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Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities

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INTRODUCTION

The twentieth century witnessed the revival of Islamic finance in various parts of the Muslim world as an alternative mode of financing that is in compliance with *shari'a*. From its mundane beginnings, when Islamic financiers were mainly providing Islamic trade financing solutions, the Islamic finance industry today offers a wide range of products and services including personal finance, corporate finance, project finance, equity funds, property funds, and private equity. All these products and services are structured in accordance with *shari'a* principles as interpreted in their respective jurisdictions. The existing product range, which is often priced competitively, provides Muslims with a viable option to manage their financial matters Islamically.

With the dawn of the twenty-first century, we are witnessing the Islamic finance industry constantly venturing into new and exciting areas of finance. One of the important recent endeavors is the development of Islamic debt securities commonly known as *sukuk*. Most Islamic financiers often end up with high levels of liquidity due to various reasons. The Islamic finance industry also lacks *shari'a*-compatible derivative products that could mitigate any asset-liability mismatch risks. The high levels of liquidity often led to inefficiency in the Islamic finance market and the industry leaders actively sought solutions. The *sukuk*, which is a tradable and potentially liquid investment, was seen as a possible avenue for the Islamic financiers to invest their surplus liquidity.

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HISTORY OF ISLAMIC DEBT SECURITIES

Interestingly, *sukuk* or *sakk* is not a new invention of the Islamic finance industry. The concept of *sukuk* has been with the Islamic world since the early days of Islamic civilization. Malik has recorded the first historical account of *sukuk* in his famous treatise *al-Muwatta*. It is stated that in the first century Hijri (corresponding to the seventh century AD) the Umayyad government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of *sukuk al-badai,* which has been translated as "commodity coupons"[2] or "grain permits."[3] The holders of the *sukuk* were entitled to present the *sukuk* on its maturity date at the treasury and receive a fixed amount of commodity, usually grains. Some of the holders used to sell their *sukuk* to others for cash before the maturity date. Although the validity of such trade was been questioned by scholars of that period, it shows that the concept of *sukuk al-badai* as a tradable instrument has been known to the Islamic world for a very long time.

The word *sakk*, though it may sound unfamiliar, is astonishingly well known to all of us. The origin of the word *check*, ubiquitous in the modern financial world, is from the Arabic word *sakk*. It is well known that many of the commercial practices and customs of the Muslim world were transmitted to medieval Europe through Islamic Spain, and *sakk* is one of them.[4] However, like many other inventions of Islamic civilization, the concept of *sukuk* was not exploited to its full potential by the Muslims. The financial community in the West adopted and refined the concept of *sukuk* and expanded its scope of use to a wide range of commercial and financial activities. Today, we see the Islamic financial world adopting the practices of Western finance and adjusting them to meet the requirement of *shari'a*.

In 2001, almost fourteen centuries later, the *sukuk* re-emerged in Bahrain as an Islamic alternative to conventional debt securities.[5] The State of Bahrain[6] offered its inaugural *sukuk al-ijara* issue in the domestic market. The issue amount was USD250 million and had a tenor of five years. The *sukuk al-ijara* concept was derived from the prevailing practices of "lease ending with purchase" *(ijara muntahia bi-tamlik)* which is commonly known in conventional finance as "finance lease."[7] The *sukuk* carried six-monthly lease rentals that were fixed at the lease inception and

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[2] *See* Kamali 2000 for more details.
[3] *See* Ibn Anas 2000: 296.
[4] Schact 1982.
[5] In 2000, the State of Bahrain led the way by issuing the innovative *sukuk al-salam* but these securities were non-tradable.
[6] As it was then known; now the Kingdom of Bahrain.
[7] For a detailed exposition of *ijara muntahia bi-tamlik*, *see* Standard no. 9, *Shari'a* Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5 Hijri / 2003-4 AD).

paid in arrears during the lease term. The *sukuk* offering was highly successful. The Bahrain *sukuk* issue was a major milestone in Islamic finance as it marked the birth of an Islamic capital market where Islamic equity and debt-based instruments are issued and traded.

In 2002, the Federation of Malaysia created another landmark by issuing the first Islamic securities that complied with the U.S. Regulation S and Rule 144A formats that are used for conventional global bonds.[8] The Malaysian *sukuk al-ijara* was the first *sukuk* to be listed in the Luxembourg Stock Exchange and rated by Standard & Poor's and Moody's. The USD600 million *sukuk* was offered globally to Islamic and conventional investors including "Qualified Institutional Buyers" in the United States. The issue was hugely successful and was twice oversubscribed. The Malaysian *sukuk* was a significant development because it was able to successfully fuse the concept of *sukuk al-ijara* with conventional bond practices such as listing, ratings, dematerialized scripts, and centralized clearance.

Subsequently, there have been a number of successful *sukuk* issues in Regulation S format, including the Islamic Development Bank's offering of USD400 million *sukuk* in 2003, the State of Qatar's debut USD700 million *sukuk al-ijara* issue in 2003, and the Kingdom of Bahrain's USD250 million *sukuk al-ijara* issue in 2004. These successful issues have created a lot of excitement in the Islamic finance markets and more issuers are looking at the *sukuk* option as a viable and attractive alternative source of funds. This paper will examine some of the key *sukuk* products currently available in the Islamic finance markets and analyze the structure of each product. It will highlight the salient features of each product and examine the various *shari'a* innovations and the legal aspects of the structures. The paper will also look at the prospects for Islamic profit sharing products[9] and the current impediments to the growth of such products.

SUKUK AL-IJARA

A *sukuk al-ijara* issue is typically structured as follows:

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[8] Prior to that, in December 2001, Kumpulan Guthrie Berhad, a Malaysian public listed company involved in the plantation and construction sectors, has offered a *sukuk al-ijara* issue in the U.S. Regulation S format. The company offered a USD150 million *sukuk* issue with a floating rate return and the tenor was divided into three years (USD50m) and five years (USD100m). The *sukuk* was listed on the Labuan International Financial Exchange.

[9] The term "Islamic profit sharing product" refers to a product or security that is structured on the principle of profit and loss sharing based on *mudaraba*, *musharaka,* or similar concepts.

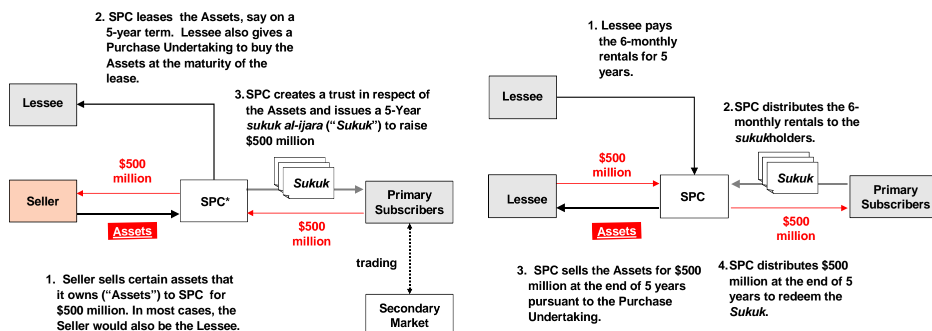

Figure 1. A Typical *Sukuk al-Ijara* Structure

The above structure was used, with minor modifications, in the USD250 million Kingdom of Bahrain *sukuk al-ijara* issue, the USD600 million Federation of Malaysia *sukuk al-ijara* issue, and the USD700 million State of Qatar *sukuk al-ijara* issue. The underlying assets were bought from the seller and immediately leased to the lessee based on the principle of *ijara muntahia bi-tamlik* (lease ending with purchase). The SPC will act as the trustee for the *sukuk* holders and will distribute to the *sukuk* holders the rental proceeds of the leased assets in accordance with the terms of the trust. At the end of the lease period the SPC will sell the assets to the original seller for a sum equal to the original sale price, which the SPC will distribute to the *sukuk* holders to redeem the *sukuk*. Some of the salient features of the *sukuk al-ijara* are discussed below.

Sukuk Characteristics

One of the fundamental requirements of *shari'a* for a security to be tradable is that the security must reflect or evidence the security holder's share in an underlying asset or enterprise.[10] For example, contemporary *shari'a* scholars have allowed investment in equity or share in a company on the basis that the security reflects the holder's ownership of the underlying assets of the company. Through the ownership of the company the shareholders are deemed to indirectly own the assets held by the

[10] The asset or enterprise itself has to be *shari'a*-compatible. Hence, an enterprise involved in alcohol or gambling is not compatible with *shari'a*.

company.[11] By making a link between the ownership of the company with the ownership in the company's assets, the *shari'a* scholars have been able to allow "the buying and selling of these securities on the model not of partnership in the enterprise,[12] but of undivided co-ownership of the company's assets."[13] If the company as a going concern makes a profit by trading in goods, assets, or services the shareholders are entitled to receive from the company a share in the profit through dividends.

