

SHARIAH APPRAISAL OF SUKUK

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THESIS SUBMITTED FOR THE DEGREE OF
LLM (CORPORATE LAW)

SUPERVISED BY

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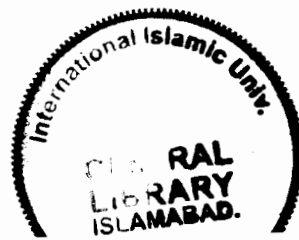
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Reg No. 104 SF/LLM/CL F05

In the Name of Allah, Most Merciful, Ever-Merciful

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**Thesis submitted in partial fulfillment of the requirements for
the degree of LLM (Corporate Law)**

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Dedications

For My late Father and Brother

May God rest their Souls In Heaven and Peace

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Abbreviations

| | |
|--------|--|
| IMF | International Monetary Funds |
| AAOIFI | Accounting and Auditing Organization of Islamic Financial Institutions |
| SPV | Special Purpose Vehicle |
| SPE | Special purpose Entity |
| NBFIs | Non Banking Financial Institutions |
| LIBOR | London Inter Bank Offer Rate |
| MTFCS | Mudarabah Term Finance Certificates |
| SBP | State Bank of Pakistan |
| SECP | Securities and Exchange Commission of Pakistan |
| IPO | Initial Public Offer rate |
| NHA | National Highway Authority |
| GoP | Government of Pakistan |
| WAPDA | Water and Power Development Authority |
| PKR | Pakistani Rupee |

| | |
|-------|--|
| KIBOR | Karachi Inter Bank Offer Rate |
| BPs | Basis Points |
| CII | Council of Islamic Ideology |
| PIS | Pakistan International Sukuk Company Limited |
| MLCFL | Maple Leaf Cement Factory Limited. |
| SSGC | Sui Southern Gas Co |
| EBPL | EDEN Builders Private Limited |
| PEL | Pakistan Electronic Limited |
| KSEWs | Karachi Shipyard and Engineering Works |
| PIA | Pakistan International Airlines |
| PN | Primary Note |
| SN | Secondary Note |
| MIFC | Malaysian International Financial Center |
| SAMA | Saudi Arabian Monetary Agency |
| QREIC | Qatar Real Estate Investment Company |

| | |
|-----|-------------------------------|
| QGS | Qatar Global Sukuk |
| CIC | Collective Investment Company |
| GIS | Government Investment Sukuk |

ABSTRACT

When the federal government, states or cities are short of cash, they issue bonds promising to pay the principal on maturity and profit during the life of the bond. All the terms and conditions pertaining to loan (issuance of bonds) are discussed among the contracting parties to avoid any future dispute. The introduction of bonds, different issuing entities of bonds along with main characteristics of bonds has been explained in first chapter. Different types of bonds and risk associated with bonds is highlighted over there. The parties involved in bonds issuance along with the procedure of so called issuance with all necessary documentations have been looked into.

In Second Chapter I have mentioned the literal and technical meanings of Sukuk, significance of Sukuk along with difference between Sukuk, bonds and Shares. The Characteristics of SPV are thin capitalization and bankruptcy remoteness by owning the title of the assets, issuing the securities to the subscribers. The function and role of special purpose vehicle (SPV) along with the associated parties in issuance of Ijarah Sukuk have been mentioned specifically. The important rules about trading of Sukuk and various kinds of Sukuk are also been discussed. At the end of this chapter I have elucidated to different types of risks connected with Sukuk, highlighting the way of risk management in detail.

In third chapter situational analysis of Sukuk has been discussed.

In Fourth Chapter procedure of Sukuk issuance in Islamic countries like Malaysia, Saudi Arabia, Qatar, Bahrain has been discussed. In this chapter objections raised on Sukuk (not being Shariah compliant) have also been discussed, by clarifying doubts about the concept and application of Sukuk.

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INTRODUCTION

In Islamic commercial system, the mobilization of funds through issuance of bonds/Sukuk is controversial issue, the reason is that bonds are interest-bearing debt and may be used to finance the activity that is not compatible with Shariah. Investment in bonds is essential part for the social protection essential for any society but being controversial issue, there are barriers to flourish the said concept. To resolve the issue we should first know the situation. So here are the questions for the above mentioned purpose;

- i. Whether the Sukuk are alternative to conventional bonds?
- ii. Whether the Sukuk are compatible with Islamic Injunctions?
- iii. Whether Sukuk are partially alternative to conventional bonds or partially compatible with Shariah?

To give the answers of the said questions we should also know why these controversies exist? By exploring the existing procedure for the issuance of Sukuk here the following questions arises:

- i. Whether there is any Islamic Law (governing the concept of Sukuk) which permits absolutely the mobilization of funds through issuance of Sukuk?
- ii. Whether the said Islamic law has some flaws or lacunas in it?
- iii. Or whether the same (Islamic law) exists there in full flourished form but is not implemented properly which creates ambiguities in the field of Sukuk phenomenon?

In conventional bonds principal and return is guaranteed by the issuer and is not conditional with profit or loss. In case of default or nonpayment of return or principal as the case may be by the issuer, the creditor has right of lien on assets of issuer. So to distinguish the conventional bonds

from Sukuk, different issuing entities of bonds along with main characteristics of bonds have been explained in First Chapter. Different types of bonds and risk associated with bonds is highlighted over there. In bond issuance, the risk is associated in all types of debt but the most important risks are that the interest and principal amount may not be repaid, price of debt may decline and inflation will continue or bonds will be recalled before maturity. These risks vary with different types of debt; the parties involved in bonds issuance along with the procedure of so called issuance and all the detail about necessary documentations have been mentioned. The protection and safety measures available for the investor's right have also been highlighted in the above mentioned chapter.

The messenger of Allah cursed the one who accepted riba, the one who paid it, the one who recorded it and the two witnesses it, He said: "They are all alike."¹ Due to prohibition of riba, debt market could not flourish in the Muslim countries. The recent innovations in Islamic finance have changed the dynamics of the Islamic finance industry, especially in the area of bonds and securities, the use of Sukuk or other types of Islamic securities have become popular since few years; both as a means of raising funds for governmental use, called sovereign Sukuk and for companies fund raising called corporate Sukuk. In Second Chapter I have mentioned the literal and technical meanings of Sukuk, significance of Sukuk along with difference between Sukuk, bonds and Shares. The characteristics of SPV are thin capitalization and bankruptcy remoteness by owning the title of the assets, issuing the securities to the subscribers. The function and role of special purpose vehicle (SPV) along with the associated parties in issuance of Ijarah Sukuk have been mentioned specifically. The Sukuk which are tradable must represent ownership for their holders along with all other rights and obligations related to ownership. It makes no difference

¹.Al-Imam Abbi Al-Hussain Muslim bin al-Hujaj bin Muslam Al-Qashreyyi, An-naisa puri, *Sahih Muslim* Kitab al Musaqqat, Hadith No 4093 (Riyyad: Dar-usslam linashar watozi),697.

whether the assets are tangible or usufructs or services, their possession and right to dispose-off must be legal and should be compatible with Shariah. The important rules about trading of Sukuk and various kinds of Sukuk have also been discussed. At the end of this chapter I have elucidated to different types of risks connected with Sukuk, highlighting the way of risk management in detail.

In Third Chapter situational analysis of Sukuk in Pakistan has been discussed. The initiative of Sukuk in Pakistan had been taken by sitara chemical industries by issuing Sukuk in 2002; those were Mudarabah-based Sukuk, called Mudarabah Term Finance Certificates (MTFCs). However, proper working on the said subject started in 2005. Since then Sukuk worth at least RS 30 billion have been issued or in the process of issuance. To make Pakistan among the most prolific national issuer of Sukuk, hard work is required from all the market participants in order to remove the obstacles from the Sukuk issuance. In addition, I have mentioned Government of Pakistan (GoP) rules regarding Sukuk-al-Ijara. In the investment sector of Pakistan, there are two regulatory authorities who encourage the businessmen in Islamic market and those are;

- I. State Bank of Pakistan (SBP)

- II. Security and Exchange Commission of Pakistan (SECP)

- I. State Bank of Pakistan (SBP)

The SBP has been actively involved in facilitating various initiatives and to introduce favorable policies to promote Islamic banking. The new guidelines and polices are introduced by the banks for the investment in Sukuk.

II. Security and Exchange Commission of Pakistan (SECP)

The SECP regulates non banking companies and other private and public limited companies. All the arrangements in the field of Sukuk are made privately. They do not come in the ambit of SECP.

The Council of Islamic Ideology (CII) is a constitutional body responsible for providing the legal advice on Islamic issues to Pakistani government and the parliament. Up till now both the SECP and CII has not proposed any legislation upon the said case, the reason of this lacuna is infancy of the Sukuk concept in Pakistan.

In Fourth Chapter procedure of Sukuk issuance in Islamic countries like Malaysia, Saudi Arabia, Qatar, Bahrain has been discussed. In this chapter objections raised on Sukuk (not being Shariah compliant) have also been discussed, by clarifying doubts about the concept and application of Sukuk. The Sukuk are not alternative to conventional bonds but compatible with Shariah. The existing Islamic law for the issuance of Sukuk exists in full-fledged form. Non implementation of the said law creates flaws and makes the Sukuk transactions partially Islamic and partially non Islamic. In the end the conclusion of the thesis and recommendations has been given.

The people do financing through bonds, shares and Sukuk but do not know much more about its permissibility or otherwise. Since these have assumed a prominent position in the modern Islamic legal discourse on cotemporary financial transactions. So it was necessary to have a better research work to clarify this type of ambiguities. Therefore I selected this topic. According to my knowledge no one has worked on this topic in the manner which I have adopted.

In this work I have tried my best to consult original sources. I therefore referred to the Holy Quran in citing verses of this Holy Book, Ahadith have been taken from hadith collection and

opinion of the jurists have been taken from fiqu sources. Laws have been referred from its original sources and cases from law journals.

Chapter 1

Introduction to the Bonds

The Polonius advised Hamlet “neither a borrower nor a lender be”² to be a lender or to be a borrower both are onerous. To finance our day to day business either we need to be a borrower or to be a lender, to accumulate cash is incredibly multifaceted for the investor due to inflation and sky-scraping taxes and has deteriorated the purchasing power. The investors have to pay exorbitant commissions so striving feverishly; they succumb to tax shelter, promoting nonproductive and pseudo investments.³ Although the word loan is very burdensome even then governments as well as the corporations do borrow to accomplish the individual or institutions needs such as establishing the infrastructure or like matter. The firms and other borrowing entities are not self sufficient to fulfill their needs by internally generated cash. To borrow and to lend through issuance of bonds is very complex and burdensome trend.⁴ The basic problem is unfamiliarity of parties to each other and issuance of bonds is onerous and not viable where a revolving credit, multicurrency option and standby facility is prerequisite need from the investor side,⁵ even then the Industrialist and Businessman borrow money when they are short of cash, for the smooth functioning of their business.⁶ To obtain a loan through issuance of bonds is cheaper as compared to taking loan from the banks albeit of multiple layers of documentations. In addition, rate of interest on bond is much lower than bank’s loans.

².Herbert B.Mayo, *Investments An Introduction with Investment Analysis*, (USA: Thomson South Western2003), 461.

³.Thomas C Nodding, *The Investor’s Guide to Convertible Bonds*, (USA: Library of Congress Catalog1982),iii.

⁴.Philip Wood, *Law and Practice of international Finance* (London: Sweet & Maxcell, 1980),177.

⁵.Ibid.177.

⁶.Ibid.

1.1 Definition of Bonds

Bonds are basically debt instruments that represent fixed rate of return/interest and can be traded in the market. The purchaser of coupon bond lends cash to the issuer who in turn, agrees to pay interest on this loan as well as pays back the principal at the stated maturity's date. The bonds are fixed-income securities because the interest payments (if any) and the principal repayment for a typical bond are fixed at the time the bond is issued and are specified for the life of the bond. At the time of purchase, the purchaser knows the prospect stream of cash flows to be received from buying and holding the bond till maturity where bearing default by the issuer, these payments will be received at specified intervals until maturity. However, if the buyer decides to sell the bond before maturity, the price received will depend on the level of interest rates at the time of sale.⁷ According to Frank J. Fabozzi the issuer of bond assures to pay back to the investor the amount borrowed in addition to interest over some agreed period of time. The principal amount remains outstanding whereas the contractual amount of interest would be paid after every six months. The date which is fixed for the payment of principal is called maturity date, presumptuous that the issuer does not default and redeem the issue former to the maturity date. An investor holds the bond awaiting the maturity date with the assurance of an acknowledged cash flow.⁸

A bond is a debt instrument which creates rights for the issuer to repay the amount borrowed along with interest over some specified period of time and entitle the creditor to claim in case of violation by the debtor. In this contract an issuing entity is called issuer/borrower whereas the lender is called creditor or investor. When the federal government, states or cities are short of

⁷.See for description of bonds, Charles P. Jones, *Investments Analysis and management* (New York: John Wily & Sons Pvt.Ltd2002), 28-29.

⁸.Frank J. Fabozzi, *Investment Management* (New Jersey: Prentice Hall, 1994),18.

cash, they issue bonds promising to pay the principal on maturity and profit during the life of the bond.⁹ All the terms and conditions pertaining to loan (issuance of bonds) are discussed among the contracting parties to avoid any future dispute.

1.2 Different Entities for the issuance of Bonds

The following entities issue bonds;

- I. Government
- II. Local authority
- III. Corporations
- IV. Foreigners

I Government

The bonds which are issued by national government directly denominated by countries own currency,¹⁰ are called government bonds for example U.S government bonds. The government bonds market is the biggest market in the world, working in inspiring manners; the bonds of the said government are called gilts or guilt-edged bonds which mean secured investment.¹¹

II Local Authority /Public Utility

The bonds which are issued by local authority are called municipal bonds. Here local government obtains finances through issuance of bonds and this sector is exempted from tax.

There are two sub kinds of said bonds;

- (i) **General obligation bonds;** here issuer secures the debt through unlimited taxing power.

⁹.Investorswords.com. The biggest, best investing Glossary on the web, <<http://www.investorwords.com/521/bond.html>> (last accessed Dec12, 2009).

¹⁰.Government bonds-Wikipedia, the free encyclopedia, <http://en.wikipedia.org/wiki/Government_bond> (last accessed Dec12, 2009).

¹¹.Stephen Valdez, *An Introduction to Global Financial Markets* (Houndmills, Basingstoke, Hampshire RG21 6+S and London: Macmillan press Ltd1997), 112-114.

(ii) **Revenue bonds**; this is special type of municipal bonds; such bonds are issued for either project or enterprise financing where the bond issuers pledge to the bondholders, the repayment is guaranteed by the revenue generated by the projects which is being financed.¹²

III Corporations

The bonds issued by companies are called corporate bonds. According to bond information services corporations are further classified in **utilities** electric power companies, water companies and gas distribution companies. In **Transportation Companies** airlines and railroads etc are integrated. In **Industrial Companies** manufacturing merchandising and service companies are included.¹³

IV Foreign Bonds; these are the bonds which are issued by nonresident entities/persons, here the bonds are issued in local currency in domestic market, however the issuer is foreigner.¹⁴ The bonds which are issued out of their natural market are termed as Eurobonds.¹⁵

1.3 Main Characteristics of Bonds

The following are the main characteristics of bonds

I Name of the Bonds

Every issuer, gives the bond a distinction, by a particular name for example WAPDA bearer bonds and national bonds etc.

¹².Revenue Bonds, Wikipedia, the free encyclopedia<http://en.wikipedia.org/wiki/Revenue_bond>(last accessed Dec 12, 2009).

