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Comments on Discussion Papers and Notes submitted for the Harvard – LSE Workshop on Sukuk

All praise be to Allah and His peace and mercy be upon His last prophet Muhammed.

Following is a brief write up prepared to address some of the issues raised through some valuable and scholarly papers written by Professor Rodney Wilson, Shaikh Taqi Usmani and Dr. Najatullah Siddiqi and other learned scholars and distributed among the participants of Harvard – LSE Workshop on Sukuk with a view to enriching the discussion on the subject.

While I appreciate the approach and concerns of the learned scholars in raising these important issues, I would like to seize this opportunity to emphasize the need for more deliberations and research work from scholars of Islamic Jurisprudence and experts in the fields of Finance and Economics so that Sukuk could be further developed and fine tuned as an established Sharia compliant product catering to the requirements of modern finance and Islamic banking.

Our aim is to shed some light on those principles or mechanisms of Sharia which have been the subject of debate in relation to those Sukuk which are based on Mudaraba, Musharaka and Wakala contracts. I pray Allah to guide us to Truth, open our hearts and minds and to lead us to the Right Path.

What is Important in Contracts? Form and Terminology or Essence and Purpose?

Whenever a Sharia compliant contract is entered into or a product is structured in Islamic finance, it has to be in line with a basic Sharia principle, among others, which asserts that “It is the Essence & Purpose, nor the Form & Terminology, that Matter”. It means that we need to comprehend the core structure and essence of a contract or a product rather than its appearance or form. For example, if a Sukuk structure proposes return similar to a conventional bond then this will not form a basis to judge that such Sukuk are Sharia repugnant.

In the light of the above maxim, it is obvious that Sukuk should always be based on the applicable and relevant Sharia principles and it is the duty of Sharia scholars sitting on the Sharia boards of Islamic banks and financial institutions to structure and analyze, with great care, any Sharia product to ensure that the substance, the structure and the documents outlining and executing such structure do not breach any Sharia principle.

Here it must be emphasized that although this principle must be taken into consideration, but it should never be applied in a manner which could lead to neglecting or negation of the texts of Shari'a. Rather, there should always be a way to reconcile the Essence with the requirements of explicit Shari'a texts as swaying to either side of the extreme, whether by emphasizing the Essence at the cost of the Form or vice versa, is not only against the spirit of Shari'a, but it also restricts the scope of Ijtihad in facing the colossal challenge of finding Shari'a compliant solutions for issues where there is neither an explicit Shari'a text nor have the earlier Fuqaha derived the Shari'a ruling.

It may be argued that this maxim is rather emphasizing the fact that should the Essence be in compliance with the texts of Shari'a and the clear injunctions of Qur'an and Sunnah, the contract shall not be considered Shari'a repugnant if the contracting parties fail, out of ignorance, to comply with certain parameters of the Form. But no Shari'a scholar could think of applying this maxim in a manner that it would lead to negation of the explicit texts of Shari'a and the consensus views of the

Fuqaha that a certain minimum threshold of compliance with the Form is a must for any contract to qualify as a Shari'a compliant transaction; nor should this give a blanket approval to those who are seeking to set aside knowingly the requirements of the Forms and Terminology of Shari'a. Further, this maxim is based on the collective meaning of a number of Shari'a texts; and it is absurd to interpret a meaning derived from the texts in a manner that would lead to negation of the texts themselves.

It should be noted that when we decide a transaction as sharia compliant or repugnant, we should examine the transaction as a whole i.e. with all its elements together, some of these elements maybe tolerated/accepted like fixing the incentive on interest rates benchmark if its taken alone but if its combined with other elements, it will not be sharia compliant. Example of this in sharia is the marriage contract, its valid without guardian according to Hanafi school or without two witnesses according to Maliki school or without dowry (Mahr) according to Shafi' school but if a marriage contract without all of these conditions i.e. without guardian, witnesses and dowry is void. Like this our learned scholar Taqi Osmani brought to our notice what Sukuk behave like debt based bonds, we may discuss and accept one of the features which he has mentioned separately but we will not accept combination of all what he mentioned, this kind of combination will make the Sukuk sharia repugnant and I am of the opinion that no scholar would disagree with him. However I am examining all characteristics and features which he considered combination of them as debt bonds separately in order to find a way out of solution to keep the Sukuk product alive and not to kill it, its east to criticize and show defects but its difficult to review, revise replace and amend the structure to make it sharia compliant.

Such a balanced approach by seeking the means between the two extremes is necessary to avoid labeling what Allah has forbidden as Halal or vice versa.

Islamic banking and Innovation

Irrespective of the point that whether Islamic banking is still in its nascent stage or not, the industry has been, and always will be, in need for diversified and innovative banking products and alternatives that may facilitate smooth flow of its operations with highest standards of compliance with the principles of Sharia.

