

ISLAMIC CAPITAL MARKETS

PRINCIPLES & PRACTICE

With Best Compliment
From
ISRA

الأкадеمية العالمية للبحوث الشرعية
International Shariah Research Academy for Islamic Finance

ISRA
الأкадеمية العالمية للبحوث الشرعية
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Lorong University A
59100 Kuala Lumpur
Malaysia
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Fax: +603-7651 4242
Website: www.isra.my

and

Securities Commission Malaysia
No. 3, Persiaran Bukit Kiara
Bukit Kiara
50490 Kuala Lumpur
Malaysia
Tel: 603-6204 8000
Fax: 603-6201 1818
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List of Contributors

Editors

Marjan Muhammad, International Shari'ah Research Academy for Islamic Finance (ISRA),
Malaysia

Beebee Salma Sairally, International Shari'ah Research Academy for Islamic Finance (ISRA),
Malaysia

Farrukh Habib, International Shari'ah Research Academy for Islamic Finance (ISRA), Malaysia

Project Coordinator

Beebee Salma Sairally, International Shari'ah Research Academy for Islamic Finance (ISRA),
Malaysia

Writers

Abbas Mirakhor, International Centre for Education in Islamic Finance (INCEIF), Malaysia

Ahcene Lahsasna, International Centre for Education in Islamic Finance (INCEIF), Malaysia

Aznan Hasan, International Islamic University Malaysia (IIUM), Malaysia

Beebee Salma Sairally, International Shari'ah Research Academy for Islamic Finance (ISRA),
Malaysia

Edib Smolo, Indra Technology Solutions, Malaysia

Engku Rabiah Adawiah Engku Ali, International Islamic University Malaysia (IIUM), Malaysia

Farrukh Habib, International Shari'ah Research Academy for Islamic Finance (ISRA), Malaysia

Financial Reporting Foundation (FRF), Malaysia, Represented by Mas Sukmawati Abu Bakar

Habib Ahmed, Durham University, UK

Hafas Furqani, International Shari'ah Research Academy for Islamic Finance (ISRA), Malaysia

Hakimah Yaakob, International Shari'ah Research Academy for Islamic Finance (ISRA),
Malaysia

Humayon Dar, Edbiz Consulting, UK

Hylmun Izhar, Islamic Research and Training Institute (IRTI), Saudi Arabia

KPMG, Malaysia, Represented by Ahmad Nasri Abdul Wahab

Madzlan Mohamad Hussain, Zaid Ibrahim & Corporation (ZICOLaw), Malaysia

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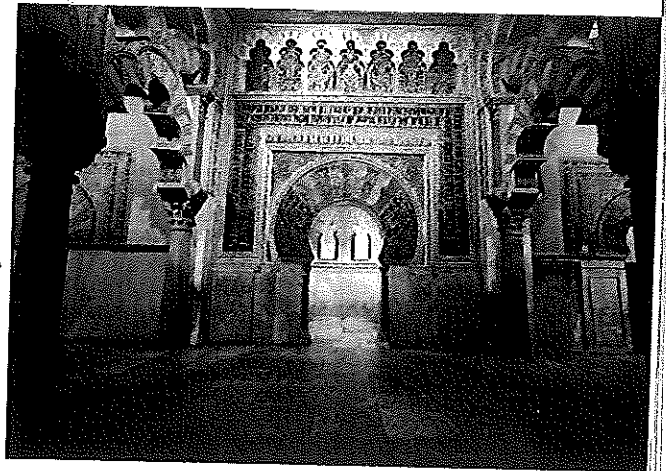
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Chapter 4

Sharī'ah Issues Relating to the Islamic Capital Market

Preview

The Islamic capital market (ICM) is often confronted with a number of Sharī'ah issues that are subject to contention and differences of views. This chapter attempts to look into the various Sharī'ah issues that are contemporary and relevant to ICM products and instruments. These Sharī'ah issues include discussions surrounding practices and concepts, such as combination of contracts; legal and beneficial ownership; recourse to the underlying assets in *shukūk*; purchase undertaking (*wa'd*); taking possession (*qabd*); security deposit (*hāmish jiddiyyah*); provision of guarantee facilities (*kafālah*); foregoing of one's right (*tanāzul*); and rebate (*ibrā'*). These matters are discussed and analysed in terms of their meanings, contemporary applications, and the relevant Sharī'ah issues and opinions on their practices. It is however acknowledged that the discussion and analysis of most of the issues in this chapter are neither conclusive nor exhaustive. It is therefore hoped that the discussion in this chapter will stimulate the interests of the readers and trigger the momentum for further deliberation, discourse and research on the said issues and related areas.



Learning Outcomes

Sharī'ah issues relating to the ICM impact on the operations of this market sector. It is important that readers have a grasp of these issues to understand the challenges faced by this sector. At the end of the chapter, the reader should be able to:

- Evaluate the current practices of ICM instruments and their compatibility with Sharī'ah requirements;
- Highlight the contentious issues raised by Sharī'ah scholars on the features of ICM instruments and understand the rationale for the permissibility of such instruments; and
- Demonstrate the challenges in developing ICM instruments

A combination of contracts can be defined as an agreement between two or more parties to put together two or more contracts with different features and legal consequences to achieve a desired viable transaction.

Combination of Contracts

As mentioned in Chapter 3, hybrid instruments can be structured through the combination of contracts. AAOIFI (2010) defines a combination of contracts as a process that takes place between two or more parties and entails the simultaneous conclusion of more than one contract. A combination of contracts can be defined as an agreement between two or more parties to put together two or more contracts with different features and legal consequences to achieve a desired viable transaction. In this case, all obligations and legal consequences arising from the combined contracts are to be realised as a single obligation.

Prohibition of Combination of Contracts

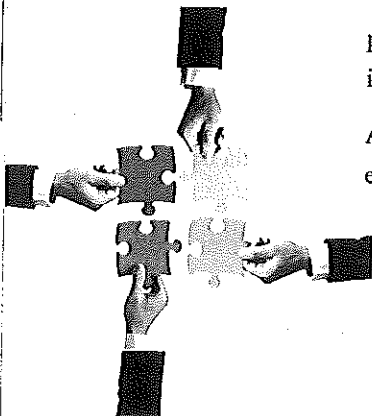
The provisions that seem to reject the concept of combination of contracts are stated in the Sunnah literature evidenced by several famous versions of *hadith*. One such *hadith* reads to the effect:

'Abdullah bin 'Amr said: 'The Messenger of Allah (SAW) said: "It is not permissible to transact a loan combined with a sale, or to stipulate two conditions in one transaction, or to make a profit on something that you do not possess, or to sell something that is not with you." (Sunan Abi Dawud, hadith no. 3504).

In this *hadith*, it is noticed that there are several transactions prohibited by the Prophet (SAW), among which is a transaction of a loan combined with a sale. The meaning of this transaction is to sell goods with a stipulation that the buyer should give a loan to the seller or vice versa. For example, where one says to another, 'Sell your book to me, and I'll lend you money of USD 100.'

In another *hadith*, it was reported by Imām Ahmad: *'The Prophet has prohibited concluding two contracts in one'* (Majma' al-Zawā'id). The scholars differed in their interpretation of this *hadith* and one such interpretation of *ṣafqatān fī ṣafqah* (two transactions in one bargain) is to conclude a contract that revolves between deferred payment with a higher price and cash payment with a lower price, and the parties to the contract separated without certainty on which of the two bargains the contract was finalised. This is the interpretation of the scholars such as 'Abdul Wahāb ibn 'Aqā', Abū 'Ubayd, Ibn Sirīn and Al-Nasā'ī. Generally, the effective reasons for the prohibition are occurrence of *ribā* (interest) or existence of *gharar* (excessive uncertainty or ignorance).

As aforementioned, the rationale behind the impermissibility of the combination of loan and exchange contracts such as a sale contract is the existence of *ribā* where the lender (who is also a seller) will factor the interest of the loan in the sale price for the buyer (who is also a borrower) to pay to him. This arrangement is deemed as *hīlah* (legal trick) to impose interest on the borrower and is strictly prohibited by Islamic law. Apart from combination with a loan contract, two contracts in one bargain is also prohibited due to the existence of



uncertainty and ignorance which may lead to injustice and will oppress the transacting parties. For these reasons, Shari'ah does not allow the combination of loan and sale contracts and combination of contracts in one bargain, especially when the structure involves contracts of exchange of values.

Parameters for Legitimacy of Combining Contracts

Notwithstanding the impermissibility of combining loan and exchange contracts as mentioned previously, Shari'ah does not outrightly forbid the combination of multiple contracts in one transaction because of the general principle of freedom of contract in Shari'ah. Jurists such as Ibn Taymiyyah, in his *Majmū'āt al-Fatāwā*, argue that the parties are free to conclude whatever contracts they deem necessary and of added value, and to fulfil contractual expectations as long as there is no explicit source prohibiting their actions. The parameters for permissible combination of contracts can be summarised as follows:

- i. **The process of combination must not contradict an explicit text.** Firstly, the combination of contracts must comply with the requirement that they do not in any way conflict with an explicit source of Shari'ah. Therefore, if there is an explicit source to the effect that certain contracts cannot be combined for whatever reason, then the product that depends on such a combination becomes unacceptable under Islamic law. This is mainly based on the *hadīth* prohibiting the combination of sale and loan contracts cited earlier. Consequently, any product structured on the basis of combining these two contracts will be against this prohibition and considered impermissible.

An example of an invalid combination of contracts is the granting of a credit facility to the customer where, in addition to the loan given, the customer is also required to sell certain goods to the provider of the facility. As argued by Nazīh Ḥammād (1998), the reason is that the transaction falls under the principle of a loan that accrues benefit, which is prohibited by Shari'ah.

- ii. **No circumvention of impermissible transactions.** A product structured on the basis of a combination of contracts must not be intended to circumvent impermissible transactions, such as *ribā*. If the structure appears to involve *ribā* or *gharar* even if indirectly, it then becomes unacceptable. It is argued, for example, that the *hadīth* that prohibits the combination of some contracts presumed that a combination of such contracts involves *ribā*. In other words, one may combine an *ijārah* contract and a loan contract to benefit from a loan contract in the name of *ijārah*. Some combinations of contracts could involve sale and buy-back arrangements, known as *'mah*. In this respect, an agreement may be reached for selling an item on a deferred payment basis and then be repurchased on an immediate payment basis. Here, there is combination of a contract of deferred payment and a contract of immediate payment, which leads to *ribā* in the name of an ordinary sale contract, if the contract of deferred and immediate payments are made inter-conditional.

The parameters for permissible combination of contracts are:

- The process of combination must not contradict an explicit text.
- No circumvention of impermissible transactions.
- The combination must not involve contradictory contracts.
- The combination of contracts should not be used as a means for practising *riba*.

- iii. **The combination must not involve contradictory contracts.** It is a requirement for a valid combination of contracts that the principal objectives of the contracts combined do not contradict each other, either customarily or legally. Therefore, if the legal consequences of contracts do not conflict with each other, then the combination becomes valid and acceptable. For example, non-binding contracts can be combined with each other. However, non-binding contracts and binding contracts juristically conflict with each other in rulings. Hence, their combination becomes unacceptable. This may refer to the contradiction in the contract nature and its legal implications such as combining a sale with a loan, a partnership with a sale, a marriage with a sale, and a commission with a sale. However, if the two contracts are not in contradiction, such as combining a sale with a gift or a lease with a gift, then it is permissible because there is no conflict between the two. The rationale for the impermissibility on the combination of a sale and a loan while the combination of a sale and a gift is permissible is the consideration of the gift as part of the selling price if the gift is given by the buyer or part of the sold asset if it is given by the seller. Thus, in essence, there is no actual combination of contracts since the end result would still be exchange of two countervalues. In the case of a loan and a sale, the loan must be returned eventually by the seller (debtor) and thus cannot be considered part of the selling price; unlike the gift that will not be returned by the seller.
- iv. **The combination of contracts should not be used as a means for practising *ribā*.** The two parties could misuse, for instance, the combination of contracts when they conclude a lending contract that at the same time facilitates some other compensatory gains to them. For example, they could stipulate in the contract that the borrower should offer accommodation in his house to the lender or should grant him a present. According to AAOIFI (2010), combination of contracts could also be misused by imposing excess repayment in quantity or quality on the borrower.

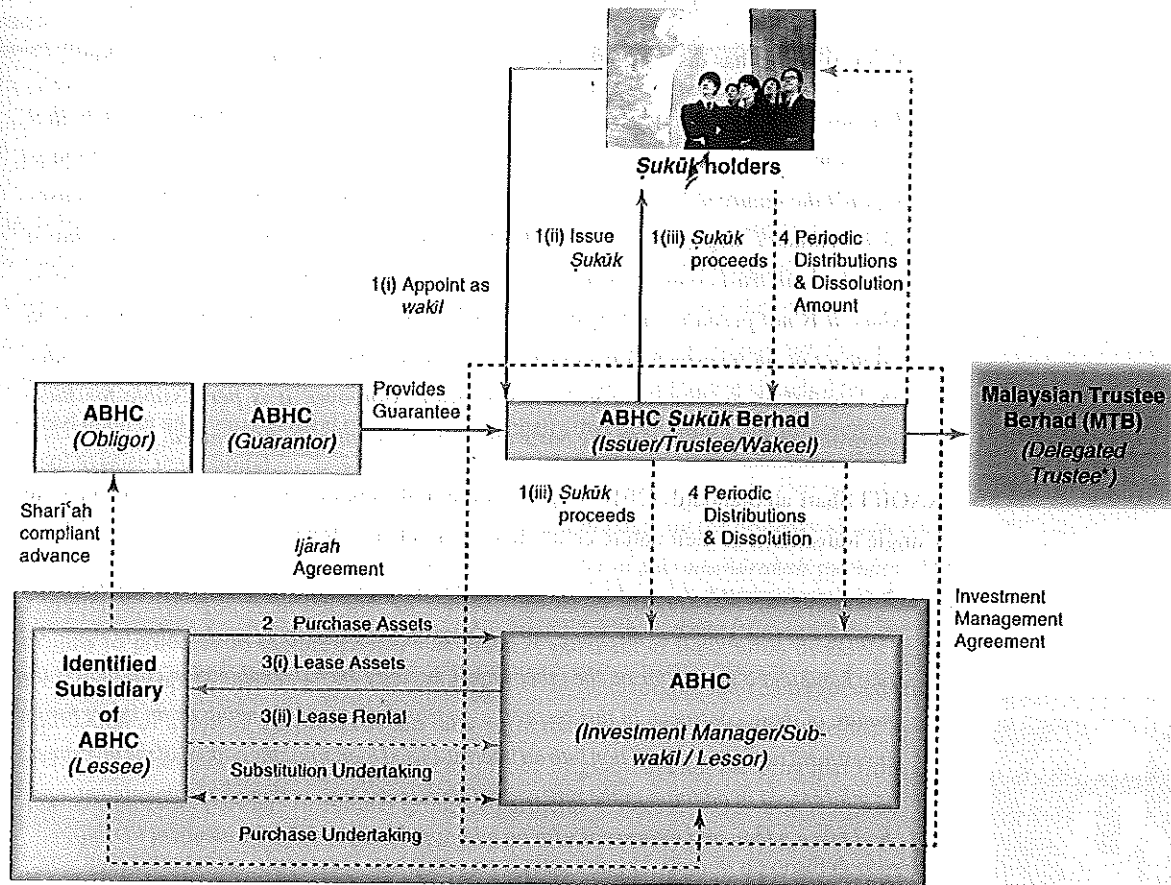
Combination of Contracts in Islamic Capital Market Instruments

The combination of contracts has been used in various ICM products especially in *ṣukūk* structures and other related products such as preference shares (if observing it from a Shari'ah perspective). What follows is the discussion of several examples of combination of contracts that occur in *ṣukūk* structuring and preference shares.

