

APPROVAL SHEET

**OWNERSHIP IN SUKUK: CRITICAL EVALUATION OF "ISSUE OF SUKUK
REGULATIONS 2015"**

By

Umal Khair Fatima

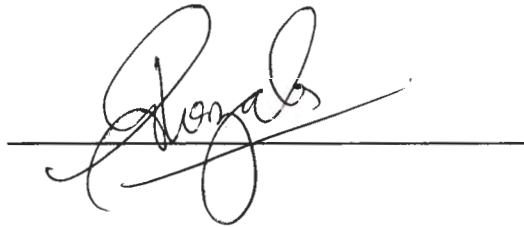
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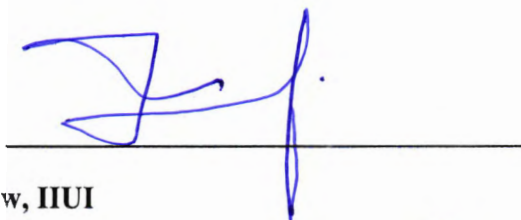
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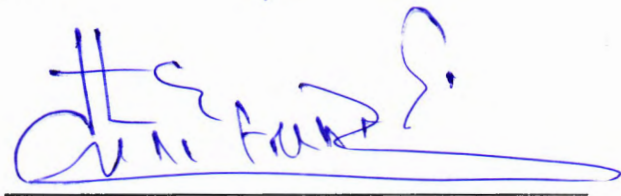
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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

Dedication

“Not even a leaf falls but by will of your Lord” (Al-Quran)

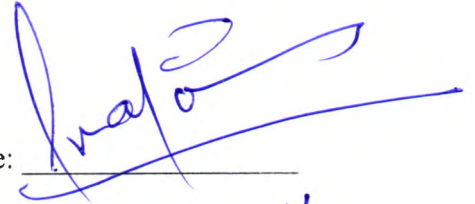
Without Allah’s will and support my goal remained a wish and I cannot accomplish my task. This work is dedicated to ALLAH ALMIGHTY who is the most merciful and best supporter.

I would love to dedicate this thesis to my parents especially my mother, to my supervisor Madam Ghazala Ghalib Khan and to International Islamic university being the cradle of education for many years.

Declaration

I, Umal Khair Fatima, hereby declare that this dissertation is original and has never been presented in any other institution. I, moreover, declare that any secondary information used in this dissertation has been duly acknowledged.

Signature: _____



Date: _____

30/08/2016.

Acknowledgements

Praise be to Allah, the sustainer of the worlds, the merciful, the compassionate! And may His everlasting blessings and peace be on Muhammad (P.B.U.H) the last of his messenger.

Acknowledgements are due to the International Islamic University, Islamabad for the support in carrying out this research. I acknowledge, with deep gratitude and appreciation, the inspiration, encouragement, remarkable assistance and continuous support given to me by supervisor Madam Ghazala Ghalib Khan. I greatly appreciate dedication, attention and patience provided by her throughout the course of this study. Working with her was an opportunity of great learning and experience.

Last but not least we are grateful to my mother, father, brothers and sisters for their extreme moral support, encouragement and patience during the course of our studies as well as throughout our academic career. No personal development can ever take place without the proper guidance of parents. This work is dedicated to my mother and father for their constant prayers and never ending love.

List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
EBPL	EDEN Builders Pvt. Ltd
GDP	Gross National Product
GNP	Gross Domestic Product
GOP	Government of Pakistan
IB	Islamic Bank
IDB	Islamic Development Bank
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IOSCO's	The International Organization of Securities Commissions
IPO	Initial public offering
IPO	Initial public offering (shares)
IPS	Investment Portfolio of Securities
IRI	Islamic Research Institute (Islamabad, Pakistan)
KE	K-Electric
KIBOR	Karachi Interbank Offer Rate
LIBOR	London Interbank Overnight Rate
MCB	Muslim Commercial Bank
MLCF	Maple Leaf Cement Factory Ltd
MOU	Memorandum of Understanding

NBFCs	Non-bank financial companies
NBFIs	Non-bank financial institutions
NHA	National Highway Authority
NHA	National Highway Authority
OIC	Organization of Islamic Countries
P.A	Per Annum
PACRA	Pakistan Credit Rating Agency.
PEL	Pak Elektron Limited
PLS	Profit/loss sharing
SCRA	Special Convertible Rupee Account
SECP	Securities & Exchange Commission of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SPV	Special purpose vehicle
SSGC	Sui Southern Gas Company Ltd
WAPDA	Pakistan Water and Power Development Authority
WHT	Withholding Tax

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Abstract

Sharī'ah legitimacy of *sukūk* has been a subject of intense debate and discussion among the religious scholars. Their major objection on it is that the real ownership is missing and it heavily relies on *hiyal* i.e. stratagems to legalize *ribā*, which frustrate the higher objectives of the *Sharī'ah*. The purpose of the research is to scrutinize the *Sharī'ah* compliance and legal analysis of *sukūk*. The dissertation is divided into four chapters. Chapter-I introduces the study by exploring the background and elaborating the structure of *sukūk* as given by AAOIFI. Chapter-II deals with the critical analysis of *sukūk*. Chapter-III addresses the historical development of law of *sukūk* in Pakistan. It critically evaluates the "Issue of *Sukūk* Regulations 2015" and scrutinizes the *Sharī'ah* compliance of WAPDA and GOP *sukūk*. The last chapter contains the result and recommendations of the study by suggesting a new model to serve the purpose of fund raising by complying *Sharī'ah* requirements. The Instant research is crucial in nature because it will aid in improving the *sukūk* structure and endow with an alternative for it, which will be beneficial for public at large. The main conclusion drawn from the study indicates that there are several elements which are rendering *sukūk* un-Islamic and a stratagem to legalize *ribā*. It is suggested that the removal of these un-Islamic elements can render *sukūk* truly Islamic.

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INTRODUCTION

Sukūk being a revolutionary product is not only popular among the Muslim countries but it has gained momentum in other countries as well. In contrast to conventional interest bearing bonds, they were offered as an Islamic instrument to mobilize funds. They were issued as the strongest element of Islamic finance till 2007 but after criticism by Taqi Usmani, its issuance had decreased. From 1997 till 2007, two countries were leading in the number, and two countries were leading in the volume of issuances. Malaysia had 267 issuances and Bahrain had 150 issuances, adding together 69.97 percent. By volume, Malaysia and United Arab Emirates were leading. Gambia was Third in number and Saudi Arabia was third in volume. It is categorized that the issuance of *sukūk* by the government sector was 33.1% of all issuance but 8.3% of total volume, in which *sukūk al-ijārah* was comprised of the largest portion. During 2007-2009 there was downfall of issuance of *sukūk* but in late 2011, US\$63 billion *sukūk* were issued globally. The government sector issued 66% *sukūk* in end year of 2011.¹ The first quarter of 2012 depicts the strongest *sukūk* market in which there was increase of 55% issuance of *sukūk* as compared to 2011. Malaysia was leading in issuing the *sukūk*, whereas, Saudi Arabia was second and Indonesia was ranked as third. On the other hand, Pakistan, Qatar, United Arab Emirates, Kuwait etc also contributed to escalation of *sukūk*.²

The *sukūk* market is a viable option to raise funds and is the important segment of the capital market. The number of countries has made laws, rules and regulations to regulate the *sukūk* market. Recently, Pakistan has formulated the "Issue of *Sukuk*

¹Michael J.T.McMillen, "Sukūk and the Islamic Capital Markets" in *Contemporary Islamic Finance*, ed. Karen Hunt Ahmed (New Jersey and Canada: John Wiley and Sons, Inc, 2013), 172.

²Ibid., 173.

Regulations, 2015” to have well-regulated *sukūk* market. The formulation of regulations is a great step by the government of Pakistan. It will flourish the economy of the country. However, the existing model of *sukūk* itself involves several issues that need to be addressed before devising the law and regulations for it. Taqi Usmani has criticized the *sukūk* by rendering 85% of the *sukūk* un-Islamic and against *maqāsid al-Sharī’ah*.³ In this scenario, the need of hour is to appraise the existing model of *sukūk* in the light *Sharī’ah*. For this purpose many questions may be raised, out of which following questions are most crucial:

1. Whether the existing model of *sukūk* is genuinely free from *ribā*?
2. Whether *sukūk* is a *hilah* to legalize conventional bonds?

The first chapter discusses the historical background of *sukūk* and its development. It further explains the kinds of *sukūk* as defined by AAOIFI with its models. It also elaborates the steps involved in the issuance of *sukūk* along with the role of the concerned parties in it. At last, the classification of *sukūk* is discussed in detail. The chapter detail out a guide towards understanding *sukūk*.

In the second chapter, the paradox of ownership in *sukūk* is briefed. Moreover, sale and lease back in *ijārah sukūk*, the creation of SPV (Special purpose vehicle), Purchase undertaking, *bay’ al wafā*, *bay’ al īnah* and other gravest *Sharī’ah* issues are discussed in detail. The most crucial area of *sukūk* is its *Sharī’ah* compatibility. Being issued under the notion of Islamic financial instrument, the *Sharī’ah* compliance should be a vital purpose. The above-mentioned issues have a domino effect i.e. they are connected with

³Muhammad Taqi Usmani, “*Sukūk and Their Contemporary Applications*,” (Paper, Accounting And Auditing Organization For Islamic Financial Institutions, 2007), 13.

other vital issues. This chapter tries to brief all the *Sharī'ah* issues in *sukūk*. Lastly, the *sukūk* are compared to conventional bonds. Consequently, they are found to be a mere *hilah* to legalize *ribā*.

In the third chapter, the legal analysis of issuance of *sukūk* in Pakistan has been discussed. It gives the background and development of law of *sukūk* in Pakistan. It critically analyzes the "Issue of Sukūk Regulations, 2015". The role of regulatory authorities in regulating *sukūk* in Pakistan is elaborated. Moreover, it briefs and critically analyzes the WAPDA and GOP *sukūk* issued in Pakistan. It is analyzed that the *sukūk* issued in Pakistan were not *Sharī'ah* compliant. The scrutiny of the issues lifted the veil of *sukūk* and depicted the true picture of it. It gives rise the most significant question that whether there is need of an alternative model to *sukūk*?

The last chapter resolved the above-discussed question by giving a new model for the mobilization of funds in the Islamic capital market. It is concluded that through *sukūk*, the Islamic capital market has gained popularity worldwide. In contrast to bonds, *sukūk* were issued as Islamic products. The AAOIFI rulings of *sukūk* were the consequence of great efforts by the scholars. Unfortunately, there are several elements which are rendering it un-Islamic and a stratagem to legalize *ribā*. The removal of these un-Islamic elements can render *sukūk* truly Islamic. *Sukūk* can be considered Islamic as long as it truly complies with the principles of Islam. Otherwise, non-compliance can shape it a worse form of bond. At the end of the dissertation, the recommendations are given.

Thesis Statement

The current “Issue of Sukūk Regulations, 2015” like the *Sharī’ah* standard of *sukūk* laid down by AAOIFI is a cover-up for interest bearing bonds.

The Research Problem

Now a days *sukūk* is burning issue globally as Islamic bonds but it involves various profound issues which are not in line with *Sharī’ah* so, it is a crucial area of research. This research primarily focuses on the challenging the *sukūk* in line of *Sharī’ah* as well as critical analysis of “Issue of Sukūk Regulations, 2015” in Pakistan.

Significance of Research

The Instant research is crucial in its nature. The appraisal of “Issue of Sukūk Regulations, 2015” exposes the *Sharī’ah* issues involved in the existing model of *sukūk*. *Sharī’ah* compliance of *sukūk* will be useful for investors as well as for scholars to appreciate that the whole arrangement of *sukūk* is a *hilah* and parallel to conventional bonds. The laws, rules and regulations are disguise for underlying *sukūk*. The proposed model in instant research can be used as sculpt for improving the *sukūk* structure and will endow with an alternative for it which will be functional for public at large.

Hypothesis

The instant dissertation focused on testing the *sukūk* in line with Islamic law, that its arrangement is not Islamic thus, it should be scraped out. It was challenged in this dissertation with counter arguments by different groups of scholars.

Framing of the Issues

Following are some of the important issues which were analyzed in this dissertation:

1. Whether ownership in asset-based *sukūk* tantamount to a complete and legal ownership or merely a *bay' al wafā*, *bay' al īnah* and *bay' al istighlāl*?
2. Is there violation of *al kharaj bi al-damān*⁴?
3. Whether “Issue of Sukūk Regulations, 2015” addresses the issues of practice of *tanazul*⁵ and the stipulation of *ibra* clause in *sukūk*?
4. Whether tradability of the *sukūk* at the secondary market under “Issue of Sukūk Regulations, 2015” is *Sharī'ah* compliant?
5. Whether purchase undertaking (*wa'ad*) and recourse to the underlying assets in *sukūk* is *Sharī'ah* compliant or not?
6. Whether the existing model of *sukūk* is genuinely free from *ribā*?
7. Whether rating of *sukūk* is *Sharī'ah* compliant?
8. Whether *sukūk* is a *hilah* to legalize conventional bonds?
9. Whether the *sukūk* regulations of 2015 provide a comprehensive tool to regulate such *sukūk*, without causing *Sharī'ah* compliance risk?
10. Is “Issue of Sukūk Regulations, 2015” is a cover-up for interest bearing bonds?
11. Whether there is need of an alternative model to *sukūk*?

⁴ Imām Hāfiz Abū 'Eisā Mohammad Ibn 'Eisā at- Tirmidhī, *Jāmi' al Tirmidhī* (Riyadh: Maktaba Dar-us-Salam, 2007), hādīth No, 1286, 90. Available at <https://futureislam.files.wordpress.com/2013/06/jami-at-tirmidhi-vol-3-ahadith-1205-1896.pdf>, “Last accessed, 18th April, 2016”.

⁵ *Tanazul* is typically applied where the right to share some portion of the profits is given to another party, http://ifkr.isra.my/if-knowledge-base?p_p_id=1008_WAR_ifkrkbcontentportlet&p_p_lifecycle=1&p_p_state=normal&p_p_mode=view&p_p_col_id=column1&p_p_col_pos=1&p_p_col_count=2&_1008_WAR_ifkrkbcontentportlet_catcode=F06&_1008_WAR_ifkrkbcontentportlet_javax.portlet.action=viewCategoryByCode, “Last accessed 25 May, 2015”.

Literature Review

Here it will critically evaluate the work of some great scholars who worked on *sukūk*.

Shahida Nazar in her unpublished work "*Sharī'ah Appraisal of Sukūk*" has discussed *sukūk* kinds and its tradability according to AAOIFI. At that time there was no specific law for issuance of *sukūk* in Pakistan, *sukūk* were issued under section 120 of companies ordinance, 1984 by considering them TFCs. The core area which she left is ownership and other controversial issues in *sukūk* which necessitates the instant research.⁶

Another unpublished work is done by Muhammad Israr under the name of "Applicability of *Sukūk* in Pakistan (Case study of WAPDA and Motorway)" in 2012. He focused on case study of WAPDA and Motorway *sukūk* in Pakistan. *Sukūk* defaults and some of the *Sharī'ah* issues i.e. ownership, *ibra* clause, *ribā*, *gharar*, *hilah* etc were unaddressed, which necessitates instant research. The dissertation focuses on the critical issues in *sukūk* along with analysis of "Issue of *Sukūk* Regulations, 2015".⁷

Muhammad Taqi Usmani in his book *An Introduction to Islamic Finance* (2002) has discussed the *mushārakah*, *salam*, *istisnā* and other Islamic instruments then he elaborated *ijārah sukūk* funds, its basic rules, *bay' al dain* and Islamic investment funds in detail. The work is appreciated to the extent of understanding of Islamic instruments and investment funds but he has left the area i.e. *sukūk* structure in detail and its basic

⁶Shahida Nazar, *Sharī'ah Appraisal of Sukūk*, (LLM diss., International Islamic University Islamabad, 2010).

⁷Muhammad Israr, "The Application Of *Sukūk* In Pakistan (Case Study Of WAPDA And Motorway)," (LLM diss., International Islamic University Islamabad, 2012).

Sharī'ah rulings. Later on some issues were highlighted in his paper in 2007.⁸ The profound investigation of vital issues in *sukūk* issued in Pakistan necessitates the instant research.

Nathif J. Adam and Abdulkader S. Thomas in book *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukūk* (2004) has contributed in understanding the structure of *sukūk* by explaining its kinds and role of SPV in market. After scrutiny, they said that Islamic instruments adapt well to the modern western capital market system. They pin pointed some international issues as well. Their work and the recommendation that there is need for more alternative and increased infrastructure are acknowledged here. There are untouched areas in their work concerning various aspects of *sukūk* necessitate further research.⁹

Salman Syed Ali in paper "Islamic Capital Market Products, Developments and Challenges" (2005) has discussed Islamic capital market briefly. The paper clarified the structure of *ijārah sukūk* in detail. It also pointed the issues in *ijārah sukūk* that aided in the instant research. The work is appreciated to the extent that some major *Sharī'ah* issues are highlighted but the gaps lie regarding vital *Sharī'ah* issues and the regulatory law of Pakistan.¹⁰ Therefore, the instant research in dissertation is crucial in the field of research.

⁸Muhammad Taqi Usmani, *An Introduction To Islamic Finance* (The Netherland: Kluwer Law International, 2002).

⁹Nathif J. Adam And Abdulkader S. Thomas, *Islamic Bonds: Your Guide To Issuing, Structuring And Investing in Sukūk* (United Kingdom: Euromoney Books, 2004).

¹⁰Salman Syed Ali, "Islamic Capital Market Products, Developments and Challenges," (Occasional paper No.9, Islamic Research and Training Institute, 2005). Available at <http://www.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IDB/CM/Publications/>

Muhammad Taqi Usmani in paper "*Sukūk* and their Contemporary Applications," (2007) criticized the practice of Islamic banking and shed light on the mechanisms of use of *sukūk*. He investigated the *sukūk* that the extent to which these complies with the precepts of Islamic jurisprudence, its principles and higher purposes. The issuers of these *sukūk* have expended a great deal of effort to make them competitive with the conventional bonds prevalent in today's capital markets. By endowing these *sukūk* with the same characteristics of bonds, they have attempted to facilitate their acceptance in both Islamic and conventional markets. Taqi Usmani highlighted issues regarding *sukūk* that are not in compliance with *Shari'ah*, which needs to be scrubbed out. Therefore, his research is playing core role in Islamic finance in evaluation of *sukūk*.¹¹ The dissertation filled the gaps of the article by investigating the critical and legal analysis of *sukūk* in Pakistan.

Muhammad Ayub in his book *Understanding Islamic Finance* (2007) provided a guide to understand Islamic finance. It elucidated the Islamic economic system and the basis of *Shari'ah* rulings to trade in contemporary commercial law. It elaborated the concept of *sukūk* comprehensively along with its tradability and *Shari'ah* issues. It also spotlights criticism on Islamic banking and finance. The work is appreciated to the extent that it explains the roots of Islamic finance comprehensively. The structures of *sukūk* are well elaborated but gap lies in the core area of issues in *sukūk*. Although, it shed light on

Occasional%20Papers/Islamic%20Banking%20and%20Finance/Islamic_Capital_Marke_%20Development_Products.pdf, "Last accessed 25 June, 2015".

¹¹Usmani, "*Sukūk* and their Contemporary Applications," 2007.

critical side of *sukūk* but still it needs thoughtful research. The dissertation focuses on the law of *sukūk* in Pakistan and the annexed issues.¹²

Natalie Schoon in her book *Islamic Banking and Finance* (2010) aided in understanding the structure of different kinds of *sukūk* as well as the risks involved in it. The core area left by her is the Shariah appraisal of *sukūk*, which necessitates the instant research.¹³ The principles of Islamic banking and finance were detailed in book. The gaps in her work are filled by the instant research by having a profound investigation of *sukūk*.

Assoc. Prof. Dr. Asyraf Wajdi Dusuki and Shabnam Mokhtar in their paper “Critical Appraisal of *Shari’ah* Issues on Ownership in Asset-Based *Sukūk* as Implemented in the Islamic Debt Market” (2010) has drawn a distinction between asset based and asset backed *sukūk*. The concept of ownership in Islamic law is well defined in their paper. Moreover, it focused on ownership rights in the asset based *sukūk* by case study of *sukūk* issued in Malaysia. Their work aided in understanding the core concept of ownership in *sukūk*. The gaps in the paper exists that it focused only on ownership issues in the *sukūk* issued in Malaysia. However, the instant dissertation focuses on the critical analysis of law of *sukūk* in Pakistan and the annexed issues.¹⁴

Abu Umar Faruq Ahmad in his book *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (2010) has discussed the practice of *ijārah* and *salam sukūk* by giving prevailing examples but the flaw in his work is that he do not

¹²Muhammad Ayub, *Understanding Islamic Finance*, (England: John Wiley & Sons Ltd, 2007).

¹³Natalie Schoon, *Islamic Banking and Finance* (Great Britain: Good News Digital Books Ltd, 2010).

¹⁴Assoc. Prof. Dr. Asyraf Wajdi Dusuki and Shabnam Mokhtar, “Critical Appraisal of *Shari’ah* Issues an Ownership in Asset-Based *Sukūk* as Implemented in The Islamic Debt Market,” (Paper, International *Shari’ah* Research Academy for Islamic Finance, 2010).

go into the details of issues in *sukūk*.¹⁵ That gap was eradicated by having a profound research in the dissertation. The instant research focuses on the *Sharī'ah* appraisal of *sukūk* and critical analysis of the "Issue of *Sukūk* Regulations, 2015."

Dr. Muhammad Tahir Mansoori in paper "Use of *Hiyal* in Islamic Finance and its *Sharī'ah* Legitimacy" (2011) has checked the *Sharī'ah* compliance of Islamic financial products. It is an informative piece of paper in understanding the concept of *hiyal*. It has also elaborated the sale and lease back *sukūk* by criticizing the WAPDA and Motorway *sukūk* in Pakistan. His focus was on the compliance with *maqāsid al Sharī'ah*. His work is appreciated to the extent that it has aided in understanding the core issues in Islamic finance. The other profound issues in *sukūk* require research that is the main objective of the instant dissertation.¹⁶

David Eisenberg in book *Islamic Finance: Law and Practice* (2012) elaborated the difference between *sukūk* and bonds, its models and the issuance of Highway *sukūk* in Pakistan. Its global impact as well as international legislation was also briefed. Moreover, the controversy in modern *sukūk* structure is discussed but, not in detail. So, there is a need to shed light on *Sharī'ah* aspects of *sukūk* which the writer has not addressed.¹⁷ The instant research focuses on the *Sharī'ah* appraisal of *sukūk* and critical analysis of the "Issue of *Sukūk* Regulations, 2015."

¹⁵ Abu Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (USA: Brown Walker Press, 2010).

¹⁶ Dr. Muhammad Tahir Mansoori, "Use of *Hiyal* in Islamic Finance and its *Sharī'ah* Legitimacy", *Journal of Islamic Business and Management* Vol.1 (2011), 70-92. Available at http://www.jibm.org/sites/default/files/files/Muhammad%20Tahir%20Mansoori_Use%20of%20Hiyal%20in%20Islamic%20Finance%20and%20its%20Sharī'ah%20legitimacy_JIBM_%20vol_1%20Issue%201_July-Dec%202011.pdf, "Last accessed, 20 June, 2016".

¹⁷ David Eisenberg, *Islamic Finance: Law and Practice* (UK: Oxford University Press, 2012).

Slim Mseddi and Nader Naifar in their paper "Rating Methodology and Evaluating the Issuer of *Sukūk*," (2012) have discussed the methods of rating *sukūk* nationally and internationally. They discussed AAOIFI guidelines that *sukūk* are not debt certificates but a trust certificates and different from bonds. They also pin pointed Taqi Usmani paper regarding flaws in *sukūk* with respect to non compliance with *Sharī'ah*. The main focus of authors was rating *sukūk* with fiduciary risk. They explained it well but the core area left is the *Sharī'ah* appraisal of *sukūk*.¹⁸ The instant research focuses on the *Sharī'ah* appraisal of *sukūk* and critical analysis of the "Issue of *Sukūk* Regulations, 2015".

Muhammad al-Bashir Muhammad al-Amine in his book *Global Sukūk and Islamic Securitization Market: Financial Engineering and product innovation* (2012) briefly enlighten the development, *Sharī'ah* issues, risk factors and rating in *sukūk*. Moreover, he shed light on the global issuance of *sukūk*. The work is appreciated in the field of Islamic finance. It will complement instant research to explore the *sukūk* issued globally as well as *Sharī'ah* appraisal of *sukūk* in true sense. The area left in his work pertains to law of *sukūk* i.e. "Issue of *Sukūk* Regulations, 2015" in Pakistan. Hence, the instant research explores the issues in *sukūk* in light of *sukūk* regulations.¹⁹

Mohamed Ariff, Munawar Iqbal and Shamsheer Mohamad in book *The Islamic Debt Market for Sukūk Securities: The Theory and Practice of profit sharing investments* (2012) gave views that an imbalance was created in beginning of 21st century between

¹⁸Slim Mseddi and Nader Naifar, "Rating Methodology and Evaluating the Issuer of *Sukūk*," (paper, Al Imam Muhammad Ibn Saud Islamic University, 2012).

¹⁹Muhammad Al-Bashir Muhammad Al-Amine, *Global Sukūk and Islamic Securitization Market: Financial Engineering and Product Innovation* (The Netherlands: Koninklijke Brill NV, 2012).

idealistic and pragmatic approach relating to *sukūk*, they elaborated its structure, critics by Taqi Usmani on contemporary applications of these structures and the resolution of AAOIFI in 2008. Their work aided in the instant research, hence acknowledged.²⁰ The core area which is un-addressed by the writers is relating to issuance of *sukūk* in Pakistan is analyze in the instant research.

Muhd Ramadhan Fitri Ellias, Muhamad Nasir Haron and Mohd Faysal Mohammed in their paper "*Sharī'ah* Issues in *Sukūk*," (2013) gave elaboration on the *Sharī'ah* issues relating to *sukūk* structures which covers issue on beneficial ownership, recourse to the underlying assets in *sukūk*, purchase undertaking, foregoing of one's right, rebate etc. The paper discussed and analyzed most of the issues, however, are neither conclusive nor exhaustive but have a major contribution in Islamic law.²¹ The crucial area as regard to law of *sukūk* and its application in Pakistan is left by the writers which is analyze in the research.

Muhammad Akram Khan in book *What is Wrong With Islamic Economics? Analyzing The Present State and Future Analysis* (2013) has discussed the *sukūk* and its variations; he said intrinsically *sukūk* is quite similar to conventional bonds, splitting into three segments making it comply with *Sharī'ah*. In theory and practice, there is totally another picture of *sukūk* is available. Original asset is substituted by another, pre determined fixed profit, and return on *ijārah sukūk* is linked to LIBOR. He overall accessed the *sukūk*. He contributed somehow enumerating some issues but still he ignores

²⁰Mohamed Ariff, Munawar Iqbal And Shamsheer Mohamad, *The Islamic Debt Market For Sukūk Securities: The Theory and Practice of Profit Sharing Investments* (UK: Edward Elgar Publishing Limited, 2012).

