Development of Sukuk: Pragmatic and Idealist Approaches to Sukuk Structures[1]

A. Saeed[*]

O. Salah[**]

Interest; Islamic finance; Securities

Introduction

Sukuk are Islamic securities that are often translated as "Islamic bonds". However, the term "Islamic bond" does not entirely cover the substance of *sukuk*. A closer look at *sukuk* shows that *sukuk* have elements that might resemble both shares and bonds, depending on the applicable underlying Islamic financial contracts and structures. In this article, we will outline the backgrounds of *sukuk* providing a better understanding of *sukuk* as Islamic financial instruments. This discussion illustrates a discrepancy between the idealist approach towards *sukuk* structures, i.e. how this financial product ideally should be structured from a Shari'ah perspective, and between a pragmatic approach to it, i.e. how it is structured in practice.

In order to place *sukuk* in context, first some concepts associated with *Shari'ah* that are relevant to any conceptualisation of *sukuk* will be briefly mentioned. These include key sources of *Shari'ah* as well as concepts of *ijtihad*, *riba* and *gharar*. A historical overview of *sukuk*, then, will be provided with particular focus on the origins of the word "*sukuk*", its use in medieval times and the recent history of *sukuk*, known today as instruments of capital markets. Finally, the development of several forms of *sukuk* will be described explaining a number of structures and mechanisms that have been developed in practice over the years, highlighting the tension between the idealist and pragmatic approaches towards *sukuk* structures today.

Shari'ah: Basic foundations of Islamic finance and sukuk

The *raison d'être* of *sukuk* lies in the *Shari'ah*. *Shari'ah* literary means "the way" and it is generally understood to be the body of Islamic religious law. Islamic law in the context of Islamic finance does not refer to the black-letter law of a particular jurisdiction. Instead, what is meant is a set of religious and moral principles, concepts and rules as developed throughout Islamic history based largely on the Qur'an and *Sunnah*. *Fiqh* (often translated as Islamic jurisprudence) is knowledge of the practical regulations and rules of the *Shari'ah* acquired by reference to and detailed study of the sources.[2] Banking and financial activities form part of the economic activities within one area of *fiqh* called *fiqh al-mu'amalat*.

Sources of Shari'ah

In accordance with the classical theory of Islamic jurisprudence there are two primary sources and a range of secondary sources of Islamic law. The primary sources are the Holy Scripture of Islam, the Qur'an, which was revealed to the Prophet Muhammad. Some 80 verses of the Qur'an refer to strictly legal matters, although there are doubts as to whether the legal injunctions in these verses are obligatory or permissive.[3] After the Qur'an, the second most important source is the *Sunnah* (the normative behaviour of the Prophet) as documented in the *hadith*. The secondary sources include *ijma'* (the consensus of the scholars), and *qiyas* (reasoning by analogy).

Ijtihad is often referred to as a secondary source of Islamic jurisprudence. However, *ijtihad* is not strictly a source of law, but it is rather a method by which the *mujtahid* recognises and makes known the legal meaning of the texts and rules of the Qur'an and *Sunnah*. While the *mujtahid* has the necessary freedom to propose interpretations of such texts and rules, it is only when the interpretations are supported by a subsequent *ijma'* (consensus) that they attain the necessary authority in Islamic law. *Sukuk*, for example, are not referred to in the Qur'an or in the *Sunnah*. The ideas that have been developed in relation to *sukuk*, how they are to be structured and their use are the result of *ijtihad*. Given the importance of *ijtihad* for any exploration of *sukuk*, a discussion of the concept of *ijtihad* is warranted.

Ijtihad

The classical view of ijtihad

Ijtihad is the process, as well as the mechanism, by which the law revealed in the Qur'an and *Sunnah* may be interpreted, developed and kept alive in line with the intellectual, political, economic, legal, technological and moral developments of society. Since the rules and instructions provided in the Qur'an and *Sunnah* are limited in number, and Muslims face new situations and

[1] This article has been published in M. Ariff, M. Iqbal, and S. Mohamad (eds), *The Islamic Debt Market for Sukuk Securities: The Theory and Practice of Profit Sharing Investment* (Cheltenham: Edward Elgar Publishing, 2012) and has been reprinted with kind permission of the publisher.
[*] Professor A. Saeed is Sultan of Oman Professor of Arab and Islamic Studies and Director of the National Centre of Excellence for Islamic Studies, University of Melbourne, Australia.
[**] O. Salah, LLM, is lawyer (advocaat) at De Brauw Blackstone Westbroek N.V. in Amsterdam, PhD Candidate at Tilburg University, and Junior Fellow of the European Banking Center in the Netherlands.
[2] S. H. Nasr, *The Heart of Islam: Enduring Values for Humanity* (New York: HarperOne, 2002), p.123.
[3] D. Pearl, *A Textbook on Muslim Law* (London: Croom Helm, 1979), p.1.

problems at all times and in all places, the revealed law may not always be able to provide specific answers. This ultimately determines the necessity for *ijtihad* and makes it an essential instrument in the development of Islamic law. In relation to *sukuk* it is possible to argue that ideas about *sukuk* also developed today in such a context. The need for funding through the capital markets required an Islamic alternative to conventional bonds. Through the exercise of *ijtihad*, the contemporary scholars—together with bankers and lawyers—developed *sukuk* as a *Shari'ah*-compliant alternative to conventional bonds.

Taken broadly, *ijtihad* began as an extremely flexible institution among the first two to three generations of Muslims. It then gradually became more rigid with the development and "writing down" of the *Shari'ah* sciences like *hadith*, exegesis, law, theology, history and *usul al-fiqh* (principles of jurisprudence). In particular, Imam Shafi'i's success in formulating and propagating his *usul* and the further development of the usul by later scholars led to a gradual decline in the flexibility available to scholars of all persuasions. The early lack of formalism in the first century of *hijra* thus gave way to a more systematic, formal and rule-governed method. By the 4th century AH, *usul al-fiqh* methodology was well-established in Islamic legal scholarship and, by the end of the 6th century, had reached its zenith in the works of eminent scholars such as al-Juwayni (d. 478 AH) and al-Ghazali (d. 505 AH). In the following centuries, serious attempts to question major aspects of *usul* were only made in rare cases.[4]

Ijtihad in the modern period

Ijtihad remained, from then on until the modern period, a formalistic, legalistic and literalistic practice. In the 19th and 20th centuries CE, faced with Western concepts such as rationalism, historical criticism, development, nationalism and human rights, many Muslims, with varying degrees of skill in Islamic scholarship, began to question the suitability of the existing methods of *ijtihad* in Islamic scholarship. This new-found awareness and critical attitude is now widespread throughout the Islamic world. Considerable diversity exists and it would be foolish to claim that the concerns and perspectives of Muslim scholars throughout the world are one and the same. Local circumstances have a strong influence; internal and external threats, demographics, levels of development, contact with different cultures, educational opportunities, all vary. Scholars differ in their perceptions of the social, economic, political and legal problems facing their respective communities.

Today, three different forms of *ijtihad* can be identified. The first one is the text-based *ijtihad*. This is the method of *ijtihad* generally recognised in the classical period and still practised in traditional Islamic legal scholarship. It is based on the foundational texts as well as *ijma'* and *qiyas*, and relies on the rules and principles of *usul al-fiqh*. For the scholar, each new legal problem should be seen largely in isolation and does not have to be considered an element of a whole system. When a new problem emerges, the scholar identifies relevant texts of the *Shari'ah* and attempts to apply the rules of *usul al-fiqh*. The new problem is then linked to an earlier ruling or a text and a decision is made as to its *Shari'ah*-compliance or otherwise. The text could be a verse of the Qur'an, a *hadith* or a view of an imam. Literal reading of texts, strict application of the rules of *usul* and heavy emphasis on conformity and traditionalism are the hallmarks of this method.

