

**Examination of the AAOIFI pronouncement on Sukuk issuance and its implication on the future Sukuk structure in the Islamic Capital Market**

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**Abstract**

The Shariah compliant bond defined as “*sukuk*” has become one of the most dynamic tools for capital mobilization in both the Islamic and conventional capital markets. Its’ rapid growth and development has proved it to be a viable tool for raising capital in the international capital markets through Islamically acceptable structures. By the end of 2007 the total issues value was estimated at US\$35 billion. However, the recent AAOIFI pronouncement on sukuk has created some fear among the investment sectors as well as the sukuk industry. The AAOIFI preannouncement? has resulted with the existence of additional standards that have to be observed by the issuers in order to comply with the Shariah rules and regulations. This has somehow slowed down the growth of the instrument in the first quarter of this year. Although the pronouncement has some impacts and implications on the sukuk industry, there is still an optimism of things getting better as it moved further. According to some of the statistics, sukuk issuance in the GCC region has increased by 17% last year to US\$17 billion, which is 30% more than conventional paper debt. In this context the paper is trying to examine the AAOIFI pronouncement on the shariah compliance issues of sukuk structuring, its impacts and implications on the future issues.

**Key terms:**

Sukuk, primary market, secondary market, investment, AAOIFI shariah standards.

## **1 Definition of Sukuk (Islamic Bond)**

“Sukuk” or “صكوك”, is the plural of “sakk” or “صك”, which means to strike or to hit, the meaning is related to striking one’s seal on a document . It is translated literally as a ‘written document’. The term “Sukuk” is now used for financial certificates that can be seen as an Islamic equivalent of bonds.<sup>1</sup> Sukuk are securities that comply with shariah rules and regulation, the investment is based on shariah principles which prohibits the charging of interest, which mean the profit in sukuk is not interest, but it is generated from the performance of the underlined assets. In the technical meaning sukuk is known as the Islamic or the Shariah compliant bond, or Islamic investment certificate.<sup>2</sup> According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its standard 17: investment sukuk are certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, thus it represents a common shares and rights in the underlined assets or their usufructs and services.<sup>3</sup>

## **2 Overall view on AAOIFI Standards**

### **2.1 Brief description of the AAOIFI as a corporate body**

#### **2.1.1 The Accounting and Auditing Organization for Islamic Financial Institutions**

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body. prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry. AAOIFI also provides professional qualification programs, e.g. CIPA, the Shari'a Adviser and Auditor "CSAA". AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 1 Safar, 1410H corresponding to 26 February, 1990 in Algiers. it was registered on 11 Ramadan 1411 corresponding to 27 March, 1991 in the State of Bahrain.

AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry worldwide. AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI’s standards and pronouncements.

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<sup>1</sup> See: Zamir Iqbal, Abbas Mirakhor (2007), An introduction to Islamic finance, p. 177.

<sup>2</sup> See: Nathif J. Adam and Abdulkader Thomas (2004), Islamic Bonds, p. 42.

<sup>3</sup> AAOIFI (2004), Arabic version, p.473.

### **2.1.2 Structure<sup>4</sup>**

#### **A General assembly**

The General Assembly is composed of all founding, associate, supporting and observing members and regulatory and supervisory authorities. Observer and supporting members have the right to participate in the meetings of the General Assembly but without a right to vote. The General Assembly is the supreme authority and convenes at least once a year

#### **B Board of trustees**

The Board of Trustees shall be composed of twenty part-time members to be appointed by the General Assembly every five years and they shall continue in office until members of the succeeding Board are appointed. The members of the Board of Trustees shall be elected from among the following categories, taking into account their geographical distribution:

- Regulatory and supervisory authorities (central banks, monetary authorities, etc).
- Islamic financial institutions
- Accounting and auditing firms whose professional work relates to Islamic financial institutions.
- Shari'a Fiqh scholars
- Users of financial statements of Islamic financial institutions.
- The conditions of electing these members are specified in Article 12 of AAOIFI Statute.
- The Board of Trustees meets at least once a year.
- With the exception of the proposals to amend the statute of AAOIFI which requires the vote of three quarters of the members of the Board of Trustees, decisions in all matters before the Board are adopted by the majority of the members voting.
- In case of a tie, the Chairman shall have the casting vote.
- The powers of the Board of Trustees include, among others, the following:

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<sup>4</sup> AAOIFI (2007), pXVI.

