RAM	Rating Agency of Malaysia
BNM	Bank Negara Malaysia
BAIDS	<i>Bay' bi thaman ājil</i> Islamic Debt Securities
IDS	Islamic Debt Securities
BOT	Built Operate and Transfer
GOM	Government of Malaysia
PLUS	Projek Leburaya Usahama
FSRA	Finance Service Reserved Account
PBSB	Penang Bridge Sdn Bhd

LIST OF REGULATIONS AND GUIDELINES

Accounting and Auditing Organization of Islamic Financial Institutions (AAIOFI Standards)
Central Bank of Malaysia Act 2009
Bank Negara Malaysia Guideline, i. e. Garis Panduan (GP)
Capital Markets and Services Act 2007 (CMSA)
Companies Act 1965 (CA)
Foreign Investment Committee Guideline (FIC)
Government Investment Act, Amendment (2005)
Guidelines on the Offering of Private Islamic Debt Securities-2000
IFSB *Shari'ah* Guidelines
Islamic Financial Services Act 2013
Securities Commission Act 1993

TABLE OF TRANSLITERATION

CONSONENTS			
Arabic	English	Arabic	English
ء	'	ظ	Ḍ
ب	B	ط	Ṭ
ت	T	ظ	Z
ث	Th	ع	'
ج	J	غ	Gh
ح	H	ف	F
خ	Kh	ق	Q
د	D	ك	K
ذ	Dh	ل	L
ر	R	م	M
ز	Z	ن	N
س	S	و	W
ش	Sh	ه	H
ص	Ṣ	ي	Y

Vowels			
Short Vowels		Long Vowels	
أ	A	آ	Ā
إ	I	إي	Ī
أ	U	أو	Ū

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE RESEARCH

Ṣukūk is an Arabic term that means securities and is the plural of *ṣakk*. The literal meaning of *ṣukūk* is certificates. Technically, the term *ṣukūk* refers to securities, notes, papers, or certificates with features of liquidity and tradability.¹ It can also be defined as documents or certificates which represent the value of an asset.² This definition was criticized by Islamic finance scholars for being incomplete and not specifying other types of assets that *ṣukūk* symbolizes. Thus the assets may include financial assets such as receivables and debt as well as non-financial assets in the like of tangible assets, usufruct and services. *Ṣukūk* has also been defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAIOIFI) as: “Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activity”, however this is true after receipt of the values of the *ṣukūk*, the closing of subscription and the employment of funds received for the purpose for which the *ṣukūk* were issued”³ *Ṣukūk* under this definition represents tangible assets, usufruct, services and assets of particular projects or special investment activity.

Ṣukūk as applied to Capital Markets pertains to the process of securitization. Securitization is the financial engineering process of fixed or floating income securities, where payment of principal and profits are derived from the cash flow

¹ Securities Commission Malaysia, *The Islamic Securities (Ṣukūk) Market*, (Kuala Lumpur: Lexis Nexis 2009), at 8.

² Ibid.

³ AAIOFI *Shari‘ah* Standard 17(2) 2007.

generated by the indebtedness that it represents, or from the receivables or revenue derived from the pool of assets that underline the transaction in the issuances of the securities.⁴

Ṣukūk can be classified into asset-based and asset-backed securities. Asset based *ṣukūk* includes debt securitization that evidences indebtedness originating from the contracts of exchange of *bay' bi thaman ājil* (BBA), *murābaḥah* and *istiṣnā'*, arising from back-to-back sales of the issuer's assets.⁵ Such *ṣukūk* gives the holders the rights to the obligations attached to the indebtedness. It also includes financial *ijārah* contracts, through the sale and leaseback or lease of third party held acquired assets, which come with purchase-option obligation (financial lease).⁶ Asset based *ṣukūk* shows the conversion of future *sharī'ah* compliant cash receivables arising from contracts such as *murābaḥah*, *bay' bi thaman ājil* and *istiṣnā'* into tradable debt instruments. In Malaysia, non-tangible assets in the form of receivables are accepted for use as the underlying asset for *ṣukūk* issuances, provided they are transacted on a cash basis (on the spot) to avoid *bay' kāli' bi al-kāli'* (sale of debt for debt).⁷

Asset-backed *ṣukūk* (ABS) is a securities-formation process for capital-market instruments, i.e. *ṣukūk*, of equal value that represent an undivided interest in the ownership of an underlying *Sharī'ah* compliant cash flow-generating asset.⁸ A Special Purpose Vehicle (SPV) held and managed by a trustee will legally be under the control of the holders of the securities or *ṣukūk* will own the asset under a true sale arrangement. The function of the SPV is therefore to hold the asset on behalf of the

⁴ Ram Rating Services Bhd, *Malaysian Ṣukūk Market Hand Book, Your Guide to the Malaysian Capital Market*, (Kuala Lumpur Ram Reating Sdn Bhd, 2008) , at.23.

