

Shari'ah* Issues in Islamic Capital Markets of Pakistan: A Case Study of *Sukūk

Dr. Talat Hussain*

Institute of Islamic Banking and Finance,
University of Management and Technology, Lahore

Muhammad Nadeem Khalil

Department of Management Sciences,
Virtual University of Pakistan
Ph .D Scholar, Islamic Banking and Finance,
University of Management and Technology, Lahore

Abstract

Islamic Capital Markets (ICM) are playing an important role in raising long term funds and thus playing their role in economic growth and development of a country. *Sukūk* are important Islamic Capital Market instruments through which long term funds are obtained from general public. *Sukūk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, or in the ownership of the assets of particular projects or special investment activities. *Sukūk* market in Pakistan is regulated by the Securities and Exchange Commission of Pakistan (SECP). Despite the continuous growth of *Sukūk* market in Pakistan, there are various *Shari'ah* issues which are still prevalent in the *Sukūk* structures which need our attention in order to make the *Sukūk Shari'ah* compliant in true spirit of Islam. The main objective of this paper to discuss and elaborate the various *Shari'ah* issues prevailing in Islamic Capital Markets of Pakistan, especially related to *Sukūk*. It is argued that while structuring *Sukūk*, the various features of conventional bonds are replicated while compromising the various *Shari'ah* injunctions. The current practices of various financial institutions are discussed and various *Shari'ah* issues related to different types of *Sukūk* are identified and the point of view of various scholars on these issues is also discussed. The various *Shari'ah* issues related to *Sukūk* which are identified in this article include purchase undertaking in equity based structures, late payment penalty upon default, ownership status in asset based transactions and trading of debt based *Sukūk*. So this paper highlights the need for a balance between growth in the *Sukūk* market and meeting the *Shari'ah* requirements while structuring *Sukūk*.

Keywords: *Sukūk*, *Shari'ah* issues, Purchase undertaking, Equity based structures, Late payment penalty, Debt based *Sukūk*

Introduction

Islamic Capital Markets (ICM) are playing an important role in raising long term funds and thus playing their role in economic growth and development. In Islamic Capital Markets (ICM), activities are carried out in accordance with *Shari'ah* principle. Therefore it is assured that there is no element of *riba*, *gharar*, gambling and all the other *Shari'ah* principles are met while conducting various activities. *Sukūk*, shares and mutual funds are important Islamic Capital Market instruments through which long term funds are obtained from general public. *Sukūk* are the important component of Islamic Capital Markets and help organizations in raising funds.¹ According to AAOIFI *Shari'ah* standard, *Sukūk* are:

*Correspondence concerning this article should be addressed to Dr. Talat Hussain, Assistant Professor, Institute of Islamic Banking and Finance, University of Management and Technology, Lahore.
talat.hussain@umt.edu.pk

¹Huma Ayub, and Behzad S. Kawish, "Design and Use of Innovative Islamic Capital Market Products: Experience of Pakistan and Malaysia," *Islamic Capital Markets* (2008): 359.

Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular project or special investment activity.²

Sukūk market is growing day by day all over the world. According to the International Islamic Financial Market (IIFM) report on *Sukūk*, the total *Sukūk* issued till December 2017 were about USD 979, 209 million. In year 2012 and 2013 were the best years in the *Sukūk* issuance remained USD 137, 599 million and USD 135, 870 million respectively. However the in year 2015 *Sukūk* issuance dropped significantly and remained only USD 67,818 million.³

Chart 1A: Total Global *Sukūk* Issuances (Jan 2001 - Dec 2017)
All Tenors, All Currencies, In USD Millions



Figure 1. Total Global *Sukūk* Issuance from January 2001- 2017 (Source: International Islamic Financial Market. “IIFM *Sukūk* Report 2018.” IIFM *Sukūk* Report 2018. Manama: International Islamic Financial Market, 2018.
http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf.

2. *Sukūk* Market in Pakistan

Sukūk market in Pakistan is also growing with the passage of time. The first domestic *Sukūk* in Pakistan was issued in year 2006 and till year 2017, *Sukūk* of Rs.1204.28 billion has been issued in Pakistani domestic market. In Pakistan various Islamic Banks have excess liquidity and the issuance of *Sukūk* has helped Islamic Banks to make investment in *Sukūk* market and increase their profitability.⁴

²Accounting and Auditing Organization for Islamic Financial Institutions, “AAOIFI Shari‘ah Standard No.17,” Manama 2017, [http://aaoifi.com/Shari‘ah a-standards/?lang=en](http://aaoifi.com/Shari%20a-standards/?lang=en).

³International Islamic Financial Market. “IIFM *Sukūk* Report 2018.” IIFM *Sukūk* Report 2018. Manama: International Islamic Financial Market, 2018.

⁴Ibid.

Domestic *Sukuk* Summary by Year



Figure 2. Domestic *Sukuk* Summary by Year (Source: International Islamic Financial Market. “IIFM *Sukuk* Report 2018.” IIFM *Sukuk* Report 2018. Manama: International Islamic Financial Market, 2018.
http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf.

Status wise *Sukuk* issuance in Pakistan

Listing Status	Number of issues	Amount in billion Rs
Privately Placed	99	1156.58
Listed	8	47.70
Total	107	1204.28

Figure 3. Status Wise *Sukuk* Issuance in Pakistan (Source: International Islamic Financial Market. “IIFM *Sukuk* Report 2018.” IIFM *Sukuk* Report 2018. Manama: International Islamic Financial Market, 2018.
http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf

About 75.9% of the *Sukuk* issued in Pakistan are *Ijara Sukuk*, 19.4% are *Musharakah Sukuk* while other constitutes only 4.7% of the *Sukuk* issued in Pakistani domestic market. Government of Pakistan also issues Government of Pakistan (GoP) *Ijarah Sukuk*. The duration of the *Sukuk* issued in Pakistan ranges from 3 to 7 years. Most of the *Sukuk* in Pakistan are privately placed as the bond market in Pakistan is not developed to a greater extent. However the two corporate *Sukuk* in Pakistan (Engro Islamic Rupiya and K-Electric Limited) have been listed on the stock exchange of Pakistan.⁵

⁵“Pakistan Stock Exchange Limited -.”

