Maslaha: A New Approach for Islamic Bonds

by

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Declaration

I, Ayman Ibrahim Alshelfan, declare that the PhD thesis entitled '*Maslaha*: A New Approach for Islamic Bonds' is no more than 100,000 words in length including quotes and exclusive of tables, figures, appendices, bibliography, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work.

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Abstract

Islamic finance is inextricably linked to Islamic law, or *sharia*, which is richly detailed and difficult to distil into simple rules. In particular, it invokes the concept of *maslaha* to prohibit or permit ac tions and choices on the basis of whether or not it serves the best interest of the community at large. This aspect of Islamic finance has not been addressed and the purpose of this thesis is to fill this gap in knowledge.

This thesis conducts a comprehensive investigation of application of the concept of *maslaha* as a new approach for Islamic bonds in theory and practice. Integrated into this is a comprehensive analysis of *sharia* auditing where knowledge in the areas of Islamic economics, finance, and law are brought together to articulate a holistic framework for Islamic finance. The thesis argues that the concept of *maslaha* must be applied in its entirety in determining *sharia* compliance of financial contracts in order to avoid increasing the level of risk faced by the participants in the Islamic finance sector. Impaired contracts, apart from increasing the level of risk, increase the probability of costly litigations and diminish the degree of market competitiveness of Islamic financial products.

The study adopts a subjective, interpretative research design based on grounded theory. It was conducted in three phases and used semi-structured interviews supplemented by case studies of *sukuks* issuances in Bahrain, Saudi Arabia and the United Arab Emirates (UAE). Both qualitative and quantitative data from 2006 to 2010 were collected. In order to add rigor to this study, the interviews of 19 respondents and case studies of 27 *sukuks* issuances were integrated and compared to enhance the reliability of the results on *sukuks* practices.

The study findings indicate that a significant proportion of *sukuks* studied resembled conventional bonds impairing the legitimacy and diminishing the level of confidence placed on Islamic financial contracts. The purchase undertaking in some *sukuks* contracts, especially in asset-based structures, included guarantees on capital investment, and in some instances guarantees on the returns, which clearly violate the principles of *sharia*. A greater concern was the use of the principal to service coupon payments. These practices, apart from violating the principles of *sharia*, are inappropriate under modern principles of financial management.

The most significant finding of the study is that, despite the dominance of asset-based *sukuks* structures in Islamic capital markets, the fundamental requirement of completion of a sale of the underlying asset is not accomplished. The practice is one of an assignment of

financial rights to the asset and income is derived from the financial rights to the obligations attached to the debt.

These features have resulted in a general confusion among the market participants as to the true nature of the *sukuks* contracts: Is it debt or equity? This has fundamental implications to the legitimacy of the transactions based on *sukuks* contracts because *sharia* prohibits trade in debt, rendering these contracts non-tradable. There have been some attempts to structure contracts to overcome some of the shortcomings, but this does not seem to be the common practice. For instance, some of the *sukuks* certificates are convertible into ordinary shares of the obligor, which can then be listed on the stock exchange market with the associated rights and obligations. In some instances, the conversion price fluctuates with conditions thereby introducing an additional layer of risk.

The results also indicate that the use of offshore Special Purpose Vehicle (SPV) create significant legal risk, mainly because of the uncertainty around the enforceability of the contractual obligations across different jurisdictions. This has implications on the risk-return profile of *sukuk* and that of the underlying asset, which in turn has implications on the pricing of the contracts.

A stringent requirement of *sharia* rules is complete transparency of all aspects of the contract so that the participants are fully informed in very clear terms as to their rights and obligations. The practice, however, is one of low transparency and the use of unnecessarily complex language, over and above the already complex nature of financial contracts. The divergent opinions and rulings made on the contracts by *sharia* scholars is a further significant problem in the industry.

For *sukuks* contracts to be safe from deceit, misunderstandings, possible disputes, and damage to the industry it is suggested that including the concept of *maslaha*, improving documentation to enhance transparency, and institutionalising and centralising issuance of *sharia* ruling is vital.

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List of Abbreviations

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ADX	Abu Dhabi Securities Exchange
AED	Dirham
ALDAR	Aldar Properties PJSC Company
BSE	Bahrain Stock Exchange
BHB	Bahrain Bourse
CBB	Central Bank of Bahrain
CMA	Capital Market Authority
CPI	Consumer Price Index
DAAR	Dar Al-Arkan Real Estate Development Company
DFSA	Dubai Financial Services Authority
DIB	Dubai Islamic Bank
DIFX	Dubai International Financial Exchange
DFM	Dubai Financial Market
DP World	Dubai World Corporation
EBI	Emirates Bank International PJSC
EIB	Emirates Islamic Bank
EIBOR	Emirates Interbank Offered Rate
EIU	Economist Intelligence Unit
GCC	Cooperation Council for the Arab States of the Gulf
GDP	Gross Domestic Product
GFH	Gulf Finance House
GNMA	Government National Mortgage Association
IFIS	Islamic Finance Information Service
IFSB	Islamic Financial Services Board
IIBR	Islamic Interbank Benchmark Rate
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial public offering
LFX	Labuan International Financial Exchange
LIBOR	London Interbank Offered Rate
LSE	London Stock Exchange
MEED	Middle East business intelligence
MEIG	Middle East Investment Grade Index
MSCI	Morgan Stanley Capital International
PBUH	Peace Be Upon Him
QFMA	Qatar Financial Markets Authority
RERT	Real Estate Right Transfer
SABIC	Saudi Basic Industries Corporation
SACP	Stand-Alone Credit Profile

SAMA	Saudi Arabian Monetary Agency
SAR	Saudi Arabian Riyal
SCA	Securities and Commodities Authority
SEC	Saudi Electricity Company
SHB	Saudi Hollandi Bank
SIB	Sharjah Islamic Bank
SIBOR	Saudi Interbank Offered Rate
SPC	Special Purpose Company
SPV	Special Purpose Vehicle
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	The United Nations Conference on Trade and Development
US	United States
YANSAB	Yanbu National Petrochemical Company

Glossary

Adl:	Justice
Bay:	Contract of sale, sale and purchase
Bay al-'Innah:	Contract of sale with immediate repurchase. It takes place when a person sells an asset on credit and immediately buys back the asset in cash at lower price.
Bay al-Dayn:	Contract of sale of debt. As far as *bay al-dayn* is concerned, it simply means a sale and purchase transaction of a quality debt.
Fatwa:	Islamic legal opinion.
Fiqh:	Islamic jurisprudence covering all aspects of life including economic. The corpus of *fiqh* is based primarily on *the Qur'an* and *the Sunna* and secondarily on *ijma* (consensus) and *qiyas* (analogy).
Gharar:	Ambiguity and uncertainty in transactions arising from events whose occurrence is subject to chance and thus not known to the parties of a transaction at the time of the contract.
Hadith:	The saying or deed of Prophet Mohammed (PBUH) and action tacitly approved by him. It is the most important source of knowledge in Islam after *Qur'an*. Sometimes used as a synonym of *Sunna*.
Ijara:	Contract of hiring or leasing.
Ijma:	Consensus of opinion among *sharia* scholars on a specific matter.
Ijtihad:	Scholarly reasoning through which a jurist or a scholar derives Islamic rule on the basis of *Qur'an, Sunna, ijma* and *qiyas*.
Israf:	Exceeding any legal, moral, ethical, decorous or other appropriate limits'. It includes aggression, transgression and extravagance. The extravagance may be quantitative or qualitative.
Istisna:	Object-deferred sale of manufactured goods.
Istithmar:	Is broadly understood to mean an "investment".
Manfa'a:	The right of a person (natural or legal) to use a specified object that belongs to someone else, whether for a preset consideration or gratis
Maslaha:	Literally meaning goodness or benefit but can be interpreted as human welfare.
Maysir:	The act of gambling or playing games of chance with the intention of making an easy or unearned profit. Used as a synonym of *qimar*
Mudaraba:	A profit and loss sharing contract in which one party provides the financial capital and the other (the *mudarib*) manages the enterprise. While profit is shared, loss is borne by the financier.

Mudarib:	The managing partner or entrepreneur in a *mudaraba* contract
Musharaka:	Partnership contract in which two or more partners provide capital on profit and loss sharing basis.
Murabaha:	Cost-plus financing contract with an agreed profit mark-up on the cost.
Qimar:	The act of gambling or playing games of chance with the intention of making an easy profit. Used as a synonym of *maysir*
Qiyas:	Inference by analogy from sources of knowledge for a given non-textual matter.
Qur'an:	The holy book of the Muslims composed of revelations made by God to Prophet Mohammed (PBUH).
Riba:	Literally meaning *increase* or *addition*. Sometimes equated with usury, but its meaning is broader. Technically it is interest on a loan transaction and disparity in the quantity or time of delivery with respect to commodity exchange.
Riba al-nasi'ah:	Premium paid to the lender in return for his waiting. It is giving or taking of every excess amount in exchange of a loan at an agreed rate irrespective of whether it is low or high.
Riba al-fadl:	Any excess that is without due consideration of commodities of the same kind.
Salam:	Object-deferred sale of merchandise/agricultural goods. It is a contract for the purchase of a commodity for deferred delivery in exchange for immediate payment.
Sharia/Shariah:	The Islamic law, derived from the divine guidance as given by the *Qur'an* and the *Sunnah*, embodying all aspects of Islamic faith including belief and practices.
Sharia scholar:	Jurists who give opinion on various juristic issues in the light of the *Qur'an* and the *Sunna* and who have thereby led to the development of *fiqh*.
Sukuk:	Participation security or investment certificate. The word *sukuk* has been used erroneously as a singular noun and *sukuks* as plural by finance professionals.
Sunnah:	The way of the Prophet Mohammed (PBUH) including his sayings, deeds, approvals and disapprovals as preserved in *the hadith* literature. Used as a synonym of *hadith*.
Takaful:	A system of insurance based on the principle of mutual support.
Wakala:	Agency; an agency contract.
Zakah:	A compulsory levy payable to the poor and needy by a Muslim on his/her wealth (a portion of the wealth of the well-to do) as a part of religious obligation.

Chapter 1: Introduction

1.1 Islamic Law and Finance

Rules and regulations are very beneficial to human life, but if they are not enforced they are seldom obeyed. For example, speed limits and drink driving regulations save lives and protect state and public property, but they would not be effective without law enforcement.

The rules of conduct and moral responsibility or legal obligation in Islamic law are known as *ahkam al-sharia* in Arabic (hereafter *sharia*). *Sharia* is derived from several sources, the most important of which is the *Qur'an*, the divine text revealed directly in human language to the Prophet Muhammad (peace be upon him (PBUH)). The *Qur'an* is enforced by a set of punishments and rewards and is exemplified in the *Sunna,* which refers to the Prophet's sayings, conduct, explicit and tacit approvals, and prohibitions, as shown through his habitual practice and behaviour. The *Sunna* constitutes the second most important source of Islamic jurisprudence (*fiqh*) after the *Qur'an*. The specific rules and regulations of *sharia* were gleaned by scholars over many centuries from the study of the *Qur'an* and the *Sunna*, and their application in everyday life.

Most non-Muslims find it difficult to grasp that there is no separation of religion and state in Islam. Islamic law, government and civil authority are controlled, ruled and regulated by the Islamic religion. There are varying degrees of interpretation amongst Islamic nations, but *sharia* has the power and authority to legislate and command what is permissible or prohibited for all Muslims in every aspect of their lives. The ultimate purpose of *sharia* is to benefit individuals and the community and to protect them from harm in life and in the hereafter. Its fundamental objective is to protect what is considered to be the five fundamental necessities for human beings, which are life, religion, intellect, lineage and wealth. This reflects the holistic view of Islam, which is a complete, integrated code of life.

The teachings of Islam also include many rules governing economic transactions, such as, the prohibitions of excessive uncertainty in contracts (*gharar*), payment and receipt of interest (*riba*), gambling and chance-based games (*qimar*) and the abolition of excessive consumption (*israf*). These rules can be described as the Islamic financial paradigm; lending and investment (see Chapter 2). In this light, the Islamic economic system places equal emphasis on ethical, moral, social and religious values to enhance equality and fairness for the good of society. In fact, the Islamic economic system can be viewed as a social order that has unique principles and employs a set of policy instruments to attain its objectives. Thus, socio-economic considerations with the promise of divine and earthly rewards are a critical pillar in Islamic finance.

Moreover, in the Islamic context, risk and uncertainty are considered synonymous with *gharar.* Almost all economic activities involve uncertainty or commercial risk as their profits are uncertain. In reality, *gharar,* like uncertainty, cannot be completely avoided. In the same manner, the idea of bringing one's future wealth to the present and creating artificially high demand does not fit with the Islamic ethos. Hence, excessive consumption is censured as a means of maximising utility. Resources are God's gifts that have been entrusted to human beings, who must utilise them in the most efficient manner to produce the maximum output and to fulfil God's plan of establishing prosperity here on earth and in the hereafter - a goal to be achieved for the trustee and all others at the same time (Maududi, 1984).

Similarly, the key feature of Islamic finance is that it pays no interest and is asset backed. In this context money has no intrinsic value and is merely a medium of exchange. Islamic financing mechanisms take into consideration the best interests of all the stakeholders and related economic considerations - money must be invested, not accumulated avariciously, and such investments must be for the benefit of the community using lawful instruments (Iqbal, 1997).

Sharia, therefore, provides the criteria for judging every aspect of one's individual and social life, and legislation of the balance of power. The concept of *maslaha*, as prescribed by Islamic law, is invoked to prohibit or permit something on the basis of whether or not it serves the public's benefit or welfare to secure the greater interests of society and prevent harm (see Chapter 3). Choices in finance are categorised according to their significance, where less harm is prioritised over more harm. If a situation arises where procuring one's interest implies the loss of another's, then greater interest should be pursued in preference to the lesser. Conversely, the reverse will apply in anything relating to loss or injury, where the greater interest will be avoided by tolerating the lesser. Thus, mere maximisation of profits cannot be a sufficient goal of a Muslim society, as it must be accompanied by efforts to ensure spiritual health at the inner core of human consciousness and justice and fair play at all levels of human interaction (Nomani, Rahnema & Nu'mani, 1994).

These faith-based injunctions ensure socio-economic justice and equality of business opportunities, which are the main differences between the capitalist and Islamic economic systems. Financial managers must make many decisions that have financial implications on the business operations of their firm, and those who are capable of identifying the appropriate mix of debt and equity by minimising costs and maximising profits are rewarded. In the case of Islamic finance instruments, however, managers are faced with additional challenges. The most important of which is to maximise the value of the firm while maintaining *sharia* compliance. The managers must optimise the investment allocation for both financial returns and spiritual benefits. Such decisions of capital structure and budgeting in relation to institutional performance are of interest to both academics and practitioners of Islamic finance.

There is now increasing demand in the Arabian Gulf region for Islamic investment products that satisfy the criteria for ethical or socially responsible investment (Alsaeed, 2012). In response to this demand, many financial institutions now claim to provide investment opportunities that balance financial returns with ethical, moral and social concerns (Hawken, Lovins A & Lovins L, 2010). Hawken et al. (2010) suggest that any institution that does not do so is likely to lose a significant share of this emerging niche market.

Islamic financial products have also emerged in other jurisdictions where Muslim investors have sought out products that are compatible with their beliefs. There are now nearly 300 Islamic financial institutions across 70 countries in the world, holding capital investments worth more than US$500 billion (Arekat, 2006). Figure 1.1 illustrates the distribution of capital market products and services in the countries that lead the international markets. It is important to note that there are 1.3 billion Muslims worldwide holding a market value of US$4 trillion (Alam, 2006; Cader, 2007). Therefore, the conventional financial system would be wise to take Islamic financial rules into account in order to attract more Muslim investors to join their non-Muslim counterparts in enhancing the global economy.

Of all the rapidly growing Islamic capital market securities, none are gaining in popularity as much as Islamic bonds known as *sukuks*. *Sukuks* (صكوك) is the plural of *Sakk* (صك), which means a legal instrument, deed or cheque in Arabic and refers to an Islamic investment trust certificate. The word *sukuk* has been used erroneously as a singular noun, and *sukuks* as plural by finance professionals. While *Sukuk* differ in their underlying structure to conventional bonds, they have become increasingly popular in financial markets in recent years. During the flourishing period of Islam in the thirteenth century, *Sakk* referred to any certificate representing a contract or conveyance of financial rights, obligations or money transactions that is *sharia* compliant for thriving trade activities (Neftci & Santos, 2003). It is believed to be the source of the European ‘cheque’.

There has been increasing scholarly interest in the core principles of *sukuks* that have insulated them from disasters such as the global financial crisis and contributed to their relative security in comparison to conventional bonds (Abdul Aziz & Gintzburger, 2009).

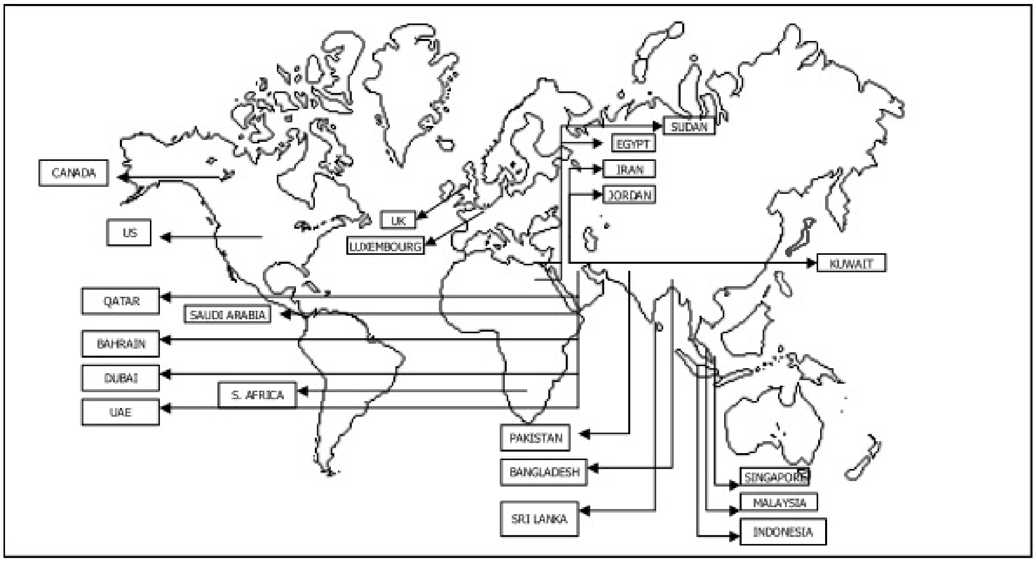

Figure 1.1. The distribution of countries that offer the most Islamic capital market products and services. Source: International Organization of Securities Commissions [IOSCO], 2004.

Since 2000, *Sukuks* have become increasingly popular both as a means of raising government finance through sovereign issues and as a way for companies to obtain funding through corporate *sukuks* (Abdul Aziz & Gintzburger, 2009). According to a Congressional Research Service report in 2009, the global market for *sukuk* was estimated to be US$70 billion in 2008 and was thought to exceed US$100 billion towards the close of 2010 (cited in Ilias, 2009). Indeed, the Islamic Finance Information Service (IFIS) (2011) stated that the total global *sukuk* issued as of 15 February 2010 amounted to US$147 billion more than this estimated figure. Gulf Cooperation Council (GCC) countries are the main source of *sukuks* issuance globally and account for roughly 30 per cent of the overall market, peaking at US$42.3 billion in 2010. The United Arab Emirates (UAE) has the most active issuances in the GCC with 53 per cent, followed by Saudi Arabia with 27 per cent and Bahrain with 17 per cent (Zawya, 2011).

In 2002, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued standards on accounting, auditing, governance, ethical, and *sharia* standards. AAOIFI released an exposure draft of its *sharia* standards concerning *sukuks.* According to the conditions set by *sharia* standard (17) of AAOIFI (2010), for *sukuks* to be tradable, they must not represent receivables or debts. However, in the case of a trading or financial entity selling all its assets or a portfolio with a standing financial obligation in which some debts, incidental to physical assets or usufruct, were included unintentionally, in accordance with *sharia* standard (21) on financial papers.

The push for innovation to satisfy commercial objectives has led many Islamic financial institutions to adopt conventional financial practices and instruments. This has created issues that conflict with Islamic principles, such as profits from penalty charges on late payments, purchase undertakings in *sukuks*, sale of debt at a discount, the promise and enforcement of contracts, profit-rate swaps, upfront profits on Islamic investments, securitisation of receivables and future cash flows. Consequently, many *sukuks* issuers and buyers have accused Islamic finance of closing 'the front door of *riba* while opening the back door of *riba'* or of only bearing 'form over substance' (Rosly, 2010, p. 133). In 2007, Sheikh Muhammad Taqi Usmani, chairman of the *sharia* board of the AAOIFI, declared that 85 per cent of *musharaka* and *mudaraba sukuks* were contrary to *sharia* laws. This had a significant impact on *sukuks* markets worldwide and the demand for new *sukuks* decreased. There is clearly a need to develop a systematic method of testing the conformity of financial instruments to *sharia* requirements (Abdel-Khaleq & Richardson, 2006).

1.2 Research Questions

This study will comprehensively inspect the concept of *maslaha* as a new approach for Islamic bonds (*sukuks*) in theory and practice in the context of the Islamic financial market. It aims to provide rich insights for financial institutions to match their products and commercial viability more accurately to the demands of Islamic ethics and morality in the market.

Specifically, this thesis will consider the link between *maslaha* and *sukuks* structures, and the reasons, aims and impulses of making particular contracts for a structure. *Sukuks* are an effective means of examining *maslaha* theory in practice because they are not limited to individuals but have a wider public impact. Individuals may use their own funds according to their own interpretation of *sharia*, but the control of part of a nation's wealth by private organisations such as Islamic banks and investment channels like *sukuks* requires diligence and doctrinal deference. Moreover, as Islamic finance is by nature participatory, *sukuk* purchasers arguably have the right to information on the purposes for which their monies are to be allocated. Thus, *sukuk* should be backed by identifiable assets and not used for general unspecified purposes, whether by a sovereign or corporate issuer.

A restricted understanding of *sharia*, focusing only on the legal forms of a contract rather than the substance when structuring a financial product, would lead to a distortion of *sharia* compliant financial instruments. *Sukuks* products should be analysed from different angles to incorporate all elements of the Islamic economic system, including the unique *maslaha* approach. Accordingly, this thesis introduced the concept of *maslaha* to the current Islamic financial environment and poses the following research question: How does *maslaha* influence financial decisions made by practitioners of the Islamic faith?

In addition, this thesis poses the following secondary questions:

1. What *sharia* parameters (standards) must be adhered to by each *sukuk* structure and what are their applicability and challenges?
2. What conceptual model and techniques for Islamic financial contracts are currently being used by financial institutions?
3. How do participants in the markets in Bahrain, Saudi Arabia and the UAE understand and implement the *maslaha* approach in conducting their economic activities?
4. What are the participants' reflections on the *maslaha* approach in pricing *sukuks*?
5. To what extent do participants in Bahrain, Saudi Arabia and the UAE markets categorise *sukuks* as debt or equity instruments?
6. To what extent do participants in Bahrain, Saudi Arabia and the UAE markets determine *sukuk* price and profit margin?

1.3 Research Objectives

Based on the research questions in Section 1.2, this study aims to achieve the following objectives:

1. To survey the current finance decisions and practices of debt markets in GCC countries, specifically Bahrain, Saudi Arabia and the UAE.
2. To develop a decision framework that incorporates the concept of *maslaha* in financial market decisions.
3. To explore the current *sukuks* market legislations and how *sharia* scholars can standardise and apply *sharia* based on the *maslaha* concept in these GCC countries.
4. To examine the perceptions and attitudes of *sukuks* issuers and buyers in these countries regarding the impact of *sukuks* on business decisions and hence business performance.

5. To determine whether there is a need for an alternative to the interest rate that is acceptable to Islamic law based on *maslaha*.

The first objective is to explore how the decisions of financial institutions in Bahrain, Saudi Arabia and the UAE are related to accepted Islamic theoretical concepts. This objective will also measure the extent to which conventional theories and models that have been taught in classrooms around the globe have found their way into these emerging markets. The success and credibility of an Islamic financial contract depend on a scrutiny of its structure and transaction in *sharia* framework in all stages of its implementation. This includes identifying the structures, the commitment of the parties and the duty of the owner in using the relative assets freely, and the tenure and responsibility towards the danger that might be inflicted on the property.

Specific laws in Islam are articulated based on fundamental principles, which are sufficiently flexible and adaptable to the dynamic world of finance. Islamic scholars are responsible for *fatwa,* which is a ruling based on their interpretation of Islamic law and often results in differences of opinion. Thus, the second and third objectives of this thesis are to examine the influence of *maslaha* on financial decisions by practitioners of the Islamic faith, as well as the role of Islamic scholars in Islamic finance. This will be used to identify specific criteria for the motive, structure and outcomes of *sukuks* implementation, which should be considered before issuing legal judgments concerning *sukuks* products to bring them more in line with *sharia* objectives.

Standard & Poor’s (2008) estimated that 20 per cent of banking customers in the Gulf region and Asia would now spontaneously choose an Islamic financial product over a conventional one with a similar risk-return profile. Thus, the fourth objective is to provide useful insights on managerial views on Islamic finance and the effect that corporate finance choices may have on corporate performance, comparing theory with practice. Incorporating religious values in the decision-making process will inevitably result in a different set of criteria for selecting investment products. Therefore, this thesis will examine the behaviour of participants in the marketplace, and how their likes and dislikes have had an impact on their economic activities based on *maslaha* criteria.

The current *sukuks* returns have origins essentially to the conventional interest rate such as (LIBOR) benchmark. Therefore, the matching financial results of the current *sukuks* and interest-based conventional bonds are generating disagreements about the actual need for *sukuks* when they are so similar to conventional bonds. Thus, the fifth objective is to provide useful insights on determining whether there is a need for an alternative to the interest rate that is acceptable to Islamic law based on *maslaha*, in order to ensure that they rest on solid foundations.

1.4 Research Motivations

This study was motivated by a perceived need to build viable local Islamic bonds (*sukuks*) markets in response to the increasing popularity of Islamic securities in recent years.

The acceptability of certain criteria in the application of *sukuks* as financial instruments has been subject to great debate among *sharia* scholars. This is because the market has tended to place *sukuks* in the same asset class as conventional bonds, identifying them as debt instruments. However, this is at odds with the almost universal view of Islamic jurisprudence that *sukuks* should be viewed as equity investments, which expose the investors to ownership risk in relation to the assets they have purchased. Therefore, there is a need to establish criteria for evaluating *sukuks* on *sharia* objectives, which can contribute to ethical investment in developing economies.

According to the Census GCC data revisited (GCC, 2012), the total population of all GCC countries in 2011 exceeded 46 million with a total liquidity of more than US$494.7 billion. GCC banks and financial institutions are beginning to publicly trade in accordance with Islamic law. The GCC also has large infrastructure projects planned for the near future, which operate in parallel with privatisation plans because most of them will be handled by the private sector. *Sukuks* offer a cheaper option for funding such projects (Damak & Volland, 2008). As a result, economic activity has shifted in this region from the public to the private sector and away from the dependence on oil revenues. These developments are diversifying the economy, increasing employment and promoting human development and innovation.

Bahrain, Saudi Arabia and the UAE were selected as case studies for a number of reasons. Their unique financial markets are considered a model for the 'dual financial system' where the conventional system and the *sharia* system exist side by side. This dual system continues to perform well in terms of *sukuks* and conventional bonds issuances. Secondary markets have been established recently in these countries, so *sukuks* are listed locally. The size and structure of their *sukuks* markets and their development expenditure are much greater than other GCC countries. Bahrain in particular is a financial services hub in the GCC region, and the Capital Market Authority (CMA) in Saudi Arabia developed a new electronic market, Tadawul, for trading *sukuks* and bonds in 2009 (Tadawul, 2011).

Moreover, these countries provide a unique setting to test the relationship between exchange rates and local *sukuks* issuances because their currencies are pegged to the US dollar. Although this policy prevents central banks from utilising domestic interest rates as a monetary tool to control inflation, it contributes to stabilising exports and government revenues, enhancing the credibility of monetary authorities and restricting currency speculation. These countries are also ideal testing grounds for corporate finance theories because of the absence of personal or corporate taxes. This is markedly different from Western countries, which are characterised by complex tax systems. While prior studies have found it difficult to evaluate the importance of debt (Al-Mutairi, 2011; Booth, Demirguc-Kunt & Maksimovic, 2001), this study will shed light on capital structure by quantifying corporate tax rates and incentives, which may help to clarify the financing decisions of firms in these countries.

1.5 Research Approach

This thesis will explore the suitability of using the *maslaha* approach in *sukuks* markets in Bahrain, Saudi Arabia and the UAE using qualitative and quantitative methods. It is interpretive in that it deals with variables in a complex, social, real-life experience and analyses the subjective data in terms of certain descriptive themes.

The research in this thesis lies within the paradigm of grounded theory and its philosophical and epistemological approach are based on inductive reasoning, specifically 1) observing the *sukuks* structures and the underlying risks; 2) identifying the available theoretical and practical strengths and weaknesses of *sukuks* structures and regularities; 3) devising and exploring tentative hypotheses; 4) synthesising and analysing the secondary and primary data; and 5) conclude with original outcomes that may take the shape of a grounded theory depending on all the patterns and the primary data analysis.

This study was conducted in three phases. Phase 1 consists of a review-based inductive reasoning to address the inadequacy of available information on the current Islamic paradigm of borrowing, lending and investment. It identifies Islamic principles of economics and finance and presents the conceptual model and practice of Islamic financial forms. It provides insights about the criteria related to *sukuks* evaluation on the basis of *sharia* objectives, which lie in between finance and ethics, and shows how the *maslaha* approach can contribute to ethical investment.

Phase 2 of this research utilizes case studies approach to investigate the validity of *sukuks* issuances based on the *maslaha* approach. It also analyses market behaviour using descriptive financial analysis framework in Bahrain, Saudi Arabia and the UAE.

Phase 3 employs a qualitative approach, which involves the use of open-ended, semi-structured interviews to explore the perceptions and attitudes among issuers and buyers of *sukuks* in Bahrain, Saudi Arabia and the UAE. These interviews focused on the practice of *sukuks* issuances and the interviewees' understanding of these instruments from a *sharia* perspective (see Chapter 7).

1.6 Research Significance

This research is significant from theoretical and practical perspectives. It aims to contribute to the body of knowledge on Islamic finance, particularly on theoretical issues of religious ethical investment. Accordingly, it offers insights on the theory of Islamic debt markets and the Islamic paradigm of borrowing, lending and investment, not only in the minutiae of its transactions but in the breadth of its role in realising the objectives of *sharia,* particularly in the emerging markets of Bahrain, Saudi Arabia and the UAE. As the Islamic economic system is an interest-free financial system, this study will provide a useful test for whether the theories of conventional markets are relevant to Islamic debt markets.

Moreover, Islamic emerging markets are still at an early stage of development, though some have been established in certain countries like Malaysia. *Sukuks* structures have increased the popularity of debt securities in the GCC and may offer investment opportunities for the growing export revenues of oil producers in the region. The Kuwait Financial Centre, Markaz (2010), reported that the aggregate primary *sukuks* market in GCC countries had increased by 601.5 per cent to US$11,309 billion in 2009 from US$1,88 billion in 2003.

The development of a *sukuk* evaluation framework for the intangible value of *maslaha* will measure the investors' degree of satisfaction if their money is returned with a profit, keeping in mind that such a transaction is considered a success if it is in the public interest. The risk and return distribution patterns of *sukuk* are aligned to the risk-return of the underlying project; this development would make *sukuk* an actual investment instrument and in compliance with the spirit of *sharia*. In addition, it would benefit the host country's economy because it encourages *sukuk* holders to take part in national growth by sharing its business risk and drawing returns according to the (expected) returns from the underlying projects. This would constitute equitable usage and distribution of wealth. Therefore, from a practical perspective, the findings of this study will guide improvements in *sukuks* market practices and decisions to minimise the financing costs and maximise the profits of both parties while maintaining a commitment to *sharia* requirements, as well as optimising the investment allocation to satisfy the financial and spiritual rewards.

The literature review in Chapter 2 highlights a gap in understanding, not only of Islamic finance and *sukuks* practices and their impact on economic performance, but also on the Islamic debt market. This study adds to this body of knowledge by providing an opportunity for *sukuks'* practitioners to improve the overall efficiency of Islamic debt markets in emerging markets. Moreover, this study gives voice to potential issuers and investors and offers them an opportunity to contribute to the overall performance of the economy in response to the criteria of reconstructing the earth.

In regards to theory, this study also sheds insight on the perceptions of different practitioners in *sukuks* markets. Furthermore, applying the *maslaha* approach to the *sukuks* market provides a useful descriptive tool for Islamic finance theory, illuminating the differences between Islamic finance and conventional finance and how socially responsible investment can be practised from an Islamic perspective.

1.7 Thesis Structure

This thesis is presented in nine chapters.

Chapter 1 presents the research objectives and the main and secondary research questions based on a background discussion. It also provides an overview of the thesis chapters.

Chapter 2 reviews the literature relevant to the Islamic paradigm of borrowing, lending and investment. It presents general Islamic principles, followed by views of the conceptual model and practice of Islamic financial contracts. It also introduces the theory and practice of *sukuks* in Islamic jurisprudence, or *fiqh*, in GCC countries, as well as their *sharia* and *sukuks* market regulations.

Chapter 3 covers Phase 1 and presents the concept of *maslaha,* which is the basis for restricting the rights of the individual by observing those of others in Islamic law. It explores how *maslaha* influences financial decisions by practitioners of the Islamic faith. Chapter 4 outlines the main characteristics of the economies of GCC countries and the key growth driver of their debt markets and expenditure sectors. It highlights the GCC's credit rating agencies and benchmarks of the debt instruments. It also discusses the major issues pertaining to GCC *sukuks* market regulations. Chapter 5 presents and justifies the research methodology, including the contexts, participants, researcher's role and materials, as well as the analytical tools applied to different data.

Chapter 6 covers Phase 2 of this project, the case studies method and the empirical estimation method. It discusses the importance of the *sukuks* market in Bahrain, Saudi Arabia and the UAE, and presents the differential ratings, structures and variation tenures of the sample. It then discusses the *sukuks* case studies.

Chapter 7 describes Phase 3 of this study. It analyses the interviews and discusses the differences between *sukuks* and conventional bonds (investor preferences, risks, returns and issuance costs), the *sukuk* pricing and margin-profit mechanisms, the significance of *sukuks* ratings and *maslaha* in determining investment decisions, the *sukuks* guarantee issue, local currency versus US dollar issuances, and factors hindering the *sukuks* market growth and structural innovation.

Chapter 8 draws together the results of the data analysis in Chapters 6 and 7 and discusses them in light of the research questions. Chapter 9 discusses the implications and limitations of this study and provides directions for further research.

Chapter 2: Literature Review—The Islamic Paradigm of Borrowing, Lending and Investment

2.1 Introduction

This chapter reviews background literature on Islamic finance, particularly the Islamic paradigm of borrowing, lending and investment. It also highlights issues pertaining to the most prevalent and successful Islamic financial product, *sukuk*.

Section 2.2 provides an overview of Islamic financial principles, including *sharia*. Section 2.3 presents the conceptual model and practice of Islamic financial contracts such as partnership contracts (profit/loss sharing), obligation contracts (deferred trading), quasi-debt contracts (asset leasing) and hybrid contracts. Section 2.4 discusses the origin and mechanism of *sukuks* and then compares *sukuks* with conventional bonds and asset-backed *sukuks* with asset-based *sukuks*. Section 2.5 discusses the theory and practice of the Islamic jurisprudence, or *fiqh*, regarding *sukuks* in the GCC. Section 2.6 summarises the key points of the chapter.

2.2 Overview of Islamic Financial Principles

The first foundations of an Islamic economic and financial system were laid more than 1,400 years ago, with about 22 references to its characteristics in the *Qur'an*. The early scholars on the subject were Abu Yusuf (d. 798), Yahya bin Adam (d. 919), al-Farabi (d. 955), al-Gazzali (d. 1121), Ibn Rushd (d. 1211), al-'Izz bin Ibn Abdulsalam (d. 1276), Ibn Taymiyyah (d. 1328), al-Maqreezi (d. 1461) and Ibn Khaldoon (d. 1424). The majority of primary works were by Muslim scholars and written in Arabic, and efforts to present them to English readers through the process of translation have been rather slow. It is; therefore, felt that authentic primary works need to be made more accessible to the English reader so that information on Islam can be traced to its primary sources, i.e. the *Qur'an* and the *hadith*.

Older literature was exclusively by Islamic scholars occupying positions in Western universities and research institutes. They include Qureshi and Nadvi (1946), Ahmad (1964), M. Siddiqi (1973; 2004), N. Siddiqi (1985), Kahf (1978), Zarqa (1983), Iqbal (1997), Archer and Karim (2002) and Alam (2006). Pakistani and Malaysian scholars have also made significant contributions, most of which is in English. In the last three decades, the principles of Islamic finance theory have been studied by Muslim and non-Muslin scholars alike. Examples of the former are Zaraq (1983), Maududi (1984), Alkaff (1986) and Metwally (1997), and examples of the latter are Wilson (1985), Phillip (1997) and Thomas, Cox and Kraty (2005).

The literature cited above provided in-depth analysis of various concepts and aspects that shape the relationship between Islam and finance. One is that Islamic law claims to regulate all aspects of life, ethical and social, and to encompass criminal as well as civil jurisdiction. Every act of believers must conform to Islamic law and observe ethical standards derived from Islamic principles. Finance and economics, like any other adherent, must perform their duties in accordance with the rules and regulations of Islam and base their actions on Islamic ethical norms. These ethical principles define what is true, fair, and just the nature of government, corporate, and individual's responsibilities; the priorities to society, along with some specific financial standards. In addition to providing a set of business ethics, certain Islamic economic principles have a direct impact upon financial practices and policies. Examples of specific rules are: a binding obligation to pay a wealth tax, or a religious levy (*zakah*); the abolition of *israf*; the prohibition of *riba*, *gharar*, *qimar*, trade or finance enterprises that deal with things such as unethical goods and services (e.g. alcohol, tobacco, prostitution) and transactions in prohibited products such as pork. Moreover, in recent time the prohibition of trading in debt contracts at discount and forward foreign exchange transactions (Childs, 2002; Segrado, 2005; Siddiqi, 2004).

There are about 22 instances in the *Qur'an* that refer to characteristics of the Islamic economic and financial system. So, it is pertinent to understand and clarify Islamic principles and its sources. The fundamental principles the Islamic system places equal emphasis on ethical, moral, social and religious dimensions, to enhance equality and fairness for the good of society as a whole.

Faithful Muslims must act upon *sharia,* a law that has several sources. *Ijma* is one *sharia* source; it is the consensus among religious scholars about specific issues not included in either the *Qur'an* or the *Sunna*. In addition, *qiyas* is the use of deduction by analogy to provide an opinion on a case not referred to in the *Qur'an* or the *Sunna* in comparison with another case that is. *Ijtihad* is the last source of *sharia*; it represents a jurist's independent reasoning relating to the applicability of certain *sharia* rules on cases not mentioned in either the *Qur'an* or the *Sunna* (Maududi, 1984; Segrado, 2005).

Islamic economics and finance aim to make a moral and equitable distribution in resources and social fairness in Muslim societies. Thus, Muslims ought to conduct their business activities in accordance with the requirements of their religion to be fair, honest and just toward others. Islamic economics is norm based on ethical goals, where individual preferences are made to conform to social preferences, and extend social states to a higher level of ethical perfection. Islam asks its believers to observe certain norms and moral codes in their family affairs, in dealings with relatives, with neighbours and friends, in their business transactions, in their social affairs, and indeed in all spheres of private and public life (Hussain, 1999).

Accordingly, purely personal enjoyment of property with merely individualistic ends is relentlessly despised by the *Qur'anic* injunction, 'O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful' (Qur'an, 4: 29). For this reason *sharia* encourages the individual and society as a whole to increase the volume of national output and raising the standard of living (Metwally, 1997).

Thus, an institution and individuals that adheres to Islamic teachings of justice and benevolence is motivated by an urge to serve society more so than institution or individuals, which means public interest is above that of any institution or individual. However, public interest is a concept in traditional Islamic law called *maslaha*, which will be discussed in detail in Chapter 3.

Islamic law ensures the optimal rate of capital formulation and efficient utilisation, which leads to sustainable economic growth and fair opportunities for all. It is a value-based system, ensuring the moral and material wellbeing of the individual and society as a whole. From this point of view, Islamic economic system is perhaps best described as a social order that has strong ethical values. This is due to the unique goals and principles of this system and the set of policy instruments it employs to attain such objectives (Chapra, 2001; Qureshi & Nadvi, 1946; Siddiqi, 2004).

2.2.1 Wealth tax (*Zakah*).

The word *zakah* means purification. It is the amount of money that every mentally and financially able, free adult, Muslim, male and female, has to pay to support specific categories of needy people. Islam believes that all things belong to God, and that wealth that is held by human beings is a mere trust. It can be purified by distributing a prescribed proportion for those in need. The relevant verses of the *Qur'an* are clear and it is mentioned in at least 27 different places in it. The objects of the disbursement of *zakah* are shown in verses 60 and 103 in chapter 9 of the *Qur'an*. The prophet Mohammad (PBUH) also commands his believers thus in the *hadith* (vol. 2, book 24), narrated by Abu Huraira in Al-Bukhari (1986).

Islamic scholar Ibn Taymiyyah[1] (as cited in Alqasim & Alqasim, 2004) declared that the soul of one who gives *zakah* is blessed and so is his wealth. It is purification in that it purifies one from selfishness and miserliness resulting in blessings. The blessing is not only spiritual blessing and growth. It has economic blessing in that it achieves wealth redistribution and ensures that the poor are adequately maintained in the only social system today that is mandated by God. *Zakah* is obligatory after a time span of one lunar year (approximately 355 days) passes with the money in the control of its owner. Then the owner is obliged to pay 2.5 per cent of the wealth as *zakah*. The owner should deduct any amount of money he or she borrowed from others (Metwally, 1994).

It can be concluded that Islam takes care of society and provides social justice. It is the system based on the theory of cooperation. Even poor persons, with some credibility, can choose the Islamic form of financing. *Zakah* is the cornerstone of the financial structure in an Islamic economy and one of the fundamental tenets of Islam.

2.2.2 Prohibition of excessive consumption (*Israf*).

Muslims regard resources of various kinds as the gifts of God that have been delivered as a trust into the hands of the human being, the trustee, who is to utilise them in the most efficient manner to produce the maximum output and to fulfil God's plan of establishing prosperity here on earth and, more fittingly, in the hereafter; a goal to be achieved for each and every Muslim and all others at the same time (see Qur'an, 7: 56).

Such an idea has vital implications for ownership of wealth or of the means of production. Accordingly, a Muslim has to engage in economic activity actuated by the relatively impersonal motive of filling their obligation of trust. This principle of economic trusteeship in Islam is dramatically opposed to the self-interest principle that is the cornerstone of the free-market economy. The *Qur'an* declared *israf* in different places, such as in chapters 6, 17and 25.

As a result, in the economic cycle, which starts with earning and acquisition of wealth, consumption is perhaps the last and very important stage. In economics, consumption stands for expending wealth for satisfaction of human wants such as food, clothing, housing, other articles of daily use, education, health and other personal or family needs. Needless to say, human wants are insatiable. As such, it is absolutely necessary that one should be very careful

[1] Taqi ad-Din Ahmad ibn Taymiyyah (1263–1328), was an Islamic scholar, theologian and logician. He lived during the troubled times of the Mongol invasions. He was a member of the school founded by Ahmad Ibn Hanbal and sought the return of Islam to what he viewed as earlier interpretations of the *Qur'an* and the *Sunna*.

in the consumption of wealth. Islam, therefore, enjoins moderation and self-control in using natural resources and spending wealth.

2.2.3 The prohibition of payment and receipt of interest (*Riba*).

The Islamic law prohibits payment and receipt of interest (*riba),* which means not only usury, but all forms of "unearned" income or income that does not involve the expending one's resources or effort. Siddiqi (2004) clarified that *riba* means any increase or growth in a loan that must be paid by the borrower to the lender, regardless of whether the increase is large or small.

Metwally (1997) links the concept of *riba* more closely to usury, by defining usury to mean an excess or addition above the principal lent, based on the following verse from the *Qur'an*:

> Those who eat *riba* (*usury*) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: 'Trading is only like *riba* (*usury*)', whereas Allah has permitted trading and forbidden usury. (Qur'an, 2: 275)

Any interest or pre-determined payment over and above the actual principal amount is strongly prohibited by the *Qur'an* and the *Sunna*. The relevant verses of the *Qur'an* are clear and unambiguous. For example, one verse declares:

> O you who believe! Be afraid of Allah and give up what remains (due to you) from *riba* (*usury*) (from now onward), if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums). (Qur'an, 2: 278–279)

Even though, the *Qur'an* did not specify any particular kind of *riba*, Muslim scholars have categorised it in two types: *riba al-nasi'ah* and *riba al-fadl*. *Riba al-nasi'ah* refers to the interest on loans and its prohibition essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted in Islam. *Riba al-fadl* is the excess over and above the loan paid in kind. It lies in the payment of an addition by the debtor to the creditor in exchange of commodities of the same kind. The *sharia* wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that which is inherent in all forms of unjust exchange in business transactions.

El-Gamal (2000) provides a translation of the Prophet Muhammad's *hadith* that explained *riba al-nasi'ah* as 'Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is Ribā' (p. 3).

Regarding, *riba al-fadl*, narrated on the authority of Abou Said Al-Khudriy:

> Bilal visited the Messenger of Allah with some high quality dates, and the prophet inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The Messenger of Allah said: 'this is precisely *riba*! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other'. (El-Gamal, 2000, p.3)

Verse 279 in chapter 2 of the *Qur'an* above characterises *riba* as unfair, as implied by the Arabic word *Zulm* as translated unjust (oppression, exploitation, the opposite of *adl*, i.e. justice). In Islamic law, a healthy economic environment at any given time does not guarantee positive return or a productive use of money capital as value productivities lie in a future surrounded by uncertainty and risk. Some risk is involved in the productive use of money capital, which, in fairness, the supplier of money capital must share if he or she wants a share in the profit of productive enterprise. Somebody seeking a loan with a positive return must share the risk involved in its use, otherwise it is to be returned without increase. As argued by Islamic economists this unfairness, which is central to the conventional financial system, is bound to impair its efficiency (Maududi, 1984).

This is especially true given that capital is generally allocated on the basis of the creditworthiness of borrowers and not in relation to the expected productivity of the projects being financed. Muslim economists have also demonstrated how interest contributes to the instability of the capitalist system, particularly with regard to loans for business enterprises. For business interest on loans violates the human principles of fairness and care for others (Phillip, 1997; Pryor, 1985; Segrado, 2005). Also, this means that both the supplier of the funds and the borrower share the risks; both prosper when returns are favourable and suffer together when returns are poor. This is in comparison to the conventional system where the risk lies entirely on the borrower, the lender facing default risk, which in most instances is covered by collateral.

Despite the fact that interest occupies a central position in modern economic system and that it became the very life blood of the existing financial institutions, Islam considers that the principle of charging interest is quite opposite of that of business in the spirit of sharing and cooperation and that lending on interest is not as a business in the real sense. It is interesting to note that some of these prohibitions have also been obeyed in non-Muslim nations (Iqbal & Mirakhor, 2011). Some writers such as Glaeser andScheinkman (1998) and Renneboog et al. (2008) documented that the Catholic Church imposed a universal prohibition on usury in 1139, which was not relaxed until the nineteenth century. In England, a law called *The Act against Usury*, which prohibited excessive interests on loans, was in effect from 1571 to 1624. The founder of Methodism, John Wesley (1703–1791) stated in his sermon number 50 'The Use of Money' (Wesley, n.d.) that people should not engage in sinful trade or profit from exploiting others. In the seventeenth century, the Quakers refused to profit from the weapons and slave trade when they settled in North America. Moreover, in the 1920s, the Methodist Church in the United Kingdom (UK) avoided investing in 'sinful' companies, such as those involved in gambling and the production of alcohol, tobacco and weapons (Iqbal & Mirakhor, 2011).

In legalising trade and condemning interest, Islam considers that there are fundamental differences between the nature of profit resulting from interest charges and that earned by trade. In interest-based transactions, there may be no equitable division of profit between the buyer who makes a profit on the sale of goods purchased, and the seller who derives a profit in consideration of the labour and time spent in procuring the goods. Moreover, there could be no end for an interest-based transaction, since there could always be interests on unpaid interests as long as the principle amount loaned is not fully returned. This could, in extreme cases, create un-repayable debt for generations.

Siddiqi (2004) provides explanations for the prohibition of *riba*. First, it is a form of social corruption referred to by Arabic scholars as *fasad*. Second, *riba* implies the wrongful appropriation of other people's property without justification. Third, *riba* decreases the resources of states through a negative effect on the growth of economies. Fourth, *riba* demeans and diminishes the humanity of individuals. Fifth, people should be productive and useful, but only by investing their money in useful trade and economic enterprise, because money is an exchange instrument that has no value in itself (Siddiqi, 2004).

In this regard, Gait and Worthington (2009) agree with Siddiqi (2004) in his explanations of social corruption that negative effect on the growth of economies and demeans and diminishes the humanity of individuals lie with the idea of the unrestricted power of the creditor to make profit from interest has no regard to the financial ability of the debtor to repay indebtedness, middle-class consumers, as well as the developing countries, could be caught up in a never-ending debt-trap. They further assert that the wrongful appropriation and decreases the resources of states, because the *riba* system encourages living beyond one's means for both individuals and governments, it results in an accentuation of macroeconomics, inflation and external imbalances in addition of squeezing the resources available for development. This leads some poorer countries to the over-exploitation of their earth's resources and thus to the destruction of the ecological system. Furthermore, the high degree of interest rate volatility in the modern economies injects great uncertainty into the investment markets and makes it difficult for entrepreneurs to have a long-term investment vision and to make their decisions with confidence. This turbulence in the financial markets and the rise to fictitious assets tend to aggravate economic instability.

The Prophet Muhammad (PBUH) *hadith* that mentioned previously that Islam considers even interest-based loans taken for investment in a productive activity as not equitable because the profits that may accrue from it is not required to be known forehand and if there is a loss, the entrepreneur has to bear the entire loss in spite of all the risk and engagement he took, whereas the money lender, who did less sacrifice than the entrepreneur, gets an effortless profit determined by a positive rate. In Islam both risks and rewards should be shared by the different parties to the contract (Siddiqi, 2004).

Iqbal and Molyneux (2005) discussing the reasons of prohibiting *riba* from an economic view, as it is regarded as being unjust to the lender as implied in the *Qur'an* (2: 279). This is because the real rate of interest may become negative if, say, the rate of inflation is higher than rate of interest. Therefore, lenders who wish to earn a profit from lending money could make a loss. Once again, the loss incurred would be unrelated to the actual use of the funds.

Based on these explanations the rationale for the prohibition of interest, the Islamic economic framework highlights how the risk-reward sharing would be more conducive to the realisation of equity and the promotion of entrepreneurship. In fact, the interest-based financial system relies heavily on collateral and gives inadequate consideration to the strength of the project or the ultimate use of the financing. While collateral and cash flow are indispensable for ensuring repayment of loans, giving them undue weight results in an inaccurate estimation of the purpose for which borrowing takes place. Hence, that system tends to enforce the unequal distribution of capital by allocating financial resources mainly to the wealthy, which has the collateral and cash flow.

2.2.4 The prohibition of excessive uncertainty in contracts (*Gharar*).

The Arabic word *gharar* is a fairly broad concept that literally means uncertainty, hazard, risk, deceit and fraud, or that might lead to destruction or loss. *Gharar* in Islam refers to any transaction of probable objects whose existence or description are not certain, due to lack of information and knowledge of the ultimate outcome of the contract or the nature and quality of the subject matter of it. Zarqa (1983) defines *gharar* as 'the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling' (p.7).

Though there is no verse in the *Qur'an* to proscribe *gharar* explicitly, but injustice is forbidden in many verses (Qur'an, 2:188; 4:161)

At the same time, in character of this meaning all business transactions cause injustice in any form to any of the parties is forbidden in Islam. Thus, the Islamic jurists' aim is to show that *gharar* is one of the major constraints on transaction which renders some transactions as invalid and void.

However, the relation between the *Qur'an* and the *Sunna* is such that the latter is a clarification of the former. Many laws and acts of worship are briefly mentioned in the *Qur'an* and elaborated, explained or interpreted in the *Sunna*. Thus, the *Sunna* gives more details about *gharar* and how it could occur in business transactions. For instance, Ahmad and Ibn Majah, narrated on the authority of Abou Said Al-Khudriy (as cited in Al-deen, 2008) declared:

> The Prophet (PBUH) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.

This *hadith* is considered one of the cardinal principles of trade law and the ground-norm of all rules governing *gharar* contracts and gives rise to three juristic consequences: The prohibition of *gharar* sale is the outcome of general consensus of *sharia* scholars, *gharar* contracts are also considered null and void by the consensus of *sharia* scholars and this prohibition extends to all forms of *gharar*. *Sharia* scholars agree upon examples of excessive *gharar*, such as the 'Pebble' 'touch' 'toss' and 'sale', selling foetuses and embryos, selling fruit before its emergence, selling the finds of a diver in advance, selling unborn animals, selling an object of unknown identity without the buyer having the right to specify it, selling an object of unknown genus and deferring the price to an unknown future date (Al-Alim, 1994; El-Gamal, 2000).

As a response to these verses and *hadith*, the majority of *sharia* scholars agree upon some basic features of *gharar* in business transactions. These features of *gharar* can be any agreement for sale or purchase that includes uncertainty in quantity of the object, kind, species, price, time of payment in deferred sales, existence of object, and identity of object. For instance Ibn Hazm (n.d.) -one of the most original religious thinkers in the cultural history of Islam- clarified *gharar* in sale when the purchaser does not know what he has bought and the seller does not know what he has sold. Meanwhile Ibn Abidin (2000) explained *gharar* in sale as uncertainty over the existence of the subject matter of sale.

On the other hand, in the Islamic context, risk and uncertainty are considered synonyms of *gharar,* but almost all economic activities involve uncertainty or commercial risk as their profits are uncertain—in reality *gharar* like uncertainty cannot be avoided totally. Some writers have discussed the reasons for prohibiting *gharar* from an economic view. Metwally (1997) posits that an exchange contracts such as gambling could lead to greater financial and societal problems because some people win a large amount of money, but others lose their money and sometimes face bankruptcy. Therefore, *gharar* seems to be a speculative transaction or game of chance, which is harmful to society. From this point of view, Al-Shatibi (1975) in his original book *Al-Muwafaqat* has mentioned the difficulty of removing all *gharar* synonyms to risk from contracts. He provides a good explanation that in all trading transactions each party hopes for profit and fears to lose. Thus, this kind of risk is permitted by the *Qur'an*, *Sunna* and consensus of scholars; the trader is a risk taker. In addition, jurists agree that the *gharar* which affects the contract is the excessive *gharar*, as it impairs the validity of the contract while a slight *gharar* has no impact at all. So, Al-Shatibi (1975) does permit some *gharar* transaction if the *gharar* is light or in the face of necessity for that transaction, given that this need is both general and specific and there is benefit (*maslaha*) from the given transaction. Besides, he tends to prohibit all gambling and gambling-like activities associated to contract. He also documented that the Prophet Muhammad's *hadith* (PBUH) that (which prohibits *gharar*) does not intend to prohibit all *gharar* because jurists permit some transactions which have *gharar* such as selling what is hidden in the ground, selling a house though its foundation has not been seen. The *hadith* intends to prohibit *gharar,* which can cause dispute and cannot be tolerated.

Consequently, all these explanations of risk and uncertainty are not far from conventional economists. The uncertainty arises when the actual probabilities cannot recognise the possible alternative occurrences to the unacceptable or unpleasant event. Thus, the frequency and consequences of unacceptable or unpleasant events has been recognised by economists as a measure of risk. Therefore, to model these uncertainties and to find the most favourable behaviour of the economic agent facing uncertainty is main objective of the economists. Frank Knight (1921) set out to parse the difference between risk and uncertainty and the significance of that difference. He argues that uncertainty must be taken in a sense radically distinct from the familiar notion of risk, from which it has never been properly separated. According to Knight risk means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating. Therefore, he attempted of explaining the nature of uncertainty by raising questions such as why do profits and losses not disappear as the result of entrepreneurial competition? Why does competition not bring about a state of affairs where the sum of the prices paid for all input factors equals exactly the price of the output, such that the product sum can be apportioned perfectly among its contributing factors? (Knight 1921). Since Knight's time, there has been some effort devoted to the understanding of uncertainty, but almost none of this has filtered itself into the world of economic, financial, or business modelling. This seems to present an opportunity for research. Therefore, Von Neuman and Morgenstern (1944, 1961) in the 1940s and was documented by Savage (1954) anticipated that utility function is appropriate to model decision making under uncertainty and modern maximisation of this theory. The proposed utility theory was introduced by Friedman and Savage (1948).

Briefly, although there is no explicit statement known in the *Qur'an* forbidding *gharar*, it is agreed by religious scholars that it is forbidden. There is a thin line between gambling and excessive *gharar*, Ibn Taymiyyah (as cited in Alqasim & Alqasim, 2004) first noticed as he consider exorbitant *gharar* as a type of gambling where the results are zero-sum. The rationale for the prohibition of *gharar* that it will results in enmity and hatred between the seller and the buyer. Exorbitant *gharar* sale is vanity and injustice causes enmity and hatred in the society (Zarqa, 1983). However, some cases of the permissible *gharar* will be discussed under types of contracts in Islamic law.

2.2.5 The prohibition of gambling and chance-based games (*Qimar* or *Maysir*).

A significant prohibition in Islam related to economic and financial system is gambling and chance-based games (*qimar* or *maysir*). Samuelson (1976) argues that gambling includes the idea of voluntary and deliberate risk taking. Gait and Worthington (2009) extend gambling to include lotteries, lotto, casino-type games and betting on the outcomes of races and other sports events. Therefore, commercial and organised gambling can be divided into two types: games of chance (lotteries and casino games) and games of chance and skill (betting on outcome of horse races, football games, etc). Brenner and Brenner (1990) have named the second type of game of speculation. According to them, speculation is an act where the gamblers pursue monetary gain by using their skill, and when they carry out the act, they do not have enough evidence available to prove whether they are right or wrong. So, both gambling and speculation are motivated by the hope of getting rich and doing that quickly and that in both cases a relatively unimportant sum of money can be increased through gambling and speculation to an important sum.

Iqbal and Molyneux (2005) argue that the activities described above share a desire for obtaining return through deliberate risk-taking. The *Qur'an* (5: 90, 91) forbids these types of games. It uses the Arabic word *maysir* for gambling, implying that the gambler strives to amass wealth without effort. Gambling in all its forms is forbidden in Islamic jurisprudence. It is mentioned in the *Qur'an* alongside drinking alcohol as an abomination, sin and grave harm to mankind. Furthermore, the *Qur'an* makes it clear that gambling leads to addictions that deplete individual and family resources, and the creation of a false economy and superficial jobs that add nothing to the local or national gross product. Gambling also causes families to break, societies to suffer and the economy to deteriorate (Iqbal & Khan, 2005; Iqbal & Molyneux, 2005).

Along with explicit forms of gambling, Islamic law also forbids any business activities which contain any element of gambling (Siddiqi, 1985). In the interests of fair, ethical dealing in commutative contracts, unjustified enrichment through pure chance should be prohibited. Likewise, Pryor (1985) mentions some commodities that are strictly forbidden by *sharia*, such as alcohol, tobacco and pork, and stress that people should not use or exchange items banned by the *Qur'an*. Lewis and Algaoud (2001) have pointed out that neither individuals or institutions can trade or that deal in forbidden items or business.

Islamic law has forbidden all forms of gambling and chance-based games. The reasons of this prohibition could be the nature of the high risk available in these types of transactions could lead to greater financial and societal problems, because, some people win a large amount of money, but others suffer from a loss of their money, and sometimes leading to grave consequences such as the destruction of families and bankruptcy. Also, these games and gambling do not add any economic value to the society beyond the employment it provides. This, when compared to the turnover could be argued is insignificant and, therefore, the net benefit is negative.

In conclusion, a variety of aspects shape the relationship between Islam and finance. Therefore, the fundamental rule in business is honesty and fair dealing. A Muslim businessperson should therefore have high ethic and moral values and not set out to mislead or exploit others. Generally, the market should be free and not subject to manipulation so that people will not be exploited by the more powerful in business transactions (Ariff and Iqbal, 2011). Hussain (1999) declared that, those engaging in trade and commerce should behave equitably. Seller of goods should not hide any defects in them, nor lie about the weight or quality of the goods or dealing in stolen goods. These are absolutely prohibited. In Islam when the intention is to force up the price in times of scarcity and to profit at the expense of others then it is forbidden. Products should be useful and not harmful as defined in the *Qur'an* and other *sharia* sources. Trading and investment can only be undertaken in activities that are not prohibited in Islam. In actuality Islam is encouraged agriculture and employment, since they are dignity of labour, and the prompt payment of a fair wage (Hussain, 1999).

The determination of what is beneficial and what is harmful cannot be left to human reasoning alone alike most of contemporary theorists had advocated, e.g. the social contract theory and the normative stakeholder theory. Human reasoning plays a role only in a framework guided by Islamic law (Nyazee, 2000). Islam recognises the role of reason and experience in theorising economic behaviour and business activities only in a manner that embraces the transcendental aspect of human existence. This is because the inherent limitations of human beings require divine guidance especially to ascertain what is right and what is wrong. Hence, the rational faculties can and should only be used to complement, support and strengthen ethics and morality defined by *sharia* (Maududi, 1984).

2.3 The Conceptual Model and Practice of Islamic Financial Contracts

As mentioned above, the Islamic finance paradigm is based on a set of prohibitions: earning returns from a loan contract (*riba*), excessive uncertainty in contracts (*gharar*), gambling and chance-based games (*qimar*), transactions in unethical goods and services, compensation-based restructuring of debts, trading in debt contracts at discount, and forward foreign exchange transactions. These have important implications for the nature of financial assets, trading in these assets, for the risks of the assets and their mitigation and for management of Islamic financial assets.

Islamic financial contracts are unique, as they not only need to offer the different parties a feasible profit but to do so in a manner compliant with *sharia* objectives. There are a number of traditional Islamic financial contracts, and through financial engineering, new contracts can be designed in compliance with *sharia*. Most of these contracts have been used in the financial market to issue Islamic bonds, or *sukuks*, which are Islamic counterparts of bonds and securitisations. They are backed by *sharia* compliant synthetic loans, sale-leasebacks or profit-sharing arrangements. In modern Islamic financial terms, *sukuks* are defined as *sharia* compliant bonds. The AAOIFI's (2010) standard (17) defines investment *sukuks* as:

> Investment sukuk are 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 or special investment activity, however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued.

Hence, what makes *sukuk* attractive to trades because it meets the Islamic requirement under *sharia* Law which is the peace of mind for trades knowing they have the sole rights to an underlying the real asset. *Sukuks* are similar to mortgage pass-throughs. However, investors own a portion of the underlying asset, which collateralises the debt (Ahmed, 2010).

Some writers such as El Qorchi (2005) categorise *sukuks* contracts in three categories (partnership, obligation and quasi-debt contracts). However, through my review of various contracts that been used in the GCC region, I find it possible to add a fourth category: hybrid contract. This is basically a mix of different Islamic contract forms to be packaged together and sold in order to form the underlying basis for issuing *sukuk.* Hence, clarifying how they work in manner of *sharia* by providing a cycle procedures of some *sukuks* issuances that have been issue in the market recently is required to achieve the aims of this study. These types are presented in details below; all the contracts and transactions are limited to those that are allowed under Islamic law.

2.3.1 Partnership contracts.

This includes all types of contracts where the rewards and costs of economic activities are shared by those who contribute towards an investment venture.

2.3.1.1 Equity participation contract.

This type of contract is called *musharaka*, a term derived from the Arabic word (*shirkah*), which means partnership association. It is a partnership arrangement between two or more parties, where each partner makes a capital contribution to the partnership, in the form of either cash contributions or contributions in kind. Basically, a *musharaka* resembles a joint venture among a group of investors but may, if required, take the form of a legal entity.

Ownership is distributed according to each party's share in pre-agreed proportions and shares the losses in proportion to their initial capital investment (Siddiqi, 1985).

Musharaka arrangements can be structured in a number of different ways, but in practice the following two structures are utilised for issuing *sukuk*:

1. Business plan commonly referred to as the '*Shirkat al-Aqd*' in Arabic. It is an arrangement pursuant to which the issuer and the investors agree to combine their efforts and resources (typically in the form of cash, or other assets or a combination from the originator and the investors) towards a common objective (El Qorchi, 2005).
2. Co-ownership is commonly referred to as the '*Shirkat al-Melk*' in Arabic. It is an arrangement pursuant to which both the issuer and the investors contribute cash to the business to purchase an asset together. Usually the originator sells an ownership interest in an asset to the investors for the purposes of jointly acquiring an asset. This transaction pass through a special purpose vehicle (SPV) as an issuer and trustee—which has been created by the originator as partner in Project Company (Co-ownership)—and transfers assets to this SPV and the SPV holds the legal title to these assets. Thereby the originator avoiding a factual sale of assets to the investors, as a result of which the issuer and the investors become co-owners of that asset (Clifford, 2009).

However, the distinction between the business plan and co-ownership contracts is that co-ownership arrangements cannot be divided or unitised in the manner that some business plan arrangements allow.

The joint venture is managed by the SPV (debtor); the investors are partners and receive shares in the project company according to their contribution. The project company can periodically buy shares from the funding company. The proceeds from this sale of shares are distributed to *sukuk* holders, according to pre-agreed formulas. The price of shares can be determined from secondary markets or pre-determined (Abdul Aziz & Gintzburger, 2009).

It is important to note that the AAOIFI's (2008) statement mentions that *sharia* scholars have taken the view that it is not permissible for an originator to grant a purchase undertaking to the SPV trustee to purchase the joint venture assets for any amount other than the trustees' share of the market value of the joint venture assets at the time of sale. The premise for this ruling has been that these types of contracts are analogous to equity-based instruments and therefore the partners in the *musharaka* must take the risk of both profit and loss. Determining the value of the *musharaka* assets by reference to the face amount of the *sukuk* (or by reference to a shortfall amount) is akin to a guarantee of profit and principal, which, unless given by an independent third party (i.e. anyone other than the originator), is not permitted under *sharia.* This ruling has resulted in a significant decline in the number of *sukuks musharaka* issuances in 2008 and 2009 (Abdul Aziz & Gintzburger, 2009).

All these types of *sukuks* structures rely upon the performance of an underlying asset or arrangement in order to generate returns for investors. The *musharaka* is no different in this respect and can be implemented in a manner that provides for regular payments throughout the life of the *sukuk*, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. These characteristics make *musharaka* relatively straightforward to adapt for use in the underlying structure for a *sukuk* issuance. To illustrate, *sukuks al-musharaka* have been applied by originators such as Abu Dhabi Islamic Bank, Emirates Islamic Bank (EIB) and Dubai Islamic Bank (DIB) in December 2006, March and May 2007 respectively on the London Stock Exchange (LSE) and NASDAQ Dubai. These issuances amount to 800, 750 and 350 million US dollars, respectively (Zawya, 2011).

2.3.1.2 Trustee finance contracts.

It is a partnership arrangement between two or more parties, where one partner makes a capital contribution and the other makes an effort contribution to the partnership, profit sharing is agreed between the two parties to the *mudaraba* contract and the losses are borne by the provider of funds. This style has been presented by the Prophet Muhammad (PBUH) when trading with a rich woman called Khadijah, whom he later married. This type of finance contract is used to create limited liability partnerships, investment funds and joint ventures. Thus, there are two main entities in this structure the issuer and investment partner. The investment partner can be a group of investors, who advance funds to launch a joint venture. They assign a manager who is usually the one who have experience and skills to manage the investment fund, or the project which was built using the funds. The manager should be responsible for managing the investors' cash contribution in accordance with specified investment parameters. Proceeds from the investments are shared according to pre-agreed terms (Hasan, 2001; Rammal, 2003).

In *sukuks* issuances each investor's purchase of *sukuk* would represent units of equal value in the venture capital, and are registered in the names of the *sukuk* certificate holders on the basis of undivided ownership of shares in the ventures capital. However, an investment plan in respect of the *mudaraba* enterprise will be tailored within *sharia* parameters to meet the financing objectives of this type of contract as set out in the contract agreement (the terms of which would also be specified in the *sukuks* prospectus). Conversely, this contract form has restrictions in its enterprise cycle, where some *sharia* scholars and AAOIFI regulations restricted, at least 33 per cent of the capital of the *mudaraba* enterprise should be invested in tangible assets (also known as the asset-backing ratio or tangibility requirement) at all times (Clifford, 2009).

The returns to the investors would represent accrued profit from the ventures capital at a pre-agreed ratio between the issuer (SPV) who act as the trustee for the investors and the originator, which would then pass to the investors according to each investor's percentage of investments in *sukuk mudaraba*. In addition to its profit share, originator may be entitled to a performance fee for providing its expertise and management skills if the profit generated by the *mudaraba* enterprise exceeds a benchmarked return. This performance fee (if any) would be calculated at the end of the *mudaraba* term and upon liquidation of the *mudaraba* (Clifford, 2009; Rammal, 2003).

In addition, the risk of passing any losses of the this enterprise to investors may be mitigated through the use of a purchase undertaking granted by originator (as promissor) in favour of issuer SPV (as promisee) so that in the event that proceeds from the *mudaraba* enterprise are insufficient in meeting any amounts payable by issuer (SPV) to investors, SPV may call on originator to purchase its *mudaraba* interests for a price which represents their market value (Clifford, 2009; Rammal, 2003).

However, it is essential to understand the AAOIFI's (2008) *sharia* scholars view that it is not permissible for an originator to grant a purchase undertaking to the trustee (SPV) to purchase the *mudaraba* enterprise assets for any amount other than the trustees' share of the market value of the joint venture assets at the time of sale. The premise for this ruling has been that these types of contracts are analogous to equity-based instruments and therefore the partners in the *mudaraba* must take the risk of both profit and loss. Determining the value of the *mudaraba* assets by reference to the par value of the *sukuk* (or by reference to a shortfall amount) is akin to a guarantee of profit and principal which, unless given by an independent third party (a party other than the originator), is not permitted under *sharia* (Iqbal & Mirakhor, 2011). This ruling is another reason why the *sukuks* market has not seen a revival of the *sukuk mudaraba* structure after 2008.

Examples of recent *sukuk mudaraba* issuances listed by originators on Tadawul, NASDAQ Dubai, LSE and Irish Stock Exchange are Saudi Hollandi Bank (SHB; *sukuk* tranche 1 & 2), Aldar Properties PJSC (ALDAR; *sukuk* 1), Dana Gas, Dubai World Corporation (DP World) and Sorouh Real Estate (*sukuk* classes A, B & C). These *sukuks* have been placed on the markets in December 2008 and 2009; March, July and October 2007, and

August 2008, respectively. These issuances are 206.7, 193.3, 2530, 1000, 1500, 751.7, 68.3 and 273.3 million US dollars, respectively (Zawya, 2011).

2.3.2 Obligation contracts.

These contracts employ the principle of deferred trading, and are divided into two debt modes, *murabaha* and *istisna*.

2.3.2.1 Purchase and resale contract *Murabaha*.

The term *murabaha* is broadly understood to refer to a contractual arrangement between a financier (the seller) and a customer (the purchaser). It is a particular kind of sale transaction, in which the seller declares the cost of the sold tangible asset such as commodities, and sells it to another person by adding some profit or mark-up. This profit is determined by mutual consent. The exact cost of the tangible asset is required to be known at the time of *murabaha* sale. *Murabaha* is not a loan given on interest. It is a sale of a tangible asset in which the payment is deferred and the price includes an agreed profit added to the cost. In other words, the financier would sell this asset to the customer for spot delivery in the expectation that the customer would be able to meet its deferred payment obligations under the *murabaha* agreement. The payments of the deferred price from the customer may be structured as periodical payments on dates specified at the outset, thus creating an income stream for the financier for the term of the transaction (Alkaff, 1986).

The same characteristics of the *murabaha* structure can also be adapted for use as the underlying structure in a *sukuk* issuance. *Sukuk* proceeds from investors may be applied by the issuer SPV to acquire commodities and on-sell such commodities to the originator to generate revenue from the *murabaha*-deferred price which would be distributed to the investors throughout the term of the *sukuk murabaha*. *Sukuk* certificates under the *murabaha* structure essentially represent entitlements to shares of debt receivables from the purchaser of the underlying *murabaha* (Ahmad & Radzi, 2011; El Qorchi, 2005).

However, there are limitations in this mode of financing, as *sukuk* certificates issued prior to a *murabaha* commodity sale would represent ownership in those commodities rather than the right to the receivables generated by their sale. With respect to *murabaha*, *sharia* prohibits the trading of debt receivables, particularly when doing so at a discount, which may give rise to interest. The transfer of *sukuk* certificates is permitted even if it is issued after the sale of commodities under the underlying *murabaha*, so long as it is traded at face value (rather than sold at a discount or premium) (Ahmed, 2011).

Another issue is whether there is some ongoing ownership stake between the investor and the *sukuk* asset following a transfer of the *sukuk* certificate (which is permitted by *sharia*) or whether the transfer shifts ownership and creates a debt obligation on a third party (which is not permitted by *sharia*). As this limits the negotiability of *sukuks* certificates issued under the *murabaha* structure, it is less commonly used in recent times (Ahmad & Radzi, 2011; Alkaff, 1986).

Examples of *sukuks al-murabaha* issuances are those of US$158 million by the National Bank of Abu Dhabi (UAE) and US$95.6 million by the Arab capital Bank (Bahrain), which were placed on the market in December 2010 and October 2004, respectively (Zawya, 2011).

2.3.2.2 Sale contracts: *Salam or Istisna*.

Salam or *istisna* refers to deferred delivery of goods, which is mostly used in manufacture and agricultural finance. They are long-term financing instruments. In order for a sale to be valid under *sharia*, the object forming the subject matter of the sale must be in existence or in the physical or constructive possession of the seller. The exceptions to this general position are sales effected pursuant to *salam* and *istisna* contracts (Adam & Thomas, 2004; Wilson, 2004).

Salam is a sale that involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. In other words, the seller undertakes to supply some specific goods to the buyer at a future date in exchange for full advanced payment in cash. The purchased goods are delivered on an agreed upon exact future date. The agreed upon price is usually less than the future spot price. *Salam* can be used only to purchase commodities whose quality and quantity can be clearly specified (Adam & Thomas, 2004).

However, *salam* contract may be construed as being synonymous with the objective of a forward sale contract. But, in general forward sale contract is forbidden under *sharia* unless the element of uncertainty (*gharar*) inherent in such contract is effectively eradicated (Clifford, 2009). For this reason, certain criteria must be met in order for this type of contract to be *sharia* compliant. These requirements have been stated in the AAOIFI (2010) *sharia* standard (10) as below:

- No uncertainty inherent in such contract as to the currency, amount and manner of payment of the *salam* capital between the seller and the buyer.
- The Payment must be made immediately at the time of entry into the contract.

