Asset-backed vs asset-based sukuk

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Sukuk are Islamic certificates of investment. They signify co-ownership of productive resources, known as the “underlying assets.” Because income to sukukholders is generated by trading or real investment rather than mere lending, sukukholders earn profit rather than interest. As co-owners of productive assets, sukukholders face the risks of ownership. In particular, they face the risk that their assets may not generate profits or that may even incur losses. They also face the risk that the assets may be damaged or destroyed completely.

Risk taking is one of the requirements of earning lawful profits in Islam. Another requirement is to share profits and losses. For a person to claim a share of income generated by an investment he helps to finance, without taking responsibility for its outcome, is inconsistent with the ethos Islam. Income needs to be earned, if not by effort, then at the very least by taking risk.

Typically, sukuk are categorised into “trade-based” and “participatory,” depending on whether they are issued to finance trade or investment. As a result of some recent defaults of a number of sukuk and the near defaults of others, a new classification entered the sukuk discourse, that between “asset-backed” and “asset-based” sukuk.

The defaults took place in the aftermath of the recent (2008) financial crisis and came as a surprise. Few investors, it seems, were aware of the differences between the “asset-based” and “asset-backed” sukuk or of the implications these differences have on investor protection. A closer examination shows that the seemingly slight difference in the name of the sukuk conceals important differences.

This was the first time any sukuk “defaulted” in modern history. What is more, all defaults were confined to the “asset-based” category. As a result, investors were asking not only why the sukuk defaulted, but why in particular the asset-based sukuk defaulted while the asset-backed did not.

One need not look far for the reason why the “asset-based” sukuk defaulted while the “asset-backed” did not. All sukuk that defaulted – the “asset-based” type – were structured to replicate conventional bonds. The debt structure of the asset-based sukuk, while providing both investors as well as issuers with the desired structure, at the same time also replicated the risk of default. Bonds require issuers (borrowers) to guarantee both fixed (interest) income as well as capital (the principal amount of a loan) to creditors. Default is a failure to repay a loan or a part of it by a debtor to a creditor. The sukuk defaulted because, in part due to the financial crisis and the economic downturn that triggered it, originators did not earn sufficient revenues to make the promised payments.

By contrast, none of the asset-backed sukuk defaulted. The reason was that the asset-backed sukuk did not have a debt structure. All “asset-backed” sukuk – unlike their asset-based counterparts – were structured to share profits and losses rather than replicate bonds. Originators of asset-backed sukuk did not promise investors profits whose quantum and due dates were determined in advance. Unlike debt-like securities such as bonds, profit and loss sharing securities cannot default simply because they
offer investors neither income nor capital guarantees. Issuers of PLS securities pay profits to investors when the underlying assets earn profits.

The debt-like structure was imparted to the asset-based sukuk by incorporating income and capital guarantees into the sukuk structures. Such guarantees are key features of conventional bonds. The incorporation of income and capital guarantees ensured that a single failure to make a periodic payment on time, or to redeem the principal amount on the due date, would constitute “default.” Not only the *ijarah* but also participatory sukuk such as the *musharakah* or *mudaraba* were structured to replicate debt instruments.

The income guarantee was incorporated into the sukuk structure by requiring issuers to pay investors a specified amount of “dividends” on specific dates. Both the amount of the dividends as well as the dates on which they were to be paid were determined in advance. In other words, the quantum of the profits that the originators were going to pay to investors was determined *before* the business activities that were to generate the profits even commenced. In a striking departure from standard business practice and a bizarre twist of common sense, entrepreneurs (originators) agreed to pay investors “dividends” even when their enterprises experienced losses.

The asset-based sukuk resembled conventional bonds also in that “dividends” were calculated as a percentage of the total amount “invested” rather than as a percentage of total profits, just as interest payments are determined as a percentage of the total amount of a given loan. The dividends, moreover, were calculated by reference to interest rates such as LIBOR, in a widely utilised process known as “benchmarking.”

The capital guarantee was incorporated into the sukuk structures by requiring originators to refund to investors their capital in full, on a specific day in the future, known as the maturity date. To comply with the Shariah – at least in form – the refund was accomplished by requiring originators to repurchase the underlying assets from investors on an agreed-upon date. The price at which the assets were repurchased was identical to the price at which they were first sold to the investors. This had the effect of returning to “investors” exactly the same amount they “invested” when they initially purchased the assets. In other words, the repurchase had the same effect in substance as repaying a loan.

It is thus hardly surprising that asset-based sukuk are commonly referred to as “Islamic bonds.” Even from the perspective of the law – for the purpose of taxation – asset-based sukuk are treated as bonds.

The asset-based sukuk were structured as debt instruments on the grounds that “this is what investors were looking for” and because “this is what the market wanted.” The “market,” however, cannot provide guidance on what type of sukuk meets Shariah requirements. Markets facilitate trade. They reflect what people are buying and selling, as well as the quantities and prices at which trading takes place. Markets are neither equipped, nor able to make, judgments.

Another reason for replicating debt-like instruments was that issuers wanted to raise capital without having to sell any assets. Investors, on their part, did not want to become owners of assets and assume the risks of ownership. They wanted bond-like instruments with income and capital guarantees. They wanted their profits to be guaranteed and to earn them without taking risk.

In order to enable both originators and investors to realise their respective objectives, a special type of securitisation would accordingly be required. Selling the underlying
assets to investors by way of a true sale, as required by the Shariah, would not achieve the respective objectives of the originators and the investors.

What was required was a type of sale that would enable originators to “sell” underlying assets to investors, and at same time allow them (the originators) to retain legal ownership of the assets thus “sold.” This could be accomplished by utilising a sale that falls short of a true sale. However, such a sale is not available in the Shariah. A sale that falls short of a true sale is, however, found in common law, widely known for its creditor friendliness, where it is recognised as a valid sale. Thus, it was necessary to depart from the Shariah on the issue of sale.

Common law (practiced in the UK) recognises sales that fall short of true sales as valid sales. A sale that falls short of a true sale allows a “seller” to “sell” an asset and to retain legal ownership of the asset thus “sold” at the same time. Such a sale does not require the transfer of legal ownership from the seller to the buyer; a sale that falls short of a true sale transfers merely “beneficial ownership” on the buyer.

In order to accommodate the objectives of both issuers (to retain legal ownership of assets) as well as of the investors (to obtain income and capital guarantees), arrangers thus resorted to the common law instead of the Shariah notion concept of sale. This decision, however, raised a number of questions.

First, was the departure from the Shariah notion of sale justified? Second, how can a departure from the Shariah concept of sale be expected to produce Shariah compliant sukuk? Third, will investor’s interests be adequately protected, given that the sales of the underlying assets give them less than legal ownership of the assets?

As a result of a lack of a true sale of the underlying assets by originators to investors, a new class of sukuk emerged, known as “asset-based” sukuk. It was this class of sukuk that was declared non-compliant by the AAOIFI in 2008, just months before the recent global financial crisis. It was in this class of sukuk that all the defaults took place.

The development of the two types of sukuk created something of a crisis in the sukuk industry, reflecting differing visions of Islamic securitisation. One vision seeks to implement profit and loss sharing, while the other appears satisfied with replicating conventional bonds and achieving at least formal if not substantial compliance with the Shariah. There is a need to harmonise (reconcile) these two visions.

This can be done by revisiting the roots of Islamic finance, and its quintessential requirements. Consensus needs to be arrived on how sukuk differ from conventional instruments and on how they need to be structured to comply with the Shariah. Revisiting the notion of sale in Islamic securitisation would be a good place to begin.