¹³. Stephen Valdez, *An Introduction to Global Financial Markets* (Houndmills, Basingstoke, Hampshire RG21 6+S and London: Macmillan press Ltd1997),116.

¹⁴. Investopedia ,A forbes digital company ,Bonds, fixed income <<http://www.investopedia.com/terms/f/foreignbonds.asp>>(last accessed Dec 12, 2009).

¹⁵.Stephen Valdez, *An Introduction to Global Financial Markets* (Houndmills, Basingstoke, Hampshire RG21 6+S and London: Macmillan press Ltd1997), 112-114.

II Interest

The payment made to the owner of debt instrument is called interest. Which is different from the dividend as the dividend is flow of income arising from profits whereas the interest is expense of borrowing which is paid to the creditors for the use of their money.

III Coupon rate

The amount of interest which issuer agrees to pay the bondholder during the life of bond each year is called the coupon.¹⁶ It is also termed as nominal rate.

IV Maturity/Redemption

The future date when the principal amount will be repaid is called maturity date.¹⁷ The redemption of the bonds tells the particular debt is ceased to exist and issuer can redeem the bond by paying the principal. The bonds having redemption period of five years or less are called short term debt. whereas bonds having maturity period more than five and less than twelve years and bonds which have life span more than twelve years are called intermediate and long term debt respectively.

V Par value

The payment made by the issuer to the bondholder at the maturity of bonds is called par value.¹⁸ The amount which is paid at the maturity is also termed as face value, redemption value or maturity value.

¹⁶.Bonds Basic: Characteristic <<http://www.investopedia.com/university/bonds/bonds2.asp>> (last accessed Dec 12, 2009).

¹⁷.Ibid.

¹⁸.Ibid.

VI Default

Where the bond issuer fails to fulfill the contractual obligation, such as payment of interest, maintenance of working capital, or payment of principal, it amounts to default.¹⁹ The default occurs when the borrower fails to meet not only the payment of interest but any of the terms of the indenture is not fulfilled. The other conditions of the indenture are just as important as meeting the interest payment on time and often they may be harder for the debtor to gratify. During period of scarce credit, the term of a loan agreement will be stricter, whereas in epoch of lesser interest rates and more readily available credit, the restrictions will be inclined to be more lenient. The vital point, however, is that if any part of the loan agreement is violated, the creditor may declare that the debt is in default and might look for a court order to implement the terms of indenture.

VII Collateral

For the security of the bondholder's interest some specific assets are pledged against the default of the firms on the bond, it provides a protection to the bond holder for any risk of default,²⁰ such security/protection is technically termed as collateral. Therefore the bondholder can claim and can receive the pledged assets on the default from issuer.

VIII Creditor

Who buys a bond is called investor or creditor, irrespective of his buying i.e. whether it is from primary market or secondary. A creditor becomes a creditor of the issuing government or the company on the terms specified in the contract.

¹⁹.Thomas C. Nodding, *The Investor's Guide to Convertible Bonds* (USA: : Library of Congress Catalog,1982), 231.

²⁰.Collateral(Finance)Wikipedia,the freeencyclopedia<[http://en.wikipedia.org/wiki/Collateral_\(finance\)](http://en.wikipedia.org/wiki/Collateral_(finance))> (last accessed Dec 12, 2009).

IX Indenture

A written agreement, evidencing of debt is called indenture.²¹ Actually the bond indenture is document consists on set of promises between the bondholder and bond issuer which give the overview of payment schedules and sets forth the precautionary measure for the protection of bondholder's rights. In these covenants sinking funds, dividend policies, coupon rates, the date of maturities, securities for the loans and conversion privileges have been discussed.²²

1.4 Different kinds of Bonds

There are different types of bonds which have been described below.

1.4.1 Insurance Bonds

These bonds are usually three party contracts in which one party agrees to guarantee the act, performance or conduct of a second party to a third party. In financing these bonds are substitute to taxation (for government), shares issue (for companies), and for the investors they are alternate to shares, cash deposits and other types of income-generating assets.

1.4.2 Mortgage Bonds

These are bonds secured by mortgage property; the issuer grants the bondholder a lien against the pledged assets. The lien means legal right of bondholder to sell the mortgage property where issuer does not satisfy the claims due on him from the bondholder. In case of default from the issuer side, bondholder can invoke this right by selling mortgaged property to satisfy the unpaid

²¹. Investorswords.com. The biggest, best investing Glossary on the web, <<http://www.investorwords.com/2421/indenture.htm>>(last accessed Dec12, 2009).

²².Thomas C. Nodding, *The Investor's Guide to Convertible Bonds* (USA: Library of Congress Catalog, 1982), 229.

debt but it happens in very rare cases as in cases of default there is financial reorganization from the issuer side for the bond holder in which settlement of debt is made.²³

1.4.3 Collateral Trust Bonds

These are secured by financial assets;²⁴ to satisfy the desire of bonds holders for security, the holding companies pledges stocks, notes, bonds, or other kind of financial instruments they own. These assets are termed as collateral (or personal property), and bonds secured by such assets are called collateral trust bonds. Some companies do not own fixed assets or other real assets and so have nothing on which they can give a mortgage lien to secure bondholder, as an alternative they own securities of the companies those are subsidiaries of the said companies.²⁵

1.4.4 Debenture Bonds

These are unsecured bonds, no any property is specifically pledged against these bonds but the creditor right of claim exists, not only on assets which have been not used to secure other debts but also on the property which in value greater than the assets used to secure the loan of other creditors.²⁶

1.4.5 Deferred interest Bonds

These are the bonds which are sold on discount. Initially no any coupon is paid to the holders and this initial period consists of three to seven years.²⁷

²³. Frank J. Fabozzi, *Investment Management* (New Jersey: Prentice Hall, 1994), 374.

²⁴. Investopedia ,A forbes digital company, Bonds, Fixed Income

<<http://www.investopedia.com/terms/c/collateraltrustbond.asp>>(last accessed Dec 12, 2009).

²⁵. Frank J. Fabozzi, *Investment Management* (New Jersey: Prentice Hall, 1994), 374.

²⁶. Ibid. 375.

²⁷. Ibid. 378.

1.4.6 Step-up Bonds

The coupon is being paid in this type of bonds. However that coupon is paid in low ratio but raises to a higher coupon rate gradually.²⁸

1.4.7 Revenue Bonds

This is special type of municipal bonds; such bonds are issued for either project or enterprise financing where the bond issuers pledge to the bondholders, the repayment is guaranteed by the revenue generated by the projects which is being financed.²⁹ In the said activity all generated revenue is being put into a revenue funds and all disbursements for expenses are made from the revenue funds. Airport revenue bonds, college and university revenue bonds, hospital revenue bonds and toll road and tax revenue bonds are the examples of the revenue bonds.

1.4.8 Convertible Bonds

A convertible bond presents an additional advantage to the bondholders. It may be exchanged (converted) for a specified number of shares of common stock.³⁰ If the price of the common stock rises then the value of the bond must rise. The convertible bonds are hybrid-type security with a pick and choose option for the investor either to get share of the common stock in accordance with the terms of bond indenture or still possess a debt obligation of the company.

1.4.9 High Yield Bonds

Bonds of high yields (interest rate) are called junk bonds. The high yield trend was introduced in U.S in the 1970s and in 1980s. These bonds were used to raise large sums of money for takeover

²⁸.Ibid.

²⁹.Revenue Bonds, Wikipedia, the free encyclopedia<http://en.wikipedia.org/wiki/Revenue_bond>(last accessed Dec 12, 2009).

³⁰.Thomas C. Noddings, *The Investor's Guide to Convertible Bonds* (USA: Library of Congress Catalog,1982),13-14.

bids. These bonds slowly became notorious because huge amount was raised through these bonds by entrepreneurs who made companies much bigger than they were. These bonds are used to finance takeover, mergers or to finance start up firms with little amount of capital and it is being used by those financial institutions who are agree to accept the larger risk in order to earn the higher yield. Some of the junk bonds do have collateral however some are debenture and may be subordinated to the firm's other obligations. These bonds have a higher risk of default.³¹

1.5 Risks associated with Bonds

In bond issuance, the risk is associated in all types of debt but the most important risks are that the interest and principal amount may not be repaid, price of debt may decline and inflation will continue or bonds will be recalled before maturity. These risks vary with different types of debt, in some bonds there is very high risk like high yield bonds and there are very less probability of risk on the interest and principal repayment on the bonds issued by federal government. The reason of safety is that federal government has power to levy tax to generate money. The different types of risks are described below.

I Price Risk

The fall in the market price of securities that the holder own, is called risk.³² The prospect market value of the portfolio is not known with certainty and the value can be declined in future. This risk is called price risk.³³

³¹.High-Yield debt. Wikipedia the free encyclopedia,< http://en.wikipedia.org/wiki/High-yield_debt>(last accessed Dec 12, 2009).

³².Investopedia,A forbes digital Company, Financial theory, < <http://www.investopedia.com/terms/p/pricerisk.asp>>(last accessed Dec 20, 2009).

³³.Frank J. Fabozzi, *Investment Management* (New Jersey: Prentice Hall, 1994), 120.

II Credit risk

The issuer of a bond may be incapable to make principal and interest payments on the issue and the said risk is also termed as default risk.³⁴

III Call risk

If a bond is callable, the issuer can redeem it prior to maturity, on defined dates for defined prices. Bonds are usually called when interest rates are falling just to leave the investor to reinvest in the proceeds at lesser rate, called call risk.

IV Interest-rate risk

The price and interest of bonds change in opposite direction when the price of bond increase the interest rate will decrease and vice versa.³⁵ If a bond holder wants to sell his bond before maturity, an increase in interest rate will mean the realization of capital loss. Here the sale of a bond below purchase price is called interest rate risk or market risk.

V Reinvestment risk

The reinvestment risk is the risk that proceeds received in the future will have to be reinvested at a lower interest rate.³⁶ In bond portfolios, reinvestment risk and price risk are contradictory to each other. For example, price risk is the risk that interest rate will rise, reducing the value of a bond portfolio. In contrast reinvestment risk is the risk that interest rate will fall, resulting in any cash flow that is received being reinvested at a lower interest rate.³⁷

³⁴ Frank J. Fabozzi, *Bond Markets, Analysis and Strategies* ((New Jersey: Prentice Hall, 1996), 6.

³⁵ Ibid.5.

³⁶ Frank J. Fabozzi, *Investment Management* (New Jersey: Prentice Hall, 1994),122.

³⁷ Ibid.122.

VI Inflation risk

According to Frank j. Fabozzi inflation risk is also called purchasing power risk. It occurs since the difference in the value of cash flows from a security due to inflation, as measured in terms of purchasing power. For instance if investor purchase a bond on which they can realize a coupon rate of 10% but the rate of inflation is 12% the purchasing power risk of the cash flow actually has declined.³⁸

Inflation risk is introduced to the investors before buying the bonds however in floating-rate bond there is low level of inflation risk.

VII Exchange-rate risk

The exchange rate risk also called currency risk. This risk occurs when in the conversion of different currencies, one depreciate as compare to the other. For instance if an investor purchases a bond who's payment is in euro. If the euro depreciates relative to US dollar, only some US dollars will be received and when euro appreciate relative to us dollar, the investor will get profit by receiving extra dollars.

VIII Liquidity risk

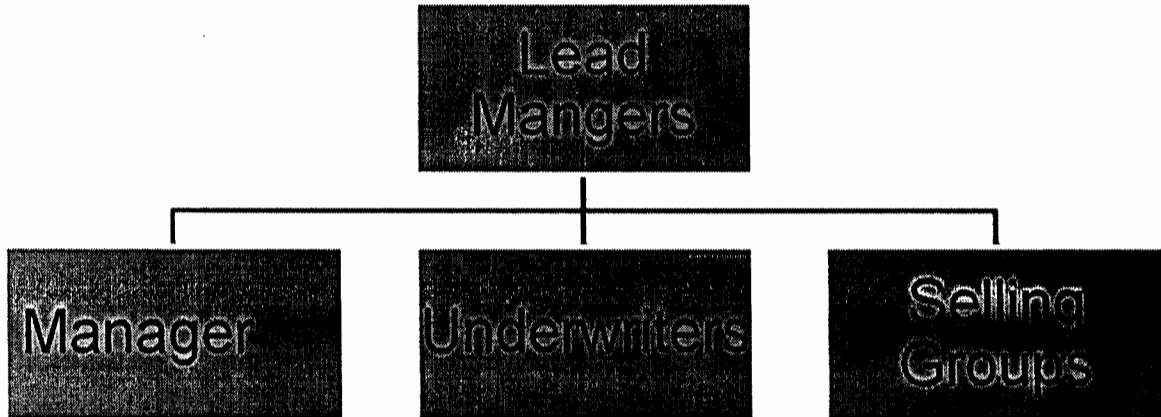
The liquidity is an ease with which conversion of assets can be made into cash when the assets are being sold before maturity that can be sold at its exact value or close to its price.³⁹ When the sale is made before maturity, in case there is big difference between the price asked and the price quoted by the dealer, it is called high liquidity risk. The chances of liquidity are less where investor holds the bonds till maturity.

³⁸.Frank J. Fabozzi, *Bond Markets, Analysis and Strategies*(New Jersey: Prentice Hall,1996),7.

³⁹.Ibid.

1.6 Persons who take part in issuance of Bonds

The following persons involved in issuance of bonds;



The **Lead Managers** use the delegated power for the preparation of documents and the **Mangers** are in charge under their supervision for managing the matter whereas the **Underwriters** underwrite the issue mostly banks take the responsibility to become the underwriters. The professional dealers in securities are the **Selling Groups** who put the bonds with exterior investors.

1.7 Procedure for the issuance of the Bonds

The Managers and Underwriters are generally members of selling group. The Manager fixes the coupon and issues price with the issuer, confirm the commitment of the Underwriters and enter in to the subscription agreement. According to Phillip Wood bonds are allotted to the selling members to whom agreement has previously been sent. In due course the list is obtained; the fiscal agency and trust deed is executed. At closing the proceeds of the issue is provided to the issuer against delivery of the bonds.⁴⁰

⁴⁰.Philip Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell Ltd. Of 11 New Fetter Lane, 1980),182.

1.8 Essential documents for the Issuance of the Bonds

I Prospectus

It furnished the necessary information about the bonds for instance nature of bond, interest rate, principal amount, and maturity date etc.

II Subscription agreement

The agreement between the manager and issuer upon which the manager agrees to purchase the bonds, is called subscription agreement.

III underwriting agreement

This agreement contains the terms and conditions on which the underwriter agrees to underwrite.

IV Selling agreement

The managers and the selling group come on one point where members of selling group agree to enter into the agreement.

V Trust deed

A trustee is appointed where the bonds are issued publically. For the protection of investor rights trustees are appointed. In case of default the trustee can take the debtor to the court for the enforcement of contract.

1.9 Safety measures for Investors provided by Law

The security regulations are altered day by day. It is essential to take some inevitable steps to give the investors security, who are credulous victim in need of legal safeguard. There is no exhaustive list of safety measures for the investor protection however endeavors can be made to minimize the risk. To protect the investor, disclosure of certain information should be made through issuance of prospectus wherein proper orientation of financial condition, description of

the terms of the bond should be conveyed. Free access of information should be available for every investor. The information about annual accounts, detail about proposed and actual drawing, redemption local facility for the replacement of bonds and coupon should be in continuous form, and available to all the investors without any discrimination. The regulatory authority should screen all the documents concerning to information separately. To shield the bondholder's interest, a trustee should be appointed as bondholder representative to guard the investor from notorious dealers and licensed system should be introduced. The solvency and high-quality reputes of the investor will be the requirement for the issuance of license where there will be outlaw and iniquitous means of practices. For the ill-treated investor, civil remedy is available but in case of more vicious deviation (from the issuer side) criminal penalties can be invoked for the culprits.⁴¹

⁴¹. Ibid,179-182.

