



HARVARD-LSE WORKSHOP:  
LONDON SCHOOL OF ECONOMICS, LONDON, UK - FEBRUARY 7, 2008

## SUKUK: ECONOMIC AND JURISPRUDENTIAL PERSPECTIVE: A SHORT REPORT

### Purpose of the Workshop

As a follow-up to the workshop on *tawarruq* held on February 1, 2007 on the London School of Economics campus, the Islamic Finance Project (IFP), a project under the auspices of the Islamic Legal Studies Program at Harvard Law School, and the London School of Economics (LSE) decided to work together again to gather a group of influential Islamic legal scholars, economists and bankers for a workshop on *sukuk*, instruments that have attained considerable prominence in Islamic finance. The goal of the workshop is to conduct an in-depth examination of *sukuk*, while furthering the conversation between *fuqaha* and economists begun in earlier IFP workshops.

### Overview

*Sukuk* are generally structured as debt instruments approved by most *shari'a* scholars, but as their general popularity has increased, so has criticism of them. Although various definitions of *sukuk* have been offered in Islamic finance literature and various forms have been used in practice, generally they are instruments used in Islamic finance to tap capital markets. Critics have questioned whether the manner in which these instruments are used lives up to the ideals envisaged by *shari'a*. The criticism has come from two fronts. Economists, who have objected to such instruments being debt based and certain scholars who have voiced criticism of some interpretations of certain jurisprudential concepts employed in structuring the recent wave of *sukuks*.

Through this workshop, it is hoped that a better understanding of *sukuk* in theory and in practice and of their advisability will be achieved while at the same time enhancing the dialogue between the various experts in the field of Islamic finance.

### Workshop Objectives

1. To understand the purpose and application of *sukuk*
  - \* To gain a better understanding of how *sukuk* are theoretically understood, conceptually structured, and practically applied in the market
  - \* How they have or have not met Islamic finance ideals
2. To identify the issues and areas of concern, theoretical and practical, that arise regarding *sukuk*
  - \* Macroeconomic factors of concern
  - \* Jurisprudential factors of concern
3. Critically evaluate *sukuk's* performance visàvis:
  - \* current practice
  - \* intended practice
  - \* future practice
4. To consider any suggested theoretical solutions to the issues and concerns raised, including any alternatives to *sukuk* as now practiced

5. To further the conversation among the various parties present by enhancing mutual understanding and links between their methodologies and approaches. Explicit attention will be given to this aspect throughout the more concrete discussions of *sukuk*

6. To make specific proposals of channels and venues through which to continue this conversation, including workshops on the development of other future products

### Guiding Questions

In advance of the workshop, participants were requested to submit their responses to the below guiding questions, with the intention of enabling a focused discussion on the issues and a prior understanding of the opinions surrounding the workshop topic.

#### **Key discussion points on *sukuk*:**

1. *Sukuks* are and will have to be structured like debt.
2. *Sukuk* behave like debt today but should be structured to behave as equity.
3. *Sukuks* should conform to the principles of Islamic law. The market should determine the question of their behavior.

#### **Macroeconomic concerns regarding *sukuk*:**

1. Why the preference of Equity versus Debt for *sukuks* and is there a preference in Islam for equity vs. debt instruments; why?
2. What are the economic results/effects of *sukuks*?
3. What are the substitutes for *sukuk*, if any?

#### **Structural concerns regarding *sukuk*:**

1. *Sukuk* ownership / asset title transfer
2. Purchase undertakings to repurchase *sukuk*
3. Principal repayment guarantees
4. Fixed periodic payments : LIBOR alternatives
5. Market value versus fixed price value
6. Ratings alternatives

### Summary

Following on from last year's well-received and inaugural workshop, the London School of Economics (LSE) once again hosted an all-day, closed-door workshop focused on *sukuk* – in conjunction with Harvard Islamic Finance Project (IFP) = held in the Box Room of the LSE London campus. The workshop was well attended, with leading economists, practitioners, and *shari`a* experts actively participating in the vibrant workshop discussion.

The event began with a warm welcome by the LSE Director, Sir Howard Davies on behalf of the LSE and by Professor Baber Johansen on behalf of the Harvard Law School.