*6<sup>th</sup> International Islamic Finance Conference 2008 Peer Reviewed Paper*

1. Appointment of members of AAOIFI's Boards and termination of their membership, in accordance with the provisions of the statute
2. Arrangement of sources of finance for AAOIFI and investing those resources
3. Appointment of two members from amongst the members of the Board of Trustees to the Executive Committee
4. Appointment of the Secretary-General
5. The provisions of the statute concerning the Board of Trustees' powers and authorities, neither the Board of Trustees nor any of its sub-committees including the Executive Committee, has the right to interfere directly or indirectly in the work of the other Boards of AAOIFI or influence them in any manner.

**C Accounting and Auditing Standards Board**

The Standards Board is composed of twenty part-time members who are appointed by the Board of Trustees for a five-year term. Members of the Standards Board represent the following various categories: regulatory and supervisory bodies, Islamic financial institutions, Shari'a supervisory boards, university professors, organizations and associations responsible for regulating the accounting profession and/ or responsible for preparing accounting and auditing standards, certified accountants, and users of the financial statements of Islamic financial institutions. The powers of the Standards Board include, among others, the following:

1. To prepare, adopt and interpret accounting and auditing statements, standards and guidelines for Islamic financial institutions.
2. To prepare and adopt code of ethics and educational standards related to the activities of Islamic financial institutions.
3. To review with the aim of making additions, deletions or amendments to any accounting and auditing statements, standards and guidelines.
4. To prepare and adopt the due process for the preparation of standards, as well as regulations and by-laws of the Standards Board.
5. The Standards Board meets at least twice every year and its resolutions are adopted by the majority of the votes of the members voting.
6. In case of a tie, the chairman of the Standards Board shall have the casting vote.

## **D Sharia Board**

The Sharia Board is composed of not more than twenty members to be appointed by the Board of Trustees for a four-year term from among fiqh scholars who represent Shari'a supervisory boards in the Islamic financial institutions that are members of AAOIFI, and Shari'a supervisory boards in central banks. The powers of the Shari'a Board include, among others, the following:

1. Achieving harmonization and convergence in the concepts and application among the Shari'a supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the fatwas and applications by these institutions, thereby providing a pro-active role for the Shari'a supervisory boards of Islamic financial institutions and central banks.
2. Helping in the development of Shari'a approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.
3. Examining any inquiries referred to the Shari'a Board from Islamic financial institutions or from their Shari'a supervisory boards, either to give the Shari'a opinion in matters requiring collective Ijtihad (reasoning), or to settle divergent points of view, or to act as an arbitrator.
4. Reviewing the standards which AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic Shari'a.

### **2.1.3 Objectives of the AAOIFI**

The objectives are as follows:

1. to develop accounting and auditing thoughts relevant to Islamic financial institutions;
2. to disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;
3. to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
4. to review and amend accounting and auditing standards for Islamic financial institutions.
5. AAOIFI carries out these objectives in accordance with the precepts of Islamic Shari'a which represents a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed.

6. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.<sup>5</sup>

## **2.2 Brief description on the Investment Standard**

The statement contains the scope of the standard, the definition of investment sukuk, types of sukuk, Characteristics of investment sukuk, Shari'a rulings and requirements and the effective date.

### **2.2.1 Scope of the Standard<sup>6</sup>**

This standard is applicable to investment sukuk. It covers sukuk of Ijarah, services, leased assets, Murabaha, Salam, Istisna'a, Mudaraba, Musharaka, investment agency and sharecropping, irrigation and agricultural partnerships. This standard does not cover shares of stock companies, interest-based bonds, certificates of funds and investment portfolios.

### **2.2.2 Definition of Investment Sukuk**

Investment sukuk are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity. One of the differences between these certificates and shares is that shares are issued only by stock companies which have been granted by law an independent juristic personality. This is not necessary in the case of investment sukuk. Therefore, these certificates are defined in this Standard as investment sukuk to distinguish them from shares and loan bonds.

### **2.2.3 Types of Investment Sukuk**

There are several types of investment sukuk such as sukuk salam, sukuk ijarah, and sukuk mudarabah.

### **2.2.4 Characteristics of investment sukuk**

- Investment sukuk are documents issued, in equal value, either in the name of the owner or of the bearer to establish the right of the certificate owner or rights and obligations such certificate is representing.

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<sup>5</sup> AAOIFI (2007), pXIII.

<sup>6</sup> AAOIFI (2004) Arabic version. Standard 17.

