



THE PRACTICE OF ASSET-BASED AND ASSET-
BACKED *ṢUKŪK* IN MALAYSIA: FROM *FIQH*
PERSPECTIVE

BY

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ABSTRACT

This research aims to analyze the *Sharfah* issues in asset-based and asset-backed *sukūk* in Malaysian practice and finally proposing some possible solutions to these issues. Most of the issues have remained controversial among *sukūk* players especially with regard to asset-based *sukūk* which is claimed as noncompliant with the *Sharfah* rules. These unsolved issues have posed huge constraints to investors especially from the Middle Eastern countries which perceive Malaysian *sukūk* as similar to conventional bond. Thus, the principles, terms and conditions of some *sukūk* issued in Malaysia have been revised in order to conform to the *Sharfah* rules. The method used in this study was mainly textual analysis to highlight the main characteristics of asset-based and asset-backed *sukūk* as practiced in Malaysia. Some selected term sheets of *sukūk* issued were analyzed to identify *Sharfah* issues. In addition, some Malaysian scholars were interviewed in order to get their views on these issues. It is found that these issues abound due to the conflicting opinions that stem from the different perceptions and interpretations of scholars on the textual evidence

ملخص البحث

تسعى هذه الدراسة لمناقشة القضايا الفقهية ذات الصلة بالصكوك المرتكزة إليها الأصول (Asset-based sukūk) والصكوك المدعومة بالأصول (Asset-backed sukūk) في التطبيق المالي، هادفةً تحليل تلك المسائل الفقهية مع محاولة اقتراح الحلول الممكنة وسبل علاج الخلاف. نظرًا لأن تلك القضايا الفقهية صارت موضوعًا مثيرًا للجدل بين الفقهاء في أنحاء العالم الإسلامي؛ وخاصة فيما يتعلق بالصكوك المرتكزة إليها الأصول التي قد يقال أنها تخالف القواعد الشرعية. حيث إن تلك الاختلافات الفقهية والآراء تمثل عقبة في الاستثمار لدى المستثمرين وخاصة المستثمرين من دول الشرق الأوسط التي تدعي بأن تلك الصكوك هي السندات الربوية نفسها المنتشرة في العالم اليوم. ولذلك، رجّع الباحث في بحثه إلى القواعد والمصطلحات والشروط والأحكام اللازمة المنصوص عليها في نشرة الإصدار لبعض الصكوك للتأكد من توفرها للشروط. أما المنهج المستخدم في هذه الدراسة فهو المنهج الاستقرائي لتتبع أهم خصائص الصكوك المدعومة بالأصول والصكوك المرتكزة إليها الأصول الصادرة في ماليزيا، بتدقيق النظر في وثائق إصدار بعض الصكوك المختارة لتحليل أهم مسائلها الشرعية. قام الباحث بإجراء بعض المقابلات الشخصية مع بعض الفقهاء والخبراء للحصول على آرائهم القيمة حول هذه القضايا الفقهية. ويتوصل الباحث إلى أن منشأ الخلاف في تلك القضايا الفقهية هو اختلاف الفقهاء في طرق الاستدلال وبناءً على ذلك أدى هذا الاختلاف في اعتبار صحة الصكوك أو عدم صحتها.

APPROVAL PAGE

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DECLARATION

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

Mohamad Zaharuddin Zakaria

Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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**THE PRACTICE OF ASSET-BASED AND ASSET-BACKED *ŞUKŪK* IN
MALAYSIA: FROM *FIQH* PERSPECTIVE**

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Affirmed by Mohamad Zaharuddin Bin Zakaria

.....
Signature

.....
Date

To my mother and my father who raised me with care and love...

To my wife who always with me along the journey...

To my children Nabil, Maryam and Deena Aafa who inspired me so much...

To all of them I dedicate this work

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TRANSLITERATION

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

Short Vowels	
ـِ	a
ـِـ	i
ـِـ	u

Long Vowels	
ا + ـِ	ā
ي + ـِـ	ī
و + ـِـ	ū

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CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

In the current situation, the Islamic economic system is growing very fast not only in Muslim countries but exceeding the boundaries of Muslim jurisdictions. Since the latest economic crisis, people are looking for solutions and alternatives in order to fulfill their financial needs. They are looking for a just and fair economic and financial system which offers them good profit with minimum risk, pleasing the needs of different segments of society. Thus, Islamic system is the answer which promotes the just balance or “*wasatīyyah*” as a way of life in all aspects including economic and financial matters. Islamic financial system promotes justice mainly by prohibiting interest charges. Instead of charging interest, Islam promotes profit and loss sharing to fulfil the diversified needs of the society in their financial matters.

