

Securitization, *Ṣukūk* and Fund Management Potential to be Realized by Islamic Financial Institutions[#]

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Investments by most of the Islamic Financial Institutions (IFIs) are concentrated in short term asset build-up based on murābahah and ijārah. Recent innovative ventures like ṣukūk issues, however, point out that IFIs have a big potential to capture larger segment of financial markets by employing proactive strategies and structural adjustments subject to Shari‘ah compliance. A number of ṣukūk issues lack in respect of Shari‘ah compliance in one way or the other. This may back fire and lead to loss of integrity of the emerging Islamic finance industry in the long-run as it nullifies its very basis and contravenes the investors’ aspiration based on their belief. While taking stock of the achievements of Islamic finance, we have to work for its development keeping in view the objectives that its pioneers had visualized. Funds mobilized using the mode of shirākah can be utilized on the basis of Sharing or Fixed-return modes keeping in view the risk preferences of investors to generate variable / quasi fixed income securities. Fund Management and Securitization, with due diligence exercised for Shari‘ah compliance, are mutually-enforcing vehicles for Islamic banking promotion and can be used to achieve the socio-economic objectives of sustainable growth with broad-based distribution of income.

1. Introduction

Growth of Islamic banking and finance has gained momentum during the last decade particularly in the area of *ṣukūk* and Securitization. Having taken notice of this development, the pioneers, financial experts and the critics are keenly observing the growth path and the trends to ascertain the direction and the quantum of growth. The areas of their quest are: what is the nature of hustle & bustle in Islamic finance. Is there any change in underlying bases leading ultimately to something really different or more or less the same patterns are being pursued under commercial imperatives albeit ensuring some ethical norms. Keeping the above pursuits in mind, this paper explores the potential of Islamic banking for sustainable growth and discusses how it can be realized.

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The paper is divided into six Sections: Section 2 briefly describes the growth of Islamic financial institutions (IFIs) and the assets they have netted in besides their innovative ventures to develop products/instruments. Section 3 covers the journey towards securitization, categories of *ṣukūk*/products and their underlying bases in various areas/countries. Section 4 contains some issues of concern associated with term structures of present *ṣukūk* issues and the potential risks for Islamic banking. The Section 5 explores the areas of real and sizeable potential of Fund Management coupled with risk-based securitization and *ṣukūk* issues. Finally, Section 6 contains the recommended approach and steps to realize the potential.

2. Development of Islamic Finance Industry

The objective of this section is to give an idea of trends and status of the Islamic finance movement to serve as a basis for further discussion on the growth potential. A significant development since late 1980s has been that conventional commercial banks started offering Islamic banking services side by side with their normal operations. Now, relatively larger part of the Islamic banking and *takāful* business is undertaken by conventional institutions, directly or through their subsidiaries, which offer Islamic financing facilities to their clients as alternative to *ribā*-based dealings. Moreover, major part of Islamic finance assets as of now pertains to institutions operating in a dual financial environment in which IFIs are operating side by side with conventional interest based banks/financial institutions. Only Sudan and Iran are pursuing nation-wide usury-free banking systems with specific characteristics and limitations of their own. This Paper mainly discusses the developments in such parts of the world where both the systems are working in competitive environment driven by market forces.

2.1 IFIs as a Whole

Out of about 75 countries where Islamic financial institutions are operating in one form or the other, Bahrain, Saudi Arabia, UAE, Malaysia, Britain and USA are respective Islamic financial hubs of varying degrees for multi-dimensional growth of Islamic finance in various parts of the world. Bahrain with the largest concentration of Islamic financial institutions in the Middle East region is hosting over 30 Islamic financial institutions dealing in diversified activities including commercial banking, investment banking, offshore banking and Fund Management. Pursuing a dual banking system, Bahrain Monetary Agency (BMA) affords equal opportunities and treatment for Islamic banks as for conventional banks.

The share of Islamic banking operations in Malaysia (the hub in the Far East) has grown from a nil in 1983 to about 10 percent of total financial system. They have a plan to enhance this share to 20 percent by the year 2010. A significant number of non-Muslim customers in Malaysia access Islamic banking products and services. However, there are some conceptual differences between Malaysia and the Middle East Islamic finance theory like sale and purchase of debt and giving

return as *tabarru'* (gifts) to investors or depositors. Islamic banking assets in Indonesia are expected to reach US \$4.1 billion or 1.8 % of total assets by end of this year.

Islamic banking is no longer confined to its original strongholds in the Middle East and South East Asia. Over 25 IFIs are operating each in USA and Britain with 20 such institutions in other European countries. The British Parliament has approved the legislation to solve the taxation issues in respect of Islamic finance. It is interesting to note that while Middle East market is tax-friendly, other markets in Islamic countries even do not normally provide, so far, this relief for the IFIs.

Assessing the accurate market size of global Islamic banking is difficult simply because a variety of non-banking financial institutions are also operating with Islamic character. Even for banks, there has been no independent empirical study using Basel capital criteria to assess market size in Islamic banking. Number of all types of Islamic financial institutions has been estimated at over 270. According to the Bahrain based General Council for Islamic Banks and Financial Institutions (GCIBFI), value of Islamic banks assets has exceeded \$260 billion with a steady growth rate of 10-15 percent per annum over the last three decades (GCIBFI, 2004). Most of these institutions are investment banks, non-bank financial companies/institutions or Windows/segregated branches of conventional financial institutions. The main areas covered by them are trade operations for a range of merchandise and commodities excluding gold, silver, currencies and commodities prohibited under *Shari'ah*, leasing of automobiles, plants and machinery, investment in equity markets, housing finance/ mortgages, fund management and portfolio investments.

The two sets of financial institutions, i.e. Full-fledged Islamic banks and the Windows have different nature of operating rules particularly with regard to *Shari'ah* aspects. While most of the individual full fledged Islamic banks and the stand-alone IB branches, as in Pakistan (SBP Website, FAQs), have their *Shari'ah* supervisory structure with its active role in all stages from product development to documentation and dealings with clients, the Windows operators have, at the most, provision for only casual advisory role of the *Shari'ah* scholars. This aspect points to a big difference in nature and quality of services offered by various banks/institutions particularly in respect of conformity or otherwise with the *Shari'ah* principles.

2.2 Supra-National Institutions

As regards the global character of Islamic finance institutions, Islamic Development Bank (IDB) is playing the most important role in promoting Islamic banking activities, development of products and instruments and other R&D activities. Bahrain is hosting a Liquidity Management Centre (LMC) and the International Islamic Financial Market (IIFM) to provide primary and secondary markets for Islamic instruments and to coordinate the operations of Islamic banks

in the world. Bahrain based Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has rendered a valuable service having prepared accounting, auditing and Shari'ah standards for almost all major modes of financing. Islamic Financial Services Board (IFSB) has been established with its headquarters at Kuala Lumpur to harmonize Shari'ah based banking system with financial system of the world. It has to develop and promulgate internationally accepted prudential regulatory and supervisory standards and best practises for global Islamic banking, including drawing on the new risk-focused Basel II Accord. With mutual efforts of these institutions, a noticeable development during recent years is that a number of instruments for assets and liquidity management have been evolved, *ṣukūk* and other Islamic financial instruments are being issued and an Islamic financial market has been developed with a global character.

