

Sukuk: A Critique of Experience, and their Possible Developmental Role in Muslim Countries

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Abstract

The article focuses on Sukuk, in the framework of Islamic finance and its possible role in the economic development of the Muslim world. Sukuk, as a new financial instrument, opened doors, since 2001-002, for drawing funds from international sources. The article, firstly, pinpoints incorrect practices in Sukuk experience (2001-17), which ought to be removed, in order to ensure the Islamic authenticity of such an instrument. Secondly, we search possibilities of employing genuine Islamic Sukuk in ways that would maximize their role in financing the development of Muslim countries. Some proposals are presented for how Sukuk can possibly support the investment activities of SMEs, as well as opening new avenues for financing promising business ventures and corporates in industrial and service sectors.

Keywords: Social Capital, Islamic Economy, Trust, World Values Research

Jel Codes: G15, G23, G28

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Introduction

All contemporary Muslim countries are in great need for economic development as a major target. No doubt that mobilization of maximum possible resources; human, financial, technological etc., are so important for success in realizing such target. With the exception of a limited number of oil or gas-rich countries, Muslim countries lack sufficient financial resources which are necessary for carrying sound development. The fundamental motive behind the inauguration of Islamic financial institutions in the 1970s was not merely the prohibition of interest (*Riba*) but more crucially, considering Sharia tenets, is the role which they ought to play in economic development. Slow rates of economic development in Muslim countries for many decades can surely be attributed, amongst other factors, to the weak and inadequate role played by the interest-based conventional financial system (Abdelrahman Yousri, 2016).

For almost 40 years, Islamic finance has grown significantly and impressively in many Muslim countries as well as globally. This has been observed in the high growth rates of investment funds deposited with Islamic banks on basis of profit and loss sharing. However, digital growth in terms of deposits and their employment is not enough to judge the success of the experience on genuine Islamic grounds. Islamic banking has used financing tools which are in principle Sharia compliant but in practice, it has mimicked conventional banking financing mechanism. In addition, Islamic finance has not been directed rightly to investment projects that would effectively serve Muslim countries' development, which is a major target¹. Such trends or modes which are dominating practices in the Islamic financial industry have mostly been forwarded to Sukuk activities. We need to pinpoint and remove incorrect practices from the Sukuk industry for two main reasons: firstly, to ensure the authenticity of Sukuk as an Islamic instrument. Secondly, to emphasize the role that can be played by genuine Islamic Sukuk in financing the economic development of Muslim countries.

1. Islamic Sukuk² and Conventional Bonds

Sukuk emerged as Islamic securities and originally thought to be an Islamic alternative to conventional "bonds"³. But, how to create an alternative to bonds while in Sharia, because of interest prohibition, it is neither permissible to guarantee the nominal value of capital nor its return⁴. These were "real puzzles" that faced *Fuqaha* (Muslim jurists) who were involved in

¹ Most of the investment was practically directed to durable consumption goods such as cars, and to real estates

² Sukuk which has become familiar in English usage is an Arabic word. It is plural of the word *Sakk*. To avoid readers' confusion In this article, the word Sukuk is used both as singular and plural.

³ This approach of designing Islamic finance products as "alternatives" to conventional finance products is questionable, as each type of products has its own underlying principles. Mimicking can, therefore, be a slippery road for Islamic finance (Al- Jarhi, 2018)

⁴ A definition given by the Islamic Development Bank (IsDB) says "Sukuk commonly refers to the Islamic equivalent of bonds which essentially falls under fixed income securities", then it adds "as opposed to conventional bonds, which merely confers ownership of a debt without any underlying assets, Sukuk grants the investor a share of profit from an income generating asset or project, along with

the scheme. Solutions, however, have been found through *fatwas* (new Sharia pronouncements) and financial engineering. And the impermissible characters of conventional bonds have been replaced by some attractive advantages to Sukuk. Unlike conventional debt securities, Sukuk share in ownership and avoid one of their real disadvantages, if, or when, the issuing company is exposed to bankruptcy. Conventional bondholders in such case represent real burden over the issuing company because of their senior “legal” rights upon all its existing assets .

Our first task in this article is to explore and examine *fatwas* and financial devices that were based upon them to assess Sukuk authenticity and success from the Islamic perspective.

2. Islamic Securitization

In practice, the basic and necessary step for issuing Sukuk, as a new Islamic security backed by ownership of real property, was taken by approving “*securitization*” within the frame of Sharia. In an Islamic perspective *Securitization* would not be different from secular definition in the sense of transforming illiquid assets into liquid ones through the market (Fisher, M. and Shaw, Z., 2003).⁵ Yet, while in secular securitization, the repackaged assets include debt-securities or loans, this is not permissible by Sharia. In Islamic securitization, the pooled assets, and their acquisition, maintenance, utilization, and income generated thereof must be interest-free and comply with other Sharia rules of finance. Besides, we have to emphasize that collateralization as practiced normally in secular finance is not Sharia permissible, which represented a real problem from the beginning. Capital when invested in an Islamic system is liable to returns only in case of profits. Thus if guarantees are given to capital or its returns Sukuk would carry the negative aspects of conventional bonds.⁶ Under rules of profit-loss sharing, we have to emphasize that the value of Sukuk by the end of its tenor should be redeemed according to market and not nominal value.

In principle, Sukuk is distinguished from bonds by the basic nature of the designated assets, which are pooled for securitization. These must be real and suitable for productive investment that would generate *halal* (*Sharia permissible*) income. Such investment and income generated therefrom can be protected in favor of Sukuk holders by risk aversion methods and precautionary measures that do not violate Sharia.

the investment risk”. The definition emphasizes that “Sukuk securities should adhere to the Sharia principles, which prohibit the charging or payment of interest against the invested amount but rather sharing the return on the investment” The irony is that Sukuk issued by IsDB assured holders about nominal value and fixed returns: IsDB, “Sukuk in Brief: A secure return through an ethical investment” http://www.isdb.org/irj/portal/anonymous/idb_capital_en

⁵ “Securitization in conventional finance is the packaging of designated pools of loans or receivables with an appropriate level of credit enhancement and the redistribution of these packages to investors. Investors buy the repackaged assets in the form of debt-securities or loans which are collateralized (secured) on the underlying pool and its associated income stream. Securitization thereby converts illiquid assets into liquid assets” Mark Fisher and Zoe Shaw, eds., Euromoney Books, London (2003)

⁶ The experience of Sukuk in this respect is important and will be further discussed and analyzed.