Such products should always address the concerns of Islamic investors in terms of risks in so far as they are supported with a valid Sharia justification. It is true that the right to earn revenue or profit is always subject to bearing the risk involved. However, on the other hand, an endeavor to achieve a maximum possible level of risk mitigation to protect the Islamic investors is not against the teachings and spirit of Sharia provided that there is no breach of Sharia principles.

It is noteworthy that Shari'a has distinguished among various levels and tiers of risk. The first level is that kind of risk which must exist in a transaction to make it Shari'a compliant. Should the transaction lack that minimum level of risk, it would become void. The Shari'a maxim which states:

الخراج بالضمنان، والغنم بالغرم

which means that right to profit is due to the risk taken refers to this level of risk.

The second level of risk is what turns a transaction/contract into a Shari'a repugnant transaction.

The Hadith:

نهى النبي صلى الله عليه وسلم عن بيع الغرر

is referring to this kind of risk. The Fuqaha have expounded the nature and characteristics of this class of risk, terming it as Gharar Fahesh (excessive ambiguity)

The third level of risk is what lies between the first two classes of risk; and as such it is neither necessary for Shari'a compliance of the contract nor prohibited by Shari'a. Although, Shari'a permits

this kind of risk but it prefers to reduce it through mitigation while, in certain cases, it makes mitigation of the risk obligatory.

Sukuk have created valuable opportunities for Islamic investors while contributing towards the development of economic and business activities around the world. Being a high profile product, the competition of Sukuk with conventional bonds is of course significant.

In such a scenario, the task of Sharia scholars is to adopt a pure scientific and realistic approach while structuring Sukuk.

Structuring of the Sukuk

The structuring of Sukuk (specifically those based on Mudaraba, Musharaka or Wakala) has raised various issues and questions among the scholars as well as bankers in the recent time. Most significant among them are the following which we would like to discuss in some detail:

Sukuk Represent Real Equity / Ownership;
The Promisor;
The Purchase Undertaking;
Sharia Status of a Feasibility Study;
Mechanism of Profit Distribution;
Use of Benchmark;
Role of Rating Agencies.

1. Sukuk represent real equity/ownership

Contrary to conventional bonds which are issued against loans, Sukuk represent either full ownership of the underlying asset (the ownership of both the corpus and the usufruct of the asset) or partial ownership (the ownership of the usufruct of the underlying asset). In the latter case, the Sukukholders purchase the usufruct of the underlying asset from its owner who sells only the usufruct of the asset while he keeps the ownership of the corpus, or they purchase the usufruct of an asset from a lessee who has taken the asset on lease (purchased the usufruct thereof) for a long term, e.g 90 years.

In case of Sukuk ul Mudaraba or Musharaka or Wakala 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 Shari'a compliant contracts and transactions such as Istisna and Murabaha provided there is no element of Riba based debts.

It must be noted that Sukuk cannot be based on Riba based debts where the bondholders are entitled to the interest of the loans or where debts are discounted by purchasing debts worth 100 for 80 for instance and the difference between the purchase price of the debt and the realized receivables form the return of the bondholders.

As far as Sukuk ul Murabaha and Istisna and Salam are concerned, the rules vary according to the stage of the underlying contract which we will discuss later.

It has been observed that in some Sukuk issues, the issuer transfers beneficial ownership or interest to the Sukukholders while keeping the title with itself. Shari'a does not recognize the term 'beneficial ownership' which stands for securitization of the dividends of shares or rights e.g. rights to receive rentals from the lessees of an asset. Hence, Shari'a scholars should unanimously agree on the following:

That securitization of debts is not permissible.

That securitization of rights or interests related to an asset is not permissible.

That a clear line of demarcation should be drawn between ownership, as meant by Shari'a, and legal registration which is the procedure required under the law of the land for transfer of title.

That as the ownership of an asset is transferred from the seller to the buyer through a Shari'a compliant sale agreement Shari'a does not require legal registration for transfer of ownership and the related risks and benefits of the asset.

However, it prefers such registration and compliance with the law of the land in order to safeguard the interests of the Sukukholders. But if it is impossible or impracticable to undertake the task of legal transfer of title under the law of the land (e.g. if the Sukukholders are foreigners and the law of the land does not allow any foreigner to own such assets) or for any other cogent reason, then the transfer of ownership through a Shari'a compliant purchase contract is sufficient. To safeguard the interests of the Sukukholders and to evidence that the legal title is held by the 'legal titleholder' in its capacity as the agent of the Sukukholders, a Deed of Trust or Agency Declaration should be obtained from him/it.

The Sukukholders, as a precautionary measure, may further ask for mortgage of the asset in their favour.

Based on these points, any Sukuk which do not represent real ownership of the underlying asset which would enable the Sukukholders, in their capacity as the real owners thereof, to exercise their rights of disposal and obtaining of the return on the asset, should be considered Shari'a repugnant.

