Asset-based vs Asset-backed *Ṣukūk*

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Ṣukūk are Islamic certificates of investment. They signify co-ownership of productive resources, known as the underlying assets. Because income to *ṣukūk* holders is generated by trading or real investment rather than mere lending, *ṣukūk* holders earn profit rather than interest. As co-owners of productive assets, *ṣukūk* holders face the risks of ownership. In particular, they face the risk that their assets may not generate profits or may even incur losses. They also face the risk that the assets may be damaged or destroyed completely.

Risk-taking is one of the requirements of earning lawful profits in Islam. Another requirement is to share profits and losses. For a person to claim a share of income generated by an investment he helps to finance – without taking responsibility for its outcome – is inconsistent with the ethos of Islam. Income needs to be earned, if not by effort, then at the very least by taking risk.

Typically, *ṣukūk* are categorised into 'trade-based' and 'participatory', depending on whether they are issued to finance trade or investment. As a result of some recent defaults of a number of *ṣukūk* and the near defaults of others, however, a new classification entered the *ṣukūk* discourse, that between 'asset-backed' and 'asset-based' *ṣukūk.*

The defaults took place in the aftermath of the recent (2008) financial crisis and came as a surprise. This was the first time any *ṣukūk* 'defaulted' in modern history. Since all defaults were confined to the asset-based category, investors were asking not only why the *ṣukūk* defaulted, but why in particular the asset-based *ṣukūk* defaulted while the asset-backed did not.

Few investors, it seems, were aware of the differences between the asset-based and asset-backed *ṣukūk* or of the implications these differences have on investor protection. A closer examination shows that the seemingly slight difference in the name of the *ṣukūk* conceals important differences.

One need not look far for the reason why the asset-based *ṣukūk* defaulted while the asset-backed did not. All *ṣukūk* that defaulted – the asset-based type – shared a common structure: that of debt-instruments. Effectively, they were replicas of conventional bonds. In particular, all asset-based *ṣukūk*, like bonds, required issuers (borrowers) to guarantee both fixed (interest) income as well as capital (the principal amount of a loan) to creditors.

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The debt-like structure of asset-based *ṣukūk* provided investors as well as issuers with what they wanted. At the same time, however, the debt-like structure of the *ṣukūk* replicated a risk that arises in relation to all debt instruments, the risk of default. This is the risk that a borrower may fail to repay a loan or a part of it to a creditor. The *ṣukūk* defaulted because in part due to the financial crisis and the economic downturn that triggered it originators did not earn sufficient revenues to make the promised payments.

By contrast, none of the asset-backed *ṣukūk* defaulted. The reason was that the asset-backed *ṣukūk* did not have a debt structure. All asset-backed *ṣukūk*, unlike their asset-based counterparts, were structured to share profits and losses rather than to replicate bonds. Originators of asset-backed *ṣukūk* did not promise investors profits whose quantum and due dates were determined in advance. Unlike debt-like securities such as bonds, profit and loss sharing, PLS (profit and loss sharing) securities cannot default simply because they come with neither income nor capital guarantees. Issuers of PLS securities pay profits to investors when the underlying assets earn profits.

The debt-like structure was built into the asset-based *ṣukūk* by incorporating income and capital guarantees in the *ṣukūk* contracts. Such guarantees are key features of conventional bonds. The incorporation of income and capital guarantees ensured that a single failure to make a periodic payment on time, or to redeem the principal amount on the due date, would constitute default. Not only the *ijārah* but also participatory *ṣukūk* such as the *mushārakah* or *muḍārabah* were structured to replicate debt instruments.

The income guarantee was incorporated into the *ṣukūk* structure by requiring issuers to pay specified dividends to investors on specific dates. Both the magnitude of the dividends as well as their due dates were determined in advance. In other words, the quantum of the profits that the originators were going to pay to investors was determined *before* the business activities that were to generate the expected profits even commenced. In a striking departure from business practice, to say nothing of common sense, entrepreneurs (originators) agreed to pay investors dividends even when their enterprises experienced losses.

