

# The Application of *Sukuk* in Pakistan

## (Case study of WAPDA and Motorway)



(This dissertation is submitted to the Faculty of Shariah & Law as partial  
requirement for the award of LLM in Islamic Commercial Law)

Submitted by:  
**Muhammad Israr**  
**Reg. No: 08-FSL/LLMICL/F07**

Supervised by:  
**Prof. Dr. Muhammad Tahir Mansoori**

**Faculty of Shariah & Law**  
**International Islamic University Islamabad**

(2012)



Accession No TH-9385

MS  
340-59  
MVA

1. Islamic Law

2. Shari'a Secular Law

DATA ENTERED

8/8/13  
S. M. B.



## **FINAL APPROVAL**

It is certified that we have gone through the thesis submitted by Muhammad Israr and we have come to the conclusion that the research work is up to the mark and fulfils all the requirements for the grant of the Masters degree in law by the faculty of Shariah and Law, International Islamic University, Islamabad.

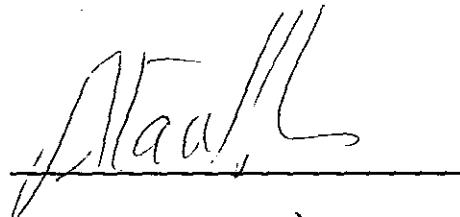
### **Viva-Voce Examination Committee**

#### **Supervisor**

**Dr. Muhammad Tahir Mansuri**

D G Shariah Academy/Professor  
Faculty of Shariah and Law

---



#### **Internal Examiner**

**Mr. Ataullah Khan Mahmood**

Assistant Professor  
Faculty of Shariah and Law



#### **External Examiner**

**Dr. Hafiz Muhammad Ijaz**

Associate Professor  
Director Sheikh Zayed Islamic Center  
University of Punjab, Lahore



## TABLE OF CONTENTS

Dedication.....	V
Acknowledgment.....	VI
List of Abbreviations.....	VII
Abstract.....	X
Introductory Chapter.....	X
1. Introduction and Significance.....	X
2. Background and Statement of the Research Problem.....	XII
3. Scope of Study.....	XVII
4. Approach of Study.....	XVII
5. Literature Review.....	XIX
6. Structure of the Thesis.....	XX
Chapter 1.....	1-34
Introduction to <i>Sukuk</i> : Basic Concepts.....	1
1.1 General Concept of <i>sukuk</i> .....	1
1.2 Definition of <i>Sukuk</i> .....	3
1.3 Historical Background of <i>Sukuk</i> .....	3
1.4 Need and Importance of <i>Sukuk</i> .....	5
1.5 Types of <i>sukuk</i> .....	7
1.5.1 <i>Ijara Sukuk</i> .....	7
1.5.2 <i>Mudaraba Sukuk</i> .....	9
1.5.2.1 Definition of <i>Mudarabah</i> .....	9
1.5.2.2 Structure of <i>Mudarabah</i> .....	10
1.5.2.3 Important Rules of <i>Mudarabah</i> .....	10
1.5.2.3 <i>Mudarabah Sukuk</i> .....	11
1.5.2.5 Trading in <i>Mudarabah Sukuk</i> .....	12
1.5.3 <i>Musharakah</i> .....	13

1.5.3.1 General concept of <i>Musharakah</i> .....	13
1.5.3.2 Types of <i>Musharakah</i> .....	14
I Permanent <i>Musharakah</i> .....	14
II Diminishing <i>Musharakah</i> .....	14
1.5.3.3 <i>Musbarka Sukuk</i> .....	14
1.5.4 <i>Murabahah</i> .....	15
1.5.4.1 Important rules of <i>Murabahah</i> .....	16
1.5.4.2 <i>Murabahah Sukuk</i> .....	17
1.5.4.3 Trading in <i>Murabahah Sukuk</i> .....	17
1.5.5 <i>Salam</i> Contract and its Significance .....	17
1.5.5.1 Important rules of <i>Salam</i> .....	18
1.5.5.2 <i>Salam Sukuk</i> .....	19
1.5.6 <i>Istisna</i> .....	20
1.5.6.1 Important rules of <i>Istisna</i> .....	20
1.5.6.2 <i>Istisna Sukuk</i> .....	20
1.5.6.3 Trading in <i>Istisna Sukuk</i> .....	21
1.5.7 <i>Muzar'a Sukuk</i> .....	22
1.5.8 <i>Migarasa Sukuk</i> .....	22
1.5.9 <i>Musagat Sukuk</i> .....	23
1.6 Parties Involved in <i>Sukuk</i> .....	24
1.7 The role of SPV in issuance of <i>Sukuk</i> .....	26
1.8 Important rules about trading of <i>Sukuk</i> .....	27
1.9 <i>Sharia'h</i> position of <i>Sukuk</i> .....	28
1.10 Ruling of AAOIFI regarding <i>sukuk</i> .....	29
1.11 Difference between <i>Sukuk</i> and Bonds.....	31
1.12 Difference between <i>Sukuk</i> and Shares.....	34

<b>Chapter 2.....</b>	<b>36-54</b>
<b>The Application of <i>Sukuk</i> in Pakistan.....</b>	<b>36</b>
2.1 A brief description of the situation of <i>sukuk</i> in Pakistan.....	36
2.2 Issuance, Approval and Regulations of <i>Sukuk</i> in Pakistan .....	37
2.3 Structure of <i>Sukuk</i> in Pakistan issued by GOP.....	38
2.4 Experience of <i>Sukuk</i> in different companies in Pakistan.....	39
2.5 WAPDA <i>Sukuk</i> Experience in Pakistan.....	40
2.5.1 Main Parties in WAPDA <i>Sukuk</i> .....	40
2.5.2 Managing body of WAPDA <i>Sukuk</i> .....	41
2.5.3 Other Arrangements.....	41
2.5.4 Purchase Agreement.....	44
2.5.5 Other terms and Conditions.....	46
2.6 Pakistan's Experience of Motorway <i>Sukuk</i> .....	50
2.6.1 Parties involved in Motorway <i>Sukuk</i> .....	51
2.6.2 Purchase Agreement.....	53
2.6.3 <i>Ijara</i> Agreement.....	54
<b>Chapter 3.....</b>	<b>60-77</b>
<b>General Principles of <i>Ijarah Sukuk</i> and the Analysis of Pakistan's Experience.....</b>	<b>60</b>
3.1 General Principals of <i>Ijarah</i> .....	60
3.2 <i>Ijarah</i> Defined.....	60
3.3 Features of <i>Ijarah</i> .....	62
3.4 Kinds of <i>Ijarah</i> .....	62
3.5 Conditions of <i>Ijarat al- ashya</i> .....	63
3.6 Some other rules concerning <i>ijarah Al-Ashya</i> .....	65
3.7 General Principles of <i>Ijarah Sukuk</i> .....	66
3.8 Analysis of Pakistan's Experience in the Light of <i>Sharia`h</i> .....	67
3.9 The Trust Assets and its securitization.....	70
3.10 Fine on client to pay to the charity in shape of increasing in the rent in the next transaction.....	73
3.11 Objection on sale of debt.....	74
3.12 Objections on the procedure of <i>Sukuk</i> issuance.....	75

3.13 Criticism on <i>Ijarah Sukuk</i> .....	77
<b>Conclusion</b> .....	<b>79</b>
<b>Recommendations</b> .....	<b>80</b>
<b>List of Bibliography</b> .....	<b>81</b>

## Dedication

*This dissertation is dedicated to my parents Mr and Mrs Muhammad Yar who always supported me and always stood by me in good and bad times and made me what I am today and all the credit goes to them and to my wife for her support and co-operation and my dear sons Muhammad Sameed and Muhammad Raheeq for making life a pleasure.*

# Acknowledgements

In the process of this task, I am thankful to Almighty Allah; as I am firmly believe, without His blessings, this accomplishment would not have been possible.

I would really like to thank my Supervisor; Prof. Dr. Muhammad Tahir Mansuri (well known scholar of Islamic Law) for his inspiring guidance and support which enabled me to complete this research work. His kind personality, the clarity of ideas he has and knowledge that he possesses helped me a lot to deal with certain legal and technical issues which I confronted during my research work.

My best regards are for Prof. Dr Muhammad Munir(Chairman Department of Law) for his extra- ordinary co-operation and valuable advices and inculcating me to complete my thesis. Also my best regards are for Prof. Dr Muhammad Zia ul Haq (Dean of the Faculty of Shariah & Law), Prof Dr Muhammad Tahir Hakeem (Head Department of Islamic Law), Dr Abdullah Rizk Almuzaini, and all other teachers for their extra- ordinary co-operation and valuable advices.

I must also not forget Mr. Imran Ahsan Khan Nyazee for his knowledge, analytical thinking and sage advices.

Last but not lease, I would like to thank Mr. Muhammad Akbar Khan (Lecturer in Law, IIUI) and Mr. Asif Raza (LL.M.), and Miftahuddin Khilji for their co-operation and positive criticism of my work, Mr. Usman Rafiq (Research Associate) and all other friends who extended their support in completion of this research. I hope they will always remember me in their best wishes and prayers.

### List of abbreviations

IMF	International Monetary Funds
AAOIFI	Accounting and Auditing Organization of Islamic Financial Institution
SPV	Special Purpose Vehicle
SPE	Special purpose Entity
NBFIs	Non Banking Financial Institutions
LIBOR	London Inter Bank Offer Rate
MTFCs	<i>Mudarabah</i> Term Finance Certificates
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
IPO	Initial Public Offer rate
NHA	National Highway Authority
GoP	Government of Pakistan
WAPDA	Water and Power Development Authority
PKR	Pakistani Rupee
KIBOR	Karachi Inter Bank Offer Rate
BPs	Basis Points
PIS	Pakistan International Sukuk Company Limited
MLCFL	Maple Leaf Cement Factory Limited.
SSGC	Sui Southern Gas Co
EBPL	EDEN Builders Private Limited
PEL	Pakistan Electronic Limited
KSEWs	Karachi Shipyard and Engineering Works
PIA	Pakistan International Airlines

PN Primary Note

SN Secondary Note

## Abstract

*Sukuk is an important topic in the current literature of Islamic commercial law and Islamic banking. The thesis in hand addresses this topic in the context of Pakistan. Two important cases i.e. WAPDA and MOTORWAY sukuk. Cases have been critically analyzed from the perspective of Shariah. In the first chapter general concepts of Sukuk and its Shariah legitimacy is discussed and various types of sukuk are mentioned therein. The need and importance of sukuk are also discussed in the same chapter. It has also concerned with the rulings of AAOIFI, Shariah Standards regarding sukuk. In chapter two, the concept of Ijarah in classical Islamic and modern literature is discussed. As, the main thesis are related to the issue of Ijarah Sukuk, therefore, chapter two has traced the basis of this kind of sukuk and analyzed that from Shariah perspective. In this chapter the two cases of WAPDA and MOTORWAY are presented and the rules and main issues concerning them are analyzed. In chapter three, the cases mentioned above are analyzed from the principles of Shariah and both the cases are analyzed para wise. The end of the research is concluded with the most important results and some recommendations.*

## INTRODUCTORY CHAPTER

### 1. Introduction and Significance

*Ijarah* is one of a well-known doctrine in Islamic commercial law. *Ijarah* is a contract on usufruct for a known consideration<sup>1</sup>. The word *Ijarah* is used for two different situations. In First situation it means to hire services of a person, to employ the services of a person on wages given to him as consideration, as a return of his services. Here the employer is called *mustajir* while the employee is called *ajir*. In second situation *Ijara* does not relate to the services of human beings but relates to the usufruct of assets and properties. In this sense *Ijara* means to transfer the usufruct of property to someone and on return take rent of that particular property for specific time. In this case, the term *Ijarah* is analogous to the English term leasing. Here the lessor is called *mu'jir*; the lessee is called *mustajir* and the rent payable to the lessor is called *ujrah*. As a concept of classical Islamic law, *Ijarah* has been of great importance in trade and commerce since age of Islam. *Ijarah* is applied in different modern transactions on the theory of permissibility and necessity.

Although the term *sukuk* is a modern one for a common man but its concept and practices are old. Much of empirical evidence appears show that *sukuk* were used, in large number, by the Muslims societies of the middle ages in form of paper for their business activities. However its modern and present structure is found in the conventional concept of securitization. Securitization of debt began in the 18<sup>th</sup> century with government debt in Europe. Corporation could also be authorized to issue equity security but not debt securities.

---

<sup>1</sup> Kasani, *bada'i' al-Sana'i'*, vol. 4, p. 174; Zaylai, *Tabyin ak haqa'iq* vol.5, p. 105

In 19<sup>th</sup> century, issuance of debt securities spent more and more. Debt securities took either the form of bond or debenture. Thus securities were traded on bond market which were more active then the equity market.<sup>2</sup>

After studying the history and background of *sukuk* we came to conclusion that issuance of financial instrument under *Sharia'h* was defended by the fourth Annual Plenary Session of Islamic jurisprudence Council in *Jadab* in 1988 concluded that:

"Any combination of assets (or the usufruct of such assets) can be presented in the form of written financial instruments that can be sold at a market price. In more authoritative pronouncement, Accounting and Auditing Organization for Islamic Financial institutions (AAOIFI), in May 2003, issued its *Shairah* Standards with the name of investment *sukuk*.<sup>3</sup>

The standard, which became effective from 1st January 2004, prescribes that *sukuk* present a common share in the ownership of the asset, usufruct, services or a mixture of all these plus intangible rights, debts and monetary assets.<sup>4</sup>

In the year 1983 the central bank of Malaysia has tried to issue the first investment papers that involve *riba* free investment. That could be said to be the first attempt of issuing *Sharia'h* compliant certificate. In 1990s other financial institutions and Muslims countries including Malaysia and other countries such as Pakistan and Egypt issued securities which were more or less similar to the conventional securities with a little bit of investment. In the beginning of the year 2000, these Muslims countries started issuing of completely *Sharia'h*

---

<sup>2</sup> Usmani, Muhammad Taqi "An Introduction to Islamic Finance" Publisher (Quranic Studies Publishers, Maktaba Maariful Qur'an Karachi Pakistan) August,2008, p. 202

<sup>3</sup> Edited by: Jaffar, Sohail, "Islamic Asset Management", p.73

<sup>4</sup>Ibid, p.73

complaint certificates. First *sukuk* was issued by Malaysia in the year 2000 followed by Bahrain in 2001 and then Indonesia in 2002. Later on other Muslim and non Muslim countries join the exercise. In 2007, there were thirteen major countries where *sukuk* were issued, nine of which were Muslim countries.<sup>5</sup>

The study has a great significance. It can be said that the concept of Islamic banking emerged as a new concept in the contemporary banking system. Most of the products, practiced in Islamic banks are considered as permissible (*halal*). Most of the transactions are justified as Islamic on the rule of permissibility in (*mua'milaat*). However, the rule is subject to the condition that the basic principles of Islamic law should not be violated. The doctrine of *Ijarah* has a distinct jurisprudence in Islamic commercial law.

## 2. Background and Statement of the Research Problem

A SPV is created and beneficial ownership is transferred to the SPV as assuming it the issuing body. In Pakistan, SPV purchases the assets to satisfy the claims only and cannot own the title of the assets. It becomes hurdle in the way of *Sukuk* issuance phenomenon in Pakistan. The obvious reason of this obstacle is lack of real ownership right on the assets therefore investors feel hesitation to invest through an entity which is not strong enough in its powers (do not have legal ownership on the underlying assets) to encourage the market players.

This study seeks to focus on the questions surrounding the application of *Ijarah Sukuk* in modern transactions. The question of this study is that whether different transactions based upon the doctrine of *Ijarah sukuk*; follow the doctrine in the real sense?

---

<sup>5</sup> Idris Umar Mohammed, Research paper, Evaluation of Research Developments on the Islamic Securities (*Sukuk*), International Centre for Education in Islamic Finance, Malaysia.

Muslims end up incorporating implicit inflation assumptions when they set profit expectation as a function of other conventional capital market returns on comparable risk. Since interest rate is usually used as a basis of cost of capital and a benchmark against interest rate of return (IRR), in an economy without any interest rate there is no mechanism to calculate the cost of capital, and the efficiency of an investment project cannot be evaluated. To solve the problem associated with use of interest rate for pricing the *Ijarah sukuh*.

The significance of this question is that if *sukuk* is really to be used in different transactions, the transactions should be completed in two different contracts. The undertaking which is made in advance is a wrong arrangement. In other words, the transaction should be in such a way that after the completion of the tenure, the contract should be over. After that if investor wishes he can enter into a new contract with the same parties, i.e., the Government to sell the property.

Another significance of the study is that the *sukuk* based transactions visa-viz., WAPDA and Motorway seem very expensive and long-termed and time consuming.