²¹Muhd Ramadhan Fitri Ellias, Muhamad Nasir Haron and Mohd Faysal Mohammed, "*Sharī'ah* Issues in *Sukūk*," (Paper, Kliff *Sharī'ah* Forum, Kuala Lumpur, 23 September 2013).

the major *Sharī'ah* issues in structure of *sukūk* itself which necessitates further research on it.²²

Meysam Safari, Mohamed Ariff and Shamsheer Mohamad in book *Sukūk Securities: New Ways of Debt Contracting* (2014) introduced the *sukūk* market and elaborated their kinds. The rationale to prefer *sukūk* over bonds is also highlighted. Moreover, the challenges to *sukūk* are also discussed. The un-addressed area in the book is ownership and other issues, which necessitate further research. The instant research focuses on the *Sharī'ah* issues and legal analysis of *sukūk* in detail.²³

Mohammad Hashim Kamali and A.K. Abdullah in book (i.e. collection of essays) *Islamic Finance: Issues in Sukūk and Proposals for Reform* (2014) added number of articles in his collection highlighted three main relevant issues in *sukūk*:

- The core issue is the issue of ownership in *sukūk*. Whether the beneficial ownership comply with the sale contract in Islam and lack of due diligence amount to *jahalalah* and *gharar* or not?
- Practice of providing loans by obligor to investor in case of shortfalls of profits is another issue.
- Third issue is methodological and procedural approaches adopted by some scholars involved in *sukūk* structuring and their implications on the market confidence and transparency.

²²Muhammad Akram Khan, *What is Wrong with Islamic Economics?: Analyzing the Present State and Future Analysis* (USA: Edward Elgar Publishing Limited, 2013).

²³Meysam Safari, Mohamed Ariff and Shamsheer Mohamad, *Sukūk Securities: New Ways of Debt Contracting* (Singapore: John Wiley and Sons, 2014).

He stated that true sale is the first step in structuring a *sukūk* transaction. True sale is the parameter for asset backed *sukūk* and differentiates it's from asset based *sukūk*. He highlighted the purchase undertaking in *ijārah sukūk* and loans in *mushārah* and *mudārah sukūk*. He discussed the *sukūk* litigation and the English courts for the protection of *sukūk* holders. Consequently, he concluded that there is a room for improvement in the different aspects of industry in *sukūk*, in particular in *Sharī'ah* aspect of *sukūk* structuring which necessities instant research on this matter.²⁴

Methodology

This is a qualitative research. For conducting this research a few notable public and educational institutions, libraries of Islamabad were visited to collect concerned data. The holy Qur'ān, translations of *Hādīth* literature, books, encyclopedias and articles were used as main sources. An important aspect of the present research was the core issue of ownership in *sukūk*, for analyzing it Arabic literature was also used as a source. Web resources were also form part of it for gathering information.

²⁴Mohammad Hashim Kamali and A.K. Abdullāh, ed. *Islamic Finance: Issues in Sukūk and Proposals for Reform* (United Kingdom: International Institute of Advance Islamic studies and the Islamic foundations, 2014).

Chapter 1

SUKŪK: HISTORICAL BACKGROUND AND ITS MODELS

1.1 Introduction to Sukūk

Sukūk is a plural of *Sakk*, meaning “certificate” or “order of payment”.²⁵ It is an Arabic name for a financial certificate but it can be seen as an Islamic equivalent of the conventional bonds.²⁶ *Sukūk* were used as a financial obligation in transactions in pre-modern period of Muslims. In earlier, theoretical official works the written mechanism of credit were found in *genizah* document.²⁷ The documents of Cairo *genizah* evidence the trade by *sakk* in 12th century CE.²⁸ They were extensively used by Muslims in the middle Ages as papers representing financial obligations originating from trade and other commercial activities. These papers were issued in compliance with verse 282 of *surah al- baqarah* of Holy Qur’ān which encourages bringing the future financial transactions to be in black and white.²⁹ As a consequence, *sukūk* were transported all over the world.³⁰

The concept of *sukūk* was then transmitted to Europe by Jewish merchants. These *sukūk* has the similar characteristics to modern day cheque. In fact, the check appears to

²⁵Muhammad Akram Khan, *Islamic Economics and Finance: A glossary* (London: Routledge, 2003), 163; Selim Cakir and Faezeh Raei, *Sukūk Vs. Eurobonds: Is There a Difference in Value-at-Risk?* (Washington, DC: International Monetary Fund, 2007), 3.

²⁶In bonds there is no representation of ownership on part of bond holder, interest bearing as percentage of capital, fixed interest and guarantee of return of principle at maturity. Usmani, “Sukūk and their Contemporary Applications,” 6.

²⁷*Genizah* is the storage place in mosque for a precious text on which name of Allah is written. Meysam Safari, Mohamed Ariff, Shamsheer Mohamad, *Sukūk Securities: New Ways of Debt Contracting* (Singapore: John Wiley & Sons, 2014), 41.

²⁸*Ibid.*, 41.

²⁹Latham & Watkins LLP, The United States of America, *The Sukūk Handbook: A Guide to Structuring Sukūk* (Saudi Arabia, Latham & Watkins LLP, 2015), 1.

³⁰Safari, Ariff and Mohammad, 42.

be derived from the Arabic word *sakk*.³¹ Therefore, in the classical period, a *sakk* was used to be issued for establishing financial obligation.³² However, the present structure of *sukūk* are different from the *sukūk* originally used and are akin to the conventional concept of securitization, a process in which ownership of the underlying assets is transferred to a large number of investors through certificates representing a proportionate value of the relevant assets. Today, the *sukūk* have the distinctive features. Firstly *sukūk* were defined by the OIC in 1998, which dealt with *mudārabah sukūk*.³³ In 2000, numerous foundations started issuing *sukūk*, which needed standardization. Hence, AAOIFI issued *Sharī'ah* standard on investment *sukūk* in 2003.

Sukūk were defined by the accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) as: "Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity".³⁴ AAOIFI has identified at least 14 types of permissible *sukūk*, ranging from instruments with equity-like characteristics to asset-backed securities. However, only several of the allowed *sukūk* structures are commonly used. They are *murābahah*, an arrangement where goods are sold at a mark-up and then payment is spread over a period of time; *salam*, an arrangement where the buyer prepays for an asset to be delivered in the future; *ijārah*, a lease arrangement where the use of an asset is leased out in return for regular payments; *istisnā*, an arrangement used to finance the sale of an asset that is currently under construction or not yet built; *mudarahbah*, a partnership arrangement where one partner

³¹Ibid., 43.

³²Latham & Watkins LLP, 1.

³³The Council of the Islamic Fiqh Academy, *Resolutions and Recommendations of the Council of Islamic Fiqh Academy, 1985-2000* (Jeddah, Saudi Arabia: Islamic Development Bank, 2000), 61-62.

³⁴Section 2, *Sharī'ah* Standards No.17, AAOIFI.

invests capital and the other offers expertise; and *mushārah*, a joint venture arrangement where both parties provide capital.³⁵ The detail of kinds of *sukūk* along with its operational structure will be discussed in the later section of the chapter.

Sukūk are securities in Islamic finance known as the Islamic bonds. There is an immense discrepancy with the idealistic approach and pragmatic approach towards *sukūk*. The idealistic approach means how *sukūk* should be structured in accordance with the *Sharī'ah* whereas pragmatic approach means the practical approach of *sukūk*. The contemporary literature on Islamic finance highlights fault line in idealistic and pragmatic approach. For analyzing this discrepancy, the roots of *Sharī'ah* foundations must be considered relating to *sukūk* and Islamic finance.³⁶

Islamic law is based on the ruling described in Qur'ān and *Sunnah*. Fiqh (Islamic Jurisprudence) literally means to know or to understand³⁷. Technically fiqh means the knowledge of the rules of *Sharī'ah* obtained by particular sources.³⁸ Fiqh is further divided into two kinds: *fiqh –al-ibadat*³⁹ and *fiqh-al-muaamlaat*.⁴⁰ All the banking and financial activities forming the part of economic activities fall within the scope of *fiqh-al-muaamlaat*.⁴¹

³⁵<http://www.islamicfinance.com/2014/12/introduction-to-sukūk/>, "Last accessed 22 may 2015".

³⁶See, A. Saeed and O. Salah, "Development of *Sukūk*: Pragmatic and Idealist Approaches to *Sukūk* Structures" *Journal of International Banking Law and Regulation* 1 (2014), 41-52.

³⁷Imran Ahsan Khan Nyazee, *Outlines of Islamic Jurisprudence* (Islamabad: Advance Legal Studies Institute, 2010), 54.

³⁸Qur'ān, *Sunnah* and *ijmā* are the primary sources of Islamic law, whereas, *qiyās*, *istihsab* and *istihsan* are the secondary sources of Islamic law. Ibid., 56 and 157.

³⁹*Fiqh al ibadat* means the Islamic law that regulates the relationship between human being and Allah SWT. For Instance; fasting, prayer etc Ibid.157.

⁴⁰*Fiqh al muamlaah* means the Islamic law that regulates the relationship among human beings. For Instance; contracts, financial transactions etc. Ibid., 157.

⁴¹Saeed and Salah, 41-52.

1.2 *Sukūk* an Outcome of Pragmatic Approach

Ijtihād is the secondary source of Islamic law but in strict terms, we cannot consider it as a source of law. It is a method by which the *mujtahid*⁴² exercises his reasoning and interprets the text of Qur'ān and *Sunnah*. Moreover, he deduces the ruling from the sources of Islamic law.⁴³ When the *ijtihād* is afterward supported by *ijmā*, it will achieve authority in Islamic law. *Sukūk* are not referred in Qur'ān and *Sunnah* but these are in practice by the consequence of *ijtihād*.⁴⁴ Through *ijtihād* the existing scholars along with lawyers and bankers build up *sukūk* as *Sharī'ah* compliant models.⁴⁵ It is argued that the Islamic bankers have opted pragmatic approach⁴⁶ in Islamic finance that is in contrast with an idealistic approach. Here is a huge question on this so-called Islamic banking. *Sukūk* is an outcome of eclectic *ijtihād*: the pragmatic approach.⁴⁷

1.3 Key Players and Their Role in *Sukūk*

For issuance of *sukūk*, key players have a significant role. The parties involved in *sukūk* are discussed in detail in the following pages. Moreover, the kinds of *sukūk* are discussed comprehensively. The key players in *sukūk* are:

⁴²Mujtahid is one who by exercising efforts, derive the law from the sources of Islamic law. Nyazee, *Outlines of Islamic Jurisprudence*, 58.

⁴³Ibid.

⁴⁴Saeed and Salah, 41-52

⁴⁵Ibid.

⁴⁶Currently, there are three approaches to the Islamic banking. Idealistic Approach intact with the classical view emphasizes on maintaining the original version of the Islamic banking literature of (1950-1960). They are sustaining all the instruments and contracts which are developed in the classical period. The liberal approach is of view that there is no need of Islamic banking. They allow interest in the modern time period by giving justification that *ribā* is different from the interest and *ribā* doesn't include modern day interest. They allow interest by giving various arguments such as on the basis of the law of necessity it should be allowed and the prohibition is of *ribā* not of simple interest. Pragmatic approach subsists in between idealistic and liberal approach seems more practical. Ibid., 45.

⁴⁷Ibid., 45.

1. **The Originator/ Issuer:** The Originator (which in many cases are banking and non-banking financial institutions) are in need of funds therefore sells assets to SPV and uses the grasped funds.
2. **The SPV:** SPV is an entity which is specifically set up for the management of *sukūk*.⁴⁸ It is also termed as a trust; the rationale for its establishment is mitigation of legal issues. Moreover, its purpose is to purchase the assets from the originator. In the procedure, SPV issues *sukūk* certificates to investors and then buys the assets from money generated through the sale of certificates. In *ijārah sukūk*, SPV then lease back the assets to the originator for fixed time period. During *ijārah*, *sukūk* holders receive rentals from the lesser i.e. the originator. At maturity of *sukūk*, SPV sells back the assets to the originator as already agreed in purchase undertaking.⁴⁹
3. **Investment Banks:** In *sukūk*, the investment banks (syndicates of IBs and some multinational banks having *Sharī'ah* window) are performing the functions, of issuing agents for accounts, underwriting⁵⁰ and lead management services. For these functions they charge fee or commission.
4. **Subscribers:** Subscribers (that can be Individuals, Islamic banks etc) are the subscriber of the *sukūk* issued by SPV.⁵¹

⁴⁸Ayub, 393.

⁴⁹Ibid., 394-395.

⁵⁰ The process of placing a new issue with investors. Underwriting involves the issuing company using one or (usually) more companies who are each responsible for placing a certain amount of the new issue. The underwriting firms contact potential investors to gauge interest and sell the issue. Underwriters guarantee the price for a certain number of shares of the new issue. Available at <http://financial-dictionary.thefreedictionary.com/Underwriting>, "Last accessed, 8th September, 2016".

⁵¹Ibid., 393.

The above-mentioned key players have a significant role in issuance of *sukūk*. However, the process of general securitization may include some other parties as well:

The Obligor: The obligor is one who is intact by a legal obligation to another. The words of promisor, creditor, debtor etc can be used for him.⁵² Here specifically the obligor means a contractual debtor to originator who pays money generating out of securitization.

The Lead Manager: These are the managers giving services for managing the issues. It may be a company, trust or mutual fund etc

The Service: It is providing the services of collecting rent from obligor as well as maintaining and monitoring of assets.

The Cash Administrator: The cash administrator is performing the functions of collecting and managing the cash (i.e. inflow and outflow) moreover, examines and obtain cash collateral.

The Credit and Enhancement Provider: Here the reassurance is provided by way of takaful, guarantee etc.

The Credit Rating Agency: These provide a rating on the basis of structure, parties, legal and tax aspect. The methods to rate *sukūk* is an important segment of *Sharī'ah* criticism. Its analysis will be discussed in next chapter.

The Auditor: It is responsible for auditing, therefore, has to apply due diligence for this purpose.

⁵²<http://www.merriam-webster.com/dictionary/obligor>, "Last accessed 19 May 2016".

The Custodian/R & T Agents: It grasps asset as agent and is mainly responsible for registering and transferring of securities.⁵³

1.4 Kinds of *Sukūk*

AAOIFI in its *Sharī'ah* standard defined the kinds of *sukūk* and elaborated rules to trade in them. 10 kinds of *sukūk* are discussed in the following:

1.4.1 *Sukūk Al-Ijārah*⁵⁴

Ijārah sukūk are the latest product in the market that is gradually increasing its roots in society. They are used by the governments and corporate entities for mobilizing funds.⁵⁵

AAOIFI defined *ijārah* certificates as:

“These are certificates of equal value issued either by the owner of leased asset or a tangible asset to be leased by promise; or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets”.⁵⁶

The certificates can be issued in ownership of usufruct of existing assets, ascertained future assets, services of the specified party and ascertained future assets. The structure originates with a party who is in need of financing, here known as the originator.

⁵³Ayub, 393.

⁵⁴The term *ijārah* begin from Arabic word meaning remuneration for service rendered by an individual. It is defined as the money paid in utilization of definite assets for a period of time. See, Dr. Habib ur Rehman, *Islamic Financial Instruments* (Peshawar Cantt: Sardar Khan Welfare Trust, 2003), 185. *Ijārah* can be for specific, general, financial and operating lease. See Further, Dr. Muhammad Tahir Mansoori, *Islamic Law of Contract and Business Transaction* (Islamabad: *Sharī'ah* Academy, 2003), 230-236.

⁵⁵Syed Ali, “Islamic Capital Market Products, Developments and Challenges,” 28.

⁵⁶3/1, *Sharī'ah* Standard No. 17, AAOIFI.

- The originator will set up an SPV, a separate legal body with the exclusive rationale of facilitating this transaction.
- Next, the SPV buy definite concrete assets from the originator at an agreed pre-determined purchase price, which will be equal to the principal amount of the *sukūk*.
- In order to finance the purchase of the assets, the SPV issues *sukūk* to *sukūk* holders. These *sukūk* holders are investors looking for *Sharī'ah* compliant securities.
- The SPV uses the *sukūk* funds to pay the originator as purchase price of the tangible assets.
- The SPV will also assert a trust over the tangible assets and grab the assets as a trustee for the *sukūk* holders, who are the beneficiaries.
- Next, the originator and the SPV will enter into a lease agreement for a fixed period of time. Under this lease agreement, the SPV (lessor) leases the assets back to the originator (lessee).⁵⁷
- Consequently, the SPV receives periodic payment (i.e. rentals) from the originator for the use of the underlying tangible assets.
- The SPV uses these amounts to pay the periodic return to the *sukūk* holders, since they are entitled to these payments as the beneficial owners of the tangible assets.
- These rentals are received by *sukūk* holders through SPV till maturity date.

⁵⁷McMillen, 177.

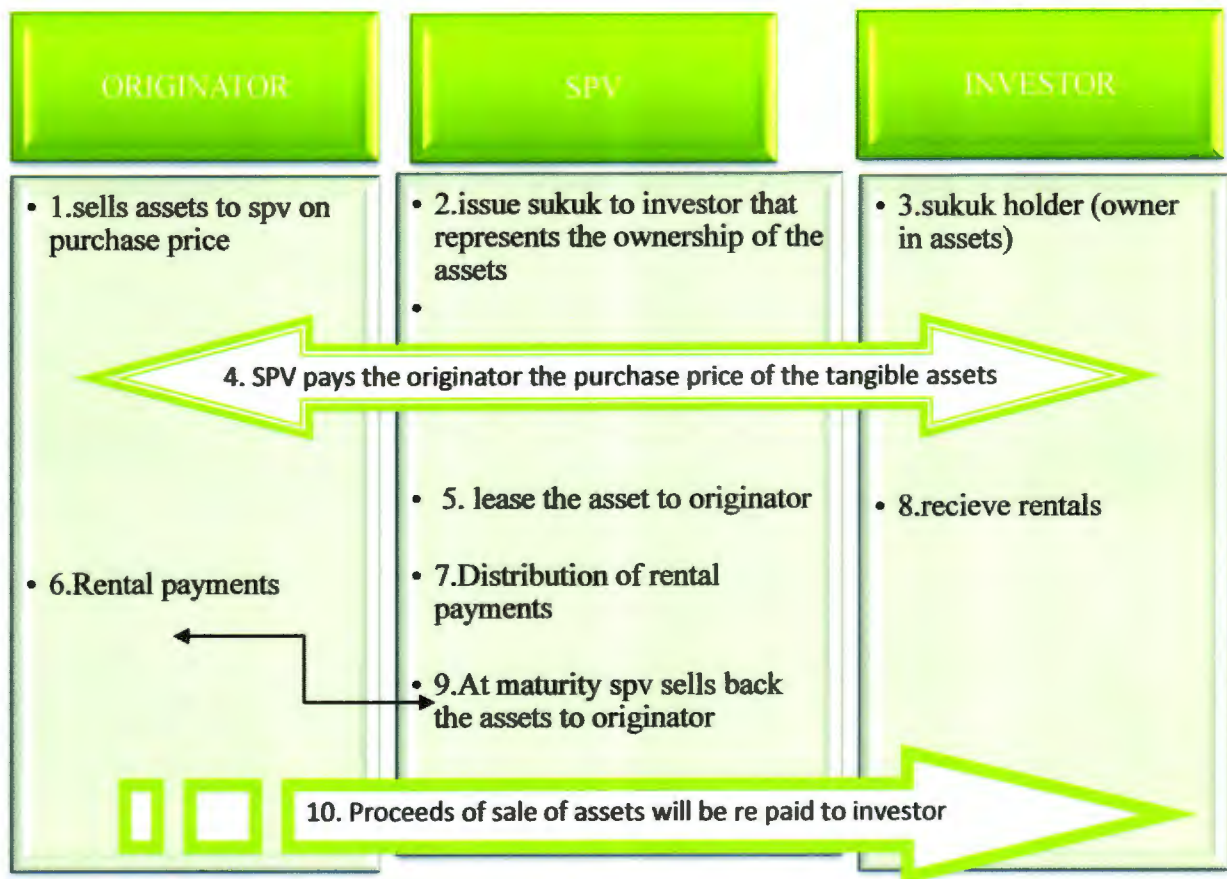


Figure 1.1 *Ijārah Sukūk*

- Here the *Shari'ah* standard made the resale of assets on market value permissible, that the originator can buy the asset at the market price, not on its face value, which itself is a buy back agreement and against *Shari'ah* norms.⁵⁸

⁵⁸<http://ebook.nscpolteksby.ac.id/files/Ebook/Accounting/Ethica%20Handbook%20of%20Islamic%20Finance/58.%20CIFE17-18%20UNDERSTANDING%20SUKUK.pdf>, "Last accessed 20 may 2015".

Ijārah sukūk is subjected to gravest criticism over the world. Numerous issues are prevalent in it. The *Sharī'ah* compliance of *ijārah sukūk* will discuss in the 2nd chapter of the dissertation. In Pakistan *ijārah sukūk* were issued by WAPDA,⁵⁹ the detail of WAPDA *sukūk* will be provided and analyzed on *Sharī'ah* parameters in later section of dissertation. Similarly *sukūk al ijārah* by national highway authority worth 500 was launched in 2005 in which the asset was the M-2 Motorway and Pakistan international *sukūk* company limited performed the functions of SPV, wholly owned by GOP, here on completion of contract GOP bought it on agreed price.⁶⁰

1.4.2 Sukūk Al- Mushārakah

In *Mushārakah*⁶¹ the capital is contributed by two or more partners where profit is shared in pre-agreed proportion. AAOIFI defined *mushārakah* certificates as:

A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of the partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits.⁶²

Any excess over profit is kept in a reserve account for maintaining profits in case of loss.⁶³ *Mushārakah Sukūk* significance is based on the principle of profit and loss

⁵⁹Akram Khan, *What Is Wrong with Islamic Economics?: Analyzing the Present State and Future Analysis*, 358.

⁶⁰<http://www.financeasia.com/search/~/News/29226,pakistan-flushed-with-success-of-pis-bonds.aspx>, "Last accessed 18 may 2015".

⁶¹The term *mushārakah* is derived from word *sharikah* means mixing of two properties in a manner that can be inseparable. See details, Dr. Wahbah Al-Zuhaylī's, *Financial Transactions in Islamic Jurisprudence* (Damascus: Dar al-Fikr, 2001), 445-521.

⁶²3/6, *Sharī'ah* Standard No. 17, AAOIFI.

⁶³Latham & Watkins LLP, 19.

sharing.⁶⁴ In *sukūk*, *sharikāt al aqd* necessitates an agreement for a contribution of assets whereas, *sharikāt al milk* consequences in joint ownership of an asset. In the initial time period of issuance of *sukūk*, *sukūk al mushārah* was popular and prevalent in the market but later on restriction on purchase undertaking⁶⁵ at par value consequence in the decline of its fame.

In Pakistan, 5-years TFCs issued by Sitara Chemical Industries, in June 2002 and CMCs and GMCs issued in Sudan; all three have secondary market.⁶⁶ Still *mushārah sukūk* is no longer away from the *Shari'ah* criticism that will be discussed in later section of dissertation.

⁶⁴Sohail Jaffer, *Islamic Asset Management* (United Kingdom: Euro Money Books, 2004), 174.

⁶⁵AAOIFI laid restriction on purchase undertaking in *mushārah sukūk* because it is just like fixing the profit without bearing any risk of loss. It is guaranteeing the capital. 2008 Resolution, AAOIFI.

⁶⁶<http://www.islamicbanker.com/education/sukūk-al-musha'ra>, "Last accessed 20 May, 2015".

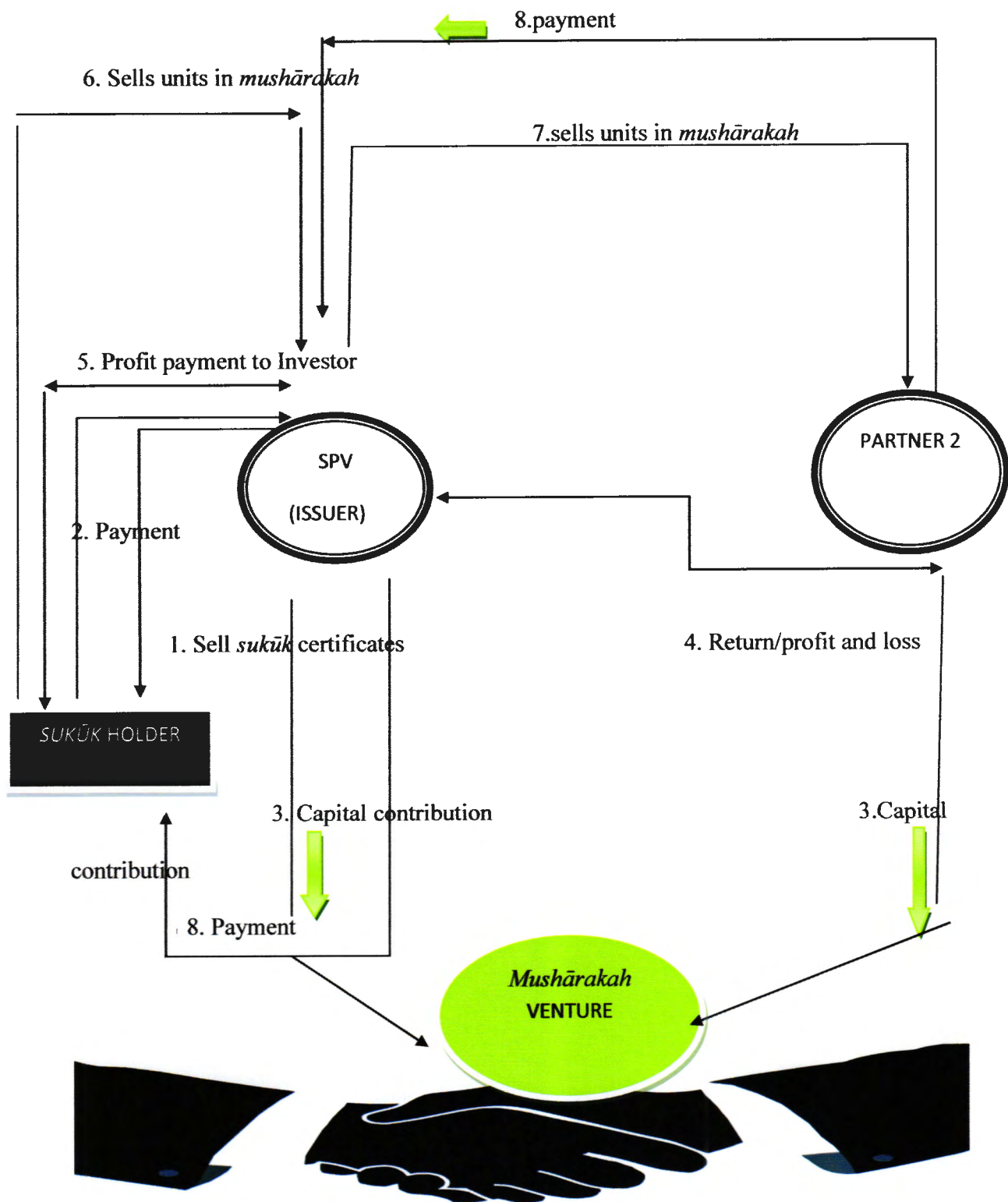


Figure 1.2 *Musharakah Sukuk*

1.4.3 *Sukūk Al-Murābaha*

Murābaha is mainly the sale of the goods, with the disclosure of the actual price and markup to the buyer. The buyer is in need of goods, he comes to the seller for its purchase. The seller purchases the goods for him and discloses the actual price and profit over it. It is a trust sale, the buyer trust on the integrity of the purchaser of goods. The chief purpose of the *murābaha* sale is to protect the innocent buyer from tactics of traders.⁶⁷ AAOIFI defined the *murābaha* certificates as “These are the certificates of equal value issued for the purpose of financing the purchase of goods through *murābaha* so that the certificate holders become the owner of the *murābaha* commodity”.⁶⁸ These certificates are popular in Malaysia owing to the liberal interpretation of sale of debt.⁶⁹

1.4.4 *Sukūk Al- Wakālah*

Wakālah is an agreement of agency where one party acts on behalf of another. One is the principle while other is *wakīl* or an agent (who has expertise in a particular field). Here the investment is made by the principle through an agent for buying particular assets. As mentioned above that the *wakīl* has expertise in the relevant field, he by using his skills and knowledge manages the investment or assets in order to generate handsome amount of profits. In *sukūk al wakālah* usually SPV is acting as the principle, it will distribute the profits periodically to the investors. Any amount over and above the profit will be paid to agent as an encouragement. At time of maturity, the *sukūk* will be liquidated in which all

⁶⁷ Mansoori, *Islamic Laws of Contract and Business Transactions*, 214-215.

