

AAOIFI Shari'ah Standard No. (62):

An Epitome of Excellence in Shari'ah Guidance for a Multi-Dollar Industry

Dr. Yousuf Azim Siddiqi

In November 2023, AAOIFI's General Secretariate has issued Draft of AAOIFI Shari'ah Standard No. (62) re. Sukuk. This release was not less a milestone in the quarter-century long history of AAOIFI. Since this was the first time, that the exposure draft of a Shari'ah Standard by AAOIFI was releasing in Arabic as well as English at the same time. This was first time that AAOIFI was releasing such a lengthy draft (more than 100 Arabic pages) which beamed the timeless message that this standard will be like no past or future standards. Usually, AAOIFI conducts hearing sessions in different parts of the Arab world and sometimes in Pakistan. This time, it was going to be different. Locations will be Dubai, Riyadh, Karachi, Kuala Lumpur besides deep interest from the legal fraternity, investment bankers and corporate senior relationship managers. In a nutshell, it was expected that AAOIFI SS. 62 will be something unique and the response it received proved it to be so.

Despite the great effort made by AAOIFI's Shari'ah Board and its General Secretariate, it was unfortunate that some voices undermined the great achievement done so far, and even overlooked greater opportunities that such an

articulated standard will usher. In this short write-up, we will highlight the key issues referred in the standard which were a matter of concern to some ill-informed professionals in the industry.

Ownership & Disposition of the Underlying Asset

To understand the difficulty of complying with the ownership requirements, it would be suitable to start with the very basic definition of Sukuk. What is Sukuk? Sukuk certificates are certificates of ownership in the underlying assets. This is the point zero from where the entire mathematics of Sukuk builds up.

On various instances, the Draft Standard made it clear that conveyance (transfer) of the ownership should be possible by virtue of Shari'ah and law. This was seen by some as end of Sukuk. Certainly, an illogical and pessimistic approach! The answer was there were many Sukuk issuances where conveyance is not possible as per the law and such a requirement will hinder such issuances. Overlooking the requirement and its repercussions. Let's assume, how the certificates of Sukuk were defined in those specific issuances. This answer is a common share of ownership in the underlying

asset. No one can invent a definition without usage of ownership or any of its legal synonyms. Although some professionals are getting confused between ownership and title-registration. The Draft Standard is not requiring the parties to Sukuk to register the underlying asset in favour of the Shari'a owner, but this could be a requirement if no title registration might result in zero ownership rights.

Materializing the ownership from Shari'a as well as legal perspective is a key factor in the survival of future Sukuk industry, otherwise a mammoth-sized paper will be floating on a thin-layer of ice that can be melted anywhere.

The ownership results in owning the rights and owing the obligations. Hence, the certificateholders do not merely own the subscription amount and its profits. This will further imply that the certificateholders have superior rights over the underlying assets than the creditors' of the originator. This results in ranking the Sukuk certificate as higher ranking senior instrument, rather a than a Shari'a substitute of senior unsecured conventional debt.

The absolute ownership gives the right of disposition (in Arabic *haqq al-taṣarruf*). Hence,

whichever party claims to be the owner of the underlying asset should have the right to dispose of the asset as it finds it suitable. This could be through on-sale or leasing to a party other than the originator.

Further, ownership entails the owner to have the right over the yield of the underlying asset. It would be Shari'a-wise invalid to envisage that the certificateholders own the assets, but their entitlement is either null or restricted over the yield generated out of such assets.

Hence, rights, benefits and obligations of the certificateholders should be a derivative of the ownership of the underlying asset and not a direct financial obligation upon the originator, with no consideration to the underlying asset.

Identification of the Underlying Asset

Knowledgeability of the subject of contract is a key element in the legal validity of contract. Imagine no court of law will resolve a dispute if the subject of contract was unknown to both the parties. The same is the case with the underlying assets of Sukuk. When simply it is assumed that assets worth billion were sold or leased so it is important to state them in particular to avoid any dispute in the future.

Performance of the Underlying Asset

Sukuk certificates existence is based on the ownership of the underlying assets, but its profitability is based on the performance of the underlying assets. Hence, the Draft Standard

requires periodic reports showing how much the underlying assets are earning. This performance is not merely a single or a double digit number! Rather, a below expectation performance will make the certificateholders suffer. Some malfunctioned Sukuk structures obligated the originator to cover up the shortfall in the Sukuk returns just because the actual rate was below the market rate.