While analyzing both the cases, the use of Bench-mark in the form of KABOR for the fixation of the profit is a one of the big questions. One view is that it is merely used as a scale for the measurement of the profit. No doubt, fulfillment of all conditions will make the transaction valid. The fixation of the profit on the basis of a benchmark does not render the contract invalid. Other view is that this practice itself is not appreciable and some methodology should be carved out to avoid this detestable action.<sup>6</sup>

---

<sup>6</sup> Samadani, Dr. Maulana Ijaz Ahmad, "Leasing (*Ijarah*) Process in Islamic Banking System", 2008, p.93

With regard to the question whether any risk is beard by the lessors? The answer is that no risk sharing phenomenon is found while making the terms of the contract between the lessors and the lessee.

While raising objections on the *sukuk* based transaction, there is an objection on the phenomenon of “*Beneficial Ownership*”. It is developed as like other tangible assets the *Sukuk* issued on these turbines represented an undivided beneficial ownership on turbines. At the end of lease period the WAPDA will take back the turbines by fulfilling its *unilateral* promise of buying back the turbines at market price.

One of the important component and question to be answered and be researched is with regard to the liability and Maintenance. The discussion is made in the sense that under the terms of an *Ijara* Agreement, the Lessee has agreed that the Issuer would not under any circumstances be liable to the Lessee or to any third party for any cost, claim, demand, loss, damage or expense of any kind or nature caused directly or indirectly by, or out of, the use of any part or the whole of the Highway Land. The Lessee has agreed to indemnify and keep indemnified and hold harmless the Issuer against all and any such costs, claim, demands, losses, damages and expenses.

Under the terms of an *Ijara* Agreement, the Lessee has agreed that if the Issuer would be preventing from making Periodic Distribution Amount to Certificate holders or does or would not have sufficient fund to pay to the same in full as a result of actions taken by the Government (including, but not limited to, the imposition of any tax or the dissolution of the Issuer), the Lessee will account to the Trustee on demand for such amounts as are necessary to enable the Periodic Distribution Amounts to be paid in full. Under the terms of an *Ijara* Agreement, the Lessee should, as its own cost and expense, he

would be responsible for the performance of all Ordinary Maintenance required for the Highway Land. Under the terms of an *Ijara* Agreement, the Issuer was responsible for the performance of all Manor Maintenance, and will be procure that the Servant Agent, in accordance with the terms and conditions set out in the Service Agency Agreement, was held to perform, or would procure the performance of, all Major Maintenance in respect of the Highway Land on behalf of the Issuer.

Another important aspect of *Ijara sukuks* is taking of Rentals. The rentals under the *Ijara* Agreement would equal the Periodic Distribution Amounts payable on Periodic Distribution Dates coinciding the Rental Payment Dates for such results. The Lessee was obligated to pay rentals into the Transaction Account the second Business Day preceding the 27<sup>th</sup> day of each January and July, commencing on 27 July 2005 up to including 27 January 2010 or, if any such day was not a Business Day, then the following Business Day unless it would thereby fall into the next calendar month, in which event such day would be the immediately preceding Business Day, or any other date on which the *Ijara* Agreement is earlier terminated in accordance with its terms.<sup>7</sup>

Under the *Ijara* Agreement, If payment of a rental was not made to the Issuer in full or its due date for payment, the Lessee (in addition to making the relevant payment) had irrevocably undertaken to donate directly, in accordance with the *Shariah* principals, a late payment amount to be paid to charity of the Issuer's choice in respect of the period from and including the due date for payment to but excluding the date of full payment, equality, for the number of days during such period, the Rental applicable to Rental Period (as

---

<sup>7</sup>Prospectus prepared for Motorway transaction, Summary of the offering, p.33

defined in *Ijara* Agreement) in respect of which the payment delay occurred, divided by the number of actual days in such Rental Period.

Under the *Ijara* Agreement, the Lessee bears the entire risk of loss of or damage to the Highway Land or any part thereof arising from the usage or operation thereof by the Lessee, and will indemnify the Issuer against the same. In the *Ijara* Agreement, the Lessee has covenanted that from the January 2005 and for so long as its liabilities under the *Ijara* Agreement have not been discharged, the Lessee will not create, assume or permit to subsist any Security, other than permitted security, upon the whole or any part of its assets or revenue to secure (i) any of its Public External Indebtedness: (ii) any of its guarantees in respect of Public External Indebtedness: (iii) the Public External Indebtedness of any other person.<sup>8</sup>

A critical analysis of these two will further clear the concept. This will further the broader perspective of *Ijarah* which will prove helpful to overcome the current economic recession and terrorism, being international issues in these days.

The current study focuses on the elaboration of the concept of *Ijarah*. It is argued that the application of *Ijarah* in different modern transactions is not based upon the true principles of *Ijarah* doctrine. It looks its application in WAPDA and Motorway transactions. Each transaction is analyzed and looked. It is justified why a transaction is incompatible with Islamic law. It is argued that the *Ijarah* may become an established principle if it is followed in its true sense.

---

<sup>8</sup> Ibid p. 34

### **3. Scope of Study**

There is a considerable scope for research and analysis of *Sukuk*. The study focuses to point out how the element of interest (*Riba*) is founded in different transactions based upon *Ijara*. It clarifies the concept in the sense that in conventional bonds there is no participation of bondholders in trade or business but mere a profit based on interest. In case of *sukuk*, *sukuk* holders have right of information in trade or business where their monies will be allocated. Moreover, we need *sukuk* for Muslim investors where they may invest their capital in *Shariah* complaint commercial activities. The study will also look *Sukuk* based transactions, i.e., WAPDA and Motorway cases. It will examine and analyze the said cases in the light of the Principle of classical *Ijarah*. This will further enhance the scope of the study as *Sukuk* can be used in other transactions in the large perspective.

### **4. Approach of Study**

The approach of the study is analytical and appraisal from the perspective of Islamic commercial law. The Holy Quran, the Traditions of the Holy Prophet (SAW), the AAOIFI *Shari'ah* Standards are used as the sources in the study. It also relies on the original sources, Books, Journals and Articles. The Holy Quran is cited in the manner that the first number denotes chapter (*sura*), the second denotes the number of verse, for example, 01: 88. All the four Sunni schools of Islamic jurisprudence, i.e. Hanafi, Maliki, Shafi and Hanbali are cited wherever is necessary.

## 5. Literature Review

Several books and articles have written on *sukuk*. Among them, important works on *sukuk* are as follows:

**Understanding Islamic Finance** by Muhammad Ayub, is one of the excellent book on this topic. Here, among the other issues, the author has described kinds of *sukuk*, parties involved in *sukuk*, securitization and many other issues related to the issuance of *sukuk*.

**Islamic bonds: your guide to issuing, structuring and investing in *sukuk*** edited by Najaf J. Adam and Abdukadar Thomas is another book on this topic. They have discussed the overview of *sukuk*, legitimacy of *sukuk*, kinds of *sukuk*, origins and distinctiveness of *sukuk*, structure of *sukuk* transaction and many other relevant issues. They have also elaborated the practice of *sukuk* in many countries like Saudi Arabia and Malaysia etc.

**Islamic asset management: forming the future for Shari'a-compliant investment strategies** by Sohail Jaffer is another prominent book in this field. Here, among the other issues, the *Shariah* principles and perspectives relating to *sukuk*, *sukuk* implementation structures and parameters, potential of *sukuk* for fund management purposes have described.

Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), *Sharia`b* Standards Standard No 17 on investment *Sukuk* has also given the definition, kinds and rules in detail. *Sharia`b* Standard No. 17 is a full-pledge guideline for investment *sukuk*.

Meezan guide to Islamic banking by Imran Ashraf Usmani has written under the title of securitization. He has also discussed how the *sukuk* concept has been engineered in Islamic banking.

Moreover, many articles are also available on this topic.

An eminent article under the title of *Sukuk* and their Contemporary Application by learned scholar in Islamic banking Maulana Taqi Usmani. Among other issues, he has discussed concept of *sukuk*, its application in Islamic banks and financial institutions, shortcomings in practice. He has also given some precious suggestions to avoid from the misuse of the concept of *sukuk* and use it as an instrument for fund raising in major projects and how to make the application of *sukuk* according to the principles of *Sharia`h*.

Husasain Hamed Hassan- the learned sholar on Islamic banking has written a detailed article on the issue of *sukuk* and has given some concrete arguments in this regard.

Another article, **DESIGN OF IJARAH SUKUK** by Rohmatunnisa Dinna in University of Nottingham. Here he has described structure of *Ijara sukuk*. He has criticized its practice from different angles.

**Structure of Islamic Bonds and Managing Financial Risk of Sukuk** by Noor Ahmed Memon. Among the other issues, he has discussed the structure of *sukuk*, its practice in financial institutions and expecting financial risk in its practice.

Fixed income securities *Sharia`h* perspective, a research paper prepared for the 2<sup>nd</sup> SBP International conference, by Muhammad Imran Usmani where he has elaborated and raised some important issues in this regard.

## 6. Structure of the Thesis

The whole thesis is divided into three Chapters. Chapter 1 addresses the conceptual issues like Definitions, brief history, types, parties, legitimacy, AAOIFI's rulings and difference between *Sukuk* and Bonds. Chapter 2 proceeds to: the Regulation and Structure of *Sukuk* in Pakistan, cases of WAPDA and Motorway based upon *Sukuk* principle and Purchase and *Ijara* Agreement.

Chapter 3 discusses the General principles, features and kinds of *Ijara*. It also discusses conditions and some rules concerning *Ijarat al-ashya*. It also analyzes of Pakistan's experience in the light of *Sharia'h*, the Trust Assets and its securitization and sale of debt. Chapter 4 sums up and draws a conclusion of the arguments along with some suggestions.

## CHAPTER 1

### INTRODUCTION TO SUKUK: BASIC CONCEPTS

#### 1.1 General concept of *sukuk*

The term of *sukuk* has been recognized by the traditional Islamic Jurisprudence.

It has a simple ideology. The interest is prohibited by *Shariab* and shuts down almost all the doors for a pure debt security, but liability/obligation that is linked to the performance of real asset is permissible. In other words we can say that *Shariab* permits the validity of those financial assets whose return is derived from the performance of an underlying real asset.

As far as the model of *sukuk* is concerned, it has similarity in large to the process of securitization of assets in conventional markets where a wide range of asset types are securitized.

These assets types contain mortgages, accounts receivables, auto loans home equity loans, and credit card payoffs. Just as in conventional securitization where they built a pool of assets and issue the securities against this pool. *Sukuk* is the name of documents of participation certificates against a single assets or pool of assets.

Generally we can say that *sukuk* represent the proportionate beneficial ownership of an asset where the period is defined, risk and return is associated with cash flows that is generated by underlying assets in a pool are passed to the *sukuk* holder (investor).<sup>1</sup> In general sense *Sukuk* is similar to conventional bonds. It is also a security instrument that provides a predictable level of return. However, technically, there is a fundamental difference between these two. A bond purely

---

<sup>1</sup><http://ssrn.com/abstract=1093064> accessed last time on 03/05/2010

represents debt of the issuer while a *sukuk* represents an ownership in an existing or well-defined asset or project which bears risk on the creditworthiness of the issuer.

Similarly in a case of bond, there is lender/borrower relation between the parties while the relationship of the *sukuk* between the parties depends upon the nature of the contract underling the *sukuk*. For example, if a lease (*ijarah*) contract underlies a *sukuk*, then it creates a lessee/lessor relationship, which is different from the typical lender/borrower relationship.

It can be easily said that *Ijarah sukuk* are the most common form of securitization. Over the recent past, *sukuk* have been structured on other Islamic finance transaction. *Ijarah sukuk* have financial obligations that are issued by a lessor and backed primarily by cash flows from lease receivables from a credit lessee such as sovereign governments, regional governments, corporations and multilateral lending institutions.

*Murabah* is the core contract that is utilized in the process of securitization to create the *sukuk* where it allows one party, on behalf of the principal or capital owner to act as an agent, on the basis of terms and conditions or pre-agreed profit-sharing arrangement. The contract of *mudarabah* is used to create a Special Purpose *Mudarabah* (SPM) entity which is similar to the conventional Special Purpose Vehicle (SPV) who is supposed to perform a well-defined role in getting certain assets and issuing certificates against the assets. The underlying assets acquired by the SPM need to be *shariah*-compliant and can vary in nature. The negotiability of issued certificates and tradability is determined on the basis of the nature of the underlying assets.<sup>2</sup>

---

<sup>2</sup> Ibid

## 1.2 Definition of *Sukuk*

*Sukuk* is an Arabic word. It is the plural of *Suk* which means “legal instrument, deed, cheque”. In other words, *sukuk* is the Arabic name for financial certificate but can be seen as Islamic equivalent of bond<sup>3</sup>

The authentic definition given by *Shariah* Standards says that: “*Sukuk* or investment *sukuk* are certificates of equal value representing undivided shares and ownership of tangible assets. Usufruct and services or (in ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the *sukuk*. The closing of subscription and the employment of funds received for the purpose for which *sukuk* were issued”<sup>4</sup>.

In simple words, we can say that *sukuk* are certificates or documents certificates that represent ownership in an asset. It provides a share of the assets to the investors in the assets including profit and risks in the result of such ownership.

## 1.3 Historical background of *Sukuk*

Although the term *sukuk* is a modern one for a common man but its concept and practices are old. Much of empirical evidence appears show that *sukuk* were used, in large number, by the Muslims societies of the middle ages in form of paper for their business activities. However its modern and present structure is found in the conventional concept of securitization. Securitization of debt began in the 18<sup>th</sup> century with government debt in Europe. Corporation could also be authorized to issue equity security but not debt securities.

---

<sup>3</sup> <http://en.wikipedia.org/wiki/Sukuk>.

<sup>4</sup> Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, (Manama), 2003, p. 292

In 19<sup>th</sup> century, issuance of debt securities spent more and more. Debt securities took either the form of bond or debenture. Thus securities were traded on bond market which were more active then the equity market.

After studying the history and background of *sukuk* we came to conclusion that fourth Annual Plenary Session of Islamic Jurisprudence Council in *Jeddah*, in 1988, defended the issuance of financial instrument under *Sharia'b* and concluded that:

"Any combination of assets (or the usufruct of such assets) can be presented in the form of written financial instruments that can be sold at a market price. In more authoritative pronouncement, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in May 2003, issued its *Sharia'b* Standard No. 17 with the name of investment *sukuk*.<sup>5</sup>

The standard, which became effective from 1st January 2004, mentioned that *sukuk* present a common share in the ownership of the usufruct, asset, services or a mixture of all these plus intangible rights, debts and monetary assets.<sup>6</sup>

Central Bank of Malaysia, in the year of 1983, has tried to issue first investment paper. It involved interest or *riba* free investment which can be said the first attempt of issuing *Shariah* complaint certificate. Another attempt was made by the financial institutions and Muslims countries including Pakistan and Egypt by issuing securities which were similar, most or less, to the conventional securities with a little bit investment. In the early days of the years of 2000, Muslims countries got more progress in this regard and they issued completely *Shariah* complaint certificates. The credit of issuing of first *sukuk* goes to Malaysia who issued first *sukuk* in the year of 2000 which was next followed by Bahrain and then by Indonesia in the year of 2002. Later on other Muslim and non

---

<sup>5</sup> Edited by: Jaffar, Sohail, *Islamic Asset Management*, p.73

<sup>6</sup> Ibid , p.73

Muslim countries adopted this practice. In the year of 2007, there were thirteen countries who issued the *sukuk*. Among them, nine were the Muslim countries.<sup>7</sup>

#### **1.4 Need and Importance of *Sukuk***

Conventional bonds that are based on interest or *niba*, are prohibited according to *Sharia`h*. The persons who are involved in its dealings and have interest although it is rare, have financed through bonds issue, whose contain activities and industries are involved in such productivity that are *haram* under *Sharia`h* as the production of alcohol. Similarly companies that are highly leveraged with banks and seek financing through issuing bonds, these companies and their products are suitable for the Muslim investors to invest.

Usually it has been noticed that when variable interest rate fall, the bond traders make capital gains as fixed-interest bond rise. Therefore, bond trading causes largely exploiting interest rate developments. To do trade in the shape of paper, has link usually to the value of underlying asset. Default in payment is the major risk for conventional holder of bond but the assessment of this risk is usually on the basis of credit rating, with rating agency rather than the purchaser of bond estimating the risk. In this case the status of the bond is just a piece of paper with third party estimating the risk and the purchaser only calculate a risk/ return who has no concern with the business or assets being financed. Many eminent scholars of the *Shariah* particularly Muhammad Taqi Usmani have stressed that one of the distinguishing characteristics legitimating of the Islamic finance is that it involve the funding of trade in, or the production of, the real assts.<sup>8</sup>

---

<sup>7</sup> Idris Umar Mohammed, Research paper, Evaluation of Research Developments on the Islamic Securities (*Sukuk*), International Centre for Education in Islamic Finance, Malaysia.