⁵ Ibid. at.29.

⁶ Ibid.

⁷ Ibid. at.30.

⁸ Ibid. at.31.

investors or *ṣukūk* holders, by way of a trust deed created over the assets.⁹ The relationship between the *ṣukūk* investors is in the form of a collective investment contract, either *mushārah* or *muḍārah* although these types of *ṣukūk* will not be accommodated in this research; what this research will concentrate on is Asset based *ṣukūk* which is debt securitization that evidences indebtedness originating from the contracts of exchanges of *murābahah*, *bay' bi thaman ājil*, *ijārah salam* and *istiṣnā'*.

The Malaysian *ṣukūk* market experience is a great example of asset securitization of debt-based *ṣukūk*. In its first *ṣukūk* issuance in 1990, Shell MDS Sdn Bhd issued the first Ringgit denominated *ṣukūk*, which was structured based on *bay' bi thaman ājil*.¹⁰ Furthermore, from 2001-2003, *ṣukūk* issuances in Malaysia were guided by the *Guidelines on the Offering of Private Islamic Debt Securities-2000*. Based on these guidelines, *ṣukūk* became restricted to instruments issued after a securitization of debt arising from the contracts of *murābahah*, *bay' bi thaman ājil* and *ijārah*.¹¹

In 2007, 22 percent of the Malaysian *ṣukūk* markets (worth RM13.8billion) were issued based on *murābahah* and *bay' bi thaman ājil* principles as approved by the Securities Commission of Malaysia.¹² Such securitization has been highly criticized by *Shari'ah* Scholars outside Malaysia. However, the Securities Commission took proactive steps by issuing the *Guidelines on the Offering of Islamic Securities -2004*, which incorporated *muḍārah* and *mushārah ṣukūk* and stipulated the necessity of enhancing the structures of *ṣukūk* in Malaysia. As of December 2010, the Securities Commission of Malaysia has approved *ṣukūk* based on various *Shari'ah* principles such as equity based *mushārah* 42.1% *ijārah* 34% and

⁹ Ibid.

¹⁰ Ram Rating Agency *Malaysian Ṣukūk Handbook*, 2008 at.5.

¹¹ Ibid.

¹² Securities Commission's Annual report 2007.

muḍārabah 0.6% likewise debt based such as *murābahah* 8.2% Combination¹³14.9% and BBA 0.2%.¹⁴

However, as of November, 2015 the *ṣukūk* issuances in Malaysia have changed tremendously as illustrated below:

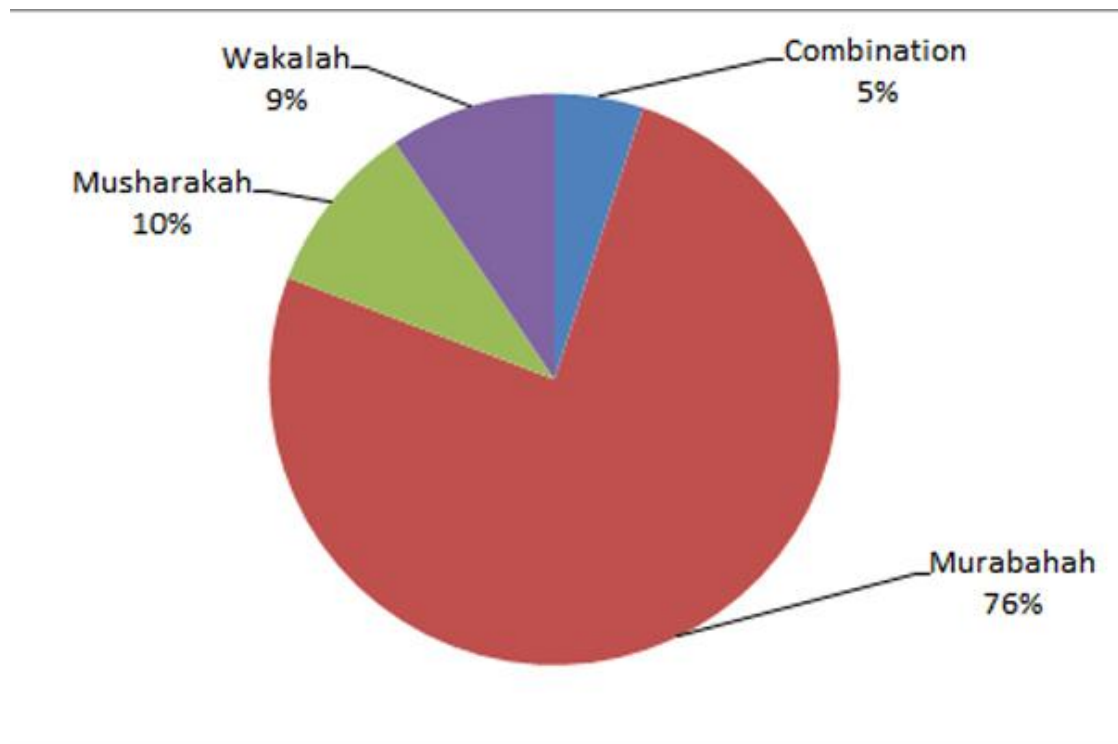


Figure 1.1 *Ṣukūk* Issuances in Malaysia
Source: Securities Commission Malaysia.