- The assets can only be fungible goods that can be weighed, measured or counted and the individual articles of which do not differ significantly, or assets manufactured by companies that can be identified by standardised specifications and are regularly and commonly available at any time.
- The assets cannot be gold, silver or any currency if the contract capital was paid in gold, silver or any currency.
- Any asset or item for which the seller may not be held responsible (e.g. land or trees) and any asset or item whose value can change according to subjective assessment (e.g. precious stones).
- The *salam* assets must be assets for which a specification can be drawn up at the time of sale so that the seller can be held to that specification.
- The quality, quantity and time of delivery of the assets must be clearly known to the seller and the buyer in a manner that removes any uncertainty or ambiguity which may lead to a dispute.
- The buyer cannot sell the assets before it has taken delivery of it as this would amount to the sale of a debt, which is forbidden under *sharia.*

The same characteristics of the *salam* structure can also be adapted for use as the underlying structure in a *sukuk* issuance. *Sukuks* certificates held by the investors are generally non-tradable, as they represent a debt. However, the *sukuk* can be traded once the *salam* assets have been delivered, provided that the tangibility of the pool of *sukuk* assets (i.e. the *salam* assets delivered) is sufficient to satisfy *sharia* requirements at that time. Thus, the liabilities associated with the *salam* assets remain with the originator and only once they have been delivered to the trustee (SPV) do the liabilities pass to the trustee. The delivery of *salam* assets prior to the agreed delivery date is permissible in *sharia* (Ahmad, 2009).

The mechanism of profit distribution is that prior to each date on which periodic distribution amounts are due to the investors, the originator delivers a proportion of the *salam* assets to the trustee. The originator (as obligor) purchases a proportion of these assets from trustee for an agreed purchase price. Originator pays the purchase price as consideration for purchasing a proportion of the *salam* assets. The amount of each purchase price is equal to the periodic distribution amount payable under the *sukuk* at that time. This amount will be calculated by reference to a fixed rate or variable rate such as LIBOR depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance. The issuer (SPV) pays each periodic distribution amount to the investors using the purchase price it has received from originator (Clifford, 2009).

As a result, for the above requirements, the use of *sukuk salam* has been very limited in *sukuks* markets. As a direct consequence of this, there has been a significant lack of development of the structure outlined above. However, the Central Bank of Bahrain (CBB) implemented in practice an alternative arrangement for short-term investment purposes. Where the originator does not buy back the *salam* assets under the purchase undertaking but is instead appointed by the trustee as its agent to sell the *salam* assets at the time of delivery through its distribution channels to a third party in the open market for a price at least equal to the amounts due under the *sukuk*. This would, however, expose the investors to risk that the originator either may not be able to sell the *salam* assets to a third party, may be able to sell the *salam* assets but at a price lower than the amount due under the *sukuk* and where a third party has already undertaken to purchase the *salam* assets, that third party fails to do so. It is important to note that *sukuk al-salam* has been used in the GCC region by Bahrain government only through CBB issuances (Al-Amine, 2008). The CBB applauded in all its issuances *salam* from 2001 to 2010 (Zawya, 2011).

Istisna, on the other hand, is a sale in which the asset to be purchased is sold before it comes into existence. It is commonly used to place an order to manufacture a specific asset thus avoid ambiguity. Therefore, broadly speaking, *istisna* translates as being 'to order a manufacturer to manufacture a specific good for the purchaser'. Under this mode of contract, it is important that the price and specification of the good to be manufactured are agreed at the outset. Thus, the details of the commodity, its exact price and the delivery dates are pre-settled. It is not necessary for the price of *istisna* to be paid in advance and the payments can be made in instalments. However, the contract of *istisna* can be cancelled before the manufacturer starts on the project (Clifford, 2009; Shaikh & Saeed, 2010).

This style in its simplest way has been presented by The Prophet Muhammad when he had ordered someone to manufacture a ring for him. The majority of *sharia* scholars have disputed its permissibility and differed over its applicability. Jurists who consider *istisna* permissible have agreed that *istisna* applies only to manufactured items, and hence invalid on natural things which are not manufactured by man such as agricultural products (e.g. corn, wheat, barley or fruits). According to the *sharia* Board of Al-Rajhi Banking Investment Corp in their *fatwas*—resolution number 48 (as cited in Al-Baraka, 2008), the Islamic Hanafi School states that it is not a condition for the manufactured item to be of fungible items that can turn into liabilities that are of many similarities in the market by which liabilities can be satisfied without any differences.

Istisna structures are another possible innovative *sukuks* because they are well suited for project financing, which is increasingly important in Muslim states where there is greater stress on private–public partnerships as governments are more and more reluctant to simply fund new infrastructure schemes from their own budgets (Abdel-Khaleq & Richardson, 2006).

The uniqueness of the *istisna* structure is that it can be adapted for use as the underlying structure in *sukuks* issuances. In modern-day Islamic finance, the *istisna* has developed into a particularly useful tool in the Islamic funding of the construction phase of a project. It is often regarded as being similar to a fixed-price contract. In order to enable investors or *sukuk* holders to receive a return during the period where assets are being constructed under an *istisna* arrangement, some *sharia* scholars have permitted the use of a forward lease arrangement *(ijara* contract) alongside such *istisna* arrangement. Accordingly, *sukuk istisna* often combines an *istisna* arrangement with an *ijara* arrangement. While the *istisna* is the method through which the investors can advance funds to an originator, the *ijara* provides the most compatible payment method to those investors. However, the use of staged payments may result in an unutilised amount of *sukuk* proceeds being held in the structure for a prolonged period during construction and it may be necessary to consider investing these amounts in *sharia* compliant investments in order to mitigate negative carry. Thus, this approach to investment of the unutilised *sukuk* proceeds has received some criticism (Siddiqi, 1985; Tariq, Dar & Al Istithmar, 2007; Wilson, 2008).

In actuality, SPV issues *sukuk*, which represent an undivided ownership interest in an underlying asset or transaction. The investors subscribe for *sukuk* and pay the proceeds to issuer SPV. Issuer (SPV) declares a trust over the proceeds and thereby acts as trustee on behalf of the Investors. Originator enters into an *istisna* arrangement with trustee, pursuant to which originator agrees to manufacture or construct certain assets and undertakes to deliver those assets at a future date, and trustee agrees to commission those assets for delivery at such future date. Trustee pays a price (typically by way of staged payments against certain milestones) to originator as consideration for the assets in an aggregate amount equal to the principal amount (Clifford, 2009).

Subsequently, the trustee undertakes to lease the assets to the originator under an *ijara* arrangement for an overall term that reflects the maturity of the *sukuk*. The originator makes payments of advance rental prior to the delivery of the assets; and actual rental following the delivery of the assets, at regular intervals to trustee in amounts which are equal to the periodic distribution amount payable under the *sukuk* at that time. These amounts may be calculated by reference to a fixed rate or variable rate such as LIBOR rate depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance (Clifford, 2009).

Examples of *sukuks al- istisna* issuances in the UAE are those of US$299.5 million by the Tamweel Residential Company (Nonconvertible *sukuk* II) and US$200 million by the National Central Cooling Company (Tabreed 06 Financing Corporation *sukuk*), in July 2008 and July 2006, respectively (Zawya, 2011).

Following from the above explanation of *murabaha, salam, and istisna sukuks* structures and their permission, generally their certificates are not readily tradable on the secondary market due to *sharia* restrictions (Usmani, 2002).

2.3.3 Quasi-debt contracts.

A quasi-debt contract can be described from an Islamic perspective as *ijara*, which literally means lease or hire. Though there are various definitions of *ijara* given by the scholars of jurisprudence, they all agree that this contract is a contract on using the benefits or services in return for compensation. In this study, *ijara* is used to refer to a contract to hire, rent or lease. There are generally two types of subjects in an *ijara* contract, one is the compensation for the use of properties such as equipments or real states (a finance lease), and the other is compensation for effort expended of skill used by an employee or a contractor (an operating lease) (El Qorchi, 2005). The *Qur'an* (28: 26–27) provides evidence of hires in the story of the prophet Musa (Moses), who was hired by his father-in-law.

The finance lease or *ijara* arrangement has been described by Ahmad (2009) is mainly a method of raising money to pay for asset without the requirements of ownership. It is an agreement that can be used to describe a lease in which the asset is tangible property. The *ijara* arrangement is calling for the lessee (user) to pay the lessor (owner) for use of an asset like land or goods for an agreed price. It is a great form f of finance as the lessee (user) can obtain and use the goods/assets without owning the goods/assets. In this case the lessee can avoid the need to borrow money and interest payment and the lessor collect the remaining value of the /goods property in addition to the agreed rental payment. A rental agreement is often called a lease, especially when real estate is rented. Real estate rentals are initiated by a rental application which is used to build the terms of the lease. In addition to the basics of a rental (who, what, when, how much), a real estate rental may go into much more detail on these and other issues. *Ijara* agreement can come in the form of short or long term but regards of both types it always has a definite beginning date and a definite ending date.

The main difference and advantage between lease and sale is that the lessor (owner) always maintains the ownership of the property (Ahmad, 2009). In addition, the asset can be sold at a negotiated market price at the end of the contract. An *ijara* contract cannot be cancelled unless both parties agree to it or if one of the parties fails to deliver. This mode enables enterprises, especially small and medium enterprise, to acquire assets, such as capital goods and high cost equipment, for which they do not have the funds to make a large upfront payment that would otherwise be involved in a direct purchase (Clifford, 2009).

Financial leases have some similar feature of secured loans. Both allow the lessee to use an asset, such as equipment, over a fixed period, in return for regular payments. The lessee chooses the equipment it requires and the lessor buys it on behalf of the lessee. After all the payments have been made, the lessee becomes the owner of the equipment. The lessor's rate of return is fixed and is not dependent upon the asset-value, performance, or any other extraneous costs. The fixed lease rentals give rise to an ascertainable rate of return on investment. Therefore, by spreading payments out over the lifecycle of the asset, the lessee is able to align the cost with the benefit derived from the use of the leased asset. The lessor generally would not provide any services relating to operation of the asset. In actuality, financial leases are non-cancellable, thus the lessee cannot return the asset and not pay the whole of the lessor's investment (Tariq et al., 2007).

Conversely, operating leases are similar to rental agreements and are not a finance lease for the purpose of acquiring assets. They take innumerable forms based on the risks the lessor takes or avoids, and the involvement of the lessor in operation of the asset. They are also referred to as ‘non-full payout’ leases because the amount of the rental does not cover the lessor’s full capital outlay for the expected economic life of an asset; the minimum lease payments over the lease term secure for the lessor the recovery of his capital outlay plus a market return on funds invested, and the lease period is always less than the working life of the asset (El Qorchi, 2005). Therefore, in an operating lease, the lessor normally holds a stock of assets with high degree of marketability to provide to other entities. He may also provide any services relating to these assets, such as maintenance or operations. The assets remain property of the lessor who has the option to re-lease them every time the lease period terminates. Accordingly, the lessor bears the risk of obsolescence, recession or diminishing demand. In contrast, a financial lease provider operates like a lender except that the lessor has the additional collateral of legal ownership of the assets without any of the risks associated with ownership (Clifford, 2009).

The basic features that differentiate a financial lease from an operating lease are related to whether the lessor or the lessee takes on the risks of ownership of the leased assets. In reality, operating leases do not put the lessee in the position of a virtual owner; the lessee is simply using the asset for an agreed period. There is always a dependence on the lessee's commitment to pay, as a result, the lessor also takes is asset based. Its rate of return in an operating lease is dependent upon the asset value, performance, or costs relating to the asset; and is always a matter of probabilities and uncertainty (Fetais, 2011).

The *ijara* structure is very popular in Islamic finance because it is the classical structure from which all other *sukuks* structures have developed. Its simplicity is favoured by *sharia* scholars, and it can be adapted for use as the underlying structure in a *sukuk* issuance. In order to generate returns for investors, *ijara* is particularly useful as it can be used to provide regular payments throughout the life of a financing arrangement. It also has the flexibility to tailor the payment profile and method of calculation to generate a profit. In addition, the use of a purchase undertaking is widely accepted in the context of *sukuk ijara* without *sharia* objections. These characteristics make *ijara* relatively straightforward to adapt for use in the underlying structure for a *sukuk* issuance (Abdul Aziz & Gintzburger, 2009).

The most common approach used in the *sukuk ijara* structure is 'sale and leaseback'. Under this approach, *sukuk* certificates issue by the issuer (SPV) who is different entity of the originator. Thereby the SPV acts as the trustee on behalf of the investors, whom pay the principal amount (proceeds) to the issuer. These certificates represent an undivided ownership interest in an underlying asset or transaction and a right against the issuer to payment of the periodic distribution amount and the dissolution amount. Then the originator enters into a sale certain assets and purchase arrangement at the end of the contract with the trustee. The trustee pays the purchase price to the originator as consideration for its purchase of the assets in an amount equal to the principal amount. Thus, the originator as the lessee makes rental payments at regular intervals to the trustee as lessor, each rental payment being equal to the periodic distribution amount payable under the *sukuk* at that time and pays it to the investors. This amount may be calculated by a fixed rate or a variable rate such as LIBOR, depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance (Ahmad, 2009).

Based on this agreement, the trustee will appoint an originator as its servicing agent to carry out certain of its obligations under the lease arrangement, namely the obligation to pay *zakah* in connection with the assets, undertake any major maintenance and insurance. Also, the originator as servicing agent claims any costs and expenses for performing these obligations which we call it servicing costs, the rental for the subsequent lease period under the lease arrangement will be increased by an equivalent amount which is a supplemental rental. This supplemental rental due from originator will be set off against the obligation of trustee to pay the servicing costs. What is more, under a lease arrangement for a term that reflects the maturity of the *sukuk* the trustee leases the asset back to the originator (Ahmad, 2009). Moreover, under the sale undertaking agreement the occurrence of an event of default or at maturity or the exercise of an optional call (if applicable to the *sukuk*), the originator will buy-back the asset from trustee at the applicable exercise price, which will be equal to the principal amount plus any accrued but-unpaid periodic distribution amounts owing to the investors payment of the exercise price by originator (as obligor). In that case SPV pays the dissolution amount to the investors using the exercise price it has received from originator (Ahmad, 2009).

Allied to *sharia* requirements, the AAOIFI (2010) established a set of principles for the mode of *ijara* in *sharia* standard (9) as follows:

- The consideration (rentals) must be at an agreed rate and for an agreed period.
- It is possible to split the term of the *ijara* into smaller rental periods where different amounts of rent may be calculated for each such rental period, the amount of rental must be fixed at the start of each such rental period and *sharia* will consider each rental period as a separate lease.
- The subject of the *ijara* must have a valuable use (i.e. things without a usufruct cannot be leased).
- The asset must be clearly identified.
- The ownership of the asset must remain with the trustee and only the usufruct right may be transferred to the originator.
- The liabilities arising from the ownership must also rest with the trustee throughout the lease period. So, in the sense that any harm or loss caused by the factors beyond the control of the originator is borne by the trustee. On the other hand, any liabilities relating to the use of the asset rest with the originator.
- The originator cannot use an asset for any purpose other than the purpose specified in the *ijara* agreement. But, if no purpose is specified, the originator can use such asset for the purpose it would be used for in the normal course of its business.

The *ijara* structure was the most commonly used in *sukuks* issuances of 2007–2008 based on volume of issuances, some of which are listed in Table 2.1.

Table 2.1: *Ijara structures used in the GCC region during 2007–2008.*

Issuer	***Sukuk* Name**	**Country**	**Date**	**Size (mUS$)**	**Exchange Listing**
Gulf Finance House	Tranche 1	Bahrain	26 July 2007	200	LSE
Saudi Electricity Company	*Sukuk* I	Saudi Arabia	11 July 2007	1,333	Tadawul
Dar Al Arkan Real Estate Development Company	International *sukuk*	Saudi Arabia	7 March 2007	600	NASDAQ Dubai
Dar Al Arkan Real Estate Development Company	*Sukuk* II	Saudi Arabia	16 July 2007	1000	NASDAQ Dubai, LFX (Labuan), BSE
Tamweel Residential ABS CI (1) Ltd	Nonconvertible *sukuk* I	UAE	25 July 2007	210	Irish Stock Exchange
Tamweel Residential ABS CI (1) Ltd	Tamweel convertible *sukuk*	UAE	23 January 2008	300	NASDAQ Dubai
National Central Cooling Company	Tabreed 08 Convertible Sukuk	UAE	30 April 2008	462	LSE
Aldar Properties PJSC	*Sukuk* II	UAE	17 June 2008	1,021	LSE

Source: Zawya, 2011.

2.3.4 Hybrid contracts.

The growth of the *sukuks* market has led to the development of a number of ‘hybrid’ structures around the *sukuk ijara* model in order to provide additional flexibility, particularly when selecting underlying assets. It is also possible for the rights under the Islamic contracts mentioned above to be packaged together and sold in order to form the underlying basis for issuing *sukuks*. However, care needs to be taken to ensure that this is not construed as trading in debt. As a result of these developments financial engineers created two contracts called *istithmar* and *wakala* contracts (Kamali, 2009). These contracts have been ruled to be valid based on *sharia* principles (Rosly, 2010). The two modes of this contract are discussed below.

2.3.4.1 *Istithmar* contracts.

The term ‘*istithmar*’ is broadly understood to mean an investment. Under an *istithmar* structure it is possible for the relevant underlying assets such as *ijara*, *murabaha* and *istisna* to be packaged together and sold as investment contracts. The income generated by such an investment can then be used to make payments to the investors under the *istithmar* contract. Some researchers such as Kamali (2009) and Fetais (2011) have described this type of structure as investment agency structure.

For instance, SPV as an issuer issues *sukuk istithmar*, which represent an undivided ownership interest in an underlying asset or transaction. This *sukuk* represents a right against the issuer (SPV) to payment of the periodic distribution and dissolution amount. The investors subscribe for *sukuk* and pay the principal amount as proceeds to SPV. Then SPV declares a trust over the proceeds and any assets acquired this proceeds. Thereby SPV acts as trustee on behalf of the investors (Kamali, 2009). Subsequently, originator enters into a sale and purchases arrangement with trustee (SPV), pursuant to which originator agrees to sell, and trustee agrees to purchase, a portfolio of certain financial assets in this case *sukuk* assets from originator. The trustee pays the purchase price to originator as consideration for its purchase of the *sukuk* assets in an amount equal to the principal amount. The trustee appoints the originator as its agent with respect to the *sukuk* assets for a term that reflects the maturity of the *sukuk*. As a result, the originator is responsible for servicing these assets and, in particular, collections of the income comprise principal and profit. At regular intervals, corresponding to periodic distribution dates, the originator will be required to make income payments to the trustee. This will be achieved through a target amount or the required return which is agreed for each collection period and may be calculated by reference to a fixed rate or variable rate such as LIBOR or SIBOR rate depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance (Fetais, 2011).

In actuality, during a particular collection period the collection amount could be in excess of the required return. Thus, in order to avoid an excess cash payment, which could have the character of *riba,* this surplus can either be credited to a reserve account with originator or in a case where a financial asset has matured and principal therefore has been repaid by the investors and, used to purchase additional financial assets under the purchase arrangement and which will then become *sukuk* assets. In addition, the balance in the reserve account can also be used to cover a shortage in collections to meet the required returns in any given collection period. In the event that there is a shortage in both collections and the reserve account, it may be permissible for originator to make an on-account payment or to provide *sharia* compliant liquidity funding to bridge any gap in funding (Fetais, 2011). Though, at an event of default or at maturity or the exercise of an optional call if applicable to the *sukuk* *istithmar* contract occurrence, the excess amount (if any) will be retained by originator as incentive fees.

The *sharia* Board of the AAOIFI (2010) has established the following set of principles for the *istithmar* mode in its *sharia* standards (17), (21) and (23):

- It is likely that the investors to whom the financial assets (comprised in the *sukuk* assets) relate will need to be informed about the sale of those financial assets to the trustee and the role of the originator in acting on the trustee's behalf.
- The role of a custodian may be required in order to ensure that the *sukuk* assets are sufficiently segregated from the other financial assets of the originator.
- Principal amounts from the underlying financial assets should never be used to service coupon payments under *sukuk al-istithmar*.

It is significant to note that *sukuks al-istithmar* historically have been used in GCC region by Saudi Arabia companies from 2006 until the end of 2010. These companies are Saudi Basic Industries Corporation (SABIC) (*Sukuks* I, II and III), Saudi Electricity Company (SEC) (*Sukuks* II and III) and Taajeer Company *sukuk*. These issuances have been placed on the markets in July 2006 and 2007; May 2008; July 2009; May 2010; and December 2007, respectively. The issuances were 799.9, 2133.10, 1333.20, 1866.50, 1866.50 and 66.7 million US dollars, respectively (Zawya, 2011).

2.3.4.2 *Wakala* contracts.

Wakala, literally translates as 'agent', referring to an arrangement whereby one party entrusts another party to act on its behalf. It is therefore akin to an agency arrangement. This contract is the more recent innovation in *sukuks* markets. Despite some similarities, the main difference between the *wakala* and *mudaraba* structures is that in a *mudaraba*, profit is divided between the parties according to certain ratios, but in a *wakala* an investor will only receive the profit return agreed between the parties at the outset. Any excess profit will be kept by the agent (Abdul Aziz & Gintzburger, 2009; Jalil & Rahman, 2010).

In this type of contract the investor appoints an agent to invest funds provided by this investor into a pool of investments or assets and the agent lends it expertise and manages those investments on behalf of the investor for a particular duration, in order to generate an agreed upon profit return. Thus, the two parties enter into a *wakala* agreement, which will govern the appointment, scope of services and fees payable to the agent, if any. The relationship between the investor and the agent must comply with certain basic conditions, which are described below (AAOIFI, 2008):

- The scope of this arrangement must be within the boundaries of *sharia*.
- The subject matter of this arrangement must be clear and unambiguous and must be set out in the *wakala* agreement such as the duration of the contract, the type or criteria of assets that the agent can select, the fees payable to the agent for its services and the conditions for termination of the *wakala* agreement.
- In order for the *wakala* to be valid, the agent must be paid a fee, even if it is nominal.
- The general view among *sharia* scholars is that it is not permissible for an obligor to agree to purchase *wakala* assets for fixed or variable amounts calculated by reference to a formula, as this would be akin to a guarantee of profit. This mechanism would only be acceptable if the seller and the obligor were different entities. Moreover, the AAOIFI (2008) statement has restricted the use of this mechanism except where the obligor and the seller are independent of one another.

The *wakala* structure is particularly useful where the underlying assets are available to the originator and can be used to support the issuance of the *sukuk*, comprising a pool or portfolio of assets or investments as opposed to a particular tangible asset or assets (Wahab et al., 2007). To illustrate, in *sukuk wakala*, the SPV as an issuer issues *sukuk*, which represent an undivided ownership interest amongst other *wakala* assets. The *sukuk* also represent a right against the issuer SPV to payment of the periodic distribution and dissolution amount. The investors subscribe for the *sukuk* and pay the principal amount as proceeds to the SPV. Then the SPV declares a trust over the proceeds and any assets acquired by them, thereby acting as a trustee on behalf of the investors (Abdul Aziz & Gintzburger, 2009). The SPV, in its capacity as principal, enters into a *wakala* agreement with the agent pursuant to which the agent agrees to invest the *sukuk* proceeds, on behalf of the SPV, in a pool or portfolio of investments the *wakala* assets, selected by the agent, in accordance with specified criteria. These eligibility criteria are established by the AAOIFI (Wahab et al., 2007). Firstly, at least 30 per cent of the portfolio of assets should comprise tangible assets such as *ijara* or equities or other asset-based *sukuks*. The agent must therefore assess whether it has a sufficient quantity of the relevant assets to satisfy this ratio. Secondly, it is limited only for the agent to purchase equities of companies where the primary business activity overall is compliant with *sharia.* However, some scholars allow for a five per cent of the aggregate revenue of the company from non- *sharia* compliant activities. Finally, if the pool comprises *sukuk*, the *sukuk* must be fully backed by tangible assets. The *sukuk* proceeds will be used by the agent to purchase the selected *wakala* assets from one or more sellers. These assets will be held and managed by the agent, on behalf of the SPV, for the duration of the contract in order to generate an expected profit to be agreed upon by the principal.

As a result, the *wakala* assets will constitute part of the trust assets held by the issuer SPV in its capacity as trustee on behalf of the investors. The profit return will be used to fund the periodic distribution amounts payable by the SPV to the Investors. Any profit in excess of the periodic distribution amounts will be paid to the agent as an incentive fee. It is possible that the *wakala* assets may generate a return that is less than the periodic distribution amounts. One possible mechanism can be used under *sharia* requirements, is that under the purchase undertaking agreement is for the obligor to agree to purchase a certain portion of the *wakala* assets at regular intervals for an exercise price equal to the periodic distribution amounts. The periodic distribution amounts will be paid to the investors on the relevant periodic distribution dates. The periodic distribution amounts will either be a fixed or variable amount calculated in accordance with a fixed formula based upon reference such as LIBOR (Tariq, 2004).

To comply with *sharia* requirements, the AAOIFI (2010) stress in their standard for the mode of *wakala,* an upfront fee to be paid to the originator as an agent. This can be combined with incentive fees payable at maturity based on the overall performance of the *sukuk* assets. Nevertheless care should be taken to ensure that this does not amount to profit-sharing (AAOIFI, 2008).

The strength of the *wakala* contract is that it may be avoid certain other risks such as currency risks or the risk that the timing of payments on the investments will not match the periodic distribution dates, for which risk management mechanisms would need to be built into the structure similar to swaps. The reason behind this type of contract is not associated to the actual performance of the asset. Instead these risks will be borne by the agent, who will be required to fund the periodic distribution amounts regardless of any shortage in the income generated by the *wakala* assets or any currency or timing mismatches (Clifford, 2009; Tariq et al., 2007).

An example of a *sukuk al- wakala* issuance is used in Saudi Arabia by Dar Al Arkan Real Estate Development Company (DAAR) (*Sukuk* IV) in February 2010 the issuance was US$450 million. In addition, the *wakala* structure has been used in different countries in the GCC region during 2011 and 2012 and the accumulated amount increased to holding capital investments worth more than US$2,743 million (Zawya, 2011).

However, these innovations have invoked many *sharia* issues and controversies. Most of the modern *sharia* scholars do agree on the illegality of one of the most popular *sukuks* used today such as *mudaraba*, *musharaka* and even some applications of *ijara*. Because they could escort to one of *sharia* prohibitions such as *riba*, *gharar*, gambling, dealing in unethical goods and services, compensation-based restructuring of debts, trading in debt contracts at discount and forward foreign exchange transactions. In addition, the applications of *sukuks* in the Gulf area particularly in Bahrain, Saudi Arabia and the UAE have resulted to a debate between *sharia* scholars who were provoked around using some of these contracts as an investment or financing tools. On the other hand, some of *sharia* scholars legalised these applications (Tariq et al., 2007).

2.4 The Origin and Mechanism of *Sukuks*

It is important to understand the origin of *sukuks* practice. The design and mechanisms of Islamic securities, or *sukuks*, are derived from the conventional securitisation process. The United States (US) Government in the 1970s through the Government National Mortgage Association (*GNMA*) issued pass-through securities collateralised by a pool of mortgage-backed loans that it guaranteed, and these papers were sold to the investors. This phenomena continued spreading in the US and Europe in the 1980s. In the 1990s, these securities became very important products in the international capital market not only confined to mortgaged-backed securities, but extending to other types of asset-backed securities (Idris, 2008).

Since mid 1970s the practitioners in Islamic financial markets attempted to use the asset-backed securities technique. As a result, the first Islamic financial instrument was presented to the securities markets in 1980 by the Pakistani Government using the *mudaraba* certificates. In 1983, the central bank of Malaysia attempted to issue investment papers that involve *riba*-free instruments. In 1990, Malaysia followed Pakistan when Shell Oil Company's Sarawak subsidiary issued *murabaha* certificates known as Islamic Private Debt Securities with Bank Islam Malaysia as the arranger (Wilson, 2008).That could be considered as the first attempt of issuing *sharia compliant* certificates. In the 1990s, other financial institutions in Muslim countries, including Malaysia, Pakistan, Egypt and Turkey, issued securities that were more or less similar to the conventional securities (Idris, 2008).

However, their presence in the market became visible only in 2001, when issues were held in scale and have attracted the attention of the international community. Islamic securities have become increasingly popular over the last seven years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through corporate *sukuk* (Idris, 2008).

Besides, Islamic transaction forms in its modern structures had been providing by Shaikh Syed Abul A'la Maududi (1984) in his book, *Economic System of Islam*, which might be recognised as the first theoretical work related to *sukuks* forms. It appeared in the Urdu language in the 1960s, and the English version was not pubhshed until 1984. Shaikh Syed Maududi argues the benefits of partnership arrangements based on the Islamic law (Maududi, 1984). Ahmad (1964) suggested partnership arrangements between the bank and the account holders based on profit sharing as a substitute to interest, and funds held in current accounts could be utilised in discounting trade bills without charging interest. However, these works were among the initial writings on Islamic transaction modes.

The recent practical works of Islamic transactions modes begins in the first half of the 1980s with a seminal book, *Partnership and Profit Sharing in Islamic Law*, by Professor Mohammad Nejatullah Siddiqi (1985), which provides significant progress in the development of Islamic bond structure and discusses the subject at length for the first time. He built up an elementary model of the *mudaraba* contracts, provied the legal foundations on which banking and financial intermediation can be reorganised in a modern Islamic economy. He also discussed the rights and duties of the financial intermediary in depth (Siddiqi, 1985).

Later, Mannan (1990) made the most important contribution to Islamic financial instruments in suggesting that some new innovative instruments to mobilise financial resources. These instruments include: Islamic commercial papers, loan certificates, index linked loan certificates, integrated investment bonds, profit sharing certificates, expected rate of dividend certificates, rent sharing certificates, firm commercial certificates, *zakah* certificates and human capital certificates. To him these products can be organised in one way or another based on the principles of *mudaraba*, *musharaka*, *murabaha* and *ijara* purchase. Some of these ideas has been used in some Islamic markets for instance Islamic commercial papers used by Malaysian market, *zakah* certificates in Pakistan market.

The recent literature on Islamic bonds can be divided into three groups. The first group of researchers is descriptive in nature, explaining the basic concept of Islamic securitisation and *sukuks* as innovative Islamic financial instruments. They include Neftci and Santos (2003), Kholid, Hassan and Sukmana (2007) and Beik and Hafidhuddin (2008). The second group of researchers pay more attention to *sharia* and legal issues, such as the process involved in *sukuks* issuances, the applicability of *sharia*-based contracts in some of the *sukuks* issuances and the identity and positions of the parties involved. The majority of this literature comprises articles and conference, seminar and symposium presentations. Researchers who have contributed significantly to the theoretical formulation of Islamic financial instruments include Rosly and Sanusi (1999), Al-Amine and Al-Bashir (2001) and Ayub (2005). The third group discusses particular issues based on empirical examination, such as the risks, profitability and market behaviour of *sukuks* and other issues, focusing on standardisation, harmonisation and globalisation. They include Rahman and Rahim (2003), Abdel-Khaleq and Richardson (2006). Some of these studies that are relevant to this thesis are discussed in this chapter.

Replicating the conventional financial products forms in accordance with the Islamic law could not on many occasions effectively copy the conventional risk management and hedging tools. For instance, Neftci and Santos (2003) tried to replicate the functions of interest rate swaps and derivatives in order to provide a synthetic framework that could be used in emerging markets. Swaps may perhaps play an important role in developing the Islamic equity market. However, swap is not compatible with *sharia*, since it is an exchange of liabilities and obligations, and involves interest-based instruments. The basic problem here is that most of the conventional hedging tools are based on excessive uncertainty and speculation which are prohibited under the Islamic code. Therefore, it is essential to innovate something that can be use for risk management as a hedging tools rest on *sharia* objectives. Neftci and Santos's (2003) work sheds light for further works to provide a possible solution to this problem for the consideration of *sharia* scholars.

Tariq (2004) offered an idea that, since the floating rate of the *sukuk* represents ownership in rented assets and/or of usufructs of assets, it is tradable in secondary markets. While a fixed rate zero-coupon *sukuk* represents debt instruments that cannot be traded on secondary markets but are exchangeable with real assets, goods, services and stocks of companies. Thus, the floating rate *sukuk* is exchangeable with the fixed rate zero-coupon *sukuk* if their face values are equal. If not, discrepancies will have to be adjusted by cash payments. In the same manner, Tariq et al. (2007) argue the possibility of a swap between floating-rate *sukuk* and fixed-rate zero-coupon *sukuk* because *sukuk* certificates as mechanisms of liquidity management present a novel asset-backed securities structure that could be the foundation for supporting risk-management derivative instruments. Nevertheless, they have not provided any solution.

The idea offered by Tariq et al. (2007) faces serious problem because in practice zero-coupon *sukuk* face liquidity issues and cannot be adjusted to variations in market conditions such as prices, interest rates and exchange rates. Therefore, investors in these assets are exposed to serious market risks until *sharia* compliant technique is developed (Wilson, 2008).

Moreover, the nature of *sukuk* itself is more towards an investment partnership, not merely debt, but this is still debated. Therefore, it is essential for this study to understand how practitioners recognise *sukuk* in the marketplace as a debt or equity instrument of diverse structures. Besides, each country's thought has inherent characteristics that cannot be accepted by others.

One way or another the rejection of Neftci and Santos' (2003) proposal has led researchers to strived hard for new structures that can be used for mobilising funds. Kholid et al. (2007) proposed a time-sharing bond that represented ownership of specific time (usufruct), which is known in the market as *al-Intifa'a sukuk*. This was recently embedded into *waqf* as one of the Islamic economics resources in Malaysia. In addition, Beik (2008) suggested the *salam* and *mudaraba bilistisna' sukuks* scheme for mobilising funds in the agricultural sector. Some constraints may exist in regulations, taxation, SPV and the capability of human resources which will have to be resolved.

Other researchers have provided schemes such as *'bay al-'innah and bay al-dayn'*. These schemes are not allowed by the majority of *sharia* scholars especially the Al-Shafie school. Therefore, this could be risks for *sukuks* to be accepted by countries following different schools of Islamic thought. Some argue that this resembles *riba* and have been designed as a back-door entry to the market (Rosly & Sanusi, 1999). Practically the possibility of reselling *salam sukuk* before taking possession of the asset can lead to *gharar* or *riba* (Al-Amine, 2008).

For this reason, certain criteria must be met in order for *sukuks* contracts to be *sharia* compliant. Thus, any further development in *sukuks* could be a challenging task as some constraints may become a bottleneck for further development of alternative *sharia* compliant *sukuks* instruments, especially given the dearth of *sharia* experts knowledgeable in financial engineering (Ayub, 2005).

2.4.1 *Sukuks v.* Conventional bonds.

The relationship between the issuers of conventional bonds and their holders is simply a relationship between debtors and creditors on a loan-based contract where interest charges are applied as a reward for granting a loan. From this point of view, conventional financial institutions offer an attractive prospect to convert one's future wealth into present wealth by charging interest. An interest rate is the price of living in a world that relies heavily on debt. In most cases, consumers pay an excessive amount on fees on top of the amount they borrow, leaving them in worse financial state than when they started (Mirakhor, 1995). The distinction of *sharia* law in regard of the idea of bringing one's future wealth to the present and creating artificially high demand does not fit with the Islamic ethos. This is because a healthy economic environment at any given time does not guarantee positive return or a productive use of money capital as value productivities lie in a future surrounded by uncertainty and risk (Nomani et al., 1994).

The Islamic finance industry has expanded enormously in response to a profusion of investment products, a scenario that has been fuelled by an increasing demand for *sharia* compliant investment opportunities. Of all the rapidly growing Islamic capital market securities none are gaining in popularity as much as *sukuks*, which in some respects have a different underlying structure compared to the conventional models.

However, only very few studies implemented comprehensive *sukuks* surveys that cover a range of issues of *sukuks* market behaviour. The best-known survey is a comprehensive survey of Cakir and Raei (2007), which examined the secondary market behaviour of Eurobonds and *sukuks* issued by the same issuer. Their study focused on four countries namely: Bahrain, Malaysia, Pakistan and Qatar. Their argument is based on analysis of the delta-normal approach and Monte-Carlo simulation methods. They confirmed that *sukuks* in the investment portfolio could significantly reduce the portfolio's value-at-risk compared to a strategy of investing only in the conventional bonds of that issuer. This is because *sukuks* are a different type of instruments to conventional bonds, as evidenced by their different price behaviour. Moreover, Cakir and Raei (2007) claimed that *sukuks* are similar to conventional bonds when it comes to such features as ratings, issuance and redemption procedures, coupon payments and default clauses. *Sukuks* returns also correlated with returns on conventional bonds.

In other study, Ahmad and Radzi (2011) investigated the sustainability of *sukuks* and conventional bonds issuances during the 2007 economic downturn, focusing on the Malaysian debt market. They used ordinary least squares regression and three variables: gross domestic product (GDP), foreign exchange and market liquidity. They found foreign exchange to be the major cause of *sukuks* and conventional bonds issuances in Malaysia. However, the latter did not consider economic conditions as proxied by gross domestic product (GDP) and market liquidity as a driving force, which implied its insensitivity to economic conditions compared to *sukuks* (Ahmad & Radzi, 2011).

It is interesting to note that Wilson (2008) found that the use of GDP-based pricing rate could lead to greater payment stability for sovereign *sukuks* in Saudi Arabia, but not in Malaysia. This finding indicates that the two markets have different characteristics. Wilson

(2008) further asserts that these differences are perhaps due to the pegging of GCC currencies to the US dollar with the exception of Kuwait. Therefore, Ahmad and Radzi (2011) study is limited in considering other markets factor which makes GCC countries different than Malaysian debt market.

In addition, Wilson (2008) argued that the GCC region *sukuks* have reasons to be optimistic because they are generally backed by oil and gas industries. Given the compatibility of American oil and gas law with *sharia* precepts, energy companies in the US may begin to look to the liquidity of the Muslim world as a major source of investment funds for petroleum projects and operations.

Poghosyan (2010) examined the factors that identified by Wilson (2008). He employed the stochastic discount factor methodology to examine the relationship between US macroeconomic variables, foreign exchange risk (for maturities of 1 month, 2 months, 3 months, and 6 months) and international oil prices in some of GCC countries, specifically Saudi Arabia and the UAE in 2007-09. He found that US consumer price index (CPI) inflation, consumption growth and oil prices have a direct impact on foreign exchange risk in the GCC in the long run, where the dependence of these economies on oil revenues has been very high historically.

Islamic finance has emerged as the fastest-growing segment of global finance in recent years due to consistently high oil prices in international markets and the resilience of Islamic financial institutions and their instruments against the recent global financial crisis. The idea behind a *sukuks* is simple: prohibition of interest virtually closes the door on pure debt security but an obligation that is linked to the performance of a real asset is acceptable. Therefore, the contract has a special role in determining the *sharia* legitimacy of financial products. Rosly (2010) states that the validity of contract rests on the fulfilment of six elements: buyer, seller, price, subject matter, offer and acceptance.

2.4.2 Asset-backed *sukuks v*. asset-based *sukuks*.

According to the Islamic Financial Services Board (IFSB) (2005) guideline no. 2, *sukuks* are ideally categorised as asset-backed and asset-based instruments, whereby the former offers fair and predictable return, such as in the case of *salam*, *istisna*, and *ijara* whilst in the latter the return is derived from profit-loss sharing of joint venture business, which offers unpredictable return, based on *musharaka* or *mudaraba* contracts. Since there are deviations in the actual implementations of *sukuks* from ideal theoretical ground of *sukuks*, there has been a concern to categorise *sukuks* in order to differentiate genuine and non-genuine ones, particularly risk factors and sale execution. In this regard, the IFSB (2009) guideline no.7 on capital adequacy requirements for *sukuks*, securitisations, and real estate investments, distinguishes three types of *sukuks* structures: asset-backed *sukuk* (ABS) and two non-ABS structures, which are pay-through and pass-through structures.

According to these guidelines, ABS is structures that meet the requirement for being an asset-backed structure as assessed by a recognised external credit assessment institution (i.e. rating bodies). Based on this guideline, there are two factors that constitute ABS. Firstly, in the case of any impairment of the *sukuk's* assets, the *sukuk* holders have to face the loss. Secondly, the risk factor of ABS is the underlying assets of *sukuk*. Therefore, *sukuk* holders derive the risk and return from the cash flows of the *sukuk's* underlying asset and have recourse to the *sukuk* asset, not the issuer, in case of default by the *sukuk* issuer. True sale execution is another dimension of ABS in which there is a real transfer of assets from the originators to *sukuk* holders with the effect of releasing assets from the issuer's balance sheet to investors (Ahmed, 2010).

In contrast, with asset-based *sukuk*, there is no true sale transaction taking place, but rather a transfer of financial rights to the asset, and income is derived from the financial rights to obligations attached to the debt (Abdul Aziz & Gintzburger, 2009). True sale transaction is absent since the *sukuk* holders have recourse to the originator instead of the underlying assets in the event of defaults. This is based on pay-through and pass-through as defined in the IFSB (2009) guidelines, in which the former constitutes recourse to the originator via purchase undertaking while the latter constitutes recourse to the issuer via guarantee.

Therefore, the risk and return of asset-based *sukuk* are derived from the obligor instead of the *sukuk's* underlying assets, so that in case of defaults, investors have recourse to the obligor and secured creditors cannot have recourse to the asset. The risks are measured solely on the issuer or obligor's creditworthiness to pay back the capital. Thus, it is not surprising that investors are mainly focused on sovereign/corporate credit quality and less concerned on the actual underlying asset performance when they buy *sukuk*. In this regard, *sukuk* holders are guaranteed to get the capital back in the event of bankruptcy. Furthermore, in asset-based *sukuk*, the structure is merely fulfilling the form of a contract with much more complexity, which ultimately leads to Islamic equivalent of unsecured conventional bond (Howladar, 2009). Hence, *sukuk* holders would only be able to dispose of the assets to the lessee and be treated as unsecured creditors or ranked pari passu with other unsecured creditors (Haneef, 2009).

Jobst (2007) highlighted four main key aspects of Islamic Securitization to be: The main reason for securitization by way of classification of valuable securitized property or assets, unrestricted and unsecured payment obligation, by combining of individual and group risk giving that loss and gain would be evenly shared by all stakeholders and confirmation of the legal rights of each investor's assets through direct business participation. Therefore, based on those four conditions, Islamic securitisation has the risk-reward sharing spirit and places paramount importance on the real economy through undertaking real project activities (Jobst, 2007). Consequently, Islamic securitisation is in line with ABS structures whereby the true sale transaction takes place between the *sukuk* holders and the *sukuk* issuer. Moreover, the return of securitised assets is derived from real activities, and the *sukuk* holders can legally enforce them in the event of defaults. However, poses major legal problems in the event of *sukuk* legal defaults is that the *sukuk* holders cannot have recourse to the securitised assets.

Asset-backed and asset-based *sukuk* are similar, but they differ significantly in terms of asset recourse to the investor, ownership, and rating perspective (Abdul Aziz & Gintzburger, 2009). These differences are summarised in Table 2.2.

2.4.3 Special purpose vehicle.

The SPV referred to as a 'bankruptcy-remote entity' whose operations are limited to the acquisition and financing of specific assets. The SPV is usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. It is originally use to isolate financial risk. Therefore, a corporation can use such a vehicle to finance a large project without putting the entire firm at risk. Problem is, due to accounting loopholes, these vehicles became a way for CFOs to hide debt. Essentially, it looks like the company does not have a liability when it actually does. In order to ensure that the assets actually achieve the bankruptcy remoteness, it is essential to move them out of the balance sheet of the originator and park them with another independent entity. Typically, an SPV is employed to purchase the assets from the originator and issue securities against these assets. Such a structure provides a comfort to the investors that they are investing in a pool of assets which is held on their behalf only by the SPV and which is not subject to any subsequent deterioration in the credit quality of the originator. The SPV is usually a thinly capitalised vehicle whose ownership and management are independent of the originator. The main objective of SPV is to distinguish the instrument from the originator (Frankel, 1998).

Table 2.2: *The main differences between asset-backed and asset-based sukuks.*

Categories	Asset-backed *sukuk*	Asset-based *sukuk*
Asset recourse of the investors	To the asset-issuing vehicle; the *sukuk* investors bear any losses in case of impairment of the *sukuk*.	To the creditworthiness of the ultimate obligor.
Ownership	Implies that ownership rights extend to the actual underlying assets such as physical real estate or rights/usufruct from particular intangible but valuable assets.	Only provides artificial ownership rights to the usufruct of certain physical underlying assets, instead of relying on the obligor's credit quality to ensure that the *sukuk* performs.
Presentation/disclosure of the asset	The asset is separated from the originator's book.	The asset stays on the balance sheet of originator/obligor.
Rating	Asset-backed rating methodology, which involves securitisation. Credit risk is determined solely by the performance of underlying assets.	Corporate rating methodology is used whenever a corporate obligor is the key driver affecting the credit risk of the *sukuk*.

Source: Hidayat, 2013.

In Islamic finance, SPV has been used in connection with a wide variety of *sharia* compliant Islamic capital market instrument transactions. These have included structures established for the purpose of making investments off-balance sheet, securitising assets and the re-packaging of financial instruments. However, SPV is established based on the trust law in which the *sukuk's* originator as the transferor transfers the assets to the *sukuk* holders as beneficiaries via the SPV as a trustee with a good faith (Ryan & Elmalki, 2010).

In *sukuks* issuances, usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). However, this typical offshore SPV leads to a problem whereby there is no uniform law, in fare as the offshore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs (Frankel, 1998). Indeed, there is a significant legal unpredictability governing *sukuks* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the UK, there can be additional impediments arising from those foreign judgments' enforceability in those foreign jurisdictions where there is an absence of bilateral treaties for reciprocal enforcement of judgments (Ryan & Elmalki, 2010). Therefore, this issue leads to weakness on the part of the local court or legislation as well as legal confusion with respect to certain laws' enforceability in case the issuer defaults. Thus, the kind of conflicts could happen in the sphere of Islamic finance due to dual law system that governs transactions.

For instance, according to a case in the High Court of England, the reference to *sharia* in a contract was no more than a reference to the fact that the bank purported to conduct its affairs according to *sharia* principles, and it did not mean that *sharia* law was applicable to the contract in an English court. On appeal, the Court of Appeal said that it was 'intended simply to reflect the Islamic religious principles according to which the bank holds itself out as doing business rather than a system of law intended to trump the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement (Potter, 2004).

This means English courts will not apply Islamic law to the contract, although the disputed choice of law provision stated that English law was to be applied 'subject to the principles of the Glorious *sharia*'(Potter, 2004). This can be seen in the case of Shamil Islamic Bank of Bahrain *v.* Pharmaceutical Company, where English common law and civil law each present distinctive problems when they collide with *sharia*. The problem in using *sharia* finance under common law jurisdiction is the conflict that emerges between them; the national/common law always prevails over *sharia* law when there are disputes. As a consequence, the contract is interpreted solely based on what is written in the contract in respect to *sharia* regulations. In the above case, the defendant was not able to make payment for his financing to the bank, and the court based its judgement on English law instead of Islamic law. The defendants argued that the contract was worded with *sharia* principles in a way that would not clash with English law. However, the judge ruled that as there cannot be two separate law systems governing a contract, the national system is the valid law based on the Roman conventions that have force in the English law system. The conflict between the two laws led to confusion over the legal basis of the verdict, which was based on sale contract law though the contract itself was actually a conventional debt contract (Potter, 2004).

Executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV. Nevertheless, some *sukuk* issuances do not execute a true sale, due to the absence of property law and bankruptcy law under civil law regimes. This again was reflected in the Nakheel *sukuk* case wherein leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE as applicable in the Emirate of Dubai (Salah, 2010). Instead, the rights were viewed as unregistered personal contractual rights binding the parties as opposed to rights to the land in question (Shenker & Colletta, 1990). This indicates that the civil law indeed impedes the undertaking of true sales that would be enforceable in *sukuk* issuance.

While bankruptcy law is crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed securities, even in cases of the originator's bankruptcy (Schwarcz, 1994). So far, in some countries under a civil law regime, especially in the GCC region, there has not yet emerged a proper bankruptcy law to protect *sukuk* holders from bankruptcy on the part of the *sukuk* originator. For example, in the UAE, bankruptcy is governed by the commercial companies' law; federal law No. 8 of 1994 does not have a specific definition of bankruptcy. The law only shows the situation where a 'trader' will be regarded as a bankrupt in the event of insolvency, as governed in article 645 of the law. In pursuant to article 4 of the law, a trader is defined as being an individual or company that carries out commercial activities. The law unfortunately does not have specific recognition of the term that describes the situation where shareholders have limited liability, as in the case of common law jurisdiction (*Gulf News*, 2009).

In common law jurisdiction and some countries under civil law jurisdiction such as the Netherlands, bankruptcy law is codified as a specific law and there are clearer administrative procedures to deal with bankruptcy.

2.5 The Theory and Practice of *Sukuks* in the GCC

This section highlights the paradigm, theory and practice, achievements, pitfalls and future prospects of Islamic income securities. It deals with the most Islamic remarks in *sukuks* practice. As is the case with most Islamic finance instruments, the typical approach to *sukuk* is to take the equivalent instrument in conventional finance and to attempt to replicate it in a way that is *sharia* compliant. In the case of *sukuk*, consideration is given to the important commercial features (such as rate of periodic return, return at maturity, and financial covenants), together with key legal considerations (such as transaction risk disclosure, events of default, and representations and warranties).

The market has tended to place *sukuk* in the same asset class as a conventional bond and has thus identified *sukuks* as debt capital market instruments. However, this view is at odds with Islamic jurisprudence, which, though differing on certain issues of interpretation in relation to detail, has almost universally agreed that *sukuks* should be viewed as equity investments, thereby exposing the investor to ownership risk in relation to the assets they have purchased through their investment in *sukuks* (Iqbal & Mirakhor, 2011).

Furthermore, the CBB issued *sukuk* in September 2001 to fund infrastructure and governmental projects, which was the first issuance in GCC region. There was a debatable between *sharia* scholars about the valuation of *sukuk* application in comparison with the fixed terms of Islamic jurisprudence meant for *ijara*, *musharaka* and *mudaraba* in the GCC region. To illustrate, this, in 2007, *sukuks* witnessed a separating transitional phase at the level of jurisprudence as been demonstrated in chapter1.

These issues came to a head in two sessions of the International Council of *Fiqh* Academy, Muscat 2004 and Sharjah 2009, where the Academy issued its resolution numbers 136(2/15), 137(3/15) and 178(4/19). The concerns of the *sharia* scholars were centered around the use and application of the purchase undertaking in *sukuks* transactions, and particularly the methodology used to determine the exercise price (or purchase price) for the *sukuk* assets upon an exercise by the issuer/trustee of its right to require the obligor to purchase those *sukuk* assets pursuant to the terms of the purchase undertaking (Ahmad, 2010; Saeed & Salah, 2012).

For this reason, the AAOIFI's (2008) *sharia* Board held three meetings between the years 2007 and 2008 to estimate these applications and issue the legitimate opinion which represent the board's opinion.

Part of this study examined a number of *sukuks* contracts in the GCC, particularly in Bahrain, Saudi Arabia and the UAE. The most prominent *sharia* notes provoked around the applications of *sukuks* are summarised below:

I. Implied contract for guarantee the nominal value of the *mudaraba*, *musharaka* or *wakala* contract from the originator under pretexts such as:
    - The obligatory resource determines to buy the *sukuk* assets with a nominal value at the end of the *mudaraba* or *musharaka* period on the basis of separating between the essence of contract and of the originator in *mudaraba*, *musharaka* and *wakala* contracts.
    - The obligatory resource determines to guarantee the capital in a separate document from the *mudaraba* or *wakala* contracts or the *sukuk* issue contract.
    - The obliged, the originator in a *mudaraba* contract, determines to lend his *sukuk* asset portfolio seeking to distribute profits at a specific level.
    - Distributing the profiles on the account without a way of future accountancy between the *sukuk* holders and the originator in *musharaka* or *mudaraba* contracts especially with the negotiable *sukuk*.
    - The originator in a *mudaraba* contract must provide fund for a project of *mudaraba* agreement to guarantee distribution of profits at a specific level.

II. Formality in contracts especially in ownership-ended *ijara* contracts. For example:

- It is not allowed for *sukuk* owners to do anything to the rented property if the tenant failed to pay for the lease and the contract was cancelled.
- Fulfillment selling is suspicious to be sinful as some *ijara sukuk*s buy the asset from the originator then lease it again to him by ownership and oblige him to give the rental fee cost back.
- Guaranteeing the nominal value from the originator of the *musharaka* or *mudaraba* contracts through determining to buy the assets at the end of the rent contract or when *sukuk* matured.
- Some *sukuks* assets cannot be lawfully owned by *sukuk* holders, as they are sovereign assets and the privileges to some governmental and quasi–governmental companies.

III. There is no consensus among *sharia* scholars for a particular *sukuk* issuance and its documents or its applications. To illustrate, in some of the *ijara*, *musharaka* and *mudaraba* cases, the *sharia* board concerned did nothing more than granting permission of the structure. So, their permissibility was limited to *sukuks* applications without certainty of involving the modifications of the complete documents of the *sukuks*, especially under the purchase undertaking agreement or the points related to defaulted cases in all these contracts. In addition, uncertainties were available concerning using the sum of *sukuks* selling in the targeted aim for which they were issued or in the defined way of *sukuks* documents or how much they make what they expected of *sukuks* assets.

The declaration of the AAOIFI's (2008) *sharia* Board had a sanitary effect on explaining the *sharia* scholars' opinion about the legality of the negotiable *sukuk*, assuring that some *sukuks* applications do not comply with *sharia* regulations. Nevertheless, this declaration is not lawfully obligatory unless a supervisory power subdues or forces it, so it has not stopped the applications that are contrary to *sharia* regulations. The following section will discuss the need for more efficient treatments to the case and prevent their sinful application.

2.5.1 *Sharia* regulations in GCC countries

One of the major issues facing the *sukuks* market in GCC countries is the absence of a centralised *sharia* supervisory board that specialises in Islamic finance, which could lead to declining public trust in Islamic financial products. Although some institutions have their own *sharia* supervisory board and follow the principles and guidelines published by international and regional institutions such as the AAOIFI, it is necessary to establish a centralised *sharia* supervisory board with some level of authority to enforce its decision and create general guidelines and rules that should be taken into consideration by entities providing Islamic financial services and products. Most opinions regarding financial products are issued by individual *sharia* scholars, who raise the probability of conflict as mentioned previously.

One such conflict in *sukuk* trading is the two different groups of scholars' opinions over the initial public offering (IPO) of Saudi Arabia's Yanbu National Petrochemical Company's (YANSAB). These differences arose because the company borrowed money from a conventional bank with an interest rate. The first viewpoint is represented by the opinion of *sharia* scholar Yusuf Alshubaili (2005), who stated that the main activities of the company were *sharia* compliant and that contributing to the IPO of the company was permitted even if the company was involved in non- *sharia* compliant activities such as borrowing small amounts of money from conventional banks. In addition, Khalid Alduaiji (2005) documented that this permitted have been limited by a percentage of the amounts of money that been borrowed from conventional banks to a total of the firm's asset. He documented that *sharia* supervisory board in Al Rajhi Banking and Investment Corporation limit the contribution of non *sharia* compliant borrowing by 25 per cent, The Dow Jones Islamic Market Index by 33 per cent, and the AAOIFI by 30 per cent, which have been taken by the most of *sharia* supervisory boards in financial institutions in the region. The other viewpoint is represented by *sharia* scholar Yusuf Al-Ahmad (2005), who adopted the view that contributing to YANSAB's IPO was not permitted due to the involvement of the company in a non *sharia* compliant activity.

In countries that have exchanges debt market, there is no separate board to assess *sharia* compliance, and scholars influence the market. Their differing opinions may result in significant damages to the issuer company, such as the above-mentioned announcement of the AAOIFI's *sharia* board's chairman in 2007, which resulted in a decline of *sukuks* issuances by 55 per cent in 2008 compared to 2007. It is important to identify the regulated accountability of markets in GCC countries.

2.5.2 Islamic investments exceeded traditional investments

The Islamic financial sector has grown and gained of strength by the creation of various support and infrastructure institutions, and expanded from being a banking-based industry to wider areas incorporating capital market based products and services. Ali (2008) clarified that Islamic capital market like conventional counterpart is an important component of the overall Islamic financial system. According to him, this market facilitates the transfer of investible funds from economic agents in financial surplus to those requiring funds. This is achieved by selling a wide array of products ranging from *sharia* compliant securities to bond like structures known as *sukuks*. Thus, the tools used to develop and structure the *sukuks* must comply with *sharia* values and principles, distinguishing it from others. Indeed, extant literature proclaims that Islamic financial system differs significantly from conventional system, not only in the ways it functions, but above all the values which guide its whole operation and outlook. The prevailing values within *sharia* are expressed not only in the minutiae of financial transactions but in the breadth of their role in realising the objectives of *sharia* or in *maslaha*. Based on previous arguments, in order for Islamic financial products, specifically *sukuks*, to promote *sharia* objectives; they must meet the demands of investors and borrowers who are motivated by profit maximisation theory and take into consideration *sharia* requirements (see Chapter 3).

The utility theory from the *sharia* perspective based on *maslaha* means mere maximisation of profits cannot be a sufficient goal of a Muslim society unless the output accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness and justice and fair play at all levels of human interaction. Indeed development of this kind of concept would be in conformity with *sharia* objectives and will inevitably lead to a society whereby every member will cooperate with each other and even compete constructively, as success in life is to obtain the ultimate happiness (Chapra, 2001). Hence, increasing numbers of ethically based business and finance organisations and individuals worldwide have become involved in Islamic finance. In response to these demands, many financial companies now claim to provide investment opportunities that balance financial return with ethical, moral and/or social concerns. Interest in this form of investment is growing rapidly in Australia and has developed into a niche investment sector reaching A$14 billion in 2009, which like its global counterparts has been dubbed ethical investment (EI) or socially responsible investment (SRI). Its proponents purport to be able to achieve financially balanced investment portfolios while maintaining a commitment to certain personal or global values.

Alan Lewis (2002) in his book *Morals, Markets and Money* shows that in most cases, from the studies reviewed, a conflict exists in the minds of most ethical investors between applying moral principles and perceived obligations to provide for one's own and one's children future. This dilemma is resolved by splitting investment portfolios between so-called ethical investments and more traditional investment options. His findings indicates that in a practical sense much of what investors do is motivated by what they want to do, not what we ought to do. Ethical reasoning, however, requires that we consider what we ought to do whether or not we want to, or it is practical to, do it. The fact that an action is not practical or is difficult does not mean that it is acceptable to do something else that may not be morally good or right. Neither can we consider the accidental or unintended outcome of investing to be a factor in determining its ethical status. A particular investment is ethical or unethical because it is what we ought or ought not to do (Lewis, 2002).

Some studies showed that religious groups have a strong impact on economic activity. Anderson (1988) claimed that participation in religious groups might pass on two economic advantages to adherents. First, for a 'lower order' individual with no established business reputation, in joining a specific group he or she would gain trustworthiness within the group and hence represent a relatively low risk in terms of potential business transactions. Second, religious groups could also provide extra-legal means of establishing trust, thereby reducing uncertainty and improving efficiency, especially where civil remedies are weak with regards to upholding contracts (Anderson, 1988). Omer (1992) found that religion was the primary factor affecting people's choice of Islamic banking institutions in the UK. Naser, Jamal and Al-Khatib (1999) also demonstrated that a bank's reputation and the religious beliefs it represents were the two most important factors that attracted people to Islamic bank services in Jordan. According to these studies, such individuals are being mindful of the profitability of the asset being financed by the investment to gain the benefits in this life and the life hereafter. This is a fundamental belief in Islam. Figure 2.1 shows the *maslaha* rate of return, which is the difference between the perceived and required rates of return for Muslim investors.

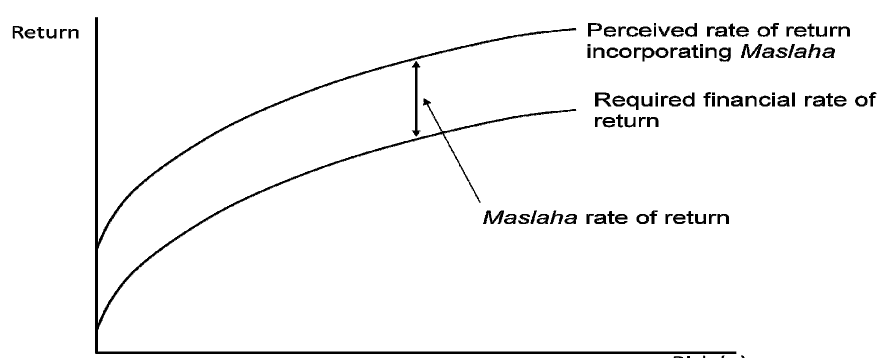

Figure 2.1. Muslim investors' *maslaha* rate of return.

Let us assume that:

S_1 = returns on *sukuk* that have been issued for financing primarily social projects such as utilities or social service centres,

S_2 = returns on *sukuk* that have been issued for financing projects with private and social benefits such as industrial concerns and real estate, and

S_3 = returns on *sukuk* that have been issued for financing primarily commercial services such as financial services.

The hypothesis is that from a financial perspective: $S_1 < S_2 < S_3$ and that from a spiritual perspective: $S_1 > S_2 > S_3$.

This assumption is supported by the findings of Glaeser and Scheinkman (1998) and Lewison (1999), who assert that investors may have a utility function with multiple attributes that is not only based on standard risk-reward optimisation but also on a set of religious, personal and societal values. They show that ethical investing has ancient origins in Jewish, Christian and Islamic traditions.

2.6 Conclusion

This chapter reviewed the literature on Islamic financial instruments and its markets, which was distinguished by set of unique features. A significant portion of the literature on Islamic finance is written in Arabic. This is partly because the *Qur'an*, the Prophet's traditions and most other sources of *sharia* that constitute the theoretical base of Islamic finance are documented in Arabic. Another reason is that the first few financial institutions operating on Islamic principles were established in Arab countries (e.g. Bahrain, Egypt, Jordan, Saudi Arabia, Sudan, and the UAE). The use of Arabic has slowed down the development of debates, particularly among Western researchers.

Older literature was exclusively by Islamic scholars occupying positions in Western universities and research institutes. They include Qureshi and Nadvi (1946), Ahmad (1964), M. Siddiqi (1973; 2004), N. Siddiqi (1985), Kahf (1978), Zarqa (1983), Iqbal (1997), Archer and Karim (2002) and Alam (2006). Pakistani and Malaysian scholars have also made significant contributions, most of which is in English.

The literature on Islamic financial instruments is based on the theoretical contributions of economists, practitioners and bankers, whom try to adopt new techniques, put forward by conventional financial instruments. However, the literature on Islamic financial instruments is relatively new, and has increased since the mid-1970s with the establishment of specialist research centres around the world, such as the World Centre for Research in Islamic

Economics at King Abdulaziz University in Saudi Arabia, the Islamic Research and Training Institute, the Islamic Foundation in Leicester, the Institute of Policy Studies in Islamabad and the AAOIFI in Bahrain. In recent years, the International Monetary Fund (IMF) has also conducted research on Islamic financial products. It is only recently that Western researchers have begun to join the debate with varying views. They include Pryor (1985), Phillip (1997), Thomas et al. (2005), Jobst (2008) and Gait and Worthington (2009).

Quantitative research on Islamic financial instruments, especially *sukuks*, has been quite rare due to the difficulty of obtaining data, the lack of specialists and the late developments in Islamic finance research. Moreover, *sukuks* were generally traded in an over-the-counter market, so they were unrecorded activities and any data may not be reliable, accurate or relevant. *Sukuk*s trading is also less frequent than conventional trading. However, in the last 10 years, various websites have been established to provide information on daily *sukuks* activities, such as the Zawya (2011) website and database, which was set up in 2000 to offer information on *sukuk*s issuances and began providing daily *sukuks* prices in 2011. The Emerging Markets service launched the Islamic Finance Information Service (IFIS) in 2004, which was designed to meet the unique requirements of *sharia* compliant finance industry participants (Euroweek, 2012). In addition, the financial news service provider Bloomberg in June 2011 launched a non-ringgit denominated *sukuks* index, which was developed in conjunction with Bank Negara (Malaysia). This index may provide a global benchmark for the performance of *sukuks* and might trace its movements.

A large volume of research on Islamic economics and finance has taken the form of submissions to seminars and conferences. English was, in most cases, the language of presentation; unfortunately, the events were attended by very few Western scholars and the proceedings were usually not published. Nevertheless, the literature in this area has been accumulating at a remarkable rate. Scholarly journals have shown interest in publishing research on Islamic financial instruments. A number of Western universities have turned out Masters and PhD theses in this field and a few research papers are still in the pipeline. The interest in Islamic finance has grown to the extent that some Western universities now offer postgraduate diplomas and degrees in this area of specialisation (e.g. Latrobe University in Australia).

This study argues that some innovations that try to achieve the same economic outcome as conventional instruments distort the vision of Islamic economics, which is based on the objectives of justice and equality in *sharia*, also known as *maslaha*. This distortion stems from a restricted understanding of *sharia*, which only focuses on the legal forms of a contract rather than the substance, especially when structuring a financial product. An understanding of the theory and practice of *sukuks* jurisprudence is required to establish the *maslaha* vision and devise criteria on which *sukuks* can be evaluated. This will be discussed in next Chapter.

Chapter 3: *Maslaha* and the Evaluation of *Sukuks*

3.1 Introduction

The previous chapter presented the Islamic paradigm of borrowing, lending and investment by highlights issues pertaining to the most prevalent and successful Islamic financial product, *sukuks*. The current chapter offers a detailed exposition of the concept of *maslaha* as an umbrella for the higher objectives of *sharia* (*maqasid al-sharia*), which provides the basis for rights and obligations under Islamic law. A restricted view of *sharia*, which only focuses on the legal forms of a contract rather than the substance, especially when structuring a financial product, would inevitably result in some distortion of *sharia* compliant financial instruments. The concept of *maslaha* incorporates elements that are pertinent for the articulation of a comprehensive framework for an Islamic financial system. Neglecting any elements of *maslaha* will affect the regulatory framework and consequently the elements of their structure, as discussed below.

The meaning of *maslaha* can be translated as "wellbeing" or "the common good". To benefit from the provisions of this concept a contract, financial or otherwise, it is vital to include the entirety of *maslaha*- rather than selectively including the provisions. If there is no means of adjusting the application and treating the defect, from an Islamic perspective it would give people the opportunity to use the statute to their unlawful ends. A *sharia* board must not only show its legal opinion of the theoretical structure of contemporary *sukuks*, but also consider the realities of trading the instruments in a modern market structure.

The current chapter will deliberate on the concept of *maslaha* in order to shed some light on its application to the current practices of *sukuks* markets. It will start with an exposition of the ultimate purposes and objectives of *sharia* law in section 3.2. It will then develop criteria to evaluate *sukuks* contracts and potentially other financial contracts based on a thorough understanding of three themes: *maqasid* of statute, regulations of behaviour for the public interest and the doctrinal bases of estimating the relevant *sharia* forms in section 3.3. Section 3.4 discusses the criteria for evaluating *sukuks* based on *sharia* objectives. Section 3.5 summarises the key points of the chapter.

3.2 The Purposes and Consequences of *Sharia* Law

The objectives of *sharia* reflect the holistic view of Islam, which is an all-inclusive, complete and integrated code of life for the individual and society both in this world and the hereafter (Dusuki & Abozaid, 2007). Hence, a detailed understanding of *sharia* objectives is vital to understand the tenets of an Islamic system, including the intense commitment of every individual and organisation to justice, brotherhood[2] and social welfare. The ultimate objective of *sharia* law is preservation and to protect individuals and the society from harm. The major schools of Islamic jurisprudence concur that: *sharia* in all its essence is full of interests, whether it's the repelling of harm or to bring benefits (Ibn Abdulsalam, 1999). The assignments imposed on people are rendered in good to them in this life and in the hereafter. Al-Shatibi (1975) asserts that 'drafting of religious laws is for the good of people, sooner or later' (p. 6). The absolute proof upon which Al-Shatibi depends in reporting this rule is based on induction from a countless number of texts from the *Qur'an* and *Sunna*. The purpose of these provisions is for preservation of people's interests not just for worship (see Qur'an, 4: 165 & 21: 107).

Moreover, *sharia* in some legislation matters are accompanied with their reasons in the *Qur'an*. This is clear in situation where there is no water or there is a difficulty to use for wash in the purpose of pray. So, God has allowed 'Tayamum' (dry ablution) in situations where sufficient water is not available (Qur'an, 5: 6).

In addition, there are many situations where concessions have been allowed. An example is the permission, or even the compulsion, to consume pork under conditions where not consuming will result in death. God has not enacted laws just to subject people and get them under his power, rather the laws have been laid for human benefits in this life and in the hereafter. Thus, there is *maslaha* in enacting any *sharia* provision, but sometimes humans are unable to understand or realise the motivation of specific *sharia* provision unless God provides the reason.

3.3 The Concept of *Maslaha*.

The term *maslaha* in Arabic literally means benefit or interest. The foundations for philosophical discussion of *maslaha* were laid down by classical jurists such as Al-Ghazali (1058 -1111) and Al-Shatibi (n.d.- 1388). Al-Shatibi (1975) defined it as 'all concerns that promote the subsistence of human life, the completion of man's livelihood and the acquisition of all his physical and intellectual qualities which are required for him'(p. 11). In other words, *maslaha* is invoked to prohibit or permit something on the basis of whether or not it serves the public's benefit or welfare. Kamali (2006) clarified *maslaha* is that about securing greater

[2] The term "brotherhood" in Islam is universal and is not restricted to males as the term suggests.

interest of the society could be is exercise when a situation arises where procuring one's interest implies the loss of another, then greater interest should be pursued in preference to the lesser. Conversely, anything regards to loss or injury the reverse will apply where the greater will be avoided by tolerating the lesser. Imam Al Ghazali (d.1111) explained *maslaha* as consisting of considerations that secure a benefit or prevent harm., which are based on protection of religion, life, intellect, lineage and wealth (Al-Ghazali, 1993).

There are many verses in the *Qur'an* that convey the essence of *maslaha*. The *Qur'an* instructs individuals to share their wealth with their neighbours. This means that the affluent of a certain street, locality or ward must support the less fortunate and indigent families of the same area. In doing so, Muslims seek benefits in this life and the life hereafter. Accordingly, Muslim entrepreneurs may seek to maximise profits only within the limits set by *maslaha* and will lower their profit margins to further the good of the society. To quote Siddiqi (1999) further, 'in Western banking, earnings/returns to shareholders is the sole criterion of success. Islamic banks, however, seek to maintain a greater balance between the interests of investors, shareholders, users and society' (p. 32).

The use of *maslaha* as an independent legal source has been advocated by many jurists and reformists such as Andalusian lawyer Al-Shatibi (d. 1388), Al-Wahhab (d.1792), Muhammad Abduh (d. 1905), Rashid Rida (d.1935), Ibn 'Ashur (d.1973) and Muhammad Sa'id Ramadan al-Buti, all of whom support the principle based on the notion that Islamic law was revealed to serve human welfare (Lubis, 1995). Hence, all matters which preserve the well-being of the society are in line with the objectives of the *shari'ah* and therefore should be pursued and legally recognised.

Furthermore, Al Ghazali (1993) provided three categories of *maslaha* based on the testimony of *sharia*. The first category is considered superior and valid, the second is considered inferior and invalid and the third is where the legislation has not been talked about its validity or invalidity. The third category according to Nomani et al. (1994) was developed by Imam Malik (d. 796), who proposed a theory known as *al-maslaha al-mursalah*, which can be translated as 'unrestricted public benefit. Although this type of *maslaha* is not mentioned specifically or qualitatively in the *Qur'an* or in the *Sunna*, legislations and judgments can be made through *Ijtihad* which refers to the process of arriving at a conclusion or a decision through deductive reasoning based on premises and principles established in the *Qur'an* and the *Sunna*. They are among the general interests that the Islamic statute has come to achieve according to *al-maslaha al-mursalah*.

Therefore, interest is explained as a benefit in itself, while corruption is harm in itself. Knowledge, profit, leisure and health are all benefits to their owner, while lack of knowledge, loss and pain are all harmful and hurt their owners. For example, temporary pleasure may result in harm for its owner and for others spiritually and financially, such as the consumption of alcohol. Making profit in some forms and methods may involve unjust acts against others or corruption resulting in outcomes that more harmful than beneficial. In the same manner Jihad (struggle in the way of God) can do harm to oneself and the life of future generations may depend upon it. Therefore, the society needs to develop models and methods to accurately measure the benefits and harm based on the interest of both the society and the individual.

The first purpose of *sharia* is to preserve and protect the five fundamental necessities for human being, which are life, religion, intellect, lineage and wealth. Based on Al Ghazali's (1993) definition, everything that includes these five necessaries is a benefit, and everything that desecrates necessities is harm; anything that is not derived from the *Qur'an*, *Sunna* or consensus, is a questionable benefit, and is not consistent with the basic principles of Islam and thus are invalid (Al-Ghazali, 1993). In addition, Al-Shatibi (2003) believed that humans should look for the best public solution in any given situation, and Al-Wahhab (d. 1792) and Muhammad Abduh (d. 1905), who recognised *maslaha* as the basis for reconciling modern cultural values with the traditional moral code of *sharia* in the late nineteenth century (Hallaq, 2004; Kamali, 2000;).

Undoubtedly, Mashal (2010) stated that harm cannot be converted into something that is benefit and vice versa. Therefore, it is important to note that the consequences of this benefit should be with *sharia* objectives. It has also been an accepted principle in Islamic jurisprudence to give priority to public interest over individual interest (Mashal, 2010). Mashal (2010) demonstrated numerous of benefits in *sharia* law which are listed below:

- The time when the effect of both interest and harm appears is not limited in this world but takes the hereafter with that time.
- The *sharia* interest value is not just in the temporary pleasure, but it springs from the need of both body and soul.
- Giving priority to protect religion over other things and the Muslim must sacrifice any other interest to keep the interest of religion.
- Goodness and badness in human acts are considered as an impact and result of the Judgments of thing is be accepted or detested in *sharia*.

- It is not acceptable that human experience shown without the *sharia* texts in determinants of people's interest. instead these experiences must be shown in front of the *sharia* texts and provisions to say their word in their experience.

In this case, the jurist uses his wisdom to pursue public interest based on *sharia* texts. Accordingly, individuals seek return on invested money on the basis of public interest. Such individuals are being mindful of the profitability of the asset being financed by the investment to gain the benefits in this life and the life hereafter. Moreover, borrowers have to raise funds for a project that invoked balance between wealth and moral objectives pursued social goals as a whole to increase the volume of national output and raising the standard of living, which is a fundamental belief in Islam.

Based on the *maslaha* concept, Chapra (2001) provided an explanation for the utility theory from *sharia*'s perspective. He recognised that mere maximisation of profits cannot, and therefore, be a sufficient goal of a Muslim society. Maximisation of output must be accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness and justice and fair play at all levels of human interaction. Conversely, classical capitalist economists have argued that the real purpose of our existence is the maximisation of our utility and that utility can only be maximised by consuming goods and services. Consequently, the goal of the consumer in such a system is to maximise consumption. Nobel Laureate Milton Friedman (1962) has asserted that one of the drawbacks of conventional economics—where the responsibility of a firm is to pursue wealth ahead of moral objectives—is the absence of social goals. In a capitalist system, capital is privately controlled and labour, goods and capital are traded in a market. Profits are distributed to owners or invested in new business opportunities and wages are paid for labour (Khan & Bhatti, 2008). For this reason, the AAOFI’s *sharia* board (2008) has advised Islamic financial institutions to decrease their involvement in debt-related operations and to increase true partnerships based on profit and loss sharing in order to achieve *sharia* objectives. Indeed, only the development of this kind of Islamic concept would be in conformity with *sharia’s* objectives and will inevitably lead to a society whereby every member will cooperate with each other and even compete constructively, as success in life is to obtain the ultimate happiness (Chapra, 2001).

3.3.1 The *maslaha* classes based on their legislative strength.

Sharia is marked by a universal wisdom whereby every legal ruling has a function which it performs, an aim which it realises, an intention which it seeks to fulfil and all of this in order to realise benefit to human beings or to ward off harm or corruption. Alizz Ibn Abdulsalam (1999) divided worldly interests into necessities, needs, improvements and supplements. Al-Ghazali (1993) also provides a justification of *maslaha* as a strength is in itself divided into necessities, needs and improvements, though perfections should be ignoring in level of needs. However, each class has its own perfections and improvements.