<sup>8</sup> Usmani, Taqi Muhammad, quoted by Adam najaf, Abdulkadar "Islamic bonds: your guide to issuing, structuring and investing in *sukuk*", published by Euromoney Books 2004, p.5

Merely funding the purchase of financial securities would involve second order financing nearer to lending for derivatives, the later gearing would be speculative and increasing uncertainty or *gharar*.

If we compare Islamic finance with different financial systems of the Word, it can easily be concluded that by nature, Islamic finance is participatory. The *sukuk* holders have the right to be informed on the purchase for which their money will be invested.<sup>9</sup>

From the statement above we came to the conclusion that in conventional bonds there is no participation of bondholders in trade or business but mere a profit based on interest. In case of *sukuk*, *sukuk* holders have right of information in trade or business where their monies will be allocated. Moreover, we need *sukuk* for Muslim investors where they may invest their capital in *Sharia`h* compliant commercial activities.

### 1.5 Types of *sukuk*

There are different kinds of the *sukuk* of different maturities that can be issued in *Sharia`h* compliant manner. Issuance of *sukuk* is quite popular in these days for raising fund and long term finance. Majority of the *sukuk* are based on the concept of *Ijara*. However, this is a great potential still untapped in utilizing different Islamic modes for the issuance of *sukuk*.<sup>10</sup>

Some commonly used types of *sukuk* are discussed below:

---

<sup>9</sup> Ibid

<sup>10</sup> Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, ( Manama), 2003, P.298

### 1.5.1 *Ijara Sukuk*

The word of *Ijarah* is an Arabic term which is similar to the term of 'leasing' in English, which means transferring of usufruct of a particular asset or property against consideration for a fixed period.<sup>11</sup>

This kind of *sukuk* is based on the principles of *Ijarah*. That is why it is called *Ijarah sukuk*. It is a newly introduced product in the market. It has been accepted among the *Sharia'h* scholars so that the Islamic financial institutions demand it. *Ijarah sukuk* is useful for mobilizing fund, fiscal needs and long term financial long term projects. That is why is gaining a rapid importance among the financial institutions. It is the alternative of conventional bonds. There is flexibility and marketability in its issuance. Any kind of complexity not is there.

The issuance of *Ijarah sukuk* and marketability of its assets have flexibility. There is no any kind of complexity. Due to these characteristics, private and public entities and intermediaries have no hurdle in issuing of these instruments.

*Ijarah sukuk* are certificates or securities that represent ownership of asset which are well defined and known and tied up to a contract of lease.

So *Sukuk* should not represent mere a right to receive rent but an ownership of the leased assets. Three parties are involved in *ijarah sukuk* agreement namely; (1) the issuer, who can be named initiator, originator or beneficiary too, (2) Special Purpose Vehicle (SPV) or Special Purpose Entity or issuer and (3) the Investor who can be named *sukuk* holder, successor-in -interest and nominee. Here the originator nominates or creates the SPV and passes the selected asset with undertaking to him that he will lease back the assets from the said legal entity.

---

<sup>11</sup> Usmani, Muhammad Taqi, "An Introduction to Islamic Finance" Publisher (Quranic Studies Publishers, Maktaba Maariful Qur'an Karachi Pakistan), August, 2008, p. 157; Mansuri, Dr. Muhammad Tahir, "Islamic Law of Contracts and Business Transactions", (Sharia'h Academy, Islamabad), 2005, P. 229

The involved parties sign the terms and conditions of rental of the agreement. After securitization of its assets, the SPV, with separate independent legal personality, issues the *ijarah sukuk* to the investors. These Certificates represent proportionate ownership of their holders in the leased assets while the lessor is assumed the right and obligation of the owner or lessor to the extent of his own share. The beneficiary-cum- lessee transfers the rent to the SPV which is paying to the *sukuk* holder. A very rare chance of risk is there and liquidity is possible effortlessly. At the end of the lease period, the assets are owned by the *sukuk* holder if they have no market value, then the investors will get the capital and the way around or vice versa. That is why a *sukuk* holder will bear the loss up to the proportionate ownership or to the extent of his ownership, in the asset, if it was destroyed totally. Sometimes it happens that there is no value of underlying assets in the market and initiator also does not show any interest in taking the said assets back and also the *sukuk* holders or investors suffer loss. This situation causes discouragement of the *sukuk* holder to invest in business of such kind. Contract of *Sukuk* mostly embeds a put option on the holders of *sukuk* that initiator will buy the assets on face value, upon the maturity. However, an objection has been raised by the AAOIFI *Sharia`b* Standard, in standard No. 17, Para 5/2/2 on this type of arrangement, says that:

“In the case of negotiable *Sukuk*, it is permissible for the issuer, to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however it is not permissible for the issuer to undertake to purchase the *Sukuk* at their nominal value.”<sup>12</sup>

Therefore, these certificates represent a proportionate ownership in a tangible asset. They can be traded and negotiated openly in the market. They can serve as an instrument easily convertible in to cash.

---

<sup>12</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama), 2003, p. 306

Thus those Islamic banks and financial institutions which are facing the problem of liquidity management can be solved through these certificates.<sup>13</sup>

### 1.5.2 *Mudarabah Sukuk*

#### 1.5.2.1 Definition of *Mudarabah*

“It is a partnership (*Shariyah*) for participation in profit in which capital from one side, whereas labour or skill (*amal*) is from the other side”<sup>14</sup>

Usually, the term *mudarabah* has been used for earning livelihood in business perspective,<sup>15</sup> in an investment partnership where the entrepreneur is provided capital by the investors in order to run an investment activity. Profit ratio is pre-determined however, in case of loss investor bears the loss and *Mudarab* loses only the expected income.<sup>16</sup>

#### 1.5.2.2 Structure of *Mudarabah*

It is a contract of partnership where two or more than two persons enter into a partnership contract. The one who gives the money is called *Rab-ul-mal* or sleeping partner while the given money is called capital. The other person is called *mudarib*. He manages the activities related to the business. He runs the business and generates profit from the business. Further, this profit is divided among the partners according to criteria (pro-rata) agreed upon at the time of contract.

<sup>13</sup> Usmani Muhammad Imran Ashraf, “Mezzan Bank’s Guide to Islamic Banking”, (Shariah Academy Islamabad), 2003 , p. 207

<sup>14</sup> Ibn Abidin, Muhammad Amin, “Radd ul-Mukhtar”, (Maktaba Majididiyah, Quetta), 1982, Vol.5, p. 645

<sup>15</sup> Dr. Habib-ur-Rehman, “Islamic Financial instruments”, (Peshawer Cantt: Sardar Khan Trust (Regd)), 2003), p. 175

<sup>16</sup> Islamic Finance Training, “Definition of major Islamic Financial instruments, A Redmoney Product”, Islamic Finance Training <<http://www.islamicfmctraining.com/glossary.php>> (last accessed September, 10, 2010)

#### 1.5.2.3 Important Rules of *Mudarabah*

According to financial statement of the Islamic banks, on the liabilities side, the depositors serve as *rabb-ul-mal* and the bank as *Mudarib* and on the assets side, vice versa. The deposits for *Mudarabah* purpose can be either general, like common pool, or restricted to a certain project or specific line of business.<sup>17</sup> Capital for *mudarib* must be in cash form but according to Hanafi and Hanablies, equipment and land can be used by converting them into cash through sale. The amount for *Mudarabah* must be evaluated in clear terms; any indeterminacy pertaining to capital renders the contract invalid. The Capital must be handed over to the *Mudarib* so that he can take the initiative for the business.

#### 1.5.2.4 *Mudarabah Sukuk*

These are the *sukuk* or financial documents which expand the business by way to create an opportunity for public to participate in the business very essential for development of economy of a country. The person who issues the *Mudarabah* certificates is called *Mudarib* who has exclusive right to manage business based on *Mudarabah*. The *sukuk* holders finance the activity by contributing that is called *Mudarabah* capital. Both these parties, mentioned above, share the generated profit from business according to the ratio, agreed upon.

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

<sup>17</sup>Mabid Ali Al-Jarhi and Munawar Iqbal, Islamic Banking: Answers to Some Frequently Asked Questions, Occasional Paper No 4,(Jeddah: Islamic Development Bank,2001),14

Basic requirement of MS contract is that, there must be the prospectus, which can provide all information required by *Sharia'h* for the said contract, like capital, the ratio for profit and all other conditions related to the issue, which must be compatible to *Sharia'h*.<sup>18</sup>

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

1. If the sale is before the operation of activity and capital is in form of cash then it will be like exchange of money for money and the transactions should fulfill the *Sharia'h* compatible criteria of *Bai'al Sarf*.
2. If the *Mudarabah* capital is in the form of debt, this sale must be according to Islamic debt trading rules.
3. If the *Mudarabah* capital is mixture of the liquid and non-liquid assets then trade must be according to market price. The SPV can also contribute in investment by providing funds. SPV will be entitled for the profit along with the profit as *Mudarib*. The Manager and the issuer must not give any type of guarantee for the capital or a fixed profit from the investment. The profit should be divided among the parties according to *Sharia'h* compliance rules and Profit and Loss. Account of the project must be published and disseminated to the MS holder. In each accounting period some funds from the profit can be reserved for uncertain events.

#### 1.5.2.5 Trading in *Mudarabah Sukuk*

After the completion of subscription, settlement of the certificates and commencement of activity, trading and redemption of *Mudarabah Sukuk* is allowed. As stated in the AAOIFI *Sharia'h*

---

<sup>18</sup>Ayub Muhammad, "Understanding Islamic Finance", (England: John Wiley & Sons, Ltd), 20007, p. 398

Standard No 17 Para 5/2/16 that: "it is permissible to trade in *Mudarabah*, *Musharakah* and Investment agency certificates after closing of subscription, allotment of the certificates and commencement of activity with respect to the assets and usufructs."<sup>19</sup>

### 1.5.3 *Musharakah*

*Musharakah* is derived from *sharikah* which means "a contract between two or more people for participation in capital and its profit"<sup>20</sup> The word "*Musharakah*" is from "*Shirkat*" which according to Malikis is permission from each of the partners to the author for appropriation and disposition while retaining the right to transact personally in such wealth.<sup>21</sup>

#### 1.5.3.1 General concept of *Musharakah*

*Musharakah* is a contract where all are contributing to run business for getting profit. Mostly, there is uncertainty in its business so the partners bear the risk of loss which justifies the proportion of profit. We can say that *Musharakah* is similar to conventional partnership where each party contributes the capital according to their capacity and every partner can take part in management according to his share of investment. The profit of the each partner would be as proportion of final total profit and in case of loss every partner will share the profit to the extent of the amount he has invested. The parties should competent and enter into contract without any duress, fraud and undue influence. The capital should be in qualified, quantified and in liquid form.

<sup>19</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Shariab Standard*( Manama: 2003), p. 307

<sup>20</sup> Ibn Abidin, Muhammad Amin, "Radd ul-Mukhtar", (Maktaba Majidiyah, Quetta), 1982, Vol.3, p. 364

<sup>21</sup> Ibni Qudamah "Al Sharh al Kabeer" Publisher( Dar al Fikr) Berut, 1984, Vol. 3, p.348

### 1.5.3.2 Types of *Musharakah*:

There are two types of *Musharakah* namely:

#### I. Permanent *Musharakah*

#### II. Diminishing *Musharakah*

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

II. Diminishing *Musharakah*; here a financer and a client jointly purchase a commodity or partake in commercial enterprise in a way that client purchase the shares of the financer one by one from time to time. So all the assets are owned by the client and he becomes the sole owner of the property<sup>22</sup>.

### 1.5.3.3 *Musharakah Sukuk*

The *Musharakah* contract is just like partnership contract. Here funds can be mobilized to constitute a new investment activity or to flourish the existing one, for the required capital, the *Sukuk* are issued and sold to the investors. The mobilized subscription proceeds are used in the project development as per the planned activity.<sup>23</sup> They distribute profit according to agreed ratio on pro rata basis and lease certain equipment or infrastructure assets through a specially formed *Musharakah*.

---

<sup>22</sup>Usmani Muhammad Imran Ashraf “*Mezzan Bank’s Guide to Islamic Banking*(Islamabad”, (ShariahAcademy) , 2003), p. 115

<sup>23</sup>. Jaffer Sohil, “*Islamic Asset Management*”, (Euromoney Books, United Kingdom), 2004, p. 174

The *Musharakah* based structure is deemed more appropriate than the *Mudarabah* structure, just because it entails the phenomenon of profit and loss sharing between the fund Manager and the *Sukuk* holders, not only profit-sharing.<sup>24</sup>

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

#### 1.5.4 *Murabahah*

The word *Murabahah* is originated from the word “*nibb*” which means profit.<sup>25</sup> The *Murabahah* is sale of goods at a price covering the purchase price plus profit margin agreed upon between the contracting parties.<sup>26</sup> When the buyer needs any commodity but he has not amount at hand, then he can buy on credit. The price can be higher than the spot price. This sale is compatible with *Sharia`b*. The *Murabahah* financing is optimal transaction for the bank to earn more with short term risk.

<sup>24</sup> In general sale, price of commodity is not told to the purchaser but in *Murabahah* sale the seller tells the original price plus profit margin which he is going to take from the buyer. For example the

---

<sup>24</sup> Ibid.170.

<sup>25</sup> Maurice Shohet, comment on “Islamic Banking Sukuk and Murabha: The Memri Economic Blog,” posted July 20,2007, <http://www.memrieconomicblog.org/bin/content.cgi?article=10> (accessed March 10, 2010)

<sup>26</sup>Mansuri Dr. Muhammad Tahir, *Islamic Law of Contract and Business Transactions* (Shariah Academy, Islamabad), 2003, p. 211.

purchaser has purchased a commodity of Rs 500/- and want to get profit of Rs 50 then he should tell the exact price and the price which has incurred on the product with the profit he wants to take. This sale can be on cash or deferred payment in installment at certain intervals agreed upon in the contract. The reason of deferred payment is that the client may not have cash otherwise he will not resort to the bank.

This sale might be called the price deferred sale. Bank's activity to purchase the commodity for the client as well as the sale to the client should be independent. The Islamic banking institution, on request of a client purchases certain commodity i.e. house hold appliances, real estate to provide housing finance, machinery, equipment and raw material can be subject of *Murabahah*. From 80% to 90% financing transactions are of *Murabahah* based. The phenomenon behind the *Murabahah* sale is non availability of the commodity to the general public. In case when the buyer is unknown about the market trends, to avoid the wiles and stratagems of sharp traders, purchaser can enter in *Murabahah* sale.<sup>27</sup>

#### **1.5.4.1 Important rules of *Murabahah***

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

#### **1.5.4.2 *Murabahah Sukuk***

---

<sup>27</sup>Ibid.212.

As stated in AAOIFI *Sharia`b* Standard No 17 Para No 5/1/5/5 that: "The issuer of the certificate is the seller of the *Murabahah* commodity, the subscribers are the buyers of that commodity and the realized funds are the purchasing cost of the commodity. The certificate holders own the *Murabahah* commodity and are entitled to its sale price".<sup>28</sup>

#### 1.5.4.3 Trading in *Murabahah Sukuk*

The *Murabahah Sukuk* are negotiable instruments, with one condition that sale is not allowed after delivery of *Murabahah* commodity to the buyer. Before this, as selling to the buyer is allowed. As stated in the AAOIFI *Sharia`b* Standard No 17 Para 5/2/15 that: "it is not permissible to trade in *Murabahah* certificates after delivery of the *Murabahah* commodity to the buyer. However, trading of *Murabahah* certificates is permissible after purchasing the *Murabahah* commodity and before selling the same to the buyer".<sup>29</sup>

#### 1.5.5 *Salam* Contract and its Significance

The word "salam" means to advance. A contract whereby the purchaser pays the price in advance and the delivery of subject matter is postponed to a specified time in future.<sup>30</sup>

This sale can be termed as commodity/object deferred sale. It is an exception to the general rule<sup>31</sup> because it is a contract among the parties on the non-existing subject matter at the time of contract. This relaxation is to fulfill the needs of farmers, who need money in advance before their crops

<sup>28</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama), 2003, p. 302

<sup>29</sup> Ibid, p. 302

<sup>30</sup> Dr. Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Shariah Academy, Islamabad), 2003, p. 200.

<sup>31</sup> Usmani Muhammad Imran, comment on "Fixed Income Securities Shariah perspective: SBP Research Bulletin Volume 3", comment posted November 1, 2007 <http://www.sbp.org.pk/research/bulletin/2007/vol3/Sharia-Perspective.pdf> (last accessed March 7, 2009)

become ready for sale. There are benefit for the both the parties purchaser and seller. The first can get the product at cheaper price and the later can get money in advance to fulfill his needs. In contract the price of the commodity, particulars of commodity, time of delivery and place of delivery should be fixed among the parties.