3. Sukuk Issuances in Development

Issuers of Sukuk have ranged from sovereigns, quasi-sovereigns, financial institutions and corporates. Total global issuance of Sukuk in 2001 and 2002 was just about \$1.2, and \$ 1.4 billion respectively. These issuances which were almost carried by the Malaysian carried a message that Islamic institutions have become ready to compete for financial resources at the international level. Global issuance increased afterwards at a tremendously high rate to reach \$50 billion in 2007. Besides Malaysia, issuances were made by sovereign and quasi-sovereign issuers such as Bahrain, Islamic Development Bank (Jeddah), Indonesia, Turkey, Saudi Arabia, UAE, Brunei, and Qatar. Expectations of a continuous booming Sukuk market were toned down by the outbreak of 2008 crisis. The global shortage of liquidity caused by the International Financial Crisis, besides the dispute among Muslim jurists over the methods used to provide guarantees to Sukuk holders, have resulted in a significant decline in Sukuk issuance (Abozaid and Al-Jarhi, 2009). According to IIFM, issuances in 2008 were only \$ 24.1 billion, a decrease of 51%. However, the impact of the crisis on Sukuk market was almost confined to 2008. A strong demand from Muslim countries and conventional global institutions for Sharia-principled bonds not only reduced the impact of the crisis but the potential for Sukuk was viewed to be promising (S.R. Vishwanath And Sabahuddin Azmi, 2009). The Sukuk market recovered to \$ 38 billion in 2009.⁷ The volume of Sukuk issuances was leaping by astonishingly high rates to reach records in 2012 and 2013 of \$ 137.6 and 135.9 billion respectively - See Chart 1 (IIFM, 2016, 2017)⁸.

The decline in 2014 and 2015 to \$ billion 108.3 and \$billion 60,7 can be explained partly by ongoing uncertainties in the global financial market as well as by Bank Negara Malaysia (BNM) strategic decision to stop issuance of its Short-Term Sukuk(IIFM,2016). In 2016 the Sukuk global market was recovering from the low level of 2015, showing an increase of 45.5% to reach \$ 88.3 billion. Yet, that 2016' level was only 64% of the 2012 record level. However, Sukuk issuance in 2017 continued its recovery. It increased by 45.3%, reaching \$97.9 billion, "underpinned primarily by the jumbo issuances of some Gulf Cooperation Council (GCC) countries"(IIFM,2016)⁹. It was the good liquidity conditions in the GCC, as well as activity by some countries to further develop their Islamic finance industries. Saudi Arabia, in particular, was able to choose Sukuk over bonds. The \$9 billion Sukuk issued by Saudi Arabia was the largest issued globally to date. The market recovery encouraged the first issuance of a Sukuk in Nigeria and Hong Kong to make a third issuance.

⁷ S.R. Vishwanath And Sabahuddin Azmi,(2009), "An Overview of Islamic Sukuk Bonds", The Journal of Structured Finance Winter 2009, 14 (4) 58-67; DOI: <https://doi.org/10.3905/JSF.2009.14.4.058> . Yet, the study has overestimated growth by saying "The total value of issued Sukuk is likely to grow to more than \$200 billion by 2010 from the current \$100 billion". P. 59

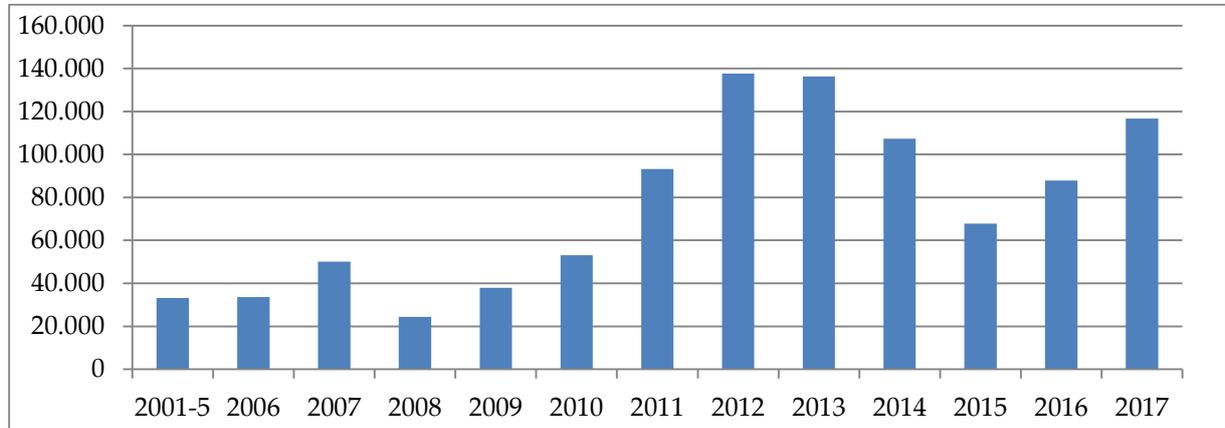
⁸ IIFM,(2016), Sukuk Report, 5th Edition, A Comprehensive Study of the Global Sukuk Market. Also IIFM, Sukuk Report, 2017 <https://www.islamicfinance.com/wp-content/uploads/2016/04/IIFM-Sukuk-Report-5th-Edition-A-Comprehensive-study-of-the-Global-Sukuk-Market.pdf>

⁹ S&P Global Ratings, "Global Sukuk Market Outlook: Another Strong Performance..? P.2, January 7, 2018

According to S&P global ratings, the outlook for the market in 2018 looks uncertain. The S&P report expects Sukuk issuance volumes to hover at \$70 billion-\$80 billion. It is not clear in whether the global Sukuk market can stage the same performance of 2017 in 2018(IIFM,2016).