CHAPTER 2

Introduction to Sukuk

Islam is complete code of life. It encompasses all human activities, from family life, through social, political and economic activities to international relations. All these spheres of activity come within the ambit of Islamic Law.¹ The Islamic law has strictly forbidden the charging interest on loans. In Quran Allah (s.w.t) says “and Allah (s.w.t) has permitted sale and prohibited usury.”² The second source of Islamic law is the Ahadith of Holy Prophet SAWS; the Scholars agree that six Ahadith are the strongest about the prohibition of Riba.

The messenger of Allah cursed the one who accepted riba, the one who paid it, the one who recorded it, and the two witnesses it, He said: “They are all alike”³ At the time when Muslims migrated from Makkah to Madina and were cut off from their wealth and land, the Holy Prophet (s.a.w.s) formulated the Islamic Laws and Shariah compliant rules for the empty handed immigrants by creating brotherhood among Muhajjar and Ansaar in the properties of Ansaar for the re-establishment of immigrants (Muhajjar) and prohibited the charging and paying of interest. That was a big example of the prohibition of Riba and it enlightens us that in the dying necessity the Holy Prophet (s.a.w.s) taught his companions the lesson to abide by the Islamic teachings. Due to the prohibition of Riba, debt market cannot flourish in the countries where Muslim population is an important segment and have sought strict observance of the Shariah. There is dire need for the development of substitute to traditional debt market that can be

¹.See for detail, Dr. S M Hasanzaman, *Encyclopedia of Islamic Banking and Insurance* (London: Institute of Islamic Banking and Insurance,1995),67.

². Al-Quran.2:275.

³. Al-Imam Abbi Al-Hussain Muslim bin al-Hujaj bin Muslam Al-Qashreyyi, An-naisapuri, *Sahih Muslim* Kitab al MUSAQAT, Hadith No 4093 (Riyyad: Dar-usslam linashar watozi)697.

compatible with Shariah rules. The ultimate purpose of Islamic Law and Islamic Financing is elimination of prejudice financial dealings and to bring about equal distribution of wealth in the society, there are numerous examples of Islamic modes of transactions like Mudarabah, Musharakah and Ijarah are prevailing since the period of Holy Prophet (s.a.w.s). The recent innovations in Islamic finance have changed the dynamics of the Islamic finance especially in the area of bonds and securities. The use of Sukuk or Islamic securities has become increasingly popular since few years.

Sukuk have developed as one of the significant mechanism for raising funds in the international capital markets through acceptable (Islamic) structures. The multinational corporations, sovereign bodies, state corporations and financial institutions use international Sukuk as an alternative to syndicated financing.⁴

2.1 Meaning of Sukuk

The literal and technical meanings of Sukuk are following;

2.1.1 Literal meaning of Sukuk

Sukuk are termed as an Islamic bond, but a more accurate translation of the Arabic word would be “an Islamic investment certificate”.

In Arabic term “Sukuk” is as plural of “Sakk” which means a security or bond.⁵ It has also been described as “to hit” or “to strike one’s seal on a document”, or to “imprint one, s mark on a clay tablet.”⁶

⁴.Shariq Nisar, *Islamic Bonds (Sukuk): its introduction and application: finance in Islam*, February 12, 2007, <http://www.financeinislam.com/article/8/1/546> (last accessed January 10, 2010).

⁵.Muhammad Ayub, “*Potential of Ijarah Sukuk in Islamic Finance*,” (Karachi: National Institute of Islamic Banking and Finance, 2005), 1.

⁶.Nathif J. Adam and AbdulKader Thomas, *Islamic Bonds* (London: Euromoney Books Nestor House, 2004), 43.

2.1.2 Technical meanings of Sukuk

The AAOIFI, Shariah Standard No 17 defines Sukuk as certificates which represent undivided shares in ownership of tangible assets, usufructs and services or (in the ownership) of the assets of particular projects, or special investment activity however, this is factual after delivery of the value of the Sukuk assets , the closing of subscription and the payment of funds”.⁷

Zamir Iqbal and Horishin Tsubota hold the view that the Sukuk reflect participation right in the underlying assets. The purpose of security is derived from the conventional securitization procedure in which a SPV is set-up to obtain assets and to issue financial claim on the asset”.⁸

The Maurice Shohet concluded that Islamic financial bonds (Sukuk) are new devices and their existence is seen in the market from the past half decade. They are compatible with Shariah due to prohibition of interest and trading of debt. The said bonds are backed by corporeal property.⁹

The Sukuk are papers and certain rights have attached with them for their holders. When any financial institution/issuer/borrower is short of cash, it borrows money and gives its Sukuk as evidence of financial obligations. The purchaser of these Sukuk lends money to these institutions and they become entitle for return.

2.2 Significances of Sukuk

The significant element of the Sukuk is that these are written financial instruments; Shariah also encourages the documentation of contract as described in Surah 2 Verse No282:

“When you deal each other, in transactions involving future obligations in fixed period of time, reduce them in writing. It is more just in the sight of God, more suitable as evidence and more

⁷.Accounting and Auditing Organization of Islamic Financial Intuitions, *Shariah Standards*,(Manama:2003),298.

⁸. Zamir Iqbal and Hiroshi Tsubota, “The World Bank Emerging Islamic Capital Market” http://treasury.worldbank.org/cmd/pdf/Euromoney_2006_Handbook_International_Debt_Capital_Markets.pdf (last accessed January 10, 2010).

⁹.Maurice Shohet, “Islamic Banking Sukuk and Murabahah: the memri economic blog,” August 20, 2007,<http://www.memrieconomicblog.org/bin/content.cgi?article=10> (last accessed January 10, 2010).

convenient to prevent doubts among you.”¹⁰

For the development and growth of any economy, efficient financial system is very efficacious. For that purpose, financial system should be very resilient to assist the government to implement the monetary policies. The economy of a country has far-reaching impact on its nationals so the augmentation of nations is in vigorous economy.

All the evils, squabbles and discriminations among the nations are due to money, by elimination the concept of wealth from the world, evils, crimes and destruction of other's rights can be brought to an end but this type of elimination is unattainable. Everybody living in this world is in need of money. To earn money one need to expand the business. Sometimes this expansion requires borrowing either privately or publically. These are also called investment funds like bonds, shares, and derivatives etc. These are interest based instruments therefore Shariah Scholars have given a substantial thought to bring an alternate. The Sukuk have been introduced from last decade and have gained momentum as an Islamic substitute of financing. When the investors want to invest in halal profit they contribute in business venture that will has strict conformity with the percepts of Islamic Shariah.

In Islamic modes of investment securitization is the new phenomenon which introduced a process of pooling of the non marketable and illiquid assets into tradable certificates of investment. The person who invests his money is called subscriber/investor and he receives a certificate for the entitlement of subscription and after the initiation of business the subscribers get agreed pro-rated profits, this return is not absolutely fixed but variable or quasi fixed. The subscribers must know that return on their subscription is linked-with the profit and loss sharing. If the Funds generate profit, the subscribers will get increase to that proportion similarly they have to bear loss, if the entity suffers loss. If the loss is caused by any negligence of management

¹⁰. Al-Quran.2:282.

then only management has to accommodate the same.

The radical step was taken by the government of Pakistan when it decided to bring about an absolute change in economic system in 1979 by enforcing the law for compulsory deduction of Zakat with interest free banking system in the country in 1980. Under the policy of Islamization of the economy the banking industry in Pakistan started a new procedure wherein the payment and receipt of interest on the domestic funds was prohibited. However, the depositors have to pay proportional proceeds and the fund recipients are required to pay proportional share of rent, profit or mark up as the case may be.¹¹

All the above mentioned steps have changed the dynamics of the finance industry. The conventional system is being replicated by the Islamic system. The financing through the issuance of Sukuk is Shariah compliant and does not take advantage of interest rate movements. In this phenomenon a large number of people can participate in financing of projects. The versatility of this framework is that it can be applied on all types of legitimate assets including infrastructure such as roads, airports bridges and ports. This distinctive nature of Sukuk generate predictable income stream regulated by Shariah.

In a policy paper, discussing the “Islamic Bonds Issuance” the author says that he has posed many new challenges for debt managers because structured finance instruments are receiving increasing intention owing largely to enabling capital market regulations and financial innovation, amid an establishing greater inclusiveness of Shariah compliance. The above mentioned paper says that the sovereign Sukuk are likely to gain popularity as more governments in both Muslims and non Muslims countries explore options to diversity their traditional debt

¹¹ .Dr Habib ur Rehman, *Islamic financial instruments* (Peshawar Cantt: Sardar Khan Welfare Trust (regd) 2003),158.

portfolios.¹²

2.3 Difference between Sukuk and Bonds

Sukuk are in consonance with the conventional bonds in generating profits or to accomplish the requirements of financial institutions and entities. However they have certain features which distinguish Islamic Finance System from conventional finance system. Some of the points of difference are as follows.

1-Sukuk are not a debt of issuer but they represent actual ownership in well defined assets, usufructs, projects and business activity or services as Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI) Shariah Standard No 17 Para 4/2 describes that: Investment Sukuk represent a common share in the ownership of the assets made available for investment whether these are non-monetary assets, usufructs, services or a mixture of all these plus intangible rights, debts and monetary assets. These Sukuk do not represent a debt owed to the issuer by the certificate holder.¹³ However Bonds do not represent ownership on the part of bond holders in the commercial and industrial enterprises for which the bonds were issued. Rather, they document the interest bearing debt owed to the holders of the bonds by the issuer, the owner of the enterprise.¹⁴

2- Sukuk are asset backed securities and these underlying assets are Islamically permissible in both their nature and use. As stated in the AAOIFI Shariah Standard No 17 Para 5/1/1 that: "It is permissible to issue investment certificates by way of subscription on the basis of any of Shariah nominated investment contract."¹⁵ However Bonds are not assets backed securities and may be used to finance the activity that may not be permissible in Shariah but legal in its jurisdiction. In

¹².Ahmed Amin, "Sharp rise in Sukuk issuance," Dawn, August 09, 2008, Business Section.

¹³. Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*,(Manama:2003),300.

¹⁴.M. Taqi Usmani, "Sukuk and their contemporary application".

<http://www.muftitaqiusmani.com/Downloads/Publications/Articles/Sukuk.pdf>

¹⁵. Ibid.301.

issuance of bonds, nature of contract, its usage and underlying phenomenon is not given such importance and parties' core intention is to earn money on money which is called riba. -

3-The Sukuk holders have right to claim on the specific underlying assets. The Bond holders do not have right to claim on assets directly. However principal and return is guaranteed by issuer at maturity, whether the entity gained profit or suffer loss.

4 -The Sukuk holder share the return from the assets, projects and services limited to the extent of participation in the issue. As stated in the AAOIFI Shariah Standard No 17 Para 4/5 that "the owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificate owned (held) by them."¹⁶On the other hand bondholders have not any relation with assets, usufructs and projects and simply rely on credit worthiness of the issuer. Generally creditor can claim on the borrowing entity in case of default or failure of issuer, creditor reserves the right of lien on assets. In case of bankruptcy of issuer, the issuer cannot take loopholes from the payment which is due upon him from the creditor.

5-The sale of Sukuk is a sale of ownership as AAOIFI, Shariah Standard No 17 Para 4/1 describes that : investment Sukuk are certificates of equal value issued in the name of the owner or bearer in order to establish the claim of the certificate owner over the financial rights and obligations represented by the certificate.¹⁷ The sale of bond is sale of debt only.

6-When investor desires cash he can sell his share of Sukuk either wholly or a part thereof. There is no constraint in the sale and purchase of share in Sukuk. As AAOIFI, Shariah Standard No 17 Para 4/4 describes that: trading of investment Sukuk is subject to the terms that govern trading of the rights they represent¹⁸ whereas in bonds, sale can only be made after the maturity of the life of bond.

¹⁶.Ibid.300.

¹⁷. Ibid.300.

¹⁸. Ibid.300.

7-Sukuk holders are entitled to share the revenues generated by the Sukuk as well as, share in the proceeds of realization of the Sukuk assets, because Sukuk holders have beneficial right in the underlying assets.¹⁹ As AAOIFI, Shariah Standard No 17 Para 4/5 describes that: The owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates owned (held) by them.”²⁰ However in bonds regular interest payments are made to the bond holders. The amount of interest is determined as a percentage of capital and not as a percentage of actual profit. Sometime the interest is fixed, while often time in bonds with longer tenure the rate is allowed to float.²¹

8- Sukuk are connected with real sector activities, hence they will not create short term speculation over funds like bonds.²²

2.4 Difference between Sukuk and Shares

Sukuk are different from shares in a number of ways, some points of difference are as follows;

1-The Sukuk represent ownership in well defined assets whereas shares represent ownership in the whole company/corporation.

2- Being asset backed securities, Sukuk holders have right to claim on the specific underlying assets. The Sukuk holder will share the return from the assets, projects and services limited to the extent of participation in the issue. The AAOIFI Shariah Standard No 17 Para 4/5 states this position in the following words: The owners of these certificates share the return as stated in the subscriptions prospectus and bear the losses in proportion to the certificate owned (held) by

¹⁹. Noor Ahmed Memon , “Structure of Islamic Bonds and Managing Financial Risk of Sukuk,”(Karachi: Institute of Business and Techonology,2008).43.

²⁰. Accounting and Auditing Organization of Islamic Financial Intuitions, *Shariah Standards* (Manama:2003).300.

²¹. Muhammad Taqi Usmani ; “Sukuk and their contemporary application”

<http://www.muftitaqiusmani.com/Downloads/Publications/Articles/Sukuk.pdf>

²².Noor Ahmed Memon ; “Structure of Islamic Bonds and Managing Financial Risk of Sukuk.” (Karachi: Institute of Business and Techonology, 2008):47-48.

them”.²³ On the other hand shares are not assets backed instruments therefore shareholders claim ownership on the whole company and held responsible for the affairs of the company limited to the extent of holding the shares in the company.

3-Sukuk ownership in specified assets is for fixed time period as agreed upon among the parties whereas representation of shares in a company is for indefinite time period.

2.5 Kinds of Sukuk

2.5.1 Ijarah Sukuk

2.5.2 Mudarabah Sukuk

2.5.3 Musharakah Sukuk

2.5.4 Murabahah Sukuk

2.5.5 Salam Sukuk

2.5.6 Istisna Sukuk

2.5.7 Muzar'a Sukuk

2.5.8 Mugarasa Sukuk

2.5.9 Musaqat Sukuk

2.5.10 Contractor Sukuk

2.5.1 Ijarah Sukuk

Ijarah: The term Ijarah is originated from the Arabic word which gives meaning of reimbursement or remuneration for the services provided by an individual. It also indicates for the payment made by one person to another for the utilization of a specific asset over a period of

²³. Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards* (Manama:2003),.300.

time.²⁴

Legitimacy of Ijarah

The legality of Ijarah is established by the Quran as Allah has said “And if they suckle your (offspring) give them their recompense.”²⁵

2.5.1.1 Different types of Ijarah

I Specific lease

In this sort of contract the lessee is allowed to require from the lessor the similar thing²⁶, which has particularly been mentioned, amid them at the time of contract. For example Mr. Ali rents out a flat no D to Mr. Zaid against rent of Rs 50 only for a period of one year but later on Mr. Ali changes his mind and offer to Mr. Zaid the flat No “C” which is situated in the same location and providing equal level of facilities. Here the lessee has right to demand for the flat “D” for which the contract was made.²⁷

II Service lease or General lease

Under this type of lease the lessee is concerned only with the service already contracted. The origin of service and the mode thereof is left open to the lessor. It is the responsibility of the lessor to fulfill the commitment. For example “X” approaches “Y” and demands some labor for the construction purposes. “Y” agrees to provide labor at a predetermined rate per Labor Day for a period reciprocally agreed, “X” will disburse amount of contract and “Y” will provide numbers of labors required for the accomplishment of the project. Here “X” is not concerned with the

²⁴.See, Dr Habib ur Rehman, *Islamic financial instruments* (Peshawar Cantt: Sardar Khan Welfare Trust (regd) 2003),185.