3.3.1.1 First class: The necessities.

The first class is necessities means the acts and behaviours upon custody of the five fundamental bases which are necessary for the survival of the human raise, if one of them is lost the resulting imbalance would in turn result in suffering. The prohibition of missing these five bases or saving them can happen by two things; first thing is doing what strengthens these pillars and ensure their existence. Second thing is doing what prevents imbalances from happening in them or expected to happen to them (Al-Shatibi, 1975). Supporting this vision, Islamic classical scholar Ibn Ashur (2007) stressed that keeping these five bases means keeping them at the level of both the individual and the nation as well.

By observing these explanations, we realise that God legislates keeping religion in terms of strengthening its pillars, belief and witnessing the oneness of God. Also legislates protecting the religion by warding off corruption and performing Jihad. Protecting religion means keeping the thinking of the individual Muslim from being polluted by bad ideas and thoughts and hence affects his acts after that. Protecting religion at the level of the nation comes by combating everything that may violate the fundamentals of the religion and by passing the religion from present to future generations (Al-Bouti, 1982). Furthermore, God legislated preserving and sustaining life by allowing food, drink and accommodation and all that life depends upon. God enacted the punishment for those who kill a human by compensation paid to the heirs of a victim or retaliation. Protection of life means protecting them from harm, at the level of the individual and the nation even before the harm takes place, it is like resisting diseases. However, the punishment is the weakest method of preservation as it is applied after the harm has occurred (Ibn Ashur, 2007). Moreover, God legislated preserving the intellect in terms of protecting one's body and the intellect from harm, the reason for prohibiting the consumption of addictive and harmful substances including recreational drugs and alcohol. Preserving the intellect implies the conservation of the mind from injuries, corruption, immorality and dysfunction. Marriage was established to preserve lineage and the family as a vital social unit whereby an environment is provided that is conducive to the creation of a fertile environment for the younger generation to grow into one that contributes to the greater good of the society. A strong family unit also prevents social ills such as adultery. However, this is rarely discussed in the older texts on *sharia* as all nations from ancient times had built-in social mechanisms that provided protection (Al-Bouti, 1982; Ibn Ashur, 2007). Likewise, *sharia* provided protection to the wealth of individuals and the societies by certain prohibitions such as *israf*, *riba*, *gharar, maysir* and theft and the prescribed punishments for breaches (Dusuki & Abdullah, 2007).

This basic set of necessities has been extended by some scholars to include the provision of security and shelter, health facilities, food and clothing, knowledge and education, and the needs of daily life (Zarqa, 1982).

3.3.1.2 Second class: the needs.

Needs refers to acts and behaviour that are not essential for maintaining the five basics. To illustrate, in regards of maintaining religion, God permitted for fasting Muslims during the holy month of Ramadan concessions in cases of travel, illness and other reasons; in relation to maintaining lineage, God legislated dowry and divorce. In related of maintaining and growing *sharia* allows the earning of income and the accumulation of wealth through allowable means (Ibn Ashur, 2007). Consequently, all of these permissions in Islam are established for the needs of Muslims.

3.3.1.3 Third class: the improvements.

Elements of this class are not categorised as necessities or needs; they are not essential for sustaining life but improvements that enhance the quality of life and include such things as purification, modesty in everything, mutual respect and politeness in interpersonal relationships (Al-Shatibi, 1975; IbnAshur, 2007).

3.3.1.4 The supplementary items of each of the three classes.

Each of the three classes consists of supplementary items on the same level as the class itself. Examples of *sharia* rules in terms of the necessities are the punishment of a person who is not completely drunk by drubbing, compensation paid to the heirs of a victim, and the permitting of trade and prohibition of usury.

3.3.2 *Maslaha* theory from the perspective of *sharia* scholars.

The above discussion on the different classes of *maslaha* helps to give a holistic picture of the types of interests that are at the root of *sharia*. They can be used to consider unresolved matters that have not been discussed by *sharia* scholars and do not have precedence in order to build provisions or judgments to realise their legalisation. As a result, *sharia* scholars offered some conditions for unresolved matters for issuing an opinion. These conditions should be taken in account, as mentioned by Al-Shatibi (2003) when he approved Al-Ghazali's (1993) list and sequence, thereby indicating that they are the most preferable in terms of their harmony with the essence of *sharia.* These conditions are summarised below:

- To be an absolute *maslaha* means it must not contradict with another interest that has either more importance than it or as important as the other interest.
- To be a public interest not limited to a specific person or group.
- To be a necessary interest that assist to resolve an issue.
- To be suitable for *sharia* objectives, without any collision between it and any legislative text in the *sharia* sources.

3.3.3 Balancing conflicting interests from the *sharia* perspective.

Shari'ah rules declare that preventing harm is prioritised over private interests because public harm always leads to greater devastation (Lewis, 2002; Mannan, 1970; Maududi, 1984). This implies that goods and services must be classified based on their contribution to individual and social welfare. Therefore, *Shari'ah* has three norms: knowing the object's value and its importance, its comprehensiveness and lastly its potential outcomes. To illustrate, if there are two objects with conflicting objectives, be the choice between the two should be made according to the framework (Al-Alim, 1994). What is important is not to shift the focus away from the root principles. All conflicts should be resolved by the application of the principles that allow the prioritisation of objectives. As discussed earlier, the objectives of *sharia* are hierarchical and this priority order must be preserved in all choices. For instance, protection of religion has priority over all others and preservation life is higher than maintaining the intellect. In the same manner, protection intellect is prioritised over preservation lineage, which is prioritised over maintenance of wealth (Al-Ghazali, 1993). Any imbalance would lead to defects and a dysfunctional system (Al-Shatibi,1975).

These principles of choice are relevant to the financial sector as well, both at the individual and at the government policy making levels. The private investor has the right to invest provided that the investment does not breach *sharia* law or conflict with a higher order objective. This set of principles drives market demand (Mashal, 2010).

3.4 Criteria for Evaluating *Sukuks* Based on *Sharia* Objectives

Islamic financial instruments, particularly *sukuks*, were established to conform to Islamic laws, which prohibit interest on all forms of transactions, excessive uncertainty in contract and gambling and chance-based games. However, in reality, some of the *sukuks* adopted in the financial system do not adequately reflect this fundamental difference of *sukuks* from the conventional financial system.

Islamic finance is not about financial institutions or instruments alone. It extends to the behaviour of participants in the marketplace, their likes and dislikes and how these tendencies have an impact on their economic activities. Moreover, as discussed above, the issuing of *sukuks* is not an individual case with limited effect on society, but a public case that affects a multitude of people who participate in the marketplace, especially when they spread to markets in a number of countries. Individuals may use a fund according to their own interpretation of *sharia*, but the control of a part of the nation's wealth by a private organisation such as Islamic banks and investment channels like *sukuks* requires diligence and doctrinal deference. The legislative council concluded its recommendations saying that it 'recommends others to reduce processes of dementedness and increase real participation based upon distributing and diving profits and losses in order to achieve *sharia* objectives' (AAOIFI, 2008, p.4).

Sharia scholars differed on the issue of determining the basis of contract validity. Some emphasise its legal form while others stress its substance and the intention of contracting parties. These differences can be attributed to the *sharia* texts, as some scholars have based their opinions on one *hadith* narrated by Omar bin Al-khattab in Sahih Muslim book (as cited in Al-Naysabur, 1977) that states 'matters are determined by intention' (Hadith no.1907). Based on this *hadith*, the validity of all contracts must be determined by intention, i.e. the purpose or substance of the contract, not by just looking at its form or structure alone. However, Abozaid (2008) decomented that some scholars like Imam Shafi`i found it is impractical to determine the validity of contracts by means of intention, as it is difficult and sometimes impossible to identify the intention of the contractors. Moreover, scholars found some *sharia* texts suggesting that things should be judged on their form and appearance (Abozaid, 2008).

As a result, the logical idea of evaluating *sukuks* products currently rests with *sharia* objectives at the level of contracts only. Therefore, *sukuk* is required to extend its validity of the application as well, since it is based upon specific criteria. These criteria are the motive, structure and outcomes of implementing the contract. Considering these criteria before issuing any legal judgments bring the Islamic bases upon which these *sukuks* products and their application stand more in line with the purposes of *sharia* in financial transactions.

3.4.1 The motivations of contracts.

The legality of the contract must be restricted to the structure of the contract but a *sharia* scholar's opinion should include clear reasons for this agreement on the contract product, such as the product complies with Islamic purposes, which is represented in keeping religion, life, intellect, lineage and wealth safe and secure at the level of necessities, needs and improvements (Al-Baraka, 2008). The product must follow the hierarchy of needs established by *sharia*. The product should not have the ability to produce outcomes that are detrimental to the individuals or the society. It is not lawful to fund a need, which will lead to the deterioration of something necessity; it is also unapproved to fund an improvement while this improvement will cause damage to a need. We must consider that the purpose of the necessity, need and improvement are keeping one's religion and life. Protection religion is more privileges and superior than maintenance one's life.

Safety from deceit means that the product structure mist be free from deceitfulness in its base otherwise it will be declares sinful. The aim of the *sukuks* products is to fulfil the real funding needs directly and the shortest path without complexity in structure or procedures. Deceiving or cheating is the presentation of a superficially lawful subject to make the unlawful accepted as lawful or to drop a musty matter (Al-Shatibi, 2003).

Furthermore, clarity and warranty the resolution of disputes is one of the criteria have to be considered. Which means that the scholar opinion or the product itself should consider clarity and comprehensiveness all aspects of treatment such as documentation of rights and liabilities using the lawful ways of writing, witnesses, mortgage and sponsorship to avoid disputes or harming the fund, keep it from loss. The opinion or product must ensure and with the available ways of arbitration or judgments of laws and regulations (Mashal, 2010; Salah, 2010).

The public interest also has the priority care. Which means that the product or the scholar opinion must not contradict as a private interest with the public interest, and if contradicts accrues, public interest must take the priority and the product must follow laws and regulations that are not contrary to the Islamic law (Mashal, 2010). This point is the main criteria relating to this study (see chapter 8).

3.4.2 The structuring of contracts.

First of all, harmony between the contract's identity and credibility in the application, requires that the form and the substance of the contract must provide explicit detail of all its features, rights, and obligations and the stages of implementation (Mashal, 2010; Alqasim & Alqasim, 2004).

The original *sharia* from which Islamic financial products are derived are divided into three classes: first, partnership such as *musharaka* and *mudaraba,* second, *ijara* and third, credit sales such as *murabaha*, *salam* and *istisna* (Errico, 1998). Within each class, there are sub classes based on the nature of the assets that determine the characteristics of cash flow. The design of *sukuks* structure based on partnerships reflects the rule, 'when you sell you must guarantee'. The design features of these structures are based on credit sales and lease. The AAOIFI's (2008) *sharia* board has encouraged investors to choose partnerships and share in both profit and loss, and discouraged lending. As both partners in a partnership win or lose together, this is considered to be fair in principle (Dusuki & Abdullah, 2007).

3.4.3 The outcomes of implementing contracts.

One of the major concepts in Islamic law is the outcome of contracts. Therefore, it requires reviewing numerous questions that affect the legitimacy of the entire contract, including the potential outcomes. Some of these questions such as imposing delay fine on the debtors and the dissolution of debt by debt or converting the debt on the debtor, has increased recently in a number of financial products (Mashal, 1992).

It is important to note that *sharia* encourages and supports the reconstructing the earth, promote social economic development and giving human being a legislative authority which is premise on human's perception of what is beneficial and non-beneficial for the nation as whole. Thus, it may be based on certain legal principles in addressing a particular issue which keeps the nations strong economically socially and scientifically. Mashal (2010) lists the following aims of the Islamic economic system, which support the contribution of *sukuks* products to reconstructing the earth and promote social and economic development:

- Economic boom, circulation of wealth and the prevention of monopoly.
- Adding economic value.
- Encouraging efficiency in utilising resources in the best possible way
- Reduce deficits in payment balance and controlling inflation.
- Improving income distribution.

- Improving the quality of life and self-esteem
- Improving the sustainability of the environment promoting respect for the environment.
- Achieving economic security and independence for the whole nation.

Therefore, in order for Islamic financial products to achieve these aims, it must be directed in some ways to meet the demands of investors and borrowers who are motivated by profit maximisation based on Islamic law in keeping with the *sharia* requirements. It has to be in activities based on real assets rather than financial derivatives and assets that do not have inherent values. Based on this principle financial products should be capable of adding economic value and develop capital. Further, greater attention should be paid to the processing of raw material into end use products and the development of technology to improve efficiency and reduce monopoly powers. Other criteria for investment include the development of skilled labour force and employment opportunities, promotion of social projects such as education, health, accommodation and basic needs (Mashal, 1992). Abdul-Rauf (1979) offers compelling argument supporting the above results:

> The Islamic doctrine of economics permits degrees of individual freedom and state intervention, but leaves the determination of these degrees to the wisdom and conscience of those involved, who should take current conditions into account. This flexibility has made Islamic economics open to alternative options within its framework. (p. 14)

Pryor (1985) believed that 'by examining particular institutions and constraints on decision making, we can gain insight into the unique features of the Islamic economic system' (p. 199). Thus, establishing these criteria will assist in determining to what degree religious convictions affect investors and borrowers in their financial decision making based on the concept of *maslaha*.

3.5 Conclusion

This chapter defined *sharia* as a system of values covering all aspects of life (e.g., personal, social, moral, spiritual, political, economic and intellectual), which cannot be separated from Islam's basic beliefs, values and objectives. In other words, it reflects the holistic view of Islam, which is a complete and integrated code of life, be it individual or social, both in this life and the life hereafter. Therefore, a contemporary understanding of a concept such as *maslaha* according to *sharia* may lead to a theoretical understanding of economics, science, technology, the environment and politics. Similarly, not understanding a key concept may thwart developments in all of these fields.

The objectives of *sharia* allow for flexibility, dynamism and creativity in social policy. According to Al-Ghazali (1993), the formulation of a rule on the basis of al *maslaha al mursalah* must take into account the public good and conform to *sharia* objectives. According to Al-Ghazali (1993) the Maliki School states, this tool must fulfil three main conditions. First, it must deal only with transactions that are deemed necessity through one's rational faculties. This is unlike actions related to religious observance, such as an act of worship, which is strictly subject to the *sharia*'s main sources. Second, the interests should be in harmony with the spirit of *sharia*. Third, the interests should be of the essential type, as opposed to the embellishment type. Here, 'essential' implies preserving the five fundamental necessities of human life (Al-Ghazali, 1993).

This chapter demonstrated that it is important for all Muslims, be they individuals or organisations, to consider the public interest in their actions. Accordingly, applying this to Islamic finance and investment would assist in achieving the spirit of *sharia*. In addition, although the Islamic financial institutions are private investors, they should have special judgements and rules. This is because these institutions gather the public funds, so their policies should depend on the previously mentioned points (keeping and protecting the five fundamental principles, considering the power of interest, creating criteria for the earth's reconstruction and pritoritising the common good). These points will be utilised to evaluate *sukuks* as distinct from conventional bonds.

Thus, practitioners in *sukuks* markets should consider an action in terms of not only its immediate effect in this life but also of its effect on the life hereafter. Leading a virtuous life, performing particular duties and obeying particular injunctions are very important. The rights and duties that are relevant to financial and economic issues include all prohibitions such as *riba*, *gharar* and *qimar* as discussed in Chapter 2.

This study will adopt some of these criteria in its evaluation of *sukuks* products. In relation to the motivation of financial contracts, the *sharia* scholar's opinion should consider clarity and comprehensiveness in all aspects of treatment such as documentation of rights and liabilities using the lawful ways of writing and sponsorship to avoid disputes or harming the fund. In addition, the public interest has priority, implying that public benefits should not be sacrificed for private benefits. Public interest must be prioritised and the product must follow laws and regulations that are not contrary to the Islamic law. Structuring contracts that prohibit the payment and receipt of interest is actually the major difference between Islamic and conventional financial products. This does not mean simply avoiding interest but must comply with all principles of *sharia*. *Sharia* also encourages and supports the concept of conservation and sustainability of resources. Here the term resource has a wide application including social and economic resources such economic growth and development, free enterprise, competitive markets, the promotion of efficiency, equity in distribution of income, national, social, and personal security.

The concept of *maslaha* might help to resolve disagreements between different *fiqh* schools and achieving mutual understanding over contemporary controversial rulings on *sharia* compliant financial instruments. It would also realise an important value and objective of *sharia*. It is seems likely that *maslaha* concept should applied in package in determining *sharia* legitimacy of the use of a particular *sukuk* structure to avoid costly errors that might lead to litigations and loss of competitiveness in the Islamic financial products.

Chapter 4: The GCC Economies—Debt Markets, Expenditure and *Sukuks* Market Regulations

4.1 Introduction

This chapter provides background on this research. Section 4.2 presents the key growth drivers of the GCC countries' debt markets and their expenditure. It discusses their efforts to shift economic activity from the public to the private sector, highlighting the effects of their privatisation plans on non oil sectors. It also outlines the capital markets in the Gulf region and how its negative impacts have resulted in establishing debt markets. Section 4.3 explains the attractiveness of debt instruments as a financing or investment option in GCC countries and reviews the characteristics of their debt markets. Section 4.4 summarises the chapter.

4.2 Key Growth Drivers of the GCC Debt Markets

The GCC was founded on 25 May 1981, the original Council comprised six states of the Arabian Peninsula, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE. The unified economic agreement between the countries of the GCC was signed on 11 November 1981 in Abu Dhabi with the aim of coordinating, integration and inter-connection between member states in all fields, to build strength between their peoples, formulating similar regulations in various fields such as economy, finance, trade, customs, tourism, legislation, administration, as well as fostering scientific and technical progress in industry, mining, agriculture, water and animal resources, establishing scientific research centres, setting up joint ventures, and encouraging cooperation of the private sector. Therefore, this union includes various political, economic and social matters across the gulf region. These countries are often referred to as the GCC States. The gulf region stands out as one of the most important economic regions in the global economy. This fact stems from the capability of the region to meet the world demand for petroleum, which has driven the region's strategic significance in the global economy. According to British Petroleum (BP) (2012), GCC countries account for 29.9 per cent of the world's proven crude oil reserves and 20.3 per cent of global natural gas reserves (see Figures 4.1 and 4.2).

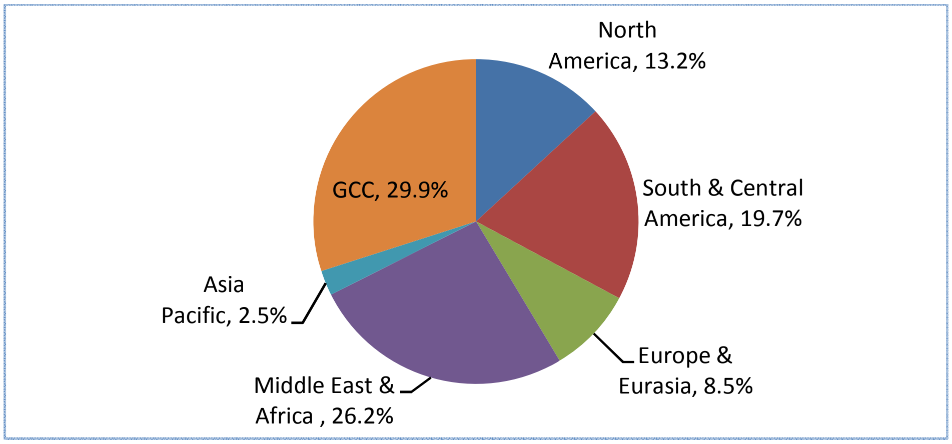

Figure 4.1. The geographical distribution of global oil reserves. Source: BP, 2012.

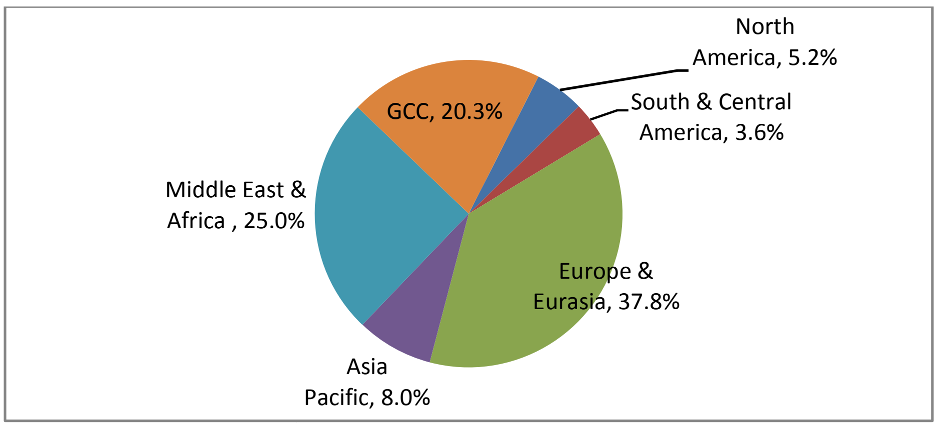

Figure 4.2. The geographical distribution of global gas reserves Source: BP, 2012.

Overall, the GCC's real economic growth has averaged six per cent a year over the past eight years, and real GDP increased by 5.3 per cent in 2010 and 6.3 per cent in 2011, compared with 1.3 per cent growth in 2009 (Table 4.1). However, real GDP growth in the region decelerated from 7.4 per cent in 2008 to 1.3 per cent in 2009 due to OPEC-induced cuts in oil production. According to an IMF report published in April 2010, the GCC economies would continue to grow at an annual rate of 8.1 per cent during 2010–2015, more than double the growth rate of the advanced economies like the US, the UK and France. The robust macroeconomic fundamentals augur well for the growth of the *sukuks* markets in the GCC. Therefore, the overall economic outlook for the region is positive, for the near future.

Table 4.1: *GDP growth in GCC countries (2004–2011).*

Country	GDP (% real change pa.)								
	2004	2005	2006	2007	2008	2009	2010	2011	Average
Saudi Arabia	5.3	5.6	3.2	2.0	4.2	0.1	4.1	6.7	3.9
UAE	9.6	4.9	9.9	3.2	3.3	-1.6	1.4	3.3	4.2
Bahrain	5.6	7.9	6.7	8.4	6.3	3.1	4.5	1.8	5.5
Kuwait	10.2	10.6	5.2	4.4	6.0	-4.6	3.1	4.4	4.9
Oman	3.4	4.0	5.5	6.7	12.8	1.1	4.5	4.4	5.3
Qatar	20.8	5.8	12.8	17.1	11.7	9.5	14.0	17.2	13.6
Accumulative Average	9.2	6.4	7.2	7.0	7.4	1.3	5.3	6.3	6.3

Source: The World Bank, 2012.

While a majority of the GDP in the GCC region is derived from oil and oil-related businesses, the GCC countries, in their effort to diversify their economies, are channelling their efforts to explore opportunities in other sectors like construction, transportation, manufacturing and logistics. According to IMF (2012) data, the non-oil sector real GDP in GCC grew at an average of 6.1 per cent during 2000–2010 as compared to the oil sector-real GDP which grew at an average of 1.2 per cent during the same period. Moreover, the real GDP of the non-oil sector is growing at a faster pace than that of the oil sector. This progress has been achieved with an open borders for foreign labour and as well as liberal capital flows. As a result of the growth of non-oil economic activities, there will be a demand and increase in capital requirements, including debt financing, in GCC countries (see Figure 4.3).

It is well known and documented that GCC has made a significant profit in the last 10 years from the sale of crude oil and other hydrocarbons. During 2009, while the market was suffering from lower oil price, quantity of oil exported, GCC reported a significant profit of 7.7 per cent of GDP and over 20 per cent GDP in the last 8 years. Due to this strong growth in surpluses and the lack of any external debts, GCC directed these profits to offshore investing opportunities or and savings in the form of gold and the foreign-exchange (FX) reserves. Consequently, FX and gold reserves of all GCC countries increased from US$63 billion in 2004 to US$679.9 billion in 2011 (IMF, 2012; see Table 4.2).

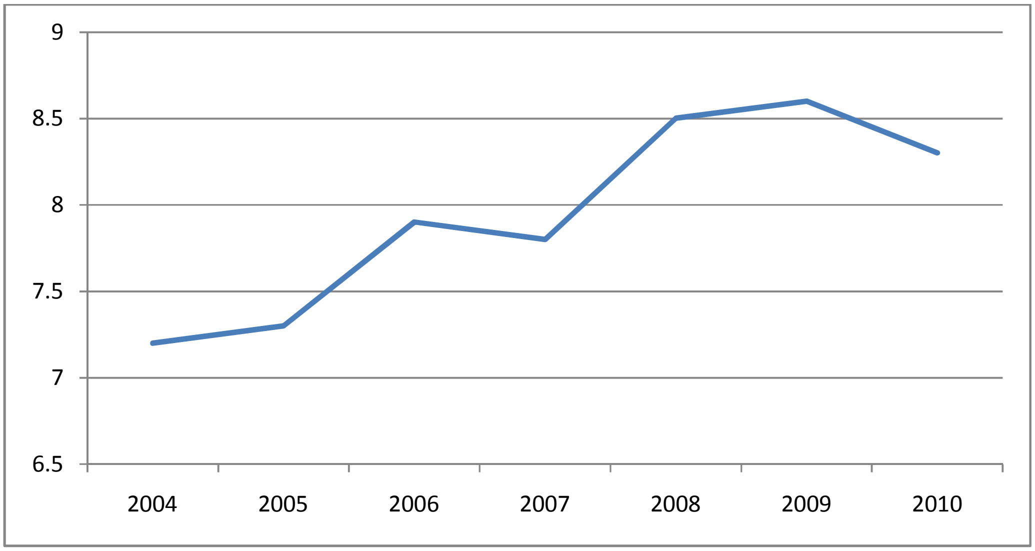

Figure 4.3. Real GDP growth in the GCC non-oil sector (2004–2010). Source: IMF, 2012.

The GCC area has become an important center for Middle East regional economic growth. As a result, the *2011 World Investment Report* released in September by the United Nations Conference on Trade and Development (UNCTAD) (2011), shows foreign direct investment (FDI) inflows to GCC countries at US$48 billion in 2007, up US$8 billion from the year before. The figures exceeded US$61 billion in 2008 compared to US$11.8 billion in 2004 (IMF, 2012; See Table 4.3). Among member countries, Saudi Arabia was the preferred destination for FDI inflows in 2008, attracting US$39.4 billion, or more than half of the total, followed by the UAE with US$13.7 billion. Way down the list was Kuwait with a negative share of US$6 million.

Table 4.2: *Total reserves minus gold by country in the GCC region (current US$ billion).*

Country/ Year	2004	2005	2006	2007	2008	2009	2010	2011
Saudi Arabia	27.5	155.3	226.3	305.7	442.7	410.1	445.1	559.8
UAE	18.5	21.0	27.6	77.2	31.7	36.1	42.8	56.0
Bahrain	1.6	1.9	2.7	4.1	3.8	3.5	4.8	4.3
Kuwait	8.3	9.0	12.7	16.8	17.2	20.4	21.4	29.3
Oman	3.6	4.4	5.0	9.5	11.6	12.2	13.0	13.0
Qatar	3.4	4.6	5.4	9.8	10.0	18.8	31.2	17.4
Total	63.0	196.0	279.7	423.1	517.0	501.1	558.3	679.8

Source: IMF, 2012.

According to IMF (2012) data, Saudi Arabia is one of the largest economies in the world and is the largest one in the GCC region. Figure 4.4 shows that Saudi Arabia's GDP represents 43 per cent of the combined GDP for 2011, followed by the UAE 26 per cent and Qatar 13 per cent (IMF, 2012).

Table 4.3: *Foreign direct investment inflows by country (US$ million).*

Country/year	2004	2005	2006	2007	2008	2009	2010
Saudi Arabia	-334	12,107	18,317	24,334	39,455	36,458	21,560
UAE	10,004	10,900	12,806	14,187	13,724	4,003	3,948
Bahrain	865	1,049	2,915	1,756	1,794	257	156
Kuwait	24	234	121	112	-6	1,114	81
Oman	111	1,538	1,596	3,332	2,952	1,509	2,333
Qatar	1,199	2,500	3,500	4,700	3,779	8,125	5,534
Total GCC	11,869	28,328	39,255	48,421	61,698	51,466	33,612

Source: IMF, 2012.

In addition, oil accounts for 90 per cent of Saudi Arabia's exports and 75 per cent of government revenue, which is being used to facilitate an infrastructure boom and increased foreign-exchange and gold reserves, reaching US$559 billion in 2011 compared to US$27.5 billion in 2004. After gaining foreign direct investment to exploit oil and gas, the UAE has diversified into a prosperous economy. Qatar has one of the highest levels of GDP per capita in the world, driven by oil revenue. Oxford Business Group (2008) reports that the current Emir is keen on liberalising and diversifying the economy. Bahrain is an island country in the Persian Gulf and has relatively diversified economy and does not have great reliance on oil revenue. There is a major infrastructure overhaul in progress, aiming to cement Bahrain's place as the gateway to the Northern Gulf. On the other hand, Kuwait is slowly beginning to diversify its economy, with the hope of reducing dependency on oil revenue. However, it remains relatively closed-minded towards new inward investment. Oman is also regarded as one of the more conservative and traditional GCC states, where the local citizens are still a majority. The construction industry is beginning to see returns from the diversification policies instigated under the Vision 2020 plan (IMF, 2010).

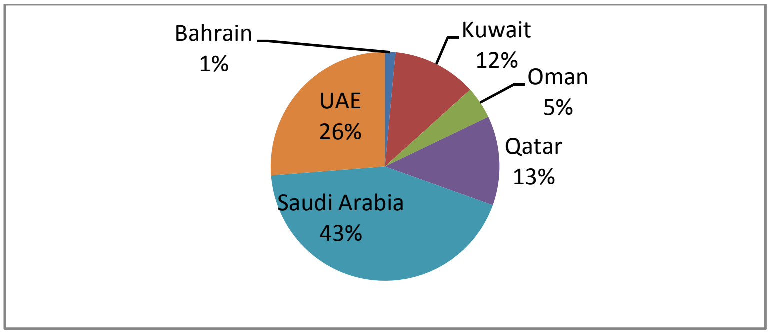

Figure 4.4. Total GDP in the GCC according to countries (2011). Source: IMF, 2012

GCC has suffered from nominal GDP rate between the year of 2008 to 2009 from US$1133 billion to US$921 Billions, however GCC was able to absorb this shrink by the assistance and handover provided by larger governments. (see Table 4.4).

Table 4.4: *Nominal GDP (US$ billion).*

Country/Year	2004	2005	2006	2007	2008	2009	2010	2011
Saudi Arabia	250.3	315.6	356.6	384.9	476.3	376.7	447.8	596.1
UAE	147.8	180.6	222.1	258.1	314.8	270.3	297.6	362.2
Bahrain	11.2	13.5	15.9	18.5	22.1	19.6	21.9	19.8
Kuwait	59.4	80.8	101.6	114.6	148.8	109.5	124.3	163.6
Oman	24.7	30.9	36.8	41.9	60.6	46.9	57.8	63.3
Qatar	31.7	43.0	60.5	80.8	110.7	98.3	128.1	173.9
Total GCC	525.2	664.4	793.4	898.8	1133.4	921.3	1077.5	1378.9

Source: IMF, 2012.

All these achievements come from a prosperous fiscal policy that been followed by GCC countries. Fiscal policy in GCC countries has been expansionary and has been designed to sustain the social contract between state and society. Public spending has been the primary tool used to influence economic performance. This has remained the case even after oil prices dropped from an average of $99.5 in 2008 to US$61.7 per barrel in 2009. GCC countries have funded projects where reduction in global liquidity has affected financing in2008, but on the back of government support, US$149 billion of new contracts was awarded across the GCC in 2009, an increase of 15 per cent on 2008. Therefore, a large proportion of government spending in the GCC has been focused on infrastructure investments to support economic development. While the average price of crude oil was lower in 2009 than in 2008, it was still high enough to ensure that governments could continue with their project plans. The key factor supporting this increase in capital spending was stability in oil prices. To illustrate, the

UAE government grants more than doubled to US$58 billion in 2010 from US$26 billion. In Saudi Arabia, the government increased their projects by 57.6 per cent to US$52 billion in 2010 from US$30 billion (Deloitte, 2010; IMF, 2012).

In general these indicators demonstrate that GCC countries have been shifted in economic activity from the public to private sector. Also, they diversified the economy away from the dependence on oil revenue, and promoted human development. These achievements lie with the spirit of *sharia* and *maslaha* by successes of equity and justice of public policy and providing welfare functions that contribute Islamic financial resources to promote human development and enhance the effectiveness of employments from Islamic perspective. Moreover, the pegging of the major GCC currencies to the US dollar has helped to stabilise exports as well as government revenues.

GCC countries have undertaken substantial services development in various areas, including information technology, education, tourism and financial activities. These developments in service sectors are aimed at achieving greater economic diversification and creating opportunities for the private sector that result in greater foreign investment. As an example of these efforts in education, Saudi Arabia's King Abdullah Foreign Scholarship Program initiated in 2005 provides the means to study at the world's best universities (for a BA, MA or PhD) in a wide range of disciplines. There are around 101,000 Saudis currently studying abroad (Ministry of Higher Education 2012). The program aims to meet the needs of job markets in government ministries, national corporations and the private sector across the kingdom.

4.2.1 The expenditure of GCC countries.

A large part of public expenditure in the developing countries is allocated to the development of infrastructure projects. Governments of the developing countries have big responsibilities in the development of social-infrastructure—schools, hospitals, bridges, road-links etc.—which may not be financed by the private sector because of the underlying externalities. Financing such projects is one of the main causes of budget deficit. However, GCC countries differ from other developing countries, because they are returning to solid growth, underpinned by higher oil prices that are supporting production and exports, robust government spending, and some normalization of global trade and capital flows. Also, most of these projects will be handled by the private sector, which is work parallel with the Privatization plans in GCC countries and promoting human development and enhancing the effectiveness of employments and innovation (Bayina, 2010).

The GCC countries have benefited enormously from oil and gas reserves and assets that have generated significant financial liquidity in the last eight years (2004–2011). They have designed a self-sustaining growth strategy that entails excelling in manufacturing and the development of certain service industries, real estate, commercial and residential properties and public utilities. However, most importantly, GCC countries have been focusing attention on the diversification of their economies away from large dependence on oil, through larger support to manufacturing and some service industries.

As shown in Table 4.5, these countries have wisely used the gains from spiralling oil prices by investing in large-scale infrastructure and development projects as well as expanding non-oil sectors. With this in mind the countries in the region are engaging in establishing cities designed to create value added, elaborately manufactured outputs such the one in Saudi Arabia (e.g. King Abdullah Economic City) and the UAE (e.g. Dubai Industrial City). These countries are running an aggressive marketing campaign inviting a number of Fortune 100 companies to set up manufacturing plants in the region, thus vitalising both the local and international economy. They also support commercial development by building shopping malls that serve as distribution outlets and support residential development by building luxurious homes and apartment buildings that meet individual needs in terms of public utilities; water, electricity, public transportation, universities, medical research laboratories, entertainment centers, new airports, marine ports, communication, radio and TV and postal services (MEED, 2011; SAMA, 2011).

Table 4.5: *Sectoral share % of real GDP in the GCC region, 2010.*

Country	Oil & Gas (including manufact-uring)	Finance & Insurance	Construction	Transport & Commun-ications	Govt. Services	Trade & Hospitality	Other
Saudi Arabia	39%	13%	7%	6%	17%	8%	10%
UAE	49%	6%	6%	6%	7%	12%	14%
Bahrain	29%	27%	0%	9%	14%	8%	13%
Kuwait	47%	11%	0%	8%	17%	5%	12%
Oman	39%	12%	7%	10%	10%	12%	10%
Qatar	56%	9%	8%	5%	12%	8%	2%

Source: EIU, 2011; SAMA, 2011.

Moreover, the GCC economies have also developed their service sectors, with banking and financial services playing a major role, particularly in Bahrain where they contributed more than 25 per cent of its real GDP. Increased liberalisation (like privatisation of certain public enterprises in the telecommunications, utilities and banking sectors) and improved regulatory regimes have facilitated the development of the service sector in GCC. Additionally, expansion of container port facilities (in Bahrain, Oman and the UAE) and airline networks have led to the growth of trade and transport services in the GCC. The tourism sector has also grown rapidly, especially in the UAE (facilitated by the Dubai Shopping Festivals and Dubai Summer Surprises) and Saudi Arabia (due to religious destinations such as Makkah and Madinah for Muslims). Thus, it seems the growth in the tourism sector in the GCC would entail increased investment in hotels in the medium-to-long-term (Bayina, 2010).

According to MEED (2011), GCC spent US$720 billion on capital projects through 2000–2008. Thus, government infrastructure projects are driving development in GCC countries. Some huge projects that have been financed in GCC countries are shown in Table 4.6.

Table 4.6*: Some projects that have been financed in GCC countries (2006–2009).*

Signing Year	Project	Sponsors	Country	Commercial Debt (US$ million)
2006	Greater Equate	Dow Chemicals/PIC	Kuwait	2,500
2006	Rabigh Petrochemical	Aramco/Sumitomo	Saudi Arabia	2,300
2006	YANSAB	SABIC	Saudi Arabia	1,700
2007	Qatar Aluminium	QP/Hydro	Qatar	2,970
2007	Qatargas IV	QP/Shell	Qatar	2,800
2007	EMAL	Mubadala/Dubal	UAE	4,875
2008	National Chevron Philips	SIIC/CP Chem	Saudi Arabia	1,880
2008	Saudi Kayan	SABIC	Saudi Arabia	1,750
2008	Maaden Phosphate	Maaden/SABIC	Saudi Arabia	2,000
2008	La Sorbonne	Mubadala	UAE	350
2009	King Abdullah Economic City, 28 Buildings	Emaar Economic City Company	Saudi Arabia	5,000
2009	Princess Norah University	Ministry of Higher Education, Ministry of Finance	Saudi Arabia	3,300
2009	King Abdullah Financial Centre	Public Pension Agency	Saudi Arabia	2,910
2009	Al-Falah Development Project, Abu Dhabi, 5,000 villas	Aldar Properties	UAE	750
2009	Barwa Financial District	Barwa Real Estate Company	Qatar	1,440

Source: MEED, 2011; Bayina, 2010.

Governments in the GCC have funded projects where reduction in global liquidity has affected financing reflecting that by the number of contracts awarded by the private sector fell from US$50 billion in 2008 to US$16 billion in 2009. On the other hand, on the back of government support, US$149 billion of new contracts was awarded across the GCC in 2009, an increase of 15 per cent from 2008. Therefore, a large proportion of government spending in the GCC has been focused on infrastructure investments to support economic development. The key factor supporting this increase in capital spending was stability in oil prices. Whilst the average price of crude oil was lower in 2009 than in 2008, it was still high enough to ensure that governments could continue with their project plans. Al-Awad (2010) stated that, transport and tourism infrastructure investment ahead of the 2022 World Cup in Qatar and will become a key driver of growth after 2012. In addition he state that the private sector expects lending growth to accelerate modestly in 2011. Generally speaking project financing continues to show large potential in GCC countries. The GCC Region seems to have the most growth potential in the current global economy as have been demonstrated previously. Consequently, gradually more, projects are looking to the debt markets (bonds or *sukuks*) as an alternative funding source, because most these projects have longer tenure, as short-term funding cannot finance long duration projects and might lead to mismatches (pertaining to income generation versus debt repayment obligations) resulting in payment defaults. According to a report issued by SHUAA Capital in January 2011, this growth underpinned by strong infrastructure investment and a gradual recovery in private sector activity. Thus, exploring the attractiveness of bonds or *sukuk* as a financing or investment option is essential in GCC markets (SHUAA, 2011).

The two sectors attracting the lion's share of Islamic investment are the real estate and oil and gas industries. According to Kuwait-based Global Research, the contribution of the real estate sector to GDP in the GCC countries accomplish US$27.2 billion in 2004, which means 5.8 per cent of accumulated GDP. Saudi Arabia accounted for US$12.8 billion alone. The market capitalisation of listed real estate companies in the GCC totalled some US$74.9 billion in February 2006, some 6.7 per cent of the total and Saudi Arabia accounted for US$17.7 billion alone (IMF, 2012). This because the increasing of total population reaching 37 million of these countries with a total demotic liquidity of more than US$494.7 billion based on statistics of the GCC issued in 2008.

Conversely, GCC economies are characterised by dominance of the public sector in terms of ownership and management of most activities. There is some contradiction in this in that many are structured on a non-recourse basis while aiming to achieve full benefit from the sponsor's implicit support such as *sukuks* to fund the Shuaiba East power project in Saudi Arabia by Al-Rajhi Bank, the construction of buildings for 400 public schools funded by the Ministry of Education of Saudi Arabia and Al Rajhi Banking and Investment Corporation, the expansion of the Dubai International Airport by Department of Civil Aviation of UAE, the

Customs and Free Zone Corporation by Dubai Ports and Abu Dhabi Abar Petroleum oil exploration and production fully convertible *sukuks* (Bayina, 2010).

The demand of project funding in GCC countries requires to analysis the attractiveness of debt instruments as a financing or investment option in GCC markets, which will be explain in the next sections.

4.2.2 An overview of capital markets in the GCC region.

Stock markets in the GCC region are fairly recent compared to the well-established financial markets of the Western World. The stock markets in GCC were established during the late 1960s and 1970s. With the exception of the very lively Saudi and emirates stock exchange, most of the GCC stock markets are relatively small and still in their infancy. However, before 2003, listed companies were few, most stocks were infrequently traded, and trading volume was low. This changed when large numbers of family-owned companies became public companies and listed their stocks in exchange markets, specifically in the Saudi and UAE exchange markets (Al-Masah, 2010). Therefore, the size of these markets has more than doubled in terms of the number of companies listed and market capitalisation. Commercial banks are the most dominant sector in the Gulf financial markets and highly concentrated.

The size of stock markets varies considerably within the GCC region. The Saudi financial market is the largest market in terms of market capitalisation in the GCC and North Africa regions and the eleventh largest in the world. It is at least 22 times larger than that of Qatar and almost seven times larger than those of Bahrain and Oman. The UAE financial market is the youngest market in the GCC region, established in the year 2000, whereas the Saudi stock market was established in the year 1984. Both stock markets dominate the GCC region. The Saudi stock market had market capitalisation in 2010 that reached US$353,414 million, as shown in Table 4.7. However, there are only 146 different companies that traded on the Saudi stock market, compared to an average of 350 companies in other emerging markets such as the Egyptian stock market based on the Economist Intelligence Unit (EIU) database (EIU, 2011).

Table 4.7: *The number of listed companies in GCC countries and their market capitalisation in 2003 and 2010.*

	No. of Listed Companies		**Market Capitalisation (US$ million)**	
Country / Year	**2003**	**2010**	**2003**	**2010**
Saudi Arabia	70	146	157,302	353,414
UAE	30	101	30,363	104,668
Bahrain	42	44	9,701	20,429
Kuwait	97	215	59,408	119,620
Oman	96	120	5,013	20,267
Qatar	0	43	26,701	123,591
Total GCC	**335**	**669**	**288,488**	**741,989**

Source: EIU, 2011

Financial markets in the UAE are not sophisticated, lending to local companies and financing trade are the basis of local banking business. The UAE has the fourth largest stock market after the Saudi stock market in terms of market capitalisation (see Table 4.7). While the UAE has two local financial markets: Dubai Financial Market (DFM) and Abu Dhabi Securities Market (ADSM), there are only 101 different companies traded on both stock markets. The Dubai International Financial Exchange (DIFX) recently opened to trade international stocks. The ADSM has more companies listed than DFM, but trading volume is usually much less. There are 66 listed firms in ADSM in four sectors, whereas only 40 publicly traded companies in DFM. In terms of market capitalisation, the service and the banking sectors dominate the market (comprising 85 per cent of the total market value), while industry is having a minor share in the market (Moustafa, 2004).The Qatari stock market, which opened in early 1999, is among the smallest in the Gulf. Limited share trading is conducted through banks, but the market is currently not a significant factor in the domestic financial environment (Iqbal & Molyneux, 2005). The Bahrain Stock Exchange (BSE) was established in 1987, more local public shareholding companies began to operate, reaching their peak in the beginning of the 1980's. During this period, shares of public shareholding companies were being actively traded in a non-official market called 'Al Jowhara Market'. The BSE officially commenced operations in June 1989 with 29 Bahraini shareholding companies listed. The only instruments traded at that time were common shares. Since the bourse's establishment in 1989 (formerly BSE), trading was conducted manually through a system called the 'Auctional Trading' System. Using this system, the broker had to write the bid and offer orders that they receive from the investor on the trading boards at the trading floor. The transaction takes place when the bid and offer prices match. In 2010, Bahrain Bourse (BHB) was established as a shareholding company to replace the BSE.

In general, these markets have witnessed a high volatility in market returns. To illustrate, the average annual return (based on market capitalisation) in the GCC equity markets has been -5.9 per cent during 2006–2010. This volatility coupled with risks attached with them has led to the growth of the debt markets in GCC in the past eight years. Additionally, the global financial meltdown has led to investors seeking respite in the debt markets due to higher risk in the equity markets. Notably, the Morgan Stanley Capital International (MSCI) GCC Index, which gauges the six equity markets of the GCC, posted -12.9 per cent returns during the same period. In contrast, HSBC/NASDAQ Dubai Middle East Investment Grade Index (MEIG), which tracks the return of an emerging MEIG bond portfolio consisting of US$, £ ,¥ and € denominated fixed/floating rate vanilla *sukuks*/conventional bonds, generated a return of approximately two per cent in the same period (Bayina, 2010).

The remarkable issue with these markets is a very low investors' participation rate may be due to the active investors in these countries as a percentage of total adult population is on average less than three per cent—in comparison to more than 20 per cent in developed countries—the relatively small number of listed companies on the GCC financial markets and the insufficient diversification across industrial sectors within these markets. For example, shares of banks are massively overcrowding the market, while shares of service companies and manufacturing firms are rare. In addition, the governments of GCC own a large number of the more attractive companies in the region. Such a market structure limits the ability of investors to properly diversify their risks and consequently reduces their incentive to invest. To illustrate, the Saudi government owned approximately 25 per cent of the listed shares. Consequently, this contributes largely to lower market liquidity because governments across GCC countries tend to hold on to their shares for longer periods (Al-Sultan, 1999; Limam, 2001).

Moreover, the role of institutional investors in the GCC financial markets remains very thin or non-existent compared to Western countries such as the USA. As a result, this contributes significantly to a reduction in overall market liquidity and has constrained their growth and development. Moreover, financial markets in the GCC countries remain closed to foreign investors. On the Bahraini stock exchange, non-resident foreign investors are only allowed to trade within five to 37 listed companies, whereas trading in the Qatar financial market is only opened to its nationals and, trading in the Kuwait stock exchange and Saudi

Arabia exchange are open only to the GCC nationals. The Omani stock market is considered more liberal than its counterparts; GCC nationals are allowed to invest directly in its market, while foreign investors can do so through mutual funds. Finally, on the UAE financial markets, the only GCC without a formal exchange, forbids foreign investors' participation in trading of local stocks. Because of foreign access restriction, free flow of needed skills and technology into developing markets of the region remains an impediment and hinders the development of capital markets in the countries of the GCC (Al Suwailem, 2000).

To overcome these impediments, the exchange markets of GCC countries need to increase the participation rate of national investors by offering more diversified investment options such as bonds and *sukuks* instruments and increasing the level of transparency as well as strengthening their regulatory structures and disclosure requirements, harmonise the regulatory and supervisory frameworks that govern these markets, minimise transaction costs, and, reduce the implicit barriers to flow funds between GCC countries. This integration will ensure greater liquidity and depth (Limam, 2001).

4.2.3 An overview of debt markets in the GCC region.

Equally, all countries around the world are in need of large amount of financial resources to promote human development and enhance the effectiveness of employment. Thus, local currency bonds markets have increasingly become an alternative funding source in several emerging economies (Hesse & Dalla, 2009). These markets are playing an important role in the provision of finance to emerging-market governments, financial institutions, corporations, and investors, which were largely shut out of international financial markets during the global financial crisis, and in reducing their dependence on the banking sector.

Determined efforts of the GCC economies to reduce their overdependence on oil has led to investments in other sectors such as real estate, financial services, manufacturing etc., which led to the emergence of the GCC debt market as an attractive financing alternative. Along with GCC's economic development, steps have also been taken to launch and develop the debt market infrastructure. These included launching bonds and *sukuks* markets, computerization of market infrastructure, scruples form issuing system and improvement of the payments and settlements systems (Al-Awad, 2010).

In GCC countries, the dominant source of financing is bank lending. Financing through debt securities constitutes only at a small fraction of the total. However, in recent years the GCC debt markets have seen an increasing amount of corporate and sovereign bond issuances (both conventional bonds and *sukuks*) as shown in Figure 4.5. Notably, debt issuance in GCC witnessed strong growth and more than doubled in frequency and value during the 2004–2010 period. These issuances are of two types, *sukuks* and conventional bonds, and were issued in local currency or US dollars and listed either on national exchanges specifically (Bahrain, Saudi Arabia and the UAE) or on the NASDAQ Dubai. Some of these issuances were also placed privately or through syndication and listed offshore (LSE, Luxembourg Stock Exchange, Irish Stock Exchange, Bursa Malaysia, LFX-Labuan Malaysia) or not listed at all; most of these have originated in Saudi Arabia, the UAE and Qatar (Zawya, 2011).

The aggregate bond issuances in the GCC during the 2004–2010 have ranged from three months for Bahrain treasury bills to 30-year bonds. There are seven categories of maturity in the bonds market: less than one year, one to three years, three to five years, five to 10 years, 10 to 20 years, 20 to 30 years, and 30 years or more. During this period, issuances with a maturity of less than one year had the biggest share in terms of issuing frequency, representing 30.2 per cent of the total number of issues, followed by those with five to 10 years maturity (29.5%), while those with maturities of 20 to 30 years and 30 years or more had the fewest number of issues (1% and 0.35%, respectively) (Markaz, 2010; 2011; Zawya, 2011).

The GCC bond market expanded annually on average by 51 per cent during the 2004–2010. The majority of these issuances are conventional bonds. The strong demand from Muslim investors, Islamic financial institutions and conventional global institutions for *sharia* compliant bonds led to the growth of *sukuks* issuances globally and regionally (Markaz, 2011). Though total debt issuance in GCC countries dropped sharply in 2008 following the onset of the global financial crisis, 2009 saw a strong rebound with the greatest amount raised during this period with US$62.4 billion.

Globally, the growth path of *sukuks* can be seen through three phases. In the first phase from the mid-1990s to 2001, *sukuks* issues accounted for an insignificant share in the total issuances, while in the second phase from the beginning of 2002 to the end of 2008, there was strong growth in *sukuks* led by increase oil prices and rapid economic growth in the GCC countries. Nevertheless, the third phase from 2009 to 2010, which witnessed the global financial crisis and *sharia* compliance issues, saw a marked slowdown in issuances (Markaz, 2010).

Regionally Islamic funds are one of the main sources driving the debt markets in GCC countries. Thus, *sukuks* markets have grown rapidly for several reasons in the region. First, the higher infrastructure development and diversification initiatives in GCC countries have resulted in an increased need for long-term financing. Second, the volatility in regional stock markets during 2004–2006 has forced issuers and investors to look for alternative avenues of fundraising and investment, respectively. Besides, according to a report published in October 2010 by Al Masah Capital Limited based in Dubai, in 2009 when the effects of the global economic crisis were felt, most *sukuks* performed better than conventional bonds. They took the lead in the Dow Jones citi global *sukuks* total return index, rising 127.1 per cent, contrary to the 120.1 per cent increase in the Middle East conventional bond total return index (Al-Masah, 2010).

4.3 The Characteristics of GCC Debt Markets

Although there was no pressing need among the GCC governments to borrow, a robust debt market is vital for economic growth to offer greater fiscal and monetary flexibility to regional economies. Salman Al Khalifa, Head of Global Markets, MENA, Deutsche Bank, in his interview with CNBC Arabic TV network in February 2008, said 'an active debt market offers access to sources of capital to non-traditional regional investors, like pension funds and fixed income portfolios, which have historically focused on investing in government bonds'. Therefore, the GCC governments determined to invest in manufacturing and some service industries to diversify their economies away from large dependence on oil and construct an active debt market that will provides the government and corporate sector an alternative mode of financing as well as an asset class for diversification purposes.

During 2004–2010, GCC countries issued US$149.6 billion of conventional bonds with a 72 per cent share compare to US$58.2 billion of *sukuks* with a 28 per cent share. Consequently, corporate issuers issued US$110 billion of bonds dominating the bond market in GCC with a 53 per cent share (average % share during the period). In comparison, the sovereign issuers issued US$97.8 billion of bonds with an average 47 per cent share during the same period (Markaz, 2011). Moreover, since 2004, issuances of *sukuks* raised the greatest amount during 2007 with US$18.7 billion representing 66 per cent of the total value raised through 49 issuances, compared to US$11.2 billion for conventional bonds through 23 issuances. Conventional bonds raised the greatest amount during 2009 with US$54.4 billion representing 87 per cent of the total value raised through 93 issuances, compared to US$8 billion for *sukuks* through 34 issuances (Markaz, 2011).

In addition, sovereign bond issues have dominated the bond market landscape in GCC and accounted for 66.6 per cent (average % share during 2004–2005) of the total bond issuance. However, the situation was quite different in 2006 and 2007 when corporate bond issuances dominated the GCC bond market with a 72.2 per cent and 84.2 per cent share, respectively. However, the impact of the global financial crisis in 2009 resulted in a sharp increase of conventional sovereign bonds issuances compared to *sukuks* (see Figure 4.6). The increase was fueled by new issuances of sovereign issuers and corporations that are fully or largely owned by the governments, which together represented 93.8 per cent of the total issuance in 2009.

Taken as a whole, secondary bonds and *sukuks* trading platforms exist only in Bahrain, Dubai and Saudi Arabia. The secondary debt market in the GCC is still in its infancy and is characterised by lower trading activity and lack of money market instruments and hedge tools.

4.3.1 The *sukuks* market structure in the GCC region

Bahrain was building on its status as the regulator of the region's financial hub to create *sharia* -friendly laws and craft comprehensive Islamic rulebooks. The success of the Bahraini initiative is reflected in the fact that 26 Islamic banks with total assets of $26.3 billion (in June 2009) operate in Bahrain today, in addition to 19 Takaful companies. The government also regularly issues short-term *al salam sukuks* (Markaz, 2011).

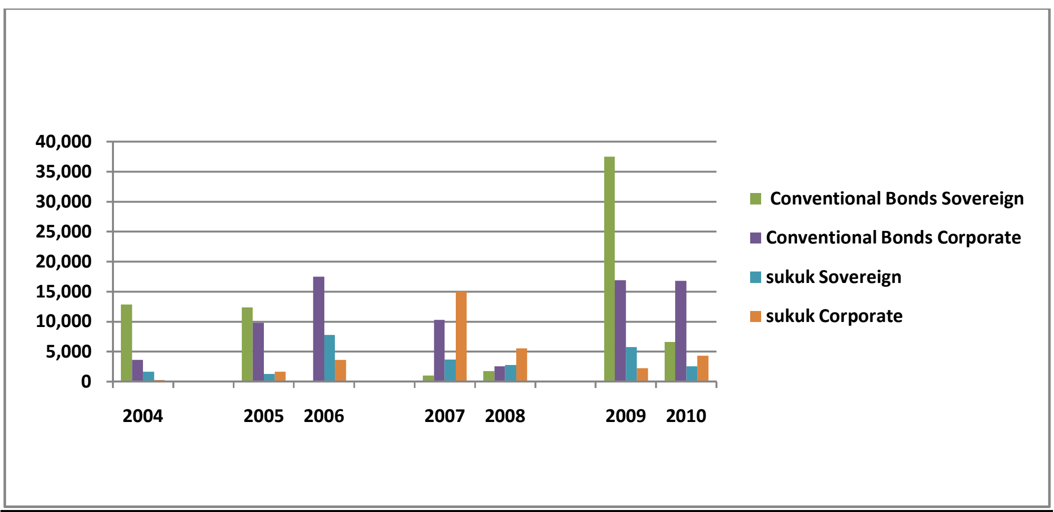

Figure 4.5. Sovereign and corporate issuance (conventional bonds & *sukuks*) in the GCC (US$ million). Source: Markaz, 2011; Zawya, 2011.

According to the Zawya (2011) database, *sukuks* issuances in GCC witnessed strong growth and increased during the 2004–2010 period to more than double, particularly sharing

65.9 per cent of total issuances during 2006–2008. Geographically, the UAE acquired the majority share of the amount issued during 2004–2010, raising US$31.3 billion (52%), followed by Saudi Arabia with US$15.4 billion (25.6%), Bahrain with US$7.7 billion (12.8%), Qatar with US$3.7 billion (6.1%) and Kuwait with US$2 billion (3.3%), as shown in Figure 4.7 (Zawya, 2011).

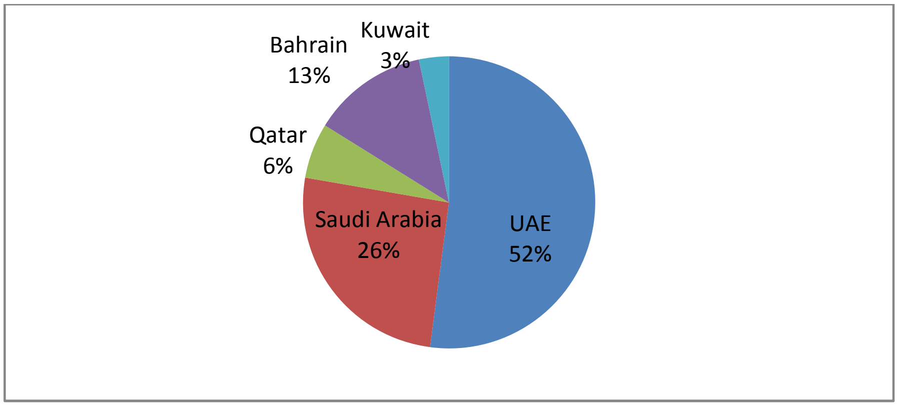

Figure 4.6. Geographical distributions of *sukuks* issuances in the GCC region (2004–2010). Source: Zawya, 2011.

Despite the UAE acquiring the majority share of amount issued, Bahrain garnered the majority share of the number of issues, with 179 issuances of the total number; out of which 154 issuances were issued by the CBB in the same period. This was followed by the UAE with 41 issuances, Saudi Arabia with 22 issuances and Kuwait with 13 issuances. Qatar was the least active among the GCC issuers, with only seven issuances.

Conversely, in terms of activities, out of the 243 *sukuks* issuances between 2004 and 2010, only 95 issuances have been listed in exchange markets, of which only 31 issuances (13%) have been listed in the local secondary markets. These 31 issuances are listed in local exchange markets worth US$15.7 billion, compared to issuances on the NASDAQ Dubai, which were worth US$19.1 billion, and offshore-listed issuances worth US$28.1 billion (see Figure 4.8).

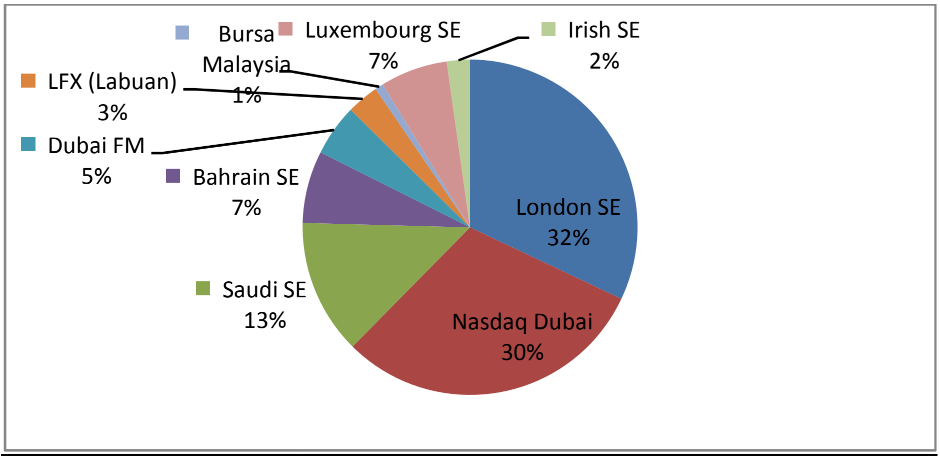

Figure 4.7. GCC *sukuks* issuances by stock exchanges (2004–2010). Source: Zawya, 2011.

Five sectors have attracted the lion's share of Islamic funds during the 2004–2010 period: real estate, which issued *sukuks* worth US$15.98 billion, governmental institutions (US$11.12 billion), financial services (US$9.98 billion), power and utility (US$6.7 billion), and oil and gas, including manufacturing (US$5.72 billion) (see Figure 4.9).

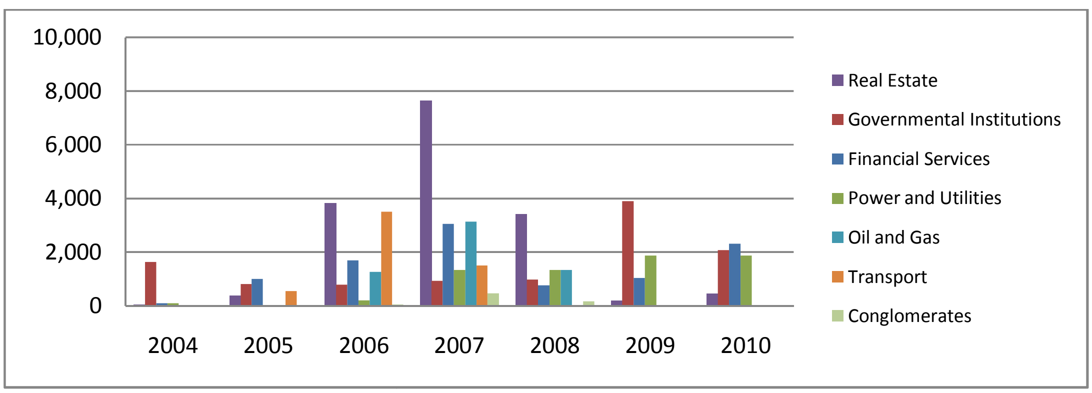

Figure 4.8. Total *sukuk* issuance by major sectors (US$ million). Source: Zawya, 2011.

There are several different types of *sukuks* structures, each of which is based on an Islamic financial structure. The most prevalent and best known of these is *ijara*, which represents almost 42 per cent of the total number of *sukuks* issuances regionally, worth US$25 billion. It is followed by the *al-Salaam* structure in terms of the number issuances, or the *musharaka* in terms of size (see Table 4.8).

Table 4.8: *Breakdown of sukuks structures by type in the GCC region during 2004–2010.*

Structure	Total no. of issuances	Total size (US$ million)	Breakdown as percentage
Ijara	109	25,042	41.70%
Al Salaam	96	2,431	4.05%
Musharaka	20	10,815	18.01%
Modarabah	16	9,713	16.17%
Al-Istithmar	6	8,066	13.43%
Murabaha	6	1,013	1.69%
Al-Wakala Bel-Istithmar	3	1,400	2.33%
Ijarah-Istisna	2	171	0.28%
Istisna	1	299	0.50%
Manfa'a	1	650	1.08%
Wakala	1	450	0.75%
Total	261	60,050	100.00%

Source: Zawya, 2011.

4.3.2 Credit agency ratings of debt instrument issuances

In 2009, 45 issuances (81.8% of the total) were rated by one of the following rating agencies: Moody's, Standard & Poor's or Fitch. According to Moody's, the average rating in the GCC has migrated from A1 in 2008 to Baa1 in 2009, as a result of the downgrades for many regional issuers during the year. Most prominent were Dubai's corporate government-related issuers, downgraded due to uncertainties concerning the repayment of their debt and the degree of government support they will effectively receive. In addition, corporate defaults such as Saad Group in Saudi Arabia and the Dubai World Corporation in the UAE have raised worries about the creditworthiness of the large corporate in the GCC (Bayina, 2010). Consequently, sovereign debt issuances in the GCC rose more than four times to US$52.6 billion in 2009 compared to US$13.1 billion in 2008, with the corporate bond issuances almost doubling to US$20.1 billion in 2009 from US$9.6 billion in 2008 (Zawya, 2011).

4.3.3 Benchmarks of debt instruments in the GCC region

The GCC debt market is characterised by a lack of breadth, depth and liquidity, a low investor base and absence of a clear legal and regulatory framework. Other critical issues include the lack of a credit rating culture and benchmarks, unsatisfactory market transparency, dearth of long-term debt instruments and absence of a derivatives market for managing interest rate and credit risk. Recently, some greater value (more than US$500.0 million) *sukuks* and floating rate notes of banks have been issued (e.g. Islamic Development Bank, Emirates Bank International and Abu Dhabi Commercial Bank) with a short tenure (Al-Sultan, 1999). On the government side, only Qatar and Bahrain have issued long-term Eurobonds, but not enough to form a yield curve benchmark across GCC bond markets.

Moreover, an active government debt market with regular sovereign bond issuances covering all maturities creates a yield curve that serves as a benchmark to price other debts such as corporate bonds. However, the GCC countries are awash with cash surpluses on the back of sustained high oil prices, and only a few regional governments (Bahrain and Oman) have felt the need to issue sovereign bonds at regular intervals. The relatively short tenures of *sukuks* remain a constraint given the long durations of many of the planned investment ventures in GCC region. Most *sukuks* issuances have maturities of three-to-five years, which reduces their competitiveness as compared to bank funding. It also acts as a disincentive to institutional investors with long-term liabilities. The financial crisis has highlighted the limitations of these short tenures bonds which require the GCC markets to focus more on issuing bonds with long-term maturities (Markaz, 2011).

Conversely, Alsaeed (2012) pointed that a low interest rates coupled with a creditor-friendly environment has fuelled growth in the GCC debt markets. The GCC governments have been able to keep interest rates low due to healthy fiscal and current account balances. Moreover, after the global financial crisis in 2007, interest rates in the GCC countries have reached near zero. Due to the inherent strength of GCC companies and the GCC economies, raising debt has been relatively easier for GCC companies than for their international counterparts. Figures 4.10 and 4.11 show the most common money market rates that been used for *sukuks* issuances (3 & 6 months) in the GCC, namely Saudi Arabia (SIBOR), UAE (EIBOR), Bahrain (IBOR) and UK interbank (LIBOR) during the 2005–2010 period. These figures kept fluctuating in line with oil output. Both the SIBOR and LIBOR rates were the lowest compared to the IBOR and EIBOR.

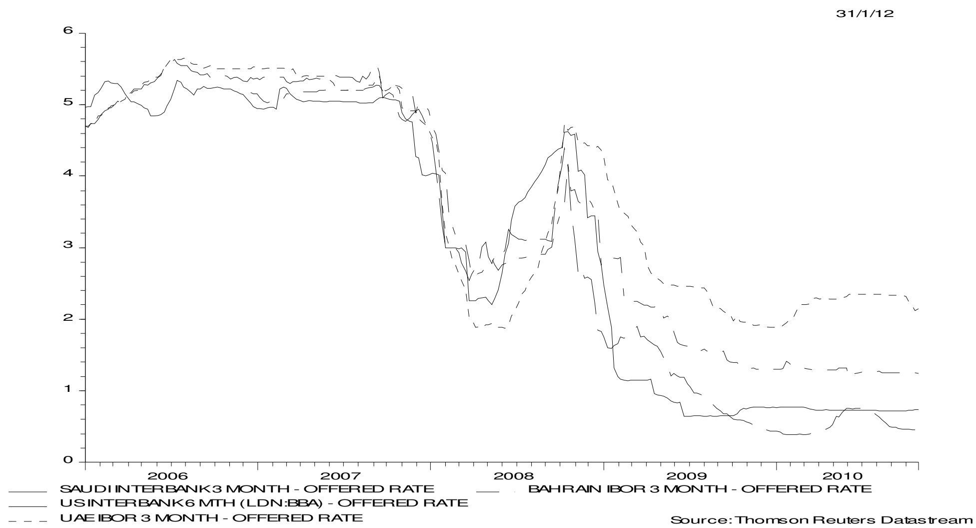

Figure 4.9. Actual value 3 months, 2006–2010. Source: Thomson Reuters DataStream, 2012.

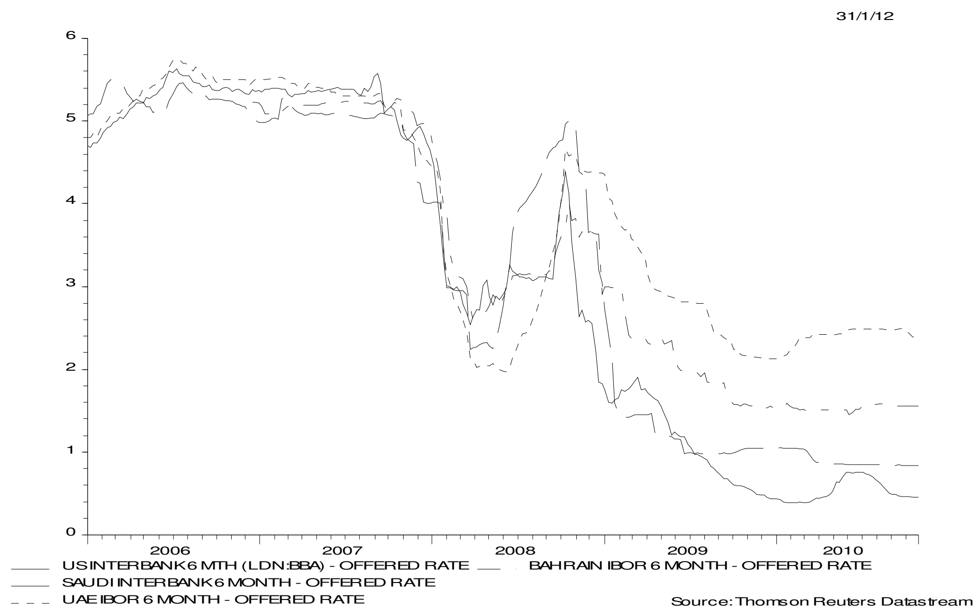

Figure 4.10. Actual value 6 months, 2006–2010. Source: Thomson Reuters DataStream, 2012.

According to Reuters (2011) the Islamic instrument markets witnessed the industry's first international Islamic Interbank Benchmark Rate (IIBR) on 22 November 2011, launched by Thomson Reuters Corp in cooperation with the Islamic Development Bank, the AAOIFI, the Association of Islamic Banking Institutions Malaysia, the Bahrain Association of Banks, the Hawkamah Institute for Corporate Governance, the Statistical Economic and Social Research Center for Islamic Countries and 19 Islamic banks, most of which are based in the Gulf region. This rate is offering a *sharia* compliant alternative to traditional interest-based benchmarks. It is based on rates contributed by 16 Islamic banks and Islamic sections of conventional banks, and is the average expected return on *sharia* compliant, short-term interbank funding. Tenures for the IIBR will range from overnight to one year. Its creators hope the IIBR will be used as a basis for pricing a wide range of Islamic financial instruments, including *sukuks*, corporate financing and common Islamic treasury agreements. The new system is based on the rate of return on capital used by Islamic banks, representing the average profit rate at which bids are made for *sharia* compliant interbank transactions, such as *murabaha* and *wakala* deals, between top Islamic financial institutions. *Murabaha* is a cost-plus-profit structure used for funding, while *wakala* involves the use of an agency agreement in which one firm accepts funds from another to invest on its behalf in a *sharia* compliant manner (Reuters, 2011). As mentioned in chapter 2, Islamic finance bans pure monetary speculation that is not based on an underlying asset, and its proponents present it as a less risky and more stable alternative to conventional finance.

4.3.4 The GCC *sukuks* market regulations

The debt markets regulations in the GCC countries are currently at their developmental stages. It is important to highlight that the GCC regulatory authorities are putting more emphasis on properly regulating the debt market in the region. With the creation of the Capital Markets Authority (CMA) in 2004, Saudi Arabia demonstrated its intention to provide a modern and regulated capital market. For any *sukuk* issuance, a private placement notice must be sent to the CMA to inform it of the intention to release the financial instruments, although the regulator is not responsible for the accuracy of the document. The CMA stores issuer prospectuses on its website, and is responsible for authorizing any public offering. The CMA is also responsible for ensuring that any issuance abides by the companies law and listing rules, and has the right to remove or suspend the listing of *sukuks*, if necessary. Conversely, Saudi Arabia’s companies regulations 1965, restricts the issuance of bonds to joint stock companies with maximum size of the bonds issued by a company to not to exceed its paid-up capital. Also, the expected aggregate market value of the issue must be at least US$13.3 million for any debt instrument (Alsaeed, 2012).

Beside, the regulator in Saudi Arabia has increasingly shown itself to have control over the market. In the second quarter of 2010, Saudi Arabia established *sukuks* market on Tadawul (market for listing, order submission, trade execution, clearing and settlement, and prices information dissemination of *sukuks*) as part of its aim to regulate the debt market in the economy (Tadawul, 2011). These developments are improving the prospects of *sukuks* becoming attractive investment alternative, especially for the local and cross-border investors. Besides, Saudi Arabia is working on launching its first mortgage and finance law expected to publish in 2012. However, the issuance of *sukuk* in Saudi Arabia is regulated by the offer of securities regulations, issued by Saudi CMA. The regulations do not provide any specific framework for the issuance of *sukuk*. Currently, *sukuks* are being issued under the broad definition of debt instruments in the regulations.

The UAE bond market is regulated by the Dubai Financial Services Authority (DFSA) under the supervision of the UAE Securities and Commodities Authority (SCA). In late 2008, the SCA issued a circular stipulating that any listed company (It excluded government institutions) must obtain credit rating from a reputed authority before issuing bonds. The UAE commercial companies law 1984 as amended restricts the issuance of bonds to a minimum paid-up capital of US$9.5 million for the domestic bond issuer, whereas the foreign bond issuer should have a minimum paid-up capital of US$10.0 million and must appoint a representative in the country to handle all matters related to the registration of the bonds, distribution of interest, submission of required reports to regulatory authorities and any other relevant matters (DFSA, 2011).

The CBB regulates the debt securities market in Bahrain. The issuance of government debt securities is executed in coordination with the Ministry of Finance. The domestic bond issuer must be regulated by the commercial companies' law in Bahrain (21/2001). The issuer must obtain the approval of the CBB if the debt securities are either denominated in foreign currency or local currency, however, are being offered for subscription in international markets. Whereas, the foreign bond issuers should be issued in accordance with the laws of their countries of origin, and should have a minimum paid-up capital of at least US$10 million with appoint a representative office in Bahrain to handle all matters related to the registration of the bonds, distribution of interest, submission of required reports to regulatory authorities and any other relevant matters (BHB, 2011).

The other GCC countries are also persisting with the out dated regulatory frameworks for debt markets and they do not have exchanges debt market at all. In countries like Kuwait are regulated by the Ministry of Commerce and Industries. Thus, the governments and regulatory authorities of these countries need to take additional measures to accelerate the development of these markets (Al-Sultan, 1999).

Though capital market authorities in the GCC have issued their own corporate governance codes, the regulators need to give more emphasis on their implementation. It is important to note that *sukuks* trading is not strictly limited to the Islamic world, and that external interest in the instruments has increased. The UK Finance Act 2007 removed certain tax barriers that limited the benefits of *sukuk* issuance (HM Treasury, 2008), and the 2009 Finance Bill provided further relief from capital gains and stamp duty for organisations that chose to issue *sukuk*. A brief summary of the debt market regulatory framework in the GCC is presented in Table 4.9.