A conventional bond, on the other hand, typically confers on the bondholder a contractual right to receive from the issuer of the bond certain interest payments during the life of the bond and the principal amount at the maturity of the bond. The bondholders themselves are deemed as creditors to the issuer of the bond and are ranked as senior unsecured and unsubordinated creditors of the issuer in priority to the shareholders.[14] The juridical nature of a conventional bond is clearly contrary to *shari'a*.

The major challenge was to structure a *shari'a*-compatible instrument that embodies the ownership characteristic of an equity instrument as well as the priority status and the fixed income characteristics of a bond instrument. In addition to those, the *shari'a*-compatible instrument also has to be transferable, rated by recognized rating agencies, listed on major securities exchanges, cleared through major clearinghouses, and documented, in terms of legal documents and disclosures, on par with the prevailing standards in the conventional bond market.

After much concentrated effort, a *shari'a*-compatible solution was finally found, interestingly, with the aid of the common law of trust. At common law, when a person holds an asset on trust for another, the latter can be construed as the beneficial owner of the asset held by the former. The relationship between the trustee and the beneficiary is evidenced by a trust deed executed (often unilaterally) by the settlor. The trust deed can

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[11] At one time the common law also used to treat the shareholders as having some sort of equitable interest in the assets of a company. The company itself was deemed as holding the assets as trustee for the shareholders. However, the prevailing common law position is that a share is a chose in action which confers on the shareholders the contractual right to vote, to receive dividends, return of capital upon winding up, and other rights except that it does not confer a right to possess any physical assets. *Gower's Principles of Modern Company Law* (Paul L. Davies ed., 6th ed. 1997), 299-302.

[12] It is important to note that, from a *shari'a* perspective, if the shares in a company are construed as co-ownership in an enterprise only, the shareholders will then be construed as partners in an enterprise like *mudaraba* and the strict rules of *mudaraba* will come into play. But when the link is made with the ownership in the assets owned by the company, the shareholders will be treated as co-owners of an asset or *shirkat al-milk* and this will allow a co-owner to freely sell his share without the consent of the other co-owners. *See* Vogel and Hayes 1998: 175-176.

[13] *See* ibid., 175.

[14] *See* generally, Ravi C. Tennekoon, *The Law & Regulation of International Finance* (1991), 161-176.

also be documented to allow the relationship between the trustee and the beneficiaries to be created through the issuance of a trust instrument by the trustee to the beneficiary or class of beneficiaries. For instance, a settlor can create a trust over, say, a house pursuant to a trust deed and appoint a trustee to issue trust instruments to a class of beneficiaries. The class of beneficiaries will be limited to the investors who purchase the trust instruments offered by the trustee for a certain consideration. The investors who purchase the trust instruments will automatically become the beneficiary of the trust and be construed as pro-rata owners of the house held on trust by the trustee. The trust deed can also be structured to allow the holders of the trust instrument to transfer the trust instruments to others on a willing-buyer and willing-seller basis. If the trustee leases the house to a tenant for a fixed or variable rental term, the holders of the trust instrument will be entitled to a pro-rata share of the rental income derived from the house held on trust.[15]

These characteristics of the trust instrument squarely meet the requirements of *shari'a*. The trust instruments were aptly named in Arabic as *sukuk* or *sukuk al-ijara* because the trust assets were leased out to produce a lease income. The holders of the *sukuk* will be construed under *shari'a* as co-owners of an asset, although held on trust, similar to a *shirkat al-milk*. As a co-owner of an asset, each co-owner is entitled to sell his share in the asset without the consent of the other co-owners at whatever price he can command in the market. When the trustee receives the variable rentals from the lessee, the *sukuk* holders will receive a proportionate share in the rental proceeds. At the maturity of the lease, which corresponds to the redemption date of the *sukuk*, the trustee will sell the trust asset to the lessee for a price equal to the original acquisition cost of the trust asset.[16] With the proceeds of the sale, the trustee will redeem the *sukuk* and the *sukuk* holders will receive their principal investment. The payment profile of the *sukuk* is thus comparable to a conventional bond or a floating rate note.

The lessee's obligation to pay the lease rentals and the purchase price will be ranked as a senior unsubordinated debt obligation of the lessee toward the trustee, as lessor. This ranking in priority is also comparable to the ranking of a conventional bond instrument.

The concept of trust instrument is also familiar to the conventional investors. In the United States, for example, Equipment Trust Certificates or ETCs have been widely used since the time of the railway boom. A railway company will order the rolling stock from the manufacturer and request the manufacturer to sell the rolling stock to a trustee company set up by the

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[15] See Pettit 1997: 14-17.

[16] This aspect of the transaction is structured as an *ijara muntahia bi-tamlik* in line with the Standard no. 9, *Shari'a* Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5 Hijri / 2003-4 AD).

railway company.[17] The railway company will then agree to lease the rolling stock from the trustee for an agreed period. The trustee will then issue trust certificates to the investors to raise the funds required to pay the manufacturer. From the proceeds of the lease collected from the railway company, the trustee will pay the periodic interest and the principal amount to the trust certificate holders. Since the trustee will own the rolling stock, it will be able to repossess the rolling stock if the railway company defaults on the lease and re-lease it to other railway companies. Because the rolling stock was quite standardized and there was a deep secondary market for it, the trustee was able to obtain the lowest rates in the bond market.[18]

The commonality between the *sukuk* and the trust instrument, such as the ETC, is a key factor because it made the *sukuk* familiar and easily acceptable to the conventional investors, the leading rating agencies, the major securities exchanges, and the leading clearinghouses. The *sukuk* issues by the Federation of Malaysia, the Islamic Development Bank, and the State of Qatar were all rated by international rating agencies like Moody's, Standard & Poors, or Fitch. The *sukuk* issues were also successfully listed on leading exchanges such as the Luxembourg Stock Exchange, the Labuan International Financial Exchange, and the Bahrain Stock Exchange. The *sukuk* were also cleared through Euroclear and Clearstream. These features made the *sukuk* a truly tradable security that met the requirements of *shari'a* as well as the expectations of the conventional bond investors in line with the bond market norms.

Legal and Beneficial Ownership

In the Malaysian *sukuk* issue, one of the *shari'a* concerns was that the trustee was only acquiring the beneficial ownership of the assets held on trust. Usually, when a seller sells a landed property to the buyer, the buyer will acquire the legal ownership of the property when the seller transfers the title to the property to the buyer after receiving full payment from the buyer. In the Malaysian *sukuk* issue, the seller[19] sold the landed assets to the trustee but did not transfer the title to the landed assets to the trustee in order to avoid payment of certain charges and taxes. Instead, the seller declared that it was holding the landed assets on trust for the buyer. The concern from a *shari'a* perspective was whether such a transfer is valid under *shari'a*.

The position under Malaysian law, which is quite similar to the position at common law, is that when the buyer pays the full consideration

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[17] The trustee company will be an orphan entity with no corporate relationship with the railway company.
[18] Fabozzi and Modigliani 2002: 515-516.
[19] The Federal Land Commission, a statutory body that holds all federal lands in Malaysia.

for a landed asset, the seller becomes a bare trustee and the buyer[20] becomes the beneficial owner of the landed assets.[21] As a bare trustee the seller cannot dispose the land to another without the consent of the beneficial owner. From a legal perspective, the law considers the beneficial owner as the true owner with the power to possess and dispose the landed assets.[22] To protect the rights of the beneficial owner against any third party who may claim any interest on the landed assets held on trust, the bare trustee was required to procure a trust endorsement on the land title held at the land registry.[23] The trust endorsement will give a clear notice to third parties of the beneficial owner's right in the landed assets and will avoid the bare trustee from inadvertently transferring the landed assets to any third party.

The distinction between legal and beneficial ownership was initially not familiar to most *shari'a* scholars particularly those who come from civil law jurisdictions.[24] There is no concept of beneficial ownership in civil law. Through fresh interpretations, the contemporary *shari'a* scholars were able to extend the scope of ownership in *shari'a* to include the concept of beneficial ownership when, as illustrated in Malaysia, the true owner in the eyes of law is the beneficial owner and the seller remains only as a bare trustee.

Unilateral Undertaking to Buy the Assets

The issue of whether a unilateral purchase undertaking given by the lessee to the trustee is a binding promise has been debated among the contemporary *shari'a* scholars. Some scholars are of the view that a unilateral purchase undertaking or promise does not create a legal obligation at all but only a moral obligation on the part of the promisor. The proponents of this view rely on the opinions of Abu Hanifa, Shafi'i, Ahmad, and some Maliki jurists. The opponents of this view, however, argue that unlike a bilateral contract of deferred sale,[25] all unilateral undertakings or

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[20] The buyer, however, has to be a bona fide purchaser for value without notice of any prior third party rights attached to the landed asset.

[21] This principle was firmly laid down in the Malaysian case of *Borneo Housing Mortgage Finance Bhd v. Bank Bumiputra Malaysia Bhd*, [1991] 2 MLJ 261.

[22] Such a disposal, however, has to be made through the bare trustee who will have to comply with the instructions of the beneficial owner.

[23] This endorsement is done under section 344 of the Malaysian National Land Code, 1965. For more details *see* Mary George, *Malaysian Trust Law* (1999), 11.