2.3 Product Development

In addition to instruments for retail banking, the *ṣukūk* market and securitization in the framework of Islamic finance industry has developed a lot of momentum. A *muḍārabah* based inter-bank money market exists in Malaysia since 1994 and can be developed in countries with sufficient number of IFIs. While *shirākah* based instruments like *muḍārabah* Certificates and Participation Term Certificates (PTCs) are in use since early 1980s, instruments/*ṣukūk* other than those *shirākah* based in local currencies are being issued since 1992. The first Issue of Dollar denominated Islamic bonds of \$600 million was offered by Malaysia in 2002. It was followed by launching of \$400 million Solidarity Trust *ṣukūk* of Islamic Development Bank in September 2003. After that, about thirty Sovereign and Corporate *ṣukūk* issues have been offered in Bahrain, Malaysia, Saudi Arabia, Qatar, UAE, UK, Germany, Pakistan, etc. Development in this direction has been discussed in detail in Section 2 and data given in Annexure-A.

2.4 Supervision and Regulation

The policy, nature and the level of regulation and supervision as also the legal frameworks have important bearing on the size, growth, Shari'ah compliance and integrity of the Shari'ah based finance discipline. Work of varying degrees and nature has been done in countries like Bahrain, Malaysia, Saudi Arabia, Kuwait, UAE, Iran, Sudan, Pakistan, Bangladesh, Indonesia, Brunei, Britain and USA. AAOIFI's standards on accounting and auditing aspects of Islamic banking can help in harmonizing Islamic banking practises over the world. The establishment of the Prudential Information and Regulatory Framework for Islamic Banks (PIRI) by the BMA in conjunction with AAOIFI could be helpful in framing a legal and regulatory framework to meet the specific risks inherent in Islamic financing structures. Islamic banks have to purchase assets for onward sale or lease to their clients. As such, levy of taxes and fees on their purchases leads to uneven playing field for them compared with their conventional counterparts. In order to avoid such costs, Islamic banks, except for a few countries with tax free environment,

resort to practices creating doubts with respect to Sharī'ah compliance when seen in terms of standards set by AAOIFI and the Islamic *fiqh* Academy of the OIC.

2.5 Sharī'ah Compliance

Notwithstanding visibly good performance as a whole in terms of growth rate and the penetration levels in global finance, a relatively weaker area is the aspect of Sharī'ah compliance which is not being taken care of properly by many IFIs. Credibility of Islamic banks is the most important aspects and the key to success and development. Islamic banks must give special care to this aspect otherwise they would be facing systemic risk for the whole industry. It has been seen in many cases that the Sharī'ah Advisors are there simply to endorse the formats of documents and the bankers are free to conduct business in response to market signals without any effective follow up by Sharī'ah people. Such relaxed environment results in non Sharī'ah compliance of transactions undertaken by bankers who may or may not be sufficiently trained in Sharī'ah matters.

Murābahah operations in general and in early perishable goods or Shares of Companies etc have given rise to a number of Sharī'ah related issues that must be catered for by the Sharī'ah supervisors. Particularly, when *murābahah* transactions are used for Tawarruq (buying goods on credit and selling it for a spot price to get cash), it leads to mockery of Islamic financial system specifically when buy-back arrangement is involved. For that very reason the Federal Sharī'ah Court in Pakistan altogether prohibited the use of *murābahah* by Islamic banks in Pakistan (FSC, 1991). In this perspective, the role of Sharī'ah compliance inspection by regulators cannot be over emphasized. The finalization of Sharī'ah compliance inspection manual in the light of first such inspection of an Islamic bank in Pakistan conducted last year on experimental basis and inspection of the IFIs on the basis of such manuals would go a long way in ensuring Sharī'ah compliance and enhancing integrity of Islamic banking industry.

3. Categories of *Ṣukūk* and Securitization

3.1 *Ṣukūk* Structures and Parameters

Ṣukūk (plural of word *sak*) were extensively used by the Muslim societies of the Middle Ages as Papers representing financial obligations originating from trade and other commercial activities. However, the present structures of *ṣukūk* are different from the *ṣukūk* originally used and are akin to the conventional concept of securitization, a process in which ownership of the underlying assets is transferred to a large number of investors through Papers commonly known as *Sanadat*, Certificates, *ṣukūk* or other instruments representing proportionate value of the relevant assets.

Ṣukūk can be of a number of types based on the Sharī'ah modes as the underlying contract or sub-contract, most important of which are *shirākah*, *ijārah*,

salam and *istiṣnāʿ*. As per the basic rules of Sharīʿah, investment *ṣukūk*¹ have to be structured, on one side, on the principle of *muḍārabah*. On the other side, business could be conducted through participatory or fixed return modes / instruments. Thus, the rates of return on *ṣukūk* will be either variable (in case the modes on second leg are participatory) or quasi-fixed (in case of modes with fixed return). *Ṣukūk* of the second category can be made fixed return *ṣukūk* through the provision of any third party guarantee (Islamic *fiqh* Academy, 1985–2000: 65).

In terms of the use of funds mobilized by financial institutions, following may be the categories of *ṣukūk*: *muḍārabah ṣukūk*, *mushārahah ṣukūk*, *ṣukūk* of ownership in leased assets, *ṣukūk* of ownership of usufructs, *salam ṣukūk*, *istiṣnāʿ ṣukūk* and *murābahah ṣukūk*. As *muḍārabah* principle is the basis of all other *ṣukūk*, we shall discuss it in detail followed by other categories of *ṣukūk*:

3.1.1 *Sanadatul Muqāraḍah or Muḍārabah Ṣukūk*

Muḍārabah ṣukūk or Deeds can be instrumental in enhancing public participation in investment activities in any economy. These are certificates that represent projects or activities managed on *muḍārabah* principle by appointing any of the partners or any other person as *muḍārib* for management of the business. In terms of the Resolution of the Islamic *fiqh* Academy of the OIC (2000: 61-65), following are the salient features of *muḍārabah* certificates:

1. *Muḍārabah ṣukūk* (MS) represent common ownership and entitle their holders share in the specific project against which the MS have been issued.
2. The MS contract is based on the official notice of the Issue or the Prospectus which must provide all information required by Sharīʿah for the *Qirāḍ* contract such as the nature of capital, the ratio for profit distribution and other conditions related to the issue, which must be compatible with Sharīʿah.
3. The MS holder is given the right to transfer the ownership by selling the deeds in the securities market at his discretion. Market value of *muqāraḍah* deeds varies with the business status and anticipated or expected profits of the concerned project. The sale of MS must follow the rules listed below:
 - i. If the *muḍārabah* capital, before the operation of the specific project, is still in the form of money, the trading of MS would be like exchange of money for money and it must satisfy the rules of *bayʿ al ṣarf*².