Another form of *ijtihad* is referred to as eclectic *ijtihad*. In eclectic *ijtihad*, the scholar faces a problem or issue and must decide whether or not it is acceptable from an Islamic perspective. Often, the scholar is convinced of the *Shari'ah*-compliance of the issue and then attempts to justify his position by selecting texts such as verses, *hadith* or views of imams that support the scholar's preconceived position. Such a method is *ad hoc*, opportunistic and does not systematically follow principles or rules. No consideration is often given to *usul al-fiqh* methodology and the scholar often ignores possible textual or historical evidences to the contrary. As far as intellectual honesty is concerned, this is the most hazardous and problematic approach of all: hazardous because it has no clear boundaries, signposts or methods that can be conceptualised and followed. A number of examples of eclectic *ijtihad* are found in the emerging areas of Islamic economics, banking and finance as well.

The third form of *ijtihad* is the context-based *ijtihad*. Although it existed in an undeveloped form in early Islam, context-based *ijtihad* should be seen as a relatively new phenomenon. It is distinguished by the fact that it attempts to understand a problem in both its historical and modern contexts. If a problem emerges for which an Islamic view is needed, the scholar first looks carefully at the problem, identifying its features, purpose and function or role in today's society. If it is found that a related or similar problem existed in the time of the Prophet, the scholar will examine the historical problem (precedent) exactly as he would for the modern one. In this the scholar is often guided by the concept of *maslaha* (generally translated as "public interest" or "common good"). The scholar is less concerned with the outward "form" of the problem, historical or modern. More emphasis is placed on the underlying objectives of the *Shari'ah* in relation to the problem, such as fairness, justice and equity. A decision will then be made as to the attitude Muslims should adopt vis-à-vis the problem in today's environment. In context-based *ijtihad*, the scholar is not interested in specific *ijma'* formed in the classical period, or in certain *usul*-based tools like *qiyas*, but mainly

[4] Notable exceptions are 'Izz b. Abd al-Salam's (d.660AH) and Shatibi's (d.790AH) attempts to understand the problem of *ijtihad* from a *maqasid* (objective) perspective without antagonising the agreed upon principles of *usul*. The Hanbali jurist Najm al-Din al-Tufi (d.716AH) is another exception. He went beyond any other jurist and declared that it is the *maslahah* (public interest) which should determine what is Islamic and what is not. Contrary to the generally accepted view, he argued that the *maslahah* could override even a clear text of the Qur'an or *Sunnah* in cases other than worship.

conducts what we may refer to as a "context analysis" both for the modern situation and that of the classical period.

Islamic financial principles

Islamic law, in principle, recognises contractual freedom, and all contracts and contractual provisions are allowed, unless explicitly prohibited in the foundation texts. The obvious and crucial questions then are what these explicit prohibitions are and how they pertain to financial transactions. The foundation texts identify two explicit prohibitions: (1) the ban on receiving and paying *riba* (often translated as "interest" in Islamic finance literature); and (2) the ban, to the extent possible, on *gharar* (uncertainty) in contracts.

Riba

Riba is often divided into three different forms: the *riba al-jahiliyya*, *riba al-fadl*, and *riba al-nasi'a*.[5]*Riba al-jahiliyya* has been prohibited directly in the Qur'an, while *riba al-fadl* and *riba al-nasi'a* have been prohibited in the *Sunnah* of the Prophet. *Riba al-jahiliyya* refers to the *riba* of the pre-Islamic period.[6] According to the practice in pre-Islamic Arabia, interest was charged at the maturity of debts from interest-free loans or credit sales, and compounded at later maturity dates.[7] This form of *riba* has been prohibited in the Qur'an.[8] In the Qur'an it is also mentioned that Muslims should abandon all remaining *riba*.[9] One of the most discussed verses on the prohibition of *riba* in the Qur'an is verse 2:275 according to which God has permitted trade, but prohibited *riba*:

> "Those who devour [riba] will not stand except as stand one whom the Evil one by his touch [h]ath driven to madness. That is because they say: 'Trade is like [riba],' but Allah hath permitted trade and forbidden [riba]. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat ([t]he offence) are companions of the Fire: They will abide therein (for ever)."[10]

The prohibitions of *riba al-fadl* and *riba al-nasi'a* originate from the *Sunnah* of the Prophet Muhammad.[11] There are several *hadith* prohibiting both *riba al-fadl* and *riba al-nasi'a*. The most quoted *hadith* on the prohibition of *riba* is:

> "[Ubada b. al-Samit] ([may] Allah be pleased with him) reported Allah's Messenger (may peace be upon him) as saying:
>
> Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand."[12]

As appears from this *hadith* the essence of *riba* here does not concern interest over loans, but sales, i.e. delay or excess in exchange of certain types of property such as currency and foodstuffs. The phrase "equal for equal" in this *hadith* establishes that certain goods of a single type can only be exchanged in equal amounts.[13] This is the so called *riba al-fadl*. The phrase "hand to hand" refers to the *riba al-nasi'a*, according to this form of *riba* the exchange of certain goods may only take place in present and as instant barter.[14] Based on an explication of *riba al-jahiliyya*, *riba al-fadl* and *riba al-nasi'a*, many contemporary Muslim scholars have argued that all forms of interest are forbidden as *riba*.

Under the rules of *Shari'ah*, granting a loan is considered an act of charity.[15] If that is the case, it would be improper to make a profit on a loan by charging interest to the borrower. This does not mean that making a profit itself is forbidden within Islam. Quite the reverse—Islamic law encourages circulation of wealth, investment and profit.[16] But profit must be made through trade and other similar activities. A return on investment is only justified when the investor takes a commercial

[5] N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13–14; M. A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006), p.49–50.
[6] Ibn Rushd, *The Distinguished Jurist's Primer, Volume II: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (Reading: Garnet Publishing, 1996) (translated by I. A. K. Nyazee), p.158; N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13–14; M. A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006), p.49–50.
[7] Ibn Rushd, *The Distinguished Jurist's Primer, Volume II: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (Reading: Garnet Publishing, 1996), p.158; N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13–14;M. A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006), p.49–50.
[8] Qur'an 3:130.
[9] Qur'an 2:275; Qur'an 2:276; Qur'an 2:277; Qur'an 2:278; Qur'an 2:279.
[10] Qur'an 2:275, translation of the Qur'an by Yusufali, available at the Centre for Muslim-Jewish Engagement, University of Southern California at *http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/quran/002.qmt.html* [Accessed October 27, 2013].
[11] Ibn Rushd, *The Distinguished Jurist's Primer, Volume II: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (Reading: Garnet Publishing, 1996), p.158; N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13.
[12] Sahih Muslim, Book 10, No.3853, translation of Sahih Muslim, available at the Centre for Muslim-Jewish Engagement, University of Southern California at *http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/010.smt.html* [Accessed October 27, 2013].
[13] Ibn Rushd, *The Distinguished Jurist's Primer, Volume II: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (Reading: Garnet Publishing, 1996), p.158; N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13; A. Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Leiden: Brill, 1996), p.32.
[14] Ibn Rushd, *The Distinguished Jurist's Primer, Volume II: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (Reading: Garnet Publishing, 1996), p.158; N. A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge: Cambridge University Press, 1986), p.13A. Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Leiden: Brill, 1996), p.32.
[15] U. F. Moghul and A. A. Ahmed, "Contractual Forms in Islamic Finance Law and Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V.: A First Impression of Islamic Finance"[2003] *Fordham International Law Journal* 27–1, 168.
[16] Qur'an 4:29; Qur'an 2:275.

risk. Lending money does not qualify as a commercial risk,[17] because the risk of non-repayment (poor debtor creditworthiness, for example) is deemed insufficient to warrant charging interest. Profitability requires taking a real commercial risk.

Given the *riba* ban, the concept of profit-and-loss-sharing is extremely important in Islamic finance.[18] Financiers generally do not receive interest on the funds they provide, but instead participate in the project to the extent that they share in any profits or losses made.[19] So unlike interest payments, charging for funding-based project participation can be justified, provided that the project yields a profit.