Total Global Sukuk Issuances (2001-5 - 2017) All Tenors, All Currencies, In Us\$ Millions

Chart 1: Total Global Sukuk Issuances USD 979,209 Millions



Source: IIFM, Data Base, “Sukuk Report, 2018”

4. Analysis of the Sukuk experience in the Global Market, and Observations on Critical Issues

4.1. Guarantees to capital and returns

Profit/loss sharing in Islam means that capital, when invested, cannot be guaranteed, i.e. secured from the probability of loss, and (thus) cannot be promised a fixed return in advance¹⁰. The real problem in all issuances of Sukuk is that buyers were rest-assured, in advance, of the nominal value of their securities in addition to returns that they will receive. Rates of return were either fixed or floating while tied to a benchmark which is the LIBOR¹¹. The use of LIBOR, as benchmark, has become familiar in Islamic banks since the 1990s, by approval of their Sharia boards. The same ill practice has, disappointingly, been forwarded to the Sukuk, instead of trying to find out rates of return that are guided by ex-issues’ profit rates and anticipated future rates. Issuers of Sukuk tried to justify using the LIBOR for some Sukuk by saying that in case if the actual profits exceeded such an interest rate, the enterprise manager shall obtain the excess amount as an efficiency incentive, and in the opposite case the manager shall make a free loan or donation to the Sukuk holders. Taqi Usmani (2008), who has been

¹⁰ In case of loss, this will be totally borne by the capital owner, and not by the partner who is carrying or managing the investment, unless it is firmly proved that this partner committed a dishonest behavior, neglected familiar business practices, or invalidated the contract. Any amount of money (or benefit) promised, surely, to the capital owner in advance is a promise of Riba (interest) payment, which is utterly prohibited in Sharia.

¹¹ Ibid, P.7. LIBOR is London Interbank Offered Rate. In fact, the approval of their Sharia boards, to the use of LIBOR was a big mistake, if targets of Islamic finance would be taken into consideration. Abdelrahman Yousri Abdelrahman, (2013), “Fundamental Issues in Islamic Economics”, See argument in, Chapter 5;” Prohibition of Riba (Interest) in Islam: Its Economic Rationale and Implications.”

deeply involved in Sharia boards, discussed such practices, giving his pieces of evidences and found that they are Sharia non-compliant.

It has been observed that Sukuk floating rates that are tied to the LIBOR have gradually become uncommon while “the trend of fixed rate Sukuk issuances has continued in practice (IIFM, 2017). However, both trends cannot be defended when talking about profit/loss sharing principle in Sharia. Besides, a pressing question that cannot be neglected: Is it necessary to structure Sukuk as fixed-income instruments? How far doing away with this condition would improve Sukuk and relieve the burden of providing guarantees? On their part, Muslim *Fuqaha* and financiers who engineered Sukuk assert that such assurances which Sukuk have are not the “guarantees” which Sharia prohibits. But, the hard fact is clear. Financial and legal devices which issuers adopted enabled them to go around Sharia rules and give such “guarantees” to holders and to claim that Sukuk are Islamic trust certificates sharing in profit and loss.¹²

In several important cases, the guarantee of Sukuk’s nominal value and their rate of return was further supported by sovereign entities (e.g. the governments of Malaysia, Bahrain and Qatar etc.). Guarantees given by sovereigns are claimed to be Sharia permissible, which is not true. In principle, the State in an Islamic system should not be involved in projects which the private sector is capable of carrying¹³. If it is argued that the State should establish the infrastructure projects or undertake some big or strategic projects, because of the inability of the private enterprise, the question that would arise is: why through Sukuk in particular? Why not by other means of finance? And even if Sukuk are considered the most suitable instrument, the rule of profit/loss sharing in Sharia still applies perfectly well to governments. Devices which would allow for guaranteeing Sukuk by twisting of Sharia rules are not acceptable whether Sukuk are issued by sovereigns, semi sovereigns, or by the private sector. Guarantees given by sovereigns to Sukuk’s capital or its returns is even worse than those given by the private sector when Sharia tenets (*Maqasid*) are considered. This is because in case of loss, public revenues would be used in favor of Sukuk holders who, nevertheless, are only a section

¹² The guarantee for the nominal value of the instrument or the proceeds is done in tortuous ways, where it is not given directly by the actual “issuer” (Originator) of the Sukuk to buyers as done normally by corporates issuing bonds. Sukuk are offered through various intermediaries or brokers. The actual issuer: “Originator” would sell assets to an Agent which may be different than the Originator in *legal terms but not in Sharia terms*! For example, in case of IsDB’ Sukuk 1435 H, the bank was the Originator and the Agent was “The Islamic Corporation for the Development of the Private Sector” (ICD) which is an IsDB’s affiliate. Thus, when saying IsDB selling assets to ICD, we are in fact saying IsDB is selling assets to IsDB. The Agent would sell the assets portfolio to a “Trustee”, which is Solidarity Trust Services Limited. The trustee obtains proceeds through sale of the assets in form of Sukuk. Such proceeds would be transferred to Originator through the said Agent. The Originator acts as a “guarantor” to the Trustee! It should be noted, however, that IsDB does not guarantee the payment by the Trustee of the profit participation to the certificate holders. This is a Sharia device. Yet, the IsDB promised to repurchase the Trustee’s portfolio (which may not be identical with the portfolio originally sold to it) for the original sale price upon the maturity date of the certificates or following certain “dissolution events”.

¹³) Such tradition was strictly maintained by the Islamic state in its early centuries, and was explained and defended by Ibn Khaldun: *The Muqaddimah*.

of people in society. This issue calls for special Sharia consideration since it concerns the justice of national income distribution.

Without such assurances or guarantees concerning the nominal value and a fixed rate of return, renowned rating agencies such as Standard & Poor, Fitch and Moody would not have given top rating to Sukuk, which in principle are profit and loss sharing financial securities.¹⁴ Surely, rating made by these international financial agencies take into consideration guarantees given by Sukuk issuers, who are mostly sovereigns, semi sovereigns, banks and big corporations of sound financial positions.