¹ Investment *ṣukūk* are different in nature from common shares of the joint stock companies. These are certificates of equal value representing undivided share in ownership of tangible assets of particular projects or specific investment activity, usufruct and services. These are issued on the basis of Shariah-nominated contracts in accordance with relevant rules of the concerned contracts. (AAOIFI, 2003, Pp. 298-300).

² *Bayʿ al ṣarf* refers to exchange of Gold, Silver, monetary values/receivables or currencies; has to be equal for equal and simultaneous in case the items of exchange are homogeneous

- ii. If *muqāraḍah* capital is in the form of debt, it must be based on the principles of debt trading in Islamic jurisprudence.
 - iii. If capital is in the form of combination of cash, receivables, goods, real assets and benefits, trade must be based on the market price evolved by mutual consent.
4. The Manager/SPV who receives the funds collected from the subscribers to MS can also invest his own funds. He will get profit for his capital contribution in addition to his share in the profit as *muḍārib*.
 5. Neither prospectus nor MS should contain a guarantee, from the Issuer or the manager of the fund, for the capital or a fixed profit, or a profit based on any percentage of the capital. Accordingly, a) The prospectus or the MS issued pursuant to it, may not stipulate payment of a specific amount to the MS holder, b) The profit is to be divided, as determined by applying rules of Sharī'ah; that is, an amount in excess of the capital, and not the revenue or the yield; and c) the Profit and Loss Account of the project must be published and disseminated to MS holders.
 6. It is permissible to create reserves for contingencies, such as loss of capital, by deducting from the profit a certain percentage in each accounting period.
 7. The prospectus can also contain a promise made by a third party, totally unrelated to the parties to the contract, in terms of legal entity or financial status, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided such commitment is independent of the *muḍārabah* contract. However, it is not permissible for the issuer to guarantee the capital of the *muḍārabah* (OIC Fiqh Academy, 2000: 61-65).

3.1.2 *Mushārahah Shukūk*

These are certificates of equal value issued for mobilizing funds to be used on the basis of partnership so that their holders become owner of the relevant project or the asset as per their respective shares that are part of their assets portfolio. *Mushārahah shukūk* can be issued as redeemable certificates by or to the corporate sector or to the individuals for their rehabilitation/employment, for purchase of automobiles for their commercial use or for establishment of high-standard clinics, hospitals, factories, trading centres, endowments, etc.

Mushārahah redeemable *shukūk* are relatively similar to *muḍārabah shukūk*. Therefore, basic Sharī'ah rules relating to *muḍārabah* would also apply to *mushārahah* certificates. The only major difference is that the intermediary-party will be a partner of the group of subscribers represented by a body of *mushārahah* certificate holders in a way similar to a joint stock company (Hamoud, 1998).

like Gold for Gold or US Dollar for US Dollar; and simultaneous in case the items being exchanged are heterogeneous, e.g. Gold for Silver or Rupee for Dollar.

An excellent example of *mushārahah ṣukūk* are the 5-years Term Finance Certificates (TFCs) worth Pak Rupees 360 million issued by Sitara Chemical Industries, a public limited company in Pakistan in June 2002. These TFCs for the period of 5 years are based on the mechanism of profit and loss sharing and are tradable in the Securities Market. The payment of profit to or sharing of loss with the TFC holders are linked to the operating profit or loss of the Company. The exact rate of profit on investment in the TFCs is not possible to be determined for each year in advance. The investors assumed the risk of sustaining losses proportionate to their principal amount in case of operating losses incurred by Sitara. Changes in any government regulations may also affect the profitability of the TFCs. By investing in the TFCs, the investors also assume the risk of not being able to sell the TFC without adversely affecting the price. According to end-December 04 data, Sitara gave very good returns during last two years (21.3 and 22.8 percent per annum respectively).

In Sudan, a number of assets of Ministry of Finance and the Bank of Sudan, Bank of Khartoum, Nilain Bank and other public entities have been identified for the purpose of Securitisation on *mushārahah* basis. Instruments known as Central Bank *Mushārahah* Certificates and Government *Mushārahah* Certificates are issued for the investors and are used in place of Treasury Bills and other interest bearing securities for Open Market Operations. The CMCs are sold (or bought) by the Central Bank through auctions and can be traded in the secondary inter-bank market. (Ayub, 2002: 128-131).

3.1.3 *Ijārah Ṣukūk*

Ijārah ṣukūk are the securities representing ownership of well defined existing / defined and known assets tied up to a lease contract, rental of which is the return payable to *ṣukūk* holders. By dint of flexibility in rules of *ijārah*, Securitizing the *ijārah* contracts is a key factor in solving liquidity management problems and for financing the public sector needs in developing countries. Payment of *ijārah* rentals can be unrelated to the period of taking usufruct by the lessee, i.e. It can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide. This flexibility can be used to evolve different forms of contracts and *ṣukūk* that may suit different purposes of issuers and the holders. Governments can use this concept as alternative tool to interest based borrowing provided they have durable assets useable in the process of performing government functions. Use of assets by the Governments is necessary while it does not matter whether these assets are income generating or not. (Kahf, 1998).

Following features may be kept in view for securitization under *ijārah*:

It is necessary for an *ijārah* contract that the asset being leased and the amount of rent both are clearly known to the parties at the time of the contract and if both of these are known, *ijārah* can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the

lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee (AAOIFI, 2003 :140 - 157). The lessor can sell the leased asset provided it does not hinder the lessee to take benefit from the asset. The new owner(s) would be entitled to receive the rentals of remaining period. Similarly, they can dispose of their share in the asset to the new owners individually or collectively.

Rental in *ijārah* must be stipulated in clear terms for the first term of lease, and for future renewable terms, it could be constant, increasing or decreasing by benchmarking or relating it to any well known variable like inflation rate, any periodically announced price index, or otherwise by any settled percentage. The mainstream Shari‘ah experts have permitted the benchmarking with any interest rate reference, although it is not an ideal practise to them (Usmani, 2000: 168-171).

As per Shari‘ah rules, expenses related to the corpus or basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be borne by the lessee. Therefore, the expected return flow from such *ṣukūk* may not be completely fixed and determined in advance. In this perspective *ijārah ṣukūk* should be taken as Quasi fixed return instruments in Islamic finance. It can be agreed, however, between the parties that the rentals would consist of two parts, one for payment to the lessor and the other as ‘on account’ payment, to be held by lessee for any costs relating to ownership of the asset. (AAOIFI, 2003).

