

THE STRUCTURAL DEVELOPMENT OF *ISTISHNĀ' ŞUKŪK* FROM A SHARĪ'AH PERSPECTIVE

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Abstract: *Istishnā' şukūk* structures have been widely accepted for manufacturing and construction financing purposes. This paper looks at the structural development of *Istishnā' Şukūk* and evaluates both its basic and combination structures. Concerning the former, the paper argues that when *Istishnā'* is used for asset purchasing exercises, it should strictly comply with the general Sharī'ah rules regarding *Istishnā'* contracts. Prices must therefore be stipulated at the beginning, as must quality and expected delivery times. The paper then highlights some conflicting features arising from the combination of *Istishnā'* and *Ijārah* transactions. These raise Sharī'ah issues when the issuer seeks to lease an asset to the end user at maturity, even though the asset has been transferred to that end user by way of the *Istishnā'* contract. It is therefore recommended that the market innovates in order to develop additional structures free from this type of impediment. The study proposes a 'multiple contract' structure be used whenever *Istishnā' şukūk* is issued in combination with other debt and equity instruments. This will help overcome Shari'ah issues related to secondary markets in *Istishnā' şukūk* issuances.

Keywords: *Istishnā'*; *Şukūk*; Structure; Sharī'ah

Introduction

Şukūk (Islamic bonds) are very sophisticated and have generated tremendous interest around the world. *Şukūk* represent a great evolution in domestic and global capital markets. It is the fastest growing sector in Islamic finance and is viewed by many as the most innovative product of Islamic finance. One of the most important features of *şukūk* is that they are backed by a true asset, making it possible for *şukūk*-based investment portfolios to produce returns that are interest-free. *Şukūk* issuance processes must follow Sharī'ah requirements and should not engage in unauthorised business practices. Furthermore, the transaction must fulfill the objectives (*maqāşid*) of al-Sharī'ah. If any *şukūk* assets cease to be Sharī'ah compliant at any moment during the duration of the *şukūk*, those assets become invalid and all measures must be taken to remove them from the pool of assets. They may then be replaced with other Sharī'ah compliant assets.

Despite its popularity, *ṣukūk* are also controversial. This is because some argue that *ṣukūk* can be used to evade restrictions on usury (*ribā*). Under Islamic law, however, *ṣukūk* cannot be issued based on interest income and must be structured in a manner that rewards investors based on their exposure to business risk. Furthermore, *ṣukūk* portfolios should not, under any circumstances, contain non-*halāl* assets as income generators. *Istiṣnāʿ* *ṣukūk* are generally intended for construction and manufacturing purposes. Different types of *Istiṣnāʿ* structures are illustrated in this paper. The paper focuses on the structural development of *Istiṣnāʿ* *ṣukūk* and explores Sharīʿah issues related to structures presented in the paper.

Ṣukūk Definition

Ṣukūk (the plural of *Ṣakk*) refers to papers, securities, notes, or certificates with features of liquidity and tradability.¹ *Ṣukūk* can also be defined as a set of documents or certificates which represent the value of an asset.² This definition, however, has been criticised by some Islamic finance scholars for being incomplete and for not specifying other types of assets *ṣukūk* could represent. Thus, assets may also include financial assets, such as receivables and debt, as well as non-financial assets in the form of tangible assets, usufruct and services. The Securities Commission of Malaysia has also defined *ṣukūk* as certificates of equal value that evince the undivided ownership of, or investment in, assets using Sharīʿah principles and concepts endorsed by the SAC.³ Likewise, *ṣukūk* has been defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as: “Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activit[ies].” This, however, is only true “after receipt of the values of the *ṣukūk*, the closing of subscription and the employment of funds received for the purpose for which the *ṣukūk* were issued.”⁴ *Ṣukūk* under this definition represent tangible assets, usufruct, services and assets of particular projects or special investment activities.