Domestic *Sukuk* Distribution According to Structure

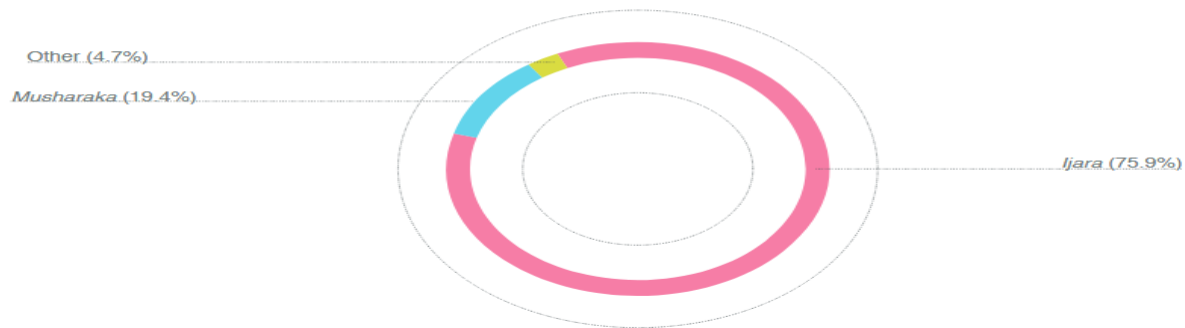


Figure 4. Domestic *Sukūk* Distribution According to Structure (Source: International Islamic Financial Market. “IIFM *Sukūk* Report 2018.” IIFM *Sukūk* Report 2018. Manama: International Islamic Financial Market, 2018. http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf)

Pakistan has issued four international *Sukūk* till year 2017. First international *Sukūk* of USD 600 million was issued in year 2005 with semi-annual floating rate of return (LIBOR+ 220 bps). The second international *Sukūk* of USD 1 billion was issued by Pakistan in year 2014 at profit rate of 6.75 percent. Similarly third and fourth international *Sukūk* of USD 1 billion each was issued in year 2016 and 2017 respectively. These international *Sukūk* were listed on at Luxemburg stock exchange.⁶

International *Sukuk* by the Government of Pakistan

Auction	Issue Date	Maturity Date	Amount of <i>Sukuk</i>
Pakistan First International <i>Sukuk</i>	Jan-05	Jan-10	USD 600 million
Pakistan Second International <i>Sukuk</i>	Nov-14	Nov-19	USD 1,000 million
Pakistan Third International <i>Sukuk</i>	Oct-16	Oct-21	USD 1,000 million
Pakistan Fourth International <i>Sukuk</i>	Nov-17	Nov-22	USD 1,000 million

Figure 5. International *Sukūk* by the Government of Pakistan (Source: International Islamic Financial Market. “IIFM *Sukūk* Report 2018.” IIFM *Sukūk* Report 2018. Manama: International Islamic Financial Market, 2018. http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf)

Despite the continuous growth of *Sukūk* market all over the world, there are some *Shari‘ah* issues pertaining to various *Sukūk* structures. In November 2007, the renowned *Shari‘ah* scholar, Sheikh Taqi Usmani pointed out that almost 85% of the *Sukūk* in the market are not issued in the lines with the *Shari‘ah*

⁶International Islamic Financial Market, “IIFM *Sukūk* Report 2018.”

principles. Being a chairman of AAOFI, this statement hampered the growth of growth of *Sukūk* market and a new risk called *Shari‘ah* Compliance Risk emerged in *Sukūk* market. So the need was felt to tackle these issues while structuring various *Sukūk* in the market. This study is an attempt to identify the various *Shari‘ah* issues in the structures of *Sukūk* issued in Pakistan so that these issues can be addressed effectively in order to make the structures of *Sukūk Shari‘ah* compliant and in true spirit of Islam.

Problem Statement

Are the *Sukūk* structures in Islamic Capital Markets of Pakistan *Shari‘ah* compliant? or there are some *Shari‘ah* issues in *Sukūk* structure of Islamic Capital Markets of Pakistan which need to be addressed in order to make the *Sukūk* structures *Shari‘ah* compliant.

Research Objectives

1. Analyze the various *Sukūk* structures issued in Islamic Capital Market of Pakistan.
2. Provide Juristic point of views of various schools of thoughts on the *Shari‘ah* issues in *Sukūk* structures.
3. Structuring the *Sukūk* keeping in view of the *Shari‘ah* principles and true spirit of Islam.
4. Healthy growth of Islamic Capital Market in Pakistan.

Significance

This study helps in removing the *Shari‘ah* issues in the *Sukūk* structures of Islamic Capital Markets in Pakistan. Juristic point of views of various schools of thoughts are provided on the various *Shari‘ah* issues in the *Sukūk* structures and keeping in view of these juristic opinions various suggestions and recommendations at the end of this paper are given for making the structure of *Sukūk Shari‘ah* compliant in the true spirit of Islam.

Literature Review

The religious dimension is an integral part of the marketing effort of the Islamic capital market. In structuring *Sukūk* contracts, a dividing line needs to be drawn between financial innovations and deviations from *Shari‘ah* principles. Rosly⁷ outlines four parameters *Shari‘ah* scholars need to observe in determining whether a financial contract is *Shari‘ah* compliant, and argues that they must be considered as complementary to one another. The first parameter is the contract (*‘aqad*) approach, where an instrument is deemed *Shari‘ah* compliant if it has fully satisfied the technical requirements of the contract. *Maqasid al-Shari‘ah* is the second parameter used to evaluate *Shari‘ah* compliance of a contract in terms of its socio-economic costs and benefits. This approach is derived from two general purposes of *Shari‘ah*, namely, securing of benefit and the repelling of harm.⁸ Accounting and financial reporting approaches are the third parameter necessary to ensure that a financial contract is free of ambiguities (*gharar*) and fraud or short-changing (*tatfeef*) through complete disclosure. The fourth and final parameter is the legal documentation of a contract, where *Shari‘ah* compliance screening aims to ensure that the rights and obligations of contracting parties expressed are enforceable in a way that is consistent with the Islamic principles of *Sukūk*.

Operating side by side with the conventional bond market, balancing the religious requirements and market realities remains a challenging task faced by *Sukūk* practitioners.⁹ The lure of the enormous potential of Islamic capital markets and the breadth of the concept of *Sukūk* have allowed for experimentation and errors in contract design. The innovation and practice of several questionable contract

⁷Saiful Azhar Rosly, “Shari‘ah Parameters Reconsidered,” *International Journal of Islamic and Middle Eastern Finance and Management* 3, no. 2 (2010): 132.

⁸Ibid.

⁹Marjan Muhammad, and Beebee Salma Sairally, “Shari‘ah Criticisms against Sukuk, w: *Sukūk* Perceptions and Forecast Study 2014, Red.” *EA Alim, Thomson Reuters Zawya* (2013): 112–116.

mechanisms have raised strong criticisms among *Shari'ah* scholars. A widely cited criticism is the one made by Sheikh Muhammad Taqi Usmani, the president of AAOIFI *Shari'ah* board, in November 2007 that almost 85 percent of *Sukūk* (equity-like structure) contracts in the market do not comply with *Shari'ah* principles. His criticism concerns mainly with the following three questionable practices: i) *Sukūk* holders do not have ownership in the underlying assets; ii) the regular return payment to *Sukūk* holders is not based on the performance of the underlying assets; and iii) the use of purchase undertaking and liquidity facility to guarantee the principal amount and return payment to the investors. Concerns about the prevalence of these practices were also raised by other prominent *Shari'ah* scholars, leading to the release of AAOIFI *Shari'ah* resolution on *Sukūk* in 2008, which clarifies the permissible structure as well as the nature of issuer-investor rights and obligations.

