Islamic Finance: The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures

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Abstract

The growth of the Islamic financial market in recent years has been remarkable, but this market has faced growing pains in terms of the struggle with Shari'ah-compliance of its products. A major criticism of Islamic financial products has been their resemblance to conventional financial products. This article explores the developments in the Islamic financial market in regard to equity-based sukuk structures, the sukuk al-mudarabah in particular. It shows how a Resolution of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has influenced the legal structural features of equity-based sukuk structures and discusses recent attempts to issue equity-based sukuk structures that are in line with the AAOIFI Resolution. Through a discussion of several offering circulars, the Islamic legal framework of these products will be clarified, showing the different structural and legal mechanisms the architects of these products can acquire when structuring these transactions.
ISLAMIC FINANCE: THE IMPACT OF THE AAOIFI RESOLUTION ON EQUITY-BASED
SUKUK STRUCTURES

Omar Salah

A. INTRODUCTION

The growth of the Islamic finance market has been remarkable over the last years. While the
conventional finance industry was suffering from the realms of the credit crunch, the Islamic
finance sector witnessed a growth of 28.6% with its assets reaching a record of USD 822
billion in 2009.1 Within the world of Islamic finance, sukuk have proved to be promising products.
Sukuk are Islamic financial securities.2 Total global sukuk issuance increased from a size of just
over USD 1 billion towards the end of 2001 to USD 136 billion as of 30th June 2009, showing a
compounded annual average growth rate of 88%.3

However, the immense growth of the market has not only brought prosperity to the Islamic
finance sector. Part of its growing pains remains the struggle with the Shari’ah-compliance of the
products. One of the main criticisms of Islamic financial products has been with regard to their
resemblance to conventional financial products. Thus, in regard to sukuk, the equity-based sukuk
structures have often been criticised for building in features that replicate the economic effects of

1 The Banker & HSBC Amanah, Top 500 Islamic Financial Institutions, TheBanker.com,
http://top500islamic.thebanker.com/index.cfm?fuseaction=top500.home&CFID=1053940&CFTOKEN=101775
53 accessed on 22 August 2010.
2 Sukuk are among the most important Islamic financial products and are often regarded as the Islamic equivalent
of bonds. Sukuk is the plural of the Arabic word sakk, which can be translated as ‘(financial) certificate’.
Islamic Financial Market, 1st Edition, February 2010), 7,
http://www.iifm.net/default.asp?action=category&id=66 accessed on 22 August 2010 (hereinafter: IIFM Sukuk
Report).
conventional loans. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued a Resolution in February 2008 on sukuk (AAOIFI Resolution) in regard to this matter. This resolution declared certain legal features as non-Shari’ah-compliant and caused much disturbance within the Islamic finance market. As a result, the market turned away from the equity-based sukuk structures.

This article explores the developments in the Islamic finance market with regard to equity-based sukuk structures. It shows how the AAOIFI Resolution has influenced the legal structural features of equity-based sukuk structures and discusses recent attempts to issue equity-based sukuk structures that are in line with the AAOIFI Resolution. By doing so, the Islamic legal framework of these products will be clarified, showing the different structural and legal mechanisms the architects of these products can acquire when structuring these transactions.

First, an introduction to the background of Islamic finance will be given. The main principles of Islamic finance be discussed followed by a description of two equity-type Islamic financial contracts. These Islamic financial contracts form the essence of the equity-based sukuk structures. The focus in this article will be on equity-based sukuk structures and on the sukuk al-mudarabah in particular. Through a case study of several offering circulars the criticized legal features of the equity-based sukuk structures will be illustrated. The AAOIFI Resolution that limited the Islamic legal framework of these structures then be considered. Lastly, a more recent sukuk issuance will be discussed to illustrate the most recent development in the sukuk market.

B. ISLAMIC FINANCE

1. Islamic Law

Islamic banking and finance has the same purpose as conventional banking and finance, except that it operates in accordance with Islamic law, often referred to as the Shari’ah. Therefore, it is important to understand what Islamic law is. Shari’ah literally means ‘the way’ and is the body of Islamic religious law. Islamic law in the context of Islamic finance does not refer to the black letter

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code of any particular jurisdiction. Instead, it concerned with a set of religious and moral principles as developed throughout history.

According to the classical formulation of Islamic law, there are two main sources of law. The first one is the Holy Book of Islam, the Quran. After the Quran, the second of the classical sources is the collection of authentic Hadith, which is considered to be the proof of the Sunna. The Sunna is the normative or model behaviour of the Prophet Muhammad. The discipline of Usul al-Fiqh, the ‘roots of Islamic law’, can be described as the Islamic legal theory. There are four official bases of Islamic law: the Qur’an, the Sunna, Ijma’, and Qiyas. Ijma is the consensus of the religious scholars and Qiyas refers to reasoning by analogy. Thus, there are two material sources, a method, and a declaratory authority; the decisive instance is the Ijma’, since it guarantees the authenticity of the two material sources and it determines their correct interpretation. Some scholars also consider Ijtihad as a secondary source of Islamic law. Ijtihad refers to independent reasoning.