- Investment sukuk represent a common share of ownership of assets available for investments, whether they are non-monetary assets, usufructs, a mixture of tangible assets and usufructs and monetary assets, such as receivables and cash. These sukuk do not represent a debt owed to the issuer by the certificate holder.
- Investment sukuk are issued on the basis of a Shari'a-compliant contract in which case the issue of trading of these sukuk are governed by the rules of respective contract.
- The trading of investment sukuk is subject to the terms that govern trading of the rights they represent.
- The owners of these certificates share the return as stated in the subscription prospectus and bear the losses, each according to his respective share of ownership.

#### **2.2.4.1 Shari'a Rulings and Requirements**

The shariah rules requirement are divided into two, the sharaih requirement in issuance and the shariah rules in trading as follows:

#### **2.2.4.2 Issuance of Investment Sukuk**

- It is permissible to issue investment certificates, on the basis of any of Shari'a-compliant investment contracts, whereby the subscription funds will be used for investment purpose.
- It is permissible to issue securities for trading in tangible assets and usufructs. This could be accomplished by partitioning the assets or usufructs into units of equal value and issue securities that represent the value of the assets. It is not permissible to issue securities for receivables.
- The contract of issue must be governed, after closing date and allocation of the certificates, by all effects of the contract for which the issue is concluded.
- The two parties of the contract of issue are the issuer and the subscribers.
- The relationship between the two parties of the issue contract may be ascertained as per the contract that form basis of the issue and its Shari'a characteristics. The explanation for this was elaborated further more in detail.

### **2.2.5 Trading in Investment Certificates**

1. After closing subscription, identification of the certificate holders and commencement of investment activity, it is permissible, in principle, to trade in and redeem investment sukuk that represent common ownership of tangible assets and usufructs. It must be noted that the Shari'a requirements of exchange contract must be observed when investment activities are yet to commence. Again, rules of receivables must be observed if all the assets are, on the date of liquidation, receivables or the assets represented by the certificates were sold on a deferred payment basis.
2. In the case of negotiable investment certificates, it is permissible for the issuer to include in prospectus of issue a provision stating that the issuer will purchase, at market value, any certificate that may be offered to him after completion of the process of issue. It is not permissible for the issuer to undertake to purchase the certificates at a nominal value.
3. The certificates may be traded through any acceptable means that do not violate Shari'a rules and principles. The trading may take place, for example, through registration, electronic means or actual delivery by the bearer to the purchaser.
4. It is permissible, right after the time of issue up to the date of maturity, to trade in issues that represent ownership of existing leased assets or assets to be leased on promise.
5. It is permissible to redeem, before maturity, certificates of ownership of leased assets from the issuer according to the price agreed upon between the certificate holder and the issuer.
6. It is permissible to trade in securities of ownership of usufructs of tangible assets prior to a contract of sub-leasing the assets. When the assets are sub-leased, the certificate is then representing rent receivables, which makes it a debt certificate. Therefore, the certificate is subject to rules and requirements of disposal of debts.
7. It is permissible for the issuer to redeem, either at a market price or as agreed upon at the time of purchase, the issues of ownership of usufruct of tangible assets from certificate holder after allocation of sukuk and payment of subscription amounts. The permissibility of the redemption is circumscribed with a condition that the amount of subscription or of redemption is not deferred, see item 3/ 4 of the Shari'a Standard in respect to Ijarah and Ijarah Muntahia Bittamleek.
8. It is permissible to trade in certificates of ownership of usufructs of an asset to be made available after the asset is identified. It is not valid to sublease or trade in usufructs of an asset to be made available prior to identification of the asset, in which case trading must be carried out in line with the requirements of currency exchange.

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9. It is permissible to trade in securities of ownership of usufructs to be provided by a specified source prior to sub-leasing such usufructs. When the usufructs are sub-leased, the certificate is representing rent receivables to be collected from the second lessee. In this case, the certificate is representing a debt and, therefore, is subject to rules and requirements of disposal of debts.
10. It is permissible to trade in securities of ownership of usufructs to be provided by a specified source after the source of usufructs is identified. It is not valid to sublease or trade in usufructs to be provided by a specified source prior to identification of the source, in which case trading must be carried out in line with the requirements of disposal of debts.
11. It is permissible to arrange a parallel ijarah on services or tangible assets which usufruct lines with specification of the usufructs owned by the certificate holders as in items 5/2/8 and 5/2/10 provided the two lease contracts remain independent.
12. It is permissible for the second buyer of usufructs of existing assets to resell them. The buyer is also entitled to issue certificates in this respect.
13. It is permissible to trade in or redeem Istisna'a certificates if the funds have been converted through business or trade into assets owned by certificate holders during the operation of Istisna'a. If the realised funds are immediately paid as a price in a parallel Istisna'a contract or the manufactured item is submitted to the ultimate purchaser, then trading in Istisna'a certificates is subject to rules of disposing debts.
14. It is not permissible to trade in Salam certificates.
15. It is not permissible to trade in Murabaha certificates after delivery of the Murabaha commodity to the buyer. However, trading of Murabaha certificates is permissible after purchasing the Murabaha commodity and before selling it to the buyer.
16. It is permissible to trade in Mudaraba certificates after closing of subscription, allocation of certificates and commencement of investment operation in respect to the Mudaraba assets and usufructs.
17. It is permissible to trade in Musharaka certificates after closing of subscription, allocation of certificates and commencement of investment operation in respect to Musharaka assets and usufructs.
18. It is permissible to trade in sukuk of investment agents after closing of subscription, allocation of sukuk and commencement of investment operation in respect to the assets and usufructs.