#### **1.5.5.1 Important rules of *Salam***

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

The subject matter of *Salam* should be those things which can be measured and weighed. All the particulars of the products should be fixed in clear terms. Non fungible things are not the subject of *Salam* contract<sup>32</sup>. The buyer can claim for any hypothecation to avoid the inherent risk that bank will not able to provide the goods timely. The exact date and place of delivery should be mentioned.<sup>33</sup> If the contract spans over different countries, the banks will have to append markdown of premium for the future exchange rate between the different countries.

#### **1.5.5.2 *Salam Sukuk***

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

---

<sup>32</sup>Mansuri Dr. Muhammad Tahir, "Islamic Law of Contract and Business Transactions", (Shariah Academy: Islamabad), 2003, p. 203

<sup>33</sup>Ibid, p. 202

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

One of the *Sharia`b* requirement about Salam and for creation of *Salam Sukuk*, is the condition that the purchased goods can be resold after actual possession at maturity, otherwise these transactions will be seemed like selling of debt. Due to this restraint the *Salam* instruments become less liquid and hence somewhat less attractive to investors. An investor will buy a *Salam* certificate only if he expects prices of the underlying assets to be higher on the maturity date.<sup>34</sup>

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

Trading in *Salam Sukuk* before maturity is not allowed. As stated in the AAOIFI *Sharia`b* Standard No 17 Para 5/2/14 that: "It is not permissible to trade in Salam certificates".<sup>35</sup>

#### 1.5.6 *Istisna*

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

##### 1.5.6.1 Important rules of *Istisna*

<sup>34</sup> Ahmed Memon Dr. Noor "Structure of Islamic Bonds and Managing Financial Risk of *Sukuk*," *Islamic Banking & Finance* (2008), p. 47-48

<sup>35</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Sharia Standard* ( Manama), 2003, p. 307

The subject matter of *Istisna* should be such that needs manufacturing. Full advance payment is not a condition in *Istisna*. The payment can be made on any time and can be allowed in installment. Time of delivery is not fixed. All the essentials are specified about the commodity in clear terms.<sup>36</sup> *Istisna* agreement can be revoked unilaterally before the manufacturer starts the work. Contract of *Istisna* will terminate after the completion of work or by the death of the manufacturer<sup>37</sup>. The buyer has right of inspection. In case of infringement of their rights both parties have right to resort to the court.

#### 1.5.6.2 *Istisna Sukuk*

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

---

<sup>36</sup>Dr. Muhammad Tahir Mansuri, "Islamic Law of Contract and Business Transactions", (Shariab Academy: Islamabad), 2003, p. 209

<sup>37</sup>Ibid, p. 210

### 1.5.6.3 Trading in *Istisna Sukuk*

Trading in *Istisna Sukuk* is compatible with *Shariah* rules if the conversion of funds into assets becomes complete within the period of *Istisna* contract. As stated in the AAOIFI *Shariah* Standard No 17 Para 5/2/13 that: "It is permissible to trade in or redeem *Istisna* certificates if the funds have been converted, within the period of *Istisna*, into assets owned by certificate holders. If the realized funds are immediately paid as a price in a parallel *Istisna* contract or the manufactured item is submitted to the ultimate purchaser, then trading in *Istisna* certificates is subject to rules of disposal of debt."<sup>38</sup>

### 1.5.7 *Muzar'a Sukuk*

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

(b) The issuer of these certificates may be the cultivator (the worker), the subscribers are the owners of the land (investors whose subscription amounts are used to buy the land); and the certificate holders are entitled to a share of the produce of the land as per agreement.<sup>39</sup> About the trading of *Muzara'a Sukuk* the *Shariah* Standard No 17 Para 5/2/17 states that: it is permissible to trade in *Muzara'a* and *Musaqaa* certificates after closing of subscription, allotments of certificates and

---

<sup>38</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* (Manama), 2003, p. 307

<sup>39</sup> Ibid, 307

commencement of activity with respect to the assets and usufructs. This rule applies when the certificates holders own the land. Thus trading in these certificates is not allowed where the certificate holders act as workers (who undertake to provide agricultural or irrigation works) in which case trading in these certificates is not permissible before the maturity of the fruits and plants.<sup>40</sup>

#### 1.5.8 *Mugarasa Sukuk*

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

- (a) The issuer of these certificates is the owner of the land suitable for planting (trees), the subscribers are those who assume the obligation of planting on the basis of a *Mugarsa* contract, while the realized funds are the cost of maintaining the plantation.
- (b) The issuer may be the planter (the owner of the work) the subscribers are the owners of the land (investors whose subscription amounts are used to undertake plantation in the land), and the certificates holders are entitled to a share in both the trees and the land as per agreement."<sup>41</sup> About the trading of *Mugarsa'a Sukuk* the *Sharia'h* Standard No 17 Para 5/2/18 states that: "it is permissible to trade in *Mugarsa* certificates after closing of subscription, allotment of certificates and commencement of activity irrespective of the certificate holders being owners of the land or

---

<sup>40</sup> Ibid, p.303

<sup>41</sup> Ibid, p. 303

workers".<sup>42</sup>

#### 1.5.9 *Musaqat Sukuk*

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

The above mentioned names of *Sukuk* are paradigms and come in *Sharia`b* perspective. The *Sukuk* can be issued not only tangible assets but also on intellectual property rights like copy right, patent and good will. However *Sharia`b* does prohibit the issuance of *Sukuk* of sinful activities like gambling, pornography, manufacturing and distribution of alcohol, tobacco weapons and pork. As stipulated in the *Sharia`b* Standard No 5/1/8/5 that: "The prospectus must state that the investment of the realized funds and the assets into which the funds are converted will be undertaken through *Sharia`b*-compliant modes of investment".<sup>43</sup>

### 1.6 Parties Involved in *Sukuk*

In *sukuk* transition, various parties are involved. Key players in various issues of *sukuk* are:

#### i. The originator or the issuer of *sukuk*

The originator sells its assets to the special purpose vehicle (SPV) and uses the realized fund. In most of the cases, originators are the banking or non-banking Islamic financial institutions. The issuers may delegate, for a consideration or a commission, the process of arranging the issue.

---

<sup>42</sup>. Ibid, p. 307

<sup>43</sup>. Ibid, p. 304

## ii. The SPV

An entity set up especially for securitization process and managing the issue. The SPV purchases assets for the originator and funds the purchase price by issuing *sukuk*; the SPV is also referred to as the issuer.<sup>44</sup>

## iii. Investment banks

In *sukuk* transaction, investment banks are those banks who issue agents for underwriting, lead managing and book-making services for *sukuk* against any agreed upon fee or commission. Syndicates of Islamic banks and big multinational banks operating Islamic window provides these services.

## Iv. Subscribers

Subscribers of *sukuk* are mostly central banks, Islamic banks and individuals who subscribe to securities issued by SPV. The above parties are the mile-stone parties in *sukuk* transactions. Other parties to the general securitization process may be including:

The obligor: a contractual debtor to the originator who pays cash flows that are securitized.

The lead manager: as structural for designing and executing the transaction as arranger for securities.

The lead manager may be a company/ trust/mutual fund that provides services for managing the issues.

The service: collects and ministers the rentals from obligor, monitors and maintains assets.

The cash administrator or receiving and paying agent: The bankers for the deal who manages inflows and outflows interest interim funds and access cash collateral.<sup>45</sup>

---

<sup>44</sup>Ayub Muhammad, “*Understanding Islamic finance*”, (John Wiley & Sons Ltd), 2007, P. 393

The credit and enhancement provider: provides credit enhancement by way of a guarantees, *takaful*/ insurance etc.

The credit rating agency: provides or rating for the deal based on structure, rating of parties legal and tax aspect.

The auditor: appointed for registration / transfer of securities safe custody of the underlying documents. It holds actively the assets as agent and bailee for trustee.<sup>45</sup>

### 1.7 Role of SPV in issuance of *Sukuk*

SPV has a legal entity. It is stand for Special Purpose Vehicle for the purpose to manage the securities issues. The Characteristics of SPV are thin capitalization and bankruptcy remoteness by owning the title of the assets, issuing the securities to the subscribers. It is called trust because it is an inert entity. The basic purpose of the creation of SPV is, to own that assets which are going to be observed for the issuance of *sukuk*. The rational to create the SPV or SPE is to mitigate the legal issues. In fact, in *sukuk* transaction, keeping the assets away from the original owner is basic problem. The SPV generates issue the certificates and offers them to the investors and use the proceeds for purchasing the revenue generating assets or cash generating property from financial institutions or any other entity. It is also SPV which leases the purchased property to financial institutions (if the lessee is the same party from whom SPV has leased the assets).<sup>47</sup>

As for the period of the lease is concerned, it depends upon the duration of the *sukuk* with assets

---

<sup>45</sup> Ibid

<sup>46</sup> Ibid, p.393

<sup>47</sup> Muhammad Ayub, "Understanding Islamic finance" (England: John Wiley & Sons, Ltd), 2007, p. 394-395

that is held on trust for the *sukuk* holders while the rental proceed must be matched and must be equal to the payment to the *sukuk* holders.

The rental payment can be fixed or calculated with reference to the inter bank offered rate plus a margin which represents the market rate for rental payments.<sup>48</sup>

Financial institutions pay to the SPV in a *sukuk* transaction. This payment should be unconditional, direct and irrevocable. Although, SPV has enjoys a legal entity in *sukuk* transaction but he has many responsibilities too. Once the sale and transfer of the assets takes place, the title along with risk transfers to the SPV which argues that he owns the assets as well as bears the risk which make him entitled get profit from the undertaking assets. Furthermore, the rights of ownership of SPV can neither be challenged nor be annulled or otherwise averted in an insolvency or bankruptcy of the original owner. It is his constructive ownership and he is not shareholder with the original owner of the assets. He pays the price and gets the ownership of the assets. SPV issues *sukuk* of its own, after completion of a sale transaction. It is obligatory for the SPV to purchase the property on maturity and to proceed the repayment of the principal to the holders of *sukuk*.

### 1.8 Important rules about trading of *Sukuk*

It is essential for the *sukuk* that it must be tradable and represent the ownership for their holders accompanying all other rights and obligations that are related to the ownership. It is necessary that their possession and right to use or dispose-off must be legal. And this position must be compatible with *Shariah*. However, it has no meaning that the assets either are tangible or usufruct or services. The manager has to keep the record about the transfer of *sukuk*. He should not

---

<sup>48</sup> Ibid, 397

show it as his own assets. Investment manager, partner or agent is not allowed to purchase the assets from *sukuk* holders on nominal value at maturity rather permissible to agree holders on nominal value at maturity. As AAOIFI, *Sharia`h* Standard No 17 Para 5/2/2 describes that: In the case of negotiable *Sukuk*, it is permissible for the issuer to undertake to purchase back, through the prospectus of issue, any certificates that may be offered to him; however, it is not permissible for the issuer to undertake to purchase the *Sukuk* at their nominal value.<sup>49</sup>

A lessee can take the *Ijarah sukuk* for nominal price on maturity. If he is Investment Manager or Agent, then he cannot do so.

If *ijarah sukuk* are backed by the real assets, then its tradability is possible in the secondary market. Whereas *Sukuk* structured otherwise like on pure receivable may encounter to *Sharia`h* because *Sharia`h* bans debt trading.

### 1.9 *Sharia`h* position of *Sukuk*

Although no compulsion is there to comply with the rules made by the *Fiqh* Academy of Organization of the Islamic conference, their rulings carry considerable weight with most financial institutions and their *Sharia`h* committees and advisors. At the request of delegates from Pakistan, Jordon and Malaysia, the academy held fourth plenary annual session at *Jeddah* in 1988 and considered the question of Islamic investment certificates. In the meeting they noted that *Sharia`h* encourages the documentation of contracts as stipulated in the Holy *Qur'an*: "When ye deal with each other, the transaction involving future obligations in fixed period of time reduce them to

---

<sup>49</sup>Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standards*, (Manama), 2003, p. 306

writing..... it is more just in the sight of Allah. More suitable as evidence and more convenient to prevent doubts among yourselves".<sup>50</sup>

Subject to proper legal documentation, under the decision number 5 of 1988, the *Fiqh* Academy incorporated some rules which are reproduced as the following:

Any collection of assets can be presented in written note or bond: and

The bond or note can be sold at market price, provided that the composition of assets, representing by the security, consists of majority of group of assets and financial rights. With only a majority being cash and interpersonal debts.<sup>51</sup>

#### 1.10 Ruling of AAOIFI regarding *sukuk*

AAOIFI has paid a significant role in issuance of *sukuk*. Many meetings have been held in this regard. A public interest was increased in issuance of *sukuk* plus many observations and objections were raised regarding its issuance. Therefore, the AAOIFI studied the issue of *sukuk* in detail in its three sessions.

The first session was held in *al-Madinah al-Munawwarah*, on 12 *Jumada al-Akhirah* 1428 AH (27 June 2007), second, in *Makkah al-Mukarramah*, on 26 *Sh'aban* 1428 AH (8 September 2007), and third, in the Kingdom of Bahrain on 7 and 8 *Safar* 1429AH (13 and 14 February 2008).<sup>52</sup>

---

<sup>50</sup> Qur'an, 2: 282

<sup>51</sup> Adam najaf, Abdulkadar "Islamic bonds: your guide to issuing, structuring and investing in *sukuk*", published by Euromoney Books 2004. p.4

<sup>52</sup> See <http://www.isra.my/fatwas/investment-banking/modes-of-sukuks/121-aaoifi-shariah-resolutions-issues-on-sukuk.html>. last accessed on September 12, 2009

On 6 *Muharram* 1429AH (15 January 2007) in meeting, held in Bahrain, the working group that was appointed by the Board, presented its report to the *Sharia`b* Board. The significant member of representative from different Islamic banks and financial institutions attended that meeting.

In meeting, the board studied in detail the report and rules from different angles presented to it. The Islamic financial institutions and *Saria`b* supervisory Boards were advised by the *Sharia`b* Board to give support to the following six matters when issuing the *sukuk*:

That *sukuk* will be tradable and *sukuk* holder must own them with the characteristics of all rights and obligations that accompany such ownership.

That *sukuk* must not be of such kind that they represent mere receivable or debt except in the case of a trading or financial entity selling all of its assets, or a portfolio with a standing financial obligation.

The manager of a *sukuk* issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.

For the manager of *sukuk*, it is not permissible to undertake to offer loans to *sukuk* holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same is mentioned in the prospectus.

It is permissible for the lessee in a *Sukuk Al-Ijarah* to agree to purchase the leased assets when the *sukuk* are extinguished for their nominal value, provided that the lessee is not also an investment partner, investment manager, or agent.<sup>53</sup>

---

<sup>53</sup> Ibid

It is not permissible for the investment manager, partner, or investment agent to agree to repurchase assets from *sukuk* holders at nominal value when the *sukuk* are extinguished at the end of their maturity. It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase, in accordance with *Shariah*'s rules of partnership and modern partnerships, and on the subject of guarantees;

The role of *Shariah* supervisory boards should not be limited to the issuance of *fatwa* on the structure of *sukuk*. It should also oversee its implementation and compliance at every stage of the operation.<sup>54</sup>

14-9385

### 1.11 Difference between *Sukuk* and Bonds

*Sukuk* are the alternative of conventional bonds. They are similar to the conventional bonds in generating profits or to fulfill the requirements of financial institutions and entities.

Anyhow, there are certain grounds which differentiate system of Islamic finance from system of conventional. Some of the major and distinctive points are the following:

1- *Sukuk* represent the actual ownership in well known and well defined asset, usufruct, business activity, projects or services. That is why it is not mere debt of the issuer.