But the *riba* ban reaches much further. *Shari'ah*-compliant transactions preclude making money with money. Money itself may not be a source of profit, because, many scholars of Islamic economics argue money has no intrinsic value within Islam.[20] The ultimate purpose of money, from their point of view, is to help fulfil basic needs, such as food, clothes and shelter. In this approach money must be seen (and used) as a means of exchange only, not as a basic need in itself.[21]

This position, for instance, is at the heart of the *bay' al-dayn* doctrine or trade in debt claims.[22] Most *Shari'ah* scholars agree that the *riba* ban extends to this trade,[23] because trading in debt claims is similar to the forbidden use of money as a source of profit. In the case of *sukuk* therefore, they must be backed by tangible assets. Typically (and unlike in conventional forms of funding), *sukuk* certificate holders have (or should have) a claim to one or more tangible assets. These certificates can be traded on the international capital markets because their holders are entitled to the underlying tangible assets, and it is not only debt claims that are traded.

While the equation of *riba* with interest has become commonplace among Muslims, there is still a significant number of scholars who do not believe that *riba* can simply be equated with interest. One such scholar, Mohammad Omar Farooq, notes that there are a number of problems with the "orthodox" understanding of *riba* as interest. He emphasises the following points: First, it is a misunderstanding that the prohibition on *riba* as interest is directly derived from the Qur'an.[24] There is no support from foundational texts (the Qur'an and *hadith*) that any conditions of an initial contract or agreement, including any stipulated excess over the principal, are covered by the Qur'anic prohibition of *riba*.[25] Nor is there *ijma'* or consensus that *riba* equals interest, even though such a view is widely held.[26] The prohibition on *riba*, specifically pre-Islamic riba (*riba al-jahiliya*) in the Qur'an (2:275) is primary referring to loans (presumably a particular type of loan that existed in pre-Islamic times).[27] Thus *hadith* concerning *riba* in the context of trade or credit sales cannot legitimately be used to broaden the scope of the prohibition on pre-Islamic *riba*.[28] Moreover, the discussion on *riba* and loans in the Qur'an occurs in connection with transactions or contracts characterized by *zulm* (injustice and exploitation), with the broader context of the verse discussing spending and charity (*sadaqa*).[29] Thus, he argues, it is a certain type of *riba* - one that renders a debtor financially vulnerable to poverty or need - that is specifically prohibited.[30] Although this view has been supported by several scholars from a wide range of perspectives,[31] the view is not accepted in Islamic finance.

Gharar

The second ban in *Shari'ah* in relation to Islamic finance is that of *gharar* or excessive uncertainty and risk. In contracts, *gharar* must be avoided as much as possible;[32] the *Shari'ah* recognises that ruling out uncertainty in financial transactions altogether is unrealistic.[33] For that reason, the *gharar* ban primarily concerns essential

[17] A. Hanif, "Islamic Finance—An Overview" [2008] *International Energy Law Review*1, 10.
[18] D. Olson and T. A. Zoubi, "Using Accounting Ratios to Distinguish between Islamic and Conventional Banks in the GCC Region" [2008] *The International Journal of Accounting* 47.
[19] This element is particularly noticeable in Islamic financial contracts, such as the *musharaka* and the *mudaraba*. For an account of Islamic financial contracts, see M. T. Usmani, *An Introduction to Islamic Finance* (Arab & Islamic Law Series) (The Hague: Kluwer Law International, 2002); M. A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006); M. Ayub, *Understanding Islamic Finance* (Hoboken: John Wiley and Sons, 2008); H. S. F. A. Jabbar, "Sharia-compliant financial instruments: principles and practice" [2009] *Company Lawyer* 6, 176–188.
[20] This is not the same as denying the time value of money. On this distinction, see M. A. El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Indiana: ISNA, 2000).
[21] Several *hadith* attest to this. On the interpretation of these *hadith*, see see M. A. El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Indiana: ISNA, 2000); H. S. F. A. Jabbar, "Islamic finance: fundamental principles and key financial institutions" [2009] *Company Lawyer* 1, 23–32.
[22] M. T. Usmani, "Principles of Shariah Governing Islamic Investment Funds" *Albalagh* at *http://www.albalagh.net/Islamic_economics/finance.shtml* [Accessed October 27, 2013].
[23] With the exception of Malaysia, which allows debt claims to be traded (*bay' al-dayn*). See also A. H. Ismail, "A Malaysian View of Sharia" [2003] *AJIF.org LLC* ; A. Thomas, "Malaysia's Importance to the Sukuk Market: March 2007 Report" [2007] *AJIF.org LLC* ; N. J. Adam and A. Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), p.48–50; Securities Commission Shariah Advisory Council, *Resolutions of the Securities Commission Shariah Advisory Council*, 2nd edn (Kuala Lumpur: Securities Commission, 2006), p.19.
[24] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007) at *http://www.globalwebpost.com/farooqm/writings/islamic/intro_riba.doc* [Accessed October 27, 2013], p.7.
[25] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.14.
[26] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.9.
[27] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.7.
[28] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.8.
[29] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.7–8.
[30] M. O. Farooq, *Toward Defining and Understanding Riba: An Outline Essay* (2007), p.15.
[31] Some of these scholars are Muhammad Abduh, Rashid Rida, Abd al-Razzaq Sanshuri, Doualibi, Muhammad Asad, and Fazlur Rahman.
[32] Qur'an 2:90; 2:91.
[33] M. Fadeel, "Legal Aspects of Islamic Finance" in S. Archer and R. A. A. Karim (eds), *Islamic Finance: Innovation and Growth* (London: Euromoney Books and AAOIFI, 2002), p.91; IOSCO, *Islamic Capital Market Fact Finding Report* (Malaysia: Islamic Capital Market Task Force, 2004) p.8.

elements of contracts, such as price, deliverability, quality, quantity, etc.[34] Therefore the essentials of a contract may not remain unspecified. The *gharar* prohibition is also somewhat related to the ban on *qimar* which is strictly forbidden by the *Shari'ah*.[35]*Qimar* pertains to yields that depend solely on luck or chance, such as gambling.[36] Many Islamic economists would argue that excessive speculation and gambling are prohibited, because profits achieved through them cannot be justified.[37] Yet ordinary entrepreneurial risks are not included in this ban. Conventional derivatives contracts are considered in this context to contain elements that are akin to speculation.[38]

Approaches to Islamic finance: idealist, liberal, and pragmatic

When considering the principles of Islamic finance, it must be emphasised that the early idealistic vision of Islamic banking and finance, which existed in the literature in the decades prior to the 1970s, has changed significantly in practice. The idealism of the early period of Islamic banking during the 1950s and 1960s saw the development of models of Islamic banking and finance that adhered closely to ideas developed by the classical jurists. However, the reality of operating in today's financial markets, in a context very different to the classical period, has meant that modern scholars have been challenged to reconsider these conceptions. Although the ideal models still exist, other more pragmatic approaches have been developed.

Overall, three approaches to Islamic banking and finance have emerged that can be placed on a continuum: idealist, liberal and pragmatic. The idealist approach seeks to maintain the original vision of the Islamic banking literature of the 1950s and 1960s and to remain faithful to the instruments and contracts developed in *fiqh* as far as possible during the classical period. At the opposite end of the continuum are Muslim scholars who argue that interest is not inherently evil and *riba* does not include modern bank interest. This "liberal" approach even makes a case that there is no need for "Islamic" banks and financial products at all. Between these two extremes lies a more pragmatic approach, which is realistic enough to see that idealist models of Islamic banking have significant problems in terms of practicality and feasibility, but at the same time still maintains the interpretation of *riba* as interest.

It is possible to argue that the majority of Islamic bankers should be classified as pragmatists, prepared to balance practical realities with traditional Islamic principles. The result has been that these bankers and their *Shari'ah* advisers have opted for a more pragmatic form of Islamic banking, interpreting relevant texts using an eclectic approach to the sources of Islamic law and principles of Islamic jurisprudence. Here the practical and feasible is given priority over the idealistic and impractical, even though this has led to a somewhat questionable outcome in terms of moving towards a so-called "Islamic" banking and finance system.

