A COMPARATIVE STUDY OF ASSET BASED AND ASSET BACKED *SUKUK* FROM THE SHARIAH COMPLIANCE PERSPECTIVE

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ABSTRACT

The aim of this article is to compare between asset based and asset backed *sukuk* structures and their compliance to the shariah. The article has been intended to figure out the motives that asset based *sukuk* structure is the most dominant in the *sukuk* market in the face of the critics that have been elevated by many scholars since 2007. The two structures of Asset backed and Asset based *Sukuk* are compared in their technical and commercial features using literature-based methodology, which is a qualitative approach. It is highlighted that asset backed *sukuk* structure is more compliant to the Shariah compare to Asset based *Sukuk* in a form and substance. This article found that there are three reasons that could be explained why asset based *sukuk* structure is the most dominant in the market up to 2014, namely shariah, legal framework and market demand. The research is intended to figure out why these two structures are not in the same level of demand in market and to create civic awareness in the importance of compliancy to shariah in the form of substance. This research is expected to contribute to regulators such that they can amend some of their governing and regulatory frameworks and create a conducive environment for the *sukuk* market players to enhance asset backed *Sukuk*.

Keywords: Market demand, asset based, asset backed, *shariah*, regulatory framework *sukuk*

INTRODUCTION

Sukuk is plural of Sakk, legal instrument, is the Arabic name for financial certificates, but commonly referred to as "sharia compliant bonds, are one of the important instruments in Islamic capital and money markets. The Accounting and Audit Organization for Islamic Financial Institutions (AAOIFI) defines *sukuk* as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects. On the other hand, bond is defined as a pure debt security issued to finance any activities and whose price solely depends on the creditworthiness of its issuer (Godlewski et al., 2011). These definitions clearly differentiate *sukuk* from bond both in concept and structure. As a consequence, some scholars are in the opinion that it is rather inappropriate to call *sukuk* as an "Islamic bond". Although the *sukuk* term has been used since the classical period of Islam, the current form of *sukuk* has only taken the attention of the world since 2002. A report by Bloomberg mentions that during 2002-2007, the volume of global *sukuk* issuance increased from below USD5billion in 2002 to USD30.8 billion in 2007 (Sarea, 2012). This data clearly shows us that *sukuk* has become one of the areas in Islamic finance with spectacular growth for the last decade. However, the tremendous growth in the industry as it has been mentioned earlier had been disrupted in 2008 due to a statement released in November 2007 by Shaikh Muhammad Taqi Usmani, Chaiman of the AAOIFI shariah board, declaring that up to 85% of the *sukuk* issued up to then may not have been fully shariah compliant. As a result, the volume of business for *sukuk* fell from USD 30.8 billion in 2007 to USD 1.4 billion in 2008 (Sreih, 2011). The statement also prohibits the usage of some credit enhancements mechanisms in equity based *sukuk* due to their non-compliancy with Shariah. The above mentioned announcement has also generated a shariah compliance risk as one of the risks faced by *sukuk* holders (Hidayat & Abu Bakar, 2011). This type of risk is not clearly noted in the *sukuk* market within 2002-2007 periods. But, the following years (2008-2011) have witnessed the appearance of this risk in the market leaving us with some important notes to be understood. One of the notes is the issue of asset based and asset backed *sukuk*. Therefore, this study attempts to explore this issue in order to explain why the issue still remains hot in the market despite it has been raised since the early 2008. In other words, the objectives of this study include ,figuring out and analyzing the Shariah Compliance of asset based and asset backed *sukuk* structures from shariah perspective, exploring the reasons why asset based *Sukuk* structure became dominant in the market and to identify the relevancy of Asset backed *Sukuk* structures investment in the developing countries.