If an IFI sells its assets to Sukukholders, and takes the mantle of the Manager of those assets on behalf of the Sukukholders, it must put all those assets OFF THE BALANCESHEET. However, it has been noted that certain IFIs, encouraged by their external auditors or rather in connivance with them, have continued to show such assets sold by them to the Sukukholders on the Balancesheet inflating it by deception on the pretext that the sale of the Sukuk assets has been made notionally, and the title of the assets have not been transferred to the Sukukholders. This, in our opinion, is tantamount to deception and fraud.

1. The Purchase Undertaking

The following points should be discussed in relation to the purchase undertaking:

The Promisor

A purchase undertaking may be given by the Mudarib, or the investment agent or the managing partner; and all these three are referred to as "Sukuk Manager".

Sometimes, the purchase undertaking may be given by a Sukuk Manager who has sold either the leased assets or the usufruct of the assets which are the subject matter of the Sukuk. (i.e. the Sukuk of leased assets or usufruct). However, if the purchase undertaking is given by a party other than the Sukuk Manager, then such a scenario does not form part of our discussion as no body considers this kind of promise as a guarantee of the capital by the managing partner or the agent. Being a stranger/third party, he can promise to purchase the Sukuk assets at their market value or their face value provided there is no other Sharia repugnancy such as Bai Al Eina or Bai Al Wafa involved.

Since both Murabaha Sukuk after the goods have been sold and Istisna Sukuk after the described Istisna asset has been delivered represent a debt/liability on the part of the person who has purchased the asset by way of Murabaha or Istisna, there could be no purchase undertaking, irrespective of it being at face value or at the market value, from the issuer of the Sukuk or the manager or a third party. In these cases, the Shari'a principles relating to sale of debt shall apply.

As far as Salam Sukuk before delivery of the Salam goods / assets to the purchaser are concerned, they represent a tangible liability (not a debt in monetary terms) on the seller. Therefore, such Sukuk do not involve the question of purchase at face value and consequently that of guaranteeing the capital. However, an undertaking to purchase the assets of Salam Sukuk by the issuer or the manager or a third party before they are delivered to the purchaser is not permissible according to the majority of jurists, while there are more than one opinion on the issue amongst Malikiyyah and some Hanabilah. If the view which allows such a promise is adopted, then it is permissible to redeem Salam Sukuk at face value according to the Malikiyyah, and at market value according to the Hanabilah. Similarly, it allows sale of these Sukuk to third parties.

2. Is purchase undertaking a guarantee?

Is a purchase undertaking, irrespective of whether it is at face value or market value, tantamount to guaranteeing the Sukuk assets by the promisor? In other words, is it correct to consider the promisor to be held responsible to make good any loss of, or damage to, the Sukuk assets; and as such a purchase undertaking would be deemed as stipulating of guarantee of the capital or the profit in a Mudaraba contract and therefore would result in voiding of the contract on the basis of the principle that stipulating of a condition which is in conflict with the nature and essence of the contract leads to its voiding?

Apparently, such a promise cannot be considered as guarantee negating the essence and purpose of the contracts which fall under the classification of trust (i.e. contracts of Mudaraba, Musharaka and Wakala for example).

3. Undertaking to purchase at market value

There could be no two opinions amongst the jurists on the fact:

that the Sukuk assets are owned by the Sukukholders and consequently they shall be liable for all ownership risks and entitled to the related benefits except what was agreed to be given to the Sukuk Manager (in his capacity as Mudarib, managing partner or investment agent);

that a condition stipulating guarantee of loss, damage or destruction of those assets by the Sukuk Manager is void because it is against the essence and purpose of the contract. But would the contract itself be deemed void or not as a result of such a condition could be subject to Ijtihad;

that the Sukuk Manager is required by Shari'a to liquidate (encash) the Sukuk assets at the end of the Sukuk period by selling them to third parties or by purchasing for himself according to the principles of Sharia (i.e. but without giving a purchase undertaking). To sell the assets at market value is the natural situation and as such there is no need for a purchase undertaking.

4. How to ascertain the purchase price in terms of the market price?

Following are some points of discussion in relation to ascertaining the purchase price in terms of the market value:

It may be argued that the market value is unknown at the time of issuance of the purchase undertaking while normally a promise has to be based on a known price undertaken to be paid by the Promissor. However, in my opinion, this does not affect the validity of the promise as it is enough to agree on the mechanism which would determine the price of the asset at the time of entering into the sale contract.

As there is no secondary market for Sukuk assets, who will ascertain the market value of the assets? Sukuk Manager alone (as it seems from the opinions of jurists)? Or is it necessary that the Sukukholders also agree on his valuation? What will happen if the Sukukholders do not agree on the valuation of the Sukuk Manager? Do we need an external expert valuator for ascertaining the market value of the assets?

Hence, only adding a provision in the purchase undertaking that the exercise price will be the market price will not provide a solution; rather there should be an agreement on who will determine the value of the assets and on the valuation mechanism.

