

Islamic Thoughts about issuing SUKUK by conventional banks

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I. INTRODUCTION

Growing western interest in Islamic financing is damaging the industry by compromising its religious principles. More conventional banks are getting involved in investing in Islamic financial instruments like sukuk and others. Some scholars suggested that conventional banks should be banned from issuing Islamic bonds, or sukuk, because the funds they raised could help to finance other parts of their business that did not comply with sharia or Islamic law. A conventional bank, with the exception of multilateral development banks like the World Bank and the Asian Development Bank, should not be allowed to issue sukuk.

The debate could affect Western access to a fast-growing area of the financial world. Estimated at over \$100 billion, global sukuk issuance is still dwarfed by trillions of dollar's worth of conventional bonds. But Western banks are becoming more involved in Islamic finance as its pool of wealthy, conservative investors from the Gulf and Southeast Asia makes it a stable source of funds during the global financial crisis.

HSBC's Middle East unit became the first Western bank to issue a sukuk last May 2011 with a \$500 million, five-year Islamic bond. France's Credit Agricole said last October it was considering whether to issue a sukuk. Goldman's sukuk became controversial partly because for many investors, the U.S. investment bank embodies aggressive, sophisticated Western financial engineering. It announced in October 2011 that it planned to issue a sukuk worth as much as \$2 billion based on murabaha (is a particular kind of sale, compliant with shariah, where the seller expressly mentions the cost he has incurred on the commodities for sale and sells it to another person by adding some profit or mark-up thereon which is known to the buyer), a structure that instead of interest, which is banned by Islamic principles, uses a cost-plus-profit arrangement to pay investors. For such sale transaction, while the seller is required to disclose total cost and mark up, the seller has the discretion to detail out cost and mark up for each items. Some Islamic finance analysts questioned whether the underlying structure of the sukuk was really murabaha, and suggested Goldman might use the proceeds of its sukuk to fund interest-based banking activities.

It has also been observed that sukuk might violate a ban against pure monetary speculation if it traded between investors on the Irish Stock Exchange, where it would be registered, at levels other than par value. The controversy has put the top authorities of Islamic finance in a difficult position. Big Western banks such as Goldman could help the industry grow by providing trading liquidity, trained personnel and access to Western investors. But the credibility of the industry could suffer if it is perceived to be manipulated by Western institutions.

The objective of this paper is to find out the Islamic issues regarding to sukuk issuing by the conventional banks. So the issues are, first, the raising funds are being used for Shariah compliant (halal) activities and not against the maqasid of shariah. Second issue is whether the conventional banks are following the rules and regulations of Auditing Organization for Islamic Financial Institutions (AAOIFI). And last but not least, cross-check the scholar's theory about the issue.

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The research methodology of our paper is fully qualitative. We have taken all the information from secondary data. Some authors have written about this issue. To examine the bigger picture of the issue a review of literature has been conducted.

II. LITERATURE REVIEW

Application of Maqasid of Shariah on Sukuk:

Al-Juwaini's student, Abu Hamid al-Ghazali (d.505 AH/1111 CE), developed his teacher's theory further in his book, *al-Mustafa* (The Purified Source). He ordered the 'necessities' that al-Juwaini had suggested in a clear order, as follows: (1) faith, (2) soul, (3) mind, (4) offspring, and (5) wealth.²

Al-Ghazali also coined the term of 'preservation' (al-hifz) of these necessities. Despite the detailed analysis that he offered, al-Ghazali refused to give independent juridical legitimacy (hujjiyah) to any of his proposed maqasid or masalih, and even called them 'the illusionary interests' (al-masalih al-mawhumah)³. The reason behind that is related to the maqasid being, sort of, read into the scripts, rather than being implied literally, as other 'clear' Islamic rulings are.

Nevertheless, al-Ghazali clearly used the maqsid as a basis for a few Islamic rulings. He wrote, for example: 'all intoxicants, whether liquid or solid, are forbidden based on analogy with liquor, since liquor is forbidden for the purpose of the preservation of people's minds.'⁴ Al-Ghazali also suggested a 'fundamental rule,' based on the order of necessities he suggested, which implies that the higher-order necessity should have priority over a lower-order necessity if they generate opposite implications in practical cases.⁵

Now if we consider the Maqasid al Shariah as Imam Ghazali has illustrated in his book, we need to examine that allowing conventional banks to issue the sukuk is a threat for the mankind as we are not sure where they are spending the acquired money. We think as Blake Goud has written in his blog that "limiting issuance to Islamic banks and other companies (would a company be allowed to issue sukuk if one of its subsidiaries provided conventional financial services) is counterproductive because it limits the potential for growth of the industry. However, that is not the only consideration. The main point of contention with the Goldman sukuk was that there was no separation between the proceeds from the sukuk and the rest of the bank, nor were there specific assets which would be financed by the sukuk proceeds. Had there been a building that was owned by Goldman sold to an SPV and an ijara sukuk were issued (assuming Goldman has buildings it owns that house other businesses that are not conventional banking), there would probably be little in the way of criticism" (Goud, 2012).