As regards procedure for issuance of *ijārah ṣukūk*, an SPV is created to purchase the asset(s) that issues *ṣukūk* to the investors, enabling it to make payment for purchasing the asset. The asset is then leased to Government or any corporate body for its use. The lessee makes periodic rental payments to the SPV that in turn distributes the same to the *ṣukūk* holders. As the lessor can stipulate the rentals in advance, the rentals on *ṣukūk* issue can be indicated in advance with possibility of very small variation that might be possible due to payment of ownership-related un-predictable expenses by the lessor or possibility of any default by the lessee.

3.1.4 *Istiṣnā‘ Ṣukūk*

Istiṣnā‘ is a contractual agreement for manufacturing goods allowing cash payment in advance and future delivery or a future payment and future delivery of the goods manufactured as per the contract. It can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, bridges, roads and highways. By way of parallel *istiṣnā‘* contract with subcontractors, Islamic banks can undertake the construction of any asset and its sale for a deferred price, and sub contract the actual construction to any specialized firm.

In *istiṣnā‘*, full ownership of the constructed item is immediately transferred to the purchaser against the deferred sale price that normally covers not only the construction costs but also profits which could legitimately include, inter alia, the cost of tying funds for the duration of the repayment period. The payable deferred

price can be documented in the form of *ṣukūk* (certificates of indebtedness) known as *istiṣnāʿ ṣukūk*. Prohibition of *ribā* precludes the sale of these debt certificates to a third party at any price other than their face value. Therefore, such certificates which may be cashed only on maturity cannot have a secondary market. However, they can be transferred at face value to a third party. The builders, big industrial concerns and whole-sale suppliers can sell to the IFIs certain assets on *istiṣnāʿ* basis on deferred payment and issue *istiṣnāʿ ṣukūk* redeemable periodically according to their payment dates. The holders of *istiṣnāʿ ṣukūk* may acquire against them property or merchandise for a deferred price. Once acquired, such property or merchandise can be disposed of in any manner. As indicated earlier, the deferred price of goods acquired against such certificates would be higher than the spot price of the same goods. The certificate holder acquiring the goods now at higher than the spot price is in fact relinquishing to the seller of the goods some, (all, or even more) of the price differential which the former obtained from the client above the construction cost of the project he financed. This would mean that the market forces can play a role in encouraging or curtailing the exchange of these certificates for goods (Muhammad al-Bashir, et. Al. 2001)

3.1.5 *Salam* Securities /*Ṣukūk*

Salam is a contract in which advance payment of price is made for goods to be delivered later on. It is not permissible to sell the commodity concerned before receiving it. Therefore, the recipient may not resell the *salam*-commodity before receiving it, but he may resell the commodity by another contract which is parallel to the first one. In this case, the first and the second contracts should be independent of each other. Specifications of the goods and delivery dates of the two contracts may conform to each other, but both the contracts would be independently enforceable.

Salam sale is attractive to the seller whose cash flow is enhanced in advance and to the buyer as the *salam* price is normally lower than the prevailing spot price. The BMA, in June 2001, developed *salam* based securities with LIBOR-related 3-months tenure used by Islamic banks for liquidity management. Bahrain government sells aluminium to Bahrain Islamic Bank which has been nominated to represent the other banks wishing to participate in the *salam* contract. The Government of Bahrain undertakes to supply a specified amount of aluminium at a future date. At the same time, BIB appoints the Government its agent to market the aluminium at the time of delivery through its channels of distribution at a price which provides a return to security holders.

The possibility of having negotiable *salam* certificates is yet to be decided. So far, scholars are not inclined to accept it. It needs sound analysis of reselling goods purchased under *salam* before taking possession by the original buyer especially in the situation when he maintains inventory of that kind of goods in which case banks would be selling those goods out of the stock maintained by them without

specifying any units of the goods. If it is allowed, the *salam ṣukūk* could be negotiable.

3.1.6 *Murābahah Ṣukūk*

Any ‘Paper’ representing a monetary obligation arising out of a credit sale transaction by banks cannot create a negotiable instrument. While *murābahah* receivables cannot fetch any return, their assignment also has to be at face value. *Murābahah Ṣukūk* are more likely to be used in respect of purchases of goods by the public sector. In case the government needs items of huge price, it may purchase them through credit sale by paying in instalments. The seller will amortize his cost and return (profit margin) over the period of instalments. The government will issue certificates according to the number of instalments. Each certificate having maturity date would represent property right of the seller that can change hands provided amount of the claim does not change. The seller or the original certificate holder can transfer his collection rights to another party against payment that would be equal to the face value of the certificate minus collection cost at the transferee’s end. Any ‘*murābahah* Funds’ can also issue *murābahah ṣukūk* proceeds of which could be used for sale of pre-specified and general assets on the basis of *murābahah* to give quasi fixed return to the *murābahah ṣukūk* holders.

3.1.7 Mixed Portfolio Securities / *Ṣukūk*

Banks may securitize a pool of *mushārahah*, *ijārah* and some *murābahah*, *salam*, *istiṣnāʿ*, and *juʿālah* (a contract for performing a given task against a prescribed fee in a given period) contracts. The return/risk on such securities will depend on the chosen mix of contracts. A prominent example of such mixed portfolio *ṣukūk* are IDB’s Solidarity Trust *Ṣukūk* for US\$ 400 million issued in 2003. Their salient features are given in Annexure-A. In June 2005, IDB issued \$500 million floating rate *ṣukūk* under its \$1 billion medium term notes (MTN) programme based on mixed portfolio comprising assets leased by IDB, not less than 30 per cent of total value, and instalment payments under *murābahah* and *istiṣnāʿ* contracts which the IDB has entered into with some of its clients.

3.2 Securitization/*Ṣukūk* Issues

Some attempts were made in 1980s to develop tradable Islamic instruments / securities, but the proper process of *ṣukūk* issue started in 1992 in Malaysia and in 2001 in Bahrain after which *ṣukūk* market emerged rapidly in almost all parts of the World. During 2001-2004 the volume of investment in *ṣukūk* has been estimated at 8 to 9 billion US Dollars out of which *ṣukūk* worth about 6 billion are *ijārah* based while the remaining are based on *shirākah*, *salam* or pooled assets. *Ṣukūk* issues of Malaysia are mostly based on the concepts of *bayʿ al ʿīnah* of underlying asset and the concept of *tabarruʿ* while their trading in secondary market took place through *bayʿ al dayn*. Lately, they have also been issuing *ijārah ṣukūk*.

Malaysian Islamic bonds based on *bay' al-ʿinah* and *bay' al-dayn* principles are not acceptable to mainstream juristic opinion and majority of Sharīʿah experts. According to a research study undertaken by Rosly & Sanusi (1999), there is no significant Sharīʿah justification of *bay' al-ʿinah* for issuance of *ṣukūk*. Similarly, trading of *ṣukūk* at a discount using *bay' al-dayn* has been found unacceptable by the majority of 'ulamā' including Shawafī'e.