The *Shari'ah* compliance issues accompanying the development of the *Sukūk* market have attracted a significant amount of research which can be divided into three discussions: i) asset based versus asset-backed – an issue of investors' ownership right in the *Sukūk* assets; iii) purchase-undertaking and liquidity-facility in equity-like *Sukūk*; and iii) *bay al-inah* (sale with an immediate repurchase) in debt-like *Sukūk*.

From an Islamic finance perspective, asset-backed *Sukūk* are closer to the principle of *Shari'ah*, both in form and substance, because they involve a genuine legal transfer of the asset, and the return distribution to investors is directly linked to the performance of the asset.¹⁰ Nevertheless, asset-backed *Sukūk* remain unpopular despite increasing advocacy for their practice. Based on the data of *Sukūk* deals retrieved from Bloomberg, only 11 out of 618 deals of *Sukūk* issued between 2001 and 2014 were categorized as asset-backed. Researchers attribute this trend to investors' aversion and unwillingness to be exposed to real economic risks associated with the underlying assets as well as enforceability issues due to inconsistency between *Shari'ah* and conventional law.¹¹

In contrast, asset-based *Sukūk* grant only beneficial ownership in the assets. Thus, underlying assets in this type of *Sukūk* contract serve more as creditors' securities rather than the source of cash flows. In most cases, returns are derived from other contracts devised to ensure a smooth payment to the investors.¹² Dusuki and Mokhtar¹³ reported the use of assets in asset-based *Sukūk* meets the ownership requirement only in form but not in substance. Assessing 47 selected *Sukūk* issuance term sheets, they note that most *Sukūk* contracts violate the *Shari'ah* -compliant requirement that *Sukūk* must represent ownership in the underlying assets. In particular, they find that secured *Sukūk* holders only have a security interest in the collateral, but not an ownership interest in the assets.

The second controversy relates to the use of purchase undertaking and liquidity facility in *mudarabah* and *musharakah Sukūk* which, according to *Shari'ah* scholars, violates the PLS principle.¹⁴ A purchase undertaking agreement provides assurance to the investors that, upon maturity or in the event of default, the originator will buy back the underlying assets at a price equivalent to the principal amount (nominal value) contributed by the investors. On the other hand, liquidity-facility provision is an undertaking by the originator to make up for any shortfall in the actual return below the expected rate. The use of these two mechanisms renders *Sukūk* similar to conventional fixed income securities in terms of the return distribution. In its 2008 resolution, the AAOIFI clarified that *mudarabah* and *musharakah* structures

¹⁰Rafisah Mat Radzi, and Mervyn K. Lewis, "Religion and the Clash of 'Ideals' and 'Realities' in Business: The Case of Islamic Bonds (Sukuk)," *Thunderbird International Business Review* 57, no. 4 (2015): 295.

¹¹Asyraf Wajdi Dusuki and Shabnam Mokhtar, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukūk as Implemented in the Islamic Debt Market* (Kuala Lumpur: International Shari'ah Research Academy for Islamic Finance (ISRA), 2010).

¹²Bill Maurer, "Form versus Substance: AAOIFI Projects and Islamic Fundamentals in the Case of Sukuk," *Journal of Islamic Accounting and Business Research* 1, no. 1 (2010): 32.

¹³Dusuki and Mokhtar, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukūk as Implemented in the Islamic Debt Market*.

¹⁴Asyraf Wajdi Dusuki, "Do Equity-Based *Sukūk* Structures in Islamic Capital Markets Manifest the Objectives of *Shari'ah* ??" *Journal of Financial Services Marketing* 15, no. 3 (2010): 203.

are intended to be similar to equity-based instruments. Therefore, the return on investors' capital cannot be guaranteed and pre-determined.

The third controversial practice, *bay al-inah*, has been widely practiced in the Malaysian market in *murabahah Sukūk* in order to create indebtedness. The *bay al-inah* contract involves the sale of an asset by the borrower to the creditor in exchange for cash (spot payment), to be followed immediately by a sale of the same asset by the creditor at a higher price on a deferred payment basis. The *Shari'ah* authorities of the Central Bank of Malaysia and the Securities Commission Malaysia adopt the ruling of the Shafi'i school which recognizes the validity of *bay al-inah*. However, according to the majority of *Shari'ah* scholars in the Middle East who base their opinion on the Hanafi school, this practice is not acceptable since it violates the sale principle due to the absence of ownership interest in the assets.¹⁵ More directly, most scholars reject *bay al-inah* because it is a clear trick to circumvent the religious prohibition of *riba* – the profit earned by the creditor from the difference between the spot and deferred payments is deemed similar to the interest earned on a conventional debt contract. To attract greater global interest in the Malaysian *Sukūk* market, the capital market regulators of Malaysia have been advocating other alternative mechanisms to create indebtedness in sale-based *Sukūk* structures, notably *tawarruq*.

With a series of controversies involving dubious *Shari'ah* -practices in the *Sukūk* market, it is tempting to question the incentives for *Shari'ah* advisors, who are ultimately responsible for screening and endorsing the contract, to consent to a 'dilution' of *Shari'ah* compliance in *Sukūk*. The preceding discussion in this chapter indicates that the compromises made by *Shari'ah* advisors may well be in part a response to high investor demand for securities of this type. Indeed, in an interview with Reuters following the controversial pronouncement by Sheikh Taqi Usmani, the AAOIFI board member Sheikh Mohamed Ali Elgari responded that some *Shari'ah* boards have overlooked the repurchase clause (referring to equity-like *Sukūk*) to allow the industry to develop, but it is now time to review standards. It is also important to note that practitioners' efforts in dealing with the market reality in *Shari'ah* -compliant manners have been complicated by the lack of *Shari'ah* resolutions on the practical aspects of *Sukūk* arrangements.¹⁶ This shortcoming in the *Shari'ah* authority has created uncertainties as to what is *Shari'ah* -compliant and what is not, thereby exposing the market to *Shari'ah* compliance risk.