Ṣukūk as applied to Capital Markets pertains to the process of securitisation. Securitisation is the financial engineering process associated with fixed or floating income securities, where payment of principal and profits are both derived from the cash flow generated by the indebtedness that the securities represent, or from the receivables or revenue derived from the pool of assets that underline the transaction in the issuances of the securities.⁵

Ṣukūk can be classified as either asset-based or asset-backed. Asset-based *ṣukūk* includes debt securitisation evincing indebtedness originating from the contracts of exchange of *bayʿ bi thaman ājil* (BBA), *murābaḥah* or *istiṣnāʿ*, each of which arise from the back-to-back sale of the issuer’s assets.⁶ Such *ṣukūk*

give the holders the rights to the obligations attached to the indebtedness. It also includes financial *ijārah* contracts, through the sale and leaseback or lease of third party-held acquired assets, which come with purchase-option obligation (financial lease).⁷ Asset-based *šukūk* show the conversion of future Sharīʿah compliant cash receivables arising from contracts such as *murābaḥah*, *bayʿ bi thaman ājil* and *istiṣnāʿ* into tradable debt instruments. In Malaysia, non-tangible assets in the form of receivables are accepted as the underlying asset for *šukūk* issuances, provided they are transacted on a cash basis (on the spot) to avoid *bayʿ kālī bi al-kālī* (sale of debt for debt).⁸

Understanding Sharīʿah

Sharīʿah is a code of law derived from the Holy Qurʾan and the teachings and traditions of the Prophet Muḥammad, peace be upon him. Sharīʿah not only regulates man's relation with Allah, but also provides Muslims with a legal code governing their everyday life. The Qurʾan states that Allah created and owns every single thing; the wealth of men is therefore only held in trust and must be handled in the way Allah desires. The manner in which this should be done is found in the Sharīʿah. When any new financial issue arises, however, on which traditional Sharīʿah rulings are unclear or silent, it is necessary to seek the legal opinion and interpretation of capable religious scholars (*Mujtahid* or *Muftī*). Each and every Islamic financial institution must therefore have a committee of Sharīʿah experts who will evaluate all Sharīʿah transactions and their validity, with all new Islamic financial products being either accepted or rejected according to the evaluation of this committee.⁹ It is important to note, however, that the legal interpretation of one *Mujtahid* might vary from another, depending on which rules of interpretation are being followed.

The Sharīʿah prohibits Muslims from dealing in *ribā*, excessive risk, gambling and other such activities. Muslims are not, however, averse to earning legitimate profit, with Islam encouraging them to use their money in legitimate Islamic ventures, not just to keep it idle. Keeping this in mind, the main feature of *šukūk* in Islamic banking and finance is the prohibition of *ribā*, and where this is generally understood to mean, both usury and standard interest.¹⁰

The theoretical foundation of an Islamic financial system, where banking is the most developed part of that system, goes beyond the interaction of factors of production and economic behaviour. While the conventional financial system focuses primarily on economic and financial aspects of transactions, the Islamic system places equal emphasis on ethical, moral, social and religious issues in order to enhance the equality and fairness of the system for the good of society. Nevertheless, in an Islamic system the banks still perform the same function

as those in a conventional system – that is, they act as administrators of the economy's payments system and as financial intermediaries.¹¹

The most unique aspect of investment *ṣukūk* is Sharī'ah compliance; this aspect differentiates it from other, more conventional asset class investments. The Sharī'ah offers a detailed explanation of the Islamic concept of money and capital, the relationship between risk and profit, and the social duties of financial institutions and individuals with regards to *ṣukūk* structures.¹²

Istiṣnā' Ṣukūk

Istiṣnā' literally means "seeking construction." Technically, *istiṣnā'* is a construction contract which involves a contractor, a client and the property to be constructed.¹³ Shaykh Aḥmad al-Fahmī defines it as a contract of sale for a property to be constructed by the seller in line with specifications and a set price determined by the purchaser.¹⁴ This is mirrored by Ibn 'Ābidīn, who defines *istiṣnā'* as requesting labour from a manufacturer for the fabrication of a specific item, in a particular way.¹⁵ Al-Kāsānī likewise identifies *istiṣnā'* as a contract in which a person asks a manufacturer to manufacture goods from materials the person himself provides, for a specific cost and to parameters fixed by that person.¹⁶ Al-Babartī also defines *istiṣnā'* as a contract in which a person comes to the manufacturer and requests him to manufacture something by giving a description of it. The manufacturer in turn gives the client its price, which is paid after delivery, either in full or in part.¹⁷

Ḥanafī scholars have different opinions about whether *istiṣnā'* is *wa'd* (a promise to buy) or a sale contract, and whether the thing being sold is the labour itself or the manufactured item. Shaykh al-Ḥākim al-Marwazī, Saffār and Moḥammad ibn Salāmāh are all of the opinion that an *istiṣnā'* contract is initially merely a promise to buy; only after the completion of the item is the sale contract enforced.¹⁸ That means, however, that an *istiṣnā'* contract is not binding on the seller, entailing that he will not be compelled to execute the contract as stipulated. This is not, however, the view of all Ḥanafī scholars. Rather, the majority uphold the opinion that *istiṣnā'* is a contract of sale for an item (i.e. not for labour). Therefore, the contractor (or *ṣāni'*) is obliged to provide and complete the contract as stipulated.¹⁹ This means, however, that for Ḥanafīs an *al-istiṣnā'* contract is an exception to the prohibition of *bay' ma'dūm* (the sale of non-existent items).