Islamic economic and finance principles can be found in the juristic literature derived by jurists from the *Qurʿān*, *sunnah*, *Ijmāʿ* and *Qiyās* as primary sources beside *Istihṣān*, *Istiṣḥāb*, *Maṣāliḥ al-Mursalah*, and *ʿUrf Ahli Madīnah* which are also known as secondary sources in Islamic law. In a frequently cited Quranic verse, Allah (SWT) responded to the assumption of the *Jāhili* people contending that trade is similar to usury or *ribā*:

الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ذَلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ
مِثْلُ الرِّبَا وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا.

*Those who take usury, they shall not be able to stand upright but shall rise up like one whom Satan has demented by his touch, for they claimed that: "Trade is like usury." Whereas Allah has permitted trading and forbidden usury.*¹

Allah also warned those who still dealing with usury and The Almighty said:

فَإِنْ لَّمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِنَ اللَّهِ وَرَسُولِهِ.

*If ye do it not, take notice of war from Allah and His Messenger*²

What has been warned by Allah (SWT) has become a reality with the arrival of the economic crisis which can be understood as a war from Allah when people are still dealing with usury and do not obey His commands. Thus, it is the obligation of the Muslims to start promoting and practicing Islamic economic system to get blessings from Him.

Allah (SWT) reminds in the Qur'an:

وَلَوْ أَنَّ أَهْلَ الْقُرَىٰ آمَنُوا وَاتَّقَوْا لَفَتَحْنَا عَلَيْهِم بَرَكَاتٍ مِّنَ السَّمَاءِ وَالْأَرْضِ وَلَكِن كَذَّبُوا فَأَخَذْنَاهُم بِمَا كَانُوا يَكْسِبُونَ.

*If the people of the towns had but believed and feared Allah, We should indeed have opened out to them (All kinds of) blessings from heaven and earth; but they rejected (the truth), and We brought them to book for their misdeeds.*³

In order to overcome the financial crisis, Islamic capital market can be an option. It offers no *ribā* or interest products which are forbidden by *Sharfah*. It was clear that *ribā* is the reason behind the present financials crisis⁴. Then, it must be avoided at all

¹ Al-Baqarah: 275

² Al-Baqarah: 279

³ Al-A'raf: 96

⁴ Ahamed Kameel Mydin Meera, *Riba & Global Economic Crisis*, presented in World Conference on *Ribā* organized by Thinkers Trends Resources and International Islamic University Malaysia, Kuala Lumpur. Retrieved November 29, 2010. <http://www.worldribaconference.org/>

cost. Therefore, Islamic capital market should play the role to promote Islamic products by providing alternative funding avenues for individuals, corporates and governments.

In general, the Islamic capital market consists of two main components: the equity market and the debt market. The former involves active trading of Islamic securities, shares and other exchange-traded instruments, while the latter normally is represented by *sukūk*, which has been the most active Islamic debt market instrument⁵.

Sukūk is an instrument in Islamic capital market which has been issued to provide liquidity to investors. Indeed, *sukuk* is one of the fastest growing segments in the Islamic financial market. At present, Malaysia is the world's largest market for *sukuk*. Most of the *sukuk* in the world today are issued by Malaysia. For instance, the amount of sovereign *sukuk* issued by the government of Malaysia in year 2012 is USD1.25 billion which is six times bigger than the whole amount of *sukuk* subscribed by investors from Asia, middle eastern countries, Europe and the United States of America.⁶ The government of Malaysia is very supportive in order to improve the current economic situation by creating a stable economic environment to attract investors to invest in Malaysia. Its Bursa Malaysia topped the world's exchanges in *sukuk* listings, recording a total of US\$17.6 billion (RM58 billion) in *sukuk* last year; and with 1,080 *sukuk* issuances amounting to US\$67 billion (RM221 billion), the country accounted for 63 per cent of the global *sukuk* issued since 2006⁷.