Combination of *Wakālah* (Agency) and *Kafālah* (Guarantee)

A combination of *wakālah* and *kafālah* can be seen in some *ṣukūk wakālah* structures. In such structures, an investment agent appointed by an issuer on behalf of *ṣukūk* holders provides a guarantee to the *ṣukūk* holders on the performance of the investment portfolio. The example of such combinations may be illustrated in the case study of ABHC *Ṣukūk Wakālah* in Exhibit 4.1.

A combination of *wakālah* and *kafālah* can be seen in some *ṣukūk wakālah* structures.

Exhibit 4.1 ABHC RM 1.0 Billion *Shukuk Wakalah* 2013

In this structure, ABHC acts as an investment agent (*wakil*) and a guarantor (*kafil*) at the same time. ABHC, in its capacity as the investment agent, is to distribute the periodic distribution to the *shukuk* holders from the investment portfolio. At the same time, ABHC as the guarantor will guarantee the periodic distributions by ABHC the investment agent.

This practice may involve a combination of two contracts (i.e. *wakalah* and *kafalah*) in the same arrangement and this practice may lead to a debate among Shari'ah scholars because the agency (*wakalah*) contract is a contract of trust (*amanah*); and there can be no guarantees except in the case of negligence or *mala fides*.

In the structure of ABHC *Shukuk Wakalah*, discussed in Exhibit 4.1, it is argued that the guarantee issued by ABHC as guarantor is permissible as it guarantees the payment of rental between ABHC's subsidiaries as lessee and ABHC as lessor-cum-investment manager. Guarantee of rental payment is widely accepted by various Shari'ah boards including the AAOIFI Shari'ah Council and the Shari'ah Advisory Council (SAC) of Securities Commission Malaysia (SC Malaysia).

Furthermore, the terms and conditions for the agency contract and the guarantee contract are documented in separate agreements. Notwithstanding the permissibility, this structure attracts

concerns as ABHC assumes multiple roles in the *shukūk* structure, notably sub-*wakīl*, investment manager, lessor, guarantor and obligor. This kind of arrangement might trigger conflict of interest especially in the case of the investment manager who also acts as guarantor.

AAOIFI (2010: 61) has discussed this concern in its Standard for Guarantees as follows:

It is not lawful to stipulate in trust contracts e.g. wakālah or wadī'ah contracts that a personal guarantee or pledge of security be produced because such a stipulation is against the nature of trust contracts unless such a stipulation is intended to cover cases of misconduct, negligence or breach of contract. The prohibition against seeking a guarantee in trust contracts is more stringent in mushārahah and muḍārahah contracts since it is not permitted to require from a manager in the muḍārahah or mushārahah contract or an investment agent or one of the partners in these contracts to guarantee the capital or to promise a guaranteed profit. Moreover, it is permissible for these contracts to be marketed on the basis that investor capital is guaranteed.

AAOIFI Shari'ah Standards (2010: 60) also prohibit the combination of agency and guarantee in a single transaction as their nature contradicts each other as follows:

It is not permissible to combine agency (wakālah) and personal guarantee (kaḍālah) in a contract at one time (i.e. the same party acting in the capacity of an investment agent on one hand and a guarantor on the other hand), because such a combination contradicts the nature of these contracts. In this respect, a guarantee by a party acting as an agent for an investment turns the transaction into an interest-based loan since the capital of the investment is guaranteed in addition to the proceeds of investment (i.e. as though the investment agent had taken a loan and returned it with an additional sum, which is tantamount to ribā).

However, AAOIFI (2010) resolved that a guarantee given by a party acting as investment agent is allowed, provided that the guarantee clause is not stipulated in the agency contract and a guarantee by the agent is voluntarily given in a separate agreement and in a different capacity from that agent capacity. In this situation, the agent will be a guarantor, not in his capacity as agent but in a separate and independent capacity, such that if the agency were to be withdrawn, the guarantee contract will still remain unaffected.

Combination of *Mushārahah* and *Kaḍālah* (Guarantee)

It is claimed that the resemblance of combination of *mushārahah* and *kaḍālah* contracts can be envisaged in preference shares. From the Shari'ah perspective, it is argued that the holders of the shares, be it ordinary or preference shares, are the *mushārahah* partners. They jointly invest in the business of the company which issues the shares. The main contention on the preference shares lies with its basic features which, among others, are the preference shareholders being guaranteed a specified dividend rate and entitled to preference in the payment of dividends and return of principal investment upon liquidation/winding up of the company. Apart from the said features, a preference share is a share that does not give a right to the shareholders to vote at the annual general meeting of the issuing company.

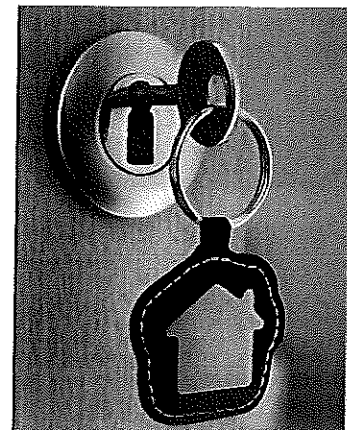
The main contention on the preference shares lies with its basic features which, among others, are the preference shareholders being guaranteed a specified dividend rate and entitled to preference in the payment of dividends and return of principal investment upon liquidation/winding up of the company.

Generally, there are various types of preference shares including redeemable preference shares, participating preference shares, cumulative preference shares and non-cumulative preference shares. So far, the SAC of SC Malaysia only approves the non-cumulative preference shares. Non-cumulative preference shares refer to preference shares whose period of holding by the investor is permanent and similar to ordinary shares except that dividends are fixed and non-cumulative. They have features similar to those of ordinary shares that have no maturity date and non-cumulative dividend payment.

The SAC of SC Malaysia resolved that non-cumulative preference shares are permissible based on application of the Shari'ah concept of *tanāzul* (waiver), which means surrendering the rights to a share of the profits based on partnership by giving priority to preference shareholders. It is also known as *isqāf al-haq* in Islamic jurisprudence. By applying the concept of *tanāzul*, therefore, the right to profit of the ordinary shareholder is willingly given to a preference shareholder. *Tanāzul* is agreed upon at an annual general meeting of a company that decides to issue preference shares as a tool to raise new capital.

The act of waiving of rights to profit to the preference shareholders by the ordinary shareholders seems to be akin to guaranteeing (*kafālah*) returns to some of the *mushārahah* partners. The same approach also applies in the case of winding up where the ordinary shareholders waive their rights to proceeds to the preference shareholders pursuant to liquidation of assets in the event of winding up. In such an event, the ordinary shareholders might receive no proceeds from the liquidation of assets if the proceeds are only sufficient to cover the capital invested by the preference shareholders. Again, there is a resemblance of guaranteeing the principal from one group of *mushārahah* partners to another group of partners.

The term 'non-cumulative' also means that if in a particular interval, there is no profit declared by the issuing company, there will be no profit distributed to preference and ordinary shareholders and no profit will be accumulated for that interval. In this case, the feature of non-cumulative preference shares does not contravene any of the *mushārahah* requirements as all shareholders will not receive any dividend since none is distributed by the issuing company. Notwithstanding this fact, the remaining contentious issues pertaining to non-cumulative preference shares are preference in the payment of fixed dividends and upon liquidation of the company.



Legal and Beneficial Ownership

Among the contentious issues in *shukūk* structuring is that of ownership. Since *shukūk* represents its holders' ownership over a certain underlying asset, it gives rise to a serious question of whether the *shukūk* holders do own the underlying asset of the *shukūk*.

Ownership from the Shari'ah Perspective

From the Shari'ah perspective, ownership (*milk/milkiyyah*) has been defined by Nazih Hammād (1998) as 'a legal right by a person over an asset, to the extent that he is free to transact with it, and exclude others from dealing with that asset.' There are two basic types of ownership:

There are two basic types of ownership: complete ownership (*al-milk al-tāmm*) and incomplete ownership (*al-milk al-nāqis*). Complete ownership is the ownership that covers both property and its usufruct. Incomplete ownership is the ownership of the property but not of its usufruct, or vice versa.

Other terminologies, that have been used interchangeably with the term 'beneficial ownership' are beneficial interest, beneficial title, equitable ownership and equitable interest.

complete ownership (*al-milk al-tāmm*) and incomplete ownership (*al-milk al-nāqis*). Complete ownership is the ownership that covers both property and its usufruct. This type of ownership gives the owner all possible legal rights associated with the owned property, and it is unconditional and has no time limit as long as the property continues to exist. Moreover, ownership of such properties cannot be abolished (because this will render the property ownerless). On the other hand, incomplete ownership is the ownership of the property but not of its usufruct, or vice versa. In this regard, ownership of usufruct may be a personal right tied to the individual rather than the property (e.g. if a person inherits the right to use a property for the rest of his life). Ownership of usufruct may also be attached perpetually to the property, regardless of the individual extracting the usufruct, such as easement rights that are established only for real estate and land.

Beneficial Ownership from the Shari'ah Perspective

The concept of beneficial ownership originates from the English common law, which recognises the dichotomy between legal ownership and beneficial ownership.¹ Other terminologies that have been used interchangeably with the term 'beneficial ownership' are beneficial interest, beneficial title, equitable ownership and equitable interest.

Beneficial ownership or interest has been defined in contemporary legal literature either in a general manner or in a more specific context of trust arrangements and/or investment in securities. Black's Law Dictionary defines beneficial interest generally as '*profit, benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control.*' The same dictionary further defines a beneficial owner in the context of investment in securities as '*the actual owner of securities and the rightful recipient of the benefits accorded; the beneficial owner is often different from the title holder (generally a financial institution holding the securities on behalf of clients).*'

In another definition by Cornell University, beneficial ownership is said to be '*a trust arrangement whereby the beneficial owner of a security has the power to vote on and influence decisions regarding that security, and receives the benefit afforded by the security, even though in street name the security may be held by someone other than the true owner, such as a broker, for safety or convenience reasons.*' It follows that a beneficial owner is '*someone recognised in equity as the owner of property even though legal title may belong to someone else. The use and enjoyment of the property belong to the beneficial owner. In securities law, the term refers to someone who is a shareholder even though a broker may hold legal title to the shares.*'

As opposed to beneficial ownership, legal ownership is where the legal owner in general is someone recognised as the legal owner of property. The term 'legal owner' is sometimes used to describe a person who holds legal title to property for someone else's benefit. Examples of legal owners are trustees and record owners.²

¹ The segregation between legal title and beneficial title under English law is said to go back to the seventh and eighth centuries in England (see Watt, 2003: 8–9).

² A record owner is a property owner whose name appears on the title. The term commonly refers to brokers who hold legal title to shares but pass the voting rights, profits and losses onto the beneficial owners.

Based on these definitions, it is clear that a beneficial owner is legally regarded almost always as the real or actual owner who is entitled to enjoy the benefits of the asset, although he/she does not have the legal title to the asset.

The crucial issue now is: what is the Shari'ah perspective of beneficial ownership and legal ownership as practised in the context of the ICM, and *sukuk*, in particular? The OIC Islamic Fiqh Academy has resolved that both legal and beneficial ownership are recognised from the Shari'ah perspective. The SAC of BNM, as published in its *Shariah Resolutions in Islamic Finance*, and the AAOIFI's Shari'ah Board, as published in the AAOIFI Shari'ah Standard No. 17, have taken the same opinion with the academy. These resolutions however come with a clear condition that the beneficial ownership must result in all rights and liabilities attached to the purchased asset to be attributed to the buyer, albeit short of legal title.

Such condition set by the various Shari'ah bodies can be achieved legally through the English law of trust, which has been said to be one of the most important creations of the English principle of Equity. When a person holds an asset in trust for another, the beneficiary can be construed to be the beneficial owner of the asset held by the trustee. The relationship between the trustee and the beneficiary is evidenced by a trust deed executed by the settlor. Alternatively, the trust deed can also be documented to allow the relationship between the trustee and the beneficiary to be created through the issuance of a trust instrument by the trustee to the beneficiary or class of beneficiaries. For instance, a settlor can create a trust over a house pursuant to a trust deed and appoint a trustee to issue trust instruments to a class of beneficiaries. The class of beneficiaries will be limited to the investors who purchase the trust instruments offered by the trustee for a certain consideration. The investors who purchase the trust instruments will automatically become the beneficiaries of the trust and be construed as pro-rata owners of the house held on trust by the trustee. The trust deed can also be structured to allow the holders of the trust instrument to transfer the instrument to others on a willing-buyer, willing-seller basis. If the trustee leases the house to a tenant for a fixed or variable rental term, the holders of the trust instrument will be entitled to a pro-rata share of the rental income derived from the house held on trust.

Rafe Haneef (n.d) argues that the position in Malaysian law is quite similar to the position in English law. For example, when a buyer pays the full consideration for a landed asset, the seller becomes a bare trustee and the buyer becomes the beneficial owner of the landed asset. As a bare trustee, the seller cannot dispose the land to another without the consent of the beneficial owner. The law considers the beneficial owner as the true owner with the power to possess and dispose the landed asset. However, such a disposal has to be made through the bare trustee who will have to comply with the instructions of the beneficial owner. To protect the rights of the beneficial owner against any third party who may claim any interest on the landed asset held on trust, the bare trustee is required to procure a trust endorsement on the land title held at the land registry. The trust endorsement will give a clear notice to third parties of the beneficial owner's right in the landed asset and will prevent the bare trustee from inadvertently transferring the landed asset to any third party.

These characteristics of the trust instrument and its subsequent legal effects squarely meet the requirements of *milkiyyah* from the Shari'ah perspective, either as complete ownership (*milk*

The OIC Islamic Fiqh Academy has resolved that both legal and beneficial ownership are recognised from the Shari'ah perspective. The SAC of BNM and the AAOIFI's Shari'ah Board have taken the same opinion with the academy. These resolutions however come with a clear condition that the beneficial ownership must result in all rights and liabilities attached to the purchased asset to be attributed to the buyer, albeit short of legal title.



tāmm) or at least incomplete ownership (*milk nāqish*), depending on the extent of liberty and control enjoyed by the beneficial owner(s) as prescribed by the trust deed.

In the context of *shukūk*, for instance, most of the transactions underlying the issuance involve the sale of assets by an originator to a Special Purpose Vehicle (SPV) or trustee, but the originator only transfers beneficial interests of the asset to the latter, and not the legal title, to avoid contravening certain legal restrictions, for convenience or for cost-efficiency purposes. This gives rise to a concern on whether the sale of an asset resulting in a transfer of beneficial interests without the legal title is recognised under Shari'ah. Based on the discussion about beneficial ownership under English law as well as the Shari'ah resolutions by the OIC Islamic

Fiqh Academy, AAOIFI Shari'ah Standards and the SAC of BNM, it is clear that the sale of assets where only the beneficial ownership is transferred is recognised under Shari'ah.

Thus, when an SPV that has acquired beneficial ownership over the asset later issues *shukūk*, they would represent real ownership of the asset, albeit being described as beneficial interest. The holders of the *shukūk* will be construed under Shari'ah as owners of the asset, although it is being held on trust by the seller who acts as a bare trustee. Based on this arrangement, it can be argued that the *shukūk* holders have complete ownership (*milk tāmm*) over the asset though they are not the registered owners as far as the legal title is concerned, provided that there are no substantial restrictions put on the liberty of the *shukūk* holders to deal with the asset. If the *shukūk* documents contain such substantial restrictions, the *shukūk* holders would still have ownership over the asset, albeit incomplete (*milk nāqish*). In subsequent subtopics, there will be further discussion on the restrictions put on the *shukūk* holders in dealing with the underlying *shukūk* asset, and their effects on the nature of the *shukūk* holders' ownership of and recourse on the asset.