Fixed rates of return and guarantees to capital have really made Sukuk popular and competitive in the capital market. Yet, the difference between Sukuk and conventional bonds has been minimized or lost. Taqi Usmani (2008)¹⁵ rightly says Sukuk, in fact, mimic the bonds until they almost bear their sins as well.

4.2. Sale of Debt

Shariah prohibits selling of debt for a price other than its face value(Sami Hamoud, 1998)¹⁶. From the very beginning, Malaysian Sukuk by securitizing debt contract opened the door for practices which did not comply with such Sharia rule. Abozaid and Al-Jarhi(2009) asserted

¹⁴ Moody's Investors' report, announced (2015) says: "The IsDB (Islamic Development Bank) has a long-term issuer rating of Aaa with a stable outlook". The Report highlights that IsDB's healthy debt structure, strong capital base, and level of liquidity were behind top rating of its Sukuk. Adds: "IsDB is one of the largest issuers of Sukuk, along with the governments of Malaysia (A3 positive), Indonesia (Baa3 stable) and Qatar (Aa2 stable), all IsDB members. IsDB issued four series of Trust certificates in 1435H under the recently upsized MTN program, increasing total *borrowings* by 19% to Islamic Dinars (ID, or SDR) 7.4 billion in 1435H (\$10.9 billion). In late 1436H, the IsDB decided to increase the ceiling on its Sukuk program (IDB Trust Services Limited, Aaa) to \$25 billion from \$10 billion. Moody's Investors, "Announcement: Moody's: Islamic Development Bank's increased sukuk issuance promotes the development of Islamic finance market- Global Credit Research - 20 Oct 2015" https://www.moodys.com/research/Moodys-Islamic-Development-Banks-increased-sukuk-issuance-promotes-the-development--PR_336898. Notice in the report that Sukuk are described as "Trust certificates" and that four Sukuk issues were done "under the IsDB recently upsized MTN program. MTN (Medium Term Note) are (in finance) unconventional bond, offered through various brokers, rather than issued all at once like other bonds. All issuing mechanism and procedures of Sukuk are typical MTN. Besides, MTN "*functions much like corporate bonds: unsecured, non-callable, with fixed coupons and investment grade ratings*". See also MTN in Euro medium-term note

¹⁵ Muhammad Taqi Usmani is a Hanafi Islamic scholar from Pakistan. He served as a judge on the Federal Shariat Court of Pakistan (1981- 1982) and the Shariat Appellate Bench of the Supreme Court of Pakistan (1982- 2002) He is an expert in the fields of Islamic Jurisprudence (fiqh) and has remarkable contributions in Islamic finance. See his paper(2008), "Sukuk and their Contemporary Applications" Fiqh Academy , 19th Round Session, Sharjah, UAE, 2009. Find at [http://alqalam.org.uk/wp-content/uploads/Sukuk.pdf\(2008\)](http://alqalam.org.uk/wp-content/uploads/Sukuk.pdf(2008))

¹⁶ This prohibition covers both discounts and premiums in the sale and purchase of debt; Sami Hamoud,1998, " Sale of Debt ..etc.": Reference is available in Arabic : " بيع الدين بالدين " الدكتور سامي حسن حمود، " وسندات القرض وبدائلها الشرعية في مجال القطاع العام والخاص"، كتاب مجلة مجمع الفقه الإسلامي ، الكتاب العدد الحادي عشر، 1998 . في نفس المرجع مقالات في نفس الموضوع ، علي محيي الدين القره داغي وتقي الدين عثمانى

that this had caused Malaysian instruments to be unable to obtain external acceptance in Islamic countries, and their circulation was confined to the neighboring markets and Western countries. In fact, despite the assertion in Islamic jurisprudence that sale of debt and receivables is not permissible, some Muslim jurists have allowed for such sale to be carried if necessary for Sukuk issuance. The *Islamic Fiqh Academy* in its 4th Round Session (1988)¹⁷ allowed the securitization of contracts such as *Murabaha* and *Istisna'a* which are debts, but only exceptionally and at the lowest possible levels. Such decision was based on necessity to considering the actual circumstances of contemporary Islamic finance. It is argued that in case of Sukuk, restructuring the package of assets which are pooled and designated for securitization may be necessary and only possible through adding debt assets such as *Murabaha* and *Istisna'a* contracts. Such exception, as always the case with exceptions, has opened up undesirable consequences. "Exceptional Circumstances" and "Lowest Possible Levels" that are stipulated by the Fiqh Academy, for allowing debt assets in Islamic securitization, should have been defined carefully in a specific manner. Exceptions from Sharia are subject to the "rule of Necessity", and this should be based on temporary, limited and urgent conditions. In fact *Fatwa* in the area of "Necessity", if not carried on a strict and austere basis will take us away from the Sharia permissible and open a wide door for the impermissible.¹⁸

In practice, exceptions have been made in securitization for Sukuk issuing, but these were not done "to the lowest possible levels" as stipulated by the *Islamic Fiqh Academy's* decision. *Murabaha* and *Istisna'a* contracts have been introduced into the securitization package at rates that have reached in some cases highest possible level (more than two-thirds of the designated assets!) Most striking in violation of Sharia, was indeed the Sukuk issuance that was fully based on *Salam Contract* (an aluminum deal) carried by the Government of Bahrain¹⁹ According to AAOIFI Sukuk-based on debt contracts (*Murabaha, Istisna'a, or Salam*) cannot be exchanged in the securities market. Yet, it is difficult to imagine that a new instrument such as Sukuk, which are internationally top rated, would not be traded in financial markets while no rules or regulations would prevent this in practice. In fact, some experienced Sharia Scholars expressed no objection to exchange of these Sukuk in the secondary market. Hussain Hamed Hassan (2013 argued, by referring to some *Fiqh* rules, that nothing is wrong in packaging of debt or receivables assets in Islamic securitization. But, his argument was clearly based on *micro evidence*, such as most of the classical *Fiqh* rules. The *macro dimension*, as well as *the dynamic*

¹⁷ Decision No. 30 (3/4)[1], of the Fiqh Academy: Fourth Round Session (1988), <http://www.iifa-aifi.org/1713.html>

¹⁸ Knowledge about the Necessity Rule can be found in ; Wahbah a-Izuhayli , (1985)" The Theory of Necessity in Islamic Law "(Nazariyyat al- Darürah al-Shar`iyyah), Beirut; Also Jamil Mubarak,(1988), Theory of Sharia Necessity; its Scope and Limits (Nazriyyat al-Darürah alShar'iyah,: Hudüduhä wa Dawäbituhä), Al-Mansurah, Egypt.