[24] Most of the countries in the Gulf Cooperation Council are civil law jurisdictions.

[25] The concept of unilateral undertaking or promise has a unique existence in Islamic law because Islamic law prohibits an agreement to sell in future (i.e. a deferred sale) and only allows a sale contract where the property in the goods is transferred to the buyer at the time of contract. Most Muslim jurists argue that for a valid sale under *shari'a*, at least one of the counter values, either the purchase price or the goods, has

promises to do something in the future are valid arrangements that are binding on the promisors. The opponents rely on the authority of a prominent companion of the Prophet and the opinions of other renowned scholars including al-Bukhari. Some other scholars, particularly from the Maliki school, have taken the middle view that a unilateral undertaking is only binding on the promisor if "the promisor has caused the promisee to incur some expenses or undertake some labor or liability on the basis of [the] promise."[26] It has been argued elsewhere[27] that the proponents of the view that a unilateral undertaking is not binding at all have not been able to successfully attribute their views to Abu Hanifa and Malik. As mentioned below, both the Hanafi and Maliki jurists have recognized the validity of the promise to effect a sale in future made by the buyer in a *bay'al-wafa'* contract. Furthermore, there is also evidence in the primary sources of *shari'a*, the Qur'an and the *Sunna*, to imply that a promise is binding on the promisor. It is mentioned in the Qur'an: "O ye who believe! Why say ye that which ye do not? Grievously odious is it in the sight of God that ye say that which ye do not."[28]

There are also compelling social and economic arguments to support the view that a unilateral purchase undertaking or promise should be binding. Imagine someone promising to another that if the latter goes and buys certain goods from the market, the promisor will buy the goods from him at a specific price. If the promisor is allowed to repudiate his promise and decline the goods, the promisee will be left exposed to the risk of liquidating the goods without any remedy against the promisor. The promisee may suffer economic losses due to the breach of promise. For example, the promisee may end up selling the goods to another at a discounted price. This will seriously hinder the development of various economic activities such as the *murabaha* contracts where the financier will be relying on the promise of the client when it purchases the goods ordered by the client.

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to be delivered at the time of contract. Deferring both counter values at the time of contract vitiates the contract. *Murabaha* contracts, for instance, have been allowed because only one of the counter values, i.e. the purchase price, is deferred. Another example is the *salam* contract, where only the commodities are deferred while the purchase price is paid at the time of contract. The only exception seems to be the *istisna'* contract, where both counter values are allowed to be deferred based on the prevailing custom *(urf)*. For a detailed discussion on the *shari'a* treatment of deferred sale, *see* Kamali 2000: 131. For a comparative analysis of the common law position, where both a deferred sale and a sale contract are allowed, *see* Goode 1995.

[26] Usmani 2002: 122.

[27] Ibid., 123.

[28] Qur'an: 61:2-3 (Abdullah Yusuf Ali translation).

Based on these grounds and the views taken by many prominent scholars, the Islamic *Fiqh* Academy resolved[29] that a promise made in a commercial transaction, like a *murabaha* contract, is binding on the promisor subject to the following conditions:

1. the promise should be unilateral;
2. the promise must have induced the promisee to incur some liability;
3. if the promise is to purchase something in the future, the parties must enter into the actual sale contract at the appointed time; and
4. if the promisor breaches his promise, the promisee can seek legal remedy in a court of law for specific performance or damages.[30]

Contemporary scholars have extended the above ruling to the *sukuk al-ijara* issue and ruled as valid the unilateral purchase undertaking given by the lessee to buy the assets at the maturity of the lease.[31] This was a significant development that made the *sukuk* issue economically feasible. Otherwise, it would lead to an inequitable result where the lessor would be exposed to the economic losses that may result from the breach of promise while the promisor would be absolved of any liability.[32]

[29] Islamic *Fiqh* Academy 1988.

[30] Actual damages are confined to "actual monetary loss suffered by [the promisee], but will not include the opportunity cost." Usmani 2002: 126.

[31] It has been argued elsewhere that the scope of the Islamic *Fiqh* Academy resolution should not be extended beyond the ambit of *murabaha* transactions and an example was given of a *salam* transaction involving unilateral promise that could lead to "anomalous and radical" results from a *shari'a* perspective. Vogel and Hayes 1998: 126-128. While there is some merit in limiting the scope of the resolution in cases where it may lead to inconsistent results, this should not in itself be taken as a ground to bar the extension of the resolution to cases where if the promisor is allowed to repudiate his promise it would lead to an inequitable situation.

[32] It is interesting to note that this development in the contemporary *fiqh* has some resemblance to the development of the principle of promissory estoppel at common law. The common law had for a long time taken the stand that a promise made in a commercial transaction is only binding if there was consideration for it. In the celebrated English case of *High Trees*, [1947] 1 KB 130, Denning J., changed the course of common law by ruling that when a person makes a promise and knows or reasonably should know that the promisee will rely on his promise, the promisor will be bound by his promise if the promisee has actually relied on that promise and acted upon it. The court ruled that it would otherwise be inequitable to the promisee if the promisor is allowed to dishonor his promise in such circumstances. This is a classic instance where equity has come to remove the rigors of common law, which would have allowed to the promisor his strict right to retract his promise. Since *High Trees*, there has been a plethora of cases reaffirming the principle of promissory estoppel.

Sale of Assets to the Original Seller

Another concern among some *shari'a* scholars was the issue of the trustee selling the assets back to the lessee (being the original seller) at the original cost. Their view was that this arrangement resembles the contract of *bay'al-wafa'* which has been prohibited on the basis of *riba* by the Maliki and Hanbali schools as well as the earlier generation of scholars from the Hanafi and Shafi'i schools. *Bay'al-wafa'* is a contract usually involving a landed asset where the seller will sell the landed asset to the buyer for an agreed price and subsequent to the sale the buyer will promise to sell the landed asset back to the seller whenever the seller pays an amount equal to the original purchase price paid by the buyer. The later generation of scholars from the Hanafi and Shafi'i schools, including the prominent Hanafi scholar Ibn Abidin, however, have allowed this type of contract provided that the promise is made after the sale has been concluded and the promise itself is not made a condition of the sale contract.[33] They took the opposite view that such a transaction actually prevents one from getting involved in *riba* and therefore should be allowed.[34] Some Hanafi scholars have even allowed a *bay' al-wafa'* transaction where the promise has been given prior to the sale itself.[35]

Historically, *bay'al-wafa'* arrangements have been widely practiced in Central Asia and South East Asia for a very long time and they have been recognized as valid by many Islamic scholars.[36] In a *sukuk* issue the sale of the assets to the trustee is made independent of the purchase undertaking given by the lessee to the trustee and the undertaking itself is not made a condition to the sale contract. Based on this arrangement contemporary scholars have allowed the sale of the assets back to the original seller.

Sale of Assets at Market Value

Some scholars took the view that the sale of the assets to the lessee should be at market value determined at the time of actual sale.[37] From a

[33] Nyazee 1995: 74.
[34] *See* Malaysian Securities Commission 2002: 26-28.
[35] Usmani 2002: 87-89 and 123.
[36] In Malaysia, there is ample evidence that such arrangements have been in practice for decades and they have been recognized as valid contracts under *shari'a*.
[37] It is important to observe that, like the issue revolving unilateral undertakings, the issue of selling back the asset to the original seller at the original price goes to the root of *ijara muntahia bi-tamlik* where the lessee will invariably undertake to buy the assets from the lessor at the original cost. Such practice has been in vogue for a long time and has been endorsed by Standard no. 9, *Shari'a* Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5

classical *fiqh* perspective, the predominant view is that the sale price has to be known to both the seller and the buyer in advance in order to make the contract valid. The Shafi'i and Maliki schools have both maintained that any ambiguity and ignorance of the price will vitiate the contract and that uncertainty or *gharar* is removed only by determining a specific price.[38] The Hanbali scholars Ibn Taymiyya and Ibn Qayyim, however, have taken a more liberal view by stating that the price can be determined by assigning a fixed amount or by reference to a certain convention, for example, "the price which other people pay; or the market price, provided that the parties find [that] agreeable and is clear enough to avoid disputes."[39] These opinions, when extended to the unilateral purchase undertaking given by the lessee, mean that the price of the asset can either be determined as a fixed sum at the inception or at the time of actual sale based on the market practice. Since both these options were validly recognized under *shari'a*, the unilateral purchase undertaking given by the lessee in the Malaysian *sukuk* issue to buy the assets at a specified amount based on the original purchase price paid by the trustee is a valid arrangement under *shari'a*. This was in fact in line with the majority view that required a fixed sum to be determined by the parties at the inception of a bilateral or unilateral arrangement in order to avoid any *gharar*.