Below the use of eclectic *ijtihad* resulting in a pragmatic approach will be discussed in regard to *sukuk* structures. This pragmatic approach will be considered in contrast to the idealist approach.

History of sukuk

Origins of sukuk in medieval times

The Arabic word *sukuk* is the plural of the word *sakk*, meaning "certificate" or "order of payment".[39] Documentary evidence confirms the use of the word "*sakk*" in the early Islamic caliphates.[40] The Muslim societies of the pre-modern period used *sukuk* as forms of papers representing financial obligations originating from trade and other commercial activities.[41] In the earlier theoretical legal works, written instruments of credit were present. Such written instruments are encountered frequently in *genizah* documents.[42] *Genizah* documents are documents that were stored in the Middle Eastern mosques and synagogues, because the word "God" was written either in Arabic or Hebrew and, therefore, the merchants were reluctant to destroy such documents. The Cairo *genizah* documents contain fragments that indicate the existence of *sakk* in the 12th century CE and these

[34] S. Archer and R. A. A. Karim, "Introduction to Islamic Finance" in S. Archer and R. A. A. Karim (eds), *Islamic Finance: Innovation and Growth* (London: Euromoney Books and AAOIFI, 2002), p.3; IOSCO, *Islamic Capital Market Fact Finding Report* (Malaysia: Islamic Capital Market Task Force, 2004), p.8.
[35] Qur'an 2:219; 5:90.
[36] M. Ayub, *Understanding Islamic Finance* (Hoboken: John Wiley and Sons, 2008), p.112.
[37] IOSCO, *Islamic Capital Market Fact Finding Report* (Malaysia: Islamic Capital Market Task Force, 2004), p.8.
[38] A. Hanif, "Islamic Finance—An Overview" [2008] *International Energy Law Review*1, 10.
[39] M. A. Khan, *Islamic Economics and Finance: A Glossary* (Routledge: London, 2003), p.163; S. Cakir and F. Raei, *Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk?* (IMF Working Paper 07/237) (Washington: International Monetary Fund, 2007), p.3.
[40] N. J. Adam and A. Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), p.43.
[41] N. J. Adam and A. Thomas, "Islamic fixed-income securities: sukuk" in S. Jaffar (ed), *Islamic Asset Management: Forming the Future for Shari'a-Compliant Investment Strategies* (London: Euromoney Books, 2004), p.73; A. Thomas, "What are Sukuk?" [2003] *AJIF.org LLC*; M. A. Khan, *Islamic Economics and Finance: A Glossary* (Routledge: London, 2003), p.163.
[42] A. L. Udovitch, "Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages" in Centre for Medieval and Renaissance Studies, UCLA (ed), *The Dawn of Modern Banking* (New Haven & London: Yale University Press, 1979), p.268–274.

money orders are remarkably similar in form to modern cheques.[43] They stated the sum to be paid, the order, the date, and the name of the issuer.[44]

During the Middle Ages, a *sakk* was a written vow to pay for goods when they were delivered and it was used to avoid money having to be transported across dangerous terrain.[45] As a result, these *sukuk* were transported across several countries and spread throughout the world. The Jewish merchants from the Muslim world transmitted the concept and the term *sakk* to Europe.[46] An interesting outcome of the trade and transport of these *sukuk*, is that it functioned as a source of inspiration for the modern day cheque. Although the cheque has a British background,[47] the modern Western word "cheque" appears to have been derived from the Arabic word "*sakk*".[48]

Recent history of sukuk in Islamic capital markets

Today *sukuk* are known as instruments of the Islamic capital markets. In modern day Islamic finance, *sukuk* refer to Islamic securities with rather distinctive features. One of the very first definitions of modern day *sukuk* was given in February 1988 during the fourth session of the Council of the Islamic *Fiqh* Academy in Jeddah. Resolution No.30 (5/4) of the Council of the Islamic Fiqh Academy dealt with the matter. This resolution was on investment certificates and more specifically on *muqarada* bonds (also known as *mudaraba sukuk*), which is a specific form of *sukuk*. The Council defined these *sukuk* as:

> "(…) investment instruments which allocate the [muqarada] capital ([mudaraba]) by floating certificates, as an evidence of capital ownership, on the basis of shares of equal value, registered in the name of the owner, as joint owners of shares in the venture capital or whatever shape it may take, in proportion to (…) each one's share therein."[49]

This is arguably the first description of *sukuk* in present times. Shortly after this description, in 1990 one of the first *sukuk* was issued by Shell MDS in Malaysia.[50] After this issuance, there were no other active issuances by other *sukuk* issuers until the beginning of the 21st century.[51] From 2000 onwards, a number of institutions started issuing *sukuk* and the *sukuk* market took off from there.[52] The immense growth of the market required certainty in regard to *Shari'ah* related matters and standardisation. Hence, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) issued its *Shari'ah* Standard No.17 on 'Investment *Sukuk*' in May 2003, which became effective from January 1, 2004. This Shari'ah Standard provides a definition of *sukuk* in s.2 of the Shari'ah Standard. The AAOIFI defines investment *sukuk* 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 …"[53]

The AAOIFI *Shari'ah* Standard on *sukuk* describes that there are fourteen different *sukuk* structures structured on the basis of Islamic financial contracts such as

[43] A. Z. J. B. J. Ha-Kohen, "Cheques", *Taylor Schechter Collection* (Cambridge University Library) at *http://www.lib.cam.ac.uk/Taylor-Schechter/exhibition.html* [Accessed October 27, 2013]; Genizah document, "T-S Ar.30.184", *Taylor Schechter Collection* (Cambridge University Library) at *http://www.lib.cam.ac.uk/cgi-bin/GOLD/thumbs?class_mark=T-S_Ar.30.184* [Accessed October 27, 2013].

[44] See Ha-Kohen, *Taylor Schechter Collection*; Genizah document, "T-S Ar.30.184", *Taylor Schechter Collection*. Some even suggest that the ancient Romans had used an early form of cheque known as *praescriptiones* in the first century BC. During the 3rd century AD, banks in Persia and other territories in the Persian Empire also issued letters of credit known as *sakk*. Hence, it is mentioned that the Arabic word "*sakk*" comes from the Persian language. See StateMaster, *Encyclopedia: Cheque*, NationMaster.com at *http://www.statemaster.com/encyclopedia/Cheque#_note-Vallely* [Accessed October 27, 2013]; A. Markels, "The Glory That Was Baghdad" *US News* April 7, 2008 at *http://www.usnews.com/articles/news/religion/2008/04/07/the-glory-that-was-baghdad.html* [Accessed October 27, 2013]; M. Wright, "Just write me a 'sakk'" SundayMirror.co.uk, February 22, 2009 at *http://www.mirror.co.uk/sunday-mirror/2009/02/22/just-write-me-a-sakk-115875-21142872/* [Accessed October 27, 2013]. However, the first evidence of *sakk* dates from the Middle Ages.

[45] P. Vallely, "How Islamic inventors changed the world" *The Independent*, March 11, 2006 at *http://www.independent.co.uk/news/science/how-islamic-inventors-changed-the-world-469452.html* [Accessed October 27, 2013].

[46] F. Braudel, *The Mediterranean and the Mediterranean World in the Age of Philip II, Volume II* (New York: William Collins Sons & Co, 1973), p.817.

[47] The cheque has got a British background. English banks started using cheques around the 17th and 18th century in order to counteract the issuance monopoly of the Bank of England. See P. de Vroede, *De Cheque: de postcheque en de reischeque* (Antwerpen: Kluwer, 1981), p.3; J. A. F. Geisweit van der Netten, *De Cheque* (Utrecht: Utrechtsche Stoomdrukkerij, 1892), p.5; H. Cabrillac, *Le chèque et le virement*, nr. 2; J. van Ryn and J. Heenen, *Principes de droit commercial*, nr. 2976.

