A Critical Analysis of Asset-Backed Sukuk from Sharia Perspective and Observed Risk Mitigation Process in Sukuk Structure: A Case Study in Saudi Arabia

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A Critical Analysis of Asset-Backed *Sukuk* from Sharia Perspective and Observed Risk Mitigation Process in *Sukuk* Structure: A Case Study in Saudi Arabia

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List of Abbreviations

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ABS	Asset-backed Securities
CBO	Collateralized Bond Obligations
CDO	Collateralized Debt Obligations
CLO	Collateralized Loan Obligations
CMA	Capital Market Authority
CMBS	Commercial Mortgage-backed Securities
DAAR	Dar Al-Arkan Real Estate Development Company
FLP	First Loss Position
ICMA	International Capital Market Association
IFSB	International Islamic Financial Services Board
IIFM	International Islamic Financial Market
MBS	Mortgage-backed Securities
OC	Offering Circular
PLS	Profit Loss Sharing
RMBS	Residential MBS
SABIC	Saudi Basic Industries Corporation
SAC	Sharia Advisory Council
SAMA	Saudi Arabian Monetary Agency
SAMA	Capital Market Authority
SAR	Saudi Arabia Riyal
SBS	Sharia-based *sukuk*
SCS	Sharia-compliant *sukuk*
SEC	Saudi Electricity Company
SPV	Special Purpose Vehicle
UK	United Kingdom
USD	United State Dollars
VaR	Value-at-risk

Glossary

Amanah	A form of trust
Fatwa	Islamic legal opinion
Fiqh	Islamic jurisprudence covering all aspects of life including economics
Gharar	Ambiguity and uncertainty in transactions
Hadith	Synonym of *Sunnah*
Hiyal	Stratagem
Ijara	Contract of hiring or leasing
Ijara muntahia bittamleek	Lease to own
Ijma	Consensus of opinion among Sharia scholars on a specific matter
Ijtihad	Scholarly reasoning through which a jurist derives Islamic rule
Inah sale	Contract of sale with immediate repurchase.
Intifa' sukuk	Time-share *sukuk*
Istisna	Object-deferred sale of manufactured goods
Istisna'	Requesting to construct, build or manufacture an asset.
Jahala	Ignorance
Mudharib	The entrepreneur who solely manages the business of *mudharaba*
Murabaha	Cost-plus sales
Musharaka	Partnership contract
rahn	Mortgage, collateral
Riba	Usury or interest
Salam	Pre-payment of an asset for future delivery
Sukuk	Participation security or investment certificate
Sunnah	The way of the Prophet Mohammed (PBUH) including his sayings, deeds, approvals and disapprovals
Takaful	A system of insurance based on the principle of mutual support
Urf	Customary laws
Wa'd	A unilateral promise
Wafa	Sale with a right of the seller to repurchase the property
Wakala	An agency contract

Statement of Copyright

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Abstract

Recent issuances of *sukuk* were confronted with wide criticism from, both by Islamic scholars and investors. The part of the problems arise due to the agency relations in *sukuk* structures that have a distinctive nature with great complexity and various features. Due to the higher complexity of the responsibilities undertaken by the agent, greater exposure to agency costs results. This research aims to examine *sukuk* associated risks, agency costs and Sharia issues. Specifically, it analyses asset-backed *sukuk* structures from financial and Sharia viewpoints. This is achieved by adopting a case study strategy and inductive approach to examine the legal and financial issues arising in three different types of asset linked *sukuk* structures. The data is collected using content analyses of *sukuk* prospectuses, AAOIFI Sharia standards and publications issued by international agencies with the aim of enabling the study to achieve insights into the market. Furthermore, information is gathered from Sharia scholars using semi structured interviews to generate some specific information on the issues involved.

The objectives of this study are to analyse three key issues: based on theoretical discussions identify the risks arising in securities in general and *sukuk* in particular; to carry out a comparative analysis of the principle/agent conflicts which arise in different cases of *sukuk* investment; and to determine the extent of adherence to Sharia rules. The dissertation discusses in depth the agency costs that arise in asset-backed *sukuk* structures. It determines how these costs are minimized and conflicts managed in the applications. Among the strategies and tools used to reduce agency costs is to apply the concept of co-ownership. Under this type of agreement between the originator and investors, the *sukuk* structure becomes more competitive and shows a better allocation of the risks.

Although the issuance of *sukuk* are reviewed and approved by eminent scholars, they show different levels of contradictions with AAOIFI Sharia standards. The study identifies the status of different stipulations of different contracts in terms of Sharia requirements. The research then shows the extent to which the compatibility of the *sukuk* cases differ with key Sharia principles. The analysis found that the key requirements are mostly related to the guarantee, ownership, principle, return and maintenance costs. It found out that SEC *sukuk* are far away from the spirit of Sharia as most of the essential requirements are not fulfilled.

Sadara *sukuk* show better harmonious with AAOIFI requirements because of their unprecedented feature involved in their structure, which highlighted some of the distinctive nature of *sukuk*. Zamzam *sukuk* achieved the best harmonious with Sharia among the three applications. This positive result is attributed to the real ownership to the investment, meaning that there is no guarantee for the principle or the return.

The results show that there is a higher exposure to risks related to liquidity legality in *sukuk* cases than in conventional bonds. More importantly is that the credit risk in *sukuk* cases are higher than in bond investments. The three cases were more exposed to the credit risks since any loss in the assets has to influence both the distribution amounts and the purchase undertaking. The critical point found is that despite SEC and Sadara *sukuk* cases involve higher exposure to credit risk as required in Islamic finance, they do not provide in turn a recourse to the assets according to the concept of *sukuk*. The cases also show that the purchase undertaking solves the agency conflicts, caused by the originator being the servicer. The undertaking device has reduced the incentive asymmetries from different perspectives.

Chapter 1: Introduction

1.1 Background

Starting in the 1970s, Islamic finance has grown rapidly and has now become a global phenomenon. While the bulk of the growth in Islamic finance in the earlier period was in the banking sector, Islamic capital markets have also been expanding recently. The expansion of Islamic capital markets has led to a resurgence of Sharia-compliant financial securities called *sukuk*. The global *sukuk* market has, since its recovery after the 2008 crisis, grown with issuances reaching more than $116 billion in 2014. Therefore, this market is deemed as an important source of funds and wealth for many sovereigns, companies and institutions in the North Africa, Southeast Asia and Middle East regions (Latham & Watkins, 2015). While *sukuk*[1] are sometimes termed Islamic bonds, they differ from them significantly since instead of supplying interest to investors, the originator provides profit or rent to them.

Sukuk have recently been considered to be one of the fastest growing products in the international financial landscape, as well as the most successful instrument in the Islamic financial landscape. The global volume of *sukuk* in 2011 was $76 billion, which was five times more than in 2005 (Nagano, 2013). During the first half of 2014, the *sukuk* volume in the secondary market reached $286.41 billion with growth of 16.8% year on year and 5% quarter-on-quarter (Rasameel, 2014). Statistically, a study named '*Sukuk* Perceptions and Forecast' indicated that *sukuk* are expected to grow to $907 billion by 2020 while the outstanding *sukuk* issuance in 2014 was only about $175 billion[2]. Furthermore, in 2014, 19 jurisdictions tapped the *sukuk* market, which is regarded as the highest number yet in the *sukuk* market. Thus, *sukuk* products have received an estimable position in the financial market due to their high volume and demand (Ahmed, et al., 2015). This study develops

[1] This research applies the word '*sukuk*' to refer to Islamic bonds and this is plural term. The singular form of *sukuk* is '*sak*'.

[2] The study was conducted by Thomson Reuters at the 21st Annual World Islamic Banking Conference in Bahrain 2014. It is based on 44 *sukuk* lead arrangers, 106 investors and other key market players such as regulators, legal advisors, and rating agencies predominantly based in Islamic markets in the Middle East and Southeast Asia.

from the rapid expansion of *sukuk* as an alternative tool of financing[3] and more importantly as a better structure in resisting financial crisis. (Wicaksono, 2015) confirms that the market of *sukuk* shows better resistance to the 2008 crisis in comparison to their counterparts in conventional finance. This status gives the *sukuk* market a competitive position in the financial sector.

In the market, there exist differences of opinion pertaining to the Sharia compliance of *sukuk*. This means that different Sharia rules are applied in the *sukuk* sector by different financial institutions, which has caused chaos in the market. In this regard, an international autonomous non-for-profit corporate body Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), was established in 1990 to promote and maintain Sharia standards for Islamic financial organisations, participants, institutions and the entire industry of Islamic finance as well as to play a key role in harmonizing Sharia standards related to finance in the market (Lahsasna, 2008). The AAOIFI consists of a number of scholars that represent several Muslim countries and it is thus deemed as an industry-level representative body of Sharia jurists (Latham & Watkins, 2015). It identifies 14 types of *sukuk* that can be classified based on debt, assets, services and equity. The asset-backed *sukuk* are issued with an entire reliance on the existence of tangible assets in order to generate returns for investors (IFSB, 2009).

1.2 Statement of the Research Problem

Sukuk are securities that must comply with the principles of Sharia. Thus, adherence to the rules of Islamic financial jurisprudence is a cornerstone of these instruments. Despite the global acceptance of AAOIFI standards, the structure of *sukuk* does, in fact, reflect the interpretation and decision of the Sharia boards embedded in different financial institutions. In the absence of any regulatory oversight, Sharia boards for Islamic financial institutions are able to issue *fatwa* (religious edict) which contradict AAOIFI standards. These edicts would be incompatible with Sharia-sensitive investors' demands and do not have transparency with regards to the basis in Sharia. Although the size of the Islamic finance

[3] In the contemporary applications of finance, Islamic finance has emerged as an alternative source of finance.

industry has reached $1.7 trillion, its development has exposed a critical flaw in terms of the lack of a clear consensus on the acceptability of the issuances of Sharia pronouncements (Zawya, 2014). This problem becomes serious when investors with high sensitivity to Sharia-compliance drift away from the market due to the lack of transparency on compatibility.

Most financial institutions attempt to confer legitimacy upon their specific issuance of *sukuk* in the market in order to achieve more acceptances among investors, especially Sharia-sensitive investors. They commonly provide a section in the prospectus that confirms the product's compatibility with Sharia. However, a number of reliable scholars in this field confirm the illegality of most of the asset-based *sukuk* applications. For instance, Usmani, a renowned scholar, asserted that 85% of partnership-based *sukuk* in the market are illegal according to Sharia (Usmani, 2008). These opposing attitudes regarding *sukuk* applications indicate the gap which exists between Islamic financial rules and the current market. Thus, this research attempts to investigate *sukuk* practices by screening, analysing and examining the content and structure of *sukuk* to determine the extent of their adherence to Sharia rules.

From a financial perspective, *sukuk*, as with any contractual relationship, are potentially subject to the agency problem. In fact, principal/agent relations in *sukuk* have a distinctive nature with greater complexity and various features. In agency relations, the higher complexity of the responsibilities undertaken by the agent lead to a higher discretion for the agent, resulting in greater possibilities of agency costs. In addition, due to the unique nature of *sukuk* risks, the concerns raised are indicated by Ahmed et al. (2015) as that 'the problem for financial institutions is that they pursue to convey the belief of investors to regard the *sukuk* as similar to conventional assets rather than being distinctive from a financial viewpoint, as this is simply risk valuation. Investors are more comfortable when a security has a common structure than being unknown'. In fact, the novelty of *sukuk* involves a higher exposure to risks that have been systematically altered in the market, as the risk exposure for investors is minimized to a level that contradicts Sharia rules. Thus, as a result, a gap exists between the financial risks of *sukuk* in theory as compared to current operations. Hence, this study focuses on investigating *sukuk* cases from different perspectives.

1.3 Research Aims and Objectives

This dissertation aims to explore the financial and Sharia perspectives concerning *sukuk* by firstly describing the theoretical viewpoint and then assessing practice by examining three *sukuk* case studies. Theoretically, *sukuk* are discussed from two perspectives: the financial framework and the Sharia background. The research then analyses and evaluates the cases based on the standards derived from the theoretical framework. Given the above, the dissertation has two broad objectives that have been further classified into the following sub-objectives.

The first objective is to explore the financial features of asset-backed *sukuk*, which involves the following sub-objectives:

i. To compare the risk/return allocation of bonds with asset-backed *sukuk* to determine the financial position of risk allocation in *sukuk* investment.
ii. To discuss the problems of agency involved in the structure of asset-backed *sukuk* by identifying the principle/agent relations, conflicts and problems.

The second objective is to examine the Sharia basis of asset-backed *sukuk*, and it includes the following sub-objectives:

i. To assess three *sukuk* cases issued in Saudi Arabia according to the AAOIFI standards in order to provide a precise measurement with respect to their compliance and to raise the transparency of their permissibility.
ii. To identify critical issues faced in the applications in order to investigate the points of view of experts, experience and some solutions.

1.4 Research Questions

This study focuses on asset-backed *sukuk* and asks the following three main questions.

i. What are the differences between risk allocation in bonds and in asset-backed *sukuk*? To what extent do *sukuk* cases differ from the theoretical framework of *sukuk* risks?

ii. What are the agency problems embedded in asset-backed *sukuk* investment? What are the principle/agent conflicts that appear in different cases of *sukuk* investment?

iii. To what extent do the three practices of *sukuk* comply with Sharia rules? What are the critical Sharia issues that face asset-backed *sukuk*? How would they be dealt with practically?

1.6 Research Methodology

The research methodology will help to respond to the research aims, objectives and questions:

Table 1-1 the Research Aims, Objectives and Questions

Aims	Objectives	Questions
To explore the financial features of asset-backed	To compare the risk/return allocation of bonds with asset-backed *sukuk* to determine the financial position of risk allocation in *sukuk* investment.	What are the differences between risk allocation in bonds and in asset-backed *sukuk*? To what extent do *sukuk* cases differ from the theoretical framework of *sukuk* risks?
	To discuss the problems of agency involved in the structure of asset-backed *sukuk* by identifying the principle/agent relations, conflicts and problems.	What are the agency problems embedded in asset-backed *sukuk* investment? What are the principle/agent conflicts that appear in different cases of *sukuk* investment?
To examine the Sharia basis of asset-backed	To assess three *sukuk* cases issued in Saudi Arabia according to the AAOIFI standards in order to provide a precise measurement with respect to their compliance and to raise the transparency of their permissibility.	To what extent do the three practices of *sukuk* comply with Sharia rules?
	To identify critical issues faced in the applications in order to investigate the points of view of experts, experience and some solutions.	What are the critical Sharia issues that face asset-backed *sukuk*? How would they be dealt with practically?

To fulfill the requirements of these aims, objectives and questions, the research uses qualitative method since it is based on understanding asset-backed *sukuk* in depth and observing the process of specific applications in order to assess the research in exploring the

financial and Sharia features. The dissertation adopts a case study strategy using an inductive approach to examine cases in terms of legal and financial issues. This provides the research with an opportunity to gather evidence from different sources and to support the analysis in ways that cannot be achieved using other strategies (Bryman, 2012, p. 66). In fact, this strategy allows for a systematic method and links the data to be collected and the conclusions to be drawn with better coherence.

The data are primarily based on library-collected information, such as textbooks and journal articles, and are also based on regulations issued by the internationally recognized Islamic financial authorities and institutions such as the AAOIFI. The majority of these resources can be accessed via libraries and online material which includes the most relevant books, articles and other materials that are relevant to Islamic finance and provide the background to the Saudi market. Data is collected using content analyses of *sukuk* prospectuses, AAOIFI Sharia standards and publications issued by international agencies with the aim of enabling the study to achieve insights into the market rather than depending just on the literature. Furthermore, information is gathered from Sharia scholars using semi-structured interviews to generate some specific information on the issues involved. These various sources and methods of treatment help in investigating the discrepancies that arise from contradictions between the existing literature and operation in the real world.

1.7 Research Motivation and Scope of the Research

The initial significance of this research is derived from dealing with *sukuk* as a source of finance that is a relatively new phenomenon. In the *sukuk* market, there is a split between Sharia-sensitive investors and others with less sensitivity. *Sukuk* that adhere to Sharia principles will receive a better access to the former investors who tend to be more focused, disciplined, and sensitive to the risk of breaking Sharia law. Thus, if one issuance contravenes some of the AAOIFI standards, their reliability becomes tenuous. The issuance might be called into question by an individual judge, even if it is compliant with other standards that have been passed with a narrow majority, regarding who can invest and subscribe with stronger majority standards (Majid, et al., 2011). Meanwhile, actual adherence to Sharia rules can attract even more of non-sensitive investors, if the structure is

financially well-formulated. Thus, satisfying Sharia-sensitive investors does not mean losing other investors.

For these reasons, the present study will put a number of applications on a more transparent level related to their Sharia compliance based on AAOIFI standards[4]. Being more transparent will attract new investors who have avoided the *sukuk* market due to losing confidence on product permissibility. This method helps in deciding to what extent each issuance complies with Sharia rules. Furthermore, the research discusses the legal issues found in the cases with some eminent scholars in an attempt to bring to light other views and options which can reduce both the time and costs of due diligence in each issuance.

In addition to high Sharia compatibility, adverse risks affect the competitiveness of the *sukuk* market. This is because the novelty of *sukuk* inherently involves a higher exposure to certain agency and financial risks. In this respect, Abdul-Rauf and Ibrahim (2014, p. 66) have recently confirmed the importance of this sort of study: 'identifying the risks related with *sukuk* is largely considered as vital for the future development of that particular market. It is also most important for managing such markets in a better way'. However, *sukuk* risks vary according to the specific structure applied. Muhamed and Radzi (2014) emphasize that *sukuk* risks differ depending on the structure of the *sukuk*. Unlike traditional bonds, *sukuk* applications cannot be judged or assessed according to their cover or contract type. For example, *ijara sukuk* can be asset-based or asset-backed, yielding entirely different profiles of risks and returns in the event of liquidation and default. This is in addition to the agency risks, where each case has distinctive agency relationships yielding considerable differences in agency costs. Thus, more attention to the development of *sukuk* is required in order to ensure that their applications are financially attractive. This research comparatively discusses their embedded risks, as there is still a requirement to understand and explain to the complicated *sukuk*, as much as the crucial need to interpret their current applications to identify the challenges and risks. This dissertation aims to provide a clear and in-depth summary of the complexities of the current situation with *sukuk*. This study will provide a

[4] The AAOIFI continuously attempts to standardize *sukuk* and establishes standard-setting bodies in order to address the standardization issues impeding the development of the *sukuk* market.

useful test to show to what extent the relevant theories and Sharia principles have been utilized in the cases. Equally important, this will shed light on and make recommendations concerning the financial issues in the asset-backed *sukuk* market.

The originality of this study is identified in three areas. This research establishes a theoretical basis based on AAOIFI standards and agency theory that helps the analytical study to achieve meaningful conclusions. The discussion of agency lends additional originality to the thesis because it seems that no previous study has analysed the agency relationships in asset-backed *sukuk* structures[5]. Also, the critical legal and financial issues that may face AAOIFI[6] applications have not yet been discussed, at least to the extent that this research covers[7]. The analysis looks at the SEC *sukuk*, the first Saudi International *sukuk*, and a basic plain structure of *ijara sukuk*. Then, the study examines Sadara *sukuk* the complex structure titled with forwarded *ijara sukuk* and then at first application for *intifa' sukuk* (Zamzam *sukuk*). While *intifa' sukuk* seem to be in practice the type most compatible with Sharia, there is a shortage found on discussing them, especially in relation to their financial risks which the present research attempts to cover. The study aims to fill some gaps by providing legal and financial discussions of asset backed *sukuk* according to well-built theories.

The analytical discussion in this dissertation has two main boundaries. The first is the assessment process using mainly the AAOIFI standards. This is because these standards have been formulated in consultation with leading Sharia scholars and have introduced a great harmonization of Islamic finance practices across the world. The choice a well-developed standard enables the analysis to focus on assessment rather than on deeper juridical discussion. This focus in the assessment helps the study to draw some important

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[5] Research Samadzadeh & Melander (2012) discusses the implications of agency theory on *mudarabah* and *musharakah* agreements. However, this current study is different as it looks at the implications of agency theory on asset-backed *sukuk*.

[6] The importance is derived from the standards that have been used. AAOIFI has gained support for implementing its clarified standards. It has a board of 20 members of Sharia scholars that are additionally members of other Sharia boards in most of the largest financial organisations and institutions in the world. The AAOIFI is also supported by 200 other institutional members, coming from 40 different countries, who belong to Islamic financial organisations, central banks and the international Islamic financial and banking industry, globally (AAOIFI, 2006).

[7] More explanation is provided in the methodology chapter.

conclusions in the financial field. Secondly, the chosen applications are limited to cases linked to assets and applied in Saudi Arabia, whether in the domestic or international markets. The Saudi market was chosen because it is still nascent that requires more attention and effort. Also, this market is a relatively conservative market compared to other *sukuk* markets, meaning that it is more likely for such a market to be interact with AAOIFI standards.

1.8 The Research Contributions and Key Findings

This research has examined financial and Sharia issues identified in the applications. It attempted to contribute to the existing literature by first, exploring how the Basel types of risks interact with Sharia-based *sukuk* (SBS). It also attempted to compare the risks of SBS with those of conventional bonds in order to highlight why SBS are considered as alternative investment tools. The research then examined how SBS risks qualitatively differ in the applications and emphasize the extent of these differences. Second, the study analysed the agency relations in SBS structures that haven't formerly discussed in such a way that identifies hidden actions, incentives and information asymmetries. The discussion indicated the agency problems that arise in SBS structures, how these problems are minimized and how the conflicts are managed in the applications. Finally, the study has evaluated Sharia issues in the applications by adopting the AAOIFI standards as a benchmark. It tested the cases and showed some evidence of harmoniousness and contradiction with Sharia according to those standards in order to improve the transparency of the applications with Sharia rules.

The key Results found are related to risks allocation, agency problems and Sharia compliance issue. This research analysed the differences between SBS and conventional bonds and found a number of fundamental differences, proving that these two types of securities provide different solutions in the market. In the applications of SEC and Sadara *sukuk*, they do not offer a guaranteed return. The research found in their prospectus that if the originator fails to generate rental payments, investors will face a loss without any type of guarantee for the distribution. This is a key difference between these applications and bonds were the distributions are guaranteed in any cases. Thus, *sukuk* investors have higher

exposure to the credit risk; however, they do not receive an actual relationship to the assets. Investors are supposed to have the advantage of the recourse to their assets, while the cases only offer beneficial ownership without any actual relationship. This research asserted that *sukuk*-holders should not be treated equally as bondholders without taking into account the variation in their risk profiles.

Each structure is embedded with a variety of different agency relationships depending on the positions taken by the originator, such as being as a manager, a lessee, an issuer, a servicer, and a contractor, leading to different levels of exposure to agency problems. In fact, the higher level of the responsibility undertaken by the originator, the greater the possibility of agency costs. The research shows some hedging procedures that have been used in the cases to reduce the adverse selection and the moral hazard. For instance, the cases precisely determine the incomes as a rental payment and hence the cash flow generated from the assets becomes more specified. Another instance is that SEC and Sadara *sukuk* managed the agency conflicts by the purchase undertaking. The repurchase agreement shows a dimension of sharing between the originator and investors, resulting in a better managing for the agency problems. The study also found that Sadara *sukuk* use a further device to manage these conflicts by applying the concept of co-ownership. The originator and the investors become co-owners of the assets. This particular device increases the investors' confidence that the originator, as co-owner, will maintain a high quality of performance.

Although the three cases considered have been reviewed and approved by renowned scholars, the issuances show a different level of contradictions with AAOIFI standards. The aggregate percentage compliance of SEC *sukuk* was only 11.5%, Sadara *sukuk* reached 81.7% and Zamzam *sukuk* achieved 90%. The prospectus of the cases shows their approving *fatwa* without any evidence or explanation. However, the best financial practice requires greater transparency in order to protect the reputation of the issuance and also to maintain the investors' confidence.