According to an interview¹⁵ session conducted with Prof. Dr. Engku Rabiah¹⁶ for better understanding of the current development of debt based *ṣukūk* in the market she demonstrates that there appears to be a degree of instability regarding percentage

¹³ Combination between Multiple *Sharī'ah* principles issuances including commodity *Murabahah*.

¹⁴ Securities Commission Malaysia "*Malaysia ICM 2010*", vol.5 (December, 2010) : 4.

¹⁵ Prof. Engku Rabiah Adawiah Bt Engku Ali, interview by author, Gombak, Selangor, 23 November 2013.

¹⁶ Prof. Dr. Engku Rabiah Adawiah Bt Engku Ali, Professor of *Sharī'ah* Law, Ahmad Ibrahim Kulliah of Laws IIUM, a member of the *Sharī'ah* Council of Central Bank of Malaysia and one of the *Sharī'ah* advisers of the Securities Commission of Malaysia.

of debt based *ṣukūk* structure in the Market. In 2006/2007, *mushārah* contracts dominated the Market. However, after AAIOFI's announcement on some of the *muḍārah* and *mushārah* and *wakālah bi istithmār ṣukūk* the market adjusted accordingly to the effect that the features of fixed income as a purchase undertaking and investor assurance of return through liquidity facility may have encouraged investors, but after the announcement all these, fixed income features disappeared and the market adjusted accordingly.

The assets used to structure *ṣukūk* are classified into two different types; tangible and intangible assets. Tangible assets are those that have physical substance and can be physically controlled such as currencies, buildings, real estate, vehicles, inventories, equipment and precious metals.¹⁷ Intangible assets lack physical substance and are usually very hard to evaluate. They include patents, copyrights, franchises, goodwill, trademarks, trade names and so on.¹⁸ The process of using asset as collateral in assets securitization to facilitate the issuance of an instrument of value is part of the principle of *māl* (wealth) in Islam.

Māl (wealth) refers to anything valuable and can be legally used according to the principles of *Sharī'ah*. The differences between assets depend on the features prohibited by *Sharī'ah*, which simply means items such as pork and liquor will not be considered as *māl* according to the *Sharī'ah*. However, some differences of opinions on the definition of *māl* exist between the Ḥanafī School of thought and the majority of the Islamic Schools of thought. According to definitions given by the Ḥanafī Scholars, which will be discussed in details later, *māl* is something appreciated by

¹⁷ Wikipedia <http://en.wikipedia.org/wiki/Asset> Thursday 02/06/2011 @ 09:20PM.

¹⁸ Ibid.

human nature and can be used and kept for another usage.¹⁹ This definition excludes some important items from consideration as *māl* because they are not touchable and they cannot be kept, such as usufruct, debt and some invaluable things. Furthermore, today there are a lot of things which are considered *māl* but are not appreciated by humans such as bio medical weapons used to destroy lives. However the definition given by the majority *jumhūr* has given the widest meaning of *māl* which includes the items mentioned earlier. This leads to the understanding that the concept of *māl* depends on the custom *‘urf* and could be varied according to the time and place.

This research will be focusing on four major *Sharī‘ah* issues surrounding the underlying assets used to structure debt based *ṣukūk* as follows: the theories of *Sharī‘ah* on *māl* (*al-ḥuqūq al-māliyyah*), the *Sharī‘ah* theories on tangible assets, (*‘ayn ḥāḍir*) and also the *Sharī‘ah* theories on intangible asset (*‘ayn mustaqbal*) and nonexistent assets (*‘ayn ma‘dūm*). These issues are very important because they are surrounded with *Sharī‘ah* rulings that need to be given attention, as well as some *Sharī‘ah* questions need to be resolved to pave the way to a clearer understanding of *Sharī‘ah* compatible *ṣukūk* structures.

1.2 OBJECTIVES AND AIMS OF THE RESEARCH

This research aims to achieve the following:

- (1) To examine the perspective of *Māl* in the underlying assets of debt based *ṣukūk* structures.
- (2) To investigate the *Sharī‘ah* compatibility of tangible and intangible assets in debt based *ṣukūk* structures.