¹⁹ Bahrain Monetary Agency Salam Sukuk. Aluminium has been designated as the underlying asset of the Bahrain Government al Salam contract, whereby it promises to sell aluminum to the buyer at a specified future date in return for a full-price payment in advance. S.R. Vishwanath And Sabahuddin Azmi. An Overview of Islamic Sukuk Bonds.

consequences, have not been considered. Sharia scholars, even with excellent Fiqh background, are not aware of the macroeconomic consequences of selling debt through Sukuk in an organized and expanding domestic and international markets²⁰. Trade in debt means trade in money and involve prohibited *Riba* (interest). In practice, we cannot ignore the fact that trade in debt at the global level was behind financial crisis, e.g. 2008 crisis.

4.3. Use and Misuse of Islamic Financial Contracts

Ijarah Sukuk has historically been the leader of all kinds of Sukuk in the international market by 47% of all issues during the period 2001-009. Yet, its relative importance changed after that as it declined to 35% in 2010-2015 and to and 12% in 2016 and 2017 respectively (IIFM,2018). The main reason behind the decline in relative importance was the sudden and major increase in Wakalah Sukuk.²¹ In the domestic market Sukuk Al Ijarah were also important but came second after Murabaha Sukuk.

Ijarah Sukuk is almost ideal for Muslims who seek a reasonable and an almost secured return on their investments without involvement in any practices which disagree with Sharia's profit-loss sharing principle. Ijarah assets can be securitized, yield regular and stable returns through productive activities, and can be insured and maintained within normal practice and application of known Sharia rules. Naturally, Ijarah Sukuk would entail risk, such as any investment that is carried under the Islamic profit-loss sharing principle. Yet, the expected risk in Ijarah activity would surely be much less than that which is involved in other activities. Yet, in practice, not all assets that backed Ijarah Sukuk were targeted for purposes of leasing activities. Debt assets, such as Murabaha and Istisna'a contracts were used to back the issuance of Ijarah Sukuk as mentioned earlier. The Ijarah contract has also been misused by other practices, such as using the LIBOR (+ or – basis points) instead of adopting a rate of return that is consistent with Sharia rules, i.e. a rate which expresses rental conditions in leasing markets.

Musharaka and Mudaraba Sukuk were next in importance to Ijarah Sukuk in the international market till 2009 by about 30% of total Sukuk issues.²² However, such position has not

²⁰ Hussain Hamed Hassan, 2013, "Comments on Discussion Papers and Notes submitted for the Harvard –LSE Workshop on Sukuk" (<https://kantakji.com/media/7228/a-35-.pdf>), defended the use of debt assets which supported Sukuk. He asserts that such debts are Sharia compliant, e.g. Murabaha and Istisna'a contracts because they are not based on interest. The crucial question is: would such debts remain Sharia compliant after being securitized and become part of Sukuk, which are exchanged in markets at values that may be less or more than their nominal value? He says: "In case of Sukuk ul Mudaraba or Musharaka or Wakalah the Sukuk represent ownership of the assets of these investments as the proceeds are applied for purchase of the underlying assets. The assets could be either tangible assets or a mix of tangible assets, usufruct, receivables and debts resulting from Sharia compliant contracts and transactions such as Istisna and Murabaha provided there is no element of Riba based debts."

²¹ However, because Sukuk Al-Wakalah generally used Ijarah, the share of Ijarah Sukuk can be considered at 25%, and not just 12%: IIFM, Sukuk Report, 2018, Chapter one, P. 48.

²² Musharaka Sukuk (US\$ million 8,693) 19% and Mudaraba Sukuk (US\$ million 4,725) 10.55%.

continued. Mudaraba Sukuk dropped to 4%, and 5% in 2010-2015 and 2016 respectively, while Musharaka Sukuk also dropped to less than 1% in 2016-2017. **In the domestic market**, Musharaka Sukuk was relatively more important during the period 2001-2016 by 27% in 2001-09 but declined in percentage to only 9% after that. Sukuk Al Mudaraba was much less important in the domestic market than the international market.²³

Issuing Mudaraba or Musharaka Sukuk with such arrangements that secure the capital from loss and promise fixed rates of return was not only Sharia non-compliant, but also inconsistent with proper use of these contracts. Mudaraba and Musharaka are contracts that are suitable for those investors who are seeking higher profit rates in promising or innovative projects that are consistent with risk appetite. Claims of risk removal in projects that were financed by Mudaraba or Musharaka Sukuk, security given by issuers to their holders were far fetching, deceitful, and abusive of the basic characters of these contracts.²⁴ Islamic banks issued Mudaraba Sukuk at rates of returns that were among high ones in the Sukuk market.²⁵ The fact that Mudaraba and Musharaka Sukuk have been among the leading kinds in the global market indicates that neither the issuers nor the buyers were aware of Sharia principles or cared for its right application.

The share of *Wakalah (Agency) Sukuk* in the international market increased dramatically from 3% to 43% between 2001-2009 and 2010-2015 respectively. The major change continued in 2016 where *Wakalah Sukuk* amounted to 77% of the total international issuance. In the domestic market, *Wakalah Sukuk* increased from 1% in 2010-2015 to 10% of total issuances in 2016 and 2017.