[48] For more on this, see G. W. Heck, *Charlemagne, Muhammad, and the Arab roots of capitalism* (Berlin: Walter de Gruyter, 2006), p.217–218; A. L. Udovitch, "Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages" in Centre for Medieval and Renaissance Studies, UCLA (ed), *The Dawn of Modern Banking* (New Haven & London: Yale University Press, 1979), p.268–274; A. L. Udovitch, "Trade" in J. R. Strayer (ed), *The Dictionary of the Middle Ages, Volume 12* (New York: Charles Scribner's Sons, 1989), p.105–108. The UK based educational project and exhibition exploring the Muslim contributions to building the foundations of Modern Civilisation, called "1001 Inventions: Discover the Muslim Heritage in Our World", also confirmed that the word "cheque" comes from "*sakk*". See 1001Inventions at *http://www.1001inventions.com* [Accessed October 27, 2013]; P. Vallely, "How Islamic inventors changed the world" *The Independent*, March 11, 2006.

[49] Resolution No.30 (5/4) concerning "Muqaradha" Bonds and Investment Certificates, The Council of the Islamic Fiqh Academy, holding its 4th Session in Jeddah, Kingdom of Saudi Arabia, from 18 to 23 Jumada Tahni 1408 AH (February 6–11, 1988), in International Islamic Fiqh Academy, *Resolutiong and Recommendations of the Council of the Islamic Fiqh Academy 1985–2000* (Jeddah: Islamic Devlopment Bank, Islamic Research and Training Institute & Islamic Fiqh Academy, 2000), p.61–62.

[50] A. W. Dusuki, "Challenges of Realizing Maqasid al-Shari'ah (Objectives of Shari'ah) in the Islamic Capital Market: Special Focus on Equity-Based Sukuk Structures" *ISRA Research Paper*, No.05/2009, p.8.

[51] A. W. Dusuki, "Challenges of Realizing Maqasid al-Shari'ah (Objectives of Shari'ah) in the Islamic Capital Market: Special Focus on Equity-Based Sukuk Structures" *ISRA Research Paper*, No.05/2009, p.8.

[52] R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk", (2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126; A. W. Dusuki, "Challenges of Realizing Maqasid al-Shari'ah (Objectives of Shari'ah) in the Islamic Capital Market: Special Focus on Equity-Based Sukuk Structures" *ISRA Research Paper*, No.05/2009, p.8–9.

[53] Section 2 AAOIFI *Shari'ah Standards No.17 on Investment Sukuk*.

musharaka, *mudaraba*, *ijara*, *murabaha* and so on. Over the first decade of the 21st century the market has witnessed several *sukuk* issuances in different forms and structures. In 2007, the *sukuk* market reached its peak in terms of issuance volume.[54] The AAOIFI *Shari'ah* Standard No.17 on *sukuk* also provides specific rules to safeguard the *Shari'ah*-compliance of each *sukuk* structure.

Sukuk structures: pragmatic and idealist approaches

In the light of the prohibition of *riba* under the *Shari'ah*, trading in pure debt instruments is forbidden. Hence, *sukuk* are structured to generate the same economic effects as conventional bonds, but in a *Shari'ah*-compliant manner.[55] Each *sakk* represents an undivided interest in an asset.[56]*Sukuk* reflect participation in the underlying tangible assets, so that what is being traded is not merely a debt.[57]*Sukuk* are entitlements to rights in certain assets inclusive of some degree of ownership.[58] For a *sukuk* structure to comply with *Shari'ah*, the underlying assets must themselves also comply with *Shari'ah*, which means that they should be *halal*.[59]

In this section we will discuss *sukuk* structures and contextualise them in the broader discussion of the different approaches of Islamic finance. First, the *Shari'ah* requirements for *sukuk* will be described to determine what the conditions are for a valid *sukuk* structure from a *Shari'ah* perspective. Once the *Shari'ah* framework is clarified, we will discuss how some *sukuk* structures were structured in practice. This will show that the *sukuk* practitioners developed several mechanisms that seemed necessary from a practical point of view adopting a pragmatic approach. We will place this pragmatic approach in contrast to the idealist approach.

Shari'ah requirements for sukuk structures

The most important Islamic principle for *sukuk* transactions—and probably for Islamic finance as a whole—is the prohibition of *riba*. Two important aspects of the prohibition of *riba* will be discussed: paying or receiving interest and the forbidden *bay' al-dayn*. As mentioned above, according to the majority of the contemporary scholars the prohibition of *riba* includes a prohibition on all forms of interest. Since interest payments are forbidden under the *Shari'ah*, the transaction must be structured such that no interest payments are present in the entire transaction. Contrary to conventional bonds where the periodic payments are interest payments, the source for the periodic payments of the *sukuk* must be the return on the underlying transaction.

In the AAOIFI definition we read that the *sukuk* certificates must represent ownership rights in the underlying assets. This is the result of the prohibition of *riba* that indirectly leads to a prohibition on trading in debt receivables (*bay' al-dayn*). Therefore, pure debt instruments are forbidden. Money must be used to create real economic value and the trade in claims and receivables is not allowed. Consequently, the presence of underlying tangible assets in the transaction is required. This means that the Special Purpose Vehicle (SPV) needs to hold underlying tangible assets in order to issue *sukuk*. In addition, the *sukuk* holders must hold some degree of ownership in the underlying tangible assets as a consequence of the prohibition on the *bay' al-dayn*.[60] This makes the *sukuk* tradable in secondary markets: when the *sukuk* are traded in secondary markets, what is being traded is not merely a debt claim, but rather an ownership right in a tangible asset.

Sukuk structures: A pragmatic approach

Sukuk al-Ijara structure

Now that the *Shari'ah* framework of *sukuk* transactions is clarified, three *sukuk* structures will be discussed in further detail. This will illustrate how these *sukuk* are structured in practice. First, the *sukuk al-ijara* will be discussed. The *sukuk al-ijara* structure is based on the contract of *ijara*.[61] An *ijara* contract allows the transfer of the usufruct of an asset in return for rental payment; as such, it is similar to a conventional lease contract.[62] Thus, the *sukuk* are based on the underlying tangible assets that the SPV has acquired rather than being debt securities, which is the case with the issuance of conventional bonds.[63] Instead, the *sukuk al-ijara* structure uses the leasing contract as the basis for the returns paid to investors, who are the beneficial owners of the

[54] The prevailing *sukuk* structures were the equity-based *sukuk* structures in 2007, see S. Mokhtar, "A Synthesis of Shari'ah Issues and Market Challenges in the Application of Wa'd in Equity-Based Sukuk"(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 139–145A. W. Dusuki, "Challenges of Realizing Maqasid al-Shari'ah (Objectives of Shari'ah) in the Islamic Capital Market: Special Focus on Equity-Based Sukuk Structures" *ISRA Research Paper*, No.05/2009, pp.8–10. From 2008 onwards, the *sukuk al-ijara* started to dominate the *sukuk* market due to a drop in equity-based *sukuk* structures as a result of a Resolution issued by the AAOIFI in 2008, see O. Salah, "Islamic finance: The impact of the AAOIFI Resolution on equity-based sukuk structures", (September 2010) Law and Financial Markets Review vol.4 No.5 , 507–517.

[55] M. Ainley, *Islamic Finance in the UK: Regulation and Challenges* (London: Financial Services Authority, 2007), p.24.

[56] N. J. Adam and A. Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), p.42.

[57] Z. Iqbal and A. Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Wiley Finance) (Singapore: John Wiley & Sons (Asia), 2006), p.177; L. Saqqaf, "Middle East debt: The new sukuks; Innovative structures are changing the face of Islamic bonds" [2006] *International Finance Law Review* 10, 19.

[58] Allen & Overy, *Allen & Overy Advises on Islamic First* (Internet Press Release), August 12, 2003.

[59] T. Box and M. Asaria, "Islamic finance market turns to securitization" [2005] *International Finance Law Review* 7, 22; M. J. T. McMillen, "Contractual Enforceability Issues: Sukuk and Capital Market Development" [2006–2007] *Chicago Journal of International Law* 427–429.