LITERATURE REVIEW

In the beginning of its appearance, *sukuk* was only categorized as "trade or asset based" and "equity or participation based". For example, Islamic financial services board (IFSB) guideline No 2 released in 2005 defines the former as a *sukuk* where the underlying assets offer fairly predictable returns to the sukūk holders, such as in the case of Salam, Istisna and Ijārah". The latter category is defined as *sukuk* where the returns are determined based on a profit and loss sharing in the underlying investment, which does not offer fairly predictable returns" (IFSB, 2005). Eventually, after some default cases in *sukuk* market in 2008 due to the global financial crisis, the issue of the ownership in the *sukuk* asset appeared, resulting in the popularity of categorizing the *sukuk* into asset based and asset backed structures (Abdullah, 2012). According to Securities Commission Malaysia (SCM), the classification of *sukuk* into asset based and asset backed is made based on the *sukuk's* technical and commercial features. In the first category, the underlying asset used to structure the issuance remains on the balance sheet of the originator after the issuance of the *sukuk*. In this category, the originator only passes beneficial ownership of the asset to *sukuk* holders, while still keeping its legal ownership. In other words, from the legal perspective there is no true sale in asset based structure since *sukuk* holders do not have any concern in the underlying asset. As a consequence, the *sukuk* holders cannot sell the asset to a third party. It also means the *sukuk* holders only have the recourse to the originator/obligor. On the other hand, asset backed *sukuk* can be defined as an Islamic security issued pursuant to a securitization transaction (SCM, 2009). Based on the above definition, it is clear that the securitization transaction is the most important feature of asset backed *sukuk* (Dusuki & Mokhtar, 2010). This transaction involves true sale and

Table 1:

Differences Between Asset Based and Asset Backed *Sukuk*

S/N	Categories	Asset Based	Asset Backed
1	Source of payment	The source of payment comes from originator/obligor's cash flows.	The source of payment comes from the revenue generated by underlying asset.
2	Presentation/disclosure of the asset	The asset stays on the balance sheet of originator/obligor.	The asset is separated from the originator's book.
3	Type of *Sukuk* holders' ownership	Beneficial ownership with no right to dispose the asset.	Legal ownership with right to dispose asset.
4	Recourse	Purchase undertaking at par from obligor is the ultimate recourse. The recourse is only to obligor and not the asset.	*Sukuk* holders only have recourse to asset thus asset plays genuine role in defaults.

the transfer of legal ownership of the asset from the originator to a third party, which is normally a Special Purpose Vehicle (SPV). The SPV is in turn an explicit trustee of the *sukuk* holders that receives fees as the issuer of the *sukuk*, while the *sukuk* holders are the legal part-owners of the underlying asset that receive a return on investment based on the performance of the underlying asset (Sreih, 2011). In other words, for the payment, the *sukuk* holders rely solely on the underlying asset since the asset is already separated from the originator's book and there will be no recourse to the originator. Some important notes for the underlying asset are that the asset must be acceptable according to shariah principles, able to generate cash flows and there must be no barrier that prevents the transfer of legal ownership of the asset from the originator to SPV (SCM, 2009). **Table 1** below summarizes the differences between asset based and asset backed *sukuk*.

METHODOLOGY

This article uses qualitative method research in order to compare the technical and commercial features between asset based and asset backed *sukuk* structures. The methodology reveals a range of experts' opinions in the field regarding the issue which is used to fulfill the objectives of the study.

DISCUSSION

Sukuk are Islamic certificates of investment. They signify co-ownership of productive resources, known as the "underlying assets." Because income to *sukuk* holders is generated by trading or real investment rather than mere lending, *sukuk* holders earn profit rather than interest. As co-owners of productive assets, *sukuk* holders face the risks of ownership. In particular, they face the risk that their assets may not generate profits or that may even incur losses. They also face the risk that the assets may be damaged or destroyed completely.

Risk taking is one of the requirements of earning lawful profits in Islam. Another requirement is to share profits and losses. For a person to claim a share of income generated by an investment he/she helps to finance, without taking responsibility for its outcome, is inconsistent with the ethos of Islam. Income needs to be earned, if not by effort, then at the very least by taking risk.

Typically, *sukuk* are categorized into "trade-based" and "participatory," depending on whether they are issued to finance trade or investment. As a result of some recent defaults of a number of *sukuk* and the near defaults of others, a new classification entered the *sukuk* discourse, that between "asset-backed" and "asset-based" *sukuk*.

Therefore comparing the structures and features of the asset based and asset backed *sukuk* Based on our analysis, we found that asset backed structure is more compliant to Shariah principles than asset based *sukuk*. The reason is that asset backed nature of Islamic financing and some shariah issues in the asset based structure (Abdullah, 2012). Dusuki (2009) highlights some of the shariah issues of asset based *sukuk*:

1. The contradiction between legal documentation and shariah requirement.
2. *Sukuk* holders do not have the rights to sell the underlying asset.
3. The usage of wa'ad (purchase undertaking) in equity based *sukuk* has made the *sukuk* in substance debt based instrument.
4. SPV's independency.