Late Payment Treatment

Another contentious issue in contemporary *fiqh* is whether a creditor is entitled under *shari'a* to charge a late payment to a debtor who has either delayed or defaulted on a payment obligation. The general principle of *shari'a* is that any additional amount charged to a debtor for any late payment is *riba* and is clearly prohibited. This form of *riba* is commonly known as *riba al-jahiliyya*.[40] Accordingly, in the early days of Islamic finance, the *murabaha* and *ijara* contracts did not contain any provision allowing the Islamic financiers to charge any late payment amount from the purchasers or the lessees. This practice naturally resulted in some debtors abusing the system by delaying, often willfully, the payments due to the Islamic financiers while making every effort to make their payments on time to their conventional lenders. The conventional lenders will invariably impose on the debtors late-payment charges, which are sometimes

Hijri / 2003-4 AD). This matter therefore should not be confined to *sukuk* issues alone. If the practice is acceptable in *ijara muntahia bi-tamlik* transactions, it should be automatically applicable to *sukuk al-ijara* since the underlying transaction evidenced by the *sukuk* is *ijara muntahia bi-tamlik*.

[38] Kamali 2000: 95.

[39] Ibid., 95.

[40] To connote a type of *riba* widely practiced during the pre-Islamic days in Arabia.

compounded on a daily basis. The strong moral basis behind the prohibition of *riba al-jahiliyya* is that a debtor in difficulty should be given a respite until he can improve his financial conditions instead of imposing on him further hardship in the form of late payment charges. The prevailing practices, however, led to a moral hazard whereby the Islamic financiers, and their depositors, were exposed to hardship caused by the willful delays of the debtors.

A fresh *shari'a* interpretation was required to address the contemporary problem faced by the Islamic industry. The scholars who favored the late payment compensation to be charged to the debtor relied on the well-known *hadith* that "a wealthy person who delays the payment of his debts, subjects himself to punishment and disgrace."[41] It is not uncommon for a wealthy person to be short of liquidity due to excessive leverage or a lavish lifestyle and based on the above *hadith* he should not be excused for delaying a payment obligation to another. He should be penalized for the delay and for causing the hardship to the creditor. The form of punishment includes payment of monetary compensation to the creditor. Therefore, late payment charges can be validly imposed on a willful defaulter.

The opponents of the above view, however, contend that any penalty on the defaulter can only be imposed by a competent judicial authority or by arbitration. *Shari'a* does not allow a creditor to decide unilaterally that the debtor has willfully defaulted and also impose the quantum of compensation payable by the debtor. Unless a creditor brings a legal action against the debtor to prove the willful default, the creditor cannot claim compensation from the debtor.

The middle view is that a creditor can validly procure the debtor to irrevocably undertake that if he delays any payment due to the creditor, he will donate to a charity nominated by the creditor a specific amount of money. Since the creditor does not receive the late payment amount or benefit from it, the scholars have allowed such an undertaking without any need for the creditor to bring a legal action. If the debtor fails to honor his undertaking, the creditor can enforce the undertaking in a court of law.[42] The scholars hope that this mechanism will eliminate or reduce the moral hazard faced by the creditor. This method was accordingly adopted in the Qatar *sukuk* issue.

For practical purposes, the scholars have also allowed a debtor who delays any payment to pay the late payment amount directly to the creditor who will then donate the late payment amount to charity after deducting any

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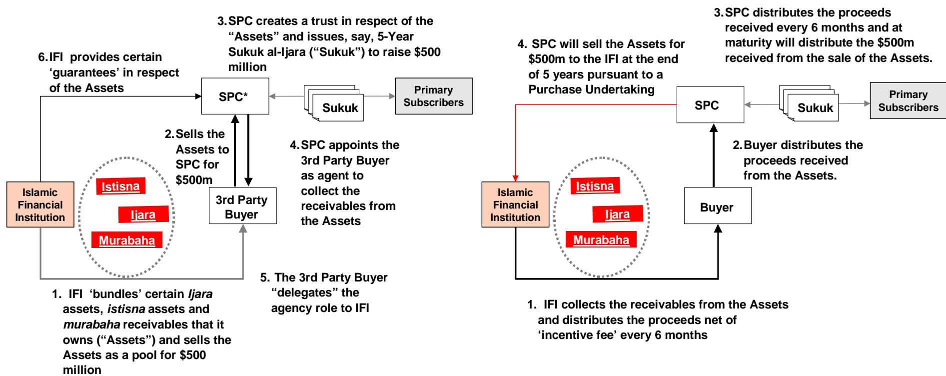
[41] *See* Usmani 2002: 134.

[42] Whether such an action will be enforceable in a court of law will depend on the respective legal jurisdiction. Under English law, the current view is that such an undertaking will be enforceable by the creditor although the creditor is not the recipient of the payment.

administrative expenses that the creditor has incurred in monitoring and recovering the delayed payment. This method for recovering a late payment amount was adopted in the Malaysian *sukuk* issue.

SUKUK AL-ISTITHMAR

The USD400 million *sukuk* issue by the Islamic Development Bank (IDB) was based on the following structure:



** A special purpose company established solely for the purpose of facilitating the issuance of the Islamic securities.*

Figure 2. Structure of the USD400 Million *Sukuk* Issue by the Islamic Development Bank

The IDB *sukuk* issue was highly structured and a detailed elucidation of the structure is beyond the scope of this paper. Some of the key characteristics are discussed below.

Mixed Portfolio of Assets

One of the most innovative *shari'a* features in the IDB *sukuk* is the extension of the *khulta* principle to the field of commercial transactions like the sale of a mixed portfolio of assets consisting of tangible assets and receivables. The validity of sale of receivables or debt, known in *fiqh* as *bay'al-dayn* or *bay' al-kali' bi-al-kali'*, has been a contentious subject among contemporary scholars. The majority of scholars in the Middle East have taken the view that the sale of debt or receivables is not allowed under *shari'a* because it is tainted by *riba*. This ruling severely constrains the Islamic financial institutions from securitizing the receivables due from

their *murabaha* facilities, which form the bulk of their assets. However, utilizing the principle of *khulta*, the Islamic financiers can now create a mixed portfolio or a mixed fund[43] by pooling together the receivables *(dayn)* with tangible or physical assets *(‘ayn)* and then sell the mixed portfolio. The important criterion from a *shari‘a* perspective is that the percentage of tangible assets in the mixed portfolio has to be at least 51 percent.

When an object consists of two substances and one of those is prohibited under *shari‘a*, the object can still be construed as *shari‘a*-compatible if the quantity of the non-compatible substance is insubstantial. For example, if a ring is made of gold and silver, it is permissible for a Muslim male to wear it if the quantity of the gold substance is insubstantial. Opinions differ among scholars as to what amounts to an “insubstantial” quantity. Most scholars have taken the view that the non-compatible substance will be regarded as insubstantial if the quantity of the *shari‘a*-compatible substance is at least 51 percent.[44] Some Hanafi scholars have taken a more liberal view of the *khulta* principle. They have not allocated any fixed percentage or quantity but have left the matter to be decided on a case-by-case basis. Hence, there may be circumstances where even if the non-compatible component is more than 50 percent, the object can still be considered to be *shari‘a*-compatible as a whole.

In the IDB *sukuk*, the mixed portfolio consisted of *ijara* assets comprising 65.8 percent of the portfolio and *murabaha* and *istisna‘* receivables comprising 34.2 percent. The 65.8 percent of *ijara* assets is comprised of certain physical assets owned by the IDB and which have been leased out to various counter parties. Since the *ijara* assets can be freely transferred at any price by the IDB, by mixing the *murabaha* receivables *(dayn)* with *ijara* assets *(‘ayn)* the IDB was able to transfer the *murabaha* receivables as well.

Replacement of Maturing Assets

Since the receivables in the mixed portfolio will mature during the life of the *sukuk*, the *sukuk* structure has to accommodate two changes in circumstances. First, the composition of the portfolio will evolve into a

[43] The concept of a mixed fund has been espoused for some time by prominent scholars like Sheikh Taqi Usmani and the IDB *sukuk* has caused the concept to gather wider acceptance. *See* Usmani 2002: 218.

[44] Based on the bare or simple majority rule. A similar rule was used in screening *shari‘a*-compatible equities: only equities of companies having not more than 45 percent account receivables were accepted as *shari‘a*-compatible. *See* the Methodology Overview of Dow Jones Islamic Market Indexes (visited April 10, 2004) at www.djindexes.com/jsp/imiMethod.jsp.

mixed portfolio of *ijara* assets, *murabaha* and *istisna‘* receivables, and cash from the matured receivables. In this scenario, the cash will be re-invested in new *ijara* assets or new *murabaha* trades to be sourced by the IDB. The key aim is to ensure that the cash is not held idle and is promptly invested in *shari‘a*-compatible assets.

Secondly, some of the *ijara* assets in the portfolio may be redeemed from the portfolio prior to the *sukuk* maturity. In the event, the composition of the mixed portfolio will change and the percentage of *ijara* assets may fall below the 51 percent requirement and may taint the *shari‘a*-compatibility of the whole portfolio. The *shari‘a* scholars have tackled this matter quite ingeniously. They have allowed the percentage of the *ijara* assets in the mixed portfolio to temporarily drop to the level of 25 percent of the total portfolio during the interim period when the cash is being re-invested into new *ijara* assets. The key objective is to give sufficient time for the cash to be re-invested in *ijara* assets so that the makeup of *ijara* assets can be increased back to the level of at least 51 percent. However, if the level of *ijara* assets falls at any time below the threshold of 25 percent, the level of *shari‘a* tolerance comes to an end and the portfolio has to be promptly unwound. The IDB will then be bound to buy the mixed portfolio of assets at a price equal to the original price paid by the *sukuk* holders.