The scholars exercised Ijtihad and interpreted the meanings of the rules of the Shari`ah. Under the definitive formulated rule of taqlid, the doctrine must not be independently accrued from the Qur’an, the Sunna, and Ijma’, but it must be accepted as it is being taught by one of the recognized schools, which are themselves embraced by consensus. There are two main divisions in Islam, ‘Sunni’ and ‘Shi’a’. The four Sunni Islamic schools of law are ‘Hanafi’, ‘Maliki’, ‘Shafi’i’ and ‘Hanbali’. The three Shi’a branches are ‘Ithna ‘Ashari’, ‘Isma’ili’, and ‘Zaydi’. The four Sunni schools of law have been active in the development of Islamic banking and finance. Since each school of law has its own interpretations, the development of the Islamic finance

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7 Schacht 1964, supra n 6, 112-15.
8 Some scholars believed that from about 900 AD, the exercise of Ijtihad had exhausted itself and the ‘door of independent reasoning’ was closed. Other scholars, however, refer to the early tenth century as the date of the closing of the door of Ijtihad. See, eg Pearl 1979, supra n 5, 14-5.
9 Schacht 1964, supra n 6, 71.
10 Islam consists of a number of religious denominations, with the primary division being between ‘Sunni’, by far the largest group in Islam, and ‘Shi’i’, the second-largest group in Islam. An important point on which they differ is the question who the rightful successor of the Prophet Muhammad was.
11 Pearl 1979, supra n 5, 16.
12 Pearl 1979, supra n 5, 17.
market has witnessed a lack of uniformity. While some transactions are approved as Shari’ah-compliant by a Shari’ah Review Board of one Islamic financial institution – a board within a financial institution that (dis)approves transactions from a Shari’ah perspective, the same transactions are prohibited by the Shari’ah Review Board of another Islamic financial institution as a result of a different interpretation of the Shari’ah by another school of law. This has affected the legal certainty in the industry. Institutions such as the AAOIFI, which publishes the widely followed Shari’ah Standards, and the Islamic Financial Services Board (IFSB), which publishes various technical standards for Islamic banks, have made several attempts to achieve some form of standardization. The Shari’ah Standards of the AAOIFI play an important role in particular. These standards contain several Islamic legal rules on Islamic finance that are generally accepted throughout the Islamic finance industry. The AAOIFI Shari’ah Standards can be regarded as soft law.

2. Islamic Finance: Main Principles

Islam endorses the concept of making profit by trade.\(^\text{13}\) It encourages and promotes the right of individuals to pursue personal economic wellbeing.\(^\text{14}\) So long as higher values stay intact, striving to gain profit is ethically justified.\(^\text{15}\) Furthermore, Islam stimulates commercial transactions.\(^\text{16}\)

From a Shari’ah-perspective, trade should take place based upon a legal structure: there should be a contract,\(^\text{17}\) because the Quran encourages the written commitment of obligations, such as in commercial contracts.\(^\text{18}\) The contract is binding and must be executed.\(^\text{19}\) In addition, the legal concept of good faith should be known in the contract,\(^\text{20}\) which means that the seller has a pre-contractual obligation to inform the purchaser about the quality of the goods. Thus, within Islam,

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\(^\text{13}\) Quran 2:275.
\(^\text{15}\) H. Kung, De Islam: de toekomst van een wereldreligie (IJseldijk, Uitgeefmij Kon Ten Have, 2006), 742.
\(^\text{16}\) Quran 4:29; Quran 2:275.
\(^\text{18}\) Quran 2:282.
\(^\text{19}\) Quran 5:1; Quran 17:34.
\(^\text{20}\) Quran 17:35.
commercial transactions and contracts are permissible, unless there is a clear prohibition or unless it is *haram*, i.e. forbidden by Islamic law.\(^{21}\)

This raises the question what activities are clearly prohibited and what is *haram* within Islam. The former will be discussed later; the latter refers to the fact that within a transaction all activities should be for permitted purposes, so they should be *halal* transactions. It is not permissible to invest in businesses which are *haram*. These prohibited investments concern investments relating to, amongst others, alcohol, pork, armaments, military technology, pornography, prostitution, and gambling. It also not permissible to provide any financing to conventional businesses, which are not *Shari’ah*-compliant.\(^{22}\) A very strict rule, however, would limit Islamic banks disproportionally.\(^{23}\) Hence, in light of the practical considerations of international commerce, a number of prominent *Shari’ah* scholars have advanced the view that it is permissible to invest in businesses which are not entirely *Shari’ah*-compliant so long as certain conditions are met.\(^{24}\)

Another important principle of Islamic finance is the *zakat*, giving alms. One of the five pillars of Islam, the five duties incumbent on every Muslim, is the payment of *zakat*.\(^{25}\) It derives from the Quran\(^ {26}\) that the payment of *zakat*, a tax on property, results in purification from sin.\(^ {27}\) The notion is that if an owner sees the value of his property increase, then he should share some of this growing prosperity in this world to gain favour in the next world.\(^ {28}\) It is a mandatory charity that, beyond a threshold of one year’s accumulated wealth, every Muslim has to pay to the poor and the needy.\(^ {29}\)

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\(^{23}\) Ibid.

\(^{24}\) Ibid.

\(^{25}\) The other four pillars of Islam are: *Shahada*, profession of faith; *Salat*, prayers; *Sawm*, fasting during the holy month of Ramadan; *Hajj*, pilgrimage to Mecca.

\(^{26}\) Quran 87:14


3. Prohibitions within Islamic Finance

As mentioned above, within Islam commercial transactions and contracts are permissible, unless there is a clear prohibition or unless it is *haram*. The *haram* businesses were discussed above. This leaves the question what explicit prohibitions there are in regard to Islamic finance. Islamic finance knows primarily two prohibitions: (i) the prohibition of *riba*, and (ii) the prohibition of *gharar*.

The most known feature of Islamic finance is the prohibition of *riba*, often translated as interest. However, such translation is not entirely correct, because *riba* refers to more than a sole prohibition on interest; due to its broader scope, it is also translated as ‘unjust enrichment’. The Quran contains several references to the prohibition on *riba*. According to Ibn Rushd, in Europe also known as Averroes, the Shari’ah scholars made a distinction between *riba* in sales and other forms of *riba*, such as the *riba* of the time of *jahiliyya*. Within Islamic finance, the *riba* in sales is relevant which, in turn, is divided into *riba al-fadl* and *riba al-nasi’a*. *Riba al-fadl* refers to sales within a single type with inequality with or without delay, while *riba al-nasi’a* refers to all exchanges with delay among the listed goods with or without equality or identity of type.