¹⁹ Ibn ‘Ābid Muhammad ‘Alā‘uddīn al-Afandī, *Ḥāshiyat rad al-mukhtār ‘alā dār al-mukhtār*, (*Dār al-fikr li al-ṭibā‘ah wa al-nashr*, Beirut, 2000), vol.4 at.510.

- (3) To provide *Sharī'ah* understanding on the issues and challenges on possession and the sale of tangible and intangible assets in debt based *ṣukūk* structure.
- (4) To propose potential asset to be used as an underlying asset in structuring debt based *ṣukūk*.

1.3 STATEMENT OF PROBLEM

Debt based *Ṣukūk* is one of the most controversial *ṣukūk* issuances, there is no certainty whether the assets used to structure debt based *ṣukūk* have satisfied the *Sharī'ah* requirements of *māl* (wealth) or not. Debt based *ṣukūk* is dealing with non-existent assets and according to the Prophetic traditions a property should not be sold prior to taking over or delivery. Debt based *ṣukūk* includes sale of debt, future assets, non existing assets, tangible and intangible assets which most of them were sanctioned by the general rules of *Sharī'ah* except where applicable. This research will be investigating such assets and look at the possible ways to make sure the assets used to structure debt based *ṣukūk* are in line with the precise rules of *Sharī'ah*.

1.4 RESEARCH QUESTIONS

This research will be answering the following questions:

- 1- Has the *Sharī'ah* perspective on *māl* (wealth) been observed in the underlying assets used to structure Islamic Debt based *ṣukūk*?
- 2- Is the current use of tangible asset as an underlying asset *Sharī'ah* compliant?

- 3- Does the usage of intangible, future and nonexisting assets as an underlying asset of *ṣukūk* comply with the precise rules and regulations of *Sharī‘ah*?
- 4- What are the *Sharī‘ah* rulings on possession and trade of tangible and intangible assets?
- 5- Does the trade of Islamic Debt based *ṣukūk* comply with *Sharī‘ah* ?

1.5 HYPOTHESIS

The existing applications of different types of assets which include tangible and intangible assets in structuring Islamic debt based *ṣukūk* are *Sharī‘ah* compliant, this is according to the precise rules and regulations of the classical *Sharī‘ah* theory. Some scholars have criticized *ṣukūk* due to unresolved issues including the ownership of *ṣukūk* asset and transfer of that ownership to the *ṣukūk* subscribers. The dispute also arises whether it can be regarded as *māl* or not, and whether intangible assets can be regarded as debt or *‘ayn*. Similarly the dispute also arises on issues surrounding future and non-existing assets *‘ayn ma‘dūm*, such critics raise the *Sharī‘ah* questions that have already been discussed in the classical writings of Islamic prominent scholars from the four Islamic Schools of Jurisprudence. This would help to understand the Islamic compatible process of securitization which would lead to the issuance of Islamic compatible debt based *ṣukūk*. The researcher hypothesizes that generally the current applications of different types of assets in structuring Islamic debt based *ṣukūk* are deemed *Sharī‘ah* compliant. However, additional components are necessary to ensure the compliant of Debt Based *Ṣukūk* in the Islamic capital markets.

1.6 LITERATURE REVIEW

Different types of books, articles, thesis and papers have been written on the topic. The literatures mentioned below are to be examined in order to understand their contributions and relationships to the current study as well as unpardonable gaps that need to be filled.

Ṣukūk has proved to be one of the most essential instruments for fund raising, investment purposes and infrastructure development. The role of *ṣukūk* in the capital market has now become more identifiable. However, developing *ṣukūk* market is very challenging and complex, it requires a strong regulatory and Government policy support. *Ṣukūk* will be less challenging if factors such as *Shari'ah* framework, innovation, and secondary market activities are duly addressed. *Ṣukūk* underlying assets must be *Shari'ah* compliant. For example, a building does not qualify as an underlying asset for *ṣukūk* if the major tenant operates a conventional banking in it, an activity that is prohibited under the Islamic law. However, some other views demonstrate concern based on the contract itself, if the contract is valid such as the contract of *ijārah* in this case, then the asset's return is *ḥalāl* in the *ṣukūk* operation, disregarding the tenant's source of income. This view demonstrates that the prophet (peace be upon him) used to engage in contracts with Jews despite their involvement in *ribā* and gambling activities.²⁰

Structuring Islamic debt securities includes a sale of assets based on the Islamic principles of *murābaḥah*, *bay' bi thaman ājil* or *istiṣnā'* and *salam*. There is a notable concern on the aspect of the Islamic conception of sale contract and its implications in the Islamic financial Markets. It is apparent that *Shari'ah* has allowed the exchange of “similar for similar” in *riba* bearing items which has to be done in spot mode without

²⁰ Abdulkadir Thomas , *Ṣukūk, Islamic Capital Market Series*, (Sweet & Maxwell Asia, 2009). At 1