Table 4.9*: Summary of the debt market regulatory framework in the GCC region.*

	Saudi Arabia	**Bahrain**	**UAE**	**Kuwait**	**Qatar**	**Oman**
Regulator	Capital Market Authority (CMA)	Central Bank of Bahrain (CBB)	Securities and Commodities Authority (SCA); Dubai Financial Services Authority (DFSA)	Ministry of Commerce and Industry	Qatar Financial Markets Authority (QFMA)	Oman Capital Markets Authority
Regulatory Law or Reference Work	Offer of Securities Regulations, Capital Market Law, 2003	Article 4 of the Central Bank of Bahrain and Financial Institutions Law 2006; Commercial Companies Law (No. 28/1975)	The UAE Securities and Commodities Exchange Law, 2000	Capital Market Law 2010	QFMA Law, 2005 (amended in 2007)	Capital Market Law promulgated by Royal Decree No.80/98; Executive Regulations issued by Ministerial Decision No. 4/2001
Minimum Capital Requirement for a Bond Issuer	The expected aggregate market value of all securities to be listed must be at least SR50 million (US$13.3 million) for debt instruments	Paid-up capital of not less than US$10 million	Minimum paid-up capital of Dh35.0 million (US$9.5 million) for domestic issuer, US$10 million for foreign issuer	Not Available	Not Available	For listing in regular markets, paid-up capital shall not be less than RO2 million (US$5.2 million)

Source: Respective capital market regulators in Bahrain, Saudi Arabia and the UAE; Press release.

4.4 Conclusion

The economic indicators of GCC countries demonstrated that these countries have steadily shifted their economic activity from the public to the private sector. Their efforts diversified the economy away from dependence on oil revenue, promoted human development and enhanced the effectiveness of employment from an Islamic perspective. These achievements are in line with the spirit of *sharia*, as it achieves equity and justice in public policy and provides welfare. Moreover, the pegging of the local currency to the US dollar by major GCC countries is an important factor in stabilising exports as well as government revenues. GCC governments require huge funds in their privatisation plans to facilitate their booming projects, which are handled by the private sector.

The attractiveness of debt instruments as a financing or investment option in GCC markets was a result of the high volatility in capital market returns, where the average annual return in the equity markets has been -5.9 per cent during 2006–2010. This volatility coupled with their associated risks has led to the growth of the GCC debt markets in the past eight years. These markets have a very low investors' participation rate perhaps because the active investors in these countries are on average less than three per cent of the total adult population, in comparison to more than 20 per cent in developed countries. There are a relatively small number of listed companies on the GCC financial markets, and the GCC governments own a large number of the more attractive companies in the region. This contributes greatly to lower market liquidity because the governments tend to hold onto their shares for longer periods.

The above discussion demonstrates that Islamic funds are one of the main sources driving the debt markets in GCC countries. The five foremost sectors that have attracted the lion's share of Islamic funds are real estate, governmental institutions, financial services, power & utility, and oil and gas (including manufacturing). Most *sukuks* issuances have maturities of three-to-five years, which reduces their competitiveness compared to bank funding and acts as a disincentive to institutional investors with long-term liabilities. After the financial crisis highlighted the limitations of these short-tenure bonds, GCC markets have needed to focus more on issuing bonds with long-term maturities. *Sukuks* originators in GCC region rated by one of the following rating agencies: Moody's, Standard & Poor's or Fitch.

As secondary bonds and *sukuks* trading platforms exist only in Bahrain, Saudi Arabia and the UAE, the secondary debt market in the GCC is still in its infancy. Consequently, the secondary debt market is characterised by lower trading activity and the lack of money market instruments and hedge tools.

In conclusion, the GCC debt market is characterised by a lack of breadth, depth and liquidity, a low investor base and the absence of a clear legal and regulatory framework. Other critical issues are the lack of a credit-rating culture and benchmarks, unsatisfactory market transparency, the dearth of long-term debt instruments and the absence of a derivatives market for managing interest rate and credit risk. To overcome these impediments, the GCC debt markets need to increase the participation rate of national investors by offering more diversified investment options such as bonds and *sukuks* instruments, increasing the level of transparency, strengthening their regulatory structures and disclosure requirements, harmonising the regulatory and supervisory frameworks that govern these markets, minimising transaction costs, and reducing the implicit barriers to flow funds between GCC countries.

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Chapter 5: Methodology

5.1 Introduction

This study is designed to be a qualitative, subjective, interpretative research project based on grounded theory. The research methodology processes and associated concepts used in this study are presented in this chapter. Section 5.2 outlines the research paradigm adopted in this study. Sections 5.3 and 5.4 detail the epistemology and methodology of this research, respectively. Section 5.5 outlines the method and research design for this study, and Section 5.6 presents the settings and participants, including the data collection and analysis for both the interviews and case studies. Section 5.7 discusses the validity and reliability of the data. Section 5.8 presents the ethical clearance, and Section 5.9 summarises the chapter.

It is important to note that the subject matter of this study covers an area that is relatively new and immature - Bahrain, Saudi Arabia and the UAE are examples of the new emerging debt markets in the Middle East. In some respects, this study will set a pattern for a financial market, which is still evolving in terms of regulatory and legal frameworks for the Islamic finance industry. The lack of *sukuks* issuances and of market depth in the GCC region means that information and data are limited, which in turn has an impact on the analysis and methods of the research.

5.2 Theoretical Paradigm

It is important to consider what kind of frameworks exists when designing a research proposal. Creswell (2003) discusses three approaches: quantitative, qualitative and mixed methods. The first two have been available for decades, but the last is new and still developing in form and substance. To understand them, we need to consider the elements of the three frameworks:

1. Philosophical assumption about what constitute knowledge claims.
2. General procedures of research called strategies of inquiry.
3. Detailed procedure of data collection analysis and writing, called methods.

Creswell (2003) proposed that three questions should be asked when designing research: What knowledge claims are being made by the researcher (including a theoretical perspective)? What strategies of inquiry will inform the procedures? And what methods of data collection and analysis will be used? Figure 5.1 maps this research design process.

Before starting an inquiry, researchers need to clarify their ontological and epistemological perspectives to frame their study (Miles & Huberman, 1994). Stating a knowledge claim means that they start a project certain about how and what they will learn during their inquiry. This can be called a paradigm, which is defined by Lawrence Neuman (2006) as: '[a] general organising framework for social theory and research. It includes basic assumptions, underpinning questions asked, research practice and theory, and approaches or methods for finding the answers to questions' (p. 515). Paradigms allow researchers to identify the relationship between variables and specify appropriate methods for conducting particular research (Guba & Lincoln, 1994).

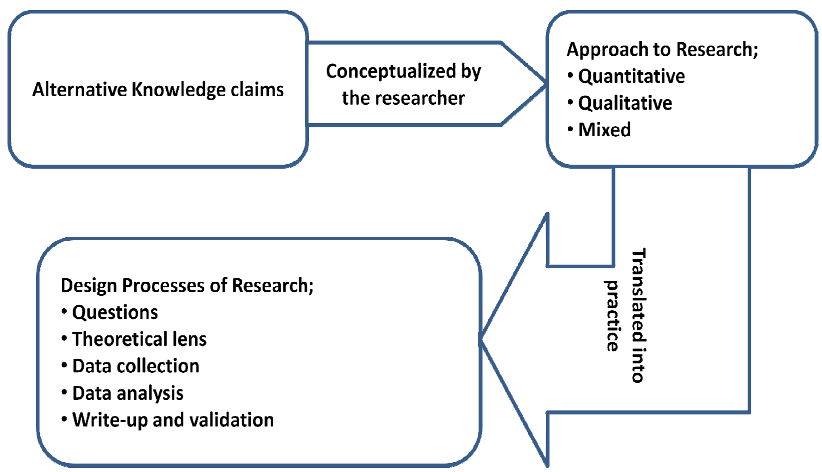

Figure 5.1. Conceptual map of the research design process.

According to Guba and Lincoln (1994), the basic principles of paradigms are ontology, epistemology and methodology. Ontology is the study of examines questions like, what reality is out there? In simple words, it is concerned with the meaning of being and the nature of reality. It is about what kinds of things do and can exist and, the way they are related. Crotty (1998) defines epistemology as 'what it means to know' and argues that it is not possible to conceptualise ontology, or 'what is' (p. 8), separately from epistemology because these two issues are related and tend to emerge together. Methodology refers to how to investigate reality.

5.3 Epistemology

Epistemology deals with the nature of knowledge with its general basis, scope and possibility (Hamlyn, 1995). Some scholars such as Maynard (1994) state that epistemology is concerned with providing a philosophical grounding for deciding what kinds of knowledge are possible and how we can ensure that they are both adequate and legitimate. In other words, epistemology is a theory of knowing, or, ways of knowing and justified beliefs, or, how we obtain knowledge of external reality and how we know the world. It is concerned with the origin, nature, limits of human knowledge, and, how things can be communicated to the researcher. Crotty's (1998) conceptual framework recapped three epistemological constructs, including objectivism, subjectivism and constructivism.

Crotty (1998) states that 'in this objectivist view of 'what it means to know', understanding and values are considered to be objectified in the people we are studying and, if we go about it in the right way, we can discover the objective truth' (p. 8). In other words, objectivists view the real world as objects, assume meaning is already inherited within the object being examined and, the attributes of an object can be measured and quantified. In this regard, objectivism has formed the basis of epistemological stance for social sciences in the Western world and is closely aligned with the positivism theoretical perspective. From this perspective, the social world can be examined by 'value-free' methods (Mertens, 2009).

However, the absolute position of objectivists and their claims of reality have been challenged and tempered by the tentativeness of their present limited knowledge. Therefore, one can grasp reality in imperfect ways because we as researchers are constrained by human limitations, including underlying knowledge and understandings of reality (Crotty, 1998; Mertens, 2009). Because of the downside of the concepts of objectivism, it is still difficult to control variables in the social and natural environment.

Conversely, Crotty (1998) explained subjectivism as the view that a comprehending person's actions consist exclusively in reconstructing the self-understandings of those engaged in performing them. To comprehend others is to understand the meaning of what they do and to understand this meaning is to understand them in their own terms. Consequently, the epistemology of subjectivism suggests that meaning has emerged out of nothing because meaning does not come out of interplay between subjects and object, but is imposed on the object by the subject. Here the object as such makes no contribution to the generation of meaning (Crotty, 1998). When applying subjectivism to the social world, a human being will face difficulties in making meaning out of something, and, may also import meaning from other sources quite imperceptive from the object at hand, or even from a fantasy world or the world of make believe. Subjectivists also tend to emphasise the subjective meaning of social objects, which in turn neglects the external factors that influence the relationships between the perceptions of the subjects (individuals), interpretations and actions, which in turn can expose interpretations of reality to be heavily influenced by various social groups or the perceptions of reality by significant figures.

In contrast to objectivism and subjectivism, constructivism, often referred to as constructivism, can be applied comfortably to the social world because meanings are continually constructed by social actors, not discovered, and interconnectedness exists between the subjects and the objects (Bryman, Becker & Sempik, 2008; Crotty, 1998). In other words, the cornerstone of reality in constructivism is socially constructed meaning (Mertens, 2009). Crotty (1998) asserted that people construct all of their knowledge, social and meaningful reality when human beings are engaging with the world that they live in because individuals are not passive recipients of a set of meanings, but are actively and reflectively involved in constructing the meaning of reality. In this sense, people tend to construct meaning about the social phenomena in different ways when they are looking at the same phenomena. This implies that researchers tend to reach different perspectives when exploring the same phenomena on how different stakeholders construct their beliefs in a social context (Schutt, 2006).

Since this study deals with variables in a complex, social, real-life experience, one aspect of the research epistemology is subjectivity. In addition, the study explores the suitability of crossing the border with the information collected and of using the *maslaha* approach to *sukuks* markets in some GCC countries, which is in line with the epistemology of subjectivism definition. This thesis is interpretive in that the data are subjective and interpretative in nature and will be analysed in terms of descriptive themes.

The philosophy and epistemological approach of this research are based on inductive reasoning. The inductive approach takes the following steps:

1. Observe the *sukuk* structure and underlying risks;
2. Identify the available theoretical and practiced strengths and weaknesses of *sukuk* patterns and regularities;
3. Synthesise the secondary and primary data and analyse them;
4. Conclude with original outcomes that may take the shape of a grounded theory, depending on all the patterns and the primary data analysis.

5.4 Methodology

Methodology has been defined by Crotty (1998) as 'the strategy, plan of action, process, or design underlying the choice and use of particular methods, and linking the choice and use of methods to the desired outcomes' (p. 3). In other words, methodology is how to investigate the reality. So, researchers who adopt a position on one of the principles tend to constrain the position that may be taken on the by other researchers. Some scholars such as Guba and Lincoln (1994) and Sarantakos (2004) categorise five types of paradigms in social research: positivism, critical theory, constructivism, realism and post-positivism.

The positivism paradigm was the dominant epistemological paradigm in social science until the 1960s (Guba & Lincoln, 1994). Its core assumptions are objective and independent of human concern, which forms the basis of natural science and has influenced scholars of management as a rational system (Buttery & Buttery, 1991). In plain language, reality is fixed and governed by natural law that explains how the universe operates. Buttery and Buttery (1991) argue that problem solving starts with formulating hypotheses that are subjected to empirical testing through quantitative methods. However, in reality positivists view is a measurable items that use of exact measurement with free mistakes (Neuman, 2000). Thus, this paradigm does not fit for this research as it deals with variables in a complex, social, real-life experience, as stated by Crotty (1998).

Critical theory assumes that a reality developed over time by social, political, cultural, belief, economic and gender forces (Mulaik & James, 1995). There is a certain association between the researcher and the test object in the way the researcher tries to change the world where respondents live to make them more informed (Perry, Alizadeh & Riege, 1997). This research does not attempt to understand the changes within the debt market and management environments, but rather the behaviours of people in the debt market. As a result, critical theory is not a suitable paradigm for this research.

Constructivism is philosophy of learning reflected on the experiences as humans construct their own understanding of the world surroundings. It implies that learning and social phenomena are not only produced through social interaction, but that they are constantly in the state of revision. In other words, it assumes that researchers should participate with the world being investigated to explore the perceptions of participants. The role of the researcher is to understand, reconstruct and analyse the perceptions of participants in a way that leads to constructive meaningful outcomes and findings (Guba & Lincoln, 1994). This implies that knowledge is intermediate, as seen in postmodernism (Bryman et al., 2008). However, this paradigm is not suitable for this research.

On the other hand, Norman Blaikie (2007) explains realism as ultimately a search for generative mechanisms. He points out that, realists recognise that the underlying mechanisms can act apparently independently or 'out of phase' with the observable events, and that, events can occur independently of them being experienced. This is a view that Hatch and Cunliffe (2006) describe as a stratified form of reality whereby surface events are shaped by underlying structures and mechanisms but that what we see is only part of the picture. Realists take the view that researching from different angles and at multiple levels will all contribute to understanding since reality can exist on multiple levels and hence realism is not a suitable paradigm for this research (Chia, 2002).

Post-positivism is another paradigm developed in the social science to overcome the major issues associated with positivism (Guba & Lincoln, 1994). It challenges the absolute truth and recognises that we cannot be 'positive' about knowledge. In other words, post-positivism emphasises the importance of using multiple measures and observations, each of which may possess different types of errors. For this reason, triangulation is needed to get a better picture of what is happening in reality. From this perspective, researchers tend to emphasise deductive logic in which research is influenced by theory. This paradigm also emphasises the objectivity of the researcher by triangulating across multiple perspectives while acknowledging the biases. For that reason, this research is seen to be quite laid down within the post-positivist paradigm.

In light of the above discussion, this research adapts post-positivism as its philosophy. The overall underlying reasoning of the research design is based on the cause-and-effect conceptual framework of *maslaha*, which is another source in Islamic jurisprudence; it is usually defined as public interest. The complex nature of the *sukuks* structures has necessitated that the dissertation places the conceptual framework at the beginning of the dissertation specifically in Chapters 1 and 3.

5.4.1 Quantitative *v.* qualitative research methods

Quantitative and qualitative methods are two major approaches often used in social studies. The distinction between qualitative and quantitative research includes their research questions and analytical objectives, the data produced, and the degree of flexibility in the design of the research (Mack, Woodsong, MacQueen, GREG & Namey, 2005).

The qualitative research method is a scientific method of exploring phenomena to look for unambiguous facts to precisely explain, translate, and construe the meanings of phenomena happening in their typical common circumstance (Fryer, 1991). Creswell (2003) explains qualitative research as:

> [a] means for exploring and understanding the meaning individuals or group ascribe to social or human problem. The process of research involves emerging questions and procedures, data typically collected in the participant's settings, data analysis inductively building from particulars to general themes, and the researcher making interpretation of the meaning of the data. (p. 4)

In other words, qualitative research emphasises the interactive process of discovering how the social meaning is constructed. It is described as modes of systematic enquiry, which are concerned with understanding human beings and the nature of their interactions. The qualitative approach takes into account both participants' and researcher's worldviews (Marshall & Rossman, 1999). It involves soft, deep, rich and non-numerical interpretation of social phenomena for discovering the underlying meaning of relationships (Creswell & Clark, 2007; Merriam, 1998). Qualitative research differs from qualitative approaches as it develops theory inductively, which is open and interactive and where observation often precedes theory. The purpose of data collection is to discovers information from the perspective of participants about the social phenomena, such as attitudes and perceptions that are not directly observable (Neuman, 2000). It seeks to learn why or how. Unlike quantitative research which will be explained later, the findings in qualitative research are not used to test a theory and make generalisations about a population, but rather to build or modify a theory (Aaker, Kumar& Day, 2001; Bryman et al., 2008). By recognising these explanations, the nature of this study lends itself to qualitative research.

Quantitative research is defined by Burns and Grove (1993) as 'a formal, objective, systematic process in which numerical data are utilised to obtain information about the world' (p. 140). Others such as Morgan and Smircich (1980), Duffy (1985) and Leach (1990) describe quantitative research in terms of 'empiricism' and 'positivism', based on the assumption that social reality has an objective structure that can be measured and explained scientifically. As a result, quantitative research involves hard, objective and standardised types of data, measurement and the analysis of causal relationships between variables, not processes. Variables and relationships are the fundamental idea in quantitative research by using a deductive model where theory precedes observation in testing the relationship between the variables to provide evidence for testing the existing hypothesis (Neuman, 2000).

Thus, it is necessary to have a detailed planning process prior to data collection to measure concepts, plan design stages, and deal with sampling issues using a deductive model where theory precedes observation in testing the relationship between the variables to provide evidence for testing the existing hypothesis and make generalisations about a population (Burns & Grove, 1993). Furthermore, Creswell (2003) suggested that researchers employ the quantitative research method because it allows them to collect statistical data on pre-determined instruments, which they reduce to specific variables and use to develop and test cause-and-effect hypotheses.

Therefore, quantitative research is based on traditional scientific methods, which generates numerical data and usually seeks to establish causal relationships between two or more variables to provide evidence of cause-and-effect relationships, using statistical methods to test the strength and significance of the relationships. However, the subject matter of this study covers an area that is relatively new and immature, and the lack of *sukuks* issuances in the GCC region and of market depth means that information and data are limited. This has an impact on the direction of the analysis and the methods of the research.

5.4.2 The Selection of the qualitative method for this study

Since the subject matter of this study covers an area which is relatively new and immature, this in turn impacts on the direction of the analysis and the methods of the research. Therefore, the qualitative method was used in all phases of this research to enable the researcher to gain 'in-depth' and 'real' information on the issues concerning the financial returns and the spiritual benefits. It was used to understand the field of study from the perspective of the participants in the marketplace.

In general, the reason for applying the qualitative method is to build longitudinal perspectives into existing qualitative work on the aspects of *sukuks* market behaviour. It aspires to build an archive of ideas from the experience of key players in some of the important Islamic financial markets in GCC region.

In interpretive research approach, researchers begin with the supposition that entrance to reality (given or socially constructed) is simply through social constructions such as language, consciousness and shared meanings (Myers, 1997). The philosophical base of interpretive research is hermeneutics and phenomenology (Boland, 1985). Interpretive researchers usually try to understand phenomena through the meanings that people assign to them and interpretive methods of research. Interpretive research does not define dependent and independent variables, but concentrates on all complications of human sense making as the condition emerges (Kaplan & Maxwell, 1994).

Thus, this research is phenomenological and interpretive in the chosen methodology, the methods complements the theoretical approach that emphasises the importance of human relationships within development and significance of cultural and context. This study also use a comparative analytical approach, using *sharia* requirement forms for each issuance to collect the data and examining the questions in light of the rules of the domestic investment system and economic condition in some of GCCs' debt markets.

The qualitative approach is used to investigate the issues related to emerging the financial returns and the spiritual benefits concerns for two main reasons: Firstly, principled financial decisions and practices are a relatively new topic in academic finance and economics literature of Islamic finance. A qualitative method is required to explore this complex topic in depth with experts studied and/or applied knowledge practically used to generate ideas rather than to evaluate ideas (Miles & Huberman, 1994). Secondly, by its nature, the qualitative approach or interpretive research approach is capable of yielding significant levels of rich data and thus allows the research to develop an understanding of the meaning or nature of other's experiences, attitudes and perceptions. The outcomes of data can be beneficial in identifying patterns, themes and processes that may be valuable for the limited-known area of research. Thirdly, it assumes that realities can be perceived differently by individuals involved in it, and, these realities benefit from their interpretations, rather than being measurable by a researcher.

In other words, qualitative methods provide an opportunity for participants to express their views, perceptions and feelings to facilitate the construction of social meaning and sense making of reality. The characteristics of a qualitative approach are consistent with the objectives of this study to gain an in-depth, holistic view and, a clearer and fuller picture of the context. This research introduced the narrative of *sukuks* issuances in some GCC markets and its function to provide alternative measure for Islamic financial instruments based on Islamic principles.

In addition, applied minor quantitative method for this research is to explore the current practices related to financial decisions. Also, it examines the impact of participant Islamic financial instruments specifically *sukuks* on the one hand and on financial gain, on the other hand on contribute to socio-economic development as required by *sharia*. So, this study focuses on how to incorporate the concept of *maslaha* current Islamic financial environment and to examine how this approach could affect the pricing of *sukuks*. The effects of *sukuks* on the risk structure of such debt instruments are extremely valuable.

5.5 Research Methods of this Study

Given that this research is concerned with determining the concept of *maslaha* as to highlight its reliance and influence on financial decisions among the practitioners of the Islamic faith, and the principle of financial instruments. It is also concerned with determining the current corporate *sukuks* performance, status and market conditions. This is based on the Islamic paradigm of borrowing, lending, investment and a wide range of economic indicators and information such as GCC countries' economy, the banking and financial system, the development policy, investment and financing needs and financing instruments such as corporate *sukuks*.

Therefore, in this study, some research is carried out to provide answers to 'what, why and how' types of questions, such as 'What are the aspects shaping the relationship between Islam and finance?' In this respect, Chapter 2 reviewed *sharia* and its principles. It also discussed the conceptual model and the practice of Islamic financial contract forms such as partnership contracts (profit/loss sharing), obligation contracts (deferred trading), quasi-debt contracts (leases an asset) and hybrid contracts (contracts to be packaged together for investment purposes).

As for why corporate *sukuks* have an unlimited potential in GCC region, the existing Bahrain, Saudi Arabia and the UAE *sukuks* issuances and the most relevant literature about *sukuks* and its market mechanisms have produced evidence to establish this.

In regards to how the concept of *maslaha* can be incorporated into the current Islamic financial environment, and how this approach could affect the pricing of *sukuks*, the concept of *maslaha* was discussed in Chapter 3. This is the first study to comprehensively inspect *maslaha* as a new approach for Islamic bonds in theory and practice in the context of the Islamic financial market. The findings contribute to the body of knowledge on Islamic finance in this context, in particular on the theoretical and theological foundations of religion based ethical investment. Figure 5.2 summarises the procedures of this research.

This qualitative research is designed to be a traditional descriptive study, posing questions, gathering and analysing data to and/or addressing concerns regarding the present status quo of the topic of research. This study has three phases, but the two sets of data collection are utilised in Phases 2 and 3:

- Phase 1: since the *sharia* provides the ultimate criteria for judgment on every aspect of one's individual and social life. It should be consciously subject to the reality-check of Islamic law.

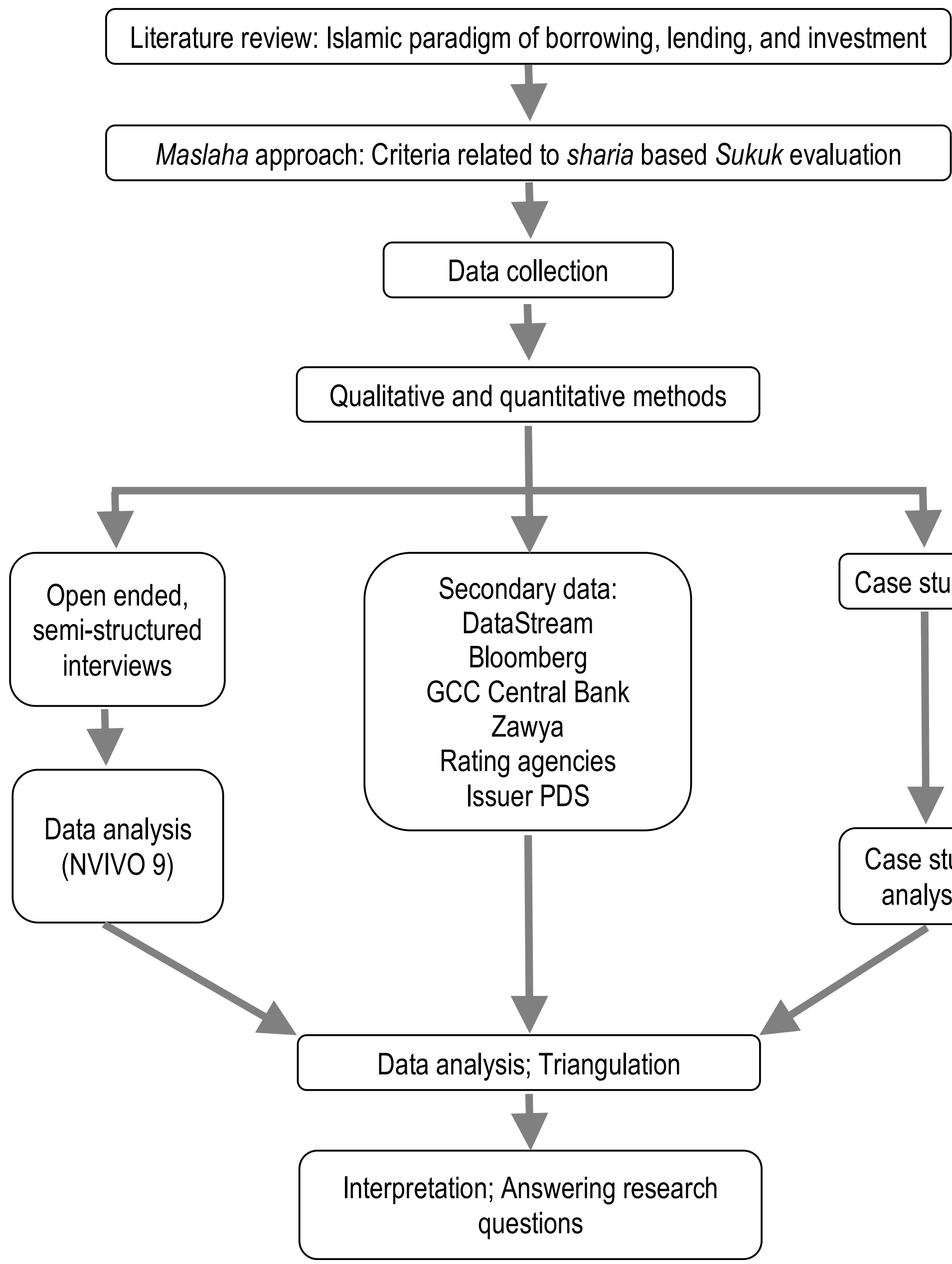

Figure 5.2. The research design and procedures of this study.

There was a review-based inductive reasoning to set up a theoretical structure for the science of Islamic finance that identifies Islamic principles in related to economics and finance. The findings of this phase address the inadequacy of available information on current Islamic paradigm of borrowing, lending and investment and present the conceptual model and practice of Islamic financial forms. It also presents the major structures that are being currently used with an in-depth analysis of the most prevalent and successful Islamic financial product, *sukuk*. It analyses different *sukuks* structures and highlights various problems with these issuances. It also set up a theoretical structure for the concept of *maslaha* application to the current practice of financial decisions particularly *sukuks* in the context of Bahrain, Saudi Arabia and the UAE, as an example of developing debt markets. The findings of this phase bridge the gap in the literature associated with the Islamic financial decisions in the context of an emerging market. The output of this phase provides insights about the criteria related to *sukuks* evaluation on *sharia* objectives basis, which is lay in between finance and ethics, and show how the *maslaha* approach can contribute to ethical investment.

- Phase 2: this phase of the research adopted a case studies approach as an exploratory tool to investigate the impact of *sukuk* issued according to *maslaha* concept, on the cost and risk structure characteristics.

The results of this phase provide a measurement of efficiency in utilising the resources in the best possible way to measure the profitability of *sukuks* issuances based on the *maslaha* approach. In order to support the contribution of *sukuks* products in reconstructing the earth, it must promote the aims of social and economic development. This model has been explained in Chapter 6.

- Phase 3: qualitative approach was employed use a survey-based open-ended, semi-structured interview explores perceptions and attitudes among issuers and buyers of *sukuks* in Bahrain, Saudi Arabia and the UAE.

Through interviews, the issuers of *sukuks* will provide their narratives of *sukuk* issuance and describe how they engaged in the topic and the level of understanding they arrived at. The buyers of *sukuks* will tell their narratives of *sukuk* investment practice and their opinion about *sukuks* pricing methods and market mechanisms. The interview questions pertain to the participants' financing or investment decisions in *sukuk* based on religious beliefs and the desire to benefit from participating in *maslaha*, as well as their opinions regarding the market mechanism and *sukuk* price determination. The results of this phase provide insights relevant to *sukuks* market practices. Table 5.1 summarises the research plan of this study.

Table 5.1: *Research plan (2009–2012).*

Phases	Research Plan	Time Frame
Phase 1	Theoretical structure for the science of Islamic finance and economics. The criteria for *sukuks* evaluation based on *sharia* objectives, which lie in between finance and ethics, and how the *maslaha* approach can contribute to religious, ethical investment.	March 2009–December 2010
Phase 2	*Sukuks* case studies and examination of the relationships between *sukuk* issuance and the principle of reconstructing the earth at the root of the *maslaha* approach.	March 2011–March 2012
Phase 3	Interviews based on current financial decisions of *sukuks* practitioners in Bahrain, Saudi Arabia and the UAE.	March 2011–August 2011
Writing up of Thesis		October 2012

5.6 Settings and Participants

In order to add rigor to this study, the interviews and case studies were integrated and compared to provide a reliable and complete picture of *sukuks* practices and financial decisions.

In this instance, the methods have been designed to help interpret experience and gain a view of the understandings and meanings that can be created in secondary market situation. Methods include records of experience as expressed in interviews, articles, news reports and legal cases related to *sukuks* defaults, offer circulars and specialist sources such as financial data agencies such as Zawya, Bloomberg and Thomson Reuters.

Therefore, data collected through multiple sources were a necessity to add rigor to the study. Data was collected using quantitative and qualitative methods from primary and secondary sources. Both method chosen because of their ability to investigate the phenomenon of religious beliefs related to Islamic finance and the economic and providing a better understanding of research problems and its complex phenomena than either approach alone (Creswell & Clark, 2007).

The time frame of the data in general is 2006 to 2010. This study has employed the triangulation methods for data collection comprising qualitative, quantitative and descriptive information. The study will be located in Bahrain, Saudi Arabia and the UAE. The reason for selecting these countries is purely practical: secondary markets have been established where the bonds and *sukuks* are listed locally, the size and structure of the *sukuks* market, developments expenditure are huge compared to other countries in the region. This data include the *sukuk* volume, offering date, coupon or profit margin plus the reference, maturity and credit rating, market capitalisation of the issuer. Information about the type of the *sukuk* contract is required as is the purpose of issuing *sukuk* and any relative information to the issuance.

However, lack of historical information about the trading activities of the debt instruments generally and *sukuks* specifically in GCC debt markets leads to use of case studies by focusing on the four largest industries issued *sukuks* namely: real estate, financial services, power & utility, and oil & gas, including manufacturing have been described in chapter 4, excluding Governmental Institutions. The issuances that have not been listed in any exchanges market will be excluded from the researcher data as well. The triangulation strategy comprised two approaches.

5.6.1 Interviews

It should be emphasised that this is an inter-disciplinary study that cuts across economic, financial and ethical disciplines and should, therefore, be assessed accordingly. This study seeks to know what the issuers and buyers (investors) think about Islamic bonds (*Sukuks*). Moreover, did issuers and buyers take their decision to financing or investing in *sukuks* based on religious beliefs and the desire to benefit from participating in *maslaha*? Do investors employ a different set of criteria for selecting financing methods or investing products? What are their opinions regarding the market mechanism and *sukuk* price determination? To what extent profit determination has implicated time value of money with different types of *sukuks* forms? What will happen to the issuer and investors when default accrues? Through interviews, the issuers of *sukuks* will provide information on their experience with *sukuks* issue practices and describe how they arrived at the views expressed and the buyers of *sukuks* will provide their views.

In the case of the investors, the information gathered will focus on the criteria used to assess the trade-off between market financial returns and *maslaha* returns. The qualitative research interviews strive to understand the subject's point of view (Kvale, 1996). Particularly, this study seeks to learn about phenomena that cannot be observed directly such as feelings, thoughts and intentions, which they attach to the decisions they make (Patton, 1987).

Although there were many strengths in each method, the success of an interview depends on the notion that the fundamental principle of qualitative interviewing is to provide a framework within which the respondents can express their own understandings in their own terms (Patton, 1987). For this reason the semi-structured interviews and open-ended questions were designed with high regard to ensure the accuracy of the responses. Semi-structured interviews were conducted with a quite open framework, which allow for focused, conversational, two-way communication to explore issues (Silverman, 2006).

Participants

With regard to the sampling methods, the researcher was targeting existing corporate *sukuks* issuers and buyers to ensure a random sampling of most public companies in Bahrain, Saudi Arabia and the UAE. This means, all companies would have equal opportunity of being selected to be represented in the sample. The final sample included 19 respondents, comprising nine issuers and 10 investors in Bahrain, Saudi Arabia and UAE. Each interview was about 45 minutes.

However, after permission was obtained from the Control and Investigation Board in Saudi Arabia, which collaborates with the CMA in Bahrain, Saudi Arabia and the UAE, a plan was designed for collecting data from *sukuks* issuers and investors. At the beginning of 2011, the consent letter with the information sheet was personally delivered to all participants in each country (Bahrain, Saudi Arabia and the UAE) and handed to high-ranking officers such as senior managers, senior sections and CEOs of commercial organisations of the target firms who would be asked to participate in this project. The researcher visited each country and met these officers to give them a brief explanation about this study and inform them about the nature of the research and the contributions that were expected from them to implement the project. It is pertinent to mention that during data collection Bahrain witnessed protests especially during March and April 2011 and the researcher was advised by his sponsor to leave Bahrain immediately, consequently, only one buyer was included in the interview.

During the interviews participants were able to explain their views in detail and to discuss sensitive issues on a confidential basis. The participants provided information freely when the interviews were not recorded on a device and hence the responses were not recorded and the respondents had no objection to writing down the responses. Initially, the semi-structured interview included the following example questions and were then extended to further questions or shortened depending on the progress of the interview:

- If you prefer to deal with *sukuks* rather than the conventional bonds, what are the main reasons for this?

- Do you think *sukuk* is a debt instrument or an equity instrument? Please elaborate.
- Do you employ a different set of criteria for selecting financing methods or investing products based on religious beliefs?
- Assuming that you have two scenarios to financing or investing in *sukuks*, have you considered religious beliefs in your decision? Please elaborate. If you had to choose between two projects, do you choose the one with greater social benefit?

5.6.2 Case studies

Case-study research excels at bringing us to an understanding of complex issues or phenomena and can extend experience or add strength to what is already known through previous research. Case studies emphasise detailed contextual analysis of a limited number of events or conditions and their relationships. Researchers have used case-study research method for many years across a variety of disciplines and it is characterised in different schemes. However, there is no consensus amongst the scholars about its definition. According to Stone (1978), Benbasat (1984), Yin (1984) and Benbasat, Goldstein and Mead (1987), a case study examines a phenomenon in its natural setting, employing multiple methods of data collection to gather information from one or a few entities (people, groups, or organisations). The boundaries of the phenomenon are not clearly evident at the outset of the research and no experimental control or manipulation is used. Therefore, social scientists in particular have made wide use of the quantitative and qualitative method to examine contemporary real-life situations on which they base the application of ideas and extension of methods.

According Benbasat et al. (1987), case studies are important because they enable the researcher to study a phenomenon in its natural setting, ask ‘how’ and ‘why’ questions to understand its nature and complexity, and conduct research in an area where few, if any, previous studies have been undertaken.

It important to note that, critics of the case study method believe that the study of a small number of cases can offer no grounds for establishing reliability or generality of findings. Others believe that the intense exposure to study of the case biases the findings. Some dismiss case study research as useful only as an exploratory tool. In addition, there are problems in the interpretation and application of case-study research as described by Robert Yin (1994) and grounded theory methodology. Yet researchers continue to use the case-study research method with success in carefully planned and crafted studies of real-life situations and issues. Reports on case studies from many disciplines are widely available.

Yin (1994) suggests that the case study 'benefits from the prior development of theoretical propositions to guide data collection and analysis' (p. 13), whereas Glaser and Strauss (1967) insisted that a grounded theory approach should have no pre-conceived ideas or hypothesis. A criticism of the case study as a research method is that findings cannot be generalised. Grounded theory specifically sets out to investigate the real world, usually by using interview data. It discovers the concepts grounded in the data and uses those concepts to build theory. The use of both these methods, therefore, minimises this criticism. There is, therefore, no real anomaly between the use of case studies and of grounded theory.

Therefore**,** in the current thesis, case studies are used in (a) to answer the 'how' and the 'why', (b) to prevent any behaviour being manipulated in the study, (c) to cover contextual conditions relevant to the phenomena, (d) to make boundaries clear between phenomena and context (Yin, 2008). The case studies observed 27 *sukuks* issuances issued by 14 companies in the selected countries in GCC region.

A concurrent triangulation research approach was utilised to confirm findings within multiple case studies, the literature review and narratives study (Creswell, 2003). The literature review was used as an exploratory source to help identify statements, which were used in the examination models as well as constructing survey interviews. By implementing case studies approach a number of sources were utilised, including Zawya, GCC central banks' websites, and reports by rating agencies and related offering memorandums.

The sample size is determined by information availability on all requested variables, notably *sukuks* samples downloaded from Zawya. This data include the issuer, the issue size, issue date, maturity, coupon rate and the profit margin, if any, which are indexed to LIBOR, SIBOR, EIBOR or IBOR, and the *sukuk* structure's type from January 2006 to December 2010. The data on the references rate originate from three different sources: daily and monthly prices are downloaded from DataStream, Bloomberg and GCC central banks' websites. The market capitalisation of the issuer was obtained from the CMA in Bahrain, Saudi Arabia and UAE. To avoid the criticism of a small sample of case studies, the sample represents 68 per cent of the total number of corporate issuances during 2006–2010 in the GCC. In terms of issue size, it represents 41.05 per cent of the US$21,924 million of corporate issuances accumulated in the same period.

5.6.3 Data analysis.

This study employed grounded theory data analysis, which involves looking for codes, then concepts and finally categories. Barney Glaser (1992) recommends identifying key points (rather than individual words) and allowing concepts to emerge. The aims of the analysis process are to clarify the statement of the participants.

It is important to consider the relevance of the data analysis for specific periods. The data for *sukuks* origination, pricing and yields prior to the global financial crisis in 2008 would be very different to those for 2008–2010, when even the *sukuks* market was affected by the economic fallout of the global financial crisis. As such, to test the proposition of this thesis, a large part of the analysis is based on data collected for the pre-crisis period. This applies to the *sukuk* issuance data and, as a comparison, to the data for competing types of financing such as corporate finance and government soft loans (Miles & Huberman, 1994).

Interview data

The first phase of interview data analysis involved familiarisation followed by producing the transcripts. This was followed by incorporating the contents of the reflective journal into the processing of the interview responses. The next stage was first level coding by a combination of identifying meaning units, categories, and assigning codes to categories (Tutty, Rothery, Grinnell and Austin, 1996). The second-level coding involved the identification of similarities and differences between the categories in an attempt to detect relationships. This completed the coding process and resulted in the identification of the main themes which were then analysed in relation to the objectives of the study. Thematic analysis used to analyse the data of the interviews followed Bogdan and Biklen (1998), who describe qualitative data analysis as:

> The process of data analysis is like a funnel: Things are open at the beginning (or top) and more directed and specific at the bottom. The qualitative researcher plans to use part of the study to learn what the important questions are. He or she does not assume that enough is known to recognise important concerns before undertaking the research. (p. 7)

The thematic analysis of the interviews were supplemented with case studies data analysis to understand and explain the subject matter in depth, focused on the context in which issuers and investors impart their wealth and benefits according to *maslaha*.

All interviews were transcribed and interview responses were electronically coded to match interview questions (Bazeley & Richards, 2000), and thematically coded to reveal major themes and sub-themes (Ezzy, 2002). Data was tabulated and manually cross-matched to individual interviewees, themes and sub-themes, regionally and sectors. These levels of coding provided a means of separating and combing data, and finding similarities and differences across and within the participants. Whilst the questions asked of issuers generally targeted the same themes as those asked of investors' interviewee with little different in some questions. Original interview language was an English coding scheme was developed.

The present study looked for data which covered various aspects of *sukuks* issues including, favourite, identity, risk, pricing, structure, tradability, legality, the criteria for selecting this type of instruments, and issues that related to *sukuks* in some of GCC countries namely Bahrain, Saudi Arabia and the UAE. The researcher was interested in different perceptions of management, depending on the sector of issuer or investor. Therefore, nodes such as 'importance of *sukuks* over conventional bonds', 'regulatory issues', and 'pricing mechanism' were searched and a matrix intersection between nodes and companies was produced. All documents were included into the analysis and the results were displayed as a thematic report.

The thematic analysis was combined and categorised related patterns into themes and sub-themes, which were defined as units derived from patterns such as 'conversation topics, vocabulary, recurring activities, meanings, feelings, or folk sayings and proverbs' (Taylor & Bogdan, 1998, p. 131). Themes were identified by bringing together components or fragments of ideas or experiences, which often are meaningless when viewed alone. Themes that emerge from the informants' stories are pieced together to form a comprehensive picture of their collective experience. Therefore, this study concludes with 11 themes and five sub-themes as follows:

- Preferences between *sukuks* and conventional bonds
- *Sukuks* as debt or equity instruments
- Risks associated with *sukuks* versus conventional bonds
    - The liquidity perspective
    - The liability perspective
    - The *sukuk* structure perspective
- The Returns of *sukuks* versus conventional bonds
- *Sukuks* pricing and profit margin mechanisms
- Costs associated with the Issuance of *sukuks* in contrast to conventional bonds
- The significance of *sukuk* ratings in determining investment decisions
- Guarantee issues with *sukuk*
- Local currency issuances versus US dollar issuances
- The factors hindering *sukuks* market growth and structure innovation
- The *maslaha* concept in financial or investment decision

- Do religious convictions have affect issuers' financial decision making?
- Do religious convictions affect investors' decision making?

Case studies data

Lack of historical information about the trading activities of the debt instruments generally and *sukuks* specifically in the GCC debt markets narrowed the study to focus on the four largest industries issuing *sukuks*: real estate, financial services, power and utilities, and oil and gas including manufacturing; governmental institutions were excluded. The issuances that have not been listed in any exchange markets were also excluded. The sample of *sukuks* issuances comes from a number of sources, including DataStream databases, Bloomberg, Zawya, GCC central banks' websites, reports by rating agencies and related offering memorandums.

Specific techniques include use quantitative data to corroborate and support the qualitative data, use multiple investigators to gain the advantage provided when a variety of perspectives and insights examine the data and the patterns. In addition, creating categories, placing information into arrays, creating flow charts or other displays, and tabulating frequency of events are most useful for understanding the rationale or theory underlying relationships. Therefore, when the multiple observations converge, confidence in the findings increases.

The various structures, pricing, rating, purchase undertaking, *sharia* acceptability and other *sukuks* market dynamics relating to the individual issuances were analysed and illustrated with flow diagrams, charts and graphs. Four main criteria and 14 sub criteria related to *sukuks* evaluation based on *sharia* objectives have been established as follows (see Appendix A: Summary of the implications of the case studies):

- Basic Information
  - Foundation
  - Government support
- Motivation Criteria
  - Purpose of *sukuk*
  - Identity of the underlying assets
  - Characteristics of *sukuk* price and returns
  - Nature of the assets transaction
  - Rating assigned
- Criteria relating to the structuring of contracts
  - Type of structure

- Clarity of the underlying assets
- Characteristics of ownership and responsibility
- Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)
- Legitimacy of the product

- Criteria relating to the outcomes of implementation contracts
    - Adequacy of scholars' opinions
    - Advantages/disadvantages of transactions

5.7 Validity and Reliability

Validity and reliability in qualitative studies are discussed using a variety of terms such as verification, trustworthiness, dependability, and transferability (Creswell, 2003). Thus, research validity was considered in constructing and implementing this research study. Validity can be enhanced by the transparency of researchers' biases and triangulation (Merriam, 1998).

In the current study, transcribed interviews, including notes taken after the recording concluded, were forwarded to each interviewee. Participants were asked to review the transcripts to ensure that their thoughts were accurately represented by the text. Also multiple methods were used to collect data. These included review of a variety of documents and interview.

However, Creswell (2003) explains that reliability in the customary sense does not apply to qualitative research, which is multi-faceted and highly contextual. Instead, results should be considered in terms of dependability and/or consistency. More simply, results should be deemed consistent with the data that is collected. Thought multiple methods were used to collect data to add more reliability, which means reliability was further supported by the maintenance of a chain of evidence that connected data and conclusions that detailed the description of research activities (Yin, 2008). Through integrated the result of case studies and interviews made triangulation to the study. This is consistent with Yin (2008), who stresses that investigator triangulation is a significant component of the research design.

5.8 Ethical Considerations

Researchers who have used qualitative data collection methods to investigate their research have discovered that the application of existing ethical guidelines can sometimes result in confusion and doubt. Ethics is defined as 'what is or is not legal to do, or what moral research procedures involves' (Neuman, 2006, p. 129). Expressions of ethical discord within the research literature are common (e.g. Hemmings, 2006; Kvale & Brinkmann, 2008; Lincoln, 1998; Laine, 2000; Myers, 2009).

Ethics forms an integral part of research planning strategy (Mertens, 2009). In qualitative research, participants play a critical role because they are treated as instruments for data generation and analysis. The ethical relativism (e.g., the teleological view) requires researchers to look beyond the rules to either immediate or long-term effects or consequences as a basis for ethical action (Anderson & Kanuka, 2009). As a result, one of the purposes of the research is to develop trustworthy understandings in an ethical way (Merriam, 1998).

The strength of this perspective is that ethical action rests on the need for researchers to self-reflect on their research practices and assume responsibility for the consequences of their actions when conducting research.

To comply with these ethical considerations, this research followed the ethical research procedures of the ethics guidelines of Victoria University, in order to conduct the study. Ethical clearance was obtained prior to conducting this research. Moreover, this research does not deal with invasive information, and thus, ethical problems are not anticipated.

Furthermore, during the data collection stages, the researcher ensured that:

1. The participants were informed about the nature, purpose, methods, benefits, possible risks and consequences of the study.
2. Kept the data (digital records and transcripts, and collected assignments and resources) in the researcher's computer so that nobody could access them.
3. The participants were not identified. The study will not present their personal information but presents the gathered information from them in a way that could lead the readers to assume their identities and will not use the participants' real names in the research report and other documentations (Zikmund, 2003).
4. The participants were informed that participation is voluntary and participants are free to withdraw from the project at any time and to withdraw any unprocessed data previously supplied (Zikmund, 2003).

5.9 Conclusion

This chapter discussed the research design, paradigm and methods of this study, including the data collection methods, tools and participants. It concluded with a description of the ethical considerations relating to the data collection process.

In summary, this study uses an innovative of quantitative and qualitative research methods to collect data from primary and secondary sources on the emerging debt markets of Bahrain, Saudi Arabia and the UAE. Qualitative method analysis was chosen to provide a more thorough understanding of the complex phenomenon of religious beliefs related to Islamic finance, investment and economics. In addition, this thesis utilises case studies in order to add strength to what is already known through previous research.

Chapter 6: Phase 2—Case Studies

6.1 Introduction

This chapter analyses the structures, pricing, ratings, purchase undertakings, *sharia* acceptability and other relevant dynamics of the *sukuks* market, illustrating them with flow diagrams, charts and graphs. It presents the case studies based on the offering circular of each issuance, the prices and profit margins obtained from Zawya (2011), and of the issuances their rating grades obtained from other rating agencies.

Case studies are common across different disciplines where qualitative and quantitative research methods are applied to observe contemporary practices and provide the foundation for the development of theories and extension methods. As mentioned in Chapter 5, numerous researchers view case-study research as an empirical query that explores an existing phenomenon within its real-life context when its boundaries are not clearly evident and multiple sources of evidence are used. Some researchers argue that a small sample of case studies can lead to unscientific generalisations and conclusions. Therefore, to avoid this criticism, the case studies in this thesis represent 68 per cent of the total number of corporate issuances during 2006–2010, which amount to 41.05 per cent of the accumulated US$21,924 million corporate issuances in the same period.

Section 6.2 presents an overview of the sample including differential rating, structures and variation tenure. Section 6.3 presents the case studies of each *sukuk* and the basic information about the obligor. It uses the criteria established in Chapter 3 to evaluate *sukuks* based on *the sharia* objectives relating to the motivation, structure and outcomes of their implementation. Section 6.4 summarises the chapter and presents summary analysis of the case study results

6.2 The *Sukuks* Markets in Bahrain, Saudi Arabia and the UAE

This study restricted its sample of corporate *sukuk* to those issued publicly by firms from Bahrain, Saudi Arabia and UAE issued from 2006 to December 2010. This enabled the collection of trade data on all *sukuks* for six months after issuance. The data collection methods employed in the second phase of the research was restricted to three countries in the GCC region, for reasons outlined in Chapter 1. This data includes *sukuk* volume, coupon or profit margin, plus the reference, maturity, price and credit rating. Information about the type of *the sukuk* contract, the purpose of issuing *sukuk* and any relative information to the issuance required.

However, the lack of a credit-rating culture to yield benchmarks as well as the lack of historical information about the trading activities of the debt instruments generally and *sukuks* specifically in GCC debt markets, led to the use of case studies. The sample size is determined by information availability on all requested variables. This data originates from Zawya database for Bahrain, Saudi Arabia and the UAE. While the data on the reference rate originate from three different sources: daily and monthly prices are downloaded from DataStream, Bloomberg and GCC central banks' websites. The data include the indexed of LIBOR, SIBOR, EIBOR and IBOR. The final corporate sample comprises 27 *sukuks* issuances by 14 companies, which are ALDAR, Dana, DAAR, DIB, EIB, GFH, Tabreed, SABIC, SEC, SHB, SIB, Sorouh, Tamaweel and DP World.

6.2.1 Differential ratings.

All *sukuks* within a rating class may not be viewed as equally risky. There are several characteristics of *sukuks* which might be useful in dividing it within a rating class into new groups. The finer breakdown of ratings produced by the rating agencies themselves, Standard&Poors (2008b, 2011) and Moody's (2010) have introduced plus and minus categories within each letter rating class. One obvious possibility is that bonds that are rated as a plus or a minus are viewed as having different risk than bonds that receive a flat letter rating. If this is true, then estimating one set of spot rates for all *sukuks* in a class should result in consistent pricing errors for *sukuk* rated 'plus' (too low a model price and hence negative errors) or bonds rating 'minus' (too high a model price and hence positive errors). However, for much of the sample, the paucity of *sukuks* in many of the subclasses makes it difficult to estimate meaningful spot rates for a subclass.

Although there is some evidence that past rating changes predict future rating changes, it is unclear if the tendency is strong enough to show up in price data. Moreover, investors might consider *sukuk* within the same rating class to have different risk. Investors might believe that a particular *sukuk* is likely to be downgraded or upgraded. One predictor of this might be past rating changes. Past rating changes might predict future rating changes, either because rating agencies tended to make changes in steps or because a company whose risk has increased or decreased in the past is more likely to experience similar changes in the future. Some researchers were finding that past rating changes contain information about future rating changes. In this study sample, *sukuks* with rating changes was quite small, thus the number of rating changes is so small that the effect is swamped by random pricing errors.

Investors clearly take the difference in rating into account. If the S&P rating is lower than Moody's, then investors act as if the bond is higher risk than is implied by the Moody's rating and they will set a lower market price, and this results in a model price above invoice price and a positive error. Likewise, if S&P rates the *sukuk* higher than Moody's the *sukuk* is considered by investors as lower risk compared to bonds where they agree and the pricing error is negative.

In general, characteristics of our *sukuks* sample which might be useful in dividing it within a rating class into new categories. These categories are high or higher medium grade, lower medium grade, speculative or highly speculative grade, and finally unrated category. These categories are based on the rating agencies descriptive and are shown in Table 6.1.

Table 6.1: *Breakdown of sukuks rating categories by country*

Rating category	Total	Saudi Arabia	UAE	Bahrain	%
High or higher medium grade	12	6	6		44%
Lower medium grade	7		6	1	26%
Speculative or highly speculative	2	1	1		7%
Unrated	6	4	2	0	22%
Total	27	11	15	1	100%

Source: Moody's, 2010; Standard & Poor's, 2008b, 2011; Zawya, 2011

The sample (see Figure 6.1) shows that six issuances (22% of the sample) were not rated by any of the three major credit rating agencies, and eight companies issued more than one issuance. Overall 44 per cent of the sample received a rating of high or higher medium grade, where the financial services sector gained 19 per cent, both power and utilities, and oil and gas including manufacturing acquired 11 per cent each, and real estate represented only four per cent. Saudi Arabia and UAE firms were superior by six issuances each that attained this rating. Twenty-six per cent of the *sukuks* sample received the lower medium grade, the majority of which were financial services, power & utilities and real estate with the same number of issuances (7% each) and the transport sector with one issuance (4%). UAE firms had six issuances that gained this grade besides one issuance issued by a Bahraini firm. Seven per cent received the speculative or highly speculative grade, which includes two issuances from the real estate sector, one from a Saudi firm and one from a UAE firm.

It is important to note that 22 per cent of the *sukuks* samples were unrated, including four issuances by Saudi Arabian firms and two by UAE firms. Surprisingly, two *sukuks* issuances by Saudi Arabian firms came from the financial services sector and two came from the real estate sector. There was one issuance from the oil and gas sector and one from the real estate sector in the UAE.

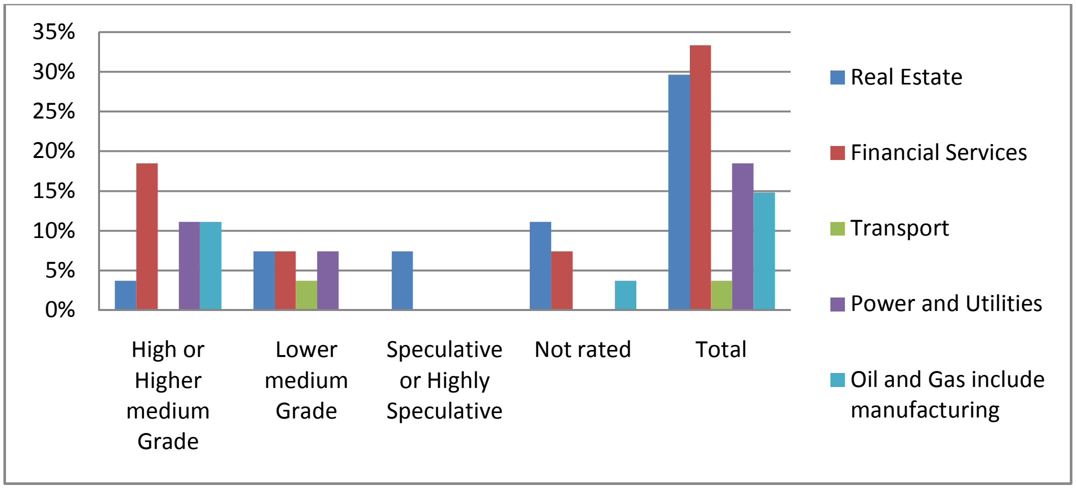

Figure 6.1. Sukuks rating categories by sectors.

According to Moody's, the average rating in the GCC has migrated from A1 in 2008 to Baa1 in 2009, as a result of the downgrades for many regional issuers during the year. Most prominent were Dubai's corporate government-related issuers, downgraded due to uncertainties concerning the repayment of their debt and the degree of government support they will effectively receive. In addition, corporate defaults like those of DP World (UAE) and Saad Group (Saudi Arabia) have raised concerns about the creditworthiness of large corporations in the GCC. However, some of these issuances were not rated at all, indicating that the *sukuks* markets in Saudi Arabia and the UAE have not given that much for such grade for the issuers. Maybe this is because of the absence of local agencies or because investors consider other factors such as the structure or the underlying assets.

In order to be able to compete and be attractive comparing to conventional bonds, it is pivotal for *sukuks* issuers to seek a rating by international rating agencies. Rating will also support *sukuks* creditworthiness and pricing guidelines to attract a wider global investors' base. A thorough rating course of action would scrutinise different aspects of the *sukuk* legal structure, the quality of the underlying asset pool, the ability of the originator to meet the financial obligations, and the structure of the transaction and the repayment mechanism.

There are many calls within the region for creating a local rating agency to curb the high cost of rating, especially for *sukuks* markets developments. Besides, *sukuks* credit enhancement procedures should be encouraged to substantiate *sukuks* appeal for global investors. It is critical for the future of *sukuks* to mitigate the current level of intrinsic risk in *sukuks* transactions to avoid mass default of *sukuks* as new and untested debt instruments. Credit enhancement procedures such as cash reserves, over-collateralization, third party guarantees, bank guarantees and/or insurance coverage could be very important options for solid a *sukuks* legal structure. Also, it is vital for the GCC's jurisdiction to recognise *sukuks* contracts construed under different laws, like the dominant English law, in order to attract global investors and their value added essence in developing such nascent instruments.

6.2.2 Differential structures.

There are several different types of *sukuks*, each of which is based on an Islamic financial structure. The most prevalent and best known are *ijara* and *mudaraba*, which acquired 30 per cent each of the total sample worth US$11,650.3 billion. The *al-istithmar* structure came second in terms of the number issued but first in size, accumulating almost US$8 billion. *Musharaka* came third with an 11 per cent share, while *istisna* and *wakala* were fourth and fifth (7% and 4%), respectively (see Table 6.2).

Table 6.2: *Sukuks structures as a percentage share of the total sample.*

Structure	Saudi Arabia	UAE	Bahrain	Total	Percentage of structure share	Issue size (US$ m)
Al-Istithmar	5			5	19%	7,999.2
Mudaraba	2	6		8	30%	6,523.3
Ijara	3	4	1	8	30%	5,127.0
Musharaka		3		3	11%	1,325.0
Istisna		2		2	7%	499.5
Wakala	1			1	4%	450.0
Total	11	15	1	27	100%	21,924.0

Table 6.2 demonstrates that Saudi Arabian firms prefer the *al-istithmar* structure, as reflected in the number of issuances, most of which were used by the power and utilities, and manufacturing sectors. The *ijara* structure is the second preference, especially with two issuances in the real estate sector and one issuance in the power and utilities sector. The

mudaraba structure is less important, used by the financial services sector with two issuances, and one issuance from the real estate sector has the *wakala* structure.

In contrast, the UAE firms prefer the *mudaraba* structure, as six issuances have accumulated more than US$6.5 billion. This structure has been used by most of the UAE sectors (transport, oil & gas and real estate) except the financial services sector, which prefers the *musharaka* structure with three issuances. The *ijara* structure comes second with four issuances, two from the financial services sector and one each from the real estate and power and utilities sectors. *Istisna* is not universally accepted in the GCC region, as the majority of *sharia* scholars have disputed its permissibility and its applicability. However, this structure has been used by the financial services sector and the power and utilities sector in the UAE. It is interesting to note that jurists who consider *istisna* permissible have agreed that it applies only to manufactured items, and is hence invalid on things that are not manufactured. Finally in the case studies sample, there was one issuance from Bahrain, issued by the financial services sector.

6.2.3 Variation in tenure.

The dates and periods of *sukuks* in the sample are divided in accordance with the issue prospectus and range between three to 30 years. The tenures of the *sukuks* issued in Saudi Arabia, the UAE and Bahrain between 2006 and 2010 were concentrated in the five-year bracket. Figure 6.2 illustrates that 11 out of the total 27 issuances had a maturity of five years at the time of issue. Six issuances had a maturity of three to six years, followed by six with a maturity of 20 years, three with a maturity of 10 years and only one with a maturity of 30 years.

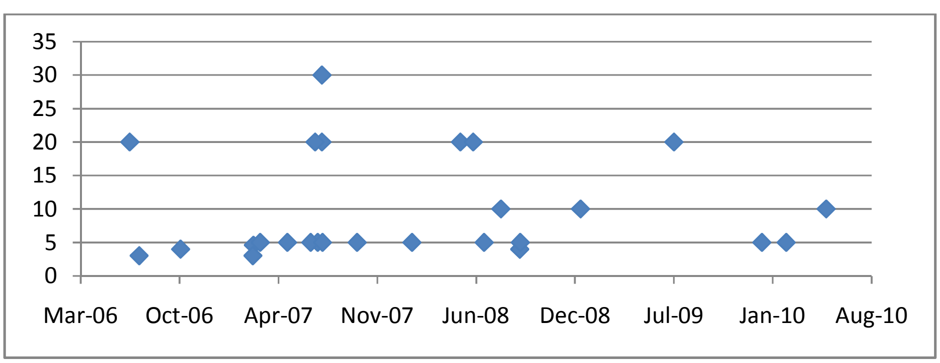

Figure 6.2. Scatter plot of *sukuks* issues by tenures.

In fact, the *sukuks* market so far has been used by institutions to raise money largely for the short to medium term. The market therefore only caters to investors who are willing to deploy their funds in the Islamic capital market over a short to medium-term horizon. Conventional wisdom dictates that institutions with longer term liabilities such as investment banks, insurance companies, pension and endowment funds need longer term investments in order to implement best practices in the asset-liability management area. Insurance companies or pension funds on the other hand are at a disadvantage compared to their conventional counterparts as they do not have longer term Islamic instruments with which to match duration of their assets and liabilities.

6.3 Qualitative Analysis of the Corporate *Sukuk* Case Studies

The following sections present and discuss each company studied, in alphabetical order of company name. However, Appendix A shows a table summary of the implications of the case studies.

6.3.1 Case 1: Aldar Properties PJSC.

ALDAR is a real estate development company based in the UAE. It has multi-billion dirham (AED) civic projects to help develop the capital Abu Dhabi into an international business magnet and tourist destination. As the UAE's premier real estate development, management, and investment company, ALDAR's vision is to establish Abu Dhabi as the UAE's most dynamic forward-thinking real estate market by creating unique and prestigious development projects that can be used as a benchmark of quality, whilst adhering to the cultural and natural heritage of the city. The company owns over 50 million square meters of land in strategic locations throughout the Emirate. The current property portfolio includes major developments and re-developments within the Emirate of Abu Dhabi. These include Yas Island, Al Raha Beach, Central Market, Nareel Island, Noor Al Ain, and HQ project which has voted 'Best Futuristic Design 2008' by the Building Exchange Conference. ALDAR was established in 2000 as a limited liability company through the UAE offsets programme, and in 2005, it moved to a public company listed on the ADSM (ADX, 2011; ALDAR, 2011). Since then, the company has announced assignments worth more than US$75 billion, in a property development portfolio diverse in scope and style, attracting considerable worldwide interest and inward investment. ALDAR has a key competitive advantage due to its sound financial backing, large resources, and the Government's support in undertaking large scale, market-driven projects that add value to the Emirate's booming property industry (ALDAR, 2011). The market capitalisation of ALDAR as of 31 December 2010 was US$1,597 million (Zawya, 2011).

6.3.1.1 The motivation of ALDAR's *sukuk*.

At the core of what ALDAR stands for is the corporate focus on balancing the evolving needs of a modern city while maintaining and conserving the environment. Its projects seek to priorities both the immediate and future physical, social and economic requirements of the UAE and Abu Dhabi specifically for the benefit of those who live and work in the region. Therefore, ALDAR is committed to designing projects that balance the need for infrastructure with environmental sustainability. Consequently, ALDAR's *sukuks* were issued to raise funds in accordance with *sharia* requirements and to achieve their previous goals.

During this study period (2006–2010), ALDAR (2007, 2008) issued two *sukuks* in March 2007 and June 2008. The first *sukuk* issuance was of US$2,530 million exchangeable *sukuk* based on the *mudaraba* form. It is US dollar denominated offering an indicative annual rate of return of 5.767 per cent payable quarterly and has a tenure of four years and six months. It is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under *the sukuk* certificates. This issuance has not received any rating from any of the three largest ratings service agencies, and is traded as an unrated instrument. The price was 100 per cent of the aggregate face value of the *sukuk*, and *sukuk* was issued in denominations of US$1,000. It is subject to a minimum holding of US$100,000. The proceeds of issuances of the *sukuk* certificates will be used to invest in accordance with the investment plan under *mudaraba* agreement. The *mudaraba* capital will be used to purchase the initial *mudaraba* assets and to fund a senior expenses reserve, an infrastructure fund and a liquidity reserve. These assets primarily consist of all of ALDAR's rights, title and interest in the outstanding assets of *the mudaraba* agreement. However, the offering circular of this issuance has not clearly stated the nature of these assets (ALDAR, 2007). The deal represents the equivalence of a receivables securitisation without actually selling debt. The non-recourse nature of the deal means that the contract is a true sale transaction and the receivables may be de-recognised from the originator's balance sheet. In addition, the structure in the case of an income from the assets is distributed as profit to the investors with separate amounts being used to pay the quarterly profit and repurchase a share of the Trustee's interest in the assets providing the principal amortization mechanism.

The second *sukuk* (Aldar Properties *Sukuk* II) issued in June 2008 available in local currency to UAE nationals and foreigners. The issuance is equivalent to US$1,021 million (AED 3,750 million), the issuance is AED denominated, offering a floating annual rate of return designated as the Emirates interbank offered rate (EIBOR) for three-month AED deposits, plus 175 basis points, payable quarterly and having a tenure of five years due in June 2013. This issuance received a solid (B-) grade rating at the time of subscription from Standard & Poor's (2011), so this places the instrument in speculative or highly speculative grade category. The price was 100 per cent of the aggregate face value of the *sukuk*, which was issued in denominations of AED 100,000 and subject to a minimum holding of AED 500,000. The proceeds of issuance of *the sukuk* certificates will be used to invest in accordance with the investment plan under *ijara* Agreement, *the ijara* capital will be used to purchase through the grant of a *musataha* interest (a right *in rem*) - it is the grant of a right to use and develop certain land- in the initial *ijara* assets and to fund a senior expenses reserve, an infrastructure fund and a liquidity reserve. It is given the right to use and develop land with such rights over that land in a manner that allows the holder to be the outright owner of the buildings constructed on that land during the period of the *musataha*. It should, however, be noted that a *musataha* provides an interest less than freehold or absolute ownership. The *musataha* right, when created, is granted by the owner of the freehold property to the holder. The right, while not a leasehold interest, is quite similar to a leasehold interest. Certain *sharia* scholars consider this sufficient to enable the holder (or *musatahee*), in turn, to lease the land and any buildings thereon to the originator under an *ijara* arrangement. Basically, a *musataha* contract replaces the sale and purchase agreement in the sale and leaseback structure and it is also possible for a head-lease arrangement to be used instead of the sale and purchase agreement, such that the trustee is granted a long-term right to use an asset under the head lease, which in the case of ALDAR, the *musataha* interest is the grant of a right to use and develop certain land located at its Al Raha Beach development for a term of 50 years commencing on the closing date. Thus, it is allowing the trustee to enter into a sub-lease (the *ijara*) (ALDAR, 2008).

6.3.1.2 The structure of ALDAR's *sukuk*.

The ALDAR *sukuk* issuance in 2007 was based upon the structure of *mudaraba*, which in turn is based on AAOIFI (2010) standards (13), (17) and (21). The structure of ALDAR *sukuk* was exchangeable in certain circumstances. The initial exchange ratio will be equal to 645.161 shares per US$1,000 and is subject to adjustment. The transaction involves a

SPV structure, Aldar Funding Limited (SPV and issuer) incorporated under the laws of Jersey. ALDAR will transfer the land and all the associated rights under the contract to Aldar Funding Limited. Among *sukuks* structures, the *mudaraba* form is viewed highly optimistically by the AAOIFI (2008) in view of its ability to start-up businesses and venture capital and applicability to practically any asset class that can generate legitimate and predictable cash flows. Figure 6.3 explains ALDAR's 2007 *sukuk* issuance.

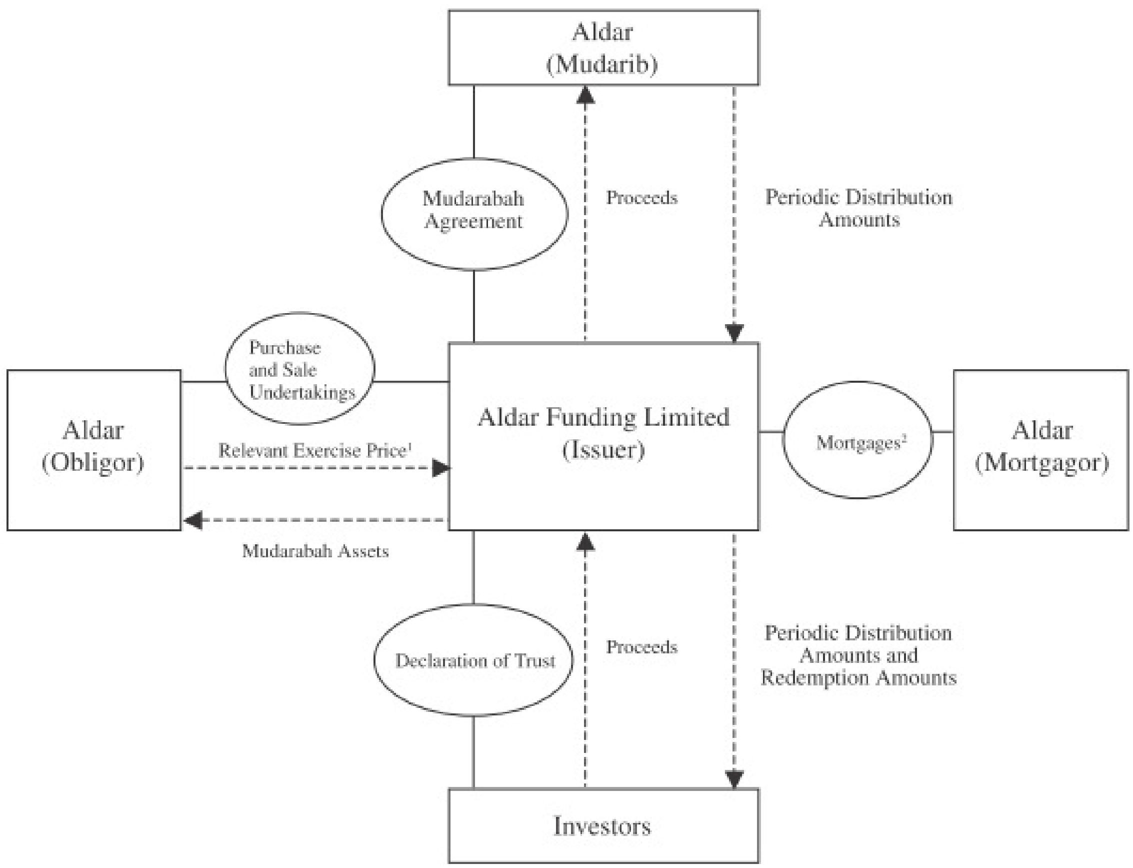

Figure 6.3. ALDAR's 2007 *sukuk* structure. Source: ALDAR, 2007.

However, it is critical for the purposes of *sharia* compliance that the *mudarib* is entitled to a share in the profits rather than a flat fee, so the investment plan and the terms of the *mudaraba* agreement contemplate that the *mudaraba* will generate a profit which shall be distributed 99 per cent for issuer on behalf of investors and 1per cent for obligator. The certificates may also be redeemed at the option of the issuer in whole or in part on notice at their principal amount plus all accrued but unpaid periodic distribution amounts either (a) at any time after 27 August 2009 and prior to 3 December 2009 if the issuer call reference price is greater than 140 per cent of the prevailing exchange price. In this structure, there has also been undertakings from the *mudarib* to purchase the investment of the *sukuk* corticated holders for an amount that enables them to recover the balance of their outstanding investments.

Aldar Funding Limited, in its own capacity and not as *mudareb*, will enter into an irrevocable purchase undertaking in favour of the investors, pursuant to which Aldar will undertake to purchase, on each exercise date, a certain portion of *sukuk* holders' beneficial interest in the plots forming part of *the mudaraba* assets. The portion of the *sukuk* holders' beneficial interest to be purchased on each exercise date will be calculated by reference to all, or a portion of, the amortisation payments which will be paid by Aldar Funding Limited in its capacity as trustee in order to amortise the *sukuk* certificates on the relevant periodic distribution date.

ALDAR's *sukuk* issuance in 2008 was based upon the structure of *ijara*. The *sukuk* proceeds to purchase by way of a *musataha* agreement from ALDAR (in such capacity, the owner) a grant of a *musataha* interest, being a right to use and develop a plot of land located at ALDAR's Al-Raha Beach development for a term of 50 years. The contractual agreement was between *sukuk* Funding (No.2) Limited based in the Cayman Islands (SPV), acting as trustee for the *sukuk* holders (in such capacity, the Trustee) and the owner and would only be registered with the Lands Department in Abu Dhabi at such time as the parties mutually agree to so register or upon the occurrence of an ALDAR event in accordance with Abu Dhabi law (ALDAR, 2008).

The purchase price paid for the *musataha* interest will be an amount equal to the aggregate face amount of certificates issued by the issuer. Thus, from the structure itself, it is clear that the *sukuk* complies with the *sharia* requirement to have real underlying assets from which revenue can be generated and shared with the *sukuk* holders. The rationale for this transaction is to allow ALDAR to raise funds in accordance with *sharia* requirements although the distribution paid to *sukuk* holders comes from income generated by the underlying assets. Figure 6.4 explains ALDAR's 2008 *sukuk* issuance, which is governed by a master *musataha* agreement. SPV leases the land that is subject to *the musataha* to ALDAR, for which ALDAR will pay a regular rent that is equal to the periodic distribution amounts dispersed to *the sukuk* holders (ALDAR, 2008).

Both the *musataha* and *ijara* agreements are governed by Abu Dhabi law, but the Land Department currently does not allow registration of such an interest as been mentioned in chapter 4. Therefore, ALDAR has agreed in the purchase undertaking and master declaration of trust to indemnify *sukuk* holders for any and all obligations, liabilities and actual cost incurred in connection with any enforcement of the relevant undertakings, which means this transaction is guaranteed by obligor.