Today we witness the latter form of *riba* as interest paid over loans. From an Islamic perspective this is not allowed, because a loan is regarded as a charitable act within Islam. Nevertheless, making profit is permitted, so long it is realised by trade. Thus, money must be used to create real economic value and it is only permissible to earn a return from investing

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33 Ibn Rushd (1126-1198) was an Islamic jurist, doctor and philosopher. He was a master of Islamic theology, Islamic philosophy, and Islamic jurisprudence. In Europe he was known as Averroes and he is even referred to as the founding father of secular thought in Western Europe.
35 Vogel & Hayes 1998, supra n 31, 74.
37 Quran 2:275.
money in a permissible commercial activity which involves the financier or investor taking some commercial risk.\textsuperscript{39} Since Islamic banks cannot charge fixed interest in advance, they operate by participating in the profit resulting from the use of bank funds.\textsuperscript{40} The concept of interest is replaced by the concept of profit-and-loss-sharing.\textsuperscript{41}

Due to the prohibition on \textit{riba}, charging and receiving interest is prohibited. Interest is the payment of money for the use of money. Therefore, within Islamic financial transactions, there must always be tangible assets at (at least) one side of the transaction. Consequently, the trade in debts – the so called \textit{bai al-dayn} – is also forbidden within Islamic financial transactions. The exchange of money for money must be for the same value; otherwise it resembles the forbidden \textit{riba}. Since a debt is equal to money from a financial perspective, the trade in debts must also occur at par value.

The second prohibition is the prohibition of \textit{gharar} in contracts,\textsuperscript{42} which means that there should not be uncertainty as to the subject-matter of a contract. A financial contract should not lack specificity in its terms,\textsuperscript{43} i.e., in its sale price, deliverability, quantity, quality, existence, etc.\textsuperscript{44} Therefore, open-ended terms and those that are deliberately structured to convey more than one meaning are prohibited.\textsuperscript{45} In relation to conventional finance, \textit{gharar} exists, among other contracts, in insurance, futures and options contracts.\textsuperscript{46} Business risks that are generated by financial and commercial factors are allowed as long as the parties to the transaction have advanced knowledge of the elements which constitute the transaction.\textsuperscript{47} The rationales for prohibiting \textit{gharar} include mitigating disputes over the interpretation of contacts and mitigating

\textsuperscript{39} Hanif 2008, \textit{supra} n 24, 10.
\textsuperscript{40} D. Olson & T.A. Zoubi, “Using accounting ratios to distinguish between Islamic and conventional banks in the GCC region” (2003) 43 \textit{The International Journal of Accounting} 1, 47.
\textsuperscript{41} Ibid.
\textsuperscript{42} Quran 2:90; Qur’an 2:91
problems arising from asymmetric information, so that injustice and inequity does not fall on the ill-advised contracting party from the outset. However, a transaction with minimal gharar could be valid, because the Shari‘ah acknowledges the impossibility of totally eradicating gharar.

As a result of the prohibition of gharar, mayseer and qimar are also prohibited under the Shari‘ah. Mayseer concerns a transaction, where something is gained by purely speculation and not by productive effort. Qimar includes every form of gain of money, the acquisition of which purely depends on luck and chance. Speculation or gambling exists whereby two or more parties each undertake the risk of a loss where a loss for one means the gain for the other. This is prohibited, because it involves an attempt to make profit and amass wealth without putting in any productive effort. Conventional future contracts and equity derivatives contain elements of mayseer.

C. ISLAMIC FINANCIAL CONTRACTS AND STRUCTURES

As a result of the prohibitions on financial transactions, conventional loans are not permitted within Islam. Hence, Islamic finance contains different financing techniques to fulfil the needs of Islamic entrepreneurs who require financing. Rules such as the prohibition on riba and gharar are meant to achieve fairness through equitable distribution of wealth in society. Therefore, Islamic finance prefers profit-and-loss-sharing arrangements as a way of financing. These forms of equity-based financing are in line with the Islamic view on financial transactions that one cannot

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50 Qur’an 2:219; Qur’an 5:90
51 Hanif 2008, supra n 24, 10
52 M. Ayub, Understanding Islamic Finance (Hoboken, John Wiley and Sons, 2008), 112.
54 Ibid.
55 Hanif 2008, supra n 24, 10; Jabbar 2009, supra n 46, 25.
be entitled to a reward if one has not taken any risk. Thus, within Islamic law the real and ideal instruments of financing are the profit-and-loss-sharing agreements, such as *musharaka* and *mudarabah* agreements.\(^{58}\)

1. *Musharaka* Contract

The *musharaka* agreement is a form of partnership contract, often compared to a ‘joint venture’. Financing through *musharaka* means participation in the business by the financer as a partner.\(^{59}\)

The party who requires financing, often an entrepreneur, enters into a partnership with the financier, often an Islamic financial institution, by mutual contract (a so called *shirkat-al-‘aqd*).\(^{60}\)

Within this partnership, each partner contributes capital – either in cash or kind, both are permissible under the Islam – in the *musharaka* venture.\(^{61}\) Both partners have a right to management to the *musharaka* venture.\(^{62}\) The partners are, however, allowed to appoint one partner as the manager.\(^{63}\) In a *musharaka* agreement, the partners agree and fix the proportion of the profit to be distributed to each partner based upon the actual profit made.\(^{64}\) From an Islamic perspective, it is not allowed to fix the profit on a percentage of the contributed capital nor on a lump sum.\(^{65}\) In addition, all the distributions to the partners are subject to final settlement at the maturity of the *musharaka* agreement.\(^{66}\) Both partners also bear the losses of the *musharaka* and


\(^{63}\) Usmani 2002, *supra* n 58, 10; Thomas, Cox & Kraty 2005, *supra* n 60, 54.