[60] A. H. Abdel-Khaleq and C. F. Richardson, "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings" [2006–2007] *Chicago Journal of International Law* 418–419.

[61] Z. Iqbal and A. Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Wiley Finance) (Singapore: John Wiley & Sons (Asia), 2006), p.182.

[62] HM Revenue & Customs, *Stamp duty land tax: Commercial sukuk; Consultation Document, June 26, 2008*, London: HM Revenue & Customs 2008, p.20; HM Treasury, *Government sterling sukuk issuance: a consultation, November 2007* (London: United Kingdom Debt Management Office, 2007), p.17.

[63] HM Revenue & Customs 2008, p.20; HM Treasury 2007, p.17.

underlying asset and as such benefit from the lease rentals as well as sharing in the risk.[64] Figure 3.1 illustrates the structure of *sukuk al-ijara*.

The structure commences with a party who is in need of financing, here referred to as the originator. The originator will establish an SPV, a separate legal entity with the sole purpose of facilitating this transaction. Next, the SPV purchases certain tangible assets from the originator at an agreed predetermined purchase price, which will be equal to the principal amount of the *sukuk*. In order to finance the purchase of the assets, the SPV issues *sukuk* to *sukuk* holders. These *sukuk* holders are investors looking for *Shari'ah*-compliant securities. The SPV uses the *sukuk* proceeds to pay the originator the purchase price of the tangible assets. The SPV will also declare a trust over the tangible assets and hold the assets as a trustee for the *sukuk* holders being the beneficiaries.

Next, the originator and the SPV will enter into a lease agreement for a fixed period of time, which is the *ijara* agreement. Under this lease agreement, the SPV (lessor) leases the assets back to the originator (lessee). Consequently, the SPV receives periodic rentals from the originator for the use of the underlying tangible assets. The SPV uses these amounts to pay the periodic return to the *sukuk* holders, since they are entitled to these payments as the beneficial owners of the tangible assets.

The lease payments from the originator to the SPV, and the periodic payments from the SPV to the *sukuk* holders will continue until maturity date. At maturity date, the originator purchases the assets back from the SPV at a predetermined value pursuant to a purchase undertaking. The originator becomes the legal owner of the assets and pays a purchase price equal to the initial purchase price of the assets and, thus, also equal to the principal amount of the *sukuk*. Hence, the SPV can pay the *sukuk* holders their principal amount back, which allows the *sukuk* certificates to be redeemed.

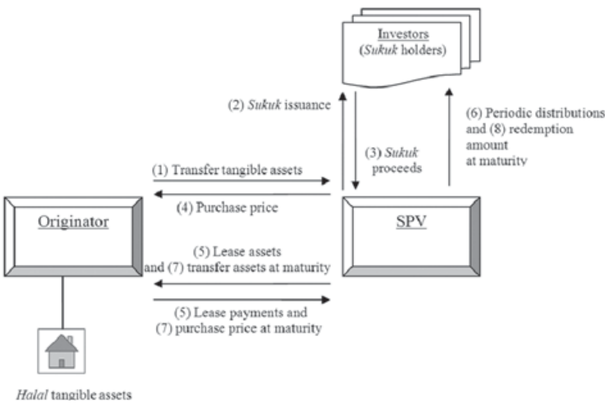

Figure 3.1: Structure of sukuk al-ijara

Although in a *sukuk al-ijara* structure the *sukuk* holders must acquire the ownership rights over the tangible assets from a *Shari'ah* perspective, from a practical perspective this is often not possible due to legal impediments in most jurisdictions such as the impossibility to register the immovable assets in the name of thousands of *sukuk* holders. As a result, under the *sukuk al-ijara* structure the SPV holds the tangible assets in trust for the *sukuk* holders. This means that the legal ownership of the tangible assets will remain with the SPV and the *sukuk* holders merely acquire the beneficial ownership of the underlying tangible assets.

In practice, however, more difficulties arose to meet the ownership requirements of the *sukuk* holders. This is the first explication of the pragmatic approach of *sukuk* practitioners. Additional transfer taxes and restrictions on the disposal of governmental assets made it rather impossible for several originators to even transfer the title of the assets to the SPV.[65] As a result, in practice the legal ownership of the assets is not even transferred to the SPV. The *sukuk* holders are, consequently, one step further from the underlying tangible assets. The combination of the absence of transfer of legal ownership of the assets from the originator to the SPV with purchase undertakings and other forms of guarantees given by the originator, provided the SPV and, consequently, the *sukuk* holders recourse to the originator instead of recourse to the underlying tangible assets.[66] In the literature, this development has been referred to as a move from asset-backed *sukuk* to asset-based *sukuk*.[67]

Hybrid sukuk structure

Due to the significant growth of the market, *sukuk* issuance and trading have become important means of investment. However, the above described *sukuk al-ijara* structure limits the originator: the originator cannot issue *sukuk* if it does not have sufficient tangible assets. Thus, to meet the demands of investors, the hybrid *sukuk* emerged in the market.[68] In a hybrid *sukuk* structure, the underlying pool of assets can comprise of *istisna'* contracts, *murabaha* contracts as well as *ijara* contracts, which allows for a greater mobilisation of funds.[69] Hence, the hybrid *sukuk* gives the possibilities to use financing contracts for refinancing means: it is a refinancing tool. It even shows similarities to a securitisation structure, whereby debt receivables are sold to an SPV over which the SPV issues conventional bonds.

[64] HM Revenue & Customs 2008, p.20; HM Treasury 2007, p.17.

[65] R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk",(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126.

[66] R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk",(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126.

[67] R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk",(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126.

[68] In the literature, hybrid *sukuk* are also referred to as "blended assets" *sukuk*, see R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk",(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126.

[69] A. A. Tariq and H. Dar, "Risks of Sukuk Structures: Implications for Resource Mobilization" [2007] *Thunderbird International Business Review* 2, 205; Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.31.

The structure involves the following steps. First of all, the originator transfers tangible assets with underlying *ijara* deals as well as *murabaha* and *istisna'* deals to the SPV.[70] The SPV issues *sukuk* to the *sukuk* holders and receives *sukuk* proceeds from them, which are used to pay the originator.[71] The revenues realised with these *ijara* contracts, *murabaha* contracts, and *istisna'* contracts are paid through to the *sukuk* holders. At maturity date, the originator purchases the assets back, consisting of tangible assets with *ijara* contracts, *murabaha* contracts, and *istisna'* contracts, from the SPV.[72] The *sukuk* holders receive fixed payment of return on the assets and the *sukuk* will be de redeemed.[73] In essence, the hybrid *sukuk* concerns the same transaction as the *sukuk al-ijara* transaction. However, while in a *sukuk al-ijara* the SPV always owns tangible assets which are transferred from the originator to the SPV, in a hybrid *sukuk* there is not merely a transfer of tangible assets, but also of *ijara*, *murabaha*, and *istisna'* deals from the originator to the SPV. Figure 3.2 illustrates the hybrid *sukuk*.