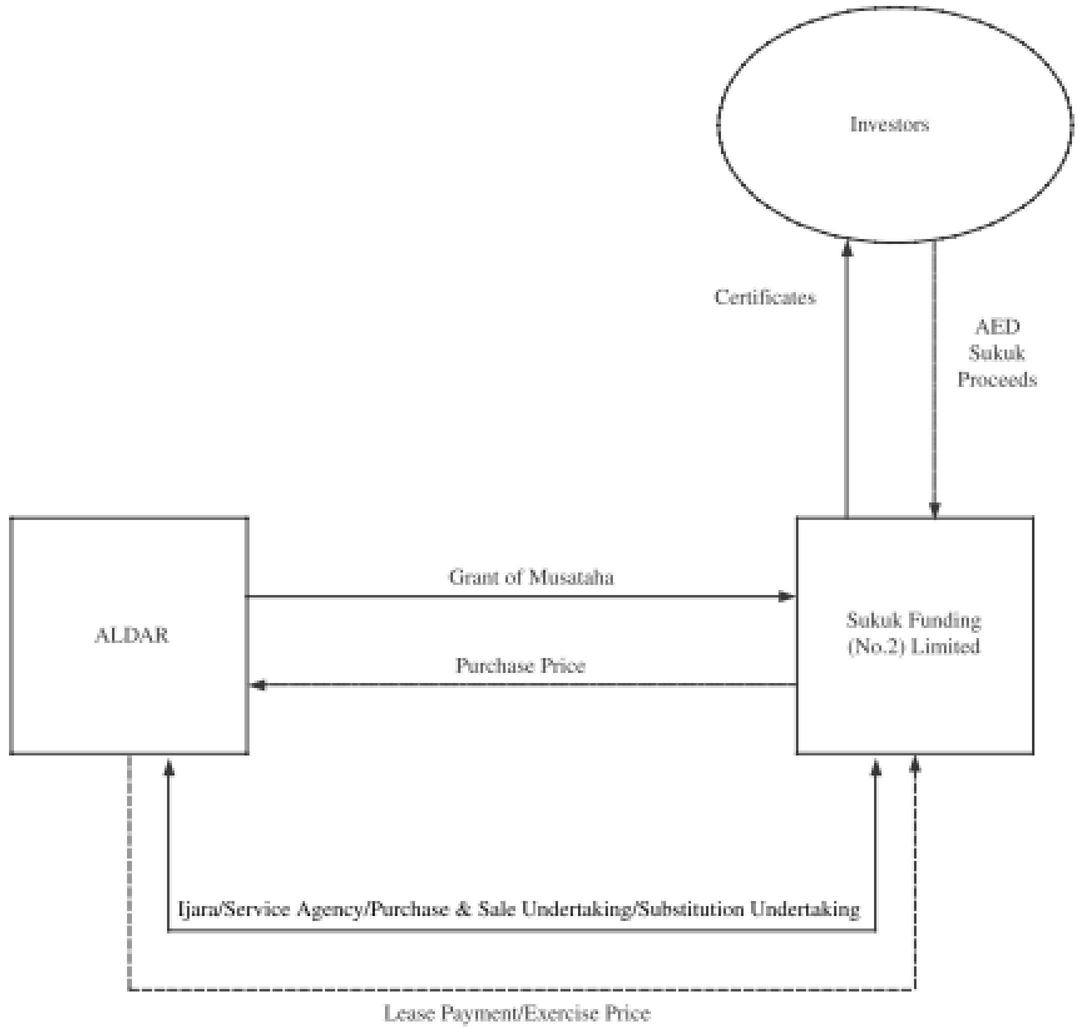

Figure 6.4. ALDAR's 2008 *sukuk* structure. Source: ALDAR, 2008.

6.3.1.3 The outcomes of implementing ALDAR's *sukuk*.

As mentioned in Chapter 2, the ALDAR's 2007 issuance form of contract was has restrictions in its enterprise cycle to allocate at least 33 per cent of the capital of the *mudaraba* enterprise to be invested in tangible assets at all times till maturity of the contract (Clifford, 2009). In the case of ALDAR's *sukuk*, 90 per cent of the capital of *the mudaraba* enterprise invested in tangible assets. As a consequence, this transaction in compliance with Article (8/8) of the AAOIFI *sharia* standard (13) and article (3/1/6/2) of AAOIFI (2010) *sharia* standard (12) on *mudaraba,* in which it is permissible to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. Also, the fourth rule allows the obligator to undertake or to repurchase the assets from *sukuk* holders or from one who holds them, at the end of its maturity 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. It seems this structure conforms to article (5/1/8/5)7 of AAOIFI (2010) *sharia* standard (17).

The scenarios and consequences for default of ALDAR's *sukuks* were clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As in the case of ALDAR's *sukuks*, investors have direct rights to the underlying assets, so they are taking true risk in the underlying assets. In other words, any losses are passed on to the SPV and, subsequently, to the *sukuk* holders, who are then directly exposed to asset price risk and, as a result, its liabilities.

The scenarios and consequences for default in the second issuance is the sole right of *sukuk* holders. If a legal action is taken to the courts in the Emirate of Abu Dhabi, a local court may contest the validity of the *musataha* interest against the obligor. It seems this structure conforms to article (5/1/8/5)7 of AAOIFI (2010) *sharia* standard (17).

6.3.2 Case 2: Dana Gas.

Dana Gas is a private sector natural gas company based in the UAE city of Sharjah, with a network of offices in Saudi Arabia, Iraq's Kurdistan region, Egypt and the UK. It operates primarily in the upstream sector (exploration and production) but to a lesser degree in the midstream and downstream sectors, especially where it adds value to its upstream activities. The company has a geographic focus on the Middle East, North Africa and South Asia. It was established in 2005 with over 300 prominent founder shareholders from across the GCC region and is listed on the Abu Dhabi financial market (ADX, 2011; Dana, 2011). Its market capitalisation as of 31 December 2010 was equivalent to US$1,309 million. It had 16 affiliate companies at the date of its offering circular (Zawya, 2011).

6.3.2.1 The motivation for Dana's *sukuk*.

Dana Gas's *sukuk* was issued in October 2007 (Dana, 2007). It was the first major accelerated convertible bond to be issued in the Middle East and was issued to finance Dana's expansion plans and ongoing business activities. Thus, it was issued in accordance with *sharia* requirements. The issue price was 100 per cent of the aggregate face value of the *sukuk*, which was issued in denominations of US$10,000, subject to a minimum holding of US$100,000. Dana Gas *sukuk* Limited (SPV/Issuer) is wholly owned by Bedell Trustees

Limited as trustee of the Dana Gas Funding Charitable Trust, incorporated in Jersey with its registered office in the Channel Islands. The issuer has no subsidiaries.

The issue of the convertible *sukuk* offering was approved by Dana's shareholders at an extraordinary general meeting held in July 2007. Structured as a *sukuk al- mudaraba*, Dana Gas's *sukuk* mature in 2012 with a fixed profit rate of 7.5 per cent. The reference share price, to which an exchange premium of 10 per cent will apply, will be set in nine months' time, reflecting the management's confidence in the company's near-term future growth. The issue is dollar denominated, US$1,000 million in size, offering an indicative annual rate of return payable quarterly with a tenure of five years. This *sukuk* is tradable in the debt market.

An investment plan in respect of the *mudaraba* enterprise will be tailored within *sharia* requirements to meet the financing objectives of this type of contract as set out in the contract agreement (the terms of which would also be specified in the *sukuk* prospectus). Thus, the tangible assets of Dana's *sukuk* were transferred to the SPV on behalf of the *sukuk* holders, who hold 99 per cent of the undivided co-owned assets.

Dana Gas's issuances have not received any rating grade from the three largest ratings services, so they are in the unrated category. In addition, one of the major issues for Dana Gas was the external macro-economic and political events outside its control in Iraq's Kurdistan region and in Egypt, which could not be predicted by the stakeholders at the time of issuance but have led to unpaid bills.

6.3.2.2 The structure of Dana's *sukuk*.

Dana's *sukuk* is the most sophisticated equity-linked structure issued in the region, due to their unique features combining a forward-start pricing structure and delayed settlement within a *sharia* compliant instrument. The Dana Gas *sukuk* is based upon the structure of *mudaraba*, where Dana Gas acts as the manager of the partnership who invests the capital into pre-approved business activities while the Dana Gas *sukuk* Limited incorporated in Jersey (SPV) is appointed as the financier who provides the capital (collected through the proceeds of *the sukuk*). There is a pre-determined profit sharing ratio of 99 per cent to the SPV, in order to be passed on to the *sukuk* holders, and one per cent to Dana Gas. The agreement has been made in order to ensure that only 7.5 per cent per annum is passed on to the certificate holder because anything in excess will be paid to Dana Gas (the manager) as incentive fee while any shortfall will have to be made up by Dana Gas through short term liquidity financing (Dana, 2007). Figure 6.5 explains Dana Gas's 2007 *sukuk* issuance.

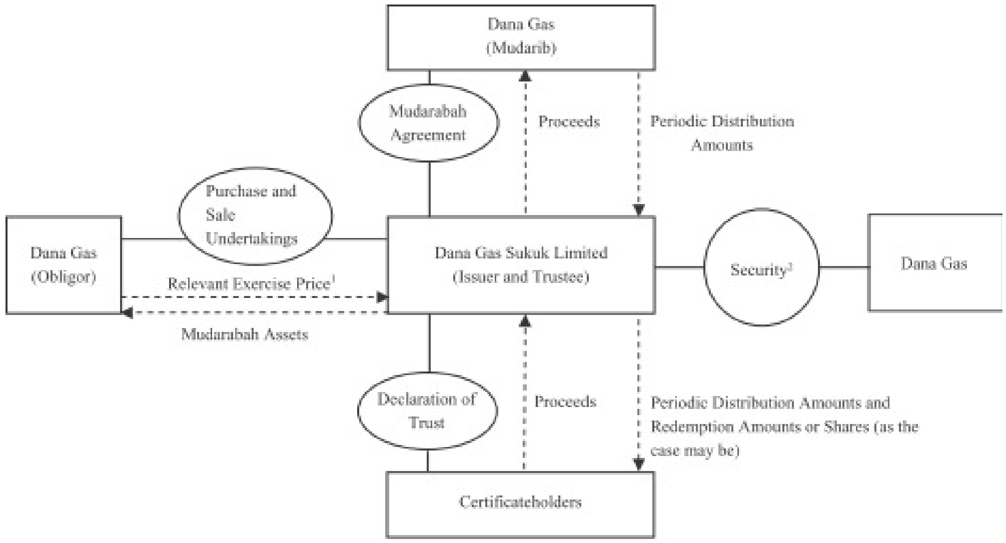

Figure 6.5. Dana Gas's 2007 *sukuk* structure. Source: Dana, 2007.

This performance fee (if any) would be calculated at the end of the *mudaraba* term and upon liquidation of the *mudaraba*. The risk of passing any losses from this enterprise to investors may be mitigated through the use of a purchase undertaking granted by the originator (as Promissor) in favour of the issuer SPV (as promisee) so that in the event that proceeds from the *mudaraba* enterprise are insufficient in meeting any amounts payable by the issuer SPV to the investors, the issuer SPV may call on the originator (Dana Gas) to purchase its *mudaraba* interests for a price which represents their market value.

Besides, the structure makes use of a purchase undertaking and a sale undertaking that ensures principal amount is paid in full on maturity of the issue, or on redemption. The purchase undertaking which comes into effect during the life of the *sukuk* if at any time there is a default on any payment or change of control in the parent company or any such major event, indirectly assures the *sukuk* holders of the periodic profit payments as well as the redemption amount. The *sukuk* certificates are also redeemable before maturity at the option of any *sukuk* holders. Thus, the security is granted over certain assets owned by Dana Gas, were the Security secures the obligations of the obligor under the purchase undertaking.

6.3.2.3 The outcomes of implementing Dana's *sukuk*.

Dana Gas produces most of its gas in Egypt and Kurdistan and political upheaval in these regions have held up payments. However, in order to ensure *sukuk* holders principal amount the certificates are exchangeable into the ordinary shares of Dana Gas which are listed on the ADX (2011), either redeemed in cash or against issued shares is determined by certain conditions. If the *sukuk* certificates are held to maturity, they will be redeemed in full in cash, therefore early exercise would depend on whether or not the value of the shares on exercise is greater than the redemption amount of the unexercised certificates. The exchange ratio between the *sukuk* and the shares of Dana Gas at any point in time, as well as the redemption amount payable on redemption or maturity will be determined in the same way as for any conventional convertible or exchangeable issue, except that in this case it is governed by the *sharia* compliant contract of the purchase undertaking and the sale undertaking.

However, AAOIFI (2008) stresses that it is not permissible for an originator to grant a purchase undertaking to the trustee (SPV) to purchase the *mudaraba* enterprise assets for any amount other than the trustees' share of the market value of the joint venture assets at the time of sale. Determining the value of the *mudaraba* assets by reference to the par value of the *sukuk* (or by reference to a shortfall amount) is akin to a guarantee of profit and principal which, unless given by an independent third party (a party other than the originator), is not permitted under *sharia*. Therefore, Dana *sukuk* to be tradable in accordance with *sharia* law, the conversion price has been left to be fluctuates with the market price of the shares of Dana Gas, which actually represents beneficial title to tangible assets of Dana Gas *sukuk*. It seems this structure conforms to article (5/1/8/5)7 of AAOIFI (2010) *sharia* standard (17).

6.3.3 Case 3: Dar Al Arkan Real Estate Development Company.

DAAR is a leading real estate development company in Saudi Arabia based in Riyadh, active in residential real estate specialising mainly in undeveloped land and residential houses. DAAR was established in 1994 as a limited liability company. Following this private placement, DAAR converted to a joint stock company in 2005 and listed on Tadawul (Tadawul, 2011). The market capitalisation of DAAR as of 31 December 2010 was US$2,589 million (Zawya, 2011). It is involved in all major aspects of real estate development, including sourcing and purchasing land, overseeing design and construction and marketing and sales. Its business is focused on planning and developing basic infrastructure for undeveloped lands for residential and commercial use in addition to the development and sale of residential units. Thus, it has a plan for the years 2005 to 2010 to manage the targeted development of a total of 65,000 residential units by 2010 (DAAR, 2011).

6.3.3.1 The motivation of DAAR's *sukuk*.

During this study period (2006–2010), DAAR issued three *sukuks* in March and July 2007 and February 2010 (DAAR, 2007a,2007b, 2010). DAAR issued its first international *sukuk*, at US$600 million in March 2007 (DAAR, 2007a), and the second issuance was US$1,000 million in July 2007(DAAR, 2007b), US dollar denominated and offering a floating annual rate of return designated as the London interbank offered rate (LIBOR) for three-month US dollar deposits, plus 200 and 225 basis points respectively payable quarterly and having a tenure of 3 and 5 years respectively. Both issuances based on *ijara* form.

While the third of DAAR's (2010) issuance issued in February 2010 was based on *wakala* form, which is a companion of *murabaha* and *ijara* investments structure, the issue is dollar denominated, US$450 million in size, offering an indicative annual rate of return of 10.75 per cent payable semi-annually and having a tenure of five years. It is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under the *sukuk* certificates.

In addition, the first two issuances have not rated by any of the three largest ratings services agencies. The third issuance received (BB-) grade from Standard &Poor's (2011) placing it in speculative or highly speculative grade category (Zawya, 2011). The *sukuks* were issued to finance growth and capital expenditures, to support the future growth of its business and the proceeds raised affiliates and subsidiaries to refinance existing debt obligations by DAAR. Therefore, DAAR *sukuks* were part of DAAR's Islamic structured debt program (*sukuks* program), initiated in 2007. The aim of the program was to provide high quality long-term external financing to complement the company's robust internal cash flow at a time of strong growth in the Saudi real estate market. During 2006–2010, an extremely challenging period for the international debt markets, DAAR has successfully issued three *sukuks* raising a total of US$2,050 million. The Islamic *sukuks* program has aided the company in the implementation of the company's various projects over Saudi Arabia. Thus, these funds had facilitated DAAR to provide more than 16,000 residential units, which contributed in fulfilling the residential demand in Saudi Arabia.

Furthermore, at the time of subscription DAAR's *sukuks* enjoyed active support from prominent local financial institutions and investment funds. In addition to broadening the investor base and raising the profile internationally, the *sukuks* investors have provided DAAR with financial flexibility and liquidity during a period of required investment in its projects and the medium term future of the business. Accordingly, its *sukuks* have been listed in different international markets including Bahrain, Malaysia, the UAE and UK. Consequently, DAAR has successfully met and complied with the highest standards of corporate governance and disclosure prevailing in these international markets. The first issuance (DAAR International *sukuk*) was listed on the DIFX in May 2007, making it the first from Saudi Arabia to be listed there.

The first and second issue price were 100 per cent of the aggregate face value of the *sukuks*, and *sukuks* issued in denominations of US$1,000, subject to a minimum holding of US$100,000 based on an *ijara* structure. The transactions involves a special-purpose company (Usul Al Omran Company), a limited liability company incorporated in Saudi Arabia (Saudi SPV) owned by Abdulaziz bin Mohammed bin Abdulrahman Al Qasim and Abdullah bin Saleh bin Abdulaziz Al Sa'awi. DAAR International *Sukuk* Company, a limited liability company incorporated in the Cayman Islands (the issuer). Through proceeds of certificates issued by DAAR International *Sukuk* Company from certificate holders, the issuer pays for the real estate right transfer (RERT) to Saudi SPV, who then uses payment received from issuer to pay DAAR for Property. Saudi SPV sell *sukuks* assets to issuer under the RERT agreement, in and to certain land and buildings identified as selected blocks of land and development within the Al-Qasr Project in Riyadh the Yanbu Project, the Ishbiliya Project and various real estate located in Jeddah and Al-Khobar (the Property), allowing the issuer to bear the risks and rewards relating thereto. The issuer leases *sukuks* assets to DAAR. Thus, each trust certificate (*sukuks al-ijara*) represents an undivided beneficial ownership of the trust assets, pursuant to a declaration of trust made by DAAR International *Sukuk* Company (the issuer and the trustee) undertakes to hold its interests under *the sukuks* terms in trust for the benefit of the *sukuks* holders. The rationale for this transaction is to allow DAAR to raise funds in accordance with *sharia* requirements.

In the third issuance, the issue price was 99.058 per cent of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of US$1,000, subject to a minimum holding of US$100,000 based on the *wakala* form, comprising *ijara* agreements and *murabaha* agreements entered into between the investment manager and restricted subsidiaries of Dar Al-Arkan International *Sukuk* Company II. The transaction involves a special-purpose company (Usul Al Omran Company), a limited liability company incorporated in Saudi Arabia (Saudi SPV). DAAR International *Sukuk* Company II as the issuer and trustee, a wholly owned Cayman Islands SPV of Dar Al-Arkan. The issuer, pursuant to a declaration of trust, undertakes to hold its interests under the *sukuk* terms in trust for the benefit of the *sukuk* holders. Pursuant to an investment management agreement, so Dar Al-Arkan *Sukuk* Company acting as an investment manager, the investment manager is required to invest the proceeds of the sale of the *sukuk* in a portfolio of *murabaha* and *ijara* investments, which is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under the *sukuk* certificates. The return on the *sukuk* will be paid on a semi-annual basis. This agreement will be made by the investment manager and will be undertaken with subsidiaries of Dar Al-Arkan, to finance their projects.

6.3.3.2 The structure of DAAR's *sukuk*.

In the first and second issuances were based on the *ijara* structure (DAAR, 2007a,2007b), while the certificates represent a share of assets primarily consisting of rights and interests in and to certain land and buildings (such asthe Shams ArRiyadh zone 1, Shams ArRiyadh zone 2, the Al Qasr project, Al Maseef compound in Riyadh, the Yanbu Project, the Ishbiliya Project and various real estate located in Jeddah and Al Khobar) purchased by the Saudi SPV from DAAR. DAAR International *Sukuk* Company incorporated in the Cayman Islands (the issuer and the trustee) undertakes to hold its interests under the *sukuk* terms in trust for the benefit of the *sukuk* holders. Thus, from the structure itself, it is clear that *the sukuks* complies with *sharia* requirement to have real underlying assets from which revenue can be generated and shared with the *sukuks* holders. The rationale for these transactions is to allow DAAR to raise funds in accordance with *sharia* requirements. The distribution paid to holders of the certificates comes from income generated by the underlying assets, but the guarantor grants the guarantee in favour of the issuer pursuant to which DAAR irrevocably and unconditionally guarantees the payment obligations of SPV obligor under the SPV purchase undertaking. Here the purchase undertaking agreement (the SPV purchase undertaking) in favour of the trustee granted in favour of the issuer on Saudi SPV, a guarantee (the guarantee) granted by DAAR -in its capacity under the guarantee, the guarantor- in favour of the issuer upon trust absolutely for the certificate holders pro rata according to the principal amount of certificates held by each certificate holder. Thus, the SPV obligor shall execute a purchase undertaking (the SPV purchase undertaking) in favour of the issuer. Pursuant to the SPV purchase undertaking, the SPV obligor shall undertake to purchase the *sukuks* assets at the exercise price following the issue of a notice from the issuer (the SPV Exercise Notice). DAAR will be the managing agent of the co-owned assets. The issuer will act as a trustee in respect of the trust assets for the benefit of *sukuks* holders. The trustee will delegate its powers, duties and authority to the Trustee Company Limited to, among other things, enforce or realise the trust assets following a dissolution event. Figure 6.6 explains DAAR's 2007 *sukuks* structure.

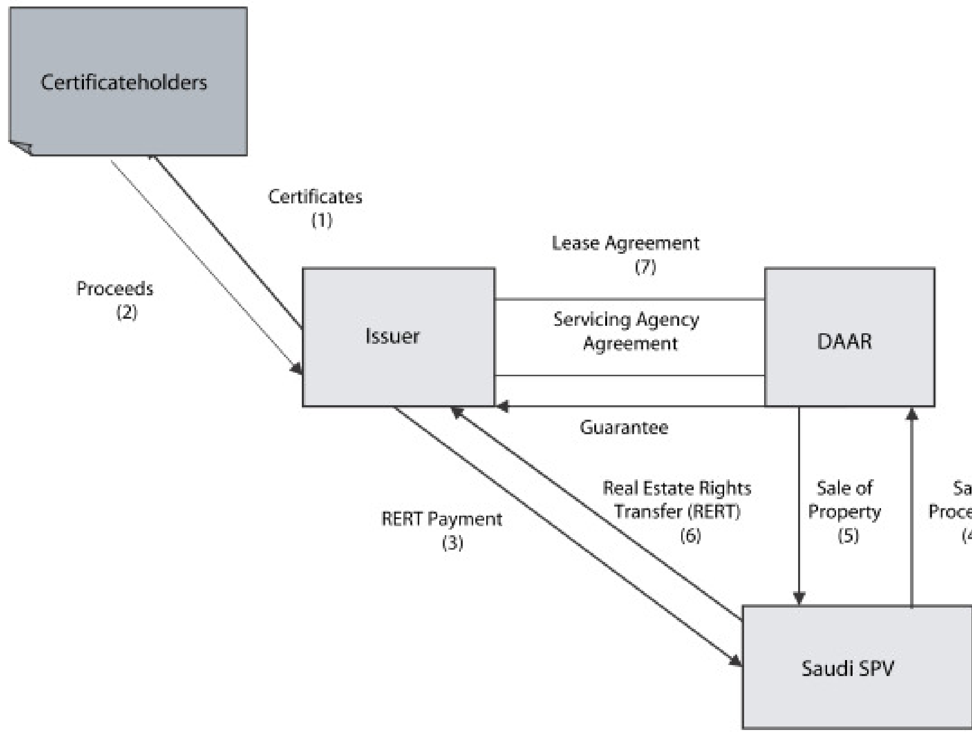

Figure 6.6. DAAR's 2007 *sukuks* structure. Source: DAAR, 2007a, 2007b.

In fact, where the rental payments from the co-owned assets are insufficient to meet the required periodic amounts payable to *sukuks* holders, DAAR will pay a late payment amount in respect of the period from, and including, the due date for settlement to, but excluding, the date of full settlement, calculated on a daily basis as the product of LIBOR applicable to the rental adjustment period in which the late payment occurred plus 300 basis points per annum.

In the third issuance, transaction make use of the *wakala* structure, which comprises *ijara* agreements and *murabaha* agreements entered into between the investment manager and restricted subsidiaries of Dar Al-Arkan International *Sukuk* Company II, while the certificates represent a share of assets primarily consisting of all of Dar Al-Arkan International *Sukuk* Company II's rights, title, interest and benefit in, to and under *the sukuk* Portfolio, present and future, in, to and under the transaction documents, all monies standing to the credit of the transaction account from time to time and all proceeds of the foregoing (DAAR, 2010). Under the *ijara* investments, a subsidiary of Dar Al-Arkan International *Sukuk* Company will enter into a sale and lease-back arrangement with the investment manager (DAAR) whereby that subsidiary will sell part, or all of its assets to the investment manager, which will then use the *sukuk* proceeds to pay for those assets.

Subsequently, the subsidiary will enter into an *ijara* agreement with the investment manager to lease back those assets. DAAR subsidiary will then use proceeds from the sale to finance its projects and the investment manager will use the rent payable by the subsidiary to pay a portion of the periodic return due to the *sukuk* holders. While, under the *murabaha* investments, a subsidiary of DAAR in need of materials for its projects will request the investment manager to purchase those materials using the *sukuk* proceeds and sell the materials to it on a cost-plus basis via installments.

The mark-up at which the materials are sold to the subsidiary will constitute the return on *murabaha* investments; from which the return on *sukuk* will be paid to *sukuk* holders. *Sukuk* is guaranteed by DAAR by way of a guarantee issued in favour of the issuer (Dar Al-Arkan International *Sukuk* Company), whereby DAAR undertakes to pay the issuer for payment to *sukuk* holders any shortfall in the profits due to *sukuk* holders at any given time in certain limited circumstances. On the maturity date, if there is any shortfall between the amount realised from liquidating *sukuk* portfolio and the par value of *sukuk*, DAAR undertakes to make up the shortfall. So this transaction is compliant with article (5/1/8/5) of AAOIFI (2010) *sharia* standard (17), (8) and (9) in the *wakala* agreement. Figure 6.7 explains DAAR's 2010 *sukuk* structure.

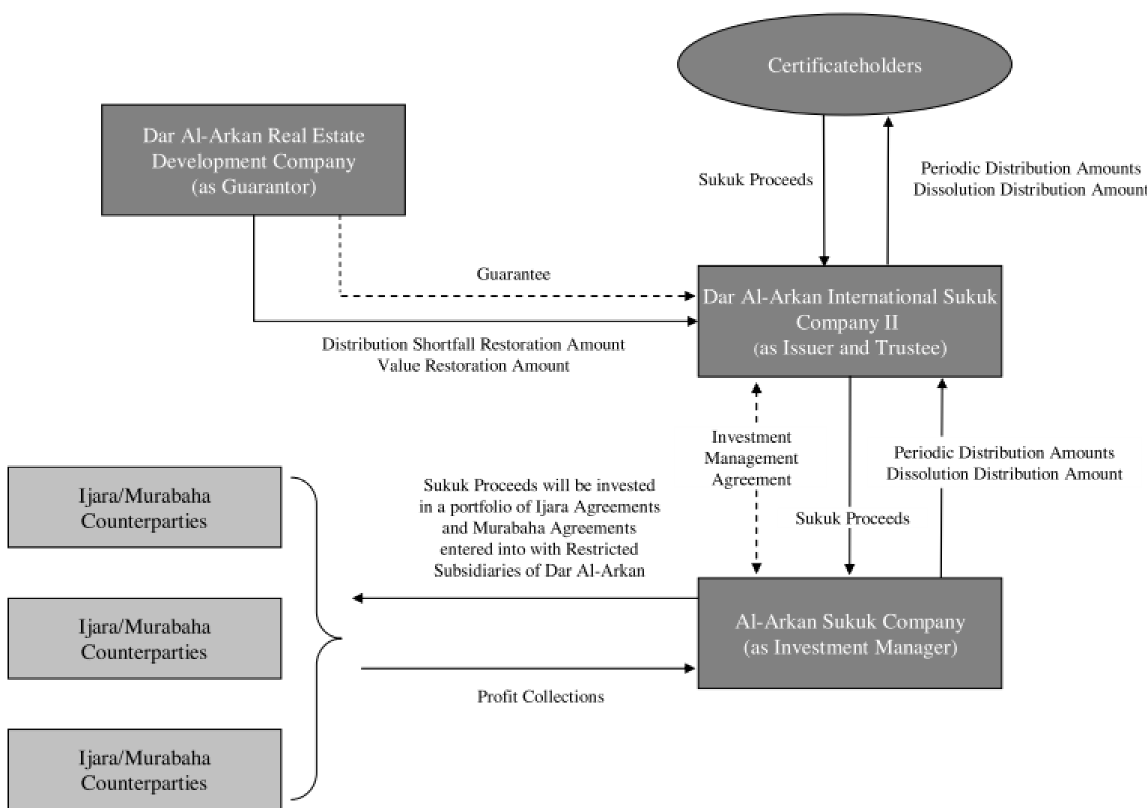

Figure 6.7. DAAR's 2010 *sukuk* structure. Source: DAAR, 2010.

6.3.3.3 The outcomes of implementing DAAR's *sukuk*.

The agreement were made in order to ensure that it complied with *sharia* requirements, specifically standard (9) of the AAOIFI (2010) on the *ijara* mode. The scenarios and consequences for DAAR's *sukuks* are clearly identified in offering circulars. The assets were specified in order for the investors to assess their risk taking in a transparent manner. The *sukuks* purchase undertaking gives the right to *sukuk* holders to sell the *sukuk* to DAAR at face value.

However, given that *sharia* prohibits guaranteeing capital in any investment or any profits received thereon, the guarantee is only triggered when the above-mentioned shortfalls result from the negligence or the failure of the investment manager to comply with its obligations under the terms of the *sukuks* and the various transactions documents. The guarantee specifically excludes the fluctuation in value of the underlying real estate or commodities to which the *ijara* and the *murabaha* investments relate to as an event that would trigger the terms of the guarantee.

According to *sharia* principles, liquid assets can only be traded at par value, without any profit. In order to allow the *sukuk* to be tradable at a fluctuating price and pay a profit, the underlying asset must therefore be an illiquid asset. In the case of DAAR, the illiquid nature of the *sukuk* Portfolio is ensured by requiring that *ijara* investments shall constitute at least 51 per cent of the *sukuk* Portfolio. Obviously, this agreement works in favour of the ruling of the AAOIFI (2008) resolution, so DAAR *sukuks* transactions were *sharia* compliant for the previous reasons.

As a result, DAAR's *sukuks* issuances represent the first *sukuk* issuances in the GCC region with a proper covenant package. The offering circulars set out in full detail the covenants to which the guarantor is subject to in addition to any qualifications or exceptions. Pursuant to the guarantee issued by DAAR, these covenants include among others incurrence of additional indebtedness, paying of dividends to shareholders, selling of assets, entering into transactions with affiliates, engaging in different business activities, creation of liens on assets to secure debt, entering into sale and leaseback transactions and merging or consolidating with another company.

The success of the DAAR'S *sukuks* represents another significant milestone in the development of Islamic finance. The successes of these issuances were all the more remarkable in view of the downcast mood surrounding regional *sukuks* issuances. The DAAR issuances have provided a foundation for future similar transactions and establish another funding source beyond the traditional sources of capital in GCC region.

6.3.4 Case 4: Dubai Islamic Bank.

DIB is the first, the largest and the oldest Islamic commercial bank in the UAE, active in financial services. DIB is a Dubai-based bank founded in 1975 and is the first Islamic bank to have incorporated the principles of *sharia* in all its practices. DIB is a public joint stock company, and its shares are listed on the DFM (2011). It enjoys a reputation as a leader and innovator in maintaining the quality, flexibility and accessibility of its products and services. DIB currently operates a large network of branches in the UAE and it is dedicated to the nation's economic development and prosperity and is also providing products and services in the realm of corporate finance to stimulate trade and industry progress and expansion. DIB providers many services parallel to conventional banking which includes leasing, equity investments, funds, private equity, venture capital, unit trusts, bonds and hire purchase. DIB provides for example savings accounts based on profit sharing with profits distributed on quarterly bases (DIB, 2011). The market capitalisation of DIB as of 31 December 2010 was US$2,249 million (Zawya, 2011).

6.3.4.1 The motivation of DIB's *sukuk*.

The proceeds of DIB (2007) *sukuk* will be ultimately used for general funding purposes of DIB, which will sell a given percentage of a pool of their assets to the issuer. These assets are undivided right, title and interest in a portfolio of assets, which are the subject of the lease and the *musharaka* transaction, originated and managed by DIB, will be co-owned by both DIB and the issuer (SPV). The transaction involves a special-purpose company (DIB *Sukuk* Company Limited) incorporated in accordance with the laws of the Cayman Islands as the issuer and act as trust. The rationale for this transaction is to allow DIB to raise funds in accordance with *sharia* requirements.

DIB issued its first *sukuk* at US$750 million in March 2007, the issuance is US dollars denominated (DIB, 2007). It is offering a floating annual rate of return designated as the three-month LIBOR (for three-month US dollar deposits) plus 33 basis points payable quarterly and having tenure of five years. DIB (in such capacity, the seller) will sell to the issuer as trustee for and on behalf of the certificate holders (90 per cent of the seller's undivided right, title and interest in a portfolio of assets), which are the subject of lease and *musharaka* transaction documents. The DIB issuance price was 100% of the aggregate face value of the *sukuk*, and was issued in denominations of US$10,000, subject to a minimum holding of US$ 100,000. The SPV holds 90 per cent of the undivided interest in co-owned assets and of DIB is 10%. The certificates are limited recourse obligations.

The issuance received (A) and (A1) at the time of subscribed from Standard &Poor's (2008b) and Moody's (2010) respectively. However, Standard&Poor's (2011) later downgraded its rating to (BBB-) grade, putting it in the lower medium grade category.

6.3.4.2 The structure of DIB's *sukuk*.

The structure of this transaction makes use of *musharaka* agreement, while the certificates represent a share of assets purchased by a SPV (DIB *Sukuk* Company Limited) from the DIB. DIB *Sukuk* Company Limited, a company incorporated in accordance with the laws of the Cayman Islands. The distribution paid to holders of the certificates comes from income generated by the underlying assets. In addition, DIB will enter into the purchase undertaking in favour of the trustee. Under the purchase undertaking, DIB will undertake to purchase the Issuer's rights, benefits and entitlements in and to the Co-owned assets in consideration for the payment of a US dollar sum equal to the relevant exercise price following the delivery of an exercise notice (Exercise Notice) by the trustee on DIB following either the occurrence of a dissolution event or on any day during the ten day period immediately preceding the fifth anniversary of the date of the purchase undertaking. DIB will be the managing agent of the co-owned assets. The issuer will act as a trustee in respect of the trust assets for the benefit of *sukuk* holders. The trustee will delegate its powers, duties and authority to Citicorp Trustee Company Limited to, among other things, enforce or realise the trust assets following a dissolution event. Figure 6.8 explains DIB's 2007 *sukuk* structure.

In fact, where the rental payments from the co-owned assets are insufficient to meet the required periodic amounts payable to *sukuk* holders, DIB will provide the necessary support to the issuer, to make up any shortfall, and meet the issuer's obligations toward certificate holders. DIB has an obligation, under the *sukuk* terms and conditions, to distribute the portion of rental payments from the leased and investment co-owned assets to which *sukuk* holders are entitled, and to make up any shortfall between rental payments and the periodic distribution amounts payable to *sukuk* holders. This obligation will rank pair pass with all other unsecured and unsubordinated obligations of DIB. The dissolution amount payable on the trust certificates at the dissolution date is also dependent on an obligation of DIB. This obligation is the irrevocable undertaking of DIB to purchase the issuer's portion of the co-owned assets at the agreed price. Obviously, the strength of DIB issuance solid on the government of Dubai who is DIB's largest single owner, which would provide support if needed (DIB, 2007).

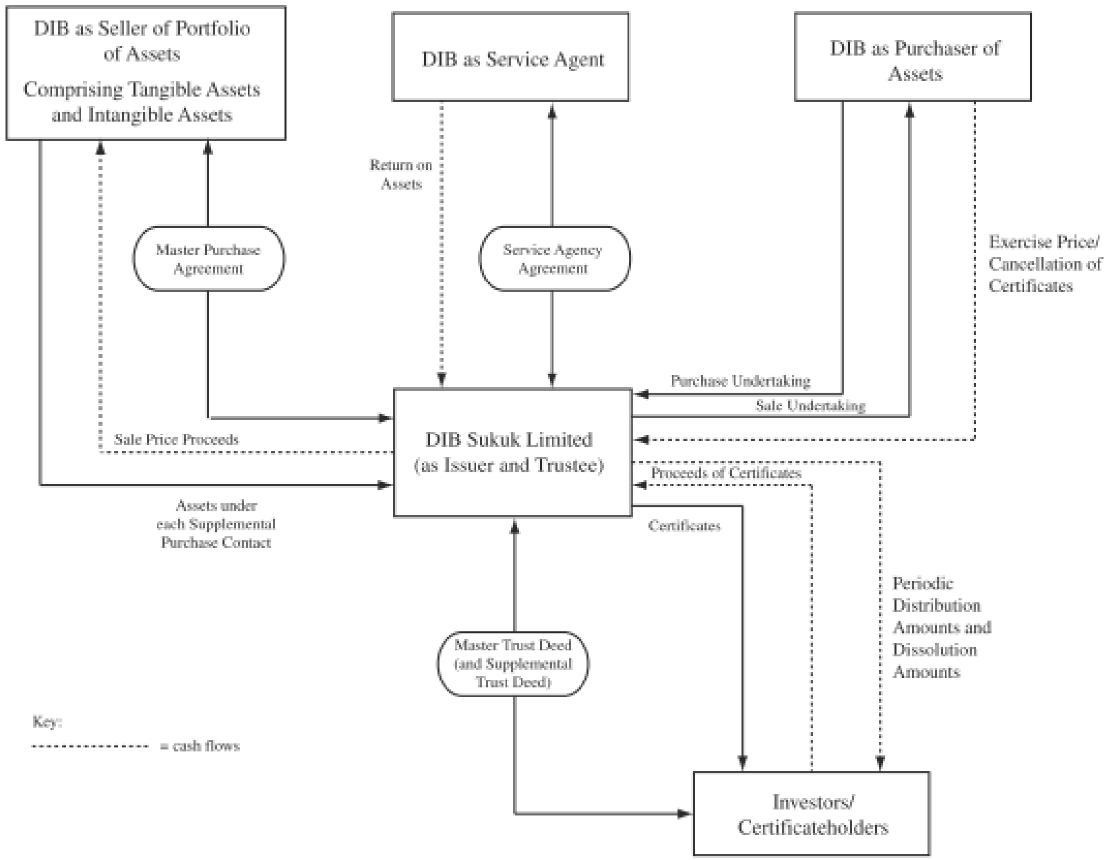

Figure 6.8. DIB’s 2007 *sukuk* structure. Source: DIB, 2007.

This type of structure is highly encouraged by the AAOIFI (2008) in view of the ability of these contracts to start-up businesses and venture capital. Thus, such contract creates a balance to *ijara sukuk*, which only tends to recycle existing assets. *Sukuk musharaka* can be applied to practically any asset class that can generate legitimate and predictable cash flows.

However, the agreement has been made in order to ensure that any unusual event that any periodical net income would fall below a particular amount, DIB will provide the necessary support to the issuer, to make up for any shortfall, and meet the issuer's obligations toward certificate holders.

6.3.4.3 The outcomes of implementing DIB's *sukuk*.

According to AAOIFI (2010) *sharia* standard (12) on *musharaka* and *sharia* standard (5) on guarantees, it is not permissible to offer interest-free loans to the *sukuk* holders in case of shortfalls. However, it is permissible to establish a reserve account for the purpose of covering such shortfalls, which has not been mentioned in the DIB *sukuk* agreement. The AAOIFI also permitted on account payments, so long as they are subject to final settlement at maturity date (AAOIFI, 2008).

The scenarios and consequences for the default of DIB's *sukuk* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As most *sukuk* holders are under the assumption that they have direct rights to the underlying assets, in most *sukuks* structures, this is not the case in DIB's *sukuk* as the investors are taking the issuer's risk. In the event of default, the *sukuk* holders are not entitled to cause the sale or other disposition of any of the *sukuk* assets. The sole right of *sukuk* holders against the issuer shall be to enforce the obligation of *the sukuk* purchase undertaking. The *sukuk* purchase undertaking gives the right to *sukuk* holders to sell the *sukuk* to DIB at face value. Based on this agreement, it was possible for the originator to grant a purchase undertaking to the trustee and for the exercise price to be a fixed amount determined in accordance with a formula and not by reference to the market value of the *musharaka* assets. The exercise price would therefore typically have been, in the event of a default or maturity, equal to the face amount of the *sukuk* plus any accrued but unpaid periodic distribution amounts. The investors were therefore 'guaranteed' to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure.

Obviously, this agreement works not in favour of the fourth ruling of the AAOIFI (2008) resolution, which clarified that purchase undertakings according to which interests in the partnerships, i.e. *mudaraba*, *musharaka*, or *wakala* are purchased back at nominal value are not permissible. Accordingly, it is permissible to offer a purchase undertaking according to which the originator can purchase the interests back at their market value or at a price to be agreed upon at the moment of the sale. As a result, DIB *sukuk* transaction was not *sharia* compliant.

6.3.5 Case 5: Emirates Islamic Bank.

EIB, formerly known as Middle East Bank PJSC, is based in the UAE. It was founded in 1976 as a conventional commercial bank with limited liability in the Emirate of Dubai and registered as a Public Joint Stock Company in July 1995. In 2004 at an extraordinary general meeting of shareholders, a resolution was passed to convert EIB's activities to be fully *sharia* compliant. The conversion process was completed on October 2004 when it obtained the authorities' approval. Since then, the bank has changed its name to Emirates Islamic Bank PJS. EIB is a public joint stock company, and its shares are listed on the DFM (2011). Since its conversion to Islamic banking, EIB has realised substantially increased growth rates in assets, deposits and profits as reflected in its financial statements for 2005 and 2006. The total assets grew by 103 per cent in 2005 and 118 per cent in 2006. Similarly, the customers' accounts, total shareholders' equity and net income grew by 191 per cent, 4.4 per cent and 120 per cent, respectively, in 2005 and 151 per cent, 12.3 per cent and 131 per cent, respectively, in 2006 (EIB, 2011). It is the third largest Islamic bank in the UAE by assets. The bank provides full banking services and a variety of products through *sharia* compliant financing and investments. The market capitalisation of EIB as of 31 December 2010 was US$540 million. EIB is a wholly owned subsidiary of Emirates Bank International PJSC, which is headquartered in Dubai and had total assets of AED 95.9 billion (US$23.4 billion) as of year-end 2006 (Zawya, 2011). The systemic support of EIB comes from the bank's strong relationship with the Dubai government including its 77 per cent direct ownership and importance in the banking system in the UAE (DFM, 2011).

6.3.5.1 The motivation of EIB's *sukuk*.

EIB decided to issue *sukuk* trust certificates under a US$1,000 million trust certificate issuance programme. EIB (2007) issued its first *sukuk* (Tranche 1) at US$350million in June 2007, the issuance is US dollar denominated. It is offering a floating annual rate of return designated as a three-month LIBOR (for three-month US dollar deposits) plus 30 basis points payable quarterly and having tenure of five years (EIB, 2007). The structure of this transaction makes use of *musharaka* agreement. In addition, this issuance received (A1) at the time of subscribed from Moody's (2010). However, afterward Moody's downgraded its rating to A3 grade, but still it's in high or higher medium grade category according to my classes (Moody's, 2010).

The *sukuk* was issued for the purpose of financing growth and capital expenditures, to support the future growth of its business and the proceeds raised ultimately used for purchase of a co-ownership interest in the Co-ownership assets comprising income generating assets (*ijara*-leased), asset-based *sukuk* (trust certificates) and/or units in asset-based funds from the bank, which is the subject of *musharaka* transaction. EIB *sukuk* was part of EIB's Islamic structured debt programme (*sukuks* programme), which was initiated in 2007 to provide high quality medium- to long-term external financing to complement the bank's robust internal cash flow at a time of strong growth in the UAE market. During 2006–2010, an extremely challenging period for international debt markets, EIB successfully issued its first *sukuk* (Tranche 1). The rationale for this transaction is to allow EIB to raise funds in accordance with *sharia* requirements.

The EIB issuance Price was 100% of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of US$10,000 subject to a minimum holding of US$100,000. The agreement consists that the SPV hold 95.78 per cent of the undivided interest in co-owned assets whereas 4.22 per cent hold by EIB. The certificates are limited recourse obligations (EIB, 2007).

6.3.5.2 The structure of EIB's *sukuk*.

The structure of this transaction makes use of *musharaka* agreement, while the certificates represent a share of assets purchased by a SPV from the EIB. Accordingly, a special purpose entity, EIB *Sukuk* Company Ltd, (issuer/ trustee) incorporated in the Cayman Islands, issues *sukuk* to investors (*sukuk* holders). It uses the proceeds to acquire a co-ownership interest in a portfolio of assets comprising income generating assets (*ijara*h-leased), asset-based *sukuk* (trust certificates) and/or units in asset-based funds, held or owned by the bank, with the two parties becoming co-owners in the co-ownership assets (Trust assets). EIB, as managing agent, will collect all payments from the Co-ownership assets and will pay the issuer an amount sufficient to fund the periodic distribution amount to *sukuk* holders on each distribution date. The distribution paid to holders of the certificates comes from income generated by the underlying assets. In addition, EIB will enter into the purchase undertaking in favour of the trustee. Under the purchase undertaking, EIB will undertake to purchase the issuer's interest in the co-ownership assets at the exercise price either upon the maturity date or prior to maturity due to a dissolution event in consideration for the payment of a US dollar sum equal to the relevant exercise price following the delivery of an exercise notice (Exercise Notice) by the trustee on EIB.

Therefore, EIB will be the managing agent of the co-owned assets. The issuer will act as a trustee in respect of the trust assets for the benefit of *sukuk* holders. Emirates Bank International PJSC as the guarantor has, in the guarantee, guaranteed the obligations of the Bank under the transaction documents including, in particular, its payment obligations under the management agreement and the purchase undertaking deed. Figure 6.9 explains EIB's 2007 *sukuk* issuance structure. This type of structure is highly encouraged by the AAOIFI in view of the ability of these contracts to start-up businesses and venture capital. Thus, such contract creates a balance to *ijara sukuk*, which only tends to recycle existing assets. *Sukuk musharaka* can be applied to practically any asset class that can generate legitimate and predictable cash flows.

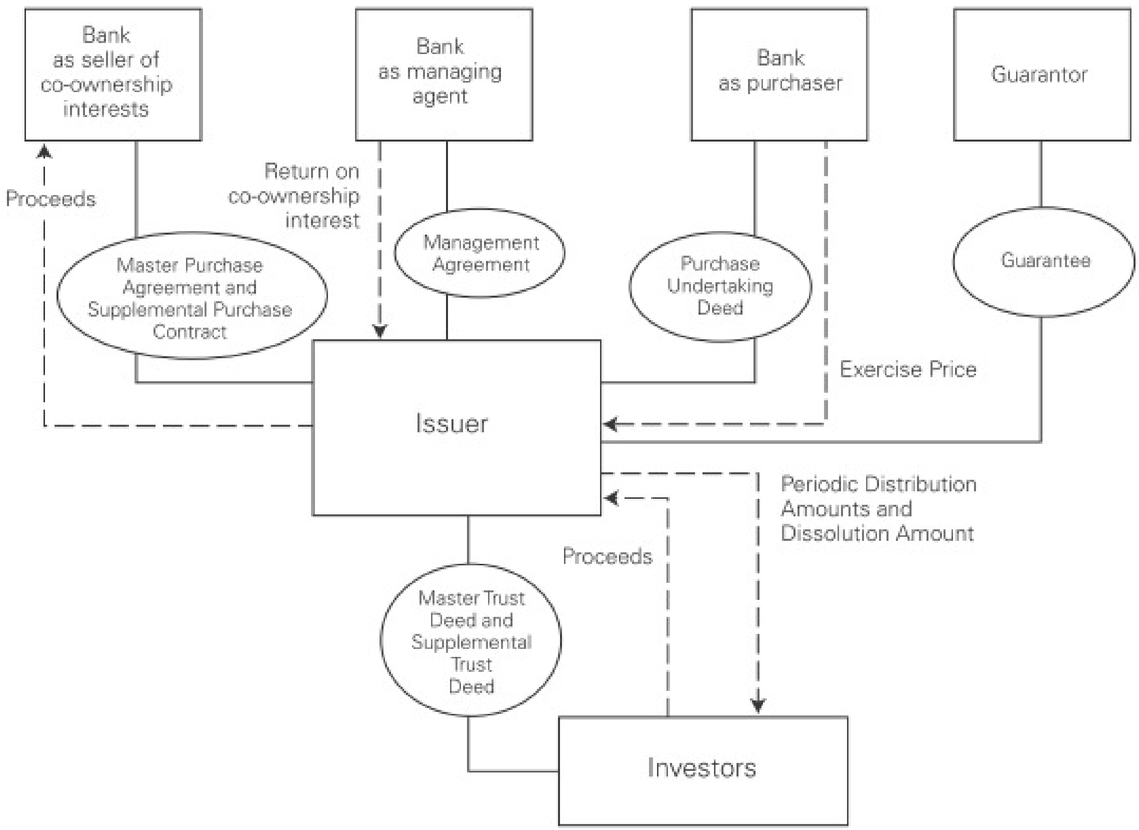

Figure 6.9. EIB's 2007 *sukuk* structure. Source: EIB, 2007.

In fact that, in the case where the rental payments from the co-owned assets are insufficient to meet the required periodic amounts payable to *sukuk* holders, EIB will provide the necessary support to the issuer, to make up any shortfall, and meet the issuer's obligations toward certificate holders. EIB has an obligation, under the *sukuk* terms and conditions, to distribute the portion of rental payments from the leased and investment co-owned assets to which *sukuk* holders are entitled, and to make up any shortfall between rental payments and the periodic distribution amounts payable to *sukuk* holders. This obligation will rank pair pass with all other unsecured and unsubordinated obligations of EIB. The dissolution amount payable on the trust certificates at the dissolution date is also dependent on an obligation of EIB. This obligation is the irrevocable undertaking of EIB to purchase the issuer's portion of the co-owned assets at the agreed price. The strength of EIB issuance lies on the Guarantee by Emirates Bank International PJSC which had total assets of AED95.9 billion (USD23.4 billion) as at year end 2006. The Guarantor has unconditionally and irrevocably guaranteed the timely payment of all amounts due.

6.3.5.3 The outcomes of implementing EIB's *sukuk*.

The agreement has been made in order to ensure that in the unusual event that any periodical net income would fall below a particular amount, EIB will provide the necessary support to the issuer, to make up any shortfall, and meet the issuer's obligations toward certificate holders.

The agreement of the EIB *sukuk* has not specified a reserve account for the purpose of covering such shortfalls, which is permissible by the AAOIFI (2008) *sharia* standard (5) on guarantees. However, the transaction involves a third party as the guarantor (Emirates Bank International PJSC), which is a wholly owned subsidiary by EIB. Therefore, it makes this transaction arrangement non-compliant from a *sharia* perspective, as this "third party" identity satisfies secular legal requirements but does not satisfy the requirements according to *sharia*.

The scenarios and consequences for the default of EIB's *sukuk* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As most *sukuk* holders are under the assumption that they have direct rights to the underlying assets, in most *sukuks* structure, this is not the case in EIB *sukuk* as the investors are taking the issuer's risk. In the event of default, the *sukuk* holders are not entitled to cause the sale or any other forms of disposal of any of the *sukuk* assets. The sole right of *sukuk* holders against the issuer shall be to enforce the obligation of *sukuk* purchase undertaking, which gives *sukuk* holders the right to sell the *sukuk* to EIB. In addition, the (A1) rating assigned to the unsecured *sukuk* is at the same level as the long-term foreign currency deposits and senior unsecured ratings already assigned to EBI, the guarantor, on the premise that EBI has (a) irrevocably undertaken to cover any shortfall between the payments from the co-owned *ijara/sukuk* assets and the required periodic distribution amount to *sukuk* holders; and (b) irrevocably undertaken to purchase the issuer's interest in the co-ownership assets at the exercise price, either on maturity or on dissolution, sufficient to pay *the sukuk* holders (Moody's, 2010). Given that the obligations of EBI will be direct, unconditional, and unsecured and will rank at least pari passu with its other unsecured and unsubordinated obligations, the senior *sukuk* rating is placed at the same level as EBI's rating. The investors were therefore 'guaranteed' to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure. This does not meet sharia requirements.

This issuance will be governed by the trust certificates in accordance with English law, including the master trust deed, each supplemental trust deed, the programme agreement, the agency agreement, the purchase undertaking deed and the costs undertaking deed. It is subject to the exclusive jurisdiction of the English courts. The remaining transaction documents will be governed by the federal laws of the UAE; the courts of Dubai have non-exclusive jurisdiction to hear all disputes relating to them. The corporate services agreement will be governed by the laws of the Cayman Islands, where the courts have jurisdiction to hear all disputes relating to it. Obviously, this agreement does not work in favour of the *sharia* spirit, so EIB's *sukuk* transaction was not *sharia* compliant.

6.3.6 Case 6: Gulf Finance House.

GFH, based in Bahrain, is active in financial services investments. It was founded in 1999 and its shares are listed on the Kuwait and Bahraini stock exchanges and the DFM. In 2007, its shares were listed on the LSE. In addition, GFH focused on the conception and delivery of high-value economic infrastructure projects harnessing the enormous potential offered by the region's dynamic economies. Therefore, GFH has established some of the region's leading financial institutions including first energy bank, the world's first Islamic investment bank focused exclusively on the energy sector. Other financial institutions founded by GFH include Khaleeji Commercial Bank in Bahrain, QInvest in Qatar, Arab Finance House in Lebanon, First Leasing Bank in Bahrain and Asia Finance Bank in Malaysia (BHB, 2011; GFH, 2011). In addition, GFH projects include GFH's financial harbour in the Kingdom of Bahrain and Tunisia, and energy cities in Qatar, Libya and India. The market capitalisation of GFH as of 31 December 2010 was US$237 million (Zawya, 2011).

6.3.6.1 The motivation of GFH's *sukuk*.

Double-digit growth rates for *sharia* compliant assets over the past decade have naturally driven Islamic financiers to look beyond historical boundaries to explore new territories, both within and outside the Arab world. In response to the increasing competitive pressure stemming from the entrance of new players into the market, existing Islamic banks have started to leverage on their natural competitive advantages, which include customer loyalty, sensitivity to religious practices, and stable bases of cheap deposits. The retail market, the key profit driver of banking in the Gulf, is attracted by what Islamic banking can offer. A *sharia* compliant investment bank such as GFH is challenging the old rules of Islamic finance with more aggressive (and so far very successful) business models. Therefore, issuing *sukuks* is probably the most appropriate way to achieve this goal, as the regional economic environment is currently benign and pricing is attractive (Standard & Poors, 2008b). Thus, GFH *sukuk* was issued to raise funds in accordance with *sharia* requirements and to achieve their liquidity management goals.

GFH (2007) issued its first *sukuk* at US$200 million in 2007, the issuance is US dollars denominated. It is offering a floating annual rate of return designated as a three-month LIBOR (for three-month US dollar deposits) plus 125 basis points payable quarterly and a tenure of 5 years. GFH *sukuk* issue price was 100% of the aggregate face value of the *sukuk*, and issued in denominations of US$1,000, subject to a minimum holding of US$100,000. The proceeds of issuances of the *sukuk* certificates will be used to invest in accordance with the investment plan under the *ijara* agreement, the *ijara* capital will be used to purchase the initial *sukuk* assets trust property corresponding to (1 share in QIvest LLC incorporated in Qatar valued US$75 million, and 391,763,203 shares in Khaleeji Commercial Banks incorporated in Bahrain valued at US$125 million) (GFH, 2007). This issuance received (BBB-) grade at the time of subscribed from Standard &Poor's ratings services, putting it in lower medium grade category (Standard & Poor's, 2008b).

The GFH contains several innovative elements that will be beneficial to the development of the *sukuks* industry. It has won numerous local and international awards for its commitment to excellence and its pioneering and innovative approach, including 'Best Investment Bank 2008', by Islamic Banking and Finance; 'Best Investment Bank' three years running (2005–2007), by Banker Middle East; 'Best Islamic Investment Bank', by World Finance 2007; 'MENA Investment Bank of the Year 2008', by Acquisitions Monthly; and 'Best Islamic Finance House', at the Banker Middle East Industry Awards 2009 (GFH, 2011). Thus, issuing *sukuk* is one of GFH's priorities to attract investors and clients.

The purpose of this issuance is to fund a senior expenses reserve, an infrastructure fund and a liquidity Reserve. The offering circular of GFH (2007) mentioned that net proceeds are less than US$200 million by US$1,164,167.75 to cover the issuance expense. This left US$198 million for investment in the assets. The proceeds raised from the *sukuk* will be used to match fund the investment bank's medium term strategic investment portfolio comprising its investments in the equity of Khaleeji Commercial Bank in Bahrain and QInvest in Qatar. The proceeds will be used to expand GFH's proprietary business.

6.3.6.2 The structure of GFH's *sukuk*.

The contract agreement consists of *musharaka* enterprise in tangible and intangible assets. The issuance is a private offering aiming to support its capital base by using a *sharia* compliant structure, which involves an SPV (GFH *Sukuk* Limited as issuer and trustee) incorporated in accordance with the laws of the Cayman Islands. The first *sukuk* issuance in its programme was in July 2007, the proceeds of which were used to achieve their liquidity manage goals. Therefore, the main objective of this *ijara* contract will be to earn profit from the application of capital in accordance with the *ijara* agreement. Under this arrangement, GFH could strengthen its capital base to develop its *sharia* compliant services and products with the option to consolidate with its existing *sharia* compliant business. Figure 6.10 explains GFH's 2007 *sukuk* structure. GFH acts as a managing agent in connection with the *sukuk* assets pursuant to the management agreement (GFH, 2007).

In the case of GFH's issuance, the pool of trust property assets is securitised merely through the issuance of *sukuk* and not through any form of transfer of ownership rights in the underlying assets or projects. Indeed, the structure of this *sukuk* makes it an equity-linked instrument, but without any form of transfer of ownership in rights, assets, or projects the question is raised whether this is sufficient for a *sukuk* structure. The distribution paid to holders of the certificates comes from income generated by the assets, interests or contracts, which may include, inter alia, *ijara*, real estate, *murabaha* contracts, *istisna* contracts, shares, and/or other *sharia* compliant assets, interests or contracts (the '*Sukuk* Asset Trust Property'). This structure complies with AAOIFI (2010) *sharia* standard (12) on *musharaka* and modern corporations.

According to the management agreement, GFH (2007) has guaranteed to make available a *sharia* compliant liquidity facility to the issuer to ensure timely payment of, inter alia, periodic distribution amounts in respect of each series of *sukuk* certificates and to cover any cost and expenses incurred by the issuer in connection with having an ownership interest in the *sukuk* assets.

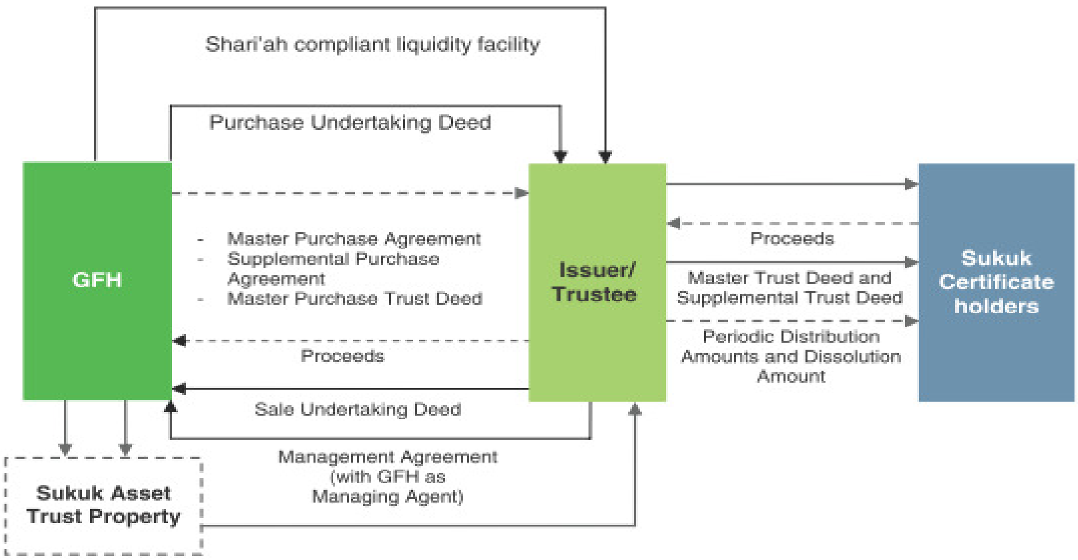

Figure 6.10. GFH's 2007 *sukuk* structure. Source: GFH, 2007.

6.3.6.3 The outcomes of implementing GFH's *sukuk*.

From the *sharia* perspective, it is essential that *sukuks* are backed by a specific, tangible asset throughout its entire tenure, and *sukuk* holders must have a proprietary interest in the assets financed. In addition, the AAOIFI (2008) has advised originating companies to sell and legally transfer ownership of the underlying assets to investors.

Therefore, the *sukuk* is secured by a charge over a floating pool of assets and is priced competitively. The initial price guidance given by the bank was not widened reflecting the strong investor confidence in GFH's *sukuk* issuance.

The scenarios and consequences for the default of GFH's *sukuk* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As most *sukuk* holders are under the assumption that they have direct rights to the underlying assets, in most *sukuks* structures, this is not the case in GFH *sukuk* as the investors are taking the issuer's risk. In the event of default, the *sukuk* holders are not entitled to cause the sale or other disposition of any of the *sukuk* assets.

The sole right of *sukuk* holders against the issuer shall be to enforce the obligation of the *sukuk* purchase undertaking deed, which gives the right to *sukuk* holders to sell the *sukuk* to GFH at face value. It was possible for the Originator to grant a purchase undertaking to the trustee and for the exercise price to be a fixed amount determined in accordance with a formula and not by reference to the market value of the assets. The exercise price would therefore typically have been, in the event of a default or maturity, equal to the face amount of the *sukuk* plus any accrued but unpaid periodic distribution amounts. The investors were therefore ‘guaranteed’ to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure. As a result the scenarios and consequences in this agreement do not work in favour of the fourth ruling of the AAOIFI (2008) resolution, and articles (2/2/1) and (2/2/2) of the AAOIFI (2010) *sharia* standard (5) on guarantees.

6.3.7 Case 7: National Central Cooling Company.

National Central Cooling Company (Tabreed) is a utilities company based in UAE, active in cooling solutions to government, commercial, residential and private organisations in the GCC. Tabreed is an Abu Dhabi-based utility company that pioneers solutions for the ever-growing demand for cost-effective, environmentally friendly cooling solutions in the Middle East. Founded in June 1998 and listed on the DFM (2011), Tabreed is the largest district cooling provider in the region, aiming to deliver sustainable long-term returns for its shareholders and comfort for all of its customers (Tabreed, 2011). Tabreed currently owns and operates 49 district cooling plants, and via joint-ventures and subsidiaries, has operations in Bahrain, Kuwait, Oman, Qatar and Saudi Arabia In addition, the company’s objectives include distributing and selling chilled water for use in district cooling technologies (Tabreed, 2011). The market capitalisation of Tabreed as of 31 December 2010 was US$110 million (Zawya, 2011).

6.3.7.1 The motivation of Tabreed’s *sukuk*.

The *sukuks* were issued to finance the capital expenditure and expansion of Tabreed operations. Tabreed issued two *sukuks* at US$200 million in 2006, the issuance is US-dollar denominated. It is offering a floating annual rate of return designated as the six-month US dollar LIBOR plus 125 basis points payable semi –annually with a tenure of five years (Tabreed, 2006). The second issuance is equivalent to US$462.8 million in 2008, is AED denominated, offering an indicative annual rate of return of 7.25 per cent payable annually with a tenure of three years (Tabreed, 2008). The structure of these two transactions makes use of hybrid *sukuks* composed of both an *ijara* and *istisna* agreement.

In addition, these two issuances received (BBB-) at the time of subscription but later received (CCC+ and CC) grade from Standard &Poor’s ratings services, so this put the two issuances in substantially risky or may be in default grade category (Standard & Poor’s, 2008b; 2011). The basis of rating the Tabreed *sukuks* as (BBB-) is the functional equivalence of unconditional purchase undertaking and the parent organisation's guarantee (Standard &

Poors, 2008b). This meant the rating assigned to the *sukuks* is the same as that of senior secured corporate debt obligation of the parent.

Therefore, investors are directly exposed to the parent company's credit risk, rather than the risks of the *sukuks* assets; hence, the *sukuks* rating is same as the parent's credit rating. Tabreed's ratio of secured debt to asset ratio was less than 20 per cent. There were enough features in the structure of Tabreed *sukuks* to render the financing comparable with other existing Tabreed secured financings. Hence, the ratings of the *sukuks* reflect the credit standing of the issuer, rather than the riskiness of the secured assets (Tabreed, 2006; 2008).

Tabreed (2006) issuance was for the construction of two cooling plants. The issuance Price was 100% of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of US$1,000, subject to a minimum holding of US$100,000. Tabreed (2008) price was 100 per cent of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of AED 1,000, subject to a minimum holding of AED 10,000.

In reality, when the global credit crisis made its way into the GCC region economy, leading to delayed and/or cancelled projects as well as late payments or worse defaults, companies especially in UAE which depended significantly on debts to finance their business build-up had no choice. Tabreed was one of those firms and consequently recognised massive impairment losses. To illustrate, Tabreed was mostly running on borrowed money to the tune of AED 5.08 Billion (as of end-2010). The recapitalisation has since helped Tabreed to reduce total borrowings to AED 3.67 Billion (as of end-2011). Tabreed was not only highly-geared or highly-leveraged, its capital structure was also not flexible, in that most of its credit pre-recapitalisation programme was short term in nature. That added further pressure, as operating cash flow was already restricted by market conditions.

Moreover, a JP Morgan report issued in 2010 indicated that the CDS market during 2006–2009 clearly showed increased concern about the debt funding of local projects and the real estate market in the UAE, as a vast number of long-term projects were financed with short-term funds, putting additional pressure on current tight capital markets. These factors have encouraged Tabreed to look for alternative sources of financing such as short- and medium-term *sukuks*.

6.3.7.2 The structure of Tabreed's *sukuk*.

In both issuances, Tabreed's financing used a hybrid structures composed of three Islamic finance instruments: *ijara sukuk*, which is used to securitise assets, *istisna*, which used as a forward purchase agreement, and *murabaha*, which is used as debt. The use of Palladium

Metal in the first issuance (Tabreed, 2006) to create assets for Tabreed was very ambiguous. Tabreed financing posed two problems in its compliance with *sharia* requirements, which led to its intricate structure. According to *the sharia* Law, for the *sukuk* to be tradable, it has to represent an ownership interest in a physical entity, instead of just money. To comply with this rule, 51 per cent of the assets representing the *sukuk* assets have to be in physical form. For the Tabreed project, *sharia* scholars made an exception and required that the percentage of physical assets representing the *sukuk* assets can be 33 per cent of the face value of *sukuk* (Tabreed, 2006). Tabreed was unable to meet this requirement in its 2006 issuance, since it could deliver at most $40 million in real assets as *sukuk* assets, which represented only 20 per cent of the face value of the *sukuk*. This meant that additional physical assets worth $26 million were required to meet the 33 per cent threshold. To solve this problem, *sharia* scholars suggested that Tabreed sell US$26million worth of Palladium to the issuer so that 33 per cent of *the sukuk* assets will be in physical form. Figure 6.11 explains Tabreed's 2006 *sukuk* issuance.

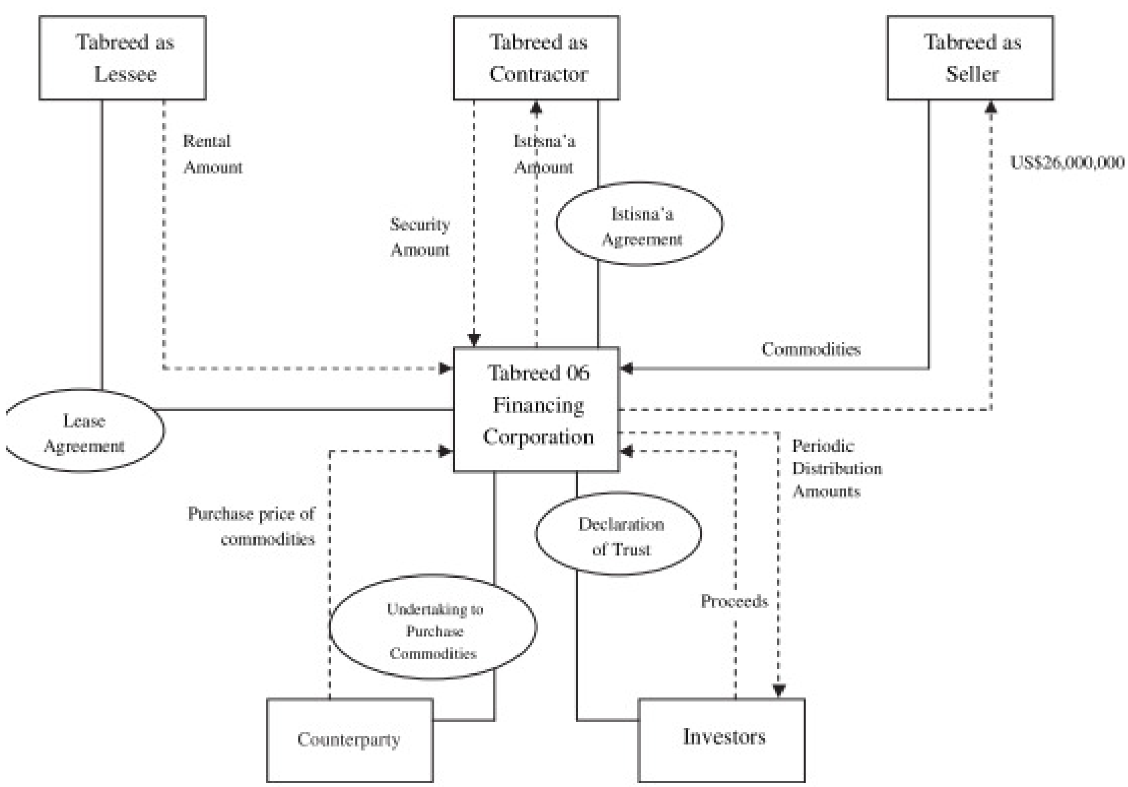

Figure 6.11. Tabreed's 2006 *sukuk* structure. Source: Tabreed, 2006.

In both issuances the transactions involved SPV (Tabreed 06 & 08 Financing Corporation) incorporated in the Cayman Islands under the companies' law as the issuers. However, in Islamic-law compliant lease structures, where assets are still under construction, the owner of assets cannot charge rent from the lessee on the present date for the assets which will be finished and rented on a future date. Islamic law jurists proposed a new mechanism to fulfil this requirement. On each bi-annual rental payment date, Tabreed will pay a security amount of US$1.25 million to the *sukuk* issuer as a security for its future construction obligations. If the construction of the cooling plants did not occur, issuer will keep the aggregate security deposit and will not return it to Tabreed. In addition, Tabreed will pay the rental amount for the plants leased to the issuer and for so long as it still has obligations to perform under the *istisna* agreement, as a security amounts in respect of those obligations. Taken together, these amounts are intended to fund the periodic distribution amounts payable by the issuer under the certificates.

The use of *istisna* agreements in the second issuance, along with credit enhancements by periodic security payments to procure future cooling plants, was an innovative aspect of this *sukuk* issue. As these plants come online, they are transferred to the SPV and leased back. Any interruption in the rents results in a dissolution event, in which Tabreed is required to purchase the *sukuk* certificates for investors at face value. If Tabreed is unable to do so, *sukuk* investors can sell the *sukuk* assets to recover their investments and may not recover their initial investments. This makes the risk structure of *sukuk* to conventional corporate bond. However the price of the *sukuk* issue ends up becoming more than conventional bond because of the transaction costs involved in the creation of an offshore SPV and extra legal work. Figure 6.12 explains Tabreed's 2008 *sukuk* issuance.

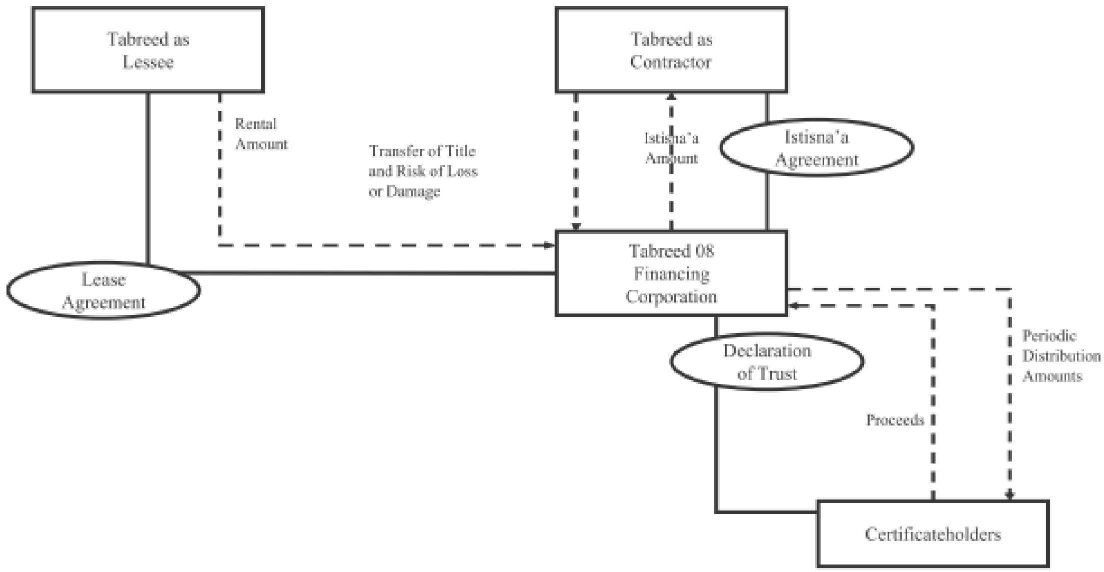

Figure 6.12. Tabreed's 2008 *sukuk* structure. Source: Tabreed, 2008.

In contrast, in the Tabreed 06 transaction, the company will buy the cooling plants through exercising the purchase undertaking that in turn ultimately redeems the notes. The points of comparison exist between the 'debt-like' features of the Tabreed 06 *sukuk* and the 'equity-like' features of the Tabreed 08 *sukuk*. Under the Tabreed 08 *sukuk*, all lease payments are subordinated under normal circumstances to other senior creditors of Tabreed, as well as in the event of a payment default. This subordination of the Tabreed 08 *sukuk* includes its subordination to payment of the Tabreed 06 *sukuk*.

In Tabreed issuances, the ratings of the *sukuks* reflect the credit standing of the issuer, rather than the riskiness of the secured assets. As a result, this matter goes against the substance of Islamic finance, which requires investors to take the risk of the underlying asset while entering into a financial contract rather than the credit risk of the counter-party.

6.3.7.3 The outcomes of implementing Tabreed's *sukuk*.

The weakening of Tabreed's 2006 issuance stand-alone credit profile (SACP) reflects the underperformance in the years to date compared with the company's guidance as set out in its 2006 and 2008 business plan. The major area of underperformance was the company's failure to obtain the targeted AED 1 billion proceeds from general asset sales including to various joint ventures. In addition, the company faces a high ongoing exposure to refinancing risk through the rollover of various short-term banking facilities, according to the rating agencies services. It is important to note that the company does not provide a clear and sustainable business plan to counteract the liquidity challenge and improve levels of free cash flow.

In the offering circular, it is not mentioned how Tabreed gets the US$26 million worth of Palladium. If it already owned the metal, it could have sold the metal in the market to get this amount. Most likely HSBC had arranged a *murabaha* for Tabreed, in which it gave Palladium to Tabreed for deferred payment. Tabreed converted Palladium to pure debt by selling it to *sukuk* holders. *Sukuk* holders may not be aware of the fact that they were a party to the *murabaha* transaction, which is inefficient, because many customers of Islamic finance consider *murabaha* as being non-compliant with *sharia* requirements if it is tradable. The issue says that 'Islamic law scholars made an exception in Tabreed *sukuk* issue, and reduced the required percentage of physical and tangible assets from 50% to 33 %'. It is not known on what basis this exception was made (Tabreed, 2006).

