



Challenges in Making Sukuk Shariah Compliant

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*(views expressed are personal)

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DEFINITIONS AND BASIC CONCEPTS

- By “**financial instrument**” I shall mean a **negotiable certificate representing some ownership right. Negotiability means transferability at any mutually agreed price.**
- Sukuk are financial instruments that are income-generating. To be Shariah-compliant they must be based, wholly or mainly, on **ownership in real (i.e. tangible) assets.**
- Most **sukuk** structures are based on leased real assets. Other structures are possible but will not be considered here.

Distinguishing a mode of finance from a financial instrument

- Sale for a deferred price (*bay'' bithaman muajjal*) is an Islamic mode of financing that is income-generating, as it includes the seller's profit, but cannot be used directly to create a financial instrument. This is so because the I.O.U. given by the buyer to the seller represents money debt, and as such is **not negotiable** in Shariah. Such debt cannot be discounted or sold for a price different from its face value. It is however transferable **at face value**, through *hawalah*, but this does *not* render it negotiable in the above sense.

Negotiability is the basis of liquidity

- **Negotiability** is clearly the basis of liquidity of a **financial instrument**, and is granted by Shariah only to those willing to **own real assets**. But **real ownership** (just like real marriage!) comes with attendant risks and rewards.

Real Assets vs. Financial Claims

- Shariah rules in the Holy Quran and Sunnah of the Prophet, peace be on him, and Muslim jurists throughout history, clearly differentiate between money and credit on the one hand, and real or tangible assets and services on the other.
- Modern economic theorizing has awakened to that important distinction. (Nobel laureate Joseph Stiglitz deems this differentiation a cornerstone to correct understanding of monetary economics and policy).

Most **sukuk** are structured on tangible **leased** assets

- But all leases are not born equal!
- Modern finance recognizes the differences between Financial and Operating leases. So does the tax man and the International Accounting Standards.
- The rulings of International Fiqh Academy of OIC, and the standards of AAOIFI in Bahrain are all meant to apply to Shariah-compliant **operating leases**. They don't approve conventional financial leases. So it is important to underscore the differences between these two types of leases.

A Financial lease -1

- A Financial lease (also called capital lease) is usually finances equipment or buildings for the major part of its useful life, and there is **a reasonable assurance that the lessee will obtain ownership of the equipment by the end of the lease term.**

A Financial lease -2

- A financial lease, usually **transfers the risks and rewards of ownership to the lessee. It is usually treated as a sale by the lessor and as a purchase by the lessee.** Thus a financial lease has similar characteristics to a term loan and a conditional sales contract. It is usually booked as receivables in the lessor's accounts.
- In between these two polar cases are many varieties of leases that may be classified differently by accounting standards , national commercial codes, tax authorities, and lately, by fiqh academies.

Operating leases in conventional finance and in Islamic fiqh

- An operating lease, **OL** , usually finances equipment or buildings for less than their useful life, and at the end of the lease term the lessee can return the equipment to the lessor without further obligation.
- This is the old standard lease known in all societies and the type addressed in classical Islamic fiqh.
- In **OL**, the risks and rewards of owning the asset remain with the lessor. Accordingly, the asset is not treated as sold by the lessor to the lessee but **remains on the lessor's balance sheet**.

Important Consequences

- Whether a lease is deemed an operating or capital lease has far reaching consequences for the lessor, lessee and third parties, all the more so under Islamic fiqh rules.
- We must know what type of lease we are considering and whether it meets the standards for its type.

Islamic Operating lease standards -1

Conditions for Shariah compatibility as adopted by the International Fiqh Academy, and AAOIFI:

I list four main conditions (A) to (D), the last of which is violated in my view by many sukuk, with significant consequences.

(A) Risk of loss or destruction of leased asset, unless caused by lessee's negligence or misconduct, must be borne by lessor, who may insure himself in a Shariah compatible manner.

Islamic Operating lease standards -2

- **(B)** Maintenance : operating maintenance can be made the responsibility of lessee. However : major maintenance must be born by the lessor. The underlying Shariah principle of justice seems to be : lessor should not be enriched at the expense of the lessee beyond the term of lease.
- **(C)** While the leased asset is not providing its usufruct as in (A) or (B), rentals must be suspended or adjusted as the case may require.

Islamic Operating lease standards -3

(D) The lessor may NOT require lessee to repurchase the asset at cost or at a predetermined price.

This condition has been compromised in most Sukuk including those issued by IDB, Bahrain, Qatar and others, where repurchase at original price is the rule rather than the exception. This is a major Shariah lapse in my view and that of many other economists and Shariah scholars. The consequences are serious.

Consequences of stipulating repurchase of leased-asset at original price

- Stipulating **repurchase by lessee of the leased asset** guarantees the principal to the provider of finance(lessor), hence **transforms his funds from fiqh point of view into a loan**. In fact this is also the point of view rating agencies such as Standard and Poor (see e.g., Kristel Richard “ A closer look at Ijarah Sukuk”) who treat such sukuk as secured debt. Two serious consequences follow:
 1. Any stipulated return on a loan is prohibited *riba* in Shariah.
 2. The operating lease on which Sukuk where based becomes virtually a financial lease, which qualifies as “receivables”, not as real negotiable asset. Sukuk based on it are not negotiable, hence illiquid.

Conclusion

- To have true Shariah acceptability, we have to work harder at the substance not merely the form of Sukuk.
- Sukuk, though undoubtedly a welcome and important Islamic financial innovation with great potential, are still best viewed as “ project under construction”, to be developed further to fully conform to Shariah standards.

Thanks for your attention

Wa assalamu alaikum.