Wakalah Sukuk "are certificates that represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation on behalf of the certificate holders" (AAOIFI, 2004). The application of the *Wakalah* contract in the Sukuk industry granted *Wakil* (agent) an authority to collect financial resources, to buy the assets which are the subject matter of *Wakalah*. No specific rules were established to guarantee that the structure of the assets portfolio which the agent controls would always be compliant with Sharia. Such a portfolio may include debt contracts or shares in corporations that are not committed to Sharia. The common practice of fixed rate Sukuk issuances has applied to *Wakalah*. Yet in addition to this, the *Wakil* is allowed to keep for himself, as an incentive, any extra profits above what is sufficient to maintain the Sukuk holders' fixed rate of return. In the

²³ The share of Sukuk Al Mudaraba ranged between 2% for most of the period to 8% and 9% in 2016 and 2017 respectively. Such a trend was against that kind of Sukuk in the international market.

²⁴ It will be argued, below, that Mudaraba and Musharaka Sukuk can be issued under Sharia rules if we accept that this instrument would be actually subject to the outcome of operations in terms of realized profit or loss.

²⁵ In 2016, Ahli United Bank (Kuwait) issued US\$ million 200 Mudaraba Sukuk in the International Sukuk Market, at a rate of return 5.5% - Perpetual Tenor. The same year, Boubyan Bank (Kuwait) issued Mudaraba Sukuk of US\$ Million 250 at a rate of 6.75%- Perpetual Tenor.

opposite case, the Wakil is responsible to make *tabaru* (donation) to Sukuk holders in order to maintain their promised fixed rate of return.

Such unprecedented authority given to Wakil, which allowed him flexibility in managing the Wakalah portfolio and in distributing returns, can be counted among explanations of major growth and success of Wakalah Sukuk in practice. Yet, the continuation of such growth and success cannot be guaranteed! The practice of Wakalah contract through Sukuk neglected not only relevant Sharia rules but also some important economic issues that are involved in the Principal/Agent relation. In classical Fiqh rules, the principal selects the agent carefully to manage his capital assets in the best possible business practice to the benefit of the principal. In case of the agent violating terms of the contract or neglecting his duties he has to compensate the principal. The agent performs his duties against a commission, salary, or lump sum. But the agent neither has right to share in profits nor is responsible for loss, if this happens. The Wakalah contract, as known in Sharia, has been misused. Sound governance rules would help in providing some protection to Wakalah Sukuk holders. But nothing can be found in the past experience of Wakalah Sukuk refers to governance or monitoring rules to ensure its sound management or the commitment of Wakil to the best of business practice. Governance, in business activities which are run by the agency, has become, worldwide, so important and necessary for protecting the rights of all stakeholders. The rights of Sukuk holders (the principal) are relinquished with respect to all procedures that were adopted in establishing Wakalah and managing it. The Wakalah Sukuk turned the owners into no more than sleeping partners, waiting for a fixed rate of return just like interest-based bondholders.

Murabaha Sukuk held the most dominant structure for Sukuk in the domestic market by 34% and 64% of total issuances in 2001-2009, and 2010-2015 respectively.²⁶ The share of *Murabaha Sukuk*, however, declined afterwards, to 38% in 2016. Within Sharia rules, assets can be acquired for purpose of re-selling them with a profit margin, and securitized to be *Murabaha Sukuk*. Returns achieved from selling such *Murabaha* assets in the market are Sharia permissible. Yet, *Murabaha* contracts which are “debts” cannot be securitized, sold and exchanged in the market in form of Sukuk. The details and reality of *Murabaha Sukuk*, kind of operations carried through such an instrument and how rates of return are fixed cannot be detected from available data which is mainly supplied by IIFM. These rates varied between 3.52% (Jambatan Kedua- a Malaysia-Quasi- sovereign) to 22.9% (Maybank)

5. Sukuk and Targets of Islamic Finance

Islamic finance is based on ethics that are derived from the Quran and Sunnah. These ethics, on the one hand, prohibits some practices such as *Riba* (interest), the sale of debt, *Eina*²⁷ and

²⁶ That was against an insignificant or a small share in the international market (1% - 2% in the period 2001- 2016).

²⁷ Briefly, *Eina* is buying by debt a commodity from somebody at a higher future price and then selling the same commodity to the same person at a lower cash present price. *Eina* is a backdoor to *Riba* (usury). *Eina* can also be done by selling a commodity and then buying it back from the same person to get around the *Riba*. In Sharia *Riba* and *Eina* are twins.

*Gharar, etc.*²⁸ . On the other hand, Islamic ethics aim at the best use of resources and the realization of society's interests.

Apart from neglecting some basic Sharia rules or misusing Islamic financial contracts, we can neither deny nor underestimate that Sukuk in the past experience has contributed in financing some large infrastructure projects that are important to development in Muslim countries. Examples can be given in Sukuk of the "Tabreed" project in the UAE²⁹, and the \$ 3.5 billion Sukuk of Dubai Ports, Customs and Free Zones Corporation, which contributed in developing the potential capacity of the world's third largest port. This type of projects are undoubtedly important to Muslim countries, including the rich Gulf countries, but economic development means much more than this. In my estimation, with the maintenance of genuine Islamic financial ethics and Sharia rules, Sukuk can be used in Muslim countries to finance small and big projects, and in a manner that would effectively enhance their economic development and rates of growth.

One of the sectors that really need financial help to grow and can effectively help in pushing economic development in Muslim countries is the SMEs. According to recent studies and statistics, SMEs and informal enterprises, account for over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries³⁰. SMEs contribute to the satisfaction of many local needs of manufactured goods. SMEs also have a vital role which they play in the services sector besides their role in cottage industries in villages and rural areas. In many cases, SMEs contribute to export development(OECD, 2004). The sector also enjoys a higher level of competition compared with large industries, which would be reflected in market efficiency and in an ability to withstand economic fluctuations and international crises .