\(^{64}\) Usmani 2002, *supra* n 58, 7-8.

\(^{65}\) *Ibid.*

this will be according to the ratio of their investment. The profit and loss sharing will continue until the date of the maturity of the financing. At maturity, the partner wishing to continue the musharaka venture – mostly the entrepreneur – will purchase the share of the partner wishing to exit the musharaka – often the financial institution – by mutual consent for a price agreed upon by the partners. This price will often be equal to the amount invested by the financer into the musharaka, which would be the principal amount of a loan provided by a bank in a conventional transaction.

2. Mudarabah Contract

The mudarabah agreement, often compared to a ‘venture capital’, is also a form of financing through participation in the business by the financer. In a mudarabah contract the financing entity, called rab-al-maal, provides the funding for the business venture; and the entrepreneur, called mudarib, provides expertise, labour, and management. Contrary to a musharaka contract where all parties provide capital and have an equal right to management, in a mudarabah contract the investment is solely from the rab-al-maal and merely the mudarib has the right to management. Similar to a musharaka agreement, the profits will be distributed to all partners based upon actual profit and must be agreed and fixed by the partners in advance. However, in a mudarabah contract the rab-al-maal bears all the losses, because the mudarib does not invest anything. One should not overlook the fact that the mudarib sustains the loss of the time, effort, and labour he has put in the venture. Furthermore, the mudarib shall be liable for the loss

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68 Usmani 2002, supra n 58, 11-2; Thani, Abdullah & Hassan 2003, supra n 59, 55.
69 Usmani 2002, supra n 58, 17.
70 Qadri 2008, supra n 67, 59-60; Usmani 2002, supra n 58, 12-3; Vogel & Hayes 1998, supra n 31, 193-95; Thani, Abdullah & Hassan 2003, supra n 59, 50-1; Thomas, Cox & Kraty 2005, supra n 60, 47-8.
caused by his negligence or misconduct, if he has worked with negligence or has committed dishonesty. A last important difference between the *musharaka* agreement and the *mudarabah* agreement is the liability regime of both: in a *musharaka* the liability of the partners is unlimited, unless all partners have agreed that no partner shall incur any debt; while in a *mudarabah* the liability of the *rab-al-maal* is limited to his investment, unless he has permitted the *mudarib* to incur debts on his behalf. The profit sharing in a *mudarabah* also continues until the entrepreneur becomes the complete owner of the business, which often takes the form of a buy-out of the interest of the financing entity.

**D. EQUITY-BASED SUKUK STRUCTURES: SUKUK AL-MUDARABAHO**

1. **Sukuk**

The above-mentioned Islamic financial contracts form the foundation of sukuk issuances. **Sukuk** are Islamic financial instruments. These securities 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. The equity-based *sukuk* structures do not represent ownership interests in tangible assets directly; they rather represent ownership interests in the

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75 Usmani 2002, *supra* n 58, 12-3; Thani, Abdullah & Hassan 2003, *supra* n 59, 55.
77 Article 2 *Shari’ah Standard No. 17 on Investment Sukuk*, AAOIFI.
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 underlying 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.  

2. Sukuk Al-Mudarabah

The mudarabah contract is the foundation of the sukuk al-mudarabah structure. The party that requires financing from the capital markets (the originator) commences the transaction. The originator will set up a Special Purpose Vehicle (SPV), a legal entity with the sole purpose 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, 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

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78 An example of a sukuk structure that represents ownership interests in tangible assets is the sukuk al-ijarah structure or the sukuk manfaa-ijarah structure. In these structures, the sukuk holders acquire ownership claims in underlying leased tangible assets. For a short discussion of certain legal aspects of these structures, see O. Salah, “Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk” (2010) 4 Berkeley Journal of International Law, Publicist Spring Issue, 19-32.

79 The structure of all equity-based sukuk transactions is similar. The difference between these forms of sukuk lies in the underlying Islamic financial contracts and the clauses therein, as described above. Hence, for the difference between, for example, a sukuk al-mudarabah and sukuk al-musharaka one can compare the contract of musharaka with the contract of mudarabah. Therefore, this article will merely discuss the sukuk al-mudarabah structure, because of recent developments in the Islamic finance market, as will be discussed below.
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 maturity date. At maturity date, 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. Figure 1 gives an overview of this structure.

Figure 1

Structure of Sukuk Al-Mudarabah

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80 Author’s own.
From an Islamic perspective, this structure is Shari’ah-compliant, because there is no interest payment over the sukuk: the periodic payments are not fixed but rather dependent on the performance of the underlying transaction, i.e. the mudarabah venture. Therefore, the prohibition on riba is not violated. Another difference with conventional bonds is that the principal amount of the sukuk holders is not fixed either. The principal amount of the sukuk holders is invested in the mudarabah and the purchase price of the shares in the mudarabah venture will be paid to the sukuk holders at redemption of the sukuk. Depending on the performance of the mudarabah, the value – and, thus, the purchase price – of the shares can be either higher or lower than the principal amount of the sukuk certificates. Furthermore, due to the prohibition on bai al-dayn (trading in debts) the sukuk holders must have some form of ownership in tangible assets. When trading the sukuk in capital markets, what is traded is not merely a debt but also an ownership interest in a tangible asset. As the beneficial owners of the shares of the SPV, all sukuk holders are regarded as the rab-al-maals. The rab-al-maals are (together with the mudarib) the owners of all the assets – which must be predominantly tangible – in the mudarabah.