2. Rules and regulations imposed by Auditing Organization for Islamic Financial Institutions (AAOIFI) are not getting followed by all the institutions who are getting involved in issuing Islamic instruments in all over the world. Bodies such as the Malaysia-based Islamic Financial Services Board and the Bahrain-based Accounting and AAOIFI set standards which they hope banks will follow, but they cannot impose rules; that is up to national regulators in each country. Ultimately, therefore, the success of Islamic financial products offered by Western banks is likely to come down to whether investors choose to buy them (Davies, 2012).

² Al- Juwaini, Al-Ghayyathi, p. 434.

³ Ibid. p 172.

⁴ Ibid. p 174.

⁵ Ibid. p 265.

Goldman registered its sukuk programme with the Irish Stock Exchange in October 2011, setting up a special-purpose vehicle in the Cayman Islands to issue a sukuk based on murabaha, a common cost-plus-profit arrangement in Islamic finance. The plan ran into criticism from some Islamic scholars and analysts who suggested Goldman might use the proceeds of the issue to conduct conventional banking, violating Islam's ban on interest payments (Torchia, 2013).

No	Securitization of/ Purpose	Contract
1	Existing or to be acquired tangible asset	Ijarah
2	Existing or to be acquired leasehold asset	Ijarah
3	Presale of services	Ijarah
4	To fund construction	Istisna'
5	Presale of the production of goods or commodities at a future date	Salam
6	To fund the acquisition of goods for future sale	Murabahah
7	To fund capital participation in a business or investment activity	Mudarabah/ Musharakah
8	To fund various asset, goods or services acquisition which are then entrusted to an agent to manage on behalf of the owners.	Wakalah
9	To raise funds for agricultural land cultivation, land management and orchard management activities	Muzara'ah

3. There was also concern that the issue might not trade at par value on the Irish exchange, which would contravene sharia law's prohibition on monetary speculation, and debate over whether the underlying structure of the sukuk was murabaha or reverse tawarruq, which has been ruled unacceptable by some Islamic scholars as an effort to hide the use of interest (Torchia, 2013).

4. A recent article quotes Badlisyah Abdul Ghani, the chief executive of CIMB Islamic, a large Malaysian Islamic bank (an Islamic window at CIMB Bank), who said: "A conventional bank, with the exception of multilateral development banks like the World Bank and the Asian Development Bank, should not be allowed to issue sukuk". I have heard from other people in the industry, contrary explanations that the issuer's activities are not relevant for whether they can issue a sukuk, because investors are not investing in the equity of the company, and therefore they are not generating income from non-Shari'ah-compliant activities. While I accept the premise of the latter argument, I find it a bit too cynical to be convincing to many people not involved in the day-to-day activities of the industry (Goud, 2012).

A copy of the fatwa or Islamic ruling behind the Goldman sukuk, which was seen by Reuters, showed five sharia scholars had signed it. The AAOIFI's guidelines stipulate that at least three scholars advising on a bond programme should approve it in writing before issuance. However, the Goldman controversy could cause conventional banks to take more steps in future to allay potential concerns over whether they are following Islamic principles. Aznan Hasan, one of the scholars who signed the Goldman fatwa, said there were no sharia-related problems with the sukuk. The intention to list on the Irish exchange is purely for tax purposes, he said. But he added that Goldman should consider more measures to address doubts. "I personally think the issue now is what is the mechanism to ensure that it is not traded, and even if it is traded, that it's traded at par, and they have to come up to us with a mechanism for that," he told Reuters. He said Goldman might issue an additional or complementary prospectus to address this aspect and describe how it would ensure proceeds of the sukuk were only used for sharia-compliant purposes. Goldman might also agree to issue a letter to its board of sharia scholars whenever it used the proceeds, or agree to quarterly audits, he added. "If they can put all the mechanisms in there, then there shouldn't be any problem," said Hasan. "The murabaha is not a new one -- there is nothing new in the structure." Another scholar, Sheikh Edam M. Ishaq, said the

Goldman case might lead to institutional reforms in the industry and closer scrutiny of sukuk issues in general (Davies, 2012).

