

Sukuk: Shariah-Western law matrix

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INVESTORS EXPECT TWO basic qualities in *Sukuk*. First, *Shariah* compliance. Second, efficient enforcement. The deal structure must show a market acceptable Shariah-Western law matrix.

Sukuk are akin to, but not identical with, Asset-based Securities. Conceptually, whereas ABS have a security interest in the underlying assets, *Sukuk*, are an undivided pro rata share in ownership interest. This asset-connectivity serves *Shariah* compliance and makes *Sukuk* a cousin of collective investment scheme units.

Sukuk are the fastest growing Islamic asset class, transaction size varying from the equivalent of US\$30 million to US\$3 billion each. Oil price-led increased liquidity and opportunities to recycle funds originating from the Gulf Co-operation Council (GCC) within the GCC region. I believe this would not have been possible without the pioneering work of the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), Prof Rifaat's¹ inspired leadership, alongside the patronage and encouragement given by the Bahrain Monetary Agency, Bank Negara Malaysia, Islamic Development Bank (IDB), Asian Development Bank, Dubai Financial Services Authority and other committed central banks, *Shariah* scholars bankers and lawyers.

Sovereign *sukuk*-type papers have been issued by Turkey, Iran, Sudan and Pakistan since the 1980s for financing infrastructure and energy projects, without adding to taxation, budgetary burden or increased domestic or foreign debt.

However, it is Malaysia and Bahrain followed by Qatar, the United Arab Emirates and Saudi Arabia which launched *sukuk* as cross-border listed and traded instruments attractive to the enlarging universe of global investors in Islamic products.

Four recent qualitative developments deserve mention:

1. World Bank and International Finance Corporation (IFC) issues, establishing *Sukuk*'s international acceptance, e.g. 2004, RM500 million IFC and 2005 World Bank RM60 million issues. *sukuk* formation expenses deductibility and their tax neutrality are strong incentives for future *sukuk* issues in Malaysia.
2. Islamic banks' initiatives to replicate the US banks and finance houses established practice of raising finance. Selling their 50% risk weighting conforming mortgage portfolio to US government agencies, e.g. Gennie Mae and Fannie Mae, then repurchasing them after the agency's added wrapper. This reduces risk weighting to 20% and greatly increases the papers' marketability.
3. The new use of sovereign or central bank related *sukuk* as a central bank monetary policy tool and that of Islamic banks' liquidity and asset-liability management, e.g. the February 2006, the Pakistan government-guaranteed WAPDA Rs 8 billion issue eligible for banks' statutory liquidity requirements.
4. The internationally accepted benchmark (instead of LIBOR), e.g. the March 2006 Dow Jones Citigroup *Sukuk* Index tracking seven *sukuk* issues, namely the Islamic Development Bank, Solidarity Trust Services Ltd, Qatar Global *Sukuk*, BMA International *Sukuk*, Malaysia Global *Sukuk*, Sarawak *Sukuk* and Dubai Global *Sukuk*. For new issues inclusion, the minimum criteria are amount: US\$250 million; maturity: 1 year and rating: BBB equivalent.

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SHARIAH ELEMENTS

The *Shariah* is not a code. It is a set of principles adduced and developed, on well-defined axioms and bases, from two primary sources: the holy *Quran* and the *Sunnah*. *Fiqh* is to *Shariah*, what Jurisprudence is to law. *Fiqh ul muamlath* (law of commercial transactions) principles have been researched to extract modern Islamic finance techniques, e.g. *Murabaha*, *Mudaraba*, *Ijarah* and *Musharika*. *Shariah* board approval depends, amongst others, on the answers to two basic questions on the referred facts and circumstances of the particular deal:

1. What is the most appropriate applicable interpretation (literal, alluded, inferred or liberal) of the *Quranic* verse or the *Sunnah*?, and
2. What is the most appropriate applicable doctrine, e.g. *Qias*, *Istehsan*, *Istislah*, *Masalah Mursalaha*, and rule, e.g. *Istishab*, *urf* and *Al baraha wal aslah*?

Thus, *Shariah* application is a dynamic process of *Ijtihad* (intellectual rigour within prescribed limits) to find solutions to new situations. This can result in varying answers in different time-space realities. For instance, 20 years ago I had great difficulty in persuading a *Shariah* scholar that financing to a legal entity was permissible under the *Shariah*. Now scholars approve stock exchange listed funds. Similarly, it was improbable, even 5 years ago, to approve future flows of income from a building not even finally planned, let alone constructed, as being *Shariah* compliant; or that time-shares were *Shariah* compliant.

Yet again, the different approaches of the four *Sunni fiqh* schools – *Hanbali*, *Hanafi*, *Shafie* and *Maliki* may offer different answers.

