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Sukuk in Its Infancy: Misstep and Sequel

Islamic capital markets development began in earnest on the equity side in approximately 1999 with the implementation of the Dow Jones Islamic Market Indexes and on the finance side in approximately 2003 with the first large-scale sukuk issuances. Few areas of Islamic finance have grown as rapidly as the sukuk markets, although secondary market activity has been limited. The expressed desire of issuers and sponsors that sukuk be structured so as to draw investment from both Shari'ah-compliant and non-compliant conventional investors seems to have achieved fruition: witness the holdings of Western hedge funds, insurance companies and investment vehicles.

However, as in all developmental processes, there have been noticeable missteps. Structural issues with recent sukuk issuances were identified by Justice Muhammad Taqi Usmani, the Chairman of the AAOIFI Shari'ah Committee. He noted that sukuk, despite designations and approvals of Shari'ah compliance, have been endowed with the same economic and structural characteristics as conventional riba-based bonds. Specifically, and acknowledging authoritative sanctioning of degrees of permissible impurity during the early stages of development of the Islamic finance industry, he focused on the fact that these recent issuances: (a) do not confer true asset or enterprise ownership and are in fact mere conferrals of rights to returns; (b) involve interest-free loans from the manager to the sukuk holders in instances where actual profits are less than the prescribed rates of return on the sukuk (with the loans being repayable out of subsequent excess profits over those rates of return or from a decrease in the cost of asset repurchase at maturity of the sukuk); and (c) involve guarantees of return of principal to the sukuk holders. Each of the foregoing is violative of the Shari'ah. And each of the foregoing firmly inclines these issuances toward defining characteristics of bonds: (i) lack of asset or enterprise ownership; (ii) interest returns calculated as a percentage of capital rather than as a percentage of actual profits; and (iii) guarantees of return of principal.

Firm and directed guidance in respect of these missteps were the subject of a March (date of web posting) statement by the Shari'ah Committee of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). It noted that tradable sukuk must represent holder ownership, with all attendant rights and obligations, in real assets (tangible, usufructs or services) that may be possessed and disposed of under the Shari'ah, and that ownership transfer must be noted on the appropriate accounting records. Further, tradable sukuk may not represent revenue streams or debt (an exception is noted for certain incidental debt obligations relating to financial instruments complying with AAOIFI Shari'ah Standard (21)). Loans to sukuk holders to cover profit shortfalls, however repayable, were noted as impermissible, as were asset repurchases at nominal value (the appropriate repurchase amounts being stated relative to net asset value, market value, fair market value or an amount agreed at the time of repurchase, and noting an exception for leases ending in possession (ijara muntahiya bi't-tamlik), where the remaining lease payments could be used as the net asset value).

Despite its directness and clarity on some fundamental principles, the clarification does raise some new issues (consider, for example, those in respect of tax characterizations (asset sales that might accelerate transfer taxes) and collateral security and perfection requirements (e.g., frequently, in the face of massive administrative and tax burdens, technical requirements are postponed to post-sale dates). Of more immediate moment, in recent discussions practitioners in the Middle East and Europe have downplayed the import of the clarification. This observer believes that this clarification renders many recent transactions of limited, even negligible, precedential value and that it behooves all in the Islamic finance industry to begin anew in thinking about sukuk and about the conveyance of knowledge of the Shari'ah to practitioners within the industry. The industry has grown rapidly, encouraging opportunistic involvement and further opportunistic growth. Too often we witness mimicry of received rules (often imperfectly informed rules received from questionable sources or distorted by evolutionary application in disparate circumstances) without an understanding of the relevant fundamental principles and precepts of the Shari'ah. Innovative drive spawns the clever, but non-compliant, construct, even if to the admirable end of facilitating access to and integration with conventional markets. It seems that the AAOIFI sukuk clarification makes clear that the level of scrutiny will increase (see the penultimate paragraph of the clarification), and that growth at any cost and perversion of principle will be unacceptable, even if the pace of growth must be decelerated in order to ensure adherence to essential fundamentals.

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