Through this fresh interpretation, contemporary Shari'ah scholars are able to extend the scope of ownership in Shari'ah to include the concept of beneficial ownership when, as illustrated in the *shukūk* structures from Malaysia, the true owner in the eyes of the law is the beneficial owner and the seller remains only as a bare trustee. This, however, might not be a generic conclusion as the legal framework varies from one country to another.

The Islamic Financial Services Board (IFSB) elucidates the parameters of ownership in its standards (IFSB-7) on *Capital Adequacy Requirements for Shukūk, Securitisations and Real Estate Investment* where it states that the structure must transfer all ownership rights in the assets from the originator via the issuer to the investors. Depending on the applicable legal system, these ownership rights do not necessarily include registered title. The transfer could be a simple collection of ownership attributes that allow the investor (a) to step into the shoes of the originator and (b) to perform (perhaps via a servicer) duties related to ownership. The transfer could also include rights granting access to the assets subject to notice and, in case of default, the right to take possession of the assets.

Recourse to the Underlying Assets in *Shukūk*

Recourse means a legal right to claim. The term 'without recourse' means that one party has no legal claim against another party. It is often used in two contexts:

- i. In litigation, someone without recourse against another party cannot sue that party, or at least cannot obtain adequate relief even if a lawsuit moves forward. Someone completely without recourse cannot sue anyone for an alleged injury, or cannot obtain any relief even if lawsuits are filed.
- ii. In financial transactions, the words 'without recourse' disclaim any liability to the subsequent holder of a financial instrument. Thus, endorsing a cheque and adding 'without recourse' to the signature mean that the endorser takes no responsibility if the cheque bounces due to insufficient funds. If the bank accepts such a cheque and deposits the stated amount in the endorser's account, the bank will have no right to withdraw that amount from the account.

Recourse means a legal right to claim. The term 'without recourse' means that one party has no legal claim against another party.

Shari'ah Issues Relating to Recourse in Asset-Backed and Asset-Based *Shukūk*³

Many Shari'ah scholars are of the view that asset-backed *shukūk* is perfectly in adherence to the Shari'ah requirement on ownership in *shukūk* origination. The central feature of asset-backed *shukūk* is a true sale, which results in the transfer of ownership to the *shukūk* holders via the SPV, and in most cases there is no 'controversial' purchase undertaking from the originator or obligor. As for asset-based *shukūk*, particularly the unsecured ones, Shari'ah scholars raise several concerns especially relating to the issue of sole recourse on the creditworthiness of the originator or obligor. Among the concerns include the nature of the *shukūk* holders' interest in the underlying assets, restrictions on asset disposal and due diligence regarding *shukūk* assets. These issues will be briefly discussed in the later part of this section.

Among the concerns relating to asset-based *shukūk* include the nature of the *shukūk* holders' interest in the underlying assets, restrictions on asset disposal and due diligence regarding *shukūk* assets.

In the few years prior to February 2008, *musharakah* and *muḍarabah shukūk* still adopted the conventional credit risk rating simply because the quality of the *shukūk* in terms of ability of payment and timely payment of the issuer are essentially based on the originator's credit standing pursuant to the purchase undertaking at a price representing the face value of the *shukūk* at maturity or following an event of default. Shortfalls in periodic distribution amounts are similarly covered by the originator/obligor in the event insufficient returns are generated by the *shukūk* assets.⁴ This had been the subject of scrutiny by the AAOIFI Shari'ah Board, which led to the prohibition of such practices in February 2008.

The practice of an obligor granting a purchase undertaking to purchase the *musharakah* and *muḍarabah* asset at a predetermined formula has been heavily criticised by the scholars and perhaps most notably by Muhammad Taqi Usmani, chairman of the AAOIFI Shari'ah Board. In his paper to the AAOIFI Shari'ah Board, Usmani (2007) states:

³ The issue of asset-backed and asset-based *shukūk* will be discussed at length in Chapter 9. For now, the Shari'ah issues relating to recourse in these two types of *shukūk* will be examined.

⁴ This is particularly true with a number of GCC issuances, such as Dubai Port Sukuk, Aabar Sukuk and Al-Dar Sukuk.

All of today's sukūk, however, guarantee by indirect means the sukūk holders' principal. The manager pledges to the sukūk holders that he will purchase the sukūk assets at face value upon maturity, regardless of their true value on that day. What this means is that the principal paid originally by the sukūk holders will be returned to them at maturity. There is no other significance to such a commitment. If the enterprise is not profitable, the losses will be borne by the manager. If it is profitable, however, the profits will accrue to the manager, regardless of how great the amount. The sukūk holders have no right to other than the return of their principal, as is the case in conventional bonds.

There are, however, other scholars who do not view a purchase undertaking as an indirect guarantee of the principal in *musharakah* or *muḍārabah* contracts and ruled it to be permissible.

There are, however, other scholars who do not view a purchase undertaking as an indirect guarantee of the principal in *musharakah* or *muḍārabah* contracts and ruled it to be permissible. For example, Mohd Daud Bakar in his Shari'ah Pronouncement for Sabah Credit Corporation's *sukūk al-musharakah* said:

Such undertaking by the obligor to purchase the trust assets which is managed by the issuer is permissible and is not a capital guarantee as the undertaking can only be exercised if the assets are still available. Unlike capital guarantee, which requires the obligor to refund the full capital irrespective of the availability of the assets of venture, the purchase undertaking by the obligor will and could be exercised if the assets of the venture are available to make the purchase contract valid.

In furtherance to a series of deliberations, AAOIFI has issued an enhanced standard on Investment *Sukūk* (i.e. Standard No. 17) in which a detailed explanation on *musharakah sukūk* is given. According to the said standard, the issuer of the certificates (*sukūk*) invites *sukūk* holders to enter into partnership with him to carry out a specific project or determined activity. The subscribers are the partners in the *musharakah* contract. The realised funds are the share contribution of the subscribers in the *musharakah* capital. The certificate holders own the assets of the partnership with the accompanying profits and losses and are entitled to their share in the profits of the partnership, if any.

The AAOIFI Shari'ah Standard No. 17 on Investment *Sukūk* states the following:

The prospectus must not include any statement to the effect that the issuer of the certificates accepts the liability to compensate the owner of the certificates up to the nominal value of the certificates in situations other than torts and negligence nor that he guarantees a fixed percentage of profit. It is, however, permitted to an independent third party to provide a guarantee free of charge, while taking into account item 6/7 of Shari'ah Standard No. (3) in respect of guarantees . . .

This position of AAOIFI shall also be read in close link with what has been stated in Standard No. 5 concerning the issue of guarantee in particular. The standard states the following:

It is permissible for a third party, other than the muḍārib or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the muḍārabah financing contract or investment agency contract.

Another Shari'ah issue related to the discussion of recourse particularly in unsecured asset-based *sukūk* is the status of the ownership over the underlying asset held by the *sukūk* holders. In such *sukūk* structure, the originator typically transfers only the beneficial ownership or equitable interest in the assets to the SPV issuer. Technically, there is no true sale transaction unlike in the case of asset-backed *sukūk* (ABS) and as a result, the *sukūk* holders generally have recourse to the issuer/obligor. Even in the event of default, the *sukūk* holders being the beneficial owner cannot outrightly sell the asset to recover their capital but rather they have to exercise the purchase undertaking given by the obligor at the onset. Therefore, the transaction does not focus on asset risk, but rather on the creditworthiness of the originator/obligor of the *sukūk*.

From the Shari'ah perspective, the *sukūk* holders should be able to deal freely with the underlying asset as they are its owners. This is to conform to the gist of ownership (*milkiyyah*) from the Shari'ah perspective which comprises the principle of *tamkīn wa takhliyah*, which denotes that the buyer as owner must have full access to the object of sale without any encumbrances. However, under the asset-based *sukūk*, the *sukūk* holders do not have an outright right to dispose the asset especially upon the occurrence of the event of default. This has triggered a debate amongst Shari'ah scholars as to whether ownership is actually transferred to the *sukūk* holders, or otherwise, the relationship between the issuer/obligor and the *sukūk* holders is merely that of creditor-debtor. To answer this question, it has been concluded that ownership does transfer in the sale contracts made in *sukūk* transactions, be they asset-backed or asset-based. This is the original position as a direct Shari'ah and legal consequence of a valid sale contract, regardless of whether legal title or beneficial title is being transferred. However, the nature of ownership right enjoyed by the *sukūk* holders may differ, depending on the nature of restrictions made on the *sukūk* holders' liberty to deal with the asset in the terms and conditions of the *sukūk* issuance. If there is no substantial restriction, the *sukūk* holders enjoy complete ownership; but if there are substantial restrictions, the *sukūk* holders enjoy incomplete ownership only.

Among the alternative structures that are already in the market is a hybrid structure between the current unsecured asset-based *sukūk* structures and the asset-backed transactions. This structure is called covered *sukūk*, which is comparable to the features of a covered bond. Such structures would provide investors with recourse to both the corporate credit of the obligor which they desire, as well as to the underlying assets to the extent that the obligor fails to fulfil its obligations under the purchase undertaking, making for a much safer investment as a result of the dual recourse.

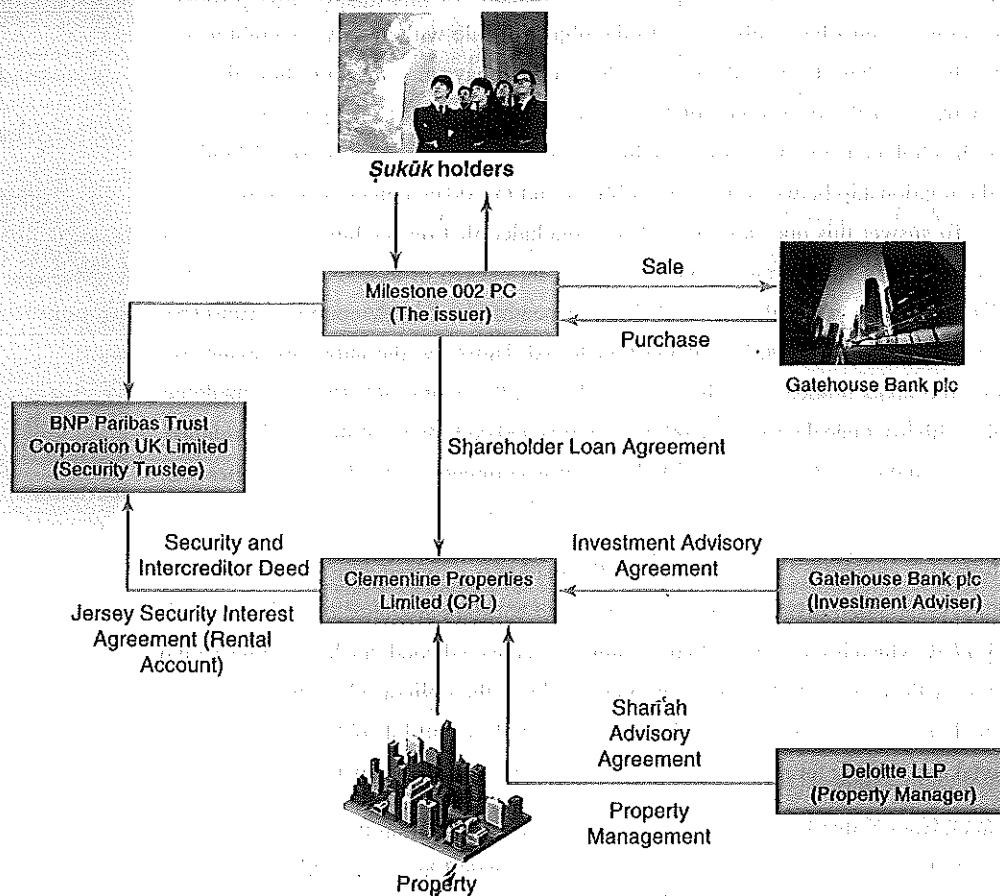
What is also interesting is that in such structures, additional security from the obligor would be unnecessary as, following a default by the obligor, investors would have recourse to the assets, which they would be able to realise in much the same way as any security to secure the obligations of such obligor in a secured asset-based structure. An example of covered *sukūk* is Gatehouse *Sukūk* which was issued in 2012 and the structure of the *sukūk* is as follows:

When observing the structure in Exhibit 4.2, it is noticed that the features of the covered *sukūk* are perfectly in consonance with the requirement of *milkiyyah* (ownership) from the Shari'ah perspective. The *sukūk* holders being the owners of the asset (via their ownership in the company

Under the asset-based *sukūk*, the *sukūk* holders do not have an outright right to dispose the asset especially upon the occurrence of the event of default. This has triggered a debate amongst Shari'ah scholars as to whether ownership is actually transferred to the *sukūk* holders, or otherwise, the relationship between the issuer/obligor and the *sukūk* holders is merely that of creditor-debtor.

(i.e. Clementine Properties Limited (CPL)) have the right to dispose the asset should the obligor fail to honour its obligation under the purchase undertaking. Unlike the asset-based *ijarah sukūk*, the *sukūk* holders of the covered *sukūk* or their agent should carefully examine the quality and performance of the asset by conducting due diligence to ensure that the income generated from the asset can meet the periodic distribution; and in the event of disposal of the asset, the *sukūk* holders would be able to get back the principal and profit due from the originator/obligor. This means the *sukūk* holders bear some risks associated to their holdings in the asset, yet they are entitled to the income generated by the asset. This is in line with the Shari'ah principles of *al-ghunm bi al-ghurm* (reward is to be accompanied with risk) and *al-kharāj bi al-damān* (any benefit must be accompanied with liability).

Exhibit 4.2 Gatehouse *Sukūk* Structure Issued in 2012



In this structure, the bank, via its special purpose company (SPC) called Milestone 002 PC, issued its first real-estate-backed *sukūk* that comprises shares in a company, which owns a property leased to Fujitsu Services Limited (the lessee). Rental payments made by the lessee will be applied to fund the periodic distributions to the *sukūk* holders. This structure allows investors to have recourse to the originator pursuant to the purchase undertaking but, in the event of a shortfall, the *sukūk* holders are entitled to enforce their rights against the underlying asset of the *sukūk* (i.e. the property). However, there is no assurance that the proceeds from the underlying asset will be sufficient to make all payments due in respect of the *sukūk*.

Purchase Undertaking (*Wa'd to Purchase*)

Wa'd is translated as a promise, and originates from the Arabic root word of *wa'ada*, which literally connotes both good and bad meanings. The verbal noun *wa'd* is used for promises to do good or bad, whereas the term *wa'id* is reserved only for a promise to inflict harm. Technically, there are two main definitions given by scholars for *wa'd*. According to Ibn 'Arafah (1989), *wa'd* means 'an expression by the person who gives it to do something good in the future.' Likewise, al-'Ayni (n.d) defines *wa'd* as: 'the expression of intent to deliver something good in the future.'



The majority of jurists upholds that fulfilling a promise is highly recommended and urged by Shari'ah. Fulfilment of a promise is neither mandatory nor enforceable through courts of law. However, a number of the Muslim jurists such as Samurah bin Jundab, Umar ibn 'Abd al-'Aziz, Ibn Shubrumah, Hassan al-Basri, Ibn 'Arabī and Imām Bukhārī opined that fulfilling a promise is not only morally binding, but also enforceable in the court of law.

The middle opinion upheld by the Ḥanafīs and the Mālikīs looks more towards the effect of such a promise. Hence, the Ḥanafīs maintain that a promise is binding if it is tied up (*mu'allaq*) with the occurrence of a certain/specified condition (*sharf*). This is to prevent detriment or fraud on the promisee. The Mālikīs opine that though a promise is generally not binding, if the promisor had caused the promisee to incur some expense or undertake some labour or liability on the basis of the promise, this promise is mandatory upon him. The court may enforce the promise if sufficient evidence is provided by the plaintiff that he has suffered losses due to the promise given to him by the defendant. This opinion has been adopted by the OIC Islamic Fiqh Academy of Jeddah in one of its resolutions, AAOIFI in its Shari'ah Standards, and is widely accepted by contemporary jurists. It is not the intention of this chapter to examine this matter in detail. It suffices to state here that this line of opinion is the preferred view to ensure the legality and enforceability of promises that are widely used in the structuring of many Islamic financial products.