***Sukūk* Structures in Pakistan**

About 75.9% of the *Sukūk* issued in Pakistan are *Ijara Sukuk*, 19.4% are *Musharakah Sukūk* while other constitutes only 4.7% of the *Sukūk* issued in Pakistani domestic market. As far as the international *Sukūk* market is concerned, Pakistan recently has issued its 3rd international *Sukūk* based on *Ijarah* in which the motorway (M2) was identified as underlying assets. The details of this *Sukūk* are as follows:

Table 1. Pakistan Third International *Sukūk*¹⁷

SPV Name:	The Third Pakistan International <i>Sukūk</i> Co Ltd
Asset	Asset: Lahore-Islamabad motorway. The assets to be purchased by the Trustee on the Issue Date will be a certain part of the land comprising the M-2

¹⁵Saiful Azhar Rosly, and Mahmood Sanusi, "Some Issues of Bay'al-'inah in Malaysian Islamic Financial Markets," *Arab Law Quarterly* 16, no. 3 (2001): 263.

¹⁶Muhammad Al-Bashir Al-Amine, "*Sukūk* Market: Innovations and Challenges," 2008.

¹⁷The Third Pakistan International *Sukūk* Company Limited, "Prospectus of The Third Pakistan International *Sukūk* Company Limited," Pakistan, 2016, <https://www.sukuk.com/sukuk-new-profile/the-third-pakistan-international-sukuk-co-ltd-5031/>.

	Motorway. Bids of \$2.4bn were received for the \$1bn issuance.
Profit rate:	5.5%
Type	<i>Ijara</i>
Issue Size	1 billion
Currency	USD
Maturity	13 October 2021
Country of Issue	Pakistan
Tenor	5 years
Issue Date	13 October 2016
<i>Sukūk</i> Rating	Moodys: B3, Fitch: B
Exchanges:	Luxembourg Stock Exchange ,
Arrangers:	Citigroup , Deutsche Bank , Dubai Islamic Bank , Noor Bank , Standard Chartered ,

***Shari‘ah* Issues in the *Sukūk* Structures of Pakistan**

Issue of True Ownership Transfer of *Sukūk* Assets and Views of *Shari‘ah* Scholars

An important issue in *Sukūk* structures which needs our attention is the non-transfer of ownership right to the *Sukūk* holders. In order meet the *Shari‘ah* requirement, the Originator (Party which is in need of finance) should transfer all the ownership rights to Special Purpose Vehicle (SPV) and it should not be shown in the balance sheet of the Originator. So all the rights and responsibilities related to this asset should be transferred to SPV and when SPV issues *Sukūk* certificates, it should truly represent the ownership rights for the *Sukūk* holders. *Sukūk* holders should be paid keeping in view of the performance of the underlying asset which they own.

Structure Diagram

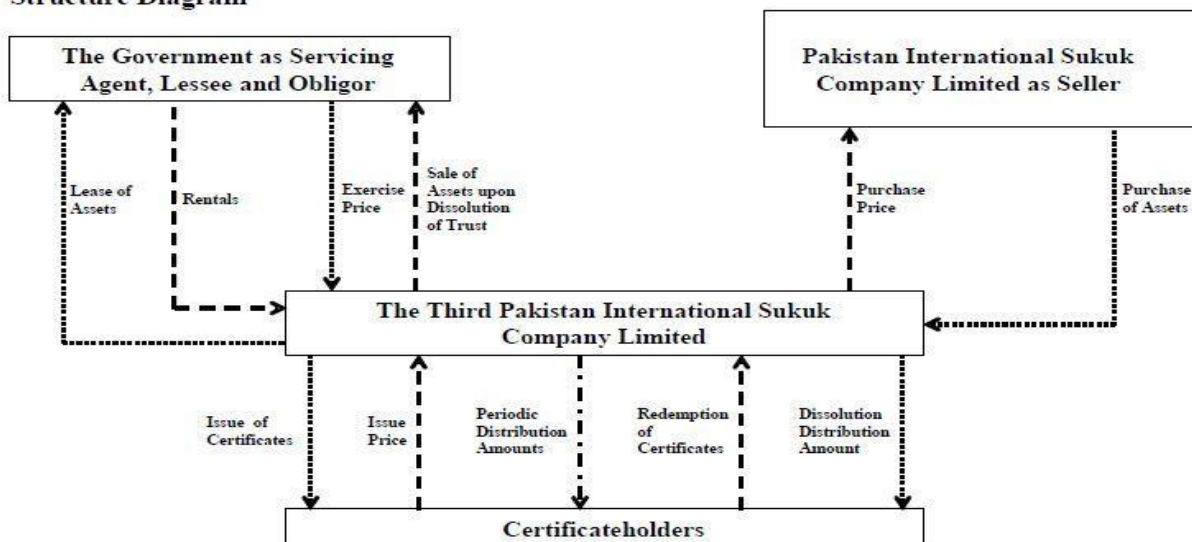


Figure 6. Structure Diagram of Pakistan Third International *Sukūk* (source: The Third Pakistan International *Sukūk* Company Limited. “Prospectus of The Third Pakistan International *Sukūk* Company Limited.” Pakistan, 2016. <https://www.Sukuk.com/Sukuk-new-profile/the-third-pakistan-international-Sukuk-co-ltd-5031/>)

However if we look at the current practices in Islamic Capital Markets of Pakistan and look at the structure of *Sukūk al Ijara* and read the terms and conditions of the certificate issued by The Third Pakistan International *Sukūk* Company Limited (3.2 Limited Recourse and Non-Petition), we come to know that the true ownership is not transferred to the issuer and true ownership of Motorway M-2 has not been transferred to the issuer but only a beneficial ownership or equitable interest is transferred to the *Sukūk* holders and a true sale is not carried out. Resultantly *Sukūk* holders have no recourse to the issuer and the asset.¹⁸ They are not allowed to sell the asset at their will and even in most cases they don’t even know much about the underlying assets and its performance as the main motive is to earn interest based on the credit worthiness of the Originator rather than sharing the risk and reward of the underlying *Sukūk* assets. On default, they are even not allowed to dispose of the asset at their will. On default, they have only the option to ask the trustee to call a meeting of *Sukūk* holders and issue a notice to Originator to fulfill his promise to purchase the underlying *Sukūk* asset on maturity or default of *Sukuk*. The other option the *Sukūk* holders have the restructuring of the debt including the reduction in the sums outstanding. So practically, *Sukūk* are based on the credit worthiness of the Originator, guarantors and other co-obligors. Here it should be noted that these *Sukūk* are being traded at Luxembourg Stock Exchange which arises the issue that whether an instruments which do not represent the true ownership of the seller can be sold in the secondary market or not?

According to a Hadīth narrated by Ibn Hizzam (RA), Prophet (SAW) forbade the sale of a thing which a person does not possess and said: “Do not sell that which you do not possess.”¹⁹ Based upon this Hadīth, it is agreed upon by the scholars that the object of sale should be owned by the seller and there should be a possibility of delivery of the subject matter in a sale transaction. According to the Hanafi and Maliki scholars, the condition that the subject matter should be owned by the seller is a condition of executability while it is the condition of conclusion in the eyes of *Shafi* and *Hanbali* jurists. Due to this reason the sale and purchase of an un-commissioned agent is suspended according to the point of view of

¹⁸Ibid.