The dynamism inherent in *Ijtihad*, vests broad discretion in *Shariah* scholars, and more so with *Shariah* court judges. However, this dynamism can be seen negatively as uncertainty in the *Shariah*, i.e. a *fatwa* of a *Shariah* board approving a certain structure may be, but is not necessarily binding, on another board, and indeed on the same board in a next referral. Most importantly, it does not bind the *Shariah* judge before whom a potential dispute may have to be decided. The *Beximco* and *Symphony* cases of the English Court of Appeal have been much commented upon. A further complexity arises in the trust laws and structures. In the GCC region, the commercial dispute codes and rules are influenced by the French-Swiss civil law

which first entered Syria and Egypt. These do not, for example, recognise the division of ownership into legal (e.g. of the trustee) and beneficial (e.g. of the *sukuk* holder) as in the English or New York law.

It is necessary, but insufficient, in the *sukuk* documentation, to only specify that the law applicable to *sukuk* documentation is English or New York law and their respective courts. For example, where, say, (a) some parties to the *Sukuk* are in Malaysia, GCC countries, Europe and USA, and (b) the underlying assets of the *sukuk* are, say, in the Kingdom of Saudi Arabia, then counsel's opinion should, without unduly broad qualifications, stipulate that any judgment or arbitral award by the English or New York forum, would be enforced by the courts of *both* (a) & (b). This becomes problematic due to the mutual reciprocity principle, because, their own laws may bind the English and New York courts, precluding enforcement of certain foreign judgments.

WESTERN LAW ELEMENTS

The crafting and function of the western law arm of the *sukuk* legal matrix is very similar to a typical western securitisation, i.e. to transform the income generating illiquid loan assets into liquid capital market instruments. In the basic structure identified assets are transferred from the originator to a limited purpose SPV which issues the *sukuk*, subscribed and paid by the investors, and the proceeds are passed on to the originator. The *sukuk* are discharged by the income from the underlying assets of the *sukuk*. This enables the originator to improve balance sheet ratios, upgrade *sukuk* ratings by credit enhancement and access capital markets as an additional and lower-cost funding source. A bank originator can also release regulatory capital for further financing. In real life, the structures are more complicated to reduce tax and ensure insolvency protection within the applicable legal and regulatory regimes. There may be both onshore and offshore special purpose vehicles (SPVs), trusts where trustees hold the assets to ensure bankruptcy remoteness. The documentation may include common terms and inter-creditor arrangement agreements, particularly where separate Islamic and conventional streams of financing cascade into the same vessel.

I will enumerate a few major elements of legal due diligence. These elements will involve creating factual documentary and conduct evidence of parties and the applicable legal bases for:

1. Valid, binding and enforceable authorisations, consents and filings. 'True Sale' or sale/transfer of assets are perfected or perfectible at the issuer's option according to all applicable laws and procedures;
2. Inability of the originator or their liquidator or insolvency officer to successfully contest the transfer of assets to the issuer;
3. Reasoned grounds and evidence for protection against substantive consolidation, questionable preferences, transfers at under value, set off rights, recharacterisation of the sale as a loan and a fixed charge as a floating charge, fraudulent transfers, recognition of the 'water fall' priority of senior over junior tranches and avoidance of floating charges;
4. Bankruptcy remoteness, i.e. *de minimis* potential of voluntary (through 'golden shares' or 'independent' directors) or compulsory insolvency petitions for the SPV;
5. All tax obligations are predictable and no withholding or other taxes and duties are payable by the SPV. Foreign exchange availability by ring-fencing overseas foreign exchange balances and assets; and
6. Not only legality, but also the willingness of all parties to perform their commitments. The importance of the project to the national economy – its linkage to international institutions for further financing – adds to the willingness of a sovereign originator.

All men are created equal, but some are more equal than others. All Counsel's opinions have qualifications, but *sukuk*-related opinions have more and broader qualifications. The opinions on raptors in the Enron saga have heightened onerous tests. Clients must accept that a lawyer gives an opinion and,

though liable for negligence, is not an insurer. In my view, a counsel should not demand of another counsel an opinion in such strong terms that, if the situation were reversed, he himself would be unable to give it. Sometimes counsels of rating agencies, for their own valid reasons, require a clearer opinion.

Ratings by Moodys, Standard & Poor's and Fitch do not comment on the Shariah arm of the matrix – it is neither their role nor function nor indeed capability. Their only concern is the extent to which dependence on the *Shariah* would compromise full and timely payment of the returns and the principal amount of the *sukuk*.

For the sake of completeness, I should add that, due to the less developed legal, regulatory and managerial infrastructure and the nascent state of the securitisation market in the GCC region, the agencies-rated *sukuk* have direct or indirect repurchase or guaranteed obligations (e.g. sale-leaseback-repurchase or head lease-sublease, portfolio based or *Musharika*-based, and whether sovereign or corporate or the IDB). It has been commented that the *sukuk* investor really looks to the repurchase or guarantee obligations with the reference to asset only an ornamental adornment for *Shariah* compliance. I do not agree with this. However, we should recognise that thus far, Islamic *sukuk* are different from the non-recourse, only asset secured obligations in the matured markets of conventional Residential or Commercial Mortgage-back Securities (RMBS/CMBS). There, the originator's credit rating is truly substituted by the transferred assets' credit rating **BJM**

Editor's Note:

This article is abstracted from the Chairman's address at the 2nd IFSB Seminar on Legal Issues in Islamic Financial Services Industry, London, March 2006.