Ṣukūk originating from Bahrain and other Middle East are based on *ijārah*, *salam*, *istiṣnā'*, *istiṣnā'-cum-ijārah*, or the pool of mixed assets. Such *ṣukūk* are acceptable to almost all of the Islamic banking experts subject to fulfilment of minimal Sharīʿah essentials associated with underlying contracts. Besides major penetration of *ṣukūk* Issues in Malaysia and Bahrain, other countries like Sudan, Iran, Saudi Arabia, UAE, Philippines, Germany and Pakistan have developed some 'Sharīʿah compliant' and tradable securities/*ṣukūk*. Prominent *ṣukūk* issues in various countries along with some description are given in Annexure-B.

4. Issues in Term Structures of *Ṣukūk*

4.1 Conclusive Rates of Return in *Ṣukūk*

A pertinent issue relating to *ṣukūk* having a long term effect on integrity of the Islamic financial system is that return rates on most of the *ṣukūk* are conclusively pre-agreed even without any provision for the 3rd party guarantee. Many *ṣukūk* issues are subject to severe criticism due to involvement of *bay' al-ʿinah*, *bay' al-dayn* and other non Sharīʿah compliant traits that make the *ṣukūk* as good or as bad as interest based bonds. *Bay' al-ʿinah* is a double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, with the net result of a loan with interest. As such, it is a legal device to circumvent the prohibition of *ribā*.

Rosly & Sanusi (1999) conclude in this regard, "The use of legal device is therefore an evidence that the *niyyah* factor is undermined or made secondary in the securitization process of Islamic bonds in Malaysia. To retain the basic structure of traditional bonds in Islamic finance, that is providing fixed return to investors, practitioners and the relevant Sharīʿah experts may have wrongly applied Sharīʿah laws, which implies now that the legitimacy of Islamic bonds issued using *bay' al-ʿinah* is suspect."

Ijārah has a great flexibility and a large potential for *ṣukūk* issue, but some of the features of *ijārah ṣukūk* issues or the agreements involved in the process are pointer to different Sharīʿah related problems. As per Sharīʿah rules, *ṣukūk* holders have to jointly bear the risks of assets price and the ownership related costs and share its rents by leasing it to any user. As discussed earlier, due to possibility of non predictable expenses relating to the ownership of relevant leased assets and possible defaults, the returns could be Quasi-fixed and not absolutely fixed or unmodified when pegged with any bench mark. However, the returns on most of

the *ṣukūk* are absolutely fixed or unmodified. This aspect encompasses systemic risk of non Sharī'ah compliance which nullifies the very basis of the Islamic financial system and contravenes the investors' aspiration based on their belief.

4.2 *Bay' al-Dayn*

Secondary market trading of Islamic securities is possible through *bay' al dayn* as in case of a variety of Malaysia based *ṣukūk*. However, Jamhoor '*ulamā'* do not accept this even though the debt represented by *ṣukūk* is supported by underlying assets. The traditional Muslim jurists are unanimous on the point that *bay' al-dayn* with discount is not allowed in Sharī'ah. The overwhelming majority of the contemporary Sharī'ah scholars are also of the same view. However, some brothers from Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafi'ite school, but they did not consider the fact that the Shafi'ite jurists allowed it only in a case where a debt was sold at its par value (Usmani, 2000: 217). Rosly & Sanusi (1999) have observed in this regard, "The trading of Islamic bonds at a discount using *bay' al-dayn* has been found unacceptable by the Jumhur '*ulamā'* including al-Shāfī. As such, the position of Malaysian Islamic bonds remains unacceptable among the Middle Eastern jurists although some Malaysian jurists found this the opposite." OIC Islamic *fiqh* Academy, which has the representation of all Islamic countries, including Malaysia, has also approved the prohibition of *bay' al-dayn* unanimously without a single dissent.

4.3 Sale-and-Lease-Back Methodology

As against the *bay' al 'inah* concept that is prohibited, the experts in Sharī'ah principles allow the use of 'Sale-and-lease-back' technique. This is because of flexibility in the *ijārah* contract as discussed earlier. An asset can be purchased from a party and then leased to that party. In this case, the *ijārah* contract should not be executed unless and until the IFI has acquired the asset (AAOIFI, 2003: 140,152). As such, the Sale-and-lease-back technique does not create any Sharī'ah related problem as considered by some writers on the subject. Assets leased under this technique can again be sold to the original owner as in case of most of the Sovereign *ijārah ṣukūk* issued so far. Sharī'ah scholars suggest, however, that in such cases the client should purchase back the asset at least after one year of sale. It is to ensure that the technique is not used as back-door to interest.

4.4 Sovereign *Ijārah Ṣukūk*

All sovereign *ijārah ṣukūk* issued so far carry the guaranteed and benchmarked fixed rate without involvement of 3rd party guarantee or any provision for the lessor bearing any ownership related liabilities. A cursory analysis of related documentation of such Issues has revealed that a number of Sharī'ah requirements are not being taken care of by the SPVs, Issuers or the Arrangers. For example, in case of sovereign *ijārah ṣukūk* issued in recent past by an SPV - an entity belonging to the sovereign itself, the sovereign sold a landed property to the SPV

with upfront agreement that it would take back the ownership title after the lease period. (It is permissible, as discussed above.) The sovereign would pay a fixed annual rental equivalent to (---) above 6-Months LIBOR and redeem the principal of *ṣukūk* to bond holders after (---) years. Payment of rentals has been guaranteed in the contract itself in the form of contractual obligation of the sovereign to pay the rent. The principal is also guaranteed as at the time of contract the sovereign guaranteed to buy the asset back after the lease period at a pre-fixed price. The transaction as a whole involves five or six Agreements all of which have been made integral part of the main contract. Sequencing of these agreements, having bearing on Sharī'ah compliance, is not known. As such, Islamic or conventional banks took equal interest in investing in the *ṣukūk*. In view of the above, majority of experts in Sharī'ah related finance are worried that sovereign *ṣukūk* are fixed income instruments and as good or as bad as interest based bonds; something should be done at this stage to set the train on right track.

4.5 *Ṣukūk* for Financing Public Sector Deficits

A related point of concern is that most of the *ṣukūk* issued for financing Government deficits are not based on the best possible structures of Islamic finance. *Salam ṣukūk* of Bahrain and some *shirākah* related certificates in Sudan are the only exceptions. *Ijārah ṣukūk* introduced in recent past need some refinements. No doubt, development of Sharī'ah compliant instruments for financing government budget deficits is really a difficult task. But *ijārah*, *salam* and *istiṣnā'* modes, if properly structured, have the possibility of being used as alternative to interest based deficit financing. (Kahf, 1998).