The asset-based *ṣukūk* resembled conventional bonds also in that dividends were calculated as a percentage of the total amount invested rather than as a percentage of total profits, just as interest payments are determined as a percentage of the total amount of a given loan. The dividends, moreover, were calculated by reference to interest rates such as LIBOR (London Interbank Offered Rate), in a widely utilised process known as benchmarking.

The capital guarantee was incorporated into the *ṣukūk* structures by requiring originators to refund to investors their capital in full, on a specific day in the future, known as the maturity date. To comply with the *sharīʿah* – at least in form – the refund was accomplished by requiring originators to repurchase the underlying assets from investors on an agreed-upon date. The price at which the assets were repurchased was identical to the price at which they were first sold to the investors. This had the effect of returning to investors exactly the same amount they invested when they initially purchased the assets. In other words, the repurchase had the same effect in substance as repaying a loan.

It is thus hardly surprising that asset-based *ṣukūk* are commonly referred to as Islamic bonds. Even from the perspective of the law, for the purpose of taxation, asset-based *ṣukūk* are treated as bonds.

The asset-based *ṣukūk* were structured as debt instruments on the grounds that this is what investors were looking for and because this is what the market wanted. The market, however, cannot provide guidance on what type of *ṣukūk* meets *sharīᶜah* requirements. Markets facilitate trade. They reflect what people are buying and selling, as well as the quantities and prices at which trading takes place. Markets are neither equipped, nor able, to make judgements.

Another reason for replicating debt-like instruments was that issuers wanted to raise capital without having to sell any assets. Investors, on their part, did not want to become owners of assets and assume the risks of ownership. They *wanted* bond-like instruments with income and capital guarantees. They wanted their profits to be guaranteed and to earn them without taking risk. As selling the underlying assets to investors by way of a true sale, as required by the *sharīᶜah*, would not achieve the respective objectives of the originators and the investors, a special type of securitisation needed to be arranged.

What was required in particular was a type of sale that would enable originators to sell underlying assets to investors, and at same time allow them (the originators) to retain legal ownership of the assets thus sold. This could be accomplished by utilising a sale that falls short of a true sale. However, such a sale is not recognised as a valid sale in the *sharīᶜah*. A sale that falls short of a true sale is, however, recognised as a valid sale in common law, widely known for its creditor friendliness.

Common law (practiced in the UK) recognises sales that fall short of true sales as valid sales. A sale that falls short of a true sale allows a seller to sell an asset and to retain legal ownership of the asset thus sold at the same time. Such a sale does not require the transfer of legal ownership from the seller to the buyer; a sale that falls short of a true sale transfers merely beneficial ownership on the buyer.

Conclusions and Recommendations

In order to accommodate the objectives of both issuers (to retain legal ownership of assets) as well as of the investors (to obtain income and capital guarantees), arrangers thus resorted to the common law instead of the *sharīᶜah* notion concept of sale. This decision, however, raised a number of questions.

First, was the departure from the *sharīʿah* notion of sale justified? Second, how can a departure from the *sharīʿah* concept of sale be expected to produce *sharīʿah* compliant *ṣukūk*? Third, will investor's interests be adequately protected, given that the sales of the underlying assets give them less than legal ownership of the assets?

- As a result of a lack of a true sale of the underlying assets by originators to investors, a new class of *ṣukūk* emerged, known as asset-based *ṣukūk*. It was this class of *ṣukūk* that was declared non-compliant by the *Accounting and Auditing Organization for Islamic Financial Institutions (*AAOIFI) in 2008, just months before the recent global financial crisis. It was also in this class of *ṣukūk* that all the defaults took place.
- The development of the two types of *ṣukūk* created something of a crisis in the *ṣukūk* industry, reflecting differing visions of Islamic securitisation. One vision seeks to implement profit and loss sharing, while the other appears satisfied with replicating conventional bonds and achieving at least formal if not substantive compliance with the *sharīʿah*. There is a need to harmonise (reconcile) these two visions.
- This can be done by revisiting the roots of Islamic finance and its quintessential requirements. Consensus needs to be achieved on how *ṣukūk* differ from conventional instruments and on how they need to be structured to comply with the *sharīʿah*. Revisiting the notion of sale in Islamic securitisation would be a good place to begin.