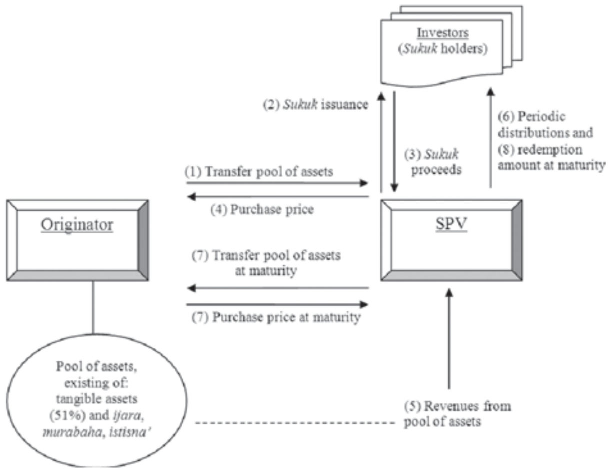

Figure 3.2:Structure of hybrid sukuk

With this structure, we witness the second explication of the pragmatic approach. Due to the growth of the market and the demand of issuers and investors for the product, the *sukuk* market seemed to deviate from the strict requirement of tangible assets in *sukuk* transactions. As a result, at least 51 per cent of the pool in a hybrid *sukuk* must comprise of tangible assets. This refers to the presence of *ijara* contracts, because *murabaha* and *istisna'* contracts cannot be traded in the secondary market as securitised instruments.[74] These contracts cannot be traded in the secondary market, because they create debt as the result of the *istisna'*- and *murabaha*-based sale. Since the prohibition of *riba* does not allow the trade in debt receivables, at least 51 per cent of the pool in a hybrid *sukuk* must comprise *ijara*, because that means that there are underlying tangible assets in the transaction. The *sukuk* market witnessed an even further deviation over time: in some structures even a minority of 30 per cent of tangible assets included in the pool of assets was accepted by the relevant *Shari'ah* scholars.[75] Once again, the pragmatic approach towards the *Shari'ah* framework is clearly evident in the mentality of the market.

Sukuk al-Mudaraba structure

sukuk al-mudaraba is structured through the *mudaraba* contract, which is a form of partnership. The structure commences, once again, with a party looking for *Shari'ah*-compliant financing, the originator. The originator will establish an SPV and enter into a *mudaraba* contract with this SPV. Both the originator and the SPV will be the partners to the *mudaraba* contract. The originator will act as the managing partner, the entrepreneur of the *mudaraba* venture. As the *mudarib*, the managing partner will contribute his labour, skills and expertise. The SPV will act as the silent partner, the *rab-al-mal* of the *mudaraba* venture. As the *rab-al-mal*, the SPV contributes in the form of financial investment.

As the financing party to the *mudaraba*, the SPV will issue *sukuk* certificates to *sukuk* holders. The *sukuk* proceeds will be used to make the financial investment in the *mudaraba*. The SPV will declare a trust over all the units it is holding in the *mudaraba* in favour of the *sukuk* holders. Thus, *sukuk al-mudaraba* allows the pooling of investors' funds with the *sukuk* holders having a common share of the *mudaraba* capital, so they are entitled to returns in proportion to their investment.[76] The profits of the *mudaraba* agreement will be paid to the *sukuk* holders according to an agreed percentage of the realised revenues.

The participation in the *mudaraba* will continue until maturity date. At maturity date, the managing partner will buy the units in the *mudaraba* from the *sukuk* holders through the SPV. The managing partner will pay an amount to the SPV to purchase the units in the *mudaraba*. That amount is used by the SPV to pay the *sukuk* holders their capital back, so that the *sukuk* certificates can be redeemed. Figure 3.3 gives a schematic overview of this structure.

[70] Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.33.
[71] Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.33.
[72] Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.33.
[73] Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.33.
[74] A. A. Tariq and H. Dar, "Risks of Sukuk Structures: Implications for Resource Mobilization" [2007] *Thunderbird International Business Review* 2, 205; Dar Al Istithmar, *Sukuk, An Introduction to the Underlying Principles and Structure, June 2006* (Oxford: Dar Al Istithmar Ltd, 2006), p.31.
[75] R. Haneef, "From 'Asset-Backed' to 'Asset-Light' Structures: The Intricate History of Sukuk",(2009) ISRA International Journal of Islamic Finance vol.1 Issue 1, 103–126.
[76] HM Treasury 2007, p.19.

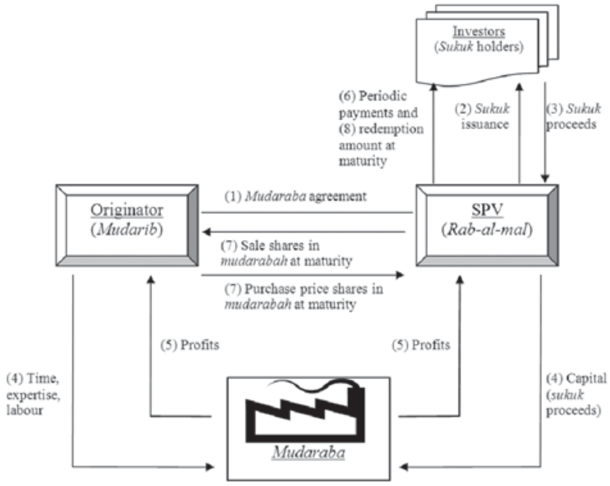

Figure 3.3:Structure of sukuk al-mudaraba

The *sukuk al-mudaraba* structure is an equity-based *sukuk* structure where profits and losses are shared between the partners. Therefore, the periodic payments to the *sukuk* holders cannot be fixed returns; neither can their principal amount be guaranteed at maturity. However, in practice several instruments were used to fix the periodic returns over the *sukuk* and to guarantee the principal amount of the *sukuk* holders.[77] The periodic returns were often fixed returns: when the actual profits realised were less than the promised returns the originator provided for funding, while in case of excess profits any surplus was for the originator as an incentive fee.[78] This limited the equity character of these securities, since the losses were born by the originator and the periodic returns to the *sukuk* holders were fixed, regardless of the performance of the underlying projects.

At maturity, pursuant to a purchase undertaking the assets were purchased back by the originator for a price equal to the principal amount of the *sukuk* holders. The purchase undertaking guaranteed the principal amount of the *sukuk* holders, regardless of the possible appreciation or deprecation of the assets.[79] These structural features practically turned the equity-based profit-and-loss-sharing arrangements into fixed-income instruments. Here we witness the third deviation from the *Shari'ah* framework as a result of the pragmatic approach in the *sukuk* market.

The AAOIFI resolution: An idealist approach

The idealist approach towards *sukuk* structures is strongly present in the AAOIFI Resolution on sukuk. Before the issuance of the AAOIFI Resolution, Muhammad Taqi Usmani, a well-known *Shari'ah* scholar, criticised the developments in the *sukuk* market in a paper on the contemporary application of *sukuk*.[80] He stated that 85 per cent of all the *sukuk* outstanding at that moment was not *Shari'ah*-compliant.[81] The main target of his criticism was the equity-based *sukuk* structures—the *sukuk* issues based on *musharaka*, *mudaraba*, and *wakala*.[82] He, nevertheless, also addressed some elements of *sukuk* issuances that were relevant in regard to the *sukuk al-ijara* structure and the hybrid *sukuk* structure.[83]

Usmani's critique

First, Usmani addressed the issue of the ownership rights of the *sukuk* holders. He mentioned that the presence of ownership rights in *sukuk* structures is the most distinguishing characteristic of *sukuk* when compared to conventional bonds.[84] Usmani noticed that the *sukuk* market had witnessed several structures in which there is doubt in regard to their representation of ownership rights, e.g. the *sukuk* merely offered the *sukuk* holders rights to returns.[85] Usmani emphasised that such *sukuk* structures cannot be *Shari'ah*-compliant.[86] This point is relevant in regard to the *sukuk al-ijara* structure.

Usmani also addressed the occurrence of the hybrid *sukuk* structure in the *sukuk* market. In regard to this structure, he noticed that the hybrid *sukuk* raised questions of *Shari'ah*-compliance and has to be considered carefully, due to the presence of debts in the pool of assets.[87] According to Usmani, the presence of debts and receivables in the hybrid *sukuk* structure raises issues in regard to the forbidden *bay' al-dayn*, even if the percentage of the debts (as a result of the *murabaha* contracts) is considerably less than that of the tangible assets (linked to *ijara* contracts).[88] Thus, he not only addressed the development of hybrid *sukuk* structures where the tangible assets form a minority of 30 per cent of the pool of assets, but even questioned the *Shari'ah*-compliance of hybrid *sukuk* structures where the pool of assets exists of a majority of 51 per cent of tangible assets.