5. Areas of Real and Sizeable Potential

5.1 Expectations Versus Apprehensions

It needs to be emphasized that keeping in view the growth of Islamic banking over past three decades, future potential should be related to the expectations of the pioneers of the concept of Islamic banking and apprehensions of contemporary scholars who are minutely watching the direction and trends of its growth. One many refer to scholarly works by Maududi (1961,...), Siddiqi (1976), Qureshi (1946), Uzair (1978), and others to arrive at the conclusion that Islamic finance was visualized as a means for correcting the imbalances caused by working of the conventional interest-based system. While the conventional system is contributing mainly to financial growth resulting in increasing disparities between the haves and the have-nots, both in developing as also developed countries³, Islamic financial

³ For example, financial industry makes up nearly one-quarter of United States of America's overall stock market capitalization, up from over 5% in the 1970. Profits of financial firms in 'finance based economy' of US rose from 4% of overall profits to more than 40% during 1982-2004 (The Economist, February 12-18, 2005, P. 57). The severity of the exploitation of the nations producing goods by those excelling in creation of financial

structure has to be developed with the objectives of achieving balanced growth of financial and commodity sectors and help achieve the socio-economic objectives of development with broad-based distribution of income. There are apprehensions that the way Islamic finance movement is heading, it may be a zero-sum game and end up in total loss of its creditability.

5.2 Potential for Development and Growth

All Islamic modes have potential for development. *Shirākah* based (PLS) modes that provide the much needed risk-based funds can be used for short, medium and long-term project financing, import financing, pre-shipment export financing, working capital financing and financing of all single transactions. The institution of *muḍārabah* serves as a basis of business to be conducted by combining funds and the expertise of different groups of people. *Muḍārabah Shukūk* can be issued to mobilize funds and strengthen trading and industrial activities. SPVs can manage such assets as Trusts/Funds for conducting business for their benefit as also of the *shukūk* holders. It could generate higher rates of return for the investors relative to the return realizable on any interest-based investment. As visualized by Homoud (1998), if the profit rate in *muḍārabah* based businesses is as low as 10 per cent and the annual turnover is 3, the realized profits may reach 30% per annum. "These profits may be distributed at an equal sharing ratio or at the rate 1/3 to 2/3 between MC holders and the management of the institution. The idea has the potential to alleviate the hardships of low income people in many countries." In case of big projects, the IFIs may form a consortium to issue certificates to the public for subscription. Similarly, they can carry out the work on infra-structure and socio-economic projects in coordination and partnership with the engineering firms.

The non-PLS techniques not only complement the PLS modes but also provide flexibility of choice to meet the needs of different sectors and economic agents in the society. *Murābahah* with lesser risk and better liquidity options has several advantages vis-à-vis other techniques and can be helpful in employment generation and alleviation of poverty. Leasing can be very much conducive to the formation of fixed assets and medium and long-term investments.

Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It provides incentive to enhance production and lead to creating a stable commodities market with stability of prices. To realize this potential, IFIs can organize a forward commodity trade market on the basis of *salam*. It will provide not only a non speculative forward market for resource mobilization and investment but would also be a powerful vehicle for rural finance. (Khan, M. Fahim, 1995).

assets out of thin air can be gauged from the fact that the Economist's Commodity Price Index (1845-50=100) has gradually fallen to 20 in 2004 (The Economist, *ibid*, P. 64).

5.3 Securitization and Fund Management

Securitization and Fund Management are the mutually-enforcing vehicles for Islamic banking promotion. While the former is asset monetization for transferring assets' cash flow to investors through some financial papers, the latter refers to investors pooling their resources to purchase larger number of shares through any manager collectively, which otherwise they could not purchase individually. Any combination of assets (or the usufruct of such assets) can be represented in the form of written financial instruments that can be sold at a market price, provided that the pool of assets represented by the *ṣukūk* consists of a majority of tangible assets. In this way, Islamic banks may increasingly develop Islamic variable return and quasi fixed-income securities.

AAOIFI issued standard for 'Investment *Ṣukūk*' in May 2003 which contains over a dozen types of eligible assets on the basis of which *ṣukūk* can be issued in Sharī'ah compliant structures (AAOIFI, 2003: 298-313). These include *Ijārah Ṣukūk* representing ownership of assets, ownership of usufructs of existing and future assets and ownership of services of any specified party; *Salam* Certificates, *Istiṣnā'* Certificates, *Murābahah* Certificates, Participatory Certificates, *Mudārabah* Certificates / *Ṣukūk*, Investment Agency *Ṣukūk* and *Muzāra'* / *Musāqah* Certificates.

5.4 Structural Changes in Banking Business

In the global competitive environment, IFIs must diversify their operations to offer broader portfolio services both to the savers/investors as also the fund users. By providing only short-term commercial loans, they cannot compete with giant conventional banks. Through syndication arrangements, they must also provide corporate advisory services like issuance of Sharī'ah compliant *ṣukūk*/certificates and balance sheet and corporate restructuring, etc.

This, however, would require some structural changes and amendments in legal and regulatory frameworks which are crucial for ensuring Sharī'ah compliance as also for better performance of the IFIs. Banking business should not be taken as a sacred cow to preclude any change in its tools, processes and operations. Survival in the world of finance which is undergoing rapid transformation is possible only through adjustments and transformation needed time to time due to changing ground realities. The Investment Funds are providing better opportunities and access to various real sector businesses around the world. After the 'Glass- Steagall Act 1933' was repealed in 1999, banks in USA had been running Islamic investment institutions fulfilling the dual purpose of realizing higher profits and providing needed facilities to community who avoid *ribā*.

Islamic financial institutions have also to do all sorts of businesses – retail banking to Fund management and corporate services by affecting some structural changes. It would require close coordination between central banks and SECs in

respective countries enabling the IFIs to adopt suitable models and structures for businesses keeping in view the demands of the market and the Shari‘ah principles.

5.5 Growth of Non-Bank IFIs

Thus, potential lies in establishing NBFCs and Islamic Funds for the purposes of asset management and Securitization. Shaikh Taqi Usmani (2000:203-218) has indicated following categories of Islamic Investment Fund: **(1) Equity Fund**, the proceeds of which are invested in shares of joint stocks companies, and returns in the form of capital gains and dividends are distributed on pro rata basis among the investors. Management of the Funds can be carried out on *muḍārabah* or agency basis. In case of *muḍārabah*, the fund manager would get any pre-agreed percentage of the realized profit while in case of agency arrangement, the manager would get fee on agreed terms, that may be any specified amount or percentage of the net asset value of the Fund; **(2) Ijārah Funds**: The amounts subscribed under such funds are used to purchase the assets for the purpose of leasing. Rentals received from the user are distributed among subscribers of the Fund. Ijārah *Ṣukūk* can be traded in the secondary market on the basis of market forces. Any one who purchases these *ṣukūk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. In *Ijārah* Funds the management can act as an agent of the subscribers or *muḍārib* and would be paid a fee for its services or share in the realized profits, respectively; **(3) Commodity Funds**: in which the subscription amounts are used in purchasing different commodities for the purpose of resale. The profits generated by the sales are distributed among the subscribers; **(4) Murābahah Funds**: any Fund created for *murābahah* sale should be a closed-end fund; its units cannot be negotiable in a secondary market as Islamic banks’ portfolio of *murābahah* does not own any tangible assets; and **(5) Mixed Funds**: the subscription amounts of which are employed in different types of investments like equities, leasing, commodities, etc. For trading of Mixed Funds the tangible assets should be more than 51% while the liquid assets and debts less than 50 percent.