Differences between *Wa'd* (Unilateral Promise) and *Muwā'adah* (Bilateral Promise)

As stated previously, *wa'd* means a promise or undertaking that may involve good things as well as bad. From an Islamic perspective, the promise given by a party (promisor) is considered a unilateral binding promise (*wa'd mulzim*) that obliges him to perform the promise, whilst the other party who receives the promise (promisee) can decide whether to exercise the option or discontinue the arrangement. This kind of *wa'd* is allowed in Shari'ah since the *wa'd* is unilateral, and binds only the seller as the promisor. By definition, it is understood that *wa'd* means an undertaking by a person to do an action in the future that relates to other individuals. *Wa'd* is a promise by one party (unilateral) to another party to do certain things, such as a promise to sell or buy, in the future.

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Muwā'adah is defined as both parties promising to each other to do something where the impact or implications of such promises will be on both parties.

On the other hand, *muwā'adah* is derived from the word *wā'ada*, a verbal form which connotes a mutual relationship between the two parties involved. Technically, according to al-Ḥaṭṭāb (1992), *muwā'adah* is defined as both parties promising to each other to do something where the impact or implications of such promises will be on both parties. The bilateral promise indicates two parties acting upon each other; it cannot happen unless there are two actors.

The OIC Islamic Fiqh Academy resolved in its 17th meeting that the original ruling on *muwā'adah* is its bindingness from a religious perspective (*diyānatan*) on both contracting parties without any legal consequences. *Muwā'adah* from both parties to conclude a contract for the purpose of circumventing the prohibition of *ribā* like mutual understanding to do *'imah* or bilateral promises to do sale and loan is prohibited by Shari'ah. However, *muwā'adah* can be made judicially binding according to local law or international trade regulation if there is any urgent public need to such effect. This resolution focuses on the prohibition of *muwā'adah mulzimah* (binding bilateral promise) in *murābahah* contracts and does not refer to other types of Shari'ah contracts.

Similarly, according to AAOIFI's (2010) resolution on *Murābahah for the Purchase Orderer*, it is not permitted for the contract document to include a binding bilateral promise or other means that carry the same effect on the two contracting parties. AAOIFI (2010) however has permitted the option of condition (*khiyār al-sharṭ*) that preserves the option of annulment of contract for either or both of the contracting parties subject to certain agreed conditions.

Many Shari'ah boards such as AAOIFI, Dallah al-Baraka, Kuwait Finance House and the SAC of BNM agree on the impermissibility of *muwā'adah mulzimah* in the currency exchange even for the purpose of hedging. Among the justifications for this prohibition is that the transaction is analogous to a sale contract.

Shari'ah Issues Regarding Application of *Wa'd* in ICM Instruments

The Shari'ah issues relate to the following:

Purchase undertaking by the manager or partner in *mushārahah*, *muḍārahah* and *wakālah bil istithmār ṣukūk* structures

Prior to the AAOIFI Shari'ah Board's resolution/pronouncement on *ṣukūk* in February 2008, many equity-based *ṣukūk* such as *mushārahah* and *muḍārahah ṣukūk* contain an undertaking from the manager (cum obligor pursuant to such undertaking) to purchase the *ṣukūk* holders' interest in the venture at a pre-agreed purchase price upon the dissolution of the *ṣukūk*, irrespective of the actual market value of the *ṣukūk* assets on the date of dissolution. The agreed purchase or exercise price formula for the purchase undertaking ensures that the principal amount invested by the *ṣukūk* holders will be returned to them at dissolution date. Thus, no matter how the venture goes, profitable or not, the return of investors' capital is ensured.

In this circumstance, one may argue that the purchase undertaking is valid as it is a form of unilateral *wa'd* which is allowed under Shari'ah and can be made binding and enforceable.

However, proper assessment must be done on the effect of fixing the formula for the purchase price regarding whether it violates the purpose or the essence of the underlying contract (*muqtadā al-'aqd*). In *muḍārabah* and *mushārahah sukūk*, it has been argued that the undertaking applies in a way that the capital amount and the profit are indirectly guaranteed through the payment of the purchase price under the purchase undertaking. Muhammad Taqi 'Usmani (2007) had severely criticised such practices.

Pursuant to a series of debates among the Shari'ah scholars relating to incorporation of the purchase undertaking in equity-based *sukūk*, the AAOIFI Shari'ah Board ruled in its Shari'ah Standard No. 12 (2010) that:

It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation, all the assets of the partnership as per their market value or as per the agreement at the date of buying. It is not permissible, however, to promise to buy the assets of the partnership on the basis of face value.

Based on this ruling, if the obligor undertakes to buy their partner(s)'s stakes in the venture, the purchase/exercise price must be based on the prevailing market value or any price agreed by the transacting parties at the point of purchase. These recommendations aim at eliminating the 'price fixing' element, which is tantamount to guaranteeing the principal and the profit to the *sukūk* holders.

However, according to some contemporary Shari'ah scholars, the practice of granting a purchase undertaking with a predetermined formula by the obligor is not necessarily tantamount to a capital guarantee. One of the justifications that can be cited in the Shari'ah pronouncements of equity-based *sukūk* is the Shari'ah advisers' argument that the purchase undertaking given by the obligor to purchase the underlying assets in equity-based *sukūk* can only be exercised if the assets are still available. Unlike capital guarantee, which requires the obligor to refund the full capital irrespective of the availability of the assets of the venture, the purchase undertaking by the obligor will and can only be exercised if the assets of the venture are available to make the purchase contract valid.

Application of two unilateral *wa'd* via purchase and sale undertaking in *sukūk* structures

In some practices, there are *sukūk* arrangements that use two undertakings or *wa'dān* (two unilateral promises) — a purchase undertaking and a sale undertaking — whereby certain conditions are stipulated to be exercised by the obligor and the trustee on behalf of *sukūk* holders. Among the Shari'ah concerns relating to this arrangement is whether the two undertakings fall under *wa'dān* which leads to two different impacts, or replicates the effect of *muwā'adah* where the two undertakings lead to the same result. If the two different undertakings lead to two different results, the arrangement satisfies the requirement of *wa'dān*. However, if the two different undertakings lead to the same result, it requires an in-depth analysis of the conditions in the undertakings to ensure that they do not resemble *muwā'adah mulzimah* instead of *wa'd* or *wa'dān*.

In fact, the practice of *wa'dān* has been widely applied in *sukūk* structures through a purchase undertaking and a sale undertaking. For instance, the Global *Sukūk Ijārah* issued on 29 January

In *muḍārabah* and *mushārahah sukūk*, it has been argued that the undertaking applies in a way that the capital amount and the profit are indirectly guaranteed through the payment of the purchase price under the purchase undertaking.

The practice of *wa'dān* has been widely applied in *sukūk* structures through a purchase undertaking and a sale undertaking.

2013 by Sime Darby amounting to USD 1.5 billion incorporated both purchase and sale undertakings as quoted in Box 4.1.

Box 4.1 Purchase and Sale Undertakings Clause in Sime Darby *Ṣukūk Ijārah*

1. Purchase Undertaking

Sime Darby shall execute an undertaking on the date of the establishment of the Programme, in favour of the Trustee (the 'Purchase Undertaking'). Upon maturity of the Certificates issued in respect of a Series or upon an earlier date for dissolution of the Trust established in respect of such Series following the occurrence of a Dissolution Event, the Purchase Undertaking provides the Trustee, on behalf of Certificate holders, with an option to require Sime Darby (as 'Obligor') to purchase the Assets relating to a Series at a predetermined Exercise Price.

2. Sale Undertaking

The Trustee shall execute an undertaking on the date of the establishment of the Programme in favour of Sime Darby (in its capacity as Obligor) (the 'Sale Undertaking'). Sime Darby, pursuant to the Sale undertaking, is provided with an option:

- (a) *to require the Trustee to sell the Assets relating to a Series at the Exercise Price where:*
 - (i) *dissolution of the Trust is to occur following the exercise of an optional dissolution call option by Sime Darby (if such option is specified as applicable in the final terms of the Certificates); and*
 - (ii) *dissolution of the Trust is to occur following the exercise of the right to redeem the Certificates upon the occurrence of certain tax events as specified in the terms and conditions of the Certificates.*
- (b) *to require the Trustee to transfer to Sime Darby a proportion of the Assets corresponding to Certificates purchased by Sime Darby or any of its subsidiaries and which are to be cancelled in return for the Trustee cancelling such Certificates.*

Based on these clauses about the purchase and sale undertakings, it is safe to conclude that these undertakings are *wa'dān* instead of *muwā'adah*. This is due to the fact that each undertaking refers to different events and leads to different consequences — though both undertakings lead to the dissolution of the *ṣukūk*, the exercise price payable upon such dissolution pursuant to each undertaking is different.

Adoption of *Wa'd* in Derivative Instruments

Wa'd has been used in structuring Shari'ah-compliant hedging instruments such as the Islamic FX Forward (IFF). This instrument is originated to hedge against the currency fluctuation risk and it is comparable to the conventional FX Forward.

In current business transactions, which involve cross-currency transactions, corporations face a number of risks that affect their profitability. One of these is foreign exchange risk. This is the risk that fluctuations in currency rates could adversely affect the profitability of the company.

The popular method for an IFF is currently based on a *wa'd* structure. This consists of a single, unilateral promise from the corporate to the bank that it will enter into a *bay' al-ṣarf* (currency

Wa'd has been used in structuring Shari'ah-compliant hedging instruments such as the Islamic FX Forward (IFF).

exchange) at a future date for an agreed price/rate. On the forward date, the bank will call the corporate and execute the *bay' al-sarf* transaction resulting in the foreign currency being exchanged for the local currency at the agreed rate. The illustration of an IFF is provided in Exhibit 4.3.

Exhibit 4.3 Islamic FX Forward

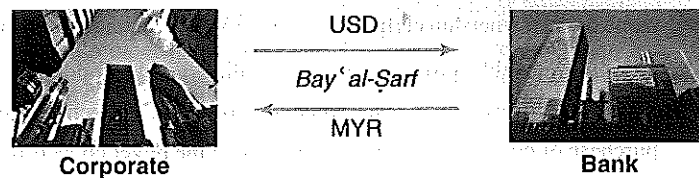
An example of this would be for a Malaysian exporter of goods to the United States. The exporter would be paid in US Dollars (USD) for the goods and would need to convert the payment into Malaysian Ringgit (MYR).

Wa'd details:

The corporate promises the bank that it will sell USD 2.0 million for MYR at a USD/MYR exchange rate of 3.30 (i.e. for MYR 6.6 million) in one month's time.

On maturity within one month's time

If the prevailing USD/MYR rate is 3.40 on that date, the bank will exercise (i.e. take up) its right (under the *wa'd*) to buy the USD for MYR at the agreed rate of 3.30. If the prevailing USD/MYR rate on that date is 3.30 or lower, the bank will not invoke the *wa'd* given by the corporate and the *bay' al-sarf* will not materialise.



This structure is approved by various Sharī'ah boards including the SAC of BNM. In the structure, the obligation to honour the undertaking lies with the promisor (i.e. the corporation) and is not binding upon the counterparty (i.e. the bank). Hence, there is no resemblance of *muwā'adah*, which is contentious to many Sharī'ah scholars. In addition, the party who suffers losses due to non-fulfilment of the promise may claim compensation.

While many Sharī'ah boards and scholars approve the structure of Islamic derivative instruments such as IFF, they resolve that trading such instruments to create profits is impermissible! To these scholars, the creation of an option (and the subsequent exercise or cancellation of it) for genuine trade hedging purposes is broadly viewed as permissible, as it reduces risks and uncertainty (*gharar*) and is therefore regarded as contributing towards public good (*maṣlahah*). However, the trading of such instruments with or without any underlying assets, undertaken solely for the objective of making a speculative gain is deemed impermissible by a number of Sharī'ah scholars, as this contains prohibited elements such as *gharar* and *maysir*.



Taking Possession (*Qabd*)

According to Islamic jurists, *qabd* means to have a control and an ownership of something that usually refers to an *'uqūd al-mu'āwadhāt* (exchange contract). It can be done explicitly by claiming the goods after the sale transaction, or implicitly by recognising that as a result of a certain action,

qabḍ has successfully taken place. Generally, *qabḍ* depends on the perception of 'urf or the common practices of the local community in recognising that control and possession of a good has taken place. The jurists also use a number of other terms that have the same meaning as *qabḍ*, among which are *naqd*, *munājazah*, *ḥiyāzah*, *yadd*, *yadd bi yadd*, *hā' wa hā'* and *qaḍā' wa iqtidā'*.

Categories of *Qabḍ*

In general, Islamic jurisprudence has outlined two categories of *qabḍ*:

Qabḍ Ḥaqīqī or *Qabḍ Ḥissī*

This *qabḍ* is explicit and as an example, a *qabḍ* transaction occurs when the buyer is seen taking the goods sold to him. *Qabḍ* in this form usually takes place when it involves two types of assets:

- a. *'Aqār*—fixed property such as land and buildings. *Qabḍ ḥaqīqī* for a fixed property like land is considered to have taken place when the original owner gives permission to the buyer to take control of the land and carry out whatever activity he wishes without any hindrance. In the context of administering the real estate, official transfer of ownership by changing the name on the ownership certificate and the like is adequate to evidence and complete the *qabḍ*;
- b. *Manqūl*—movable property such as trading goods, foods and vehicles. *Qabḍ ḥaqīqī* is considered to have taken place when it involves the collection of goods. For example, for the purchase of books, *qabḍ ḥaqīqī* occurs when the buyer collects the books and pays the price.

Qabḍ Ḥukmī or *Qabḍ Ma'nawī*

Qabḍ ḥukmī in which the transaction will take place in an implicit manner is akin to *qabḍ ḥaqīqī* in its legal effect. Thus, Islamic jurisprudence equates its status with that of *qabḍ ḥaqīqī*. The following conditions must be met for *qabḍ ḥukmī* to be considered:

- a. *Takhliyah*—that is, the seller gives permission to the buyer to take the sold goods unhindered. For example, the seller delivers the sold goods to an agent appointed by the buyer to receive the goods on his behalf. Another example is where the seller opens up his warehouse to show the wheat to the buyer, as an indication of handing over the wheat to be sold;
- b. *Muqāṣṣah*—meaning a contra debt. In a contra debt, an implicit settlement takes place between the two parties (i.e. debtor and creditor). As a result of the contra transaction, there is no more debt between the two parties. For example, Ahmad owes Ali RM 2,000, and then Ali owes Ahmad the same amount. This means the two parties are no longer in debt to each other. In this context, *qabḍ ḥukmī* to the amount of the debt has taken place in the form of contra;
- c. Earlier action—*Qabḍ ḥukmī* can also take place due to an earlier action, which shows that *qabḍ* has taken place earlier, although the earlier *qabḍ* differs in form from the new *qabḍ*. An example would be a *qabḍ* rental that is followed by a purchase. During the rental period, the tenant occupies the rented premises. This represents a form of early *qabḍ*. Later, the premises are sold to the tenant, and *qabḍ ḥukmī* takes place although the *qabḍ ḥaqīqī* is after the sale and purchase 'aqd (contract);

Islamic jurisprudence has outlined two categories of *qabḍ*:

- *Qabḍ ḥaqīqī* or *qabḍ ḥissī*
- *Qabḍ ḥukmī* or *qabḍ ma'nawī*.

- d. *Itlāf*—meaning damage. If the goods are damaged by the buyer before the sale and purchase *'aqd* has been executed (e.g. when the goods are in the hands of the buyer), then *qabḍ ḥukmī* is considered to have taken place. At this point, the buyer has to pay for the damaged goods if he causes the damage while examining them (e.g. dropped the goods) because *qabḍ ḥukmī* for the goods is considered to have taken place.

