

The Mudarabah Certificate (Sukuk)

Mohamed A. Elgari

1- What is Mudarabah

Mudarabah is contract of partnership between a provider of capital (called Rub-ul-mal) and another who invests that capital to produce a return (called Mudarib). Mudarabah can be for a specific transaction and it can be left to the discretion of the Mudarib. It is required that full capital of Mudarabah is paid at the time of contracting and that a ratio of dividing profit is agreed upon at that time also. The Mudarib is only entitled to his share of the profit while Rub al mal is not allowed to interfere in the management during the currency of the Mudarabah contract. Profit is defined as the positive difference between initial nominal capital and the proceeds of the liquidation at the end of the contract. The Fiqh academy of the OIC has issued a fatwa permitting Mudarabah to be formed through issue of Sukuk whereby the Mudarib may issue such Sukuk and float them in the market. When an investor purchase a certificate then a Mudarabah contract is formed in which the holder is Rub-al-mal and issuer is Mudarib. Terms and conditions including profit sharing ratio and terms are spelled out in the prospectus.

2- Issuing a Mudarabah Certificate:

A contract of Mudarabah can be formed between natural and or legal persons. Therefore, a company can issue Mudarabah certificates and become a party to a Mudarabah contract with who ever buys these Sukuk during the IPO or later as these certificates circulates in the market.

Let us assume we have company XYZ which need to be financed but doesn't want to borrow money neither from bank nor from the market (in the form of bonds or

conventional notes). Rather they want to do it Islamically and quazi-equity. XYZ can then issue these Mudarabah certificates. The following steps can be followed.

- a) A valuation of the company must be completed by an independent party. Let us assume that the value turned out to be SR. 100M and the company would like to issue Mudarabah certificates whose total nominal value is SR. 10M.
- b) A prospectus must be prepared in which all the terms and conditions are spelled out. Approval by purchaser and payment of the nominal value of the certificates means that a contract of Mudarabah has been effected. In the prospectus the following details must be included.
 - 1) Term of certificate (say 1 year).
 - 2) Ratio of Mudarabah profit sharing as a % of company income (say 80% to Rub-al-mal and 20% to Mudarib).
 - 3) Restrictions on the company Vs expense during the currency of the certificates.
 - 4) The non-voting status of the certificate holder.

3- Determination of profit:

If, based on the aforementioned valuation of the XYZ Company it turned out that the total Mudarabah capital equals 10% of that value. This means that the Mudarabah capital share of income of the company is 10%. If we assume that income from this company at the end of the year was SR. 2M (income here means revenue minus operating expenses). The share of the Mudarabah capital in the income of the XYZ Company is SR. 200,000. Now Mudarabah profit sharing will be applied to this amount. Hence SR. 160,000 will go to certificate holders and SR. 40,000 will go to XYZ Company. This means that:

- Mudarabah Sukuk holders will not participate in any expenses (such as salaries of employees or rent) that are not related to sales.
- Return to Mudarabah certificate holders is separate and independent from dividend to share holders.
- Mudarabah Certificate holders will get their share of profit prior to company share holders (They have seniority).
- Company debt payments, reserves and debt service will be paid by the company only from its share of profit (i.e. the SR. 40,000). Therefore, it is not unlikely that Mudarabah certificate holders will get profit while company share holders get little or no dividend.

4- The case of loss:

In Mudarabah loss means that the value of the Mudarabah assets at the end of the period are lower than when Mudarabah contract was initiated. Under this proposed structure the relevant source of profit for Mudarabah certificate holder is the income as defined earlier. Operationally loss can take place only when the XYZ Company fails to make any income, i.e. revenue minus operating expenses turns out to be a negative number. In this case Mudarabah certificate holders will bear pro-rata their share of loss. Let us assume that, based on the initial valuation, we decided that the share of Mudarabah capital is 10%. Then 10% of the difference between revenue and operating expenses will be deducted from the Mudarabah capital and the rest (which will be less than the nominal value of the certificate) will be paid back to Sukuk holders.

5- Liquidation:

Mudarabah certificate holders will receive back the normal value of their Sukuk at the end of the term alongside their share of profit. Their claim to their capital is as strong as that of the creditors of the company. Only in the case of loss

(item 4 above), they will receive less than that normal value (or nothing at all).

6- Negotiability:

Mudarabah certificates can be traded in the market. That market may clear a price for each certificate lower or higher than the nominal value of the certificates. Because assets backing the certificates are real goods and services it would be Shari'ah acceptable to sell or purchase the certificate before maturity.

7- Source of income for Bank:

Bank can be one or all of the following:

- Arranger.
- Custodian.
- Collection agent.
- Issuer for the benefit of a company.
- Distributor

In each of these functions a fee can be charged. Such fee must be fixed. Furthermore, an incentive in the form of percentage of profit may be added to the fixed fees. The bank however can't be:

- Underwriter or Guarantor.

8- Restrictions on the issuer:

The issuing company may not do any of the following during the currency of the Sukuk.

- Any alteration or amendment to Memo and Article of Association.
- Appointment (but no removal) of CEO or CFO.
- Change in share capital.
- Investment or participation in any company having separate legal entity.
- Consolidation, merger with another company.
- Material change in the scope or nature of the business.
- Conversion of the company to a new legal status (from joint to private)

- Declaration or payment of any dividend before allocating share of Sukuk holders.
- Material borrowing.
- Creation of mortgage, pledge or security interest that is detrimental to the rights of Sukuk holders.
- Giving of any guarantee.
- Appointment or removal of auditors.
- Appointment or removal of bankers.
- Change in accounting principles.
- Change in name of the company.
- Any step to wind up the company.