The contradiction between legal documentation and shariah requirement

From shariah perspective, the underlying asset belongs to the *sukuk* holders. However, there is no indication in the legal documents of asset based *sukuk* that the *sukuk* holders own the underlying asset. Thus, only beneficial ownership is transferred and the underlying asset is just used to facilitate the shariah requirement. In other words, there is no true sale transaction in asset based *sukuk*. The sale transaction in this structure is made just to comply with shariah in form but not in substance. While in fact, all financial instruments must fulfill formal and substantial compliance in order to be labeled as shariah compliant securities (Dusuki, 2010). In addition, the return that the *sukuk* holders obtain is also not linked with the asset used in the deal.

Sukuk holders do not have the rights to sell the underlying asset

As it has been discussed earlier that *sukuk* holders do not have interest in the underlying asset, thus they cannot sell the asset to third parties. The restriction has not only raised a question whether asset based *sukuk* structure truly comply with shariah principles but also somewhat against the fairness principle (A'dalah) especially in the case of default. Are *sukuk* holders' interests adequately taken care of given the fact that they don't have any legal ownership of the underlying assets?

The usage of wa'ad (purchase undertaking) in equity based sukuk has made the sukuk in substance debt based instrument

Unconditional purchase undertaking (wa'ad) at par acts as a guarantee of principal and return regardless of the performance of the venture. The purchase undertaking (waa'd) is an acceptable instrument when it is used on its own. But, when the wa'ad is combined with other credit enhancements, it changes a participatory contract in shariah (Musharakah and Mudarabah) into a resembled debt security. In other words, it creates indebtedness in trust contracts similar to conventional bond contract.

It also means that asset based *sukuk* in substance is the same as conventional bond. According to AAOIFI standard on *sukuk*, a prospectus to issue any certificates (not only those which are equity based) must not contain any clause that the issuer is obliged to compensate certificate holders up to the nominal value in situations other than torts and negligence, or that he guarantees a fixed percentage of profit (Ayub, 2007). Referring to the standard, it is clear that asset based *sukuk* structure has shariah issues.

SPV's independency

In asset based structure, *sukuk* holders through SPV have the recourse to originator/obligor in case the underlying asset does not provide enough cash flows. Thus, the SPV is credit-linked to the obligor. In this case, the rating bodies will not consider the SPV as an independent entity. According to many guidelines, a true sale requires the SPV to be an independent entity from originator. It again indicates that asset based structure does not fulfill the criteria of a true sale.

The above highlights also indicate that moving towards asset backed structure is highly recommended. In addition to better compliancy to shariah principles, asset backed *sukuk* structure also has many advantages to both originator and *sukuk* holders. Among them are (Khan, 2007; SCM, 2009) who highlighted the following:

A) For an originator: asset backed structure has created a new source of funding for a financial institution and other companies. Asset backed structure also reduces asset and liability mismatch since it monetizes previously illiquid assets. It also transfers the risks of the asset into third party since the asset is separated from the book of the originator.
B) For *sukuk* holders: Asset backed structure can be used by *sukuk* holders to diversify their investments, thus minimizing their investment risks. *Sukuk* holders are also free from the bankruptcy risk of the originator since they have a recourse only to the underlying asset not to the originator.

Surprisingly, despite the shariah issues in asset based *sukuk* and the additional advantages offered by asset backed *sukuk*, up to 2012, the asset based structure, is still the most common form of *sukuk* issued in the market. It is reported that currently around 90 percent of *sukuk* issuances are asset based (Pasha, 2012). Therefore, this study also attempts to find out some possible reasons that might explain why asset based is still preferable than asset backed *sukuk* based on literatures and industry experts' opinions. In general, the reasons can be classified into shariah, legal framework and market demand (SCM, 2009; Dusuki & Mokhtar, 2010; Abdullah, 2012; Pasha, 2012).