⁵ Ashraf Wajdi and Shabnam Mokhtar, *Critical Appraisal of Shariah Issues on Ownership in Asset-Based Sukūk as Implemented in the Islamic Debt Market*, Research paper, No.5, (Kuala Lumpur, International Sharī'ah Research Academy For Islamic Finance ISRA, 2009) 7

⁶ Zeti Akhtar Aziz, "Instrumen Sukuk Jadi Tarikan Terbaru", *Utusan Malaysia*. Retrieved October 13, 2010, http://www.utusan.com.my/utusan/info.asp?y=2010&dt=1013&pub=utusan_malaysia&sec=Ekonomi&pg=ek_03.htm&arc=hive

⁷ Hamisah Hamid, "Malaysia Maintaining Pole Position In Islamic Finance", *Business Times*. Retrieved May 31, 2010. http://www.btimes.com.my/Current_News/BTIMES/articles/MONVIEW4/Article/index.html

1.2 PROBLEM STATEMENT

Essentially, *ṣukūk* refers to certificate or document representing the ownership of the *ṣukūk* holders in an underlying asset.⁸ It can be derived from the definition that one of the crucial elements in *ṣukūk* issuance is the presence of an asset that is compulsory as a subject of a transaction in issuance process. Indeed, without the existence of an underlying asset, it will turn the certificate into interest based bond. With reference to the asset in the *ṣukūk* issuance, *ṣukūk* can basically be divided into two categories, namely asset-based *ṣukūk* and asset-backed *ṣukūk*.⁹

At the beginning, only asset-based *ṣukūk* was issued by the issuers where the *ṣukūk* holders temporarily hold their beneficial ownership on the asset with restriction not to recourse to the asset but to the originator in the event the issuer were to default or become insolvent. The *ṣukūk* holders have no rights over the asset even though they have purchased the asset at first in order to invest in the *ṣukūk*. The asset also cannot be disposed by the *ṣukūk* holders to refund their losses even though according to *SharĤah* law they are the owners of the asset. In fact, the asset remained in the balance sheet of the obligor and not transferred into the balance sheet of the *ṣukūk* holders¹⁰.

The issuance of asset-backed *ṣukūk* started when the issuance of asset-based *ṣukūk* had become controversial with a bundle of *SharĤah* issues being brought up by *SharĤah* scholars. In asset-backed *sukuk*, the *ṣukūk* holders enjoy asset backing where ownership of the asset is legally transferred to them, should the issuer were to default or become insolvent, the *ṣukūk* holders would be able to recover their exposure by

⁸IFSB, *Islamic Financial Services Board (IFSB)'s Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services*. (Kuala Lumpur: IFSB, 2005).

⁹This categorization refers to the technical aspect of the issuance. Although there is another type of *ṣukūk* that is hybrid *ṣukūk* but in general only two previous types are being discussed thoroughly because of their contentious issues.

¹⁰ Ashraf Wajdi and Shabnam Mokhtar, *Critical Appraisal of Shariah Issues on Ownership in Asset-Based Ṣukūk as Implemented in the Islamic Debt Market*, Research paper, 21

taking control of and ultimately realize the value of the assets. Indeed, the *ṣukūk* holders will bear any losses due to impairment of the assets. In other words, in asset-backed *ṣukūk*, the *ṣukūk* holders have recourse to the asset and not the originator.¹¹ This implies that the asset-backed *ṣukūk* involves full transfer of legal ownership of the underlying asset. In fact, this type of *ṣukūk* has lesser criticisms from scholars.

Although asset-based *ṣukūk* has received a lot of criticisms from scholars and investors, the issuance of this type of *ṣukūk* still dominates the *ṣukūk* market. Malaysia which is the biggest market of *ṣukūk* has also been affected by this issue. Thus, this research aims to enlighten the *Sharfah* issues that arise in *ṣukūk* structure and operation especially in asset-based type; in particular, *Sharfah* issues with regard to ownership are going to be identified and discussed. Four major issues have emerged in the structure and operation of asset-based *ṣukūk*. They are:

- i. The *ṣukūk* holders' status of ownership in asset-based *ṣukūk*. Can the contract of sale between the *ṣukūk* holders and the obligor be regarded as true sale or not and what are the consequences of the contract from the legal and *Sharfah* perspectives?
- ii. The concept of beneficial ownership. Is it approved by *Sharfah*?
- iii. The restrictions on asset disposal. Is this condition valid according to *Sharfah*? Hence, what are the consequences of the restriction over the contract and the profit according to the *Sharfah* law?
- iv. Due diligence regarding *ṣukūk* assets. Who will be responsible with regard to asset loss if the asset still remains in the balance sheet of the obligor although the contract of sale has taken place?

¹¹ Ashraf Wajdi and Shabnam Mokhtar, *Critical Appraisal of Shariah Issues on Ownership in Asset-Based Ṣukūk as Implemented in the Islamic Debt Market*, Research paper, 7

The research will also analyze the structure of asset-backed *ṣukūk* to find any contentious issues especially with regard to the practice in the market.