Risk beyond Bonds'

Risk of interest-bearing bonds are simply and directly related to the ability of the bond issuer to pay interest coupons on time. In Sukuk, when it is claimed that the entire mechanism is based on the asset (whether asset-backed or asset-based), so risk has to be beyond credit risk of the originator. This means the certificateholders are bearing all types of risks that are associated with the underlying assets. Any damage or loss of the underlying assets will directly affect the existence or the profitability of the certificates. Hence, Risk Analyst of Sukuk should closely identify and monitor all types of risks that are beyond the tiny list of Bonds' Risks. Further, it is important to identify the party bearing the risk. Hence, in the investment-based Sukuk no asset risk should be borne by the originator.

Accounting Effect

Many times, complex structures of Sukuk are carried out with no accounting impact of Shari'a documentation. The Draft Standard made it a

requirement that accounting statements of the originator should state that its assets, if shown in the statements, are no longer in the ownership of the originator.

Many times, assets of SPVs are neither segregated nor maintained, which means an asset-backed Sukuk turns into asset-stripped Sukuk. Any periodic returns are simply coupon payments. Hence, financial statements of the SPV will ensure such malpractices are not taking place. Such requirements will expose any wrongdoings in recording expenses and costs. Hence, if the SPV, through its corporate service provider to the paying agent, is paying late payment interest of any delay in transfer of periodic returns, then such act will be exposed by periodic financial statements.

Legal Status of Fatwa

The Shari'a Pronouncement (Fatwa) of Sukuk is an overall Shari'a opinion regarding the structure of Sukuk and its relevant documentation. As per the common practice, such an important thing remains a stand-alone document with no legal impact. The Draft Standard made an effort to get this document into the main stream of documents, rather than remaining a silent observer.

Focus of Credit Rating Agency

It became a decade-long practice that Credit Rating Agencies focus entirely on the credit worthiness of the originator. May be because

this was the same way how bonds were analysed. If it is argued that Sukuk are different from bonds due to the underlying assets, so the rating agencies should look beyond credit of the originator and focus on developing rating of the underlying assets.

Impact of Promise to Purchase

Certificateholders secure their rights through promise to purchase wherein the underlying assets are returned to the originator. However, if the originator is no position to sign then it is not permitted to consider a trigger event of promise to purchase as an automatic conclusion of the purchase contract.

Warranties and Guarantees

Since the Sukuk deal is based on transacting in the underlying assets, so it is essential that the underlying assets are worth-transacting. Sometimes, it was observed, that it is stated if a trigger event (usually a credit one) takes place then the underlying assets stands resituated and any price paid by the certificateholders is returned. In other words, it's a contingent sale which is not permitted by Shari'a. As per the Draft Standard, such a stipulation is not acceptable. Similarly, in all circumstances, the principal and profit amounts cannot be guaranteed by the originator in all those structures where such guarantee is not permitted by virtue of Shari'a (including Wakala, Mudaraba and Musharaka).

This even includes those theoretical cases where the underlying asset of Service Agency Sukuk are damaged and the service agent is automatically held responsible for the delay in receiving the reimbursement amount from the insurance company. The Draft Standard did not allow imposing such a condition upon the service agent.

Further, in Tier-1 Sukuk, it was not permitted to issue Sukuk for a conventional entity, because in this case, the certificateholders shall collectively guarantee conventional portfolio of the originator.

Public Listing

Sukuk certificates that represent entirely debts cannot be negotiated by listing them in the financial markets. Further, if tangible assets-to-total assets ratio (tangibility ratio) is breached then Sukuk certificates will be delisted from the market.

A Flare of Shari'a Governance

The Draft Standard introduced a new dimension to Shari'a governance of Sukuk issuance. This involves, establishing a Shari'a Board of Sukuk, rather than relying on one-time birth certificate, instead a continuous demand of providing a character certificate will ensure higher Shari'a credibility.

Also, the Sukuk certificates should have a Shari'a pronouncement with specific requirements and

contents, and the Fatwa itself should be part of legal documentation.

Further, Shari'a Audit of Sukuk ensures the underlying assets' compliance to Shari'a from operational and commercial perspective. The audit plan needs to be endorsed by the Shari'a Board of the Sukuk.

In Summary

Considering its record time of execution, its wide scope, its unmatched depth and breadth, and small number of experts who worked on it, the Draft Standard No. (62) is certainly an epitome of excellence in Shari'a governance which can open many doors in terms of aligning business innovation with Shari'a requirements and providing opportunities to Sukuk Experts who shall master hundreds of Shari'a requirements then help originator, investor, and rating agencies to make an informed assessment and a sound judgement that will avoid any future regret resulting in loss of millions.

Yousuf Azim Siddiqi

A Shari'a trainer and translator (Arabic to English), worked with Arcapita, Dubai Bank, Emirates Islamic and currently with ADIB (UAE). Writes extensively in English and Arabic. Can be reached over siddiqiya@yahoo.com