¹⁹Narrated by at-Tirmidhi, 1232; an-Nasaa’i, 4613; Abu Dawood, 3503, Ibn Maajah, 2187, Ahmad, 14887. Classed as saheeh by al-Albaani in *Irwa’ al-Ghaleel*, 1292).

Hanafi and *Maliki* jurists while it is void in the eyes of *Shafi* and *Hanbali* jurists. The same situation exists in case of a pawned or rented property. According to the point of view of *Hanafi* and *Maliki* jurists, the sale of such property is suspended while it is void in the eyes of *Shafi* and *Hanbali* jurists.

International *Fiqh* Academy, Jaddah through its resolution no. 53 (4/6) opined that the possession may be physical (*Qabd e Hissi*) or constructive (*Qabd e Hukmi*) and *Qabd e Hukmi* will be treated as similar to *Qabd e Hissi* in this case. According to AAOIFI *Shari'ah* Standard no. 18 requires the *Sukūk* should be an equity type investment which should not represent a debt owed to the holders and investors should become legal instead of beneficial owner in *Sukūk* structures. *Shari'ah* Advisory Council of Securities Commission in Malaysia resolved the issue of *Qabd* by stating that “*Urf*” should be taken as the basis for determining the status of *Qabd* in a transaction. They allowed the transactions in Malaysian capital markets on the basis of the argument that what is accepted by the “*Urf*” as *Qabd* will be considered as *Qabd*.

Issue of Guarantee and Views of *Shari'ah* Scholars

Jurists are unanimous on this issue that in *Mudarabah* contract, all the loss is born by the *Rabb ul Mal* while *Mubarib* as trustee do not share the loss of the business unless it is proved that loss was occurred to the misconduct or negligence of the *Mubarib*. That's why the guarantee of capital by the *Mubarib* is not permissible. According to *Hanafi* and *Hanbali* jurists, if the guarantee is given by the *Mudarib* then the contract will be valid but the guarantee given will be nullified. However in the point of view of *Shafi* and *Maliki* jurists, contract will be nullified immediately in this case.

Similar is the case for *Musharakah*. In a *Musharakah* contract, partners act as trustee for each other and no one is allowed to guarantee the capital of other partner. However the AAOIFI *Shari'ah* standards,²⁰ resolutions of International *Fiqh* Academy²¹ and *Shari'ah* Advisory Council (SAC) of Securities Commission (SC) of Malaysia²² allow the third party guarantee which is independent of the contract.

However if we look at the current practices in Islamic Capital Markets of Pakistan and look at the structure of *Sukūk al Ijara* and read the terms and conditions of the certificate issued by The Third Pakistan International *Sukūk* Company,²³ we come to know that the govt. acts as servicing agent, lessee and obligor at the same time which means that the party giving the guarantee in this case is not an independent body which raises the questions on the *Shari'ah* compliance of the *Sukūk* structures in Pakistani Capital Markets.

Issue of Purchase Undertaking by the Originator and Views of *Shari'ah* Scholars

According to some *Maliki* Jurists, if the promisor has caused the promisee to incur some expenses or undertake some labor or liability on the basis of promise, it is mandatory on him to fulfill his promise. In the opinion of Samurah ibn Jundub (RA), Umar ibn Abd al-Aziz, Hasan al-Basri, Sa'id ibn al-Ashwa, Ishaq ibn Rahwaih and Imam al-Bukhari, promise can be enforced through courts of law. This view is preferred by *Maliki* Jurist ibn al-'Arabi and Ibn al-Shat, and endorsed by al-Ghazzali, the famous *Shafi'i* jurist, who says the promise is binding, if it is made in absolute terms. Islamic *Fiqh* Academy Jeddah has made the promises in commercial dealings binding on the promisor if it is a one sided promise, the promise has incurred some liabilities on the basis of this promise and the actual offer and acceptance is carried out

²⁰Accounting and Auditing Organization for Islamic Financial Institutions, “AAOIFI *Shari'ah* Standard No.12,” Manama, 2017, <http://aaofi.com/Shari'ah-a-standards/?lang=en>.

²¹Majma' al-Fiqh al-Islami (Organisation of Islamic Conference), and Islamic Research and Training Institute, *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy: Muqaradha Bonds and Investment Certificates* (Jeddah, Saudi Arabia: Islamic Development Bank, 2000), <http://zulkiflihasan.files.wordpress.com/2009/12/majma-fiqh.pdf>.

²²Securities Commission Malaysia, “Resolutions of the *Shari'ah* Advisory Council of the Securities Commission Malaysia: *Kafalah* in *Sukūk* Structuring,” Kuala Lumpur, 2018, <https://www.sc.com.my/api/documentms/download.ashx?id=5f0c31dc-daa9-43c1-80ac-e7ecf70c8e44>.

²³The Third Pakistan International *Sukūk* Company Limited, “Prospectus of The Third Pakistan International *Sukūk* Company Limited.”

at the time of sale. If these conditions are met then court can force the promisor to fulfill his promise or pay actual damages excluding opportunity cost.

According to Imam Abu Hanifa, Imam Shafi, Imam Ahmad bin Hanbal and some Maliki jurists promise to purchase in non-binding (it's not *wājib*). Even if you consider the point of view of Maliki Jurists, they allow the promise to purchase to be binding, if the all other conditions of sale (ownership and possession) are fulfilled, otherwise not. Jurists accepted the binding nature of a promise only with regard to unilateral gifts or other voluntary payments but not in case of monetary transactions.

In November 2007, Sheikh TaqiUsmani commented that most of the *Sukūk* (about 85%) in the market (those using a Musharakah or Mudharabah structure) are not in line with the principles of *Shari'ah* because of the purchase undertakings where a promise to pay back capital violates the principles of risk and profit sharing on which such *Sukūk* should be based. However, if we look at the Shirkat-ul-Milk *Sukūk* Process flow of K-Electric Limited, we come to know that purchase undertaking by K-Electric is given to the *Sukūk* holders in which the obligor undertakes to purchase the asset at exercise price in the event of default, which violates the *Shari'ah* principles.²⁴