According to Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI) *Shariah* Standard No 17 Para 4/2 describes that:

“Investment *Sukuk* represent a common share in the ownership of the assets made available for investment whether these are non-monetary assets, usufructs, services or a

---

<sup>54</sup>Ibid

mixture of all these plus intangible rights, debts and monetary assets. These *Sukuk* do not represent a debt owed to the issuer by the certificate holder".<sup>55</sup> On the other hands bonds have no such features. Bond holders do not have ownership in the commercial and industrial enterprises for which the bonds were issued. Rather, they are documents, representing debt which is interest bearing, being in debt to the holders of the bonds by the issuer, the owner of the enterprise.<sup>56</sup>

- 2- As for as the permissibility is concerned, *sukuk* are the certificates that are backed by securities. These underlying assets are permissible according to *Sharia`h*, both in their nature and use. It is mentioned in the AAOIFI, *Sharia`h* Standard No. 17 Para 5/1/1 that: "It is permissible to issue investment certificates by way of subscription on the basis of any of *Sharia`h* nominated investment contract".<sup>57</sup> Contrary to it, bonds do not have assets backed by securities. Bonds may be used in finance of activities which may be prohibited under *Sharia`h* but legal in its jurisdiction. In issuance of bonds, no proper criteria regarding nature of contract are given. Also, no importance for its usage, underlying phenomenon and parties is given. Because their intention of issuance of bonds is just to earn money. That is a debt security, causes *riba* which is prohibited according to *Sharia`h*.
- 3- In case of *Sukuk*, the *Sukuk* holders have right to claim on the specific underlying assets. On the other hand, Bond holders do not have right to claim on assets directly. However principal and return is guaranteed by issuer at maturity, whether the entity has gained profit or suffered loss.
- 4- It is stated in the AAOIFI *Shariah* Standard No 17 Para 4/5 that "the owners of these

---

<sup>55</sup> Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, (Manama), 2003 p. 300

<sup>56</sup> Usmani M. Taqi, "Sukuk and their contemporary application". See <http://www.mufitataqiusmani.com/Downloads/Publications/Articles/Sukuk.pdf>

<sup>57</sup> Jbid. p. 301

certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificate owned (held) by them. The *Sukuk* holders share the return from the assets, projects and services limited to the extent of participation in the issue".<sup>58</sup> On the other hand bondholders have not any relation with assets, usufructs and projects and simply rely on credit worthiness of the issuer. Generally creditor can claim on the borrowing entity in case of default or failure of issuer, creditor reserves the right of lien on assets. In case of bankruptcy of issuer, the issuer cannot take loopholes from the payment which is due upon him from the creditor.

5- The sale of *Sukuk* is a sale of ownership as AAOIFI, *Sharia'h Standard No 17* Para 4/1 describes that: "investment *Sukuk* are certificates of equal value issued in the name of the owner or bearer in order to establish the claim of the certificate owner over the financial rights and obligations represented by the certificate".<sup>59</sup> The sale of bond is sale of debt only.

6- "When investor desires cash he can sell his share of *Sukuk* either wholly or a part thereof. There is no constraint in the sale and purchase of share in *Sukuk*. As AAOIFI, *Sharia'h Standard No 17* Para 4/4 describes that: "trading of investment *Sukuk* is subject to the terms that govern trading of the rights they represent"<sup>60</sup> whereas in bonds, sale can only be made after the maturity of the life of bond.

7- *Sukuk* holders are entitled to share the revenues generated by the *Sukuk* as well as, share in the proceeds of realization of the *Sukuk* assets, because *Sukuk* holders have beneficial right in the underlying assets.<sup>61</sup> As AAOIFI, *Sharia'h Standard No 17* Para 4/5 describes that:

"The owners of these certificates share the return as stated in the subscription prospectus and bear

---

<sup>58</sup> Ibid, p. 300

<sup>59</sup> Ibid.300

<sup>60</sup> Ibid.300

<sup>61</sup>Memon Noor Ahmed , "Structure of Islamic Bonds and Managing Financial Risk of *Sukuk*,"(Karachi: Institute of Business and Technology)2008), p. 43.

the losses in proportion to the certificates owned (held) by them".<sup>62</sup> However in bonds regular interest payments are made to the bond holders. The amount of interest is determined as a percentage of capital and not as a percentage of actual profit. Sometime the interest is fixed, while often time in bonds with longer tenure the rate is allowed to float.<sup>63</sup>

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

### 1.12 Difference between *Sukuk* and Shares

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

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

2- *Being asset backed securities*, *Sukuk* holders have right to claim on the specific underlying assets. The *Sukuk* holder will share the return from the assets, projects and services limited to the extent of participation in the issue. The AAOIFI *Shariah* Standard No 17 Para 4/5 states this position in the following words: The owners of these certificates share the return as stated in the subscriptions prospectus and bear the losses in proportion to the certificate owned (held) by them".<sup>64</sup> On the other hand shares are not assets backed instruments therefore shareholders claim ownership on the whole company and held responsible for the affairs of the company limited to the extent of holding the shares in the company.

---

<sup>62</sup>. Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*(Manama), 2003, p. 300.

<sup>63</sup>Usmani Muhammad Taqi , "Sukuk and their contemporary application". See <http://www.mufitaqiusmani.com/Downloads/Publications/Articles/Sukuk.pdf>

<sup>64</sup> Accounting and Auditing Organization of Islamic Finance Institutions, *Shariah Standard* ( Manama), 2003, p. 300

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

## CHAPTER 2

### THE APPLICATION OF SUKUK IN PAKISTAN

#### 2.1 A brief description of the situation of *sukuk* in Pakistan

So far the introduction of *sukuk* Pakistan is concerned, it was Sitara chemical industries which took the initiative by issuing *Sukuk* in 2002 which were mainly *Mudarabah*-based *Sukuk* called MTFCs. However, *sukuk* were properly worked out when they were issued in 2005. The early transaction was a worth of Rs.30 billions.

Since the Islamic banking is passing through a nascent progress, particularly in Pakistan, therefore, all the concepts and products related to Islamic banking are also in the process of getting progress and development. *Sukuks* are no exception to such a situation. It is because the concept of *sukuk* is purely given by the Islamic banking and Islamic commercial doctrines.

In Pakistan Special Purpose Vehicle (SPV) is operating the transactions which involve *sukuk*. The arrangement is made in such a way that the beneficial ownership is transferred to the SPV. The SPV purchases the assets but cannot own the title of the assets. The arrangement in such transaction contains one of the short-comings, i.e., lack of real ownership. The situation discourages the investors to invest for the reason that they do not get the legal ownership over the assts.<sup>65</sup>

#### 2.2 Issuance, Approval and Regulations of *Sukuk* in Pakistan

A detailed procedure for issuance, approving and regulating of *Sukuk* is said to be followed by the Securities and Exchange Commission of Pakistan (SECP). Any financial institution which wants *sukuk* to be issued to it, should apply to SECP. The SECP will make a report and will finalize

---

<sup>65</sup> Nazar Shahida, "Shariah Appraisal of *Sukuk*" (Unpublished LLM thesis), p. 71

the pre-IPO placement. The SECP also will fulfill other formalities like arrangement of credit rating and underwriting, checking the dividends and return on previous five years securities and appointing a legal advisor. After fulfilling the above formalities, *sukuk* are issued to the institution. It is pertinent to mention here that the said procedure is not applicable in Pakistan for the reason that the SECP has not made any rules so companies and financial institutions issue *sukuk* privately.<sup>66</sup>

The SECP gives and makes guidelines and policies for the *Sukuk* which are issued through government. Even then *sukuk* are issued in private capacity. The *sukuk* of National Highway Authority (NHA) were issued through Government of Pakistan, however, SECP has not proposed any law. The reason is that the concept of *sukuk* is still in infancy.

The State Bank of Pakistan (SBP) introduced new policies and guidelines for the promotion of Islamic banking, made rules for the investment in *Sukuk* as well. The rules are particularly related to *Sukuk al-Ijarah* as most of the transactions are based upon *Sukuk al-Ijarah*.

### 2.3 Structure of *Sukuk* in Pakistan issued by GOP

There are main parties involved in *Sukuk* agreement:

- a) The issuer i.e. Originator, initiator or beneficiary
- b) SPV or issuer or special purpose entity (SPE)
- c) The investor i.e. *Sukuk* holder, successor-in-interest and nominees.

An SPV is created by the originator who will lease back the assets from the said legal entity. The terms and conditions of rent are agreed and signed by the parties involved in the contract. The

---

<sup>66</sup>Sibghatulla Ahsan, "Sukuk and its Regulatory Framework in Pakistan" (Islamabad), August 27, 2008,42

rest of the contractual obligations, *inter alia*, should be according to the AAOIFI *Sharia'h* Standard No 17 Para 5/1/8/1. It is stated as:

"The prospectus must include all contractual conditions, adequate statements about the participants in the issue, their legal position and rights as well as obligations such as statements about the issue agent, issue manager, originator, investment trustee, the party covering the loss, payment agent as well as other along with the conditions of their appointment and dismissal."<sup>67</sup>

*Sukuk* are issued by SPV too. The latter is ensured securitization of the assets. The status of such certificates is such that they are of equal value representing undivided shares in ownership of tangible assets. The sale which is made is received from SPV and payment is made to the originator. The rent is passed on to the SPV and paid to the *Sukuk* holder. It is also to mention here that there is very less probabilities of risk and liquidity.

Sometimes the underlying assets of *Sukuk* lose its market value. This discourages the *Sukuk* holder to invest in such kind of business. The drawback is overcome in such a way that an option is embedded in which the initiator will buy back the *Sukuk* on face value upon maturity. However, this arrangement is objected by para 5/2/2, *Sharia'h* Standard No 17 AAOIFI. The Standard states as:

"In the case of negotiable *Sukuk*, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however it is not permissible for the issuer to undertake to purchase the *Sukuk* at their nominal value".<sup>68</sup>

---

<sup>67</sup> Accounting and Auditing Organization of Islamic Financial Institutions, *Shariah Standards*, (Manama), 2003, p. 304  
<sup>68</sup> Ibid, p. 304

## 2.4 Experience of *Sukuk* in different companies in Pakistan

- a. EDEN Builder Private Limited (EBPL)
- b. Pakistan Electronic Limited (PEL)
- c. Karachi Shipyard and Engineering Works(KSEW)
- d. Pakistan International Airline(PIA)
- e. Water and Power Development Authority (WAPDA)
- f. National Highway Authority (NHA)
- g. *Sitara* Chemical Industries
- h. Maple Leaf Cement Factory(MLCF)
- i. Sui Southern Gas Co (SSGC)
- j. Wateen Telecom<sup>69</sup>

As we have concern with the first two mentioned experiences/ cases of *Sukuk* issuance in Pakistan, therefore the WAPDA and Motorway *Sukuk* experiences will be focused and elaborated in detail. Rests of the experiences have been mentioned here because of their relevancy with the topic under discussion.

## 2.5 WAPDA *Sukuk* Experience in Pakistan

### 2.5.1 Main Parties in WAPDA *Sukuk*

---

<sup>69</sup> Nazar Shahida, “*Shariah Appraisal of Sukuk*” (Unpublished LLM thesis), p. 75

**Issuer:** WAPDA Second *Sukuk* Company (Special Purpose Vehicle “SPV”) was created for the purpose of *Sukuk* Issuance- a wholly owned subsidiary of Water and Power Development Authority.

**Lessor:** WAPDA Second *sukuk* Company (SPV), which was supposed to act on behalf of the *sukuk* holders, held purchase identified unencumbered assets of WAPDA (the assets) and held lease the assets by way of *ijara* MTB to WAPDA (the SPV was supposed to hold the title to the assets as Title Agent on trust for the *sukuk* holders) pursuant to the Declaration of Trust.

**Lessee:** WAPDA had to take the assets on lease from the lessor for an agreed period and rental pursuant to the lease agreement.

**Sukuk Holders:** A group of financial institutions was selected by the Lead Arrangers.

**Trustee:** SPV acted as trustee on behalf of the *sukuk* holders, pursuant of Declaration of Trust. SPV acted as agent on behalf of *sukuk* holders.<sup>70</sup>

## 2.5.2 Managing body of WAPDA *Sukuk*

**Paying Agent/ Reference Agent:** it was held to be decided later on by the Lead Arrangers.

**Registrar:** WAPDA Bond Cell

**Guarantor:** Government of Islamic Republic of Pakistan acted as guarantor through the Ministry of Finance.

**Lead Arrangers and book runners:** National Bank of Pakistan, Standard Chartered Bank (Pakistan) Limited and Dubai Islamic Bank Pakistan Limited.

---

<sup>70</sup> A hard copy of the rules, made for *Sukuk* transaction, taken from WAPDA House Lahore, p. 104

It was held that Lead arrangers may at their sole discretion share this role or award additional roles to other banks or financial institutions provided it did not result in any additional cost to the Issuer.

**Assets:** Turbines for power generation.

**Sukuk Issue Amount and Currency:** Up to a maximum of Pakistan Rupee, 8,0000 million

### 2.5.3 Other Arrangements

**Use of Proceeds of the Sukuk:** To purchase the indentified unencumbered assets of WAPDA, SPV held to purchase the assets from WAPDA. The assets' title passed to the SPV which hold the title of the assets as a trustee on behalf of the *Sukuk Holders*.

**Lease of Assets:** The indentified unencumbered assets purchased by application of the proceeds of the *sukuk* issue were leased to the WAPDA.

**Rental Payment:** the first 8 semi-annual rentals started from the 6<sup>th</sup> month and ending on 28<sup>th</sup> month from the date of signing the Lease Agreement was comprised the following:

1. Variable element (to be calculated on the basis of the base amount/ the outstanding fixed elements). The variable element was determined in accordance with the agreed benchmark/ formula in the beginning of each lease/ rental period.<sup>71</sup>

### Conditions Precedents:

Under the undertaking relating to subscription the terms and conditions were as under:

- (a) At the closing date it was held that:

---

<sup>71</sup> Ibid, p. 100

- (i) No adverse change or development including a prospective adverse change in the condition (financial or otherwise) or general affairs of WAPDA since the date of agreement or from that set out in the Information Memorandum, which is the context of the Certificates;
- (ii) No adverse change or any development reasonably to involve and adverse change in the condition (financial or otherwise) of, or the general affairs of, the Issuer since the date of the agreement or from the set out in the information memorandum, which is material in the context of the issue of the Certificates; and
- (iii) No event making any of the representation and warranties contained in Clause 6 and 7.1 of the Agreement untrue or incorrect in any material respect on the Closing Date as though they would give and made on such date and each of the Issuer and WAPDA having performed all the obligations to be performed by it under this Agreement on or before the Closing Date;<sup>72</sup>

(b) The delivery to the Joint Lead Managers on or before the Closing Date of:

- (i) Legal opinions dated the Closing Date in such form and with such contents as the Joint Lead Managers may required from;
- (ii) A certificate signed by duly authorized representatives of the Issuer to the effect stated in paragraphs (i) and (ii) above with regard to the Issuer and certificate singed by duly authorized representatives of WAPDA to the effect stated in paragraph (a) above with regard to the Issuer and WAPDA;
- (iii) Evidence to the satisfaction of the Joint Lead Managers of the authority of each of WAPDA and the Issuer to enter into and perform their respective obligations under the Transaction Documents to which each of them may respectively be a party;

---

<sup>72</sup> Ibid, p. 99

- (iv) Evidence to the satisfaction of the Joint Lead Managers of the authority of the authorized signatories of each WAPDA and the Issuer to execute on their respective behalf Transaction Documents to which each of them was respectively a party;
- (v) Evidence to the satisfaction of the Joint Lead Managers that the Certificates have been notified by the Government Statutory Liquidity Reverse eligible instrument for Islamic banks and Islamic branches of commercial banks for the purposes of Section 9 of the banking Companies Ordinance 1962;
- (vi) Any other documents (including, but not limited to, any resolutions, contents and authorities) relating to the issue of the Certificates which the Joint Lead Managers may reasonably require and notify to the Issuer and WAPDA in writing on or before the Closing Date; and

(c) The execution of the Transaction Documents by parties thereto on the date thereof (including any other deed or agreement to be executed on or before the Closing Date by the parties thereto, pursuant to the terms of the Transaction Documents).<sup>73</sup>

#### **2.5.4 Purchase Agreement**

- (a) The sale of the Turbines by the Seller to the Purchaser will confirm but the execution of the acknowledgement in substantially the form of set-out in Schedule 2.
- (b) No extraordinary circumstances or change of law or other action by the Government shall have occurred, in each case after the date thereof, which shall make it impossible that the Seller will be able to observe and perform the covenant and obligations on its

---

<sup>73</sup> Ibid, p. 98

part to be performed under this Agreement or any other documents required by the Purchaser to be executed by the Seller on the thereof;

- (c) The representation and warranties containing in Clause 4 being true, accurate and correct in all material respects as if made on the date on which the release of the Purchase Price is to be made;
- (d) There shall not have occurred any default in performance by the Seller of any covenant of agreement contained in this Agreement or any other document required by the Purchaser to be executed by the Seller on the date thereof;
- (e) The Certificates shall have been issued and net proceeds of the issue of the certificates shall have been received by, or on behalf of, the Purchaser; and (NOTE: proposed to be deleted by DIB *Sharia`h*)
- (f) The Purchaser shall have received all the consents and approvals referred to Schedule 4. Further, the Issuer needs to ensure that the following consents and approvals are in place:
  - 1) Approval of the Government for undertaking the transaction by Pakistan Water and Power Development Authority (WAPDA) as envisage by the Transaction Documents and provision of Federal Government guarantee securing certain obligations of WAPDA under the Transaction Documents.<sup>74</sup>
  - 2) WAPDA Authority Resolutions for:
    - (a) Promoting WAPDA second *Sukuk* Company Limited (the Issuer) as a wholly owned subsidiary, contribute its entire paid-up capital and pay all incorporation expenses.