1.9 Structure of the Dissertation

To answer the research questions of the present study, this dissertation is divided into 11 chapters. It begins with a brief introduction and then presents a literature review explaining the concepts, structures, principles and risks of securitization, conventional bonds and asset-backed *sukuk*. Then, the methodology and rationale for conducting this study are explained. Critical analyses and discussions of *sukuk* cases are treated in the subsequent chapters before describing the interviews conducted and drawing conclusions.

Chapter 1 provides the background of the study. It introduces the research problems and objectives with the aim of analytically and critically dealing with the theoretical and practical components that make this study important.

Chapter 2 discusses the characteristic features of securitization and the background of the research work. This chapter aims to give a foundation to the study where different types of financial structures are presented before examining the risks associated with bond investment.

Chapter 3 deals primarily with the jurisprudence of asset-backed *sukuk*. *Sukuk* are discussed from the Sharia perspective and based on AAOIFI standards. Sharia issues which are the subject of arguments among scholars are examined according to the concepts presented in this study. A framework is established to evaluate the applications.

In chapter 4 an analytical study of *sukuk* is presented as an Islamic product in the financial sector. The chapter mainly considers the specific risks of *sukuk* in order to distinguish this investment from conventional bonds before moving to the agency theory.

Chapter 5 discusses the financial sector in Saudi Arabia and its capital market. More specifically, the research attempts to identify the important issues facing the Saudi *sukuk* market in particular. The rationale for this chapter is to clarify Saudi financial regulations related to the *sukuk* market.

Chapter 6 explains the methodology employed and the analysis used in the study. The chapter introduces the research methodology and methods applied in this research and how it has guided data collection and analysis.

Chapter 7 examines *ijara sukuk* that has been applied to the Saudi Electricity company *sukuk*. This case is evaluated in order to highlight the financial issues, challenges and also risks involved. The chapter also assesses the level of Sharia compliance in applying these *sukuk* in order to draw conclusions as to what extent they adhere to Sharia standards.

Chapter 8 presents insights in the case of forward *ijara* that have been applied in Sadara *sukuk*. This chapter uses the same framework as in the previous chapter to conclude with financial and Sharia assessments.

Chapter 9 analyses Zamzam *sukuk* as a case study for *intifia' sukuk.* The discussion is based on financial and Sharia perspectives and uses the same framework that has been used in the two previous chapters.

Chapter 10 provides the results from an interview-based survey on the critical issues found in the cases.

Chapter 11 provides the conclusions and recommendations for the thesis. It presents a summary of the analysis and concluding remarks.

Chapter 2: Securities as Financing Instruments: Risks and Agency Conflicts

2.1 Introduction

Securitization represents an established and substantial part of US and global capital markets; however, the process of asset securitization has evolved over the last few decades for funding and risk management purposes (Skarabot, 2001). The conventional view prior to the financial crisis tended to highlight the positive role of securitization in increasing the resilience of the financial system (Alper, et al., 2015). It was characterized as 'one of the most important financing vehicles in the United States' (Shenker & Colletta, 1991). Some researchers have even referred to asset securitization as 'alchemy', since it purportedly generates value where none existed earlier (Schwarcz, 1994). Now, securitization is often characterized as one of the main contributing causes to the 20072009 global financial crises (Alper, et al., 2015). The increasing dependence on asset securitization, particularly by financial organisations, has been singled out as a major catalyst to the financial crisis. While shifting the credit risk off of bank balance sheets is not a recent phenomenon, the securitization wave differs from earlier ones due to the widespread use of sophisticated mechanisms enabling banks to shift the credit risk of more opaque assets to different market participants. Information related to structured securities is considerably more ambiguous than that for traditional securities (Guoa & Wub, 2014).

This chapter aims to provide background information on securitization as a mode of finance, to explain securitization and to gain a broader understanding of the fundamentals of securitization process. It begins with an overview of the securitization, and then defines different types of structures in order to offer a basis for the analysis. The chapter then moves on to discuss the major risks which investors are exposed to. It outlines the major risks and shows their negative impact on securitization investment. This discussion paves the way for

an analysis the agency conflict which arises in investment, highlighting the influence of shifting the risks.

2.2 An Overview of Securitization

No uniform definition of securitization exists. Nevertheless, a number of commentators have endeavoured to provide a working definition. Mwoungang and Grosen (2003, p. 35) have broadly described asset securitization as 'the matching up of borrowers and savers wholly and partly by way of the financial market'. This broad definition covers all issuance of securities such as bonds, commercial papers[8], sales of mortgage backed and other asset-backed securities as they depend on financial intermediation to create loans through financial markets. Securitization links the sellers and buyers of capital more effectively than traditional methods of funding, including issuing shares of stock or bank lending (Lipson, 2012). On the other hand, Kothari (2006, p. 9) provides a more precise definition of securitization as 'the process by which homogeneous, but illiquid, assets are pooled and repackaged, with security interests representing claims to the pool sold as security to third-party investors'. This definition is limited to asset-backed securities; however, the more appropriate definition for securitization that is commonly cited is: '(1) a contract, transaction, or; (2) scheme whereby a person invests his or her money in a common enterprise with the expectation of profits; (3) solely from the efforts of the promoter's or any third party' (Deacon & Prendergast, 1979, p. 215). This definition includes any stock, note, security future, treasury stock, security based swap, debenture, bond, evidence of indebtedness, collateral-trust certificate, certificate of interest or participation in any profit-sharing agreement or generally any interest or instrument that is commonly considered to be a 'security' (Girasa, 2013, pp. 139-140).

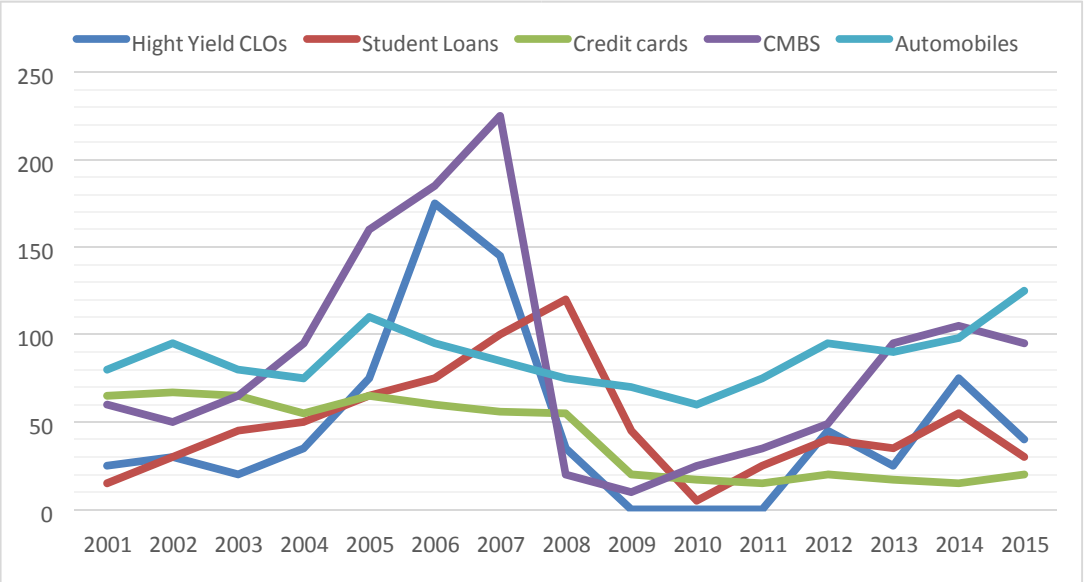
Over the last decades, the development of securitization markets has had several beneficial effects on capital markets. Securitization allows more participants, such as corporate and others, to be involved as a result of introducing a further class of debt instruments. This has deepened the market. In addition, securitization permits originators to

[8] Commercial paper is a short term unsecured promissory note that is issued via a high credit quality institution (Melicher & Norton, 2014, p. 33).

dispose of assets efficiently with a more beneficial funding profile and better financing terms. Securitization also allows investors to invest in assets that they otherwise would not have access to. Thus, securitization has contributed to the accessibility of highly rated securities to investors and has become a major effective tool for diversification for both originators and investors alike (IFC, 2004).

The market for new securitizations in 2015 decreased by 6% from 2014, to only $436 billion from $462 billion (Business Standard, 2016). In January 2016, US securitizations issuance also decreased by $2 billion from December 2015 (S&P, 2016). Figure 2-1 below demonstrates the experience of the main classes of assets in securitization from 2001 until the first half of 2015. Issuance of all these securitized assets increased dramatically between 2005 and 2007, decreased during the housing crisis, and then has recovered. Both high-yield collateralized loan obligations (CLOs) and automobile securities reached to a level higher than in 2001. Figure 2-1 shows how all classes of assets fell sharply after 2007. From 2001 to 2014, automobile securitizations rose by 14%, high-yield CLOs by 156%, CMBS by 58%, and for credit cards and student loans decreased by 23% and 5% respectively (Goodman, 2015).

Figure 2-1 Securitization of Non-mortgage Asset Classes, 2001-15 (billions of dollars)



Source: Securities Industry and Financial Markets Association and Urban Institute.

2.2.1 Bonds

Over the past 40 years, the Saudi government's issuance of debt instruments has been intermittent. For the first time, the government issued its own borrowing instrument (Government Development Bonds) in 1988. In 1991, the government started to issue Treasury bills in order to finance its fiscal deficit. However, the issuance of these debt securities was paused when the fiscal situation improved (Alhumaidah, et al., 2016). Recently, the two-year decrease in oil prices has left the country with huge budget deficits: $98 billion in 2015 and round $87 billion in 2016. Saudi Arabia has raised $17.5 billion through issuing global bonds in order to repair the damage caused by the collapse in the oil price since 2014 (Elaine & Kerr, 2016).

Bonds' issuers have a number of different types of collateral and structuring, which can be either unsecured, subordinated (junior) and senior securities. In secured senior bonds, bonds are backed by a legal claim on an identified property that belongs to the obligor in a default case (Reilly & Brown, 2006, p. 651). For instance, mortgage bonds are secured by tangible assets, and in the case of financial distress, the assets can be sold to fulfil the bondholders' obligations (Sundaresan, 2009, p. 8). However, junior debentures have a claim on the securitized assets and their cash flow is subordinated to other debentures (Reilly & Brown, 2006, p. 650). These bonds can be described as convertible bonds which mean that they can be converted into a more junior grade of securities in certain circumstances (Hirschey & Nofsinger, 2010, p. 483). Additionally, one of the most popular bond types is called zero coupon bonds, which are a discount bond that does not make any regular payment of interest (Bomfim, 2005, p. 305). The investors in a zero coupon bond realize interest by purchasing the bond considerably below its principal value. The interest will be paid at the date of maturity with the exact amount being the difference between the paid price and the principal value of the bonds (Fabozzi, 2004, p. 4). Therefore, instead of receiving periodic payments of interest, the bondholder obtains a single payment at maturity that equals the entire interest gained along with the principal amount (Hirschey & Nofsinger, 2010, pp. 465-466).

Debenture bonds, which are unsecured obligations, secure only the obligor's credit since they rely on the corporation's credit strength (Reilly & Brown, 2006, p. 651). As a

result of relying on a high credit company, these bonds are offered at a low rate of interest along with no particular pledge for the property involved (Melicher & Norton, 2014, p. 239). On the other hand, if these bonds are issued by companies that are not financially strong, this will be compensated for by higher interest rates (Qais, 2006). Although, fixed rate bonds are common, in some situations bond market participants prefer adjustable interest rates on a daily, monthly or annual basis. This allows the interest rate payment on a given bond to carefully track the interest rates in the market. The floating rates of bonds are changed periodically according to changes in an underlying interest rate standard (Hirschey & Nofsinger, 2010, p. 465).

Moreover, public bonds are a typically fixed obligation with a long-term debt securities package in affordable and convenient denominations for sale to financial institutions and individuals. They differ from other debt, such as privately placed debt obligations and individual mortgages, as they are sold to the public instead of channeled directly to a particular lender. The public debt market is mainly divided into three time segments depending on the issue's original maturity. The first segment is short-term, which is known as the money market, the intermediate segment is commonly known as (notes), and finally long-term obligations with maturities exceeding 10 years are called bonds (Reilly & Brown, 2006, p. 650).

In the bond market, there is a wide range of debt that can meet borrowers' desires in terms of the duration of issuance. Although it is common for bond securities to be mature over one year, a maturity of less than a year is considered to be a money market debt (Choudhry, 2001, p. 3). In general, bonds with a maturity of between one and five years are viewed as short-term bonds, while bonds with a maturity between 5 to 10 years are intermediate-term bonds, and long-term bonds have a maturity of more than 10 years (Hirschey & Nofsinger, 2010, p. 469). The importance of the period to maturity is because the yield on bonds is influenced by the duration of the issuance. Also, the volatility of a bond's price relies on its maturity, since a longer maturity results in a greater risk of price volatility which causes changes in market yields (Fabozzi, 2004, p. 4). However, involving a call feature in the structure can influence the bond's maturity (Sundaresan, 2009, p. 9). An embedded feature of a call option permits the obligor to modify the maturity of a bond, as it

serves the obligors to replace the current issue with a lower-interest cost issue in cases where the interest rates in the market decline. Due to this advantage, most loans are embedded with the right to call an obligation (Fabozzi, 2004, p. 5). Therefore, it can be seen that there are different approaches to bonds depending on the type of call. One extreme call option is a freely callable provision which allows the bonds to be retired by the obligor at any period, with the typical notification time being between 30 and 60 days. The other extreme is non-callable provision where bonds cannot be retired by the obligor before their maturity. An intermediate call option is the deferred call provision, when the obligor cannot call the bond for a specific time after the issue date, such as 5 to 10 years (Reilly & Brown, 2006, p. 651).

2.2.2 Asset-backed Securities (ABS)

There is no uniform definition of an ABS; however, different definitions are found in the literature (Klee & Butler, 2002). Shenker and Colletta (1991, p. 1374) defined asset securitization narrowly as 'the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets'. Meanwhile the broader view describes them as 'securities that are backed by a discrete pool of self-liquidating financial assets. Asset-backed securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into instruments that may be offered and sold in the capital markets' (SEC, 1999). According to this broad definition, ABSs have different asset classes which are attributed to collateralized debt obligations (CDO), mortgage backed securities (MBSs) and asset backed securities in its narrower sense (Vink & Thibeault, 2008). These asset classes have been sub-divided into further sub-asset classes which are CLOs, collateralized loan obligations (CBOs), commercial MBSs (CMBSs), residential MBSs (RMBSs), and other sorts of ABSs that are backed by a variety of different assets as shown below (Breidenbach, 2003). The universe of asset classes can be additionally expanded resulting from the innovation of new types of asset securitization in the market.

2.2.2.1 ABSs: Different Terminologies

For the purpose of more precise understanding, the differences between ABSs and other similar terminologies will be clarified. Firstly, the principal difference between ABSs and bonds relates to risk exposure. Investors in bonds are exposed to all risks related to the obligors' business, while in the case of ABSs, investors bear only risks related to the assets in the pool, not to the obligor's business. This is a beneficial feature for investing in ABSs since investors will be unaffected if the obligor becomes insolvent, which is not the situation with bonds. The only influence on the entire ABS process will be through the servicing agency if the obligor is the servicer, but this can be simply resolved by appointing another company to perform this role. In any situation, the cash will remain to flow to the ABS holders (Lapanan & Anchev, 2011, p. 16). What is important to highlight is that ABS holders are only exposed to the risks of the securitized assets, which include defaults on loans, prepayments, delays and some legal risks. This exposure to the assets' risks means that the ABS is to be claimed only on the securitized assets, but not on the entire originating company (Fabozzi & Kothari, 2008, p. 93).

Secured lending is asset-based lending (traditional asset lending), which means that the borrower specifies an asset as collateral for the lending arrangement. The specified asset can be long-term such as equipment or short-term such as receivable accounts (Fabozzi & Kothari, 2008, p. 25). The key difference is that asset securitization is sold or assigned to a third party that is a special-purpose company and can also be a trust (Giddy, 2000). Another distinguishing factor is that securitization has a lower borrowing cost than in secured lending. The lower cost in securitization is attributed to the transfer of the assets, resulting in a better quality of credit for the receivables than the originator's creditworthiness. Secured lending, by contrast, is based on the originator's own creditworthiness (Slaughter & May, 2010). In other words, the liabilities and asset can be separated from the originator's balance sheet through true sale in assets securities; whereas, in a secured financing, the originator maintains the assets on its own balance sheet plus the extra liability in an amount equal to the secured funding (Klee & Butler, 2002). Therefore, the securitization will incur a higher credit quality than in secured lending.

CDOs, MBSs and ABSs are classes of ABS in its general sense. Each one of the classes has a distinct structure in the capital market. The class of security is determined by what the securities are backed. For example, securitizations backed by debt obligations, pools of bonds or loans are called CDOs; whereas securitizations backed by consumer-backed assets are called ABSs. Finally, MBSs are securities backed by mortgages (Vink & Thibeault, 2008). It can be seen that the key dividing line between CDOs and MBSs is that the former are securitizations of unsecured loans whereas the latter are securitizations of secured loans. Unsecured loans function as security for the investors, while in secured loans there is additional collateral security for investors such as a mortgage (Breidenbach, 2003).

Although the majority of securitizations are designed for MBSs, there has been an increase in the number of real estate securitization (RES) transactions. Commonly, the RES concept is confused with mortgage-backed securitization. MBSs are securities originated by a bank which are backed by either residential or commercial mortgage loans. These securities involve payment claims against an SPV which are backed by secured loans that involve cash flows from real estate loans such as mortgages. Basically, MBSs are securities that represent derivative real estate cash flows (Breidenbach, 2003). RES refer to the securities that involve claims against the SPV which holds the real estate assets. This means that the cash flows from actual real estate are being securitized and not the cash flows from the real estate loans. Another distinguishing point, depending on the originator's type and the assets involved, is that MBSs are backed by real estate loans that are originated by banks, whereas RES represents securities that are originated by corporates or governments and that are backed by real estate cash flows or real property (Breidenbach, 2003). To summarize the differences, it can be seen that there are two categories of assets: receivable and non-receivable assets. CDOs and ABSs represent receivable or loan securitizations, and MBSs and RESs stand for real estate assets which are non-receivable.

2.3 The Structure of Asset Securitization

The structures of ABSs depend on the establishment of special purpose vehicle (SPVs). Establishing an SPV is done mainly for three purposes, firstly for converting non-standardized, illiquid and unique assets into marketable, liquid and standardized financial

assets. The second purpose is to lower the cost, as despite the fact that transferring assets to the SPV includes some expenditure such as taxes, the net income will be low as the investors will accept lower returns. Another purpose is to protect the originator from the claims of investors in the case of insolvency and to reduce the investors risk from originator's bankruptcy (Frankel, 1999). The basic process of cash flow in asset securities is as follows. The originator sells a portfolio of loans to the SPV. In order to purchase the portfolio of loans, the SPV raises funds by means of selling securitizations to investors. The borrowers are often unaware that their loans have been securitized because the originator continues to service the loans such as by collecting loan repayments and enforcing delinquent loans. The cash flow from the loan repayments is passed from the originator to the SPV. Then, the SPV utilizes the liquidity to pay ongoing costs such as trustee and management fees as well as meeting the debt-servicing obligations on the securities (principal and interest repayments) (Bailey, et al., 2004). To conclude, when all principals are paid and the securities have matured, the SPV will be extinguished and all remaining assets and income will be returned to the originator by extracting them from the SPV.

In structuring ABSs, there is an ultimate flexibility of priorities, maturities, and rates of return that can be conferred on the investors. For instance, asset securitizations are traded in different classes. Each class has a different priority on the cash flow from the assets such as in senior and subordinate tranches (Klee & Butler, 2002). Also, there may be single or multiple originators, such as multi-SPVs, and differences in the nature of the sale, the existence of the assets, tranche types and other structured features that affect the securitization and allow it to move to more sophisticated levels. These different structures are discussed and compared sections in the following.

2.3.1 One-off Securitization vs. Multi-seller Securitization

These two opposite structures rely on two different types of SPV. In one-off securities, the SPV is especially invented for a specific originator and more precisely for only a specific transaction, which is also known as a stand alone transaction (IFC, 2004). In this structure, significant flexibility is required to customize the securitization in order meet the investors' desires and needs. However, the cost of the transaction will be relatively higher as a minimum of stated capital is needed, commonly one to three per cent of the amount of

the security issued, in order to prevent the SPV from being the alter ego of the originator (Arnold, et al., 1992). One-off securitization is commonly structured for assets that are residential mortgages and the individual SPV is financed by issuing the security (Bailey, et al., 2004). Also, in most cases, one-off securitization is utilized in private placements when the investors are institutional, in order to design an SPV that suits their conditions and requirements (Wang, 2004, p. 20). Depending on the creativity of the experts involved, there is an abundance of ways to structure the one-off securitization as each structure of the security represents a specific transaction (Schwarcz, 1994).

Moving to the opposite structure, multi-seller securitization is also known as a conduit transaction (IFC, 2004). Multi-seller securitization is when more than one originator is utilizing a specific SPV. As a result, the conduit SPV holds a broader range of assets that includes both asset-backed and non-asset-backed securities as well as individual loans (Bailey, et al., 2004). Most pre-existing SPVs are administered and sponsored by main investment banks or commercial banks and the seller commonly is a client of such a bank (Dorris & Panayotou, 2004). Allowing multiple originators to employ a pre-existing SPV will minimize the cost of the transaction as only a nominal amount of capital is required because the multitude of originators reduces the risk of the SPV being an alter ego of any single originator (Schwarcz, 1994). However, the exposure to bankruptcy claims is higher when a single originator is bankrupted (Gurulkan, 2010). The prospective risk caused by the originator's insolvency can often be mitigated by accommodating only investment-grade originators as they are less likely to become bankrupted (Wang, 2004, p. 20). The distinction discussed above between one-off securitization and multi-seller securitization cannot be decisive in all cases; however, case by case analysis of cost arbitrage, incentives and motivations can provide conclusions as to whether one-off securitization and multi-seller securitization is a more adequate description of particular originator (Schwarcz, 1994).

2.3.2 Multi-seller Securitization vs. Multi-tier Securitization

Having more than one originator in asset securities is called multi-seller securitization, as previously discussed. A multi-tier securitization is when the asset securities have more than one SPV, which is considered to be a means of reducing the role associated with bankruptcy risk (Telpner, 2003). In a multi-tier securitization, the originator transfers

the pool of assets to the first-tier SPV through a true sale. Then, the first-tier SPV sells the assets to the second-tier SPV who will then issue the securities or debt instruments. Although both means of transfer can proceed by means of a true sale in order to avoid the risk of the originator's bankruptcy, it is not essential for the second transfer to be a true sale. The bankruptcy remoteness is fulfilled by the first transfer; however, the second transfer can be for accounting reasons. Also, the second transfer allows the first-tier SPV to offer internal credit enhancement to investors at the second tier SPV level (Klee & Butler, 2002).

2.3.3 True Sale Securitization vs. Synthetic Securitization

A true sale securitization has a variety of meninges that depends on each applicable legal area, such as bankruptcy, accounting and tax. It basically means that the transfer of assets from an obligor to an SPV proceeds through a sale according to each applicable law (Wang, 2004, p. 21). Essentially, there are two requirements for a true sale. Firstly, the SPV has to be a qualified SPV, and secondly, the sponsor is obliged to surrender control of the assets. This means that the sponsor cannot maintain efficient control over the transferred receivables through the power to unilaterally cause the SPV to return certain assets, and there is a demonstrable separation between the asset and the transferor (Gorton & Souleles, 2007). The true insulation between pooled assets and the originator enables both parties to achieve the main benefits of securitization. One of the benefits of true sale securitization is that the assets and liabilities, as discussed, will be removed from the originator's balance sheets (Klee & Butler, 2002). The true sale permits the originator to be financed through better terms than would be the case with an on-balance sheet loan. It helps originators to securitize assets that cannot meet their credit qualities. Thus, originators who do not have their own capital market rating can be financed through true sale securitization (IFC, 2004).