The paradigm of *sukuk* security originated from the conventional securitisation mechanism in which a SPV is established to acquire assets and to issue financial rights on the assets. The rights of these financial assets represent a proportionate beneficial ownership to the *sukuk* holders. However, the purchase undertaking given by the *sukuk* manager in Tabreed issuance who manages the *sukuk* assets to buy back the *sukuk* assets at the pre-determined face value makes the investment relatively risk free. This makes this form of *sukuk* a debt like instrument making it not compliant with sharia principles.

6.3.8 Case 8: Saudi Basic Industries Corporation.

SABIC is a manufacturing company based in Saudi Arabia, active in chemicals and intermediates, industrial polymers, fertilisers and metals. SABIC was established pursuant to Royal Decree number M/66 dated September 1976 and registered in Riyadh under commercial registration dated January 1977 and listed on Tadawul (2011). It is the largest public company in Saudi Arabia, 70 per cent owned by the Saudi Arabian government and 30 per cent owned by citizens of Saudi Arabia and other GCC states (EIU, 2011). The market capitalisation of SABIC as of 31 December 2010 was US$83,690 million (Zawya, 2011). It has 17 affiliate companies including the former GE Plastics division (SABIC, 2011).

6.3.8.1 The motivation of SABIC's *sukuk*.

SABIC issued three *sukuks* in 2006, 2007 and 2008 available in local currency to Saudi nationals (SABIC 2006; 2007; 2008). The issuances are Saudi Arabian Riyals (SAR) denominated, equivalent to US$4,266.2 million in size (US$799.9, 2133.1 and 1333.2

million, respectively), offering a floating annual rate of return designated as the Saudi interbank offered rate (SIBOR) for three-month SAR deposits plus 40, 38 and 48 basis points respectively payable quarterly and having a tenure of 20 years. In addition, these three issuances received an (A+) grade from Standard & Poor's (2008b; 2011) ratings services, putting them in the high or higher medium grade category.

The *sukuks* were issued to finance growth and expansion marketing plans of SABIC and the proceeds raised affiliates and subsidiaries plan to expand production capacity at a number of existing plants which in turn is expected to increase the quantities of products available for marketing by SABIC under a number of the marketing agreements. The issue price were 100 per cent of the aggregate face value of the *sukuks* issued in denominations of SAR 10,000, subject to a minimum holding of SAR 10,000 (SABIC 2006; 2007; 2008).

The fund is also used to pay 10 per cent of the face value of the *sukuks*, every five years throughout its 20-year life. This ensures that 40 per cent of the face value of the *sukuks* is fully paid at years 5, 10 and 15, with a variable rate of return paid to investors. At the end of the *sukuks* tenure, whether it be at 20-years or earlier, if the *sukuks* are purchased by SABIC prior to that time, then any remaining balance in the reserve is paid to SABIC with a strong incentive to improve its marketing performance.

Although SABIC is 70 per cent owned by the Saudi government the *sukuk* do not enjoy any government guarantee as SABIC is a joint stock company which means the government's liability for its debt is limited to its paid-up capital (Tadawul, 2011). Thus, the strength of the SABIC *sukuks* structure are in its credit enhancement, as SABIC provides *sukuks* holders with a purchase undertaking. The *sukuks* are structured to be redeemed on expiration for the purpose of substantially enhancing their credit by equalizing the issue rating with that of the corporate credit rating of the issuer as *sukuks* holders are assuming risk.

According to bank loans prior to the 2006–2009 global financial crisis, banks in GCC countries have become more conservative by tightening their lending standards and implementing very restrictive and selective lending guidelines as well to increasing their loan rates (Standard & Poor's, 2011). Hence, cautious lending has been dominating the domestic credit market in these countries on the one hand, and an unstable equity market has deterred private corporate from raising funds in fear of low valuation, on the other. As a result, SABIC was enjoying cheaper funding by issuing *sukuks* compared to bank loans during this period. The evidence shows that *sukuks* have lower debt-servicing costs than bank loans. For instance, the cost of the five year bank loan is a minimum of SIBOR plus 75 basis points, whereas the service charge for the five-year *sukuk* is SIBOR plus 40, 38 and 48 basis points and 35, 37 and 27 basis points less on the lower side, respectively (SAMA; Tadawul, 2010). Nevertheless, upfront arrangement fees are likely to be higher for *sukuk* than bank loans due to their legal and *sharia* advisory requirements. Subsequently the profile of *sukuk* profile as a viable substitute for banks lending and equity market has been increasing. These factors have encouraged SABIC to look for alternative sources of financing such as *sukuk*.

6.3.8.2 The structure of SABIC's *sukuk*.

SABIC's *sukuks* are based upon the structure of *al-istithmar* (investment agency structure) which in turn is based on AAOIFI (2010) standards (17), (21) and (23), which issued certificates of ownership against the usufruct of the services of a specified party. The structure of SABIC *sukuk* was very inventive where under an asset transfer agreement, SABIC transferred certain rights, and obligations for a specific marketing agreement to SABIC *Sukuk* LLC (SPV), a wholly-owned subsidiary of SABIC and registered in Saudi Arabia. These represented SABIC *Sukuk* LLC's underlying assets, which it held as a custodian for the benefit of the *sukuk* holders. This structure was developed to identify any possible intangible assets with cash flow generation of the originator to structure the *sukuk* issuance (Fetais, 2011; Kamali, 2009).

However, as mentioned in Chapter 2, the issuer must ensure that this is not interpreted as trading in debt. From a *sharia* perspective, it is considered to be permissible for the rights and obligations of *sukuks* contracts to be securitised simultaneously and to become tradable. Under this type of structure, it is possible for *murabaha* and *istisna* contracts, shares and other *sukuks* certificates to be securitised as *sukuk* contract and traded. Figure 6.13 explains SABIC's *sukuks* structure.

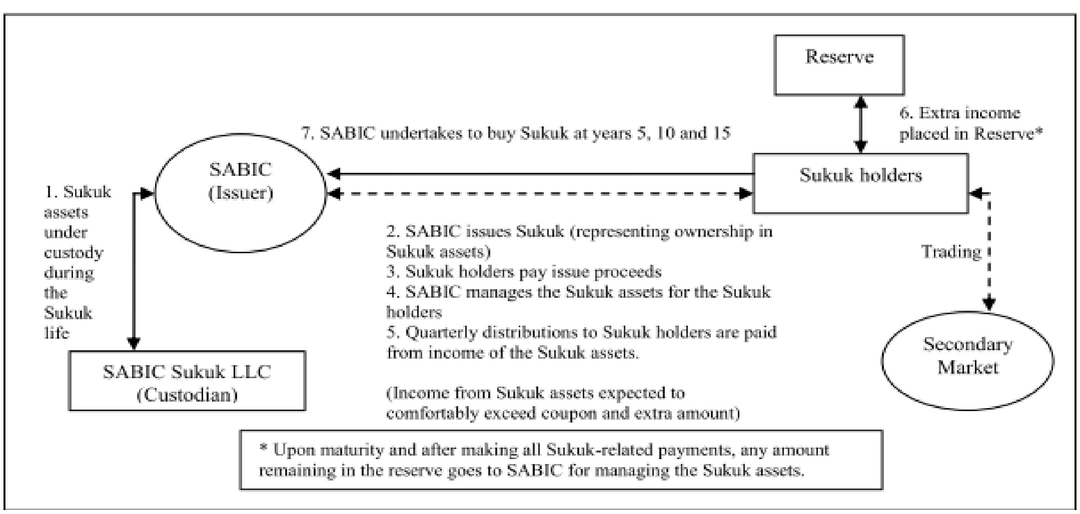

Figure 6.13. SABIC's 2006 *sukuk* structure. Source: SABIC, 2006.

The agreement has been made in order to ensure that any surplus income was diverted into a reserve fund as a security cushion to shield *sukuk* holders in the unusual event that any periodical net income would fall below a particular amount. This reserve fund was established to protect the *sukuk* holders from default, up to a given threshold. This means that the risk deriving from the underlying assets is distributed between the *sukuk* holders and the issuer.

Therefore, all the excess income from the *sukuks* assets, after paying the periodic distribution amounts to the *sukuks* holders will be kept in a reserve. If there is a shortfall in the periodic distributions, reserve will be used to fill the shortfall. *Sukuks* holders will be entitled to receive an extra amount up to 10 per cent of the face value of their *sukuks* payable on each fifth year date to the extent their *sukuks* are current on that date. These payments will also come out of the reserve. Any excess amount after paying *sukuks* holders will belong to the *sukuks* administrator (SABIC), thereby providing an incentive for it to manage the reserve and *sukuks* assets in the best possible manner.

6.3.8.3 The outcomes of implementing SABIC's *sukuk*.

SABIC's *sukuks* structure was based on diversification of cash flow streams, a strong brand and considerable cash holdings as a major global petrochemicals holding corporation. The SABIC *sukuks* structure purchase undertaking has been influential in enhancing its *sukuks* creditworthiness and acceptability by investors. However, the *sukuks* structure did not completely comply with the required transparency level in Islamic finance, that require the issuer to specify the assets into which the *sukuks* proceeds will be invested, even though SABIC's *sukuks* benefitted from a purchase undertaking from SABIC to repurchase the *sukuks* underlying assets at maturity or upon default. In this case, there is no unambiguous government guarantee against any claim by creditors.

Besides, the portion of the redemption amount guaranteed by the purchase undertaking gradually decreases, whereas the portion tied to the extra reserve (which is not guaranteed by purchase undertaking) gradually increases. This redemption method gradually exposes SABIC's *sukuks* holders to the risks of the underlying assets to some extent. The purchase undertaking adds a risk-free nature to SABIC *sukuks* and exposes the investors to SABIC's credit risk, rather than the risks of the *sukuks* assets. Most of the investors will exercise the put option on the *sukuks* on the first fifth anniversary, since they will redeem the 100 per cent of the price they had paid for the *sukuks* certificates (provided they receive the entire 10% of the face value from the extra reserve). Therefore, for the first five years SABIC's *sukuks* are similar to a secured floating rate note. SABIC's *sukuks* certificate pricing behaviour in secondary markets are similar to the pricing behaviour of floating rate notes, as it has been trading at 100 per cent of the purchase price since it were issued.

Additionally, *sharia* regulations are open to different interpretations, giving more unpredictable discretion to courts. This is adds more uncertainty in the legal system for a relatively new investment asset class such as *sukuk*. Ratings are more difficult as there is no clear system on which to base them. Yet it is expected that some rating agencies would face some difficulties in rating new *sharia* compliant securities like *sukuk*. Thus, the scenarios and consequences for the default of SABIC's *sukuks* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. Most *sukuk* holders are under the assumption that they have direct rights to the underlying assets in most *sukuks* structures, but this is not the case in SABIC's *sukuks* as the investors are taking the issuer's risk.

In the event of default, the *sukuks* holders are not entitled to cause the sale or other disposition of any of the *sukuks* assets. The sole right of *sukuks* holders against the issuer shall be to enforce the obligation of the *sukuks* purchase undertaking. The *sukuks* purchase undertaking gives the right to *sukuks* holders to sell the *sukuks* to SABIC at face value. The custodian (HSBC Bank) is indemnified of all liabilities.

Interest-rate risk management at SABIC had significant exposure to short term interest rate fluctuations because of its borrowings at floating rates. SABIC entered into an interest rate swap agreement with a notional value of SR 13.6 billion to hedge the volatility in interest rates related to outstanding debts. This transaction was not *sharia* compliant.

As a result, SABIC *sukuks* transactions did not reflect AAOIFI (2010) *sharia* standards (17), (21) and (23), which require that the investors to whom the financial assets (comprised in the *sukuk* assets) relate will need to be informed about the sale of those financial assets to the trustee and the role of the originator in acting on the trustee's behalf. The role of a custodian may be required in order to ensure that the *sukuk* assets are sufficiently segregated from the other financial assets of the originator. Principal amounts from the underlying financial assets should never be used to service coupon payments under *sukuk istithmar*.

6.3.9 Case 9: Saudi Electricity Company.

SEC is an energy and utilities company based in Saudi Arabia. It is an integrated electricity generation, transmission, and Distribution Company and the primary supplier of electricity in Saudi Arabia. The Gulf's largest utility by market value, was created by the amalgamation of 10 local electricity firms in Saudi Arabia in April 2000 (SEC, 2011). It has since enjoyed a monopoly on the generation, transmission and distribution of electricity across Saudi Arabia, managing 37,000 megawatts of power across some 45 plants. The share capital is approximately 80 per cent owned by the government directly or indirectly (approximately 73 per cent directly owned by the government approximately and 7 per cent owned by Saudi Arabian Oil Company (Saudi Aramco), which is wholly-owned by the government at present), with a float of 20 per cent on the Saudi stock market. SEC's shares have been listed on Tadawul since SEC's inception (Tadawul, 2011). The market capitalisation of SEC as of 31 December 2010 was US$15,590 million (Zawya, 2011).

6.3.9.1 The motivation of SEC's *sukuk*.

SEC issued three *sukuks* in 2007, 2009 and 2010 available in local currency to Saudi nationals (SEC, 2007, 2009. 2010). The issuances are SAR denominated, equivalent to US$1333.2, 1866.5 and 1866.5 million, respectively, offering a floating annual rate of return designated as the three-month SIBOR plus 45, 160 and 95 basis points respectively payable quarterly with a maturity of 20 years. The net proceeds of the issue of the *sukuks*, after deduction of the combined management and selling commission, will be used by the issuer for general corporate purposes including meeting working capital requirements, refinancing existing financial obligations and capital expenditure and the making of other investments. The issue price was 100 per cent of the aggregate face value of the *sukuks*, and *sukuks* issued in denominations of SAR 500,000, 100,000 and 10,000 respectively.

They are subject to a minimum holding of SAR 500,000, 100,000 and 10,000, respectively. The fund is also used to pay 10 per cent of the face value of the *sukuks*, every five years throughout its 20-year life. The agreement was structured to ensure that 40 per cent of the face value of the *sukuks* is fully paid at (7 years for the first and 5 years for second and third issuances), with a variable rate of return paid to investors. At the end of the *sukuk* tenure, whether it be at 20 years or earlier, if the *sukuk* is purchased by SEC prior to that time, then any remaining balance in the reserve is paid to SEC with a strong incentive to improve its business performance. According to Zawya (2011) database, these three issuances received

(AA-) grade from Fitch ratings services, so this put the three issuances in high or higher medium grade category.

Benefiting from the company's direct and indirect government ownership and a robust business was favourably reflected in the pricing of just 45, 160 and 95 basis points respectively over SIBOR, given the long tenure of 20 years (SEC, 2007, 2009. 2010). Conversely, SEC's *sukuks* do not enjoy the government guarantee as SEC is a joint stock company which means the government's liability for its debt is limited to its paid-up capital (Tadawul, 2011). Thus, the strength of SEC's *sukuks* structures are in its credit enhancement, as SEC provides *sukuks* holders with a purchase undertaking. The *sukuks* are structured to be redeemed on expiration for the purpose of substantially enhancing their credit by equalising the issue rating with that of the corporate credit rating of the issuer as *sukuks* holders are taking the issuer risk of the issuer. By achieves effective segregation of *sukuks* assets from SEC's own assets, contractually required to hold *sukuks* assets as custodian for the benefit of the investors, wholly owned by SEC, but subject to annual statutory audit.

One of SEC's strategic objectives is to diversify the source of financing for its expansion through the development of debt markets. It is vital to create a broader financing base and options to reduce the role of the government in the provision of financing. As a result, SEC was enjoying cheaper funding by issuing *sukuks* compared to bank loans during this period. The evidence shows that *sukuks* have lower debt-servicing costs than bank loans. For example, the cost to SEC's five-year bank loan is a minimum of SIBOR plus 75 basis points whereas the service charge for the five-year SEC's first *sukuk* is SIBOR plus 45 basis points, 30 basis points less on the lower side (Tadawul, 2011). Nevertheless, upfront arrangement fees are likely to be higher for *sukuk* than bank loans due to their legal and *sharia* advisory requirements. Subsequently the profile of *sukuk* profile as a viable substitute for banks lending and equity market has been increasing. These factors have encouraged SEC to look for alternative sources of financing such as *sukuks*. As a result, SEC's *sukuks* were eventually the first GCC corporate to issue a multi-billion domestic *sukuks* that attracted a strong order from domestic investors, mainly financial institutions, reaching nearly US$20 billion, three times the offered size (EIU, 2011).

6.3.9.2 The structure of SEC's *sukuk*.

SEC's *sukuks* issuances are based upon the structure of *al-istithmar* (investment agency structure) which in turn is based on AAOIFI (2010) *sharia* standards (17), (21) and (23), which issued certificates of ownership against the usufruct of the services of a specified party. The structures of SEC's *sukuks* were under an asset transfer agreement, SEC transferred certain assets to be entered into between SEC (the issuer), and *Sukuk* Electricity Company (SPV), a wholly owned subsidiary of SEC. These represented *sukuk* Electricity Company's underlying assets, which it held as a custodian for the benefit of the *sukuks* holders. These structures were developed to identify any possible intangible assets with cash flow generation of the originator to structure the *sukuks* issuances.

Thus, the issuer will transfer to the custodian the applicable percentage of certain specified rights and entitlements (under CMR 169 and the distribution license) to undertake and levy the connection services for the life of each *sukuk* until maturity (20 years). The issuer undertakes to provide certain services in respect of *the sukuk* assets in return for the administration fee. The agreement excludes industrial, agricultural and governmental customers' services. Therefore, these structures are an investment in intangible rights (operating business). Coupon payments are derived solely from income generated by the business. In addition, the agreement has not represented kind of guarantees or liquidity facility since one unilateral undertaking by *sukuks* holders (no call option), so risk remains. Thus, under the purchase undertaking, the issuer (SEC) will undertake to purchase *the sukuks* from holders at a specified pre-determined purchase price, expressed as a percentage of the face value of *the sukuks* (90%, 60% and 30% at the first, second and third fifth-year dates, respectively). The instruments are tradable during their life. Figure 6.14 explains SEC's *sukuks* structure.

However, Chapter 2 demonstrated that the issuer must ensure that this is not interpreted as trading in debt. From a *sharia* perspective, it is permissible for the rights and obligations of *sukuk* contracts to be securitised simultaneously and become tradable.

6.3.9.3 The outcomes of implementing SEC's *sukuk*.

The agreement has been made in order to ensure that any surplus income was diverted into a reserve fund as a security cushion to shield *sukuk* holders in the unusual event that any periodical net income would fall below a particular amount. This reserve fund was established to protect the *sukuk* holders from default, up to a given threshold. This means that the risk deriving from the underlying assets is distributed between the *sukuk* holders and the issuer.

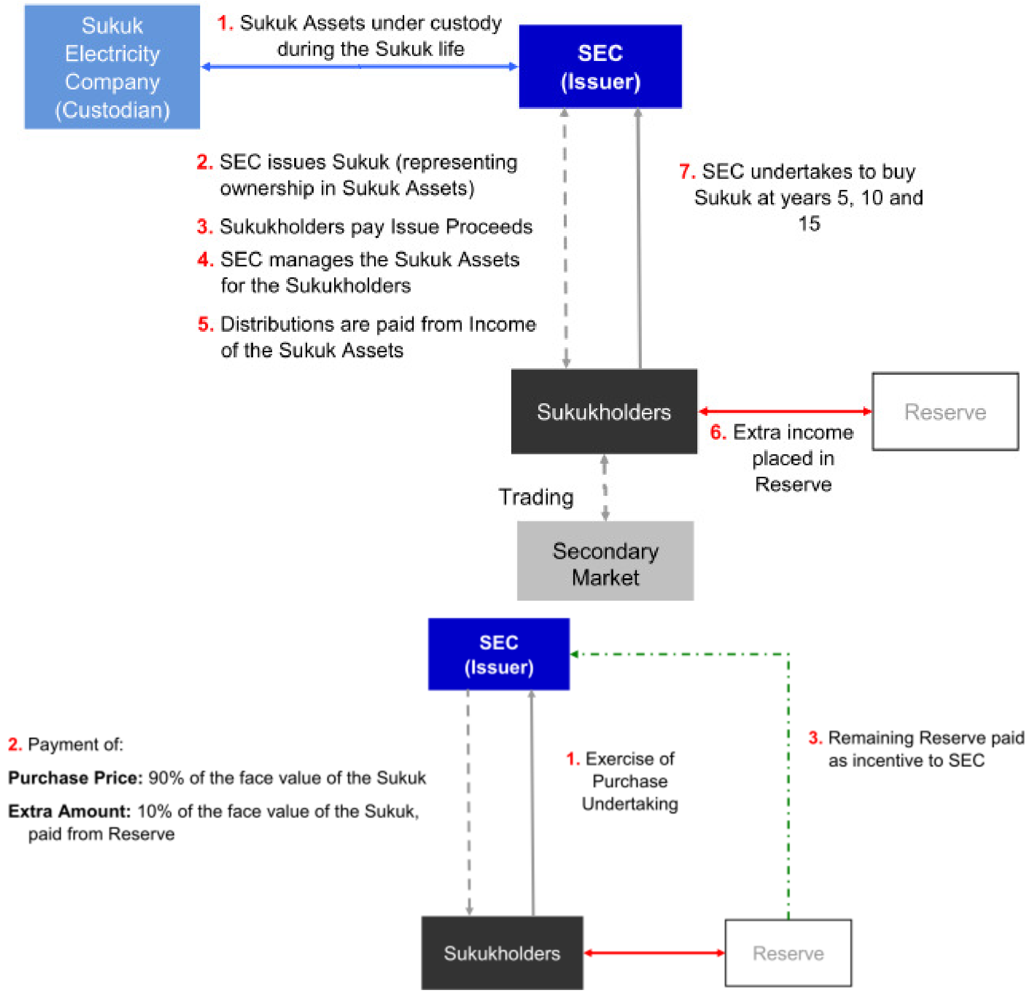

Figure 6.14. SEC's *sukuk* structures. Source: SEC, 2007, 2009, 2010.

Therefore, all the excess income from the *sukuks* assets, after paying the periodic distribution amounts to the *sukuks* holders will be kept in a reserve. If there is a shortfall in the periodic distributions, reserve will be used to fill the shortfall. Holders of the *sukuks* will be entitled to receive an extra amount up to 10% of the face value of their *sukuks* payable on each fifth year date to the extent their *sukuks* are current on that date. This payment will also come out of the reserve. Any excess amount after paying *sukuk* holders will belong to the *sukuk* administrator (SEC), thereby providing incentives to manage the reserve and *sukuks* assets in the best possible manner.

Despite that, SEC's *sukuks* structure was based on diversification of cash flow streams, a strong brand and considerable cash holdings as a monopoly on the generation, transmission and distribution of electricity across Saudi Arabia. The SEC *sukuks* structure purchase undertaking has been influential enhancing its *sukuks* creditworthiness and acceptability by investors. However, the *sukuks* structure did not completely comply with the required transparency level in Islamic finance, that require the issuer to specify the assets into which the *sukuk* proceeds will be invested, even though *sukuk* Electricity Company benefit from a purchase undertaking from SEC to repurchase the *sukuks* underlying assets at maturity or upon default. In this case, there is no unambiguous government guarantee against any claim by creditors.

Besides, the portion of the redemption amount guaranteed by the purchase undertaking gradually decreases, whereas the portion tied to the extra reserve (which is not guaranteed by purchase undertaking) gradually increases. This redemption method gradually exposes SEC *sukuk* holders to the risks of the underlying *sukuks* assets to some extent. The purchase undertaking adds a risk-free nature to SEC's *sukuks* and exposes the investors to SEC's credit risk, rather than the risks of the *sukuks* assets. Most of the investors will exercise the put option on the *sukuk* on the fifth anniversary, since they will redeem 100 per cent of the price they had paid for the *sukuks* certificates (provided they receive the entire 10% of the face value from the extra reserve). Therefore, for the first five years, SEC's *sukuks* were similar to a secured floating rate note. SEC's *sukuks* certificate pricing behavior in secondary markets are similar to the pricing behavior of floating rate notes, as it has been trading at 100% of the purchase price since they were issued.

The scenarios and consequences for the default of SEC's *sukuks* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. Most *sukuk* holders are under the assumption that they have direct rights to the underlying assets in most *sukuks* structure, but this is not the case in SEC's *sukuks* as the investors are taking the issuer's risk. In the event of default, the *sukuks* holders are not entitled to cause the sale or other disposal of any of the *sukuks* assets. The sole right of *sukuks* holders against the issuer shall be to enforce the obligation of the *sukuks* purchase undertaking. The *sukuks* purchase undertaking gives the right to *Sukuks* holders to sell the *sukuks* to SEC at face value.

As a result, SEC *sukuks* transactions did not completely reflect AAOIFI (2010) *sharia* standards conditions of (17), (21) and (23). The role of a custodian may be required in order to ensure that the *sukuks* assets are sufficiently segregated from the other financial assets of the originator. Principal amounts from the underlying financial assets should never be used to service coupon payments under *sukuk istithmar*.

6.3.10 Case 10: Saudi Hollandi Bank.

SHB is a financial services provider based in Saudi Arabia, active in financial services. It was the first operating bank in the Kingdom of Saudi Arabia and was originally founded in 1926 as a branch of the Netherlands Trading Society to serve the Hajj pilgrims from the Dutch East Indies (now Indonesia), and operated out of one office in Jeddah. As it was the only bank in the Kingdom at the time, it acted as the central bank, keeping the Kingdom's gold reserves and receiving oil revenues on behalf of the Saudi Arabian government. In 1928, the Saudi riyal, a new silver coin commissioned by late King Abdulaziz, became the Kingdom's first independent currency. The Netherlands Trading Society office in Jeddah assisted the government with the launch of the local currency. In 1954, the Netherlands Trading Society expanded its operations in the Kingdom by opening two additional branches, in Al Khobar and Al Dammam, in the Eastern Province. In 1969, ABN Bank, the successor of the Netherlands Trading Society, was one of the first foreign banks to implement the Saudization initiatives set forth by the Saudi Arabian Monetary Agency (SAMA) and became the model for other foreign banks in the Kingdom. In 1977, SHB was established as a joint-venture company with a paid-up capital of SAR 35 million. SHB is a publicly listed bank on Tadawul (SHB, 2011; Tadawul, 2011). The market capitalisation of SHB as of 31 December 2010 was $US 2.59 billion (Zawya, 2011). SHB offers many services include *sharia* compliant banking and finance solutions through its suite of Islamic products and services (SHB, 2011).

6.3.10.1 The motivation of SHB's *sukuk*.

The issuance of SHB is a private offering aimed to support its capital base by using a *sharia* compliant structure. SHB has been issuing since 2004, so it is the first conventional bank in the Middle East to issue *sukuks* (SHB, 2011). SHB issued *sukuks* in 2008 and 2009 which are available in local currency to Saudi nationals (SHB, 2008; 2009). The issuances are SAR denominated, at SAR 775 million and SAR 725 million, equivalent to US$206.7 million and US$193.3 million, respectively.

These issuances were offering a floating annual rate of return designated as the six-month SAR SIBOR plus 200 and 190 basis points respectively payable semi-annual with a tenure of 10 years each. In addition, these two issuances did not receive any rating from any of the three major rating agencies (SHB, 2008; 2009). However, its latest *sukuk* was tranche 2 *sukuk* program issued in December 2009, the proceeds of which were used to boost its tranche 1 Capital. Thus, the *sukuk* tranche 1 in 2008 was issued to achieve their liquidity management goals. The main objective of the *mudaraba* will be to earn profit from the application of the capital in accordance with the *mudaraba* agreement. Under this arrangement, SHB could strengthen its capital base to develop its *sharia* compliant services and products with the option to consolidate *mudaraba sukuk* proceeds with its existing *sharia* compliant business.

The SHB *sukuk* tranche 1 issue price was 100 per cent of the aggregate face value of the *sukuk*, which was issued in denominations of SAR 100,000, subject to a minimum holding of SAR 500,000. The SAR 775 million *mudaraba sukuk* is private placements and such profit will be distributed among the issuer and the *sukuk* holders in accordance with the ratios applied over the net profit less-costs. The SHB (issuer/*mudarib*) and *sukuk* holders, sharing ratio, which in this case has been affixed as the *sukuk* holders and SHB (*mudarib*) agreed to share in the return generated by the *mudaraba* business in pre-stipulated percentages (60% for SHB and 40% for *sukuk* holders).

SHB's *sukuk* Tranche 2 issue price was 100 per cent of the aggregate face value of the *sukuk*, which was issued in denominations of SAR 100,000, subject to a minimum holding of SAR 500,000. The SAR 725 million *mudaraba sukuk* is private placements and such profit will be distributed among the issuer and the *sukuk* holders in accordance with the ratios applied over the net profit less the *mudaraba* costs. The SHB (issuer/*mudarib*) and *sukuk* holders, sharing ratio, which in this case has been affixed as the *sukuk* holders and SHB (*mudarib*) agreed to share in the return generated by the *mudaraba* business in pre-stipulated percentages (10% for SHB and 90% for *sukuk* holders).

6.3.10.2 The structure of SHB's *sukuk*.

The transaction commenced with SHB issuing *sukuk* certificates, entering into a declaration of agency with its subsidiary Saudi Hollandi Capital appointed to act as an agent for and on behalf of *the sukuk* holders. Saudi Hollandi Capital as *the sukuk* holders' agent entered into a *mudaraba* agreement on behalf of *the sukuk* holders (all together as the financier) with SHB (as *the mudarib*). SHB as the issuer and *the mudarib* hold all the assets in *the mudaraba* on behalf of *the sukuk* holders. Thus, the structures of the SHB *sukuks* are quite different compared to most of *the sukuks al- mudaraba* structures. Figure 6.15 explains SHB's 2009 *sukuk* issuance structure.

Although the periodic distribution amounts on the *sukuks* are fixed, the profits of the *mudaraba* will be the sole source of payment of the periodic distributions to the *sukuks* holders. If the profits made with the *sukuks* proceeds exceed the periodic distribution amounts, the surplus will be placed in a reserve account. Any shortfalls will be covered out of this reserve account. If the amounts in the reserve account are insufficient to cover shortfalls, the issuer will make on account payments. However, these on account payments will be subject to final settlement. At maturity or early termination in the event of default, the issuer will redeem the *sukuks* and pay the aggregate face value of the *sukuks* less any loss relating to the *mudaraba* assets not covered by the balance of the reserve account. There is no purchase undertaking in the transaction. This means that if the *mudaraba* suffered losses, the *sukuks* holders cannot receive the face value of the *sukuks* certificates. To cover this risk, SHB has the option to redeem the *sukuks* subject to the value of the assets of the *mudaraba* not being below the aggregate face value of the *sukuks* certificates. Any remaining monies in the reserve account are for the issuer as an incentive fee.

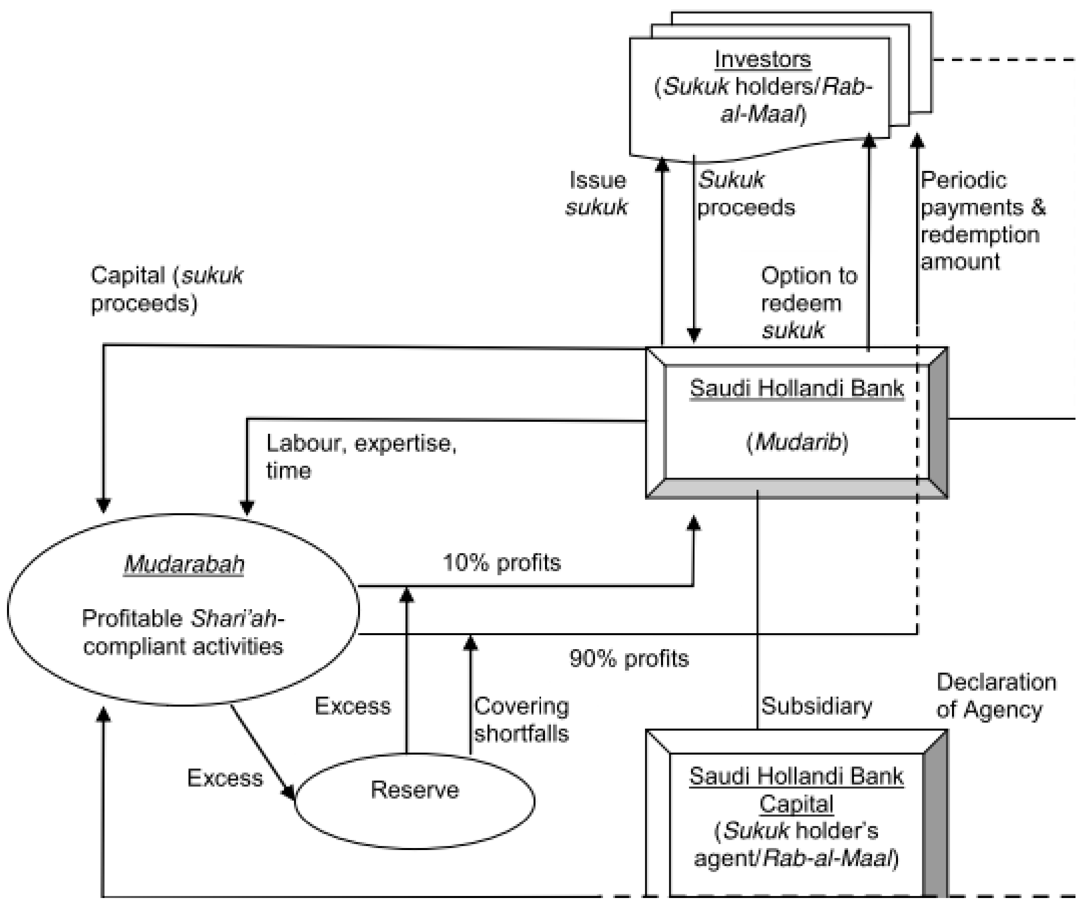

Figure 6.15: SHB's 2009 sukuk structure. Source: SHB, 2009.

In case of SHB issuances, the *mudaraba* assets are securitised merely through the issuance of *sukuks* and not through any form of transfer of ownership rights in the underlying assets or projects. Indeed, the structures of these sukuks make them an equity-linked instrument, but without any form of transfer of ownership in rights, assets, or projects the question is raised whether this is sufficient for a *sukuk* structure. Nevertheless, the SHB contains several innovative elements that will be beneficial to the development of the *sukuks* industry. From a proprietary law perspective, the *sukuks* holders do not gain any proprietary rights; there is neither transfer of any assets nor a declaration of trust. This raises the question of whether merely contractual rights are sufficient from the perspective of *sukuks* holders.

6.3.10.3 The outcomes of implementing SHB's *sukuk*.

The structure of the SHB *sukuk* issuances seems to comply with the AAOIFI (2008) resolution, being one of the few equity-based *sukuks* structures issued after the AAOIFI resolution. By close locking to the two structures there are no interest-free loans. Compared to the pre-AAOIFI resolution regarding *sukuks* issues, this aspect of the SHB answers the question how to deal with periodic payments to *sukuks* holders. In the SHB (2009) *sukuk*, the use of the reserve account is innovative when compared to the pre-AAOIFI (2008) resolution issues.

In addition, there is no purchase undertaking in the structure. The on account payments are subject to final liquidation of the *mudaraba*, this means that the *sukuks* holders are taking true risk of loss of the *mudaraba* agreement. Though, SHB has the right to redeem the *sukuks* in early time as long as the value of the *mudaraba* is at least equal to the face value of the *sukuks*. This may have the same effects of a purchase undertaking redemption at the face value of the *sukuks*, which is a form of guarantee of the principal amount. However, in this case it will always be dependent on the actual performance of the *mudaraba*. If the *mudaraba* does not make enough profit to cover the principal amount, SHB will not be able to perform this right. Neither the AAOIFI (2008) resolution, nor the AAOIFI (2010) *sharia* standards on *sukuk*, nor any other Islamic financial rule explicitly prohibits such a clause. Therefore, this innovative mechanism seems to be *sharia* compliant. This is also in line with the above-mentioned Islamic maxim that all transactions and clauses are permissible, unless explicitly forbidden.

6.3.11 Case 11: Sharjah Islamic Bank.

It is a surprising that until 2006, Islamic banks in GCC countries have not been active issuers of *sukuks*. The market had to wait until October 2006 for an Islamic bank to issue the first sizeable bank *sukuk* ever. The move came not from one of the larger Islamic banks in Saudi Arabia or Bahrain, but from a relatively smaller institution, Sharjah Islamic Bank (SIB), which was formerly known as the National Bank of Sharjah based in UAE, active in financial services. SIB is a Sharjah-based bank founded in 1976 and in 2004 converted into a fully *sharia* compliant bank (SIB, 2011). SIB is a publicly listed Islamic bank on the ADX (2011). In addition, SIB's objectives include offering many services parallel to conventional banking which includes leasing, equity investments, funds, private equity, venture capital, unit trusts, bonds and hire purchase. The market capitalisation of SIB as of 31 December 2010 was US$613million (Zawya, 2011). Moreover, the strength of SIB solid on the government of Sharjah who is SIB's largest single owner, which would provide support if needed (ADX, 2011).

6.3.11.1 The motivation of SIB's *sukuk*.

As a number of prominent Gulf-based Islamic financial institutions are lining up to raise *sharia* compliant money through *sukuks*. Islamic banks face the same kinds of challenges as conventional peers. One of these is amending their funding mix by raising more long-term funds in order to better manage maturity mismatches at a time when asset tenures are increasing. Issuing *sukuk* is probably the most appropriate way to achieve this goal, as the regional economic environment is currently benign and pricing is attractive. Therefore, SIB (2006) issued its first *sukuk* at US$225 million in 2006, the issuance is US dollar denominated. It is offering a floating annual rate of return designated as the three-month US dollar LIBOR plus 65 basis points payable quarterly and having tenure of five years. The structure of this transaction makes use of *musharaka* agreement. In addition, this issuance received (BBB) grade at the time of subscribed from Standard &Poor's, so this put it in lower medium grade category (Standard & Poor's, 2008b). It is important to note that SIB *sukuk* is the first-ever rating assigned by Standard & Poor's on bank *sukuk* trust certificates issued by a GCC institution.

The proceeds of the *sukuk* will ultimately be used for general funding purposes of SIB, which will sell a given percentage of a pool of assets to the issuer. These assets, originated, leased, and managed by SIB, will be co-owned by both SIB and the issuer.

SIB (2006) *sukuk* was issued to raise funds in accordance with *sharia* requirements and to achieve their liquidity manage goals. SIB *sukuk* issue price was 100% of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of US$10,000, subject to a minimum holding of US$100,000. The SPV (issuer) holds 88.3 per cent of the undivided co-owned assets.

In fact, the rating on SIB issuance is based on long-term counter-party credit rating, where in case the rental payments from the co-owned assets are insufficient to meet the required periodic amounts payable to *sukuk* holders, SIB will provide the necessary support to the issuer, to make up any shortfall, and meet the issuer's obligations toward certificate holders. In addition, SIB will undertake irrevocably to purchase the issuer's interest in the co-owned assets at the maturity.

However, SIB credit enhancement is a collateral aspect, which may be sought for a *sukuk* transaction in addition to the underlying assets. The purpose of credit enhancements is to reduce the risks to the Investors and to increase the rating of the *sukuk*. They could be internal or external and the assets sold would have value greater than the value for which they were bought for by the SPV.

6.3.11.2 The structure of SIB's *sukuk*.

The structure of this transaction makes use of *musharaka* agreement, which involves a special purpose company (SPC), SIB *Sukuk* Company Limited, incorporated in accordance with the laws of the Cayman Islands. The certificates represent a share of assets purchased by a SPV from the SIB. The distribution paid to holders of the certificates comes from income generated by the underlying assets. In addition, SIB will enter into the purchase undertaking in favour of the trustee. Under the purchase undertaking, SIB will undertake to purchase the issuer's rights, benefits and entitlements in and to the co-owned assets in consideration for the payment of a US dollar sum equal to the relevant exercise price following the delivery of an exercise notice by the trustee on SIB following either the occurrence of a dissolution event or on any day during the ten day period immediately preceding the fifth anniversary of the date of the purchase undertaking.

This type of structure is highly encouraged by the AAOIFI (2008) in view of the ability of these contracts to start-up businesses and venture capital. Such contracts create a balance to *ijara* structures that only tends to recycle existing assets. *Sukuk musharaka* can be applied to practically any asset class that can generate legitimate and predictable cash flows. Figure 6.16 explains the SIB's 2006 *sukuk* issuance.

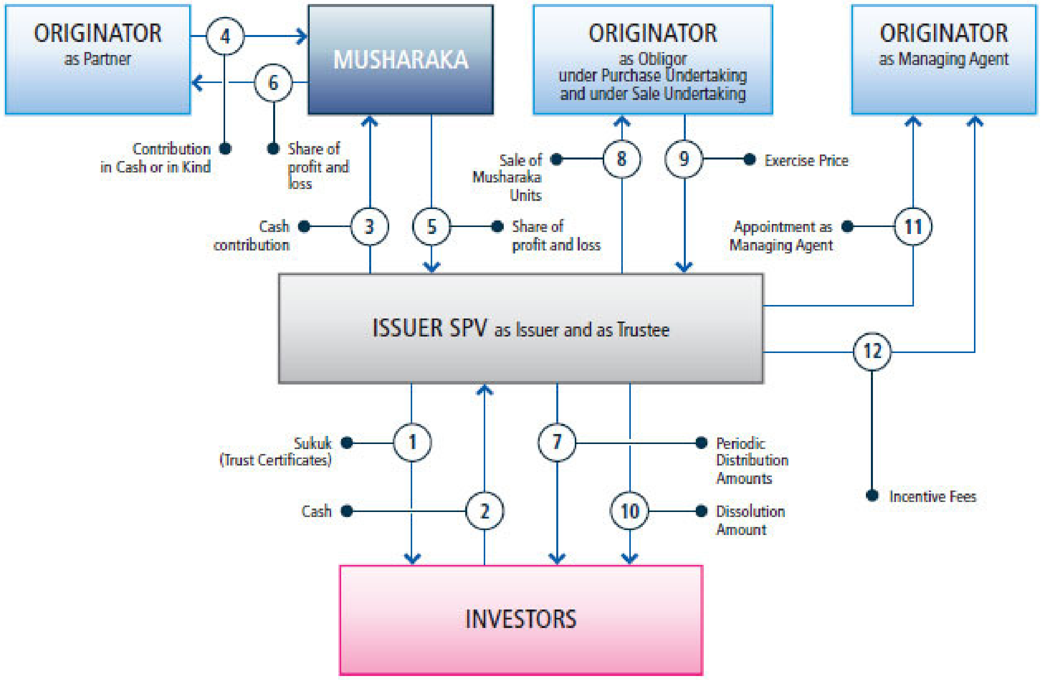

Figure 6.16. SIB's 2006 *sukuk* structure. Source: SIB, 2006.

6.3.11.3 The outcomes of implementing SIB's *sukuk*.

The agreement has been made in order to ensure that any unusual event that any periodical net income would fall below a particular amount, SIB will provide the necessary support to the issuer, to make up any shortfall, and meet the issuer's obligations toward certificate holders. In addition, SIB will undertake irrevocably to purchase the issuer's interest in the co-owned assets at the maturity. Therefore, the purchase undertaking adds a risk-free nature to SIB *sukuk* and exposes the investors to SIB's credit risk, rather than the risks of *the sukuk* assets. Thus, SIB *sukuk* is similar to a secured floating rate note. SIB's *sukuk* certificate pricing behavior in secondary markets is similar to the pricing behavior of floating rate notes, as it has been trading at 100 per cent of the purchase price since it was issued.

The Islamic identity tends to provide a bank with an immediate and true element of differentiation, which helps in building barriers to entry at a time when domestic, regional, and foreign competition in the Gulf is becoming more intense by the day. It is difficult for a conventional competitor to replicate the natural reputation an Islamic financial institution has with retail clients, who are far more sensitive to religious considerations than are corporations, which care more about service and price. This intangible but powerful asset bodes extremely well, as the key profit driver of Gulf banking today is the retail market, which displays the most attractive risk-return trade-off. SIB uses this to attract their clients.

The scenarios and consequences for the default of SIB's *sukuk* should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. Most *sukuk* holders are under the assumption that they have direct rights to the underlying assets in most *sukuk* structures, but this is not the case in SIB *sukuk* as the investors are taking the issuer's risk. In the event of default, the *sukuk* holders are not entitled to cause the sale or other disposition of any of the *sukuk* assets. The sole right of *sukuk* holders against the issuer shall be to enforce the obligation of the *sukuk* purchase undertaking, which gives the right to *sukuk* holders to sell the *sukuk* to SIB at face value. It was possible for the originator to grant a purchase undertaking to the trustee and for the exercise price to be a fixed amount determined in accordance with a formula and not by reference to the market value of the *musharaka* assets. The exercise price would therefore typically have been, in the event of a default or maturity, equal to the face amount of the *sukuk* plus any accrued but unpaid periodic distribution amounts. The investors were therefore 'guaranteed' to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure.

The structure of the SIB *sukuk* issuance seems not to comply with the AAOIFI (2010) or AAOIFI (2008) resolution. Since the premise for this ruling has been that *sukuk al-musharaka* are analogous to equity-based instruments and therefore the partners in the *musharaka* must take the risk of both profit and loss.

6.3.12 Case 12: Sorouh Real Estate Company PJSC.

Sorouh is a real estate development company based in the UAE. It is has a range of master developments that are high profile and innovative within the UAE. These developments range from commercial, community, hotel and resort, leisure, as well as residential and retail. Sorouh was established in June 2005 with the purpose of developing real estate projects in Abu Dhabi with a vision of turning the emirate into a major investment destination. It has since benefitted from the government decision in 2005 to allow foreigners buy for the first time. It is also launching a unit in Dubai that it will use to make overseas acquisitions and is setting up companies in Egypt and Morocco to start commercial, residential and lodging construction projects (Sorouh, 2011). Sorouh's shares have been listed on ADX (2011) in December 2005. The market capitalisation of Sorouh as of 31 December 2010 was US$1,162 million (Zawya, 2011).

6.3.12.1 The motivation of Sorouh's *sukuk*.

In fact, as part of Sorouh's partnership with the Abu Dhabi Government in its Plan 2030, it has been awarded the contract to produce a master plan for three investment zones in Abu Dhabi: Lulu Island; Shams Abu Dhabi on Al Reem; and Seih Sdeirah, the site of the Alghadeer development (Sorouh, 2011). The company is engaged in establishing, developing, owning, managing, investing, leasing, and renovating real estates and buildings; commercial, medical, learning, and residential centers. It also owns hotels, tourist amusement and sports resorts, playgrounds, and industrial structures in addition to owning, leasing and registering patents and copyrights. Thus, Sorouh *sukuks* were issued to raise funds in accordance with *sharia* requirements and to achieve the previous missions.

Sorouh issued three classes of *sukuks* in 2008 (A, B and C) available in local currency to UAE nationals and foreigners. The issuances are equivalent to US$751.7 million class A, US$68.3 million class B and US$273.3 million class C in 2008, the issuances are AED denominated, offering an a floating annual rate of return designated as the one-month AED EIBOR plus 200, 250 and 350 basis points respectively, payable monthly and having a tenure of 4 years due 2012 and legal final maturity of 2015 (Sorouh, 2008).

The transactions are the first Islamic securitisations of the land and associated rights to payment (the assets) from a pool of UAE obligors. The obligors are primarily GCC real estate developers who pay in scheduled instilments to purchase undeveloped land, concentrated within two real estate developments within Abu Dhabi, the capital city of the UAE. The purchase contracts were originated by Sorouh who have been granted land on preferential terms by the government. Furthermore, the transaction is also the world's largest *sharia* compliant securitisation to date includes *sharia* compliant tranches and represents one of the few fully distributed asset-backed transactions since the advent of the credit crisis. Therefore, it complies with *sharia* asset ownership principles to an extent that most deals in the sector have failed to do.

The prices of the three issuances were 100 per cent of the aggregate face value of the *sukuks*, and *sukuks* issued in denominations of AED 100,000. They are subject to a minimum holding of AED 500,000. The proceeds of issuances of the *sukuks* certificates will be used to invest in accordance with the investment plan under the restricted *mudaraba* agreement, the *mudaraba* capital will be used to purchase the initial *mudaraba* assets and to fund a senior expenses reserve, an infrastructure fund and a liquidity reserve. These assets consist of title to land blocks in the master developments and an assignment of all of 109 the rights, title and benefit of Sorouh under the sale and purchase agreements, including the right to Subdeveloper payments there under. The securitised assets are composed primarily of plots of land and associated rights to payment from the obligors under the terms of the 109 plot sale and purchase agreements (PSPA).

The investors of this *mudaraba* participated in the ownership of land in Abu Dhabi as well as instilment sales receivables and project assets, which proved an efficient means to raise non-recourse funding in 2008 as the global markets worsened significantly. The deal represents the equivalent of a receivables securitisation without actually selling debt. The non-recourse nature of the deal means that the transaction is a true sale transaction and the receivables may be derecognised from the originator's balance sheet. In addition, the structure in the case of an income from the assets is distributed as profit to the investors with separate amounts being used to pay the monthly profit and repurchase a share of the trustee's interest in the assets providing the principal amortisation mechanism. In addition, the three Sorouh classes *sukuks* certificates (A, B and C) received (A),(BBB+) and (BBB-) grade respectively from Standard & Poor's (2011) ratings services, so this put the three issuances between high or higher medium grade and lower medium grade category.

6.3.12.2 The structure of Sorouh's *sukuk*.

The Sorouh *sukuks* issuances are based upon the structure of *mudaraba*, which in turn is based on AAOIFI (2010) standards (17), (21) and (13). The structures of Sorouh *sukuks* were under an asset transfer agreement, so there will be a transfer and registration of title of the land to Sorouh Abu Dhabi Real Estate LLC (PropCo). Thus, the deal represents the equivalent of a receivables securitisation without actually selling debt. The non-recourse nature of the deal means that the transaction is a true sale transaction. As a result, Sun Finance Limited, an SPV incorporated under the laws of Jersey, will issue three classes of AED denominated notes to fund the purchase of the Assets. The transactions involve a dual SPV structure; first Sorouh will transfer the land and assign the PSPA instilments and all the associated rights under the contracts to Sorouh Abu Dhabi Real Estate LLC ('PropCo'), a company incorporated in Abu Dhabi, so as to isolate the assets from Sorouh. The second, the issuer will extend an inter-company loan to PropCo, and then PropCo will create security interests over all of its assets in favour of the local Security trustee acting on behalf of the issuer.

The decline in confidence in the credit and capital markets has created an opportunity for the launch of a new investment product among leading GCC investment entities. Several *sukuks* funds were launched as an alternative investment product for many retail and institutional investors. Figure 6.17 explains Sorouh's 2008 *sukuk* issuance.

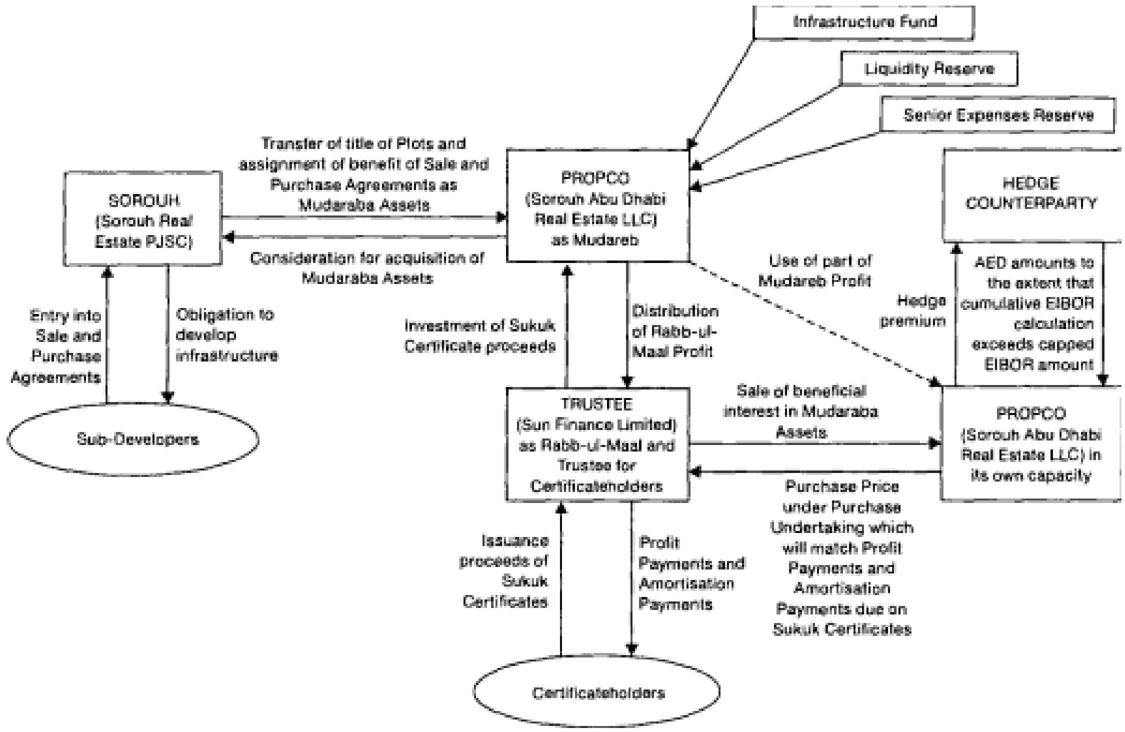

Figure 6.17. Sorouh's 2008 *sukuk* structure. Source: Sorouh, 2008.

PropCo (SPV), in its own capacity and not as a *mudarib*, will enter into an irrevocable purchase undertaking in favour of the investors, pursuant to which PropCo will undertake to purchase, on each exercise date, a certain portion of *sukuk* holders' beneficial interest in the plots forming part of the *mudaraba* assets. The portion of the *sukuk* holders' beneficial interest to be purchased on each exercise date will be calculated by reference to all, or a portion of, the amortisation payments, which will be paid by Sun Finance Limited (SPV) in its capacity as trustee in order to amortise the *sukuk* certificates on the relevant periodic distribution date.

6.3.12.3 The outcomes of implementing Sorouh's *sukuk*.

In case of Sorouh *sukuks*, 79 per cent of the capital of *the mudaraba* enterprise will be invested in tangible assets. As a consequence, this transaction is in accordance with the relevant standards of AAOIFI (2010) on *mudaraba*. It seems this structure conforms to AAOIFI (2008) resolution.

The scenarios and consequences for the default of Sorouh's *sukuks* were clearly laid out for investors in order for them to assess their risk taking in a transparent manner. As Sorouh's *sukuks* investors have direct rights to the underlying assets, they are taking true risk in the underlying assets. Any losses are passed on to the SPV and, subsequently, to the *sukuks* holders, who are then directly exposed to asset price risk and, as a result, its liabilities. To illustrate, the transaction includes a transfer and registration of title of the land to Sorouh Abu Dhabi Real Estate LLC (PropCo) as issuer. This registered transfer, as well as the assignment of the PSPA rights is governed by local Abu Dhabi law, while the remaining security documents are governed by English law.

The sole right of *sukuks* holders against the issuer shall be to enforce the obligation of the *sukuks* purchase undertaking, which gives the right to *sukuks* holders to sell the *sukuks* to the trustee and for the exercise price to be a fixed amount determined in accordance with a reference to the market value of the *mudaraba* assets. The investors were therefore not guaranteed to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure. As a result, this agreement seems to be a *sharia* compliant transaction.

6.3.13 Case 13: Tamaweel PJSC.

Tamaweel is a financial solutions provider company based in the UAE. Its financing solutions are structured into two main divisions: home financing and commercial financing. It is primarily engaged in *sharia* compliant financing and investment activities, such as *ijara*, *murabaha* and *istisna*, and is also involved in the business of property development and trading (Tamaweel, 2011). Tamaweel was established in March 2004 as a limited liability company and in July 2006, it moved to a public company listed on the DFM (2011). Tamaweel had funded itself through wholesale credit, but the onset of the global financial crisis in 2007 revealed the weaknesses of this business model after it was shut out of capital markets. The company's funding difficulties were thought to have been resolved by an AED 374.7 million deal in which DIB increased its shareholdings in Tamaweel from 21 per cent to 58.3 per cent, taking control of the company (Standard & Poor's, 2008a). The market capitalisation of Tamaweel as of 31 December 2010 was US$174 million (DFM, 2011; Tamaweel, 2011).

6.3.13.1 The motivation of Tamaweel's *sukuk*.

Tamaweel (2007; 2008a; 2008b) issued three *sukuks* in July 2007 and January and July 2008. Tamaweel issued its first *sukuk* (nonconvertible *sukuk*) at US$210 million in July 2007, and had four *ijara sukuks* tranches (classes A, B, C and D) (Tamaweel, 2007). The underlying assets that back this lease to buy *ijara* are single-family homes (villas). This issuance was US dollar denominated, and offering a floating annual rate of return designated as the one-month US dollar LIBOR plus 35, 120, 395 and 1000 basis points respectively payable monthly with a tenure of 30 years. Each tranche received different rating from Fitch ratings services agency (Zawya, 2011), Table 6.3 shows these classes. Overall these issuances are categorised between the high or higher medium and highly speculative grade category; however, 85 per cent of this transactions in terms of size is an (AA) grade which means this structure is high or higher medium grade.

Table 6.3: *Illustration of Tamaweel's 2007 issuance and its four ijara sukuk tranches.*

Class of Notes	Principal Amount (US$ million)	Variable Return	Fitch Rating
A	177.45	LIBOR + 0.35%	AA
B	15.33	LIBOR + 1.20%	BBB+
C	9.87	LIBOR + 3.95%	BB-
D	7.35	LIBOR + 10.00%	N/A
Total	210		

Source: Tamaweel, 2007.

Although these transactions were a true assets sale, there were multiple classes (A, B, C and D) of investors, with each class having a more senior legal claim to the secured assets similar to securitised mortgages. Thus, risks relating to *sukuk* class one purchases arise owing to the waterfall effect: if payments are slow, delinquencies rise and defaults increase.

While the second Tamaweel (2008a) issuance issued in January 2008 based on *ijara* form and was asset based, exchangeable *sukuk***,** which was US dollar denominated, US$300 million in size, offering an indicative annual rate of return of 4.310 per cent payable quarterly and having a tenure of five years. It is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under the *sukuk* certificates. The exchange price of the exchangeable *sukuk* has been adjusted from US$2.2711 per share to US$2.2021 per share. The adjusted exchange price has been calculated following the approval of a dividend of AED 0.218 per nominal share of AED 1 by Tamaweel's annual general meeting of shareholders held on 31 March 2008. This issuance received (A) grade rating at the time of subscribed from Fitch ratings services, putting it in the high or higher medium grade category.

The third issuance (Tamaweel, 2008b) was in July 2008 (Nonconvertible *sukuk* II) based on *istisna* form and was AED denominated, AED 1,100 million or equivalent to US$299.5 million in size, offering a floating annual rate of return designated as the three-month AED EIBOR plus 225 basis points payable quarterly and having a tenure of five years. This issuance received a rating of (A) at the time of subscribed from Fitch ratings services, so this put the issuance in high or higher medium grade category.

In fact, villas were scarce in the booming real estate market in UAE before 2007, with limited available expansion space and infrastructure. Such properties are thought to be more resistant to price volatility and depreciation compared with apartments, of which there are many, more, and villa purchasers tend to be families, rather than more transient, single residents. The first Tamaweel *sukuk* freehold titles to the underlying properties were transferred to the *sukuk* holders with the associated *ijara* cash flows.

The complex structure of the first Tamaweel *sukuk* issuance reflects its objectives, to meet its business cycle, while the company is engaged in establishing, developing, owning, managing, investing, leasing, and renovating real estates and buildings; commercial, and residential properties. Thus, Tamaweel *sukuk* was issued to raise funds in accordance with *sharia* requirements and to achieve its goals.

The proceeds of the issuance of the *sukuk* specifically will be used by the issuer to pay the purchase price for the assets including various fructify related rights relating to the properties such as the rental payments under the leases and certain other rights and interests related to the properties. Consequently, for this transaction to be *sharia* compliant, property titles are registered in the name of the SPV that issued the *sukuk* and the *sukuk* holders. Any losses are passed on to the SPV and, subsequently, to the *sukuk* holders, who are then directly exposed to asset price risk and, as a result, its liabilities.

The first issuance price was 100 per cent of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of US$1,000. It is subject to a minimum holding of US$100,000. The proceeds of issuances of the *sukuk* certificates will be used to invest in accordance with the operation plan under the *ijara* agreement. In the first issuance, the deal represents the equivalent of a receivables securitisation without actually selling debt. The multiple classes (A, B, C and D) of investors, with each class having a more senior legal claim to the secured assets similar to securitised mortgages. Thus, risks relating to *sukuk* class one purchases arises owing to the waterfall, effect if payments slow, delinquencies rise and defaults increase since the transaction is a true sale transaction and the receivables may be de-recognised from the originator's balance sheet. Subsequently, the *sukuk* holders are then directly exposed to asset price risk and, as a result, its liabilities.

In the second issuance of Tamaweel (US$300 million) price was 100 per cent of the aggregate face value of the *sukuk*, which was issued in denominations of US$10,000, subject to a minimum holding of US$100,000. The transaction was asset-based, where the investor's legal rights for the ownership of the underlying assets is limited. The proceeds of the issuance of the *sukuk* specifically will be used by the issuer to purchase a 99 per cent co-ownership of Tamaweel's undivided right, title and interest in the initial assets

The third issuance AED 1,100 million or US$299.6 million was special issuance contains two types of *sukuks*, which merge into one asset. It has a portfolio of leased assets, residential *ijara* lease-to-own assets, and a portfolio of *istisna* property assets that are under construction. This issuance was also AED denominated. The price was 100 per cent of the aggregate face value of the *sukuk*, and *sukuk* issued in denominations of AED 100,000. It is subject to a minimum holding of AED 500,000. The prospectus has no clear mention of whether the *sukuk* issue is asset-based, but there are some signs this is the case on transferring the portfolio of assets, the originator has given no assurance that any rights, title and interest in and to the portfolio assets has been, or will be, transferred to the trustee.

6.3.13.2 The structure of Tamaweel's *sukuk*.

The first issuance was based upon the complex structure of *ijara*, as nonconvertible *sukuk* amounted US$210 million in July 2007. This issuance had four *ijara* tranches (classes A, B, C and D). Figure 6.18 shows how Tamaweel's 2007 *sukuk* issuance works. The transaction involves a dual SPV companies; Tamaweel Residential ABS CI (1) Ltd (offshore SPV) as an issuer, a limited liability company incorporated in the Cayman Islands for the sole purpose of acquiring the assets it will purchase under the issuer acquisition agreement, including usufruct related rights including the rental payments under the leases. The second (UAE SPV) is Tamaweel Properties (1) Limited (TPL), a private company with limited liability incorporated in the Dubai international financial centre (DIFC) as Tamaweel's successor in title in respect of the properties and leases upon the sale of such properties by Tamaweel to TPL, and subsequently some of these assets and rights will be sold and transferred by TPL to the issuer (offshore SPV). Tamaweel will act as an originator of the leases and, prior to the sales described above, the owner of the properties and the lessor under the leases and will be servicer. This transaction in turn is based on AAOIFI (2010) standard (9), *sukuk al-ijara*. The structure of Tamaweel *sukuk* was under an asset transfer agreement, so there will be a transfer and registration of title of the land to Tamaweel Residential ABS CI (1) Ltd (offshore SPV).The underlying assets that back this lease to buy *ijara* are single family homes (villas). Thus, the deal represents the equivalent of a receivables securitisation without actually selling debt. The non-recourse nature of the deal means that the transaction is a true sale transaction.

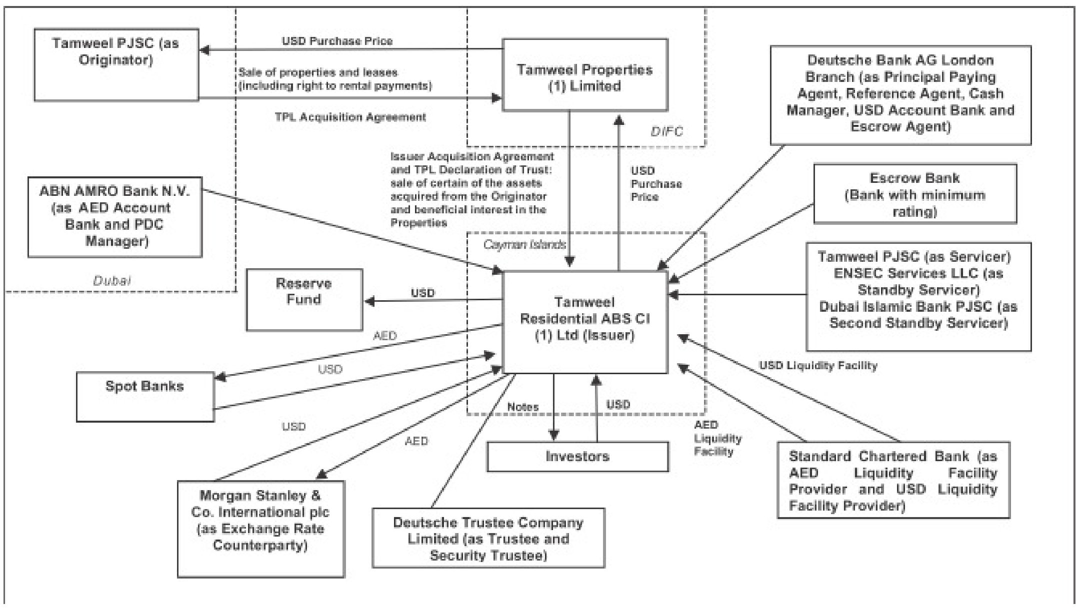

Figure 6.18. Tamaweel's 2007 *sukuk* structure. Source: Tamaweel, 2007.

The second issuance (US$300 million) was based upon the simplest *ijara* structure, with a convertible option (Tamaweel, 2008a). Figure 6.19 shows Tamaweel's January 2008 *sukuk* issuance. The transaction involves one SPV company, Tamaweel Funding Limited (SPV) as an issuer and trustee, a limited liability company incorporated in Jersey (Channel Islands), which is wholly owned by Bedell Trustees Limited. Tamaweel PJSC will act as an originator of the L\leases and managing agent. The structure of Tamaweel *sukuk* was under an asset transfer agreement, so there will be a transfer 99 per cent of the Tamaweel undivided right, title and interest in a portfolio of leased assets under the purchase agreement (co-ownership interest). It is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under the *sukuk* certificates. Under purchase undertaking, the obligor shall undertake to purchase all or part of the Trustee's Co-ownership interest at the relevant exercise price calculated by reference to the proportion that the aggregate face amount of the certificates that are the subject of the relevant voluntary early redemption. On the other hand, the trustee shall execute a sale undertaking in favour of the obligor pursuant to the sale undertaking, subject to the issuer being entitled to redeem the certificates early.

In addition, the exchange price has been adjusted from US$2.2711 per share to US$2.2021 per share. The adjusted exchange price has been calculated following the approval of a dividend of AED 0.218 per nominal share of AED 1 by Tamaweel. Unlike asset-backed *sukuk*, the certificate holders have no recourse against any other assets of the issuer, or the trustee, or any right to cause the sale or other dispersion of any of the trust assets, except during the initial purchase undertaking. The unique part of this *sukuk* is the company made an in-kind contribution of the overriding royalty interest in the lease properties.

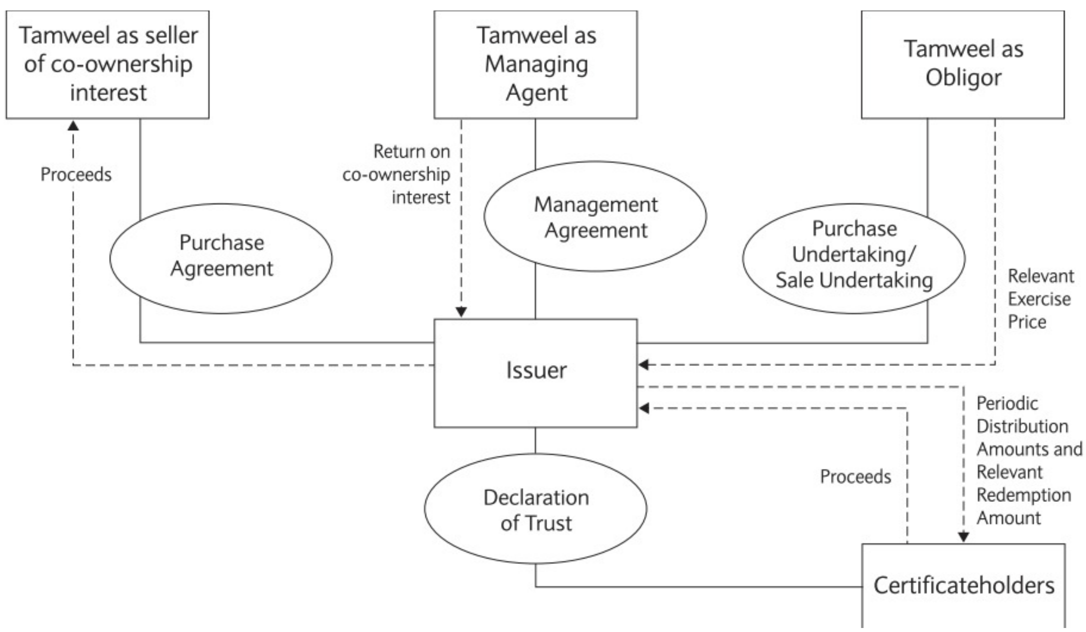

Figure 6.19. Tamaweel's January 2008 *sukuk* structure. Source: Tamaweel, 2008a.

The third (Tamaweel, 2008b) issuance (AED 1,100 million or US$299.6 million) was special, containing two types of *sukuks* that merge into one asset, which can be seen in Tamaweel's July 2008 *sukuk* issuance (see Figure 6.20). *Ijara sukuk* is used to securitise assets. *Istisna* also is used as a forward purchase agreement. In this issuance, Tamaweel turned from asset-backed securitisation to an asset-based guaranteed deal. *The sukuk* is structured with the special-purpose entity Tamaweel *Sukuk* Limited (TSL) as issuer and trustee, in front of Tamaweel PJSC (Tamweel) as obligor, service agent, the seller of underlying assets, provider of a *sharia* compliant liquidity facility and purchase undertaker (a collection of roles that together form the guarantees backing the issue).

According to *sharia* law, for *sukuk* to be tradable, it has to represent an ownership interest in a physical entity, instead of just money. To comply with this rule, 99 per cent of the assets representing the *sukuk* assets have to be in physical form. Consequently, Tamaweel sells the rights, title and interest in a pool of *sharia* compliant assets to issuer TSL which will hold them as trustee on behalf of the *sukuk* holders, so SPV issues *sukuk*, which represent an undivided ownership interest in an underlying asset or transaction. The investors subscribe for *sukuk* and pay the proceeds to issuer (SPV). The originator enters into an *istisna* arrangement with the trustee, pursuant to which originator agrees to manufacture or construct certain assets and undertakes to deliver those assets at a future date, and the trustee agrees to commission those assets for delivery at such future date. The trustee pays a price (typically by way of staged payments against certain milestones) to originator as consideration for the assets in an aggregate amount equal to the principal amount. Subsequently, trustee undertakes to lease the assets to originator under an *ijara* arrangement for an overall term that reflects the maturity of the *sukuk*. The originator makes payments of advance rental prior to the delivery of the assets; and actual rental following the delivery of the assets, at regular intervals to trustee in amounts which are equal to the periodic distribution amount payable under the *sukuk* at that time.

These amounts may be calculated by reference to a fixed rate or variable rate such as EIBOR rate in the Tamaweel case and subject to mutual agreement of the parties in advance. As service agent, however, Tamaweel itself is committed to collect the returns from the assets sold, and will provide an optional *sharia* compliant liquidity facility to TSL, with which TSL can make up any shortfall between returns from the assets and payments due to holders. If asset yields are in excess of holder payments, the surplus will form a reserve account that can fill future payment shortfalls, or if still standing at maturity, be captured by Tamaweel.

It is important to note that the offering circular has no clear mention of whether the *sukuk* issue is asset-based, but there are some signs this is the case on transferring the portfolio of assets, the originator has given no assurance that any rights, title and interest in and to the portfolio assets has been, or will be, transferred to the trustee. This transaction in turn is based on AAOIFI (2010) standard (12), *istisna* and parallel *istisna*. The structure of Tamaweel *sukuk* was under an asset transfer agreement, so there will be a transfer of the Tamaweel undivided right, title and interest in a portfolio of leased assets under the purchase agreement (co-ownership interest). It is expected to generate periodic returns equal to the periodic profits that the *sukuk* holders are entitled to under the *sukuk* certificates.

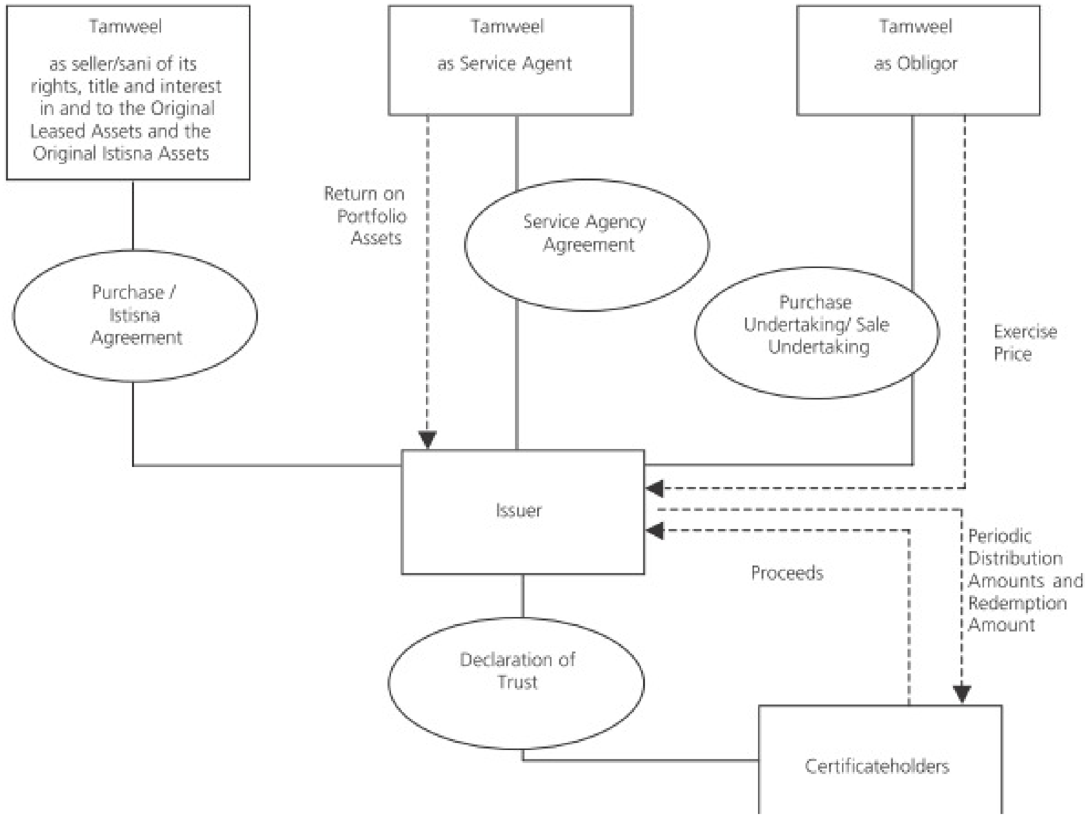

Figure 6.20. Tamaweel's July 2008 *sukuk* issuance. Source: Tamaweel, 2008b.