The SMEs sector is really an important one to all Muslim countries. It cannot be neglected, and solving its financial problems would considerably help in economic development. Land, buildings, a new type of machinery, capital equipment that are needed for starting or expanding the activity of a small or medium enterprise involve high costs and requires considerable liquidity. SMEs, however, are generally unable to access sufficient finance from the market except at high costs and tough terms. Conventional banks, in case of approving to lend SMEs, impose burdensome conditions on them in terms of high interest payment and collaterals. Unfortunately, when SMEs resort to the informal credit market, they would fall in

²⁸ Briefly *Gharar* occurs in transactions when some or all terms and conditions of the contract are intentionally neglected or non-intentionally missed. *Gharar* necessarily involves elements of uncalculated or irrational risk, that yields unjustifiable gain or loss to one of the contract's parties.

²⁹ Tabreed Trust Certificate.

³⁰ Recent empirical studies show that SME's also "contribute to over 55% of GDP and over 65% of total employment in high-income countries. In the European Union countries, for example, there are some 25 million small businesses, constituting 99% of all businesses; they employ almost 95 million people, providing 55% of total jobs in the private sector": Hidayet Keskgn, et al, "The Importance of SMEs in Developing Economies",2nd International Symposium on Sustainable Development, June 8-9 2010, Sarajevo, PP. 183-192

hands of the loan sharks. They would be excessively exploited as they need to pay exorbitant interest rates for very short periods of time. Such conditions cripple their growth in spite of their economic importance (OECD, 2015).

6. Ijarah Sukuk and its Possible Role in SMEs Financing

Issuing Ijarah Sukuk would be of great help to SMEs. Yet, the problem in practice is that SME finance would be in small sums and securitization would, therefore, be quite costly. Getting over such a problem needs an active role to be played by Islamic financial intermediaries. Islamic banks and financial companies that would respond to leasing demands of SMEs would possess the assets which they require, securitize them and issue Sukuk for their interest.

Leasing finance has been practiced by Islamic banks through "*Ijara Muntahia Bittamleek*", i.e. leasing and ownership (L&O). L&O played an important role in Islamic banking finance, but most operations focused on expensive durable commodities such as vehicles, apartments, and houses. The small and medium enterprises sector (SMEs) has benefited little from L&O finance, except in case of Sudan (Abdelradi Mero, et al, 1986).³¹ Now, Islamic banks need to give due attention to SMEs financing. They are capable of doing this by securitization of L&O contracts. In fact, within the basic conception of Sukuk as an Islamic alternative to bonds, the most relevant contract for securitization is Ijarah contracts. Leasing (Ijarah) assets are productive and can within normal practice generate stable and regular income. Assets can be maintained and insured without need to twisting or violating Sharia rules.

Ijarah Sukuk is expected to expand successfully in domestic markets and in some cases in international markets as well³². But, L&O contracts which are designated for securitization should not be mixed with prohibited debt assets. Thus Ijarah Sukuk will be 100% backed by assets whose usufructs are consistent with the requirements of SMEs whether in the manufacturing, or agricultural and services sectors.

We need to emphasize, however, three extra points. First; that Islamic leasing contract requires some financial restructuring, within Sharia framework, to be on one hand, competitive with arrangements that conventional leasing companies offer³³, and on the other hand to be more

³¹ Sudan has an excellent experience in financing SMEs: Faisal Islamic Bank, Um Dorman Branch, Publications in different years. Abdelradi Mero et. al, 1986. (Reference in Arabic: عبد الراضي ميرو، أرباب، بابكر وعبد الباقي عباس، "الحرفيون - اقتصادياتهم وتجربة فرع الحرفيين- بنك فيصل الإسلامي السوداني"، السلسلة العربية 14- مركز البحوث والإحصاء.)

³² Some Small and Medium scale industries have comparative advantages, have export opportunities and Ijarah Sukuk in their cases are likely to be more secure and offer higher rates of returns.

³³ Over the last 50 years, the world has gradually developed leasing activities and hire purchase of durable goods and capital equipment. Thus the leasing business in the developed world and in a number of developing countries has grown steadily with SMEs. Leasing finance empowered SMEs, within the limits of their available liquidity, to carry out their activities. Available information shows that contracts arranged by the leasing financing companies enabled SMEs to organize their payments in a way which did not burden them or impede their growth. In addition, competition amongst leasing companies has also motivated them to develop their leasing contracts in various new ways that helped their customers (lessees) with appropriate payment modes in case they need renovation or replacement

effective in helping and developing SMEs. Second; rates of return on Ijarah Sukuk have to be guided by the leasing market demand and supply mechanism and never, as in common practice today, by the interest rate³⁴. For genuine Islamic *Ijara Sukuk*, we have to rely on the prevailing market rental rate of the leased assets or for similar assets (in Islamic jurisprudence this is known as the *rental of the equivalent*).³⁵ Thus, the returns to *Ijarah Sukuk* will differ between different activities and sectors. This will allow for collecting financial resources and allocating them to investment projects according to productivity consideration, a matter that is favorable to economic development.. Activities which are more productive will promise higher regular returns to holders of *Ijarah Sukuk*. Third; the risk of financing the SMEs through Ijarah Sukuk should be taken into account for sake of security and stability. Ijarah Sukuk ought to facilitate finance to SMEs that are (i) enjoying growing domestic markets for their products, (ii) having foreign demand for their products, particularly when these are of special traditional or indigenous characters (iii) having vertical or horizontal linkage with big industries in the domestic market. It is to be noted that such projects by the nature of their relations with big industries are usually based on modern technologies and enjoy efficient managerial qualities. Financial support to these projects by leasing finance, managed through Ijarah Sukuk, would increase their productivity, and enhance their competitiveness.

7. A Possible Developmental Role by Mudaraba and Musharaka Sukuk

Ijarah Sukuk, as displayed and explained can play a distinctive role in the development of Muslim countries. Other kinds of Sukuk, can have different roles to play in economic development, provided that we do not stick to the conception of Sukuk as an Islamic alternative to conventional bonds³⁶. Sukuk of Mudaraba and Musharaka with prefixed known

of their leased capital equipment. This is quite important if an SME desires to maintain or develop its business in a competitive market. In the developed world, leasing companies have taken into consideration flexibility in payment of installments to be consistent with technical and economic durability of the leased assets. Besides, they organized maintenance operations as required for preserving perfectly the benefits of such assets. See: Abdelrahman Yousri. Does Islamic Banking help in Economic Development of Muslim Countries?, 2016.