---

<sup>74</sup> Ibid, p. 98

- (b) Selling the Turbines to the Issuer in terms of the Purchase Agreement for a Purchase Price of up to;
- (c) Entering into *Ijarah* Agreement for leasing the Turbines by WAPDA from the Issuer.
- (d) Executing a Cost Understanding for payment by WAPDA for all expenses with regard to the issue of Certificates by the Issuer.
- (e) Execute a Purchase Undertaking, whereby WAPDA shall agree to purchase the Turbines from the Issuer.
- (f) Executing Service Agency Agreement, whereby WAPDA shall be appointed as a service agent of the Issuer in respect of the Turbines.
- (g) Authorized WAPDA Bond Cell to act as a Registrar, Transfer and Replacement Agent for the Certificates.
- (h) Undertaking the transactions by WAPDA as envisage by the Transaction Documents.

3) Exemption from the obligation to deduct income tax under Section 153 of the Income Tax Ordinance,2001 from the payments to be made by the Issuer to WAPDA under this Purchase Agreement.

4) Exemption from the obligation to deduct income tax under Section 152 of the Income Tax Ordinance,2001 from the payments to be made by WAPDA to the Issuer under the Purchase Undertaking.

5) Exemption for the Issuer for payment of minimum income tax under Section 113 of the income Tax Ordinance.<sup>75</sup>

---

<sup>75</sup> Ibid, p. 98

- 6) Exemption/Clarification from the Securities and Exchange Commission of Pakistan from the requirement of Issuer to obtain NBFC License.
- 7) Declaration of the Certificates as eligible security by the Central Depository Company of Pakistan.
- 8) Notification by the Federal Government notifying rules relating to Certificates.
- 9) Notification by the Federal Government declaring the Certificates as approved securities for the purpose of Section 29 of the Banking Companies Ordinance, 1962.<sup>76</sup>

#### 2.5.5 Other terms and Conditions

1. All stamp duties payable on Security Documents and any other ancillary documents held on WAPDA account.
2. The *Sukuk* Issue had been offered on a reasonable effort basis.
3. This offer was subject to the proposed Issue being declared as a Statutory Liquidity Reserve (SLR) eligible instrument for Islamic banks and commercial banks with Islamic branches by the State Bank of Pakistan.
4. That offer held subject to the internal credit/*Sharia'h* approvals of participating institutions/*Sukuk* Holders.
5. Compliance with all applicable State Bank of Pakistan / SECP / Government of Pakistan regulations.
6. All levies, duties, surcharges, taxes etc of whatsoever nature, imposed by the Federal and / or Provincial government would be for the account of WAPDA.

---

<sup>76</sup> Ibid, p. 97

7. Documentation / Issue Structure would be in line with *Sharia 'b* principles and subject to final *Sharia 'b* approvals.
8. WAPDA had to submit un-audited half-year accounts within 90 days of half-year end and, annual audited accounts within 120 days of the financial year-end and projection for a given year within the first 70 days of that year.
9. There were no litigation or arbitration proceedings pending, nor had there been any adverse order or orders affecting the proposed financing by any competent court of law arbitrator in the name of WAPDA, which might adversely or materially affect the proposed financing.
10. All security arrangement and acceptable documentation held to be in place.
11. All applicable regularity approvals held to be in place.
12. Any other conditions might be necessary from time to time.<sup>77</sup>

It is concluded here that the water and power development authority (WAPDA) is a sovereign entity.

It is whose pivotal role is to expand the resources for the generation of electricity through hydile power in Pakistan. The said entity also works for the management of water. The ultimate purpose of it's to facilitate the public. To be more productive and to accomplish its duties the said institution issued *Sukuk* of RS 80 billion. The WAPDA First *Sukuk* Company (WFS) acted as an SPV and purchased from WAPDA ten hydile power generation turbines, installed at Mangla Hydile power station and kept the acquired assets in trust for the benefit of the investors till the maturity period. Then SPV lease back the turbines to WAPDA for maturity period of seven years. The rental entity requires funds. So it mobilized funds by issuance of *Sukuk al Ijarah* of worth PKR payment is

---

<sup>77</sup> Ibid, p. 96

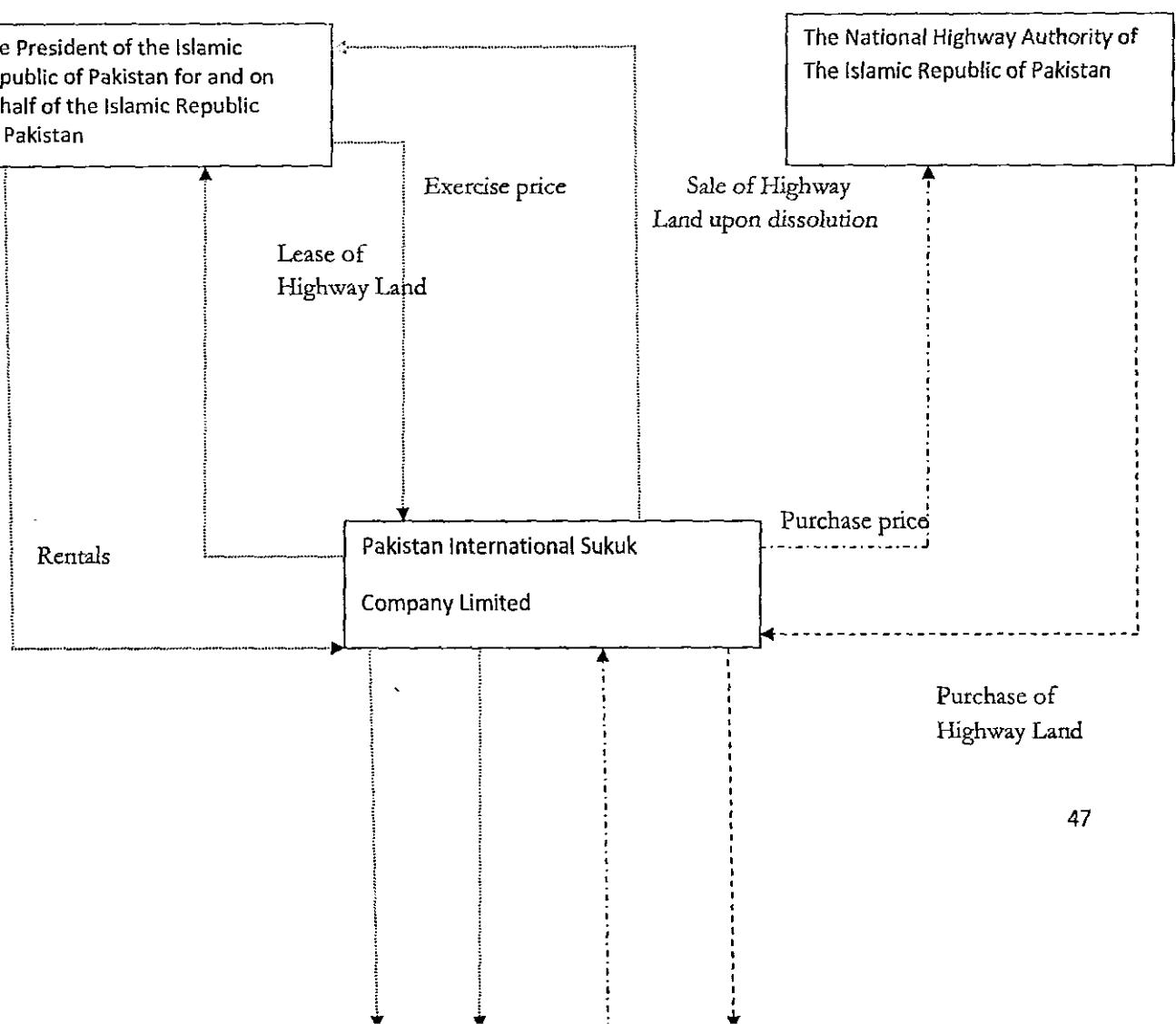
on KIBOR plus thirty five BPs of purchase consideration. Like other tangible assets the *Sukuk* issued on these turbines represented an undivided beneficial ownership on turbines. At the end of lease period the WAPDA will take back the turbines by fulfilling its unilateral promise of buying back the turbines at market price.

The managers were Citi Bank, Jahangir Sadique & company. The Muslim Commercial Bank (MCB) and the GoP gave unconditional and irrevocable guarantee for the return and ensure principal amount. The SBP approved the said issuance being *Shariah* compliant and SLR eligibility for Islamic banks and conventional banks having Islamic windows. The WAPDA *Sukuk* got strong market reply from the organizations, employ benefit fund and mutual funds. The utilization of these funds (proceed) will be used in *Mangla* dam project.<sup>78</sup>

---

<sup>78</sup> Ibid

## 2.6 Pakistan's Experience of Motorway *Sukuk*



Distributions

Redemption Cash

Certificates

Investors

The application of *sukuk*, in the case of Motorway was based on the rules of *ijara sukuk*.

First of all let to know about the parties involved in Motorway *sukuk* and then will highlight its *Ijara* Agreement.

#### **2.6.1 Parties involved in Motorway *Sukuk***

##### **A) Issuer**

Pakistan International *Sukuk* Company Limited, a public limited liability company incorporated in Pakistan under the Ordinance, 1984 (Ordinance No. XLVII of 1984) and the wholly-owned by the government (The Issuer). The Issuer has been incorporated solely for the purpose of participating in the transaction contemplated by the Transaction Documents.

##### **B) Seller**

The National Highway Authority of Islamic Republic of Pakistan (The Seller) will convey to the Issuer (as trustee for and on behalf of Certificate holders) title to certain Highway land.<sup>79</sup>

**C) Lessee**

The President of the Islamic Republic of Pakistan for and on behalf of the Islamic Republic of Pakistan (in such capacity, the Lessee) will lease the Highway Land from the Issuer on the terms set out in the *Ijara* Agreement for the period commencing on the lease commencement date and terminating on the Periodic Distribution Date falling on 27 January.

**D) Book runners and Lead Managers**

Citigroup Global Markets Limited (“Citigroup”) and the Hongkong and Shanghai Banking Corporation Limited (“HSBC”).

**E) Local Structuring Advisor:**

*Meezan* Bank Limited (Pakistan).

**F) Trustee**

The Issuer will act as trustee in respect of the Trust Assets, for the benefit of Certificate holders in accordance with the Delegation of Trust and Conditions. Under the Delegation of Trust, the Trustee will unconditionally and irrevocably delegate the authority to Hongkong and Shanghai Corporation Limited to take all necessary action on its behalf should a Dissolution Events occurs.<sup>80</sup>

**G) Payment administrator**

---

<sup>79</sup> Prospectus prepared for Motorway transaction, Summary of the offering, p. 5

<sup>80</sup> Ibid p. 5

Citibank, N.A. will act as Payment Administrator under the Agency Agreement (as defined in the conditions of *agreement of prospectus*). Among the other things, the Payment Administrator will operate the Transaction Account, receive payments from the Lessee under the *Ijara* Agreement and make certain payments in respect of certificates.

**E) Principle Payment Agent, Transfer Agent, and Reference Agent**

Citibank and N.A

**F) Registrar**

Citigroup Global Markets Deutschland AG and Co. KGaA

**Summary of Certificates:** U.S 600,000,000 Trust Certificates due 2010 (the Certificates or *Sukuk*)

**Closing Date:** January 27, 2005

**2.6.2 Purchase Agreement**

The terms and conditions of the purchase agreement were as under:

Pursuant the Purchase Agreement, the Seller has sold the Highway Land (free from all claims and encumbrances and with all attached or accrued rights as of the date of the Purchase Agreement) to the Issuer.

The net proceeds received by the Issuer from the issuance and sale of the Certificates would be used to pay the purchase price for the Highway Land.<sup>81</sup>

### 2.6.3 *Ijara* Agreement

Under the terms of an *Ijara* Agreement dated 19 January 2005 between, *inter alios*, the Issuer as lessor and the and the President of the Islamic Republic of Pakistan for and on behalf of the Islamic Republic of Pakistan, as lessee, and the Issuer has agreed to lease, and the lessee has agreed to lease from the Issuer, the Highway Land during the term commencing on the Lease Commencement Date (as defined in the *Ijara* Agreement) and extending to the Schedule Dissolution Date.

Under the terms of an *Ijara* Agreement, the Lessee has agreed that the Issuer would not under any circumstances be liable to the Lessee or to any third party for any cost, claim, demand, loss, damage or expense of any kind or nature caused directly or indirectly by, or out of, the use of any part or the whole of the Highway Land. The Lessee has agreed to indemnify and keep indemnified and hold harmless the Issuer against all and any such costs, claim, demands, losses, damages and expenses.

---

<sup>81</sup> Ibid p.33

Under the terms of an *Ijara* Agreement, the Lessee has agreed that if the lessee would be preventing from making Periodic Distribution Amount to Certificate holders or does or would not have sufficient fund to pay to the same in full as a result of actions taken by the Government (including, but not limited to, the imposition of any tax or the dissolution of the Issuer), the Lessee will account to the Trustee on demand for such amounts as are necessary to enable the Periodic Distribution Amounts to be paid in full.

Under the terms of an *Ijara* Agreement, the Lessee should, as its own cost and expense. He would be responsible for the performance of all Ordinary Maintenance required for the Highway Land. Under the terms of an *Ijara* Agreement, the Issuer was responsible for the performance of all Manor Maintenance, and will be procure that the Servant Agent, in accordance with the terms and conditions set out in the Service Agency Agreement, was held to perform, or would procure the performance of, all Major Maintenance in respect of the Highway Land on behalf of the Issuer.

The rentals under the *Ijara* Agreement is equal the Periodic Distribution Amounts payable on Periodic Distribution Dates coinciding the Rental Payment Dates for such results. The Lessee is obligated to pay rentals into the Transaction Account the second Business Day preceding the 27<sup>th</sup> day of each January and July, commencing on 27 July 2005 up to including 27 January 2010 or, if any such day was not a Business Day, then the following Business Day unless it would thereby fall into the next calendar month, in which event such day would be the immediately preceding Business Day, or any other date on which the *Ijara* Agreement is earlier terminated in accordance with its terms.<sup>82</sup>

Under the *Ijara* Agreement, If payment of a rental is not made to the Issuer in full or its due date for payment, the Lessee (in addition to making the relevant payment) has irrevocably

---

<sup>82</sup> Ibid p.33

undertaken to donate directly, in accordance with the *Sharia`b* principals, a late payment amount to be paid to charity of the Issuer's choice in respect of the period from and including the due date for payment to but excluding the date of full payment, equality, for the number of days during such period, the Rental applicable to Rental Period (as defined in *Ijara* Agreement) in respect of which the payment delay occurred, divided by the number of actual days in such Rental Period.

Under the *Ijara* Agreement, the Lessee bears the entire risk of loss of or damage to the Highway Land or any part thereof arising from the usage or operation thereof by the Lessee, and will indemnify the Issuer against the same.