⁶⁸ 3/5, *Sharī'ah* Standard No. 17, AAOIFI.

⁶⁹ <https://ifresource.com/2010/04/27/how-sukūk-works-introduction-structuring-and-application-of-sukūk-bonds/>, “Last accessed 18 May, 2015”.

the proceeds are paid to the principle to fund the dissolution amounts payable to the investors by the issuer.⁷⁰

1.4.5 Sukūk Al-Istithmar

Here the word investment is used for *istithmar*. Under a *sukūk al-istithmar* structure, rights under Islamic contracts (including rights under *ijārah* contracts and *murābaha* or *istisnā'a* receivables) can be packaged together and sold to form the underlying assets for a *sukūk* issuance. The earnings of such project will be distributed among investors.⁷¹

1.4.6 Sukūk Al-Mudārabah

It is a partnership in which one party is giving capital (i.e. *rabb ul maal*) while other party is providing his expertise (i.e. *mudarib*). Under agreement they agree to share the profits accordingly.⁷² The model of *mudārabah sukūk* is explaining the steps involve in it.

⁷⁰Latham & Watkins LLP, 12.

⁷¹Ibid., 22.

⁷²3/6/2, *Shari'ah* Standard No.17; AAOIFI; Latham & Watkins LLP, 14.

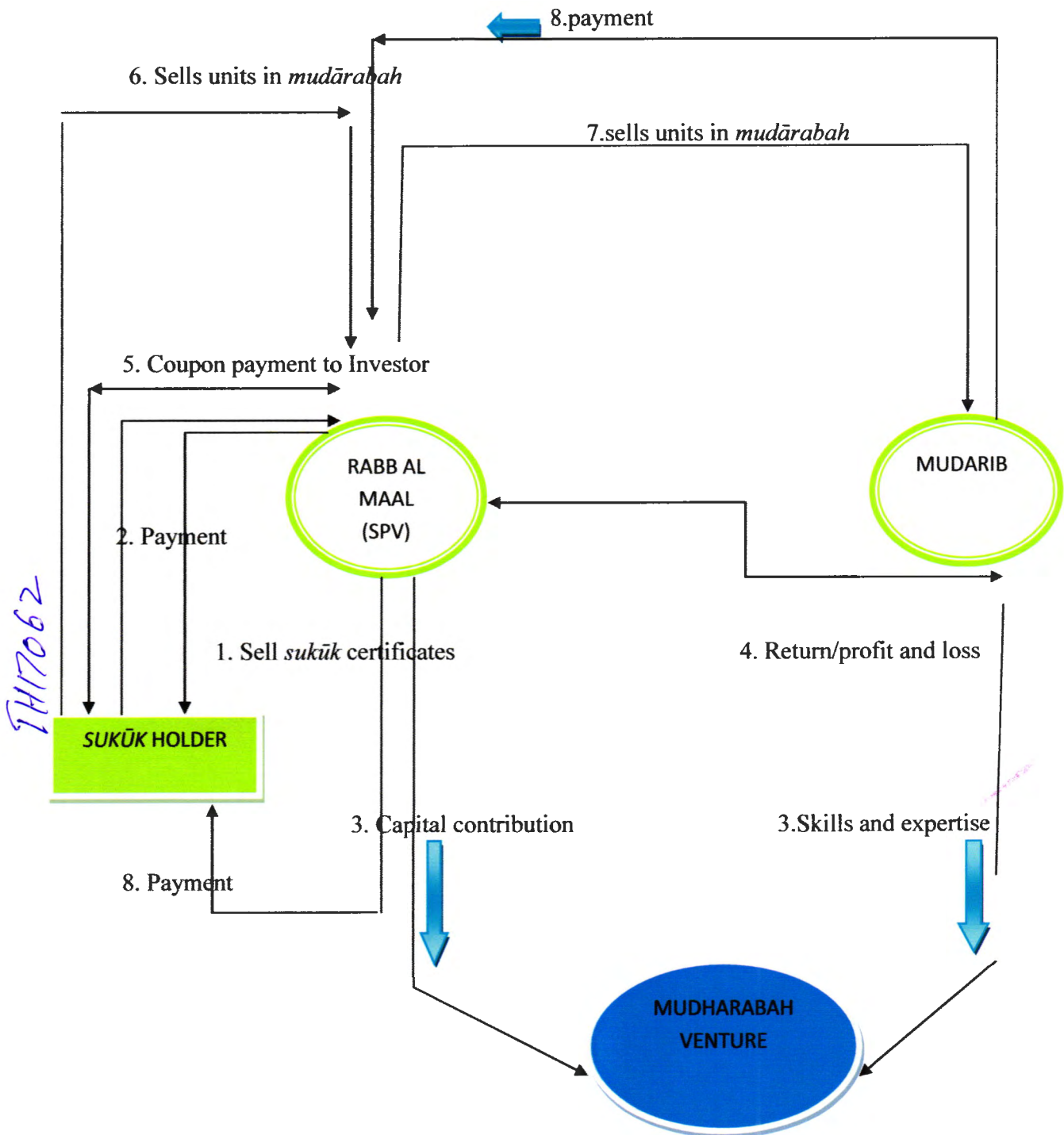


Figure 1.3 *Mudārabah Sukūk*

1.4.7 *Sukūk Al- Istisnā*

The word *istisnā* means manufacturing.⁷³ AAOIFI defined *istisnā* certificates as “ These are certificates of equal value issued with the aim of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the certificates holders.”⁷⁴ The funds from the *sukūk* holder are transferred to the buyer in full on the issue date, but only paid to the manufacturer in accordance with the schedule agreed in the contract.⁷⁵ The banks can contract with the subcontractors for completion of the project, by way of parallel *istisnā*.⁷⁶ Once the funds transferred to the buyer, the following steps have been taken place:

1. SPV issues *sukūk* certificates to raise funds for the project.
2. Issue proceeds are used to pay the contractor/builder under the *istisnā* contract to build and deliver the future project.
3. Title to assets is transferred to the SPV.
4. Completed property/project is leased or sold to the end buyer. Here the SPV becomes the lessor and under lease agreement, the property is transferred. The end buyer pays monthly installments to SPV.

⁷³In *istisnā*, the subject matter should be of a nature that needs manufacturing and its specification needs to be in clear terms. The buyer specifies the goods for construction. Full advance payment is not a prerequisite to enter into a contract but it can be made at anytime, can be in installments. On delivery, the buyer has right to inspect the goods, if found goods contradictory to specifications or defective, the buyer can reject them. Mansuri, *Islamic Law of Contract and Business Transactions*, 207-210.

⁷⁴3/ 4, *Sharī'ah* Standard No.17, AAOIFI.

⁷⁵Schoon, *Islamic Banking and Finance*, 50.

⁷⁶An *istisnā* contract in which the buyer (manufacture orderer, or *almustasni'*) doesn't set a condition in the contract obliging the seller (*al-sani'*) to undertake manufacturing the subject matter (commodity, asset, item, etc) by himself. In this sense, the seller is legally or contractually allowed to fulfill his contractual obligations by entering into a second *istisnā* contract with a third party seller, in which he becomes a buyer. The second contract is referred to as parallel *istisnā*. Available at <http://www.investment-and-finance.net/islamic-finance/p/parallel-istisna'a.html>, “Last accessed 20th September, 2016”; Ayub, 404.

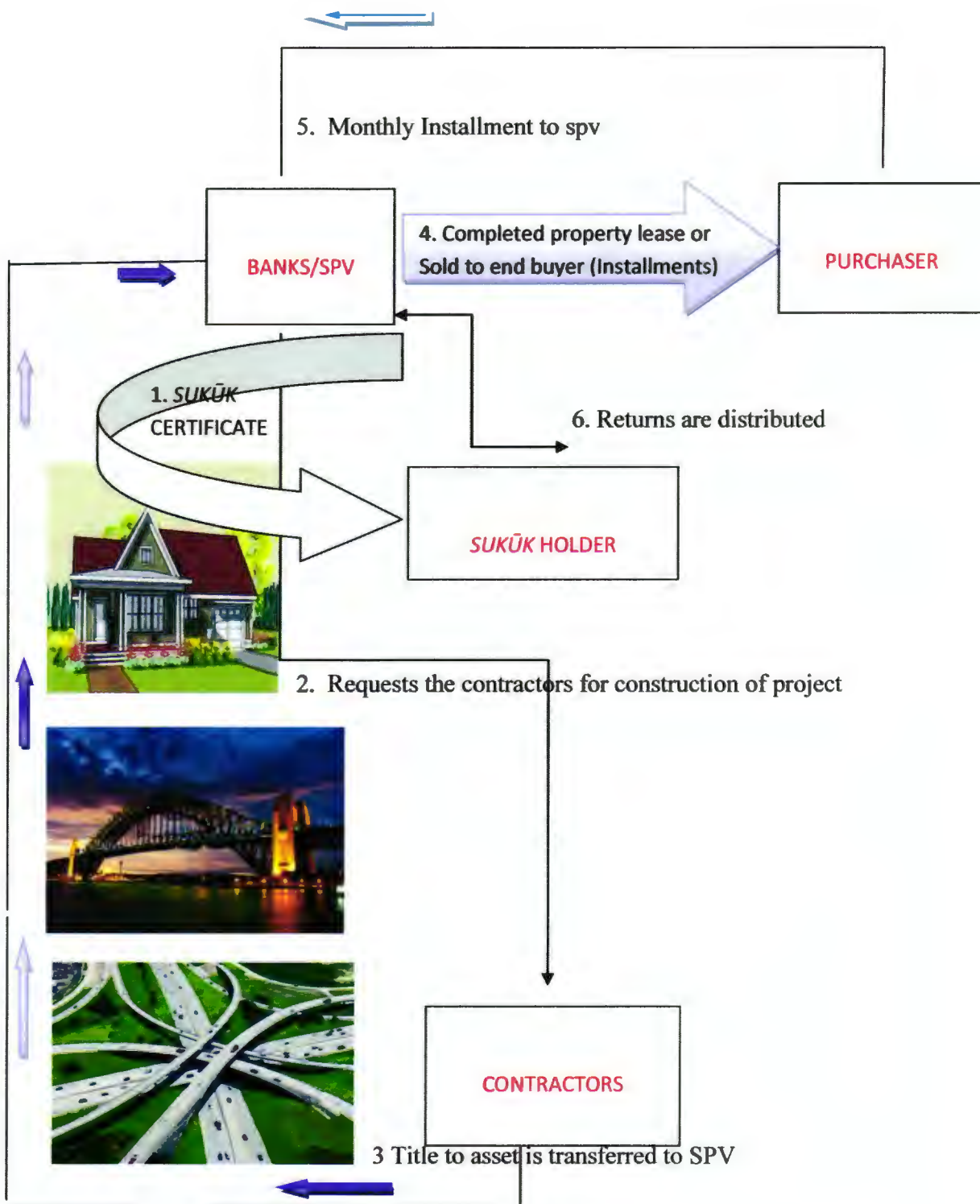


Figure 1.4 *Istisnā Sukūk*

5. The returns are distributed among the *sukūk* holders.⁷⁷

Sharī'ah restricts trading of these debt certificates other than face value, in the secondary market i.e. to any third party.⁷⁸ The structure of *istisnā sukūk* is explained in figure no.4.

Following are the risks to the *sukūk* holder:

- Asset not delivered by the manufacturer then, in this case, the lease agreement will cease to exist. In case of insolvency of the manufacturer the claim will be on administrator and in any other situation, the funds paid to the manufacturer will be reclaimed.
- Lessee cannot pay rental then the *sukūk* holder has a right to proceeds of the sale of an asset.
- An asset becomes impaired then the lessee is no longer liable for payment of rentals.
- Lessee cannot buy back the asset then SPV will sell it into the market which will definitely be in lesser price and ultimately the loss will be caused to the investor.⁷⁹

A combination of *ijārah istisnā* and *ijārah Mawsufah fī al dhimmah* (or forward leasing contracts) *sukūk* were issued by Tabreed's five-year global corporate *sukūk*.⁸⁰

1.4.8 *Sukūk Al-Salam*

In *salam*, advance payment is made and goods are delivered on a specified future date.⁸¹

AAOIFI defined *salam* certificates as "purchase of a commodity for deferred delivery in

⁷⁷http://www.mifc.com/?ch=ch_kc_definitions&pg=pg_kcdf_Sukūk&ac=236, "Last accessed 18 may 2015".

⁷⁸Ayub, 405.

⁷⁹Schoon, 52.

⁸⁰ <http://ifresource.com/2010/04/27/how-sukūk-works-introduction-structuring-and-application-of-sukūk-bonds/>, "Last accessed 16 may 2015".

⁸¹Mansoori, *Islamic Law of Contracts and Business Transactions*, 203.

exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment”⁸² Trading in them before maturity is not permissible.⁸³

1.4.9 Muzara'a Sukūk

The owner of the land can issue these *sukūk* to mobilize funds over the agricultural land. The *sukūk* holders here will share the portion of the produce of land as stipulated in an agreement.⁸⁴

1.4.10 Mugarasa Sukūk

Mugarasa sukūk are issued on the basis of *mugarasa* contract in which the funds are used for plantation and fulfilling the expenses of the work. The *sukūk* holders here entitle to share the ownership of land as well as of plantation.⁸⁵

1.5 Sukūk Classifications

1.5.1 Asset-Backed and Asset-Based Sukūk

For a profound *Shari'ah* analysis of *sukūk*, it is indispensable to understand the classification of *sukūk*. The classification of *sukūk* is based on the underlying contracts, the nature, and type of asset characterized in *sukūk* as AAOIFI has identified 14 types of *sukūk* on the basis of underlying *Shari'ah* contracts such as *musharakah*, *mudarabahh*, *ijarah* etc. The diagram represents the classification of *sukūk* in detail:⁸⁶

⁸²Latham & Watkins LLP,34.

⁸³5/2/14, *Shari'ah* Standard No.17, AAOIFI.

⁸⁴3/7, *Shari'ah* Standard No. 17, AAOIFI.

⁸⁵3/9, *Shari'ah* Standard No.17, AAOIFI.

⁸⁶Dusuki and Mokhtar, 5.

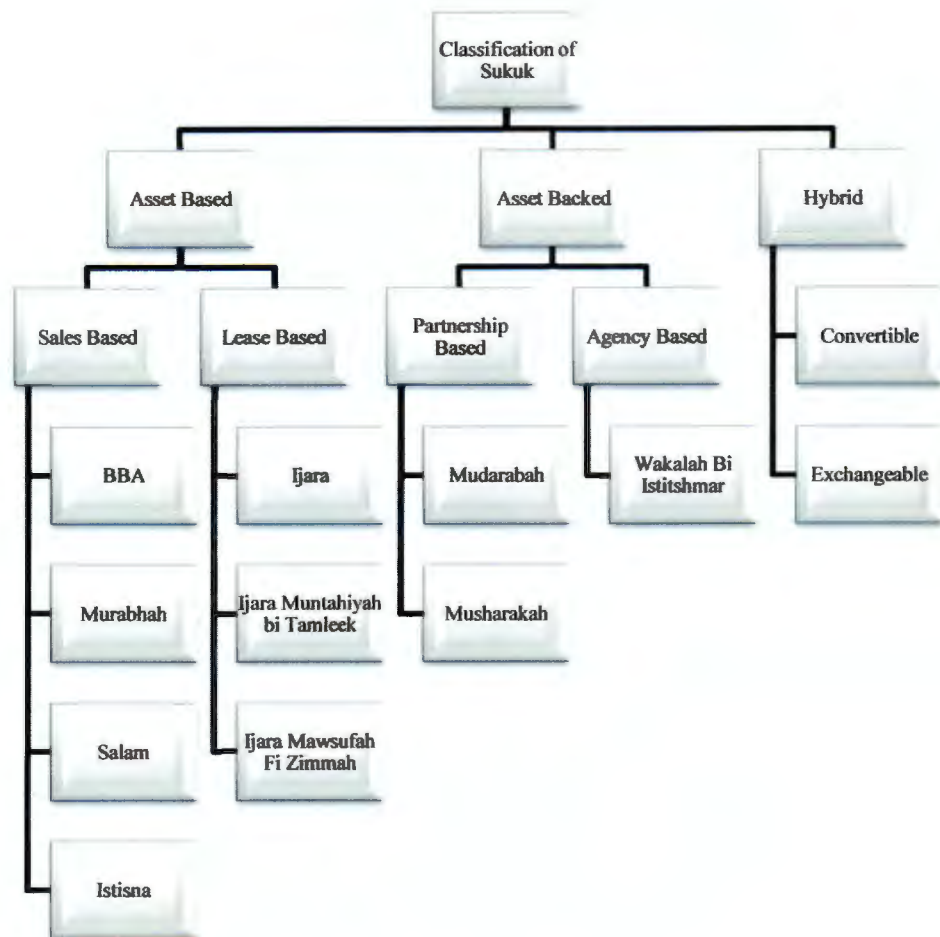


Figure 1.5 Classification of Sukūk

Firstly, IFSB recognized two classes of *sukūk* in 2005: asset-backed and equity *sukūk*. Asset-based *sukūk* are defined as “*Sukūk* where the underlying assets offer fairly predictable returns to the *sukūk* holders, such as in the case of *salam*, *istisnā* and *ijārah*”. On the other hand Equity based *sukūk* are defined as “*Sukūk* where the returns are determined on a profit and loss sharing in the underlying investment, which does not offer fairly predictable returns (e.g. *mushārah* or *mudārah* for trading purposes)”. Later on due to the lacuna in definition, in 2009 an additional standard, IFSB 7 – Capital

Adequacy Requirement for *Sukūk*, Securitizations and Real Estate Investment, was issued. Under which other issues were discussed such as the capital adequacy requirement for non-asset-backed securities and it also provides a guideline for asset de-recognition criteria for asset securities.⁸⁷ IFSB differentiated between three types of *sukūk* structures i.e. an asset-backed *sukūk* and two non asset-backed *sukūk*. In asset-backed *sukūk* the *sukūk* holder has right to recourse to an asset or it can be said that there is full transfer of ownership of an asset to the investor. In cases of destruction of an asset, he will bear losses. Two types of asset-based *sukūk* categorized by IFSB are:

- 1) *Sukūk* with the purpose, to use a purchase undertaking from the originator.
- 2) *Sukūk* with a guarantee from the issuer in case the originator defaults.

Moody's⁸⁸ draw a distinction between asset-based and asset-backed *sukūk* by defining that in asset-backed investors enjoy a right of lien over the assets and have preferential position over the unsecured creditors but in asset-based originators takes the purchase undertaking to buy the assets on maturity irrelevant of market price. Here the investors enjoy no special rights over the assets and have no preferential position over the creditors.⁸⁹

1.5.2 Asset-Backed *Sukūk* and Securitization

After discussing asset-based and asset-backed *sukūk*, the asset-backed *sukūk* are compared with the conventional securitization for a purpose of *Sharī'ah* scrutiny. In the securitization, the originator who is in need of financing sells assets in the market and gets cash. The assets will no longer remain in the books of the originator. One of most

⁸⁷Dusuki and Mokhtar, 6.

⁸⁸Moody's is an international rating agency and vital unit of global capital market that provides credit rating, research, tool and analysis that contribute to transparent and integrated financial markets. Available at, <https://www.moodys.com/Pages/atc.aspx>, "Lat accessed, 29 June 2016".

⁸⁹Dusuki and Mokhtar, 8.

important element of securitization is the 'true sale'. The assets will no longer belong to originator. The sale requires all the legal and accounting requisites to remove the assets from the originator books. From the scrutiny, it is therefore considered that in the case of bankruptcy, the creditor of the originator cannot get access to investor's asset. The rating agencies deem investors owner of assets. In the same way, the asset-backed *sukūk* also involves the true sale of asset; therefore the investors are the owners of asset. The real performance of asset determines the return to *sukūk* holder. They are also liable for the loss of an asset because they are owner. In case of bankruptcy of originator, the investor's asset is no longer liable. Therefore, his assets are protected. *Sukūk* holder is open to the elements of market and credit risk.⁹⁰ It involves risk of loss and other issues.

To summarize, *sukūk* can be divided into two types: asset-based *sukūk* and asset-backed *sukūk*. Both of the kinds of *sukūk* are already discussed in detail. Asset-based *sukūk* is further categorized in secured asset-based *sukūk* and unsecured asset-based *sukūk*. Holder of the secured asset-based *sukūk* has collateral over the asset of the originator whereas the holder of unsecured asset-based *sukūk* doesn't possess collateral over the asset of originator.⁹¹

The Chapter has discussed the historical development of *sukūk* briefly, AAOIFI *Shari'ah* standard and its kinds in details. Hence, the structure and application of *sukūk* are clear, to analyze the critical evaluation of it in light of Islamic law. Further division of asset-based and backed *sukūk* cleared the picture more in understanding *sukūk*. The

⁹⁰Credit risk is defined as the the danger that a bank's extension of credit will not pay out as promised, reducing the bank's profitability and threatening its survival. <http://bankersreview.weebly.com/credit-risk.html>, "Last accessed 26th September, 2016".

⁹¹Ibid., 5.

paradox of ownership and other gravest criticism on *sukūk* will be discussed in next section.

Chapter 2

THE PARADOX OF OWNERSHIP IN *SUKŪK*

Sukūk being a revolutionary product in Islamic finance has underlying assets, involving the issue of ownership. "The Issue of *Sukūk* Regulations, 2015" is a current development in the history of *sukūk* in Pakistan. Before appraising these regulations, there is a need to comprehend the issues in the existing model of *sukūk*. There are many issues in current model and the major issue arises when there is a gap between real ownership and beneficial ownership in *sukūk*. The chapter will analyze the *Sharī'ah* definition of ownership, the rights originating from it, as well as the real and beneficial ownership. It will also focus on the co-ownership, as in *sukūk*: the *sukūk* holders have an undivided share in the ownership. Subsequently, it will evaluate the annexed issues related to ownership in *sukūk*, by piercing the veil of *sukūk*. For *Sharī'ah* analysis of ownership in *sukūk*, it is mandatory to comprehend the concept of ownership in Islam comprehensively. The chapter will explicitly explain the *Sharī'ah* issues in *sukūk*.

Is ownership a complicated issue or became complex in *sukūk*? The principles of Islam lay great importance on ownership rights. In Arabic, the word "*milkiyyah*" or "*milk*"⁹² is used for ownership meaning holding a thing and ability to exploit it. Technically, ownership is defined in a wider horizon.⁹³ Four eminent schools of thought have defined it in various ways. *Hanafī* scholars laid emphasis on the right of disposal in

⁹²Munir Ba'albaki, *Al-Mawrid* (Beirut, Lebanon: Dar El-Ilm Lil-Malayēn, 1980), 647.

⁹³Nik Abdul Rahim bin Nik Abdul Ghani, Muhammad Yusuf Saleem & Ahcene Lahsasna, "Beneficial Ownership: To What Extent It Complies with *Sharī'ah*?" *Canadian Center of Science and Education* 11 (2015): 1-13.

ownership and declared it essential unless, there is any legal barrier.⁹⁴ Some *Hanafīs* described it as exercising the right of exclusive freedom over property including right to put a restriction on others.⁹⁵ Whereas Al-Qarafi, an eminent scholar of *Mālikīs*, described it as an authority to get the benefit over an asset and to accept any compensation for it.⁹⁶ Al-Subki also defined it in terms of getting usufruct over asset.⁹⁷ Some *Shāfīs* such as Abu Shuja' has defined it as a legal exclusivity over a useable item. Ibn Taymiyyah defined it as "a legal ability justifying the right of disposal of the asset".⁹⁸

By analyzing all the above-mentioned definitions it is evident that ownership requires the right to use and right of disposal. The Profound analysis shows that ownership is linked with the right to possess, use, sell, donate and to give it as a gift. If there is any legal obstruction then only these rights can be delayed. Otherwise, the owner has and can exercise all of these rights. It is also obvious that right to use and disposal is the primary purpose of ownership. These rights will later on be analyzed in *sukūk*.⁹⁹

Ownership can be of Private property¹⁰⁰ as well as public property¹⁰¹ which can be acquired by buying, inheriting, accepting as a gift and through work or by

⁹⁴Ibn al-Humam, *Fath Al-Qadīr Sharh Al-Hidayat* (Beirut: Daar Sadir, 1900), 74; Ibn Nujaym and Zayn al-Dīn bin Ibrāhīm, *Al-Ashbāh Wa Al-Nazā'ir* (Beirut: Dar al-Kutub al-Ilmiyyah, 1968), 449.

⁹⁵Ubaydillah bin Mas'ud Sadr al-Sharī'ah, *Sharh Al-Wiqayah Fi Masa'il Al-Hidayah*, Vol 2, 196, quoted in Ghani, Saleem and Lahsana, "Beneficial Ownership: To What Extent It Complies with *Sharī'ah*," *Canadian Center of Science and Education* 11 (2015): 155-167.