KE Shirkat-ul-Milk Sukuk Structure

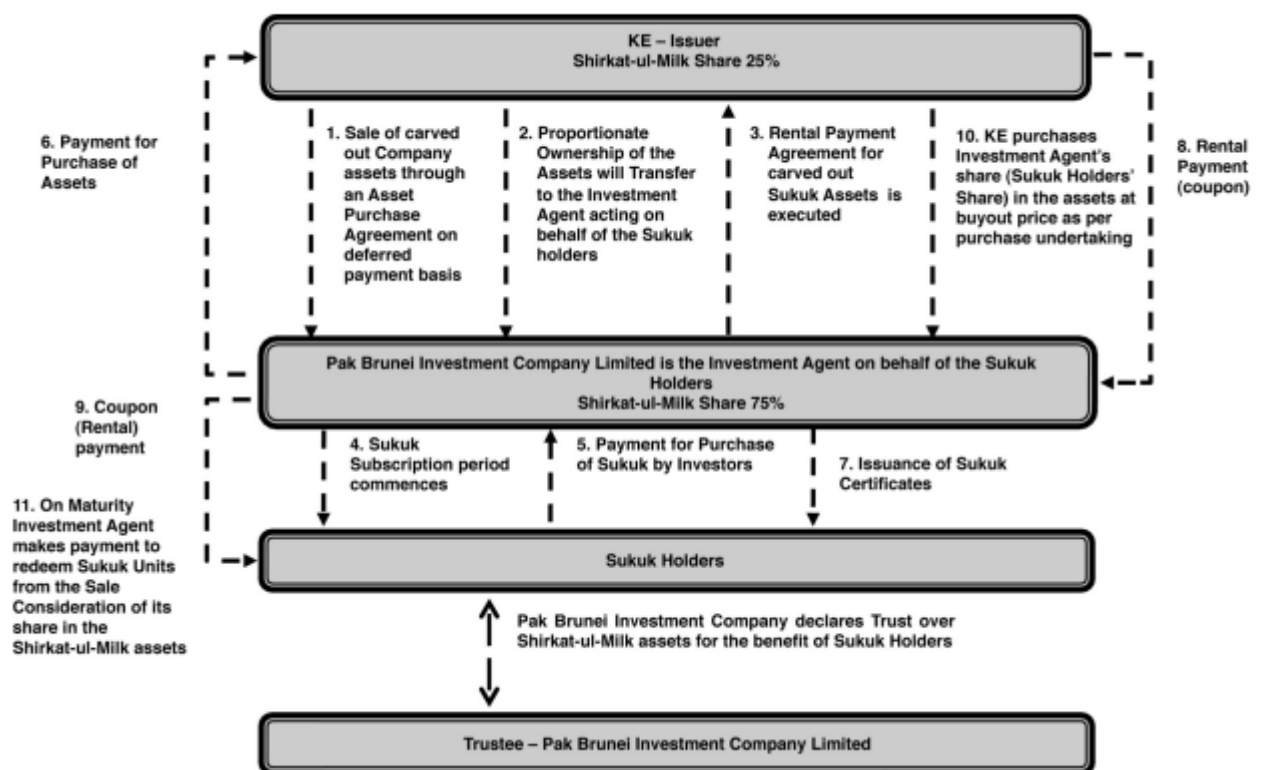


Figure 7. K. Electric Shirkat-ul-Milk *Sukūk* Structure (source: K-Electric Limited.: “K-Electric *Sukūk* Prospectus,” n. d. <https://www.ke.com.pk/download/financial-data/AZM-Sukuk-Prospectus.pdf>)

Trading at a Discounted Price for *Sukūk* Representing Debt

Trading of debts arising from selling of goods or services on deferred payment basis (*Bay al Dayn*) is not allowed in *Shari'ah*. *Hanafis*, *Hanbalis* and *Shafi* jurist do not allow the sale of debt to a third person at all. However Maliki and some *Hanafi* and *Shafi* jurists allow the sale of debt to a third person at the same

²⁴K-Electric Limited, “K-Electric *Sukūk* Prospectus.”

price under some conditions. According to the majority point of view *Sukūk* issued on the basis of *Murabaha* are only tradable before the sale of goods to the buyers, or if the receivables are less than 50%. Otherwise they will be traded only at face value. Islamic *Fiqh* Academy Jeddah, through its resolutions opined that the sale of debt is not allowed, however if *Sukūk* are based on mixed assets including cash, debt and tangible assets, then the trading of *Murabaha Sukūk* is permissible on mutually agreed prices provided that the majority of the *Sukūk* assets are tangible. AAOIFI also declared the trading of *Murabaha Sukūk* as unlawful.²⁵

However in Malaysia, *Bai al Dayn* is considered tradable, therefore in Malaysia various *Sukūk* are issued on the basis of *Bai al Dayn* which are tradable in secondary markets. *Shari'ah* Advisory Council (SAC) of the Securities Commission (SC) of Malaysia allowed the trading of debts in Islamic Capital Markets of Malaysia and argued that the *illah* (underlying reason) of the prohibition of *bai Al Dayn* is the inability of the seller to deliver the sold item to the buyer. However in a transparent mechanism regulated by Securities and Exchange Commission of Malaysia, the delivery of the sold item can be assured. In addition it is also in the public interest (*masalah*) of the general public. However it should be noted here that generally the '*illa*' (underlying reason) for the impermissibility of *Bai al Dayn* is considered the *gharar*, absence of possession, *riba* and risk to the buyer.

However if we look at the current practices in Islamic Capital Markets of Pakistan and look at the structure of Engro Islamic Rupiya- 2 *Sukūk* which is listed and being traded on Pakistan Stock Exchange (PSX) and is based on the concept of *Musharaka* and *Murabaha*, we come to know that although the tradability of the *Murabaha Sukūk* is not allowed by majority of the jurists, still this *Sukūk* is being traded on Pakistan Stock Exchange (PSX).²⁶

Table 2. Engro Islamic Rupiya- 2²⁷

Name & address of the Issuer	Engro Islamic Rupiya- 2
Date of Issue	9-Jun-14
Type of Issue	Listed <i>Sukuk</i> Musharaka and Murabaha
Size of Issue (Rs. in million)	1,000.00
Credit Rating of Issuer	“AA-” (Double A Minus) by PACRA
Credit Rating of Instrument	“AA (Double A)” by PACRA
Tenure (in years)	5
Rate of Return	13.50%
Secured / Unsecured	Secured
Convertible/ non-convertible	NA
Redeemable / perpetual	Redeemable
Nature and amount of security backing the Instrument, if any	First ranking paripassu floating charge over all the present and future movable properties (including all type of investments) of Engro Corporation Limited

²⁵Accounting and Auditing Organization for Islamic Financial Institutions, “AAOIFI Shari'ah Standard No.17,” Manama 2017, <http://aaoifi.com/Shari'ah-a-standards/?lang=en>.

²⁶“Pakistan Stock Exchange Limited -.” Accessed May 5, 2019. <https://www.psx.com.pk/>.

²⁷“Capital Markets – Data & Statistics | SECP.” Accessed May 8, 2019. <https://www.secp.gov.pk/data-and-statistics/capital-markets/>.