Finally, in order to be *Sharfah* compliant, the *ṣukūk* must comply with all the requirements not only in the documentation of the issuance but also in terms of the characteristics and consequences arising from the *ṣukūk* transaction. Hence, several identified term sheet of *ṣukūk* will be analyzed to identify what are the possible *Sharfah* issues which might arise particularly related to asset-based and asset-backed *ṣukūk*.

1.3 RESEARCH QUESTIONS

- i. What are the real situations of asset-backed and asset-based *ṣukūk*?
- ii. What are the differences between asset-backed and asset-based *ṣukūk* and how do they differ in their legal and contractual consequences?
- iii. How is the trend of Malaysian *ṣukūk* issuances in relation to asset-backed and asset-based *ṣukūk*?
- iv. What are the main *Sharfah* concerns in asset-backed and asset-based *ṣukūk* within the three main categories of *ṣukūk* i.e. sale-based, lease-based and equity based-*ṣukūk*?

1.4 OBJECTIVES OF THE STUDY

The specific objectives of the study include the following:

- i. To study the reality of asset-backed and asset-based *ṣukūk* in the issuance of *ṣukūk*.
- ii. To examine the differences between asset-backed and asset-based *ṣukūk* and their legal and contractual consequences.

- iii. To evaluate the practice of Malaysian *ṣukūk* issuances related to asset-backed and asset-based *ṣukūk*.
- iv. To analyze *SharḤah* issues in asset-backed and asset-based *ṣukūk* within the three main categories of *ṣukūk*: sale-based, lease-based and equity-based-*ṣukūk*.

1.5 RESEARCH METHODOLOGY

This research was mainly based on textual analysis. All materials were collected and reviewed in order to get a clear understanding regarding *ṣukūk* and its practices in Malaysia. Descriptive method was used to highlight the main characteristics of asset-backed and asset-based *ṣukūk* particularly in Malaysian Islamic Capital Market. The arguments regarding this matter from Muslim jurists were accordingly analyzed.

The principles, rules and regulations of asset-backed and asset-based *ṣukūk* which had been issued by selected financial institutions in Malaysia was outlined and scrutinized to assess whether they comply with the principles of *SharḤah*. Other than that the contemporary issues and discussions related to principles and regulations were examined and analyzed for better understanding regarding the subject. For that, the term sheets of asset-backed and asset-based *ṣukūk* were selected from the Securities Commission Malaysia in order to understand the term of issuance. The clauses in these term sheets were examined very carefully in order to see the real concepts of *ṣukūk* which had become an issue in Malaysia. All the informations were grouped according to certain themes.

The second part of the methodology was based on the informations gathered from the interviews with experts, *SharḤah* advisors, lawyers and researchers. The purpose of the interview is to get a better understanding of the terms and regulations of

the *ṣukūk* issuance that were determined from the term sheets. Those scholars interpreted the clauses and concurrently relate the clauses with the real practice in the market. Some selected cases of asset-backed and asset-based *ṣukūk* are also discussed with them.

SharḤah advisor shared the arguments and evident behind the rulings of every *fatwa* issued by *SharḤah* Advisory Council pertaining to asset-backed and asset-based *ṣukūk*. Afterward, the researcher analyzed the *fatwa* by going back into its original sources or books of Islamic Jurisprudence to determine the views of scholars in *ṣukūk*'s *fiqh* issues, so that the researcher might get the reason of the criticisms from the scholars especially from the Middle Eastern countries regarding the practices of Malaysia's *ṣukūk*. If the Malaysia's *fatwa* is in accordance with the *SharḤah* rules and principles, the researcher will support the *fatwa* unless there is a stronger evidence showing that the Malaysia's *fatwa* is not accurate. Then, the researcher suggests to rely on the stronger argument and evidence with some recommendations to improve the practice. The comparative methodology therefore used to analyse the most accurate arguments and evident among the scholars.

1.6 LITERATURE REVIEW

The literature can be divided into two groups. First, are those which deal with the *ṣukūk* in general and secondly those which specifically focus on asset-backed and asset-based *ṣukūk*.

°Ali Muhyiddīn °Ali al-Qarahdāri has compiled his research on Islamic economic in *Buhūth fi al-Iqtisād al-Islāmī*¹². His article in the book under the title *Al-*

¹² Al-Qarahdari, °Ali Muhyiddīn °Ali, *Al-Tatbīqāt al-Syar°iyyah Li Iqāmah al-Ṣūq al-Islāmiyyah, Buhūth fi al-Iqtisād al-Islāmī*, (Bayrūt: Dār al-Basha°ir al-Islāmiyyah, 2nd ed., 2006)