³⁴ Guidance by the interest rate as a benchmark, whether done by selecting a fixed rate or by dependence on (LIBOR + or – BP) has been practiced as mentioned in a previous section of this article . This should be brought to an end for sake of best allocation of resources (Abdelrahman Yousri, 2013), and not merely to avoid mimicking the *Riba* mechanism.

³⁵ Liquid capital in Islam does not have an ex-ante market price, due to the interest (Riba) prohibition. When liquid capital is employed in Musharaka or Mudaraba, it receives a profit share or may face loss. Physical capital in terms of productive assets has a market price that reflects the value of the income flow which it yields through usage. The market value of a productive asset which is ready for leasing depends on the expected stream of its usufructs. The rental of such an asset will be consistent with market supply and demand for its usufructs.

³⁶ Dr. Mabid al-Jarhi says in a comment which I received from him “ I tend to take the position that the characterization of sukuk as similar to bonds was a mistake from the very beginning. Sukuk can be considered as securitized titles to assets used in investment. Such assets would bear the usual business risk. Securitization would make investments more liquid, which is useful to investors, even if they would bear business risk. To provide an instrument that would satisfy risk avoiding investor in Islamic economics should be considered a folly.”

returns and safety of capital are a real failure if we talk about their authenticity in terms of Sharia rules and Islamic ethics.

In fact, Musharaka and Mudaraba Sukuk can be used in proper Sharia manner to extend long run finance to big projects in different economic sectors. Genuine Mudaraba Sukuk will find a market among investors who are ready to bear a higher level of risk for sake of greater profit. Yet, this kind of Sukuk has to be designed in a professional manner by establishing a suitable and efficient risk mitigation system within Sharia boundary. Firstly, by selecting carefully viable investment projects with promising profit rates. Secondly, the Mudareb, who is a co-partner and responsible managing director, should be selected from amongst most experienced and trusted businessmen. Thirdly, some restrictions may be imposed on Mudareb's actions, for sake of minimizing risk. But such restrictions should neither impede his entrepreneurial faculty nor his managerial decisions, to be consistent with Sharia rules of *Restricted Mudaraba*³⁷. Fourthly, partnership (Musharaka) of the Mudareb with his own capital in any Mudaraba operation will be desirable as it would also reduce the level of risk involved in Mudaraba for the Sukuk holders. Fifthly, full information about Mudaraba assets, which will be designated for securitization, risk involved in each Mudaraba operation and share of profit which associates such risk should be declared to the public in full transparency. This is important to Islamic ethics of trustfulness and sincerity in transactions as well as to an efficient marketing of Sukuk. On bases of *Restricted Mudaraba*, issuers of Mudaraba Sukuk should declare their full responsibility to compensate Sukuk holders if loss results from major shortcomings in feasibility studies that preceded the selection of investment project or wrong selection of the Mudareb. Wrong selection of Mudareb would be clear in case if he violated the contract or neglected his business duties³⁸. Mudaraba Sukuk can play a distinctive role in Muslim economies development particularly when employed in financing big projects in high tech manufacturing or services sectors.

Musharaka Sukuk can play a role in corporate finance, but in our opinion such role should not restrict the role played by common shares. Corporates in conventional finance are normally dependent on stocks and interest-based bonds. Within an Islamic frame, corporates will depend on common shares, which were almost unanimously sanctioned by majority of Sharia scholars since the late 1970's³⁹, and Musharaka Sukuk. Corporates would be able to get extra finance by issuing Musharaka Sukuk against selected fixed assets. Musharaka Sukuk would be liable to profit or loss, just like common stocks. Yet, they would be particularly backed and protected by the fixed assets which have been designated and securitized, such as

³⁷ Abdelrahman Yousri Abdelrahman, "Islamic banking modes of finance: Proposals for further evolution." 2005.

³⁸ Mudareb has to bear the loss in such cases, but the issuers should be responsible for taking the necessary action towards him, on one hand, in order to compensate the Sukuk holders on the other. For more details see Abdelrahman Yousri, op. cit.

³⁹ Shares played an important and successful role in financing big projects such as Islamic banks, insurance-takaful companies and corporates.

land, buildings, fixtures, equipment and machineries. Musharaka Sukuk can also be issued on basis of *Diminishing Partnership* contracts *المشاركة المتناقصة* which is practiced by Islamic banks. This will give the holders the option of getting returns, on basis of profit/loss sharing, and restoring their capital within a given period of time.

Concluding Remarks

The growth of the Sukuk market, during 2001-2017, was remarkable by all known conventional financial measures. But, it was unsatisfactory and rather disappointing when examined by rules and principles of Islamic finance.

The experience shows misapplication of Sharia rules of profit/loss sharing. Sukuk nominal value and returns were practically guaranteed all times. Guarantee of Sukuk was arranged indirectly and backed by sovereign, semi-sovereign entities and other originators. All that explains high ranking given to Sukuk by famous credit rating agencies. The paper reveals that Sukuk, in practice, neglected and twisted the essential functions and rules of the Islamic financial contracts. Besides, issuers and organizers in the Sukuk industry were clearly unaware of the negative economic consequences of using the interest rate as a benchmark in fixing profit rates and in selling debts through Sukuk.

Sukuk, during 2001-2017 contributed, surely, to economic development in some Muslim countries by financing big infrastructure projects. Yet, the developmental role of Sukuk can be much wider and important. The article visualizes an effective role that can be played by *Ijarah* Sukuk in the development of Muslim countries through financing SMEs. Another possible developmental role can be played by *Mudaraba* Sukuk when designed in a professional manner within Sharia frame of *Restricted Mudaraba*. *Mudaraba* Sukuk can participate effectively in the development of promising and innovative projects particularly in service, industrial and trade sectors

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