In the *Ijara* Agreement, the Lessee is covenanted that from the January 2005 and for so long as its liabilities under the *Ijara* Agreement would not be discharged, the Lessee will not create, assume or permit to subsist any Security, other than permitted security, upon the whole or any part of its assets or revenue to secure (i) any of its Public External Indebtedness; (ii) any of its guarantees in respect of Public External Indebtedness; (iii) the Public External Indebtedness of any other person.<sup>83</sup>

Under the *Ijara* Agreement if:

- (i) The Lessee in its capacity as lessee shall default for a period of 10 days or more in the payment of any sum payable under the *Ijara* Agreement or any of the Related Documents; or
- (ii) the Lessee in its capacity as lessee shall default in the performance or observance of or compliance with any of its other obligation, covenants or undertakings under the *Ijara* Agreement or

---

<sup>83</sup> Ibid p. 34

any of the Related Documents and either such default is not capable of remedy or such default (if capable of remedy) is not remedied within 30 days after written notice of such default shall have been given to the Lessee by the Issuer; or

(iii) any representation or warranty made or given by the Lessee under the *Ijara* Agreement or any of the Related Documents or which is contained in any certificate, document or statement furnished at any time pursuant to the terms of *Ijara* Agreement any of the Related Documents shall prove to have been incorrect in any material respect on or as of the date made; or

(iv) (A) the acceleration of the maturity (other than by optional or mandatory repayment or redemption) of any External Indebtedness of the Lessee shall occur; or

(B) any default in the payment of principal of, or premium or prepayment charge (if any) or interest on, any External Indebtedness of the lessee shall occur when and as the same shall become due and payable if such default shall continue for more the period of grace, if any, applicable thereto; or

(C) any default shall occur in the payment and due and called upon (if the expiry if any applicable grace period) of any Guarantee of the Lessee in respect of any External Indebtedness of any other person.<sup>84</sup>

Provided that the aggregate amount of the relevant External Indebtedness in respect of which one or more of the events mentioned in this paragraph (iv) have occurred equal or exceeds U.S.\$. 25,000,000 or to its equivalent; or

---

<sup>84</sup> Ibid

- (v) A moratorium on the payment of principal of or interest on, the External Indebtedness of the lease shall be declared by the Lessee; or
- (vi) Pakistan shall cease to be member of the International Monetary Fund or eligible to use general resources of the International Monetary Fund; or
- (vii) The validity of *Ijara* Agreement shall be contested by the Lessee or the Lessee shall deny any of the Lessee's obligation under the *Ijara* Agreement or any of the Related Documents (whether by a general or suspension of payments or moratorium on payments of debt or otherwise);<sup>85</sup> or
- (viii) As a result of any change in, or amendment to, the laws or regulations in Pakistan or any ruling of any court in Pakistan whose decision is final and non-appealable, which change or amendment takes place, or the date of the ruling is, after the date of the *Ijara* Agreement (a) it shall become unlawful for the Lessee to perform or comply any of its obligations under or respect of the *Ijara* Agreement or any of the Related Documents or (b) any of such obligations shall become unenforceable or invalid; or
- (ix) Any regulation, decree, consent, approval, license, or other authority necessary to enable the lessee to make or perform its obligations under the *Ijara* Agreement or any Related Document or for the validity or enforceability thereof, shall expire, be withheld, revoked, terminated or otherwise cease to remain in full force and effect, or shall be modified in manner which adversely affects any rights or claims of the Issuer; or
- (x) The Lessee or the State Bank of Pakistan shall not at all times exercise the

---

<sup>85</sup> Ibid, p. 35

full ownership, power and control over any of their respective International Monetary Assets as they exist from time to time unless, prior to the occurrence of such event, a public sector entity that has substantially all of the powers and assets of the State Bank of Pakistan (including, without limitation, all of its International Monetary Assets) and perform the functions of the central bank shall assume and acquire such assets, powers and functions; or

(xi) There shall be a compulsory acquisition, confiscation or expropriation of all or any part of the Highway Land by the governmental authority; or

(xii) The Lessee confirms in writing to the Issuer that it disagree with the calculation of the relevant Rental Rate (as defined in the *Ijara* Agreement) and Rental as referred to in Clause 3.9 of the *Ijara* Agreement; or

(xiii) The Issuer shall cease to be wholly owned by the Government,

Then, in any such event, the Issuer may, without prejudice to any other right or remedy the Issuer may have under the *Ijara* Agreement, the Rental Documents or the law, by written notice, terminate the *Ijara* Agreement and the lease there under.

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

to pay off periodic liabilities arising on the trust certificates. On the completion of contract the GoP will repurchase the land from PIS at agreed price, enabling it to redeem the *Sukuk*.<sup>86</sup>

## Chapter 3

### GENERAL PRINCIPLES OF *IJARAH SUKUK* AND THE ANALYSIS OF PAKISTAN'S EXPERIENCE

#### 3.1 General Principles of *Ijarah*

In this part of the thesis first of all the general principles of *Ijarah* will be discussed as the subject under discussion has relevancy with *Ijarah* therefore the general principles of *Ijarah* are mentioned here for the sake of knowledge and elaboration of the concept of *Sukuk*.

#### 3.2 *Ijarah* Defined

The word *Ijarah* literally means to give something on rent. In the terms of Law it means lending some subject to somebody in return for some rental against a specific period. It can also be stated as sale of usufruct for consideration. Here letting things, movable and immovable for hire and rendering services such as custody of property and professional services.

The word *Ijarah* is used for two different situations. In First situation it means to hire services of a person, to employ the services of a person on wages given to him as consideration, as a return of his services. Here the employer is called *must'jir* while the employ is called *ajir*. In second situation *Ijara* does not relate to the services of human beings but relates to the usufruct of assets and properties.

---

<sup>86</sup> Ibid, p. 36

In this sense *Ijara* means to transfer the usufruct of property to someone and on return take rent of that particular property for specific time. In this case, the term *Ijarah* is analogous to the English term leasing. Here the lessor is called *mu'jir*; the lessee is called *musta'jir* and the rent payable to the lessor is called *ujrah*.

In Islamic jurisprudence different jurists have formulated various definitions of *Ijarah* having regard to its principle features.<sup>87</sup>

The definition of *Ijarah* in different schools of thought:

#### **Hanafi School**

“*Ijarah* is a contract on usufruct for a known consideration”<sup>88</sup>

#### **Maliki School**

“It is a transfer of lawful usufructs for a fixed charge for a fix period. A Maliki Ibn Rushd says; *ijarah* resembles a contract of sale whereby price and use are exchanged”<sup>89</sup>

#### **Shafi School**

“*Ijarah* is a contract on a known and permissible benefit in exchange of a known return.”<sup>90</sup>

#### **Hanbali School**

“*Ijarah* is contract for the lawful and defined use of a lawful and determined corporeal object for specific period of time. It is also defined as proving a defined work for a fixed price”<sup>91</sup>

<sup>87</sup>Usmani, Muhammad Taqi “*An Introduction to Islamic Finance*” Publisher (Quranic Studies Publishers, Maktaba Maariful Qur'an Karachi Pakistan) August,2008, p. 157,158

<sup>88</sup> Kasani, “*bada i' al-Sana'i'*” vol. 4, p. 174; Zaylai, “*Tabyin ak baqa'iq'*”, vol.5, p. 105

<sup>89</sup> Ibn Qudamah, “*al-Shurb al-Kabir*”, vol. 4, p. 2; Ibn Qudamah, “*al-mughnî*” vol.5, p. 398; Ibn Rushd, “*Bidayat al-Mudtabid*”, vol.2, pp. 219-220

<sup>90</sup> Shirbini, “*Mughnî al-Muhtaj*”, vol. 2, p. 332

### 3.3 Features of *Ijarah*

The preceding definitions set the following features of *Ijara*:

The purpose of *Ijarah* contract is an alienation of usufruct unlike contract of sale, which aims at alienation of property.

The benefits to be derived should be known and specified.

The benefits, which are the subject matter of contract, should be permissible in *Shariah*.

Thus, the hiring of a house for manufacturing wine is not permissible. Similarly, hiring a woman for the purpose of singing would also be against Islamic Law.

The rent or compensation should be specially fixed.

The period of contract should also be specified in the contract.

### 3.4 Kinds of *Ijarah*

There are main two kinds of *Ijara*, namely *inarat al-ashya* and *ijarat al-ashkhas*.

*Inarat al-ashya* refers to hiring refers to hiring of things such as house, shops, lands, animals and beasts etc. this is also known as *ijarat al-ayn*.

*Ijarat al-ashkhas* refers to hiring of services, such as to hire a painter to paint a house. This kind is also called *ibarat al-dhimmah*.<sup>21</sup>

The person hiring for rendering services is called *ajir* who is either *ajir khas*, the employee or *ajir mushtarak*, i.e, independent contractor. *Ajir khas* renders service for one person for a fixed period while *ajir mushtarak* for a large number of people like tailor, laundryman, and ironsmith.

---

<sup>21</sup> Baruti, "al-Rawd al-Murbi", p. 214

<sup>22</sup> Al-jaziri, "Kitab al-Fiqh ala al-Mudhahib al-Arba'ah", Birut, vol. 3, p. 110

### 3.5 Conditions of *Ijarat al- ashya*

The subject of *ijarab* must have a valuable. There for, things having no usufruct it all cannot be leased.

It is necessary for a valid contract of leased that the corpus of the leased property remains in the owner ship of the lessor, and only its usufruct is transferred to the lessee. Therefore, the leased cannot be effected in respect of money, eatables, fuel and ammunition, because there use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charge on leased shall be treated as interest charged on a loan.<sup>93</sup>

As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the used of the property shall be borne by the lessee.

#### Example

A has leased has house to B. the taxes referable to the property shall be borne by A, while electricity bills and all expenses referable to the used of the house shall be borne by B, the lessee.<sup>94</sup>

The subject-matter of *ijarab*, namely, the usufruct shall be known, and identified. There should not be any uncertainty and vagueness about the usufruct, which may lead discord and dispute among the parties. The lesser should specifically mention the subject-matter. It is not permissible to lease an unspecified thing. This if a person says: "I rented you one of these

---

<sup>93</sup> Usmani, Muhammad Taqi, "An Introduction to Islamic Finance" Publisher (Quranic Studies Publishers, Maktaba Maariful Qur'an Karachi Pakistan) August,2008, p.157

<sup>94</sup> Ibid.

two houses", the contract would be invalid because the subject-matter in this case as unknown and unidentified.<sup>95</sup>

The leasing period should be fixed, whether, it is long or short. It is the viewpoint of the majority of the *fusqahah*. Imami malik, on the other hand maintains that a long period for the usufruct is not advisable, because it may cause dispute and tussle.<sup>96</sup> As regards property of orphans and *waqf*, the *Hanafi* jurists hold that long period of leased of these properties is not permissible so that the lessee may not claim ownership over them because of long possession. They propose that it should not be hired out for more than three years.<sup>97</sup>

The subject-matter should be something that can be actually delivered. Thus, the renting out of a stray animal is not permitted.

The object and purpose of the contract should be lawful. Thus, it is not permissible to hire a house for the purpose of gambling or manufacturing wine.

The article to be hired should be physically fit for hire.

In the contract of hiring a land, use of land should be specified whether it is for cultivation or construction of building.

In a beast of burden is hired for carrying a burden, the quantity and quality of burden. The destination and the period for which it is required should be stated. If the lessee loads with the burden more than the specified, he will be called compensate. Similarly, if he uses the animal in an unusual manner, which causes its death, he will be regarded *ghasib* (usurper) and called for indemnification.<sup>98</sup>

The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement, if no such purpose is specified in the agreement, the lessee can use it for

<sup>95</sup> Kasani, "beda'l al-sana'l", vol.4, p.180

<sup>96</sup> Sharbini, "mugbni al-mubtaj", vol.2,p.349; Ibn Qudamah, "al-mugbni", vol.5, p.401

<sup>97</sup> Ibn Abidin, "Radd al-Muhtar", vol.5, p.2-3

<sup>98</sup> Zayala` I, "Tabyan al-Haqaiq", vol.5, p.113

whatever purpose it is used in the normal course. However, if he wishes to use it for an abnormal purpose, he cannot do so unless the lessor allows him express terms.

The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence on the part of the lessee.

The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between or among all the joint owners according to the proportion of their respective shares in the property.

A joint-owner of a property can lease his proportionate share to his co-sharer only and not to any other person.

Rent to be paid should be a lawful thing and known.

Rent should be paid in the same genus or species. Thus, a house cannot be rented in exchange of house. This condition is peculiar to the *Hanafi* School.<sup>99</sup>

### 3.6 Some other rules concerning *ijarab Al-Ashya'*

The property hired is a trust in the hands of the lessee. Thus, if it is destroyed without any negligence on the part of the lessee, he will not be responsible for that loss or damage.

The lessee is required to exercise maximum care of the property and use it properly. An improper and unusual use of the property will change his status from trustee to usurper, and in case any destruction takes place, he will be liable for compensation.

---

<sup>99</sup> Kasani, "Bada'i", vol.4, p.194

Rent of hired property becomes due:

On the attainment of usufruct of the hired property or goods; and

Ability of the lessee to use the usufruct of hired goods.

*Ijarah* is a binding and irrevocable contract. Thus, it cannot be revoked unilaterally.

Unlike the sale the contract of *iijarah* can be enforced from some specified future date. Thus, it is permissible to say that this contract will be effective from January 1, 2006

Concluding the discussion here it is stated.

### 3.7 General Principles of *Ijarah Sukuk*

*Ijarah sukuk* is a security that represents ownership of an equal share in the usufruct of an asset that is well defined, existing and known, tied to an *Ijarah* contract as defined by Sharia'h. The *sukuk* gives the owner the right to own the underlying assets, receive rent and dispose the *sukuk* without any impact on the *sukuk* issuer's right to use the asset. There are ownership risks related to this instrument; for example owners have to bear all costs related to the basic characteristics of the assets and the lessee is responsible for bearing the cost of maintenance".<sup>100</sup>

According to Al-Amine, *Ijarah sukuk* has four characteristics:

<sup>100</sup> Al-Amine, M.B.M, "The Islamic bond market: Possibilities and challenges", International Journal of Islamic Financial Services, 200, vol. 3, no. 1;

Ayub, M.(n.d), "Securitization, sukuk and fund management potential to be realized by Islamic Financial Institutions", Available on:  
[http://islamiccenter.kaau.edu.sa/7iecon/Ahdath/Con06/\\_pdf/Vol2/48%20Muhammad%20Ayub%20Securitization,%20Sukuk.pdf](http://islamiccenter.kaau.edu.sa/7iecon/Ahdath/Con06/_pdf/Vol2/48%20Muhammad%20Ayub%20Securitization,%20Sukuk.pdf) [Accessed: July 2, 2010]

1. *Ijarah* bonds can be traded in the market at prices determined by market forces, such as general market and economic conditions, the financial market, opportunity cost and the price of real investment.

The *Ijarah* bond is also subject to risk related to the ability and desire of the lessee to pay the rental payment, and the market risk arising from the potential changes in asset pricing, maintenance and insurance cost.

2. Due to the presence of maintenance and insurance expenses that cannot be perfectly known in advance, the expected return on some forms of *Ijarah sukuk* cannot be completely fixed and determined at the beginning of the contract.

3. *Ijarah sukuk* is completely negotiable and tradable in the secondary market.

4. *Ijarah sukuk* offers a high degree of flexibility, derived from the approach to issuance management and marketability. The flexibility rules in *Ijarah* mean that securitization of the *Ijarah* contract is the key factor to solving the liquidity management problem. Therefore,

*sukuk* has both the characteristics and the necessary conditions to be a successful security".<sup>101</sup>

### 3.8 Analysis of Pakistan's Experience in the Light of *Sharia'h*

In this chapter the rules of Motorway and WAPDA *sukuk*, has been analyzed, that these are either according to *Sharia'h* or not? First rules for *sukuk* of Motorway have been analyzed.

---

<sup>101</sup> Al-Amine, M.B.M, "The Islamic bond market: Possibilities and challenges", International Journal of Islamic Financial Services, 2001 vol. 3, p. 1

**Use of Benchmark:** In rules of *sukuk* of Motorway, it is mentioned that LIBOR for each Return Accumulation Period shall be determined by or behalf of the Issuer.

Here a question arises that either KABOR be used as a benchmark for fixation of rentals in the contract of *Ijarah*? Is this practice is permissible according to *Shariah*?

The majority of contemporary *Shariah* scholars holds that interest rates could be used as benchmark for fixing prices and rents, or granting incentives. Such determination results in arriving at a fixed price or rent required to make a sale or lease transaction valid, and grant of incentives as per agreed terms but in lines with *Shariah* principles. Undoubtedly, it is very much desirable to have or develop an alternative benchmark for Islamic banks, but based on principles of *Shariah* we see no *haram* in using conventional benchmark for fixing prices and rents or incentives.<sup>102</sup>

According to Dr. Maulana Ijaz Ahmad Samadani<sup>103</sup> says that nevertheless it is not suitable for an Islamic bank to keep the interest rate as the basis of benchmark for fixation of the rental in *Ijarah*. It is a fact that for the one who looks at the issue without contemplation could not find the real difference. But there is no doubt that the fulfillment of all conditions will make the *Ijarah* valid. And only the fixation of the rentals on the basis of a benchmark does not render the contract invalid.<sup>104</sup>

This issue can be explained with an example. Zaid and Khalid are brothers. Zaid gives the people loan and charges 10% interest. Khalid has a business of garments. He decides that as his brother charges 10% interest of loan, he will also sale the garments on 10% profit.

Though it is not good to make the rate of interest a basis of profit in the business, but however, if Khalid abides by the ruling of *Shariah* in this business, his transaction will

<sup>102</sup> Hassan, Hamed Hassan, *Comments on Discussion Paper Notes Submitted for the Harvard- LSE Workshop on Sukuk*

<sup>103</sup> Dr. Maulana Ijaz Ahmad Samadani is a learned scholar of *Darul-Uloom Karachi*.

<sup>104</sup> Samadani, Dr. Maulana Ijaz Ahmad, "Leasing (*Ijarah*) Process in Islamic Banking System", 2008, p.93

not be held illegal, merely on the grounds that he has adopted the rate of interest as a basis of profit. The same situation occurs here in Islamic banking that they keep the rate of interest rate as a basis of profit, as the conventional banks do, but this practice does not render the contract of *Ijarah* invalid. However, the practice itself is not appreciable and some methodology should be carved out to avoid this detestable.<sup>105</sup>

Here a question arises that: Can *sukuk* holders negotiate/sub-lease the *sukuk* with another party?

It is lawful to lease something for a certain amount of rent and then sub-lease it to another for the amount as rent in the original lease, or for more, or for less, as long as the original lessor has no objections and customs allows it.