E. MITIGATING RISKS BEFORE AAOIFI RESOLUTION ON SUKUK

1. Risks of Equity-Based Sukuk Structures

In the equity-based sukuk structures the periodic payments are dependent on the performance of the underlying projects, since the revenues of those projects are the sole source of the periodic payments made by the SPV to the sukuk holders. This means that the sukuk holders do not receive a fixed return and there is even a risk that the sukuk holders will not receive the expected return in case the underlying projects do not perform. Furthermore, as partner of the originator the SPV (and, as a consequence, the sukuk holders) bears the risk of depreciation of the underlying projects, which might affect their principal amount when they sell their shares back to the
originator at maturity. These aspects could make equity-based sukuk less attractive financial instruments from an investor’s perspective when compared to fixed-income securities.81

2. Mitigating Risks in Practice

In practice, several instruments were used to fix the periodic returns over the sukuk and to guarantee the principal amount of the sukuk holders. Next, four offering circulars of sukuk al-mudarabah issuances will be discussed to illustrate how several instruments were used to mitigate risks before the AAOIFI Resolution.82 A study of these four offering circulars shows what common-practice used to be in the international Islamic finance market and in the sukuk market in particular. First, the structure of the sukuk issued by DP World Sukuk Limited83 will be discussed. Since the structure of the following three sukuk issuances – that of IIG Funding Limited84, Aabar Sukuk Limited85, and Dubai Sukuk Centre Limited86 – are generally similar to that of DP World Sukuk Limited, merely their structural features that dealt with the mitigation of the above-mentioned risks will be discussed in more detail.

(a) DP World Sukuk Limited: Sukuk Al-Mudarabah Structure

81 Fixed income securities are securities that provide a fixed return to the investors. The most common form of fixed income securities is a conventional bond, where the return is based on a fixed interest rates, such as LIBOR, EURIBOR, etc. However, there are also Shari’ah-compliant fixed income securities. The sukuk al-ijarah is the most common form of sukuk that is a fixed income security. For more on this, see M.I. Usmani, “Fixed Income Securities Shari’a Perspective” (2007) 3 SBP Research Bulletin 1, 63-74.

82 The study of the four offering circulars will merely deal with their structure and highlights certain features that dealt with mitigating the above-mentioned risks. Although, the four sukuk structures contain other elements that might be interesting and relevant for a (general) legal analysis, those elements will not be discussed in this article since they are not relevant for the analysis made in this article.


84 The sukuk issued by IIG Funding Limited will be discussed through a study of the prospectus/offering circular of the IIG Funding sukuk, see IIG Funding Sukuk, Offering Circular, IIG Funding Limited 5 June 2007, available at http://www.nasdaqdubai.com/marketinfo/list_of_securities.html accessed on 5 September 2010 (hereinafter: Offering Circular IIG Funding Sukuk).

85 The sukuk issued by Aabar Sukuk Limited will be discussed through a study of the prospectus/offering circular of the Aabar sukuk, see Aabar Sukuk, Offering Circular, Aabar Sukuk Limited 22 June 2006 (hereinafter: Offering Circular Aabar Sukuk).

The *sukuk* issue by DP World Sukuk was based on the *mudarabah* contract. The originator in this transaction who required financing is DP World Limited (DP World), a subsidiary of the government-owned company Dubai World.\(^{87}\) DP World incorporated a new SPV in the Cayman Islands to facilitate the transaction on 17 May 2007: DP World Sukuk Limited (DP World Sukuk).\(^ {88}\) DP World Sukuk was the issuer of the *sukuk* certificates on 2 July 2007. DP World Sukuk also declared a trust in favour of the *sukuk* holders over all its interests, rights, and entitlement in the assets of the *mudarabah* partnership between DP World and DP World Sukuk.\(^ {89}\) Pursuant to a *mudarabah* agreement, entered into between DP World (as the *mudarib*) and DP World Sukuk (as the *rab-al-maal*) the *sukuk* proceeds were applied as the capital of the *mudarabah* constituted by the *mudarabah* agreement.\(^ {90}\) The capital of the *mudarabah* agreement will be invested in accordance with an investment plan that was prepared by the *mudarib* and according to this plan, the *mudarib* will invest the capital in *Shari’ah*-compliant profitable activities.\(^ {91}\)

The profits made with the *mudarabah* are distributed among the *mudarib* and *rab-al-maal* according to an agreed upon percentage of the profit: the *mudarib* will receive 1% of the profit, while the *rab-al-maal* will receive 99%.\(^ {92}\) The profit made with the *mudarabah* is the source of the periodic payments paid by the *rab-al-maal* as the issuer to the *sukuk* holders. This would imply that the periodic payments to the *sukuk* holders were not fixed. Nevertheless, the periodic distribution amounts are based on a fixed rate of 6.25% per annum.\(^ {93}\) In case the profits of the *mudarabah* exceed the periodic distribution amounts to the *sukuk* holders, the surplus will be paid to the *mudarib* as an incentive fee for good management.\(^ {94}\) In case of shortfalls in the profits of the *mudarabah*, the *mudarib* will provide *Shari’ah*-compliant liquidity funding to the *rab-al-maal* to

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\(^ {87}\) *Offering Circular* DP World Sukuk, *supra* n 83, 6 & 64-148.

\(^ {88}\) *Offering Circular* DP World Sukuk, *supra* n 83, 63.

\(^ {89}\) *Offering Circular* DP World Sukuk, *supra* n 83, 149.

\(^ {90}\) *Offering Circular* DP World Sukuk, *supra* n 83, 43.

\(^ {91}\) *Offering Circular* DP World Sukuk, *supra* n 83, 43-4.

\(^ {92}\) *Offering Circular* DP World Sukuk, *supra* n 83, 8 & 43.

\(^ {93}\) *Offering Circular* DP World Sukuk, *supra* n 83, 44-5.