19. It is permissible to trade in Muzara'a, Musaqqa and Mugarasa certificates after closing of subscription, allocation of certificates and commencement of investment operation in respect to the assets and usufructs. This rule applies when the certificate holders are own the land. Thus, trading in these certificates is not allowed where the certificate holders act as workers, i.e. undertake to provide agricultural, irrigation or planting works. This is the case unless the certificate holders have contributed, in addition to labour, some equipment and plant seeds.

### **3 The AAOIFI pronouncement on Sukuk: 13 & 14 February, 2008**

The formal pronouncement was a result of three meeting conducted by AAOIFI members as follows:

1. First, in al-Madinah al-Munawwarah, on 12 Jumada al-Akhirah 1428 AH (27 June, 2007).
2. Second, in Makkah al-Mukarramah, on 26 Sh'aban 1428 AH (8 September, 2007).
3. Third in the Kingdom of Bahrain on 7 and 8 Safar 1429AH (13 and 14 February, 2008).

The formal pronouncement was issued by the working group, appointed by the Board, which met in Bahrain, on 6 Muharram 1429AH (15 January, 2007), which was also attended by significant number of representatives from various Islamic banks and financial institutions.

### **4. Analysis of AAOIFI pronouncement**

#### **4.1 Clause One**

- **The Full ownership of Sukuk holder**

The AAOIFI announcement emphasize on the ownership of the of the sukuk assets, the ownership of the sukuk assets is pre-requirement for sukuk trading before placed into the secondary market, it is clearly stated that "Sukuk, to be tradable, must be owned by Sukuk holders"<sup>7</sup> The ownership include all rights and obligations in real assets, whether tangible, usufructs or services.

- **Shariah compliant of Sukuk in trading**

The sukuk must be compliant with shariah rules and regulation in trading in the secondary market, this requirement has been mention in AAOIFI standards in Articles (2)' and (5/1/2)2 of the AAOIFI Shari'ah Standard (17) on Investment Sukuk.

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<sup>7</sup> Clause one in the AAOIFI pronouncement.

- Article 2: Sukuk: Investment sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) assets projects or special investment activity, however, this is true after the receipt of the value of the sukuk, the closing of the subscription and employment of funds received for the purpose for which the sukuk were issued”.
  - Article (5/1/2): It is permissible to issue certificates for (to securitize) assets that are tangible assets, usufruct and services by dividing them into equal shares and issue certificates for their value. As for debts owed as a liability, it is not permissible to be securitized for the purpose of trading.<sup>8</sup>
- **The Genuinity of transfer of the ownership of the asset to the Sukuk books (investors)**

The announcement pointed out the importance of the genuine requirement of the real transfer of the ownership, it stated “The Manager issuing Sukuk must certify the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as his own assets”<sup>9</sup>. Therefore it is not accepted to keep the asset in the book of the sukuk issuer as it is his own asset but in the sukuk books. Therefore the investors will be entitled for any dividend or return if any as well as sharing any loses. This will expose the concept of beneficial ownership to some debates and arguments, even though all ownership right and liabilities are assigned to the beneficial owner such as rental income, but other rights such as legal title of ownership is still with the issuer, and that definitely limits the right of the sukuk holder in the underlined assets, thus, the pronouncement stresses on the existence of full and unlimited right of the sukuk holder on the underlined assets.

#### **4.2 Clause Two**

- **Sukuk must not represent Debt or receivable**

Sukuk representing receivables or debt are not tradable, therefore securitization must be purely based on assets, usufruct or services, except in the following cases:

- A financial institution that is selling all its assets including the receivable as part of it.
- A mixed portfolio which consists physical assets and debt or some receivable, whereby the debt and receivables are included incidental, this is in accordance with the AAOIFI standard 21 regarding the financial papers in which it allows the trading of sukuk backed by a portfolio consisting a hybrid assets made up of debts, receivables and physical assets, where the later constitutes at least 30% of the portfolio.