Nature of Charges in favor of Trustee, if any	Paripassu floating charge over <i>Sukūk</i> assets in favour of trustee.
Put option, call option, conversion option	Put / early redemption Option

Structure of *Sukūk al-Murabaha*

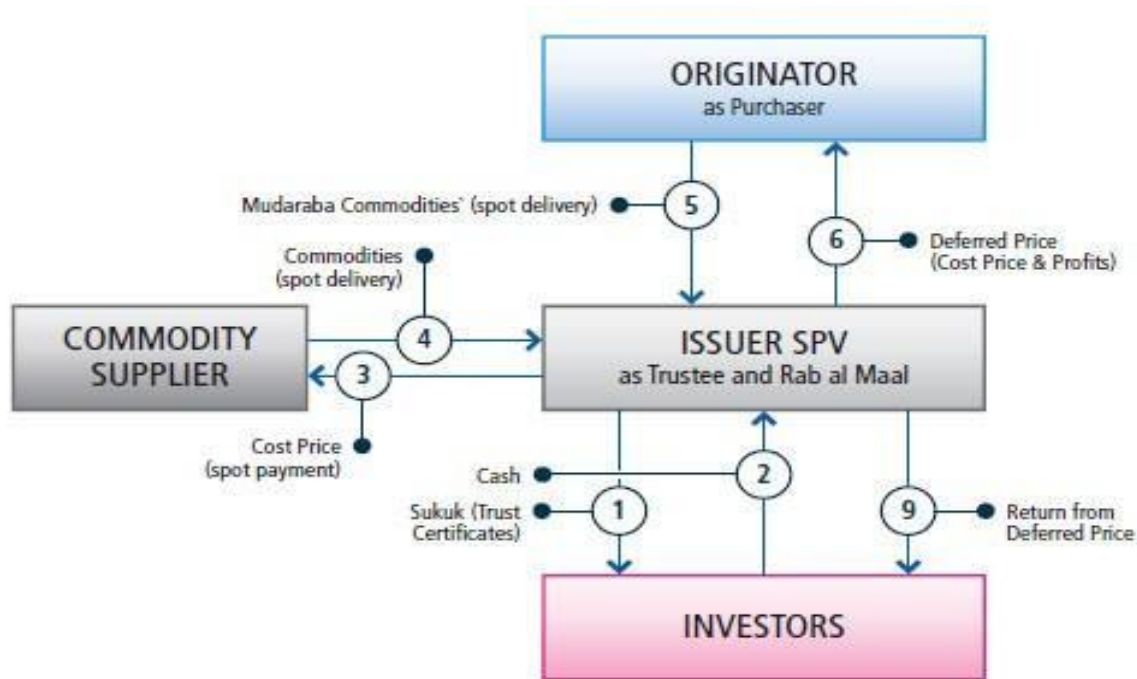


Figure 8. Structure of *Sukūk al-Murabaha* (source: “*Sukūk al-Murabaha* - IslamicMarkets.Com.” Accessed May 6, 2019. <https://islamicmarkets.com/education/Sukuk-al-murabaha>)

Issue of Imposing Penalty on Late Payment and Views of *Shari‘ah* Scholars

According to Imam Abu Yusuf, Imam (ruler) can impose late payment penalty, if he thinks that it is in public interest (*masalah*). If we consider the point of view of Al Buhuti, he says that Tazir in the form of money is permissible by seizing or confiscating the wealth. The same is the view of Ibn Taimiyah and Ibn Qayyim. Similarly, according to the one Maliki opinion, if the debtor defaults without a valid reason, then financial penalty can be imposed on him. Islamic Fiqh Academy Jeddah and AAOIFI have allowed the imposition of financial penalty in the form of charity, if it is not included in the income of the creditor but is used for some charitable purpose. *Shari‘ah* Advisory Council (SAC) of the Securities Commission (SC) of Malaysia and Bank Negara Malaysia (BNM) has also approved the imposition of penalty on late payment in exchange contracts including debt securities and set the late payment penalty as one percent of the arrears.

However if we read the Qur’ān, we find that Qur’ān put emphasis on giving extra time and flexibility to the debtor, if he finds himself in difficult position to pay off his debts.²⁸ According to Imam Abu Hanifa, (RA), Imam Shafi (RA), Muhammad al-Shaybani and Maliki scholars, financial penalty on late payment is not allowed. Ibn Qudamah al-Maqdisi (a Hanbali Scholar) also declared it invalid. According to the Maliki scholars, *Ta’zīr* in the form of money is not allowed. This view is adopted on the basis that

²⁸Al-Baqarah 02:280

Ijma (the general consensus) approve it. Ibn Qudamah al-Maqdisi also disapproved the imposing of penalty on late payment. The Islamic Fiqh Academy opined that it is invalid, if it is specifically mentioned in the contract.

Table 3. Maple Leaf Diminishing Musharakah Sukuk²⁹

Name & address of the Issuer	Maple Leaf Cement Factory Limited, 42, Lawrence Road, Lahore Tel: 042-6278904-5 Fax: 042-6316659
Date of Issue	3-Dec-2007
Type of Issue	Diminishing Musharakah
Size of Issue (Rs. in million)	8,000
Credit Rating of Issuer	BBB +
Credit Rating of Instrument	A-
Tenure (in years)	6
Rate of Return	6 months Kibor + 170 pbs
Secured / Unsecured	Secured
Redeemable / perpetual	Redeemable
Nature & amount of security backing the Instrument, if any	Rs.10.667 billion over all present and future fixed assets of the company with 25% margin
Nature of Charges in favor of Trustee, if any	First paripassu charge
Put option, call option, conversion option, if any	Call
Postal address, email address, telephone number & fax number of compliance officer of the Issuer	Abdul Rauf Mushtaq, 42, Lawrence Road, Lahore Tel: 042-6305883 Fax: 042-6316659 E-mail: abdul.rauf@kmlg.com
Consultant/ adviser/ Lead manager to the issue	Meezan Bank Limited
Trustee	Allied Bank Limited

Maple Leaf Cement Factory Limited issued Diminishing Musharakah *Sukūk* of PKR 8 billion on 3rd December, 2007 but failed to make payments to the *Sukūk* holders. In December 2009, Maple Leaf had to pay about PKR 617 million rupees to its *Sukūk* holders but it failed to meet its financial obligations. So Maple Leaf Cement Factory announced Board of Directors meeting on 5th April 2007 in order to restructure its *Sukūk* issued.³⁰ So the *Sukūk* issued for a period of eight years were restructured with a maturity date of December 2018.³¹ Practically whenever *Sukūk* are restructured on default, new terms and conditions are set

²⁹“Capital Markets – Data and Statistics | SECP.”

³⁰“Maple Leaf Cement | Business Recorder,” Accessed May 6, 2019, <https://fp.brecorder.com/2012/07/201207031208545/>.