It is also proposed that the exercise price should be the price agreed between the two parties i.e. the Sukukholders and the Sukuk Manager. This proposal is not practicable because it does not provide a dispute settlement mechanism in case a dispute between the Sukukholders and the Sukuk Manager arises; and there is no denying the fact that there is a need for such a mechanism which could be achieved by appointment of an expert valuator, a dispute-settlement body, external auditor, a court or an arbitrator.

Further, it must be decided whether it is enough to agree on the evaluation mutually even if it is different from the market value or the face value or should a Shari'a compliant mechanism be adopted?

Is it possible to agree on a formula to ascertain the purchase price instead of market value or the face value?

Is it permissible to stipulate in the Sukuk documents that Sukuk Manager would be obligated to liquidate the assets, by himself or through a third party, at a price not less than the face value. It may be noted that some jurists allow Mudarib to purchase the Mudaraba assets for himself?

The conclusion is that a mere purchase undertaking at a price to be agreed between the representative of the Sukukholders and the Sukuk Manager is not practicable as it cannot remove possible disputes.

Purchase at Face Value

It has been a practice in the investment Sukuk (i.e. those based on Mudaraba, Musharaka or Wakala) to agree on the face value as the exercise price at which the promisor will purchase the Sukuk assets i.e. at a price which is equal to the capital. The majority of the contemporary jurists are of the view that such an undertaking is not permissible in Sharia as it is tantamount to stipulating guarantee of the capital by the Sukuk Manager. Needless to say that such a condition, being in conflict with the purpose and essence of these trust-based contracts, is null and void which in the opinion of the majority leads to voiding of the contract also, while some may hold that only the condition is void but the contract will remain valid.

On this issue, we have the following comments:

Purchase of the Investment Sukuk assets at face value does not create an issue in case the market value of the Sukuk assets on the date of exercise of promise (which is generally a date of profit distribution or a date of completion of Sukuk tenor) is higher than the face value i.e. the capital. This

is because the profit (which is an amount exceeding the capital according to all jurists) in this case is distributed and the market value of the assets after such distribution is equal to the face value i.e. the capital.

In case the value of the Sukuk assets on the date of exercise of promise is equal to the face value (i.e. the capital) which means that there is no profit or loss, the market value is equal to the capital in this case as well.

However, if the value of the Sukuk assets is less than their face value (i.e. the capital) it means that there is a loss situation. In this scenario, the face value is not equal to the market value and the Sukuk Manager has to pay more than the market value which is considered to be a kind of a partial guarantee (i.e. guaranteeing the shortfall) according to those who deem a purchase undertaking in such case as a requiring the Sukuk manager, by way of a condition, to guarantee the capital and that such a condition is against the essence and purpose of the contract and therefore it will be void on that basis. In this case, we are of the view that the exercise price should be the market value of the Sukuk assets, but the cause of the loss should be investigated to find out whether the Sukuk Manager is responsible for the loss, and consequently should compensate the Sukukholders, or that the loss has happened due to reasons out of his control and therefore he shall not be held liable. If the Sukuk Manager is found to be responsible for the loss, it has to compensate the Sukukholders for the shortfall which is the difference between the market value and the face value (i.e. the capital), and the compensation amount shall be added up to the market price and thus the Sukukholders shall get the full value of the capital.

However, if the Sukuk assets are lost or destroyed totally, the Sukukholders are not entitled to enforce their right to sell because a purchase undertaking is not a guarantee. This is because it is a pre-requisite of any Shari'a compliant sale contract that the asset subject of sale contract should exist at the time of entering into the sale contract; and if the Sukuk assets are totally destroyed then such a sale would be tantamount to sale of something which is non-existent. However, in such case if the Sukuk Manager is found to be responsible for such a loss the Sukukholders shall get the face value as a compensation for negligence or breach by the Sukuk Manager and not as a purchase price of the non-existent assets.

Is an undertaking to purchase at face value tantamount to guarantee of the capital of the Sukuk?

While we agree with the opponents of face value in a purchase undertaking on the fact that it is not permitted that the Mudaraba, Musharaka or Wakala contract should stipulate that the Mudarib, managing partner or investment agent shall guarantee the capital or a fixed amount of profit on the basis of the fact that this condition is in conflict with the essence of these contracts, we disagree with them on their assertion that a purchase undertaking of the assets at face value will be considered as a condition on the Sukuk Manager to guarantee loss of those assets. The fact of the matter is that there are a number of differences between a condition to guarantee and an undertaking to purchase at face value some of which we mention as follows:

Stipulating guarantee as a condition obliges the guarantor to guarantee the capital in case of loss, damage or defect and this is not the case in an undertaking to purchase at face value. This is because the promisor is not obliged to purchase if there are no assets at the time of entering into sale contract due to total loss of the Sukuk assets.