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<sup>8</sup> AAOIFI. Shari'ah Standard (17).

<sup>9</sup> Clause one in the pronouncement.

### **4.3 Clause Three**

- **Prohibition of undertaking to offer Loan to Sukuk holder (liquidity facility)**

The AAOIFI pronouncement mentioned clearly the prohibition of a loan offer by the manager of sukuk to the sukuk holders in case the actual earning fall short of expected earning in order to meet the expectation of the investors. Such an offer is not permissible for the fact that it means guarantee of profit by the issuer in his position as Mudharib, partner or an agent.

- **The Permissibility of establishment of the Reserve Account**

As mentioned it is not permissible for the manager of sukuk to undertake to offer loans to sukuk holder, however in order to overcome this issue AAOIFI suggests the establishment of a reserve account for the benefit of the sukuk holders in the following pointys:

- The permissibility of establishment of the reserve account.
- The manager can establish a reserve account for the purpose of covering such shortfalls to the extent possible.
- The establishment of the reserve should be mentioned in the prospectus.

- **The Permissibility of distribution of the expected Earning**

There is no objection by the AAOIFI regarding the distribution of the expected earnings, on account, or to obtaining project financing on account of the Sukuk holders, this is in accordance with Article (8/8) of the AAOIFI Shariah Standard (13) on Mudaraba. According to articles the Mudarib is entitled to a share of profit as soon as it is clear that the operations of the Mudaraba have led to the realization of a profit. However, this entitlement is not absolute, as it is subject to the retention of interim profits for the protection of the capital. It will be an absolute right only after distribution, i.e. when actual or constructive valuations take place. It is permissible to distribute the realized profit among the parties on account, where the distribution is revised when actual or constructive valuation takes place. The final distribution of profit should be made based on the selling price of the Mudaraba assets, which is known as actual valuation. It is also permissible that the profit be distributed on the basis of constructive valuation, which is valuation of the assets on the basis of fair value. Receivables shall be measured at the cash equivalent, or net realizable, value, i.e. after the deduction of a provision for doubtful debts. In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration.<sup>10</sup>

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<sup>10</sup> AAOIFI, Article, (8/8).

#### **4.4 Clause Fourth**

- **The prohibition of undertaking to Repurchase the Assets with its nominal value**

This issue is related to the repurchase of the underlined sukuk assets at the maturity date of the sukuk. AAOIFI announcement stated that It is not permissible for the Mudarib to undertake during the issuance of the sukuk to re-purchase the assets from Sukuk holders for its nominal value, when the Sukuk are extinguished at the end of its maturity. Whether the Mudarib who is the investment manager is sharik (partner), or wakil (agent). However, it is permissible for the Mudarib to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed at the time of their actual purchase. As result the repurchase should be based on the following:

- Market value
- Fair value
- According to mutual agreement between the parties at the time of the execution of the transaction

The transaction of the sale should be in accordance with the following AAOIFI standards of Sharikah (Musharaka) and Modern Corporations and Guarantees:

- Article (3/1/6/2): It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation, all the assets of the Sharika as per their market value or as per agreement at the date of buying. It is not permissible, however, to promise to buy the assets of the Sharika on the basis of face value.
- Article (2/2) Guarantees in trust (fiduciary) contracts
- 2/2/1: It is not permissible to stipulate in trust (fiduciary) contracts, e.g. agency contracts or contracts of deposits, that a personal guarantee or pledge of security be produced, because such a stipulation is against the nature of trust (fiduciary) contracts, unless such a stipulation is intended to cover cases of misconduct, negligence or breach of contract. The prohibition against seeking a guarantee in trust contracts is more stringent in Musharaka and Mudaraba contracts, since it is not permitted to require from a manager in the Mudaraba or the Musharaka contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment.

- 2/2/2: It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent.

- **Guarantee of the Capital at its Nominal value by the manager in case of negligence**

The case varies in case of negligence or misconduct of the Mudarib, whereby the manager is a guarantor of the capital at its nominal value in case of his negligent acts or omissions or his non-compliance with the investor's conditions whether the manager is a Mudarib (investment manager), Sharik (partner) or Wakil (agent) for investments.

- **The permissibility to undertake to purchase the asset in Ijarah Muntahia Bittamleek at the maturity of Sukuk**

In case the assets of Sukuk of al-Musharaka, Mudarabah, or Wakalah for investment are of lesser value than the leased assets of Ijarah Muntahia Bittamleek, it is permissible for the Sukuk manager to undertake to purchase those assets - at the time the Sukuk are extinguished - for the remaining rental value of the remaining assets; since it actually represents its net value.