Regarding the status of *qabḍ* in a sale contract, the Ḥanafīs are of the opinion that *qabḍ* is not an essential requirement of a sale but a subsidiary condition. It is perfectly lawful to postpone it. The only exception is the case of transactions of *ribāwī* items, in which *qabḍ* is elevated to a prerequisite of a valid contract. On the other hand, the Mālikīs confined the application of the *ḥadīth* on *qabḍ* to food grains, which means that non-food-grain items (e.g. cotton, palm oil) may be sold prior to taking possession. There is also no dispute that for *ribāwī* food (wheat, barley, dates and salt), possession is a condition for its sale. As for non-*ribāwī* food, Mālikīs have two opinions: first, that it is disallowed (without prior possession) and second, it is permissible to sell non-*ribāwī* food prior to taking possession. For the Shāfi'īs, possession is a condition for all kinds of property. The Shāfi'īs strictly adhere to the literal meaning of the *ḥadīth* لَا تَبِيعُ مَا لَيْسَ عِنْدَكَ (do not sell anything until you receive it) to the extent that even the sale of immovable objects must satisfy the possession requirement prior to resale. However, the view of Shāfi'īs is not shared by the other schools, which do not require *qabḍ* prior to resale in the case of immovable objects like land.

Ibn al Qayyim and Ibn Taymiyyah departed from the majority position by expanding the concept of *qabḍ* through consideration of customary practices (*'urf*). Both justify their opinion based on the principle that no form of sale is prohibited unless it is stated as such in the Qur'ān, the Sunnah or the *fatwās* of the Companions. As for the Prophet's prohibition of sale before possession, they interpreted it as being directed at sales with excessive uncertainty and risk (*gharar wa mukhāṭarah*), where the object may be undeliverable, whether it exists or not (e.g. a runaway horse or camel). Thus, the wisdom in the prohibition is not linked to existence or the lack thereof.

The jurists concluded that the rationale or effective cause (*'illah*) of prohibiting sale prior to taking possession (*qabḍ*) was mainly due to the presence of the element of *gharar* (excessive risk and uncertainty) resulting from the inability to deliver the object at the time the contract is concluded and the dispute that may consequently result. Thus, Islam prohibits any transactions involving *bay' mū'ad dam* since the delivery of the subject matter cannot be affected and this brings about the prohibited element of *gharar*.

The Issues of *Qabḍ* in Islamic Capital Market Instruments

In the present context of the capital market, the concept of *qabḍ* often touches on issues like short selling and contra trading of shares as practised by the industry players. Hence, understanding this concept is very important in determining whether the trading status of the instrument is in line with Sharī'ah principles.

Ibn al Qayyim and Ibn Taymiyyah departed from the majority position by expanding the concept of *qabḍ* through consideration of customary practices (*'urf*).

Bursa Malaysia defines short selling as 'the action of a person selling shares which he does not own at the time of selling'.

Short Selling of Shares

In Malaysia, Bursa Malaysia defines short selling as '*the action of a person selling shares which he does not own at the time of selling*'. Meanwhile, according to BNM (2014) short selling refers to '*a sale of eligible securities where the seller does not have presently exercisable and unconditional right to vest the eligible securities in a purchaser at the time of the sale*'. Short selling can be categorised into two types:

- i. **Covered short selling** refers to short selling activities with borrowed securities, obtained via reverse repo or securities borrowing and lending facilities on the short selling transaction date; and
- ii. **Naked short selling** refers to short selling activities without borrowed securities. Dealers close out the naked short selling position by conducting an offsetting deal at a later date.

Short selling is a method used by investors to profit from the falling price of an overpriced market. In Bursa Malaysia, short selling is regulated under Regulated Short Selling (RSS) and Securities Borrowing and Lending (SBL) guidelines, which were introduced to the market in January 2007. Prior to 2006, short selling was banned for about eight years following the economic crisis, which threatened the stability of the share market activities in the Kuala Lumpur Stock Exchange (now Bursa Malaysia).

To ease understanding, let us look at an example of how short selling is actually implemented in the stock market. Suppose Ahmad anticipates that Company A common stock is overpriced at USD 20 per share and wants to be in a position to benefit if his assessment is correct. Ahmad contacts his broker, Ali, indicating that he wants to sell 100 shares of Company A. Ali will do two things: (1) sell 100 shares of Company A on behalf of Ahmad; and (2) arrange to borrow 100 shares of Company A from another party so that it can be delivered to the buyer. Suppose that Ali is able to sell the stock for USD 20 per share and borrows the stock from Umar. The 100 shares borrowed will then be delivered to the buyer. The proceeds from the sale (ignoring commissions and other transaction costs)⁵ will be USD 2,000. However, the proceeds are not released to Ahmad because he has not given Ali the 100 shares. Thus, Ahmad is said to be 'short 100 shares'.

If one week later the price of Company A stock declines to USD 15 per share, Ahmad may instruct his broker (Ali) to buy 100 shares of Company A. The cost of buying the shares (ignoring commissions and other transaction costs) is USD 1,500. The shares purchased are then delivered to Umar, who loaned 100 shares to Ahmad. At this point, Ahmad sold 100 shares and bought 100 shares, so he no longer has any obligation to his broker or to Umar, hence covering his short position. He is now entitled to the funds in his account that were generated by the trading activity. In this example, Ahmad sold the stock for USD 2,000 and bought it for USD 1,500. Thus, he realises a profit before commission of USD 500.

⁵ In actual market transactions, besides the commission paid to the broker, there will be two possible costs involved. First, a fee is charged by the lender of the stock. Second, for any dividend paid by the company while the stock is borrowed, the short seller (Ahmad) must compensate the actual owner of the stock for the dividend to which he was entitled.

In its 69th meeting on 18 April 2006, the SAC of SC Malaysia, resolved that Regulated Short Selling (RSS) is in line with Shari'ah as the inclusion of SBL principles in RSS eliminates the element of *gharar*. This resolution is an extension of their earlier ruling on accepting SBL at its 13th meeting on 19 March 1998. To ensure prudence and diligent practice of RSS, Bursa Malaysia has determined the eligibility criteria of approved securities for RSS as follows:

- i. Average daily market capitalisation of more than RM 500 million for the past three months;
- ii. At least 50 million shares in public float;
- iii. Average monthly volume traded of more than 1 million units for the past 12 calendar months.

In general, as has been explained under Exhibit 2.9 in Chapter 2, short selling involves the selling of shares not owned by the seller. As a result, these transactions fall under the category of *bay' ma' dūm*. Islam prohibits such transactions involving *bay' ma' dūm* since the delivery of the subject matter cannot be affected and this brings about the prohibited element of *gharar*. However, the issue of *gharar* can be overcome in RSS — the inclusion of SBL principles in RSS reduces *gharar*. In other words, the introduction of SBL can increase the probability that the shares sold will be delivered. When the probability of delivery is high, then the element of *gharar* will no longer be significant. Consequently, when an obstacle that hinders the recognition of a certain activity as Shari'ah-compliant is overcome, then that activity can be classified as Shari'ah-compliant. This fulfils a *fiqh* methodology which states: '*When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible.*' (Resolution of the SAC of SC Malaysia, 2007: 72–73).

Islam prohibits such transactions involving *bay' ma' dūm* since the delivery of the subject matter cannot be affected and this brings about the prohibited element of *gharar*.

Referring to the example given earlier, Ahmad as the short seller is required to deal with a broker licensed by Bursa Malaysia. The broker (Ali) is responsible to act on Ahmad's behalf by borrowing the shares (of Company A) from other traders, before subsequently selling it to the interested buyers. This inevitably secures delivery since the shares are traded by a licensed broker who acts on the short seller's behalf. Furthermore, the traded shares are always available in the market since it is monitored and regulated by Bursa Malaysia. This further reinforces the probability of share delivery to the buyer and hence alleviates the excessive risk and uncertainty (*gharar*) associated with short selling transactions.

As for Ahmad, he can hold a short for as long as he wants. In other words, Ahmad does not have to purchase the borrowed stocks immediately after selling them to the respective buyers in the market. However, he can be forced to cover if the lender (Umar) wants the stock he borrowed back. Brokerages cannot sell what they do not have, so Ahmad will either have to come up with new shares to borrow or is forced to cover. This is also known in finance terminology as 'called away'.

Contra Transaction in Shares/Stocks Trading

A contra transaction is defined as a transaction where a participating organisation allows its client to settle outstanding purchase positions against outstanding sale positions of the same securities where the orders in respect of the purchase and sale transactions are transacted within the period stipulated by the Fixed Delivery Settlement System (FDSS).

A contra transaction is defined as a transaction where a participating organisation allows its client to settle outstanding purchase positions against outstanding sale positions of the same securities where the orders in respect of the purchase and sale transactions are transacted within the period stipulated by the Fixed Delivery Settlement System (FDSS).

The trading of units on Bursa Securities following the standard trading rules of Bursa Malaysia is T+3. According to Bursa Malaysia's website, contra dealing is not a right of the client but rather a privilege accorded by the stockbroking company to its clients. This means that the stockbroking company is not obliged to allow contra dealing facilities for all its clients.

Box 4.2 shows the movement of a holder's shares and cash (for cash account) ('Cash Account Holder'). It is for illustration purposes only.

Box 4.2 Illustration of 'Cash Account Holder'

Cash Movement

On Transaction Day (T-Day)

- Step 1:** The brought forward trading available limit of the Cash Account Holder as at 12 November 2012 is RM 14,304.94.
- Step 2:** The Cash Account Holder made various purchase transactions amounting to RM 14,289.99 which comprises the purchase of 12,000 Company N shares and 19,000 Company T shares.
- Step 3:** The Cash Account Holder disposed of 19,000 Company T shares amounting to RM 8,109.52.
- Step 4:** Pursuant to the transactions mentioned in Steps 2 and 3, the carried forward trading available limit of the Cash Account Holder has reduced to RM 8,124.47 (RM 14,304.94 - RM 14,289.99 + RM 8,109.52).

Shares Movement

The daily shares movement of the Cash Account Holder pursuant to the transactions will be captured by the Account Stock Detail Information System of Bursa Securities.

Company N Shares

- Step A:** The brought forward Company N shares of the Cash Account Holder are 18,000 units.
- Step B:** The Cash Account Holder purchased 12,000 Company N Shares.
- Step C:** The Account Stock Detail Information System of Bursa Securities shows that the Cash Account Holder holds 30,000 (18,000 + 12,000) Company N shares.

Company T Shares

- Step D:** The brought forward Company T shares of the Cash Account Holder are 51,900 units.
- Step E:** The Cash Account Holder purchased 19,000 Company T Shares.
- Step F:** The Cash Account Holder disposed 19,000 Company T Shares.
- Step G:** The Account Stock Detail Information System of Bursa Securities shows that the Cash Account Holder holds 51,900 (51,900 + 19,000 - 19,000) Company T shares.

Based on these facts, it can be argued from the Shari'ah point of view that when the buyer purchased the shares, he already possessed their beneficial ownership, which entitles him to enjoy all rights accruing to the shares (including the right to sell the shares and the right to receive any distributions accruing from that transaction) immediately after the transaction concludes. This is based on the fact that once the purchase of securities by the client has been executed by the broker, the trading limit (for

cash account) and/or the facility limit (for margin trading account and non-margin trading account) of the client will be reduced by the said purchase amount and it will be captured in the Broker Front End (BFE) system on T-Day. On T+1, the purchase amount, brokerage charges and other charges (if any) will be transferred into the broker's trust account and cannot be used either by the client or the broker, save for settling the payment to Bursa Securities on T+3 and the client shall have no rights to claim over the said purchase amount anymore. This has amounted to *qabd hukmi* (constructive possession) of the purchase price by the seller. However, as illustrated earlier, due to the standard trading rules of Bursa Securities, the seller will physically receive the purchase price on T+3.

In light of this, Shari'ah scholars are of the view that the investors who buy the shares on cash basis and margin trading account basis are allowed to perform contra selling as they already purchased and hold full ownership of the said shares though these will only physically be in their Central Depository System (CDS) account on T+3 per the standard Bursa trading rule. In addition, there is no issue of *ta'jil al-badalayn* (deferment of both exchange values) as the purchased shares have been captured by the Account Stock Detail Information System of Bursa Securities on a real-time basis.

In this regard, Bursa Malaysia in its guidelines of best practices for Islamic stockbroking services stated that, for settlement of trade on contra transactions, in the event that there are losses arising from such contra transactions (i.e. contra losses), no interest should be charged against the client for the amount due to the Islamic participating organisation pursuant to the losses. The Islamic participating organisation is only entitled to recover the principal amount in connection to the contra trade. Thus, for settlement of trade on contra transactions resulting in contra profits, the client enjoys the full profit and no interest should be imposed on it. This is to strengthen the Shari'ah control on the practice of contra transactions, in shares trading.

Security Deposit (*Hāmish Jiddiyyah*)

According to the AAOIFI Shari'ah Standards, *hāmish jiddiyyah* is a sum of money (token) paid by one party (promisor/customer) to another (promisee/owner) as an assurance to buy or lease an asset from its owner (promisee) in the future. *Hāmish jiddiyyah* acts like a security deposit which is held in trust by the recipient (asset owner) and involves a promise (*wa'd*) because the contract is yet to be executed at that time. This margin of payment conveys a firm commitment to fulfil one's promise (in buying or leasing an asset) and the promise is binding (*wa'd mulzim*) on the promisor within a specific period. *Hāmish jiddiyyah* is applied before a contract of sale or lease is executed, which implies that *hāmish jiddiyyah* does not become part of this contract.

Hāmish jiddiyyah seems to be identical to *'urbūn* as both concepts require one of the transacting parties to pay a sum of money up front with regards to any contract to be concluded later such as sale and *ijārah*. Classical jurists define *'urbūn* as 'a deposit given by the buyer to the seller in a buying and selling contract. If the sale proceeds, the deposit will be part of the price of the goods. Otherwise, it will be considered the seller's portion' (Al-Buhūti, 1982: 195). For example, A wishes to buy a car costing RM 40,000 from XYZ Company. A is asked to pay *'urbūn* of RM 4,000 as deposit, with a condition that this money will not be returned if he cancels the order.

According to the AAOIFI Shari'ah Standards, *hāmish jiddiyyah* is a sum of money (token) paid by one party (promisor/customer) to another (promisee/owner) as an assurance to buy or lease an asset from the owner of the asset (promisee) in the future.

Hāmish jiddiyyah is a mechanism that can be applied both in contracts of sale (*bay'*) and lease (*ijārah*).

However, if he proceeds with the purchase, the deposit will be considered as part of the cost of the car. This means A needs to pay only RM 36,000 as the balance. This definition and example clearly show the different features of *'urbūn* compared with *hāmish jiddiyyah* that will be detailed later in this discussion.

Hāmish jiddiyyah is a mechanism that can be applied both in contracts of sale (*bay'*) and lease (*ijārah*). The AAOIFI Shari'ah Standards have discussed its application from the perspective of *murābahah* to the purchase orderer, where the owner of the asset and the seller may require that the customer (promisor) pays him a sum of money to guarantee the commitment to purchase the asset. AAOIFI has also resolved that payment of *hāmish jiddiyyah* is not part of a sale price, unless both contracting parties agree to this. Should the customer breach his promise, then the asset owner can take compensation from the *hāmish jiddiyyah* for the actual cost he has incurred up to the *hāmish jiddiyyah* amount.

Also, when the customer has fulfilled his promise and executed the contract of *murābahah* to the purchase orderer, the institution must refund the *hāmish jiddiyyah* to the customer. However, it is permissible for the institution to agree with the customer that the amount of *hāmish jiddiyyah* will be deducted from the price payable by the customer pursuant to the contract of sale.