In case of partial loss or damage, the guarantor is responsible to compensate/indemnify the beneficiary in all cases to the extent of such partial loss or damage to the assets. However, in case of an undertaking to purchase at face value, we have to ascertain first the causes of the loss, whether it

is due to embezzlement or mismanagement of the capital by the Sukuk Manager, his negligence in protecting the capital, gross errors in taking proper investment decisions or breaching the terms of contract and therefore he will be held liable to compensate the Sukukholders; or the loss is not attributable to his acts, and hence the loss shall be borne by the Sukukholders without any responsibility on the part of the Sukuk Manager. Thus, it is obvious that the matter is treated differently under different circumstances as we shall discuss later.

A purchase undertaking cannot be considered a guarantee unless the option has to be exercised under all circumstances which is not the case here as an undertaking to purchase does not fit into this due to the following reasons:

The legal and Sharia impact of a purchase undertaking is that it is a unilateral document binding only on the promisor but does not bind the promisee or beneficiary. It means that it does not lead to actual purchase in all cases as the promisee / beneficiary may not use his option to oblige the promisor to purchase the asset if for example the market value of the assets is higher than the exercise price.

If there is a total loss (destruction), the promisor will not be obliged to purchase the assets because Sharia requires for a valid sale that the assets to be purchased should exist at the time of signing the sale contract while such a question is not relevant in a guarantee.

Even if the promisee / beneficiary decides to exercise its option and to oblige the promisor to purchase the asset, this will not lead to an actual purchase because promisor may decide not to enter into a sale agreement. Thus, the promisee will have to sell the asset in the market and seek from the promisor the difference between the sale price and the exercise price (i.e. the face value of the capital) if any.

Further, it must be noted that the Fuqaha, when discussing Shari'a repugnancy of guarantee of the capital, have discussed total or partial destruction of the assets by force majeure (الهلاك أو التلف) but have never discussed loss due to commercial activity. But while it is quite understandable that one cannot be held responsible for something that he could not control (and hence it would be absurd to get a guarantee from him) there is no harm in holding a party which has prepared a feasibility study on professional grounds and wooed potential investors on the basis of the projections that he has made responsible for the estimated results of his feasibility study after we agree that should he prove that his failure to achieve the results was due to unforeseeable circumstances and for reasons beyond his control he would not be held liable to make good such a genuine loss of the capital.

From the above discussion, it has become crystal clear that an undertaking to purchase at face value does not constitute a guarantee, and in no case whatsoever it should be construed to be a contract of guarantee or a condition of guarantee on the Sukuk Manager.

However, the Shari'a position on undertaking to purchase at face value and its impact on Sharia compliance of the related Sukuk is a different subject. We have discussed how this issue arises in case of a total or partial loss of the Sukuk assets due to reasons neither foreseeable nor avoidable by the Sukuk Manager. However, in case the loss is attributable to him, he will be responsible to the Sukuk holders for the face value fully or proportionately as the case may be; and the amount paid by him to the Sukukholders will be in the form of compensation and not as purchase price for non-existent assets. As far as the responsibility of the Sukuk Manager to compensate the Sukukholder for the promised profit there are different opinions amongst the contemporary Shari'a scholars.

The Sukuk Manager vis a vis the Sukukholders: Shari'a Strikes a Balance

Shari'a is the religion of Allah chosen to be practiced by the entire humanity and for all ages to come; and there is no doubt that the principles of Shari'a guarantee fair play and justice and are always in consonance with sound reason. Therefore, the principles or commandments of Shari'a could never be lopsided or tilted towards one party at the cost of the others.

In case of financial transactions based on trust, while Shari'a, on the one hand, has protected the fiduciary status of the trustee or agent by not burdening him with any liability for any loss not caused by his omission or commission, it has, on the other hand, protected the rights of the fund providers/principals by requiring the agent/trustee to produce convincing evidence that a real loss has occurred and that he had no hand in causing that loss and no reasonable capability to take corrective measure. This is on the basis of the maxims which state: (a) whosoever takes something has to return it; and (b) the Claimant has to produce evidence proving his claim and the party who denies the claim must swear that his stand is correct.). This approach is undoubtedly fair for both parties as an assertion that any claim by a trustee should be taken at face value without asking for any evidence would be not only greatly unfair with the fund providers but it will also be in conflict with the requirements of justice and sound reason. Further, a party who prepares a feasibility study must be made responsible for the figures and estimates made in the feasibility study on the basis of which he wooed potential investors succeeded to raise funds.

Therefore, it is but logical that the onus of proving a loss claim should be on the claimant irrespective of his status as a trustee or agent.

Onus of proof on the Sukuk Manager

The burden to prove the loss, if any, of the capital will be on the Sukuk Manager based on the following Sharia principles:

The Sukuk Manager will be responsible to return the face value (i.e. the capital) in following cases:

Embezzlement and mismanagement of the capital (التعدي على المال);

Negligence in protecting the capital (التقصير في الحفظ);

Committing gross errors in taking proper investment decisions (الخطأ في اتخاذ القرار الاستثماري); and

Breach or violation of the terms of contract (مخالفة شروط العقد).