Shariah reasons: (a) Limited numbers of suitable asset classes. One of the requirements of asset backed *sukuk* is the availability of underlying assets for a true sale. As it has been mentioned earlier, the underlying assets must comply with shariah and some additional criteria in order to be qualified for a securitization transaction. For example, loans and receivables are obviously not the options since they must be traded at par. With lack of suitable asset classes that fulfill the criteria, obviously asset backed structure is not preferable. (b) Another shariah reason is the argument raised by some shariah scholars about the permissibility of beneficial ownership in Islam. This argument has been used by shariah scholars as the basis for asset based *sukuk* approval. In other words, shariah wise, there are still many proponents to asset based *sukuk* despite the critics and issues raised by the opponents.

Legal framework: Despite *sukuk* being viewed as shariah compliant instrument, in practice, the *sukuk* issuances are still governed mostly by common law (English law). As a consequence, *sukuk* issuance has to comply with accounting, tax and legal standards for a conventional bond (the closest conventional finance instrument to *sukuk* recognized by common law). Comparing the two *sukuk* structures, asset based *sukuk* is the most suitable structure for the issuance since it resembles the features of conventional bond. In addition, common law recognizes sales that fall short of true sales as valid sales (Abdullah, 2012). With asset based *sukuk* dominating the market no wonder that *sukuk* is also called "Islamic bond". In addition, it is also reported that in some jurisdictions, structuring asset backed *sukuk* is costly and time consuming (Pasha, 2012).

Market demand: (a) Asset backed *sukuk* structure is more complex as compared to asset based, thus potential investors seem to be unfamiliar with the structure. As a result, asset backed *sukuk* may be priced more expensive than asset based. (b) In addition, lack of trained and skilled personnel where not many can manage and analyze asset portfolios and structure of asset backed *sukuk*. *Sukuk* have made investors in the market looking for the *sukuk* that are structured as debt instruments. (c) Another argument is since many *sukuk* holders and potential *sukuk* investors are not shariah conscious, some of them are even non-Muslims, they are not concerned with the issue of shariah compliancy thus preferring asset based *sukuk* structure that guarantees their capital and income. (d) In addition, most *sukuk* issuers want to raise capital without having to legally sell their assets. In other words, the market prefers Islamic securities that fit the credit environment.

Based on the above explanations, it is clear that there is a dilemma between shariah concerns, legal framework and market demand surrounding the issue of asset based and asset backed *sukuk*. In one side, there are shariah issues in asset based *sukuk* as they have been raised by many scholars. However, the legal framework of the *sukuk* which is based on common law still suits asset based structure than asset backed structure. In addition, the market seems to prefer the asset based structure than asset backed structure. This dilemma also poses a question to all Islamic finance stakeholders: *"should shariah always be accommodative to all these issues in favor of legal framework and market demand?"* Since shariah gives rooms for different interpretations of its principles especially in the cases of transactions (muammalah), there are always ways to find legitimacy in form for something that seems wrong in substance.

Therefore, in order to solve this issue, it is important to refer it to one of the primary sources of knowledge in Islam which is the sayings (hadith) of the Prophet (p.b.u.h). In one of his sayings, the Prophet said: "All deeds depend on intention". Since the wisdom behind the establishment of Islamic finance is to dedicate all aspects of our lives to the teachings of Islam, all acts should be based on sincere intention (Hidayat, 2010). Therefore, it is very important for all Islamic finance stakeholders to purify their intentions thus any decisions made will reflect shariah principles both in form and substance. As a result, the welfare of the society (maslahatul ammah), other objectives of shariah (maqasid al-shariah) and most importantly the blessing of Allah will be achieved.

According to the Fatwa from (ISRA) The International Sariah Research Academy for Islamic Finance, dated on October, 2013 Edition stated that asset-backed *sukuk* are a type of asset/business venture that is fully shifted to the Special Purpose Vehicle (SPV) with elements of a true sale. The asset is the only object of recourse for the *sukuk*-holders. Thus, the impairment of the asset or non-performance thereof reflects directly in the value of the *sukuk* that the investors hold. According to the Islamic Financial Services Board (IFSB), in an asset-backed *sukuk*, the investors will bear any losses due to the impairment of the asset(s); likewise the *sukuk* investors have recourse to the asset(s) and not to the originator. Thus, in time of default, investors will not be able to recourse to the originator, but instead, they have to recourse directly to the asset; exposing them to losses if there is any impairment to the asset. In addition, asset-backed *sukuk* lead to full-transfer of the legal ownership of the underlying asset(s). To further comprehend on the issuance of asset-backed *sukuk*, the transaction steps are as delineated in the table below.