⁹⁶Abu al-Abbas Ahmad ibn Idris Al-Qarafi, *Al-Furuq* (Beirut: Dar al-Kutub al-Ilmiyyah, 1998), 208.

⁹⁷Abd al-Wahab ibn Ali Taj al-Din al-Subki, *Al-Ashbah Wa Al-Naza'ir*, 1st ed. (Beirut: Dar Al-Kutub Al-Ilmiyyah, 1991), 76.

⁹⁸Ahmad bin Abd al-Halīm Ibn Taymiyyah, *Al-Qawa'id Al-Nuraniyyah Al-Fiqhiyyah* (Riyad: Maktabat Al-Tawbah, 2002), 334.

⁹⁹Ghani, Saleem and Lahsana, 155-167.

¹⁰⁰Private property is that property which is owned by the people such as land, building etc, <http://dictionary.cambridge.org/dictionary/english/private-property>, "Last accessed 13 April, 2016".

¹⁰¹Public Property is that property which is owned by the government on behalf of the people for providing the services to the public such as electricity, water, administration of justice etc, Ibid.

manufacturing.¹⁰² In Islam, the word *milkiyah* is used for ownership and the word *qabd* is used for the possession.¹⁰³ Ownership and possession are different in spirit. It is possible that someone has possession but not ownership,¹⁰⁴ which will be discussed in later section in detail. Transfer of ownership is germane in every sale contract.¹⁰⁵ It is essential for buyer to acquire possession (*qabz*) of sale object although it can be an actual or constructive possession.¹⁰⁶

The Sale is an ordinary way of transfer of ownership recognized in *Sharī'ah*. Sale of valuable thing requires recording as a deed and registering in public documents as per law. A valid sale requires the transfer of ownership of an asset to the buyer. After transfer of the ownership, the seller cannot claim the asset. *Sharī'ah* recognizes only "real sale" in which all the rights in an asset should be transferred from the seller to the buyer. These rights also include a right to sell the property to the third party. In real sale the buyer becomes the legal owner of asset sold.

The controversial issue here is beneficial ownership which is originated from the common law,¹⁰⁷ is practiced now a day. It is also known as "a sale that falls short of a real sale,"¹⁰⁸ In beneficial ownership, some of the rights are not transferred from the seller to buyer such as, the right to get revenue, right to get possession, right to sale etc. Right of sale to the third party which is attached to the ownership of property will be

¹⁰² Abdul Karim Abdullah, "Legal and Beneficial Ownership," *Economic, Finance, Zakat & Awqaf*: 1-4. Available at www.iais.org.my/.../266_413f30fc2c00d64e7ec4cc25ca3ce9f4.html, "Last accessed 20 April, 2016".

¹⁰³ Ibid.

¹⁰⁴ For instance children are possessing thing but their parents are legal owner. See, Ibid.

¹⁰⁵ Islamic Scholars of all *madhaib* are agreeing on transfer of ownership. Ghani, Saleem and Lahsana, 155-167.

¹⁰⁶ Ibid.

¹⁰⁷ Common law is defined as the English law, derived from the customs and precedents. <http://www.oxforddictionaries.com/definition/english/common-law>, "Last accessed 5 May, 2016".

¹⁰⁸ Abdullah, "Legal and Beneficial Ownership," 1-4.

profoundly scrutinized here. "A sale that falls short of a real sale" is defeating the primary purpose of law i.e. the transfer of ownership. It could be used for the fraudulent purpose i.e. the buyer understands himself as an owner which in fact, is not a legal owner.¹⁰⁹ From a long time, it is criticized that Islamic banking replicates conventional banking.¹¹⁰ The focus of criticism is often on beneficial ownership in financial products. The criticism emphasize that in *sukūk*, *Sharī'ah* concept of ownership is violated and consequence in contradicting *maqāsid-al-Sharī'ah*.¹¹¹

Beneficial ownership restricts the right of disposal of an asset. Is it complying with *Sharī'ah*?

The issue will be investigated by Fiqh analysis. By *takyif fiqhi*¹¹² of transfer of moveable property, it is observed that beneficial ownership is allowed in *rahn*.¹¹³ On the other hand, some *Hanafīs* allows it as *bay' al wafā* whereas, others don't allow it. There is a difference of opinion on *al-shurut al-taqyidiyyah*,¹¹⁴ three different views¹¹⁵ are observed. The majority of fuqaha disapprove *al-shurut al-taqyidiyyah* on the ground that prophet

¹⁰⁹Ibid.

¹¹⁰Ayub, 463; Thorsten Beck, Asli Demirgüç-Kunt and Ouarda Merrouche, "Islamic vs. Conventional Banking Business Model, Efficiency and Stability," (Paper, The World Bank Development Research Group Finance and Private Sector Development Team, October 2010), 3. Available at http://www.wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2010/10/18/000158349_20101018092550/Rendered/PDF/WPS5446.pdf. "Last accessed 10 May, 2016".

¹¹¹Al-Amine, *Global Sukūk and Islamic Securitization Market: Financial Engineering and Product Innovations*,

¹¹²It is defined as a fiqh analysis of new transaction to check its permissibility in Islam. <http://investment-and-finance.net/islamic-finance/t/takyif-fiqhi.html>, "Last accessed 22 July, 2016".

¹¹³Rahn is defined as to pledge a tangible property against debt; in case of default, the creditor has right to recover the debt by selling the property. http://www.islamic-banking.com/glossary_r.aspx, "Last accessed 24 July, 2016".

¹¹⁴*Al-shurut al-taqyidiyyah* means impositions such as restriction on ownership Ghani, Saleem and Lahsana, 155-167.

¹¹⁵*Mālikīs* and Ibn tamiyyah allows minor restrictions with a condition that it shouldn't be harmful to buyer. On the other hand Ibn Shubrumah allows all forms of conditions on basis of *hādīth* that "Muslims are bound by their stipulations". Ibn Shubrumah view shouldn't be views in restricted terms but it should be taken in issues of *maslaha* only. Ibid.

(PBUH) disapprove sale with a condition and it is not in line with original repercussion of contract of sale i.e. *muqtada al-aqd*.

By *takyif fiqh* of transfer of immoveable property, it is found that the core theory revolves around the possession (*qabd*).¹¹⁶ In moveable property, possession is efficient when buyer takes goods by hand (i.e. *tanawul bi al-yad in fiqh*) but in immoveable property it is effective when he can access and use the assets, devoid of restrictions (i.e. *takhliyyah wa tamkin*). Here in immovable property, the concept of a beneficial ownership is observed in trust. Whereas, in Islamic finance it is recommended that it should be observed by case to case in designing Islamic financial products i.e. by deeply investigating every contract and issue.¹¹⁷ Therefore, the instant research will focus deeply on investigating the issue in line of *Shari'ah*.

Not only real sale but beneficial sale is also exercised in *sukūk*. In asset-backed *sukūk* there is real sale whereas in asset-based *sukūk* there is a beneficial ownership.¹¹⁸ IFSB explain that in asset-backed *sukūk*, the *sukūk* holders have a right of recourse to the asset in event of default and have to bear the losses in case of destruction of the asset. The legal ownership of the assets exists in asset-backed *sukūk* in which the originator has no right of recourse to asset.¹¹⁹ All of three conditions i.e. Profit and loss structure, real sale requirement and real ownership, are prevalent in asset-backed *sukūk*. Therefore,

¹¹⁶Possession (*qabd*) is further classified into *qabd haqiqi* and *qabd manwi*. Nyazee, *Outlines of Islamic Jurisprudence*, 240.

¹¹⁷Ghani, Saleem and Lahsana, 155-167.

¹¹⁸Abdullah, "Legal and Beneficial Ownership," 1-4.

¹¹⁹Shabana M. Hasan, "Asset- Backed & Asset-Based *Sukūk*: An Introduction" *International Shari'ah Research Academy* (2013): 1-4. Available at <http://ifkr.isra.my/documents/10180/16168/isra-bloomberg-oct-2013-fatwā.pdf>, "Last accessed 1st May, 2016"

these are considered as *Sharī'ah* complaint.¹²⁰ Whereas, high transaction costs, legal and regulatory challenges, lack of suitable asset classes, lack of trained and skilled personnel in structuring are some of the issues faced by financial institutions in asset-backed *sukūk*.

Nomura *Sukūk* Ltd issued *ijārah sukūk* for the period of 2 years, worth of USD 100 million involving the physical asset of two aircrafts. The case study shows that there was transfer of real ownership of the asset to *sukūk* holders which renders it *Sharī'ah* compliant. On the other hand, *sukūk* issued in Pakistan lacked the transfer of ownership to *sukūk* holders (details of case study will be explained in next chapter). Asset-backed *sukūk* also attract little criticism upon it that there is no direct transfer of ownership to investors but these are transferred indirectly as contrast to securitization. Here the assets are considered as the mere receivables (also known as debts) in *Sharī'ah* principles. So, there is mere trading in debts instead of assets which consequence in exploitation of asset. Here the recourse lies to SPV and its assets rather than originator. At this point, it is recommended that measures should be taken to implement AAOIFI standard in real sense.¹²¹

On the other hand, in asset-based *sukūk*, the *sukūk* holders have recourse to the originator or to the issuer not asset and have no real ownership of asset. The dividend is measured by the ratio of investment rather than the ratio of profits attained. Hence asset-based *sukūk* are replicating the conventional bonds on the above-mentioned grounds as well as from the viewpoint of taxation in law. Still the investors do prefer the asset-based *sukūk* for the reason that it is easy to understand the structure of asset-based *sukūk*.

¹²⁰Ibid.

¹²¹Kamali and Abdullah, ed. *Islamic Finance: Issues in Sukūk and Proposals for Reform*, 18.

Lastly, these are well-known to investors than asset-backed *sukūk*. *Sharī'ah* scholars criticize asset-based *sukūk* as there is no interest of *sukūk* holders in underlying asset, restriction lies on disposal of asset and *sukūk* holders have no right to exercise due diligence on the asset.¹²² Scholars are of view that asset-based *sukūk* are in fact a duplicate of conventional bond because rights of investor are not protected in it.¹²³ Moreover, the investors are getting the cash flow¹²⁴ instead of the asset which can generate the cash flow. AAOIFI resolution in 2008 was against the asset-based *sukūk*.¹²⁵ The transaction is not through underlying assets then the money which is generated here is simply against money. Some issues are raised in relation to real sale vs. beneficial sale:

- A transaction in which the asset termed as “sold” remains intact with seller. Can it be termed as “sale”?
- Whether the objective of sale is the transfer of ownership from buyer to seller?
- If ownership is not transferred to buyer, can one claim with realistic degree of authority that sale has taken place?
- If sale is not done in real then what is the rationale to come in this transaction in the first step?¹²⁶

The current study analyzes these issues in the light of juristic approaches. As discussed above the *Sharī'ah* analysis depict that the *sukūk* holders should deal freely with the asset including the right of disposal. *Hanafīs* scholars and Ibn Tammiyyah specifically

¹²²Hasan, 1-4.

¹²³Kamali and Abdullah, 169.

¹²⁴Cash flow is incomings and outgoings of cash, representing the operating activities of an organization. Available at; <http://www.businessdictionary.com/definition/cash-flow.html>, “Last accessed 1st May, 2016.

¹²⁵Ibid., 11.

¹²⁶Abdullah, “Legal and Beneficial Ownership,” 1-4.

mentioned the right to disposal in defining the ownership. So, *sukūk* should transfer all the rights of ownership. Restricting the right of disposal doesn't comply with *Sharī'ah*. After criticism of Sheikh Taqi Usmani on ownership, AAOIFI held resolution in 2008 in which it is recommended that all of the rights of ownership (including right to use and sell) necessitate in *sukūk* to be transferred.¹²⁷ The documentations should also be maintained and the manager shouldn't keep it as his own assets in harmony with Articles (2) and (5/1/2) of the AAOIFI *Sharī'ah* Standard (17) on Investment *sukūk*.¹²⁸

One of the objectives of *Sharī'ah*¹²⁹ is the protection and preservation of property. Islam recognizes all the rights attached to the ownership of property and adopts all the means for preservation of property.¹³⁰ All the crimes relating to property are punishable under *Sharī'ah* such as theft¹³¹ (Punishable with *hadd*).¹³² Islam recognizes the right of people to own property. The Property is enjoyed as a convenience of life. It brings facility and ease (*taysir*). Property and its protection is one of the objectives (*maqāsid*) of the *Sharī'ah*. Applying the real rights of ownership on *ijārah sukūk*, it is illustrated that the *ijārah sukūk* involves real sale of the asset rather than generating mere fictitious right to get rents. Risk also transfers with ownership complying with *hādīth* "*al-kharaj bi al-damān*". It is further explained that in case of any destruction the loss is

¹²⁷<http://www.kantakji.com/media/7760/f173.pdf>, "Last accessed 10 May 2016"

¹²⁸ Articles (2) and (5/1/2), *Sharī'ah* Standard (17), AAOIFI.

¹²⁹ There are five objectives of *Sharī'ah*: 1) protection of deen 2) protection of life 3) protection of Nasl 4) Protection of Intellect 5) Protection of wealth See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (Islamabad : International Institute of Islamic Thoughts and Islamic Research Institute Islamabad, 2000), 195.

¹³⁰ Abdullah, 1.

¹³¹ Property stolen without permission of other see, Nyazee, *Outlines of Islamic Jurisprudence*, 443.

¹³² Maulana Muhammad Ali, *The Religion of Islam* (USA: Ahmadiyah Anjuman Ishaat Islam , 2011), 524 ; Imran Ahsan Khan Nyazee, *Outline of Islamic Jurisprudence* (Islamabad : Advance Legal Studies Institute, 2010), 443.

equally divided in co-owners up to their share in ownership. If it is truly used by the market players then the profit and loss ensure compliance with *Shari'ah*.¹³³

As in beneficial ownership, there is certain restriction including the right to sell the asset to the third party. It has gravest implications to the buyer in case of bankruptcy of originator. The buyer will have no recourse to asset in such case. Investor faces this issue in asset-based *sukūk* unlike asset-backed *sukūk*.¹³⁴ Moreover, it generates the issue of liquidity. The buyer is unable to liquidate the asset¹³⁵ that makes the instrument less tradable in market, hence lacking investor's confidence to invest in it. Global financial crisis in which number of *sukūk* defaulted gave evidence that number of people were not aware of the fact that they were not the legal owners. In fact, they were beneficial owner. Moreover, they couldn't differentiate between legal and beneficial ownership. Therefore, investor's protection was vague.¹³⁶

2.1 Musha' and Sharikat Al Milk

The ownership is further linked with co-ownership. Therefore, it is necessary to understand the rules of co-ownership in light of *sukūk*. Modern scholars linked the ordinary shares with the concept of *musha'* (means undivided share in the joint property). By analogy, they allowed the sale of shares in corporation because each co-owner is stranger with respect of other; hence, they can sell their shares. In co-ownership each owner is holding each and every particle of property jointly. The *khalt* or mixing of

¹³³<http://www.kantakji.com/media/7760/f173.pdf>, "Last accessed 10 May 2016"

¹³⁴ Abdullah, "Legal and Beneficial Ownership," 1- 4.

¹³⁵ Ibid.

¹³⁶ Kamali and Abdullah, 169.

capital is prerequisite in every form of partnership. Moreover, all rights go back to your old way in *sharikah al milk* when partnership comes to an end or becomes *fāsid*.¹³⁷

Co-ownership is categorized into *ayn*¹³⁸ and *dayn*.¹³⁹ The jurists agree with respect to *ayn* but disagreement exists with respect to *dayn*. The proponent including *Hanafīs* permits *dayn* on the ground that gift is permitted in it whereas the opponents are of view that there is metaphorical partnership because in reality, it is abandonment of right to claim. The *Hanafīs* view is preferred mostly.¹⁴⁰ The only kind of this type of *sharikah* is *khalt* or where there is mixing of two *ayns* or two *dayns*. This mixing can happen by the act of owner or by the act of others. If it is done by the act of other then it cannot be revoked leading to mandatory co-ownership. The first case involves ownership by choice (*sharikah al ikhtiyar*) but later involves mandatory co-ownership (*sharikah al jabr*). Following are the necessary conditions for co-ownership:

1. Each co-owner can only use and dispose of his own share. He is stranger with respect of other co-owner and cannot use and dispose of the share of co-owner. The only exception is house which can be used by both.

¹³⁷Imran Ahsan Khan Nyazee, *Islamic Law of Business Organization Corporations* (Islamabad: The International Institute of Islamic Thought and Islamic Research Institute, 1998), 36.

¹³⁸*Ayn* is defined as the corpus or substance of a thing. *Hanafīs* renders it things measurable during sale transaction. See, Ibid., 192. Majallah elaborated the co-ownership of *ayn* as "the joint and exclusive ownership of two or more persons resulting from one of the causes of ownership, like purchase, gift, acceptance of a bequest, inheritance, or by the mixing (*khalt*) or their property in a manner that doesn't accept distinction or separation." See, Ibid., 36.

¹³⁹*Dayn* is defined as receivables. The term doesn't apply on *qard*. See, Nyazee, 193. Majallah elaborated the co ownership of *dayn* occur "when two or more persons are owed a debt attached to a *dhimma* (liability) of another person, and that has arisen from a single cause. This is common debt and is held in co-ownership between them. If the cause is not common, the debt is not a co-ownership." See, Ibid., 37.

¹⁴⁰Ibid., 36.

2. In case of *khalt* where the capital is mixed the co-owner cannot sell his own joint share without the permission of other. If the share is not mingled properly then the co-owner can sell his own joint share without the permission of other.

The logic behind this condition is that ownership is undivided (*musha'*) and every co-owner owns property in each and every particle. This opinion is held by Majallah whereas modern scholars permit selling of such shares without partition.¹⁴¹

3. The rules of *wadiah* (deposit) are applicable here in co-ownership.¹⁴² In *wadiah*, the one who is holding the trust property is liable only if the property is destroyed by him by negligence.¹⁴³ The same rules will be applied here in co-ownership, if one co-owner deposits the property to any third person without obtaining or seeking the permission of co-owner then liability is borne in case of destruction of property.
4. Joint receipt of revenue amounts to *sharikāt-al-milk* in such revenue.
5. If someone has taken debt then the co-owners can demand it jointly or severally.
6. Rules of *sharikāt-al-milk* are applicable to an *ayn* if the debt is possessed by one partner. Moreover, period of debt cannot be postponed without the permission of co-owner.

In law, *sharikāt-al-milk* is referred as co-ownership. The Law doesn't categorize it under partnership but clearly, differentiate in both of them. From the point of view of Islamic law, the following distinction is drawn between co-ownership (*sharikāt-al-milk*) and partnership (*sharikāt-al-aqd*).

¹⁴¹Ibid., 37.

¹⁴²Ibid., 38.

¹⁴³Shahid Ashraf, *Judicial Culture in Islam* (New Delhi, India: Anmol Publication, 2006), 271.

2. When the property under *sharikāt-al-milk* is ascertained then the sharing of profit is not necessary. On the other hand, the basic purpose of establishing partnership is sharing of profits.
3. Al-Kasani says that there is consensus of *ijmā* on fact that the division of proceeds will be according to ratio of shares in *sharikāt-al-milk* but in *sharikāt-al-aqd* *Hanafīs* and *Hanbalī* jurists says that the division of revenue can be changed.
4. In general, every co-owner is stranger with respect to the share of other in *sharikāt-al-milk* but if they establish any contract of agency then they have to pay wages for it rather than profits. On the other hand, partnership itself establishes the contract of agency and necessitates the division of profits.
5. The co-owner can sell his share without the permission of other only if his share is ascertained and apportioned but partnership always requires permission from the other.¹⁴⁷

The rules of *sharikāt-al-milk* are very germane to understand because on *sharikāt-al-milk* joint ownership is created which is relevant to *sukūk*.

2.2 Criticism on Corporation

According to Arab scholars, corporation¹⁴⁸ is formed under a contract or *sharikah*. It is criticized that at the time of sale of share they used the rules of co-owner that the co-owner can sell their share without the permission of other if their share is ascertained.

¹⁴⁷Nyazee, *Islamic Law of Business Organization Corporations*, 39.

¹⁴⁸Corporation is defined as a joint stock company where the liability of the members is different from the company. In Pakistan the term of corporation is associated with the companies sponsored by state through ordinances such as Companies Ordinance, 1984. See, *Ibid.*, 113. Guthman and Dougal defines corporation as "The formation of an association of persons into an autonomous legal unit with a distinct legal personality that enables it to carry on business, own property and contract debts through its agents and officers". Guthman and Dougal, *Corporate Financial Policy* (New York: Prentice Hall.1952), 9.

They do not apply the rules of partnership. It is argued that there is no joint ownership in capital of corporation. It is only owned by the legal person i.e. the corporation.

Modern scholars firstly rendered corporation as legal person¹⁴⁹ but later on overlooked the rules of legal personality and renders it contract of *sharikah*. In event of sale of share, they ignored the ruling of *sharikah* and allowed it on ground of concept of *musha'* (co-ownership). All this logic is capricious.¹⁵⁰

2.3 Critical Analysis of *Sukūk*

Despite gravest criticism on ownership in asset-based *sukūk* focusing on *ijārah sukūk*, the *sukūk* (particularly *ijārah sukūk*) is further criticized on other vital issues which are discussed below:

2.3.1 Guarantee in *Sukūk*

The issue arises when the guarantee is given by the originator against any shortfall.¹⁵¹ AAOIFI *Sharī'ah* standard depicted that the third party guarantee is allowed¹⁵² but it should be given without any consideration. Following issues arises in guarantee in *sukūk* that are analyzed in dissertation:

- What if the guarantee is given by public unit for sake of encouragement of investments in a country? Is it allowed?

¹⁴⁹The word person communicates with the word *mukallaf* but *mukallaf* is used for human being. An additional attribute personality (*Shakhsiyah*) is given by law. Here fictitious personality is given to the corporation. See Further, Imran Ahsan khan Nyazee, *Theories of Islamic Law*, chapter on legal capacity and its defects.

¹⁵⁰Nyazee, *Islamic Law of Business Organization Corporations*, 40.

¹⁵¹Muhammad Al-Bashir Muhammad Al-Amine, "Sukūk Market: Innovation and Challenges", *Islamic Economic Studies*, Vol. 15, No. 2. (2008), 4.

¹⁵²See, Clause 5/1/8/7, *Sharī'ah* Standards No.17 on Investment *Sukūk*, and Clause 7/6, *Sharī'ah* Standards No. 5 on Guarantees, AAOIFI.

- Whether guaranteeing the capital amounts to *ribā*?

There are two opinions by contemporary Muslim scholars on this issue:

- 1) The first group is of view that in *sukūk al ijārah*, *sukūk al mudārabah* and *sukūk al mushāarakah*, guarantee the principal amount paves the road to *ribā*. As it is also against the *mudārabah* contract where guaranteeing is prohibited by all schools of thoughts.
 - As for as guarantee by government is scrutinized, the group is of view that such guaranteeing is impermissible because the property of government belongs to community and is trust in hands of government. It shouldn't be open to financial risks for some entities.
 - Moreover, from practical point of view, benevolent guarantee by any individual or entity is impossible because no one will give guarantee without any specific interest or consideration.¹⁵³
- 2) The other group argues that the guarantee by the third party is permissible. They gave the following arguments in this regard:
 - As Islamic law prescribes everything is permissible except prohibited. So, guaranteeing by the third party is not prohibited in the text. Moreover, they argue that as long as the third party possesses independent personality to contracting party he can guarantee the capital. If this guarantee is from partner of *mudārabah* then it is not allowed.

Two global *sukūk* models are practically observed in ascertaining the instant issue.

¹⁵³ Al-Amine, "Sukūk Market: Innovation and Challenges", 5.

- Trust certificates issued by Solidarity Trust Services Limited (SPV) which is wholly owned and subsidiary of IDB (originator here).
- Malaysia Global (SPV) wholly owned by Ministry of finance, Malaysia issued *sukūk al ijārah* where the originator was the Government of Malaysia. (Here IDB and government of Malaysia are guarantors).

Here the proponents argue that the in both of these cases SPV are autonomous legal entities in terms of financial liability from guarantors. Therefore such guarantee by a third party is permissible whereas the opponents stated that it is *ribā al-duyun* on basis of following arguments:

- By this guarantee the money which is invested in the trust certificate will be fully redeemed on date of maturity.
- Moreover, the certificates holders are getting here fixed periodic returns regarding trust certificates.

The proponents argue that all such transactions are interest based where the guarantee is given by the issuer or any interested party and *sukūk* holders are getting fixed periodic returns. In both of these cases the guarantors are not mere third parties and haven't given the gratuitous guarantee but they have vested interests in issuance of these *sukūk*. From the consequences of this guarantee the fund is collected for purchase of *sukūk* which otherwise will not be achievable.¹⁵⁴

¹⁵⁴Ibid., 6.

2.3.2 Sale and Lease Back Structure

I. *Sharī'ah* Compliance of Sale and Lease-back Arrangement: Is It Permissible?

Here the dissertation focuses on the vital issue i.e. sale and lease back arrangement. This deal is evident in *sukūk al-ijārah* where the arrangement is made i.e. the customer is in need of finances, he has ownership in asset, and therefore, he sells the asset. After sale, the asset will be lease back to originator against rentals for usufruct of assets. Here the issue is about the permissibility of this arrangement. The arrangement is permissible in Islam only in cases of dire need but generally, this practice should be evaded. Moreover, in major business and Islamic finance, there is restriction that they should not adopt it for key approach of business. Besides, it is said that the Islamic banks can accommodate the customer who wants to get free of *ribā* and doesn't have any further substitute.

The ruling evidently depicts that sale and leaseback arrangement should be used in exceptional cases which should conform to the *Sharī'ah* rules. As discussed earlier sale and lease back is allowed in dire need, can be used for investment in new assets as well as converting the conventional instruments involving elements of *ribā* into Islamic financing. The sale agreement should be made prior to lease agreement in such transaction. It is recommended by some scholars that for avoidance of *bay' al īnah* the lease assets can be sold back after some reasonable time in which the value of property has altered.¹⁵⁵

¹⁵⁵ Ayub, 323.

Ii. Sale by Lessor

Lessor can sell the asset to any third party, in that case, the sale will be valid and the *ijārah* may carry on. It necessitates the ownership should be transferred, a mere right to receive rentals is not allowed because in that case the money is sold for money. The new lessor can fully exercise all the rights attached to asset and has to bear the liability. It ensures the secondary market on basis of *ijārah*.

The market risk is involved in *ijārah sukūk* i.e. price, maintenance of asset and Takaful costs, ability of lessee to pay the rent etc. The risk is borne here by the lessor for the reason that ownership requires it.