Islamic banks may engage in ‘Fund Management’ and offer individual investment portfolios/investment funds on fixed return (Mark-up based) and on variable return (PLS based) modes according to risk profile of the investors. If they are pensioners, widows and other groups of people not in position to bear the risk of loss, their funds will have to be invested in quasi fixed income *ṣukūk*, but their profit rate will be relatively lower than that of those who are ready to take the risk of investing on *shirākah* basis. Since *murābahah* operations are least risky and leasing operations can also be selective to choose only low risk transactions, the securitization of such transactions will give low risk capital instruments for the Islamic capital market. In case of government *ṣukūk*, the risk would definitely be the minimum.

‘Sale and Lease Back’ arrangement of *ijārah* is suitable for sovereign, corporate bodies or local governments’ securities. The governments in need of resources may

sell unencumbered specific fixed assets that could be used by one way or the other, to the SPV for forming a pool of assets for leasing to the Government against which the SPV would issue *ijārah šukūk* in local or international markets to those interested in investment. Once the government has sold any asset, the same asset cannot become basis for further securitization unless the government repurchases it in the normal way or through *ijārah wal iqtinā'* with separate agreements.

Through syndication arrangement, Islamic banks can supply goods/assets of enormous value to the government entities or corporations on *murābahah* basis by setting up joint *murābahah* Funds. In that case, ownership of '*murābahah* Funds' can also be securitized to offer equity based investment opportunities to the investors and the banks themselves. Return of these Funds would be distributed among *šukūk*/certificate holders on pro-rata basis.

SPV or a syndicate of IFIs can issue *murābahah šukūk* in case the Governments or the corporate firms have to purchase very expensive goods or assets. With the proceeds of such *šukūk* the assets could be purchased and sold on marked up price on deferred payment basis giving profit to the investors. Lesser the chance of default, as in case of Governments, more stable income stream would be available to the *šukūk* holders who could get quasi fixed return on their investments. Recently, Arcapita Bank, a Bahrain based investment bank, has mandated some Lead Arranges to issue US \$ 200 million five-year multi-currency *murābahah*-backed *šukūk* the proceeds of which will be used for the sale and purchase of assets via a series of commodity *murābahah* transactions. However, details of the Issue are not known to assess its Sharī'ah compliance or otherwise. Similarly, *istišnā'*-cum-*murābahah šukūk* can be issued to finance construction of huge social and economic projects.

Islamic banks can finance public sector's Commodity Operations on *murābahah* basis. The banks or their subsidiaries/designated branches that intend to participate in Commodity Operations can establish a Trading Company registered with SEC of respective country to purchase goods from the farmers/suppliers and sell them to the relevant Governments entities on profit margin. Shares of the Company could be traded on the Stock Exchange and the Central Bank may allow the Islamic banks to invest in the shares to meet their SLR requirements.

5.6 Trading in *šukūk*

Securities/certificates/*šukūk* can be freely traded in the market depending on market signals provided compliance of following Sharī'ah rules:

- Instruments representing real physical assets and usufructs are negotiable at market price. Certificates or *šukūk* issued by *mushārahah*, *muḍārabah* and *ijārah* are covered under this category.

- Instruments representing debts and money are subject for their negotiability to the rules of *hawālah*⁴ (assignment of debt) and *bayʿ al-ṣarf*.
- Instruments representing a pool of different categories are subject to the rules relating to the dominant category. If cash and debts/receivables are relatively larger, the rule of *bayʿ al-ṣarf* would apply, and if real/physical assets and usufructs are overwhelming, trading would base on the market price. (AAOIFI, 2003: 305 – 307).

While discussing trading in Units of Investment Funds, Shaikh Taqī excludes the sale of units of *Murābaḥah* Funds on the ground that *murābaḥah* portfolios of Islamic banks own only cash and receivables/debts as they sell the goods immediately after purchase by them. In my view, however, the honourable Shaikh should have advised the IFIs to get themselves involved in actual trading activities and maintaining inventory for the purpose of *murābaḥah* and leasing through setting up of Trade or Asset Management Companies not only for making possible the Units' trading, but also to enhance Islamic banks' integrity in terms of Sharīʿah compliance. IFIs need to develop trade, leasing and infrastructure banking, although not as retailers, but as wholesale and specialized suppliers and facilitators. In this regard they should seek from the regulators the permission to engage in genuine business and to choose the structure which suits them fulfilling all requirements of prudent operations and corporate governance.

Ijārah Ṣukūk that have a good potential for trading would be issued at par value while subsequent trading in secondary market could be conducted at any price above or below the face value. Another suggestion is that the respective central bank may purchase the entire issue from the SPV at face value and then call an auction and announce the targeted amount and the rentals that the SPV has agreed to pay. Islamic banks could quote any price above or below par. The central bank would determine its cut-off rate and sell the securities accordingly. Once auctioned, the secondary market trading can take place at any price. The central bank will declare their net assets value on daily or weekly basis and, as lender of the last resort, purchase them on penal rate and sell them at the market price.

6. Summary and Conclusion

This paper discusses the status of Islamic finance movement, features and structures of various *ṣukūk*/securities based on *shirākah*, *salam* and *ijārah* contracts, or a pool of contracts, Sharīʿah essentials involved, integrity of the system and systemic risk in case of non Sharīʿah compliance. IFIs need to accord

⁴ Literally, *Hawalah* means transfer; legally, it is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt – this transfer of debt has to be on face value.

due care to the aspect of Shari'ah compliance that would require intensive role of Shari'ah boards / supervisors.

Islamic banking and finance industry has a large potential ahead. In a highly competitive environment, IFIs have to transform the nature of their business not only to consolidate the success achieved so far but also to realize the huge potential in the areas of Fund Management and Securitization, provide *halal* and relatively better return flow to investors and thus contribute to world economic growth and prosperity. They would require structural adjustments enabling them to deal with real sector businesses, implementation of trading, leasing and real-estate related contracts using both PLS and 'fixed-rate' Islamic modes of financing. Such an approach would enable them to earn higher profits, as businesses of real sector normally earn, and pass-on greater part of the profits so earned to the savers/investors. In addition to securitizing their pooled assets portfolio, they may resort to Fund Management and invest in *shirakah* based variable income and trade and leasing based fixed income operations to provide Shari'ah compliant investment facility to various classes of investors according to their risk preferences.