6.3.13.3 The outcomes of implementing Tamaweel's *sukuk*.

In fact, villas were scarce in the booming real estate market before 2007, with limited available expansion space and infrastructure. Such properties are thought to be more resistant to price volatility and depreciation compared with apartments, of which there are many, more, and villa purchasers tend to be families, rather than more transient, single residents. The first Tamaweel *sukuk* freehold titles to the underlying properties were transferred to *the sukuk* holders with the associated *ijara* cash flows. Property titles are registered in the name of the SPV that issued *the sukuk* and *the sukuk* holders. Any losses are passed on to the SPV and, subsequently, to *the sukuk* holders, who are then directly exposed to asset price risk and, as a result, its liabilities. This transferring and registering ownership of assets to *sukuk* holders has turned to a debate between scholars and lawyers, because the fees of such registration are costly for the issuer. However, legal ownership offers *sukuk* holders protection in case of Tamaweel, for example, went into insolvency, this type of securitisation should continue to perform regardless of the financial distress of the originator.

Certainly, the process of liquidating assets will be much easier for *sukuk* holders. From a *sharia* perspective, this transaction is permitted because investors take the risk of the underlying asset while entering into a financial contract rather than the credit risk of the counter-party.

In the second issuance, the transaction is the same but the difference is that the *ijara* structure in this case was associated with a convertible option, to nominal share of AED 1 by Tamaweel. The proceeds of the issuance, will be used by the Issuer to pay the purchase price for the assets purchased by Tamaweel from TPL under the Issuer Acquisition Agreement (including various usufructory related rights relating to the properties such as the rental payments under the leases and certain other rights and interests related to the properties) and, as at the issue date, to pay the balance of such proceeds not used to purchase the initial properties, into the escrow account. In this case there is direct links to actual assets, which is a condition of *sharia*. Therefore, this transaction is related to the point raised by the AAOIFI (2008) where *sukuk* holders should stand in the line of owners of underlying assets and not in the line of creditors.

Nevertheless, the two previous issuances are acceptable, but the structures are problematical from the legality perspective, because the SPV of the Tamaweel *sukuk* issuances were located (the Cayman Islands), far from Dubai, the originator's country. However, this typical offshore SPV leads to a problem whereby there is no uniform law, insofar as the offshore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs. Indeed, there is a significant legal unpredictability governing *sukuk* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the UK, there can be additional impediments arising from the enforceability of foreign judgments' in the absence of bilateral treaties for reciprocal enforcement of judgments. Therefore, this issue leads to a weakness on the part of the local court or legislation as well as legal confusion with respect to certain laws' enforceability in case the issuer defaults.

Conversely, the third issuance was based on two types of *sukuks*, which merge into one asset, *ijara sukuk* was used to securitise assets, and *istisna* was used as a forward purchase agreement. According to *sharia* law, for the *sukuk* to be tradable, it has to represent an ownership interest in a physical entity, instead of just money. To comply with this rule, 99 per cent of the assets representing the *sukuk* assets have to be in physical form. Thus, Tamaweel sells the rights, title and interest in a pool of *sharia* compliant assets to SPV, which will hold them as trustee on behalf of the *sukuk* holders, so SPV issues *sukuk*, which represent an undivided ownership interest in an underlying asset or transaction. Although the *istisna* contract can be used for providing the facility for financing the construction of houses or plant projects, the price must be fixed with the consent of the parties involved, but the foggy nature of the offering circular of whether the *sukuk* issue is asset-based, makes *sukuk* is the likelihood of linked to the credit of the originator that raises the funds, not to physical assets. Subsequently it is not permitted according to *sharia* law. In addition In the case of the manager acts as a partner of the *sukuk* holders, it is also unlawful for him to guarantee the return of capital to the *sukuk* holders as it would interrupt the partnership in the event of losses / in the sharing of profits.

6.3.14 Case 14: The Dubai World Corporation

The Dubai World Corporation (DP World), based in the UAE, is active in international marine terminal operations and development, logistics and related services. It operates more than 60 terminals across six continents, with container handling generating around 80 per cent of its revenue. In addition, the company has new developments and major expansions underway in 10 countries. However, the company does not currently operate in the US, where its purchase of a number of US ports led to great controversy. The company was founded in 2005 by merging Dubai Ports Authority and Dubai Ports International (founded in 1999) and therefore indirectly by the Government of Dubai (DP World, 2011). It purchased Peninsular and Oriental Steam Navigation Company (P&O) of the UK in 2006 for US$7 billion, which was at the time the world's fourth largest ports operator. DP World is listed on NASDAQ Dubai (2011) in 2007 and to the official list of the LSE in June 2011. Headquartered in Dubai, DP World’s market capitalisation as of 31 December 2010 was equivalent to US$2,796 million (Zawya, 2011).

6.3.14.1 The motivation of DP World’s *sukuk*.

The originator in this transaction who required financing is DP World Limited (DP World), a subsidiary of the government-owned company Dubai World. DP World incorporated a new SPV in the Cayman Islands to facilitate the transaction in May 2007 DP World *Sukuk* Limited (DP World *Sukuk*). The *sukuk* was issued in order to fund business needs of the company, which had just come out of a massive restructuring strategy on part of its parent company and had major expansion plans. DP World invests the capital in its business activities in accordance with an agreed *sharia* compliant investment plan (essentially constituting the development of Terminal 2 at Jebel Ali port in Dubai) designed to generate profits, which will be used to service the certificates.

DP World's (2007) *sukuk* was issued in July 2007. The issue is dollar denominated, US$1,500 million in size, offering an indicative annual rate of return of 6.25 per cent payable semi-annually and having a tenure of 10 years. DP World *Sukuk* was issued in accordance with *sharia* requirements. The issue price was 99.765 per cent of the aggregate face value of the *sukuk*, which means this *sukuk* was issued at a 0.25 per cent discount. DP World's *sukuk* was issued in denominations of US$10,000, subject to a minimum holding of US$100,000. The DP World *Sukuk* Limited (SPV/Issuer) is owned by DP World *Sukuk* (SPV/ issuer) and DP World limited (obligor/ *mudarib*), sharing ratio, which in this case has been affixed as 99% to the SPV, in order to be passed on to the *sukuk* holders, and one per cent to DP World limited. This form of agreement in this case is characterised by a pre-determined profit sharing ratio.

DP World's *sukuk* issuance received (BBB-) grade at the time of subscription but later received (BB+) grade from Standard & Poor's (2008b) ratings services, putting it in the speculative or highly speculative grade category. The ratings reflect the SACP of DP World and do not include support or constraint from its ultimate parent, the Dubai government. According to Fitch's DP World's links with the Dubai government are moderate given the absence of any formal financial guarantees and the fact that DP World's assets remained ring-fenced during the debt restructuring process of its direct parent company, Dubai World.

6.3.14.2 The structure of DP World's *sukuk*.

The DP World *sukuk* is based upon the structure of *mudaraba*, where DP World Limited acts as the manager of the partnership who invests the capital into pre-approved business activities while the DP World *Sukuk* Limited (SPV) is appointed as the financier who provides the capital (collected through the proceeds of *the sukuk*). There is a pre-determined profit sharing ratio of 99 per cent to the SPV, in order to be passed on to *the sukuk* holders, and one per cent to the DP World limited. The agreement has been made in order to ensure that only 6.25 per cent per annum is passed on to the certificate holder because anything in excess will be paid to DP World Limited (the manager) as incentive fee while any shortfall will have to be made up by DP World limited through short term liquidity financing.

The profit made with the *mudaraba* is the source of the periodic payments paid by SPV as the issuer to the *sukuk* holders. This would imply that the periodic payments to the *sukuk* holders were not fixed. Nevertheless, the periodic distribution amounts are based on a fixed rate of 6.25 per cent per annum. This performance fee (if any) would be calculated at the end of the *mudaraba* term and upon liquidation of the *mudaraba*. The risk of passing any losses of this enterprise to the investors may also be mitigated through the use of a purchase undertaking granted by the originator (DP World Limited) in favour of the issuer SPV (DP World *Sukuk* Limited) so that in the event that proceeds from the *mudaraba* enterprise are insufficient in meeting any amounts payable by the issuer SPV to the investors, the issuer SPV may call on the originator (DP World Limited) to purchase its *mudaraba* interests for a price which represents their market value.

The structure makes use of a purchase and sale undertaking that ensures principal amount is paid in full on maturity of the issue, or on redemption. The purchase undertaking comes into effect during the life of the *sukuk* if at any time there is a default on any payment or change of control in the parent company or any such major event. This indirectly assures the *sukuk* holders of the periodic profit payments as well as the redemption amount. According to the sale undertaking, the SPV is obliged to sell the assets to DP World Limited (obligor/*mudarib*) under certain tax events that add to the costs of the transaction due to the additional costs of taxes. Once again, the exercise price will be equal to the principal amount of the *sukuk* holders and will be paid through to them in order to redeem the *sukuk*. Figure 6.21 explains DP World's 2007 *sukuk* structure.

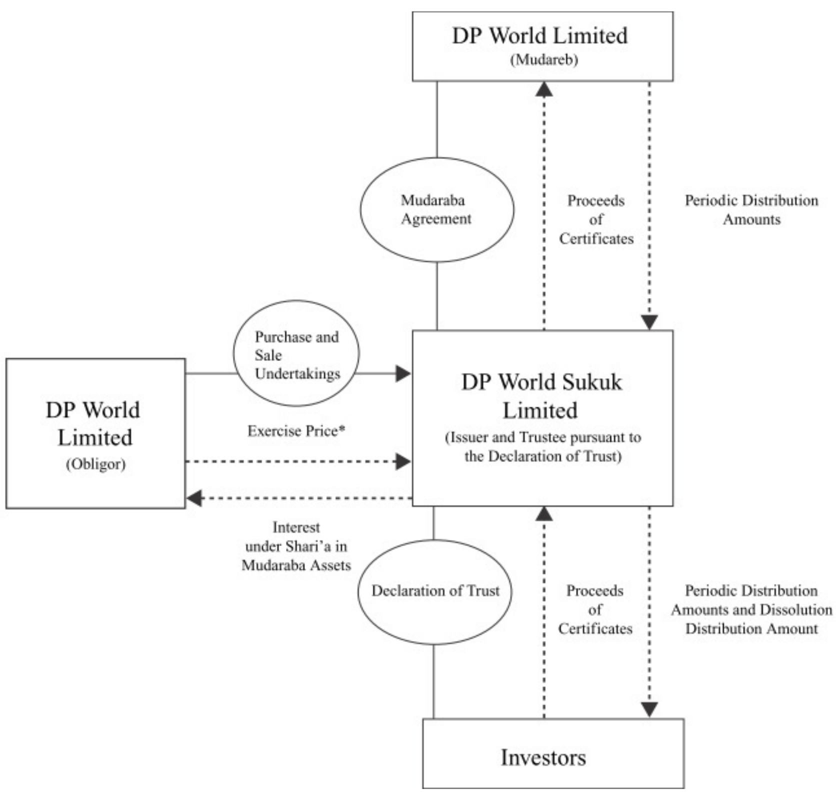

Figure 6.21. DP World's 2007 *sukuk* structure. Source: DP World, 2007.

6.3.14.3 The outcomes of implementing DP World's *sukuk*.

This structure has certain features that deal with the mitigation of the risks of equity-based *sukuk*. It might look like an equity-linked security because the source of the payment to the *sukuk* holders is the profits of the *mudaraba* distributed according to an agreed percentage of the profit (99% for the SPV and 1% for DP World Limited). Such a profit distribution based on a 99/1 ratio used to be very common in *sukuk* structures.

Nevertheless, a closer look at this structure clarifies that both the periodic payments and the redemption payment to the *sukuk* holders are fixed and guaranteed returns. Note that a *mudaraba* agreement, being an investment partnership, cannot specify or guarantee a pre-determined rate of return as in the case of sales contracts such as *ijara*, *salam* or *murabaha*, therefore the rate of profit is only indicative. However, if insufficient profit is generated, then DP World will be required to provide *sharia* compliant funding to meet the payments in full. The credit risk therefore is eventually DP World's and in a way DP World will ensure that *sukuk* holders do receive the indicated 6.25 per cent rate of return. Whereas, any surplus over the periodic payments to the *sukuk* holders was for the originator as an incentive fee, annulling the possibility to pay the real (excess) profits of the *mudaraba* to the *sukuk* holders as would be expected from equity-linked securities.

Furthermore, the structure weakened the equity character of this issuance, since the losses were born by the originator and the periodic returns to the *sukuk* holders were fixed return, regardless of the performance of the underlying projects. The purchase undertaking guaranteed the principal amount of the *sukuk* holders, regardless of the possible appreciation of deprecation of the assets. Through this purchase undertaking, the originating party was guaranteeing the principal amount of the *sukuk* holders and this is not in line with the concept of profit-and-loss-sharing.

As a result, all these features made the DP World *sukuk* resemble conventional bonds and lose their own authenticity based on the third ruling of the AAOIFI (2008) resolution, and AAOIFI's (2010) *sharia* standard (5 & 13) on *mudaraba*.

6.4 Conclusion and Summary Analysis of the Case Study Results

As discussed in Chapter 1, the purpose of the study is to conduct a comprehensive investigation of *maslaha* as a new approach for Islamic bonds in theory and practice, and to present a framework integrating the principles of *sharia* with those of conventional approaches to pricing of bonds. It is imperative that the principles of *sharia* when applied to Islamic finance operations do not hinder competition and preserve the rights and obligations provided under the law of the land. Some scholars argue that it is impractical to determine the validity of contracts by means of the intentions of the parties due to the difficulty of identifying them, and that they should be judged on their form and appearance (Abozaid, 2008).

The consideration of public interest represents one of the promising bases of *sharia* for addressing the needs of Muslim societies at large. With the changing nature of human civilization and needs, *sharia* has given consideration to *maslaha* as a source of law in order to accommodate natural development and social changes and needs.

The principles of *maslaha*, considering its benefits, are aimed to shape human needs, hence is a tool which allows creativity, dynamism and flexibility in terms of social policies. Therefore, the foundations of Islamic economics, the parent science of Islamic finance, are based on the concepts of economic wellbeing, universal brotherhood and justice, equitable distribution of income, and freedom of the individual within the context of social welfare. Given that the charging of interest, sell pure debt, speculative transactions or deal with contract contain *gharar* is strictly forbidden by *sharia.*

Consequently, *sukuk* is instrument constructed in such a way as to avoid the accrual of interest, and thus be fully compliant with Islamic principles. It has emerged as a key means for financial institutions, sovereign borrowers, and multinational corporate borrowers to raise finance as an alternative to conventional financing. It comes in various forms, according to the issuer's requirements. It can be issued to help finance specific new projects, while asset-specific *sukuk* is often employed to sell the beneficiary right of existing assets. It is founded on the part-ownership of an approved assets or a pool of underlying tangible assets in return for a price which offers the investor the potential to benefit from a rise in the price of the underlying asset.

From the above analysis, it is clear that the current practices of *sukuks* are, in many cases, not in conformity with *sharia* standards. In order to realize *sharia* objectives for equitable distribution of wealth and promoting economic development and growth, many Muslim economists and scholars, favour asset-backed instruments which place greater social welfare responsibilities and religious commitments. However, the current practices of *sukuk* structures are range from *ijara, mudaraba*, and *istithmar* structures which are presented as asset-based instruments and do not execute a true sale.

The overall finding indicated that these issuances comprise clear reasons for using *sukuks*, which are consistent with the Islamic purposes according to *maslaha* criteria. However, it appears that some contractual arrangements do not efficiently meet the stated funding needs and that the structures are unnecessarily complex. An example of this is Tamaweel nonconvertible *sukuk*. This structure had four *ijara* tranches (classes A, B, C and D) in one issuance based upon the structure of *ijara* in a complex structure.

The results verify that a low level of transparency in *sukuks* documentation or the manner of its transactions may render them illegal from a *sharia* perspective. The results further show that the offering circular of Aldar's first issuance has not clearly stated the nature of the underlying assets. The assets transferring was based on the right of *musataha* – it is a mechanism widely used by private land owners and governmental entities alike for achieving third party investment in, and ownership of, buildings-, however the land department in the Emirate of Abu Dhabi does not maintain or recognise it bylaw. Therefore, a local court may contest the validity of the *musataha* interest against the obligor. In addition, the Tabreed 2006 issuance was required to meet 33% of physical assets worth 26 US$ Million but the offering circular does not mentioned how Tabreed gets the 26 US$ million worth of Palladium. Furthermore, SEC *sukuk* did not specify the assets into which the *sukuk* proceeds will be invested. Tamaweel's third *sukuk* issuance was based really on two types of *sukuks*, which were merged into one asset, *ijara* and *istisna* but the circular is foggy on whether the *sukuk* issue is asset-based or not. It is likely that the *sukuk* is linked to the credit of the originator that raises the funds and not to physical assets. This arrangement clearly lacks compliance with *sharia* principles. In addition, *sukuk* holders may not be aware of the details of the contractual arrangements or the contractual details such as the obligor entering into arrangements that could violate the expectations such as an interest rate swap agreement. This was, in fact, the case of SABIC, where the company entered into an interest rate swap agreement on a notional value of SR13.6 billion to hedge the volatility in interest rates related to outstanding debts because the role of a custodian requires to ensure that the *sukuks* assets are sufficiently segregated from the other financial assets of the originator. This means that SABIC entered into non *sharia* compliant transaction in violation of the expectations of the *sukuks* buyers. Here the transparency requirements of *sukuks* issues were clearly violated.

To create *sukuk*, the cash flows extracted from the underlying assets should be characterized by a fair degree of predictability. However, this feature does not necessarily make them risk-free instruments. Therefore, DAAR *sukuk* represents the first *sukuk* issuance in the GCC region with a proper covenant package. The offering circulars set out in full detail the covenants to which the guarantor is subject to in addition to any qualifications or exceptions. Other example of successful *sukuk* presented in this study is Dana Gas *sukuk*, which actually represents beneficial title to tangible assets of Dana Gas. This type of contract is analogous to equity-based instruments and therefore the partners in *sukuk* take the risk of both profit and loss. The conversion price has been left to fluctuate with the market price of the shares of Dana Gas where the guarantee specifically excludes the fluctuation in value of the underlying real estate or commodities to which the *ijara* and the *murabaha* investments relate to as an event that would trigger the terms of the guarantee. Evidently these agreements work in favour of the ruling of the AAOIFI resolution. So, the success of the DAAR's *sukuk* and Dana Gas's *sukuk* represent another significant milestone in the development of Islamic finance. The DAAR issuances have provided a foundation for future similar transactions and establish another funding source beyond the traditional sources of capital in GCC region, whereas, Dana Gas issuance extended the terms of the guarantee beyond the traditional methods.

Proper registering and timely transfer of ownership is essential under Islamic principles so that the rights and obligations are clearly assigned at all times. The results indicate that both Tamaweel *sukuks* and Sorouh *sukuks,* offers the investors direct rights to the underlying assets. This means *sukuks* holders are taking true risk in the underlying assets. Therefore, the assets should continue to perform regardless of the financial distress of the originator. From *sharia* perspective these transactions are permitted because investors take the risk of the underlying asset while entering into a financial contract rather than credit risk of the counter-party. As the results indicate the investors were therefore 'unguaranteed' to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any conventional bond structure.

In contrast, Aldar had agreed in the purchase undertaking and master declaration of trust to indemnify *sukuk* holders for any and all obligations, liabilities and actual costs incurred in connection with any enforcement of the relevant undertakings. This is because the investors have no direct rights to the underlying assets, implying that transaction is guaranteed by obligator and seems to be a non *sharia* compliance transaction. In the case of SIB *sukuk* the investors were assuming the issuer's risk. So, in the event of default, the *sukuk* holders are not entitled to effect the sale or other disposal of any of the *sukuk* assets. The sole right of *sukuk* holders against the issuer shall be to enforce the obligation of *sukuk* purchase undertaking.

The results show that in many contracts the investors were guaranteed to receive their principal and profit subject to the usual risks, such as insolvency, present in any conventional bond structure. This seems to be the case in DIB *musharaka* issuance, GFH *musharaka* issuance, SIB *musharaka* issuance, and DP World *mudaraba*. However, in the eyes of mainstream *sharia* scholars this arrangement does not meet *sharia* compliance. These transactions are not in favour of the fourth ruling of the AAOIFI (2008) resolution, and articles (2/2/1) and (2/2/2) of AAOIFI (2010) *sharia* standard (5) on guarantees.

Subscribers to *sukuks* are meant to be part owners of assets in theory. Therefore, *sukuks'* credit and risk profiling should be based purely on an assessment of the value of and revenue generating potential of those assets. However, the results indicate that some of the current *sukuks* issuances are assigned on the paying ability and balance sheet of the issuers. For example, EIB *sukuk* assigned (A1) rating to the floating rate, senior, unsecured *sukuk* placing it at the same level as the long-term foreign currency deposit and senior unsecured ratings already assigned to EBI. In addition, Tabreed's ratio of secured debt to asset ratio was less than 20% hence the ratings of the *sukuk* reflect the credit standing of the issuer, rather than the riskiness of the secured assets. SABIC and SEC issuances expose the investors to SABIC's credit risk, rather than the risks of the *sukuks* assets.

According to the results, different *sukuks* structures have been emerging over the years but most of the *sukuks* issuances according to our sample have been *sukuks al-ijara* and *al-mudaraba*. *Ijara* structures are used because they are based on the undivided pro-rata ownership of the underlying leased asset, it is freely tradable at par, premium or discount, which makes them more attractive. Whereas, *mudaraba* structures are used because they make use of a purchase undertaking and a sale undertaking that ensures principal amount is paid in full on maturity of the issue, or on redemption. The main criticism of DP World *sukuk mudaraba* is inequitable profit distribution. The credit risk, therefore, eventually rests with DP World and in a way DP World will ensure that *sukuk* holders do receive the indicated 6.25 per cent rate of return. These features made the DP World *sukuk* resemble conventional bonds and lose their own authenticity.

In any financial instrument the details of the rights and the obligations of the parties involved and the mechanism of transfer of profits and losses should be unambiguous. In addition to this, in the case of *sharia* based financial instruments, the opinion and the ruling of the *sharia* scholar should be very clear. The results of this study indicate that *sharia* scholars made an exception for Tabreed 2006 issuance, and reduced the required percentage of physical and tangible assets from 50 per cent to 33 per cent. It is not known on what basis this exception was made. The other case is Tamaweel third issuance, where the manager acts as a partner of the *sukuk* holders as well. However, the manager guarantees the return of capital to the *sukuk* holders, which would interrupt the partnership in the event of losses, which, from *sharia* perspective this is unlawful.

Usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law). The results indicate that 26 issuances involved SPV companies in its transaction of which 11 SPVs were located offshore incorporated under the laws of Jersey (the Channel Islands) and 8 SPVs were incorporated under local laws. While, Saudi Arabia companies include 8 SPVs incorporated under a dual legal system (the laws of Jersey and local laws). Arrangements that are issued under foreign legislation create a significant legal unpredictability governing *sukuks* transaction if they are issued through an offshore SPV. Frankel (1998) aserts that typical offshore SPV leads to a problem whereby there is no uniform law, to the extent that the offshore jurisdiction is, in many such arrangements, very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the needs of the various parties.

In conclusion, the development of Islamic financial products can only be achieved in conformity with *sharia* objectives. This implies the necessity on the Islamic financial institutions to develop products based on the overall welfare and a greater perspective from the *sharia* framework, and not simply focusing on the legal forms of the products.

Therefore, it has become one of the biggest challenges of time, to develop financial contracts which are not only Islamic compliant, but are also *sharia* compliant, i.e. compliant with the *maslaha*, without violating the business natures of being competitive, profitable and viable in the long run. However, based on various findings and views from case study respondents and regulators, some of the observed issuances are valid structures and are consistent with *sharia* principles whereas others are not. However, all of the structures have received confirmations from *sharia* scholars.

Chapter 7: Phase 3—Interviews

7.1 Introduction

This chapter discusses the semi-structured interviews employed in this study to gain insight into the unique features of the Islamic economic system and the degree to which religious convictions affect investors/ borrowers in their financial decision making. They were based on the understanding of *sharia* in Chapter 1 as a system of ethics and values encompassing all aspects of life and the *maslaha* concept in Chapter 3, according to which all Muslims must prioritise the public interest in their actions. These interviews gleaned opinions, reflections and comments from issuers and buyers in the Islamic finance industry, highlighting the practitioners' attitudes in the marketplace and constraints on decision making. Semi-structured interviews were used because they are more adaptable than structured interviews or surveys, as they facilitate changes in the order and/or wording of questions.

Section 7.2 presents the organising processes for Phase 3. Sections 7.3 to 7.13 analyse the interviews and interpret their findings in regards of interview questions. Section 7.14 summarises the chapter.

7.2 Organising Processes for Phase 3

The face-to-face interviews enabled the researcher to obtain greater insight into the meaning, perceptions and beliefs through participants' views and comments. Through developing a cordial relationship with the interview participants at the beginning of the interview process, the researcher was able to elicit information on very sensitive issues in the area of practical Islamic finance. The interviews started with a predetermined set of questions which paved the way for a detailed discourse on the subject matter. Initially, the semi-structured interviews included the following key questions and were extended as the interview progressed:

1. If you prefer to deal with *sukuks* rather than the conventional bonds, what are the main reasons for this?
2. Do you think *sukuk* is debt instrument or equity instrument? Please elaborate.
3. In your opinion which has a higher cost of issuing *sukuks* or conventional bonds? Please elaborate.

4. S*ukuk* has assumed an unprecedented level of importance as an instrument in Islamic finance. In your opinion do the risks associated with *sukuk* hinder financial engineering?
5. Do you have a different set of criteria for selecting financing methods or investing products based on religious beliefs
6. What are your opinion regarding *sukuk* price determination? Is there a standard or procedure that is well accepted in the Islamic finance industry that can be relied upon for price determination? Please elaborate.
7. Are the risks associated with the issue of *sukuks*, such as market risk, interest rate and default risk, substantial and do these risks need detailed management strategies? And what kind of strategies do you employ to manage the risks facing the *sukuks* you purchase?
8. When you are faced with a choice of investment instruments, such as *sukuks*, have you considered religious beliefs in your decision? Please elaborate (if we have two projects ones have more benefit for the society than other).

This phase of data collection comprised 19 interviews. Table 7.1 indicates the distribution of the participants based on country, sector and nationality of the respondent's person.

All interviews were transcribed and interview responses were electronically coded to match interview questions as referred to in Chapter 5. Additionally, memos and reflection journals were included and attached to the study. These were important elements of the coding and interpretation process.

In this study, the researcher was looking for data which covering various aspects of *sukuks* issues including, favourite, identity, risk, pricing, structure, tradability, legality, the criteria for selecting this type of instruments, and issues that related to *sukuks* in some of GCC countries namely Bahrain, Saudi Arabia and the UAE. The researcher was interested in different perceptions of management, depending on the sector of issuer or investor.

Therefore, nodes such as 'importance of *sukuks* over conventional bonds', 'regulatory issues' and 'pricing mechanism' were searched and a matrix intersection between nodes and companies was produced. All documents were included into the analysis and the results were displayed as a thematic report.

Table 7.1*: Description of the participants based on country, sector and nationality.*

Country	**Issuers**	**Investors**	**Total**
Saudi Arabia	5	6	11
UAE	4	3	7
Bahrain	0	1	1
Total	9	10	19
Sector			
Utility	3		3
Real Estate	2		2
Industrial	1		1
Banks	2	2	4
Fund Management Companies		2	2
Logistic Services	1		1
Government Entity		2	2
Other Corporate		3	3
Individual (Businessperson)		1	1
Total	9	10	19
Nationality			
GCC Nationals	4	6	10
Non-GCC Nationals	5	4	9
Total	9	10	19

Themes were identified by bringing together components or fragments of ideas or experiences, which often are meaningless when viewed alone. Themes that emerge from the informants' stories are pieced together to form a comprehensive picture of their collective experience. This study concludes with eleven themes and five sub-themes. Figure 7.1 show initial thematic map.

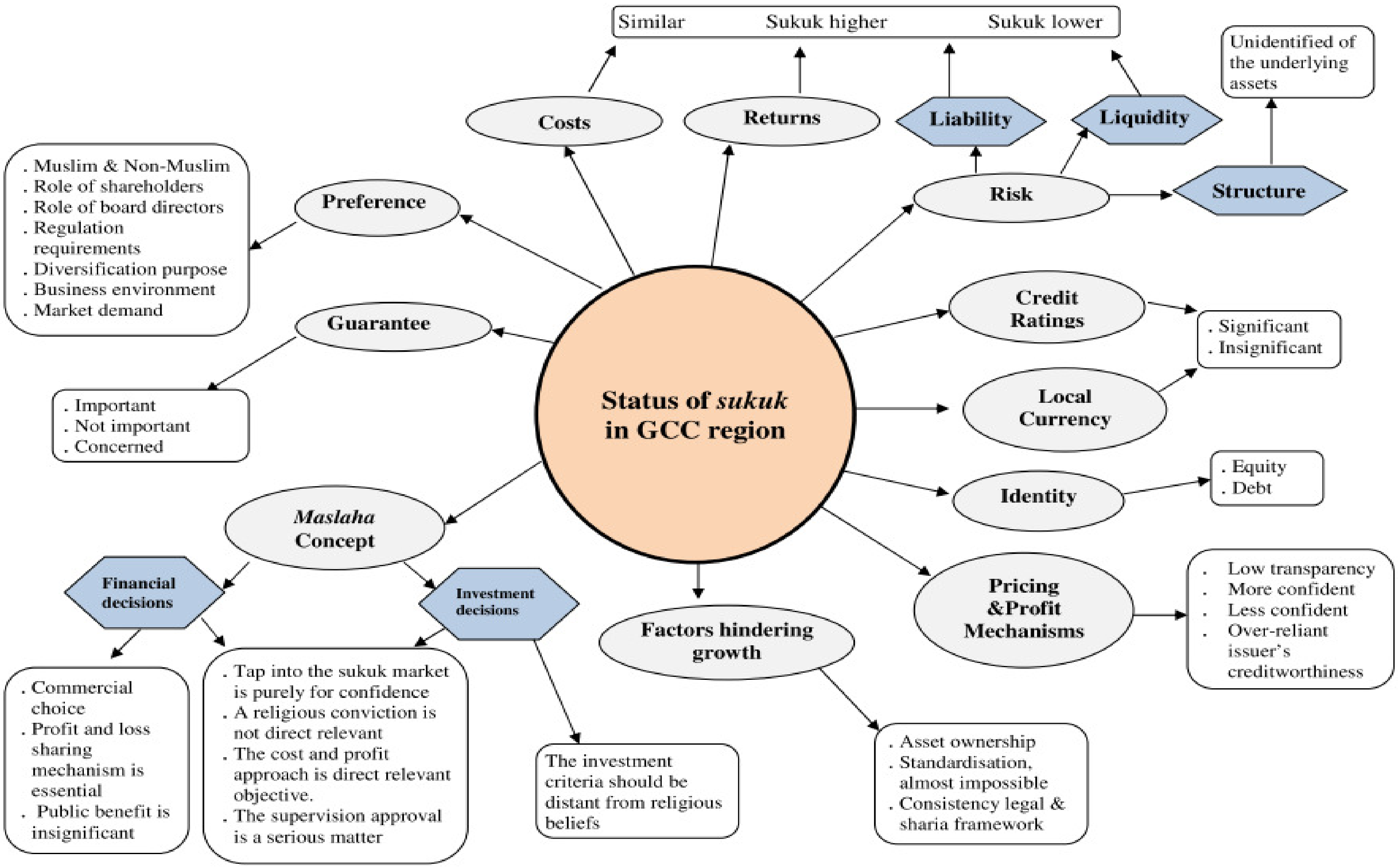

Figure 7.1. Initial thematic map, showing status of *sukuks* in GCC region.

7.3 Preferences between *Sukuk* and Conventional Bonds

During the interviews, it was clear there has been increasing optimism in these markets as regulators are currently finalizing the development of mortgage and finance law, which has been introduced in 2012 especially in Saudi Arabia (SAMA, 2012). All the interviewees are anticipating a better uptake in GCC markets especially in Saudi Arabia, UAE and Bahrain, as companies and issuers seek to diversify their sources of financing. To explore the keys factors driven *sukuks* issuances in the GCC region, the 19 interviewees have been asked to answer a question regarding their preferences between *sukuks* and conventional bonds. They were also asked to explain the reason behind their decision in detail and which may be sensitive on a confidential basis. Table 7.2 shows the summary of the respondents' preference between *sukuks* and conventional bonds.

Table *7.2: Summary of the preference for sukuks*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Tracing the demand in Muslim countries	6	67%			6	32%
Carry participation from Muslim and Non-Muslim	4	44%			4	21%
The rule of board directors, whom pursue Islamic method.	5	56%	4	40%	9	47%
The role of shareholders, whom pursue Islamic method.	2	22%	4	40%	6	32%
A religious thing attached to operation business cycle	3	33%	2	20%	5	26%
A regulation requirements			4	40%	4	21%
Diversification purpose of portfolio investment			1	10%	1	5%

The consensus among the 19 interviewees was that a *sharia* compliant approach is preferable to everybody in the market especially in GCC region. The keys drivers of these preferences are the participants' sectors or their business activities and whether they are the borrower or the investor.

Six issuers (67% of the issuers) agreed on the most important reason for issuing *sukuks* was investors demand in Muslim countries. According to them, the strength of the *sukuks* market is that people inherently follow *sharia* guidelines, which stresses that Islamic financial transactions and arrangements can only be used to acquire *sharia* compliant assets. In addition, four issuers stated that another important reason is that it provides alternatives to traditional investment channels which may possibly encourage Muslims as well as non-

Muslim to invest in *sukuks*. This will give the issuers a priority to access of both investors' funds thereby encouraging issuing of *sukuks* by both private and public sector participants. As stated earlier, the majority of *sukuks* are issued in utility sector and financial sector.

In the sample five issuers and four investors (47% of the total) had stressed that it is imperative for the board of directors to pursue Islamic approaches to finance. Furthermore, two issuers and four investors (32%) emphasised that the shareholders of the company should play a role in this decision. Three issuers and two investors stated that they participated in the *sukuks* market because their own business operations were based on Islamic principles.

Some investors were encouraged by regulations or direct order from the government to participate in *sukuks* markets. A significant proportion of GCC companies are required by regulators to place a substantial percentage of their investment in local currency assets, and *sukuks* are one of these assets classes that qualify for this. Two investors were persuaded by the regulation to invest their funds in *sukuks*. On this point, an investor from the insurance sector said:

> We don't think there are many opportunities to choose and we have no other place to invest in. Because we are bound by this regulation to allocate 20 per cent as a maximum limit for *sukuks* that are issued by local companies in which the government has a significant ownership, and the solvency margin is equivalent to the government's participation in capital.

In addition, two investors who were with independent government entities clarified their reasons by saying, 'we are encouraged by the government to invest in the *sukuks* market'. This indicates that governments in GCC countries support *sukuks* market in an indirect manner. Only one investor in GCC region shed light on diversification purpose of portfolio investment in their decision to participate in *sukuks*.

As a result, the launching of the *sukuks* platform markets has substantially enhanced the prospects of *sukuk* becoming a pivotal investment asset class, particularly for local investors in Bahrain, Saudi Arabia and the UAE as demonstrated in Chapter 4. Thus, *sukuks* have a significant priority in these countries compared to conventional bonds.

7.4 *Sukuk* as Debt or Equity Instruments in Practice

Sukuks contracts are distinctive to the extent that their ownership privileges and financial obligations are based on diverse *sharia* compliant contracts. Most such flexible financing contracts can be securitised and turned into the long-term tradable instruments under the concept of *sukuk*. There are tradable *sukuks* and non-tradable *sukuks*. Tradable *sukuks* are representing tangible assets or proportionate ownership of a business or investment portfolio. While the main types of *sukuks* structures are theoretically straightforward, they may become complicated in practice compared to bonds, as some financial institutions combine characteristics of two or more types of tools to form hybrid instruments as referred to in Chapter 2. The main principle of Islamic commercial jurisprudence is that all commercial transactions are lawful except for a few non-negotiable and entrenched restrictions such as the prohibition of interest, gambling, *gharar,* short sales, speculative transactions, and the trading of pure debt.

The 19 interview respondents were asked to answer a question regarding *sukuk* identity from their point of view which elicited a range of responses as shown in table 7.3. Four issuers and eight investors (63% of total interviewees), said that *sukuk* is a debt instrument in neuter regardless of the type of structure. From the issuers' perspective, most of those *sukuks* were structured to replicate debt features, which in reality is identical to conventional bonds although they tend to use equity type contracts for their construction. From the perspective of the investors, what is important is the credit rating of the issuer and the specific structure is not relevant including whether they are *sharia* compliant. What is really important for the investor is whether the *sukuk* has received a favourable religious ruling (*fatwa*). As one investor responded:

> There is no or very little difference compared to conventional bonds so nothing additional is required other than a *Fatwa*.

Table 7.3*: The classification of sukuk as a debt or equity Instruments*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Debt Instruments	4	44%	8	80%	12	63%
Equity Instruments	5	56%	2	20%	7	37%

Conversely, five issuers and two investors (37% of total participants) believed that *sukuks* were more equity instruments than debt instruments. One issuer in Saudi Arabia expressed his opinion as follows:

> [N]ot every *sukuk* is[a]bond because an Islamic bond is a portion of the *sukuk*, depending on the structure of a *sukuk*. It is very much possible that the company doesn't have to pay—because if you are taking a true risk on the assets, it's no

more a bond, it's more of equity—so not all *sukuks* satisfy the definition of a bonds.

Another investor in the UAE defined *sukuk* as an equity instrument when he said, '*sukuks* are asset backed, [they have] an asset, and so if you see [it] from a pure risk, and if you followed everything, we would say documentation wise, *sukuks* would be less risky than conventional bonds'.

Thus, it is clear there is a debate among practitioners in defining *sukuk* as a debt or an equity instrument, which could affect the potential investors who believe that Islam prohibits trade in debt. The foggy explanations of each *sukuk* structure have resulted in this situation. Therefore, the classification of *sukuk* as a debt or equity can be on the balance sheet of the issuer. However, based on the case study analysis it can be seen as an instrument of debt but with better participation.

7.5 Risks Associated with *Sukuks* v. Conventional Bonds

Issuers are promoting *sukuks* with the same features as conventional bonds so as to facilitate their recognition in both Islamic and conventional financial markets. When comparing *sukuks* to bonds, the crucial underpinning concept is that *sukuk* certificate holders share the profit or loss of an enterprise resulting from the investment of the proceeds of issuance. However, bond represent pure debt obligations and *sukuk* holders may be affected by different types of risks, so the 19 interviewees have been asked to answer a question regarding the differences between *sukuks* and conventional bonds in regards of all types of associated risks. The semi-structured interviews highlighted the importance of risks associated with *sukuks* issuances.

The majority of the 19 respondents (74%) -seven issuers and seven investors - agreed on the risk paradigm in general has to be identical vis-à-vis conventional bond in relation to the market, interest rate, and credit risk. However, two issuers and one investor (16%) thought that *sukuks* had higher risk than conventional bonds, and two investors (11%) believed *sukuks* was less risky (see table 7.4).

This diversity of opinions among the 19 interviewees was as a result of the participants' believes about the risks associated with *sukuk* in terms of liquidity, liability and *sukuk* structures. These dimensions are discussed below.

Table 7.4*: Risks associated with sukuks v. conventional bonds*

The factors	Issuers	%	Investors	%	Total	The percentage overall
identical vis-à-vis conventional bond in relation to the market risk, interest rate and credit risk	7	78%	7	70%	14	74%
sukuk has higher risk than conventional bond	2	22%	1	10%	3	32%
sukuk is less risky			2	20%	2	20%

7.5.1 The liquidity perspective.

Two issuers and four investors (32% of total interviewees) saw *sukuks* as being of higher risk than conventional bonds, but they did not seem concerned about this issue because they saw that most of the *sukuks* holders held their *sukuks* to maturity in the absence of good alternatives in the market and the available ones were new and lacked information for informed choice. In contrast, 68 per cent of respondents agreed on that *sukuks* and conventional bonds have similar liquidity risks. This result presented in Table 7.5 below.

Table 7.5*: The liquidity risks*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Sukuk is higher risk than conventional bond.	2	22%	4	40%	6	62%
Sukuk identical vis-à-vis conventional bond in relation to the liquidity risk	7	78%	6	60%	13	68%

As a result, the liquidity risk in *sukuks* is not a significant one because the *sukuks* market is still new and *sukuks* holders prefer to hold them until maturity, as evidenced by empirical evidence. This may change in the future when the number of *sukuks* and market activities increase.

7.5.2 The liability perspective.

Sukuks products require issuers to originate *sharia* acceptable assets (rather than buy asset pools in the market) due to the absence of eligible collateral assets. Moreover, the comparative scarcity of historical data on defaults hinders reliable estimates for recovery rates used in pricing and rating trenched products, and leads rating agencies to use very conservative assumptions, especially if lender credit scoring and infrastructure are not up to the standards usually sought by the rating agencies.

Almost half of the respondents (47%)—five issuers and four investors—believe *sukuk* has same risk as conventional bond in defaults event. They assume there is a common misconception that *sukuks* are less or more risky than bonds because the way *sukuks* are structured, especially using equity contracts. One investor was clearly concerned about the legal framework in the event of default:

> Before we buy *sukuk* we have a chance to examine or do due diligence on the underlying assets and the legality framework. If a country has a good legal system—or good jersey like in the UK—then we will feel comfortable, but if not then we will not go for it. On the other hand, when we buy conventional bond of a particular company and this company goes bankrupt, we have to carry it with senior or subordinated, so we have to look at this entire category. So, from our point of view, *sukuks* are more like senior debt instruments.

The respondents agreed on the similarity between *sukuks* and conventional bonds and that the most important factors in *sukuks* decisions are the country and issuer ratings, which show the quality of the issuer in the assessment of default risk (see table 7.6). Therefore, the nature and the characteristics of the underlying assets is not an issue to which they pay attention.

Table 7.6*: The liability risk*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Sukuk identical vis-à-vis conventional bond	5	56%	4	40%	9	47%
Sukuks are lower risk than conventional bonds.	2	22%	5	50%	7	37%
Sukuks are higher risk than conventional bonds.	2	22%	1	10%	3	16%

Conversely, 37 per cent of the respondents—two issuers and five investors—thought conventional bonds are of a higher risk than *sukuks*, because *sukuk* is backed by asset, which give *sukuk* holders more confidence in the event of default.

Theoretically, *sukuks* have different risks than conventional bonds. *Sukuk* is structured around some asset, so it will be more comfortable for the investors. Conversely, conventional bonds rely upon financial assets or on the rating or the character or worthiness of the issuer itself. Therefore, *sukuks* in that sense give investors better risk participation for an asset, and better returns than conventional bonds.

The respondents' belief that conventional bond is more risky could be based on experience. In particular, half of the investors who participated in this study have expressed their opinions on that basis. Their views could be based on their knowledge of *sharia* objectives, as demonstrated in Chapter 3. *Sharia* encourages and supports the concept of responsible utilisation of resources and sustainability. *Sukuks* products are designed to contribute to this and achieve the objectives of Islamic economic system by promoting the aims of social and economic development and adding economic value.

However, 16 per cent of the respondents—two issuers and one investor—thought that *sukuks* have greater risk than the conventional bonds because of foreign investors who are not familiar with *sukuks* and its structure. Thus, they prefer a conventional bond, and they perceive conventional bonds as being a less risky investment than *sukuks.* The legal issue also has an impact on the documentation in English or US law, or any of the jurisdictions that has written laws, rules and guidelines that are enforceable under the jurisdiction where it was issued. In the case of disputes on *sukuks*, however, one is not clear on the relevant jurisdiction; no defaults have taken place as yet and consequently there are not any precedence. We do not know exactly how a compromise is reached between the investors and the issuer, how it will be being treated in the courts or what will happen if the dispute is argued in a *sharia* court.

Conversely, there have been historical cases of conventional bonds, so people are aware of the possible consequences in the event of defaults. As a result, a perceived amount of risk for *sukuk* becomes higher rather than a conventional one due to lack of relevant information.

The respondents who thought *sukuk* had a greater risk than the conventional bond argue their case based on *sukuk's* exposure to single-asset as opposed to conventional bond where the investor is assuming the risk of the entire set of assets. Obviously holding only one asset in the portfolio is very risky compared to diversified portfolios as in the case with a conventional bond holders who would periodically takes the risk of the whole balance sheet thereby balancing out the risk.

One investor pointed to the underlying asset itself, saying that if the asset stopped generating revenues, investors would associate with the proper *sukuk*, not the issuer. Therefore, the default component will really be how good or how bad the underlying asset is.

If it is a real estate asset that was issued in Dubai for example, which is high-end development and if the issuer is unable to find a buyer the default risk will continue to affect the value of the *sukuk*. What is really important is they continued performance of the asset. In the case of *sukuk*, therefore, one would need prolonged periods for the markets to achieve acceptable levels of infrastructure to be competitive in liability, liquidity and structure.

This can be illustrated by the example documented by Jobst (2007) of CARAVAN I Limited's *sukuk* issuance. In March 2004, the Beirut-based BSEC Investment Bank and the Bahrain-based Shamil Bank issued a SAR 102 million (US$27 million) *sharia* compliant *ijara* investment *sukuk* to securities a Saudi Arabian car fleet inventory (CARAVAN I Limited) over a three-year maturity term. The *sukuk* was issued from the proceeds of a synthetic risk transfer through a dual SPV structure to overcome the legal risk of true-sale recognition under Islamic law, the impact of local laws on the securitisation structure's key contractual terms, and strict laws on foreign ownership. BSEC acted as the deal arranger and structure, while Shamil Bank was the underwriter of Caravan I Limited.

The transaction was over-collateralised by SAR 5.09 million and secured by a first loss protection provided by HANCO Rent-A-Car, a leading Saudi Arabian car leasing and rental company, of 4.25 per cent via SAR4.17 million redeemable participating shares and an excess spread reserve account of SR4 million. The residual value could be claimed by HANCO after redemption of the issued *sukuk* notes. In this transaction, a Saudi Arabian SPC funds the acquisition of a pool of vehicles and vehicle lease agreements from HANCO via an offshore SPV, based in Jersey (Channel Islands, UK), which issues *sukuk* notes to investors. This arrangement is essential because under Saudi law an offshore SPV is barred from buying or leasing vehicles, while a locally domiciled SPV is not bankruptcy remote and, therefore, is not permitted to issue securities. The relationship between the SPC and the SPV is governed by a 'funding agreement' that includes periodic funding repayments and the transfer of net profits from the SPC to the SPV. While deferrals are possible, in the event of default, investors have recourse to the underlying assets and can force the sale of the cash-flow generating assets.

Although the transaction structure implies business risk from identified and direct investor participation in the asset performance of permissible real economic activity without payment or receipt of interest consistent with *sharia* law, the legal risk from Islamic jurisprudence continues to impinge on the legal enforceability of investor interests. Saudi courts and other adjudicatory authorities might apply different interpretations of *sharia* principles to the transaction. Since *sharia* law remains the governing law of the transaction, legal uncertainty might compromise the ability of the Jersey-based SPV to enforce investor interests. Moreover, the integrity of the funding agreement in this dual-SPV structure of Caravan 1 Limited hinges on the capacity of the SPV to oblige the SPC to make pre-specified and contingent payments from lease revenues to repay *sukuk* investors—a guarantee whose enforcement runs against the condition of investment risk under the basic tenets of *sharia* law. All of these aspects taken together have precluded an official rating of the transaction.

To conclude, issuers and investors recognised that only a few or not existing *sukuks* have ownership in tangible assets, or usufruct and services (in the ownership of) the assets of particular projects or special investment activity. Asset-backed *sukuks* or Islamic securitisations generally perform very differently from asset–based ones under stress. Most Islamic market participants are aware that *sukuks* sometimes should grant the investor a share of an asset or business venture along with the cash flows and risks commensurate with such ownership. However, while this is indeed the *sharia* 'ideal', most current structures have more in common with conventional fixed income or 'debt' instruments from a risk/return perspective. Thus, the respondents stated that the assets in the structure are commonly for *sharia* compliance only, and ultimately have little or no bearing on the risk or performance of the *sukuks*.

7.5.3 The *sukuks* structure.

Thirty-two per cent of the respondents—two issuers and four investors—were concerned about this type of risk, especially the presence of sophisticated *sukuks* structures that have been used in the market recently. They had demonstrated that some *sukuks* structures do not clearly identify what the underlying assets are and how the profits are generated especially in the case of hybrid contract, because *sukuk* could be structured as debt or equity and could lead to significant misunderstanding among the parties to the contract (see table7.7).

Sukuks are also structured negotiable or non-negotiable forms of instruments. For instance, *murabaha* is pure debt and not tradable based on *sharia* law; accordingly, *sukuks* are currently used as medium term debt instruments. Therefore, debt-based *sukuks* cannot be traded other than at par value as if the amount exceeds the par value then it will default to *riba*. Conversely, *sukuks* based on the contracts of *mudaraba* and *musharaka* are typically known to be equity contracts. Thus, lack of knowledge leads to confusion and misunderstanding.

Table 7.7: *The sukuk structure risk*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Unidentified of the underlying assets and the profits sources are serious matters.	2	22%	4	40%	6	32%

The Islamic debt financing instruments, *sukuks*, are urgently needed in GCC countries because not everyone who owns money has trading skills or the proper level of understanding to do business, and not everyone who has skills in trading possesses money or resources.

7.6 The Returns of *Sukuks v.* Conventional Bonds

During the semi-structured interviews, it was clear that there has been increasing confidence in the returns of *sukuks***.** Nine issuers and nine investors (95 % of the respondents) stressed that *sukuk* has similar profitability compared to conventional bond depending on the overall market condition as shown in table 7.8. They assumed that both returns were based on the common required returns in the market, which is generally benchmarked with reference to a conventional index such as LIBOR, SIBOR or EIBOR.

Table 7.8: *The returns of sukuks v. conventional bonds*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Sukuk has similar profitability compared to conventional bond	9	100%	9	90%	18	95%
Sukuk has higher profit than conventional bond			1	10%	1	5%

One investor differed from the others, defining *sukuks* as being more profitable than conventional bonds. He stated that *sukuks* are essentially asset-backed instruments, which obviously support building of the underlying assets and give better risk participation and better returns than conventional bonds. According to him, this asset can generate more profit margins than credit-rating-based such as conventional bonds, or at worst equal levels of profit.

7.7 *Sukuks* Pricing and Profit Margin Mechanisms

The semi-structured interviews demonstrated that maintaining the time value of money should be agreeably on a known index. This actually is a demand and supply instrument for money in the market. Nine issuers were more confident in the pricing mechanism, since it is based on acceptable benchmarks such as LIBOR, SIBOR or EIBOR. In their opinion, in order for *sukuks* to remain competitive in its business case and the fact that Islamic financial sector does not exist in isolation from the conventional, pricing of *sukuks* (and for that matter, pricing of all Islamic financial instruments) is always done in line with the market practice for such debt-like instruments. Thus, in practice *sukuks* and conventional bonds have the same standards and procedures that can be relied upon to determine the optimal price. Also, this category of respondents highlighted that *sharia* permits similar reference to pricing as calculation mechanism so far as the underlying structure is based on an acceptable mode of Islamic finance. The issuers are confident of the effectiveness of mechanism (see table 7.9), as demonstrated by the follow in response:

> *sharia* does not stop you from selling [an]orange for the price of apple or selling coke for the price of wine as long as the buyer and seller are agreeable to it,[the issuer is still selling oranges for the economic benefit equalling apples or selling coke for the economic benefit equalling wine].

Table 7.9: *Sukuks pricing and profit margin mechanisms*

The factors	Issuers	%	Investors	%	Total	The percentage overall
more confident in the pricing mechanism that been used currently	9	100%			9	47%
Less confident in the pricing mechanism that been used currently			10	100%	10	53%
Sukuks are over-reliant on issuer's creditworthiness			6	60%	6	32%
The premium is determined by complexity of the structure			4	40%	4	21%
The low level of transparency in *the sukuks* documentation resulted in decreasing the premium.			3	30%	3	16%

Furthermore, when the discussion turned to whether the profit margin is determined by the benchmark or on the profits generated from the underlying assets, nine issuers cited factors such as the economic situation, market condition, strength of the company and investors' perceptions of the company, that play a big role in determining the coupon. One issuer gave an example of their issuances, were the pricing was based on anticipated profit margins which in turn were based on market condition:

> in 2009 were not good compared to 2010 when market conditions were more settled, while his company was almost the same and the company assets did not change, but the margin had gone down. Thus, market conditions play an important role in profit margin determination.

In addition, all the issuers stressed that price determination is a market phenomenon and not a *sharia* issue. Hence, there is no need to find another method of price determination. One respondent demonstrated that issuers normally do not know how to measure the price of currency, although they may be competent with the pricing of a commodity such as potato. He explained that real estate is a very good index and if the *sukuks* market has transparent, fair benchmarks available in future, and the lender and buyer agree, it would be great for the Islamic financial industry.

From the investors' perspective, all 10 respondents thought that standardising the pricing of *sukuks* was very important, as it would lower the price and increase the confidence of *sukuks* in the market place. However, six of the 10 investors demonstrated that the existing *sukuks* in the market associated to an underlying asset in purpose of *sharia* requirement, which in practice are being priced according to the issuers' credit rating. According to them, this is just a proxy. They mentioned the biggest problem is about consistency and handful of tools that can use for *sukuks*.

In the absence of standards or procedural designs, especially for the *sukuks* market, the practitioners tended to follow the general practice of conventional markets. However, the majority of the respondents were keen to see sovereign issuances or an Islamic benchmark, which would serve as a better pricing benchmark and yield curve for *sukuks* than the conventional benchmark.

Four investors (40% of the respondents), raised the importance of *sukuk* structure, where the premium is determined by complexity of the structure, if the structure is simple, then the premium would be less, and if the structure is complicated, then the premium will increase. This is due to the fact that the limited transparency in the documentation is causing a critical lack of understanding of some of the *sukuks* instruments. Additionally, three respondents commented on the lack of transparency in the *sukuks* documentations, with little disclosure on the underlying assets. The disclosure documentation is mainly focused on the issuer's balance sheet, business and risk profile as regional investors are in favour of having risk exposure to the issuer's credit. Consequently, more investors are increasingly demanding greater transparency and extensive due diligence when it comes to securitisation of assets, which result in increasing the premium.

Two investors (20% of the respondents) stressed that the profit margin will be calculated along with that expected rate in the market and the type of underlying assets. The expected rate is based on some factors such as the company SACP, market condition, the interest rate and the *sukuk* structure, similar to the conventional bonds, besides the expected profit would be generated from the assets in determining the premium of particular asset.

The majority of the respondents agreed that *sukuks* pricing should be mainly affected by market forces to make *sukuks* attractive and competitive alongside conventional bonds. Four issuers and eight investors were optimistic about the development and establishment of benchmarks that reflects the spirit of *sharia* other than the benchmarks based on interest rates. This indicates a misunderstanding over *sukuks* pricing among investors: whereas the issuers indicated the important factors related to the interest rates and economic conditions in determining *sukuks* profit margins, some investors thought they were overreliant on underlying assets which suggests the lack of clarity of some *sukuks* contracts for investors.

7.8 Costs Associated with Issuing *Sukuks v.* Conventional Bonds

One of the running debates in the Islamic finance industry is the issue of cost of *sharia* compliant products versus conventional products. The conventional wisdom is that there is a premium associated with Islamic finance.

Certain fees and costs will be incurred by the applicant in connection with the issuance of *sukuk* through the authority, lawyers and *sharia* scholars to assess the compliance of new issues. These fees and costs will vary depending on the type of financing being done, financing structure used and other factors. So, the costs of structuring and issuing *sukuk* remain high relative to conventional bond issuance. Legal and accounting fees contribute to this higher cost structure, as does uncertainty regarding the perceived risk associated with these instruments (Karim Nassif, 2009).The lack of standard structures, perceived differences in approach to *sharia* compliance and a relatively illiquid secondary market may discourage investors' appetite for *sukuks*.

In relation to this matter, of the total interviews only 14 responded to this issue, nine issuers and five investors as shown in table 7.10. Seven issuers and three investors (53%) were convinced that it is easy to raise *sukuks* in GCC region rather than conventional bonds and that there is no significant difference in the cost of issuing. However, the interviewer observed some reluctance on the part of the respondents to provide detailed information on this matter. This made the interviewer explore this matter further with the other respondents. Consequently, two issuers and two investors (21%) clarified this by providing further information. They stated that *sukuk* involves higher levels of cost because the conventional bond is more popular and market infrastructure is more sophisticated than that of the *sukuks* markets. In the case of conventional bonds great reliance is placed on the rating of the issuer and all that remains is for the issuer to create a prospectus to meet the legal requirements. Once a prospectus is prepared it could be used for multiple issuances. Conversely, in case of *sukuk*, the issuer must keep doing this for every new asset, as *sukuk* cannot be replicated; each issuance has to be a special case mainly because of the specificity of the underlying assets and the uniqueness of the structure.

Table 7.10: *Costs associated with issuing sukuks v. conventional bonds*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Coast is almost same	7	78%	3	30%	10	53%
sukuk is higher cost	2	22%	2	20%	4	21%

In addition, they explained why *sukuks* have a higher cost than conventional bonds from another perspective. There are many costs involved in *sukuk* issuance, including legal expenses, as lawyers charge much more for *sukuks* structures than for conventional bonds, and the cost of preparing a ruling (*fatwa*) paid to *sharia* scholars. This is consistent with the opinion of Trowers & Hamlins, an international UK-based firm, who announced in January 2011 that the cost of issuing *sukuks* is about 60 per cent more than for conventional bonds. However, the respondents believe that the high cost is due mainly to the lack of efficiency and the inability to reap the benefits of economies of scale because of small markets. The respondents are of the view that these two reasons are as a result of the markets being new and lack maturity. They further believe that these markets will be able to significantly reduce the costs of operations when the markets grow, expand and mature, and eventually operate under a standardised set of framework..

One of these two issuers alerted to a critical issue in this matter:

> we do not explain to our scholars the real root of a products because there are considerations that require quick turnaround time for approval. If there is

> something wrong, which at times is blamed on the scholars, I would blame the bankers for that because bankers do not explain the root problems of this structure.

He also stressed that scholars have done a great job given the constraints under which they provide their services. During the conversation he declared a surprising conflict of interest: “these scholars who approved our *sukuk* structure are board’s members [of] our firm[s] already”. Others have reported that some scholars join the board after they approve a contract.

To conclude, a combination of commercial, structural, and legal factors led to steep increases in the cost of *sukuks.* During periods of financial stress investors tend to avoid newer, complex and less tested forms of investment in favour of more traditional investments. This trend is likely to continue in the absence of a centralised arrangement for providing rulings of *sukuk* contract proposals. Centralised arrangement would also remove conflicts of interest and differential rulings based on subjectivities and idiosyncrasies of the scholars.

7.9 The Significance of *Sukuk* Ratings in Determining Investment Decisions

It important to note that the absence of a credible local, or regional, rating agency is affecting *sukuks* market prospects in GCC countries. However, rating services are offered by major global agencies where Fitch and Standard &Poor’s focus on the issuer’s ability and willingness to meet financial obligations, while Moody’s focuses on default rate, which are becoming capital market requirements to grant the mandatory *sukuks* ratings.

For that reason investors have been asked to answer question related to their considerations of *sukuk* rating in determining investment decision. Four respondents or 40 per cent of the investors in the study sample strongly emphasised the significance of the rating because of its information value for calculating the risk and the associated levels of confidence on the instrument (see table 7.11). These respondents were concerned anxious over the fact that Saudi Arabia and the UAE does not compel *sukuks* issuers to obtain ratings, which creates an environment of uncertainty and exposes investors to poor and unprofessional due diligence.

Nevertheless, *sukuk* rating is becoming a necessity in order to obtain a favourable pricing, longer tenure of *sukuk* and to diversify the investors’ base. As well as with the recent regional *sukuks* difficulties, two respondents thought that rating is not the only element that can provide comfort to investors. Rating would be necessary if the issuer wants to tap the international market. They demonstrated that the recent Saudi Binlad in corporation *sukuk* issuance undertaken locally in Saudi Arabia without any rating, which was oversubscribed two and a half times, so far they thought this was fine as long as the liquidity is available and the subscription is local or even regional.

Table 7.11: *The significance of sukuk ratings in determining investors' decisions*

The factors	Investors	%	Total	The percentage overall
Credit rating is significant factor	4	40%	4	21%
If the issuer wants to tap the international market	2	20%	2	11%

All the four respondents suggested that the central banks in GCC countries should establish a rating agency for the purpose of determining the creditworthiness of all listed companies or create an international rating agency specialising in Islamic financial instruments. This step, while filling a gap would also provide a vital function of providing reliable independent opinion on the issuers' financial status and creditworthiness with respect to debt instruments. One of these respondents suggested that rating agencies should work together with the *sharia* scholars to provide potential investors with a solid standardised *sukuks* structures and develop a standard mechanism for a unified approach on *sukuks* with credit enhancement mechanism which would lead to a feasible credit rating methodology, and correct is calculated market risk, take into account the distinguishing characteristics of *sukuks*, and to decrease the cost of issuing.

These suggestions have been reflected in the launch of a non-ringgit denominated *sukuks* index by Bloomberg in June 2011. In addition, a consortium of banks and financial institutions launched the IIBR in November 2011(see Chapter 4). However, Shaikh Muddassir Siddiqui**,** a scholar on the committee's board and partner at law firm SNR Denton in Dubai, believes that adoption of the IIBR by a wide range of Islamic institutions may take time for banks to familiarise themselves with the new system.

7.10 Guarantee Issues with *Sukuks*

As discussed in Chapter 2, the Islamic finance paradigm is based on a set of prohibitions. *Sukuks* have ownership in tangible assets, or usufruct and services (in the ownership of the assets of particular projects or special investment activity, which are similar to mortgage pass-throughs, as investors own a portion of the underlying asset, which collateralises the debt (Ahmed, 2010). In addition, the purchase undertaking in some *sukuks* contracts is akin to a guarantee of profit and principal, which, unless given by an independent third party (i.e. anyone other than the originator), is not permitted under *sharia.* This issue was recognised by the chairman of the AAOIFI's *sharia* board, who declared in 2007 that 85 per cent of *sukuks* based on the principles of *musharaka* and *mudaraba* were contrary to the Islamic *sharia* laws (see Chapter 1).

The respondents were asked to provide responses to questions on the issues of purchase undertaking and guarantees. Fifteen out of the 19 respondents (79%) (see table 7.12) were concerned about the foggy circumstances of initiating and exercising the purchase undertaking of different *sukuks* structures in the event of originator defaults, especially *sharia* scholars' opinions in this matter if they practice their rights in court.

Table 7.12: *Guarantee issues with sukuks*

The factors	Issuers	%	Investors	%	Total	The percentage overall
They worried about the foggy circumstances of initiating and exercising this clause especially *sharia* scholars' opinions in court	9	100%	6	60%	15	79%
The guarantee of purchase undertaking is important clause of *sukuk* contract	9	100%	6	60%	15	79%
The guarantee of purchase undertaking during the process of *sukuk* structuring is not important clause.			4	40%	4	21%

Nine issuers stated that most institutional investors do not wish to take the risk of the fluctuating market value of the underlying assets at maturity because they are in no position to take on market risk. They stated that the purchase undertaking offers more comfort for investors in case of default and that most investors in GCC *sukuks* markets require this clause, which can be triggered if the *sukuk* obligor has difficulties in meeting financial obligations. They also mentioned that under the law of the country in which the originator is based, the due diligence process, or rating agencies, must ensure that the purchase undertaking is enforceable.

Furthermore, six investors stressed that such an clause in any agreement is necessary to establish more confidence in this type of debt instrument and to shield them from any potential losses. The absence of such an clause would imperil the credibility of the issuer. They suggested that in order to rule out any misinterpretations of this issue, the GCC governments have to regulate and implement a framework and mechanism to protect investors in case of default. In particular, one investor said:

> *Sukuk* have been issued by X financial institution and could be structured as *mudaraba*. In this case, we don't know if there [was a] cash flow or [not] because [no] one's going to monitor their activities and we [didn't] know what they're investing in it.

Conversely, four investors (21% of total respondents) thought that the guarantee of purchase undertaking during the process of *sukuk* structuring is not important. Therefore, they do not pay any great attention to the underlying assets. They argued that the companies might find debt agreements to be too limiting. It is well known that any company would find it hard meeting their debt repayment if it is highly leveraged. Due to external events which is beyond their control or any internal events such as incompetent management big firms could find it extremely difficult servicing the cost of their debt. This is usually the case when the amount of debt is significantly greater than the value of the company. In addition, they stated that the risks associated with the underlying assets in *sukuk* could be indefinite and unknown in markets because it is not fully tested. The uncovered risks could be grave if they are not carefully estimated and fully incorporated into the structure among those who are involved in the *sukuk* issuance, such as *sharia* scholars, law makers and accountants.

In conclusion, the purchase undertaking aspect of the *sukuks* contracts is critically questionable in GCC markets. Consequently the effectiveness of this matter has a huge impact in promoting *sukuks*, as it enhances the creditworthiness of the issuance especially in the eyes of the rating agencies. However, given that subscribers to *sukuks* are meant to be part owners of assets, at least in theory, their credit and risk profiling should be based purely on an assessment of the value of and revenue generating potential of those assets, instead of just the repaying ability and balance sheet of the company issuing the *sukuk*. In the absence of such a treatment and the ability to properly segregate those assets for the *sukuk* holders, *sukuks* contracts will be little or no different from conventional bonds.

7.11 Local Currency Issuances *v.* US Dollar Issuances

GCC local currencies are predominantly pegged to US dollars. However, the US dollar continues to be the currency of choice for *sukuks* issuers, which has been declining in favour over the past five years.

For that reason, the interviewees were asked to provide responses to question relating to the denomination of the *sukuks*. The majority of the respondents were in favour of the local currency *sukuks* over the US dollar as shown in table 7.13. Nine issuers stated that *sukuks* are an alternative to financing their business or their projects, and financial institutions are increasingly turning to *sukuks* to sustain strong lending growth with stable funding sources and to curb maturity mismatches. They also mentioned the weakness of the US dollar in the last five years compared with other major currencies, as well as the huge amount of liquidity in the Gulf that *sukuks* issuers want to tap. They stressed that more local currency issuance whenever the pool of the underlying assets is denominated in local currency especially when genuine asset-backed *sukuks*. In addition, they thought that local demand for *sukuks* is a market driven decision, demanded mostly be government entities and financial institutions that are major investors in the market, and obliged by regulators to invest in local currency asset class.

Table 7.13: *Local currency issuances v. US Dollar issuances*

The factors	Issuers	%	Investors	%	Total	The percentage overall
They are in favor of the local currency *sukuks* over the foreign currencies	9	100%	7	70%	16	84%
A significant share of foreign currencies *sukuks* will remained	3	33%	3	30%	6	32%

Three issuers considered that a significant share of *sukuks* issuers to continue to depend on the US dollar, mainly because they are financing infrastructure projects where the costs in most cases are denominated in foreign currencies, especially for raw materials.

In September 2012, Thomson Reuters confirmed that tapping the *sukuks* market could help improve the capital structure and liquidity profiles of GCC companies, particularly those operating in capital-intensive industries such as infrastructure. It could provide such companies the longer-term funding they need via a different funding source. This source is becoming more liquid as it reaches across border and becomes more global and grows in scale.

Seven investors preferred local currency because they are required by regulators to invest in local currency asset class. They stated that as long as local currencies are pegged to the US dollar the local currencies receive a degree of stability which helps to provide market confidence to the local monetary system.

Three investors felt that the features of the preferred currency should be liquid especially at times of high currency speculation. According to them there is an initial risk to currency exposure which is evaluated according to the market conditions and liquidity, making them adopts a strategy of diversification.

In conclusion, the respondents indicated that local currencies issuances would continue to be the currency of choice for *sukuks* issuers. Considering local currencies pegged to US dollars which gives the currency a degree of stability, as well as the local demand for *sukuks* is driven by government entities, financial institutions and insurances sector that are major investors in the market, and are required by regulators to invest in local currency asset class. In addition, financing infrastructure projects which the costs in most cases are denominated in foreign currencies, especially for raw materials will lead to more US dollar issuances.

7.12 Factors Hindering *Sukuks* Market Growth and Innovation

The *sukuks* markets in the GCC region is confronted with several serious challenges that could have negative consequences for innovation and regulation. Although innovators have developed numerous *sukuks* structures, which are proving to be flexible and sustainable to meet future market growth, some *sukuks* structures have recently been rejected by the majority of *sharia* scholars in the region because the principal payment is only guaranteed at par.

On the issue of high risks associated with *sukuk,* this should encourage the experts in financial engineering to develop innovative instruments to create a better balance between risk and return. Fourteen out of the 19 respondents (74%) (see table 7.14) commented that there is an increasing demand from the *sharia* compliant community to make asset ownership in a *sukuk* transaction more real than it currently is, whereas 26% (four issuers and one investor) believed that if a position of compromise is reached on this by industry standardisation, it would be almost impossible to market *sukuk* as corporate senior debt and it will be more along the lines of securitisation.

Table 7.14: *Factors hindering sukuks market growth and innovation*

The factors	Issuers	%	Investors	%	Total	The percentage overall
credibility and acceptance for standardisation asset ownership in a *sukuk* transaction	5	56%	9	90%	14	74%
Thought that standardisation, it would be almost impossible.	4	44%	1	10%	5	26%
Consistency is the most factor, so standardisation legal and *sharia* framework is vital to boost confidence			9	90%	9	47%

Eight out of 19 respondents (42%)—four issuers and four investors—stressed that each and every company adopts a different way to handle structures that affect their organisation and business. However, as the whole market depends upon the pricing and investors' perception, their perception will change the whole dynamics. According to them the most important objective is to satisfy the preferences of the investors and issuers. Thus, financial engineers have an enormous opportunity, and to some extent responsibility, to be more inspired to develop different structures and different tools of money market instruments and techniques. In this respect, one investor expressed his opinion as follows:

> [in] truth practitioners and financial engineers are not doing their duty in *sukuks* markets, actually they adopted the conventional practice in Islamic financial system.

Four investors believed that the lack of uniformity in operations of commerce act as deterrent to financial engineering. Therefore, the traditional hedging operations such as options, futures, and forwards are not available, although some options in the form of *arbon* or *khiar alshard* is available in *sukuks* contracts.

Nine investors, however, agreed that the biggest problem is not tools but consistency and uniformity in religious ruling. Disagreements and differential rulings among *sharia* scholars create uncertainty resulting in the efficient functioning of financial markets. There is a great need for standardised regulatory and *sharia* framework in order to boost confidence levels in the *sukuks* market. The limited existing standards as provided by AAOIFI seem to suffer lack of recognition; three respondents reported that the AAOIFI standards are not fully acceptable especially in the Saudi Arabian market.

As a result, AAOIFI is not providing sufficient levels of standardization and has some limitations for wide scale acceptance, and obviously it is going to hamper people who are trying to engineer new structures or tools. It appears that it is not the risk that's hampering financial engineering but the apparent lack of consistency associated with *sukuks*. The majority of respondents (85%) stated that practitioners in the *sukuks* market should develop new strategies, mechanisms, and structures that reduce risks associated with *sukuks*.

One of the investors lamented over cases where investors are reluctant or refuse to buy because *sharia* board of some of other intuition has forbidden a particular structure because of the possible presence of prohibited transactions such as *riba* or *gharar* in the *sukuk* contract. Thus, he clarified what he meant by the term credibility by suggesting that all *sharia* scholars should be gathered under one central body, preferably under the umbrella of the central bank or market authority, and cooperate with experts in finance to develop a range of *sharia* compliant financial instruments to meet various objectives of the financial fraternity. In conclusion, since Islamic financial products are operating in a conventional system, researchers and practitioners have to be more innovative to maintain these financial products competitive against the conventional products and provide an environment for sustainable development and improvement. The scholarly opinions on the contracts and the product information disclosure should be in detail and in clear accessible language for the business community to understand the basic features of the contract, if not the entire contract. This information provided would ideally include, amongst others, rights and obligations of the parties to the contract, potential losses and associated risks, and dispute resolution procedures. If a contradiction occurs, public interest must take priority and the product must follow laws and regulations that are consistent with Islamic law.

7.13 The *Maslaha* Concept in Financial or Investment Decisions

The *maslaha* concept can be realised in the outcomes of implementing *sukuk*, which is the welfare and interest of the community and society. *Sharia* encourages and supports the concept of the development and the building of the earth's resources. In order to achieve the objectives of the Islamic economic system, *sukuks* products must promote the aims of social and economic development by adding economic value and creating more job opportunities.

Muslims are mindful of the profitability of the asset being financed by the investment to gain the benefits in this life and the life hereafter. This is a fundamental belief in Islam.

The consensus among the 19 interviewees was that a *sharia* compliant approach is preferable to everybody in the market especially in GCC region. The key factors driving these preferences varied between the interviewees according to the participants' sectors or their business activities or their position in the transaction (borrower or investor). Table 7.15 is summarized respondents opinion regarding *maslaha* concept in financial or investment decisions.

Table 7.15: *The maslaha concept in financial or investment decisions: religious convictions affect participants in their financial decisions*

The factors	Issuers	%	Investors	%	Total	The percentage overall
Tap into *the sukuks* market is purely for confidence	8	89%	10	100%	18	95%
A religious conviction is not direct relevant objective.	8	89%	5	50%	13	68%
The cost and profit approach is direct relevant objective.	8	89%	10	100%	18	95%
Tap into *the sukuks* market is commercial choice	9	100%			9	47%
The supervision of the *fatwa* and *sharia* supervisory board approval is a serious matter.	3	33%	5	50%	8	42%
profit and loss sharing mechanism is essential in the market	7	78%			7	37%
public benefit is insignificant	9	100%			9	47%
The investment criteria should be distant from religious beliefs and evaluated based on the risks and returns			1	10%	1	5%

7.13.1 Do religious convictions affect issuers' financial decisions?

The *sukuks* market started gaining momentum only when major public corporate entities started issuing *sukuks* on almost an annual basis to diversify their funding base. *Sukuks* became the most popular *sharia* compliant financing instruments since 2006 in the GCC. The debt market in GCC countries needs to mobilise local assets for domestic development, to develop sophisticated financial engineering for funding large infrastructure development and to meet a growing demand for *sharia* compliant financial products, as demonstrated in Chapter 4.

However, in modern economical paradigm, financial intermediary of savings in the economy and financing of productive activities is absolutely critical for which the alternative to conventional banks have to be based on a commercially acceptable Islamic format. This means the commercially oriented profit motive on both asset and liability side of an Islamic finance necessitates the use of trade based modes of Islamic finance as well as considering *sharia* objectives. This means borrowers have to raise funds for a project that invoked balance between wealth and moral objectives pursued social goals as a whole to increase the volume of national output and raising the standard of living which is a fundamental belief in Islam.

So, to explore the perception of the issuers in market place, they have been asked to answer questions regarding the religious convictions in their financial decision making which is related to the motivation, aim and outcomes of implementing *sukuks*.

Eight out of the nine issuers agreed that participating in *sukuks* just gives them the comfort that they have acted in line with their religious beliefs, and it was not the directly relevant objective in their financial decisions. They were concerned about the cost and profit, so the best *sukuk* structure that fit their need is required. They would also choose the cheaper option to increase their profit and reduce their obligation cost. In addition, they argue that belief only affects the range and type of financing universe we may have available and not the financing criteria. Three issuers pointed out the importance of *sharia* approval of a particular structure, which should indicate that it does not comprise in its final aim or transaction any kind of *riba* or *gharar.*

One issuer expressed that unless the issuer is a sovereign and seeking to fund a project exclusively for the benefit of public (say road infrastructure, bridge, school, hospital etc), *sukuks* are issued to raise financing for a specified purpose. Thus, every *sukuk* issuance has some direct or indirect public benefit associated with it. Therefore, their company deals in real estate which creates more houses for the people that helps the society.