Synthetic securitization is comparable to true sale securitization in most structural features. The major difference is that the originator, in synthetic structures does not transfer the pool of assets entirely to the SPV. Instead it sells only the credit risk associated with the assets without substituting the legal title. In other words, the originator will engage in a credit default swap with the SPV relating to the pool of assets (Franke, et al., 2012). Through this engagement, the SPV will be obligated to the originator to pay an amount equivalent to any credit losses related to the assets. Therefore, the originator's exposure to the assets is moved

to the SPV. In turn, the originator will pay a fixed amount to the SPV whereas the SPV will issue securities to the investors. The SPV's revenue will be the amounts paid by the originator through the credit default swap as well as the interest received on the collateral (IFC, 2004). The benefit of synthetic securitization is that the SPV can exploit price differences between the price of the acquired assets and the price that investors desire to pay for them (Jobst, et al., 2008). In addition, synthetic securities function generally as an effective means to hedge credit risks (Wang, 2004, p. 24). Also, a synthetic sale securitization is an on balance sheet financing instrument, whereas a true sale securitization is an off-balance sheet financing tool, and in addition the SPV is necessary in the true sale securitization while it is not necessary in the synthetic sale securities. In fact, the more access that the originator has to the underlying assets, the less likely it is that the structure will be a true sale (Schwarcz, 1994). In this case, if a structure of asset securities is based on a cash flow that does not include a true sale, then it is secured lending and the holders of these securities issued through the SPV would have only a security interest without ownership (Iacobucci & Winter, 2005).

2.3.4 Future Flow Securitization vs. Existing Assets Securitization

According to the collateral of assets, structures can fall into two categories: existing assets and future assets. Instances of existing assets are commercial mortgage loans, residential mortgage loans, automobile car loans, student loans and corporate loans. By contrast, securities of future assets can be exemplified by tax revenue receivables, oil and gas royalties and airline receivables (Fabozzi & Kothari, 2008, p. 8). The differences between these structures are mainly attributed to the availability of the assets. In addition, there is an existing claim to the value in an existing asset securitization, whereas there is no existing claim or contractual right to a cash flow in future flow securitization since contractual rights will be generated in the future. Moreover, while the off-balance sheet feature is common in the existing asset securitizations, usually there is no off-balance sheet transaction in the case of future flow. This is reasonable, because there are no on-balance sheet assets that would go off. Finally, from a taxation and legal viewpoint, future flows are considered to be closer to debt than the selling of an asset and this has a relatively higher risk ranking (Fabozzi & Kothari, 2008, p. 150).

2.3.5 Pass-through vs. Pay-through

Securitizations are certificates that can be divided into pay-through certificates and pass-through certificates depending on the type of payments (Wang, 2004, p. 19). The key distinction between these two certificates refers to the nature of the claim that the certificate holders have on the cash flows from the asset pools. A pass-through certificate, which is also called a beneficial interest certificate, is utilized when investors have a direct claim on the entire cash flow as well as having a proportionate share of the collateral's cash flow. Conversely, securities will use pay-through certificates if there are some rules that are stated to distribute the collateral's cash flow between varying bond classes (Fabozzi & Kothari, 2008, p. 30). Strictly speaking, a pass-through certificate refers to the ownership of interest in the underlying assets and therefore in the subsequent cash flow. This means that the principal and the interest are passed through to the investors while the seller is mainly a servicer. However, in pay-through security, the assets are retained via an SPV which issues securities that are collateralized by assets. Also, in pay-through, similarly to pass-through, the cash flow meets the debt service which is paid through to the certificate holders out of the pledged collateral. The certificate holders are not the collateral owner of the pooled assets, as they have basically invested in a security that is backed by various assets (IFC, 2004). Overall, when there is only one class of investors with the same level of credit priority, the structure is called a pass-through, and subsequently the pay-through structure is when there is more than one class of investors at given levels of credit priority (Fabozzi & Kothari, 2008, p. 255).

The above discussion confirms that the flexibility, cost and also benefits can vary depending on the structure of a certificate (Schwarcz, 1994). In securitization, each issuance has its own distinct features as there are various forms of assets transfer, SPV, credit enhancement, cash flow allocation, and cash flow transformation. To decide which structure is more suitable for issuing a particular securitization, a number of features can be used to guide one towards the proper decision. The right market existence, investor preference, asset availability, obligor's design and amount of cash flow have roles in building a security. However, the main influence is the flexibility of the legal framework that the security will

be originated through. This has to be considered in structuring securities, since obligors and investors' choices are often constrained by regulations (Giddy, 2000).

2.4 Major Risks in Securitization

Securitization is typically designed to shift risks from the banking sector to outsider investors (Acharya, et al., 2013). In securitization, there is a lower risk in comparison with shared investment, and hence regularly a lower payment over a longer term. Generally, some securitizations are safer than others; for instance, the government bonds are considered to be guaranteed investments since the final repayment is virtually definite (Choudhry, 2001, p. 4). However, these securities are not free from risks since, at times, mortgage-backed securities suffer from sharp drops in value in the United States. This has occurred because of interest rate movements that result in large postponements and accelerations of payments (Giddy, 2000). Therefore, one of the main challenges is to carefully identify risks and then reallocate them to those who are the most able to efficiently bear them.

Basel II report, which analysed a bottom-up assessment the risks of financial organisations, stressed holding capital for three principal risks: credit risk, market risk, and operational risk. Although, the liquidity risk was acknowledged, there was no explicit dealing in 'Pillar1' of the Basel II framework, and also received less attention in other parts of the framework (Rosengren, 2009). Recently, the Basel Committee has revised and expanded its examination of sound practices for managing liquidity risk by both banking institutions and their supervisors (BCBS, 2015). The following section discusses the principal risks that have been emphasized by the Basel Committee[9].

2.4.1 Credit Risk

Basel I simply defined the credit risk as 'the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms (BCBS, 2002). Credit risk is found in all activities where success depends upon the performance of a counterparty,

[9] 'The Basel 2 and Basel 2.5 proposals have been implemented in many developed countries (with some variations in detail), while the proposals of Basel 3 are still being debated and refined)' (McNeil, et al., 2015, p. 20).

issuer, or borrower as there is uncertainty in any counterparty's capability to fulfill all of its obligations. From the investor's perspective, the credit risk is the possibility of the issuer defaulting on fulfilling the terms related to the timely payment of interest plus the payment of the amount borrowed (Hirschey & Nofsinger, 2010, p. 108). As the credit rating is the current assessment of the credit risk of securities, market participants measure this risk by looking at their credit rating assigned by a rating agency[10] (Reilly & Brown, 2006, p. 656). These agencies examine and study the quality of the securitized assets, as the SPV is typically designed to only hold the securitized assets. They also examine the cash flow from these assets because it is important to consider any default by the borrowers such as the car owners in the case of automobile securitization (Giddy, 2000). From the obligors' perspective, the principal benefit of securitization is its advantage in managing credit risk exposure. The securitization process minimizes their exposure to the credit of the securitized assets by shifting the unexpected portions of the default risk to investors and credit enhancers.

Raising the credit rating of the issuance through credit enhancement minimizes the credit risk for investors. SPVs have to maintain sufficient cash flows to pay due obligations even without receiving the predicted revenues (Slaughter & May, 2010). In this regard, the obligor often functions as a credit enhancement provider and thus retains exposure to the credit risk. As the first loss exposure is incurred by the credit enhancer, this can mitigate possible adverse selection and the incentives can be managed to ensure the adequate performance of the pooled assets (FDIC, 2007, p. 83). Also, originators are exposed to the credit risk from the securitized asset pools caused by their reputation. For example, poor credit performance and quality can limit the obligor's future access to the asset securitization market, impacting the pricing of subsequent issues or affecting funding costs from other sources. Hence, adding to the credit risk available in on-book residual interests, the obligor also maintains a further degree of credit risk referred to as moral recourse. Obligors are compelled to absorb more of the loss or offer more credit enhancements than is contractually obligatory according to the securitization documents in order to maintain their reputation in

[10] Bond ratings assess both the collateral underlying the bonds along with the issuer's ability to produce timely payments of principal and interest (Melicher & Norton, 2014, p. 237).

the markets and, therefore, access to market funds. Managing this risk is critical because it influences the issue's ability to access and maintain the source of funds. Poor performance and quality of the underlying receivables can, as mentioned, limit the source of funding and, in a worst case scenario, can result in an early amortization incident and possibly a liquidity crisis that can threaten the obligor's viability (FDIC, 2007, p. 83). Therefore, originators should now have a high awareness of the requirement to identify, control, measure and monitor credit risk as well as to decide that they hold sufficient capital against these risks and that they are sufficiently rewarded for any risks incurred.

The Basel Committee encourages banking supervisors internationally to improve sound practices for managing credit risk. However, although the Committee's principles are most appropriate for the lending business, they should be useful to all exercises where credit risk exists (Glantz, 2002). The sound practices specifically address the following areas: (i) establishing a suitable credit risk environment; (ii) practicing under a sound credit-granting method; (iii) maintaining suitable credit administration, monitoring and measurement mechanisms; and (iv) ensuring appropriate controls over credit risk (BCBS, 2000). Thus, as obligors effectively absorb a considerable amount of losses in most securitized pools, the credit risk becomes shared between investors and originators. However, this risk over time can become less transparent due to the fact that delinquency risk rises and economic circumstances change which leads to more retention of the credit risk by the originator (Calomiris & Mason, 2003).

2.4.2 Market Risk

Market risk refers to fluctuations in the value of securities as a result of adverse movements in market prices (Madura, 2008, p. 355). In the securitization market, risk mainly stems from the negative effects of exchange rates and movements of interest rates on the investor's cash flow. The interest rate risk is defined by Basel as the exposure to adverse movements in interest rates which affects the value of bonds more directly than stocks (BCBS, 2015). The bond's price will change in an opposite direction from the change in interest rates. This means that if interest rates increase, the price of a bond will fall and vice versa (Hirt, et al., 2003, p. 72). Also, in the case that an investor has to sell a bond before the

maturity date, a raise in interest rates means the realization of capital loss such as by selling the bond below the buying price (Fabozzi, 2004, p. 9). Maturity can also influence the interest rate risk, as the longer the securities take to mature, the greater the risk that their value can be affected by changes in interest rates prior to maturity. Thus, to compensate investors in long-term bonds for higher exposure to interest rate risk, issuances typically offer higher coupon rates than with short-term securities of equal credit quality (SEC, 2008).

A decrease in interest rates usually causes a prepayment risk[11] for the certificates. If the borrowers pre-pay because they can re-finance at inferior cost, this basically leads to forcing investors to re-invest at a lower rate. For this reason, prepayment risk commonly involves interest rate risk. From the investor's viewpoint, there are three drawbacks to this situation. The first is the uncertainty of a callable bond's cash flow pattern. Secondly, since the obligor calls the bonds once the interest rates have declined, the investor will have to re-invest the income at a relatively inferior interest rate if the bond is called. Finally, the capital appreciation of a bond will drop, since the callable bond's price may not increase much above the price at which the obligor will call the bond. Due to this relationship, it is principally important to consider the interest rate risk if bonds are purchased in a low-interest rate environment (Fabozzi, 2004, p. 9). Also, it is well known from the theory of the term structure of interest rates that the exposure to this risk by an individual is minimized to zero when the maturity structure of their assets has met the time structure of his payment requirements. In this situation, there is no need for either premature liquidations or reinvestments, and thus neither valuation risks nor reinvestment risks play a role. However, such a maturity matching supposes that the time structure of payment requirements is identified initially (Hellwig, 1994).

In addition, asset securitization can be used as a means to considerably minimize any interest rate risk associated with an asset/liability gap on the part of the originator (Federal Reserve System, 1990). The risk of the interest rate is by far the major risk to all bondholders, even if the bonds are insured or government guaranteed. However, no concern seems to be given to the possibility of transferring interest rate risk to investors through securitization.

[11] Prepayment risk refers to the possibility of the issuer redeeming a callable bond prior to maturity (Fabozzi, 2004, p. 9).

This is more significant, because shifting interest rate risk to the investors would represent the only option for transferring this risk without at the same time generating a possible credit risk associated with the interest rate risk (Hellwig, 1994).

Market risk also includes currency risk, which is also known as an exchange risk. Recently, the swings in global currencies have highlighted the risk associated with exchange rates (Goedhart, et al., 2015). This arises when the currency of denomination of the security is different from the investor's local currency. If securities are denominated in foreign currencies, the possibility of the currency to depreciate might have an adverse effect on the investments and also on the related return (Fabozzi & Kothari, 2008, p. 82). Thus, it becomes important to measure the compensation that investors can expect from bearing such risk. However, a number of academic researchers in currency risk advocate that investors bearing currency risk are not rewarded with higher returns which means that it is principally an unnecessary risk to bear and that investors can reduce currency risk by using hedges and other techniques designed to offset any currency-related gains or losses (Investopedia, 2008).

2.4.3 Liquidity Risk

Securitization includes bundling illiquid asset assets in an attempt to generate a more liquid asset that can be traded in the market. Liquidity refers to the degree to which the assets can be sold without affecting their price; hence, the risk of liquidity is related to potential price distortions caused by the lack of liquidity (Madura, 2008). This may arise from the obligor's failures to manage unplanned situations in funding sources that may threaten its viability, or in fulfilling its obligations without suffering major loses (FDIC, 2007). Consequently, and from the obligor perspective, the securitization process increases the originator's liquidity position by minimizing its position in illiquid assets and improves its position in more liquid assets (Investopedia, 2008). Liquidity risk is an economically essential determinant of expected securitization returns. Low interest in a specific issuance can result in significant price volatility and have an adverse impact on the investor's total return (upon sale). In their empirical study, Lin, et al. (2011) found a positive and significant link between liquidity risk and expected securities returns even after controlling for the

influence of default and term betas, market risk factors, stock, the level of liquidity, ratings and bond characteristics.

For liquidity risk, sufficient risk management considers the future cash flow requirements in both stressed and normal situations. This represents a challenge even in relatively positive market situations since it needs the ability to analyse information from several operations of the bank and evaluate the influence of external incidents on the availability of funding liquidity. This challenge is more acute; however, in stressed situations as the assumptions underlying liquidity risk can change markedly during changes in market conditions and counterparty behaviour that influence the liquidity of financial tools and the availability of funding. These factors result in a significant and different set of challenges for institutions in evaluating their liquidity risk and for supervisors in the assessment of risk control and management (BCBS, 2008). For liquidity, the Basel Committee offered two new universal quantitative measures to manage the liquidity risk in December 2009: a (stressed) 1-month liquidity coverage ratio (LCR) and a structural (> 1year) net stable funding ratio. The first ratio is to protect banks against short-term liquidity shocks (liquidity reserve). The second minimizes the re-financing risk and the maturity transformation in funding. The risk associated liquidity can be segmented into two categories: funding liquidity risk and market liquidity risk. The funding risk is the principal concern of the obligor to maintain a sufficient cash flow to meet all liabilities. A typical indicator of this liquidity risk is the current ratio (current liabilities/current assets) (Neu & Vogt, 2010).

2.4.4 Operational Risk

Although the definitions of credit risk and market risk are relatively concise, the definition of operational risk, has developed rapidly over the past few years. Initially, it was defined as every type of unquantifiable risk confronted by the obligor (Lopez, 2002). However, further changes have refined the definition significantly, and then finally the Basel Committee and industry representatives have approved a standardized definition that is ‘the risk of monetary losses resulting from inadequate or failed internal processes, people, and systems or from external events’ (BCBS, 2001). In general, losses from external incidents, such as a natural disaster that harms the company’s physical assets or telecommunications, or electrical failures that interrupt business, are relatively simple to define compared to losses

from internal events such as product flaws and employee fraud. Thus, originators should be more firm with internal risks than external incidents because risks from internal issues will be closely associated with an obligor's business lines and specific products (King, 2010). The Basel definition[12] depends on the categorization of operational risks based on underlying causes. It can also be categorized, based on the standard definition, into two fundamental types: (i) the risk of a loss because of the firm's operating system/technology, including failure in transactions and internal processes, either because of an error in the production (or back office) process or because of the legal concerns; and (ii) the risk of a loss because of agency costs, including mismanagement and fraud due to the segregation between the ownership and management. These two categories rely on two different economic considerations, as one depends on the production, process, trading, system generating revenues, and the other is based on managerial incentives (Jobst, 2005). In general, the operational risk is intrinsic to financial firms, and hence should be a significant component of their risk management systems. Although operational risk is harder to demonstrate and quantify than credit and market risks, improvements over the recent few years in computing technology and management information systems have unlocked the way for an improved operational risk management and measurement. Over the next few years, financial firms and their regulators will develop methods for managing operational risk and capital budgeting (Lopez, 2002).

Legal risk, as previously mentioned, is involved in the standardized framework of operational risk according to the Basel committee's point of view. In securitization, it is challenging to develop a watertight legal security structure. The challenge becomes more serious in developing countries where the legal structure is still evolving. Different countries have adopted different securitization laws. These laws and their content differ, since each has been specially formed to overcome legal obstacles that had formerly prevented us of the securitization in the relevant jurisdictions (IFC, 2004). For example, most countries have unique bankruptcy laws and, particularly in Europe, it is difficult to design securities that satisfy all of their bankruptcy laws. These particular bankruptcy laws make it difficult for

[12] Their definition involves legal risk and excludes reputational and strategic risk.

institutions to achieve off-balance sheet treatment. These transactions become very difficult, especially for the originator who desires to conduct an off-balance sheet transaction but does not want to sacrifice the advantages of the portfolio as well (Breidenbach, 2003).

2.5 Securitization and Agency issues

Securitization accentuates agency problems due to the separation of ownership and management. Discussing the agency conflicts in the process of securitization will help to fill a gap found in the literature related to the agency conflicts in *sukuk* structures. It arises when the obligor and investors have different interests with asymmetrical information that is in favour of the obligor. The obligor, as an agent, is usually motivated to act in their particular interests rather than in the interests of the investors. Also, agency conflict arises when these two parties have different attitudes towards risks due to the differences in risk tolerance. Consequently, investors cannot ensure that the originator will always act in their best interests. Adding to this, the securitization market is seen as an opaque and also a conservative market. It does not disclose substantial amounts of information to the public (Lapanan & Anchev, 2011, p. 5). This is because most financial loan files consist of a considerable amount of non-public and confidential information (Dugan, 1997, p. 42). Furthermore, the asymmetry does not only exist between the managers and outsider or insider investors; it also exists between different classes of outsider investors. Moreover, the asymmetry is not only concerned with the returns and revenues on the general assets of the institution, but it also exists in the securitized assets (Iacobucci & Winter, 2001, p. 42). These different dimensions of informational asymmetry are the main causes of this problem in the securitization market. Although banks desire to honour the conservative nature of the markets, they are also obligated to reveal all the substantial information that a potential investor has to know (Dugan, 1997, p. 42).

Thus, the major impediment for transferring the risk of default is the asymmetric information which exists in the securitization process (Franke, et al., 2012, p. 1125). Originators typically have better information about the assets or loans that are being utilized as collateral for the securities issued compared to investors both ex-post and exante. They receive more information, they are often superior at analysing it and they are better at dealing

with defaults. Taking into account that banks, as originators, are far superior at bearing and assessing risks, it makes no economic sense to shift or transfer those possible risks to other parties using ABSs or other instruments. As this is the case, bankers, who directly transfer and pass on their loans to other parties, are no longer motivated to properly investigate the original borrowers (Bui, et al., 2010, p. 316). The existence of asymmetric information gives the originator the incentive to transfer lower quality loans and to preserve the best, thus resulting in an adverse selection. However, others have claimed that originators have incentives to securitize high-quality assets and keep low-quality assets. For instance, Haensel and Krahnen (2007) argue that, if the securitized assets are replaced with less highly correlated assets, then the originator's equity beta is assumed to decrease. Meanwhile, if securitized assets are replaced with a highly diversified asset portfolio, the association with the market portfolio is assumed to increase and the equity betas will approach market betas. Similarly, Lemmon et al. (2010) argue that if institutions securitize their high-quality assets and retain low-quality assets, the total institutional risk should rise, therefore increasing the cost of capital.

Despite these arguments, evidence has been found by Carey (1998) that the default rates on the loans retained by the originator are noticeably lower than the default rates on the loans transferred to outsider investors. More importantly, studies by Mian and Sufi (2009), Dell'Ariccia, et al. (2009) and Keys, et al. (2010) have found that, during the last few years, American banks securitized their lowest quality mortgage loans. Also, prior to the financial crisis, more than half of the securities rated by Moody's received a rating of AAA, which is the maximum possible rating and thus are considered to be extremely low risk. During the crisis, the creditworthiness of the asset securitization depreciated dramatically. Around 40,000 of Moody's-rated tranches were reduced, and nearly one-third of the reduced tranches had been rated with AAA (Agarwal, et al., 2010). The ensuing confusion on the actual value and risk of securitization and the level of the institutions' exposure fuelled extra market uncertainty and additionally minimized the availability of credit. If this adverse is selection combined with an inefficient allocation of risk, it is difficult to understand the reasoning of purchasing ABSs at a price that satisfies the originator. This can be attributed to the rating agencies' justification for the quality of the assets. The agency rating remained as an attractive feature of the issuance, despite all suspicion (Bui, et al., 2010, p. 324).

Now, this raises the question of conflicts of interest between the originator and the rating agencies. Most of these agencies are financed by the originators of the instruments they rate and hence the agencies are financially dependent on the originator. This conflict of interest between the rating agencies and the obligor is known as 'rating shopping', since the obligor is seeking the best rating even though these agencies may not offer a fair rating on the securities. During the financial crises, the delayed reaction from the rating agencies, despite great numbers of investors withdrawing from the market, confirmed their unrealistic ratings (Makrevska, 2013). However, investors typically cannot perform precise due diligence because of the limited information available, and thus investors would blindly rely on the ratings provided by these agencies without any attempt to confirm if the price of these securities is fair (Akseli, 2011, p. 12). Investors ignored the fact that these agencies are financed by the originators and also that the agencies have a bias in favour of a rating that is better than the actual risk level (Deventer, 2008, p. 4).

The originator's effort level, before and after the issuing date, is not an incentive compatible with investors' interests. As discussed, after shifting the credit risk, the originator will no longer be motivated to ensure that borrowers will fulfill their loans, which results in an ex-post moral hazard. Also, issuers usually commit additional moral hazard by adding lower quality to the underlying portfolio than the credit quality of the overall underlying portfolio, resulting in ex-ante moral hazard. Hence, sensible investors are misled by the obligors regarding the true value of the credit quality since obligors are at an informational advantage when and after assessing such securities (Jobst, 2002). In addition, a further moral hazard of securitization highlighted by Alles (2001) is that the originators have no motivation to monitor the securitized loans. Originators offer loans to investors and one of their primary obligations is to effectively monitor the performance of those securitized loans. This is because monitoring the borrowers and the loans, after the loan is approved, minimizes the problem of moral hazard, where borrowers might take excessive risks with the borrowed amount**.** Securitization has reduced the incentive to monitor the loans because monitoring is expensive and the cash flows from the securitized loans go to the investors and not the originator (Lapanan & Anchev, 2011, p. 24). Thus, ABSs can be described as products that offer perverse motivation to banks, minimize the value of loans, and transfer risks to parties

that cannot assess, evaluate and deal safely and competently with them as banks do. Therefore, Bui, et al. (2010, p. 323) make the obligors of securitization comparable to a used-car dealer. Since the dealer knows the car's problems, but almost never informs the potential customers of them, thus, potential used car buyers often become suspicious; whereas, the customers in securitization usually do not have this reaction and mostly feel satisfied without any suspicion of wrong-doing.

In this situation of conflicts when selling high quality assets, if the market cannot efficiently separate the low-quality assets from the others, the obligor will bear an adverse selection premium since investors will demand a discount on the price of ABS in return for the ambiguity about the true value of the securitized asset (Akerlof, 1970). Thus, rational investors will form negative beliefs on the true quality of the securitized assets, and assumed the adverse selection of the securitized debt turn the investment comparable to the lemons market problem. The expected value of private information about the true value of securitized assets places a lemons premium on the originator. Because investors will suppose that most securitization includes poor quality assets, they ask for a reservation utility in the form of an inferior selling price or a higher rate of return as a compensation for the expected investment risk of adverse selection (Jobst, 2005). Wolfe (2000) also illustrates how asset securitization can minimize information asymmetry and reduce Akerlof's 'lemon' problem. He argues that originators have an informational advantage over security holders regarding the creditworthiness of the borrowers which may result in investors' lack of interest. Because of this, originators have to offer credit enhancements or other forms of guarantee to the investors in order to obtain a fair price for the securitized assets; otherwise the dominant price would be the one of a 'lemon'.