Shukuk create a framework for participation of a large number of people in financing projects in public and private sectors, including those of infrastructure, such as roads, bridges, ports, airports, etc on the basis of various modes. The return on the *shukuk* would depend on the income realized by the projects. A variety of target-specific *shukuk* can be issued on the basis of various modes keeping in view the relevant Shari'ah rules. It would require appropriate enabling laws to protect the interests of investors and issuers, appropriate accounting standards, study of the targeted market, monitoring of standardized contracts, appropriate flow of financial data to investors and provision of standard quality service to customers at large. Creation of Islamic universal *shukuk*, structured by IIFM as SPV, fulfilling the Shari'ah essentials of *ijarah* can serve as a basis to promote cooperation among Muslim countries and their financial Markets.

Building a sustainable and progressive Islamic financial system involves restructuring of business, creation of the key components comprising the Islamic banking industry, Islamic financial markets and the development of non-bank Islamic financial institutions. Progress in this direction would enable the banks to manage liquidity more efficiently and the investors to get relatively higher rates of return with additional benefits attached to financial assets. Regulators need to provide enabling environment and ensure that proper procedures for good corporate governance, transparency and ensuring Shari'ah compliance are in place.

In order to realize the potential effectively the regulators, authorities in the government and the practitioners have to work collectively in order to take care of the areas like education, training and public awareness about Islamic financial system, effective enforcement of contracts, strengthening recovery systems and conducting internal and external Shari'ah compliance audit of IFIs' operations.

Annexure - A

Salient Feature of IDB Solidarity Trust *ṣukūk*

Solidarity Trust Services (STS) served as Trustee to issue the Fixed Rate Trust Certificates that were issued to purchase a portfolio of *ṣukūk* assets comprising *ijārah*, *murābahah* and the *istiṣnā'* contracts originated by the IDB. Each certificate represents an undivided beneficial ownership in Trust Assets and ranks pari passu with other Trust Certificates. Most part of Assets (over 50 %) would all time during the period comprise *ijārah* assets. If at any time the proportion of Assets evidenced by *ijārah* contracts falls below 25%, a Dissolution Event will occur, and IDB by virtue of its separate undertaking will be obliged to purchase all of the Assets owned by the Trustee pursuant to the terms of the 'Purchase Undertaking Deed'. Profit on *ṣukūk* assets, net of expenses of the trust, would be used to give periodic return to the certificate holders. Certificates would be redeemed at 100% of their principal value. In case of any early dissolution event, the redemption will be according to adjustment keeping in view the Return Accumulation Period. Principal amounts of *ṣukūk* will be re-invested in *ijārah* and *mushārahah* contracts to form the part of *ṣukūk* assets.

On the basis of a separate undertaking, IDB has guaranteed payments in respect of assets owed by the Trustee by reference to the schedule of payments given by IDB at the time of sale of assets to the Trustee. Certificate holders will not have any recourse for payment of any amount in respect of certificates in case the Trust Assets are exhausted.

As such, IDB's guarantee (for the rate on the certificates) does not comprise a guarantee of payments in respect of the Trust Certificates but represents a guarantee, inter alia, of the amount scheduled as being payable by the obligors of the underlying transactions in respect of the Assets. In case of any shortfall in return on the *ṣukūk* assets the IDB has agreed to meet the shortfall. IDB has also agreed to provide interest free facility to the STS to ensure timely payment of any periodic distribution amounts on the Trust Certificate. Thus ability of the trust to pay the due on certificates would ultimately depend on IDB.

On the basis of the 'Purchase Undertaking Deed' between IDB and the Trust, the IDB will purchase the *ṣukūk* assets on the earlier of the maturity date or the dissolution date. The proceeds will be distributed by the Trust among the certificate holders who would periodically receive fixed rate of return net of any withholding or any other taxes.

Annexure-B

Prominent *Şukūk* Issues in Various Countries

Name of <i>şukūk</i>	Type	Amount	Maturity	Pricing
Malaysian Global First	Corporate	US\$ 150M	5 years	Floating reference rate on underlying <i>ijārah</i>
IFC Wawasan Ringgit <i>şukūk</i> (<i>bay' Bil Thamānah</i> 'ājil)	Corporate	US\$132 million	3 Years	Fixed, 2.82 %
Malaysian Global <i>ijārah şukūk</i>	Sovereign	US\$ 500M	7 years	Floating LIBOR related
Qatar Global <i>ijārah şukūk</i>	Sovereign	US\$ 700M	7 years	0.4 % above LIBOR
Tabreed Global <i>ijārah şukūk</i>	Corporate	US\$ 100M	5 years	Fixed; 6 %
<i>şukūk</i> Al Intifaa Makkah	Corporate	US\$ 390M	24 years	Sale of usufruct rights as weekly time shares
<i>ijārah şukūk</i> Saxony-Anhalt Germany	Sovereign	Euro 100M	5 years	1 basis point over 6-month EURIBOR
Dubai Department of Civil Aviation (DCA) <i>ijārah şukūk</i>	Corporate	US\$ 750M	5 years	Floating reference rate on underlying <i>ijārah</i>
Sitara <i>mushārah</i> Term Finance	Corporate	Pak Rupees 360M	5 years	<i>Shirākah</i> based profit / loss
Solidarity Trust Certificates IDB	Corporate	US\$ 400M	5 years	Fixed rate, based on performance of Mixed Portfolio, IDB Guarantee
Bahrain Monetary Agency (BMA)	Sovereign	US\$ 100	5	Fixed; 4.25%
GoB - BMA	Sovereign	US\$ 70	3	Fixed; 4 %
BMA	Sovereign	US\$ 80	5	Fixed; 4%
BMA	Sovereign	US\$ 50	3	Fixed; 3 %
BMA	Sovereign	US\$ 80	3	Fixed; 3 %
BMA	Sovereign	US\$ 100	5	Fixed; 3.75 %

Name of <i>şukūk</i>	Type	Amount	Maturity	Pricing
BMA	Sovereign	US\$ 250	5	0.6 % above LIBOR
BMA	Sovereign	US\$ 200	5	Floating rate reference
BMA	Sovereign	US\$ 106	10	Fixed; 5.125 %
1st Islamic Investment Bank, Bahrain	Corporate	US\$ 75	3	LIBOR related
Philippines	Sovereign	US\$ 300 M	3-10	
Malaysia Global <i>ijārah</i>	Sovereign	US\$ 600 M	5	0.95 % above LIBOR
Dubai Civil aviation <i>şukūk</i>	Sovereign	US \$ 1000 M	5	Fixed
Durrat real Estate <i>şukūk</i>	Sovereign	US\$ 120 M	5	1.25 % over 3 Months LIBOR
Sarawak Corporate <i>ijārah şukūk</i>	Sovereign	US \$ 350 M	5	1.25 % above LIBOR
<i>ijārah şukūk</i> , Pakistan	Sovereign	US\$ 600 million	5	2.20 % over 6 months LIBOR

Source: Web Site of LMC (<http://www.lmcbahrain.com>); Tariq, Ali Arsalan, Managing Financial Risks of *şukūk* Structures; a dissertation submitted in Loughborough University, UK in September, 2004 with some additional information from different sources; (As the data could not be confirmed from the original sources, there might be some mistakes.)

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