#### **4.5 Clause Fifth**

- **The permissibility to undertake to purchase the Leased Asset for its nominal value**

The scenario of leasing is different from the above cases, whereby it is permissible for a lessee in a Sukuk al-Ijarah to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided that the lessee is not a partner, Mudarib, or investment agent.

#### **4.6 Clause Sixth**

- **Shariah Supervisory Boards obligations and duties in monitoring the process**

This clause concerns the obligations and the functions of Shariah Supervisory Boards in order to ensure the shariah compliance in all stages, according to AAOIFI announcement the obligations and functions should be as follows:

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- Shariah Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of Sukuk only.
- The careful review of all relevant contracts and documents related to the actual transaction.
- Oversee the actual means of implementation in the Islamic financial institution by taking into account all the parties involve in structuring sukuk.
- Ensure that the operation complies, at every stage, with Shariah guidelines and requirements as specified in the Shariah Standards.

The shariah should be involved in the whole process of sukuk which include the following:

- ❖ Issuing the fatwa of the permissibility of sukuk
- ❖ Structuring the sukuk product
- ❖ Checking the contract agreement
- ❖ Checking all the relevant documentation
- ❖ Profit distribution and loss
- ❖ Oversee the means of implementation
- ❖ Oversee the various stages of the process
- ❖ Ensure the enforcement of shariah rules and regulation in the process
- ❖ Ect .....
- **Ensure shariah compliant in Investment of Sukuk proceeds and in conversion of the proceeds into assets**

The AAOIFI emphasize again on the shariah compliant regarding the investment of Sukuk proceeds and the conversion of the proceeds into assets, therefore it is must to use one of the Shariah compliant methods of investments, the used methods must conform with the following AAOIFI standards article (5/1/81/5): The prospectus must state that the investment of the realized funds and the assets into which the funds are converted will be undertaken through Shari'ah-compliant modes of investment.

- From debt operations towards true Partnership (PLS) to achieve Maqasid al Shariah in business and finance

AAOIFI announcement ended with advice and recommendation to the Islamic banks and the Islamic financial institution to decrease their involvements in debt-related operations whether investment or financing and to increase true partnerships based on profit and loss sharing in order to achieve the objectives of the Shariah.

## 5 Impact of the pronouncement on Sukuk issuance

The pronouncement of AAOIFI put the industry in a very challenging position, whereby the industry should move away from the current practice of issuing sukuk, to the new model, the new sukuk products should be designed and structure according to the six clauses of AAOIFI announcement in order to ensure the shariah compliant and ensure the fast marketability of the sukuk and attract a large number of investor especially if the sukuk are issue for the international market.

### 5.1 List of Sukuk Approved by SC 2008

2008 <sup>11</sup>				
		Issuer	Shariah Principle	Size of Issues (RM mil)
Q1	1	Westports Malaysia Sdn Bhd	<i>Musharakah</i>	800
	2	WCT Engineering Berhad	<i>Musharakah</i>	300
	3	WCT Engineering Berhad	<i>Musharakah</i>	300
	4	Hong Leong Industries Berhad	<i>Musharakah</i>	500
	5	Stratavest Sdn Bhd	<i>Ijarah</i>	120
	6	New Pantai Expressway Sdn Bhd	<i>Musharakah</i>	900
	7	The Export-Import Bank of Korea (PN2A)	<i>NA</i>	3,000*
	8	Cosmo-Jupiter Berhad	<i>Ijarah</i>	600
	9	Lingkar Trans Kota Sdn Bhd	<i>Musharakah</i>	1,145
	10	Lingkar Trans Kota Sdn Bhd	<i>Musharakah</i>	300
	11	Lingkar Trans Kota Sdn Bhd	<i>Musharakah</i>	100
	12	Industrial Bank Of Korea (PN2A)	<i>Ijarah, Musharakah, Mudharabah &amp; Istisna'</i>	3,000*
	13	Tanjung Langsat Port Sdn Bhd	<i>Musharakah</i>	250
	14	Tanjung Langsat Port Sdn Bhd	<i>Musharakah</i>	135

<sup>11</sup> Securities commission statistic (Malaysia), retrieved on: 5/9/2008. At. 9.44 am. See: [http://www.sc.com.my/eng/html/icm/icm\\_default.html](http://www.sc.com.my/eng/html/icm/icm_default.html)

*6<sup>th</sup> International Islamic Finance Conference 2008 Peer Reviewed Paper*