There is a Sharia principle based on a tradition of the Prophet which states (على اليد ما أخذت حتى تؤديه (أو ترده)). This means that whosoever takes an asset/fund is obligated to return it. Hence, the Sukuk Manager is under Shari'a obligation to return the capital, but should he claim any loss, damage or defect in the assets he must provide evidence to prove the following two matters:

that the Sukuk assets have been destroyed totally or partially or that a loss has been incurred; and

that the above loss, damage or defect is not due to his default, negligence, misconduct or breach. In other words, he should prove that the loss has happened for reasons or circumstances beyond his capability to foresee or power to rectify.

The Sukuk Manager is a claimant required to produce proof:

This principle is based on a Hadith which asserts that producing evidence is the duty of the party which lodges a claim while the party denying the claim is required to take oath that his stand is

correct (البينة على المدعي واليمين على من أنكر). Jurists unanimously hold that Al Muddai (the Claimant) refers to a person who claims occurrence of an event which is not common or the norm.

When applied in case of a Sukuk Manager who claims loss or destruction of the Sukuk assets, it means that such a claim shall not be acceptable unless he produces evidence that the Sukuk assets have been destroyed totally or partially or a loss has been incurred; and that the above loss or damage or defect is not due to his default, negligence, misconduct or breach. In other words, he should prove that the loss has happened for reasons or circumstances beyond his capability to foresee or power to rectify.

The reason for the above position is that the Sukuk Manager will be considered to be claiming what is uncommon and abnormal. We all agree that it is quite common and normal that an asset/fund taken by someone for the purpose of investment remains intact or grows. Therefore the claim that it has been destroyed or incurred a loss needs to be substantiated by evidence.

In other words, loss or destruction of assets is a rare phenomenon and not something common, as we do not see, for instance, large number of Mudaraba/investment activities (80 % for example) incurring losses. Further, destruction of the assets occurs only rarely; and hence, an undertaking by the Sukuk Manager to purchase the Sukuk assets at market value will only result in his paying the face value for the assets, in most cases, which is the capital if no profit has been generated by the investment. Thus by way of transferring the burden of proof of total or partial loss to the Sukuk Manager, the risks of the Sukukholders are reduced considerably due to the fact that only in rare circumstances there could be a total or partial loss situation not attributable to Sukuk Manager. We must note that even then the structure contains the minimum level of risk required by Sharia for any transaction to qualify as Shari'a compliant on the basis of the principle of Al Ghunm Bil Ghurm and Al Kharaj Bidhaman.

Shari'a Status of Feasibility Study

Protection of capital and assets is one of the five basic established Sharia objectives. Hence, no Islamic financial institution should enter into any investment or financial transaction except after making sure that the transaction is feasible and that its risks are in proportion with the expected returns. Otherwise, an investment act without this level of prudence will be considered as wasting of funds and construed as Tabzeer (squandering) which is prohibited by Sharia.

Further, it must be noted that Islamic financial institutions act as agents and trustees for and on behalf of the depositors and investors. This fiduciary capacity requires that these institutions should ask their customers who seek financing to submit proper feasibility studies giving the details of the project or the activity for which investment is sought, establishing its feasibility and highlighting the risks and expected returns so that the institutions could make a calculated decision and enter into low-risk and high-return activities.

In line with this practice, the Issuer or agent of a Sukuk issue, or the agent of the investors, prepares a feasibility study on professional grounds in which it explains in detail the activity or the project, market study of the products related to the project and the expected risks and returns. Based on this feasibility study, the Sukukholders enter into the investment or purchase the underlying assets. It's quite logical to hold responsible the author of the study for the integrity and correctness of the study and for the fact that it has been prepared in line with the principles of preparing feasibility and market studies.

So what are the implications of the failure of the Issuer or Sukuk agent who has prepared the study to achieve the desired returns?

There is an opinion in Islamic jurisprudence which states that deception by words entails compensation/indemnification in the same way as deceiving by acts requires. For example, if some one digs a well or a hole on a thoroughfare and covers it with some paper or palm leaves, then he will be responsible for loss or damage caused to property or life of any one due to his act. It means that he shall be responsible both under criminal and civil laws. The same rule applies to a party who has presented a feasibility study to lure a financial institution into extending financing to him on the basis of his study should he fail to achieve the estimated returns and the promised results.

Based on this principle, some jurists say that the one who presents the feasibility study (the Sukuk Manager) of a project is fully responsible for non realization of the expected results i.e. for occurrence of loss or failure to generate the expected profit while a number of them hold him responsible to the extent of protection of the capital only.

But on the other hand, there are others who are not in favour of applying the above principle on the Islamic financial institutions in general and in case of Sukuk transactions in particular. In fact, this subject requires more deliberations and discussion.