²⁵.Al Quran, 65:6.

²⁶.Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003),230.

²⁷. Muhammad Imran Asharaf Usmani, *Meezan Bank's Guide to Islamic Banking* (Karachi: Darul Ishaat,2002),148.

color and dogma of labor rather he will pay according to the work done²⁸.

III Financial Lease

The financial lease is based on a contract between the lessor and the lessee for hire of a specific asset selected from a manufacturer by the lessee. The lessor retains the ownership of the asset and the lessee has possession and use of the asset on payment of specified rentals over a period.²⁹

This lease is sale by the lessor to the lessee (purchaser) where risk and reward transfer to the lessee. The distinction point of this lease is that at the end of the lease period lessee obtain the ownership of the leased equipments.³⁰

IV Operating Lease

Its time period is not with the life of equipments and the same will be returned to the lessor at the end of lease period without any future obligation.³¹ In this lease the residual value is recovered through disposal or re-leasing the equipment to other users. The risk of damage and depreciation is borne by the lessor.³²

2.5.1.2 Important Rules of Ijarah

I Subject matter of contract

The subject matter of Ijarah should be valuable, identifiable and quantifiable in clear terms. Any type of ambiguity will render the contract invalid. At the time of contract both parties should know the nature of the assets to be benefited. The subject matter and its use should be

²⁸. Mahmoud,A.El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge university press,2006),102.

²⁹. Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003).235.

³⁰. Mahmoud,A.El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge university press,2006),103,104.

³¹.Ibid.

³².Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003).236.

permissible under Shariah principles. The things of perishable nature cannot be subject matter for Ijarah contract.³³

II Ownership of subject matter

In the corpus of leased asset, ownership remains with the original owner, only the right to use transfers to the lessee. Similarly all the liabilities pertaining to ownership of asset will be borne by the owner and all the expenses relating to maintain the asset in operating condition will be borne by the lessee.³⁴

III Period of Lease

The period of lease can be long or short but it should be certain and specified in absolute terms. According to Imam Abu Hanifa the lease period should not be more than three years. The long period of lease creates disputes among parties and the person using the hired property from a long time, claims ownership.³⁵ As now a day's people vacillate in renting out the house to lawyer because after using the property they claim ownership and order the owner to vacate the house.

IV Purpose of lease

The purpose of lease should be specifically mentioned in lease agreement. If the lessee uses the asset in any other way for which the asset was not hired and damaged the leased asset then he is liable for compensation and if there was an animal and lease used in unusual manner and caused the death of animal he has to indemnify the lessor but the lessee will not be accountable for

³³. Muhammad Imran Asharaf Usmani, *Meezan Bank's Guide to Islamic Banking* (Karachi: Darul Ishaat, 2002), 147.

³⁴. Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003) 231.

³⁵. Ibid, 232.

some unavoidable harm and loss which is beyond the control of the lessee.³⁶

V Joint owned property

A jointly owned property can be leased out and rental shall be distributed among them accordingly. Similarly if any one among the joint owner wants to lease out his proportionate share he is allowed to give his share to his co sharer only and not to anyone else.³⁷

2.5.1.3 Rules of rentals

All the terms and conditions about rentals should be specifically mentioned at the time of contract. Different amount of rent can be specified for different lease period. The rental payment can be adjusted to LIBOR³⁸ or KIBOR³⁹ and thus can be revised periodically with the ups and down of the said benchmarked standard, such benchmarking is controversial among the Scholars due to the likelihood of interest. They argue that benchmarking is similar to lending on interest. To overcome this controversy, a ceiling on maximum and minimum rental can be fixed, which eliminates the gharar by ensuring both the parties clear responsibilities.⁴⁰

The commencement of lease period shall start from the date on which the leased asset has been delivered to the lessee. Any type of increase in the rental unilaterally by the lessor only shall not be allowed.

2.5.1.4 Binding promise in leasing to sell the property at the end of lease period

The object/subject matter of a lease agreement should be known, permissible and accessible

³⁶.Ibid, 233.

³⁷.Ibid,233.

³⁸.London Inter Bank Offer Rate.

³⁹.Karachi Inter Bank Offer Rate.

⁴⁰.Ioannis Akkizidis and Sunil Kumar Khandelwal, Financial Risk Management for Islamic Banking and Finance (New York: Palgrave Macmillan, 2008),22.

usufructs, and rent on so called subject is called the price or compensation for that usufruct.⁴¹

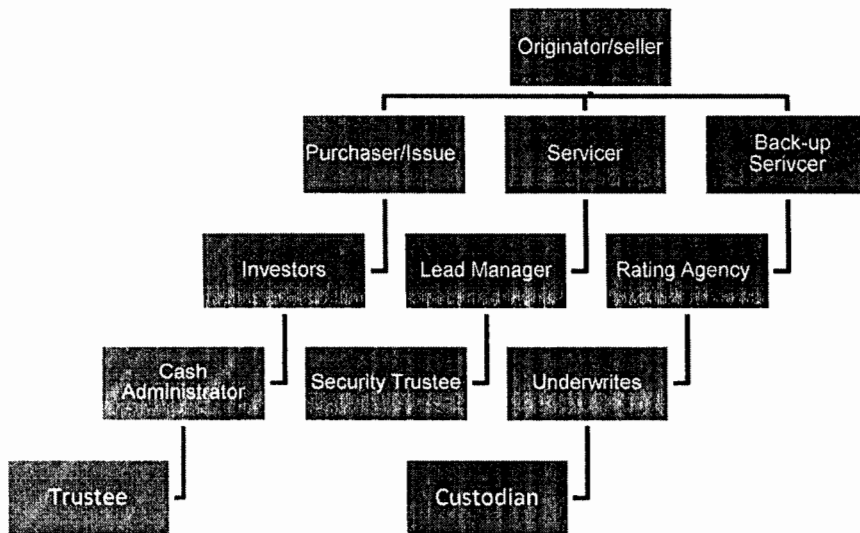
The property can be leased out prior to obtaining it or for a future starting date. Mostly in the structure of Sukuk the property is sold out to the SPV by the owner of the property and on maturity of the lease period the property is taken back either through sale transaction or as a gift many contemporary Jurists intimated that the stipulation in the lease contract that property should be sold back at the end of lease period is not allowed. According to Jurists the reason of prohibition is the tradition of the Holy Prophet (s.a.w.s) that “two contracts in one” or “two sales in one contract is not allowed.” One way out from the prohibition is that lessor may make a unilateral promise to sell the property or to gift the property at the lease end but this promise should be independent from the lease contract itself. The said promise once made would become binding upon the lessor and it must not be made a condition of the lease. The promise is not binding for lessor if the lease is not concluded otherwise it would be binding.

However according to Justice Usmani one-sided undertaking to give the property as gift is binding just like the promise to sell the property at the end of lease period.⁴² Here Common –law provisions and Classical rules are the same that uncompensated (unpaid) transactions are not binding and there should be some financial consideration even minimal or symbolic with the unilateral promise to sell the property at lease end.

⁴¹.Mahmoud,A.El-Gamal, Islamic Finance: Law, Economics, and Practice (Cambridge: Cambridge university press,2006),98.

⁴². Ibid, 99.

2.5.1.5 Parties involved in Sukuk al-Ijarah



These above said are numerous parties that play pivotal role in issuance of Sukuk al-Ijarah.

2.5.1.6 Role of SPV in issuance of Sukuk

The SPV stands for Special Purpose Vehicle which is legal entity, designed for the management of securities issues. The Characteristics of SPV are thin capitalization and bankruptcy remoteness by owning the title of the assets, issuing the securities to the subscribers. It is an inert entity that's why termed as trust. The sole purpose of its creation is to own the assets which are going to be reserved for the issuance of Sukuk. The rational to create the SPV or PSE is to mitigate the legal issues. The basic problem in Sukuk transaction is segregation of assets from the original owner. The SPV issues Sukuk certificates to investors and use the proceeds for purchasing the revenue generating assets or cash generating property from financial institution or any other entity. The SPV leases the purchased property or give back on lease (if the lessee is

the same party from whom SPV has purchased the assets) to the financial institutions.⁴³

The period of lease is corresponding to the duration of Sukuk with the assets being held on trust for the Sukuk holders. The rental proceed must match and equal to the payment to the Sukuk holders.

The rental payment can be fixed or calculated with reference to the interbank offered rate plus a margin which represents the market rate for rental payments.⁴⁴

All the payments to the SPV by financial institution under the Sukuk transaction should be direct, unconditional and irrevocable. Once the sale and transfer of the assets is affected the title risk transfer to the SPV and this is foundation that he owns the assets as well as bears the risk which entitles him for profit from the underlying assets. The rights of ownership of SPV cannot be challenged, annulled or otherwise averted in an insolvency or bankruptcy of the original owner. However SPV's ownership is constructive on the assets and has not any shareholding with the original owner of the assets. The SPV pays the price and gets the ownership of the assets. After completion of sale transaction SPV issue Sukuk at its own. On maturity, SPV is under obligation to purchase the property, the proceed of which will be used by the SPV for the repayment of the principal to Sukuk holders.

2.5.1.7 Ijarah Sukuk

Sukuk al-Ijarah is newly emerged and latest product in the Market. Islamic Financial Institutions demand it due to its acceptance among Shariah Scholars. This rapidly gaining importance product is very useful for mobilizing funds for fiscal needs and for long term financing of mega projects. The concept of Ijarah Sukuk is a substitute to conventional bonds. The issuance and marketability of these assets have flexibility in it and no any type of complexity is found. So

⁴³. Muhmmad Ayub, *Understanding Islamic finance* (England: John Wiley & Sons, Ltd, 2007), 394-395.

⁴⁴. Ibid.397.

financial intermediaries, private and public entities can issue these instruments.

Ijarah Sukuk are certificates or securities representing the ownership of well defined and known assets tied up to a lease contract, so Sukuk should represent real ownership of the leased assets and not only a right to receive rent. The three parties involve in Ijarah Sukuk agreement; (1) the issuer, can also called originator, initiator or beneficiary (2) the special purpose vehicle (SPV) or issuer or special purpose entity; and (3) the investor can be named Sukuk holder, successor-in – interest and nominee. The originator creates special purpose vehicle (SPV) to whom he passes through the selected assets with the understanding that he will lease back the assets from the said legal entity.

The terms and conditions of rentals are signed by the concerned parties. The SPV with separate independent legal personality issues Ijarah Sukuk to the investors after securitization of its assets. This certificate will represent the holder's proportionate ownership in the leased assets and the lessor will assume the rights and obligations of the owner/lessor to that extent (his own share). The beneficiary-cum- lessee passes the rent to the SPV which is paid by him to the Sukuk holder. There are very less probabilities of risk and liquidity is possible effortlessly. At the expiry of lease period, Sukuk holder own the assets if the said assets have not market value then the investors will get capital loss and vice versa. Therefore, in the case of total destruction of the asset; Sukuk holder will suffer the loss to the extent of his ownership. Sometime the underlying assets have no market value and initiator is not interested to take back the said assets and the investors suffer loss so this phenomenon discourages the Sukuk holders to invest in this type of business. Sukuk contracts embeds a put option on the Sukuk holder that initiator will buy back the assets on face value upon maturity. However AAOIFI Shariah Standard No17 Para 5/2/2 puts objection on this type of arrangement, describing "in the case of negotiable Sukuk, it is

permissible for the issuer, to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however it is not permissible for the issuer to undertake to purchase the Sukuk at their nominal value.”⁴⁵

These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as an instrument easily convertible in to cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.⁴⁶

2.5.1.8 Important rules about trading of Sukuk

The Sukuk which are tradable must represent ownership for their holders along with all other rights and obligations related to ownership. It makes no difference whether the assets are tangible or usufructs or services, their possession and right to dispose-off must be legal and should be compatible with Shariah. The manager should keep the record about the transfer of Sukuk and not to show as his own assets. It is not permissible for the investment manager, partner or agent to agree for purchase of assets from Sukuk holders on nominal value at maturity, but permissible to agree to purchase the assets at market value. As AAOIFI, Shariah Standard No 17 Para 5/2/2 describes that: In the case of negotiable Sukuk, it is permissible for the issuer to undertake to purchase back, through the prospectus of issue, any certificates that may be offered to him; however, it is not permissible for the issuer to undertake to purchase the Sukuk at their nominal value.⁴⁷

In Sukuk al-Ijarah lessee can take Sukuk on maturity for their nominal value as long as he is not

⁴⁵. Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama: 2003),306.

⁴⁶.Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking*(Islamabad: ShariahAcademy,2003),207.

⁴⁷.Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standards* (Manama, 2003),306.

Investment Manager or Agent. The tradability of Sukuk al-Ijarah in Secondary Market is possible, as it is backed by real assets whereas Sukuk structured otherwise like on pure receivable may encounter to Shariah because Shariah bans debt trading.

2.5.2 Definition of Mudarabah

In business perspective, the term has been used for earning livelihood,⁴⁸ in an investment partnership where the entrepreneur is provided capital by the investors in order to run an investment activity. Profit ratio is pre-determined however, in case of loss investor bears the loss and Mudarabah loses only the expected income.⁴⁹

Legitimacy of Mudarabah

The Quran says; “And others who journey through the earth seeking the bounty.”⁵⁰

2.5.2.1 Mudarabah

In Mudarabah contract, two or more persons enter into a partnership contract where one gives money that is called capital. He is called Rab-ul-mall or sleeping partner. The other partner is called Mudarib. All the activities related to business management run by mudarib and profit generated from business is divided among the partners according to (pro-rata) which was agreed upon at the time of contract.

2.5.2.2 Important Rules of Mudarabah

According to financial statement of the Islamic banks, on the liabilities side, the depositors serve as rabb-ul-mal and the bank as Mudarib and on the assets side, vice versa. The deposits for Mudarabah purpose can be either general, like common pool, or restricted to a certain project or

⁴⁸.Dr. Habib-ur-Rehman, Islamic Financial instruments (Peshawar Cantt: Sardar khan Trust (Regd), 2003),175.

⁴⁹.Islamic Finance Training, “Definition of major Islamic Financial instruments, A Redmoney Product”, Islamic Finance Training,

<<http://www.islamicfinancetraining.com/glossary.php> > (last accessed January10, 2010).

⁵⁰.Al Quran,73:20.

specific line of business.⁵¹

Capital for mudarib must be in cash form but according to Hanafi and Hanablies, equipment and land can be used by converting them into cash through sale. The amount for Mudarabah must be evaluated in clear terms; any indeterminacy pertaining to capital renders the contract invalid. The Capital must be handed over to the Mudarib so that he can take the initiative for the business.