III. Destruction of Assets

In case of overall destruction of assets, the *sukūk* holders are bound to bear the losses as per share in the ownership of assets. Hence, *ijārah sukūk* may generate a quasi-fixed return since there might be default or some unexpected expenses that could not be envisaged in advance. As such, the amount of rent given in the contractual relationship represented by *ijārah sukūk* represents a maximum return subject to deduction on account of unexpected expenses.¹⁵⁶

As AAOIFI allowed sale and lease back in *sukūk al ijārah*.¹⁵⁷ Here following controversial issues will be determined:

- It will be analyzed that whether such sale and leaseback amounts to *bay' al wafā*, *bay' al īnah* and *bay' al- istighlāl* or not?

¹⁵⁶Ibid., 325.

¹⁵⁷AAOIFI 2008. Resolution available at <http://www.kantakji.com/media/7760/f173.pdf>, "Last accessed 10 May 2016"

- Whether it amounts to *ribā* or not?

The opponents labeled it another form of *bay' al- wafa*, *bay' al īnah* and *bay' al- istighlāl*.

2.3.3 *Bay' al wafā*

Bay' al wafā is defined as the seller sells the property with the condition to buy back the property in case of payment.¹⁵⁸ Here in *ijārah sukūk*, the seller is in need of cash, for cash he sell out his property and when he is able to returns the cash he will buyback the property from the buyer. The asset is leased to the seller and the rent is collected as installments ends into ownership giving effect similar to *ijārah muntahiya bi al- tamleek* (in which lease contract ends into ownership) is analogous to *bay' al wafā*.¹⁵⁹ *Bay' al wafā* is considered as a defective sale by *Hanbalī*, *Mālikīs*, early *Shāfīs* and *Hanafīs* jurists. They gave the rationale that in such sale legal modes are used as a cover-up to indulge in forbidden practices in *Sharī'ah*. Moreover, they argue that the apparent sale is just like the loan and the use of property is interest (*ribā*) collected over the loan hence prohibited. Incredibly this structure is again enforced in *sukūk* where money is generated over the usufruct by leasing back the asset to the seller but the modern scholars allowed it.

Generally in Islamic jurisprudence, there is no objection to selling the property to the person from whom he has bought but it shouldn't be in single contract.¹⁶⁰ The reason

¹⁵⁸ Al-Amine, "Sukūk Market: Innovation and Challenges", 7.

¹⁵⁹ Ibid.

¹⁶⁰ Mahmoud A. El -Gamal, *Islamic Finance Law, Economics and Practice* (New York: Cambridge University Press, 2006), 74. Available at, <https://books.google.com.pk/books?id=2EIRUvoVRxYC&printsec=frontcover#v=onepage&q&f=false>, "Last accessed 1st June, 2016".

is depicted in the *hādīth* of the holy Prophet SAWW that prohibited joining two sales in one contract.¹⁶¹ The separate contracts can be concluded in this regard. If it is in a single sale can we call it valid sale? We cannot call it sale because absolute rights of ownership are not transferred in original by restricting the right of sale.¹⁶²

International Islamic Fiqh Academy declared it Invalid by giving rationale that it put limitation on absolute exercise of proprietary right as the owner cannot dispose of the property as he has no right to sell and right to give property as gift but in actual he bound to sell it to the first seller on face value. Therefore this transaction is parallel to loan transaction. Here the first seller needs money he is borrower and the buyer is the lender who gives money. The property is mortgage here to the lender from which he is getting benefits. It is a recognized fact that any benefit drawn out of mortgage property is *ribā*. In this transaction the second sale i.e. buyback of assets is in actual return of loan to lender.¹⁶³

2.3.4 Bay' al- Istighlāl

It is also known as exploitation sale¹⁶⁴ and sale of usufruct. It is a sale in which the right of redemption is created by the seller. The seller here takes the property on lease and uses the proceeds.¹⁶⁵ After paying the price he will get back the property. The opponents consider that it is parallel to sale and lease back structure in *sukūk*.¹⁶⁶

¹⁶¹Mansoori, *Islamic Law of Contracts and Business Transactions*, 10.

¹⁶²El -Gamal , *Islamic Finance Law, Economics and Practice*, 74

¹⁶³Dr. Muhammad Tahir Mansoori, "Use of *Hiyal* in Islamic Finance and its *Shari'ah* Legitimacy", 70-92.

¹⁶⁴Ibid.

¹⁶⁵<http://investment-and-finance.net/islamic-finance/b/bay-al-istighlāl.html>, "Last accessed, 20 June, 2016".

¹⁶⁶Al-Amine, "*Sukūk* Market: Innovation and Challenges", 7.

2.3.5 Bay' al īnah

Here sale and lease back is also viewed as a kind of *bay' al īnah*¹⁶⁷ in which two sales are joined together: one is spot sale and other is deferred sale (that is with higher price). For instance on spot sale was made on 800 Rs but later on pre-agreed price he will buy back such as 700Rs. Here difference between two prices amounts to *ribā*. The invalidity of *īnah* is based on the following *hādīth*:

Hādīth reported by Abu Hurairah

“Whoever makes two sales in one sale, then for him is the lesser value or it is *ribā*.”¹⁶⁸

Hādīth reported by Al-Awzai

“A time will come over people when they will seek to permit *ribā* through sale”¹⁶⁹

On basis of these issues it is argued by opponents that such sale and leaseback arrangement in *sukūk* is subterfuge or a trick to legalize *ribā*.¹⁷⁰

2.3.6 Issue: Is Unilateral Promise to Purchase has binding Implications?

I. Wad or Purchase Undertaking in Sukūk

As discussed that AAIOFI 2008 resolution mandated real sale and transfer of all rights in ownership, pre AAOIFI period depicts that some issuer relied on wad but pre AAOIFI period depicted some decline in it but still some issuers never observed AAOIFI

¹⁶⁷Ibid.

¹⁶⁸Abu 'Isa Muhammad ibn 'Isa at-Tirmidhi, *Sunan at-Tirmidhi*, ed. Hafiz Abu Tahir Zubair (Riyadh: Maktaba Dar-us-Salam, 2007) Vol. 3, hādīth No. 1232. Two sales in one are prohibited in number of *hādīth*. Abū Dāwūd, *Sunan, Kitāb al-Buyū*, Bāb fī man bāa bay'atayni fī bay'atih, No.3461, Vol.3, 274.

¹⁶⁹Muhammad Nasir-ud-Dīn al-Albani, *Ghaya Tul al Marami Fi Takhrej Ahadith al Halāl wa al Haram*, 3rd ed (Bairut: Al Maktab al Islami, 1985), hādīth No. 13, 25.

¹⁷⁰Al-Amine, “*Sukūk* Market: Innovation and Challenges”, 8.

recommendations. It demonstrates the mind set of people that they do prefer asset-based *sukūk*.¹⁷¹ Purchase undertaking is an irrevocable promise in the contract to buy to assets from SPV at maturity. It is normally on par value which is, in fact, guaranteeing the returns of principal replicating conventional bonds. When any asset is buy back at par value then the risk associated with asset is not actually borne by the buyer i.e. the risk of loss to the capital. Therefore, it secures the capital against the risk.¹⁷² The legal presumption with *sukūk* is that there can be no guarantee that capital will be returned to investors. Instead, they have a right to the real value of the *sukūk* assets, regardless of whether their value exceeds that of their face value or not. Modern day *sukūk*, however, guarantee by indirect means *sukūk* holders principal.

The practice of Issuer granting such purchase undertaking has been heavily criticized by the scholars and perhaps the most notable one is by Taqi Usmani.¹⁷³ He criticized that it is not allowed to buy assets at par value but can be allowed at market value or money agreed at time of re purchase. The justification for the ruling of "unlawful" with regard to the binding promise by one of the partners to purchase the assets of the partnership at face value is that this is the same as a capital guarantee, which is unlawful.¹⁷⁴ AAOIFI stated in 2008 that repurchase can be on market value. This rule was made to eliminate the element of "price fixing".¹⁷⁵

The institutions having Islamic windows for operation of Islamic finance (here for transacting in *sukūk*) have mindset of bond market. They do not want to bear risk

¹⁷¹Ibid., 12-13.

¹⁷²Ibid., 20.

¹⁷³Ellias, Haron and Mohammed, "*Sharī'ah issues in Sukūk*," 8.

¹⁷⁴Usmani, "*Sukūk and their Contemporary Applications*," 15.

¹⁷⁵Ellias, Haron and Mohammed, "*Sharī'ah issues in Sukūk*," 8.

associated with *sukūk* due to inflation, liabilities and profit making. The institutions fear that due to inflation the price of asset may devalue. For securing themselves from such risk they avoid to have *Sharī'ah* compliance in it. Management of liabilities concerning clients as well as profit making is another leading factor for avoidance of risk by them. In asset-based *sukūk* originator wants to raise funds irrespective of delivering ownership of assets in *sukūk*. Legal ownership remains with originator whereas beneficial ownership remains with SPV on behalf of *sukūk* holders.¹⁷⁶

By applying Islamic normative theory of profit it is determined that the risk is the vital element of profit making and not bearing risk amounts to interest. In interest, money is given somebody as the loan for a time period where returns are guaranteed. The fixed amount is enjoyed here by exploiting the labor of others. It is observed in asset-based *sukūk* the investor wants to secure money, fixed returns and no risk in assets. All of these elements are crucial component of conventional bonds. These *sukūk* are not functioning at the market level of Islamic institutions but by the institutions having mindset of conventional banks.¹⁷⁷ Usmani criticism also highlighted that transactions involving lack of transfer of ownership, fixed returns based on percentage of capital instead of profits and capital guarantying are characteristics of bonds.¹⁷⁸ If these are found in any form of *sukūk* then there is no difference between bond and *sukūk* rather than nomenclature.

It is criticized in sovereign *ijārah sukūk* that in Islamic banking the intention of government to create SPV is to ensure buy back arrangement only. The government usually sells the rentable assets by unilateral promise to buy back the assets on maturity if

¹⁷⁶Ibid., 15.

¹⁷⁷Ibid., 17.

¹⁷⁸Ibid., 18.

the SPV requests. Here it is critically scrutinized that SPV is established by the government, therefore entirely dependent on the government or can be named as “dummy” works solely for government. Therefore, SPV is under an obligation to exercise the right to sell the assets back to government on par value even the market price is poles apart to par value. In this way, the unilateral promise has the binding implications in practice.¹⁷⁹ This matter is clearly depicted in WAPDA *sukūk* where unilateral promise has the binding implications open to *Sharī'ah* criticism.¹⁸⁰

Prof. Dr. Sayyid Tahir also objected on the first step in *ijārah sukūk* i.e. the creation of SPV. It is criticized that the SPV and originator are not two autonomous people as required by *Sharī'ah*. The initial step is void ab initio and doesn't require supplementary steps. Here the creation of an SPV merely for the purpose of the lease and buy back of asset is suspicious.¹⁸¹ The difference is merely the difference in nomenclature i.e. the markup with rentals. For instance, on repurchase of any asset makeup is taken but here sale and repurchase agreement is made and the “rentals” are received which is, in fact, a markup. Therefore it resembles with the prohibited tricks mentioned in Holy Qur'ān al- A' rāf 162 – 166.¹⁸² So, what is need of SPV here? A well-organized structure can be designed to execute unilateral promise without an SPV.¹⁸³ For Instance, government has issued rentable monotonous asset such as useless barren land on inflated price by linking it to benchmarking. The government should execute binding unilateral promise to buy it back on specified date. On maturity price of asset in market

¹⁷⁹Salman Syed Ali, “Islamic Capital Market Products, Developments and Challenges,” 52-53.

¹⁸⁰Israr, 45-46.

¹⁸¹JIBM Discussion Forum, “Liquidity Management Product of SBP”, *Journal of Islamic Business and Management* Vol.5 No.2, (2015), 181-194. Available at <http://jibm.org/sites/default/files/files/discussion%20forum.pdf>, “Last accessed 20th April 2016”.

¹⁸²Holy Qur'ān al- A' rāf 162 – 166; JIBM Discussion Forum, 181-194.

¹⁸³Syed Ali, “Islamic Capital Market Products, Developments and Challenges”, 52-53.

will be less than the face value because it is mundane asset. Here it will be money put option¹⁸⁴ for the investors to sell it back on face value. In this way, financial needs of government will be fulfilled devoid of issuing any useful asset¹⁸⁵ but for real *Sharī'ah* compliance, the given example is not reliable. The new model of *sukūk*, will discuss in the last chapter of dissertation will try to cope with the issues.

Another controversial issue is if the assets will buy back on market value, whether secondary market exists in sovereign *sukūk*? Most of the sovereign *sukūk* issued include unilateral promise to buy the *sukūk* at market value. Sovereign *sukūk* usually issue assets of public good, therefore their market value doesn't exist and who will ascertain its fair market value is ambiguous.¹⁸⁶

2.3.7 Pricing of *Sukūk*

As benchmarking became common in Islamic finance, though it is permissible but for determination of returns it is not correct to rely upon benchmarking. In *ijārah sukūk*, it is required that the rentals should be received on basis of underlying asset but practically it is generated by linking to benchmarking irrespective of nature of property, jurisdiction and market value. Hence it is criticized that return is reflecting not the underlying asset but prevailing interest rate. For Instance: If there are two properties (i.e. asset). Both of them are completely different from each other in respect of nature, use, jurisdiction and market value of property. What is required here? Here the returns or the rentals will be different of both properties but here in *sukūk* same return will be paid because of

¹⁸⁴For a put option, when the strike price is above the market price of the underlying asset. Available at <http://www.investopedia.com/terms/i/inthemoney.asp#ixzz4CjtpBePb> , "Last accessed. 26 June, 2016".

¹⁸⁵Syed Ali, "Islamic Capital Market Products, Developments and Challenges,"53

¹⁸⁶*Ibid.*

benchmarking i.e. to prevailing interest rate. Hence, such practice is objectionable from *Shari'ah* point of view.¹⁸⁷

From the commerce point of view, benchmarking holds numerous issues. Firstly, profits are guaranteed here in a sense that even before ascertainment of profits fixed amount is ensured. Secondly, the profits are confirmed even before actually incurred. Thirdly, the amount of profit depend something other than actual profits. Lastly, here the capital is also assured. All of these elements are depicted in conventional lending. *Sukūk murābaha* which is issued by buyer assures that he will pay the deferred price of the sold item. It is depicted that in *sukūk murābaha*, the benchmark rate is implied in markup. The formula to determine the markup is similar to that of interest in conventional lending. Consequently, the price of the asset in *murābaha* is on same footing to that of loan.

There are two risks arise in Islamic financing i: e interest risk and floating rate¹⁸⁸ risk. It is argued that the benchmarking determines only profits not interest rate but they ignored various issues i. e. amount is determined even before profit incurred, amount is determined not as a share of profit but on basis of share in capital which is similar to lending and the originator assures capital and profit. The distribution of profit should be on basis on actual profit incurred.

The aforesaid mentioned activity neglects the principle of risk sharing. Here when the profits is guaranteed then the loss sharing will not be even possible. The assurance of

¹⁸⁷Ibid.

¹⁸⁸Floating rate is same as variable rate. It is an exchange rate for a currency, which can vary according to market demand, and is not fixed by the government. Available at, <http://www.businessdictionary.com/definition/floating-rate.html>, "Last accessed 20th September, 2016".

pre determined profits and capital guarantee in *sukūk* is linked with debt like instrument. It therefore hardly comes as a surprise that income and capital guarantees expose originators to the risk that commonly faces lenders: the risk of default. From macroeconomics point of view, the benchmarking amounts to price fixing which is injustice (*zulm*) in *Sharī'ah*. Price fixing causes hardship and eliminates competition in market. Therefore it is illegal in various jurisdictions including Pakistan.¹⁸⁹

I. Is Floating rate permissible in *Sukūk*?

From benchmarking a critical issue is raised regarding floating rate of rent in *ijārah sukūk*. As most of the *ijārah sukūk* issued internationally as well as nationally, most preferably here focus is in Pakistan is linked to benchmarking in which underlying rent in *sukūk* is linked to floating rate of KIBOR For Instance, Motorway and WAPDA *sukūk*. Whether it is allowed to benchmark the rentals to the floating rate of LIBOR or KIBOR? Is it permissible in *Sharī'ah*? Is *ijārah* contract allows it? The instant issue requires jurisprudential analysis.

In *ijārah* contract, the rent can be floating or variable.¹⁹⁰ In floating *ijārah* (for avoidance of injustice and disputes in long term lease) it is suggested to use a well-known benchmark in which upper limit should be used for elimination of *gharar* in order to avoid market fluctuations.¹⁹¹ In *sukūk*, it is criticized to link the rentals in *ijārah* with the floating rate of benchmarking to an interest based index. Usmani criticized by rendering

¹⁸⁹ Abdul Karim Abdullah, "Use of Interest Rate Benchmarks For Determining Profits on Islamic *Sukūk*", *Economic, Finance, Zakat & Awqaf*: 1-4. Available at, <http://www.iais.org.my/e/index.php/dirasat-sp-1862130118/economic-finance-zakat-awqaf/item/153-use-of-interest-rate-benchmarks-for-determining-profits-on-islamic-sukuk.html>. "Last accessed, 16 June, 2016".

¹⁹⁰ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi, Pakistan: Idaratul Ma'arif, 1998), 168.

¹⁹¹ <http://www.financialislam.com/ijarah.html>, "Last accessed, 26 June, 2016".

this practice to *ribā*.¹⁹² He criticized that it is an excessive interest. It is recommended by the *Sharī'ah* scholars to develop alternative Islamic benchmarking to overcome estimation and pricing procedure. The new benchmark should not rely on interest.¹⁹³ In order to overcome the *ribā* issue, government *sukūk* may possibly be analyzed through macroeconomic signs and corporate *sukūk* could be analyzed based on the company performance indicators. IMF survey depicted that internationally there are US\$ 14 billion *ijārah sukūk* issues.¹⁹⁴

2.3.8 *Sukūk* Rating

It is criticized that the rating in *sukūk* is done by accessing purchase undertaking and guarantee of company issuing *sukūk* which is controversial issues in *Sharī'ah*.¹⁹⁵ More clearly investigating the rating in *sukūk* it is explicitly viewed that all the international organizations are following these strategies to rate an instrument. Moody's rate the *sukūk* on basis of income generated from underlying asset, whereas in asset-based *sukūk* it can also be based on the purchase undertaking in *sukūk*.¹⁹⁶ Taqi Usmani also raised the issue in his paper and criticized that the International credit rating companies don't differentiate between *halāl* and *hāram*. They don't verify the transfer of ownership to investors but only come across to guarantee and fixed profit in rating an instrument. He gave rationale that these agencies are doing so because they build up in interest based atmosphere. Therefore they cannot access the instrument quality rather they focused on guarantee and fixed profits. On the other hand, Islamic economic system requires profit

¹⁹²Safari, Ariff and Mohamad, 86- 87.

¹⁹³http://academlib.com/7838/economics/ijarah_leasing, "Last accessed, 26 June, 2016".

¹⁹⁴Safari, Ariff and Mohamad, 86-87.

¹⁹⁵Al-Amine, "Sukūk Market: Innovation and Challenges". 15.

¹⁹⁶Essia Ries Ahmed, Md. Aminul Islam and Tariq Tawfeeq Yousif Alabdullah, "Islamic Sukūk: Pricing Mechanism and Rating," *Journal of Asian Scientific Research* 4: II (2014), 640-648.

and loss sharing involving risk in transactions which can never be rationalized by these conventional agencies. Usmani also supports to get free of these agencies.¹⁹⁷

2.3.9 Tanazul and Ibra in Sukūk

Despite the above-mentioned criticism on *sukūk*, there are some other issues which are heavily criticized by the scholars. Among the key concerns on practice of *tanazul* in equity-based structure such as *mushārah* is that one or some of the partners waive certain rights up-front in favor of other partners for something that is yet to be known and to be realized in the future. *Sharī'ah* scholars declared it against essence of contract i. e. *Al kharaj bi al-damān*. Sheikh Taqi Usmani opined that any condition which leads to interruption in sharing of profit will be void. A binding promise to purchase the assets at face value is unlawful because it is same as a capital guarantee, which is unlawful. This is in line with the AAOIFI *Sharī'ah* Standard which states:

It is unlawful for the conditions of partnership or for the basis of profit distribution to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void¹⁹⁸

The main issue is that whether the stipulation of *ibra* clause is in *Sharī'ah* compliance offered in the event of early settlement? The issue rebate may exist in *murābaha sukūk*, *istisnā sukūk* where *sukūk* is redeemed before its maturity date on event of default or upon early settlement. OIC Islamic Fiqh Academy in its resolution no. 64/2/7 resolves that a rebate on a debt for early payment, whether it is requested by the creditor or the

¹⁹⁷ Al-Amine, *Global Sukūk and Islamic Securitization Market*, 129-130.

¹⁹⁸ AAOIFI, 2008, *Sharī'ah* Standard No 12, 208.

debtor is legal and is not a kind of *ribā*, the Academy asserts that there should be no prior agreement between the contracting parties and the deal should involve only two parties i.e., the seller and buyer.¹⁹⁹

2.3.10 *Maqāsid al Sharī'ah*

Maulana Taqi Usmani key concern was that *sukūk* are in violation of *maqāsid al Sharī'ah*. He clearly said that:

If we consider the matter from the perspectives of the higher objectives of Islamic law or the objectives of Islamic economics, then *sukūk* in which are to be found nearby all of the characteristics of conventional bonds are inimical in every way to these purposes and objectives. The whole objective for which *ribā* was prohibited is the equitable distribution among partners of revenues from commercial and industrial enterprise. The mechanisms used in *sukūk* today, however, strike at the foundations of these objectives and render the *sukūk* exactly the same as conventional bonds in terms of their economic results²⁰⁰

2.3.11 Similarities with Bonds

In *sukūk al-ijārah*, the cash is actually given against the cash by having a sale and leaseback arrangement along with temporary ownership in it. SPV is merely created to facilitate the buyback and leasing principle whereas, the control remains with the originator. In the whole arrangement the returns are replicating the conventional bonds on the basis of principle of borrowing and lending. Bonds are prohibited because it has

¹⁹⁹The Council of the Islamic Fiqh Academy, 142; Muhammad al Bashir Muhammad al Amine, *Istisnā' (Manufacturing Contract) in Islamic Banking and Finance*, (Kuala Lumpur: A.S. Noordeen, 2006), 114.

²⁰⁰Usmani, "*Sukūk and Their Contemporary Applications*", 13.

elements that render it un-Islamic. The *sukūk* here resemble bonds due to following features:

In bonds, the bond holder doesn't have an ownership but they are in actual an interest bearing papers.²⁰¹ Similarly it is examined in *sukūk al-ijārah* that the real rights of ownership are missing. A mere piece of paper is given to the *sukūk* holders consequence in right to get returns by making sale and lease arrangement.

Moreover, the income generated has no link with the productivity of underlying assets is a vital characteristic of bond. The scrutiny of *sukūk* shows that the same exists in it (fixed or variable returns *sukūk*). *Sukūk* holders get the returns written in contract irrespective of actual profit and loss.²⁰²

In the light of above research, it is therefore concluded that the existing model of *sukūk* is fabricated in a manner that is not *Sharī'ah*-compliant. The practical application of *sukūk* is similar to conventional bonds. Moreover, it is a *hilah* to legalize *ribā*. Hence, only giving it notion of Islamic cover cannot render it Islamic. The application of *sukūk* in Pakistan will further uncover the real picture of *sukūk*. The law of *sukūk* and *Sharī'ah* analysis of *sukūk* issued in Pakistan will discuss in next chapter.

²⁰¹Usmani, "*Sukūk and Their Contemporary Applications*", 6.

²⁰²Mohammad Nejatullah Siddiqi, "Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art", *Islamic Economic Studies* Vol. 13:No. 2 (2006), 1-48.

Chapter 3

LAW OF *SUKŪK* IN PAKISTAN

3.1 Historical Development

Pakistani law does not define the word *sukūk*, though the *sukūk* has been issued officially since 2005. The new regulations drafted in 2015 and named as “Issue of Sukūk Regulations, 2015” adopted the definition of *sukūk* as defined by AAOIFI.

AAOIFI *Shari’ah* standards (No. 3, 8 .9 and 13)²⁰³ are adopted in Pakistan as a mandatory requirement with some clarifications and amendments.²⁰⁴ Besides, *Shari’ah* accounting standards are used as a basis of the national accounting standard.²⁰⁵ It has adopted *Shari’ah* standard no 17 on “Investment *Sukūk*”²⁰⁶ in 2012, including AAOIFI resolution 2008 subject to annexed amendments.²⁰⁷ It has prescribed that from time to time new regulatory requirement will also become part of it. Furthermore, noncompliance will invoke penal provisions under Banking Companies Ordinance 1962.²⁰⁸

The previously issued *sukūk*, in the absence of any obvious regulation or law were classified as redeemable capital because its definition was not available in the books of law in Pakistan. They were nor debentures, bonds, equity capital neither receivables. In

²⁰³Standard No.3 is regarding default in payment by a debtor, No.8 is regarding murābaha to purchase orderer, No. 9 is about *ijārah & ijārah muntahia bittamleek* and No. 13 is about *mudāraba*. See, Circular No.2, annex 1, IBD SBP available at <http://www.sbp.org.pk/ibd/2010/C1-Appendix.pdf> “Last accessed 10 May 2016”.

²⁰⁴See, Circular No.2, annex 1, IBD SBP available at <http://www.sbp.org.pk/ibd/2010/C1-Appendix.pdf> “Last accessed 10 May 2016”.

²⁰⁵<http://aaoifi.com/adoption-of-aaoifi-standards/?lang=en>, “Last accessed 10 May 2016”.

²⁰⁶<http://www.sbp.org.pk/ibd/2013/C3.htm>, <http://www.islamicfinance.de/?q=node/5428>, <http://www.reuters.com/article/islamic-finance-Sukūk-idUSL6N0FN0LN20130717>, <http://www.finance-news.lu/pakistan-adopts-aaoifi-standards-for-investment-Sukūk>, “Last accessed 10 May 2016”.

²⁰⁷See, <http://www.sbp.org.pk/ibd/2013/C3-Annex-A.pdf>, “Last accessed 10 May 2016”.

²⁰⁸See, Banking Companies Ordinance 1962; <http://www.sbp.org.pk/ibd/2013/C3.htm>, “Last accessed 10 May 2016”

fact, these *sukūk* were issued under section 120 of company ordinance 1984 as TFC.²⁰⁹ By considering the *sukūk* as a redeemable capital, the *sukūk* were issued by circulating and publishing the prospectus under section 57 of Companies Ordinance, 1984.

3.2 Regulatory Authorities

Sukūk are the significant instrument of Islamic capital market. It needs regulatory bodies; there are two regulatory authorities in Pakistan to regulate the Islamic capital market.

1. State Bank of Pakistan
2. SECP

The state bank is actively performing the functions to make rules and regulations to regulate Islamic capital market.²¹⁰ It has promoted the Islamic banking by making encouraging policies.²¹¹ As GOP has issued *ijārah sukūk* in past therefore state bank has formulated the rules through circular no 13 in 2008 named as “GOP *Ijārah Sukūk* Rules 2008”.²¹² The rationale behind making rules only for *ijārah sukūk* is that it is most popular *sukūk* among all over the Muslim world.²¹³ However, the instant dissertation specifically focuses on the recently issued “Issue of *Sukūk* Regulations, 2015”.