\(^ {94}\) *Offering Circular* DP World Sukuk, *supra* n 83, 8 & 43.
ensure that the available funds are sufficient to pay the periodic distribution amounts to the sukuk holders.\textsuperscript{95}

This will continue until the maturity date at 2 July 2017.\textsuperscript{96} At maturity date, the mudarib will purchase the assets back from the rab-al-maal pursuant to a purchase undertaking.\textsuperscript{97} The purchase of the assets will be for specified exercise price that is equal to the principal amount of the sukuk holders. The rab-al-maal as the issuer will use the exercise price to pay the sukuk holders their principal amount back and accordingly the sukuk will be redeemed. Furthermore, there is also a sale undertaking, according to which the rab-al-maal is obliged to sell the assets to the mudarib under certain tax events – certain events that add to the costs of the transaction due to additional costs of taxes.\textsuperscript{98} Once again, the exercise price will be equal to the principal amount of the sukuk holders and will, thus, be paid through to them in order to redeem the sukuk. Figure 2 gives an overview of this structure.

\textbf{Figure 2}\textsuperscript{99}

\textit{DP World Sukuk Structure}

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\textsuperscript{95} Offering Circular DP World Sukuk, \textit{supra} n 83, 9 & 43.
\textsuperscript{96} Offering Circular DP World Sukuk, \textit{supra} n 83, 10.
\textsuperscript{97} Offering Circular DP World Sukuk, \textit{supra} n 83, 9 & 43.
\textsuperscript{98} Offering Circular DP World Sukuk, \textit{supra} n 83, 44-7.
\textsuperscript{99} Author’s own.
Before the AAOIFI Resolution in February 2008, the above described sukuk al-mudarabah structure was common-practice in the international Islamic finance market. This structure has certain structural features that deal with the mitigation of the above-mentioned risks of equity-based sukuk structures. At first glance, it might look like an equity-linked security, because the source of the payment to the sukuk holders is the profits of the mudarabah distributed according to an agreed percentage of the profit: 99% is for the rab-al-maal and 1% is for the mudarib. Such a profit distribution based on a 99/1 ratio used to be very common in sukuk structures. The same profit distribution ratio is stipulated in the sukuk issuances of IIG Funding Limited, Aabar Sukuk Limited, and Dubai Sukuk Centre Limited. However, a closer look at these structures clarifies
that both the periodic payments and the redemption payment to the *sukuk* holders are fixed and guaranteed returns.

While studying the offering circulars of several *sukuk* issuances – i.e., *sukuk al-mudarabah* certificates issued by DP World Sukuk Limited, IIG Funding Limited, Aabar Sukuk Limited, and Dubai Sukuk Centre Limited – one can notice certain recurrent features in most of the equity-based structures. The periodic distribution amounts to the *sukuk* holders were often fixed amounts.\(^{101}\) Any surplus over the periodic payments to the *sukuk* holders was for the originator as an incentive fee, annulling the possibility to pay the real (excess) profits of the *mudarabah* to the *sukuk* holders as would be expected from equity-linked securities.\(^{102}\) In case the profits of the *mudarabah* were less than the fixed returns, the originator would provide *Shari‘ah*-compliant liquidity funding, i.e. interest-free loans.\(^{103}\) This, furthermore, limited the equity character of these securities, since the losses were born by the originator and the periodic returns to the *sukuk* holders were fixed return, regardless of the performance of the underlying projects. The purchase undertaking guaranteed the principal amount of the *sukuk* holders, regardless of the possible appreciation of depreciation of the assets. All these features made the *sukuk* resemble conventional bonds and lose their own authenticity. This touched upon their *Shari‘ah*-compliance and, therefore, the AAOIFI had a look into the matter.

### F. AAOIFI RESOLUTION ON SUKUK

First, Judge M.T. Usmani\(^{104}\) criticized the developments in the *sukuk* market in a paper on the contemporary application of *sukuk* at the end of 2007.\(^{105}\) He stated that 85% of all the *sukuk* outstanding at that moment was not *Shari‘ah*-compliant.\(^{106}\) The main target of his criticism was

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\(^{101}\) *Offering Circular* DP World Sukuk, *supra* n 83, 44-5; *Offering Circular* IIG Funding Sukuk, *supra* n 84, 58; *Offering Circular* Aabar Sukuk, *supra* n 85, 7 & 55; *Offering Circular* Dubai Sukuk Centre, *supra* n 86, 24-5.

\(^{102}\) *Offering Circular* DP World Sukuk, *supra* n 83, 8 & 43; *Offering Circular* IIG Funding Sukuk, *supra* n 84, 7; *Offering Circular* Aabar Sukuk, *supra* n 85, 76; *Offering Circular* Dubai Sukuk Centre, *supra* n 86, 55.

\(^{103}\) *Offering Circular* DP World Sukuk, *supra* n 83, 9 & 43; *Offering Circular* IIG Funding Sukuk, *supra* n 84, 110; *Offering Circular* Dubai Sukuk Centre, *supra* n 86, 55.

\(^{104}\) Judge M.T. Usmani is a well-known judge, *Shari‘ah* scholar, and president of the AAOIFI *Shari‘ah* Council.

\(^{105}\) Usmani on Sukuk, *supra* n 56.