2.5.2.3 Mudarabah Sukuk

Mudarabah Sukuk are financial documents which expand the business area by creating opportunities for the public to participate in the business very essential for the development of any economy. Mudarib has exclusive right to manage the Mudarabah business. The person who issues the Mudarabah certificates is called Mudarib. The sukuk holders finance the activity by contributing that is called Mudarabah capital. Both parties share the profit according to the agreed ratio.

In terms of the resolution of the Islamic fiqh council of the OIC (fourth session, 1988) the following are the salient feature of Mudarabah Sukuk/Certificates: The Mudarabah Sukuk represent common ownership and entitle their holders to a share in the specific projects against which the Mudarabah Sukuk (MS) have been issued.

Basic requirement of MS contract is that, there must be the prospectus, which can provide all information required by Shariah for the said contract, like capital, the ratio for profit and all other conditions related to the issue, which must be compatible to Shariah.⁵²

The Mudarabah Sukuk holder has right to sell the Sukuk according to these three conditions:

1.If the sale is before the operation of activity and capital is in form of cash then it will be like exchange of money for money and the transactions should fulfill the Shariah compatible criteria

⁵¹.Mabid Ali Al-Jarhi and Munawar Iqbal , Islamic Banking: Answers to Some Frequently Asked Questions, Occasional Paper No 4,(Jeddah: Islamic Development Bank,2001),14.

⁵².Muhammad Ayub, Understanding Islamic Finance (England: John Willy & Sons, Ltd, 20007), 398.

of Bai'al Sarf;

2. If the Mudaraba capital is in the form of debt, this sale must be according to Islamic debt trading rules.

3. If the Mudarabah capital is mixture of the liquid and non-liquid assets then trade must be according to market price.

The SPV can also contribute in investment by providing funds. SPV will be entitled for the profit along with the profit as Mudarib. The Manger and the issuer must not give any type of guarantee for the capital or a fixed profit from the investment. The profit should be divided among the parties according to Shariah compliance rules and Profit and Loss Account of the project must be published and disseminated to the MS holder. In each accounting period some funds from the profit can be reserved for uncertain events.

2.5.2.4 Trading in Mudarabah Sukuk

After the completion of subscription, settlement of the certificates and commencement of activity, trading and redemption of Mudarabah Sukuk is allowed. As stated in the AAOIFI Shariah Standard No 17 Para 5/2/16 that: "it is permissible to trade in Mudarabah, Musharakah and Investment agency certificates after closing of subscription, allotment of the certificates and commencement of activity with respect to the assets and usufructs."⁵³

2.5.3 Musharakah

2.5.3.1 Literal meaning of Musharakah

The word "Musharakah" is from Shirkat" which denotes mixing up of two commodities in such a way that distinctive identity of each commodity, lost."⁵⁴

⁵³. Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama: 2003),307.

⁵⁴.Dr.Habib-ur-Rehman, Islamic Financial instruments(Peshawar Cantt: Sardar khan Trust (Regd),2003),161.

2.5.3.2 Musharakah in general

In Musharakah contract all partners contribute to run business to get profit. The Musharakah based business is highly uncertain so partners bear the risk of loss which justifies the appropriation of profit. Musharakah is also similar to conventional partnership where each party contributes the capital in their certain capacity and every partner can take part in the management according to his share of investment. The profit of the each partner would be as proportion of final total profit and in case of loss every partner will share the profit to the extent of the amount he has invested. The parties should be competent and enter into contract without any duress, fraud and undue influence. The capital should be in qualified, quantified and in liquid form.

Legitimacy of Musharakah

Allah says: "And verily many partners oppress one another, except those who believe and do righteous deed, and they are few."⁵⁵

2.5.3.3 Types of Musharakah;

I Permanent Musharakah

II Diminishing Musharakah

I Permanent Musharakah; If the company is incorporated in whose equity the bank partake, the ownership of bank will be in common stock with entitlement of an annual shares of profit on pro rata basis. However if the company is private then banks ownership will be in shares.

II Diminishing Musharakah; here a financier and a client jointly purchase a commodity or partake in commercial enterprise in a way that client purchase the shares of the financier one by

⁵⁵.Al Quran, 38:24.

one from time to time. So all the all the assets are owned by the client and he becomes the sole owner of the property.⁵⁶

2.5.3.4 Musharakah Sukuk

The Musharakah contract is just like partnership contract. Here funds can be mobilized to constitute a new investment activity or to flourish the existing one, for the required capital, the Sukuk are issued and sold to the investors. The mobilized subscription proceeds are used in the project development as per the planned activity.⁵⁷ They distribute profit according to agreed ratio on pro rata basis and lease certain equipment or infrastructure assets through a specially formed Musharakah.

The Musharkah based structure is deemed more appropriate than the Mudarabah structure, just because it entails the phenomenon of profit and loss sharing between the fund Manager and the Sukuk holders, not only profit-sharing.⁵⁸

These Sukuk are used in enhancement of public participation in mega projects. The people can make contribution through meager capital as well. They become the owner of the asset as per their respective shares. The loss is also shared according to capital invested in the activity. Musharakah is safer activity for financing due to its in-built phenomenon of profit and loss sharing among the fund managers and Sukuk holders. Musharakah Sukuk are treated as negotiable instruments and can be traded freely in the secondary market.

⁵⁶. Muhammad Imran Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking* (Islamabad: Shariah Academy, 2003), 115.

⁵⁷. Soahil Jaffer, *Islamic Asset Management* (United Kingdom: Euromoney Books, 2004), 174.

⁵⁸. Ibid. 170.

2.5.3.5 Trading of Musharakah Sukuk

When the allotment becomes close and initiation of activity get started then trading in Musharakah Sukuk is allowed.

2.5.4 Murabahah

Murabahah: the word Murabahah is originated from the word “ribh” which means profit.⁵⁹

The Murabahah is sale of goods at a price covering the purchase price plus profit margin agreed upon between the contracting parties.⁶⁰ When the buyer needs any commodity but he has not amount at hand, then he can buy on credit. The price can be higher than the spot price. This sale is compatible with Shariah. The Murabahah financing is optimal transaction for the bank to earn more with short term risk.

In general sale, price of commodity is not told to the purchaser but in Murabahah sale the seller tells the original price plus profit margin which he is going to take from the buyer. For example the purchaser has purchased a commodity of Rs 500/- and want to get profit of Rs 50 then he should tell the exact price and the price which has incurred on the product with the profit he wants to take. This sale can be on cash or deferred payment in installment at certain intervals agreed upon in the contract. The reason of deferred payment is that the client may not have cash otherwise he will not resort to the bank.

This sale might be called the price deferred sale. Bank's activity to purchase the commodity for the client as well as the sale to the client should be independent. The Islamic banking institution, on request of a client purchases certain commodity i.e. house hold appliances, real estate to provide housing finance, machinery, equipment and raw material can be subject of Murabahah.

⁵⁹. Maurice Shohet, comment on “Islamic Banking Sukuk and Murabahah: The Memri Economic Blog,” posted July 20, 2007, <http://www.memrieconomicblog.org/bin/content.cgi?article=10> (accessed January 10, 2010).

⁶⁰. Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003), 211.

From 80% to 90% financing transactions are of Murabahah based. The phenomenon behind the Murabahah sale is non availability of the commodity to the general public. In case when the buyer is unknown about the market trends, to avoid the wiles and stratagems of sharp traders, purchaser can enter in Murabahah sale.⁶¹

2.5.4.1 Important rules of Murabahah

The subject matter should exist at the time of the sale. This sale cannot be valid on non existing things. The seller must have ownership on the things which he is going to sell. The seller must disclose the original price. Subject matter should be specifically known and compatible with Shariah. The delivery of the commodity should not be linked-with any contingency. If the client defaults deliberately, the compensation can be demanded from him. In case the payment become late to some unavoidable circumstances which are beyond the control of the client then grace period is given to him.

2.5.4.2 Murabahah Sukuk

As described in AAOIFI Shariah Standard No 17 Para No 5/1/5/5 that: The issuer of the certificate is the seller of the Murabahah commodity, the subscribers are the buyers of that commodity and the realized funds are the purchasing cost of the commodity. The certificate holders own the Murabahah commodity and are entitled to its sale price”.⁶²

2.5.4.3 Trading in Murabahah Sukuk

The Murabahah Sukuk are negotiable instruments, with one condition that sale is not allowed after delivery of Murabahah commodity to the buyer. Before this, as selling to the buyer is allowed. As stated in the AAOIFI Shariah Standard No 17 Para 5/2/15 that: “it is not permissible

⁶¹.Ibid.212.

⁶². Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard*(Manama, 2003),302.

to trade in Murabahah certificates after delivery of the Murabahah commodity to the buyer. However, trading of Murabahah certificates is permissible after purchasing the Murabahah commodity and before selling the same to the buyer.”⁶³

2.5.5 Salam Contract and its Significance

The word “salam” means to advance. A contract whereby the purchaser pays the price in advance and the delivery of subject matter is postponed to a specified time in future.⁶⁴

This sale can be termed as commodity/object deferred sale. It is an exception to the general rule⁶⁵ because it is a contract among the parties on the non-existing subject matter at the time of contract. This relaxation is to fulfill the needs of farmers, who need money in advance before their crops become ready for sale. There are benefit for the both the parties purchaser and seller. The first can get the product at cheaper price and the later can get money in advance to fulfill his needs. The advance paid price can be less than the expected future price at the time of delivery. In contract the price of the commodity, particulars of commodity, time of delivery and place of delivery should be fixed among the parties.

Legitimacy of Salam

When the Holy Prophet (s.a.w.s) migrated to Madina his companion brought this mode of sale to his notice for his guidance. He termed it as salam and allowed it with some conditions as it is necessity faced by growers and traders. As a matter of principle the sale of commodity, which is not in possession of the seller, is unlawful. This is what the Holy prophet (s.a.w.s) is stated to have laid down as a general rule. Thus the practice of salam is legalized as an exception. It is

⁶³.Ibid,302.

⁶⁴.Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003).200.

⁶⁵.Muhammad Imran Usmani, comment on “Fixed Income Securities Shariah perspective: SBP Research Bulletin Volume 3”,comment posted November 1,2007, <http://www.sbp.org.pk/research/bulletin/2007/vol3/Sharia-Perspective.pdf> (last accessed January 10, 2010).

stated that the practice as qualified by Holy prophet (s.a.w.s) continued during his life time and the following period.⁶⁶

The jurists have not confined the application of this mode of sale to those agricultural products, which as the hadith suggests, could be weighed or measured. But have expanded the list of salamable items to all the commodities that could be precisely determined in terms of quality and quantity.⁶⁷

2.5.5.1 Important rules of Salam

The buyer should pay the full price to the seller in advance for Salam product before taking the possession of the product; the buyer can not enjoy the ownership right.

The subject matter of Salam should be those things which can be measured and weighed. All the particulars of the products should be fixed in clear terms. Non fungible things are not the subject of Salam contract.⁶⁸ The buyer can claim for any hypothecation to avoid the inherent risk that bank will not able to provide the goods timely. The exact date and place of delivery should be mentioned.⁶⁹ If the contract spans over different countries, the banks will have to append markdown of premium for the future exchange rate between the different countries.

2.5.5.2 Salam Sukuk

These are certificates which are issued for the purpose of financing funds for Salam activity. So goods are delivered from the issuer to the subscribers who are the purchasers of the goods. The cash which is generated through this activity is called Salam capital. The holders of Salam certificates are the owners of Salam goods and they are entitled to the sale price of the Salam certificates. After creation of Salam capital these funds are delivered to SPV on taking a promise

⁶⁶ Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy),200.

⁶⁷.Ibid. 2001.

⁶⁸.Ibid.203.

⁶⁹.Ibid.203.

from him to deliver the required commodity in future agreed date. The SPV makes further commitment to any agent to acquire the specified goods at lower price than his first agreement. The profit which is generated from this sale and purchase price is the profit for SPV and for the Sukuk holders.

One of the Shariah requirement about Salam and for creation of Salam Sukuk, is the condition that the purchased goods can be resold after actual possession at maturity, otherwise these transactions will be seemed like selling of debt. Due to this restraint the Salam instruments become less liquid and hence somewhat less attractive to investors. An investor will buy a Salam certificate only if he expects prices of the underlying assets to be higher on the maturity date.⁷⁰

All the other conditions which apply to Salam, as clear enumeration of quantity, specified date, fixed place of delivery and full payment at the time of entering into Salam agreement, good quality of underlying assets, also apply to Salam certificates / Sukuk.

2.5.5.3 Trading in Salam Sukuk

Trading in Salam Sukuk before maturity is not allowed. As stated in the AAOIFI Shariah Standard No 17 Para 5/2/14 that: "It is not permissible to trade in Salam certificates."⁷¹

2.5.6 Istisna

In this contract the end user orders to a manufacturer or artisan to make the commodity or product or for construction of bridges or roads and dams. These things do not exist at the time of contract; require to be contracted with future delivery.

⁷⁰.Dr. Noor Ahmed Memon "Structure of Islamic Bonds and Managing Financial Risk of Sukuk," *Islamic Banking & Finance*(2008):47-48.

⁷¹. Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama; 2003),307.

Legitimacy of Istisna

The legality of this form of contract is based on a custom which is prevailed from the time of the Holy Prophet (s.a.w.s) and is also justified having regard to the need of people.⁷²

2.5.6.1 Important rules of Istisna

The subject matter of Istisna should be such that needs manufacturing. Full advance payment is not a condition in Istisna. The payment can be made on any time and can be allowed in installment. Time of delivery is not fixed. All the essentials are specified about the commodity in clear terms.⁷³ Istisna agreement can be revoked unilaterally before the manufacturer starts the work. Contract of Istisna will terminate after the completion of work or by the death of the manufacturer.⁷⁴ The buyer has right of inspection. In case of infringement of their rights both parties have right to resort to the court.

2.5.6.2 Istisna Sukuk

These certificates used to finance the manufacturing and construction of houses, bridges, high ways and motor ways. Now a day's Islamic Banks involve in this type of construction. They also enter in sub contract and engage in specialized firms for the construction of the required project. After the completion of the project the ownership is transferred to the purchaser. Normally the payment of this type of project is deferred that covers not only the sale price but also the profit margin for the manufacturer. This deferred price can be documented in the form of Sukuk/Certificates. These are called certificates of indebtedness and cannot sell to a third party before maturity and if so then sale is allowed on face value. The whole- sale supplier and big industrial concern can sell these assets to the IFIs on Istisna basis on deferred payment and can

⁷².Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy, 2003),207.

⁷³.Ibid.209.

⁷⁴.Ibid.210.

issue Sukuk. The Sukuk holders can acquire property/merchandise for a deferred price against these Sukuk whose price would be higher than the spot price. This property can be disposed of later on.

2.5.6.3 Trading in Istisna Sukuk

Trading in Istisna Sukuk is compatible with Shariah rules if the conversion of funds into assets becomes complete within the period of Istisna contract. As stated in the AAOIFI Shariah Standard No 17 Para 5/2/13 that: It is permissible to trade in or redeem Istisna certificates if the funds have been converted, within the period of Istisna, into assets owned by certificate holders. If the realized funds are immediately paid as a price in a parallel Istisna contract or the manufactured item is submitted to the ultimate purchaser, then trading in Istisna certificates is subject to rules of disposal of debt.⁷⁵

2.5.7 Muzar'a Sukuk

The Sukuk can be issued by the principal owner or lessee of the agriculture land, to mobilize funds. The Sukuk holders have share in produced crops as per stipulation in the contract. As stated in the AAOIFI Shariah Standard No 17 Para 5/1/5/9 that: "(a) the issuer of these certificates is the owner of the land (the principal owner of the usufruct of the land). The subscribers are the cultivators or their assignees). The realized funds are the cultivation cost.

