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A Comparative Analysis between Asset Based and Asset Backed Sukuk: Which One is More Shariah Compliant?[1]

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Abstract

The purpose of this study is to conduct a comparative analysis between asset based and asset backed sukuk structures from shariah perspective. The study is also intended to find out the reasons why asset based sukuk structure is still dominant in the market despite the critics that have been raised by many scholars since 2008. The two structures are compared in their technical and commercial features using library/literatures based methodology, which is a qualitative approach. 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 found that there are three categories of reasons that can explain why asset based sukuk structure is still dominant in the market up to 2012 namely shariah, legal framework and market demand. The study is intended to increase public awareness in the importance of compliancy to shariah not only in the form but also in substance. This study is also expected to benefit regulators in the sense that they should amend some of their regulatory frameworks to push the sukuk market players to move towards asset backed structure.

Keywords: Sukuk, Asset Based, Asset Backed, Shariah, Legal Framework and Market Demand

1. Introduction

Sukuk (plural of sakk) are one of the important instruments in Islamic capital and money markets. Bahrain based AAOIFI (2007) 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). The above definitions clearly differentiate sukuk from bond both in concept and structure. As a consequence, some scholars are in the opinion that it is rather

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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 taken the attention of the world only since 2002. A report by Bloomberg mentions that during 2002-2007, the volume of global sukuk issuance increased from below USD5billion in 2002 to USD30.8billion in 2007[i]. 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 30.8billion in 2007 to USD 1.4billion in 2008 (DiVanna and Sreih, 2009). 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 resulted in the appearance of shariah compliance risk as one of the risks faced by sukuk holders (Hidayat and Abubakar, 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 using library/literature based methodology 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 are:

1. To comparatively analyze asset based and asset backed sukuk structures from shariah perspective.
2. To identify the reasons why asset based sukuk structure is still dominant in the market despite the critics that have been raised by many scholars since 2008.

The study is divided into four sections. Section 1 comes out with the background of the study along with the objectives of the study. Section 2 explains in details the differences between asset based and asset backed sukuk. Section 3 comes out with findings. Section 4 concludes the study and comes out with some recommendations for an improvement.

2. Literature Review on Asset Based and Asset Backed Sukuk

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 letter category is defined as sukuk where the returns are determined 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[ii]. 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 keeps its legal ownership. In other words, from legal perspective there is no true sale in asset based structure since sukuk holders do not have 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 and Mokhtar, 2010). This transaction involves true sale and 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 (DiVanna and Sreih, 2009). 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 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.

Table 1. Differences between Asset Based and Asset Backed Sukuk

Categories	Asset Based	Asset Backed
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.
Presentation/disclosure of the asset	The asset stays on the balance sheet of originator/obligor.	The asset is separated from the originator's book.
Type of Sukuk holders' Ownership	Beneficial ownership with no right to dispose the asset.	Legal ownership with right to dispose of asset.
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.

3. Methodology

This paper uses library/literatures based research methodology 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. Library/literatures based research methodology is a kind of qualitative research approach.

4. Discussion

Comparing the features of both structures, it is found that asset backed structure is more compliant to shariah principles than asset based sukuk. This is due to the 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[iii]:

1. The contradiction between legal documentation and shariah requirement.
2. Sukuk holders do not have right 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

For point no 1, 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.

For point 2, 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 complies with shariah principles or not but also somewhat against the fairness principle (A'dalah) especially in the case of default. Are sukuk holders' interests adequately taken care given the fact that they don't have legal ownership of the underlying assets?

For point 3, 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 by 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.

For point no 4, 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):

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 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[iv]. 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[v]. In general, the reasons can be classified into shariah, legal framework and market demand (SCM, 2009; Dusuki and Mokhtar, 2010; Abdullah, 2012; Pasha, 2012).

1. 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 mentioned earlier, the underlying assets must comply with shariah[vi] and some additional criteria in order to be qualified for a securitization transaction. For examples, 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.

2. 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 dominates 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).

3. 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 back 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 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 even are non Muslims[vii], they are not concern so much 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, market prefers Islamic securities that fit the credit environment.

Based on the above explanations, it is clear that there is a dilemma between shariah concern, legal framework and market demand surrounding the issue of asset based Vs 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 is still more suitable to the asset based structure than asset backed structure. In addition, the market seems still 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 differe-nt interpretations of its principles especially in the cases of transactions (muammalah), there are always ways to find legitimacy in form for what something 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, god's willing (inshaallah), the welfare of the society (maslahatul ammah), other objectives of shariah (maqasid al-shariah) and most importantly the blessing of Allah will be achieved.

5. Conclusion, Recommendation and Suggestions

The issue of asset based Vs asset backed sukuk has been one of the hot and debatable topics in Islamic finance industry since 2008. Since the issue has not been resolved yet, 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 standardised 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 inshaallah be achieved.

List Of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial
IIFM	International Islamic Financial Market
SCM	Securities Commission Malaysia
SPV	Special Purpose Vehicle

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End Notes

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i It is quoted from slides presentation of Arul Kandasany, head of Islamic financing solutions, Barclays Capital as it is available on www.aba.org.tw/images/retrieved on 28/10/2012

[ii] SC Malaysia (2009), The Islamic Securities (Sukuk) Market, p.48, LexusNexis, KL.

[iii] He raised the issues in his speech at AAOIFI-World Bank annual conference on Islamic banking and finance in Manama, in December 2009.

[iv] Dr Bashir Al-Amine mentioned it at his presentation at BIBF research workshop on Monday 22/10/2012 at Crowne Plaza Hotel, Bahrain.

[v] The author has conducted extensive readings in the issue and also attended several seminars, workshops and conferences discussing the same issue since 2008.

[vi] The assets must be compliant with shariah both in their nature and usage.

[vii] It refers to both individual and institutional non Muslim investors.