\(^{106}\) W. McSheehy, ‘Islamic Bond Scholars Toughen Rules on Sukuk Sales’, *Bloomberg* 13 March 2008; Arabian Business, ‘Most sukuk ‘not Islamic’, body claims’, *Reuters* 22 November 2007,
the equity-based sukuk structures – the sukuk issues based on musharaka, mudarabah, and wakalah\textsuperscript{107}. The whole essence of equity-based transactions within Islamic finance is that it leads to equitable profit distribution, because the financer does not transfer all the risks to the borrower and in the meanwhile the borrower does not only acquire all the benefits of the investment of the financer, but the profits are rather shared between them.\textsuperscript{108} Therefore, Judge Usmani criticised three elements in the contemporary application of the equity-based sukuk structures. First, he mentioned that the payment of any surplus as an incentive fee to the originating partner in the transaction is a mechanism that comes from conventional financing transactions and does not adhere to the Islamic finance concept, where the investor is taking more risks and, thus, must be rewarded for those risks taken.\textsuperscript{109} The payment of any surplus to the originating partner is a form of fixing the return to the investors and limits profit-and-loss-sharing between them.\textsuperscript{110} Furthermore, he criticised the payment of interest-free loans.\textsuperscript{111} This mechanism is basically a form of fixing the periodic returns to the investors and, thus, the investors are not taken the risk that entitles them to a reward.\textsuperscript{112} The third point that Judge Usmani condemned was the use of purchase undertakings at face value.\textsuperscript{113} Through these purchase undertakings, the originating party was guaranteeing the principal amount of the sukuk holders and this is also not in line with the concept of profit-and-loss-sharing.\textsuperscript{114}

Shortly after the paper of Judge Usmani, the AAOIFI Resolution was issued in February 2008.\textsuperscript{115} The AAOIFI Resolution adopted two out of the three points mentioned by Judge Usmani. The resolution contains six rulings and two out of the six rulings are relevant for the equity-based

\textsuperscript{107} The wakalah agreement is an Islamic financial contract of agency that is also structured on the principles of profit-and-loss-sharing.
\textsuperscript{108} Usmani on Sukuk, 2007, supra n 56, 2-3.
\textsuperscript{109} Usmani on Sukuk, 2007, supra n 56, 5-7.
\textsuperscript{110} Ibid.
\textsuperscript{111} Usmani on Sukuk, 2007, supra n 56, 7-8.
\textsuperscript{112} Ibid.
\textsuperscript{113} Usmani on Sukuk, 2007, supra n 56, 8-13.
\textsuperscript{114} Ibid.
sukuk structures. First, the AAOIFI ruled in the third ruling of the AAOIFI Resolution that it is not permissible to offer interest-free loans to the sukuk holders in case of shortfalls.\(^{116}\) However, it is permissible to establish a reserve account for the purpose of covering such shortfalls.\(^{117}\) The AAOIFI also permitted on account payments, so long these payments are subject to final settlement at maturity date.\(^{118}\) Second, the fourth ruling of the AAOIFI Resolution clarified that purchase undertakings according to which interests in the partnerships, i.e. in the mudarabah, musharaka, or wakalah, are purchased back at nominal value are not permissible.\(^{119}\) It is, however, permissible to offer a purchase undertaking according to which the originator can purchase the interests back at their market value or at a price to be agreed upon at the moment of the sale.\(^{120}\)

As a consequence,\(^{121}\) sukuk issuances declined drastically in 2008.\(^{122}\) Another result of the AAOIFI Resolution is that most of the structures after 2008 have been based on other Islamic financial contracts than equity-based contracts.\(^{123}\) Since 2008, most of the sukuk issuances have been structured on the contract of ijarah (comparable to a leasing contract), which is currently dominating the sukuk market.\(^{124}\)

G. MITIGATING RISKS AFTER AAOIFI RESOLUTION ON SUKUK

1. Saudi Hollandi Bank Sukuk

\(^{116}\) AAOIFI Resolution 2008, supra n 115, 2-3.
\(^{117}\) Ibid.
\(^{118}\) Ibid.
\(^{119}\) Ibid.
\(^{120}\) Ibid.
\(^{121}\) It must be noted that the AAOIFI Resolution was merely one of the reasons for this decline. Another aspect that is also mentioned as a factor that lead to a decline in sukuk issuances is the credit crunch, see IIFM Sukuk Report, supra n 3, 12-9.
\(^{122}\) IIFM Sukuk Report, supra n 3, 18-9.
\(^{123}\) IIFM Sukuk Report, supra n 3, 15-9.
\(^{124}\) IIFM Sukuk Report, supra n 3, 15.
One of the few equity-based sukuk structures issued after the AAOIFI Resolution is the sukuk al-mudarabah issued by Saudi Hollandi Bank in December 2009. The transaction commenced with Saudi Hollandi Bank issuing sukuk certificates as the issuer. Saudi Hollandi Bank entered into a declaration of agency with its subsidiary Saudi Hollandi Capital as the sukuk holders’ agent, according to which Saudi Hollandi Capital is appointed to act as an agent for and on behalf of the sukuk holders. Next, Saudi Hollandi Bank Capital as the sukuk holders’ agent entered into a mudarabah agreement on behalf of the sukuk holders (all together as the rab-al-maal) with Saudi Hollandi Bank (as the mudarib). Pursuant to the mudarabah agreement, Saudi Hollandi Bank invested the sukuk proceeds in Shari’ah-compliant activities, i.e. the bank used the proceeds to grow its Islamic business portfolio and strengthen its capital base (Tier II Capital).