Net Asset Value Computation

Another important principle laid down by the contemporary scholars in the IDB *sukuk* is that the value of the *murabaha* and *istisna‘* receivables to be included in the mixed portfolio can be based on their net asset value (NAV). The pricing model for both the *murabaha* and *istisna‘* financing consists of two components: the cost and the agreed profit margin. The *shari‘a* scholars have allowed the NAV for the *murabaha* and the *istisna‘* receivables to be calculated net of all agreed profit margin. In the past, it was unclear whether the value of the *murabaha* and *istisna‘* receivables can be computed based on an NAV basis. The NAV computation method as adopted in the IDB created a strong precedent and is more pragmatic and in line with the needs of the industry.

The same computation method has been adopted for the NAV of the *ijara* assets that were computed on the basis of the net lease rentals after deducting the profit margin component. It is a well-entrenched principle that an *ijara* asset, being a tangible *(‘ayn)* asset, can be sold at whatever price that the parties may mutually agree including on an NAV basis. The NAV computation method for *ijara* assets in the IDB *sukuk* was therefore in line with the prevailing practice.

Seller's Guarantee

Another significant principle applied in the IDB *sukuk* issue is that the seller of an asset can independently guarantee the performance of the end-user of the asset or the payment obligations of a third party emanating from the asset. For instance, the seller of a house subject to a lease can guarantee to the buyer that if the lessee defaults on the lease payment obligations, the seller will indemnify the buyer. The key conditions for the validity of the guarantee are: (1) that the guarantee should be independent of the sale of the house and should not be made a condition to the sale contract; (2) the guarantor should not charge any consideration for the guarantee; and (3) the guarantor should not act as agent or *mudarib* of the person whose liability is being guaranteed.[45]

To meet all the three conditions above, the mixed portfolio was sold by the IDB to a third party[46] and the third party then sold the mixed portfolio to the issuer. The IDB then provided the guarantee directly to the issuer covering the payment obligations of all the lessees and the *murabaha* and the *istisna'* counter parties. There was no consideration paid by the issuer to the IDB. The issuer then appointed the third party as its agent to administer and service the mixed portfolio.[47] Without the third party's involvement, the issuer would have to directly appoint the IDB as its administrative and servicing agent. This would then mean that the IDB would not be able to provide the guarantee to the issuer because it also has to act as the agent of the issuer.

Liquidity Facility

In the IDB *sukuk,* there is a likelihood of a timing mismatch between the time for receiving the proceeds due from the underlying lessees and the *murabaha* and *istisna'* counter parties and the prescribed dates for payment

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[45] It is important to note that the above principle does not extend to the seller guaranteeing the performance of the asset itself. For example, the seller of an equity or share in a company cannot validly guarantee that the equity will yield a certain amount of dividends (e.g., if the share does not yield the dividends as guaranteed, the seller will then indemnify the buyer to the extent of the deficit). The ambit of the guarantee as used in the IDB *sukuk* is only confined to the obligations of an end-user of the assets.

[46] Islamic Corporation for the Development of the Private Sector ("ICD") was involved as the third party in the IDB *sukuk* issue.

[47] The third party then delegates the administration and servicing obligation to the IDB. From a *shari'a* perspective, this arrangement does not create a link between the issuer and the IDB. There is no contractual nexus between the issuer and the IDB and thus the IDB is not treated as the agent of the issuer.

of the periodic distributions by the issuer to the *sukuk* holders. The issuer may only receive the proceeds a few weeks after the prescribed dates for payment. Technically the issuer is only obliged to make the periodic distributions after it has received sufficient proceeds due from the mixed portfolio. This will mean that the periodic payment dates cannot be set in advance, which will in turn lead to other logistical problems for the issuer and the investors. To mitigate the timing mismatch difficulties, the *shari'a* scholars have allowed the IDB to provide an interest-free liquidity facility to the issuer whereby if there is a shortfall in the proceeds on the prescribed distribution date, the issuer can draw an amount equal to the shortfall from the liquidity facility. The issuer will then be able to make the full distribution payment on the prescribed distribution date. When the issuer finally receives the proceeds, the advance made by the IDB through the liquidity facility will be repaid in full.[48] This unique *shari'a* innovation was able to resolve the issues raised by the potential timing mismatch and facilitate the successful issuance of the IDB *sukuk*.

BAY' BI-THAMAN 'AJIL BONDS

Bay' bi-thaman 'ajil (BBA) bonds are the most popular form of Islamic debt securities in the Malaysian domestic debt capital market and in recent years have accounted for almost half of the total new debt securities issued in the domestic market. The structure of the BBA bonds, which is fairly simple, is set out below:

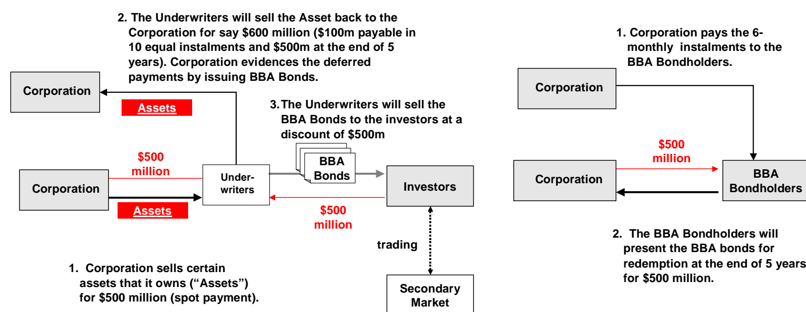

Figure 3. *Bay' bi-Thaman 'Ajil* Bond Structure

[48] Alternatively, the advance received by the issuer can be repaid when the portfolio is sold back to the IDB under the purchase undertaking. The exercise price for the portfolio will include an amount equal to the outstanding advances.

The BBA bond structure is built upon the principles of *bay'al-'ina* and *bay' al-dayn*, which are briefly discussed below.

Bay' al-'Ina

A transaction involving two sales where the seller sells an asset to the buyer on a spot payment basis and the buyer then immediately sells it back to the seller at a higher price on a deferred payment basis is known in *fiqh* as *bay'bi-thaman 'ajil*[49] or *bay' al-'ina*. The term *bay' al-'ina* also includes a transaction where the seller sells an asset to the buyer on a deferred payment basis and the buyer then immediately sells it back to the seller at a lower price on a spot payment basis. Both parties end up executing two contemporaneous contracts, one for spot payment and another for deferred payment, without taking any delivery or possession of the underlying asset.

The contemporary scholars who support the validity of *bay'al-'ina* rely on the views of Shafi'i and Zahiri schools.[50] They maintain that the validity of contracts is to be examined only through their external manifestation. The motive of the parties to the contract is immaterial and it does not invalidate the contract. Hence, the motive of the parties in entering into the two sales in a *bay' al-'ina* arrangement is irrelevant. The argument goes that only God knows the motive of man and man judges only the external deeds. The motive is left to God. These scholars rely on a *hadith* that states that in certain areas of human affairs, such as marriage, divorce, and manumission, motive or intention of the parties is irrelevant.[51]

The opponents of *bay' al-'ina* strongly contend that the *hadith* relied on by the proponents do not establish a general rule that in matters of personal affairs such as marriage, divorce, and commercial transactions one should not look at the intention of the parties. The well-established rule in Islam, they contend, is that all actions are judged by the intention of the parties. The *hadith* cited by the proponents merely lay down an exception to the general rule in certain limited circumstances. The reason for the exception, as pointed out by Ibn Qayyim, is that the acts of marriage, divorce, and manumission involve the right of God *(haqq Allah)* and it is not desirable for humans to act in jest with God. The Prophet, due to the

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[49] The term *bay` bi-thaman 'ajil* (similar to *bay' al-mu'ajjal)* is used mainly in Malaysia.

[50] Malaysian Securities Commission 2002: 21.

[51] The *hadith* relates to the pronouncement of *nikah* or *talaq* in jest. It has been recorded that the Prophet said: "He who jests with the words that will make a binding contract of marriage, or with the words that pronounce a divorce or declare a slave free, shall be taken to have meant the words seriously." *See* Malik Ibn Anas, *al-Muwatta*, Book 28 (Aisha Abdarahman at-Tarjumana & Yaqub Johnson translation).

magnitude of the acts involved, had imposed the strict obligation on those who make statements in jest. This exception is only confined to marriage, divorce, and manumission and accordingly the *hadith* clearly mentions only these three circumstances. If it had been meant to include all types of commercial contracts the Prophet would have expressly mentioned it. Since no such express statement was made, the *hadith* should only be confined to areas of marriage, divorce, and manumission and there is no justification to extend it to commercial transactions.