	15	Muhibbah Engineering Berhad	Mudharabah	400
*Combination issues (conventional and sukuk)				
<b>Total</b>			<b>11,850</b>	

**5.2 Latest Issuance<sup>12</sup>**

	Date of Issuance	Issuer	Issue Size (RM Million)	Tenor (Years)
1.	20-08-08	Tadamun Services Berhad	1000	5
2.	13-08-08	F&N Capital Sdn Bhd		
3.	06-08-08	Asia Brands Corporation Berhad	70	7
4.	10-07-08	Serrisa Sinar Berhad	20 200	8 7
5.	03-07-08	Blondal Resources Sdn Bhd	70	7
6.	01-07-08	National Agricultural Cooperative Federation	3300	15
7.	27-06-08	Malayan Banking Berhad	3500 1500 1500 610	30 10 12 10
8.	27-06-08	Cekap Mentari Berhad	3500	30
9.	27-06-08	Plus SPV Berhad	4000	18
10.	25-06-08	Vast Winner Sdn Bhd	650	7

<sup>12</sup> Securities commission statistic (Malaysia), retrieved on: 5/9/2008. At. 9.44 am. See: [http://www.sc.com.my/eng/html/icm/icm\\_default.html](http://www.sc.com.my/eng/html/icm/icm_default.html)

### 5.3 Sukuk issued in the First Quarter 2007

2007				
		Issuer	Shariah Principle	Size of Issues (RM mil)
<b>Q1</b>	1	Malaysian International Tuna Port Sdn Bhd	BBA	240
	2	Tomei Consolidated Berhad	Murabahah	100
	3	Pins Capital Sdn Bhd	Ijarah	150
	4	Pins Capital Sdn Bhd	Murabahah	10
	5	Straight A's Portfolio Sdn Bhd	Murabahah	200
	6	Lebuhraya Kajang-Seremban Sdn Bhd	Istisna`	820
	7	Lebuhraya Kajang-Seremban Sdn Bhd	Istisna`	633
	8	Cagamas Berhad	BBA	30
	9	Cagamas Berhad	BBA	40
	10	Cagamas Berhad	BBA	40
	11	Cagamas Berhad	BBA	240
	12	Horizon Hills Development Sdn Bhd	Murabahah	200
	13	Horizon Hills Development Sdn Bhd	Murabahah	70
	14	United Growth Bhd	Musyarakah	800
	15	Kuala Lumpur Kepong Bhd	Ijarah	500
	16	Capable Aspect Sdn Bhd	Murabahah	40
<b>Total</b>				<b>4113</b>

### 5.4 Comparison between 2007 & 2008 in Sukuk issuance

	First quarter	Issuer	Size of Issues (RM mil)
<b>1</b>	Q 1	2007	4113
<b>2</b>	Q 2	2008	<b>11,850</b>

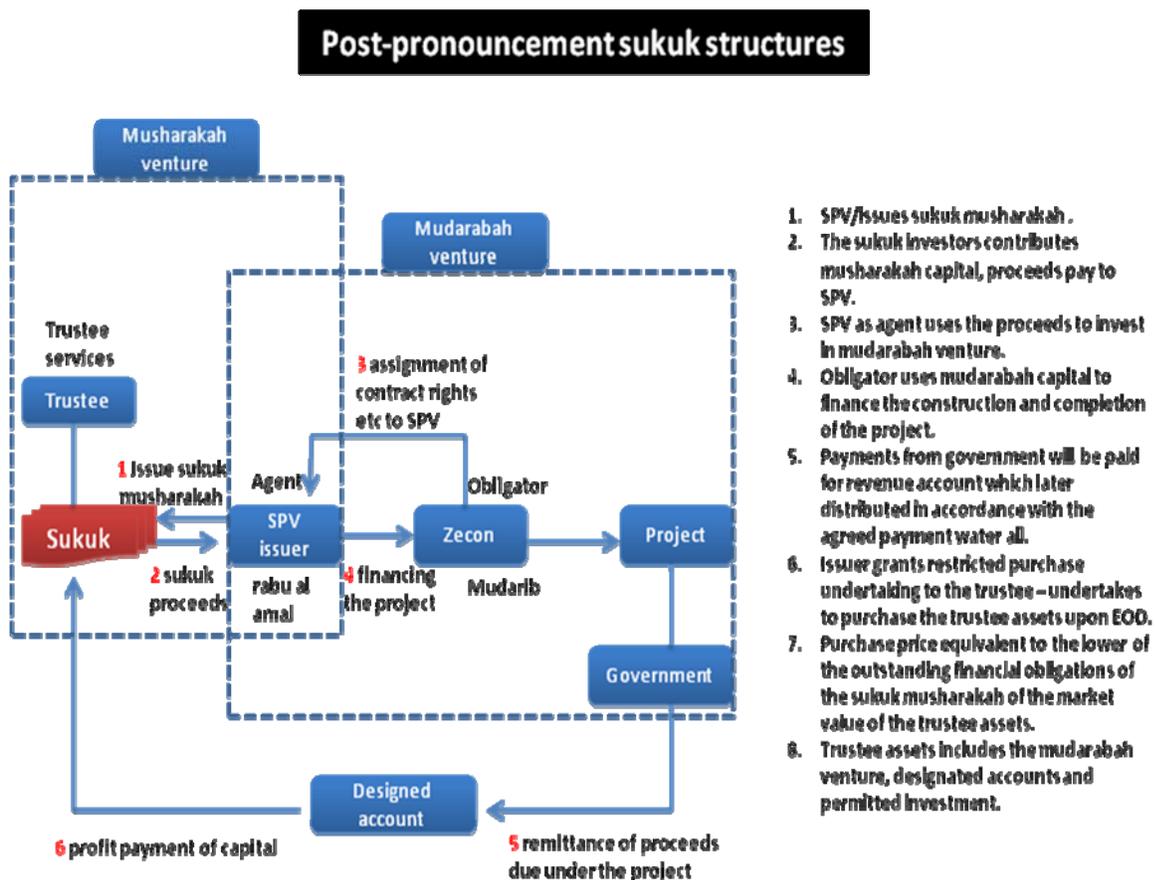
The above statistic shows that the sukuk issuance, growth, and process is very significant.