Table 2:

Descriptions of Asset Backed *Sukuk*

Steps	Description
1	The originator will sell the Sariah compliant assets to an SPV. In the ABS Guidelines 2004, it clearly states that any transfer of assets to an SPV in a securitization transaction (this includes Islamic financing receivables) must comply with the criteria of a true-sale.
2	The SPV then issues the asset-backed Sukuk to the investors. The money paid by the investors in subscribing to the asset-backed sukuk includes the proceeds of the issuance that will be used to pay the originator in return for the sale of the assets.
3	An asset-backed sukuk provides sukuk-holders with an undivided proportionate beneficial interest in the assets, thus permitting them to receive the streams of cash flow attached to the assets.

Source: Securities Commission

Compared to the Asset based *Sukuk*, also has been released fatwa by (ISRA) The International Sariah Research Academy for Islamic Finance, dated on October, 2013 Edition, the details of this fatwa focused on the Asset-based *sukuk* are a type of asset/business venture that involve full recourse to the originator or issuer, but not to the asset. There occurs no true sale of the underlying asset by the originator to the *sukuk* investor. Instead of the *sukuk* investor attaining real ownership of the asset, the *sukuk* investor will only attain beneficial ownership. The asset-based *sukuk* are structured mainly to replicate the conventional bonds. In addition, the dividends are calculated as a percentage of the total amount "invested" rather than as a percentage of total profits (similar to the way interest payments are determined as a percentage of the total amount of a given loan). Asset-based *sukuk* are also commonly referred to as "Islamic bonds" and from a legal perspective in term of taxation, asset-based *sukuk* are treated as bonds. According to IFSB, in an asset-based *sukuk*, the investors have to recourse either to the originator (via purchase undertaking) or the issuer (via guarantee). To further comprehend the method of issuing asset-based *sukuk*, the table below delineates the transaction steps for ijarah *sukuk* as an example.

CONCLUSION

The issue of asset based and asset backed *sukuk* has been one of the heated and debatable topics in Islamic finance industry since 2008. Since the issue has not been

Table 3:

Ijarah Asset-Based *Sukuk* Structure Transaction Steps

Steps	Transaction
1	The *sukuk* investors will pay *sukuk* proceeds to the Special Purpose Vehicle (SPV).
2	Upon receiving the proceeds, the SPV then issue the *sukuk* certificates to the *sukuk* Investors.
3	The SPV will then purchase an asset from the obligor/originator and obtains the ownership of the asset.
4	The SPV in its capacity as a lessor (act on behalf of investors) will lease through an ijarah agreement the same asset back to the obligor.
5	The obligor in its capacity as a lessee will pay rentals to the SPV of the asset.
6	The rentals will be distributed back to the *sukuk* holders.

Source: Al Maghlouth (2009)

resolved, this study attempts to comparatively analyze the two structures from shariah perspective based on available literatures. It is found that asset backed *sukuk* structure is more compliant to shariah both in form and substance than asset based structure. This study also identifies a dilemma between shariah concern, legal framework and market demand as a factor that leads to minimum application of asset backed *sukuk* structure in practice. Therefore, it is important to urge the legislators in countries where Islamic finance is operating to come out with legal framework that is suitable and preferable to issue asset backed *sukuk*. A practical solution is currently being developed by the Bahrain-based International Islamic Financial Market (IIFM). The institution is developing a template aimed to help *sukuk* issuers to overcome legal and operational difficulties in issuing asset-backed *sukuk* in their jurisdictions (Pasha, 2012). The template comes with a master agreement aimed to provide a standardized platform from which issuers could structure asset backed *sukuk* in line with their own jurisdictions and increase awareness about the product.

In addition to the above practical solution, it is also the time for all Islamic finance stakeholders to create more awareness to the market players that Islamic finance is not just about complying with shariah in form but also in substance. Only when compliancy with both is fulfilled, a financial instrument can be labeled as shariah compliant (Dusuki, 2010). Finally, it is only through compliancy with shariah both in form and substance, the welfare of the society (*maslahatul ammah*), other objectives of shariah (*maqasid al-shariah*) and most importantly the blessing of Allah will be achieved.

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