The government has established SECP through Securities and Exchange Commission of Pakistan Act, 1997 for legal and regulatory purpose in the field of corporate

²⁰⁹Sibhatullah Ahsan “*Sukūk* and Its Regulatory Framework in Pakistan” (Islamabad: August 27, 2008), 42. Available at, <http://www.alhudacibe.com/images/Presentations%20on%20Islamic%20Banking%20and%20Finance/Sukūk/Sukūk%20Regulations%20in%20Pakistan%20by%20Sabghatullah%20.ppt>. “Last accessed 10 May 2016”.

²¹⁰http://www.sbp.org.pk/l_frame/index2.asp, “Last accessed 10 May 2016”.

²¹¹Afaq Khan, “*Sukūk* the way Forward” Dawn, September 11 2007, Islamic Banking.

²¹²<http://www.sbp.org.pk/fscd/2008/Annex-A-C13.pdf>, “Last accessed 10 May 2016”.

²¹³Afaq Khan, “*Sukūk* the way Forward” Dawn, September 11 2007, Islamic Banking.

governance.²¹⁴ SECP regulates public limited, private limited and nonbanking companies etc. In the past, as there was no law, the *sukūk* doesn't fall in the ambit of SECP. The arrangements for issuance of *sukūk* were made privately through pre- IPO and IPO. For pre-IPO, there are generally no regulatory requirements as it is made by sponsors but for IPO which is done through general public necessitates regulatory requirements. SECP participated only by giving guidelines when the issuance of *sukūk* was through the governmental involvement.²¹⁵

3.3 *Sukūk* Issued in Pakistan

Pakistan issued sovereign *ijārah sukūk* domestically as well as internationally. It officially joined the *sukūk* market in 2005 by issuing sovereign *ijārah sukūk* internationally i.e. Motorway *sukūk*. It became popular due to its geographical position so, it attracted the investors from Islamic as well as conventional sector. Since 2005 seventy-four (74) *sukūk* has been issued valued of Rs 620billion. The domestic sovereign *ijārah sukūk* were issued since 2008, till 2014 fourteen (14) *sukūk* have been issued of Rs 501 billion. The success of these *sukūk* raised the government expectations to raise the funds through Islamic capital market.²¹⁶

The *ijārah sukūk* were issued by WAPDA for a period of 7 years. The detail of WAPDA *sukūk* will be discussed in the later section to analyze its *Sharī'ah* compliance. Similarly, NHA (National Highway Authority) issued *ijārah sukūk* in 2005 worth of US

²¹⁴Rasul Bakhsh Rais and Asif Saeed, *Regulatory Impact Assessment of SECP's Corporate Governance Code in Pakistan* (Lahore: Lahore University of Management Sciences, 2005), 6.

²¹⁵Afaq Khan, "Sukūk the way Forward" Dawn, September 11 2007, Islamic Banking.

²¹⁶<http://isfire.net/ijarah-Sukuk-to-help-sovereigns-to-generate-funds/>, "Last accessed 10 July 2016".

\$600 million over M-2 Motorway.²¹⁷ Sitara chemical Industries issued TFC's based on profit and loss sharing value of RS 510 million for period of five years.²¹⁸ Similarly Al Zamin Lease II issued *sukūk* worth of 275 million for 5 years on P & L sharing.²¹⁹ The *mushārah* *sukūk* were issued by the MLCF (Maple Leaf Cement Factory Ltd) and SSGC (Sui Southern Gas Company Ltd) in 2008. Whereas, the *sukūk* based on the diminishing *mushārah* were issued by EBPL (EDEN Builders Pvt. Ltd) and PEL (Pak Elektron Limited) respectively.

In 2014, first listed *sukūk* were issued by the K-electric Limited value of Rs 6 billion. The listing enhanced the investors' confidence in *sukūk* market and provided the liquidity to the *sukūk* holders. It also enhanced the economic development of the country. Till 2014, 78 private placed *sukūk* has been issued as depicted in SECP report 2014 out of which 32 has been entirely redeemed. On 26 November 2014, Pakistan has issued the International *sukūk* (based on *ijārah* *sukūk*) for tenor of five years to raise US \$1 billion.²²⁰ These are known as the international *sukūk* because of subscription of them in the international market. 35% subscription approaching from Europe, 32% from middle east, 20% from North America and 20% from Asia. It is expected that these international *sukūk* will boost the economy of Pakistan.²²¹ On January 31 2014, GOP *ijārah* *sukūk* has

²¹⁷Shahida Nazar, 63-64.

²¹⁸Ibid., 64.

²¹⁹<http://www.alhudacibe.com/images/Presentations%20on%20Islamic%20Banking%20and%20Finance/Sukūk/Corporate%20Sukūk%20Issuance%20by%20Muhammad%20Arif%20.pdf>, "Last accessed 10 July 2016".

²²⁰Shahbaz Rana, "Pakistan Raises \$1b Through Sukuk Bonds," *The Express Tribune*, 27 November, 2014, 2. <http://Tribune.Com.Pk/Story/798044/Pakistan-Raises-1b-Through-Sukuk-Bonds/>, "Last accessed, 17th July, 2016".

²²¹<https://www.Sukuk.Com/Sukuk-New-Profile/The-Second-Pakistan-International-Sukuk-Co-Ltd-3327/>, "Last accessed, 17th July, 2016".

been started at KSE.²²² The *Sharī'ah* compliance of GOP *ijārah sukūk* will be analyzed in later section.

3.4 Formulation of “Issue of *Sukūk* Regulations, 2015”

The *sukūk* market is a viable option to raise funds and is the important sector of the capital market. A number of issues in *sukūk* were observed by different companies. At the end of 2014, the need of the hour was to draft *sukūk* regulations because a well-regulated *sukūk* market can accomplish the purpose of development of capital market. Therefore after deep evaluation, the *sukūk* regulations were drafted as “Issue of *Sukūk* Regulations, 2015”. These regulations were examined by the committee established by *Sharī'ah* advisory board.

3.5 Critical Analysis of “Issue of *Sukūk* Regulations, 2015”

SECP made the regulations named as “Issue of *Sukūk* Regulations, 2015” under powers conferred by section 506A²²³ and 120²²⁴ of Companies Ordinance, 1984.²²⁵ Besides

²²²http://www.secp.gov.pk/annualreport/2014/AnnualReport_2014.pdf, “Last accessed 20 April 2016”.

²²³[506A. “Power to make regulations

(1) The Commission may, by notification in the official Gazette, make such regulations as may be necessary to carry out the purposes of this Ordinance:

Provided that the power to make regulations conferred by this section shall be subject to the condition of previous publication and before making any regulations the draft thereof shall be published in the manner considered most appropriate by the Commission for eliciting public opinion thereon within a period of not less than fourteen days from the date of publication.

(2) Any regulation made under sub-section (1) may provide that a contravention thereof shall be punishable with a fine which may extend to five hundred thousand rupees and, where the contravention is a continuing one, with a further fine which may extend to ten thousand rupees for every day after the first during which such contravention continues.” See, Section 506A of Companies Ordinance, 1984.

²²⁴[120. “Issue of securities and redeemable capital not based on interest

(1)[A company may by public offer or], upon terms and conditions contained in an agreement in writing, issue to one or more scheduled banks, financial institutions or such other persons as are specified for the purpose by the Federal Government by notification in the official Gazette, either severally, jointly or through their syndicate, any instrument in the nature of redeemable capital in any or several forms in consideration of any funds, moneys or accommodations received or to be received by the company,

section 120, there was no other mechanism for structuring and issuance of *sukūk* in Pakistan.²²⁶ The *sukūk* were issued as a redeemable capital under section 120 of Companies Ordinance 1984.²²⁷ Therefore, the necessity was to issue these regulations. The definition of *sukūk* is adopted in it as it is given in *Sharī'ah* standard of AAOIFI.²²⁸

The issuer (one who can issue the *sukūk*) which may be a company, SPV²²⁹ or body corporate may issue *sukūk* under section 120 of Companies Ordinance, 1984 but subject to terms and conditions in these regulations and has to require the approvals from regulatory authorities where required by regulations.²³⁰ The regulations necessitate certain conditions for issuance of *sukūk*. Moreover, it has disclosure and reporting

whether in cash or in specie or against any promise, guarantee, undertaking or indemnity issued to or in favour of or for the benefit of the company.]

(2) In particular and without prejudice to the generality of the forgoing provisions, the agreement referred to in sub-section (1) for redeemable capital may provide for, adopt or include, in addition to others, all or any of the following matters, namely:--

(a) mode and basis of repayment by the company of the amount invested in redeemable capital within a certain period of time;

(b) arrangement for sharing of profit and loss;

(c) creation of a special reserve called the "participation reserves by the company in the manner provided in the agreement for the issue of participatory redeemable capital in which all providers of such capital shall participate for interim and final adjustment on the maturity date in accordance with the terms and conditions of such agreements ; and

(d) in case of net loss on participatory redeemable capital on the date of maturity, the right of holders to convert the outstanding, balance of such capital or part thereof as provided in the agreement into ordinary shares of the company at the break-up price calculated in the prescribed manner.

(3) The terms and conditions for the issue of instruments or certificates of redeemable capital and the rights of their holders shall not be challenged or questioned by

the company or any of its shareholders as repugnant to any provision of this Ordinance or any other law or the memorandum or articles or any resolution of the general meeting or directors of the company or any other document.

(4) The provision of this Ordinance [.....] relating to the creation, issue, increase or decrease of the capital shall not apply to the redeemable capital.]” See , Section 120 of Companies Ordinance, 1984

²²⁵See, Companies Ordinance, 1984.

²²⁶<http://www.brecorder.com/pakistan/business-a-economy/222505-secp-approved-Sukūk-regulations-2015.html>, “Last accessed 10 June 2016.”

<http://www.chambersandpartners.com/guide/practiceguides/location/270/8242/2374-200>, “Last accessed 10 June 2016.”

²²⁷<http://redmoneyevents.com/main/framework/assets/2015/conferenceguides/Issuer.pdf>, “Last accessed 10 June 2016.”

²²⁸See Further, *Sharī'ah* Standard 17, AAOIFI; Section 1(q), “Issue of *Sukūk* Regulations, 2015”.

²²⁹SPV is here defined as a public limited company or a body corporate registered with commission (SECP) under Asset Backed Securitization Rules, 1999.

²³⁰Section 3, “Issue of *Sukūk* Regulations, 2015”.

requirement for issuance of *sukūk*. Furthermore, it also entails disciplinary provisions for breach of regulations.²³¹

To the extent that the conditions are considered, it requires the issuer rating shouldn't be less than (BBB-) and the instrument rating shouldn't be lower than BBB assigned by Credit Rating Company.²³² Credit rating is usually done in alphabetical letters such as AAA, BBB, and BBB- etc. It proposed to give investors an estimation of the relative level of credit risk of a bond or a company or government as a whole. These symbols are variously defined by the different credit rating agencies.²³³ SBP rate BBB- when the credit risk is low, PACRA also rate an instrument (BBB-) when credit risk is low. JCR-VIS credit rating Company gives BBB- when the protection factors are adequate.²³⁴

PACRA has developed specific rating methodologies for each business segment falling under the PACRA's rating universe. Rating methodologies are developed to incorporate varying risk factors of different economic sectors. While ratings are not calculative in nature, these methodologies form the basis of risk analysis conducted at PACRA that help rating committee to reach at the final rating opinion. These methodologies cover material risk factors, both qualitative and quantitative, affecting the profile of the rates in general. Specific issues are usually discussed in individual rating reports. PACRA's rating committee reviews the criteria and rating methodologies to keep

²³¹See, "Issue of *Sukūk* Regulations, 2015".

²³²Section 4 (a), "Issue of *Sukūk* Regulations, 2015".

²³³ https://www.sec.gov/investor/alerts/ib_creditratings.pdf, "Last accessed 20th September, 2016".

²³⁴http://www.sbp.org.pk/publications/c_rating/index.htm, "Last accessed 13th July, 2016".

up the dynamism of analytical process at all points in time.²³⁵ For Instance, for a corporate rating, it does both qualitative and quantitative analysis. For qualitative analysis, it looks at the industry risk, operating environment, market position, management, corporate governance and accounting policies. For quantitative analysis, it evaluates the cash flow measures of earning, earnings and cash flow, analyzes the capital structure, financial flexibility, project risk evaluation, coverage and profitability ratios. Subsequently, it rates the company. The rating includes long term and short term rating. In long-term rating, AAA denotes highest credit rating which shows the company has the lowest expectation of credit risk. Similarly, AA, A, BBB, BB, B, CCC, CC, C rating is given to the companies after assessment. In short-term rating A1+, A1, and A2 etc is given after assessment.²³⁶

It is appreciated here that credit rating is a sound provision hold condition for *sukūk* issuance but from *Sharī'ah* point of view, it is criticized that mostly *sukūk* rating is done through accessing purchase undertaking and guarantee given which are controversial issues. PACRA also rate the company after close scrutiny of performance in contracts involved²³⁷ whereby it is observed that all the *sukūk* issued in Pakistan has an agreement of purchase undertaking. Therefore, the rating is appreciated as long as it complies with principles of Islam. The regulations require that where security is required by investment agent the issuer has to arrange it.²³⁸ It is also valued that for depository system the regulation requires an approval of Depository Company to ensure that *sukūk*

²³⁵http://www.pacra.com.pk/pages/rating_matrix/rating_methodologies.php, "Last accessed 20th September, 2016".

²³⁶http://www.pacra.com.pk/pages/rating_matrix/methodology/Corporate%20Rating%20Methodology.pdf, "Last accessed 20th September, 2016".

²³⁷http://www.pacra.com.pk/pages/rating_matrix/methodology/Corporate%20Rating%20Methodology.pdf, "Last accessed 13 July".

²³⁸Section 4 (b), "Issue of *Sukūk* Regulations, 2015".

as appropriate security.²³⁹ Moreover, all the listed *sukūk* in stock exchange shall only be issued in book-entry form which ensures a record or documentation for issuance of *sukūk*.²⁴⁰

The *Sharī'ah* provisions for issuance of *sukūk* are appreciated as the regulations require the principal business must be all the time in accordance with *Sharī'ah*.²⁴¹ Here the words "all the time" means the tenure for which the *sukūk* is issued. All the steps involved in such issuance must hold *Sharī'ah* compliance, no stage should contradict *Sharī'ah* principles but the issue arises here. It is in actual a vague clause and can be differently interpreted by the lawyers, judges and jurists. Its scope should be defined by including all the issues such as *tanazul*, *bay' al wafā*, *bay' al īnah*, *bay' al istighlāl*, sale and lease back structure, floating rate in *ijārah sukūk* etc. They should be highlighted in the regulations. Another question arises that will these provisions be properly ensured in future or is mere a nominal provision to attract investors only? It will be clearly depicted in future contracts of issuance of *sukūk*.

The regulations requires that the name of *sukūk* should be based on the structure on which such *sukūk* are based²⁴² and the issuer shall maintain the *sukūk* proceeds to be used as mentioned in offering document.²⁴³ In addition, it also necessitates the appointment of investment agent²⁴⁴ and *Sharī'ah* advisor.²⁴⁵ The appointment of *Sharī'ah*

²³⁹Section 4 (c), "Issue of *Sukūk* Regulations, 2015".

²⁴⁰Section 4 (2), "Issue of *Sukūk* Regulations, 2015".

²⁴¹Section 4 (4), "Issue of *Sukūk* Regulations, 2015".

²⁴²Section 4 (3), "Issue of *Sukūk* Regulations, 2015".

²⁴³Section 4 (5), "Issue of *Sukūk* Regulations, 2015".

²⁴⁴"Investment Agent" means a financial institution appointed by the issuer through execution of investment agency agreement who shall be responsible to facilitate issue and sale of *Sukūk* under these Regulations and to safeguard interest of the holders of *Sukūk*", Section 2 (c) of "Issue of *Sukūk* Regulations, 2015".

advisor²⁴⁶ is appreciated here because he will scrutiny the structure of *sukūk*, invigilate all the steps involved and will give the *Sharī'ah* pronouncement in the issuance of *sukūk*.²⁴⁷ The IOSCO's also suggested the name and role of *Sharī'ah* advisor should be part of regulatory law.²⁴⁸ Moreover, it is in line with the AAOIFI 2008 recommendations which require that *Sharī'ah* supervisory board should consider the implementation of *sukūk* at every stage rather than merely issuing *fatwā*'s on the formation of *sukūk*.²⁴⁹

The instant regulations render mandatory the auditing of *sukūk* to verify *Sharī'ah* compliance on an annual basis. In auditing, the features and all the *Sharī'ah* requirements of *sukūk* need to be checked. Such audit report shall be made part of an annual financial report of the issuer.²⁵⁰ Such *Sharī'ah* compliance was suggested by IOSCO's which is followed here by making part of instant regulations.²⁵¹

Generally, no swap is allowed after issuance of *sukūk*²⁵² but the question arises here regarding the convertible or exchangeable *sukūk* into ordinary shares. The regulations approved the conversion of *sukūk* into ordinary shares with the discretion of investors and such ordinary shares are listed on the stock exchange when *sukūk* were

²⁴⁵"*Sharī'ah* Advisor" means a *Sharī'ah* Scholar who is: (i) *Sharī'ah* advisor of any Islamic banking institution appointed with the approval of the State Bank of Pakistan; or (ii) *Sharī'ah* advisor of a Takaful company or an Insurance company having Takaful windows registered with the Commission; or (iii) member of the *Sharī'ah* Board of the State Bank of Pakistan; or (iv) associated with the Accounting and Auditing Organization of the Islamic Financial Institutions on its Shariah Standard Board, Section 2 (k) of "Issue of *Sukūk* Regulations, 2015".

²⁴⁶For appointment of *Sharī'ah* advisor See, Section 5 of "Issue of *Sukūk* Regulations, 2015".

²⁴⁷<http://www.brecorder.com/pakistan/business-a-economy/222505-secp-approved-Sukūk-regulations-2015.html>, "Last accessed 10 June 2016."

²⁴⁸http://www.albanygovernmentlawreview.org/Articles/Vol07_2/7.2.493-von%20Werlhof.pdf, "Last accessed 10 June 2016."

²⁴⁹<http://www.kantakji.com/media/7760/f173.pdf>, "Last accessed 10 May 2016".

²⁵⁰See Further, Section 13, "Issue of *Sukūk* Regulations, 2015".

²⁵¹http://www.albanygovernmentlawreview.org/Articles/Vol07_2/7.2.493-von%20Werlhof.pdf, "Last accessed 10 June 2016."

²⁵²Section 4 (6), "Issue of *Sukūk* Regulations, 2015".

issued.²⁵³ Here the issue is that shares are entirely a different security than *sukūk* even though some scholars have allowed investment in shares but still there is debate or controversy that it is not allowed to invest in shares.²⁵⁴

These regulations will grab huge funds by investors who are looking to invest in *Shari'ah* compliant instruments and punitive sections of the regulations will grant investors protection.²⁵⁵ As the regulations necessitate the disclosure to the *sukūk* holders, the documents and the *Shari'ah* pronouncements shall furnish to the *sukūk* holders and also render it publically available on the website for investor guidance.²⁵⁶ The disclosure and reporting requirements as necessitated by the regulations are valued and appreciated here for the prosperity of *sukūk* in Pakistan.²⁵⁷ These disclosure requirements mirror IOSCO's principles of the disclosure.²⁵⁸ As capital market plays a major role in economic prosperity of a country and Islamic capital market is backbone of it.²⁵⁹ The disciplinary provisions²⁶⁰ for regulations of *sukūk* will capture the market and ensure investors' protections.

²⁵³Section 4 (7), "Issue of *Sukūk* Regulations, 2015".

²⁵⁴See Further, Taqi Usmani, *An Introduction to Islamic Finance* (The Netherlands: Brill, 1998), 142.

²⁵⁵<http://www.brecorder.com/pakistan/business-a-economy/222505-secp-approved-Sukūk-regulations-2015.html>, "Last accessed 10 June 2016."

²⁵⁶Section 10, "Issue of *Sukūk* Regulations, 2015".

²⁵⁷For disclosure and reporting requirements see further, Section 8 and 9 of "Issue of *Sukūk* Regulations, 2015".

²⁵⁸http://www.albanygovernmentlawreview.org/Articles/Vol07_2/7.2.493-von%20Werlhof.pdf, "Last accessed 10 June 2016."

²⁵⁹<http://www.brecorder.com/pakistan/business-a-economy/222505-secp-approved-Sukūk-regulations-2015.html>, "Last accessed 10 June 2016."

²⁶⁰For Disciplinary proceedings see, Chapter IV of "Issue of *Sukūk* Regulations, 2015".

3.5.1 Lacuna in “Issue of *Sukūk* Regulations, 2015”

Although the formation of regulations is a great step by GOP and it will boost the economic growth in Islamic capital market nationally as well as internationally but critical analysis of regulations highlights several issues to ponder upon:

1. The ownership issue is unaddressed, although the regulations require *Sharī'ah* approval of issued *sukūk* from the *Sharī'ah* scholar but will they allow mere the beneficial ownership as evident in past issued *sukūk* or the transfer of real ownership in *sukūk al ijārah*? The AAOIFI recommendations regarding ownership which requires the transfer of real ownership in *sukūk* should be highlighted here in the regulations.
2. The issue of benchmarking is still unaddressed in the regulations. There should be some Islamic benchmarking for an issuance of *sukūk* as recommended by various scholars.
3. The rules of co-ownership are unaddressed in the regulations as the *sukūk* are the certificates of undivided shares in ownership or usufruct of an asset. The *Sharī'ah* rulings regarding co-ownership should be part of regulatory law.
4. The convertible *sukūk* is another controversial matter here as discussed above.
5. Another vital issue here is that these regulations are not applicable on the *sukūk* issued by any company or SPV setup for this purpose by the GOP (federal and provincial government) under any other law.²⁶¹ These are only applicable on the *sukūk* issued by any company or SPV “to general public, or a section of public or to the existing security holders of the issuing company or to the qualified

²⁶¹Section 1 (4), “Issue of *Sukūk* Regulations, 2015”.

institutional buyers.”²⁶² If the applicability of these regulations is not on the *sukūk* issued by the government under any other law then where is the transparency, disclosure, disciplinary provisions and *Sharī’ah* compliance in that case? Who will keep check on such transactions? Most importantly, why the government is not made a mandatory part of these regulations? The leading *sukūk* issued previously were by GOP such as Motorway *sukūk* and others. The statistics shows that the largest numbers of *sukūk* were issued by the government sector worldwide.²⁶³ So, where is the law for it? The provision of these regulations is explicitly excluding the government. If it is excluding the government out of purview then there should be some other rules and regulations to govern it. Therefore, it is a loophole in the “Issue of *Sukūk* Regulations, 2015” that should be given serious consideration.

3.5.2 Post Regulations Issued *Sukūk*

KE has issued *sukūk* after formulation of *sukūk* regulations. These *sukūk* are based on the diminishing *mushārah* worth of Rs 22,000 million for a period of seven years. These will be redeemed quarterly in 20 equivalent payments after end of two years grace period from date of issuance. The profit rate has linked with floating rate of KIBOR. KE has obtained *fatāwā* in the issuance of *sukūk* as well as appointed *Sharī’ah* advisor for consultation as required by the current regulations.²⁶⁴

²⁶²Section 1 (3), “Issue of *Sukūk* Regulations, 2015”.

²⁶³McMillen, 172.

²⁶⁴See Further, <http://www.ke.com.pk/pdf/Sukūk-ul-Shirkah/Prospectus.pdf>, “Last accessed 10 June 2016.”

After a profound analysis of law of *sukūk* in Pakistan and the critical evaluation of recent *sukūk* regulations, it necessitates the scrutiny of *Sharī'ah* compliance of issuance of *sukūk* in Pakistan. The *Sharī'ah* analysis of WAPDA and GOP *sukūk* will mirror a real picture of *sukūk*.

3.6 Case Study

3.6.1 WAPDA *Sukūk*

WAPDA issued *sukūk* through SPV of Rs 80 billion with the aim of mobilizing funds, strengthen its position and promotion of Islamic financial instruments.²⁶⁵ Moreover, the purpose of this project was to improve the capacity of Mangla dam.²⁶⁶ SPV (WAPDA first *Sukūk* Company) purchased 10 hydrel power turbines from WAPDA in this regard. SPV holds the assets till maturity as a trustee on behalf of *sukūk* holders. As far as ownership is considered an undivided beneficial ownership on turbines exists here. SPV leased back the assets to WAPDA for the period of 7 years.²⁶⁷ It mobilizes funds by issuing *sukūk al-ijārah* of worth 80 billion PKR payments is on KIBOR plus 35 BPs of purchase consideration. Here rentals are received in this regard. After 7 years of lease, the WAPDA will fulfill its unilateral promise and buy back the assets from the *sukūk* holders at market price. The instant model was approved by SBP as *Sharī'ah* compliant.²⁶⁸

The parties involved in WAPDA *sukūk* were:

²⁶⁵<http://www.alhudacibe.com/images/Presentations%20on%20Islamic%20Banking%20and%20Finance/Sukūk/Wapda%20Sukūk%20in%20Pakistan.pdf>, "Last accessed 10 May, 2016".

²⁶⁶<http://pr.hec.gov.pk/Chapters/714S-4.pdf>, "Last accessed 10 May, 2016".

²⁶⁷Akram Khan, *What Is Wrong With Islamic Economics?: Analyzing The Present State and Future Analysis*, 358.

²⁶⁸Israr, 45-46.

Issuer: WAPDA Second *Sukūk* Company limited (SPV; wholly owned by WAPDA and established for the aim of *sukūk* issuance).

Lessor: WAPDA Second *Sukūk* Company (acted as an SPV, leases the assets on behalf of *sukūk* holders).

Lessee: WAPDA

Sukūk holders: A group of financial institutions selected by lead Arrangers.