Legality of *Hāmish Jiddiyyah* from the Shari'ah Perspective

According to AAOIFI, it is permissible for the institution as the seller, in the case of a binding promise given by the customer, to take a sum of money as *hāmish jiddiyyah*. This is to be paid by the customer at the request of the institution, both as an indication of the financial capacity of the customer and to ensure the compensation of any damage to the institution arising from a breach of his binding promise. Having taken this *hāmish jiddiyyah*, the institution need not demand compensation for any damage as this may be charged against the *hāmish jiddiyyah*. The *hāmish jiddiyyah* is not similar to *'urbūn*, which is an exchange contract (*aqd al mu'awadhat*). According to AAOIFI Shari'ah Standard No. 8, 2/5/3 (2008), the amount of money deposited by the customer as security for his commitment can either be held as a trust in the custody of the institution (in which case the latter cannot invest it), or it may be held, if the customer permits the institution to invest it, as an investment trust on the basis of *muḍārabah* between the customer and the institution.

In addition, if the customer breaches his binding promise, the institution is not permitted to retain the *hāmish jiddiyyah* as such. Instead, the institution's rights are limited to deducting an amount from the *hāmish jiddiyyah* to cover for actual damage incurred as a result of the breach, namely the difference between the cost of the item to the institution and its selling price to a third party. The actual damage to the institution may not include the loss of its potential mark-up in the *murābahah* transaction; that is considered an opportunity loss which cannot be recovered.

On this point, since *hāmish jiddiyyah* serves to protect the asset owner from losses due to the customer's breach of the promise to buy or lease the asset, AAOIFI opined that certain consequences flow from specific circumstances, inter alia:

- a. The total loss amount does not exceed the amount of *hāmish jiddiyyah*. The seller is only allowed to take compensation up to the amount of his incurred cost. Should there be any balance of the *hāmish jiddiyyah*, he has to refund it to the customer.

For example, a customer has paid a *hāmish jiddiyyah* of RM 1,000 as commitment fee for the promise to purchase an asset. The customer then breaches his promise to purchase the asset and this caused the seller to incur a loss of RM 800 upon selling the asset to a third party. In this situation, RM 800 is to be deducted from the *hāmish jiddiyyah* amount and the balance of RM 200 is to be returned to the customer.

- b. The total loss amount exceeds the payment of *hāmish jiddiyyah*. The seller is only allowed to be compensated up to the amount of *hāmish jiddiyyah*. He has to bear any remaining loss, which he may have incurred over and above the *hāmish jiddiyyah* amount.

For example, the seller has incurred a loss of RM 1,200 on the asset that exceeds the *hāmish jiddiyyah* of RM 1,000. Since the seller is allowed to deduct only up to the amount of *hāmish jiddiyyah*, he will bear a loss of RM 200.

Differences between *Hāmish Jiddiyyah* and '*Urbūn*

A close observation of these two concepts shows some differences that exist between them, which lead to different legal consequences from the Shari'ah perspective. The differences are summarised in Table 4.1.

Table 4.1 Differences between *Hāmish Jiddiyyah* and '*Urbūn*

No.	<i>Hāmish Jiddiyyah</i>	' <i>Urbūn</i>
1	A sum of money (security deposit) paid by one party (promisor/customer) to another (promisee/owner) as an assurance to buy or lease an asset from its owner (promisee) in the future.	Earnest money given at the time of execution of a sale as part of the price, giving an option to the buyer to exit the contract within the stipulated period.
2	<i>Hāmish jiddiyyah</i> is taken from the potential buyer before the execution of an agreement.	' <i>Urbūn</i> is taken from the buyer as part of the price upon execution of the sale agreement.
3	The seller's claim against the <i>hāmish jiddiyyah</i> is limited only to the amount of actual damage incurred as a result of the breach of promise.	The seller has the right to retain the whole amount of ' <i>urbūn</i> as a result of the buyer choosing to exit the contract.
4	Should the potential buyer agree to proceed with the execution of a sale agreement, the <i>hāmish jiddiyyah</i> may be considered as part of the sale price.	Should the buyer agree to continue with the sale agreement, the ' <i>urbūn</i> shall be considered as part of the sale price.
5	The seller may not necessarily own the underlying asset at the time of receiving the <i>hāmish jiddiyyah</i> .	The seller must own the underlying asset at the time of executing the sale of ' <i>urbūn</i> .

Application of *Hāmish Jiddiyyah* in Islamic Financial Derivative Instruments

Various Islamic financial derivative instruments such as swaps, forwards and options have been introduced by Islamic financial institutions as risk management tools to mitigate, among others, fluctuation in the interest rates and currency rates. Some of these derivative instruments have adopted the concept of *hāmish jiddiyyah* in their structures. The mechanism will be explained later in this subtopic.

First, the concept of a call option is explained. A conventional call option typically grants the holder the right to purchase the underlying asset on a particular date for a certain price. It creates a right to purchase (option) on the purchaser's side but an obligation to sell on the seller's side. Whenever the purchaser decides to purchase, the seller is obliged to sell the underlying asset. To have that right of option, the purchaser will have to pay a certain percentage of the price of the underlying asset (known as call premium). This premium would be considered as part of the purchase price should the purchaser decide to exercise the option and purchase the underlying asset.

To achieve the intended effect of a call option, the undertaking (*wa'd*) in an Islamic call option is given by the seller, not the purchaser, because he is the one who will be obliged to perform the contract.

In relation to this, it may be possible to justify the premium paid by the purchaser as *hāmish jiddiyyah* (security deposit). This will allow the purchaser to enjoy the right to buy the underlying asset at a later date. On this note, the AAOIFI Shari'ah Standard No. 8, 2/5/3 (2008) illustrates a scenario where the client approaches the bank and gives a *wa'd* (promise) that once the bank purchases the asset (from the developer or other parties), he will purchase the asset from the bank. To protect the right of the bank if the client breaches his promise and discontinues with the contract thus causing the bank some losses, the bank is allowed to request for some amount known as *hāmish jiddiyyah* (security deposit) as remedy for such losses. Here, the client gives the undertaking and pays the security deposit.

This situation is somehow different from the *wa'd* that is used to replicate the call option. The promise to sell will be made by the seller of the asset (in the conventional sense, the seller of the option), but the payment of *hāmish jiddiyyah* will be made by the purchaser who is enjoying the right of the option to buy, not the seller who makes the *wa'd*.

The application of *hāmish jiddiyyah* has also been proposed for adoption in the Islamic foreign currency option.⁶ Through this instrument, the customers who wish to hedge their future foreign currency obligations will make a promise (*wa'd*) to an Islamic bank to purchase a certain amount of commodity from the bank and also to appoint the Islamic bank (as their *wakīl*) to sell the said commodity to a third party. To safeguard the bank's interest, the bank will require the customers to provide *hāmish jiddiyyah* as a security deposit to indicate their strong commitment towards the execution of the contract. At the agreed date, *tawarruq* transactions will be conducted where the

⁶ This instrument that uses *hāmish jiddiyyah* as one of the transaction mechanisms has been approved by the SAC of BNM in its 73rd meeting on 20 February 2008.

A conventional call option typically grants the holder the right to purchase the underlying asset on a particular date for a certain price. It creates a right to purchase (option) on the purchaser's side, but an obligation to sell on the seller's side.

The application of *hāmish jiddiyyah* has also been proposed for adoption in Islamic foreign currency option.

sale and purchase of specific commodities will be executed for spot payment and spot delivery. Each of the sale and purchase transactions in the *tawarruq* arrangement will involve different currencies and the *hāmish jiddiyyah* will be refunded to the customer if both parties fulfil their promises. However, if there is a breach of promise, the Islamic bank may recover the actual loss incurred as a result of the breach from the *hāmish jiddiyyah*. If the actual loss is lower than the *hāmish jiddiyyah* value, the customer may accept a refund of the balance or agree to channel the residual amount to charitable organisations under the supervision of the Shari'ah committee of the said Islamic financial institution.

Provision of Guarantee Facilities (*Kafālah*)

Kafālah has been defined by Ibn Qudamah (1983) as surety, bail, guarantee, responsibility or amenability. Legally, the term guarantee is defined as the conjoining of the guarantor's *dhimmah* (faculty by which a person bears liabilities) to that of the guaranteed in a way that the debt or other responsibility of the original bearer is established as a joint liability of the two of them. It may relate to a person, finance or act (performance).

Shari'ah scholars have unanimously validated the contract of guarantee because it is essential for a flow of commercial dealings as it gives protection to the debtor as well as assurance and confidence about repayment to the creditor. In financial transactions, a guarantee is intended to secure obligations and protect debts from being uncollectible or from being in default. It takes the form of written documents, attestations, personal guarantees, pledges, cheques and promissory notes. A guarantee is effective in contracts of exchange, like contracts of sale or contracts of rights (e.g. right of intellectual property); but it does not affect the validity of the original contract in which it is required. More than one guarantee may also be contained in one contract, for instance, the incorporation of a personal pledge with the pledge of security collaterals in the same contract.

In the context of the ICM, the *kafālah* concept has been adopted in the provision of guarantee facilities in various *shukūk* structures such as in *ijārah shukūk*, *mushārah shukūk*, *muḍārah shukūk* and *wakālah shukūk* to enhance the creditworthiness of the issuer and to secure the payment of principal and profit to *shukūk* holders at the maturity or dissolution date.

Shari'ah Issues of *Kafālah* in *Shukūk*

There are a number of Shari'ah issues that arise in the provision of guarantee facilities when structuring *shukūk*. These are as follows:

Guarantee by the Partner/*Shukūk* Manager (*Muḍārib*)

Basically, the guarantee of principal and profit in equity-based *shukūk* such as *muḍārah shukūk* and *mushārah shukūk* by one of the partners in the venture violates the nature of a partnership contract. However, scholars are of the view that the guarantee of principal is allowed in *muḍārah* and *mushārah* in the event of loss due to negligence, misconduct or breach of terms of the contract (*mukhālafah shurūṭ al-'aḳd*) by the partner. This can be seen in the resolution issued by contemporary fatwa bodies such as AAOIFI which stated that it is allowable in *muḍārah* and

Legally, the term guarantee is defined as the conjoining of the guarantor's *dhimmah* (faculty by which a person bears liabilities) to that of the guaranteed in a way that the debt or other responsibility of the original bearer is established as a joint liability of the two of them. It may relate to a person, finance or act (performance).

In the context of ICM, the *kafālah* concept has been adopted in the provision of guarantee facilities in various *shukūk* structures such as in *ijārah shukūk*, *mushārah shukūk*, *muḍārah shukūk* and *wakālah shukūk* to enhance the creditworthiness of the issuer and to secure the payment of principal and profit to *shukūk* holders at the maturity or dissolution date.

musharakah to obtain guarantees from a partner to another in cases of negligence, misconduct or breach of contract. This is also supported by a provision in the Guidelines on Sukuk (2014) issued by SC Malaysia which indicates that it is allowable to place *rahn* as guarantee from possibility of loss on capital that may occur as a result of negligence and misconduct by the *muḍārib*. This subsection will discuss some practices in *ṣukūk* structuring that were argued to resemble the element of guarantee of capital especially for *muḍārabah* and *musharakah ṣukūk* as follows:

Muḍārabah Ṣukūk

In *muḍārabah ṣukūk*, commonly the *muḍārib* undertakes to guarantee principal returns to the investors or *ṣukūk* holders at maturity. If the amount of returns exceed the expected returns, such excess amount will be considered as an incentive fee to the *muḍārib* for his good performance. However, if the actual returns are less than the expected returns during any time of distribution, the *muḍārib* may commit to lend an amount equivalent to the shortfall to the *ṣukūk* holders based on the principle of *qarḍ* (interest-free loan). Thereafter, such amount of loan will be recovered either through the actual profit of the enterprise at the time following distribution or through the sale of the enterprise asset at maturity.

Such a commitment to investors from the *muḍārib* is void as it is a capital guarantee by the *muḍārib* to the investors, and the majority of jurists have rejected such an arrangement. In this regard, Standard No. 13, Item 8/7 on *Muḍārabah* approved by the AAOIFI Shari'ah Council states:

If the loss at the time of closing operations is greater than the earnings, the losses will be deducted from the capital and the manager, in his capacity as a trustee, will not bear any of the loss as long as there is no negligence or mala fides on his part. If the costs are equal to the earnings, the investors will receive their capital back, and the muḍārib will earn nothing. When profits are earned, these will be distributed among the two parties (investor and manager) in accordance with what the two have decided.

Musharakah Ṣukūk

In *musharakah ṣukūk*, the partner may also be appointed as the manager to manage the venture. Then, in the same way that it is unlawful for a *muḍārib* to guarantee the return of capital to investors, it is also unlawful for one partner to guarantee the return of capital to the other partner or partners. To do so would effectively interrupt the partnership in the event of losses; that is something that no jurist has ever allowed. Standard No. 12, Item 3/1/5/7 on *Musharakah* approved by the AAOIFI Shari'ah Council states:

It is unlawful for the conditions of partnership or for the basis of profit distribution to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void.

Standard No. 12, Item 3/1/6/2, specifically mentions the unlawfulness of such a commitment:

It is lawful for one of the parties to the partnership to issue a binding promise to purchase the assets of the partnership during the period of partnership or at the

In the same way that it is unlawful for a *muḍārib* to guarantee the return of capital to investors, it is also unlawful for one partner to guarantee the return of capital to the other partner or partners.

time of dissolution at market value or at an agreed price at the time of purchase.

A promise to purchase the assets at face value, however, is unlawful.

The justification for the ruling of 'unlawful' with regard to the binding promise by one of the partners to purchase the assets of the partnership at face value is that this is the same as a capital guarantee, which is unlawful. The justification for a ruling of 'lawful' for repurchase at market value comes from the fact that there is nothing in this arrangement that guarantees anything to the partners.

However, in this vein we would like to extend the discussion on the permissibility of the capital guarantee by a third party that has been discussed by contemporary Shari'ah scholars. Among others are the following:

The OIC Islamic Fiqh Academy in its resolution no. 30(5/4) pertaining to a guarantee on *muqāraḍah šukūk* states as follows:

There is no Shari'ah objection to mention in the prospectus of the issue or in the document of muqāraḍah šukūk to a promise of a third party, who is independent personally and in terms of financial liability from the two parties to the contract to volunteer an amount of money for no consideration to be allocated to make good a loss on a particular project. However, this is circumscribed with a condition that such a promise should be an obligation independent from the muqārabah contract. In other words, the third party's performance of his obligation should not be a condition for the enforcement of the contract and the conditions and liabilities of the parties to the contract. As such, neither the šukūk holders nor manager of the muqāraḍah would be entitled to claim that they may fail to honour their obligations relating to their contracts because the volunteer failed to fulfil his promise and the performance of their obligations takes into consideration the promise from the volunteer.

The AAOIFI Shari'ah Standard No. 17 (2010) on Investment *Šukūk* states:

The prospectus must not include any statement to the effect that the issuer of the certificates accepts the liability to compensate the owner of the certificates up to the nominal value of the certificates in situations other than torts and negligence nor that he guarantees a fixed percentage of profit. It is however permitted to an independent third party to provide a guarantee free of charge, while taking into account item 7/6 of Shari'ah.

Shari'ah Standard No. 17, Item 5/1/8/7 in respect of a guarantee states:

It is permissible for a third party, other than the Muḍārib or investment agent, or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the Muḍārabah financing contract or investment agency contract.

The SAC of BNM has approved the guarantee facility offered by Malaysia's national financial guarantee institution, Danajamin Nasional Berhad, which offers a guarantee facility as a credit

The SAC of BNM has approved the guarantee facility offered by Malaysia's national financial guarantee institution, Danajamin Nasional Berhad, which offers guarantee facility as a credit enhancement tool to both *sukuk* and bond issuers. Danajamin is considered a third party guarantor who provides guarantee facility for a fee.

enhancement tool to both *shukūk* and bond issuers. Danajamin is considered a third-party guarantor who provides a guarantee facility for a fee. The issue of permissibility of imposing a fee on a guarantee will be discussed in the following subtopic.