Given the last point, the majority of Muslim scholars are of the opinion that *istiṣnā'* is actually impermissible. This is, for example, the opinion of Imām Mālik, Zufar, Shāfi'ī and Aḥmad. However, these scholars still allow it, provided that it is combined with either *salam* or *ijārah* contracts so that the rules of these latter two also become applicable to *istiṣnā'*.²⁰ Thus, whereas in a standard *istiṣnā'* contract

the buyer (*mustaṣniʿ*) would be required to bring his own equipment/materials and hire the *ṣāniʿ* to both manufacture the desired item (in the manner stipulated by the *mustaṣniʿ*) and identify the cost of the labour necessary to do so (and which could be paid either immediately or by installments), when combined with *ijārah* this contract becomes binding on both parties, with neither being able to nullify it without the consent of the other party.²¹ If done through a *salam* contract, the *mustaṣniʿ* would enter into a contract of sale with the *ṣāniʿ* to buy an item with the option of specifying some of the item's features and a stipulated expected time of delivery. In this case, the payment must be done immediately (although the Mālikī *madhhab* allows a delay in payment of not more than three days).²²

Nevertheless, those *jumhūr* who base their arguments on *qiyās* (analogical deduction) still maintain that *istiṣnāʿ* violates the Sharīʿah because, not only does it involve the sale of non-existent items, but also the prohibited selling of a deferred item for a deferred payment, also known as *bayʿ al-kālīʿ bi-al-kālīʿ* (selling of debt for debt). It also includes *gharar fāḥish* (excessive risk) in the sense that the *ṣāniʿ* engages in labour while being uncertain about whether the item to be produced will be delivered in the future, as stipulated.²³ Furthermore, the Prophet Muḥammad (peace be upon him) said, “You do not sell what you do not own.”²⁴

However, Imām al-Kāsānī has tried to maintain *istiṣnāʿ*'s permissibility based on preference (*istiḥsān*) – i.e. Muslims have engaged in *istiṣnāʿ* for a long time and the Prophet (peace be upon him) said, “The Islamic *ummah* will never have a consensus on a mistake.” People have been contracting through *istiṣnāʿ* from the time of the Prophet Muḥammad (peace be upon him) until today, without objection. It has been used in various ways, from building houses, to making slippers, clothes, containers, swords and other things. This widespread usage indicates the societal need for *istiṣnāʿ*. Prohibiting it would cause difficulty for people, which is contrary to Sharīʿah.²⁵ Allah said: “And he has not placed upon you in the religion any difficulty.”²⁶ Moreover, the Qurʾan relates the following episode from the life of Dhū al-Qarnayn:

Then he followed a way until he reached (a pass) between two mountains, he found beside them a people who could hardly understand his speech. They said: O Dhū al-Qarnayn, indeed Gog and Magog are great corrupters in the land. So may we assign for you expenditure so that you might make between us and them a barrier?²⁷

The people Dhū al-Qarnayn encountered therefore requested an *istiṣnāʿ*-based project for the building of a barrier between them and Gog and Magog. The Qurʾan nowhere objects to this contract – indeed, the mere fact it is mentioned in the Qurʾan suggests its permissibility.²⁸

Turning to *istiṣnāʿ ṣukūk*, these are certificates of equal value issued with the aim of mobilising funds for the production of goods that, once produced, are owned by the certificate holders.²⁹ *Istiṣnāʿ ṣukūk* can be used for financing the construction of houses, plants, bridges, roads and highways. The issuer of these *ṣukūk* is the manufacturer (supplier/seller), while the subscribers are the buyers of the intended product. The funds realised from the subscriptions are the cost of the product. The *ṣukūk* holders possess the product and are entitled to either the sale price of the certificates or the sale price of the product sold on the basis of a parallel *istiṣnāʿ*.