Structure: Trust Certificates (*Sukūk*)

Asset: 10 Mangla Dam hydrel power generation units

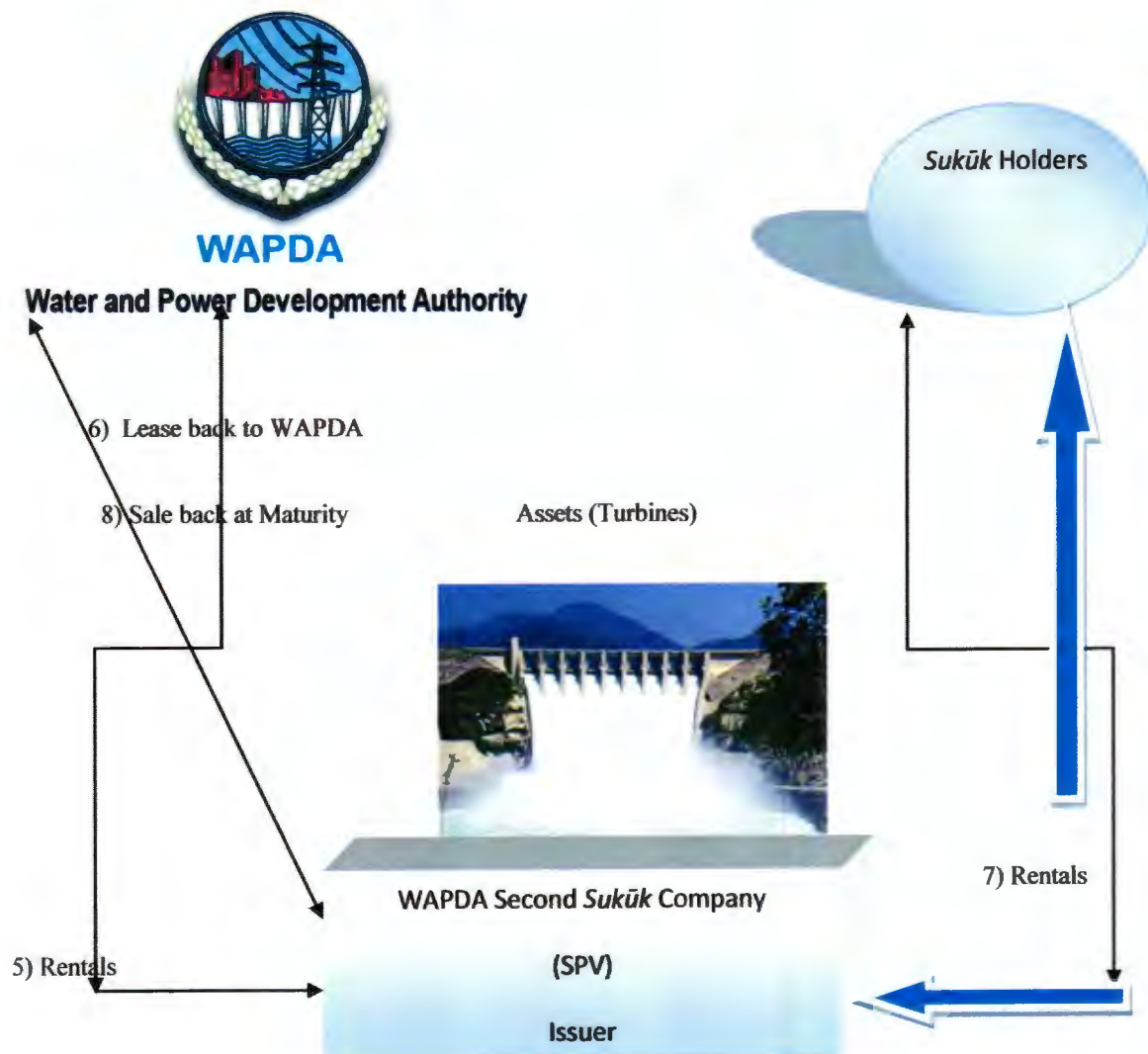
I. Steps

- 1) WAPDA established SPV for the sake of raising funds up to 80 billion rupees.
- 2) SPV purchased of an asset (turbines) from WAPDA.
- 3) SPV acts as trustee over assets on behalf of *sukūk* holders.
- 4) SPV leased the assets to WAPDA for 7 years under an *ijārah* agreement.
- 5) Variable element of rents is determined with decided benchmarks given to the *sukūk* holders.²⁶⁹
- 6) At maturity, the assets were sold back to WAPDA at market price.

II. Issues to be Determined

- a) Whether beneficial ownership of *sukūk* holders exists in WAPDA *Sukūk*?
- b) Whether Right of disposal is granted to *Sukūk* holders?

²⁶⁹Muhammad Israr, 39.



- 1) WAPDA established SPV
- 2) Purchase assets from WAPDA
- 3) SPV was established for the purchase of an asset (turbines) from WAPDA.
- 4) SPV acts as trustee over assets on behalf of *sukūk* holders.

Figure 3.1 **WAPDA Sukūk**²⁷⁰

²⁷⁰The model is made by writer of this dissertation on basis of available facts and figures.

- c) Is there any compliance with AAOIFI *Sharī'ah* standard with respect to ownership?
- d) Is there any Purchase undertaking (*wa'd*) in original contract?
- e) Is liquidity there?
- f) Whether legality of variable rent with KIBOR is justified?
- g) Whether *sukūk* may be guaranteed?
- h) Whether lessor has borne major expenses of leased property?
- i) Is there any violation of *Al kharaj bi al-damān*?
- j) Is there *bay' al wafā*?
- k) Is it a real transaction or merely circumvention of facts (*hilah*) of mobilizing funds?
- l) Is there any compliance with *maqāsid al Sharī'ah*?
- m) Whether the *sukūk* regulations of 2015 provide a comprehensive tool to regulate such *sukūk*, without causing *Sharī'ah* compliance risk?

III. Critical Analysis

The analysis highlights a few controversies:

WAPDA *sukūk* gave a picture of beneficial ownership with restrictions on the right of disposal. Thus, there is no real ownership transferred here to the *sukūk* holders. SPV acts as trustee over an asset and leases back the asset to WAPDA. Here the question arises, when ownership is not transferred to the *sukūk* holders then can it be considered as a real sale? Actually, it is not a real sale. So, it is in violation of AAOIFI *Sharī'ah* standard which requires that all of the rights of ownership (including the right to use and sell)

necessitate in *sukūk* to be transferred. The documentations should also be maintained and the manager shouldn't hold it as his own assets.²⁷¹

As discussed earlier there is no real sale then this whole arrangement is merely a *hilah* to legalize conventional bonds.²⁷² The documentation of agreement of WAPDA *Sukūk* depicts that in the original contract WAPDA agrees to execute purchase undertaking.²⁷³ Here purchase undertaking is simply guarantying the capital as well as, it puts a clear restriction on disposing of the underlying assets by the *sukūk* holders. Guaranteeing the capital means here the instant financial transaction is based on *ribā*.²⁷⁴ The *sukūk* holders cannot sell it in the market freely; he is bound here to sell it to the originator on maturity which involves a serious liquidity issue.

The *sukūk* holders have no recourse to underlying assets in case of default because ownership is not transferred here²⁷⁵ but the documentation further highlights that MCB and GOP gave unconditional and irrevocable guarantee for return and ensure principle amount. It is argued by some of the scholars that the property of the government belongs to community and is trust in hands of the government. It shouldn't be open to financial risks for some entities.²⁷⁶ The guarantee by the GOP is a controversial issue discussed in the previous chapter.

In WAPDA *sukūk*, there are some other notorious features in it such as: the major maintenance of the leased property is carried out by the lessee that means that the risk is

²⁷¹ Articles (2) and (5/1/2), *Sharī'ah* Standard No.17, AAOIFI.

²⁷² Idea Inferred, Sweder van Wijnbergen and Sajjad Zaheer, "Sukūk Defaults: On Distress Resolution in Islamic Finance," (Paper, Duisenberg school of finance and Tinbergen Institute, Amsterdam School of Economics, University of Amsterdam, July 2013),9.

²⁷³ Israr, 43.

²⁷⁴ Idea Inferred, Dusuki and Mokhtar, 22.

²⁷⁵ Sajjad Zaheer, 11.

²⁷⁶ Al-Amine, "Sukūk Market: Innovation and Challenges", 5.

not borne by the *sukūk* holders.²⁷⁷ As the rulings in *ijārah* contract requires that the lessor is liable to borne major maintenance of the property on the ground that risk lies with the ownership. The lessee is liable to bear day to day minor expenses²⁷⁸ but here, the *Sharī'ah* rulings have been violated. Moreover, it is observed in WAPDA *sukūk* that as in the event of dissolution of *ijārah*, the lessee is bound to re-purchase the property though the leased property has destroyed. It proves that the risk is borne by the lessee here instead of lessor.²⁷⁹ By analysis, it is evident that it is truly a violation of "*Al kharaj bi al-damān*".

On the other hand, the returns on the principal are guaranteed by concluding binding promise by the issuer to repurchase the asset at par value. This attribute in WAPDA *sukūk* is analogous to conventional bonds.²⁸⁰

Another objectionable feature is *bay' al wafā*; criticized by the *Sharī'ah* scholars.²⁸¹ In this structure, there is *bay' al wafā* which is prohibited and declared invalid by the International Islamic Fiqh Academy. It is depicted that the government has given the undertaking to take the assets on maturity at par value which is in fact, an arrangement of *bay' al wafā*. The amount drawn from these transactions is *ribā*.²⁸² Is another issue scrutiny of the legality of lease back and periodic returns? It is scrutinized below:

²⁷⁷ Mansoori, "Use of *Hiyal* in Islamic Finance and its *Sharī'ah* Legitimacy", 70-92.

²⁷⁸ Mansoori, *Islamic Law of Contracts and Business Transactions*, 234.

²⁷⁹ Mansoori, "Use of *Hiyal* in Islamic Finance and its *Sharī'ah* Legitimacy", 70-92.

²⁸⁰ Ibid..

²⁸¹ Syed Ali, "Islamic Capital Market Products, Developments and Challenges," 52-53.

²⁸² Mansoori, "Use of *Hiyal* in Islamic Finance and its *Sharī'ah* Legitimacy," 70-92.

The returns in WAPDA *sukūk* is determined on 6 month KIBOR plus 35 basis points. The price has no connection with the actual underlying ability, risk of loss, returns and profits. For Instance, if the rate offered by the WAPDA is more than the actual activity or actual returns of WAPDA then who is going to bear the price?²⁸³ The documentation provides that the GOP is the guarantor²⁸⁴ which means that the government is liable to pay in that case. That exceeded amount is negative growth for WAPDA.

In the wider perspective, it is fatal to the economy of the country because the government is bearing the “negative value addition”. It also leads to misallocation of resources because sometimes loss is covered by taxing WAPDA consumers or taxpayers. Although, it is allowed for *sukūk* holders to get floating returns but here it is fatal for the economy because there is the element of misallocation of resources as discussed above. This system is overall resulting in irregularity. The investors are investing in these types of *sukūk* because they are getting specified returns from which they are satisfied. On the other hand, the firms who are in need of funds are offering handsome returns to investors though they are not generating it from the underlying asset. Deeply criticizing here, it is to be said that the role of the underlying asset is nothing but a “dummy” is introduced here for rendering it *Shari’ah* compliant.²⁸⁵ There is explicit guaranteeing the returns to *sukūk* holders.²⁸⁶

²⁸³Salman Syed Ali, ed. *Islamic Capital Market Products, Regulations & Development, Proceedings of International Conference* (Saudi Arabia: Islamic Research & Training Institute, 2008), 76.

²⁸⁴Israr, 46.

²⁸⁵Syed Ali, *Islamic Capital Market Products, Regulations & Development, Proceedings of International Conference*, 76.

²⁸⁶<http://pr.hec.gov.pk/Chapters/714S-4.pdf>, “Last accessed 10 May, 2016”.

Now let suppose another situation that if the WAPDA²⁸⁷ is generating more than 6 months KIBOR plus 35 basis points from underlying assets. Aren't the *sukūk* holders here are liable to get more if they are sharing commerce risk, on the basis of their share in the capital? The answer is yes they are liable to get returns on the basis of their share in the capital. Here in case of *ijārah* returns in WAPDA *sukūk*, the *sukūk* holder will get previously agreed price and the surplus will go in hands of shareholders which in consequence raise GDP and GNP. At this juncture, the point to ponder is that the right of investor is infringed because he is not getting the equitable share.

The price (returns) in the *sukūk* should be based on the actual activity of underlying assets or actual returns of the firms but at present it is based on fixed income in the market. Fixed returns result in misallocation of resources and fatal to the national economy.²⁸⁷ In practice, the *sukūk* holders have recourse to the cash flow instead of the revenue generating out of assets. Some scholars render the KIBOR rate used here in WAPDA *sukūk* to *ribā*.²⁸⁸

To the extent of compliance with *maqāsid al-Sharī'ah*, it is clear that the purpose of WAPDA *sukūk* is only to enter into *ijārah* agreement, without this aspect the whole arrangement resembling conventional bonds. The documentation of WAPDA *sukūk* further lay down that the compliance will be made with all SBP/SECP/ GOP regulations.²⁸⁹ Moreover, the structure should comply with rulings of *Sharī'ah* and

²⁸⁷Syed Ali, *Islamic Capital Market Products, Regulations & Development, Proceedings of International Conference*, 77.

²⁸⁸<http://www.bashaoorpakistan.com/articles/pakistan-islamic-banking-hypocrisy/>, "Last accessed 22 May, 2016"

²⁸⁹Israr, 44.

requires approval for this regard.²⁹⁰ Here it is clear that the *Shari'ah* rulings regarding ownership and other issues are not followed. The recent regulations “Issue of Sukūk Regulations, 2015”²⁹¹ is just a regulatory law, it is not highlighting the basic *Shari'ah* issues, hence a cover up to legalize conventional bonds.

3.6.2 GOP *Ijārah* Sukūk: *Shari'ah* Compliance

GOP *Sukūk* was issued by the GOP during last some years. These *sukūk* were issued by the GOP under Public Debt Act, 1944 worth of Rs 100,000 for the period of 3 years. No certificates were issued to the *sukūk* holders; it was only on the books of state bank.²⁹² These *sukūk* were issued to the Islamic Banking Institutions (IBI) with the underlying contract of *ijārah*. The IBIs were the *sukūk* holders.²⁹³ The procedure of issuance of *sukūk* is through the auction where uniform based system is followed in which every single one of the bids is accepted by the government and the same rate of profit is agreed to them. The payment in these *sukūk* is linked to floating rate of benchmark which is paid semi-annually.²⁹⁴

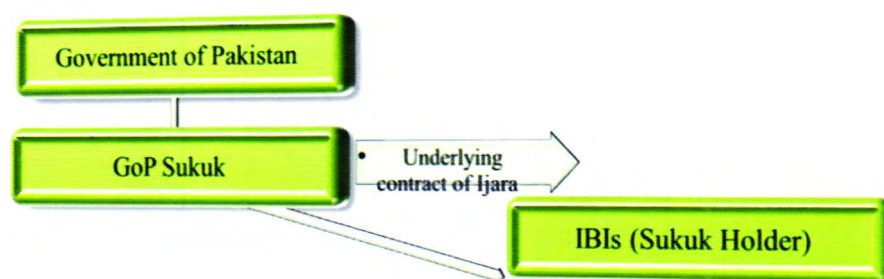


Figure 3.2 GOP *Sukūk*

²⁹⁰Ibid., 45.

²⁹¹See, Issue of *Sukūk* Regulations, 2015.

²⁹²<http://www.sbp.org.pk/dmmd/Guidelines/Sukuk.pdf>, “Last accessed 9th July 2016”.

²⁹³JIBM, 181-194.

²⁹⁴<http://www.sbp.org.pk/dmmd/Guidelines/Sukuk.pdf>, “Last accessed 9th July 2016”.

The income tax is deducted here under existing law i.e. Income Tax Ordinance, 2001 whereas, tax is not deducted at source in *sukūk*.

I. Investment Process

The prerequisite to have the investment in GOP *sukūk* is to open IPS account with banks or dealers. Through banks, the investor will buy the *sukūk* from the secondary market. As these *sukūk* holders are redeemable at maturity but till that date can be traded in secondary market. The international investors can also invest by opening SCRA with the dealers in Pak rupee. Afterward, the same procedure will be followed.²⁹⁵

II. Ownership in GOP *Sukūk*

The *Sharī'ah* issues are considered in GOP *ijārah sukūk* which was scrutinized in WAPDA *sukūk*. Firstly, the real ownership does not pass here to the *sukūk* holders. The beneficial ownership exists here whereby the right to dispose of the asset is restricted. Therefore, AAOIFI recommendations with respect to the real transfer of ownership don't comply in GOP *sukūk*.

III. Liquidity

Secondly, the liquidity of these *sukūk* is only limited up to the date of maturity of *sukūk* as the GOP will buy it back on maturity. It is discussed in the previous chapter that buy back arrangement is un-Islamic.

IV. Rentals

²⁹⁵<http://www.sbp.org.pk/dmmd/Guidelines/Sukūk.pdf>, "Last accessed 9th July 2016".

Thirdly, the rentals through *ijārah* received are linked to benchmark and returns are not subjected to the productivity of underlying asset is the violation of *al kharaj bi al-damān*. Hence, it resembles bonds. These *sukūk* are the stratagem to legalize *ribā*.

V *Sukūk* in Disguise

Lastly, the GOP *ijārah sukūk* is not only confined to these issues but it is *sukūk* in disguise. It is like two sides of a picture, one seems Islamic whereas other un-Islamic that will be depicted in the given research.

The rulings for the *ijārah sukūk* required that it can be traded in the secondary market at the market price.²⁹⁶ Till the maturity date the existing *sukūk* cannot be renewed and new *sukūk* cannot be issued.²⁹⁷ The issue lies in the GOP *sukūk* was that in practice there was little trading in secondary markets. In order to regulate the liquidity of bank, the practitioners gave the way out in this regard.

VI. Way Out in GOP *Sukūk*

In this GOP *ijārah sukūk*, a way out was suggested to *Sharī'ah* board of SBP under which *sukūk* would be sold to the SBP before maturity for the period of one year on the credit basis. It will be done in such a way that seller bank would add one year T-bills related rate to face value. The rentals received in that time period. For this step, they have obtained *fatāwā* that they can sell *ijārah sukūk* on the credit basis (Bai Mujjal) for one year.²⁹⁸

According to this procedure, there are two pivotal issues:

²⁹⁶ 5/2/4, *Sharī'ah* Standard No. 17, AAOIFI.

²⁹⁷ JIBM, 181-194.

²⁹⁸ Ibid.

1) Purchase of *sukūk* on credit basis

2) Sale of GOP *sukūk*

In the above-mentioned step of purchasing *sukūk* from the IBI is the first issue. Under which the liquidity is mopped by SBP a few days earlier than maturity on one year mark-up basis. Another issue is the sale of GOP *sukūk* (T- Bills) in the market. It is then purchased by the interest-based banks. It is observed that the *sukūk* continues to exist on the termination of the lease; the underlying cause also ceases to exist. Therefore, the right to get the return is no more there. Hence the same cannot be sold on the credit basis to the Islamic banks.²⁹⁹

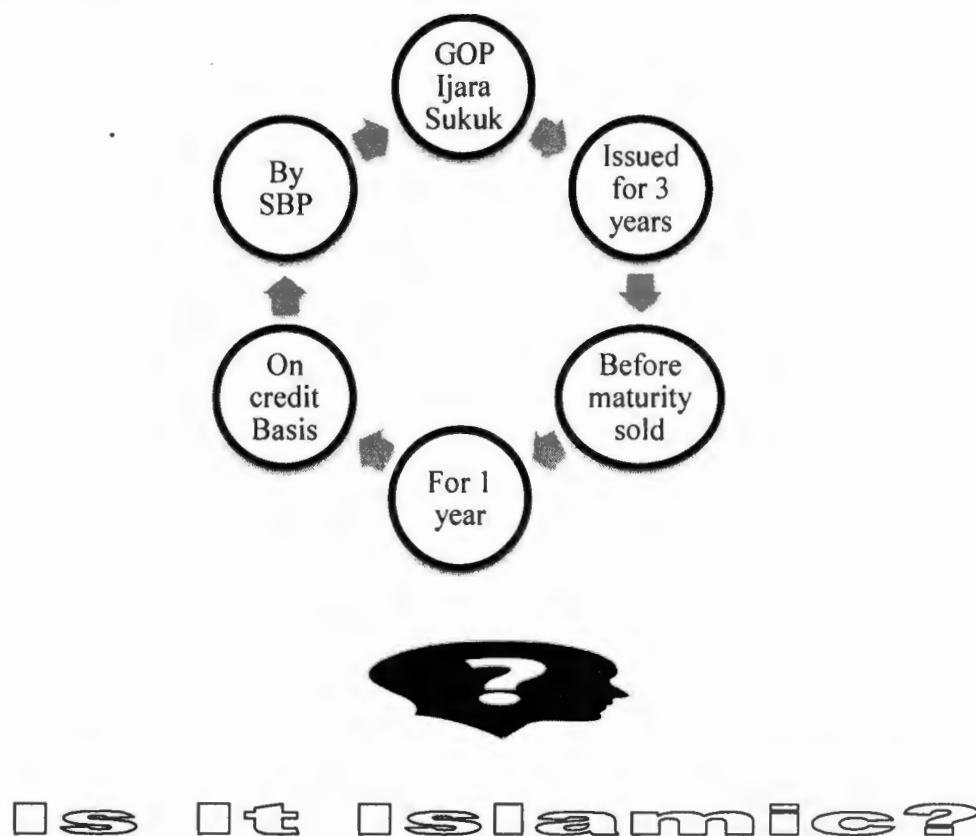


Figure 3.3 *Sharī'ah* Compliance of GOP *sukūk*

²⁹⁹Ibid.

VII. *Sharī'ah* Issues in *Bay Muajjal* of *Sukūk*

- 1) SBP in their circular hasn't mentioned any particular course of action for the bidding and pricing for that purpose. It is verbally explained that it is credit sale on mutually agreed price between SPB and IBI.
- 2) As far as the sale of GOP *sukūk* is considered, it may or may not be financial *tawarruq*. It is claimed that the *tawarruq* is allowed by the IBD Circular no 2 of 2008.³⁰⁰ No *Sharī'ah* clarification is given regarding certainty of the subject matter of sale, pricing of *sukūk* by adding one year return, the maturity of *sukūk* and the termination of lease.

VIII. *Sharī'ah* Appraisal of GOP *Sukūk*

On the basis of following reasons the product is not *Sharī'ah* complaint neither in spirit nor in letter:

- a) The ruling for sale or exchange of *aayan* (exchange of goods) is different from the rulings for sale and exchange of *athman* (money exchange).³⁰¹

For money exchange, the rulings are:

For homogeneous exchange, the exchange should be on spot and equality. For heterogeneous exchange, there should be non equality and spot exchange.³⁰² On the basis of this ground, the instant product is not Islamic.

- b) Another ruling for trade or sale contract is that the subject matter should be fully disclosed and precisely determined.³⁰³

³⁰⁰See, Circular no 2 (2008), IBD.

³⁰¹JIBM, 181-194.

³⁰²Mansoori, *Islamic Law of Contracts and Business Transactions*, 42.

In the Instant case, the *ijārah* contract ceases to exist on maturity date may be one or two days after the deal, Therefore the sale before the maturity on the basis of *bay muajjal* for the period of one year is challenging in Islamic law.

c) The subject matter of the *ijārah sukūk* characterizes that the assets were bought from the GOP through Special purpose vehicle and then taken on lease from the GOP till 31 Dec, 2015. For Instance, on the date of maturity: the subject matter will convert into receivable and the asset will be sold back to GOP.

d) At maturity, the asset of *ijārah sukūk* should be redeemed and cannot be sold before and after maturity date because these are the receivable and the holder has to get cash.

1. *Sharī'ah* rulings prohibited the trading of receivable or the debt instruments.³⁰⁴

AAOIFI resolution in 2008 also highlighted that *sukūk* which are tradable must not characterize any debt or receivable and must be dealt under AAOIFI *Sharī'ah* Standard (21) on Financial Papers.³⁰⁵ By considering the point raised by AAOIFI, it is comprehensible that the rationale is the real ownership. The *sukūk* holders shouldn't be in the row of creditors.³⁰⁶ The *sukūk* are receivable, therefore these are not tradable after maturity. In the instant case of GOP *sukūk*, it is obvious that at maturity the lease will be terminated results in no right to obtain rentals. Accordingly, it doesn't have any right to add the rentals for the duration subsequently.

³⁰³Ibid., 42.

³⁰⁴Al-Zuhayli's, 79.

³⁰⁵See, *Sharī'ah* Standard No. 21 on Financial Papers, AAOIFI.

³⁰⁶<http://www.kantakji.com/media/7760/f173.pdf>, "Last accessed 10 May 2016"

- e) Sale of debt is only allowed in an exception that is *hawālah*.³⁰⁷ In the instant case, the rent is charged expressly by knowing that the time period of lease is terminated and without any ownership of the assets.
- f) By considering above-mentioned instances it is exposed that the Islamic banks are selling the asset before maturity on credit basis and getting the rentals for the specified time period even after maturity and termination of the lease. Here the sale before maturity cannot be considered as a valid sale if rentals of the credit period are added to the credit price.

IX. Rationale of Non-Sharī'ah Compliance of GOP *Sukūk* in Spirit

Hadīth

قوله صلى الله عليه وسلم : ” (إنما الأعمال بالنية) الحديث . أجمع المسلمون على عظم موقع هذا ”

“The Prophets saying, “Actions are by Intentions”.³⁰⁸ There is agreement amongst the Muslims on the greatness of this *Hadīth*.³⁰⁹

- In Islam, the contracts require fulfilling the purpose of objectives of *Sharī'ah*. The purpose should not be against the fundamental principles of Islamic law. Here the objective is against the Islamic law. The underlying purpose is to continue earning on liquidity even after the expiry of *ijārah* and maturity of *sukūk*. Hence it is *ribā*.

³⁰⁷ *Hawālah* is defined as the assignment of debt from the liability of original debtor to the liability of another person. Mansoori, *Islamic Law of Contracts and Business Transactions*, 316: Al-Zuhaylī's, 80.

³⁰⁸ Dr. Muhammad Muhsin Khan, *The Translation of the Meanings of Sahīh Al-Bukhārī* (Riyadh-Saudi Arabia: Darussalam, 1997), Vol 1, *hādīth* No. 1, 45.

³⁰⁹ <https://alchishti.wordpress.com/2006/02/20/actions-are-judged-by-intentions-imam-nawawis-arbain-1/>, “Last accessed 20 April, 2016.”

- It is not *Sharī'ah*-compliant because there is roll over *murābaha*³¹⁰ in it. Roll over *murābaha* is not allowed as per State Bank of Pakistan instructions.³¹¹ It is a designed contract to circumvent the prohibition of *ribā*. It is *hilah fil dayn* to avoid *Sharī'ah* requirement of the prohibition of interest.

Illustration

If I have contracted the *ijārah* and I know that it will come to an end on 31st Dec, 2015 and I will not be able to get the return after the time of maturity of the contract. I found a way out that I will sell it on credit any time before the maturity and will take the rent during that period, so that my cash remains invested for that time interval. Here the obvious purpose is to get return on the money. Getting return over money is prohibited in Islamic law and amounts to *ribā*. It reflects that it is no more but *ribā* and renders the return *hāram*.³¹²

- There is an issue that whether it amounts to *tawarruq* or not? It is argued occasionally that it is not *tawarruq* but it is a trick for the investment of cash. It includes the element of *ribā* in it. As *tawarruq* is allowed by the IBD Circular No.2 of 2008 which requires approval for each specific matter but SBP's *Sharī'ah* board didn't explicitly approve financial *tawarruq*. Moreover, Makkah and Jeddah based fiqh councils prohibited financial *tawarruq*.