If we accept the principle that responsibility of the feasibility and market study is on the party that has prepared it, it will strengthen the unanimously agreed principle discussed earlier that producing evidence is the duty of the party lodging a claim while the party which denies the claim is required to swear that his stand is correct (البينة على المدعى واليمين على من أنكر). As it is quite clear that it is the Sukuk Manager who claims that a partial or total loss has occurred or that the expected results could not be achieved as per the feasibility study the burden of providing convincing proof and evidence of occurrence of the loss or destruction and that he had no hand in it rests solely on his shoulders.

Mechanism of profit distribution

Shari'a does not allow the Sukuk Manager to furnish any guarantee for a fixed return or profit to the Sukuk holders whether it is a fixed amount or a percentage or an amount based on an index (as LIBOR). No contemporary scholar is against this principle.

Therefore, an acceptable mechanism to give the Sukukholders an indication about the Sukuk returns will be as follows:

Submission of a feasibility study determining the project and activity wherein the Sukuk proceeds shall be invested and giving an indication of the expected return.

Determining the ratio of distribution of the net profits between the Sukuk holders and the Sukuk Manager as per the nature of underlying contract of the Sukuk. However, there is no harm in saying for example that if the expected profit as per the feasibility study is 15 % and the ratio of distribution between the Sukuk holders and the Sukuk Manager is 60:40, then the expected return will be 9% for the Sukuk holders. However, the given figure is only an expected amount and does not form an obligation on the Sukuk Manager to perform accordingly under all circumstances (except for those who are of the opinion that the feasibility study is an obligation with those terms and conditions which were discussed earlier).

It is permissible that the offering circular, feasibility study or the underlying contracts of the Sukuk stipulate that should the actual profits exceed a certain percentage or amount such excess profit would be given as incentive to the Sukuk Manager. This may be achieved through many mechanisms some of which are as follows:

that the profit distribution up to a percentage of 15% for example is carried out as mentioned above (60:40). In case the profits exceed 15% upto 20% then the ratio of distribution is 20:80 and if they

are more than 20% then the ratio of distribution is 10:90. This is the prevailing practice in the management of investment funds and portfolios and the books of Islamic jurisprudence allow it as this mechanism does not negate the right of profit distribution in a partnership.

It has been a practice also in many investment and Ijara Sukuk that the Sukuk Manager is granted the whole excess profit. Some contemporary scholars have objected to this practice. Although I appreciate their stand, but I do not see any valid argument or evidence supporting this point of view. This is because they have combined different aspects altogether (i.e. promise to purchase at face value, obligation of the Sukuk Manager to provide lending and liquidity) and such a combination make Sukuk resemble conventional bonds or certificates and this stand is correct but We have dealt with these aspects separately, and therefore it is necessary to review the matter of giving incentive in the light of the other relevant facts.

Ascertaining profits

On a proposed periodic distribution date, the Manager values the assets to ascertain the market value of the assets since there is no secondary market for such assets, i.e. there is no stock market available. Muslim jurists agreed that the Manager as trustee (Ameen) may value the assets of the project or the Investment Activity according to the market and such a valuation is acceptable for the purpose of ascertaining the actual position of the Investment Activity in terms of profit or loss.

If upon such valuation, it is established that the value of the assets is greater than their face value then the Investment Activity shall be deemed to have made a profit. For example, if the capital was 100 Million and the value of the assets after deducting investment expenses is 110 Million then there is 10% profit in the Investment Activity. To liquidate such portion of the assets for distribution of profit, in case there is no liquidity available with the manager we may either sell the same to the Manager or to a third party. It would be also permissible that the Manager does not purchase such portion of the asset but arranges cash from his own sources as interest free loan to be deducted from the future profits or the assets at the time of actual liquidation. This will be acceptable in Sharia if the Manager does so voluntarily without a condition by the Investors. But if it is a condition by the Investors then it is not acceptable because the Prophet (peace be upon him) prohibited combining sale and borrowing (i.e. to combine a sale contract (similar will be the contracts with consideration like Ijara, Wakala, Mudaraba etc.) with borrowing / lending).

Distribution 'on account of profit' in case of loss or no profit

In case the market value of the assets of Investment Activity on proposed distribution date is equal to their face value (which means that there is no profit), then it is permissible for the Manager to voluntarily arrange to pay 'on account of profit' an amount equal to the expected profit from his own sources or by way of a Sharia compliant financing provided such amounts are deducted from the actual profits or assets or paid back by the Investors should the activity fail to make any profits.

In case the market value of the assets of the Investment Activity is less than their face value (which means that the Investment Activity has suffered a loss) then ideally there should be no distribution. However, as discussed above, if the Manager voluntarily arranges to pay to the Investors 'on account of profit' an amount equal to the expected profit as loan, then it shall be permissible as discussed above.

Use of benchmark

The majority of contemporary Sharia scholars hold that interest rates could be used as benchmark for fixing prices and rents, or granting incentives. Such determination results in arriving at a fixed price or rent required to make a sale or lease transaction valid, and grant of incentives as per agreed terms but in line with Sharia principles. Undoubtedly, it is very much desirable to have or develop an

alternate benchmark for Islamic banks, but based on principles of Sharia we see no harm in using conventional benchmark for fixing prices and rents or incentives.