#### **Introduction**

Professor Frank E. Vogel, in his capacity as moderator, introduced the workshop and highlighted overarching contemporary issues facing the industry which the workshop discussion would inevitably touch – such as the reconciling of an Islamic finance profit-making industry with the Islam-inspired social goals imperatives, and the institutional framework and levels of cross policymaker interaction and collaboration for deciding the permissibility and acceptance of industry products.

Mansoor Shakil began by presenting a summary of current practices and issues surrounding *sukuk* by synthesizing submitted participant comments. Participant views presented at the outset a healthy divergence and spread of concerns - from the immoral and inefficient nature of a risk-less wealth creation product and the inherent equitable risk-return nature of Islamic financial transactions with their linkage to real assets - which is seen to be steadily diluting with the current developments in the *sukuk* market - to the need to first contain the *mafasid* in *sukuk* and gain overall Islamic finance market share before implementing changes that would otherwise disturb the current takeup of Islamic financial products. Views also expressed the lack of evidence for the desirability and requirement of the inter-linkage between the real and monetary sector from the *shari`a* point of view, to the position and role of debt in Islam. Given the legitimacy of an Islamic debt market, there is a need to match the risk-return profile of the average consumer, who would progress to return-maximizing equity-finance products with their inherent risk structure, only

with surplus cash beyond their short-to-medium requirements. In summarizing the spectrum of issues raised by participants, a common theme was the fundamental need to balance legal form and substance, with the fact that *ijtihad* cannot be exercised in the presence of an explicit text injunction – requiring a reconciliation of the essence but not at the cost of the form. Given the consensus goal of a just, equitable and efficient Islamic economy, there remains a divergence on the correct path to take and the overall place of the Islamic financial system in such an economic system.

Every *sukuk* is issued with an underlying contract (e.g. *mudaraba*, *murabaha*, *ijara*), and should behave with the same characteristics as the underlying contract. The workshop scholarly discussion focused on the breakaways from this fundamental tenant, firstly touching on the macroeconomic issues raised surrounding *sukuk*.

### **The role of debt**

Participants agreed that *shari'a* provides alternatives to conventional loan products in the forms of participatory finance and sale-based financing. However, there is a clear demarcation between the Islamic and conventional debt structures, which need to be adhered to. Islamic debt is unlike conventional in that it cannot be resold and cannot be discounted. The emphasis on the ills of debt – *mafasid* – has arisen primarily from the market for trading debt, which can give rise to the value of claims being greater than the actual value of the underlying physical asset. What debt is sold against is a key feature of the differentiation between Islamic and conventional debt – as Islamic debt is asset-backed and not money-for-money trades.

The participants discussed the characteristics of debt in the Islamic system as being fundamentally different – such as the leniency factored on the performance of obligation and the prohibition on occurrence of *riba* in the debt transaction – which make for debt more as an assistance product for the “needy”. Debt as an income-generating instrument to provide returns for investors, blurs this original characteristic of debt within Islamic principles. Equity-based *sukuks* such as *sukuk al-mudaraba* and *sukuk al-musharaka* are further effected in this blurring of roles and are expected to hold the debt characteristics and manner of their conventional ilk, despite the underlying contract being an equity-financing agreement.

Participants acknowledged the wider remit of “debt” in Islam. Debt in principle can form a tool in alleviating hardship with loan contracts (*qard*). However the underlying issue surrounding debt in Islam stems from how it was created and subsequently how it will be treated – highlighted in the difference between a loan (*qard*) and its subsequent debt formation (*dayn*). Every loan (*qard*) will become a debt (*dayn*). However, not every debt was the result of a loan contract – with possible originations from an underlying share contract (*musharaha*) or a lease contract (*ijara*). This debt obligation will be considered as a *dayn*. How debt is generated and treated (trading, sale and exchange with commodities) should be the crux of the debate.