(b) The issuer of these certificates may be the cultivator (the worker), the subscribers are the owners of the land (investors whose subscription amounts are used to buy the land); and the certificate holders are entitled to a share of the produce of the land as per agreement.⁷⁶ About the trading of Muzara'a Sukuk the Shariah Standard No 17 Para 5/2/17 states that: it is permissible to trade in Muzara'a and Musaqaa certificates after closing of subscription, allotments of

⁷⁵. Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama, 2003), 307.

⁷⁶. Ibid.307.

certificates and commencement of activity with respect to the assets and usufructs. This rule applies when the certificates holders own the land. Thus trading in these certificates is not allowed where the certificate holders act as workers (who undertake to provide agricultural or irrigation works) in which case trading in these certificates is not permissible before the maturity of the fruits and plants.⁷⁷

2.5.8 Mugarasa Sukuk

The funds can be generated through issuance of Mugarasa Sukuk for the plantation or for the maintenance of the crops/trees. The Sukuk holders are entitled jointly to share the ownership of land as well as ownership of trees where the trees have been planted. As stated in the AAOIFI Shariah Standard No 17 Para 5/1/5/11 that:

(a) The issuer of these certificates is the owner of the land suitable for planting (trees), the subscribers are those who assume the obligation of planting on the basis of a Mugarasa contract, while the realized funds are the cost of maintaining the plantation.

(b) The issuer may be the planter (the owner of the work) the subscribers are the owners of the land (investors whose subscription amounts are used to undertake plantation in the land), and the certificates holders are entitled to a share in both the trees and the land as per agreement.⁷⁸

About the trading of Mugarasa's Sukuk the Sharia'h Standard No 17 Para 5/2/18 states that: "it is permissible to trade in Mugarasa certificates after closing of subscription, allotment of certificates and commencement of activity irrespective of the certificate holders being owners of the land or workers."⁷⁹

⁷⁷ .Ibid.303.

⁷⁸ .Ibid.303.

⁷⁹ .Ibid.307.

2.5.9 Musaqaat Sukuk

The financing for the cultivation or irrigation purposes can be possible through issuing Sukuk for the said purpose. The produced crop will be shared according to pro rata basis. The trading law of Musaqaat Sukuk by AAOIFI has been described above in Muzarah Sukuk.

The above mentioned names of Sukuk are paradigms and come in Shariah perspective. The Sukuk can be issued not only tangible assets but also on intellectual property rights like copy right, patent and good will. However Shariah does prohibit the issuance of Sukuk of sinful activities like gambling, pornography, manufacturing and distribution of alcohol, tobacco weapons and pork. As stipulated in the Sharai'a Standard No 5/1/8/5 that: "The prospectus must state that the investment of the realized funds and the assets into which the funds are converted will be undertaken through Shariah-compliant modes of investment."⁸⁰

2.5.10 Contractor Sukuk

The person who has expertise in any profession like education, engineering and drilling etc, can issue Sukuk on such services. These services can be provided at the time of contract and would be offered in contracted time in future. The Sukuk holders shall be the owner of such services like other underlying tangible assets and can get proceed by selling these Sukuk in market. As stated in the AAOIFI Shariah Standard No 17 Para 5/2/9 that: "it is permissible to trade in securities of ownership of services to be provided by a specified party prior to sub- leasing such services. When the services are sub-leased, these certificates represent rent receivables to be collected from the second lessee. In this case, the certificate represents a debt and is therefore, subject to the rules and regulations of disposal of debts."⁸¹

⁸⁰.Ibid.304.

⁸¹.Ibid.306.

2.6 Risk underlying Sukuk

There are many types of risk associated with the assets following are the main types of Market risk. **General** risk can also termed as systematic risk. It comes up due to government and economic policies. **Idiosyncratic**; are called firm specific risk, arises because of companies products comparison with other companies Assets. The commodity risks, foreign exchange risks, or interest rate risk all are called Market risk. The following are the important types of risks;

I Default Risk

The prospectus of Sukuk transaction has rules for the termination of the certificates.⁸² If the obligor defaults in rental payments or he falls short to reimburse the principal amount, the certificate holder can take legal action against him. In case of default in payment of coupon by the obligor he has to pay some amount as penalty that very amount is recommended by scholars to be donated in charitable purposes or in some trust based entities.

II Asset redemption risk

The amount paid by the originator at the time of issuance of Sukuk and the amount they get at maturity may differ. The reason is that with the time span, the assets mislay their value so there is risk about the fully redemption of assets.

III Investor specific risk

There are copious risks associated with assets. For example risk of the loss of the assets. To mitigate the risk of assets losses there is Shariah compliance insurance named as Takaful. The quantity of risk more or less depends upon the nature of the assets. For example there are minimal risks of losses in Ijarah base assets like land parcel, apartment, bridges and road. High risk is involved in the assets which are moveable.

⁸² Tariq, Ali Araslan, "Managing financial Risks of Sukuk Structures, UK UK"(MSC Loughborough University, 2004), 52. <<http://www.sbp.org.pk/departments/ibd/sukuk-risks.pdf>> (last accessed January 10, 2010).

IV Shariah Compliance risk

To be engaged in Islamic mode of transaction, it is the fiduciary responsibility of the parties to make the Sukuk deed Shariah compliance. The breach or violation of any clause of the prospectus renders the contract null and void. If the Sukuk are issued on hybrid Mudarabah, Istisna and Salam, the Mudarabah assets must always be at least 51%. However Salam and Istisna commodities should less than Mudarabah otherwise the Sukuk deed will dissolve, correspondingly buyback agreement will spoil the contract but here the opinion of Jurists varies.

2.7 Risk Management

The Shariah compliance rule has been laid down in AAOIFI Standard No 17 Para 5/1/11 that: it is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk, of mitigating fluctuation of distributable profits (profit equalization reserve), such as establishing an Islamic Insurance fund with contributions of certificate holders, or by participating in Insurance(Takaful) by payment of premiums from the income of the shares of Sukuk holders or through donations (tabarru'at) made by the Sukuk holders.”⁸³

⁸³. Ibid.305.

Chapter 3

Issuance of Sukuk in Pakistan

3.1 A situational analysis

When any financial institution is short of cash they issue conventional or Islamic bonds/Sukuk to finance the new project or to complete the existing one. Earlier there were only conventional ways of financing in Pakistan and size of Sukuk market was very nascent than the conventional bonds. With the passage of time the Islamic mode is nourishing but the full fruition, progression and development in the issuance of Sukuk will take time. In all the speedily increasing Islamic capital market securities, none are gaining attractiveness as much as Sukuk. The Islamic finance industry has grown-up by about 15% on average over the last three years in response to an abundance of investment products, which has been fuelled by an increasing demand for investments that could compatible with Islamic perspectives.¹

The initiative of Sukuk in Pakistan was taken by sitara chemical industries by issuing Sukuk in 2002. These were Mudarabah-based Sukuk, called MTFCs. However, proper work on the said subject started in 2005. Since then Sukuk worth RS 30 billion has been issued or in the process of issuance.

To make the Pakistan among the most prolific national issuer of Sukuk much work is required from all the market participants to remove the obstacles from the ways of Sukuk issuance publically in retail market. A SPV is created and beneficial ownership is transferred to the SPV as assuming it the issuing body. In Pakistan, SPV purchases the assets to satisfy the claims only and cannot own the title of the assets. It becomes hurdle in the way of Sukuk issuance phenomenon in Pakistan. The obvious reason of this obstacle is lack of real ownership right on

¹ Amin Ahmed, *Sharp rise in Sukuk*, Dawn, August 09, 2008, Business Section.

the assets therefore investors feel hesitation to invest through an entity which is not strong enough in its powers (do not have legal ownership on the underlying assets) to encourage the market players.

3.1.1 Which law describes the word “Sukuk” in Pakistan?

No Pakistani law defines the word Sukuk, nor has any drastic step been taken to legislate it. In the legal perspective we need to know whether Sukuk are debenture, share or something else.

The **debenture** is not defined in the Companies Ordinance 1984 or any other law, however according to company law it includes debenture stock, bonds, TFCs and any other securities, other than a share of a company whether constituting a charge on the assets of the company or not. According to Section 2 (35) of the Companies Ordinance 1984 **share** means share in the share capital of a company.² **The Sukuk** are neither equity, debenture, bond or debt instruments, nor are they actionable claim or receivables.

3.1.2 How to define Sukuk and how the Sukuk issuance procedure is regulated in Pakistan?

Sukuk is a security of its own nature, not referred in any law of Pakistan and can be classified as redeemable capital. Sukuk are issued under section 120 of the Companies Ordinance 1984, considering the Sukuk as Term Finance Certificates (TFCs).

3.1.3 Procedure of Issuance of Sukuk to the Public in Pakistan

Once we consider that Sukuk are securities in the form of redeemable capital then we can issue Sukuk to public through circulating and publishing prospectus under Section 57 of Companies Ordinance, 1984.

² .Sibghatulla Ahsan “Sukuk and its Regulatory Framework in Pakistan” (Islamabad: August 27,2008),40-41.

3.2 SECP's approval for the issuance of Sukuk

For issuance of Sukuk the financial institutions have to file an application to SECP, a report is prepared about the project after finalizing the pre-IPO placement. The credit rating and underwriting arrangements are completed as well as legal advisor is appointed. The prospectus of the company is obtained from the concerned stock exchange, after analyzing the said documents. The dividends and return on previous five years securities is checked out. After the fulfillment of all the above mentioned requirements SECP sanctions the issuance of the Sukuk to the demanding company. However said procedure is not applicable in Pakistan, as SECP has not made any rules so companies and financial concerned issue Sukuk privately.³

3.3 In the investment sector of Pakistan, there are two regulatory authorities who encourage the businessmen in Islamic market and those are⁴;

I State Bank of Pakistan (SBP)

II Security and Exchange Commission of Pakistan (SECP)

I State Bank of Pakistan (SBP)

The SBP has been actively involved in facilitating various initiatives and to introduce favorable policies to promote Islamic banking.⁵ The new guidelines and polices are introduced by the banks for the investment in Sukuk as well. The SBP has provided with rules about Sukuk al-Ijarah only (detail of the said rules is in annexure). The reason to issue rules about Sukuk al-Ijarah only is that it is the Shariah compliant way of financing that is most commonly used by the new investors not only in Pakistan but in every country where Sukuk transactions take place, the ratio of Ijarah Sukuk is greater than any other type of Sukuk .

³.Sibghatulla Ahsan *Sukuk and its Regulatory Framework in Pakistan* (Islamabad: August 27,2008),42.

⁴.Afaq khan , "Sukuk the way forward" Dawn,Setember11,2007,Islamic Banking.

⁵.Ibid.

II Security and Exchange Commission of Pakistan (SECP)

The SECP regulates non banking companies and other private and public limited companies. All the arrangements in the field of Sukuk are made privately. They do not come in the ambit of SECP. For the issuance of Sukuk there is pre-initial public offering and initial public offering. They are called pre IPO and IPO respectively. For instance 100 million US dollars are required to finance any project then 50% issuance of Sukuk will be through Pre IPO and 50% issuance through IPO. In Pre IPO 50% are provided by the sponsors like friends and relatives privately which does not need any formal regulatory framework. In IPO general public participate and it needs regulations, to avoid any future dispute.

Mostly Sukuk are issued privately even then the size of Sukuk market is smaller than their conventional counterparts.⁶ SECP can give guidelines and can make policies only if the Sukuk are issued through governmental involvement. The National Highway Authority (NHA)'s Sukuk were issued in the domain of GOP but SECP has not proposed any law so the reason of this lacuna is infancy of the Sukuk concept.

3.4 Structure of Ijarah Sukuk in Pakistan issued by GOP

Three main parties involved in Ijarah Sukuk agreement are: (1)the issuer i.e. Originator, initiator or beneficiary; (2) SPV or issuer or special purpose entity (SPE); and (3) the investor i.e. Sukuk holder, successor-in –interest and nominees. The originator creates an SPV to whom he passes through the selected assets with the understanding that he will lease back the assets from the said legal entity.⁷ The terms and conditions of rent related to the said contract are signed

⁶ .Ibid.

⁷ .Government of Pakistan Ijarah Sukuk, Annexure “D”-Draft “Certificates Subscription Undertaking” September 06, 2008,3.

among the involved parties, as recommended by the AAOIFI Shariah Standard No 17 Para 5/1/8/1 which is reproduced as under:

The prospectus must include all contractual conditions, adequate statements about the participants in the issue, their legal position and rights as well as obligations such as statements about the issue agent, issue manager, originator, investment trustee, the party covering the loss, payment agent as well as other along with the conditions of their appointment and dismissal.⁸

The SPV issues Ijarah Sukuk to the investors after securitization of its assets. These are certificates of equal value representing undivided shares in ownership of tangible assets. The SPV receives funds from the sale proceed and make payments to the originator. The beneficiary-cum-lessee passes on the rent to the SPV which is paid by him to the Sukuk holder. There are very less probabilities of risk and liquidity is possible effortlessly.

Sometime the underlying assets have no market value and initiator is not interested to take back the said assets so this phenomenon discourages the Sukuk holders to invest in this type of business. To make the Sukuk market efficient, the contracts of issuance of Sukuk embeds a put option⁹ on the Sukuk holder that initiator will buy back the Sukuk on face value upon maturity but here AAOIFI,s Shariah Standard No 17 Para 5/2/2 objects on the above mentioned embedded option while saying :

“In the case of negotiable Sukuk, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however it is not permissible for the issuer to undertake to purchase the Sukuk at their nominal value”.¹⁰

⁸. Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, (Manama: 2003), 304.

⁹.For detail see Encyclopedia of Islamic Banking and Insurance (Institute of Islamic Banking and Insurance:1995),170.

¹⁰.Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards* (Manama:2003),304.

3.5 Council of Islamic Ideology of Pakistan (CII)

Under Article 228 of Constitution of Islamic Republic of Pakistan 1973, CII is a constitutional body responsible for providing the legal advice on Islamic issues to Pakistani government and the parliament.

The CII has following functions:

- 1- To recommend laws conforming to Quran and Sunnah.
- 2- To advise Parliament or government of Pakistan or President of Pakistan or governor on any question referred to the Council as to whether a proposed law is or is not repugnant to the injunctions of Islam.
- 3- To make recommendations to bring current laws to conform to Islamic injunctions
- 4- To compile guidance for Parliament and provincial assemblies.¹¹

The viewpoint of the CII of Pakistan on Bonds is following;

I The Prohibition of prize bonds scheme

Islamic Conciliation Committee gave its opinion regarding prize bond scheme in Dec, 1969 saying that “prize on such bond is riba”. The CII also insisted that government should take action strictly against such bonds which are riba based as well as investments which are made through such schemes are not permitted in Islam. These schemes bring unemployment in society. In addition the prize bonds which are received without any work are against the teaching of Quran. The CII proposed government to abolish all such type of schemes.¹²

About **prize bonds** Mufti Muhammad Imran Usmani is of the opinion that the prize bonds are prohibited because they are loan in which liability to pay a predetermined profit or an additional

¹¹.The Constitution of the Islamic Republic of Pakistan, 1973 (Karachi: Law House, 1989), 182.

