Development of Sukuk: Pragmatic and Idealist Approaches to Sukuk Structures

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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 applicable underlying Islamic financial contracts and structures. In this article, we will outline the backgrounds applicable underlying Islamic financial contracts and structures. In this article, we will outline the backgrounds applicable underlying Islamic financial contracts and structures. In this article, we will outline the backgrounds applicable underlying Islamic financial contracts and structures.

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. 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 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. Banking and financial activities form part of the economic activities within one area of fiqh called fiqh al-mu’amalat.
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 _maslahah_ (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

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4 Notable exceptions are ‘Izz b. Abd al-Salam’s (d. 660 AH) and Shatibi’s (d. 790 AH) 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. 716 AH) 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*. *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. 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. This form of *riba* has been prohibited in the Qur’an. In the Qur’an it is also mentioned that Muslims should abandon all remaining *riba*. 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 [has] 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).”

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

> “[U]bada 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.”

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. 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. 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. 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. But profit must be made through trade and other similar activities. A return on investment is only justified when the investor takes a commercial profit in lieu of more straightforward, and potentially inefficient, methods of generating income.

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4 Qur’an 3:130.


risk. Lending money does not qualify as a commercial risk, 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. 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. 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. The ultimate purpose of money, from their point of view, is to help fulfill 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.

This position, for instance, is at the heart of the bay‘ al-dayn doctrine or trade in debt claims. Most Shari‘ah scholars agree that the *riba* ban extends to this trade, 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. 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*. Nor is there *ijma* or consensus that *riba* equals interest, even though such a view is widely held. The prohibition on *riba*, specifically pre-Islamic *riba* (riba al-jahihiya) in the Qur’an (2:275) is primary referring to loans (presumably a particular type of loan that existed in pre-Islamic times). 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*. 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). 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. Although this view has been supported by several scholars from a wide range of perspectives, 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; the Shari‘ah recognises that ruling out uncertainty in financial transactions altogether is unrealistic. For that reason, the gharar ban primarily concerns essential 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. 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*. Nor is there *ijma* or consensus that *riba* equals interest, even though such a view is widely held. The prohibition on *riba*, specifically pre-Islamic *riba* (riba al-jahihiya) in the Qur’an (2:275) is primary referring to loans (presumably a particular type of loan that existed in pre-Islamic times). 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*. 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). 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. Although this view has been supported by several scholars from a wide range of perspectives, the view is not accepted in Islamic finance.

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elements of contracts, such as price, deliverability, quality, quantity, etc. Therefore the essentials of a contract may not remain unspecified. The gharrar prohibition is also somewhat related to the ban on qimar which is strictly forbidden by the Shari’ah. Qimar pertains to yields that depend solely on luck or chance, such as gambling. Many Islamic economists would argue that excessive speculation and gambling are prohibited, because profits achieved through them cannot be justified. 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.

**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”. Documentary evidence confirms the use of the word “sakk” in the early Islamic caliphates. The Muslim societies of the pre-modern period used sukuk as forms of papers representing financial obligations originating from trade and other commercial activities. In the earlier theoretical legal works, written instruments of credit were present. Such written instruments are encountered frequently in genizah documents. 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

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36 M. Ayub, Understanding Islamic Finance (Heboken: John Wiley and Sons, 2008), p. 112.
money orders are remarkably similar in form to modern cheques. They stated the sum to be paid, the order, the date, and the name of the issuer. 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. 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. 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, the modern Western word “cheque” appears to have been derived from the Arabic word “*sakk*.”

**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 *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 (muqarada)) 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.”

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. After this issuance, there were no other active issuances by other *sukuk* issuers until the beginning of the 21st century. From 2000 onwards, a number of institutions started issuing *sukuk* and the *sukuk* market took off from there. 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 ...”

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

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53 Section 2 AAOIFI Shari’ah Standards No.17 on Investment Sukuk.
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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. 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. Each sakk represents an undivided interest in an asset. Sukuk reflect participation in the underlying tangible assets, so that what is being traded is not merely a debt. Sukuk are entitlements to rights in certain assets inclusive of some degree of ownership. 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.

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. 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. 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. 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. 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

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underlying asset and as such benefit from the lease rentals as well as sharing in the risk.\footnote{HM Revenue & Customs 2008, p.20; HM Treasury 2007, p.17.} 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 ijarah agreement. Under this lease agreement, the SPV (lessee) 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.

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.\footnote{In the literature, 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.} 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.\footnote{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.} In the literature, this development has been referred to as a move from asset-backed sukuk to asset-based sukuk.\footnote{A. A. Tarq 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.}

**Figure 3.1: Structure of sukuk al-ijara**
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. The SPV issues *sukuk* to the *sukuk* holders and receives *sukuk* proceeds from them, which are used to pay the originator. 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. The *sukuk* holders receive fixed payment of return on the assets and the *sukuk* will be redeemed. In essence, the hybrid *sukuk* concerns the same transaction as the *sukuk al-ijara* transaction. However, while in a *sukuk al-ijara* the *sukuk* 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. 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. 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. 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.

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75 HM Treasury 2007, p.19.
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. 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. 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 depreciation of the assets. 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. He stated that 85 per cent of all the sukuk outstanding at that moment was not Shari’ah-compliant. The main target of his criticism was the equity-based sukuk structures—the sukuk issues based on musharaka, mudaraba, and wakala. 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.

**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. 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. Usmani emphasised that such sukuk structures cannot be Shari’ah-compliant. 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. 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). 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.

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80 M. T. Usmani, Sukuk and their Contemporary Applications (Bahrain: AAOIFI Shariah Council, 2008).
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.59 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.60 Furthermore, he criticised the payment of interest-free loans.61 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.62 The third point that Usmani condemned was the use of purchase undertakings at face value.63 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.64

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.65 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 financier 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 financier, but the profits are rather shared between them.66

**AAOIFI resolution**

Shortly after the paper of Usmani, the AAOIFI Resolution was issued in February 2008.67 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.68 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.69 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.70 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.71 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.72 However, it is permissible to establish a reserve account for the purpose of covering such shortfalls.73 The AAOIFI also permitted on account payments, so long as these payments are subject to final settlement at maturity date.74 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.75 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.76

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

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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.