Given the significant agency problem arising from both the moral hazard and adverse selection, originators install credit enhancement mechanisms which allow the incentive to be more compatible with the interest of investors and to mitigate risks arising from asymmetric information. The detrimental effects of agency conflicts are typically mitigated by a subordinate structure. Originators will securitize a considerable amount of senior tranches to outside investors, while they retain the junior tranche in order to indicate the quality of the asset and to bear the expected loss. According to conventional wisdom, the

obligor should preserve the first loss position[13] (FLP), since it is the most information-sensitive tranche, and distribute the information-insensitive senior tranches to the investors (Franke, et al., 2012). The design involves risk-sharing by loss-cascading and the loss coverage is termed FLP, which principally guards against agency conflict. Originators should maintain the FLP since it is the most information-sensitive tranche and offer the information-insensitive senior tranches. Essentially, FLP is a credit enhancement that represents a mechanism against ex-ante moral hazard in order to restore incentive compatibility between investors and originators. This credit enhancement is the most important mechanism to mitigate conflicts due to information asymmetry and to obtain better incentives for the issuance (Franke, et al., 2012). As investors only bear default losses beyond the FLP, a higher FLP means greater protection provided to investors against default losses and, hence, against issues of information asymmetries. In turn, the obligor need not maintain the FLP, but might sell some or all of it to third parties (Franke, et al., 2007).

Adding to the FLP mechanism, obligors may also commit some other external and internal resources to their securities as a costly signal to prove the quality of the asset. Credit enhancement mechanisms can be broadly classified as internal and external mechanisms. An instance of internal credit enhancement is overcollateralization, whereby the value of the assets transferred to the SPV is greater than the amount of securities that are issued by the SPV (Choudhry & Fabozzi, 2003). Overcollateralization differs from cash collateral as the latter results in collateral in cash whereas overcollateralization results in collateral in kind (Fabozzi & Kothari, 2008, p. 89). Another common form of internal credit enhancement is excess spread, when the cash flow is above the amount required for the discharge ofthe securities' payment obligations (Choudhry, 2001, p. 472). In the case of not utilizing the excess spread method, the surplus income will be either released to the originator or placed in a reserve account (Dugan 1997, p.27). Overall, this method is mainly the first defense against losses because the excess spread is the most natural method of credit support as well as being the least burdensome to the originator (Fabozzi & Kothari, 2008, p. 86). Commonly, the reserve account used to support the credit as a segregated bank account, for the SPV's benefit, and is also known as a cash collateral account. The originator can place a specific

[13] This means a security's position that will suffer the first economic loss and carries a higher risk.

amount of cash in this reserve account in order to absorb credit losses (Choudhry, 2001, p. 472).

External credit enhancement mechanisms involve credit insurance, surety bonds, and letters of credit from financial organisations. Bond insurance used to be the main form of external credit enhancement and refers to the buying of a guarantee from a special financial guarantee corporation (Giddy, 2000). However, in recent times, and particularly after the crisis, this is rarely involved in securities. This is because mono-line insurers have been strictly influenced by the financial crisis along with other insurers of other sources that are not eligible (Slaughter & May, 2010). Another form of external support is the letter of credit, which is a payment method where the buyer, who is the obligor relating to the receivables, along with the seller makes an agreement with a financial institution. In the agreement, the institution pledges to pay the purchased price to the seller, and thereafter the institution withdraws the amount paid from the buyer in order to ensure receiving the payment by the originator (seller) (Slaughter & May, 2010). In recent years, this method of credit has proven to be less popular, especially after a number of issuances which were downgraded resulting in a downgrading of assets that they had afforded letters of credit against (Choudhry, 2001, p. 472). Moreover, the letter of credit has become a more costly method since it is obtained from top-rated banks, although the number of such banks has decreased (Fabozzi & Kothari, 2008, p. 93) It is vital to note that the third party credit enhancement, which includes bond insurance, letter of credit and guarantees to related parties such as the originator, is exposed to third party credit risk and also has the highest costs among other credit enhancements (Fabozzi & Kothari, 2008, p. 91). Hence, when the rating of the third party guarantor declines, the security's rating will be declined even if the collateral is functioning as planned (Fabozzi, 2004, p. 233).

Securitization with credit enhancements may be a means of avoiding a 'lemons market' problem. Securitization typically involves various methods of credit enhancement to protect investors against two main forms of risks; the risk of adverse selection and the risk of moral hazard. Therefore, it is expected that securitization with adequate credit enhancement will implicitly show a risk sharing agreement between obligors and investors. The implicit risk sharing mechanism of these support methods is of critical importance in

showing how obligors signal their ability to absorb default risk through the trenching and loss allocation of the transaction without affecting the repayment promised to investors (Jobst, 2005).

2.6 Summary

The chapter has highlighted that there is no uniform definition for securitization or ABS. However, several definitions have been provided which allow a clearer and/or broader understanding of the terms. In practice, securitization is the process of taking illiquid assets and transforming them into a liquid security. This process has advantages for both the originator and investors. It allows more investors to participate by offering further classes of debt and more flexible financial instruments. Also, it allows originators to dispose of their illiquid assets and to allow some small firms to offer asset securitization. Thus, securitization has broadened the value of both originators and investors. Despite this, securitization is considered to be one of the most significant financing products, and the value of these instruments, as a means of finance has changed particularly after the financial crisis. Issuance of all classes of assets increased dramatically between 2003 and 2007, followed by a shape drop, leaving the market having learned some hard financial lessons.

In this regard, the chapter has addressed the downside of securitization related to major risks and agency problems. Securitization is naturally designed to shift risks rather than to share them. The major risks that have been transferred to the investors, according to Basel, are credit risk, market risk, operational risk and liquidity risk. The only possible way for investors to measure risks incurred in securitization investment is by the credit rating. In spite of all suspicions raised on these mechanisms after the financial crisis, this method is still the optimal way to understand the risks related to particular issuances. Securitization, on the other hand, has benefitted the obligors by reducing their exposure to credit risk, raising liquidity, shifting market risks to other parties and minimizing the operational risks related to the securitized assets. Thus, from the originators' perspective, the principal advantage of securitization is its means to shift a bundle of major risks. Nevertheless, the securitization developed obliges the obligors to retain some degree of these major risks by sharing them through FLP. One positive aspect of FLP for investors is that originators also retain their

monitoring incentives and information asymmetries are minimized. Through FLP, originators must continue to monitor and control the performance of the assets in the pool at the same level as prior to the issuance. This chapter also examines agency issues and concludes that the agency costs inherited in the structure of securitization due to the separation between ownership and management result in a number of types of adverse selection and moral hazards. Credit enhancements can significantly reduce the investors' exposure to agency risks. The greater mechanisms used of credit enhancements, the lower the exposure to these conflicts. Therefore, asset securitization brings some feature of risk sharing and allows funding for a less risky product through the capital market.

Chapter 3: The Basis in Islamic Jurisprudence of Asset-backed *Sukuk*

3.1 Introduction

Saudi Arabia is the second largest Islamic finance market with assets valued at $338 billion. Saudi Arabia has the biggest penetration of Islamic finance against conventional finance globally, with 53% of its population having exposure to Islamic funding. The Saudi government strongly considers that the role of Islamic finance is inevitable in offering the essential resources for multilateral banks to achieve the objectives of sustainable growth and development (Jeddah Chamber, 2015). In fact, the key principles of Islamic finance are universal and simple. The detailed implementation of these principles requires knowledge of Islamic jurisprudence.

Sukuk as Islamic securities mean conducting a structure in consonance with Islamic jurisprudence. *Sukuk* are securities that comply with Islamic commercial jurisprudence and its investment principles. They need to be Sharia compliant and pronounced by eminent Sharia scholars. In this respect, the chapter provides a jurisprudential examination of asset-backed *sukuk*. It starts with a discussion defining and analysing their main structures in order to extract their particular rules and parameters. It highlights the basic principles on which asset-backed *sukuk* are based and describes their detailed principles. Key issues related to asset-backed *sukuk* are discussed to facilitate understanding of this structure as a preliminary step to its operation in the Islamic finance market. The chapter also provides some discussion of prohibited transactions in order to build up a jurisprudential foundation to enable the applications to be investigated.

3.2 Overview of Asset-backed *Sukuk*

The AAOIFI has defined *sukuk* as 'certificates of equal value to represent undivided shares in the ownership of tangible assets, services or usufruct' (AAOIFI, 2008, p. 307). This definition is, in general, well-accepted and represents *sukuk* from a Sharia perspective, not *sukuk* that are dominant in the market. This definition describes SBSs where all Sharia requirements are fulfilled, but not the SCS where only some of the requirements are

followed. However, Haneef (2009) defined *sukuk* as 'transferable certificates representing a share in the ownership of assets or business ventures that entitle the *sukuk*-holders to receive periodic fixed returns and full redemption on maturity of the *sukuk*' (Haneef, 2009, p. 130). In Haneef's definition, there are some critical points from the Sharia perspective. Firstly, *sukuk*-holders are not entitled to full redemption on maturity since *sukuk*-holders share the profit and loss of the business. Secondly, receiving periodic fixed returns is not the case with all SBSs as *sukuk* have to offer a genuine return generated from the securitized asset which may float depending on the asset's condition. Haneef's definition can be accepted when considering the dominant practice of *sukuk* and not the SBS structure. Accordingly, *sukuk* definitions provided in the literature can be categorized into definitions based on Sharia principles and definitions based on the dominant practice in the industry.

Asset-backed *sukuk* include the structure of *ijara sukuk*. The term *ijara*, in the sense of renting the usufruct, has an analogous meaning to the English term 'leasing'[14] (Usmani, 2003). According to the common practice of *ijara sukuk*, the SPV purchases the asset from the originator that will be leased back to him for a period corresponding to the duration of the *sukuk*, and the rental payments received from the originator correspond to the distribution payment amount. Lastly, according to a binding promise, the originator at the maturity date will purchase, from the SPV, the invested asset at an agreed price that covers the principal repayment to the investors (Al-Amine, 2008). However, if the assets are unavailable, then the structure becomes a forward *ijara sukuk*. Forward *ijara sukuk* have been newly introduced as a mode of finance into the Islamic financial market based on the unanimous agreement on the legality of the forward *ijara* contract[15]. Godlewski (2014) highlighted that *ijara* structures were constrained by the requirement for existing assets which can be relaxed if looking to finance new assets through the structure of forward *ijara sukuk* where assets do not yet exist. The structure enables both the issuer and investors to benefit from *ijara sukuk* where the assets are either not available or still under construction. Recently, forward *ijara*

[14] Although, the general meanings are compatible, in practice there are essential differences which will be discussed below.

[15] However, there is some confusion over its legality since a number of contemporary scholars refer to an earlier disagreement between the early Muslim scholars and its prohibition by the Hanafi School. In fact, the traditional texts of the Hanafi School and other schools include many citations that emphasize the agreement of the Hanafi standpoint as well (Monawer, 2012).

sukuk have been used for the advance finance of major industrial projects, real estate development or large items of equipment (Alvi, et al., 2010).

In forward *ijara sukuk*, the originator makes, initially, an *istisna'* arrangement (requesting to construct) with the SPV and undertakes to provide the assets at a future specific date. The SPV pays the price, which is equal to the principal amount, to the originator for the delivery of the assets at a specified date. The SPV undertakes to lease the assets to the originator under the contract of forward *ijara* for an overall period that reflects the life of the *sukuk*. Then, the originator, as a lessee, undertakes the payments of two agreements; the advance rentals when the assets are not delivered, and the actual rentals when the assets are delivered in certain amounts that are equal to the periodic distribution amount. Typically, these amounts are usually calculated in reference to either a fixed rate or variable rate such as the LIBOR (Tariq, 2004). In fact, the structure of forward *ijara sukuk* is the same as that of *ijara sukuk* except that in the former, the assets are yet to be provided or produced when the contract is conducted.

Intifa' sukuk are a further form of *sukuk* that are backed by assets. In the financial sector, *intifa'* is linked with the word *sukuk* to describe time sharing bonds that are in line with Sharia principles. *Intifa' sukuk* represent the ownership of usufruct during a specified time and in a specified unit in a residential complex for a specified amount of years. The contract of time-sharing is open to be combined with a *wakala* contract[16]. It is permissible to appoint an agency to take responsibility for partitions that can provide some flexibility and maintain better service for the investors (Kahf, 1997, p.80). In fact, *intifa' sukuk* and *ijara sukuk* involved a contract of *ijara*; however, their basis is different. From the perspective of investors, *intifa' sukuk* are based on operation and use; whereas *ijara sukuk* are based on rental payments. *Intifa' sukuk* are relatively less often practiced in comparison to the two previous structures. The concept of the Islamic time share has not been widely used for the purpose of marketing projects in the region; however, Munsha't Real Estate Project Company, in cooperation with the Al-Baz Company, were successfully involved in

[16] This is a contract that gives the power to someone to nominate another one in order to act on his behalf based on the agreed conditions and terms such an agency contract.

implementing *intifa' sukuk* for the Zamzam Tower in Holy Makkah (Merrill Lynch International, 2008).

3.3 The *Ijara Sukuk* Industry

Islamic finance, and particularly the market in *sukuk*, is an important source of wealth that is growing rapidly. The global *sukuk* market grew with issuances that reached more than $116 billion in 2014 (Latham & Watkins, 2015). *Ijara sukuk* were the dominant type of *sukuk* until 2005 when the first *musharaka sukuk*[17] were issued through the DMCC Gold *Sukuk*. Although participatory structures such as *mudaraba*, *musharaka sukuk* and others picked up pace rapidly and outperformed *ijara sukuk* in 2006 and 2007, *ijara sukuk* returned to favour in the market due to the *fatwa* issued by the AAOIFI in February 2008[18]. In addition, Godlewski, et al. (2014) found that *ijara sukuk* encountered positive reactions from the stock market. They attributed this to both the lower Sharia risk of *ijara sukuk* in comparison with other structures and to the lower risk of adverse selection than with other types of *sukuk*. This is because *ijara sukuk* have more stable prices and returns than other structures since the return can be predicted more accurately during the life of the *sukuk*[19] (Al-Jawria, 2009, p. 134). Thus, *ijara sukuk* are associated with relatively lower risk and show a more accurate credit analysis compared to other structures (Abubaker, 2009). To prove this, during the crisis from 2007 until 2008, *musharaka sukuk* issuances dropped by more than 80% and *mudaraba* and *murabaha sukuk* decreased by 68% and 60% respectively. However, the issuance of *ijara sukuk* during the crisis decreased by only 8% (Hijazi, 2009, p. 7). To demonstrate the dominance of *ijara sukuk*, Figure 3-1 shows the volume of *sukuk* issuances according to their structure from 2001 until March 2015:

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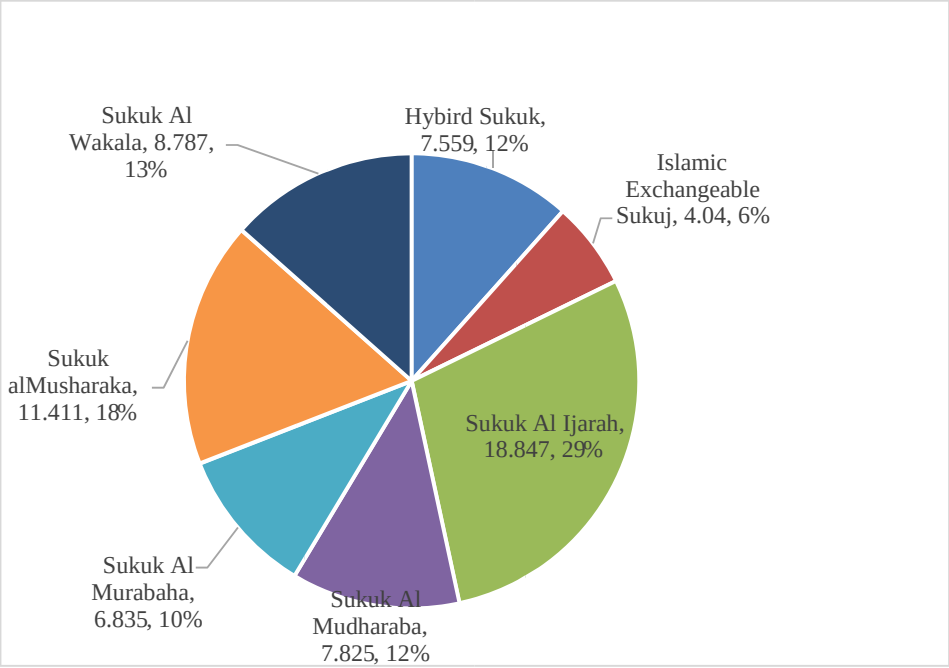
[17] AAOIFI identified fourteen possible structures for *sukuk*. *Sukuk* structures vary from *salam* (pre-payment of an asset for future delivery), *murabaha* (cost-plus sales), *istisna'* (build-to-own property), *ijara* (rental/ lease agreement), *mudaraba* and *musharaka* (partnerships) (AAOIFI, 2008).

[18] The *Fatwa* includes that the purchase undertaking in all participatory *sukuk* structures are unacceptable except under leasing contracts (AAOIFI, 2008).

[19] However, the estimated return on some forms of *ijara sukuk* cannot be entirely determined and fixed at the first stage of the contract because the insurance and maintenance costs cannot be accurately determined in advance (Rohmatunnisa, 2008).

Figure 3-1 Structural Break-up of the Global Sukuk Issuance, 2001-15



Source: International Islamic Financial Market

In Saudi Arabia, the introduction of *sukuk* instrument has been relatively late compared to other Muslim countries. The first Sharia compliant instruments were issued in the late 1990s-early 2000s, and later, the short-term *murabaha sukuk* in 2002. While, long-term *murabaha sukuk* were issued for the first time in January 2016 (Jeddah Chamber, 2015).

3.4 Critical Issues of Asset-backed *Sukuk*

The AAOFI has issued a number of guidelines and standards to improve transparency, disclosure and governance. It states particular standards for *sukuk*; however, Jobst, et al. (2008) claimed that *sukuk* lack a well-accepted standardization. In the *sukuk* market, there are a number of well-known institutions for standardization in the Islamic finance industry. To give an example, the International Islamic Financial Services Board (IFSB) is a well-known organisation in the Islamic market including the *sukuk* market. The formation of the IFSB based in Kuala Lumpur was inaugurated officially on 3rd November 2002 (IFSB, 2002). A further step related to Islamic financial standardizations has been taken by the International Islamic Financial Market (IIFM) that is headquartered in Bahrain and

has been operating since 2002. This establishment is a true example of the developing standardization of Islamic capital and money market products and practices, including the *sukuk* industry (IIFM, 2002).

The earliest and most dominant organisation in this field is the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), which was established on 26th of February 1990 in Algiers (AAOIFI, 2006). These organisations were recently established in line with conventional market organisations such as the regional structure of the International Capital Market Association (ICMA) which was created in 1974 (ICMA, n.d.). This is a natural result of the Islamic market being in its infancy level compared to the international market. These Islamic institutions have made efforts to standardize the Islamic financial market. For example, in recent years, the AAOIFI has introduced more than 20 Standards related to the Islamic financial market.

Despite all of these current organisations, the point made by Jobst, et al. (2008) is that these standardizations are not well-accepted. In practice, the major issue is not the shortage of standardization organisations, but that Islamic standardizations are not binding. Islamic guidelines are not mandatory for the issuing of *sukuk* in all Muslim countries. Hence the positive effects of the published standards, with the subject of *sukuk* in particular, will remain not to be seen. Based on the main example of *sukuk* standardizations that was the subject of a resolution by AAOIFI in 2008, questions can be asked about how these standards help to develop the practice of *sukuk* in the market. Are there any differences between the practices relating to *sukuk* before and after the AAOIFI declaration? Naim, et al (2013) attempted to answer these questions by reviewing some examples of *sukuk* preceding and after the pronouncement of the AAOIFI standard. In their review, *sukuk* samples were analysed by focusing particularly on controversial areas such as the guarantee feature, pricing and ownership transfer. The disappointing finding was that there were only negligible changes in the principal terms and also in the conditions of the *sukuk* after the AAOIFI standards. Thus, by declaring more authentic decisions and principles in their standards, the AAOIFI has not had a noticeable effect in altering the behaviour of industry players. Thus, it is undoubtedly true that the Islamic standardizations are not influential enough and there is a considerable gap between the standardization organisations and players in the Islamic finance industry.

To achieve a higher level of Sharia-compliant *sukuk* is only possible when one of the three parties involved (investor, issuer or Sharia advisor) becomes more conscious about the *sukuk* being compatible with Sharia. However, this is mainly a question of investors' decisions, since a higher demand for Sharia-based products can lead to equilibrium where it becomes optimal for the issuer to offer Sharia-based instruments. When those investors prefer to pay more or accept lower returns for products with higher levels of Sharia compatibility, the institution's incentives to cheat will also be reduced. This, furthermore, will provide the institutions with the ability to recoup the higher cost of Sharia-compliant products as well as to receive an incentive to improve their Sharia quality. This is a challenging period which requires a larger basis of Sharia-conscious investor. The numbers of more Sharia-conscious investors can possibly be improved by enhancing the education of investors to raise their awareness. At the same time, the presence of Sharia-consciousness among both Sharia advisors and issuers is essential to ensure the success of SBS (Azmat, et al., 2014). Otherwise, the enforcement of the standards by the authorities in each country may be a solution in the current situation. This enforcement could help to enhance the issuances of SBSs in the market more swiftly than the earlier process (Nazar, 2011).

It is important to point out that the current situation of the non-binding market for *sukuk* related to Sharia principles has resulted in conflict resolution and *fatwa* shopping. *Sukuk* issuance undergoes a strict screening procedure by religious advisors in order to confirm their Sharia compatibility. Their resolutions are of primary significance to investors who have to ensure that the issue which is compliant with Sharia prior to purchasing. Thus, the examination of the quality of Sharia compliance can affect the investor's reaction towards the issuance, with a higher quality audit sending a positive indication on the ability to trade the issuance in later periods. This *fatwa* provided by Sharia scholars represents a prominent difference between conventional and Islamic finance. Furthermore, the stock market's reaction towards *sukuk* can be affected by the reputation of the Sharia advisor endorsing the issuance. If doubts exist in respect of the Sharia compliance surrounding a particular issue, the signalling effect of a *fatwa* can play a key role in determining investor reactions (Godlewski, et al., 2014).

Although the Sharia advisory board has been considered as a further step to achieving the compliance of *sukuk*, some practices show the opposite situation where the Sharia advisory boards are not strict enough with Sharia principles. This high level of tolerance has led to inverting the core of *sukuk*, and this has changed the essential features of this instrument (Abdo, 2014). The practice that allows the issuer to seek *fatwa* on specific issuance from jurists, who they assume will accept their product as an investment compatible with Sharia is termed as *fatwa* shopping (Safari, et al., 2014). Searching for a friendly scholarly view on an issuance is basically a means of being granted a *fatwa* that satisfies the issuer's desires and not the principles of Sharia. For instance, one preference of traditional investors is the guarantee of return, which is not permissible in Islamic finance. However, *fatwa* shopping by the institution may find an Islamic scholar who can sidestep this difficulty and set his imprimatur on the issuance in order to make it more attractive. Such a practice is a critical threat to the Islamic finance industry as a whole, since the processes of Islamic finance will then work against the harmonization of *fatwa*.