Given the overarching Islamic principles and ethos the Islamic financial industry has to abide and reside within, the ethics and morality of debt has to be considered. Inherently there is nothing wrong with debt per se, however it can be abused. The workshop touched on the concept of debt discouragement – which has ramifications for an Islamic economic ideal of a profit-and-loss sharing system. Participants were referred to an example by way of an *hadith* (narration) which highlighted the fact that members of the household of the Prophet (pbuh) would seek to take on debt without the necessity for it, but only for the purposes of gaining the *hasanaat* (good deed) of repaying the debt. The *sukuk* structures, which bring about debt, such as *istisna'* and *murabaha* contracts, and emulate advanced payments and deferred payments similar to conventional characteristics, should not summarily be dismissed without due consideration. The ability to optimize the sources of capital should still be available in Islamic structuring. *Sukuk* are essentially a granular form of giving investors the risk related to ownership of assets. As long as investors are taking risk, there is nothing wrong with mitigating risk. Participants noted that it shouldn't be the case that the structure is not “pure” enough because it is not risky enough.

### **Dichotomy between the real and financial economy**

The discussion proceeded to address the underlying nature of the Islamic economic system – the role and relationship the financial economy plays in the real economy, and why debt was created in the first place, and the difference between an interest based loan and the purchase of a good at a higher price.

Participants noted that *sukuk* has the potential to be deemed as the first instrument to break the real-financial economy linkage, disengaging from the underlying transaction with the possibility of a “pyramid of claims” upon an underlying receivables asset whose value has diminished over time – a *sukuk* on *sukuks* - leading to a conventional derivatives market scenario.

The disengagement of transactions from their underlying originating asset is highlighted as the fundamen-

tal economic problem concerning *riba* – the immoral and inefficient justification of a lender claiming a guaranteed stake in newly created wealth beyond the capital lent.

Participants acknowledged that *sukuk* expose certificate holders to ownership risk, and the existence of purchase undertakings does not fully remove this risk susceptibility. *Sukuk* are based on their underlying contract, with the *shari'a* providing a balance between equity (*mudaraba*, *musharaka*) and sale (*murabaha*, *istisna'a*, *salam*) contracts which lead to debt, which is both needed and required. The participants acknowledged the permissibility of debt-financing, and the need to focus the discussion on its tradability. The “pyramid of claims” is a viable threat to delinking the real and financial economy through a *sukuk* fund setup – with *sukuks* of less than 100% tangibility - which would create a situation with a variable value base of the underlying asset to the claims generated on it.

### **The role of economists in Islamic finance**

Islamic economic thought at the macro level has not kept up with the rapid micro-level product development of the Islamic finance industry. There is a need to re-energize the field and thought-contributions, and bring harmony and collaboration with the product level development – an example being the impact of Islamic contracts on business cycles – which the *sukuk* structures presently in market do not seem to mitigate. Reaching par with conventional product characteristics is foreseen to lead to par economic results.

There is then a missing link between translating divine guidance into economic guidelines, and economic guidelines into specific Islamic finance rules and practices. Guidelines can be gleaned, however they are not enforceable as rulings. The participants acknowledged the role of economists in partaking in the analysis and development of products beyond the legalistic analysis of the scholars, with the example of the insight that contract monitoring costs play a crucial role in deciding between investor financing structures – with debt products suited to high monitoring costs in contracts and equity contracts viable in low monitoring cost environments. Contracts underlying transactions need to be *shari'a*-compliant, legally enforceable and importantly, commercially viable. *Shari'a* structuring, credit rating and legal documentation should support bankers and economists in initiating commercially viable concepts, as well as developing and improving the current suite. However, there is a need for political will to oversee an embracing and enabling regulatory framework.

The participants noted that there has been a lack of study on *maqasid* - perhaps given the relatively young timeframe of industry development. The focus on product development has primarily been focused on the legalistic form by the scholars. What is needed is the movement to including “*maqasid* standards” where economists would lead the holistic study and review of industry products and their wider effects. Participants acknowledged the goal is to develop the *maqasid* of products, but given the limited Islamic market capture which would limit their implementation due to market forces, the focus should be on curtailing the *mafasid* of products, engaging in responsible marketing of debt-based products for example. A limiting factor which needs to be addressed to enable the shift to adopting the underlying *maqasid* of products are a lack of educational institutions to provide the depth to the study of *maqasid* which would enable economists to understand the merits of products in light of Islamic injunctions, and whether permissible contracts are economically viable in the long run, and evaluating the balance between the *maslaha* and *mafsada* of a treatise. There is a lack of *maqasid* training on the part of contemporary Islamic economists, who imbue socialist tendencies, and hence a requirement of a hybrid of skills to guide micro-level developments, which are gleaned from the macroeconomic rulings provided in the *quran*.