[77] O. Salah, "Islamic finance: The impact of the AAOIFI Resolution on equity-based sukuk structures", (September 2010) Law and Financial Markets Review vol.4 No.5, 507–517.
[78] O. Salah, "Islamic finance: The impact of the AAOIFI Resolution on equity-based sukuk structures",(September 2010) Law and Financial Markets Review vol.4 No.5, 507–517.
[79] O. Salah, "Islamic finance: The impact of the AAOIFI Resolution on equity-based sukuk structures",(September 2010) Law and Financial Markets Review vol.4 No.5, 507–517.
[80] M.T . Usmani, *Sukuk and their Contemporary Applications* (Bahrain: AAOIFI Shariah Council, 2008).
[81] W. McSheehy, "Islamic Bond Scholars Toughen Rules on Sukuk Sales" *Bloomberg* March 13, 2008; Arabian Business, "Most sukuk 'not Islamic', body claims" *Reuters* November 22, 2007 at *http://www.arabianbusiness.com/504577-most-sukuk-not-islamic-say-scholars* [Accessed October 27, 2013]; M. Abbas, "Sukuk should be equity instruments" *Reuters* June 7, 2008, at *http://gulfnews.com/business/investment/sukuk-should-be-equity-instruments-1.110624* [Accessed October 27, 2013].
[82] Usmani, *Sukuk and their Contemporary Applications* (2008), p.4–13.
[83] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.
[84] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.
[85] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.
[86] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.
[87] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.
[88] Usmani, *Sukuk and their Contemporary Applications* (2008), p.3–4.

In regard to the equity-based *sukuk* structures, Usmani criticised three elements in the contemporary application of these structures. First, he mentioned that the payment of any surplus as an incentive fee to the originating partner in the transaction is a mechanism that comes from conventional financing transactions and does not adhere to the Islamic finance concept, where the investor is taking more risks and, thus, must be rewarded for those risks taken.[89] The payment of any surplus to the originating partner is a form of fixing the return to the investors and limits profit-and-loss-sharing between them.[90] Furthermore, he criticised the payment of interest-free loans.[91] This mechanism is basically a form of fixing the periodic returns to the investors and, thus, the investors are not taking the risk that entitles them to a reward.[92] The third point that Usmani condemned was the use of purchase undertakings at face value.[93] Through these purchase undertakings, the originating party was guaranteeing the principal amount of the *sukuk* holders and this is also not in line with the concept of profit-and-loss-sharing.[94]

An idealist approach towards the issuance of *sukuk* clearly resonates in the critique of Usmani. This is even more evident when he places his entire argument in the context of the higher purposes and objectives of Islamic economics.[95] Usmani emphasises, for example, that the whole essence of equity-based transactions within Islamic finance is that it leads to equitable profit distribution, because the financer does not transfer all the risks to the borrower and in the meanwhile the borrower does not only acquire all the benefits of the investment of the financer, but the profits are rather shared between them.[96]

AAOIFI resolution

Shortly after the paper of Usmani, the AAOIFI Resolution was issued in February 2008.[97] The AAOIFI Resolution responded to the developments in the *sukuk* market and to Usmani's critique there upon. It includes six rulings dealing with several *Shari'ah* issues raised. In its first ruling in regard to the ownership requirement, the AAOIFI resolution confirmed that *sukuk*, in order to be tradable, must be owned by the *sukuk* holders with all rights and obligations of ownership in the underlying tangible assets.[98] The AAOIFI, furthermore, rules that the manager issuing *sukuk* must certify the transfer of ownership of such assets in its books and must not keep them as his own assets, stressing that there must be a real transfer of assets.[99] As a result of this, the transfer of the beneficial ownership of the assets from the originator to the SPV is not sufficient anymore and one might even question the extent to which the transfer of merely beneficial ownership from the SPV to the *sukuk* holders is sufficient. Above we noticed that the transfer of legal ownership from the SPV to the *sukuk* holders, however, is almost impossible from a practical perspective.

In it second ruling, the AAOIFI Resolution mentioned that *sukuk*, in order to be tradable, must not represent receivables or debts at all.[100] Exceptions are made for cases where (a portfolio of) the assets of a financial entity that are sold includes unintentionally some debts that are incidental to the tangible assets present therein.[101] Thus, in all other cases the pool of assets cannot represent debts or receivables, not even when the debts represent a minority of the pool of assets of 49 per cent or even less.

In regard to the equity-based structures, the AAOIFI Resolution adopted two out of the three points mentioned by Usmani. First, the AAOIFI stated in the third ruling of the AAOIFI Resolution that it is not permissible to offer interest-free loans to the *sukuk* holders in case of shortfalls.[102] However, it is permissible to establish a reserve account for the purpose of covering such shortfalls.[103] The AAOIFI also permitted on account payments, so long as these payments are subject to final settlement at maturity date.[104] Secondly, the fourth ruling of the AAOIFI Resolution clarified that purchase undertakings according to which interests in the partnerships, i.e. in the *mudaraba*, *musharaka*, or *wakala*, are purchased back at nominal value are not permissible.[105] It is, however, permissible to offer a purchase undertaking according to which the originator can purchase the interests back at their market value or at a price to be agreed upon at the moment of the sale.[106]

The AAOIFI Resolution clearly rules out several structural mechanisms that were developed in practice. Although an idealist approach towards the *Shari'ah* framework is adopted in the Resolution, practical considerations are also taken into account and, therefore, several mechanisms are provided as alternatives such as the reserve account and on account payments in the

89 Usmani, *Sukuk and their Contemporary Applications* (2008), p.5–7.
90 Usmani, *Sukuk and their Contemporary Applications* (2008), p.5–7.
91 Usmani, *Sukuk and their Contemporary Applications* (2008), p.7–8.
92 Usmani, *Sukuk and their Contemporary Applications* (2008), p.7–8.
93 Usmani, *Sukuk and their Contemporary Applications* (2008), p.8–13.
94 Usmani, *Sukuk and their Contemporary Applications* (2008), p.8–13.
95 Usmani, *Sukuk and their Contemporary Applications* (2008), p.13–14.
96 Usmani, *Sukuk and their Contemporary Applications*(2008) p.2–3.
97 AAOIFI Shari'ah Board, *Resolutions on Sukuk, February 2008* (Bahrain: AAOIFI, 2008) at *http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf* [Accessed October 27, 2013].
98 Ruling 1 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
99 Ruling 1 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
100 Ruling 2 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
101 Ruling 2 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
102 Ruling 3 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
103 Ruling 3 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
104 Ruling 3 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
105 Ruling 4 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).
106 Ruling 4 AAOIFI Shari'ah Board, *Resolutions on Sukuk* (2008).

equity-based structures. As a result, the idealist approach in the AAOIFI Resolution did not merely criticise contemporary practice by reference to the ideal structures from a *Shari'ah* perspective, but it also provided some real alternatives showing the way forward to the market.

Conclusion

The discussion of the history of *sukuk* and its development showed that over the first decade of the 21st century, an imbalance is created in the *sukuk* market between an idealist approach to *sukuk* structures and the pragmatic approach that the *sukuk* practitioners have adapted in practice. The *Shari'ah* framework of *sukuk*, furthermore, contextualised this imbalance. It would be interesting to see how the market will react to the criticism from the idealists towards the pragmatists' approach. In practice, most likely, a compromise of these two approaches will be the result. The difficulties associated with both the idealist and pragmatic approaches, however, does not perhaps justify the liberal approach that rejects *sukuk* entirely and argues that Islamic capital markets do not differ at all from the conventional capital markets. This is, because even when the pragmatic approach is adopted certain conventional financial products such as credit default obligations or credit default swaps will be hard to realise in Islamic capital markets, if not impossible. One wonders if there is room in this debate for a more context-based *ijtihad*. Such *ijtihad* being less concerned with the outward 'form' of the structures will shift the focus towards *maslaha* and the underlying objectives of the *Shari'ah* such as fairness, justice and equity. In the future, this might provide a solution that will meet the needs of practitioners while adhering to the true spirit of the *Shari'ah*.