The problem becomes more complex in the presence of a considerable number of Sharia advisors, and thus the possibility of *fatwa* shopping may become more affordable. The number of Sharia advisors is mainly at present about 250–300 plus between 15 and 20 members who are highly sought by *sukuk* issuers (Azmat, et al., 2014). The situation where a fee is received from the issuer, who has the right to look for different views, mainly encourages *fatwa* shopping. The advisor, who is mainly concerned about losing fees, may approve a less-compliant or even non-compliant *sukuk* structure in order to receive the business (Azmat, et al., 2014). Recent research shows that about twenty Islamic scholars hold more than half of the *sukuk* market, and the top 3 of these scholars receive annually around $4.5 million in fees (Zaheer & Wijnbergen, 2013). It is apparent that the *sukuk* market is negatively affected by the same type of incentive conflicts that appear in the case of the rating agencies in conventional finance. The current situation of the *sukuk* market has resulted in a strong incentive to be excessively lenient in certification with Sharia-compliance matters (Zaheer & Wijnbergen, 2013). Thus, a number of studies such as by Majid, et al. (2011) assert that for any *fatwa* that contravenes AAOIFI standards on *sukuk*, its reliability tends to be tenuous, even when it may be compatible with other standards and

has been approved by a narrow majority. Such an issuance might be called into question by an individual judge, who might subscribe to a strong point of view.

3.5 Sharia Framework of Asset-backed *Sukuk*

In asset-backed *sukuk*, the main contract is *ijara*, meaning that all *ijara* conditions and rules have to be fulfilled. This is coupled with the issued standards for a valid *sukuk*. This section provides a Sharia framework based on AAOIFI standards, and discusses the critical rules related to both *ijara* and *sukuk* standards followed by a discussion of prohibited transactions. The section aims to identify the Sharia framework related to asset-backed *sukuk* that will form a benchmark for the rating. This section will guide the empirical chapters to fill a gap related to determining to what extent do the cases comply with Sharia rules?

3.5.1 Critical Rules of Leasing

For a valid *ijara*, the key requirements are mostly related to the asset, liabilities and maintenance. For rules related to the asset, the principle condition in *ijara* is to own the asset or the usufruct prior to the contract. The AAOIFI supports this principle by the *hadith* that the Prophet Muhammad (PBUH) prohibits one from selling what he does not own and *ijara* is a sale of usufruct (Abo-Dawod, 2009, p. 3:283). Therefore, true ownership of the securitized assets is essentially required when structuring asset-backed *sukuk*. Also, the securitized assets have to be identified as permissible according to Sharia law and liable to valuation in terms of the cash received. If the asset is not identified or not valued or not permissible this means the investors, as a lessor, will lose their access to the asset. However, in a case of default, the originator as a lessee will not be charged any penalty; however, other steps can be taken in order to recover the rent such as vacating the property from the current lessee (Haider & Azhar, 2010). Further to the asset's conditions, the leased asset should be utilized only for the purpose stated in the contract, otherwise the lessor's consent is mandatory.

For the rules related to the liabilities associated with leased assets, there is a general agreement among early jurists on the liabilities and rights in the *ijara* contract. The AAOIFI clearly elaborates on these liabilities and rights between the lessee and the lessor under the *ijara* basis. To illustrate their view, the rights and liabilities arising from the ownership of

the leased asset shall be with the lessor; whereas the rights and liabilities arising from the use of the leased assets shall be with the lessee (Merah, 2008, p. 203). This means that investors are in charge of all of the liabilities associated with the leased asset apart from the liabilities resulting from the assets' usage of it. Thus, investors would be responsible for paying property tax and insurance for the guarantee programme along with incurring all risks associated with the leased asset during the leasing period.

On the other hand, the originator is not responsible for the assets' damages except those that results from misuse and negligence. The lessee will not compensate the lessor once the asset value has been impaired, unless such impairment occurred because of the misconduct or negligence of the lessee. This is because the AAOIFI consider the leased asset in the lessee's possession as *amanah* (a form of trust). Thus, if the usufruct of the leased asset is impaired partially or wholly with no negligence on the part of the lessee, the lessor shall be responsible for repairing the usufruct and he has to bear such costs (AAOIFI, 2008). In practice, some prospectuses include a statement that the lessee shall bear the cost of asset impairment and costs such as taxes that relate to the ownership of the property. The point behind including such a statement is that the parties consider the property's ownership as it will be devolved to the lessee whereas Sharia principles will not accept releasing the lessor from their liabilities. Thus, such statements are not accepted and may turn the investment null and void (Usmani, 2003, p. 5).

In addition, the AAOIFI emphasizes that the responsibility for maintenance and insurance fall under the lessor's liabilities as the owner of the asset (AAOIFI, 2008). All expenses are incurred by the lessor since the ownership risk is vested with in the individual. However, the impairment of the leased asset due to non-maintenance of such assets may render the contract voidable. It is acceptable in Islamic law that the lessor delegates the major maintenance of the rented asset to the lessee but that all expenses incurred for such maintenance have to be reimbursed by the lessor. The only cases where the lessee is

committed to bearing the maintenance are periodical maintenance and operating maintenance[20].

Finally, with regards to rental payment rules, the rental has to be determined at the time of agreement and thereafter cannot be changed without the agreement of all parties'. Rental payment is charged from the actual delivery date of the leased asset and not from the date of the price paid or of purchase by the lessor (Usmani, 1998).

In fact, these standards relating to liabilities are not subordinate rules, as claimed by some scholars. They are agreed by all early jurists, thus contradicting these standards turning *ijara* contract to be invalid (Merah, 2008, p. 214). These standards are major rules, since they reflect the real meaning of the *ijara* contract, specifying the identity of the *ijara* contract and deciding whether it is proper or not. For instance, the real goal of the *ijara* contract will be negated if the lessee bears the liabilities for the maintenance arising from the ownership of the leased asset.

3.5.2 Standards for a Valid Issuance of *Sukuk*

The AAOIFI in 2008 set specific standards for *sukuk* investment. The key standards were related to the assets' ownership, investment guarantees, and the Sharia advisory and approval process to be observed in any prospectus of issuance. The following sections present the essential requirements in this field: '5/1/8/1 the prospectus must include contractual conditions, adequate statements about the participants in the issue, their legal position and rights as well as obligations; 5/1/8/2 the prospectus of *sukuk* must include the identification of the contract on the basis of which the certificates are to be issued, such as sale of tangible leased assets, *ijara* etc.; 5/1/8/3 the contract that forms the basis of the issue must be complete with respect to its elements and conditions, not including conditions that conflict with its objectives and rules; 5/1/8/4 the prospectus must explicitly mention the obligation to abide by the rules and principles of the Islamic Sharia and that there is a Sharia board that approves the procedures of the issues and monitors the implementation of the

[20] Operating maintenance is required for the smooth utility of the leased asset continuously, such as oil for machinery and equipment. Periodical maintenance is essential for sustaining the capability of the asset to provide usufruct and is delegated with all its expenses to the lessee (Merah, 2008, p. 209).

project throughout its duration; 5/1/8/5 the prospectus must state that the investment of the realized funds and the assets into which the funds are converted will be undertaken through Sharia-compliant modes of investment; 5/1/8/6 the prospectus must state that each owner of a certificate participates in the profit and bears a loss in proportion to the financial value represented by his certificates; 5/1/8/7 the prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence nor that the individual guarantees a fixed percentage of profit' (AAOIFI, 2008, pp. 242-243).

Accordingly, investors have to be the legal owners of the pooled assets, instead of being nominal holders of the certificates. Ownership has to include all of the obligations and rights that accompany actual ownership, which means transforming *sukuk* from being asset-based into asset-backed securities. Also, managers or issuers of *sukuk* cannot guarantee the principal investment to *sukuk*-holders. The originator cannot guarantee the principal to buy the pooled assets for the nominal value at the time of maturity or even in the event of default irrespective of potential losses or profits, but rather the assets can be obtained for their fair market value or net value. However, the AAOIFI has added a further statement that excludes *ijara sukuk* 'it is permissible for a lessee in a *sukuk ijara* to undertake to purchase the leased assets when the *sukuk* are extinguished for its nominal value, provided the individual is not also a partner, *mudharib*, or investment agent' (AAOIFI, 2008). This means that *ijara sukuk*-holders can receive their capital through purchase undertakings. In addition, the managers and originators are not allowed to offer loans to the certificates holders when actual profits from the pooled assets fall short of expected profits. Instead, a reserve account can be created for the purpose of covering such a shortfall. Moreover, a Sharia supervisory board is a requirement in order to review all documentation and transactions related to structuring *sukuk* and to verify that the manner of implementation is in accordance with Sharia rules and principles.

3.5.3 Prohibited Transactions

In Sharia law, any transaction must avoid *riba* (usury) since this is the main prohibited behaviour in terms of commercial dealings. In this field, the most emphasis has been given to *riba*, and the emphasis has been shown in different verses of the Quran, 'That they took *riba*, though they were forbidden and that they devoured men's substance wrongfully. We have prepared for, those among men who reject faith a grievous punishment' (Qur'an 4:161). In another verse, another such argument is found, 'O ye who believe! Be afraid of Allah and give up what remains (due to you) from *riba* (from now onwards) if you are (really) believers' (Qur'an: 2:278). As these texts are unequivocal and explicit texts concerning this prohibition, *riba* cannot be tolerated to any extent. Also, if *riba* is involved in any transaction, this will render the contract null and void (Alsulaiman, 2011, p. 42).

Riba of a loan is the main type that occurs in every loan that attracts a benefit. In lending, the repayment has to be for the same amount as the amount of the loan. Any increase in the amount of money returned by a borrower is *riba*, which is either imposed by the lender in the contract or even promised in the contract by the borrower; however, if the borrower pays more than the amount borrowed without any previous explicit or implicit stipulation, this is allowed since the lending has been conducted with no commercial exploitation (Rahman, 2006). In fact, charging interest on loans is *riba* and considered unjust, since a loan in Islam is strictly considered a brotherly act and not a business transaction (Tariq, 2004, p. 10).

Sharia law excludes lending from financial and business dealings in order to avoid commercial exploitation. Considering *riba* as exploitative is because it only operates in favour of the wealthy and only needy people will pay extra money for a mere postponement. Consequently, Quran sets a strict distinction between profit from trade and profit from *riba*. Profit from trade is beneficial to society and helps to develop the welfare of individuals whereas profit from *riba* contributes to scarcity, illiquidity and nonproductive outcomes (Elgamal, 2000, p. 5). Thus, the time value of money is prohibited; whereas the time value of money is widely recognized in conventional business transactions. In a situation where the borrower postpones repayment after the time that was originally agreed, the lender is not

permitted to receive compensation for the delayed payment. Charging the debtor additional money for failure to pay when due is an explicit *riba*, although this delay is considered to be a sin and might also be punished.

Similarly to *riba* of a loan, there is a contract that has a compatible essence known as the *inah* sale. To illustrate is an *inah* sale is a contract that involves sale and immediate repurchase. A seller will sell merchandise to a buyer on a cash basis and thereafter he will immediately repurchase the item sold on a deferred basis at a higher price than the cash price. *Riba* in this contract will be the difference between the two prices (Rosly & Sanusi, 1999, p. 8). To give an example, a person sells an item for $5000 and then buys it back in cash for $4000, which means that he basically borrowed $4000 in order to be repaid $5000. In this contract, what are the scholars' views? Do they permit it prima facie or prohibit it due to the motive behind the sale? According to the motive behind *inah* sales, the majority of jurists invalidate the sale of *inah* because it constitutes a legal device to receive a loan with interest (Ibn-Rushd, 1985, p. 60). However, Imam Shafi'i allowed it and mentioned that 'the unlawful intention of the parties is immaterial unless expressed in the act' (Shafi'i, 1990, p. 63). He treated the *inah* sale as two separate transactions in which each of them comply with all the essential elements and conditions of a sale contract.

In fact, the *inah* sale is an apparent stratagem for *riba* by conducting two transactions with an unwanted asset that is only being used for the legalizing of the *riba* of a loan. In addition, the *inah* sale has been explicitly prohibited by the Prophet (PBUH) as he was reported as saying: 'If people are busy with *inah* sale…' Allah will make misfortune befall them, and will not remove it from them until they return to their religion' (Ibn-Qudamah, 1984, p. 60). Due to this explicit prohibition from the Prophet (PBUH), their cannot bear any controversy about this type of sale in terms of ruling. Although Imam Shafi'i legalized this concept that was a personal opinion and did not rely on any interpretation of any authentic Islamic authority while the majority who prohibit such a sale base their opinions on one of the authority of Islamic legal sources in the Sunnah. Also, Imam Shafi'i mentioned in different statements to his followers that 'following the *hadith* and ignoring my personal view is contradictory to it', as well as 'If you find in my writings something different to the *hadith* of the Prophet (PBUH), then speak on the basis of the *hadith* of the Prophet (PBUH),

and leave what I have said' (Nawawi, 1997, p. 63). In another citation, he stated that 'For everything I say, if there is something authentic from the Prophet (PBUH) that is contrary to what I have said, then the *hadith* of the Prophet (PBUH) comes first, so do not follow my opinion' (Alrazi, 2003, p. 93). No doubt these statements of Imam Shafi'i are in favour of the majority point of view. Therefore, the reported *hadith* along with the methodology that is adopted by Imam Shafi'i supports the view of the impermissibility of the *inah* sale. Also, it is important to highlight the comments of Ibn-qayyim on the view of Imam Shafi'i, that 'The late followers referred to Imam Shafi'i some views that he did not mean it. Who knows Imam Shafi'i and how he was in his life, he knows that he never uses *hiyal* (stratagems) and he never permit it to anyone. However, he only validated the contract as a normal two separated sales without any deceit. Hence, if the parties agreed to lend 1000 and receive 1200 in turn, then they add the commodity only to enact the pure *riba* as it is in *inah* sale, he defiantly will not accept it' (Ibn-Qayyim, 1973, p. 293).

Due to the strict attitude of jurists and explicit prohibition on the *inah* sale, some people have invented other similar contracts such as the sale of *wafa* and *istighlal*. The ultimate goal of such sales, which have the same essence as the *inah* sale, is to enact pure *riba*. To illustrate these sales, the sale of *wafa* is selling with the right of redemption. It is a contract whereby the possessor of an asset sells it, with a stipulation that the seller will give it back when he returns its price to the purchaser (Haydar, 2003). In other words, it is a sale contract that includes the condition of abrogation as in the end the seller will return the cash and the purchaser will return the asset. Also, an *istighlal* sale is to sell an asset with an attached promissory condition that the seller, who leases out his asset, will receive it back once he pays back the loan.

The literal meaning of the *istighlal* sale is the exploitation sale, since the purchaser exploits the asset that is sold as he benefits from the rental through leasing it to the seller (Haydar, 2003). In fact, the sale of *istiqlal* can be considered as a form of the sale of *wafa*, since the asset is rented to the seller; whereas, the sale of *wafa* itself is considered as a form of *inah* sale since they are compatible with its main feature that the merchandise eventually returns back to the seller.

Almasri, a distinguished researcher in Islamic transactions, criticized permission being given for such sales, 'the people of *hiyal* have artificially made it a controversial contract: Is it allowed or is it forbidden? Is it a sale or a *rahn* (collateral) for those who allowed it? The reality is that *wafa* and *istighlal* sales do not bear any controversy; they are simply a usurious stratagem, i.e. a usurious loan in a form of a sale' (Almasri, 2006). In fact, the sale of *wafa* and *istighlal* are loans with the benefit of the asset involved, to use it or to invest it. Covering the loan with a sale to justify *riba* will not change the ruling that *riba* will occur in any loan that attracts benefit. The Prophet (PBUH) said: 'There will come a time on people where they allow *riba* contract under sale contract' (Ibn-Qayyim, 1973, p. 178). Although, these two sales have not been prohibited by the Prophet explicitly, such as *inah* sale has, the reported *hadith* can apparently include them. This is because, regardless of all the invented procedures, they are clearly a stratagem in order to get around the prohibition of the *inah* sale. The stratagem is to give the *inah* sale a different and new name in order to make it acceptable to the public; however; in reality it is a mere form of *inah* sale that is prohibited explicitly by the Prophet (PBUH).

From the previous discussions and pieces of evidence quoted, it can be said that the view of prohibition outweighs permissibility. In this respect, Almasri criticized the proponents of these sales by stating that 'I wonder about the mentality that propagates the prohibition of *riba* and yet goes on allowing it at higher rates, under various pretexts and stratagems. This is like closing the 'white' door and opening tens of black windows, to the point where the *ijtihad* of contemporary jurists, if we can call it *ijtihad*, focuses on no other than the inherited old stratagems. It seems that the whole of *fiqh* has been reduced to mere stratagems' (Almasri, 2006).

The reason for prohibiting *riba* exists in these sales with the extra cost and effort through buying and selling a commodity. Sharia does not forbid a lower harm that exists in *riba* and then permits what is more harmful. In this sense, Ibn-Taimiyah mentioned that 'the clear cut *riba* is more beneficial to them than these stratagems. The legislator is wise and merciful. He does not prohibit what is beneficial and allows what is less beneficial. He does not prohibit what is harmful and allows what is even more harmful. If He has prohibited such

transactions, then His prohibition of these transactions (stratagems) is even stricter.' (Ibn-Qayyim, 1973, p. 182).

3.5.4 Sale and Leaseback

Sale and leaseback is a controversial type of transaction. In this arrangement, the seller will promise to rent the asset from the buyer once the sale is conducted, then all of the obligations and conditions of the *ijara* contract are applied to the seller as a lessee and the buyer as a lessor. There are some proponents of sale and leaseback contracts, and one of the main contemporary proponents is Nazih Hammad who presented a paper under the title 'Renting the Estate to Who Sold It' to a jurists' seminar organized in Riyadh. He claimed that the permissibility of such a concept is the view of Maliki jurists and IbnTaimiyyah (Hammad, 2007). Although, al-Dharir agreed with him, Siddiq based his argument on the general principle of the natural permissibility of transactions. Nevertheless, the majority of contemporary scholars do not allow sale and leaseback transactions. This is because the structure would transform the funds into a loan which means that any stipulated return would make it a prohibited *riba*. In addition, a well-known *hadith* which prohibits two sales in one sale refers to an *inah* sale that can involve such a transaction[21].

However, the evidence provided by Nazih Hammad to support his view is not precise. He claimed that Maliki jurists and Ibn-Taimiyyah allowed such a transaction, but the situation that Maliki jurists and Ibn-Taimiyyah allowed is when someone states, 'I will sell you my house for such an amount provided that you sell me your animal for such an amount' (Ibn-Taimiyah, n.d.). In this situation, two different items are involved, while in the case of the sale and leaseback one item is returned back to the seller making it akin to the prohibited *inah* sale. Also, their other basis was its general permissibility, which is also not accurate because when concerning compound contracts which are made up of more than one contract this might lead to impermissibility. If the rule relating to the 'simple single contract' is permissible, the rule relating to compound contracts (multiple contracts in one deal) results in impermissibility. This point is based on the *hadith* that forbids two sale contracts in one

[21] The *hadith* is reported by Ahmad, al-Nisa'i and al-Tirmdhi. AI-Tirmidhi authenticated the *hadith* (see NaylalAwtar 5/248).

and two transactions in one. Thus, Islamic jurisprudence usually finds that each contract may be permitted on its own, but they are not allowed when compounded together in one contract, such as in the prohibited *inah* sale as it is compound contract (Almasri, 2006).

What is important to shed the light on is the fact that the above discussion concerns the compound contract of the sale and leaseback transaction. The promise if not compulsory and not joined to a contract means that the contract is not a compound one. On the other hand, if it is compulsory, then it becomes a condition, resulting in the compounding and the prohibition of the transaction. This is because, in Islamic jurisprudence, it is well known that a condition can alter the ruling. For example, a nonconditional *riba* is permissible while a conditional *riba* is not. If a person lends cash to another without condition and thereafter borrows from him, this is permitted; however, if this lending was with the condition that the latter lends back, this would not be permissible (Almasri, 2006). Therefore, it is unanimously agreed that it is permissible if both purchase and lease contracts are executed separately and consecutively, and the lessee may then leaseback the leased asset to the lessor at any rental amount agreed on.

3.6 Summary

This chapter has discussed *sukuk* definitions and revealed that their definitions are categorized into those compatible with Sharia and definitions compatible with the practice in financial markets. The AAOIFI definition reflects the meaning of *sukuk* with compatible Sharia. AAOIFI *sukuk* include different types of structures; however, *ijara sukuk* are the dominant type and have gained a a positive status in the financial market. This is because these *sukuk* have lower Sharia risk compared to other structures as well as a lower risk of adverse selection in comparison with other types of *sukuk*. This is attributed to the stability of their prices and returns compared with other structures, making the return more predictable during the life time of the *sukuk*. Forward *ijara sukuk* are similar except that the assets will be available at a future date. Also, *intifa' sukuk* involves the contract of *ijara*; however, its basis is different from that of *ijara sukuk*. From the investors' perspective, *intifa' sukuk* are based on the operation and use of the underlying assets, whereas *ijara sukuk*

are based on the rental payment. Thus, the returns on *intifa' sukuk* are less predictable than in the previous structures.

The chapter also deals with Sharia standards related to *sukuk* structures. The discussion highlights the requirements related to *ijara* contracts, mainly involving the asset requirements, liabilities and maintenance conditions. The principal condition related to assets in *ijara* is to own the asset or the usufruct prior to the contract. Secondly, it is important that the rights and liabilities arising from the ownership of the leased asset are incurred by the lessor, while the rights and liabilities arising from the use of the leased assets are incurred by the lessee.

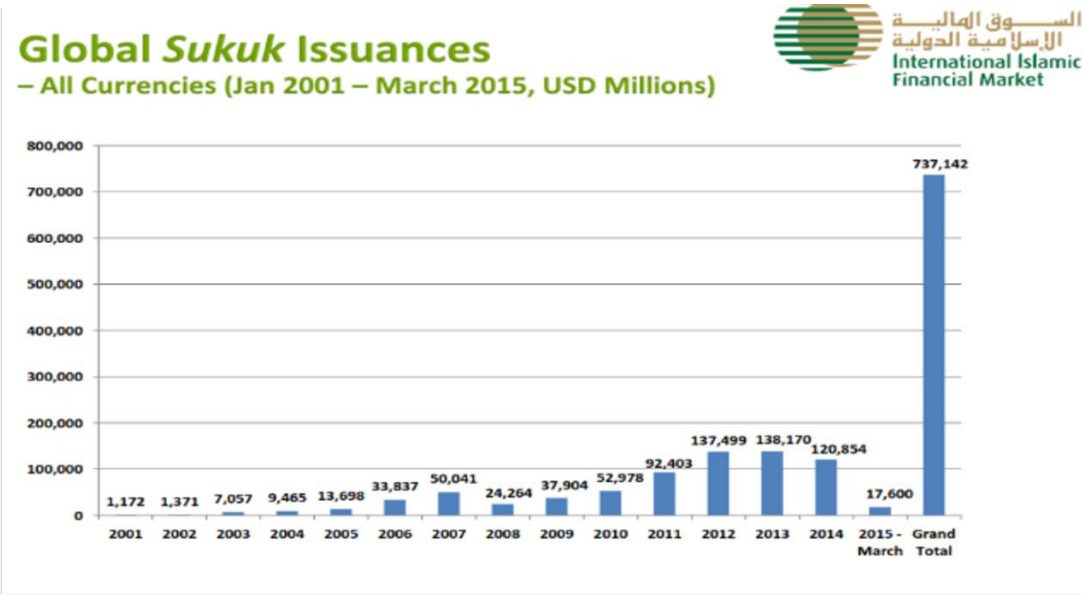
Moreover, the AAOIFI stresses that the expenses for essential maintenance and insurance are linked with the lessor due to his ownership. These discussed standards are major rules since they represent the real meaning of the *ijara* contract under Sharia law since, for example, the real sense of the *ijara* contract will be negated if the lessee incurs the liabilities that arise from the ownership of the leased asset.