Istiṣnāʿ ṣukūk is also suitable for financial intermediation because the contractor may enter into a parallel *istiṣnāʿ* contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, but sub-contract the actual construction to a specialised firm. Sharīʿah prohibits the sale of these debt certificates to a third party at any price other than their face value. Except in Malaysia, where the Sharīʿah Advisory Committee of the Securities Commission has approved the practice, such certificates cannot be traded in the secondary market.³⁰

There are also some models of *istiṣnāʿ ṣukūk* in the Islamic Capital Markets. For example, Tabreed *Ṣukūk* is a five-year global corporate *ṣukūk* issued on behalf of the National Central Cooling Company of the United Arab Emirates to fund the construction of a cooling plant. The SPV issued the *ṣukūk* and raised USD 200 million. The issuer then, and on behalf of the investors, entered into an *istiṣnāʿ* agreement with Tabreed to construct the cooling plant. Payments to investors were scheduled periodically. Under the *istiṣnāʿ* agreement, Tabreed will pay a security amount of USD 1.25 million at least two days before the periodic payments start date, so as to secure its obligation under the *istiṣnāʿ* agreement. Therefore, if the plant is not completed, Tabreed will forfeit the security amount. However, upon completion the SPV will lease the plant to Tabreed, who will then start paying rent. The rent will then be used to pay the periodic payments to the *ṣukūk* holders.³¹ *Istiṣnāʿ ṣukūk* have been used almost exclusively to finance large scale construction and manufacturing projects like this.

The Basic *Istiṣnāʿ Ṣukūk* Structure

In the most basic *istiṣnāʿ ṣukūk* structure, the SPV sells an asset to the end user. The *ṣukūk* holders will therefore be holding receivables representing an asset due for delivery. This limits the tradability of the *ṣukūk* in the secondary market. Under AAOIFI rules, *istiṣnāʿ ṣukūk* may only be traded at par, as any discounting to the *ṣukūk* would transform the trading into *bayʿ al-dayn* (debt trading).

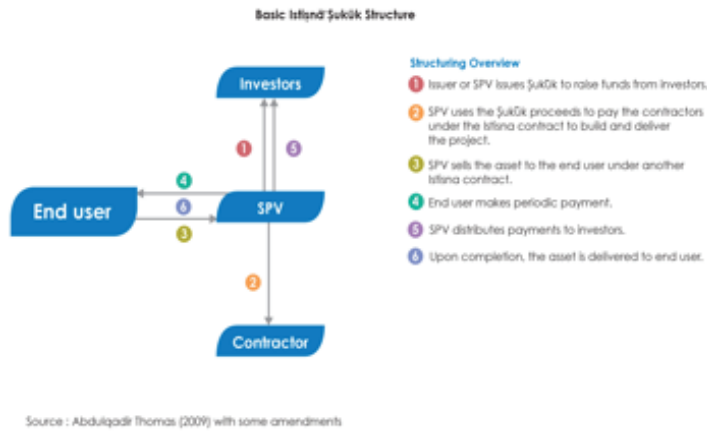


Figure 1.1 Illustration of Basic *Istiṣnā' Ṣukūk*

Istiṣnā' Ṣukūk and Bay' al-ṭinah

In Malaysia, the structures of *istiṣnā' ṣukūk* also involves *bay' al-ṭinah*. As such, instead of involving just two parties (the end user and contractor), the structure also involves a process of selling and buying back between the obligor and the SPV,³² as stipulated in the structure below:

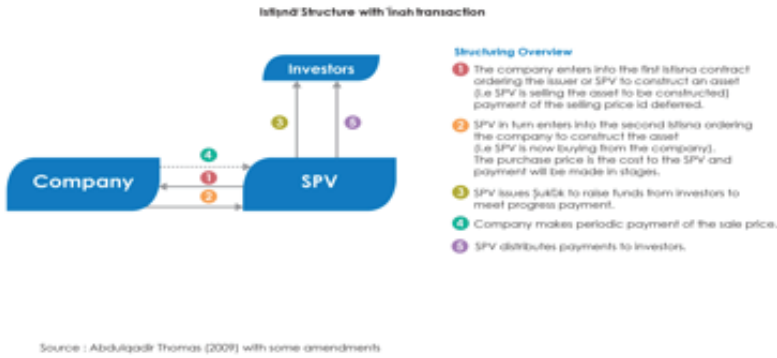


Figure 1.2 Illustration of *Istiṣnā' Ṣukūk* with *Bay' al-ṭinah* Transaction

Istiṣnā' Ṣukūk combined with an Ijārah contract

The combination of *istiṣnā' ṣukūk* and *ijārah* occurs when the SPV acquires the asset to be constructed from the builder and then sells it on to the end user via another *istiṣnā'* contract. In some cases, the tenure of the second *istiṣnā'* is structured to match the contribution period. However, in cases involving large

amounts of money, the end user will be unable to settle the total selling price. In these instances, some banks will exit the *istiṣnā'* contract with the end user by entering into an *ijārah* contract instead. This structure is illustrated below:

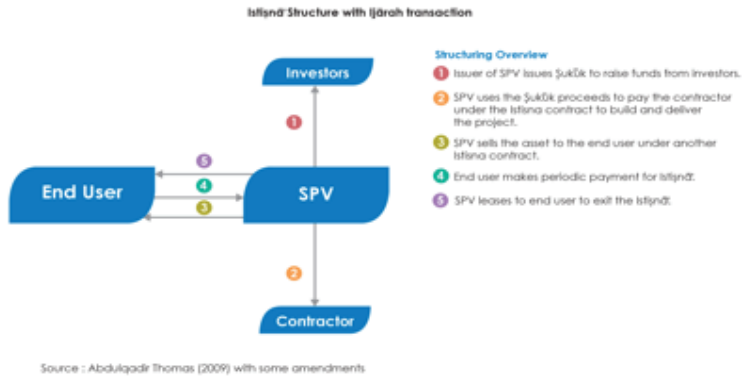


Figure 1.3 Illustration of *Istiṣnā' Ṣukūk* with *Ijārah* Transaction

This combination of *istiṣnā'* and *ijārah* displays some inconsistencies. For example, if the SPV has already sold the asset to the end user via *istiṣnā'*, it means the end user already owns the asset. Thus, it appears that the SPV is leasing the asset to a party that already owns it, the end user.

Other requirements needing consideration when combining *istiṣnā'* and forward leasing include the clarification of the assets' prices and specifications from the beginning. It is quite common for purchasers to split the purchase price (paid in advance) into staged payments that correspond to certain targets previously agreed upon with the contractor. Although it is not necessary to fix the time of delivery under *istiṣnā'*, the purchaser may fix a maximum time for delivery. This essentially means that, if the contractor delays delivery after the scheduled completion date, the purchaser will not be bound to accept the goods and pay the price.³³ In this regard, however, provisions for liquidated damages may be included in order to incentivise the contractor to deliver on schedule. Although not universally accepted, the majority of Sharī'ah scholars consider forward leasing permissible on the basis that advance rentals are taken into account (as rental which has been paid) and have to be refunded in full if the assets are not actually delivered for leasing. Such matters, however, must be carefully addressed in any documentation in order to ensure that the commercial deal is not disturbed. For example, careful calculation of any payments triggered by pre-delivery termination is necessary in order to ensure that the amount payable by the contractor is sufficient to cover the dissolution amount.³⁴

Conclusion and Recommendations

It is concluded that *istiṣnāʿ ṣukūk* is permissible if the *istiṣnāʿ* asset price is stipulated and its quality, expected time of delivery and related conditions are all specified. The most basic *istiṣnāʿ ṣukūk* structure requires that assets be sold to the end users, while the *ṣukūk* holders retain the receivables representing the asset due for delivery. This *ṣukūk* cannot be traded in the secondary market except at par because to do so would amount to the sale of debt, which is not accepted by many scholars. However, with the passing of *bay al-dayn* (sale of debt) legislation in Malaysia, *istiṣnāʿ ṣukūk* could be traded in the secondary markets in Malaysia.

This study has also found that *istiṣnāʿ ṣukūk* structures combined with *ijārah* transactions, where the SPV acquires an asset and sells it via another *istiṣnāʿ* contract with the end user, will result in an impossible settlement of total selling price within the anticipated time schedule. This is due to the huge amounts of money involved. This particular structure also has some conflicting features. For example, if the SPV has already sold the asset to the end user via *istiṣnāʿ*, it means the end user already owns the asset; the SPV cannot then lease the asset to the end user under any circumstances. The market should therefore adopt some alternative structures, including ‘multiple contracts’ that combine *istiṣnāʿ* with other equity-based instruments suitable for construction and project finance portfolios, and as illustrated by this structure:



The ‘multiple contracts’ structure proposed here could be an important alternative for construction and project finance. Although technically debt instruments, *Murabahah* and *Istiṣnāʿ ṣukūk* can be traded on secondary markets. However, according to Sharīʿah principles, money is a medium of exchange and not a commodity. Therefore, it can only be traded at par value and not for a profit. But, if *Murabahah* and *Istiṣnāʿ ṣukūk* were part of a larger portfolio comprising

more than 51% tangible assets, then the securitised certificates of that portfolio could be traded on secondary markets.

Notes

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