³¹“*Sukūk* Issued by Maple Leaf Cement Factory Fully Redeemed: Rating Withdrawn | Pakistan Press International,” Accessed May 6, 2019, <https://ppinewsagency.com/sukuk-issued-by-maple-leaf-cement-factory-fully-redeemed-rating-withdrawn/>.

and the *Sukūk* holders demand higher returns on their investment keeping in view of the higher risk, so practically it is the case of imposing late payment penalty on the Originator which is against the true spirit of *Shari'ah*.

Conclusions and Recommendations

The *Sukūk* market in Pakistan is regulated by the Securities and Exchange Commission of Pakistan (SECP). SECP has taken important measures for improving the *Sukūk* market in Pakistan. Despite the continuous growth of *Sukūk* market in Pakistan, there are various *Shari'ah* issues which are still prevalent in the *Sukūk* structures which needs our attention in order to make the *Sukūk Shari'ah* compliant in true spirit of Islam. The objective of this article is to understand the various *Shari'ah* issues in the *Sukūk* structures issued in Islamic Capital Markets of Pakistan. Various issues identified in *Sukūk* structures of Pakistani Islamic include the lack of true ownership transfer of *Sukūk* assets, guarantee by the related party, Issue of purchase undertaking by the Originator and imposing penalty on late payment in the form of restructuring the *Sukūk*. It is found that while structuring *Sukūk*, true ownership of *Sukūk* asset is not transferred to the issuer only a beneficial ownership or equitable interest is transferred to the *Sukūk* holders. Resultantly *Sukūk* holders have no recourse to the issuer and the asset. They are not allowed to sell the asset at their will and even in most cases they don't even know much about the underlying assets and its performance as the main motive is to earn interest based on the credit worthiness of the Originator rather than sharing the risk and reward of the underlying *Sukūk* assets. Similarly, it is found that the guarantee in *Sukūk* structures is issued by a related party as the govt. acts as servicing agent, lessee and obligor at the same time which means that the party giving the guarantee in this case not an independent body which raises the questions on the *Shari'ah* compliance of the *Sukūk* structures in Pakistani Capital Markets. Listing and trading of *Murabaha Sukūk* on Pakistan Stock Exchange (PSX) and purchase undertaking given by the Obligor to the *Sukūk* holders in which the obligor undertakes to purchase the asset at exercise price in the event of default, are other important issues which needs to be tackled so that *Sukūk* in Pakistani Capital Markets are structured keeping in view of the *Shari'ah* principles and true spirit of Islam.

Bibliography

- Accounting and Auditing Organization for Islamic Financial Institutions. "AAOIFI *Shari'ah* Standard No.12." Manama, 2017. <http://aaoifi.com/Shari'ah-standards/?lang=en>.
- . "AAOIFI *Shari'ah* Standard No.17." Manama, 2017. <http://aaoifi.com/Shari'ah-standards/?lang=en>.
- Al-Amine, Muhammad Al-Bashir. "*Sukūk* Market: Innovations and Challenges." 2008.
- Ayub, Huma., and Behzad S. Kawish. "Design and Use of Innovative Islamic Capital Market Products: Experience of Pakistan and Malaysia." *Islamic Capital Markets* 2008.
- Azhar Rosly, Saiful. "Shari'ah Parameters Reconsidered." *International Journal of Islamic and Middle Eastern Finance and Management* 3, no. 2 (2010): 132–146.
- "Capital Markets – Data and Statistics | SECP." Accessed May 8, 2019. <https://www.secp.gov.pk/data-and-statistics/capital-markets/>.
- Dusuki, Asyraf Wajdi. "Do Equity-Based *Sukūk* Structures in Islamic Capital Markets Manifest the Objectives of Shari'ah?" *Journal of Financial Services Marketing* 15, no. 3 (2010): 203–214.
- Dusuki, Asyraf Wajdi, and Shabnam Mokhtar. *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukūk as Implemented in the Islamic Debt Market*. Kuala Lumpur : International Shari'ah Research Academy for Islamic Finance (ISRA), 2010.
- International Islamic Financial Market. "IIFM *Sukūk* Report 2018." IIFM *Sukūk* Report 2018. Manama: International Islamic Financial Market, 2018. http://www.iifm.net/system/files/private/en/IIFM%20Sukuk%20Report%20%287th%20Edition%29_0.pdf.

- K-Electric Limited. "K-Electric *Sukūk* Prospectus." n. d. <https://www.ke.com.pk/download/financial-data/AZM-Sukuk-Prospectus.pdf>.
- Majma' al-Fiqh al-Islāmī (Organisation of Islamic Conference), and Islamic Research and Training Institute. *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy: Muqaradha Bonds and Investment Certificates*. Jeddah, Saudi Arabia: Islamic Development Bank, 2000. <http://zulkiflihasan.files.wordpress.com/2009/12/majma-fiqh.pdf>.
- "Maple Leaf Cement | Business Recorder." Accessed May 6, 2019. <https://fp.brecorder.com/2012/07/201207031208545/>.
- Maurer, Bill. "Form versus Substance: AAOIFI Projects and Islamic Fundamentals in the Case of Sukuk." *Journal of Islamic Accounting and Business Research* 1, no. 1 (2010): 32–41.
- Muhammad, Marjan, and B. S. Sairally. "Shari'ah Criticisms against Sukuk, w: *Sukūk* Perceptions and Forecast Study 2014, Red." *EA Alim, Thomson Reuters Zawya*, 2013, 112–116.
- "Pakistan Stock Exchange Limited -." Accessed May 5, 2019. <https://www.psx.com.pk/>.
- Radzi, Rafisah Mat, and Mervyn K. Lewis. "Religion and the Clash of 'Ideals' and 'Realities' in Business: The Case of Islamic Bonds (*Sukuk*)." *Thunderbird International Business Review* 57, no. 4 (2015): 295–310.
- Rosly, Saiful Azhar, and Mahmood Sanusi. "Some Issues of Bay' al-'inah in Malaysian Islamic Financial Markets." *Arab Law Quarterly* 16, no. 3 (2001): 263–280.
- Securities Commission Malaysia. "Resolutions of the Shari'ah Advisory Council of the Securities Commission Malaysia: *Kafalah* in *Sukūk* Structuring." Kuala Lumpur, 2018. <https://www.sc.com.my/api/documentms/download.ashx?id=5f0c31dc-daa9-43c1-80ac-e7ecf70c8e44>.
- "*Sukūk* Issued by Maple Leaf Cement Factory Fully Redeemed: Rating Withdrawn | Pakistan Press International." Accessed May 6, 2019. <https://ppinewsagency.com/Sukuk-issued-by-maple-leaf-cement-factory-fully-redeemed-rating-withdrawn/>.
- The Third Pakistan International *Sukūk* Company Limited. "Prospectus of the Third Pakistan International *Sukūk* Company Limited." Pakistan, 2016. <https://www.Sukuk.com/Sukuk-new-profile/the-third-pakistan-international-Sukuk-co-ltd-5031/>.