Chapter 4: Asset-based *Sukuk*: Structures and Assessment

4.1 Introduction

Sukuk are the fastest growing instruments among the activities of Islamic finance. During recent years, and particularly since 2010, the growth of the international *sukuk* market has been highly impressive. Since 2011, the market has observed record *sukuk* issuances by corporates, sovereigns and quasi-sovereigns in a number of jurisdictions worldwide, especially in the gulf countries and Asia (IIFM, 2015). This notable growth was spurred not merely by the spread of Islamic banking but also by the extensive development of the *sukuk* market and investors' demands for financial instruments in harmony with their religious beliefs (Godlewski, et al., 2014). From the year 2001 until 2014, the evolution of this market has shown a remarkable increase in *sukuk* issuance in 2014 representing 10 times more than 2001 from $1,172 million to $120, 854 billion (see Figure 4-1) (IIFM, 2015). This upward momentum has recently supported the entry of new regions and jurisdictions in to the *sukuk* market. On October 29, 2013, the British Prime Minister announced that the United Kingdom will be the first country other than countries in the Islamic world to invest in *sukuk*. This has reaffirmed the growing interest in this particular mode of finance (Di Mauro, et al., 2013).

Figure 4-1 Global Sukuk Issuances, 2001-15



Source: IIFM *Sukuk* Database.

This chapter focuses on asset-backed *sukuk*, which involve a number of different structures. The discussion adopts a theoretical approach related to agency theory focusing on risk/return assessment arising in the investment, and also uses AAOIFI Sharia standards as the basis for the analysis. Section 4.2 presents a literature review and background related to asset-backed *sukuk* and provides an overview of Sharia principles related to *sukuk* and discussing the AAOIFI standards. Sections 4.3 and 4.4 extend the previous literature through an analysis and discussion of the financial risks of assetbacked compared to conventional bonds. Section 4.5 explores the agency relationships in an attempt to contribute to the literature in terms of the agency costs of asset-backed bonds in order to design mechanisms and devices that can be implemented to manage conflicts.

4.2 Asset-backed *Sukuk* as Financial Instruments

Sukuk market in Saudi Arabia is relatively new, with occasional issuances in the initial years. The market was stable between 2008 and 2011, with 3–4 issuances/annum totalling about $2 billion. In 2012, the market grew speedily, with 10 *sukuk* issuances with a total value of $6.7 billion. This trend maintained in 2013 and 2014. Saudi Arabia issued *sukuk* totalling close to $15.2 billion in 2013, ranking it the second amongst Muslims

countries. Saudi Arabia's aggregate *sukuk* outstanding in 2014 stood at around to $50 billion, up by 35% from only $36.4 billion in 2013 (Jeddah Chamber, 2015). In Saudi Arabia, out of 12 domestic commercial banks, four are full-fledged Islamic banks and a fifth, the largest conventional bank, is in a move to become Sharia-compliant. The four Islamic banks together hold around 25% of the assets. The Islamic banking sector asset base reached about SAR 1,151 billion, showing about 21.4% of the global Islamic banking assets, with a growth rate of 8% in 2014. The market share of assets in the total banking industry surpassed 50% in 2015 (Alhumaidah, et al., 2016).

Finding suitable assets is a critical issue for both sovereign and corporates entities when issuing asset-backed *sukuk*. Identifying the underlying assets that meet Sharia requirements as well as offering attractive earnings to both suppliers and users of finance is a major hurdle in *sukuk* market expansion. The lack of proper assets to work with is because eligible assets are restricted and limited to both sovereign and corporate issuers (Jobst, et al., 2008). Many sovereigns are reluctant to part with public assets, simply because of their apprehension that the disposal of public assets to overseas investors could result in negative public sentiment. Thus, sovereigns favour the conventional securities route since they do not require any disposal of underlying assets. Similarly, the corporations either do not have the proper assets, or the assets are not adequate or have been encumbered or they might be subject to transmission taxes (Haneef, 2009). Adding to this, after finding a proper asset for certain issue, the institution has to wait until the maturity date in order to be able to re-use the same underlying asset for another issuance (Al-Amine, 2008). This shortfall of eligible assets could impede or slow down the regular issuance of *sukuk*. However, the *sukuk* market has moved towards issuing asset-based *sukuk* instead of asset-backed *sukuk* in order to overcome the problem. As in asset-based *sukuk*, there is no real ownership of the asset, sovereigns can share their public assets and companies can provide important assets for investors without any concern about losing their possessions. In the global market, around 98% of *sukuk* are associated with doubts concerning their representation of ownership (Kanji & O'Neill, 2015). The underlying asset might be the shares of companies, which do not provide true ownership, but rather merely offer a right to the returns. For instance, the state of Bahrain tested *ijara sukuk* in 2001, and although it was hugely successful, the major

problem was ownership. These *sukuk* are no more than the buying of earnings and returns from shares which are not legal from the Sharia perspective (Usmani, 2008).

Despite the fact that *sukuk* are theoretically different from conventional securities[22], it is questionable in practice to what extent *sukuk* are actually different from their conventional counterparts. This is a controversial subject in the *sukuk* literature as, there is an ongoing argument between two groups as to whether *sukuk* are really different from conventional securities. The first group is led by Miller, et al. (2007) who claims that *sukuk* structures are designed to imitate conventional bond features, whereas the second group is led by Cakir and Raei (2007). Thet adopted the opposite view that *sukuk* are unlike bonds since *sukuk* in practice offer diversification benefits that can reduce the risk portfolio. They gave evidence to support their view by using a sample of sovereign Eurobonds and *sukuk* through the same issuer. They created two hypothetical portfolios. the first contained only Eurobonds and the second contained both *sukuk* and Eurobonds. Then, they calculated and compared the value-at-risk (VaR) for the portfolio which included both instruments to the other which included only Eurobonds. Their final results indicated that VaR is reduced for the portfolio containing *sukuk* along with conventional securities, proving that *sukuk* does have some diversification benefits for investors. Thus, based on their results, it can be said that *sukuk* provide a variety of financial tools and choices which could attract a diversified investor profile.

Although Cakir and Raei (2007) used quantitative methods that have been widely referred to as far as risk evaluation between conventional bonds and *sukuk* is concerned, their study has been criticized. One of the criticisms is that when measuring the gains of diversification from using *sukuk* in a portfolio, they ought to be evaluated additionally against the lower returns along with the inherited liquidity risk because the illiquidity imposes on the portfolio a higher level of risk at periods of volatility. Furthermore, the authors designed two separated portfolios for a country rather than making a globally diversified portfolio, and then excluded conventional bonds from their investigation which may make some constraints on interpreting their results (Hassan, 2012). Regardless of the

[22] There is an agreed view that *sukuk* and conventional securities are theoretically different (Jobst, et al., 2008).

weight given to criticisms of the Cakir and Raei example, their results are supported by stock market participants who react differently towards *sukuk* and bonds. In practice, stock market participants are able to distinguish between the characteristics of conventional bonds and *sukuk*.

Even though in most cases in practice *sukuk* are similar to conventional bonds in their structure, stock market participants perceive these two instruments as being alternative financial tools, and consequently they react differently to their issuance (Alam, et al., 2013). More importantly, recent research has found that Islamic and conventional financial institutions had different levels of exposure to the financial crises (Ghoddusi & Khoshroo, 2015). As this is the situation in the market, investing in *sukuk* can help to reduce the risk of portfolios, and the discussion concludes thus in favour of Cakir and Raei's point of view.

Imitating bonds is a major issue that faces the development of *sukuk*. Issuers, by endowing *sukuk* with the same features as conventional bonds, issuers face the negative consequences of them being not compatible with Sharia and destroying the distinct features of *sukuk* (Jobst, et al., 2008). The question that may arise is to what extent the problem of imitating bonds prevails in the *sukuk* market. In other words, to what extent does the Islamic *sukuk* market not comply with Sharia principles?

Dusuki and Mokhtar (2010) found in their research that only 11 out of 560 *sukuk* issuances, that is equivalent to about 2% of the total, are eligible to be asset-backed as a result of fulfilling all the Sharia requirements of an actual sale of the asset to the *sukuk*-holders. Therefore, it can be said that, while only 2% of *sukuk* are Sharia-based in not imitating conventional bonds and are sharing ownership, the remaining 98% of *sukuk* are not. Apparently, *sukuk* that imitate bonds have flooded the market and clearly the theoretical framework of *sukuk* has not yet been applied to the market. Undoubtedly, the imitation issue has had a negative impact on the Islamic market due to the loss of investor confidence, particularly among Sharia-sensitive investors, towards investing in *sukuk*. More significant is the loss of the advantage found by Hasan and Dridi (2010), where the adherence to Sharia principles has shielded Islamic institutions from the effect of the crisis as the impact on their profitability in 2008 was limited.

However, the current situation leads to the question of why issuers do not follow the Sharia framework. Why do Islamic banks and other Islamic institutions endeavour to mimic the structure of bonds? And what is the motivation for such imitation, despite being prohibited and negative in terms of their reputation? Why are Sharia-compliant *sukuk* (SCS) more popular than Sharia-based *sukuk* (SBS)? What are the advantages of applying SCS? This chapter seeks to find answers to these questions.

In Islamic financial institutions, as in any other institutions, deciding which structure of *sukuk* should be issued is conducted by deciding which structure can maximize the profit to and value of the institution. By saying that, Islamic institutions may prefer to imitate bonds in order to attract both conventional and Islamic markets. This is because, through the imitating of the typical structure of bonds, investors are more familiar with the risks involved. Therefore, considering both markets can be seen as one of the motivations for this issue since most *sukuk* issuances are US dollar-denominated and, interestingly, around 60 per cent of *sukuk*-holders are Western companies and institutions, while the remaining 40% are other buyers including those in the Gulf countries (Salah, 2009). Understanding the link between Western investors and *sukuk* issuances makes it easy to recognize how the *sukuk* market would be motivated. Accordingly, rendering *sukuk* identical to bonds would satisfy their clients in Western markets.

Satisfying Western clients as a motivation to imitate bonds cannot be ignored, particularly in the case of international issuance. However, this justification would not suit cases of local issuances where investors mostly seek higher levels of Sharia compliance in products and the imitation issue prevails in such situations. For example, a number of *sukuk* have been issued locally in Gulf countries under the concept of SCS that do not strictly follow Sharia principles. This gives one indication that what attracts international investors is always not the main motivation for such imitation.

An additional explanation provided by Wilson (2008) is that Islamic institutions exercise particular care to render *sukuk* identical to other bonds and conventional debt securities, aiming to simplify investors' risk assessment and facilitate the understanding of these new investments. Unfamiliar investors will then be able to assess the risks of the new instrument. On the other hand, others have the opposite attitude that a strict adherence to Sharia principles will noticeably simplify the restructuring. This is because the Sharia

compliance structure involves an obvious allocation of property rights, and shareholders will be provided with full title to the underlying *sukuk* assets in cases of distress (Zaheer & Wijnbergen, 2013). Hence, it might be argued that the decision whether or not to simplify the *sukuk* structure is determined by the issuers. Both bonds and *sukuk*, in their underlying concepts, are simple to understand; a bond is a loan with interest, and *sukuk* are shares in a project. However, when it comes to practice, the concept of *sukuk* becomes more complicated to understand since most of the issuers intend to build a more complex design so as to achieve the bonds structure. The issuers have expended a great deal of effort to design *sukuk* identical to bonds. Accordingly, how complicated or simple the structures of *sukuk* are depends on the issuer's preferences and decisions.

Kuran (2004) attributed current practice in the Islamic financial market, including the *sukuk* market, to the environment that Islamic financial institutions operate in as Islamic banks coexisting with conventional financial institutions in most countries. As a result, Islamic institutions are likely to face adverse selection problems if they only offer financing instruments that are based on profit-loss sharing (PLS). An apparent omission in this argument is that moral hazard arises in conventional finance, too. PLS finance has a moral hazard when the net income is underreported in order to share less, and conventional finance has a moral hazard when the net income is over-reported in order to maximize debt finance and therefore return on their equity (Wahrenburg, 1996). Furthermore, Dar and Presley (2000) attempted to answer the questions raised, saying that the motivation for transferring *sukuk* from being equity finance to be merely conventional debt finance is that the former is basically not feasible for financing short-term projects due to high levels of risk. The high exposure to risks includes the time diversification results of the equity, resulting in institutions that rely on the imitative *sukuk* rather than the genuine *sukuk* to finance their businesses so as to ensure a preferred level of liquidity. However, this might be argued by the point that long-term finance also suffers from the imitated *sukuk* as short-term finance, and thus considering short-term finance as a cause of imitated *sukuk* seems not accurate.

The discussion would not be complete without understanding the broader macro issue that needs to be addressed in order to identify the motivation behind the heightened applications of SCS rather than SBS. A regulatory framework for securitization in the countries of the Gulf Cooperation Council has not yet been developed. The fact that

bankruptcy law is still underdeveloped in the Middle East has further minimized the risk appetite of the originators in structuring SBS design. Insolvency law is vital for facilitating true sale contacts in which investors are protected and can receive payments from asset-backed securities, even in cases of the originator's bankruptcy (Nazar, 2011). Therefore, *sukuk* structure is greatly affected by conventional bond practices regulated by the Western legal framework.

Adding to this, from the supply perspective, the issuers can receive relatively higher ratings in comparison with their Sharia-based counterparts, resulting in a substantial minimizing of the cost of funds. For example, the Tamweel's asset-backed *sukuk* have received from Moody's the maximum possible rating in the UAE of Aa2. An asset-based *sukuk* by the same institution was four notches lower at A3 (Howlader, 2009). Nevertheless, the asset-backed *sukuk*, on the demand side, provide a bankruptcy remote investment (Ahmed, 2010). For the current situation, Islamic issuers may not be interested in financing projects if adequate information is not available, and only if the risk-adjusted rate of return is more than the return on risk-free investments. This is because the issuer will act as an investment partner, and in the asset-backed structure that requires sufficient information to efficiently assess the appropriate profit and the project's risk (Ahmed, 2002).

4.3 Analysis of *Sukuk* Risks

Sukuk inherently involve a higher exposure to certain financial and market risks. The question is commonly asked whether *sukuk* and conventional bonds are different or similar in their risk exposure. To what extent do they differ in their risk/return features? Can the solutions applied in securitization be utilized in *sukuk*? The following discussion aims to respond to these questions by identifying various unique aspects of risks faced by *sukuk*-holders according to the Basel types of risks. As previously discussed, the major risks according to the Basel Committee are credit risk, market risk, liquidity risk and operational risk. However, an additional risk of being not compatible with Sharia will also be discussed since *sukuk* investment stems from Sharia principles.

4.3.1 Credit Risk

There are various unique credit risks associated with asset-backed *sukuk*. Credit risk principally involves the return payment risk and the principal payment risk (capital loss risk). The inherent credit risk is the possibility that the originator fails to meet any of the obligations stated in the agreed terms. For example, in *ijara sukuk*, a higher possibility to default in the rental payments or the final purchase of the assets means a higher exposure to credit risk. SBS naturally involve a higher exposure to the return payment risk since there is no guarantee of the return when the asset is destroyed. Investors derive their periodical distributions from the cash flows generated from the asset, meaning that any loss in the asset may affect the amounts distributed. However, the situation is entirely different with bonds since there is no exposure to asset risk, or rather to the originator's creditworthiness, due to no ownership being involved. These additional risks related to the underlying asset may not suit the appetites of particular investors who are familiar with other types of risk. However, in order to manage this problem, there are some recent innovative structures that have been implemented when issuing *ijara sukuk*, where the originator as a lessee has an option to substitute the entire or part of the underlying assets with different assets at similar value. This allows the originator to minimize the risks related to the assets and to maintain the distributional amounts by obtaining other resources. The substituted assets can be used as a resource for the next stage of the business (Al-Sayed, 2013).

As Sharia law did not allow guarantee the principal, this undoubtedly raises the risk of capital loss (Zaheer & Wijnbergen, 2013). Capital loss risk is incurred by investors in SBS since their originators would buy back the assets at the market price, which may not be equivalent to the issuance amount, thus resulting in some loss (Tariq & Dar, 2007). For instance, some *ijara sukuk* indicated that the originator unilaterally undertakes to purchase the assets at their market price that would prevail at the date of maturity. Thus, the risk would naturally increase if there was any reduction in the value of the invested assets[23]. Investors would be eligible to receive higher rates of return and they could benefit from having direct recourse to the assets in the event of default.

[23] Asset value risk refers to the market risk.

The credit risk becomes higher when they are based on a floating rate, since the rental payments will fluctuate and make the amounts distributed to less predictable, which may result in more defaults. However, as the originator is commonly the only lessee, the cases of default will be limited to cases of the originator's bankruptcy. This process reduces the possibility of credit risk; whereas, larger numbers of lessees may increase the possibility of default since the returns of *sukuk* will be subject to the desires and abilities of a number of lessees to pay the rental payment. Furthermore, with the floating rate, maturity plays another role in emphasizing the impact of this risk. This means that the credit risk in the longer-term of asset-backed *sukuk* is always higher than in the shorter-term. This is mainly because it is predictable and easier to forecast what will occur to the lessee's credit worthiness over, for example, a two-year period than predicting their credit worthiness over 20 years (Tariq, 2004). A third factor that increases the exposure to credit risk is the unavailability of the asset. The additional embedded risk is the exposure to default in delivering the securitized assets according to the identified quantity, time, specifications or requirements (Abdullah, et al., 2014).

Regardless of these factors, it can be said that *sukuk* in general are likely to face more credit risk than bonds for a number of reasons. Firstly, most of *sukuk* prospectuses include more sophisticated risk management mechanisms than in these conventional securities since, for example, the rescheduling of debt for a higher mark-up rate does not exist under *sukuk* due to the prohibition of debt trading (Tariq, 2004). Secondly, based on the fact that conventional bonds represent a debt obligation and asset-backed *sukuk* are certificates of ownership, *sukuk* investors would have only a limited opportunity to retrieve their initial capital in the case of default in comparison with conventional securities which are considered to be more liquid (Noor, 2013).

Strictly speaking, the credit risk for SBS is higher than that for bonds because the originator of the SBS, as a manager of the asset, cannot bear any default or loss except if the loss happened owing to the manager's poor performance. However, if the loss occurs due to causes beyond the manager's control, such as a global financial crisis, investors would bear the possible risk of losing either the return or the principal (Al-Sayed, 2013). Consequently, in conventional bonds, the risk of default has different aspects since there is no actual link

between the bonds and the project, whether or not the project is completed as specified or not, or whether the project fails or is successful, and the principal and interest will be paid to bondholders according to the agreed schedule. Therefore, receiving ratings from the rating agencies has to be taken into account prior to any investment in bonds to mitigate the risk of default. Meanwhile, SBS credit risk would be measured by the performance of the particular assets since the asset risk ultimately becomes the risk of investors. Through proper management of the underlying asset performance as well as its profit-generating ability, this risk can then be managed. Typical processes for asset and associated cash management have to be implemented in order to minimize the credit risks (Haider & Azhar, 2010).

4.3.2 Market Risk

The market risk of asset-backed *sukuk* refers to possible changes in the assets' prices, interest rates and currency exchange rates (Najeeb1, 2013). First is the risk arising from changes in the value of the underlying assets due to changes in demand and supply. The decrease in the prices of these assets can influence the issuance in such a way that the asset may not generate sufficient revenue to meet the obligations, or the price of the final purchase may even decrease. Hence, investors in SBS need to keep up with the value of the securitized asset due to the actual link between the investors and the underlying assets.

Moving onto the interest rate risk, SBS issuances might not be benchmarked with any of the interest indicators and would rely totally on the revenues from the asset. For instance, *sukuk intifa'*, typically, are not benched with LIBOR, thus there is no direct influence of changes in interest rates. However, there may be an indirect exposure to fluctuations in interest rates through the widespread benchmarking in the *sukuk* financing process. However, this risk, as with bonds, will be greater for fixed rate *sukuk* but minimal for floating rates ones (Bacha & Mirakhor, 2013).

In most *ijara sukuk*, the periodical distributions are linked with interest rates, resulting in an adverse correlation between interest rates and *sukuk* prices. Any *sukuk* benchmarked with LIBOR involves the possibility of later and increased rates so that the originator, on the asset side, will not generate as much revenue as future market circumstances might dictate. The originators have to respond to changes in LIBOR since any

rise in income has to be shared with the *sukuk*-holders (Kamil, et al., 2009). Thus, originators have the incentive to issue *sukuk* during seasons of low interest whereas investors have to predict a decline in the value of the *sukuk* when changes are made to the interest rate.

Although higher interest rates can provide the opportunity to invest at new rates, this is not applicable to the case of forward *ijara* non-tradable *sukuk* due to their illiquidity (Abdullah, et al., 2014). Therefore, it can be said that the exposure of *sukuk*, if they are benchmarked, to the interest rate risk is higher than in conventional bonds because of their illiquidity, which is attributed to the limited size of the secondary *sukuk* market (Hassan, 2012). The illiquidity creates more obstacles to adapt active portfolio management tools which have been implemented to protect the portfolio returns from changes in interest rates (Hassan, 2012). Furthermore, there is no standardized and recognized Islamic derivative instrument in the *sukuk* market for managing market risks, since most of the instruments available to manage this risk that are used in conventional markets are not Sharia-compliant. However, the risk can be considerably reduced or even avoided if the *sukuk* were structured according to Sharia rules. This is because the returns from *sukuk* will be calculated based on real profits from the underlying asset (Usmani, 2008). Arsalan and Humayon (2007) argue that reducing the interest rate risk is not an actual avoidance, but rather is a substitution by an asset value risk. The asset value risk is greater than the interest rate risk, since the price of the underlying asset fluctuates more in the market than the interest rate.

Finally, asset-backed *sukuk*, under market risk, are exposed to the exchange rate risk. This risk is serious since *sukuk* have become an international financial instrument and attract a great number of sophisticated foreign investors. It arises from unfavourable exchange rate changes that will have an impact on foreign exchange positions in the case of divergences between the currencies of denomination in which *sukuk* finances are accumulated (Al-Bashir & Al-Amine, 2011, p. 347). Also, it is important to note that maturity plays a significant role in emphasizing market risk. The longer life of asset backed *sukuk* results difficulty in forecasting changes in exchange rates, interest rates and asset values.

Exchange rate fluctuations may result in a loss for either the *sukuk*-holders or the originator of an international *sukuk*. In fact, exchange rate risks are unavoidable with the

rapid growth of the industry and the increase in multi-national investments. The challenge is to devise an efficient exchange risk management approach that is compatible with Sharia principles (Tariq & Dar, 2007). In general, SBS have the same nature of currency risk as the conventional securities, and thus they can be treated according to the traditional currency risk management perspective. For instance, in some issues, the originator can minimize the risk of exchange rate changes by using a number of currencies in their issuance (Al-Sayed, 2013).

4.3.3 Liquidity Risk

The exposure of *sukuk* to liquidity risk is higher than with conventional bonds due to both endogenous and exogenous causes. Endogenous reasons depend on the nature of the *sukuk*, where there is a restriction on trading in debt *sukuk* such as forward *ijara sukuk* and *salam sukuk*. Thus, forward *ijara sukuk* tend to be kept for a relatively longer time before they can be liquid; accordingly, it is a very illiquid asset. Thus, investors are not able to employ the asset to take up another superior opportunity for investment (Tariq, 2004). In this regard, Tariq (2007) proposes using embedded options as a device for *sukuk* risk management. He explains that, as it prohibits debt trading, Sharia permits its exchange for tangible assets, goods and services. Investors, thus, can receive an option to exchange their forward *ijara sukuk* based on *istisna'* with real estate after a specified period rather than waiting for the maturity of the *sukuk*.

Exogenous factors relate to the ability to trade *sukuk* in the secondary market. Most *sukuk* remain active only in the primary market, while the secondary market is not well-structured for trading (Haider & Azhar, 2010). The inactive secondary market is due to the limited number of issuances along with the lack of alternative instruments in the same asset class (Abdullah, et al., 2014). In addition, even after the *sukuk* become eligible for trading and satisfy all Sharia requirements, the exercise of 'buy-and-hold' is a further obstacle in activating the secondary *sukuk* market. Almost all *sukuk* are bought for the purpose of long term investment (Kamil, et al., 2010). For instance, in the Gulf region, there is virtually no secondary trading in *sukuk* since most *sukuk*-holders treat *sukuk* as 'buy and hold' investments, resulting in a significantly illiquid market and inhibiting the discovery of actual prices (Jobst, et al., 2008). The current situation can be attributed to the fact that that in the

sukuk market, supply is far less than demand. As the demand for *sukuk* considerably exceeds supply, investors tend to hold onto their *sukuk* dearly and no secondary market can become active (Majid, et al., 2011).

