In search for a new beginning for sukuk

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During their semi annual meeting in Medina, the members of the Shari'ah Council of AAOIFI discussed an item coming under any other matter in the agenda. The discussion proved the subject to be the most important. It was certain Sukuk issues which becoming in vogue. The discussion revealed that certain aspects of Sukuk merited a formal inclusion in the agenda of the next meeting and that a working papers was to be prepared. It was included in the agenda of the following meeting in Makkah at the end of summer 2007. Justice Taqi Usmani presented a paper summing up all the Shari'ah concerns. A through discussion took place in which members tried to deal with certain development in the Sukuk market which appeared to have taken most of them by surprise. Prime among them was:

a) What is being said repeatedly by bankers (Islamic and otherwise) that certain structures of Sukuk are, (from a financial point of view) a facsimile of conventional bonds.
b) The fact that many Shari'ah scholars who took part in approving the early issues of Sukuk are now raising concerns that certain conditions (especially the purchase undertaking at principal and the liquidity facility which is absorbed by issuer), are changing the “substance” of the Sukuk structure, albeit the form remains different from bonds.

AAOIFI has previously issued a standard for Sukuk which still stands and represent the collective opinion of AAOIFI’s Shari'ah Council and the official position of AAOIFI on the subject of Sukuk.

The deliberations didn’t reach any specific conclusion except that the process of improving the Sukuk structure was to continue and the subject was to be again picked up in the next AAOIFI Shari'ah Council meeting.

Then came the storm, when a number was quoted by Justice Taqi Usmani during a speech in Bahrain. News reporters love numbers. It suddenly became huge news and the subject of Sukuk became an item for discussion, by bankers, rating agencies, lawyers and Shari'ah scholars. What is all the commotion? The following is a summary of the most cited explanations:

a) May be because Sukuk turned out to have the same economic outcome of conventional bonds and behave in the market in a similar way.
b) Or may be that Sukuk appear to represent debt obligation and debt is not desirable from Shari'ah point of view.
c) Some say it is because Sukuk do not seem to be inline with “Maqased” of Shari'ah.
d) The most frequent referred to reason is that the promise to purchase at principal is questionable from Shari'ah point of view.
e) Finally, that Islamic Sukuk must be equity securities.

None of the above can reasonably explains the situation. This is because:

a) Sukuk can’t be objectionable because they deliver the same conventional outcome or behave in the market in similar way to bonds. On the contrary, they are desirable because they do so. We are well aware that almost all Islamic banking products are designed to deliver the same economic results of a conventional product albeit in a “legalistically” different way (compare Murabaha with Personal Loans, Arboon with Call Option, Salam with Short Sale…etc) non was objected to before. Hence the fact that Sukuk deliver the same economic results of bonds, or behave in the market in a similar way can’t be the reason for the latest displeasure, because it was intended from the very beginning.

b) The objection can’t be because sukuk represent debt. We know that the majority of Islamic banking assets are debt and almost all Islamic banking products effectively create debt. Had this been the reason, we would have objected to the “mother of all debt”, the Murabaha.

c) To say Sukuk are no longer “halal” because they are not in line with the “Maqased of Shari'ah” is methodogically wrong.

   A judgment on the permissibility or otherwise of a transaction can only be based on the rules of Shari'ah not “Maqased”.

d) As for the promise to purchase, we all know that the concept of “promise” is central to almost all Islamic financial products. Very few transactions can be structured without a promise here or there. This has always been o.k. It is now established, even by the OIC figh academy that a promise is not a contract. Therefore a promise to purchase can’t be the “villain” causing the displeasure with Sukuk structure. Some may reply that promise is o.k. but a promise to purchase at “principal” (face value of Sukuk) is not o.k. while a promise at a price different from the principal would be fine from Shari'ah point of view. However, the difference between the types of promises is not obvious. Promise to purchase at market value would be Shari'ah permissible. Such promise is meaningless since market value is available without a promise.

e) Finally, to say Sukuk must be equity securities is the “mercy bullet”. When people want an equity security they issue common shares.

If none of the above can explain the displeasure what exactly is thought to be wrong with the current Sukuk?

I will speculate: despite the fact that everything (bits & pieces) in the Sukuk is already approved for other Islamic financial products including the economic outcome, one thing is unique to Sukuk. They are the only Islamic financial product that effectively separates the real sector from the monetary sector, in the economy. Sukuk as they are designed (or at least some of them) to have their own dynamics delivering the promised financial results regardless of the state of the real assets. This is unique to Sukuk.

It has always been assumed by Islamic economists that a dichotomy between real and monetary sector is a bad thing, and that one of the superiority features of the Islamic system is that both real and monetary sectors are interlinked by the fact that Islamic law of contract does not allow the creation of pure inter-temporal monetary transaction. When money is exchanged a real “thing” must also changes hands. I don’t know of any series research on this particular point. It remains, therefore, that the ill effect of a dichotomy between the real and monetary sectors are not very obvious, except for the fact that such dichotomy causes trade cycles in capitalist system. But the matter is too complicated to reach a useful conclusion. More importantly, there is no evidence that such interlinking between the real and monetary sector is desirable from Shari'ah point of view or required. It must be clear that the risk profile of Sukuk even with the undertaking to purchase at principal remains different from the conventional bond. Such difference is reflected in the pricing of these Sukuk.

Like any other financial product Sukuk will be successful if it meets the needs (and preferences) of both issuers and investors. A corporation issues Sukuk because they need capital. Yet, they don’t want it in the form of equity because equity is more expensive. Furthermore, new shareholders will disrupt the management structure of the company and dilute the equity of the current shareholders. On the other hand an investor needs a security with low risk (because a guarantee similar to that comes with bonds effectively reduces risk) and predictable income not necessarily fixed. This need of Islamic issuers and investors is now met by the current structure of Sukuk. However we appear to have overlooked a much simpler structure based on Mudarabah which can meet the said need, yet retain the salient quality of the Islamic system of finance including the interlink between real and monetary sectors. That is if we are permitted to do loud thinking then a structure of Mudarabah Sukuk may work as follows:

A Mudarabah Sukuk holder advances the capital of the Mudarabah to the Mudarib (corporate issuer) which becomes a source of funds for him. But “him” is now the legal entity which is a corporation with assets, a going concern already active in the business and has a market value (say X). If such funds are to be utilized in a separate project this will be pure equity. However, in this proposed structure? Mudarabah capital is commingled with the rest of assets of this corporation and used in its operations. At the end of the year, if value is created over and above that (X), then this is profit in the meaning of Shari'ah which must be shared in accordance with the ratio agreed upon in the Mudarabah agreement. If the corporation loses money, the Mudarabah Sukuk holders will get no profit. However, they will not loose their capital except when all the equity of the company is wiped out. Since the Mudarib is the legal person, loss will eat in the Mudarabah capital only if equity of the corporation is wiped out. This gives the Sukuk holders a position in the capital structure of the corporation similar to the position of conventional bond holders (without even mentioning the word guarantee), thus creating the low risk features of the Sukuk without any purchase undertaking. These are “raw ideas” presented only for discussion. But unless we go in Sukuk this way, the displeasure will go on.