The subject of more *sukuks* based on equity in underlying assets was brought up during the discussion. Seventeen respondents agreed that the partnership contract with a profit and loss sharing mechanism is essential in the market. As banks and most other institutional investors implement risk averse funding policies, the thought of equity-based *sukuks* is still considered to be remote, while, some potential issuers seem to be disinclined to share their upside profit with their equity investors. Therefore, innovative more an economically viable equity based *sukuks* would facilitate to achieve *sharia* objectives in wise manner.

The consensus among the 10 issuers was that tapping into the *sukuks* market is a wise commercial choice. These debt market instruments, in reality are not designed with social benefits in mind, though social benefits are not excluded. *Sukuks* are ideal fixed-income investments, but this is not the preferred mode of income for those wishing to live by religious rules because of the involvement of *riba.*

7.13.2 Do religious convictions affect investors' decisions?

Sukuks have attracted much attention in GCC region. If it is based on Islamic principals then it should serve the spirit of *sharia.* Thus, according to the *maslaha* approach, investors seek return on invested money on the basis of public interest. The focus of the study is to assess to what degree religious convictions affect investors in their investment decision making. This might prove more effective in markets and allows Islamic financial institutions and potential issuers to match their products and commercial viability more accurately to the demands of Islamic ethics and morality. So, investors were asked to provide responses to questions on this issue.

Ten investors thought that since *sukuks* contracts operate under conventional financial systems, any practitioner will act according to the profit maximisation paradigm, which is the fundamental objective of the capitalist economic system. Religious beliefs only give them the format for investment or more specifically the contract bargain; hence, they have nothing to do with investment decisions. The risk-return characteristic is still the main driving force for the construction of the investment portfolio along with diversification as the most popular strategy for risk mitigation. Further, trading in *sukuks* gives them some level of confidence because of its compliance with *sharia* laws. Five investors stated that their investment activities are conducted in accordance with *sharia* guidelines under the supervision of the *fatwa* and *sharia* supervisory board whose members are specialists in Islamic economic and *sharia* transactions.

One investor stated that "considering the public's benefits in our investment decisions could eliminate the level of risk exposure". According to him the investment criteria should be distant from religious beliefs and evaluated based on the risks and returns associated with each issuance. Moreover, investing in *sukuks* assures investors are conducting Islamic financial instruments according to their beliefs. This view has been endorsed by other respondents.

Two investors agreed that Islam indeed maintains public benefit at the core of its objectives and lays down detailed guidelines. Thus, *sukuks* have been created to raise money for a specific purpose that helps the society to be free of prohibited transactions. They also stressed the importance of an ongoing debate on the trade off between the objectives of the shareholders and the stakeholders, because of the view among some that the stakeholder interests are as important as, or even more important than, shareholder interests. Thus, on average, assuming if a *sukuk* is genuine, invariably, it will be serving some public interest one way or the other. According to them there are two reasons for this assertion. Firstly, *sharia* compliant *sukuk* based investments cannot involve activities that result in damaging the environment, and secondly, most *sukuks* projects involve infrastructure projects, real estate development, typically for housing, some sort of asset building or capital investment activity which ultimately have great impact on income generation, social capital building, and employment generation. It was further stated that educating the market participants on the real long term benefits of the types investment that have social benefits would increase the demand for such issuance.

7.14 Conclusion

This chapter has provided valuable insight into the different issues related to the prospects of *sukuks* in GCC countries, specifically Bahrain, Saudi Arabia and the UAE.

The most significant result is the consensus among the 19 respondents that the GCC *sukuks* markets will continue to exhibit steady growth. The most important factors that have driven these markets are the massive financing requirement for the GCC's infrastructure projects, the religious considerations when issuing *sukuks* to Muslim and non-Muslim investors and the significant proportion of GCC companies that are required by regulators to place a substantial percentage of their investments in local currency assets such as *sukuk*. *Sukuks* platform markets have been launched in Bahrain, Saudi Arabia and the UAE to meet these demands.

It is clear that practitioners differ in their definition of *sukuk* as debt or equity because of the foggy explanations of each structure. This could discourage potential investors who believe that Islam prohibits trade in debt. However, the classification of *sukuk* as debt or equity depends on the issuer's financial balance sheet. Based on the interviews *sukuk* can be seen as instruments of debt, but they will have better participation if structured as equity.

The 19 interviewees differed in their thoughts about the risks associated with *sukuk* in terms of liquidity, liability and structure. The most important factor is the liability of the parties to the contracts on the underlying asset and its ownership. The majority of the respondents recognised that only a few *sukuks* have tangible asset ownership, implying that some *sukuks* have the character of debt than equity. In addition, most of the investors were aware that *sukuks* sometimes should grant the investor a share of an asset or business venture along with the cash flows and risks commensurate with the underlying asset. They concur that the assets in the structure are commonly for *sharia* compliance approval only, and ultimately have little or no relevance on the risk or performance of *the sukuks*.

There is a significant degree of concern over the recent appearance of complicated *sukuks* structures in the market, implying that the financial markets in the study area have not sufficiently matured as to be comfortable with the complexities of a modern financial system and that there is a great need for educating the market participants on the finer points of financial instruments and transactions.

In contrast to conventional markets, the Gulf markets included in the study did not consider liquidity risk as a major constraint because *sukuks* participants prefer to hold it until maturity.

There is clearly increasing confidence on the returns of *sukuks*. Almost the entire market believes that the returns on *sukuks* are comparable to that on conventional bonds. There is wide scale belief that the current benchmarks are not suitable to capture the spirit of *sharia* compliant financial instruments and for the proper functioning and growth of the *sukuks* markets there is a dire need for a more appropriate benchmark or a set of benchmarks for the market signals to incorporate the characteristics of *sharia* compliant financial instruments. The current pricing mechanisms are inadequate for providing efficient pricing signals and clarity for optimal decisions. Investors tend to overemphasise the importance of underlying assets in determining *sukuk* profit margins, whereas issuers indicated the importance of interest rates and economic conditions.

One of the ongoing debates in Islamic finance is the cost of *sharia* compliant products versus conventional products. The conventional wisdom is that there is a premium associated with *sukuks*, and the respondents indicated a combination of commercial, structural and legal factors leading to steep increases in *sukuks* costs. During times of financial stress, investors tend to avoid newer, complex and less-tested forms of investment in favour of more traditional investments. If *sukuks* forms are standardised and *sharia* rulings are centralised by one body, the costs associated with *sukuks* issuances are likely to be less costly.

Rating services are offered by major global agencies and are unable to offer sufficient flexibility to accommodate the provisions of *sharia* law in their rating mechanisms. This deficiency of the rating regime is adversely affecting the prospects of *sukuks* markets in the study area, and possibly the whole region. These markets are indeed thirsty for an Islamic rating agency, local or international, which can work together with *sharia* scholars to provide potential investors with a solid standardised *sukuk* structure and mechanism. A credit enhancement mechanism taking into account the *sukuks* characteristics would lead to a feasible credit rating methodology, and decrease issuance costs.

Subscribers to *sukuks* are meant to be part owners of assets. To be consistent with this characteristic, *sukuk's* pricing and risk profiling should be based purely on an assessment of the value and revenue-generating potential of the underlying assets, instead of just the paying ability and balance sheet of the company issuing *sukuk*.

The use of purchase undertakings from the obligor in *sharia* structures created criticism among 79 per cent of the respondents. This agreement has been use for the reasons of negating risk (which is analogous to the principal amount under a conventional bond). It is guaranteed by the requirement that the SPV sell back the underlying asset to the obligor at the original price. The respondents were worried about the foggy circumstances of exercising the purchase undertaking in case of defaults. They stated that GCC countries apply *sharia* law in their courts which might not accept such agreements. This is because in most *sukuks* cases the purchase price is pre-agreed on the issue date of the *sukuk* instead of it being determined at the time of sale in the future.

The US dollar continues to be the currency of choice for *sukuks* issuers, but it has been declining in favour over the past five years. Local currency issuances face a greater demand which gives them a degree of stability. Moreover, the local demand for *sukuks* is driven by government entities, financial institutions and the insurance sector, which are major investors in the market who are required to invest in local financial assets.

Chapter 8: Findings and Discussion

8.1 Introduction

This chapter presents a summary of the key findings of the thesis in relation to the research questions posed in Chapter 1. Section 8.2 highlights the theoretical and practical significance of the findings and discusses them in light of the primary research question, which will then shed insight on the secondary research questions. Sections 8.3 to 8.5 present the results that are relevant to the *maslaha* criteria pertaining to the motivation, structuring and outcomes of implementing *sukuk* contracts. Section 8.6 summarises the chapter.

8.2 Findings Relating to the Research Questions

This research recognises the importance of understanding the Islamic paradigm of borrowing, lending and investment theory and practice. Hence, Chapter 2 provided the main literature on Islamic finance and *sukuks*.

Since specific laws in Islam are articulated based on the fundamental principles and are flexible, there is disagreement between different *fiqh* schools regarding some issues related to *sukuk* implementation. Therefore, it is important to reach a mutual understanding over their relevant rulings on the contemporary controversial *sharia* compliant financial instruments, and this is displayed in the recognition of *maslaha*, which *sharia* scholars predominantly promote as an important value and objective of the *sharia* to reach greater consensus in the best interest of public like.

Therefore, answering the primary research questions were done in Phase 1 of this research, as described in Chapter 5. Through reviewing *maslaha* concept as is prescribed by the teachings of Islamic law which is invoked to prohibit or permit something on the basis of whether or not it serves the public's benefit or welfare. This concept has been introduced in chapter 3 of this study.

Sukuks structures and their transactions are encouraged at all times to be in compliance with the five core principles of Islamic finance. This means if the structure complies with these five core principles then it will serve the society as a whole. However, in reality some of the *sukuks* had been adopted in the financial system doesn't appropriately achieve the characteristics of Islamic financial paradigm and do not adequately reflect the fundamental differences that distinguish them from the conventions of the current financial system.

It is pertinent to highlight that a lack of reference to or the explicit exclusion of usury doe not render a financial contract *sharia* compliant. Contracts must be examined in entirety for the purposes of determining whether they comply with the principles of *sharia*. It is a commonly held view that all usury free contracts are *sharia* compliant. In addition, a healthy economic environment at any given time form Islamic law perspective does not guarantee positive return or a productive use of money capital as value productivities lie in a future surrounded by uncertainty and risk. Some risk is involved in the productive use of capital which, in fairness, must be shared in a fair manner among the parties to the contract. Therefore, a classic *sharia* scholar such as Ibn Taymmiyah gives any form of contract that employs the principles of profit/loss sharing a priority in use it. This is because it built on equality of all parties and it is far from injustice and deceitfulness and nearer to *sharia*'s fundamental objectives.

Moreover, some scholars deem it impractical to determine the validity of contracts by means of intention due to the difficulty of identifying the contractors' intentions, and they have found *sharia* texts suggesting that things should be judged on their form and substance (Abozaid, 2008) (see chapter 3, Section 3.3).

Accordingly, the overall finding of *sukuks* observed in related to motivation criteria indicated that a good reason attached of using *sukuks.* The majority of issuers' requirements for financing match the privatisation plans in GCC countries promoting economic and social development and enhancing the effectiveness of employment, welfare, and innovation. This reason goes along with the Islamic purposes or *maslaha.*

The expanding *sukuks* role played by issuers and investors as key players in financing large scale economic development is being very effective and could serve as a bridge between the large pools of capital and the demand for immense infrastructure investment requirements provided mainly by the GCC governments. As mentioned in Chapter 4, Middle East business intelligence indicated that GCC countries spent US$720 billion on capital projects through 2000–2008 (MEED, 2011). The announcement of Samba Financial Group in March 2008 by the Saudi Arabian government involving capital and infrastructure expansion projects worth US$283 billion over the next few years, of which the oil and gas sector alone accounts for a quarter, also reflect the demand for *sukuks* as alternative financing instruments. SAMA (2011) declared that some US$40.6 billion will be invested in the Saudi petrochemical industry in the five-year period starting in 2006. These investment projects highlight the importance of government infrastructure projects in driving development in GCC countries. These are being handled by the private sector, under public-private participation framework which work in parallel with privatisation plans in GCC countries.

The findings reiterate the view that the most important factors driving *sukuks* markets are the massive financing requirements for GCC infrastructure projects, the religious issues for Muslim and non-Muslim investors in *sukuks* and the significant proportion of GCC companies required by regulators to place a substantial percentage of their investments in local currency assets such as *sukuk*.

As a result, the launching of the *sukuks* platform markets has substantially enhanced the prospects of *sukuk* becoming a pivotal investment asset class. This particularly applies to local investors in Bahrain, Saudi Arabia and the UAE, which constitute nearly 90% of the *sukuks* market in the GCC. *Sukuks* have a significant priority in these countries compared to conventional bonds. This also supports the element of world reconstruction in *maslaha* by achieving and promoting social and economic development.

For *sukuks* issuances to be safe from deceit, reduce the chances of disputes and the resulting in losses, or damaging the fund, rigorous scholarly opinions and clear and comprehensive product disclosures are essential.

8.3 Criteria Relating to the Motivation of Contracts

Under the principles of *maslaha* the participation in contracts should be governed primarily by public interest. To be consistent with this, the scholars' opinions on a set of *sukuks* should not contradict this, meaning, in general, *sukuks* issued for public benefit projects should always be ranked higer by practicing Muslims than those that are issued exclusively for private benefits. This is consistent with the principles of the Islamic faith.

The case studies in the present study indicate that some scholars made exceptions to this rule either in the structure itself or transactions under the contract. This was the case in the first issuance to create assets for Tabreed (2006), and it is not known on what basis this exception was made. It seems Tabreed converted Palladium to pure debt by selling it to *sukuk* holders. However, *sukuk* holders may not be aware that they were involved in *murabaha* transaction which is pure debt. Since, many scholars of Islamic finance consider *murabaha* as being non-compliant with *sharia* requirements if it is tradable it is clear that in this case the *sukuk* holders were unwittingly participating in inefficient transaction.

In the case of SABIC the company entered into an interest rate swap agreement with a notional value of SR 13.6 billion to hedge the volatility in interest rates related to outstanding debts. This component of the transaction may not have been clearly communicated to the participants in the contract. This implies that SABIC entered into a forbidden transaction without full disclosure that would have enabled the buyers to fully assess the transaction.

Therefore, these findings are explained the opinion of the interviewee (investor from financial sector), when he said in the interview, 'There is no or very little difference compared to conventional bonds so nothing additional is required other than a *fatwa'*. El-Gamal (2000) provides a translation of the Prophet Muhammad (PBUH) *hadith* that explained *riba al-nasi'ah* and stressed that the transaction should be in equal amounts; and any increase is *riba.* Therefore, in Tabreed and SABIC issuances the conflicting interests from *sharia* perspective were accrued, which means that the products' structures mist be free from deceitfulness in its base.

The case studies seem to indicate that conventional contracts are dressed up and sold as *sharia* compliant ones which only have the appearance of *sharia* compliance but one that breaches the principles of *sharia*. Transactions that are designed to benefit one or a few at the expense of wide scale harm violate the principles of *sharia* (Al-Shatibi, 1975). One approach that could be employed to minimise the probability of such transactions is to establish a centralised rating system.

There is a healthy level of optimism in the market and the participants believe that more appropriate benchmarks and credible rating for *sukuks* would instil greater confidence among the market participants.

8.4 Criteria Relating to the Structuring of Contracts

Criteria relating to structuring contracts include full disclosure of all aspects of the contract including the form, the substance, the purpose, the players and the various parties to the contract. It should also include any changes to this information that could occur at any stage of implementation of the contract.

The *sukuks* contracts assessed in the present study exhibited a wide range of characteristics, some of which breach the conditions of *sharia*. This included guarantee of profit and guarantee of the principal by the originator. The principal can only be guaranteed by a third party as recognised by the chairman of the *sharia* board of the AAOIFI.

The rights of Tabreed's financial assets represent a proportionate beneficial ownership to the *sukuk* holders. However, the purchase undertaking given by the *sukuk* manager in Tabreed issuance who manages the *sukuk* assets to buy back the *sukuk* assets at a pre-determined face value makes the investment relatively risk free. This makes this form of *sukuk* a debt like instrument that is forbidden in Islam to be a tradable in the market.

Similarly, *sukuk* holders of ALDAR's second issuance may not be aware of the fact that land department in the Emirate of Abu Dhabi currently does not maintain a register that allows registration of such the *musataha* interest (a right in rem). So, if a legal action is taken to the courts in the Emirate of Abu Dhabi, a local court may contest the validity of the *musataha* interest against the obligor. Therefore, the contract guarantees the purchase undertaking to indemnify *sukuk* holders for any and all obligations in connection with any enforcement of the relevant undertakings, since there is no relevant law in the UAE. It is clear that ALDAR *sukuk* agreement contains some element of *gharar*.

Another example is the EIB *sukuk* which included a third party as the guarantor Emirates Bank International PJSC, which is a wholly-owned subsidiary of EIB. This arrangement violates the principles of *sharia* because the third party is in fact the originator and, hence, the investors are assuming the issuer's risk.

S*ukuk* structured as *mudaraba* and *musharaka* where the principal payment is guaranteed at par have recently been ruled to be non *sharia* compliant. The DIB *musharaka* issuances of DIB, GFH, and SIB and the *mudaraba* issuance of DP World had such guarantees. These contracts are in violation of the fourth ruling of the AAOIFI (2008) resolution, and articles (2/2/1) and (2/2/2) of AAOIFI (2010) *sharia* standard (5) on guarantees.

In the same manner, in Tamaweel's third issuance, the manager acted as a partner of the *sukuk* holders, and it is unlawful for the manager to guarantee the return of capital to them, as it would impair the partnership in the event of losses.

Similar to SABIC and SEC (*sukuks al-istithmar*), the purchase undertaking gives the right to *sukuk* holders to sell the *sukuk* to the issuers at face value so this adds a risk-free nature to these structures. In addition, they use principal amounts from the underlying financial assets to service coupon payments. Consequently, these two structures are invalid for not fully comply in with the transparency requirements of *sharia* compliant contracts.

Mudaraba contracts are constructed on the principle of equity where the benefits (profits) and risks are shared equitably between the seller and the buyer of the contract. This was not the case with DP World *sukuk mudaraba* because the structure specified that both the periodic payments and the redemption payment to the *sukuk* holders were fixed and guaranteed. Under this contact, any surplus over the periodic payments to the *sukuk* holders accrues to the originator as an incentive fee, annulling the possibility of excess profits to the *sukuk* holders. On the other hand, if insufficient profit is generated, then DP World will be required to provide *sharia* compliant funding to meet the payments in full. The credit risk therefore is eventually DP World's and in a way DP World will ensure that *sukuk* holders do receive the indicated 6.25 per cent rate of return. These features made the DP World *sukuk* resemble conventional bond and lacked *sharia* compliance. There is a widespread belief that many of the *sukuks* have features similar to the one described here as expressed by a majority of the respondents.

To create a bond-like *sukuk*, the cash flows extracted from the underlying assets should be characterised by a fair degree of predictability. However, this feature does not necessarily make them risk-free instruments. Indeed, risk taking is valued in Islam, and Islamic investment theory validates the distinction between risk (a random quantity subject to probabilistic measures) and uncertainty (radical randomness out of the scope of probability distributions). Such a nuance is at heart of the bans excessive uncertainty in contracts and gambling or chance-based games principle. *Sukuks* are always structured notes. There are numerous ways of structuring *sukuk*, the AAOIFI (2010) counts 14 different *sukuks* structures.

In the case of SHB *sukuk al-mudaraba*, there is no purchase undertaking embedded in the structure. Since the account payments are subject to final liquidation of the *mudaraba*, the *sukuk* holders are taking true risk of loss of the *mudaraba* agreement. If the *mudaraba* does not make enough profit to cover the principal amount, SHB will not be able to perform this right. Therefore, this innovative mechanism seems to be *sharia* compliant. Therefore, this mechanism have been approved by the AAOIFI's(2008) *sharia* board, who stressed that it is not objectionable to distribute expected earnings, on account, in accordance with Article (8/8) of the AAOIFI (2010) *sharia* standard (13) on *mudaraba*, or to obtaining project financing on account of the *sukuk* holders.

These remarks have had major repercussions in the fast growing global *sukuks* market, which caused it to slow down for two years from 2008. Even though it is regaining its momentum, these remarks could have done permanent damage to the niche market. Nonetheless, the solution for these remarks has been provided by Dana Gas *sukuk*. In order to ensure *sukuk* holders' principal the certificates are convertible into the ordinary shares at ADX listed Dana Gas, either redeemed in cash or against issued shares under certain conditions. The exchange ratio between the *sukuk* and the shares of Dana Gas at any point in time, as well as the redemption amount payable on redemption or maturity will be determined in the same way as for any conventional convertible or exchangeable instrument, except that in this case it is governed by *sharia compliant* contracts of the purchase undertaking and the sale undertaking. In addition, to insuring this *sukuk* to be tradable in accordance with *sharia* law, the conversion price is to be determined by market conditions and has not been predetermined. It seems this structure is conform to article (5/1/8/5)7 of AAOIFI's (2010) *sharia* standard (17).

The analysis of the case studies indicate that *sukuks* have been confirmed as alternative means to mobilise medium to long term savings and investments from a vast investor base. Investors are able to focus on the underlying asset and viability of a project and not just on the credit worthiness of the issuer. *Sukuks* involve the securitisation of real assets and raising funds to produce economic activities on the basis of sharing risk and rewards. Hence, leveraging is contained to the underlying value of the assets, which means that there has to be a high degree of transparency and disclosure in the underlying assets with the current structure of *sukuks*.

In relation to this, problems still revolve around form over substance. Asset-based *sukuks* structures are prevalent in the Islamic capital market but do not fall under Islamic securitisation because of the absence of a true sale in the operation, while asset-backed *sukuks* do fall under Islamic securitisation due to the presence of a true sale.

The case study results demonstrated that some of *sukuks* issuances in GCC market do not comply with disclosure requirements, especially on the underlying assets. This is the case with ALDAR *mudaraba* issuance, GFH *musharaka*, SIB *musharaka* and SHB *mudaraba*, where the circulars of these issuances did not clearly specify the assets. On the other hand, the circulars of SABIC and SEC *al-istithmar* issuances the underlying assets have been clearly specified.

The majority of interviewees recognised that only a handful, if none, of the existing *sukuks* have asset ownership or security. Thus, it is not surprising given that investors are mainly focused on corporate credit quality and less concerned on the actual underlying asset performance when they buy *sukuks*. Therefore, four investors (21% of interviewees) thought that the most important factors in *sukuks* decisions are country rating and the issuer rating which shows the quality of the issuer in the assessment of default risk. They demonstrated that the risk associated with the underlying assets in *sukuks* could be indefinite and unknown in markets because it is not fully tested. Thus, the unrealised risk within the underlying assets could be grave if it is not carefully calculated and fully surveyed among the people who are involved in *sukuk* issuance such as *sharia* scholars, law makers and the accounting professionals.

The above findings are consistent with those of Abdul Aziz and Gintzburger (2009), who found that in asset-based *sukuks* no true sale transaction takes place, as it is just a transfer of financial rights to the asset, and income is derived from the financial rights to obligations attached to the debt. Whereas, for *sharia* compliance any asset-backed *sukuk* issuance starts with the identification and segregation of a pool of underlying *sharia* compliant assets on the balance sheet of the company seeking finance. Tangible assets such as properties and land are naturally eligible for *sharia* compliance.

The case study results demonstrated that in some *sukuks* cases ownership rights attached to the pool of assets are then transferred to an *ad hoc* economic entity, in the form of an issuing special-purpose vehicle (SPV) that has no capital and seeks to isolate the underlying assets from the borrower. The SPV usually purchase the assets with the investor's funds, and ultimately the SPV constitutes the legal issuer of the *sukuk*. Legal or beneficial ownership is passed to the investors, but with a security agent or trustee.

This can be seen in case of ALDAR *sukuks* where investors have direct rights to the underlying assets, so they are assuming true risk of the underlying assets. Moreover, DAAR first and second *sukuks* issuances transactions make use of *ijara* structure, while the certificates represent a share of assets primarily consisting of rights and interests in and to certain land and buildings. In addition, the Sorouh *sukuks* issuances are based upon the structure of *mudaraba*, where the structures were under an asset transfer agreement, so there will be a transfer and registration of title of the land to Sorouh Abu Dhabi Real Estate LLC (PropCo). Thus, the deal represents the equivalence of a receivables securitisation without actually selling debt. Lastly, the first Tamaweel *sukuk* freehold titles to the underlying properties were transferred to the *sukuk* holders with the associated *ijara* cash flows. Property titles are registered in the names of the SPV that issued the *sukuk* and the *sukuk* holders.

Some issuances do not have meet proper disclosure requirements about the underlying assets. This can be seen in the cases of DIB's and EIB's *musharaka* issuances, which consisted of asset backed and asset based instruments. Tamaweel's second *ijara* issuance, and Tabreed's second issuance, which is a hybrid structure composed of together an *ijara*, *istisna* and *murabaha* fall into this category. These issuances have not clearly been identified and segregated into a pool of underlying assets on the balance sheet of the company.

As the above discussion of the results show there seem to be significant levels of confusion in the community regarding the proper characterisation of *sukuk* as debt or equity instruments. Four issuers and eight investors (63% of the respondents), stressed that *sukuk* is debt instrument in neuter regardless of all structures type because it replicate debt features, which in reality is identical to conventional bond. They demonstrated that *sukuks* are largely structured as debt instruments although they tend to use equity type contracts for their construction. Conversely, five issuers and two investors (37% of the participants), argued against the idea of being *sukuks* debt instruments. Their explanations show that *sukuk* is more equity instrument than to be debt instrument (see Section 7.4).

Accordingly, based on these findings, a number of the cases that been covered in this study do not satisfy the conditions set out by Jobst (2007): investor's asset ownership conferment through direct business participation, real purpose for securitisation through identification of productive securitised assets, unconditional and unsecured payment obligation (non-guarantee promissory notes), and risk-pooling spirit whereby the risks and rewards are shared among participants in the Islamic financial market.

In genuine Islamic commercial spirit, money must be invested, not accumulated avariciously, and such investments must be for the benefit of the community and in lawfully profitable instruments. This encourages profit making and risk containment in a profit-loss sharing mechanism, which is the ultimate divine justice by God (Iqbal, 1997).

Clearly, there is a great need for significant improvement in the *sukuks* securitisation structures and full product disclosure to enable the investors form accurate estimates of risk attached to the contracts. This includes legal entitlements, transfer of ownership, purchase and sale undertaking, events of default, insolvency, termination and liquidation and the foreclosure. Lack of appropriate action could hinder the development of the *sukuks* market in the GCC region.

In the case studies, *sukuks* that are guaranteed by the originator are identified as asset-based *sukuks*, where asset transfer is essentially in form rather than in substance. On the other hand, *sukuks* that do not benefit from the explicit support of the asset originator are identified as asset-backed *sukuks*, which reflect the fact that the most critical rating factor lay in the credit quality of the underlying assets. Here, the asset transfer is in substance and not just form. This distinction determines the relevant ratings approach. Asset-based *sukuk* usually attracts ratings that reflect both the creditworthiness of the originator providing the guarantee and the ranking of the *sukuk* compared to the originator's other senior unsecured obligations, whereas the ratings on asset-backed *sukuk* is a function of the credit features of the assets underlying the whole *sukuk* structure.

The EIB *sukuk* is a case in point where asset transfer is essentially in form rather than in substance. The (A1) rated EIB *sukuk* which is a floating rate senior unsecured *sukuk* is placed at the same level as the long-term foreign currency deposit and senior unsecured ratings already assigned to EBI. In this contract, the guarantor has (a) irrevocably undertaken to cover any shortfall between the payments from the co-owned *ijara/sukuk* assets and the required periodic distribution amount to *sukuk* holders and (b) irrevocably undertaken to purchase the issuer's interest in the co-ownership assets at the exercise price, either on maturity or on dissolution. This is sufficient to pay the *sukuk* holders. Given that the obligations of EBI will be direct, unconditional, and unsecured obligations and will rank at least *pari passu* with its other unsecured and unsubordinated obligations, the senior *sukuk* rating is placed at the same level as EBI's rating.

The investors were therefore 'guaranteed' to receive their principal investment and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure. In addition, Tabreed's ratio of secured debt to asset ratio was less than 20 per cent; hence the ratings of the *sukuk* reflect the credit standing of the issuer, rather than the riskiness of the secured assets. SABIC's *sukuk* is like EIB's *sukuk*, where the purchase undertaking adds a risk-free nature to it and exposes the investors to SABIC's credit risk, rather than the risks of the *sukuk* assets. SEC's *sukuk* structure is similar to that of SABIC's *sukuk* and has been influential in enhancing its *sukuk* creditworthiness. Moreover, the issuer did not specify the assets into which the *sukuk* proceeds will be invested. Therefore, the purchase undertaking adds a risk-free nature to SEC's *sukuk* and exposes the investors to SEC's credit risk, rather than the risks of the *sukuk* assets.

These findings demonstrate differences among the respondents: six out of 10 investors demonstrated that the existing *sukuk* in the market are using an underlying asset in purpose of *sharia* requirement. Whereas in practice the *sukuk* is being priced after the issuer's credit rating. Section 7.7 highlighted the fact that the limited transparency in the documentation is causing a critical lack of understanding of some of the *sukuks* instruments. It also highlighted the low level of transparency in *sukuks* documentation, with little disclosure on the underlying assets, and how premiums are increasing as investors are increasingly demanding greater transparency and extensive due diligence when it comes to securitisation of assets.

Islamic securitisation has the risk-reward sharing spirit and places paramount importance on the real economy through undertaking real project activities (Jobst, 2007). Therefore, the results of the case studies and interviews demonstrates that there is misinterpretation between practitioners in structuring and defining *sukuk* either debt or equity. Perhaps this could affect the potential investors who believe that Islam prohibits trade in debt.

The transferring and registering ownership of assets to *sukuk* holders has turned to a debate between scholars and lawyers, because the costs to the issuer of such registration are significant. But legal ownership offers *sukuk* holders the protection such as in the case of Tamaweel when it went into insolvency. This type of securitisation should continue to perform regardless of the financial distress of the originator. Certainly, the process of liquidating the assets will be much easier for *sukuk* holders, and from a *sharia* perspective this transaction is permitted (see chapter 6 section 6.3.13.2). In the case of Sorouh *sukuk*, investors have direct rights to the underlying assets, so under an asset transfer agreement *sukuk* holders are taking true risk in the underlying assets. As a result the investors were therefore not guaranteed to receive their principal and profit subject to the usual risks, such as insolvency, present in any *sukuk* or conventional bond structure.

Two issuers and one investor argued that being exposed to a single asset in *sukuk* as opposed to conventional bond where the investor is taking a risk on the entire set of assets. *Sukuks* are only linked with a particular asset in its pure form. Obviously, running the risk on one asset might fail, whereas conventional bondholders periodically take a risk on the whole balance sheet, so they will have multiple assets against which they could be insured one respondent provides an example to illustrate this:

> If it is a real estate asset that was put up in Dubai for example, which is high-end development and the issuer is unable to find a buyer the issuer will be forced to assume the risk. This risk will eventually be borne by the underlying asset. As long as the asset is performing, you are fine. Therefore, *sukuks* need time for market infrastructure to be competitive in liability, liquidity and structures matters.

In conclusion, according to the case studies results, different *sukuks* structures have been emerging over the years but most of the *sukuks* issuances according to our sample have been *sukuks al ijara* and *al mudaraba*. *Ijara* structures are used because they are based on the undivided pro-rata ownership of the underlying leased asset, and it is freely tradable at par, premium or discount. Tradability of the *sukuks* in the secondary market makes them more attractive. Whereas, *mudaraba* structures are used because they make use of a purchase undertaking and a sale undertaking that ensures that principal amount is paid in full on maturity or on redemption. Other types of *sukuks* also play significant roles in emerging markets to help issuers and investors alike to participate in major projects such as *istithmar*, *musharaka*, *wakala,* and a hybrid contract that employs *ijara* and *istisna*.

8.5 Criteria Relating to the Outcomes of Implementing Contracts

In relation to the outcomes of implementing contracts, any action that leads to elimination of *maslaha*, does not conform to the *sharia* spirit. Therefore, in order for Islamic financial products, specifically *sukuks*, to promote *sharia* objectives, they must meet the demands of investors and borrowers who are motivated by profit maximisation objective based on *sharia* requirements, and they must be in activities involving real physical assets rather than financial assets.

In the case study sample 17 respondents agreed that, banks and most other institutional investors implement risk averse funding policies, while some potential issuers seem to be disinclined to share their excess profit with their equity investors. Therefore, innovation of more economically viable equity-based *sukuks* would help achieve *sharia* objectives effectively. There was consensus among issuers that tapping into the *sukuks* market is purely for commercial reasons and investors generally seek

Ten investors expressed the view that since *sukuks* operate under secular conventional system, the prime motive of the participants is to maximise profits. The participants generally act on religious beliefs only in circumstances that would give them a better outcome and also adopting a strategy of diversification to mitigate risk and maximise returns. However, investing in *sukuks* provides the perceptions that are acting within the limits imposed by the tenets of Islamic belief.

Two investors agreed that Islam indeed maintains public benefit at the core of its objectives and lays down detailed guidelines for the practitioners to follow. They stated that the general conflict is between maximising shareholder returns and maximising stakeholder returns. They are of the view that that most participants believe that stakeholders are equally, if not more, important than shareholders, and generally if a *sukuk* is genuine, it will invariably include some level of public benefit, one way or another.

The case studies has highlighted some legal issues with respect the *sukuks* contracts. One issue of concern is whether enforceability of *sukuks* contracts can accommodate *sharia* objectives. In Islamic finance, SPV was established for the purpose of making investments off-balance sheet, securitising assets and the re-packaging of financial instruments, and generally based on the trust law in which the *sukuk's* originator as the transferor transfers the assets to the *sukuk* holders as beneficiaries via the SPV as a trustee with a good faith. Usually the issuers incorporate a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law).

Without a doubt, this typical offshore SPV leads to a problem whereby there is no uniform law, and, in general, the offshore jurisdiction is very lax on specific law enforcement with the consequence of a fragmented legal governing process in order to accommodate the parties' needs (Frankel, 1998). Indeed, there is a significant legal unpredictability governing *sukuk* transactions if they are issued through an offshore SPV. Furthermore, even if legal judgments are obtained in the Cayman Islands or the UK, there can be additional impediments arising from enforceability of judgements issued in foreign land in the absence of treaties, bilateral or otherwise, for reciprocal enforcement (Ryan & Elmalki, 2010). Therefore, this issue leads to weakness on the part of the local court or legislation as well as legal confusion with respect to enforceability certain laws in the event of issuer defaults. These conflicts are unavoidable as long as *sharia* principles are not incorporated into the law of the land, or the parties agree to resolve their disputes in a *sharia* court that is willing to consider the provisions of the secular system in its deliberations.

This can be seen in 19 of the observed issuers, which introduced SPV companies in its transaction; out of 26 issuances 11 were located offshore incorporated under the laws of Jersey (the Channel Islands), eight were located locally incorporated under the local laws, and eight were incorporated under a dual legal system (the laws of Jersey/ the local laws), and all of these issuances were issued by Saudi Arabian companies.

SPVs issued under offshore legislation could create significant legal unpredictability governing *sukuks* transactions. Under these circumstances, in the event of bankruptcy, the court follows the legal precedent that the financing is a transfer of collateral because of the presence of recourse to the originator. This could result in unfavourable outcomes in cases of asset-based *sukuk* issuance in which the *sukuks* are issued under a secured collateralised loan. In such cases, the enforceability of the contract in the court will be exactly the same between *sukuk* and secured collateralised loan. As a result, whatever the form of the *sukuk* structure, the legal environment surrounding the issuance is always a key component for analysing risk factors attached to *sukuk*. Indeed, not only the applicable legal framework, but also the nature of the legal courts expected to possibly handle the eventual disputes emanating from *sukuks* contracts, can to a large extent alter the return expectations of *sukuks* holders.

Thus, with the observed structures, the problems still revolve around form over substance of the *sukuks* structures whereby asset-based *sukuks* structures are prevalent in the Islamic capital market. The absence of true sales in current *sukuks* operations poses legal uncertainties to all *sukuks* parties, especially the *sukuks* holders. The legal infrastructure under various jurisdictions is not supportive enough for *sukuks* operations. Each legal system entails different problems in governing *sukuks* operations as a true *sharia* compliant financing. For instance, according to the English High Court, the reference to *sharia* in the contract was no more than a reference to the fact that the bank purported to conduct its affairs according to the principles of *sharia* (see section 2.4.3).

Executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV. Nevertheless, some *sukuks* issuances do not execute a true sale, as with asset-based *sukuk* issuance, due to the absence of property law and bankruptcy law under civil law regimes. This was the case in the Nakheel *sukuk* issuance where leasehold interests were not viewed as real rights or property rights under the relevant laws of the UAE (Salah, 2010). Instead, they were viewed as unregistered personal contractual rights binding the parties in question (Shenker & Colletta, 1990). This indicates that civil law indeed impedes the undertaking of true sales that would be enforceable in *sukuk* issuance.

Further, bankruptcy laws are crucial for facilitating true sale transactions in which investors are protected and will receive payment on asset-backed securities, even in cases of the originator's bankruptcy (Schwarcz, 1994). So far in some countries under civil law regime, especially GCC region, there has not yet emerged a proper bankruptcy law to protect *sukuk* holders from bankruptcy on the part of the *sukuk* originator. For instance, the bankruptcy law of UAE is incorporated into commercial companies law and does not have a specific definition of bankruptcy. The law only shows the situation where a 'Trader' will be regarded as a bankrupt in the event of insolvency, as governed in Article 645 of the Law. In pursuant to article 4 of the law a trader is defined as being an individual or company that carries out commercial activities. The law unfortunately does not have specific recognition of the term that describes the situation where shareholders have limited liability, as in the case of common law jurisdiction (*Gulf News*, 2009). On the side of common law jurisdiction and some countries under civil law jurisdiction such as Netherlands, the bankruptcy law is codified in the specific law. Besides, the law has clearer administrative procedures to deal with bankruptcy entity.

8.6 Conclusion

The most significant finding of this study is the recognition that and the improvements are supplementary to the needs and the needs are supplementary to necessities in *sharia.* Thus, the necessities are the base of all interests (*maslaha*). Therefore, *sukuks* are categorised under necessities according to *maslaha* since it supports the objective of nation building and human development, and enhancing the effectiveness of employment, welfare, and innovation.

Conversely, some aspects of *sukuks* affect the compliance of the product to comply with *sharia* requirements based on *maslaha*. Several *sukuks* were based on only the product and were risk-free instruments, which means that they guarantee profit (*riba*), trade in debt and contain some kind of *gharar*. This structure contradicts the objectives of *sharia* of staying away from *riba*, *gharar* and the obligation of a high degree of transparency and disclosure in contracts.

The *maslaha* criteria has priority, which means that if there is a conflict between private and public interests, public interest must take the priority and the product must follow laws and regulations that are not contrary to Islamic law. Therefore, the financial product should not perform a service that results in the loss of services that are ranked higher in the hierarchy of objectives. It is not lawful to fund an activity that will lead to the deterioration of something necessity or to fund an improvement, which will damage a need.

The other significant finding is the consensus that the GCC *sukuks* markets will continue to grow gradually. The most important factors that drive these markets are the massive financing requirements for GCC infrastructure projects, the religious issues involved for Muslim and non-Muslim investors in *sukuks* and the significant proportion of GCC companies required by regulators to place a substantial percentage of their investments in local currency assets such as *sukuk*.

Two principles in Islamic trading law are that guarantees are based on production and one's gain will cause a loss for another. These are the fundamental differences between Islamic funding and the conventional technique. However, there are still sceptics of the Islamic financial system, especially when some jurisprudence attempts to blur the differences to make the Islamic and conventional systems seem similar. Thus, maintaining these principles in *sukuks* products contribute to achievement of the legitimate requirements of the contract.

Chapter 9: Conclusion

9.1 Research Implications

This thesis has important implications for a range of stakeholders such as researchers, financial institutions, potential *sukuks* issuers, investors, *sharia* advisors and the regulatory authorities. This study has two main purposes. The first is to gain a detailed understanding about the concept of *maslaha* and how it influences the current Islamic financial environment. It introduced the concept of *maslaha* to the current *sukuks* practice, which helped bridge the gap in the literature on Islamic financial theory by providing insights into the criteria for evaluating Islamic financial products on the basis of *sharia* objectives, which lie in between finance and ethics.

The other purpose is how this particular approach to pricing Islamic financial products can be improved in *sukuks* structures. This study integrated analysis of *sharia* auditing where knowledge fields of economics, finance and *sharia* are integrated to assess *sukuks*. This approach could assist in resolving the disagreements between different *fiqh* schools and achieve a common set of guidelines and rulings on financial contracts. This in turn would pave the way for the development of efficient financial markets in the region.

This study finds a strong argument in favour of integrating the concept of *maslaha* when evaluating the *sharia* compliance of *sukuks* structures and rich insights for financial institutions and potential *sukuks* issuers to match their products and commercial viability more accurately to the demands of Islamic ethics and moral codes in the financial market. It is hoped that the findings would permeate through various stakeholder entities of the financial system and persuade the policy bodies to articulate innovative and progressive policies to launch a new era in Islamic finance.

Clearly, the low level of transparency in *sukuks* transactions and its documentation had resulted in creating confusion as to the nature of the instrument: is it debt or equity? In addition, subscribers to *sukuks* are meant to be part owners of assets, though some of the existing *sukuks* in the market are using an underlying asset in purpose of *sharia* requirement. However, in practice, they are being priced with the consideration of the issuer's credit rating because of the absence of a true sale in the operation, especially in asset-based *sukuks* structures.

Furthermore, in the majority of cases a critical issue is the absence of a clear legal and regulatory framework. This hinders proper evaluation of structures, especially their enforceability given the complex nature of *sukuks*, because they incorporate elements of secular legislation and divine legislation. This is further impeded by the lack of suitable benchmarks and lack of a rating mechanism. In addition, GCC countries apply *sharia* law in their courts which might not accept the use of purchase undertakings in the event of defaults.

Consequently, this study concludes that the legal infrastructure under various jurisdictions may not be able to provide the necessary provisions for *sukuks* transactions. Therefore, these countries need to develop the applicable legal framework governing process in order to accommodate the needs of the parties to the contract. Ideally this should take the form of an agreement under an international or at least a regional body. This, understandably, could take a few years to arrange, and therefore in the interim, this should be in the form of bilateral treaties which then grow into regional or international treaties. This should be further supported by a credible and acceptable rating agency capable of incorporating Islamic concepts such as *maslaha.*

Although some institutions follow the principles and guidelines published by international and regional institutions such as the AAOIFI, most opinions regarding financial products are issued by individual *sharia* scholars hired by the issuing agency and these opinions take precedence over those of the international bodies. This leads to conflict such those in the case of Tabreed 2006 issuance. *Sharia* scholars should not only judge the acceptability or the legitimacy of the product but should also include all the aspects such as the design, marketing, implementation of the product, and all documents and forms used in the product. This does not seem to be the case and results in widespread confusion and lack of recognition of *sukuks* over a wider range of markets. This could be partially addressed by establishing a centralised *sharia* supervisory board that specialises in Islamic finance with some level of authority which would further strengthen the legal system and infrastructure to cater for the further development of Islamic finance, and enforce its decision and create general guidelines and rules that should be taken into consideration by entities providing Islamic financial services and products.

The SPV concept has been used in connection with a wide variety of *sukuks* transactions in order to isolate financial risk. It was employed to purchase the assets from the originator and issue securities against these assets. However, as stated earlier, this study has found that the credit ratings assigned is subject to any subsequent the credit quality of the originator. Therefore, the question that is raised here is the credit ratings assigned for particular *sukuk* is affected by different classes of underlying asset attached to it.

Usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). The question that is raised here is whether the originator benefits from offshore SPV instead of local ones. This was because under the tax regulations in GCC profits generated from the *sukuks* are subject to 2.5% *zakah*.

It is likely that in the GCC *sukuks* markets local currency issuances will continue to grow gradually, motivated by the massive financing requirement for the GCC's infrastructure projects. The results suggest it is likely that *sharia* compliant approach is preferable to all participants in GCC markets. However, profit and risk are the most important factors driving issuer and investor behaviour and the Islamic financial instruments tend to take a character similar to those of conventional bonds.

Moreover, as Islamic finance is by nature participatory, *sukuks* purchasers arguably have the right to information on the purposes for which their monies are to be allocated. Thus, the findings of this research also have important implications for ethical investment products assessment to provide investment opportunities that balance financial returns with ethical, moral and social concerns.

9.2 Limitations of this Study

Although this study aimed to be a comprehensive study of *maslaha* as a new approach for Islamic bonds in theory and practice in the Islamic financial market, it did have some limitations.

It is clear that, exogenous economic, social, political and geographic factors will continue to impact the degree of acceptance's *sharia* scholars' opinion and compliance with AAOIFI compliance amongst the *sukuks* issuers of different nations. Due to this lack of homogeneity, it was decided to confine the study to member of GCC countries. Given that, AAOIFI had been founded by a number of financial institutions located in Bahrain, Saudi Arabia and the UAE. Therefore, these countries are the most obvious choices for an initial study of *sharia* compliance. Other GCC countries could not be included at the time of writing this thesis, since they have yet established local *sukuks* market.

Another important limitation was in the number of issuances, which led to a narrow focus on the four largest industries issuing *sukuks*—real estate, financial services, power and utility, and oil and gas including manufacturing. Governmental institutions and issuances that have not been listed in any exchange markets were excluded from the research. Therefore, the qualitative indicators of this research were limited, resulting in repeated references to the same *sukuks* structures and a limited number of corporate *sukuks* issuances. The researcher has tried to offset this through a detailed analysis of the observed *sukuks* structures.

9.3Suggestions for Future Research

This study filled a significant gap in the literature on *sukuks* and Islamic finance in Bahrain, Saudi Arabia and the UAE. However, more research is desperately needed on *sukuks* issues especially in establishing the factors contributing to the performance of *sukuks* in the long term and the performance of entities that invest the funds raised from the issuing of *sukuks*.

Furthermore, with the initiation of a non-ringgit denominated *sukuks* index by Bloomberg in June 2011, there is now a basis for examining and pricing a wide range of Islamic financial instruments, including *sukuks*, corporate financing and common Islamic treasury agreements in the GCC region. This index would be useful for more investigation on *sukuks* pricing behaviour under the concept of *maslaha*.

The conceptual framework presented in this study also provides great scope for extending this study to wider international markets. Also, it might valuable for further research on other convectional ethical investment products.

The SPV has been used in connection with a wide variety of *sukuks* transactions to isolate financial risk. It was employed to purchase the assets from the originator and issue securities against these assets. However, as stated earlier, this study has found that the credit ratings assigned is subject to the credit quality of the originator. Therefore, the question that is raised here is the credit ratings assigned for the originator would be different than the credit ratings of the underlying asset attached with *sukuk* agreement. Further systematic investigation of this aspect would result in useful information for policy purposes.

Usually the issuers do a cross-border securitisation in which the SPV is located outside the originator's country due to the absence of specific legislation on certain issues (e.g. tax law, securitisation law, etc.). The question that is raised here is whether the originator gain from using offshore SPV instead of local ones. More investigation would be valuable to understand the originators behaviour.

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Appendices

Appendix A: Summary of the implications of the case studies.

Criteria	**(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia**
Basic Information			
Founded	In 2000 and moved to a public company in 2005	In 2005 and listed on the ADX	In 1994 and moved to a public company in 2005
Government Support	Direct impact on the firm.	No impact on the firm	No impact on the firm
Motivation Criteria			
Purpose of *sukuk*	To meet the immediate and future physical, social and economic requirements of the UAE in Abu Dhabi for the benefit of those who live and work in Abu Dhabi.	To finance growth and expansion plans of Dana Gas and the proceeds raised would be invested in the ongoing business activities of the company.	To provide high quality long-term external financing to complement the company's robust internal cash flow at a time of strong growth in the Saudi real estate market.
Identity of the underlying assets	In both issuances are assets based	Assets backed	Issuances1 & 2: Assets backed, while Issuance 3 is assets based
Characteristics of *sukuk* price and Return	Issuance 1: coupon 5.767% and Issuance 2: coupon 3 month EIBOR + 175 basis points, both issuance prices were 100% and subject to a minimum holding of US$100,000 and AED 500,000 respectively.	The coupon 7.5% and the prices were 100% and subject to a minimum holding of US$ 100,000.	Issuances1 & 2: the coupons designated as 3-month LIBOR plus 200 and 225 basis points respectively, the prices were 100% and subject to a minimum holding of US$100,000. Issuance 3: The coupon was 10.75 % and the price was 99.058% of the aggregate face value of *the sukuk* and subject to a minimum holding of US$ 100,000.
Nature of the assets transaction	True sale transaction	True sale transaction.	True sale transaction.
Rating assigned	The first *sukuk* issuance unrated, while second *sukuk* issuance received a B grade from Standard & Poor's	Dana Gas *sukuk* issuance unrated.	Issuances 1&2 unrated, while third issuance received a BB-Grade rating from Standard & Poor's.
Criteria relate to structuring contract			
Type of Structure	First issuance *mudaraba*. The second issuance *ijara*	*Mudaraba*	Issuances 1&2 *ijara*. The third issuance *wakala*, which is a companion of *murabaha* and *ijara* investments structure.
Clarity of the underlying assets	Issuance 1 the underlying assets dose not clearly specified. While in the second issuance clearly specified the assets.	The underlying assets had been clearly specified.	In case of Issuances 1&2 the underlying assets clearly specified. While in the third issuance the circular did not clearly specified the underlying assets.

Criteria	**(6.4.1) ALDAR** **Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana** **Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR** **Real estate developers in Riyadh, Saudi Arabia**
The characteristics of ownership and responsibility	The transactions involve offshore SPV structure. In first issuance *mudaraba* ALDAR (in such capacity, *the mudarib*) sharing ratio 1% and SPV 99%. While in second issuance ALDAR (in such capacity, the lessor).	The transactions involve offshore SPV structure (Issuer/ trustee) sharing ratio of 99% and Dana Gas (*the mudarib*) 1%.	In all DAAR issuances the transactions involve a dual SPV structure (Local SPV) and (offshore SPV) as an Issuer and Trustee. In 1&2 issuances from DAAR (in such capacity, the lessee), while in third issuance DAAR (in such capacity, the agent)
Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)	The first issuance's principle amount and profit not guarantee, but In second issuance the contract guarantee the Purchase Undertaking to indemnify *sukuk* holders for any and all obligations in connection with any enforcement of the relevant undertakings, since absence of forensic law in UAE.	The issuance's principle amount and profit not guarantee, because the Security is granted over certain assets owned by obligor.	The issuance's principle amount and profit in 1&2 not guarantee, because the Security is granted over certain assets owned by obligor. While in issuance 3 The guarantee specifically excludes the fluctuation in value of the underlying real estate or commodities to which *the ijara* and *the murabaha* investments relate to as an event that would trigger the terms of the guarantee.
The legitimacy of the product	Yes, both issuances have an exact foundation Standard.	Yes, the issuance has an exact foundation Standard.	Yes, all issuances have a exact foundation Standard.
Criteria of the outcomes of implementing contracts			
Adequacy of scholar's opinion	Both issuances are consistent with the *sharia* requirements.	It is consistent with the *sharia* requirements.	It is consistent with the *sharia* requirements.
The advantage/ disadvantage of transaction.	In the second issuance the sole right of *sukuk* holders In the case that a legal action is taken to the courts in the Emirate of Abu Dhabi, a local court may contest the validity of the Musataha interest (a right in rem) against the obligor. The Land Department currently does not maintain a register that allows registration of such an interest. Also in both issuances using offshore SPV create, indeed a significant legal unpredictability governing *sukuk* transactions.	The issuance used offshore SPV, then a significant legal unpredictability governing.	DAAR's *sukuk* issuances represent the first *sukuk* issuances in the GCC region with a proper covenant package. The offering circulars set out in full detail the covenants to which the guarantor is subject to in addition to any qualifications or exceptions. The DAAR issuances have provided a foundation for future similar transactions and establish another funding source beyond the traditional sources of capital in GCC region. However, using offshore SPV create, indeed a significant legal unpredictability governing *sukuk* transactions.
Basic Information			
Founded	In 1975 and listed on the DFM	In 1976, listed in 1995, and became fully *sharia* compliant in 2004.	In 1999; its shares were listed on the Kuwait Stock Exchange, BSE and DFM. Its GDR was listed on the LSE in 2007.

Criteria	**(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia**
Government supports	No impact on the firm	Yes because he Dubai government owns 77% of the bank shares.	No impact on the firm
Motivation Criteria			
Purpose of *sukuk*	To be ultimately used for general funding of DIB, which will sell a given percentage of a pool of their assets to stimulate trade and industry progress and expansion.	To provide high quality medium- to long-term external financing to complement the bank's robust internal cash flow at a time of strong growth in the UAE market.	To fund a senior expenses reserve, an infrastructure fund and a liquidity reserve.
Identity of the underlying assets	Both asset backed and asset based.	Both asset backed and asset based.	Asset based
Characteristics of *Sukuk* price and Return	The coupon was designated as 3-months LIBOR plus 33 basis points, the price was 100% and subject to a minimum holding of US$100,000.	The coupon was designated as 3-months LIBOR plus 30 basis points, the price was 100% and subject to a minimum holding of US$100,000.	The coupon was designated as 3-months LIBOR plus 125 basis points, the price was 100% and subject to a minimum holding of US$100,000.
Nature of the assets transaction	True sale transaction.	True sale transaction.	The structure of this *sukuk* makes it an equity-linked instrument, but without any form of transfer of ownership in rights, assets, or projects
Rating assigned	DIB *sukuk* received a (A) from Standard &Poor's and (A1) from Moody's at the time of issuance. However, afterward Standard &Poor's downgraded its rating to BBB- Grade.	The issuance received a (A1) Grade rating from Moody's ratings Services at the time of issuance, but afterward Moody's downgraded its rating to A3 Grade.	The issuance received a (BBB-) from Standard &Poor's at the time of issuance.
Criteria relate to structuring contract			
Type of Structure	*Musharaka*	*Musharaka*.	*Musharaka*
Clarity of the underlying assets	The circular did not clearly specify the assets.	The circular did not clearly specify the assets.	The circular did not clearly specify the underlying assets, because the nature of the transaction.
The characteristics of ownership and responsibility	The transaction involves offshore SPV structure (Issuer/ trustee) sharing ratio of 90% and DIB (the seller and the agent) 10%.	The transaction involves offshore SPV structure (Issuer/ Trustee) sharing ratio of 95.78% and EIB (the seller and the agent) 4.22%.	The transactions involve offshore SPV structure (the Issuer and the Trustee) and GFH (in such capacity, the seller and the agent).
Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)	The issuance's principle amount and profit are guarantee, so the Investors were 'guaranteed' to receive their principal investment and profit subject to the usual risks.	The issuance's principle amount and profit are guarantee, so the Investors were 'unconditionally guaranteed' to receive their principal investment and profit subject to the usual risks.	The issuance's principle amount and profit are guarantee, so the Investors were 'guaranteed' to receive their principal investment and profit subject to the usual risks.

Criteria	(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE	(6.4.2)Dana Natural gas company in Sharjah, UAE	(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia
The legitimacy of the product	No, the structure itself stands on exact foundation Standard, but the transaction involve dose not compliance with *sharia* requirements.	No, the structure itself stands on exact foundation Standard, but the transaction involve dose not compliance with *sharia* requirements.	No, the structure itself stands on exact foundation Standard, but the transaction involve dose not compliance with *sharia* requirements.
Criteria of the outcomes of implementing contracts			
Adequacy of scholar's opinion	The issuance structure is having adequacy of scholar's opinion, which is consistent with the *sharia* requirements. However, the transaction was guaranteed the Investors to receive their principal investment and profit. This is not reflecting *sharia* requirements.	The issuance structure is having adequacy of scholar's opinion which is consistent with *the sharia* requirements. However, the transaction was guaranteed the Investors to receive their principal investment and profit. This is not reflecting *sharia* requirements.	The issuance structure is having adequacy of scholar's opinion, which is consistent with *the sharia* requirements. However, the transaction was guaranteed the Investors to receive their principal investment and profit. This is not reflecting *sharia* requirements.
The advantage/disadvantage of the transaction.	The issuance used offshore SPV, then a significant legal unpredictability governing. In addition, *sukuk al-musharaka* is analogous to equity-based instruments and therefore the partners in *the musharaka* must take the risk of both profit and loss.	*Sukuk al-musharaka* is analogous to equity-based instruments and therefore the partners in *the musharaka* must take the risk of both profit and loss. So, this transaction capability not in favour of *the sharia* manner whereas in legality manner it's true third party but in *sharia* wise it's not third party. As a result, the investors are taking the issuer's risk. The issuance used offshore SPV, then a significant legal unpredictability governing.	The issuance used offshore SPV, then a significant legal unpredictability governing. In addition, *Sukuk al-musharaka* is analogous to equity-based instruments and therefore the partners in *the musharaka* must take the risk of both profit and loss.
Basic Information			
Founded	In 1998 and listed on the DFM.	In 1976 and listed on Tadawul.	In 2000 and listed on Tadawul.
Government Support	No impact on the firm	No impact on the firm	Direct impact on the firm.
Motivation Criteria			
Purpose of *sukuk*	To finance the capital expenditure and expansion of Tabreed's operations.	To finance the growth and expansion marketing plans of SABIC, which is expected to increase the quantities of products available for marketing by SABIC under a number of its marketing agreements.	To meet working capital requirements, refinance existing financial obligations and capital expenditure, making other investments, reduce the role of the government in the provision of financing.

Criteria	**(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia**
Identity of the underlying assets	Assets backed by 33%; the rest is very ambiguous	Assets based on certain rights and obligations for a specific marketing agreement.	Assets based on the applicable percentage of certain specified rights and entitlements.
Characteristics of *sukuk* price and return	Issuance1: The coupon was was designated as 6-months LIBOR plus 125 basis points, the price was 100% and subject to a minimum holding of US$100,000. Issuance 2: the coupon was 7.250%, the price was 100% and subject to a minimum holding of AED 10,000.	The coupons were designated as 3-months SIBOR plus 40, 38 and 48 basis points respectively, the prices were 100% and subject to a minimum holding of SAR 10,000.	The coupons were designated as - months SIBOR plus 45, 160 and 95 basis points respectively, the prices were 100% and subject to a minimum holding of SAR 500,000, 100,000 and 10,000, respectively.
Nature of the assets transaction	True sale transaction by 33% only of the physical assets.	SABIC transferred certain rights and obligations for a specific marketing agreement to SPV. However, this is not a true sale transaction of physical assets.	SEC transferred certain rights and obligations for a specific distribution agreement to SPV. However, this is not a true sale transaction of physical assets.
Rating assigned	The 1&2issuances received a (BBB-) Grade rating from Standard &Poor's ratings Services at the time of issuance, but afterward Standard &Poor's downgraded its rating to CCC+ and CC Grade respectively.	SABIC three issuances received (A+) from Standard &Poor's at the time of issuance	SEC issuances received a (AA-) Grade rating from Fitch ratings Services at the time of issuance.
Criteria relate to structuring contract			
Type of Structure	Hybrid structures composed of together an *ijara, istisna* and *murabaha*.	*Istithmar*	*Istithmar*
Clarity of the underlying assets	The circular did not clearly specify the underlying assets.	The underlying assets had been clearly specified by any possible intangible assets with cash flow generation of the originator to structure *the sukuk* issuances.	The underlying assets had been clearly specified.
The characteristics of ownership and responsibility	The transactions involve offshore SPV structures (Issuer/ Trustee) and Tabreed (in such capacity, the seller, the contractor and the lessee).	The transactions involve local SPV structures (in such capacity, Custodian) and SABIC (in such capacity, the issuer and agent).	The transactions involve local SPV structures, (in such capacity, the Custodian) and SEC (in such capacity, the issuer, and the agent).
Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)	The issuances' principle amount and profit not guarantee, because the Security is granted over certain assets owned by obligor.	The issuances' principle amount and profit guarantee, also the purchase undertaking adds a risk-free nature to SABIC *sukuk*.	Although, one unilateral undertaking by *sukuk* holders (no call option), but this means the issuances' principle amount guarantee.

<table>
<tr><th>Criteria</th><th>(6.4.1) ALDAR
Real estate developers in Abu Dhabi, UAE</th><th>(6.4.2)Dana
Natural gas company in Sharjah, UAE</th><th>(6.4.3) DAAR
Real estate developers in Riyadh, Saudi Arabia</th></tr>
<tr><td>The legitimacy of the product</td><td>No, the structure itself stands on exact foundation standard, but in the first issuance the circular mentioned that sharia scholars had made an exception in their case and ‘reduced the required percentage of physical and tangible assets from 50% to 33 %’. It is not known on what basis this exception was made.</td><td>No, the structure itself stands on exact foundation standard. Since, the purchase undertaking adds a risk-free nature to SABIC sukuk and exposes the investors to SABIC’s credit risk, rather than the risks of the sukuk assets. So, the transaction does not comply with sharia requirements.</td><td>No, the structure itself stands on exact foundation standard, but the principal amounts from the underlying financial assets used to service coupon payments made the transaction does not comply with sharia requirements under the sukuk istithmar.</td></tr>
<tr><td colspan="4">Criteria of the outcomes of implementing contracts</td></tr>
<tr><td>Adequacy of scholar’s opinion</td><td>Both issuances structures do not meet the sharia requirements because Tabreed converted Palladium to pure debt by selling it to sukuk holders who may not be aware of the fact that they were a party to the murabaha transaction, which is inefficient if these sukuk are tradable.</td><td>SABIC sukuk structures are having adequacy of scholar’s opinion, which is consistent with the sharia requirements. However, principal amounts from the underlying financial assets should never be used to service coupon payments under the sukuk istithmar.</td><td>SEC issuances are having adequacy of scholar’s opinion, which is consistent with the sharia requirements. However, the sukuk structure did not completely comply with the required transparency level in Islamic finance, that require the issuer not use principal amounts from the underlying financial assets to service coupon payments under the sukuk istithmar.</td></tr>
<tr><td>The advantage/disadvantage of the transaction.</td><td>In Tabreed issuances the ratings of the sukuk reflect the credit standing of the issuer, rather than the riskiness of the secured assets. As a result this matter goes against the substance of Islamic finance, which requires investors to take the risk of the underlying asset while entering into a financial contract rather than the credit risk of the counter-party. In addition, the issuances used offshore SPV, then a significant legal unpredictability governing. The required percentage of physical and tangible assets were reduced from 50% to 33 %, so this transaction does not truly comply with the required transparency level in Islamic finance.</td><td>Since the role of a custodian may be required in order to ensure that the sukuk assets are sufficiently segregated from the other financial assets of the Originator. Then, SABIC sukuk should be clearly laid out for investors in order for them to assess their risk taking in a transparent manner. Also, SABIC entered into an interest rate swap agreement with a notional value of SR 13.6 billion to hedge the volatility in interest rates related to outstanding debts. This transaction was not sharia compliant.</td><td>In SEC sukuk the investors are taking the issuer's risk. The sukuk purchase undertaking gives the right to sukuk holders to sell the sukuk to SEC at face value so this adds a risk-free nature to SEC sukuk. In addition, using principal amounts from the underlying financial assets to service coupon payments under the sukuk istithmar is not acceptable under sharia requirements.</td></tr>
<tr><td colspan="4">Basic Information</td></tr>
</table>

Criteria	(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE	(6.4.2)Dana Natural gas company in Sharjah, UAE	(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia
Founded	In 1926; moved to a public company in 1977 with shares listed on Tadawul.	In 1976 and in 2004 converted into a fully *sharia compliant* bank a publicly listed Islamic bank on the ADSM (ADX).	In 2005 with shares listed on the ADSM (ADX).
Government Support	No impact on the firm	Yes, the government of Sharjah is SIB's largest single owner and would provide support if needed.	Yes because of Sorouh's partnership with the Abu Dhabi Government in its Plan 2030.
Motivation Criteria			
Purpose of *sukuk*	*The sukuk* Tranche 1 in 2008 was issued to achieve their liquidity manage goals. While Tranche 2 *sukuk* program issued in 2009 to boost its Tranche 1 Capital. Therefore, SHB could strengthen its existing *sharia* compliant business.	SIB is amending their funding mix by raising more long-term funds in order to better manage maturity mismatches at a time when asset tenures are increasing. So, Issuing *sukuk* is probably the most appropriate way to achieve this goal, as the regional economic environment is currently benign and pricing is attractive.	The Company has been awarded the contract to master plan three investment zones in Abu Dhabi. Therefore, *sukuk* were issued to raise funds in accordance with *sharia* requirements and to achieve the previous missions.
Identity of the underlying assets	Assets based on Islamic Business Portfolio.	Assets based on Islamic Business Portfolio.	Assets backed
Characteristics of *sukuk* price and Return	SHB coupons were designated as 6-month SIBOR plus 200 and 190 basis points respectively, the prices were 100% and subject to a minimum holding of SAR 500,000.	The coupon was designated as 3-month LIBOR plus 65 basis points, the price was 100% and subject to a minimum holding of US$100,000.	Sorouh issued three classes of *sukuk* in 2008 (A, B and C). The coupons were designated as 1-month EIBOR plus 200, 250 and 350 basis points respectively, the prices were 100% and subject to a minimum holding of AED 500,000.
Nature of the assets transaction	As SHB's *sukuk* constitute undivided beneficial ownership interests in *the mudaraba* assets and will rank *pari passu*, without any preference or priority among themselves, *the sukuk* are issued on an unsecured and subordinated basis.	As SIB's *sukuk* constitute undivided beneficial ownership interests in *the musharaka* assets and will rank *pari passu*, without any preference or priority among themselves, *the sukuk* are issued on an unsecured and subordinated basis.	True sale transaction and the receivables may be de-recognised from the originator's balance sheet.
Rating assigned	These two issuances unrated	SIB issuances received a (BBB) Grade rating from Standard & Poor's at the time of issuance.	The three Sorouh classes *sukuk* certificates (A, B and C) received A, BBB+ and BBB- Grade respectively from Standard & Poor's ratings Services.
Criteria relate to structuring contract			
Type of Structure	*Mudaraba*	*Musharaka*	*Mudaraba*

Criteria	(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE	(6.4.2)Dana Natural gas company in Sharjah, UAE	(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia
Clarity of the underlying assets	The nature of the assets will not be known, so the circular specify the Capital of *the mudaraba* will be invested by the Issuer in the Islamic Business Portfolio	The nature of the assets leased, sold or held will not be known, so the circular did not clearly specify the underlying assets.	The underlying assets had been clearly specified.
The characteristics of ownership and responsibility	The transactions of issuances 1&2 involve local SPV structures (in such capacity, agent) sharing ratio 40% and 90% respectively of the portfolio, and SHB (in such capacity, the issuer and *mudarib*).	The transaction involves offshore SPV structure (Issuer/ Trustee) who hold 88.3% interest in co-owned assets, and SIB (in such capacity, the seller and the agent) hold 11.7%.	The transactions involve a dual SPV structure, (Local SPV under in such capacity, *the mudarib*) and (offshore SPV in such capacity,the Issuer and the Trustee), while Sorouh (in such capacity, the seller).
Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)	The issuances' principle amount and profit not guarantee.	The issuances' principle amount and profit guarantee, also the purchase undertaking adds a risk-free nature to SIB *sukuk*.	The issuances' principle amount and profit not guarantee. So, *sukuk* holders are directly exposed to *mudaraba* enterprise asset price risk and, as a result, its liabilities.
The legitimacy of the product	Yes, both issuances have an exact foundation Standard.	No, the structure itself stands on exact foundation Standard. Since, the purchase undertaking adds a risk-free nature to SIB *sukuk* and exposes the investors to SIB's credit risk, rather than the risks of *the sukuk* assets. So, the transaction involve dose not compliance with *sharia* requirements.	Yes, all the issuances have an exact foundation Standard.
Criteria of the outcomes of implementing contracts			
Adequacy of scholar's opinion	Both issuances are consistent with *the sharia* requirements. The SHB structures answers the question of how to deal with periodic payments to *sukuk* holders. In the SHB *sukuk*, the use of the reserve account is innovative when compared to the pre-AAOIFI Resolution issues.	The issuance structure is having adequacy of scholar's opinion, which is consistent with *the sharia* requirements. On the other hand, the Investors were 'guaranteed' to receive their principal investment and profit subject to the usual risks. Which means obviously *the sukuk* structure did not completely comply with the required transparency level in Islamic finance.	The issuance structure is having very adequacy of scholar's opinion which is consistent with *the sharia* requirements.

Criteria	**(6.4.1) ALDAR** **Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana** **Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR** **Real estate developers in Riyadh, Saudi Arabia**
The advantage/disadvantage of the transaction.	There are no purchases undertaking in the structures. The payments are subject to final liquidation of *the mudaraba*. *The sukuk* holders are taking true risk of loss of *the mudaraba* agreement.. Therefore, this innovative mechanism seems to be *sharia* compliant. On the other hand, from a proprietary law perspective, *the sukuk* holders do not gain any proprietary rights; there is neither transfer of any assets nor a declaration of trust. This raises the question whether merely contractual rights are sufficient from a *sukuk* holders´ perspective.	*Sukuk al-musharaka* is analogous to equity-based instruments and therefore the partners in *the musharaka* must take the risk of both profit and loss. Whereas this agreement is not the case. In addition, the issuance used offshore SPV, then a significant legal unpredictability governing.	The issuances used offshore SPV and local SPV, then a significant legal unpredictability governing. Since *the mudaraba* Assets registered transfer, as well as the assignment of the PSPA rights is governed by local Abu Dhabi law, while the remaining security documents are governed by English law.

Basic Information		
Founded	In 2004 and in 2006, it moved to a public company listed on the DFM	In 2005 and its shares listed on NASDAQ Dubai in 2007.
Government supports	No impact on the firm	Yes, because it was founded indirectly by the Government of Dubai by merging Dubai Ports Authority and Dubai Ports International.
Motivation Criteria		
Purpose of *sukuk*	To meet the company business cycle. while, the company is engaged in establishing, developing, owning, managing, investing, leasing, and renovating real estates and buildings; commercial, and residential properties.	To fund business needs of the company, which had just come out of a massive restructuring strategy on part of its parent company and had major expansion plans.
Identity of the underlying assets	Issuances 1&2: assets back while Issuance 3 seems to be assets based.	Assets based.
Characteristics of *sukuk* price and Return	Issuance 1: (classes A, B, C and D) the coupons designated as 1 month LIBOR plus 35, 120, 395 and 1000 basis points respectively, the Price was 100% and subject to a minimum holding of US$100,000. Issuance 2: the coupon was 4.310%, the price was 100% and subject to a minimum holding of US$100,000. Issuance 3: the coupon designated as 3 month EIBOR plus 225 basis points, the price was 100% and subject to a minimum holding of AED 500,000.	The coupon was 6.25%, the price was 99.765% of the aggregate face value of *the sukuk*, which means this *sukuk* was issued at a 0.25% discount and subject to a minimum holding of US$100,000.

<table>
<tr><th>Criteria</th><th>(6.4.1) ALDAR
Real estate developers in Abu Dhabi, UAE</th><th>(6.4.2)Dana
Natural gas company in Sharjah, UAE</th><th>(6.4.3) DAAR
Real estate developers in Riyadh, Saudi Arabia</th></tr>
<tr><td>Nature of the assets transaction</td><td>The first and second issuances are true sale transactions and the receivables may be de-recognised from the originator's balance sheet. In the third issuance there are some signs this is the case on transferring the portfolio of assets.</td><td colspan="2">DP World's sukuk constitute undivided beneficial ownership interests in the mudaraba assets. So, sukuk issued on an unsecured and subordinated basis.</td></tr>
<tr><td>Rating assigned</td><td>In the first issuance, each tranche was assigned by Fitch differently, but 85% in terms of size had an (AA) grade. The second and third issuances received (A) from Fitch.</td><td colspan="2">The issuance received a (BBB-) grade from Standard & Poor's at the time of issuance, but was later downgraded to a (BB+) grade.</td></tr>
<tr><td colspan="4">Criteria relating to the structuring of contracts</td></tr>
<tr><td>Type of Structure</td><td>Issuances 1&2are ijara, while the third issuance is a hybrid structure comprised ijara and istisna.</td><td colspan="2">Mudaraba</td></tr>
<tr><td>Clarity of the underlying assets</td><td>Issuance 1: the circular clearly specify the underlying assets. But in Issuances 2and 3 the nature of the assets leased, sold or held will not be known, so the circular did not clearly specify the underlying assets.</td><td colspan="2">The nature of the transaction, sold or held the assets will not be known, so the circular did not clearly specify the underlying assets.</td></tr>
<tr><td>The characteristics of ownership and responsibility</td><td>Issuance 1: the transaction involves a dual SPV structure, offshore SPV (the issuer), local SPV (as Tamaweel's successor) and Tamaweel PJSC (in such capacity, the seller and Originator).
Issuances 2&3: the transactions involve offshore SPV structures (the issuer and the trustee), while Tamaweel PJSC will act as a seller, obligor, originator of the Leases and Managing Agent.</td><td colspan="2">The transaction involves offshore SPV structure (in such capacity, the issuer and the trustee) Sharing ratio, 99% and DP World Limited (in such capacity, the obligor and the mudarib) 1%.</td></tr>
<tr><td>Efficiency (such principle amount and profit not guarantee and not selling the asset before receive it)</td><td>In case of issuances 1 and 2 principle amount and profit not guarantee. While in the third issuance principle amount and profit guarantee.</td><td colspan="2">The issuance's principle amount and profit guarantee, also the purchase undertaking adds a risk-free nature to DP world sukuk. Also, the redemption payment to the sukuk holders is fixed. Whereas, any surplus over the periodic payments to the sukuk holders is for the originator as an incentive fee.</td></tr>
<tr><td>The legitimacy of the product</td><td>Yes, in The first and second issuances the structures itself stands on exact foundation Standard. While the third issuance was special issuance contains two types of structures, so the structures itself of this issuance stands on exact foundation Standard, but the transaction dose not clearly laid out for investors in order for them to assess their risk taking in a transparent manner.</td><td colspan="2">Some of DP World issuance structure features made it resemble conventional bond and lose its own authenticity.</td></tr>
<tr><td colspan="4">Criteria of the outcomes of implementing contracts</td></tr>
</table>

Criteria	**(6.4.1) ALDAR Real estate developers in Abu Dhabi, UAE**	**(6.4.2)Dana Natural gas company in Sharjah, UAE**	**(6.4.3) DAAR Real estate developers in Riyadh, Saudi Arabia**
Adequacy of scholar's opinion	The first two issuances are consistent with *sharia* requirements. In the third issuance, the investors were 'guaranteed' to receive their principal investment and profit subject to the usual risks, which means the agreement did not completely comply with the required transparency level in Islamic finance.		In this issuance, the investors were 'guaranteed' to receive their principal investment and profit subject to the usual risks. The losses were borne by the originator and the periodic returns to *the sukuk* holders were fixed returns, regardless of the performance of the underlying projects. Thus, the structure loses its own authenticity and does not completely comply with the required transparency level in Islamic finance.
The advantage/disadvantage of the transaction.	All Tamaweel issuances used offshore SPV, then a significant legal unpredictability governing. In addition the first issuance was based upon the structure of *ijara* in a complex structure manner. Also, in third issuance the manager acts as a partner of *the sukuk* holders, which is unlawful for the manager to guarantee the return of capital to *the sukuk* holders as it, would interrupt the partnership in the event of losses / in the sharing of profits.		Some of this structure features annulling the possibility to pay the real (excess) profits of *the mudaraba* to *the sukuk* holders as would be expected from equity-linked securities. The main criticism of this transaction was equitable profit distribution. So, the structure dose not touches the Islamic paradigm of borrowing, lending and investment. Also, The issuances used offshore SPV and local SPV, then a significant legal unpredictability governing.