Most *sukuk* in the market do not face endogenous problems but rather the exogenous problems. Therefore, the development of sufficient secondary markets is critical for *sukuk*, more so than for conventional securities, because conventional financial firms have a number of non-Islamic tools available to manage their liquidity. Also, the activation of primary markets to meet the high demand for *sukuk* is crucial for a better secondary *sukuk* market. Governments have to be more active in issuing *sukuk* which show different types of risk-bearing and a variety of maturity periods. A good example was the initiative by the government of Bahrain which issued three and six-month maturity *sukuk* (Al-Sayed, 2013). Governments should also provide proper regulatory standards for the secondary market with easy access for any possible investor. For example, the Bahrain International Islamic Financial Market has created a way to standardize the secondary market and to develop products that can be traded. This step provides some solutions to the liquidity risk in the market of *sukuk* (Haider & Azhar, 2010).

4.3.4 Operational Risks

Operational risks in asset-backed *sukuk* mirror those existing in conventional security markets. They involve any incident that negatively affects the operation of the securitized project. However, SBS involve some additional features related to true associations with underlying assets. This will add to any negative incidents concerning the assets which may have an impact on SBS investors. For instance, if partial or even full impairment of the intangible asset occurs, investors will bear the loss. This exposure is minimal if the *ijara* assets are land parcels, while in the case of cars, machines or equipment, for example, the risk of this loss cannot be ignored. However, originators can apply Sharia-compliant provisions for insurance in order to minimize the exposure to operational risk. Also, proper maintenance and servicing are essential to maintain the structures of the assets and to ensure sufficient returns to the investors (Bacha & Mirakhor, 2013).

Moving onto legal risk[24], the absence of standardized regulations that govern all *sukuk* issuances is a major impediment to the overall development of *sukuk* market. This market is not yet well-regulated to the whole extent and no documented and standardized structure has yet been introduced for *sukuk* issuances (Jobst, et al., 2008). A more specific example of this risk is that, in the forward *ijara* structure, the main aspect of legal risk arises when the specific details of time and description are not applied. There is not yet any form of consensus in respect with the appropriate procedure when a project that is the subject of a forward *ijara sukuk* is postponed and thus the delivery project does not take place on the specified date (Goud, 2011). The lack of regulation of the *sukuk* market is critical for all parties involved, especially investors. As Sharia law is involved in almost no national legislation, hence it is not realistic for *sukuk* to be issued according to such a law (Haider & Azhar, 2010). By applying commercial and Sharia law, legal inconsistencies can be exposed in insolvency resolution or asset control, since the *sukuk* structure requires the fulfilment of both sets of laws (Jobst, et al., 2008).

It can be said that the cause of the legal risk in the *sukuk* market is that in several countries the official Sharia standards on *sukuk* are lax, leaving much to the advisor's discretion. The advisor can use differences in opinions among jurists to the issuer's advantage, while the AAOIFI standard that endeavours to harmonize Sharia standards has received only unofficial status in all of its members' countries. This has resulted in difficulties for the regulator in neutralizing issues of Sharia non-compliance and has raised confusion about which official laws can be imposed and to what extent they can be imposed in issuing *sukuk* (Azmat, et al., 2014). Some issuances, in their prospectuses, rely on English laws long as they do not conflict with Sharia law. This is because English law has been in practice considered to be the law available that is in most harmony with Sharia.

Currently, resorting to English law as the governing law in the *sukuk* market is becoming more common. This is a result of the absence of well-developed local Sharia courts processing Islamic financial issues, the supposed weaknesses of local laws about issues relating to cross-border legal features, and the desire for higher ratings from the rating

[24] Legal risk, as previously discussed, is a component of operational risk under the Basel framework.

agencies which favour English law as governing law. Nevertheless, a question that can be raised is whether this particular law indeed fulfils all Sharia compliance principles. A number of legal practitioners believe that English law is the choice that best maintains Sharia compliance along with being in harmony with well-developed legal practices (Al-Amine, 2008). However, in practice, there is a problem of conflict which appears when applying Sharia finance under the jurisdiction of English law. In all incidents of disputes, the common law including English always prevails over Sharia law (Nazar, 2011). For example, in the case of the Shamil Islamic Bank of Bahrain vs. Pharmaceutical Company, the defendant was not able to pay the amount for his financing to the Shamil Bank. The court made its decision based on English law rather than Islamic law (Global Law Firm, 2012). This is because the judge ruled that governing a contract cannot be based on two different law systems. Thus, the English courts in the case of the Shamil Bank, rejected the application of Sharia law to the contract when it was questioned. The main reasons were the significant difficulty and controversy in applying such a law, and therefore the Court stated that it was 'improbable in the extreme, that the parties were truly asking [the Court] to get into matters of Islamic religion …' (Global Law Firm, 2012, p. 13).

Although most of the essential contractual clauses in issuing *sukuk* are mainly based on Sharia, using conventional courts to judge Islamic financial tools is not without short comings. The conventional courts are unaware of such principles, which definitely influence their decisions. For instance, the court would not consider the *ijara sukuk* as a relationship between lessee and lessor but a relationship between a creditor and a borrower according to some of the prospectus clauses[25] which represent an obvious departure from the spirit of the *sukuk* (Al-Amine, 2008). A permanent solution rests with the systematic harmonization of Islamic financial documentation, and the minimizing of differences among Sharia boards as well as the codification of the essential principles of Sharia commercial law into formulated legislation based on the core of Sharia principles along with the best legal international practices. This procedure will not be efficient if only some countries adopt the principles developed as a basis for their national legislation. The legal foundation must be strong

[25] A clarification of the clauses is shown in later chapters.
[26] By Usmani in 2008 (as previously mentioned).

enough to ensure protection for investors. The main area that requires emphasis is the legal foundation for *sukuk* respecting bankruptcy and collateral security laws. The few cases of defaulted *sukuk* have stimulated more emphasis on certifying bankruptcy systems and collateral security which are sufficiently backed by credible and sound legislation. Being comparatively new phenomena, these default cases are considered a wakeup call to ensure protection for investors as well as in adopting smooth bankruptcy procedures (Kusuma & Silva, 2014).

4.3.5 Sharia Risk

After the recent criticism[26] of *sukuk* as not being compatible with Sharia, Sharia risk is becoming more critical. It arises when assets lose their value as a consequence of the originators' breach of fiduciary duties with regard to the Sharia compliance. Each issuance has to satisfy the requirements and demands of the Sharia board mandated in order to be certified as an Islamic investment (Abdullah, et al., 2014). However, some dissolution clauses in the *sukuk* prospectus may render the issuance null and void from a Sharia perspective[26]. Generally, the outcome of issuing non-compliance the *sukuk* may damage the originator's reputation and will also result in an extensive effort to restore investor confidence (Tariq, 2004). For example, Goldman Sach's attempts to issue a one year *sukuk* in 2011 were withdrawn among charges that it had failed to uphold the principles of Sharia (Platt, 2014). One of the ramifications of the failure to issue the *sukuk* was the closure of the Sharia advisory firm that advised Goldman Sachs on the instrument. This aspect of Sharia risk can be best minimized by greater harmonization of commercial Sharia rules.

In addition, the Sharia compliance risk may arise due to changes in the opinions of Sharia scholars on a particular issuance. Any Sharia scholar has the right to change his *fatwa* about the approval of an issuance. To mitigate this aspect of risk, *sukuk* originators maintain that any subsequent changes in scholarly opinions would not have any impact on the validity of the statement made concerning any early issuances (Al-Bashir & AlAmine, 2011, p. 346). Thus, it is essential that the pronouncement of a particular issue remains in force even after the Sharia advisor changes his *fatwa*. Sharia compliance risk also arises if another Sharia

[26] Various examples will be shown in the case study chapters.

scholar disapproves of a particular *sukuk* issuance. This is because there is no guarantee that an issuance approved by one Sharia scholar will be approved by other parties in the field. In this situation, *sukuk* liquidity may be negatively influenced since investors may be reluctant to engage in a controversial issuance (Thakur, 2007). Hence, *sukuk*-holders are mainly recommended to refer to their personal independent Sharia advisor as to whether certificates satisfy their individual standards of compliance. A more important aspect of Sharia risk is that there can be no guarantee that *sukuk*-certificates and transaction documents will be enforced by the judicial authority in case of disputes. Although some *sukuk* have received pronouncements to confirm their compatibility with Sharia, such a statement cannot be binding on the judicial committee (Al-Bashir & Al-Amine, 2011, p. 347). For instance, there are a number of Sharia issues facing the *ijara sukuk* process that may transform the instrument to be similar to a loan with interest which is strictly prohibited in Islam. Thus, the possibility of *ijara sukuk* losing its Sharia value means that it would be judicially treated as a loan with interest.

4.4 Risk/Return of SBS and Bonds

This section provides a comparison between bonds and asset-backed *sukuk* pertaining to their financial risks in an attempt to identify the degree of danger in *sukuk* investment. The discussion will describe the results qualitatively in order to provide the literature with an understanding to the risks of SBS investment. Table 4-1 summarizes the previously identified risks along with their features and factors. Note that each risk is assigned a numerical value ranging from 0 implying no exposure to risk, to 1 indicating low exposure and 2 representing high exposure. As these rankings are based on subjective judgments, they can be considered indicative only.

Table 4-1 SBS Risks vs. Bond Risks

Risks	Features	SBS	Bonds	Factors
Sharia risk	-Not satisfying Sharia requirements -Changes in Sharia scholar's opinion -Another Sharia scholar disapproves of the issuance	1 Due to the strict adherence to Sharia principles	0 Due to no relation to Sharia and their principles	Being approved by only one scholar

	-Judicially treated as a non-Islamic instrument			
Credit risk	- Return payment risk - Principal payment risk	2 - Because any loss in the asset may affect the distributions - Due to the purchase undertaken at market price	1 Due to no link to the asset but rather to the originator's creditworthiness	-Being calculated under a floating adjusted rate -Having a long maturity period -Being securitized for unavailable assets
Market risk	Asset value risk	2 Due to the actual link to the assets	0 Due to no connection to the assets	Having a long maturity period
	Interest rate risk	1 Typically, an indirect influence as the distribution amounts are calculated based on real profits and are not benchmarked	2 Typically, is benchmarked with LIBOR with adequate management tools	-Being calculated under a fixed rate -Having a long maturity period -Illiquidity feature
	Currency exchange rate risk	2 All have the same exposure		Having a long maturity period
Liquidity Risk	Inactive secondary market	2 Due to limited issuances and the restriction on trading debt *sukuk*	1 Due to being more active and better standardized	Buy-and-hold exercise
Operational Risk	The impairment of the tangible asset	2 Due to the real ownership of the asset	0 Due to no connection to the assets	-
	Legal risk	2 Due to the absence of standardized regulations	1 Due to better standardized regulations	-
Total Risk Exposure		10 points	5 points	-

Note: 0= no exposure, 1= low exposure, 2= high exposure; factors playing a role in the level of impact of the risk.

Bonds are far safer due to the well-regulated market and well-developed management tools. As shown in the above Table, SBS have higher exposure to risks than bonds, which is not a surprising result. Being riskier than bonds is a natural result of investors changing from being debt providers to investment partners, which means the absence of guarantees. This higher exposure is attributed to the physical ownership of the underlying assets, since the transfer of ownership entails the transfer of losses, costs and maintenance associated with the underlying assets. For instance, investors have to bear all costs and expenses related to the basic characteristics of the assets.

The returns from SBS should reflect the significant risks according to the positive relationship between risk and expected return. In the financial version of 'no pain, no gain', more risks tolerated results in more profits expected. Usmani (2008) pointed out that *sukuk* – in the SBS structure - are an instrument for the equitable distribution of wealth since *sukuk* allow all holders to benefit from the real revenues and profits originating from the project or enterprise in equal shares whereas, in a standard security, the originator is not entailed to any return greater than the principal and the specified amount of interest whatever revenues and profits may have accrued from the projects established, which exclusively and entirely go to the originator. Hence, there is no right for bondholders to seek a share in the profits achieved beyond the interest received (Usmani, 2008). It is important to note that the higher level of risk inherited in SBS will also vary according to the contract applied. For instance, investors in forward *ijara sukuk* are mainly exposed to all of the risks borne by *ijara sukuk* investors; but also with some additional degree of risk related to the unavailability of the assets. This is because forward *ijara sukuk* include the *ijara* contract with further features that add to the risk. Another example is *intifa' sukuk*, treated as a secured *sukuk*, which has a greater exposure to credit risks. Thus, the risk management plan is essentially an integral part of financial planning for SBS. Although, the risks involved can be minimized and managed, they cannot be entirely avoided.

4.5 *Sukuk* and Agency issues

Agency problems that can occur at each stage of the *sukuk* process are not discussed in a way that identifies the principle/agent relations, conflicts and information asymmetries. This discussion will help to fill this gap exists in the literature of *sukuk* related to agency issues. Within the framework of agency costs, this section analyses the incentives for asset-backed *sukuk* that flow from informational asymmetries. Such asymmetries are commonly referred to as additional costs for the parties in asset-backed *sukuk*. In these *sukuk*, agency costs can refer to the loss in the value of the *sukuk* that result from the agents following their individual interests rather than the optimal interest for the investors. As indicated, in a typical structure of asset-backed *sukuk*, a number of parties are involved including the originator as a manager, a lessee, a servicer, or a contractor, which indicates the existence of potential

agency conflicts from different perspectives. These agency relations have not previously been discussed in the literature in such a way that allows analysis of the hidden actions, incentives and informational asymmetries. The following discussion aims to add to agency theory as applied to the structure of *sukuk* in order to show to what extent agency conflicts appear among the parties.

Although the details of asset-backed *sukuk* vary widely, the typical transaction involves the segregation of a specific set of cash flows from a particular originator's assets in order to issue *sukuk* based on these cash flows. For example, in *ijara*-based *sukuk*, the rental payments generated from the underlying assets are allocated to investors. However, potential investors face information asymmetries in assessing the assets, services and originator prior to the investment. While assessing the assets, there is an agency relationship between the originator and investors concerning the type of assets. The nature of the asymmetry of information depends on the type of the assets, as it may critically arise when the value of the securitized assets falls. Originators are in a position to use risky assets when structuring asset-backed *sukuk*. They have an incentive to exclude risky assets from their books and to transfer their excessive risks to another party. By securitizing these risky assets, this limits the originator's exposure to exogenous price risk. Adding to this, monitoring is inadequate since it suffers from information asymmetries between the monitor and the assets being monitored. However, originators can minimize the effects of asymmetric information by using assets that are typically less opaque (Albertazzi, et al., 2015). For instance, *sukuk ijara* typically securitizes physical and tangible assets that tend to be less opaque than securitizing loans, which helps to minimize the asymmetric information based on the type of assets.

According to the hidden-information framework, asset-backed *sukuk* asymmetric information arises from the value of the underlying assets. In these *sukuk*, there might no actual relationship between the cash received by the originator and the value of the assets. This means that the sale of these *sukuk* might not represent the actual value of the assets. Investors seek to purchase *sukuk* with confidence that the prices pai, reflect the value of the assets purchased. This is because paying a higher price, in SBS, than the assets' value becomes a critical issue in the insolvency of the originator. If the originator becomes

bankrupt, the investors would have recourse in place to cover any losses that occurred, but if the principal was far higher than the actual value of the assets this would result in a greater loss. Furthermore, if these *sukuk* will end according to their future actual value, this would also result in a loss of principal. Moreover, paying a higher price than the assets' value may affect the proceeds from the assets since the returns depend on the condition of the assets. Revenues from securitized assets vary with the exogenous fluctuations in their price and also with endogenous causes of changes to the asset's conditions. This means that investors may not receive their returns in a timely manner and, in a worst case situation, they may lose all of their returns. This demonstrates the uncertainty in terms of the returns. For example, in *ijara sukuk*, the endogenous condition of the assets during the period of the contract may influence the return. To illustrate this, when a partial loss occurs to the securitized assets, this leads to a reduction in the rental payment, and when a total loss of the asset occurs, this means a total loss of the forthcoming returns. Therefore, it is essential for investors to be confident about the value and condition of the invested asset.

Another source of uncertainty in the value of *sukuk* is when the assets are unavailable. In this case, there is another dimension of agency relationships, which is the agency existing between the investors and the originator as a contractor. The assets' value is influenced by the contractor's effort, inherent talent and other factors that cannot be observed. These unobserved factors can have a direct effect on the final value of the asset, resulting in a possible moral hazard risk. Adding to this, investors are not capable of monitoring the contractor, having no efficient access and authority, and cannot assess the business. In this case of asymmetrical information, the contractor has a compelling incentive not to perform well, which can lead to the investors being deceived into paying a far higher price for a poorly constructed asset. Moreover, when the assets become available, the originator as a manager may misuse them, misusing the surplus since the investors/owners do not have adequate information about or control of the asset The manager may misuse the surplus or spend it on personal expenses rather than meeting any forthcoming obligations such as maintenance costs for the assets[27]. If the assets increase in value, then the SPV will be able to pay all its obligations while gaining a surplus. However, the greater the access that the

[27] As discussed earlier; the maintenance costs of assets are incurred by the investors.

originator has to the earnings from the underlying assets, the more likely to suffer from agency costs. However, some structures retain a subordinate tranche for the originator where surplus may occur, and this would increase the originator's access to these earnings. In such a case, *sukuk* can be structured in a way that the originator would not have recourse to the surplus by selling the subordinated tranche to a third party. This will protect investors from agency conflicts concerning surplus earnings.

The originator in asset-backed *sukuk* is typically the servicer of the asset and investors face a costly and difficult duty in ascertaining the quality of services. Typically, there is no authorized access for investors to evaluate the services provided by the originator to determine whether or not his actions were proper and adequate. Low quality services for the securitized assets may arise as a result of the informational asymmetries of the type of services. Moreover, the quality service of the assets is difficult to evaluate owing to the simultaneous production and consumption of services (Holmstrom, 1985). As investors are unable to examine the competence of the service provider, the quality of the securitized assets, along with the hazards of malpractice, cannot be predicted. Therefore, the price of asset-backed *sukuk* may not reflect the actual value of the underlying assets. Sellers of low-quality assets can enter the market and distance the providers of high-quality assets by reducing price that the latter cannot gain sufficient returns on their investments for competency enhancement (Akerlof, 1970). To illustrate this, the behaviour of investors in asset-backed *sukuk* mainly relies on the information that is available before and after purchase. Before making the purchase decision, investors seek information about the price and the quality of the other alternatives under their consideration. However, the service quality of the assets is difficult to evaluate, resulting in assets with high and low quality services coexisting in the market for assetbacked *sukuk*, leading to a greater exposure to the lemon problem.

In asset-backed *sukuk*, an adverse selection may arise between the originator who belongs to a profit-maximizing institution and highly Sharia sensitive investors on the question of compatibility with Sharia (Azmat, et al., 2014). Most investors cannot evaluate accurately to what extent the issuance is compatible with Sharia. Sharia advisors may be able to act as intermediaries to ensure compliance and thus mitigate the informational

asymmetries between originator and investors. Nevertheless, as investors are not involved in structuring these *sukuk*, this may enable the originator to overcome some Sharia requirements through *fatwa* shopping. Adding to this, the *fatwa* usually does not provide any classification on their specific basis in Sharia or the details of the standards applied; rather, it tends to provide a general statement on compatibility with Sharia. Concerning this issue, it can be said that the *sukuk* approved by a number of scholars can indicate a higher credibility in having avoided *fatwa* shopping compared to *sukuk* approved by only one Sharia advisor. This case would bear a lower risk of being incompatible with Sharia and could minimize the risk of adverse selection. However, after the *sukuk* have been purchased, the originator may benefit from the absence of Sharia supervisors since most issuances do not include any Sharia supervision after the *fatwa* is published. This may result in a moral hazard from the originator not following all Sharia requirements.

Given information asymmetry as an inherently problematic and costly problem in asset-backed *sukuk*, there are a number of mechanisms that can be used to limit the agency costs. By addressing some collateral to securitized assets, this can make the structure more effective in reducing agency risks. Moreover, investors must ensure that the originator of the *sukuk* bears some of the risks associated with the underlying assets. This can reduce the degree of moral hazard and adverse selection problems caused by the quality of information and amount of asymmetry. For instance, if the originator as a manager/agent undertakes the purchase of the underlying assets at their nominal value, the manager's actions would be in favour of the assets, and difference in the incentive between investors and the originator would be minimized. Purchase undertaken at nominal value is one of the optimal device used to manage incentives, since the repurchase contract shows a dimension of sharing between the manager and investors in the securitized asset, resulting in reducing the costs of monitoring. However, the implementation of repurchase contracts, according to market value, can raise the incentive asymmetry as the market value is the best summary of the value of managerial decisions (Iacobucci & Winter, 2005). The managerial decisions made by the originator can be used as a means to reduce the price which would be paid to investors. However, the limitation of future agency costs through such an undertaking is only half of the story, since in order to control the agency costs in asset-backed *sukuk* there must be a commitment that the proceeds from the assets are not misused. In *ijara*-based *sukuk*, the

return is precisely determined as a rental payment and thus the cash flow for the asset will not be wasted. This leads to the better management of the agency costs. Committing the future cash intake to investors in this way reduces the agency costs of free cash flow and protects future cash flows from mismanagement. Through these two mechanisms, the investors would have an incentive to examine how the assets are managed and serviced and how the proceeds are spent. Investors will thus not have to spend on monitoring and examining the proper usage of the assets in order to that ensure the proceeds are used wisely, and as a result the incentives and risks in relationships between the originator and investors become less asymmetrical. For example, the asset's performance in *ijara sukuk* is not a concern for the *sukuk*-holders, but rather they are only interested in coupon payments. This is because the issuer undertakes to buy the underlying asset on the maturity date for an amount equal to the face value of the *sukuk*.

4.6 Summary

Asset-backed *sukuk* involve a high level of exposure to particular financial and Sharia risks. This chapter identifies various aspects related to *sukuk* risks. It is important to advise investors to follow their individual Sharia standards according to the guidance of their independent Sharia advisor in order to reduce the risk of conflict or changes in *fatwas*. Most aspects of Sharia risk can be reduced by strict adherence to Sharia financial law. In this regard, SBS structures show a harmonization with Sharia rules which leads to the better management of this risk. Also, the chapter highlights the two main features of credit risk that may face asset-backed *sukuk*. The chapter further identifies a number of factors that increase the exposure to credit risk in asset-backed *sukuk*. The potential of return payment loss and the principal payment loss are at the core of credit risk exposure. Linking the return with a floating rather than fixed interest rate makes the return less predictable. The long maturity period of the issuance also makes default less predictable. If the return is predictable and easier to forecast, this improves the management of the distribution amounts so as to avoid defaults. Furthermore, the unavailability of the securitized asset adds another dimension of credit risk. Possible default in delivering the assets according to time or specifications makes the risk exposure higher. Embedding any of these features in the structure of asset-backed *sukuk* increases the possibility of defaults. SBS are exposed more to credit risk than bonds

since the return and the principal are not guaranteed by the originator, unless the loss occurs due to misuse or negligence, while the structure of the bonds typically provides a guarantee to the capital and the return.

The research also addresses the market risk of asset-backed *sukuk*, which involves three main aspects. Firstly, asset value risk is where changes in the price of the underlying asset may influence the value of the *sukuk*. This risk is greater with SBS than with bonds. This is attributed to the association between the investors and their assets. Secondly, the SBS should be less exposed to interest rate risk as their optimal return depends on the actual revenues from the asset. However, the direct link between the return and any of the interest rate indictors will increase the risk exposure. Finally, currency exchange rates exposes the structures of both *sukuk* and bonds to risk to similar extents. The liquidity risk in *sukuk* investments is higher than in their conventional counterparts. This is due to the inactive secondary market in *sukuk* caused by the exercise of 'buy-and-hold'. The market requires an activation of the primary market to issue more *sukuk* as well as better regulation. Finally, the operational risk that appears is higher in SBS than in bond investments. This is attributed to the additional exposure to all negative incidents concerning the asset which are incurred by investors as owners. The degree of this exposure depends on the nature of the asset. In general, SBS receive higher exposure to all types of risks than bond, which is a predicted result due to the nature of *sukuk*.