¹².Council of Islamic Ideology of Pakistan, Islamabad: Annual report of 1983-84,176-177.

amount is undertaken in favor of their bearers as a whole or in favor of selected members. Moreover, these bonds have a resemblance with gambling (Qimar).¹³

The Federal Shariat Court has examined section 249-A P.P.C. relating to bonds, shares and lotteries in the touch stone of Islamic injunctions and declared that the laws relating to bonds are repugnant to the injunctions of Islam.¹⁴

II WAPDA Bearer Bonds

A meeting of the CII was held on Jan, 1988 at Karachi, wherein the members of the CII were informed about the advertisement through which people were invited to buy bearer bonds issued by WAPDA on which exception/exemption from Zakat was given. (regarding this matter the CII insisted all governmental institutions for termination of interest. Despite all these efforts, such bearer bonds were issued day by day and CII also described that to give name of "Return" to "interest" is against Shariah.) The CII attracted Government attention to the issue that WAPDA is business runner entity so floating of its shares should be on the basis of profit and loss sharing, which should be followed by other institution as well. The CII suggested that it is better for ministry of finance to take steps for floating of profit and loss sharing bonds rather than floating of interest based bonds.¹⁵

III National Bearer Bonds

A letter was received by Secretary of CII in Sep26, 1988 from SBP, which stated that a man named Ali Muhammad has filed a petition in Sindh High Court that buyer of national bearer bonds receives extra money which is totally against the teaching of Quran and Sunnah. The

¹³.Muhammad Imran Usmani, "Fixed Income Securities Shariah perspective: SBP Research Bulletin Volume 3," November 1,2007,

<http://www.sbp.org.pk/research/bulletin/2007/vol3/Sharia-Perspective.pdf> (last accessed January 10, 2010).

¹⁴.Sheikh Mushtaq Ali Advocate (Petitioner) versus Government of Pakistan (Respondent),PLD 1989 FSC 60 at p 66.

¹⁵.Council of Islamic Ideology of Pakistan, Islamabad: Annual report of 1987-88, 86-87.

petition was accepted for hearing by Court and the issue was referred to finance division which forwarded it to CII for Shariah ruling.

A meeting of CII was held at Islamabad on Sep22' 1988 in which it was decided that since the matter was pending in Honorable High Court it was appropriate to wait for the decision of said Court on this particular matter which was more authoritative than CII. The meeting of CII however purposed government to abolish all such types of schemes.¹⁶

3.6 Sukuk which were issued and proposed to be issued in Pakistan

3.6.1 Water and Power Development Authority (WAPDA)

3.6.2 National Highway Authority (NHA)

3.6.3 Sitara Chemical Industries

3.6.4 Maple Leaf Cement Factory(MLCF)

3.6.5 Sui Southern Gas Co (SSGC)

3.6.6 EDEN Builder Private Limited (EBPL)

3.6.7 Pakistan Electronic Limited (PEL)

3.6.8 Karachi Shipyard and Engineering Works(KSEW)

3.6.9 Pakistan International Airline(PIA)

3.6.10 Wateen Telecom

3.6.1 WAPDA Sukuk Experience

The water and power development authority (WAPDA) is a sovereign entity, whose pivotal rule is to expand the resources for the generation of electricity through hydle power in Pakistan. The said entity also works for the management of water. The ultimate purpose of it is to facilitate the public. To be more productive and to accomplish its duties the said institution issued Sukuk of

¹⁶.Council of Islamic Ideology of Pakistan, Islamabad: Annual report of 1988-89,122-123.

RS 80 billion. The WAPDA First Sukuk Company (WFS) acted as an SPV and purchased from WAPDA ten hydle power generation turbines, installed at Mangla Hydle power station and kept the acquired assets in trust for the benefit of the investors till the maturity period. Then SPV lease back the turbines to WAPDA for maturity period of seven years. The rental entity requires funds. So it mobilized funds by issuance of Sukuk al-Ijarah of worth PKR payment is on KIBOR plus thirty five BPs of purchase consideration. Like other tangible assets the Sukuk issued on these turbines represented an undivided beneficial ownership on turbines. At the end of lease period the WAPDA will take back the turbines by fulfilling its unilateral promise of buying back the turbines at market price.

The mangers were Citi Bank, Jahangir Sadique & company. The Muslim Commercial Bank (MCB) and the GoP gave unconditional and irrevocable guarantee for the return and ensure principal amount. The SBP approved the said issuance being Shariah compliant and SLR eligibility for Islamic banks and conventional banks having Islamic windows. The WAPDA Sukuk got strong market reply from the organizations, employ benefit fund and mutual funds. The utilization of these funds (proceed) will be used in Mangla dam project.

3.6.2 Sukuk of National High Way Authority (NHA)

The Pakistan first Islamic Sukuk worth US \$ 600 million was launched in January 2005. Pakistan International Sukuk Company Limited (PIS) performed the functions of SPV, wholly owned by the GoP, bought Highway land (M2 motorway) from the NHA and underlying assets in the said transactions were M-2 motorway. The PIS issued the trust certificates and then leased back the land to the GoP for a period corresponding to the tenure of the trust certificates. The GoP is making periodic payments under lease agreements to PIS to pay off periodic liabilities arising on

the trust certificates. On the completion of contract the GoP will repurchase the land from PIS at agreed price, enabling it to redeem the Sukuk.

3.6.3 Sitara Chemical Industries

One of the high profile conglomerates in Pakistan decided to reschedule its structure of balance sheet in Shariah compliance manner, for the development of Islamic banking in Pakistan. The company has a big contribution and trying hard to abolish the conventional interest-based financial arrangements. A part of Sitara Group wanted to expand the caustic soda plant. The company issued MTFCs called investment certificates of amount of PKR 510 million privately for the maturity period of five years. These certificates were based on profit and loss sharing.

The profit sharing ratio was worked back according to the projected profitability and expected international rate of return. The financial projection was the key element to structure the profit ratio. The profit was paid on the basis of projections bi-annually. According to annual audited accounts the final payment would be determined irrespective of profit and loss and adjustment will be made accordingly. With the collaboration of both parties (the issuers and investors) the company created Takaful (Islamic Insurance) till the maturity period of the issue. The said phenomenon is allowed according to Shariah Standard No 17 Para 5/1/11 which describes that:

It is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk, of mitigating fluctuation of distributable profits (profit equalization reserve), such as establishing an Islamic Insurance fund with contributions of certificate holders, or by participating in Insurance (Takaful) by payment of premiums from the income of the shares of Sukuk holders or through donations (tabarru,at) made by the Sukuk holders.¹⁷

¹⁷. Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, (Manama:2003),305.

The investor contribution in the Takaful Company was ¼ of their second tier yearly basis till the end of entirety of the issue. If a loss occurs, according to final audited accounts, that will be set out against Takaful reserve. If Takaful reserved amount is insufficient to absorb the loss, the unabsorbed loss will adjusted against the principal amount at the time of redemption of the issue. The reserved Takaful amount will be divided among the both parties at the maturity of MTFCs. If the company goes in genuine loss according to the report of natural auditor then investor will bear the risk of loss and they cannot recourse to the security which is reserved in hypothecation. The investor can only claim if any fraud and negligence of company is approved by the banking court. As stated in Shariah Standard No 17 Para 5/1/8/7 states that: the prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situation other than torts and negligence nor that he guarantees a fixed percentage of profit. It is, however permitted to an independent third party to provide a guarantee free of charge, while taking into account item 6/7 of Shariah Standard No (5) in respect of guarantees. It is also permitted to the issuer of the certificates to offer some tangible or personal guarantees with respect to its wrongful acts or negligence, while taking into account Para 3/1/4/3 of Shariah Standard No (12) in respect of Sharikah (Musharakah) and modern corporations as well as the contracts stated in that standard.”¹⁸

The five banks of Pakistan involved in the issuance of the said Sukuk and those are National Bank of Pakistan, Allied Bank, Dubai Islamic Bank Pakistan, First Habib Bank Mudarabah and Meezan Bank as trustee to the issuer. The structure of issuance was approved by Scholars Sheikh

¹⁸ .Ibid.203.

Nazim Yaqubi and Dr. Abu Sttar Abu Guddah and the said scholars are from Standard Charter Bank ,s Shariah supervisory committee.

3.6.4 Sukuk Experience of Maple Leaf Cement Factory (MLCF)

The maple leaf cement factory was established in 1956, is one of the leading manufacturer and listed on all three stock exchanges of the country. The cement plants are located in northern Pakistan in Dadukhal, district Mianwali. The MLCF has a diversified product portfolio. The kohinoor maple leaf group owns the majority stake (50%) in the company however various financial institutions, public and private entities own the rest. In January 2008, the MLCFL issued Musharakah based Sukuk of PKR 8,000 million for a tenure of 6 years (with two years grace period). The profit rate was 6 month KIBOR plus 170 bps, payable semi annually in arrears.

3.6.5 Sui Southern Gas Company's Sukuk Experience

The sui southern gas company established in 1989. Province Sindh and Baluchistan are included as its franchised areas. The network of the SSGC is spans over 30,000 KMs. The SSGC is fulfilling the gas requirement of 1.9 million, commercial and industrial sectors as well as for customer's domestic needs. The GoP has 60% shares in the SSGC, 16% are owned by individuals and rest by different corporate and financial intuitions. The SSGC has issued Sukuk of PKR 4,700 million in March 2008 privately, based on Musharakah to meet its debt obligations for the maturity period of 5 years plus grace period of two and half years. The profit payable was at the rate of 3 month KIBOR plus 20bps quarterly in arrears.

The Sukuk are secured on pari passu basis involving present and future moveable fixed assets of the company with additional 25% margin.

3.6.6 EDEN Builders Private Limited (EBPL)

EDEN Builders private limited needs financing for the land requisition and for the development of its projects. The project located in Lahore near to thoker niaz baig. The company issued Sukuk privately to meet the requirements of upcoming projects. The targeted land for the project is 1,500 kanals from which 55% would be reserved for housing scheme and the remaining for parks, roads, masque and various amenities.

The Sukuk of the said project was issued on diminishing musharakah having worth of PKR 2,500 millions along with green shoe option¹⁹ of PKR 500 million with the entirety period of five and half years. The profit based on three months KIBOR plus 200bps, to be paid quarterly in arrears.

3.6.7 Sukuk Experience of Pakistan Electronic Limited (PEL)

The PEL is incorporated in 1956, listed on Stock Exchange of Pakistan. It is manufacturer of transformers, energy meters and home appliances. The main function of the company is refrigerators and split air conditioners. For further diversification of their business the company is working for erection of grid station and wants to acquire engineering and power distribution among various government owned institutions on the privatization agenda.

The company issued Sukuk of worth PKR 1200 millions privately, based on diminishing musharakah for the maturity period of five years including eight months grace period. The Sukuk were issued on the profit rate of three month KIBOR and 175 bps payable quarterly in arrears.

¹⁹.for detail see An Encyclopedia of Alternative Investments(London:CRC Press Taylor &Francis Group, Boca Raton),215.

3.7 Sukuk which are in the process of issuance

The above said Nos 3.6.8,3.6.9,3.6.10 are Karachi shipyard and engineering work's Sukuk of Rs 3,500,000,000, the Sukuk of Pakistan international air lines having worth of Rs 2,000,000,000 and Sukuk of Wateen telecoms(respectively) of Rs.1, 200,000,000 are in pipe line.

When a bond certificate is supported by an asset, it is changed into a valuable object, consequently qualifies as an object of trade whereby it can be purchased and sold in the primary and secondary market.²

Through the described process the property right is created which enable the bondholder to sell the bond for liquidity or capital gain. In Islamic debt financing the underlying assets is quite perplexed issue in determining the Shariah compatibility. The underlying assets are both tangibles and intangibles assets such as factories, machinery, common stocks, inventory, buildings, properties, contracts and concessions awarded by the government.

According to Malaysian's view, the Islamic securitization is different from the conventional one. In former case, the means of security are third party guarantee, sinking funds, and debentures whereas, in conventional the legal claims, monthly installments, right to the cash flows are included. If the issuer defaults in payments, in Islamic securitization investor will suffer loss and cannot recourse to the underlying assets. The said assets are not sufficient enough to create cash flows as well as they could not proceed as collateral to the new debt and are used only for conversion purposes. The said securitization is nominal only and cannot fulfill the criteria which are required by the Islamic mode of financing where the assets (used for security) are interest protector of the investors.

In modern Securitization, if the debtor or seller of bonds fails to meet payments, the creditors can lawfully acquire the underlying assets for capital recovery."³

² Siaful Azhar Rosly and Sano Koutoub Moustapha: Studies in Islamic Banking and Finance in the 21 century Theory and Practice, edited by Muhammad Anwar & Muhammad Aslam Haneef

³ Ibid

In Fiqh Muamlat, debt (al-dayn) includes deferred payment of Murabahah sale, deferred payment of dowry, in addition rental payment to be collected at the end of the month.⁴

The sale of debt on the principle of equivalence as in hadith is *mithlin bi mithlin* is allowed. Here sale of debt at par value is permissible between debtor and creditor or sale of debt by creditor to the debtor as happen in bond redemption as long as debt is equivalent to the cash payment.

The sale of debt by the creditor to a third party is not acceptable in Islam. The reason of prohibition is that sale will take place for liquidity purposes on non equivalence basis at premium or at discount price. Wherever there is difference in debt value and cash value that would call *riba* however, sale of debt at par value by the creditor to a third party is permissible in Shariah. This is an exception to the general rule that where the debtor gave some incentive to the creditor on the early payment that is called *dhawwa ta'ajal* (pay less for early settlement.) but here on this rule Scholars have different opinions. The Scholars who do not consider the pay less for early settlement, are on strict observance of Islam and said capital gain is prohibited on the basis of the exchange of money for money.

The Malaysians has made efforts to strengthen the Malaysia position in origination, distribution and wealth management as an international hub but there the problem was the liquidity management. Therefore in July, 1983 Bank Negara in Malaysia was established and the same is working on interest free basis. The said bank cannot deal with the government's securities. To resolve the issue, government investment certificates and government investment issues were introduced which represented beneficial loans to the government. For the fixation of interest the government used its full discretion. The representatives of the Ministry of Finance, the Economic

⁴.Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets* (Malaysia: Dinamas publishers, 2005),347.

Planning Unit and the Religious Affair Section of the Prime Minister's officer was appointed to announce the rate of return regularly but there was no hard and fast prescription to decide the rate, so the decision was taken place on qualitative basis.

For the expansion of Islamic financing facilities i.e. interbank money market, on Dec18, 1993, guidelines were issued and on 3 January 1994 in Kuala Lumpur it started its functioning mainly on Mudarabah interbank investments. Here investee bank can acquire funds from Islamic financial institution (the investor bank) by issuing Mudarabah Certificate from one night to one year. To issue short term certificates is not objectionable as some scholars say. It is allowed according to AAOIFI Shariah Standard NO 17 Para 5/1/10 which states that: "It is permissible to issue Sukuk on a short term, medium term or long term basis in accordance with the principles of the Shariah. The Sukuk may also be issued without specifying a period depending upon the nature of the contract underlying the Sukuk issue."⁵

The profit on the said certificate is fixed in advance and principal is reimbursed at the end of the loan period. The Malaysian International Islamic Financial Centre (MIFC) was established in 2006 for the facilitation of Sukuk issuance and to compete with other centre of Islamic Finance. In formulating appropriate prudential and accounting standard, the role of AAOIFI is pertinent to mention here. It played a vital rule in facilitation the process of harmonization and strengthened the Islamic financial system.