Charging a Fee for *Kafālah* from the Shari'ah Perspective

In classical *fiqh* literature, a guarantee is classified as a gratuitous charitable contract for which the guarantor expects reward only from Allah (SWT) for easing the financial imbalance of his fellow being. The guarantor is not entitled to an additional payment over the amount he paid as the obligation of the principal debtor. At best, the guarantor may recover or claim back the actual expenses incurred in offering the service.

However, in the current application of *kafālah* in the modern Islamic financial system, the guarantor imposes a fee/commission over the guarantee facility and this practice has triggered debate among scholars. The opinions of the scholars can be summed up as follows:

First View: Scholars who disallow charging a fee on *kafālah*

- i. A majority of classical jurists have opined that it is unlawful to charge a fee for a guarantee as it is a voluntary contract. They are the jurists from the Ḥanafī, Shāfi'ī, Mālikī and Ḥanbalī schools of thought. This view is based on the argument that a *kafālah* contract falls under *'uqūd al-tabarru'āt* which is voluntary and benevolent in nature. Hence, no fee can be charged.
- ii. The OIC Islamic Fiqh Academy and the Shari'ah Council of AAOIFI resolved that *ujrah* on *kafālah/damān* is not permissible. However, the guarantor may claim for actual expenses incurred on the guarantee.

Second View: Scholars who allow for charging a fee on *kafālah*

- i. The SACs of both BNM and SC Malaysia resolved that generally, it is permissible to impose a third-party guarantee with a fee based on *maṣlahah* and *qiyās* on the permissibility of taking a fee on the use of reputation (*akhdh al-ujrah 'alā al-jāh*) and the permissibility of taking a fee on the incantation from the Qur'anic verses (*akhdh al-ju'l 'alā ruqyah min al-Qur'an*). In the case of *muḍārabah*, the fee can be taken from the *muḍārabah* venture, with the condition that the guarantee given is not in the form of recourse. Since *mushārahah* is also one of the partnership contracts, the ruling on *muḍārabah* may also be applicable to the *mushārahah* contract.
- ii. Among the contemporary scholars who allow charging a fee for a guarantee are Yusuf al-Qaradāwī, Nazīh Ḥammād, 'Abdullah Mānī' and Aḥmad 'Alī 'Abdullah. The following are among their evidences:
 - Possibility of converting a *tabarru'* (donation-based) contract to a *mu'āwadah* (commercial exchange) contract. According to Nazīh Ḥammād (1997), it is permissible to convert a *tabarru'* to a *mu'āwadah*-based contract with the consent of the contracting parties. He states that a guarantor deserves a good reward from the guaranteed person similar to his contribution for the guaranteed person, or even more. This is for his commitment as long as the debt is settled immediately. Nazīh Ḥammād also makes an analogy with *hibah* (gift)

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when it is associated with the expectation of a reward (i.e. *hibah al-thawāb* or *bi shart al-thawāb*). Similarly, a lending contract associated with consideration will convert it to *ijārah*. The same is true with *wakālah* which can be converted to *wakālah bil ujrah*.

- It is allowable to charge a fee for a guarantee by comparing it to the permissibility of taking rewards for some of the good deeds such as teaching the Qur'ān, the remuneration of *imām* (head of congregation) and *mu'azzin* (caller for prayer). This is also supported with some events such as the Companion who took a reward for 'ruqyah' healing by using the Qur'ān, which was approved by the Prophet (SAW).
- Ahmad Ali Abdullah (1986) was of the view that when there is a condition that the *kafālah* bears a fee, such condition is considered valid. He also emphasised that a *kafālah* contract is not *qard*. He supported his views with *qiyas*, referring to fees that are permissible to be collected on utilising someone's reputation and also on performing incantation using Qur'ānic verses. Some of the past Islamic jurists allowed both situations and favoured the charging of fees on the guarantee since it is similar from the aspect of work done.

Foregoing One's Rights (*Tanāzul*)

Tanāzul refers to an act to waive certain rights of claim in favour of the other party in a contract. In Islamic finance, *tanāzul* is typically applied where the right to share some portion of the profits is given to another party. In classical *fiqh* literature, the jurists used various terms equivalent to *tanāzul* such as *al-isqāt*, *al-ibrā'*, *al-'afw* and *al-hibah*. Therefore, the technical meaning of *tanāzul* varies according to the different types and situations in which it is used.

In the context of Islamic finance, *tanāzul* usually occurs in equity-based instruments such as *mushārah* and *muḍārah* contracts. As the concept of *tanāzul* is an exceptionally broad subject, the discussion will be focusing on the application of *tanāzul* within the contract of *mushārah* only. *Tanāzul* may thus be defined as an agreement made between the partners during the signing of the *mushārah* contract where one or some of the partners agree to give up their right to claim the profit or to bear all the losses that may occur from the contract.

Application of *Tanāzul* in *Mushārah* Venture

Tanāzul has been mostly applied in capital market instruments such as preference shares and *ṣukūk mushārah* (in the case of subordinated *ṣukūk*). Nevertheless, the application of *tanāzul* in these products has actually led to some controversial Shari'ah concerns and highlights. The main concern is that one or some of the partners waive certain rights in favour of another contracting party for something that is yet to be known and is only to be realised in the future.

Tanāzul is defined as surrendering the rights to a share of the profits based on partnership by giving priority to preference shareholders; it is also known as *isqāt al-haq*. In the context of *mushārah*, the SAC of SC Malaysia defines *tanāzul* as a waiver by a partner of his right on the profit payment from the *mushārah* venture if he so desires.

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According to some scholars, *isqāt al-haq* is closely related to the concept of *ibrā'* (absolution). Thus, to have a clear idea of *tanāzul*, the concept of *ibrā'* should be discussed.

The majority of contemporary Islamic jurists denounce this exercise as it is deemed to be out of line with the essence of a partnership contract, which is based on the profit and loss sharing principle. Muhammad Taqi Usmani (2007) opined that it is unlawful to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void as this is contrary to the concept of profit sharing in *mushārahah*, which shall be based on an agreed portion; and to the concept of loss sharing, which shall be based on the ratio of capital contribution (Usmani, 1999).

This is in line with the AAOIFI Shari'ah Standard No. 12, Item 3/1/5/7 (2008: 208) which states:

'It is unlawful for the conditions of partnership or for the basis of profit distribution to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void.'

Nevertheless, there is no dispute among the jurists on the permissibility of *tanāzul* that is made on something that has been realised (*mawjūd*) as it does not amount to a guarantee by one or some partners on the absorption of loss from the other partners. AAOIFI stated in its Shari'ah Standard No. 12 (2008: 207):

Item 3/1/5/2: '... a partner may relinquish on the date of distribution a part of the profit that is due to him in favour of another party.'

Item 3/1/5/4: '... it is however valid that one partner takes without any prior condition the responsibility of bearing the loss at the time of the loss.'

Application of *Tanāzul* in Preference Shares

The Companies Act 1965 defines a preference share as 'a share that does not give a right to the shareholders to vote at its general meeting or any right to participate in any distribution of the company that is above the stated amount, whether through dividends or redemption, dissolution or otherwise.'

Conventionally, preference shares (also called preferred stock) are defined as an equity security that may have some features not possessed by common stock including properties of both equity and debt instruments, and is generally considered a hybrid instrument. Preferred stock is senior (i.e. higher in ranking) to common/ordinary stock, but is subordinate to bonds/*ṣukūk* in terms of claim (or rights to their share of the assets of the company). Preferred stock, as mentioned in the Companies Act, carries no voting rights but may carry a dividend and may have priority over common stock in the payment of dividends and upon liquidation. The usual provision is to give the preference shareholders a fixed rate of dividends calculated based on the nature of business carried out and the degree of risk involved, and to give the ordinary shareholders the balance of divisible profits.

The latter class of common shareholders, in the event of the company failing or winding up, loses its money first and consequently the holders of this class of shares usually have a majority of representation on the board of directors and larger voting rights at general meetings.

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There have been attempts to adapt this concept into preference shares to justify it from the Shari'ah perspective. It was argued that preference shares may be structured using the Shari'ah principle of *musharakah*. Hence, the newly structured Islamic preference shares are meant to offer some unique features. Most importantly, the ordinary shareholders would have to agree that the Islamic preference shares be ranked ahead of the common shares in terms of priority to dividend payment up to an expected rate, and in terms of the return of capital in the event of liquidation. Yet this notion of hierarchy (priority to dividend and priority in liquidation) is considered by many scholars as not in consonance with the spirit of the *musharakah* requirement as expounded in the maxim 'the profit is based on the agreement of the parties, but loss is always subject to the ratio of investment' (Usmani, 1999: 38).

It was argued that preference shares may be structured using the Shari'ah principle of *musharakah*. Hence, the newly structured Islamic preference shares are meant to offer some unique features. Most importantly, the ordinary shareholders would have to agree that the Islamic preference shares be ranked ahead of the common shares in terms of priority to dividend payment up to an expected rate, and in terms of the return of capital in the event of liquidation.

Shari'ah Issues in the Application of *Tanāzul* in Preference Shares

The SAC of SC Malaysia has approved the issuance of non-cumulative preference shares on the basis of *tanāzul*; they are permissible where the ordinary shareholders have willingly given their rights to a share of the dividends to the preference shareholders. This *tanāzul* is agreed upon at an annual general meeting of a company that decides to issue preference shares in an effort to raise new capital. It is argued that since the general meeting of ordinary shareholders agreed to issue the preference shares, this indicates that the ordinary shareholders have agreed to a *tanāzul* to give priority to the preference shareholders in dividing the profits. According to the SAC, *tanāzul* in the context of preference shares means surrendering the rights to a share of the dividends arising from a partnership by giving priority to the preference shareholders. This is also known as *isqāf al-ḥaq* in Islamic jurisprudence.

On the contrary, the other authoritative *fatwā* bodies for Islamic financial institutions such as AAOIFI and the OIC Islamic Fiqh Academy prohibit such an arrangement.

According to the resolution issued by the OIC Islamic Fiqh Academy in its 14th session held from 11 to 16 January 2003:

It is not permissible for a company to issue privileges shares, preference shares or debentures.

In occasions where the company suffers losses, it is compulsory for every shareholder to bear his share of the loss, in proportion to his capital contribution.

This resolution is in line with Shari'ah Standard No. 21 of AAOIFI (2008), which states:

2/6 It is not permitted to issue preference shares, i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of dividends. However, it is permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right of vote.

However, according to the Shari'ah Board of Dallah al-Baraka, it is permissible to issue preference shares (whose owners do not have voting rights) as they are voluntarily waiving their rights of

voting. The permissibility also applies to preferred shares whose owners are given the right of redemption at the market value within specific periods as this kind of procedure does not contravene the purpose of a *musharakah* contract and does not provide any privilege or priority to the preference shareholders at the time of dividends distribution or in the case of winding up (liquidation).

Overall, there are two main issues highlighted by Shari'ah scholars relating to the features of preference shares. They are as follows:

- **Priority to specified dividend rate given to the preference shareholders over common shareholders.** In this arrangement, there is a possibility that the preference shareholders get 100% of the dividends and the common shareholders get nothing at all. This will happen if the actual dividend is less or up to the specified dividend rate that is to be given to the preference shareholders. However, if the actual dividend is more than such rate of specified dividend, there is a possibility that the common shareholders obtain some rate of dividend. There are two scenarios under this category that require further discussion as follows:

i. **Tanāzul in the case where the actual dividend is equal to or less than the specified rate of dividend.** The common shareholders agree to waive their right to a share of the dividend until the preference shareholders get their specified rate of dividend. This kind of *tanāzul* is given up front at the time of the contract to determine that it will have the intended effect if the actual dividend is equal to or less than the specified rate of dividend. This practice of *tanāzul* is contentious because it is considered by many scholars to be against the nature of *musharakah* which is a contract of profit and loss sharing. In this type of *tanāzul*, which is agreed up front at the time of contract, there is a possibility that some of the partners (i.e. the common shareholders) will not receive any share of the dividend in the event that the actual dividend is equal to or less than the specified dividend rate; all the dividends will go to the preference shareholders only.

ii. **Tanāzul in the case where the actual dividend exceeds the specified rate of dividend.** The preference shareholders agree to take their dividend share at a rate that is fixed at an agreed cap, and any dividend above the capped rate will be waived and given to the common shareholders. This principle of *tanāzul* to waive such a right to the dividend is specified as a condition of the contract. For example, in the case where the specified dividend rate is 6% and the actual return (based on the profit sharing ratio) is 10%, the preference shareholders will take 6% and forego the excess 4% to the common shareholders.

The *tanāzul* arrangement for distribution of the excess dividend above the specified dividend rate is provided up front in the *musharakah* agreement. It could be in the form of granting them part of or entire premium above a certain benchmark profit. This has been supported by the AAOIFI allowing such stipulation in the contract of *musharakah* in the AAOIFI (2008) resolution in Shari'ah Standard No. 12 on *Sharikah (Musharakah)* and Modern Corporations, regarding the outcome of *sharikah* investments (profit and loss):

3/1/5/9 It is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner.

Overall, there are two main issues highlighted by the Shari'ah scholars relating to the features of preference shares:

- Priority to specified dividend rate given to the preference shareholders over common shareholders.
- Priority in the return of capital in the event of liquidation (winding up) is given to preference shareholders over common shareholders.



This arrangement is considered a valid condition because it is still consistent with the notion of profit sharing and is in line with *muqtadā al-'aqd* of the contract which is based on profit sharing.

- **Priority in the return of capital in the event of liquidation (winding up) is given to preference shareholders over common shareholders.** This is among the most contentious issues deliberated by Shari'ah scholars. In the event of a winding up, preference shares are usually repayable at par value and rank above the claims of ordinary shareholders. Principally, this priority is not permissible since under *mushārahah*, the loss must be borne by the partners and shareholders in accordance with the ratio of capital invested by the parties. In addition, the majority of Shari'ah scholars do not permit a partner or partners to indemnify another partner or a group of partners from any loss from the very beginning of the *mushārahah* venture. However, any of the partners can agree to absorb all the losses after these have materialised. This is reflected in the Shari'ah Standard No. 12 issued by AAOIFI (2008: 207) that reads:

3/1/5/4 It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the Sharikah capital. It is not permitted therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is valid that one partner takes without any prior condition, the responsibility of bearing the loss at the time of the loss."

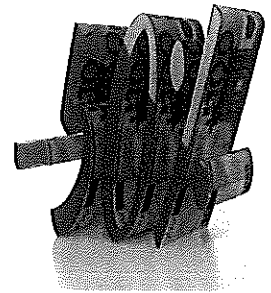
Rebate (*Ibrā'*)

One of the common issues raised in the ICM is the offering of *ibrā'* in the event of an early settlement. Before this issue is discussed further, it is important to first understand the definition of *ibrā'* literally and as a term of Islamic jurisprudence.

Linguistically, *ibrā'* denotes liberation (*al-takhlīs*), purification (*al-tanqiyah*), elimination (*al-izālah*), dropping (*al-isqāt*) and isolation from certain things (*al-mubā'adah 'an al-shay'*). *Ibrā'* means 'surrendering one's claims and rights on a certain thing. That right is other people's obligation (*dhimmah*) to him which needs to be fulfilled'. Meanwhile, the SAC of SC Malaysia (2014) defines *ibrā'* as 'an act of releasing absolutely or conditionally one's rights and claims on any obligation against another party which would result in the latter being discharged of his/its obligation and liabilities towards the former. The release may be either partially or in full'. In *fiqh* literature, the issue of *ibra'* on early payment is discussed under a topic known as *ḍa' wa ta'ajjal*. *Ḍa' wa ta'ajjal* means giving up of a part of a deferred debt, subject to an earlier settlement of an outstanding amount.