The proponents also rely on another *hadith* regarding a case of adultery and the issue of *li'an*.[52] In this case, there was a strong possibility that the accused was taking a false oath, but despite that the Prophet decided that she was not guilty based on her oral statement and her external conduct. This *hadith* was relied upon to prove that motive or intention is not relevant in personal matters that include commercial transactions. The opponents strongly deny this by submitting that the Prophet in hearing the dispute was weighing between two probabilities: the probability that the charge against the accused was true and the probability that her oath denying adultery was truthful. The Prophet acting as a judge had to weigh both probabilities and deliver a just ruling. Based on the peculiar facts of that case, the Prophet decided that the probability of the truth of an oath was stronger. The *hadith*, therefore, does not support the proposition that one is always judged by one's external deeds rather than one's intention or motive.

The majority of the scholars have therefore decided that *bay'al-'ina* is not a valid contract under *shari'a* and regard it as a *hila* or *hiyal* (legal fiction) to practice *riba*.[53] The Malaysian scholars, however, have adopted the minority opinion and allowed it as a valid *shari'a* transaction.

Bay' al-Dayn

The debt arising out of the two contracts of sale or exchanges *(awad al-muawadhat)* as described above are securitized using the concept of *bay'al-dayn*. Pursuing the above example, the corporation will evidence its debt (i.e., the sale price payable on deferred terms) to the underwriters by issuing debt securities known as *shahadat al-dayn* and these are comparable

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[52] The *hadith* relates to *li'an* and the wife of Hilal bin Umaiyyah. The wife of Hilal was charged with adultery and she denied the charge by taking the oath. Before taking the fifth oath, she faltered. It seemed for a moment that she might admit adultery but then she said that she was not going to dishonor her tribe by admitting adultery and took the fifth oath denying adultery. Here, there was a strong possibility that she was taking a false oath, but despite that the Prophet decided that she was not guilty based on her external deed (oral statement); *see* Muhammad Al-Bukhari, Sahih al-Bukhari, Volume 6, Book 60 (M. Muhsin Khan translation).

[53] Malaysian Securities Commission 2002: 21.

to zero coupon securities. The debt securities or BBA bonds are issued to the underwriters at par. The underwriters will then offer the securities in the primary market at a discount similar to a primary offering of zero coupon bonds.

The subject of *bay‘ al-dayn* is still being debated by contemporary *shari‘a* scholars. The majority of the scholars in the Middle East have prohibited *bay‘ al-dayn* on the basis of an *ijma‘* (consensus of opinion) among the scholars. Ahmad has recorded that such an *ijma‘* has taken place. These scholars also rely on a *hadith* where it is reported that the Prophet has expressly prohibited *bay‘ al-kali’ bi-al-kali’*.[54] Others argue that if the exchange of $100 today for $110 payable in cash one month later is considered as *riba*, it is inconceivable that *shari‘a* would allow an exchange of $100 today for $110 worth of receivables that will accrue one month later. The “prohibition of *bay‘ al-dayn* is a logical consequence of the prohibition of *riba* or interest. A ‘debt’ receivable in monetary terms corresponds to money, and [in] every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to *riba* and can never be allowed in *shari‘a*.”[55]

The proponents of *bay‘ al-dayn,* however, contend that there is no evidence to support the existence of an *ijma‘* on the issue of *bay‘ al-dayn*. They also maintain that the various schools have different views on what constitutes *bay‘ al-dayn* or *bay‘ al-kali’ bi-al-kali’* and it is impossible for an *ijma‘* to materialize with such a divergence in views. They also rely on prominent scholars like Ahmad, Ibn Qudama, and Ibn Taymiyya who have refuted the validity of the *hadith* prohibiting *bay‘ al-kali’ bi-al-kali’*. They conclude that since there is no clear evidence in the *shari‘a* that prohibits *bay‘ al-dayn,* the guiding principle should be that it is a permissible transaction.[56] However, they have not been able to respond to the argument of the opponents that the debt, being traded for money, should also be treated as money and consequently money traded at a discount is tainted with *riba*.

The scholars in Malaysia have adopted the minority view and using the concept of *bay‘al-‘ina* and *bay‘ al-dayn* were able to permit the issuance of *bay‘ bi-thaman ‘ajil* bonds.[57] Both these contracts have been prohibited by scholars in the Middle East.

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[54] Kamali 2000: 128 (citing the *hadith* reported by Musa ibn Ubayday on the narration of Abd Allah ibn Umar).
[55] Usmani 2002: 217.
[56] Kamali 2000: 125-130.
[57] Malaysian Securities Commission 2002: 16-19.

PROSPECTS FOR ISLAMIC PROFIT SHARING PRODUCTS

The common thread permeating all the three *sukuk* structures discussed above is that all these structures share a close resemblance to conventional debt securities. In particular, their economic profile is often identical to that of a conventional bond. All of them have a fixed income component, either in the form of a fixed profit margin or variable lease rental. Like conventional debt securities, all of them have a redemption feature where the principal investment is returned at the maturity date of the *sukuk*. These features have inevitably led to the criticism that the Islamic alternatives are merely alternatives in form and not in substance. They argue that if in substance the Islamic alternatives are not dissimilar to their conventional counterparts then the Islamic products are merely another type of product within the broad range of conventional products. The argument does hold certain weight when one looks at it from purely an economic perspective. For customers who seek Islamic alternatives, often the paramount consideration is whether the Islamic products offered are competitively priced. The yardstick used for measuring the competitive pricing for Islamic products is unfortunately the pricing prevailing in conventional finance. For example, when a customer walks into an Islamic bank seeking Islamic home finance, one of the key considerations for the customer is whether the pricing of the Islamic product is on par with the conventional mortgage products available in the market. Hence, if the pricing for a fixed rate 20-year mortgage is 10 percent par, the customer will invariably demand the same pricing for the Islamic product. While the majority of the customers seek Islamic finance solutions to satisfy their religious convictions, the economic reality is that the pricing consideration often prevails over their religious convictions. If the pricing of the Islamic product is more expensive, then there will be less demand for the Islamic alternative. It appears that only a handful of customers will be prepared to pay a premium for an Islamic solution.

Pricing an Islamic Debt-Based Product

Faced with this reality, the Islamic finance providers are compelled to structure the Islamic products in a manner so that the risk profile of the Islamic alternatives is as close as possible to their conventional products. For instance, if we look at the *murabaha* home financing solutions available in the market it will be evident that the risk profile of the *murabaha* is not dissimilar to the risk profile of a conventional mortgage. The Islamic financier will buy the property chosen by the customer and immediately sell the property to the customer for a fixed price payable over a period of, say, ten years pursuant to a *murabaha* arrangement. To secure the deferred

payment obligations of the customer the Islamic financier will take a mortgage over the property. What is the risk profile of this transaction? The Islamic financier is exposed to the credit risk of the customer and this risk is secured by the value of the property held on mortgage. Isn't this risk profile identical to the risk profile of a conventional mortgage? The law of one price[58] would dictate that in an efficient market similar products must be priced alike; otherwise it would create riskless arbitrage opportunities. It follows from this principle that an Islamic home finance product, which shares a similar risk profile to a conventional mortgage, must share the same pricing as the conventional mortgage product. The stark reality is that Islamic finance providers, being driven by the customers to price their products competitively with the conventional products in the marketplace, are compelled to structure the Islamic alternatives with a comparative risk profile. If a 20-year fixed rate conventional mortgage is priced in the market at 10 percent pa, a 20-year *murabaha* financing will inescapably also be priced at 10 percent pa. This then raises the question of whether the similarity in risk and pricing profile makes the products like *murabaha* or *ijara* doubtful in the eyes of *shari'a*.

Fortunately, the Qur'an has addressed this very question where the text states: "they (non-believers) say: 'Trade is like usury, but God hath permitted trade and forbidden usury.'"[59] According to the renowned commentaries of the Qur'an,[60] this verse was revealed to address the confusion among the non-believers regarding a particular type of transaction prevailing at the time of the Prophet. It was common at that time for people to buy goods and commodities on credit or deferred payment terms and the sellers would charge a higher price for the credit sale. For instance, if the cash sale price is $10, the price for a deferred sale payable in one month might be $12. If at the time of payment, the buyer requests an extension of one month, the seller would increase the price to $14 and then grant the extension. The Prophet has prohibited any increase in the debt in return for an extension of time and such increase is known in *fiqh* as *riba al-jahiliyya*. The non-believers "used to say that it is all equal whether we increase the price in the beginning of the sale, or we increase it at the time of maturity. Both are equal."[61] To them the $2 increase at the time of sale is the same in substance as the $2 increase at the time of extension. Why should the first $2 be allowed as sale and the second $2 prohibited as *riba*?

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[58] A well-entrenched principle of economics which states that the same item or closely equivalent item must sell for the same price or related prices in an efficient marketplace. The principle also shows that financial products with similar cash flows or payoffs should command the same price thereby denying the arbitrageurs the opportunity to profit from riskless arbitrage opportunities.
[59] Qur'an: 2:275 (Abdullah Yusuf Ali translation).
[60] Usmani 2000b: 36-37.
[61] Ibid., 37.