⁵. Accounting and Auditing Organization of Islamic Finance Institutions Shariah Standard, Manama, 2003,305

4.2.3 Objection on sale of debt

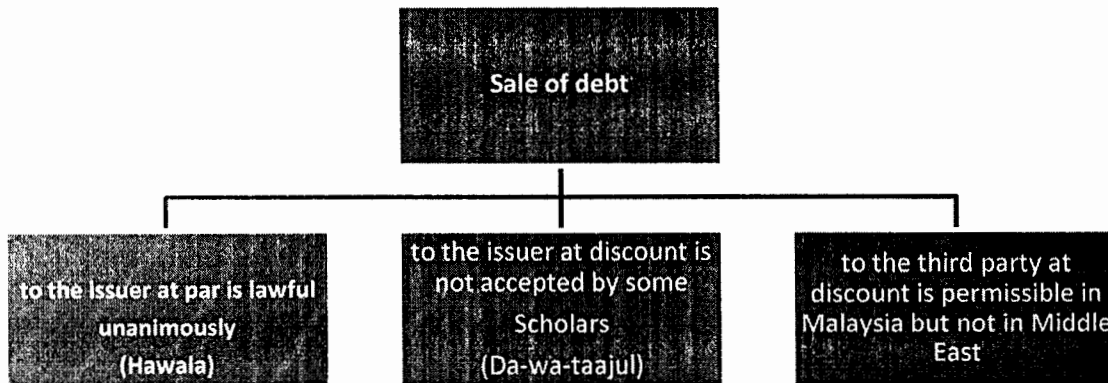
The bond is just a piece of paper how it is permissible in Islam to sell a piece of paper?

The answer lies in the Juristic debate on the sale of debt. The Malaysian Jurists say that these papers are equivalent to property (al mal). The transactions leading to the issuance of debt papers are supported by some underlying assets since property has value, it can be sold at any price.⁶

Bonds and certificates etc are basically papers but its value decrease or increase according to the price/value written on it. Therefore this value has been considered as maal.

The Federal Shariat Court has also discussed this issue particularly in the judgment on suo moto examination of laws on Companies ordinance and declared that it falls within the definition of maal and carries all attributes of maal.⁷

4.2.4 Sale of debt according to Scholars



⁶.Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets*(Malaysia: Dinamas publishers, 2005),349.

⁷.Federal Government (Plaintiff) versus Provincial Governments (defendant) PLD2009 FSC1 at P 28-29.

4.3 Sukuk in Saudi Arabia

The Saudi market in government bills and bonds has become much more sophisticated, partly reflecting the growth of government debt and consequent efforts to find more method of funding it. The Kingdom has been increasingly innovative in its funding; the short term repurchase agreement (repos) is one of them. These are short term loan in which Treasury bills serves as collateral or the asset, the lender obtains the said property where the borrower defaults in payment. The Saudi Arabian Monetary Agency (SAMA) handles through its transactions with the collaboration of commercial banks with repos serving as their liquid assets.⁸

To divert the intention of investor to the bonds, SAMA has introduced a variety of government development bonds: two, three, four and five-year development bonds were offered until 1997, when four-years issues matured and were no longer offered. In 1999, 10-years bonds were issued for the first time and in 2001 seven-year, bonds were launched.

The initiative of the new capital markets authority in 2004 originates an opportunity for Saudi Arabia to take more positive steps in launching Sukuk. Islamic Securities would means that dedicated Islamic Institutions like the Al Rajhi Banking and Corporation would be able to hold government paper.⁹

This would be the smooth progress of liquidity. Similarly, Al jazira Bank and National commercial Bank of Saudi Arabia have adapted Shariah compliance procedures and strategies to provide the Islamic securities and accept the Islamic deposits. The Saudi electricity is now trying to launch more Sukuk to finance the enhancement of capacity and to fund the projects.

⁸ .Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds*(London: Euromoney Books,2004),13.

⁹ . Ibd,14-15.

4.3.1 Case study of Hanco Fleet Securitization (in Saudi Arabia)

The SPC issued the certificate of worth USD27, 200,000 for the maturity period of three years and proceeds were used by SPC to purchase the assets from the originator. The SPC owns the assets and allows an agent to manage the assets. The SPC forwards all cash flows into an off-shore bank account, managed by the SPC. In the case of lack of cash flow to fulfill the payment obligations, the bank account is used to meet the obligations. The SPC pays the certificate holders and at maturity will sell the assets to fund the Capital back to certificate holders.

4.4 Sukuk of Qatar

The major issuance was on 8th Oct, 2003 of global Qatar Sukuk of worth US\$700 million for the maturity period of seven years. The return payable to Sukuk holder was semiannual. The Qatar International Islamic Bank and HSBC Bank were the lead managers in the issuance of the Said Sukuk. The Gulf International Bank, Kuwait Finance House, Commerce International Merchant Bankers of Malaysia, Abu Dhabi Islamic Bank and the Islamic Development Bank and the Qatar Islamic Bank acted as co-managers.

Under article 68 of the commercial companies law number 5 of 200, a joint stock company incorporated in Qatar, issued Qatar Global Sukuk. The said company is registered issuer in Qatar. The Government of Qatar (seller) delivered to the joint stock company (issuer) a parcel of land which was leased back by the government.

All rules of ijarah were applied and HSBC acted as payment administrator. The return to certificate holders is floating on the basis of LIBOR. It was used only as bench mark and return

do not represent interest payment but stands for the rental on the underlying assets, supplied by the government of Qatar.

The first corporate Sukuk issued in August 2006, having distinctive nature in Gulf capital market. The issuer of these Sukuk was Qatar Real Estate Investment Company QREIC, listed on Qatari Stock Exchange. The Qatar petroleum is one largest customer of QREIC, to finance a mega project QP, the Sukuk of worth US \$270 million was issued. In the said financing Qatar National Bank and Qatar National Bank Al Aslami worked as lead managers whereas joint lead managers were Dubai Islamic Bank, Gulf International Bank and Standard Chartered Bank, transaction administrator was Duetsch Bank (London Branch). In case of default from QREIC side, liquidation damages are payable by QREIC.

The Qatar global Sukuk (QGS) is joint stock Company owned by the government of the Qatar. The said company was formed to act as trustee for the Sukuk holders. The QGS purchased land from the state of Qatar which was simultaneously leased back to the state of Qatar for seven years. The expenses of the acquisition and construction were borne by the leasee. In pursuant to an ijarah agreement, rental payments were made by the state of Qatar to the QGS which exactly match the periodic payments payable under the Sukuk certificates. The rental payments are calculated to the bench mark US dollar plus a margin.

4.5 Sukuk issuance in Bahrain

The Bahrain Monetary Agency offered Shariah compliant government bills in June 2001. These were Sukuk certificates having worth of US\$25 millions. These are Salam based Sukuk having maturity period of three months but to trade these bonds before maturity was restricted. In this case to enhance the liquidity of market, the Bahrain Monetary Agency has issued a series of Islamic financial Instruments/certificates. One of short term instruments of 91 days based on the

mode of Salam was issued whose underlying assets were Aluminum. The government of Bahrain decided the particulars of the Aluminum on advance payment with Islamic Banks and undertook to supply the said commodity on future date. The buyer appointed the government of Bahrain as an agent to receive the delivery of the objects/commodity.

Under the agency contract, aluminum was sold in the market; return was realized by Islamic banks. However Sukuk are not tradable instruments and can be held to maturity.¹⁰

4.6 Objections on the procedure of Sukuk issuance

Here are criticisms that conventional and Islamic transactions are synonymous and these transactions are disguised by termed them Arabic names. For example;

The payment to investors is on **time –value of money**. According to Shariah money is tool for the measurement of value and not an asset itself.

- i. If **money generates money**, it will be tantamount to Riba.
- ii. Sukuk offer to investors a **pre fixed return** on their investments.
- iii. The investors have **not real ownership** on the underlying assets.
- iv. Here in this type of financing (Sukuk) **the promise is made by the originators/ initiators to repay the principal amount to the investors at the maturity of the contract** and no risk sharing phenomenon is found.

The above mentioned objections are refuted by myriad justifications by the Scholars so due to the manifestation of the expert's opinion the dilemmatic problems can be solved.

- i. Here money is not generated on money and flow of income is from the underlying assets on which sukuk have been issued. For example if Sukuk are issued on the assets which

¹⁰. Muhammad Imran Usmani, comment on "Fixed Income Securities Shariah perspective: SBP Research Bulletin Volume 3", comment posted November 1, 2007, <http://www.sbp.org.pk/research/bulletin/2007/vol3/Sharia-Perspective.pdf> (last accessed January 10, 2010).

are rented back to the issuer then SPV will collect rent from the rental products in the rental period.

- ii. The flow of income is not fixed but based on profit and loss sharing. The return would depend on the income realized by the project. As Shariah Standard No 17 Para No 4/5 states that: "The owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates owned (held) by them."¹¹

The Islam prohibits the lending and borrowing on interest or usury but permits to finance through underlying physical assets based on profit and loss sharing as Muhammad Taqi Usmani said "you must face the actual consequences of your investment". He added that "for current Sukuk, risk is not shared and reward is not shared according to actual venture proceeds about 85% of Sukuk are structured this way which is against the risk sharing principal of Shariah."

- iii. The investors/Sukukholders have real common ownership rather than nominal ownership on the underlying assets. The Shariah Standard No 17 Para No 4/2 states that: "Investment Sukuk represent a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufructs, services or a mixture of these entire plus intangible rights, debts and monetary assets. These are Sukuk do not represent a debt owed to the issuer by the certificate holder."¹²

- iv. No any promise is made by the originator to pay back the capital because this very condition violates the legitimacy of Sukuk. However repurchase clause is to allow the industry to develop and Scholars are likely to agree on it.

In the above mentioned clarification about the Sukuk the Scholars have refuted the objections and gave opinions for the Sukuk prosperity in the market.

¹¹ .Ibid.300.

¹² Accounting and Auditing Organization of Islamic Financial Institutions 1429 H -2008

Conclusion

The Sukuk are certificates which are issued to mobilize funds by the issuer having short of cash they issue Bonds on underlying some tangible assets. The subscriber has undivided ownership in the said assets. However, the major difference between the conventional bonds viz a viz Sukuk is that Conventional bonds are mere debt instruments and do not represent any ownership or any type of underlying assets.

The conventional system is being replicated by the Islamic system. The financing through issuance of Sukuk is Shariah compliance and do not take advantage of interest rate movements. It is a phenomenon in which a large number of people can participate in financing of projects. The versatility of this framework is that it can be applied on all types of legitimate assets including infrastructure such as roads, airports bridges and ports. This distinctive nature of Sukuk can generate predictable income stream regulated by Shariah precincts.

The initiative of Sukuk in Pakistan was taken by Sitara Chemical Industries by issuing Sukuk in 2002 those were Mudarabaha-based Sukuk, called Mudarabaha Term Finance Certificates (MTFCs). However, proper work on the said subject started in 2005 but there is not any law that governs the Sukuk phenomenon, the reason of this lacuna is infancy of Sukuk concept in Pakistan.

The Sukuk are not alternative to conventional bonds but compatible with Shariah. The existing Islamic law for the issuance of Sukuk exists in full-fledged form. Non implementation of the said law creates flaws and makes the Sukuk transactions partially Islamic and partially non Islamic.

Recommendations

- i. There must be law/ particular legislation that can govern and regulate the Sukuk issuance procedure.
- ii. The funds mobilization through issuance of Sukuk should be only in astonishing conditions and dreadful necessities.
- iii. Any promise should not be made by the originator to pay back the capital because this very condition violates the legitimacy of Sukuk.
- iv. The whole transactions of Sukuk should depend on risk sharing phenomenon because it is golden rule of Shariah. The promise to pay back the capital removes the risk from the financing. According to Shariah risk bearing is the golden rule of financing whenever and where ever the capital is guaranteed and element of risk is ceased the said transactions will not be according to Shariah.
- v. The SBP and SECP should work as watchdog having their own Shariah Advisor and Shariah Compliance officer who will help and will work collectively in giving guidelines to keep the Sukuk transactions in Shariah Parameters.
- vi. There are requirements for every Sukuk issuing entity to have Shariah Advisor who will provide Shariah based guidance for every transaction.

Annexure

Government of Pakistan issued Ijarah Sukuk Rules on 27th, 2008.¹³

1. **Short title, commencement and application.** (1) these rules may be called the government of Pakistan Ijarah Sukuk Rules,2008.
 - (2) These rules should come into force at once.
 - (3) These rules should apply to Government of Pakistan Ijarah Sukuk, hereinafter referred to as “Sukuk” , issued by the Pakistan Domestic Sukuk Company Limited, hereinafter referred to as “the company” (a company hundred per cent owned by the Federal Government), from time to time.
2. **Maturity period.** The maturity period of first Sukuk issued by the company shall be three years from the date of issue. Later on the company may issue Sukuk having longer or shorter maturity periods but the shortest period shall not be less than one year as notified by the State Bank of Pakistan.
3. **Denomination.** The Sukuk shall be issued in multiple of one hundred thousand rupees. Each Sukuk shall represent an undivided ownership of the assets held on trust for the holder of the Sukuk pursuant to a Declaration of Trust in the name of the company.

¹³.Government of Pakistan,Ijarah Sukuk Rules(Islamabad: State Bank of Pakistan,2008),Finance Division <http://www.sbp.org.pk/FSCD/2008/C13-GOPIjaraSukuk.pdf> (last accessed on 6 December, 2009).

4. **Profit.** The profit on the Sukuk shall be paid bi-annually on the basis of rental rate announced by the State Bank of Pakistan prior to start of each half year.
5. **Redemption.** The Sukuk shall not be redeemable before maturity.
6. **Sale.** The Sukuk shall be sold by auction to the primary dealers and Islamic Banks as determined by the State Bank of Pakistan for the purpose of Sukuk.
7. **Bidding.** Bidders shall be allowed to bid in the manner specified by the state Bank of Pakistan.
8. **Who can hold the Sukuk.** The Sukuk shall be held by individuals (subject to issue of notification by the Government of Pakistan), institutions, trusts, funds of all types, bodies corporate including banks, non banking finance companies and insurance and takaful companies irrespective of their residential status. The investment by non-residential shall be in foreign exchange remitted through the official channels. Such investments shall be eligible for repartition of the principal as well as periodic profit on the Sukuk but the exchange risks shall be that of investor.
9. **Trade and transfer.** The Sukuk shall be traded freely in the Pakistan's secondary markets and transferable through Subsidiary General Ledger Account.
10. **Registration.** The Sukuk shall be scripless and registered with the State Bank of Pakistan through Subsidiary General Ledger Account.
11. **Government Security.** The Sukuk shall be a Government Security for the purpose of the Public Debt Act 1944 (XVIII of 1944) and the payments under the Sukuk shall represent the payment obligations of the Government of Pakistan on

account of the payment of rentals in respect of assets held on trust by and leased from the company; and on account of payment of purchase price to the company for purchase of assets at the time of maturity.

12. **Approved security.** The Federal Government shall declare the Sukuk as approved security for the purpose of sub section (1) of section 29 of the Banking Companies Ordinance, 1962 (LVII of 1962).
13. **Statuary Liquidity Requirement (SLR) eligibility.** The Sukuk shall be Statuary Liquidity Requirement (SLR) eligible for Islamic as well conventional banks.
14. **Acceptability as collateral.** The Sukuk shall be accepted by the banks and financial intuitions as collateral for the purpose of financing.
15. **Tax liability.** The profit earned on the Sukuk shall be liable to income tax in accordance with the laws of Pakistan. Withholding tax on the Sukuk shall be deducted at the rate of ten per cent at source.
16. **Deduction of Zakat.** There shall be no compulsory deduction of Zakat at source and sahib-e-nisab may zakat on his own according to Shariah.

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