III. FINDINGS AND DISCUSSION

(SALAH, 2010) states that securities like sukuk are often referred to as Islamic bonds. However, such a translation is incorrect, because sukuk structures differ significantly from conventional bond structures. In its Shari'ah Standard on sukuk, the AAOIFI gives a definition of these Islamic securities. The AAOIFI defines sukuk as: "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity." The AAOIFI definition clarifies that sukuk are certificates that represent ownership interests in underlying assets or investment activities. Equity-based sukuk structures do not represent ownership interests in tangible assets directly; they rather represent ownership interests in the assets of particular projects or special investment activities. The particular projects and special investment activities refer to partnership contracts such as musharaka and mudarabah. A share in a partnership in legal terms means that the partners are the owners of all the (tangible) assets that are part of the partnership. Thus, shares in partnership are regarded as assets that can be securitized through a sukuk issuance from a Shari'ah perspective. This will be clarified through a study of the sukuk al-mudarabah structure.

The mudarabah contract is the foundation of the sukuk al-mudarabah structure. The party that requires financing from the capital markets (the originator) initiates the transaction. The originator will set up a special-purpose vehicle (SPV), a legal entity the sole purpose of which is to facilitate the transaction. The originator intends to enter into a mudarabah agreement with several capital markets investors and the SPV makes this possible. Therefore, the originator will, first, enter into a mudarabah agreement with the SPV. According to this mudarabah agreement, the originator will act as the mudarib while the SPV will be the rab-al-maal. The SPV will acquire the financing for the capital investment in the mudarabah agreement through the issuance of sukuk certificates. The investors will buy these sukuk certificates and become the sukuk holders. The sukuk certificate gives the sukuk holder a beneficial right in the interest in and rights to the assets of the mudarabah: the SPV will declare a trust over all its assets and rights under agreements entered in with the originator in favour of the sukuk holders. Hence, the sukuk holders will become the beneficial owners of the shares, rights and interests of the SPV in the mudarabah partnership. As is common in a mudarabah, profits will be distributed according to an agreed fixed percentage of the profit between the partners. As the beneficial owners, the sukuk holders are entitled to the profits of the mudarabah. Hence, the SPV will pay the profits through to the sukuk holders. As a result, the periodic payments are not a fixed return, but are dependent on the performance of the mudarabah venture. This will continue until the maturity date. At maturity, the originator will purchase the shares of the SPV in the mudarabah. The SPV will pay the purchase price to the sukuk holders, after which the sukuk will be redeemed.

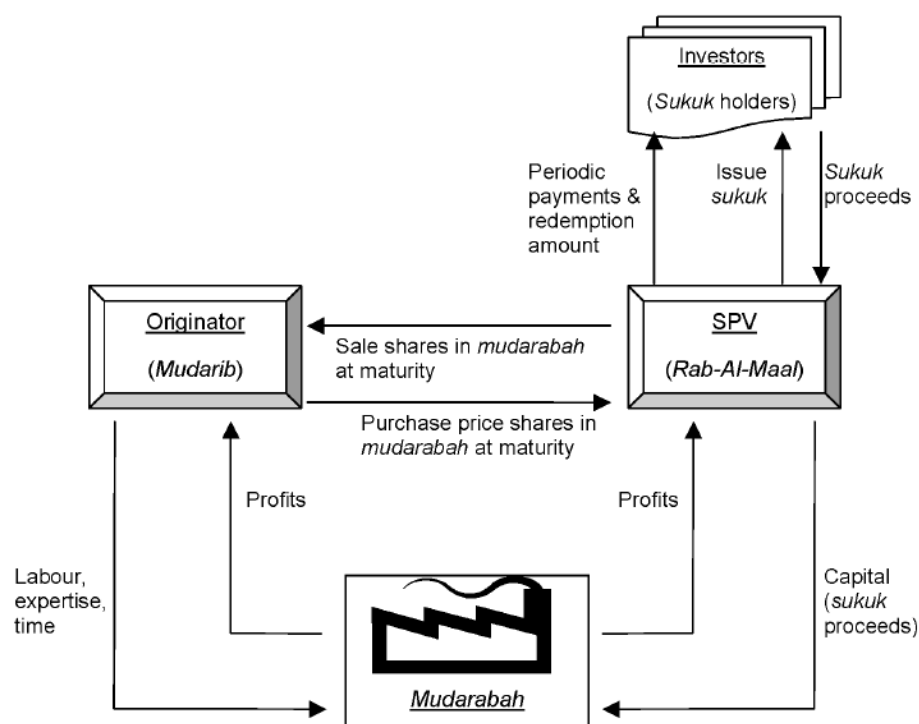


Fig: Structure of a sukuk al mudarabah

IV. CONCLUSION AND RECOMMENDATIONS

Over the last decade Islamic banking has experienced a global growth rate of 10-15 percent per annum, and has been moving into a an increasing number of conventional financial system at such a rapid pace that Islamic financial institutions are present today in over 51 countries. So now it is very important that there must be some regulatory body to monitor and ensure the compliance of these issues as we have discussed, otherwise sooner rather than later the attraction of sukuk as Islamic liquidity management instruments will lose its purposes.

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