Professor William Blair of LSE's Law Department provided comments summarizing the direction of the discussions so far with additional insights, highlighting the recent “credit crunch” being the result of the delinkage from the real economy and the learnings the group could solicit from this phenomenon, with risk only able to be passed on and not removed; the standardization of products and the self-regulation of the industry to interlock perspectives and standards; and the convergence trend with the overall international financial industry – spanning from transactional, structural and regulatory convergence.

### **Structural concerns regarding *sukuk***

The participants then directed the discussions to the structural concerns regarding *sukuk* which are deemed in conflict with the underlying contracts which form their basis; in particular, the purchase undertaking, the periodic returns, and the ownership rights.

Regarding the first issue of purchase undertakings prominent in *sukuk* contracts, participants discussed the presence of meaningful ownership risk inherent in such contract - the meaningful ownership risk of the destruction of assets, and in the change in the value of the underlying. The contract structure as a *sharikah al-milk* (co-ownership), which allows purchase undertaking, and *sharikah al-'aqd* (partnership) was then discussed and its validity as a meaningful distinction. The discussion also included the prohibition of a capital guarantee by an *ameen*, who is not

put into that obligation. The participants also discussed the structural characteristic of the *sukuk* enabling purchase at face value, noting there is no dispute if conducted at market value; its permissibility as a necessity and whether there are any alternatives, given transactions will otherwise not be dynamic or face regulatory or ratings agency issues without it.

The participants proceeded to address the second issue of periodic returns, and whether there is a requirement under *shari'a* to compare the *sukuks* performance with market peers rather than with a benchmark like LIBOR, while considering incentive structures for the investment agent (*mudarib*), and the treatment of the reserves as a *qard hasan* as an enabler of a liquidity facility.

The discussion proceeded to address the third issue of ownership rights in contemporary *sukuks*, in particular the divergence between the *shari'a* treatment and tax treatment, as well as the civil law jurisdictions not recognizing beneficial ownership.

### Workshop End

Participants acknowledged the unique contribution of the Harvard-LSE IFP Workshop in enabling an open debate on contemporary issues in the Islamic finance industry, with the aim of providing greater analysis and research into the subjects discussed. The participants looked forward to an invitation to a similar annual Workshop setting and agreed upon a spectrum of topics to be discussed. The Harvard IFP is also in the process of creating an academic journal of Islamic *fiqh* issues in Islamic finance, with a view to publishing thought research pertinent to the legal aspects of the industry – and an update of the program was provided by Dr Nazim Ali.

### In Attendance

Usman Ahmed, CEO, Citi Islamic Investment Bank, Dubai, United Arab Emirates  
Daud Bakr, Shari'a Supervisor, Kuala Lumpur, Malaysia  
AbdulKadir Barkatulla, Shari'a Supervisor; London, United Kingdom  
William Blair, Professor of Law, London School of Economics, United Kingdom  
Humayon Dar, Chief Executive Officer, BMB Islamic UK Limited, London, United Kingdom  
Majid Dawood, Chief Executive Officer, Yassar Limited, Dubai, United Arab Emirates  
Husam El-Khatib, DentonWildeSapte LLP, London, United Kingdom  
Michael Gassner, Division Head, Islamic Banking Group, Bank AlJazira, Jeddah, Saudi Arabia  
Hussain Hamed Hassan, Shari'a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates  
Hussein A. Hassan, Vice President, Deutsche Bank AG; Dubai, United Arab Emirates  
Esam M. Ishaq, Shari'a Supervisor; Manama, Kingdom of Bahrain  
Baber Johansen, Director, Islamic Legal Studies Prog. & Affiliated Professor, Harvard Law Sch.  
Mohamad Akram Laldin, Associate Dean, International Islamic University Malaysia  
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