Legality of *Ibrā'* or *Da' wa Ta'ajjal* from the Shari'ah Perspective

As evident from the various discussions, Muslim jurists hold different opinions pertaining to the issue of permissibility of *ḍa' wa ta'ajjal*. Generally, there are two points of view on this issue.



ibrā' means "surrendering one's claims and rights on a certain thing. That right is other people's obligation (*dhimmah*) to him which needs to be fulfilled".

The first view, such as the opinions of 'Abdullah Ibn 'Abbas, al-Nakhai', Abu Thawr, Zufar and Hanbalī jurists, maintains that *da' wa ta'ajjal* is valid and legal. It is also noted that Ibn Taymiyyah (1977) and Ibn Qayyim (1991) similarly advocate this opinion. Ibn Qayyim (1991) in his conclusion draws a clear distinction between *da' wa ta'ajjal* and *ribā*. The distinction can be seen as follows:

- i. *Ribā* involves an increase (i.e. 'Either you increase the amount of loan (due to late payment), or settle the loan (on time) — this is *ribā*'); and
- ii. *Da' wa ta'ajjal* involves a discount or decrease (i.e. 'Quickly settle your debt with me and as incentive I will discount part of it — this is *da' wa ta'ajjal*').

Ibn Qayyim goes on to question whether there is any real similarity between the two. He asserts that there are no *naṣṣ* (Qur'ānic verses or prophetic texts), *ijmā'* (consensus) and validated *qiyās* (analogy) that forbid this concept.

The second view is that *da' wa ta'ajjal* is not permissible since it is similar to the practice of *ribā*. Among scholars who prohibit this practice are Umar al-Khattab, 'Abdullah ibn Umar, Zayd ibn Thābit, Miqdād ibn al-Aswad and Hishām ibn 'Urwah. They argue that such dealing is similar to the practice of asking the debtor to add more money in exchange for an extension in the time of payment, which all scholars agree is prohibited. Hence, the reduction in the value of debt arising from shortening the repayment period is also regarded as *ribā*. In both cases, there is an exchange of time with money, which leads to *ribā*.

The basis of their argument is a *ḥadīth*, which reported that al-Miqdād ibn al Aswad had given another man 100 dinars in credit, then the Prophet (SAW) nominated him for a mission. Therefore, he requested the debtor to give him just 90 dinars before the time due for his debt. When the Prophet (SAW) heard about the deal, he (SAW) said to Miqdād: 'Oh Miqdād, you have eaten *ribā*' (al-Bayhaqī).⁷

Some scholars are also of the opinion that the provision on *da' wa ta'ajjal* in a debt transaction is not permissible because this practice resembles the characteristic of *bay'atayn fī al-bay'ah* (combination of two contracts in an agreement) transaction which is forbidden by the Sunnah.

However, some contemporary scholars such as 'Abd Al-Raḥman Sālih Al-Atram (2006) and 'Abd Al-Raḥman Al-Sa'dī (as cited in Hasan, 2006) are of the view that the concept of *da' wa ta'ajjal* is different from *ribā*. It is because the debtor is released early from his liability while the creditor benefits from settlement of the debt, and Shari'ah has no prohibition for such an arrangement.

Ibrā' is applied in contemporary financial practices in the case where the creditor (financier) may give *ibrā'* to those debtors who settle their debts earlier. In this case, several Shari'ah boards and councils approved the application of *ibrā'* for early settlement in *murābahah*-based contracts

Ibrā' is applied in contemporary financial practices in the case where the creditor (financier) may give *ibrā'* to their debtor for those who settle their debt earlier.

⁷ However, according to Ibn Qayyim, this *ḥadīth* is weak. See Ibn Qayyim (1991: 12).

including the OIC Islamic Fiqh Academy, AAOIFI Shari'ah Council, SAC of SC Malaysia and SAC of BNM.

Stipulation of the *Ibrā'* Clause in the Contract

One of the crucial issues related to *ibrā'* is the issue of stipulation of the *ibrā'* clause in the agreement. This concern has been discussed among the *fatwā* authorities and bodies such as the OIC Islamic Fiqh Academy, Shari'ah Board of Faisal Islamic Bank of Bahrain, AAOIFI, Kuwait Finance House Shari'ah Council, SAC of BNM and SAC of SC Malaysia.

According to the OIC Islamic Fiqh Academy, they do not allow such stipulation in the contract as it is tantamount to *ribā*. The OIC Islamic Fiqh Academy confirmed in its resolution no. 66/2/7, 'according to the Shari'ah, reduction of the deferred debt due to early settlement whether at the request of the creditor or the debtor is permissible. It does not constitute *ribā* if there is no prior agreement as long as the relationship between the creditor and the debtor is two way.'

In accordance with this resolution, the Shari'ah Board of Faisal Islamic Bank of Bahrain (as cited in De Lorenzo (2001: 48)) resolved that:

One who advances payment may be allowed a discount. It is recorded in an authentic ḥadīth that the Prophet, upon him be peace, said, 'May Allah have mercy on a person who is generous when he/she sells.' All of this is on a condition, however, that it is not to be stipulated in the contract itself.

The AAOIFI (2010) in its Shari'ah Standard on *Murābahah* to the Purchase Orderer also took the same position, stating that it is permissible for the institution to give up part of the selling price if the customers pay early, provided this was not part of the contractual agreement.

Kuwait Finance House holds that it is impermissible to stipulate the clause of *ibrā'* in the contract either verbally or in writing. However, it is allowable for the creditor to give an *ibrā'* for early settlement without having any prior stipulation in the contract.

In contrast, the SAC of BNM and SC Malaysia took a different stance. They resolved that Islamic banking institutions/*ṣukūk* holders may incorporate the clause on undertaking to provide *ibrā'* to customers who make early settlement in the Islamic facility agreement. The SAC of SC Malaysia in its latest ruling in 2014 resolved that *ibrā'* may be applied in the following situations:

■ Early Redemption

- a. *Ṣukūk* holders may offer *ibrā'* to the issuer based on the application made by the issuer for early redemption of *ṣukūk* upon occurrence of any event of default, call option, regulatory redemption and tax redemption;
- b. The formula for the computation of early settlement may be stated as a guide to the issuer; and
- c. The *ibrā'* clause and the formula for the computation of early settlement may be stated in the main agreement of *ṣukūk* which is based on '*uqūd al-mu'āwadhāt*'. However, the

One of the crucial issues related to *ibrā'* is the issue of stipulation of the *ibrā'* clause in the agreement.

ibrā' clause in the main agreement shall be separated from the part related to the price of the transacted asset. The *ibrā'* clause shall only be stated under the section for mode of payment or settlement in the said agreement.

■ Other Event(s)

Ṣukūk holders may offer *ibrā'* to the issuer in specific event(s) that requires the *ṣukūk* holders to release their rights and claim on any obligation, for example in the event of write-off at the point of non-viability for Tier 2 *ṣukūk*.

The Shari'ah justification of allowing the stipulation of *ibrā'* clause in the agreement by the SAC of SC Malaysia is to avoid uncertainty (*gharar*). It is because the inclusion of an *ibrā'* clause in the agreement may remove the confusion on the issue of uncertainty in price.

The permissibility of the inclusion of conditions in a contract referred to the theory of contract objective (*nazariyyah muqtadā al-'aqd*). The Ḥanbalīs are regarded as the most flexible on the issue of *muqtadā al-'aqd* where they allow for the addition of a condition in a contract to safeguard the interest of the parties so long as the condition does not contradict Shari'ah principles.

In addition, this resolution is in line with the opinion of some Shari'ah scholars that permit the inclusion of a prior agreement between the creditor and debtor whereby the debtor is discharged if he makes prompt payment. This deduction takes into account the principle of *isti'nās* (rule of thumb) as practised in the Ḥanafī school about the time limit in *murābaḥah* where the buyer makes a complete payment or dies during the duration (*ajal*), in a situation where the seller accepts only the previous rate. Therefore, based on this, it is permissible to implement a policy that is agreed upon and observed by the creditor and debtor based on the debtor's prompt payment of his debt. With the inclusion of *ibrā'* clauses in the facility agreement, the creditor is bound to honour the terms as agreed. This approach mirrors the concept of giving a discount on a price or reducing the debt of customers who make early settlement based on the concept of *da'wa ta'ajjal* which is acceptable in Shari'ah. The confusion on the issue of uncertainty in price (*gharar*) does not arise if the clause on *ibrā'* is stated clearly in the facility agreement.

The Shari'ah justification of allowing the stipulation of *ibrā'* clause in the agreement by both the SAC of BNM and SAC of SC Malaysia is justified on the basis of public interest (*maṣlahah*), custom (*urf*) and to avoid uncertainty (*gharar*).

Summary

- Several Shari'ah issues arise in the structuring of ICM products and instruments. These are widely debated by Shari'ah scholars. The key issues discussed pertain to the following areas: combination of contracts; legal and beneficial ownership; recourse to the underlying assets in *ṣukūk*; purchase undertaking (*wa'd*); taking possession (*qabḍ*); security deposit (*hāmish jiddiyyah*); provision of guarantee facilities (*kafālah*); foregoing of one's right (*tanāzul*); and rebate (*ibrā'*).
- Shari'ah does not allow the combination of loan and exchange contracts and the combination of contracts in one bargain, especially when the structure involves contracts of exchange of values. Nonetheless, Shari'ah does not outrightly forbid the combination of multiple contracts in one transaction because of the general principle of freedom of contract in Shari'ah.
- There are certain parameters that need to be followed for the combination of contracts to be permissible, namely: there is no explicit text prohibiting such combination; the combination of contracts must not be intended to circumvent impermissible transactions; the principal objectives of the contracts combined do not contradict each other; and the combination of contracts should not be used as a means for practising *ribā*.
- A combination of contracts has been used in various ICM products especially in *ṣukūk* structures — such as the combination of *wakālah* (agency) and *kafālah* (guarantee) — and other related products such as preference shares.
- The issues of legal and beneficial ownership and recourse to the underlying assets can be discussed in the context of *ṣukūk*. Asset-backed *ṣukūk* involves a true sale between the issuer/originator and the *ṣukūk* holders where the legal ownership is transferred from the originator to the *ṣukūk* holders and thus recourse is to the underlying assets rather than the originator. Conversely, asset-based *ṣukūk* involves the transfer of beneficial ownership or equitable interest in the assets to the *ṣukūk* holders in which recourse is to the originator or the guarantor pursuant to the purchase undertaking and/or guarantee given by the latter.
- The application of purchase undertaking with a predetermined formula in equity-based *ṣukūk*, particularly in *mushārahah* and *muḍārabah* structures, has triggered a wide debate among Shari'ah scholars as it is tantamount to guaranteeing the capital and the profit. The Shari'ah scholars however opine that it is lawful for a partner to undertake to purchase another partner's share in the partnership at the prevailing market value or at an agreed price at the time of purchase. Similarly, Shari'ah scholars allow a third-party guarantee as the guarantor is not a partner in the venture.
- *Qabḍ* is categorised into two types: *qabḍ ḥaqīqī* (physical possession) and *qabḍ ḥukmī* (constructive possession). In the ICM, the application of *qabḍ* is very much dependent on the customary practice in the financial market. The majority of jurists regarded *qabḍ* as one of the pillars of a contract; however, a small number of jurists, especially among the Ḥanafis, do not view it as a pillar of a contract but as a subsidiary condition. Shari'ah scholars debate whether the requirement of *qabḍ* is being fulfilled especially in contra trading and short selling of shares. In deriving a final Shari'ah ruling on such issues, it is important to ascertain whether there is an element of excessive ambiguity (*gharar*) in the transaction including the capability of the seller to deliver the sold shares.
- *Hāmish jiddiyyah* is generally defined as a security deposit and seems to be similar to *'urbūn* but both have different legal consequences. *Hāmish jiddiyyah*, unlike *'urbūn*, is not an exchange contract. Due to its

flexibility, this concept has been applied in the structuring of Islamic financial derivative instruments such as swaps, forwards and options, which serve as risk management tools to mitigate fluctuation in interest rates and currency rates.

- ❶ *Tanāzul* means an act of waiving certain rights of claim in favour of the other party in a contract. In preference shares, *tanāzul* is being adopted when the ordinary shareholders, at the outset, waive some of their rights to the preference shareholders including giving them priority in receiving dividends and proceeds pursuant to the event of winding up, which may result in the ordinary shareholders bearing the loss alone. Such an arrangement has been criticised by Shari'ah scholars as it violates the tenets of *mushārahah* and *muḍārahah*.
- ❷ Many Shari'ah boards approve the application of *ibrā'* in sale-based transactions if it is done by the seller on a discretionary basis. However, they dispute whether the undertaking to provide *ibrā'* can be stipulated in the agreement. In this regard, some Shari'ah boards approve such stipulation on the basis of *maṣlahah* to both transacting parties and that the stipulation does not trigger ambiguities in the sale price of the asset/commodity.

Key Terms and Concepts

Beneficial ownership	Purchase undertaking
Guarantee	<i>Qabḍ</i>
<i>Hāmish jiddiyyah</i>	Rebate
<i>Ibrā'</i>	Recourse
<i>Kafālah</i>	<i>Ṣukūk</i>
Legal ownership	<i>Tanāzul</i>
<i>Mushārahah</i>	<i>'Urbūn</i>
<i>Muwā'adah</i>	<i>Wa'd</i>
Preference shares	<i>Wa'dān</i>

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Multiple Choice Questions

1. *Ṣukūk* holders have the recourse to the asset in the following *ṣukūk*, except:
 - A. Asset-based *ṣukūk*
 - B. Asset-backed *ṣukūk*
 - C. Covered *ṣukūk*
2. Some of the contemporary scholars disallow the application of a purchase undertaking with a predetermined formula in equity-based *ṣukūk* because of the following reasons:
 - A. It contains an element of speculation
 - B. It is tantamount to guaranteeing the capital and the profit
 - C. All of the above
3. Which of these combinations is acceptable from the Shari'ah perspective?
 - A. Loan and sale
 - B. *Ijārah* and *wakālah*
 - C. *Mushārah* and *kafālah*
4. Based on the screening parameters developed by the SAC of SC Malaysia, which one of the following is NOT an impermissible activity?
 - A. Tobacco
 - B. Conventional insurance
 - C. Weapon and defence industry
5. The main feature that distinguishes *hāmish jiddiyah* from *'urbūn* is:
 - A. *Hāmish jiddiyah* is taken from the potential buyer before the execution of an agreement whereas the *'urbūn* is taken from the buyer as part of the price upon execution of the sale agreement.
 - B. The seller has the right to retain the whole amount of *hāmish jiddiyah* as a result of the buyer choosing to exit the contract.
 - C. The seller may not necessarily own the underlying asset at the time of receiving the *'urbūn*.

Review Questions and Problems

1. Why is a purchase undertaking in equity-based *ṣukūk* criticised by Shari'ah scholars?

2. What are the acceptable ways to guarantee the principal invested by a partner in a business venture?

3. What is the basis used by Shari'ah scholars in determining the tolerable benchmark in stock screening?

4. What is the current stance of Shari'ah scholars on the short selling of shares as practised in Malaysia?

5. List two issues highlighted by Shari'ah scholars regarding the ownership of assets in asset-based *ṣukūk*.

6. Compare conventional fixed income securities and *ṣukūk*. What are the key differences between these two instruments?

7. Compare *ibrā'* with *ribā*. What are the clear distinctions between these two concepts?

8. Explain the parameters set by Shari'ah scholars to distinguish between a permissible hybrid contract and non-permissible ones.

9. Why do Shari'ah scholars dispute the permissibility of preference shares?

10. List some of the key differences between *hāmish jiddiyah* and *'urbūn*.