If the profits made with the sukuk proceeds exceed the periodic distribution amounts, the surplus will be placed in a reserve account. Any shortfalls will be covered out of this reserve account. If the amounts in the reserve account are insufficient to cover shortfalls, the issuer will make on account payments. However, these on account payments will be subject to final settlement. At maturity in December 2019, the issuer will redeem the sukuk and pay the aggregate face value of the sukuk less any loss relating to the mudarabah assets not covered by

125 The sukuk issued by Saudi Hollandi Bank will be discussed through a study of the prospectus/offering circular of the Saudi Hollandi Bank sukuk, see Saudi Hollandi Bank, Offering Circular, Saudi Hollandi Bank 24 October 2009 (hereinafter: Offering Circular Saudi Hollandi Bank).
126 Offering Circular Saudi Hollandi Bank, supra n 125, 1-3.
127 Ibid.
128 Ibid.
129 Ibid.
130 Offering Circular Saudi Hollandi Bank, supra n 125, 28-9.
131 Ibid.
132 Ibid.
133 Ibid.
134 Ibid.
135 Ibid.
the monies standing in the credit of the reserve account.\footnote{Ibid.} There is no purchase undertaking in the transaction. This means that if the \textit{mudarabah} has eventually suffered loss, the \textit{sukuk} holders cannot receive the face value of the \textit{sukuk} certificates. To cover this risk, Saudi Hollandi Bank has the option to redeem the \textit{sukuk} from December 2014 onwards subject to the value of the assets of the \textit{mudarabah} not being below the aggregate face value of the \textit{sukuk} certificates.\footnote{Offering Circular Saudi Hollandi Bank, supra n 125, 28-9.} Any remaining monies in the reserve account are for the issuer as an incentive fee.\footnote{Offering Circular Saudi Hollandi Bank, supra n 125, 33.} Figure 3 gives an overview of the structure of the Saudi Hollandi Bank \textit{sukuk}.

\textbf{Figure 3}\footnote{Author’s own.}

\textit{Saudi Hollandi Bank Sukuk Structure}
2. Saudi Hollandi Bank Sukuk & the AAOIFI Resolution

The structure of the Saudi Hollandi Bank sukuk seems to comply with the AAOIFI Resolution. First of all, there are no interest-free loans. Compared to the pre-AAOIFI Resolution sukuk issues, this aspect of the Saudi Hollandi Bank answers the question how to deal with periodic payments to sukuk holders. Although the periodic distribution amounts are fixed and in case of shortfalls Saudi Hollandi Bank makes on account payments, these payments are subject to final liquidation of the mudarabah. This does not violate the AAOIFI Resolution.\textsuperscript{140} In the Saudi Hollandi Bank Sukuk, Saudi Hollandi Bank as the issuer has the right to set off all the on account payments against the redemption amount of the sukuk; the redemption amount being the aggregate face value of the sukuk less any loss relating to the mudarabah assets not covered by the monies standing in the credit of the reserve account.\textsuperscript{141} Also the use of the reserve account is innovative when compared to the pre-AAOIFI Resolution issues.

Second, there is no purchase undertaking in the structure. Since the on account payments are subject to final liquidation of the mudarabah, this means that the sukuk holders are taking the risk of loss of the mudarabah. However, one should not forget that Saudi Hollandi Bank has the right to redeem the sukuk from December 2014 onwards, so long the value of the mudarabah is at least equal to the face value of the sukuk. This may have the same effects of a purchase undertaking: redemption at the face value of the sukuk, which is a form of guarantee of the principal amount. However, in this case it will always be dependent on the actual performance of the mudarabah; if the mudarabah does not make enough profit to cover the principal amount, Saudi Hollandi Bank will not be able to perform this right. Nor the AAOIFI Resolution, neither the AAOIFI Shari’ah Standards on sukuk, nor any other Islamic financial rule explicitly prohibits such a clause. Therefore, this innovative mechanism seems to be Shari’ah-compliant. This is also in line with the above-mentioned Islamic maxim that all transactions and clauses are permissible, unless explicitly forbidden.

\textsuperscript{140} AAOIFI Resolution 2008, \textit{supra} n 115, 2-3.
\textsuperscript{141} Offering Circular Saudi Hollandi Bank, \textit{supra} n 125, 29-31.
Nevertheless, the Saudi Hollandi Bank sukuk does raise other questions that must be considered. The structure of the Saudi Hollandi Bank sukuk is quite different compared to most of the sukuk al-mudarabah structures. Saudi Hollandi Bank enters into a mudarabah agreement with its own subsidiary, instead of with a separate legal entity (often an SPV). From a proprietary law perspective, the sukuk holders do not gain any proprietary rights; there is neither transfer of any assets nor a declaration of trust. This raises the question whether merely contractual rights are sufficient from a sukuk holders’ perspective. The mudarabah assets are securitized merely through the issuance of sukuk and not through any form of transfer of ownership rights in the underlying assets or projects. Indeed, the structure of this sukuk makes it an equity-linked instrument, but without any form of transfer of ownership in rights, assets, or projects the question is raised whether this is sufficient for a sukuk structure. Nevertheless, the Saudi Hollandi Bank contains several innovative elements that will be beneficial to the development of the sukuk industry.

H. CONCLUSION

This article explored the developments in the Islamic finance market in regard to equity-based sukuk structures. Through a discussion of the main foundations of Islamic finance and sukuk structures, a deeper insight in the equity-based sukuk structures is provided. Several structural features of equity-based sukuk were discussed in light of the AAOIFI Resolution of 2008. Through a discussion of several sukuk structures, the criticised elements in these structures were discussed. This clarified the Islamic legal framework of these products. Practitioners must understand that equity-based sukuk cannot be entirely fixed and guaranteed products. This article did not only elucidate on what different structural and legal mechanisms the architects of these products can acquire when structuring the transactions, but it also clarified the limitations of certain features: the use of purchase undertakings is merely allowed at market value and fixing the periodic payments must be subject to actual valuation at maturity. A case study of the Saudi Hollandi Bank illustrated how certain innovative elements can be applied to these transactions: the use of a reserve account and on account payments subject to actual valuation are Shari’ah-
compliant tools that practitioners can apply. However, certain aspects of the structure of the Saudi Hollandi Bank *sukuk* raised questions that are worth considering for the further development of the *sukuk* market. Nevertheless, it shows that progress and innovation is possible and taking place in this relatively new market that is still in development.