This complex issue was resolved by the Qur'an in very simple terms: "God hath permitted trade and forbidden usury." According to a prominent jurist:

> The Holy Quran could have mentioned the difference between interest and profit in pure logical manner, and could have explained how the profit in a sale is justified while the interest is not. The Holy Quran could have also spelled out the evil consequences of *riba* on the economy. But this line of argument was intentionally avoided. . . . The hint given is that the question whether these transactions have an element of injustice is not left to be decided by human reason alone, because the reason of different individuals may come up with different answers and no absolute conclusion of universal application may be arrived at on the basis of pure rational arguments. . . . [O]nce a particular transaction is held by Allah to be haraam, there is no room for disputing it on the basis of pure rational argumentation because Allah's knowledge and wisdom encompasses all those points which are not accessible to ordinary reason.[62]

The above verse and commentary clearly lend support to the view that the similarity from a risk and return profile between a *murabaha* sale and a conventional loan financing does not necessarily mean that the *murabaha* sale is tainted with *riba*. From a *shari'a* viewpoint, the similarity in risk and pricing profile does not affect the *shari'a* authenticity of these products.

The Role of Debt in Islam

One could then argue that the above conclusion would mean that the Islamic finance industry could be built on the basis of *murabaha*, *istisna'*, *ijara* and other similar debt-oriented products, all of which would have risk and return profiles comparable to conventional financial products. We have already seen the economic resemblance between a *murabaha* and a loan transaction. An *ijara muntahia bi-tamlik* transaction, where the lessor leases an asset with an option to sell to the lessee, also has some resemblance to a conventional finance lease. An *istisna'* arrangement, where the Islamic financiers will finance the construction of an asset and then sell the completed asset to the customer, also shares common features with a conventional construction loan facility. In all these Islamic transactions the customers incur debt obligations, either in the form of installment payments or lease rentals or purchase consideration payable under a purchase undertaking.[63] This then attracts the criticism that Islamic finance, as currently practiced, is actively promoting debt transactions in the society instead of promoting the Islamic profit sharing products. If, for the sake of argument, a financial system moves from a conventional debt-based

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[62] Ibid., 87.
[63] Particularly in an *ijara muntahia bi-tamlik* transaction.

financing model to an Islamic debt-based financing model, will the ills of a debt-driven financial system be removed from the Islamic model? According to a prominent jurist, when "the whole economy turns into a debt-oriented economy. . . . [It] not only dominates over the real economic activities and disturbs its natural functions by creating frequent shocks, but also puts the whole mankind under the slavery of debt."[64] One then wonders whether the Islamic finance model based on predominantly debt-based solutions will end up experiencing the same problems encountered in the conventional finance model.

The above criticism does have some merit when one looks deep into the wisdom or *hikma* behind the prohibition of *riba*. One of the values behind the prohibition is to discourage Muslims from incurring debt without a reasonable need. For example Muslims are discouraged from incurring debt for "living beyond one's means or to grow one's wealth." It has been said elsewhere that "[t]he well known event that the Holy Prophet refused to offer the funeral prayer *(salat al-janaza)* of a person who died indebted was, in fact, to establish the principle that incurring debt should not be taken as a natural or ordinary phenomenon of life. It should be the last thing to be resorted to in the course of economic activities."[65] If one wants to grow one's wealth through commercial and other revenue-generating activities, Islam actively promotes financing through equity participation and profit and loss sharing mechanisms such as *mudaraba* or *musharaka*. It follows from this analysis that a debt incurred through *murabaha*, *ijara,* or other comparable products will be discouraged under *shari'a* if the debt has been incurred without a reasonable need. The key issue for consideration, then, is what is a "reasonable need"?

When analyzing a reasonable need, the scholars usually look at various factors including, among others, the nature of the need, the economic conditions of the debtor, and the prevailing conditions in the country of the debtor. The scholars are not oblivious to the reality of the prevailing economic conditions in the world today. For instance, they clearly understand that under the current economic conditions it is extremely difficult for many individuals to acquire a house without incurring a debt. For many individuals, even a lifetime of savings may not be sufficient to achieve their aspiration of owning a home. In many markets house prices keep increasing at an alarming pace and one may not be able to rely on savings alone to purchase a house. And no one will deny the fact that owning a house for self-occupation has become an indispensable

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[64] Usmani 2000b: 101 (citing the existing state of economic affairs in the world where many countries, including those in the developed world, are over-burdened by excessive domestic and foreign debts, which in some cases even exceed the country's total GDP). *See* also Tarek El Diwany, *The Problem with Interest* (1997), 61-74, 115-122.

[65] Usmani 2000b: 100.

requirement. It can therefore be strongly argued that if one can only acquire a house through incurring a debt, then such a debt is a just and reasonable need. The *shari'a* should therefore allow the individual to incur a debt provided there is no element of *riba* involved. The homebuyer can seek Islamically structured home financing based on, say, *murabaha*, *ijara,* or *musharaka mutanaqisa*. Conversely, if someone wants to incur a debt to acquire a house in the south of France for his family to use during the summer break, most scholars may conclude that such a debt is for an unreasonable or excessive need and should be discouraged.[66]

The *shari'a* scholars believe that, by screening the use of Islamic debt-oriented products through the filter of reasonable need, the Islamic products will not be used to proliferate the spread of debt in the society. Such a safeguard will hopefully prevent the Islamic finance model from inheriting the kind of problems encountered in the conventional finance world. Like many other predicaments faced by the contemporary Muslim world, the hurdle lies in the implementation. Islamic finance is currently being used to finance almost all the needs of the society, from financing a home to financing a holiday. In its zeal to compete with the conventional finance world, the Islamic finance industry is constantly innovating to produce various Islamic alternatives to match the conventional product range. While innovations are certainly healthy and always welcomed, the Islamic finance industry should be careful to avoid being used as a medium to proliferate debt in society. Various safeguards should be built in to screen the type of debt that can be incurred Islamically. Indiscriminate extension of credit without the safeguards provided by *shari'a* will eventually lead to the Islamic finance industry facing the same problems that are faced by the conventional finance industry.

Impediments to the Growth of Islamic Profit Sharing Products

If the Islamic finance industry is aware of the potential hazards linked to debt-based products, why is the industry not actively promoting or offering more Islamic profit sharing products? The Islamic finance industry is constrained by several factors in seeking to do this and some of them are highlighted below.

[66] Some contemporary scholars argue that the issue of reasonable need is very subjective and should be left to the individual incurring the debt. If the debtor decides that it is a reasonable need for him, he can incur the debt through Islamically structured financing.

1. Mindset in the industry

In any given industry the most important factor for its success is its human resources. The Islamic finance industry is no exception. Since the Islamic finance industry is relatively new, most of the Islamic finance practitioners have been appointed from the conventional finance market. It is inevitable that most of the practitioners, having been brought up in the conventional banking environment, will find it difficult to shift from the conventional finance mindset to an Islamic finance mindset. Due to the familiarity with conventional debt products, the practitioners often tend to perceive Islamic products purely from a debt perspective. Often the key focus and energy is concentrated on finding Islamic substitutes to the conventional products that the practitioners are familiar with. For example, a practitioner with a corporate loan origination background may, consciously or subconsciously, end up designing an Islamic product comparable to the conventional counterpart. Often an Islamic product is offered to the customer in the same way as a conventional product, without taking the extra effort to explain the rationale behind the Islamic structure or to explain the pricing justification. Many a time we hear the simplistic response: "The Islamic product is the same as the conventional product. Instead of paying interest you pay a profit or rental." This type of approach and mindset is injurious to the industry and a paradigm shift is urgently required. The industry leaders should promptly look into this issue and develop training programs and workshops to inspire an indigenous culture and frame of mind in the Islamic finance industry. In particular, the programs should focus on the development of real alternatives, based on profit and loss sharing mechanisms, for suitable commercial or productive activities.[67]

2. Customers' reluctance to share the economic upside

The customers who seek Islamic finance solutions also view Islamic products through the spectacles of conventional finance. Most of the customers, being familiar with conventional finance products, expect to see in the Islamic structure some resemblance to the conventional counterpart particularly in terms of pricing and security. If the customer can get a clean corporate loan at say 5 percent p.a., it expects the same terms for the Islamic

[67] Not all financing needs are suitable for profit-sharing mechanisms. For instance, consumption-related transactions like home and car financing are not suitable for profit-sharing modes of financing. Although home financing products have been structured through *musharaka mutanaqisa*, the underlying transaction is still based on *ijara*.

facility. If the corporation is offered an alternative Islamic financing structure based on a profit and loss sharing mechanism, most often the offer is declined. From a conventional finance perspective, the corporation's key aim is to maximize profits for its shareholders.[68]

If, say, a corporation obtains a loan of $100 at 5 percent p.a. and is thereby able to generate a profit of $10, the corporation has maximized its profit by $5 after paying the $5 interest. And if the profit generated is $15, the corporation has maximized its profit by $10. If the same corporation were to take an Islamic profit and loss sharing facility with a profit ratio of, say, 50:50, in the first scenario where the profit generated is $10, the company will increase its own profit by $5. The remaining $5 will be distributed as profit to the Islamic investors. In the second scenario, however, the corporation only gets $7.50 because it has to share the profit of $15 with the investors in the ratio of 50:50. This scenario makes the profit and loss structure less appealing to most of the customers. The following third scenario, however, is beneficial to the customers if they were to take the Islamic alternative. Assuming the profit generated is only $3, the corporation will still make a profit of $1.50 because it only has to distribute $1.50 to the Islamic investors as their share of the profit. Under the conventional loan, the corporation would have suffered a $2 loss since it has to pay a fixed interest amount of $5. But in reality, the well-established corporations are not prepared to share the economic upside. Often they are tempted by the best-case scenarios where they can maximize their profits manifold and the worst-case scenarios are disregarded as remote.