## **6 The new structure of Sukuk according to the new pronouncement**

The new sukuk structure should observe the following points that has been mentioned by AAOIFI announcement as requirement for shariah compliant of sukuk:

- The full ownership of sukuk holder:
- Shariah compliant of sukuk in trading
- The real transfer of the ownership of the asset to the sukuk books
- Sukuk must not represent debt or receivable unless it is a mixed portfolio
- Prohibition of undertaking to offer loan to sukuk holder when there is a shortfall in expected earning
- The permissibility of establishment of the reserve account for the benefit of the sukuk holders
- The permissibility of distribution of the expected earning
- The prohibition of undertaking to repurchase the assets with its nominal value.
- Guarantee of the capital at its nominal value by the manager in case of negligence
- The permissibility to undertake to purchase the asset in Ijarah Muntahia Bittamleek at the maturity of sukuk
- The permissibility to undertake to purchase the leased asset for its nominal value.
- The involvement of Shariah supervisory boards in the documentation and implementation of sukuk
- Additional obligation and duties for shariah supervisory to ensure shariah compliant in investment of sukuk proceeds and in conversion of the proceeds into assets
- Promoting partnership and sukuk base on musharakah structure and reducing the debt operations.

## 6.1 Post-pronouncement Sukuk structures



## Conclusion

- ❖ The AAOIFI announcement is in line with the shariah rules and regulations.
- ❖ The concept AAOIFI announcement is mentioned indirectly by the standards, however the announcement is to emphasize more on the relevant issues.
- ❖ The AAOIFI announcement is to ensure the shariah compliant in sukuk issuance and trading.
- ❖ The sukuk industry is required to meet the requirement of AAOIFI announcement to ensure the marketability of the product, especially if it is for global market.

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- ❖ The major focus of AAOIFI announcement is the following points:
  - The full ownership of sukuk holder
  - Shariah compliant of sukuk in trading
  - The real transfer of the ownership of the asset to the sukuk books
  - Sukuk must not represent debt or receivable unless it is a mixed portfolio
  - Prohibition of undertaking to offer loan to sukuk holder when there is a shortfall in expected earning
  - The permissibility of establishment of the reserve account for the benefit of the sukuk holders
  - The permissibility of distribution of the expected earning
  - The prohibition of undertaking to repurchase the assets with its nominal value.
  - Guarantee of the capital at its nominal value by the manager in case of negligence
  - The permissibility to undertake to purchase the asset in Ijarah Muntahia Bittamleek at the maturity of sukuk
  - The permissibility to undertake to purchase the leased asset for its nominal value.
  - The involvement of Shariah supervisory boards in the documentation and implementation of sukuk
  - Additional obligation and duties for shariah supervisory to ensure shariah compliant in investment of sukuk proceeds and in conversion of the proceeds into assets
  - Promoting partnership and sukuk base on musharakah structure and reducing the debt operations.