Role of rating agencies

One can not deny the significance of rating agencies while structuring and offering Sukuk since they facilitate the decision making process of the Investors. Analyzing and determining the risk factor involved in any transaction is not discouraged in Islamic Sharia. In fact Allah the Almighty orders not to give away wealth / property to those who are weak of understanding.

However, the rating agencies available in the market are not up to the task of properly analyzing Shari'a compliant structure as they lack the basic tools required for understanding these Sharia compliant structure or products. Sukuk should not be based on a debt transaction and therefore they can not be rated on the same parameters as the conventional bonds or certificates are. It will not be correct to give low ratings to Sukuk just on the premise that since all Sukuk are based on equity so they always involve higher levels of risk! There are various Sharia structures each with many more variants having their own inherent risks and advantages. For example Sukuk based on financial lease may be given higher rating than Sukuk based on other structures. The reason for such lop-sided rating of Sukuk by these conventional rating agencies in my opinion is that the rating agencies know only one conventional product since the inception of conventional banking that is loan with interest, while on the other hand Sharia has unlimited products and every product has its own risk and mitigation mechanism which should not be measured according to an interest based structure.

Marketing

The fact that there is no fixed and guaranteed return in any Sukuk should be properly reflected in the process of marketing and sale of the Sukuk (in the offering circulars etc.). It may happen that due to lack of understanding of the core structure of the Sukuk and because of the some apparent features some one may take Sukuk as the conventional bonds or certificates. This will not be correct and will undoubtedly damage the Islamic finance and banking industry. The solution to this problem is that the Islamic bankers should be provided adequate Sharia training which would help them understand the complex structures of Sukuk and other innovative Sharia products.

Conclusion:

Based on the facts mentioned above and in the light of the views suggested by the learned scholars, I would suggest incorporation of the following texts/clauses in Sukuk documents:

1. The Purchase Undertaking should include the following:

I, the Sukuk Manager, hereby undertake to purchase on the Exercise Date the Sukuk Assets at face value provided the Sukuk Assets exist on the Exercise Date and have not been destructed/damaged totally or partially even if the face value payable by me is more than the market value of the Sukuk Asset as a result of commercial loss (خسارة) incurred and sustained contrary to the projected results of the feasibility study should I fail to prove beyond any doubt that the resulting loss was due to new circumstances not predictable at the time of entering into the Sukuk transaction/documents nor avoidable or controllable at the time of their occurrence by any possible measures, and not due any of the following by me:

- a) Embezzlement and mismanagement of the capital (التعدي على المال);
- b) Negligence in protecting the capital (التقصير في الحفظ);
- c) Committing gross errors in taking proper investment decisions (الخطأ في اتخاذ القرار الاستثماري);
and
- d) Breach or violation of the terms of Sukuk Transaction Documents (مخالفة شروط العقد).

2. Feasibility Study:

2.1 The Feasibility Study should include the following:

That the Sukuk Manager has prepared, on professional grounds, this feasibility study to:

- a) explain the details of the activity/project where the Sukuk proceeds shall be deployed/invested, and
- b) verifies, after conducting a market study of the products related to the project and proper analysis of the expected risks and returns that the project shall make an expected profit of x% even in the worst case scenario, and
- c) that he would be responsible for the integrity and correctness of the study and the its figures, and answerable for the fact that it has been prepared on professional lines consistent with the principles of preparing feasibility and market studies, and
- d) that he acknowledges that the Sukukholders shall enter into the Sukuk transaction in reliance on this feasibility study, and
- e) that he shall be responsible to compensate and indemnify the Sukukholders for any total or partial destruction or loss or non realization of the expected profit should he fail to prove, beyond any doubt, that the loss has been due to circumstances that were not predictable at the time of entering into the Sukuk transaction/documents nor avoidable or controllable at the time of their occurrence by any possible measures, and
- f) that the loss or destruction was not due to embezzlement or mismanagement of the capital or Sukuk Assets by him nor due to any negligence or misconduct or any breach of the terms of the Sukuk Transaction Documents by him.

2.2 The Feasibility Study should further include the following:

Based on the Shari'a maxims which state:

- (a) whosoever takes something has to return it; and
- (b) the Claimant has to produce evidence proving his claim and the party who denies the claim must swear that his stand is correct.). the Sukuk Managers undertakes to return the capital of Sukuk should he fail to prove, beyond any doubt, that the loss has been due to circumstances that were not predictable at the time of entering into the Sukuk transactions/documents nor avoidable or controllable at the time of their occurrence by any possible measures, and that the loss or destruction was not due to embezzlement or mismanagement of the capital or Sukuk Assets by him, nor due to any negligence or misconduct or any breach of the terms of the Sukuk Transaction Documents by him.