It is likewise lawful for this partnership to occur at the same amount of rent paid by the first lessee, or at greater amount, or lesser one. When the right to the usufruct passes from the first lessee's disposal by means of a later contract of lease, it is no longer lawful for the first lease to use what has passed from his ownership and become a debt, owned to him by another<sup>106</sup>

If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor. If the lessor permits the lessee for subleasing, he may sub-lease it. If the rent claimed from the sub-lessee is equal to or less than the rent payable to the owner / original lessor, all the recognized schools of Islamic jurisprudence are unanimous on the permissibility of the sub lease. However, the opinions are different in case the rent charged from the sub-lessee is higher than the rent payable to the owner. Imam al-Shaf'i and some other scholars allow it and hold that the sub lessor may enjoy the surplus received from the sub-lessee. This is the

---

<sup>105</sup> Ibid, p. 93-94

<sup>106</sup> Delorenzo, Yusuf Talal, *A compendium of legal Opinions on the Operation of Islamic Banking*, Institute of Islamic Banking and Insurance London, UK, Vol. II, P.38

preferred view in the Hanbali School as well. On the other hand, Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus.<sup>107</sup>

Although the view of Imam Abu Hanifah is more cautious which should be acted upon to the best possible extent, in cases of need the view of Shafi'i and Hanbali schools may be followed because there is no express prohibition in the Holy Qur'an or in the *Sunnah* against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.<sup>108</sup>

### 3.9 The Trust Assets and its securitization

In this transaction the trust assets are comprised of the Highway Land (Islamabad-Lahore Motorway), all of the Issuer's rights, title, interest and benefit, present and future. The subject matter of *Ijarah* should be valuable, identifiable and quantifiable in clear terms. Any type of ambiguity will render the contract invalid. At the time of contract both parties should know the nature of the assets to be benefited. The subject matter and its use should be permissible under *Sharia'h* principles. The things of perishable nature cannot be subject matter for *Ijarah* contract<sup>109</sup>.

In Islamic debt financing the underlying assets is quite perplexed issue in determining the *Sharia'h* compatibility. The underlying assets are both tangibles and intangibles assets such as factories, machinery, common stocks, inventory, buildings, properties, contracts and concessions

<sup>107</sup>Ibn Qudamah, "Al-Mugbn", Riyadh, 1981, 5:475; Ibn 'Abidin, "Radd al-Muhtar", 5:20.

<sup>108</sup> Usmani, Muhammad Taqi, "An Introduction to Islamic Finance", Quaranic Studies Publishers, Karachi, 2008, p. 123-124

<sup>109</sup>Usmani Muhammad Imran Ashraf, "Mezzan Bank's Guide to Islamic Banking" (Karachi: Darul Ishaat,2002),147.

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

In modern Securitization, if the debtor or seller of bonds fails to meet payments, the creditors can lawfully acquire the underlying assets for capital recovery.<sup>110</sup>

In *Fiqh Muamlat*, debt (*al-dayn*) includes deferred payment of *Murabahah* sale, deferred payment of dowry, in addition rental payment to be collected at the end of the month.<sup>111</sup>

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

The sale of debt by the creditor to a third party is not acceptable in *Islam*. The reason of prohibition is that sale will take place for liquidity purposes on non equivalence basis at premium or at discount price. Wherever there is difference in debt value and cash value that would call *riba* however, sale of debt at par value by the creditor to a third party is permissible in *Sharia`h*. This is an exception to the

---

<sup>110</sup> Ibid

<sup>111</sup> Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets* (Malaysia: Dinamas publishers, 2005), 347.

general rule that where the debtor gave some incentive to the creditor on the early payment that is called *dhawwa ta,ajal* (pay less for early settlement.) but here on this rule Scholars have different opinions. The Scholars who do not consider the pay less for early settlement, are on strict observance of Islam and said capital gain is prohibited on the basis of the exchange of money for money.

The Malaysians has made efforts to strengthen the Malaysia position in origination, distribution and wealth management as an international hub but there the problem was the liquidity management. Therefore in July, 1983 Bank Negara in Malaysia was established and the same is working on interest free basis. The said bank cannot deal with the government's securities. To resolve the issue, government investment certificates and government investment issues were introduced which represented beneficial loans to the government. For the fixation of interest the government used its full discretion. The representatives of the Ministry of Finance, the Economic Planning Unit and the Religious Affair Section of the Prime Minister's officer was appointed to announce the rate of return regularly but there was no hard and fast prescription to decide the rate, so the decision was taken place on qualitative basis.

For the expansion of Islamic financing facilities i.e. interbank money market, on Dec18, 1993, guidelines were issued and on 3 January 1994 in Kuala Lumpur it started its functioning mainly on *Mudarbab* interbank investments. Here investee bank can acquire funds from Islamic financial institution (the investor bank) by issuing *Mudarbab* Certificate from one night to one year. To issue short term certificates is not objectionable as some scholars say. It is allowed according to AAOIFI *Sharia`b* Standard NO 17 para 5/1/10 which states that: "It is permissible to issue *Sukuk* on a short term, medium term or long term basis in accordance with the principles of the *Sharia`b*. The *Sukuk*

may also be issued without specifying a period depending upon the nature of the contract underlying the *Sukuk* issue".<sup>112</sup>

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

### 3.10 Fine on client to pay to the charity in shape of increasing in the rent in the next transaction

In the transaction of motorway it is stated here that:

"Issuer in full or its due date for payment, the Lessee (in addition to making the relevant payment) had irrevocably undertaken to donate directly, in accordance with the *Shariah* principals, a late payment amount to be paid to charity of the Issuer's choice in respect of the period from and including the due date for payment to but excluding the date of full payment, equality, for the number of days during such period, the Rental applicable to Rental Period (as defined in *Ijara* Agreement) in respect of which the payment delay occurred, divided by the number of actual days in such Rental Period"<sup>113</sup>

---

<sup>112</sup> Accounting and Auditing Organization of Islamic Finance Institutions Shariah Standard, Manama, 2003,305

<sup>113</sup> Prospectus prepared for Motorway transaction, Summary of the offering, p. 33, 34

Here a question arises about the permissibility of fine that either it is allowed according to *Sharia'h* or not? Or can a person be compelled to pay *sadaqa*?

According to Dr. Maulana Ejaz Ahmad Samadani Islamic bank does not fine its client on delay of payment. In fact, the client himself gives an undertaking that he will give *sadaqa* in case of delay in payment from his side. At the time of agreement, he gives an undertaking that if he fails to pay dues in time, then he will pay such and such amount in charity fund as *sadaqa*. It is just like a person who says that if I commit such and such mistake and then I will pay such and such money as *sadaqa*.<sup>114</sup>

Further, it is obligatory for an Islamic bank to deposit that amount in charity fund and spend it in the purposes according to *Sharia'h*. The bank or any financial institution is not allowed to consider that money part of the income.

### **3.11 Objection on sale of debt**

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

The answer lies in the Juristic debate on the sale of debt. The Malaysian Jurists say that these papers are equivalent to property (al mal). The transactions leading to the issuance of debt papers are supported by some underlying assets since property has value, it can be sold at any price.<sup>115</sup>

### **3.12 Objections on the procedure of *Sukuk* issuance**

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

---

<sup>114</sup>Samadani, Dr. Maulana Ejaz Ahmad, "Leasing (Ijarah) Process in Islamic Banking System", 2008, p. 95

<sup>115</sup>Saiful Azhar Rosly, *Critical Issues on Islamic Banking and Financial Markets* (Dinamas publishers, Malaysia), 2005, p. 349

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

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

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

- i. Here money is not generated on money and flow of income is from the underlying assets on which *Sukuk* have been issued. For example if *Sukuk* are issued on the assets which are rented back to the issuer then SPV will collect rent from the rental products in the rental period.
- ii. The flow of income is not fixed but based on profit and loss sharing. The return would depend on the income realized by the project. As *Sharia`b* Standard No 17 Para No 4/5 states that:

“The owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates owned (held) by them.”<sup>116</sup>

The Islam prohibits the lending and borrowing on interest or usury but permits to finance through underlying physical assets based on profit and loss sharing as Muhammad Taqi Usmani said you must face the actual consequences of your investment. He added that for current *Sukuk*, risk is

---

<sup>116</sup> Ibid.300.

not shared and reward is not shared according to actual venture proceeds about 85% of *Sukuk* are structured this way which is against the risk sharing principal of *Sharia`b*.

- iii. The investors/*Sukuk* holders have real common ownership rather than nominal ownership on the underlying assets. The *Sharia`b* Standard No 17 Para No 4/2 states that: Investment *Sukuk* represent a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufructs, services or a mixture of these entire plus intangible rights, debts and monetary assets. These are *Sukuk* do not represent a debt owed to the issuer by the certificate holder.<sup>117</sup>
- iv. No any promise is made by the originator to pay back the capital because this very condition violates the legitimacy of *Sukuk*. However repurchase clause is to allow the industry to develop and Scholars are likely to agree on it.

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

### 3.13 Criticism on *Ijarah Sukuk*

*Sukuk* remained vulnerable to criticism particularly in practical operation in different transactions. Main criticism is that the transaction is very costly as it bears insurance costs and *Sharia`b* fees and audit. They are also criticized for being time consuming and having penalties for late payment. Another very alarming criticism is related to fixation of profit in the form of benchmark based upon LIBOR (London Inter Bank Offer Rate). *Sharia`b* scholars do not permit fixation of profit based upon LIBOR, although interest rate is only used for pricing.<sup>118</sup>

---

<sup>117</sup> Accounting and Auditing Organization of Islamic Financial Institutions 1429 H -2008

<sup>118</sup> Dinna Rohmatunnisa, "DESIGN OF IJARAH SUKUK", the University of Nottingham, 2008, p. 35

Interest rate is usually used as a basis for cost of capital and also benchmark for interest rate of return in an economy without any interest rate which is meant that there is no mechanism for the calculation of the cost of capital and the efficiency of an investment project cannot be calculated and evaluated. It was suggested a procedure that utilizes Tobin's in a calculation of the cost of capital and investment. But this calculation is done without resort to a fixed and predetermined interest rate, equity financing becomes the only source of financial capital and the economy's financial system becomes equity based.

Transactions without debt, the capital is valued in market for equities and relationship between the supply price of capital and the rate used by the shareholder for discounting the expected future earning can be derived. It is also defined that the supply price of capital as the rate of return which is required by a shareholder to absorb the existing capital stock to their portfolio. Investors look to the profitability relative to the cost of capital in such a way that Investment is expected to occur when the demand price in the financial valuation exceeds the supply price as measured by the cost of physical capital. In another way it can be said that company is expected to accept investment where the return will exceed the cost of capital.

The theory of investment is related to the ratio of market to the replacement value of capital. It has been observed that under certain conditions, the rate of investment of a share- value maximizing firm is the function of Marginal is the ratio of market value of an additional unit of capital to its replacement cost. Marginal is a basic determinant of investment for the reason that it shows an increase in the market value of the firm which shows the profit of the capital which is existed.<sup>119</sup>

---

<sup>119</sup> Ibid

## Conclusion

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

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

The initiative of *Sukuk* in Pakistan was taken by Sitara Chemical Industries by issuing *Sukuk*

in 2002 those were *Mudarabah* -based *Sukuk*, called *Mudarabah Term Finance Certificates (MTFCs)*. However, proper work on the said subject started in 2005 but there is not any law that governs the *Sukuk* phenomenon, the reason of this lacuna is infancy of *Sukuk* concept in Pakistan.

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

## Recommendations

1. Any promise should not be made by the originator to pay back the capital because this condition violates the legitimacy of *Sukuk*.
2. The whole transactions of *Sukuk* should depend on risk sharing phenomenon because it is golden rule of *Sharia`h*. The promise to pay back the capital removes the risk from the financing. According to *Shariah* risk bearing is the golden rule of financing whenever and where ever the capital is guaranteed and element of risk is ceased the said transactions will not be according to *Sharia`h*.
3. There must be law/ particular legislation that can govern and regulate the *Sukuk* issuance procedure.
4. There are requirements for every *Sukuk* issuing entity to have *Sharia`h* Advisor who will provide *Sharia`h* based guidance for every transaction.
5. *Sukuk* should be issued for new commercial industrial ventures. If they are issued for established business, then the *sukuk* must ensure that *sukuk* holders have complete ownership in the real assets.

6. The returns of the enterprises should be returned to *sukuk* holders regardless of what amounts they reach after costs, including the manager's fees, or share of the *mudarib* in profits. If there is to be an incentive for manager, then let it be based on profits expected from the enterprise and not on the basis of an interest rate.

## List of Bibliography

### BOOKS

1. Al-Quran-ul-Karim
2. AAOIFI, *Shariah Standards* "Standard No 17 on investment Sukuk" Publisher(AAOIFI Publisher Mnama Bahrain) May, 2003
3. Adam najaf, Abdukadhar "Islamic bonds: your guide to issuing, structuring and investing in *sukuk*", Publisher (Euromoney Books) 2004
4. Al-jaziri, "Kitab al- Fiqh ala al- Mudhabib al- Arba`ab", Publisher(Dar Ihya al-Urath al- 'Arbabi,Birut)1963
5. Ayub, Muhammad. "Understanding Islamic Finance", (England: John Wiley & Sons Ltd), 2007
6. Bahuti, "al-Rawd al-Murbi
7. Ibn Abidin, Muhammad Amin, "Radd ul-Mukhtar", (Maktaba Majididiyyah, Quetta), 1982
8. Ibn Qudamah, "Muwaffat al-Din, al-Mughn'i", Publisher(Daru al-Fikr, Birut), 1985
9. Ibn Qudamah, "al-Sharb al-Kabir". Publisher(Daru al-Fikr, Birut), 1984

10. Ibn Rushd, Muhammad bin Ahmad, "Bidayatal- Mudtabid", Publisher (Maktaba al-Ilmiyyah, Lhore)
11. Jaffer Sohail "Islamic asset management: forming the future for Shari'a-compliant investment strategies" Publisher (Euromoney Books) 2004
12. Kasani, bada'i` al-Sana'i fi Tarbitib al-Shara'i, Publisher (Sharikah al- matbu'at al-Islamiyya), Corio
13. Maariful Qur'an Karachi Pakistan) August,2008
14. Mansuri, Muhammad Tahir, "Islamic Law of Contracts and Business Transactions", Publisher (Shariah Academy International Islamic University Islamabad) 2005
15. Shirbini, "Mughni al-Muhtaj" Publisher(Sharika wa-Matba'ah Mustafa al-Babi al-Halabim, Cario) 1933
16. Usmani, Muhammad Taqi "An Introduction to Islamic Finance" Publisher (Quranic Studies Publishers, Maktaba Maariful Quran, Karachi) 2008

#### Research Papers

1. Dinna Rohmatunnisa, "DESIGN OF IJARAH SUKUK", the University of Nottingham, 2008
2. Idris Umar Mohammed, Research paper "Evaluation of Research Developments on the Islamic Securities (Sukuk)" International Centre for Education in Islamic Finance, Malaysia
3. Memon, Noor Ahmed , "Structure of Islamic Bonds and Managing Financial Risk of Sukuk,"(Karachi: Institute of Business and Technology), 2008
4. Sibghatullah Ahsan "Presentation on Sukuk and its Regulatory Framework in Pakistan"

Islamabad, August 27,2008

5. Usmani, Muhammad Imran ,paper prepared for the 2<sup>nd</sup> SBP International conference on “*Fixed income securities shariah perspective*” on 18-19 December 2006 at State Bank of Pakistan, Karachi
6. Usmani, Taqi Muhammad, “*Sukuk and their contemporary application*”.

#### Newspaper Articles

1. Ahmed Amin, “*Sharp rise in Sukuk*”, Business Section, Dawn, August 09, 2008
2. Khan Afaq , “*Sukuk the way forward*” Dawn, Setember 11, 2007, Islamic Banking

#### ENCYCLOPEDIAS

1. Encyclopedia of Islamic Banking and Insurance (Institute of Islamic Banking and Insurance:1995),170

#### Documentations of the Cases

1. WAPDA *Sukuk*
2. Motorway *Sukuk*, 2005

#### Websites

1. <http://en.wikipedia.org/wiki/Sukuk>.
2. <http://www.isra.my/fatwas/investment-banking/modes-of-sukuks/121-aoifi-shariah-resolutions-issues-on-sukuk.html>

3. <http://www.muftitaqiusmani.com/Downloads/Publications/Articles/Sukuk.pdf>
4. <http://ssrn.com/abstract=1093064>
5. [http://en.wikipedia.org/wiki/Council\\_of\\_Islamic\\_Ideology](http://en.wikipedia.org/wiki/Council_of_Islamic_Ideology)
6. <http://www.sbp.org.pk/research/bulletin/2007/vol3/Sharia-Perspective.pdf>