The above example, although rather simplistic, shows that profit and loss sharing solutions do not generate much appeal, particularly among the well-established corporations. Newly established companies, who often find debt financing too costly or limited, however, may be attracted by the profit and loss sharing solutions, but, unfortunately, very few investors will have an appetite for such type of credit risks. This anomaly is likely to remain so long as the corporations have access to conventional debt solutions at competitive rates. We hope, however, that one day a paradigm shift will occur among the Muslim corporations and they realize that Islam provides only a limited role for leverage and they reorganize their financing requirements through profit and loss sharing means. Contemporary scholars, realizing the problems faced, have even allowed the financiers to agree on "capping" their potential returns on their investment with the corporation. If the investment generates profit beyond the agreed cap, the financiers will distribute the upside to the corporation as an "incentive fee." It is hoped that this mechanism will persuade the well-established corporations to accept Islamic profit sharing products.

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[68] Islam also encourages the maximization of profit but within the framework of *shari'a* that, among other things, discourages leverage and encourages growth through profit and loss sharing mechanisms.

3. Investors' aversion to sharing the economic downside

On the other side of the coin, some Islamic investors are risk-averse and reluctant to share the economic downside of the Islamic profit and loss sharing mechanisms. These investors are used to investing in Islamic investments with a fixed income profile like *murabaha*, *ijara,* and *istisna'*. Their investment strategy is often conservative and has little room for taking equity-type risks where the investors are also exposed to the economic downside of the investment. This mindset again inhibits the development of Islamic profit sharing products. Frequently, the investment strategy is designed by practitioners who come from conventional commercial banking backgrounds. Most of these practitioners have little exposure to profit and loss participation investments and lack the necessary skill sets. Investing in profit and loss sharing ventures requires a different type of (and more onerous) due diligence exercise and investment analysis compared to debt-based investments. These investments also require the investors to regularly monitor the performance of the business. Occasionally it may require the investors to take over the conduct of the business and appoint their own management to replace the defaulting entrepreneur. These tasks require resources with a wide range of skills including corporate finance and private equity expertise. The Islamic investors must therefore employ more people with such backgrounds to enable the shift from debt-based products to the Islamic profit sharing products.

The industry is not expecting all the investors to convert overnight their investment strategy to one entirely based on profit and loss sharing investments. The Islamic investors must gradually revise their investment strategy in line with the ideals of Islamic finance and give priority to Islamic profit sharing products. This will certainly take time and needs the critical support of all the corporations and entrepreneurs who seek Islamic financing. If the entrepreneurs are hesitant to take Islamic profit sharing products, then there will be less interest among the Islamic investors. Conversely, if the Islamic investors are reluctant to invest, there will certainly be less interest among the entrepreneurs. It is encouraging to note that some Islamic banks have been strongly advised by their *shari'a* committees to develop and invest more in Islamic profit sharing products.[69]

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[69] All Islamic banks offer profit and loss sharing investment accounts where the depositors share the profits and the losses with the Islamic banks. But these funds are invested in mainly *murabaha*, *ijara,* and *istisna'* products.

4. Moral hazard

Another reason for the slow development of Islamic profit sharing products is the minimal level of corporate transparency and corporate governance prevailing in most Muslim countries. Some Muslim countries also lack a well-defined property rights law, which is critical for profit and loss sharing mechanisms to work.[70] The investors also fear the lack of transparency and good corporate governance among the entrepreneurs *(mudarib)*. There is always the concern that the entrepreneurs may conduct the business dishonestly and may disclose a lower profit. All these concerns, added to the lack of accountability on the part of the entrepreneurs who violate these obligations, result in the Islamic investors shying away from Islamic profit sharing products. To alleviate these moral hazards, Islam advocates the importance of good corporate governance and transparency in all dealings including commercial transactions. The Qur'an unequivocally states:

> O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. . . . Let him who incurs the liability dictate, but let him fear his Lord Allah, and not diminish aught of what he owes. . . . And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust, and let him fear his Lord. Conceal not evidence; for whoever conceals it—his heart is tainted with sin. And Allah knoweth all that ye do.[71]

These Qur'anic injunctions highlight the duty of the entrepreneur who is entrusted with the trust obligations to exercise proper care and due diligence and conduct the business (for example, a *mudaraba* business) in a transparent manner. The *mudarib* is obligated to conduct the business profitably within the boundaries of *shari'a* and to truthfully make a full disclosure of the business profits and distribute the due share of profits to the *rabb al-mal* (investors). The *mudarib* is also fully accountable for any breach of trust including any negligence in carrying out the terms of the investments or willfully defaulting in his duties. Since Islam firmly advocates the importance of good corporate governance and transparency, it is obligatory upon all Muslims to implement them in their daily activities.

The industry leaders, realizing the importance of implementing these safeguards, have established the Islamic Financial Standards Board (IFSB) that will, among other things, promulgate standards for corporate governance and transparency for the Islamic finance industry. The IFSB,

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[70] In some countries ownership in a company and landed property has to be effected through a local sponsor and the enforceability of the contractual arrangement between the investors and the local sponsor is often hazy.

[71] Qur'an: 2:282-283 (Abdullah Yusuf Ali translation).

based in Malaysia, is expected to issue standards that meet the international prudential standards and comply with the principles of *shari'a*. The Muslim countries will then adopt these standards and proper sanctions will hopefully be put in place by the respective countries for any breach or violation of these standards. These standards and sanctions, once in place, will create a conducive platform for Islamic profit sharing products to flourish and reform the current landscape of the Islamic finance industry.

5. No level playing field

Another barrier to the entry of Islamic profit sharing products is the uneven tax treatment currently in place for equity-based products. Interest payment, and correspondingly profit payment in *murabaha* and rental payment in *ijara*, are all tax deductible on the ground that they constitute cost items. A profit distribution under a *mudaraba* or *musharaka* is, on the other hand, not tax-deductible. The distribution is made net of tax. This unfair tax treatment frequently makes the Islamic profit sharing products more expensive for the corporations. The existing tax environment inevitably makes leverage and gearing more attractive to the corporations.[72] Assuming the corporate profit tax rate is 30 percent and a corporation, with say $100 equity, borrows $900 at 10 percent p.a. and makes a profit of 20 percent, then the leverage will produce a return on equity of 77 percent for the corporation.[73] Conversely, if the corporation raises the $900 in equity instead of debt and still makes a profit of 20 percent, the return on equity is merely 14 percent.[74] The existing environment creates an uneven playing field for the Islamic investors who are keen to offer Islamic profit sharing products. The economics of the profit and loss sharing mechanism simply makes it less appealing for the corporations. The industry regulators must take urgent steps to reform the tax system in their respective countries and to create a level playing field for the Islamic profit sharing products. Perhaps, with equal tax treatment, the interest among corporations to seek profit and loss sharing solutions may increase and promote less reliance on the Islamic debt-based products. Obviously, more research has to be done in this area before it can be successfully implemented.

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[72] For an interesting discussion on the negative impact of leverage to the economy and the limited role of leverage in an Islamic economy, *see* Tarek El Diwany, *The Problem with Interest* (1997), 167-172.

[73] ($200 profit minus $90 interest minus $33 tax) / $100 (equity) = $77.

[74] ($200 profit minus $60 tax) / $1,000 (equity) = $140.

CONCLUSION

The various *sukuk* products discussed above have opened up to the Islamic finance market a new and attractive asset class with a fixed income profile and tradability feature. This asset class will hopefully be able to consume the huge surplus liquidity existing in the Islamic finance market. The credit goes to contemporary *shari'a* scholars who were able to inspire and guide the industry in producing the various *shari'a* innovations that made the *sukuk* a reality today. The *sukuk* product, however, should be employed judiciously to ensure that it is not used as an avenue to proliferate debt in society. The Islamic finance practitioners should channel their focus and energy in spreading the growth of Islamic profit sharing products. There are various hurdles but these are not insurmountable. History speaks for itself. Three decades ago, very few would have believed that the *sukuk* would be a reality. Perhaps, three decades from now, the Islamic profit sharing products will be the mainstream products in the Islamic finance market.