³¹⁰It is defined as charging extra money over period of time. <https://www.islamicbanker.com/education/roll-over-murabahah>, "Last accessed 22 July, 2016".

³¹¹SBP declared that the *murābahah* contract cannot be roll over for another period of time by charging extra money. The bank can extend the time period without charging extra money. www.sbp.org.pk, "Last accessed 22 July, 2016".

³¹²JIBM, 181-194.

X. Use of the Product by the IBIs in Pakistan

SBP circulated that the product is used by all the Islamic banks in Pakistan for last one year. All the IBIs got permission from their *Sharī'ah* board that SBP has approved it. If anybody in the meeting of *Sharī'ah* board expresses different opinion then the plea is taken that the SBP *Sharī'ah* Board has approved, therefore, it should be approved by the all. It has become a *mujtahid feh* subject. The members of the committee do not consider its repercussions that it is amounting to *ribā* and they are legalizing by *hilah fil dayn*.

XI. Repercussions of the Product in Pakistan and at Global Level

1. *Sharī'ah* scholar Taqi Usmani in past years renders 85% of the *sukūk* un-Islamic on the ground of various *Sharī'ah* issues such as purchase undertaking, guaranteeing the principal etc. Here the instant product has intense issues of:
 - a) Earning money over money
 - b) Trading in money

They are trading in money without any contract of *ijārah*. They are basically trading in money and financial papers. These facts render it un-Islamic.

2. After 40 years of Islamic banking, it is argued that such *hilas* cannot be allowed in case of plain need. Islamic banking has integrity and these products are injurious to the uprightness of Islamic banks in Pakistan as well as abroad. The core prerequisite in Islam is *Sharī'ah* compliance which cannot be comprised.
3. This product is providing the relief for the period of one year while the need is of the permanent solution to this issue. The issue can be resolved by changing the

mindset to do real sector business and to facilitate the other sectors of the economy in the country such as micro, agriculture and SME etc.

4. This product is only practiced in Pakistan and not in other countries. If it will practice in other countries, there will be the major loss to the integrity of Islamic banks because it involves *ribā* and earning of money over money.

3.6.3 Views of Scholars on GOP *Ijārah Sukūk*

The GOP *ijārah sukūk* is criticized widely by the scholars. Here the dissertation will explore the views of eminent scholars (Dr. Salman Syed Ali, Prof. Dr. Sayyid Tahir and Mr. Muhammad Zeeshan Farrukh) and their *Sharī'ah* analysis on GOP *sukūk*.

I. Analysis by Dr. Salman Syed Ali

Dr. Salman discussed that why *bay muajjal* is permissible in *ijārah sukūk* and why it is not *Sharī'ah*-compliant in GOP *sukūk*. Firstly he discusses that let's assume the initial structure of *sukūk* is *Sharī'ah* compliant i.e. it complies with all the conditions of *ijārah sukūk* given by OIC and AAOIFI. *Sukūk* can be traded in the secondary market as long as the asset is not destroyed in which the payment can be made on the spot as well as deferred. Here the word deferred can be interpreted as the payment can be made even after the maturity. On the other hand, in GOP *sukūk* it is criticized that it is not *Sharī'ah*-compliant. Let's assume that the date of maturity of *sukūk* is near which means on near date the *sukūk* will be liquidated. The *sukūk* here is "near money" on which the rule of *sarf* will apply. If this "near money" is sold on deferred price then it violates rules of

*sarf*³¹³ (as the rules of *sarf* require for homogeneous exchange there should be spot exchange as well as equality should be maintained). Therefore such sale is prohibited.

Moreover, the fact is admitted that the particular sale i.e. *bay muajjal* of *ijārah sukūk* is planned. The intention is explicitly earning of returns after the date of maturity by converting the *sukūk* into cash in the form of receivable. Hence the return is *ribā* and is not *Sharī'ah* -compliant.

Dr. Salman further elaborated that this GOP *sukūk* will open the floodgate of malpractices in Islamic finance. It is illustrated that the originator will issue the *sukūk* for a short period of time for instance 6 months then before maturity buys it back on the deferred price of 2 years. The money during that time period is markup and similar to non collateralized bonds. The assets were issued only for 6 months but the money is generated for 2 years and 6 months. Here the return is not linked to actual economic activity as well as SPV doesn't hold any asset on *sukūk* holder's behalf. The gray areas (the issues falls between *halāl* and *hāram*) must be judged through the intention of the parties.

II. Prof. Dr. Sayyid Tahir Critical Analysis

He objected on the first step in *ijārah sukūk* i.e. the creation of SPV. It is criticized that the SPV and originator are not two autonomous people as required by *Sharī'ah*. The initial step is void ab initio and doesn't require supplementary steps. Here the creation of an SPV merely for the purpose of the lease and buy back of asset is suspicious. The difference is merely the difference in nomenclature i.e. the markup with rentals. For

³¹³JIBM, 181-194.

instance, on the repurchase of any asset makeup is taken but here sale and repurchase agreement is made and the “rentals” are received which is, in fact, a markup. Hence, it resembles with the prohibited tricks mentioned in Holy Qur’ān al- A’rāf 162 – 166.³¹⁴ Moreover, the repurchase of *sukūk* at par value is another drawback.³¹⁵

The following vital issues are analyzed here:

Here the question arises that why SB hasn’t retired the instrument on time? One may say the step may be taken the lack of funds on time. On the other hand, the *sukūk* holders require cash for giving time. Consequently, the instant arrangement is made.

He renders selling the *sukūk* before maturity on *bay muajjal* as “sale of debt for debt” by elucidating that the money and rentals payable at maturity of *sukūk* were unpaid, it became a debt then the debt is sold on deferred price which is again a debt. The money generated out of such transaction is *ribā*. Additionally, there are some other technicalities such as on maturity the lease will be terminated and the originator will buy back the asset but here the particular transaction hasn’t taken place then rentals over the extension period is a vague idea and ill-conceived.

III. Mr. Muhammad Zeeshan Farrukh Analysis

He criticized it by rendering its ambiguous product. He commented that rather than moving towards the real solutions the conventional sector is copied here which shouldn’t be a part of it.³¹⁶

³¹⁴Holy Qur’ān al-A’ rāf 162 – 166.

³¹⁵JIBM, 181-194.

³¹⁶JIBM, 181-194.

The analysis of the law of *sukūk* in Pakistan and the case study of *sukūk* concluded that there are loopholes in the structure of *sukūk*. The regulatory law is not enough to meet the real needs of Islamic finance. Unfortunately, the analysis depicts that the principles of *Sharī'ah* are ignored in Pakistan. The advertisement of *sukūk* is offered through the religious notion which generates the assumption that the process will follow transparency in near future issuance. For that reason, the documentation for the issuance of *sukūk* has *Sharī'ah* provisions. In actual, *sukūk* is in disguise. As *sukūk* are based on the real assets, therefore, the investor should expose to the risk of capital loss, market fluctuations and rentals generated by assets but practically, the *sukūk* replicates conventional bonds. The GOP *ijārah sukūk* case study shows the *sukūk* a worse form of the bond and a stratagem to legalize *ribā*. Therefore, the next chapter will focus on providing the alternative to *sukūk* based on principles of Islamic law.

Chapter 4

SUKŪK: NEED OF A NEW MODEL

Islamic capital market is the backbone of the economy. The vital issue is the assessment of Islamic capital market, whether it replicates the conventional market or not?³¹⁷ *Sukūk*, an innovative model is developed to raise the Islamic capital market by considering principles of Islam. They were issued over the globe and currently it became a popular source of economy of Islamic capital market.³¹⁸ In fact, it has changed the dynamics of the Islamic finance.³¹⁹ Considering facts and figures, it is considered as the fastest growing instrument in the Islamic capital market. In Pakistan, *Sharī'ah* compliant funds have exceeded over 50% of the total market capitalization. For that reason, this expansion necessitates Islamic banking. Even though; the popularity is not only common in the Islamic banks but also in the commercial and International banks.³²⁰ Moreover, the current "Issue of *Sukūk* Regulations, 2015" is a great step towards the development of *sukūk* market. On the other hand, the capital market is governed by the issuance of bonds, shares and other investments. In Islam, trading in bonds is prohibited due to interest (*ribā*) in it³²¹ which renders its income *hāram*.³²²

Sukūk as an alternative to conventional bond has brought revolution in Islamic finance in past few years. They were advertised through the religious notions provides the

³¹⁷McMillen, 165.

³¹⁸Adam and Thomas, 3.

³¹⁹http://www.psp-ltd.com/JFAMM_10_2_2014.pdf, "Last accessed 30 March 2016".

³²⁰Mondher Bellala and Omar Masood ed. *Islamic banking and Finance* (United Kingdom: Cambridge Scholar Publishing, 2013), xiii.

³²¹International Monetary Fund, The Government of United States, *Finance and Development* (Washington DC: IMF, 2010), 44.

³²²Adam and Thomas, 5.

exemption that the process will follow transparency in near future.³²³ It is criticized that most of the *sukūk* doesn't comply with *Sharī'ah* standard given by AAOIFI. The product has a purpose of attracting investments from banks which are resistant to risk-taking. Moreover, these products are not designed to attract genuine risk-taking investors and banks who want real investment in line with *Sharī'ah*. Unfortunately, these products are designed in such a way that replicates conventional bonds by giving a *Sharī'ah* cover. These are composed in complex way consists of different contractual structures which in individual level are *Sharī'ah* compliant but at composite level contradicts the objectives of *Sharī'ah*.³²⁴

The close scrutiny of *sukūk* highlighted numerous issues (as discussed in the previous section of the dissertation) which are injurious to Islamic finance. *Ijārah sukūk* is targeted from all axes whereas *mushārah* and equity *sukūk* is no longer away from criticism. The first step that is the creation of SPV is also subjected to criticism. The situation of *sukūk* in Pakistan in the dissertation seems to be in disguise. Hence, the necessity is to develop a new model against *ijārah sukūk* (which was the focus of instant dissertation) conforming the principles of Islam. Before discussing new model, the principles of Islamic law need to consider.

4.1 The Principles of Islamic Commercial Transactions

Islamic law has following features in dealing business and contracts:

³²³<http://papers.tinbergen.nl/13087.pdf>, "Last accessed 30 June 2016".

³²⁴Syed Ali, ed. *Islamic Capital Market Products, Regulations & Development, Proceedings of International Conference*, 9-10.

Firstly, *ribā* is prohibited in all transactions on the ground that it involves exploitation and injustice to society.³²⁵ The severity of prohibition of *ribā* is understood by a verse of holy Qur'ān in which Allah SWT declared it war against HIM and HIS prophet Saw.³²⁶ Hence, all the contracts in form and spirit must prohibit *ribā*.

Secondly, the contracts should be free from *gharar*. The word *gharar* expresses the meaning of uncertainty and risk, which may consequence in disputes.

Thirdly, *qimār* and *maysir* are prohibited. *Qimār* includes all the money obtained from games of luck and chance. It also includes the money earned at the cost of others. *Maysir* means earning the money without working hard for it. Gambling is one of the examples of *maysir*. The Qur'ān has explicitly prohibited this practice.³²⁷

Fourthly, It is prohibited to involve in *hāram* activities i.e. all those activities that can harm the society. Holy Qur'ān prohibits eating carrion, gambling, drinking alcohol etc.

Fifthly, all forms of fraud and deception are prohibited in holy Qur'ān and *Sunnah*. Numerous practices fall within the ambit of fraud such as false bidding and short weight etc.³²⁸

Sixthly, a number of ahādīth prohibited the two mutually inconsistent contracts. Abu Hurayrah narrated that holy prophet (P.B.U.H.) has prohibited to sales in one sale.

³²⁵International Monetary Fund, 44.

³²⁶2: 275-280, Qur'ān.

³²⁷5:90, Qur'ān ; Mansoori, *Islamic Law of Contracts and Business Transactions*, 7-9.

³²⁸*Ibid*.

Seventhly, all the transactions should observe the principles of *maqāsid -al-Sharī'ah*. These principles include the protection and preservation of *dīn, nafs, nasl, aql* and *māl*.

Lastly, all commercial transaction should comply with the principle of liability to loss and entitlement to profit.³²⁹

4.2 The Aim of New Model of *Sukūk*

In the light of this study in the previous chapters, the design of the new model is driven by the following goals:

- That the principles of *sarf* and prohibitions of *ribā* are to be applied on new model.
- That the principle of *al kharaj bi al-damān* is to be observed.
- That the spirit as well as form should be Islamic in the new model.
- That the Qur'ānic verdicts should be followed.
- The two contracts should not be joined in a single one violating *hādīth* of joining two contracts into one.
- That the *maqāsid al Sharī'ah* should be followed comprehensively.
- That the true sense of ownership is to be applied in the new model.
- The new model should avoid the *gharar*.
- *Bay' al wafā* and *Bay' al īnah* are to be avoided.
- Conventional credit rating is to be avoided in the new model.
- The model will be based on the principle of profit and loss sharing i.e. risk sharing.

³²⁹Ibid., 9-13.

4.3 Existing Structure

In existing structure of *sukūk al-ijārah*, the originator issues the *sukūk* through SPV to the *sukūk* holders. The detail of the structure is already discussed in former chapters. The criticism on the structure is very harsh and critical *Sharī'ah* evaluation pinpoints numerous *Sharī'ah* issues. Summing up the issues, from the creation of SPV to maturity of *sukūk* the whole thing is disapproved. The new model will try to discard these issues through *Sharī'ah* compliance.

4.4 New Structure

(Before presenting the model it is submitted that it is proposed model. It is not developed through financial engineering. It is only an effort to present a model free from *ribā* and other prohibitions. Hence, there is need to reframe the *sukūk* model through the process of Islamic financial engineering to provide a *halāl* source of funding and investments). The structure commences with the originator i.e. let's assume the government who is in need of finances. It is the necessity of the government to raise the funds; in this regard the Islamic capital market is a major sector. For raising funds, the originator i.e. the government issues *sukūk al-ijārah*. As discussed, *sukūk* is the certificate of an undivided share of ownership in assets or usufructs etc. While it is difficult to transfer the ownership of assets belonging to the government to the public, therefore the originator must issue the *sukūk* over an asset which it is planning to privatize in near future. The rationale behind it is to avoid the issues of ownership in near future. For this purpose, there is no need to create an SPV. The issuance of *sukūk* is to be solely done by the originator. The originator after

issuance of *sukūk* transfers its ownership to *sukūk* holders in the real sense so that the risk may pass with the ownership. The transfer of ownership should not only confine to transfer in books of accounts but actual transfer of ownership. In this sense, AAOIFI recommendations regarding the transfer of ownership will be observed in true spirit.

After transfer of ownership, the originator can take it back on the lease from the *sukūk* holders. In Islamic law, the sale and lease back is only allowed in dire cases. Here it is allowed on the ground that raising funds on the *halāl* way to avoid *ribā* is the necessity of originator, so it can be considered a dire need. In the instant *ijārah* agreement, all the rules of *ijārah* should be observed comprehensively. The rentals should not be variable and must originate out of the underlying asset. The major maintenance of property should be done by lesser whereas the minor and day to day maintenance is to be held by the lessee. As when in an Islamic instrument more than one principle is tied up, there is factor of un-Islamic elements. So, the instrument should be observed profoundly. The rentals shouldn't be tied to conventional benchmarking but based on fixed rental by following the jurisdiction, nature of the asset and its usufruct. During this period, the asset risk is to be borne by the owner. At end of the lease, the asset should be transferred back to the *sukūk* holders. If the originators further want the usufruct of the assets, by making a fresh *ijārah* agreement can take asset on the lease. However, at termination, the *sukūk* holders should take possession of asset back from the lessee.

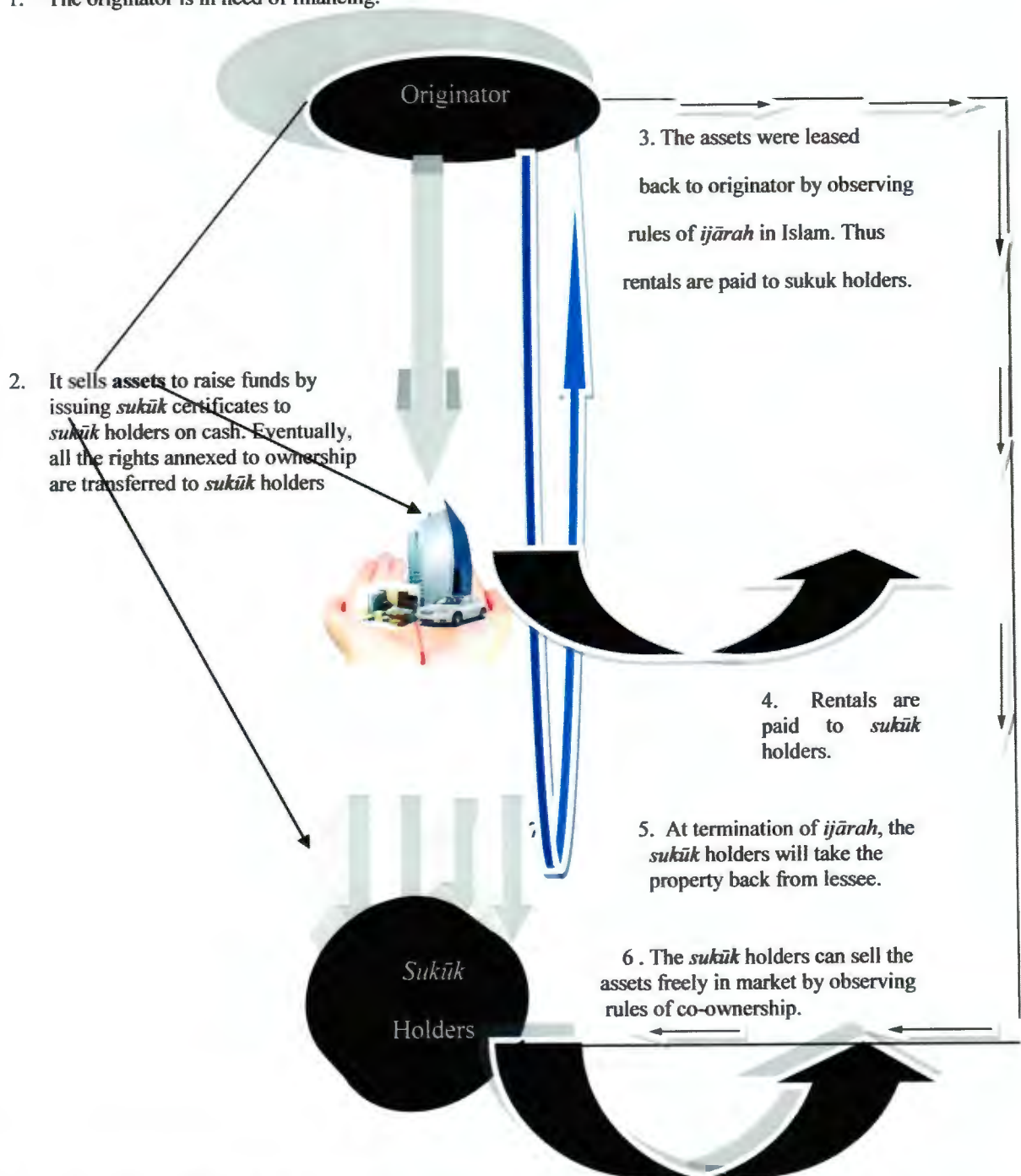
Sukūk holders are free to trade the asset in the market. As *sukūk* mostly issue to more than one person, the rulings of *mushā'* must be observed to trade in the market. *Sukūk* holders should be restricted to sells the asset back to the originator by making a

prior re-purchase agreement, in order to avoid *bay' al wafā*, *bay' al īnah* and a stratagem to *ribā*-based model. However, it can be traded freely in the market. For credit rating of *sukūk*, an alternative Islamic credit rating agency should be established. The purpose of establishment of an Islamic credit rating agency is to rate and instrument on basis of principles of Islam along with other necessary rating methodologies.

Illustration

The new model is illustrated by giving practical example and possibility. Here let's assume the government of Pakistan is need of financing. The government has assets i.e. metro buses and wants to privatize them as it is already running on the subsidy but it needs its usufruct for a time period. Here the government can issue the *sukūk* over the asset to *sukūk* holders and take it back on lease for a period of time (The Islamic principles of the lease as discussed above should observe here). Consequently, the funds will rise through Islamic capital market i.e. *sukūk* without contradicting any *Sharī'ah* principles. The Islamic capital market and the economy will boost up. At the end of the lease period, the possession of asset should be transferred back to the lessor/owner. The *sukūk* holders by observing the rules of co-ownership can trade freely in the market. The government will be restricted here to buy the asset back by making a prior re-purchase agreement, in order to, avoid *bay' al wafā*, *bay' al īnah* and a stratagem to *ribā*-based model.

1. The originator is in need of financing.



Note: The originators are barred to purchase the property for any reason by making a prior re-purchase agreement, in order to avoid stratagem to legalize *ribā*. However, it can be traded freely in the market.

Figure 4.1 New Model of *Sukūk*³³⁰

³³⁰The model is made by the writer of dissertation.

4.5 General Advantages of New Model

The new model will act as a new blood in the field of Islamic finance. It will serve the purpose of fund raising by complying *Sharī'ah* requirements concerning contracts and transactions. It will eliminate the element of *ribā* in the transaction. As a consequence, the Islamic capital market will flourish.

CONCLUSION AND RECOMMENDATIONS

Conclusion

In the light of the instant research, it is therefore concluded that *sukūk* being an innovative instrument has brought revolution in Islamic capital market. Through this instrument, the Islamic capital market has gained popularity worldwide. Keeping in view the facts and figures, it is considered as the fastest growing instrument in the Islamic capital market. In contrast to bonds, *sukūk* were issued as Islamic products. The AAOIFI rulings of *sukūk* were the consequence of great efforts by the scholars. Unfortunately, there are several elements which are rendering it un-Islamic and a stratagem to legalize *ribā* as discussed in the dissertation. The removal of these un-Islamic elements can render *sukūk* truly Islamic. *Sukūk* can be considered Islamic as long as it truly complies with the principles of Islam. Otherwise, non-compliance can shape it a worse form of bond. Dr. Tahir Mansoori also recommended that issues in *sukūk* should be addressed to free it from a mere replication of conventional bonds. He further criticized that in the present form sovereign *sukūk* are stratagem to legalize *ribā*.³³¹

On the basis of discussed facts and figures, most of the *sukūk* were issued by the government sector i.e. *ijārah sukūk*. Unluckily, *ijārah sukūk* is specifically criticized i.e. the whole arrangement in it is *hilah* to permit *ribā*. To resolve the un-Islamic elements in *ijārah sukūk*, the new model is given in the dissertation. The new model, if truly followed, will aid in the escalation of the Islamic capital market. Being an innovative Islamic model, it will mobilize the funds in all the sectors. There should be Islamic credit

³³¹Mansoori, "Use of *Hiyal* in Islamic Finance and its *Shari'ah* Legitimacy", 69-92.

rating agency to rate the instrument by accessing the instrument on the principles of Islam.

By analyzing the law of *sukūk* in Pakistan, it is concluded that the "Issue of *Sukūk* Regulations 2015" is a great step taken by the government of Pakistan but the need of an hour is to formulate a uniform and consolidated law for the government and private sector. In this regard, the recommendations of the instant research should be considered.

Recommendations

1. The *sukūk* based on already existing assets and future projects must be distinguished for the real transfer of ownership. *Sharī'ah* perception of sale and ownership should be used in *sukūk* rather than concepts of common laws.
2. *Sukūk* should be issued on the assets which the government is going to privatize in near future. In this way, the funds will be raised by the government and there be the real transfer of ownership to the *sukūk* holders. Such privatization through *sukūk* will also boost the economic activity in the state.
3. The new advised model of *sukūk al-ijārah*: an outcome of the dissertation should be considered by the relevant authorities for the issuance of *sukūk*.
4. The prospectus must contain the real transfer of ownership rights to *sukūk* holders. Furthermore, the transfer should also pursue in book accounts.
5. *Bay' al wafā* and *bay' al īnah* should be avoided by adopting new recommended structure of *sukūk*.
6. "GOP. *Ijārah Sukūk* Rules 2008" should be amended as per the recommendations.
7. To mitigate risk in *sukūk*, *takaful* can be made a part of *sukūk* transaction.

8. The returns of the *sukūk* should be based on an actual productivity of underlying assets.
9. There should be the consolidated law for the government and private entities for the issuance of *sukūk*.
10. In *sukūk al-ijārah*, there is undivided ownership of *sukūk* holders. Therefore, the *Sharī'ah* rules of co-ownership i.e. *musha'* should make a part of the law in order to regulate *sukūk* in the secondary market.
11. The conversion of *sukūk* into shares should be prohibited to eradicate discrepancy between *sukūk* and shares. The *sukūk* should be made untainted and Islamic.
12. To secure risks in *sukūk*, the benevolent third party can give the guarantee as per AAOIFI rulings but the government shouldn't give the guarantee in this respect. The guarantee shouldn't be given to ensure the return of principal amount.
13. To regulate the *mushārah sukūk* in Pakistan, the need of an hour is to ensure *Sharī'ah* compliance by making a special law for the issuance of *sukūk* by private entities.
14. Investors should be protected by disclosing the *sukūk* structure as well as its *Sharī'ah* and legal consequences.
15. The government of Pakistan should issue a specific accounting standard to regulate *sukūk* market, by considering the distinctive feature of *sukūk*.
16. The government of Pakistan should establish a proper forum for regulating and stimulating the trade of *sukūk* in the market. The regulatory forum must have qualified *Sharī'ah* scholars for effective implementation and observance of *maqāsid al Sharī'ah* in contracts.

17. For credit rating, an alternative Islamic credit rating agency should be established, which can rate the instrument on principles of Islam.
18. An alternative interest free benchmarking should develop to promote the real Islamic financial market.
19. OIC, IFSB and AAOIFI should meet on a single forum to decide the *Sharī'ah* issues in *sukūk*. A uniform structure should be adopted by all of them in structuring *sukūk* as Holy Prophet (P.B.U.H) said that my *ummah* will never agree on an error.
20. Islamic Development Bank should take measures to build up an organized framework for *sukūk* which will serve a procedural requirement for member countries.³³²
21. To regulate Islamic capital market, the need of an hour is an alternative *Sharī'ah* compliant model. In this regard, the gates of jurisprudential research should be opened for innovation and promotion of diversity in Islamic capital market.

³³²The conference was held in Tunisia in 2015 under name of "Islamic Sukūk between *Sharī'ah* Legitimacy and Legal and Accounting Requirements" in which papers were presented and recommendations were given. <http://www.isra.my/site-map/quick-link/previous-event/98-others/430-international-islamic-sukūk-seminar-Sharī'ah-legitimacy-and-legal-and-accounting-requirements.html>, "Last accessed 25 July, 2016".

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