Chapter 5: An Overview of the *Sukuk* Market in Saudi Arabia

5.1 Introduction

It is likely that Saudi Arabia will be a major contributor to the growth of *sukuk* issuance. This is because its position has positively changed after an upsurge in Riyal *sukuk* issuance with a faster expansion than for traditional bonds. In 2012, around $7.25 billion denominated *sukuk* were issued, which was up from $3.01 billion in 2011. In the first quarter of 2013, $2.74 billion had been issued, showing a rapid growth in the market (Ajlouni, 2013). In 2013, *sukuk* issuance in the country, according to Zawya, increased to the equivalent of $15.2 billion through 20 deals, compared to $11.2 billion through 18 deals in 2012. In 2014, Saudi Arabia was the second-largest *sukuk* issuer, with a total of 15 issuances that were worth more than $12 billion (Saudi Hollandi Capital, 2013). Moreover, there are a number of issuances in the pipeline, according to the Saudi Bank NCB, such as of the Saudi National Shipping Company with an announced value of around 4 billion denominated in Saudi Riyal over a 10-year tenor (Augustine, 2015).

These record numbers are motivated, according to Moody (2013), by the strong investor demand with a marked preference for Islamic financial instruments within the country. This is coupled with the increased funding opportunities to finance the Kingdom's large-scale infrastructure developments. The infrastructure sector, constituting utilities, construction and transport, was the main contributor to the *sukuk* market and accounted for the majority of the amounts raised in 2013. *Sukuk* markets in the kingdom have promoted factors such as reform initiatives, in increasing government spending and high levels of the repatriation of the Kingdom’s funds into the country after the 2008 financial crisis. Increasing capital requirements in the infrastructure sector represent strong opportunities for *sukuk* (Alawi & Al-Quati, 2014). The Finance Minister of the Kingdom officially declared government plans to issue Islamic *sukuk* in order to finance the current budget deficit due to fluctuations in oil prices (Aljazeera, 2016). On the demand side, the *sukuk* market is further enhanced by the increased participation of institutional investors, as investing in *sukuk* could

facilitate better portfolio diversification. However, the *sukuk* industry in Saudi Arabia is exposed to specific structural issues that need to be addressed. This chapter discusses the key challenges for the *sukuk* market in the country. The issues that primarily face the secondary *sukuk* market are addressed in order to draw conclusions concerning the way forward for the Saudi market on the global *sukuk* map.

5.2 Primary *Sukuk* Market

The Saudi *sukuk* market is relatively new due to the delays in its first issuance. The first issuance was the Caravan *sukuk* in 2004 by HANCO a car rental company, that was based on an *ijara* contract for three years (Ahmad, 2010). A year earlier, in 2003, the Saudi government founded the CMA as an independent regulatory body in order to develop and regulate capital market activities (Alesheikh & Tanega, 2011). This shows that the delay was a natural result of the lack of a separate body to govern the securities market. Afterwards, the Saudi Electricity Company (SEC), Saudi Basic Industries Corporation (SABIC), Saudi Hollandi Bank, and Dar Al-Arkan Real Estate Development Company (DAAR) have all issued *sukuk* to fund their long term projects, operations, or to refund existing debt. However, there have been no official *sukuk* issued by the Saudi government as there has been in Malaysia and a number of other Islamic countries.

During the crisis, international investors became more cautious of lending to any Saudi corporation after the high-profile defaults in 2009 of the Saudi Al-Saad Company and Al-Gosaibi groups. However, the price of credit default swaps for the region increased again in 2011 since, during the 'Arab Spring' Saudi Arabia has overcome this negative global situation. This is evidenced by the over-subscribed *sukuk* issued in 2013 via Saudi Aramco for its Sadara joint project, as well as the three fold over- subscription to the $4 billion *sukuk* issued by the General Authority of Civil Aviation in 2012. Table 5-1 shows other examples of *sukuk* issuances, representing a sizeable market for such volumes of *sukuk* (Ramady, 2014).

Table 5-1 Saudi Sukuk Issuance, 2009–2013

Date	*Sukuk* name	Amount ($)

2009	Saudi Hollandi Bank	193 million
2011	SATORP Aramco	1 billion
2012	General Authority of Civil Aviation	4.0 billion
2012	Saudi Electricity Global *Sukuk* II	2 billion
2012	Banque Saudi Fransi	1.25 billion
2012	Islamic Development Bank	1.3 billion
2013	Sadara Saudi Aramco	2.0 billion

Source: Saudi Aramco (2013).

Beyond the market growth in terms of size, *sukuk* have become more sophisticated by moving from plain vanilla structures to more innovative transactions. Plain vanilla *sukuk* are where only one Sharia contract is applied. This becomes more complex when it is then applied to a group of at least two Sharia contracts. In this respect, several structural innovations have been seen in the riyal *sukuk* market, including an increase in non-rated issuers entering the market (Saleem, 2013). Also, it is important to highlight that the differences in the costs of issuing *sukuk* and conventional bonds in Saudi Arabia is insignificant, and in some cases, *sukuk* issuance cost less than issuing bonds. The returns on riyal *sukuk* are low compared to those in other markets since profit rates are not determined by the prevailing money market rates; rather the scarcity of riyal issuances shows a further 30-40 bps contraction. For instance, the Sadara *sukuk*, which was a recent issuance with a lifespan of 16 years, was priced at 95 basic points above the six-month Saudi interbank offered rate, creating a profit rate of just under 2%. By comparison, the Saudi Electricity *sukuk* priced at $1 billion, a 10-year dollar denominated *sukuk* in the global market in March, offered 3.473%, making it a better and more attractive return (Pancholia & French, 2013). The current low return in this market can be attributed to the high demand for *sukuk* in the country. *Sukuk* in the Saudi market are regularly over-subscribed, showing that the demand from institutional investors far exceeds supply. Saudi investment insurers and funds, which are cash-rich in a booming economy, seek *sukuk* for their portfolios and would accept low returns for investing in them, generating a more financially attractive option for issuers (Arabnews, 2013).

On the other hand, the cost of *sukuk* in other Asian countries is still higher than that of issuing bonds. For instance, in Malaysia, despite being the largest *sukuk* market, the

average yield on *sukuk* is higher than eight percentage points over that of traditional bonds and in Indonesia, a growing market, the yield on *sukuk* is significantly higher with 86 basis points over the issuing of bonds (Reuters, 2014). Despite the lower costs of the Saudi *sukuk* market, a considerable difference in size can be seen between this market and the Malaysian market.

Table 5-2 Comparison between Saudi and Malaysia Sukuk Markets, (Jan 2001 – Dec 2015)

	Corporate *Sukuk*		**% of Total Value**
Malaysia	Issue Size ($ ml)	516,736	71.38%
	No. of Issue	4700	
Saudi Arabia	Issue Size ($ ml)	59,427	8.21%
	No. of Issue	87	

Source: IIFM *Sukuk* database, 2016

Between 2001 until end-2015, Malaysia issued 4700 corporate *sukuk* that were worth $516,736 billion, while only 87 corporate *sukuk* worth $59,427 billion were issued by Saudi corporations, taking into account that there is no comparison in the sizes of the Saudi and Malaysian economies. These figures show that Saudi banks and corporations are losing the opportunity to gain income which would have been obtained if they had invested appropriately in establishing a comprehensive and proactive *sukuk* infrastructure (Khnifer, 2011). Moreover, the Saudi government, as the biggest player in the Arab stock market, has a plan to spend around $400 billion on its infrastructure and could gain enormously from the large appetite for the *sukuk* market in the Kingdom. This would enhance investment opportunities by providing investors with a wider range of financial products and would enrich companies' financing methods by avoiding borrowing from banks in order to prevent the inclusion of long-term debts on their balance sheets (Alesheikh & Tanega, 2011). Therefore, banks need to react swiftly; otherwise, they will be mere bystanders when the corporate *sukuk* market comes to dominate.

In this context, it is important to highlight the Malaysian public policy as enabler for Islamic finance to progress. Malaysia's long-established public policy commitment to the

development and expansion of Islamic finance has been instrumental in placing the country as a key international centre for Islamic finance (ICM, 2016). Malaysia was successful in building up Islamic finance because of their pro-active nature of the public policy provides the necessary regulative environment and the required incentive mechanism. It allowed non-Islamic financial organisations to develop Islamic finance instruments, subject to the necessary Sharia safeguards (Panglima & Adjunct, 2007). Islamic banking was introduced in Malaysia through "windows," which permitted conventional financial institutions to provide Sharia-compliant banking instruments and services. Unlike some other countries, where legislation now necessitates Islamic banks to be standalone, maintaining this strategy supported the creation of a competitive and dynamic Islamic financial industry. The same year, a Sharia-compliant government Investment Act was announced to allow the government to provide Sharia-compliant investment certificates in order to facilitate managing liquidity risk of Islamic banks. This is in addition to the progressive liberalization, which allowed foreign organisations to receive Islamic banking licenses, saw an increase of parties in the industry; Malaysia presently has 16 licensed Islamic banks, of which 6 are subsidiaries of foreign organisations. Currently, Malaysia's Islamic banking assets valued at $65.6 billion and the industry sees a robust average growing rate of about 20 percent annually (Ibrahim, 2016) .

5.3 Secondary *Sukuk* Market

In June 2009, the Kingdom established a new secondary trading platform to replace the previous process of over-the-counter transactions (Jadwa, 2009). The secondary market in *sukuk* is small compared to those in other countries with comparable economic indicators. *Sukuk* trading in 2014 amounted to only 108.1 million SAR, and by the end of the first quarter of 2015, there was only a single deal amounting to 213.5 million SAR. This shows an evident weakness in a market that is worth $8.1 billion for its listed issuances (Augustine, 2015). Despite the large size of the market, the number of listed issuances on the Tadawul arise from only four issuers. The current secondary market worth SAR 28.2 billion is divided between six issuances: Sadara owns SAR 7.5 billion issued by the Aramco Company; Saudi Electricity 3 owns SAR 7 billion, Saudi Electricity 4 owns SAR 4.5 billion, the Bahri *sukuk* own SAR 3.9 billion, the Satrop *sukuk* own 3.5 billion riyals issued by the Aramco Company,

and finally the Sipchem *sukuk* own SAR 1.8 billion. The market suffers from being totally inactive since the emergence of the market. From mid-2009, only SAR 3.9 billion were traded in 220 deals (Alarabiya, 2016). The market is found with no single transaction taking place for more than 45 days. The Saudi market in *sukuk* represents enormous potential wealth that has not yet been stimulated. The primary market is in relatively better condition in terms of issuance and offering, while the secondary market is counted as one of the least active in the region, which means that it is absolutely necessary to animate this market and deliver appropriately efficient mechanisms (Al-Buqami, 2013).

Although, all Saudi *sukuk* issuances have succeeded and have been oversubscribed, the trading in these *sukuk* is not yet healthy. The current limitations of the Saudi primary market and the lack of alternative products in the *sukuk* asset class have led to a situation where demand is higher than supply, therefore incentivizing investors to hold onto *sukuk* until their maturity date. The size of the secondary *sukuk* market is negatively influenced by the presence of buy-and-hold strategies activated by major investors (Alawi, et al., 2010). Therefore, the price of any new *sukuk* issuance in Saudi Arabia can be distorted because banks are unable to get the required *sukuk* prices. In addition, the absence of securitization and active market makers which are important in ensuring an effective price discovery mechanism are further elements hampering Saudi secondary trading.

Furthermore, Saudi *sukuk* are sold with a minimum price that is over the individual budgets. *Sukuk* issued in the market are out of reach for average investors as a natural result of their huge costs. For instance, buying one *sukuk* from the SEC costs SAR 1 million, whereas most sovereign and corporation bonds cost $1000 and are sometimes issued at only $100 in some sovereign issuances. This also represents as an obstacle in activating the Saudi secondary market (Al-Hoymany, 2014). More critical is the current trading commission applied in the market, which is considered a major obstacle for growth since commissions are not applied properly so as to serve the market and investors.

A fair trading commission can motivate and activate the market; however, in the Saudi market, the maximum commission that is allowed for trading equals is one thousandth of the value of the transaction, with a minimum of 500 SAR. Despite the argument that this

level of commission is insignificant, the fact is that commission has an adverse influence in the market. Firstly, the reason for and purpose of applying a minimum commission for trading is unclear, as this may discourage individuals from trading in the market if each transaction, no matter how small, will cost a minimum of 500 SAR. However, if an individual or an institution wants to buy one *sukuk* from the fourth edition of the Electricity Company for one million SAR, they will have to pay one thousand SAR as a commission. But the return from this *sukuk* would be 16,500 SAR, meaning that 6% of the transaction will go towards paying the commission. This can have direct a impact on slowing down activities in the market, whereas the commission in the US for some transactions does not exceed $10 (Al-Hoymany, 2014).

5.4 Legal and Regulatory Framework for *Sukuk* Market

In Saudi Arabia, there are two official bodies responsible for the regulation and supervision of Islamic financial activities, including *sukuk* issuances. These financial authorities are the Saudi Arabian Monetary Agency (SAMA), and the Capital Market Authority (CMA). The SAMA was established in 1952 to act as the central bank for the Saudi government. Then, fifty years later in 2003, the development requirements of the industry and its evolution necessitated the founding of a separate regulatory body that focuses on the investment and capital markets, and thus the CMA was established.

The CMA has the sovereignty required to regulate and control the capital market (Alesheikh & Tanega, 2011). The CMA's duties include the development and regulation of the issuing of securities, controlling publicly traded companies, ensuring transparency and protecting investors from unfair market activities. Thus, no Sharia supervisory responsibilities were given to the CMA (CMA, n.d.).

Saudi Arabia strictly adheres to Sharia laws, and thus as Islamic financial instruments, *sukuk* are not particularly popular in the community. Some of the rules of Islamic investment and trading are enforced by law such as the prohibitions against consuming alcohol and pork and entering into gambling activities; however, other Islamic financial rules, such as the prohibition of contracts contaminated by fixed-interest, are not enforced by Saudi law but are generally recognized by investors (Merdad, et al., 2010).

Although Saudi Arabia is an Islamic country whose constitution prohibits dealing with *riba*, *riba* in practice does exist in its financial market. The policy of the Saudi government related to the use of interest in the banking sector is exemplified in Article 2 of the Royal decree. This established the charter of the SAMA, which represents the central bank and is forbidden from participating in any business that is based on interest. This Royal charter shows the banning of interest, confirming the Saudi government's attitude towards Sharia rules. Nevertheless, deals with interest can be seen to occur in most commercial banks where financing and trading rely on a fixed annual rate, while no objection has been made by either the government or SAMA to such practices by commercial banks (Alsulaiman, 2011). This implied permission of *riba* which creates system where conventional and Islamic systems coexist. The country allows around fifteen international and national financial institutions to operate entirely or partially along conventional lines as well as along Islamic lines.

Saudi Arabia has the largest Islamic bank in the gulf countries, namely the Alrajhi Bank; however, bank and market regulators in Saudi Arabia do not assume any Shariarelated duties. Islamic finance and banking operations have been practised in the Kingdom for decades without being regulated in a similar way to the conventional sector.

There is no specific law or policy designed for Islamic financial institutions within the context of the official regulation structure in Saudi Arabia. There is no specific framework for issuing *sukuk*, and most of the articles in the Offers of Securities Regulations and the Listing Rules indicate financial tools as securities in general or refer to stocks, debt instruments or bonds in some cases. In their articles, there is no mention of the word *sukuk*, consequently *sukuk* issuance is not operationalized under a framework that takes account of the nature of *sukuk* as different from traditional debt instruments. Rather, the CMA monitors and regulates *sukuk* issuances side-by-side with the issuing of bonds under its Listing Rules and the Offer of Securities Regulations (Alesheikh & Tanega, 2011). Despite the fundamental differences between *sukuk* and conventional debt instruments, the Offers of Securities Regulations and the Listing Rules do not account for the clear differences between *sukuk* and stocks, nor between *sukuk* and conventional debt instruments. *Sukuk* are currently issued as debt products under the broader meaning of 'Debt Instruments' in the Regulations; however, it can be argued that *sukuk* designs would not generate a debt obligation on the originator. Alesheikh and Tanega (2011) believe that the present regulations for issuing

bonds in Saudi Arabia do not provide an effective mechanism to set up and maintain transaction-specific special purpose entities. This generates substantial obstacles, thereby hampering investors' ability to obtain access to capital markets. Also, the absence of such specifications may cause confusion between *sukuk* and bonds and would define *sukuk* as debt instruments even if these *sukuk* do not generate any debt obligations on originators.

An additional issue for *sukuk* is the absence of a central Sharia supervisory board that specializes in Islamic finance. The absence of such a significant body may lead to a decrease in public trust towards Islamic financial instruments. Nevertheless, several institutions have their own Sharia supervisory boards and follow the guidelines and principles that are published by regional and international institutions such as the AAOIFI. These institutions submit themselves to a Sharia board in order to ensure their activities are compliant with Sharia principles. However, a structure or document that is allowed by one Sharia board in one institution may be rejected by another Sharia board in a different institution. Thus, the absence of a centralized Sharia supervisory board raises the possibility of conflict in *fatwas* among Islamic scholars on Saudi *sukuk* issuances.

These different opinions may result in major damage to certain *sukuk* issuances, in addition to a loss of confidence among investors (Alesheikh & Tanega, 2011). The current situation could be attributed to a lack of interest on the part of the Saudi financial regulators the SAMA and CMA who are less concerned with supporting Islamic finance than fulfilling traditional central banking roles (Wilson, 2002). Therefore, each financial institution is free to identify its own Sharia criteria, rules, board and acceptable investments (Asaad, 2007).

5.4.1 Saudi Courts and *Sukuk* Disputes

Given the current lack of *sukuk* regulation, the question that arises concerns how Saudi courts deal with *sukuk*. The strict prohibition of *riba* has influenced court decisions related to disputes involving financial institutions. This is because the policy of the Saudi court is to not submit any ruling that might be considered a breach of Sharia law. Thus, these courts have rejected any claims against customers who are in debt to any financial institutions. This can be shown in the Decision No.291 of the Supreme Judicial Council, dated 1980, which provides that all courts are banned from validating the mortgage loans of commercial banks. This decision emphasized the refusal of the Saudi Tribunal to examine

financial disputes associated with interest, considering them on a jurisprudential footing. Banks and other financial institutions still place major pressure on the courts to review decisions by referring to the risks and losses generated by this refusal. The first commercial Circuit refusal at the Board of Grievances was made in 1996 to adjudicate a situation involving bank shares, since the contractual obligations between the plaintiff and the defendant involved interest (Aljarbou, 2004). However, with regards to *sukuk*, there is no precedent case yet to define the approach of Saudi courts in dealing with disputes related to *sukuk*. This poses some doubt concerning to what extent the rules regarding *sukuk* documents would be imposed by the pertinent judiciary.

In addition, *sukuk*-holders need to show the validity of *sukuk* according to Sharia, since there is no guarantee that the approval of certain *sukuk* issuances by the originator's Sharia advisor would result in them being validated by the court, because such approval is not binding. Rather, the court has the discretion to issue its own determination related to the compliance of a particular *sukuk* issuance with Sharia and Saudi law. This means that there is no certainty regarding the jurisdiction of the court and the approach to enforcing it in cases of *sukuk* disputes. The securities regulations in Saudi have a main issue concerning the transparency of court processes and decisions, and thereby public confidence. Moreover, in certain cases, a court's legal decisions and judgments are not published, leaving ambiguity as to how legislation may be interpreted (Alsulaiman, 2011). In addition, there is a lack of well-established insolvency law in Saudi Arabia. The fact is that a separate bankruptcy law does not exist in the Saudi legal framework, and bankruptcy law in Saudi is still underdeveloped. Also, there are no clear requirements for true sale transactions which have further exacerbated the risk to *sukuk* issuers in structuring true sale *sukuk* (Dusuki & Mokhtar, 2010). Thus, there are difficulties in understanding the risk of the originator's bankruptcy in respect of the sale of assets in true sale the *sukuk* structure.

5.4.2 The *Intifa' Sukuk* System in Saudi Arabia

In Saudi Arabia, *intifa' sukuk* (time-share *sukuk*) were first formed in 2005 for tourist real estate units, such as guest-houses and hotels. *Intifa' sukuk* permit the distribution of the expenses for construction, operation, and maintenance management between a number of beneficiaries, thus minimizing the expenses for users. The demand for these *sukuk* has

increased during the past years, which has prompted the government to modernize and develop regulations governing this activity. The Saudi government introduced a version of the system to deal with *intifa' sukuk* and the system specifically defines the obligations and responsibilities of the involved parties with some penalties to be imposed upon violators of the regulation. The aim is to protect all parties involved from intentional or unintentional abuse (Saudi Embassy, 2015).

Thereafter, in 2014 the Saudi government withdrew dealing of *sukuk intifa'* with non-Saudis in the two holy cities (Medina and Makkah). The operation of the intensive hotel services and facilities in these two cities cannot now involve non-Saudis (Saudi Embassy, 2014). The reason for this is attributed to the intensive infrastructure construction undertaken by the Saudi government. This entails the construction of a number of new hotels to facilitate pilgrimage in the two holy cities. The prohibition of non-Saudis from dealing in *intifa' sukuk* has excluded the inheritance situation. The official statement instituted this resolution with immediate effect.

5.5 Saudi *sukuk* market and low oil income

The Saudi Arabian economy is heavily dependent on the oil industry. In recent times the price of crude oil has dropped more than 50%. The impact of low oil income has an influence in reducing the liquidity and causing fiscal deficit on the growth of *sukuk* market. Consequently, Saudi Arabia has witnessed a downgrading in its credit rating by both Fitch and Moody's in the last few months, with both ratings agencies quoting a drop in oil prices as the reason for the drop of Saudi Arabia's credit profile (Pettinger, 2015). Moreover, S&P rating agency also lowered its unsolicited short and long term, local and foreign currency sovereign credit ratings on Saudi Arabia to 'A+/A-1' from 'AA-/A-1+' with its outlook maintaining negative (CIMB, 2016).

Contrary to the market expectations that drop in oil prices will support the expansion of *sukuk* issuances, *sukuk* market witnessed a significant drop in their total issuance. Despite of the significant fall in oil prices since mid-2014, total *sukuk* issuance did not pick up in 2015 or even in the first half of 2016, as was expected by a number of market commentators. In fact, issuances decreased in the first half of 2016 by 12.5 percent from a year ago. While other commentators supposed low oil prices would encourage the

government to tap the *sukuk* market for funding to maintain the capital spending (Augustine, 2016).

One of the principal reasons explaining the lack of linkages between oil prices and *sukuk* market in Saudi is attributed to the large stocks of fiscal assets that Saudi Arabia have built up during many years of fiscal and current account surpluses. It has built up substantial foreign currency reserves; thus it can afford temporary drops (Pettinger, 2015). This is along with conventional debt issuances that Saudi government tend to use them as a source of public-sector deficit financing. This is because *sukuk* issuances are mainly supported by real assets. Isolating sufficient assets to support the issuances can add to the funding timeline and influence the overall financing cost while conventional bond maintains its attraction for the government (Reuters, 2016).

5.6 Recent Developments and the Way Forward

To develop a functional capital market, a structural and economic changes and legislative amendments are needed. In 2008, the CMA made a major decision to permit foreign investors to directly invest in the Saudi stock market after decades of highly conservative regulations on foreign investment. In fact, the Saudi secondary market does not need liquidity from foreign investors but only requires greater regulation and transparency (Alesheikh & Tanega, 2011). Due to its large size, the Saudi financial market does not need additional liquidity but rather the market needs to be developed by increasing transparency and reforming the regulations. In spite of government initiatives to develop the Saudi capital market, a number of hurdles still exist preventing the country from achieving its full potential, such as the lack of transparency and unclear economic policies. These are still major challenges (Ajlouni, 2013).

For the Saudi *sukuk* market to achieve their microeconomic and macroeconomic benefits, it is would be significant for *sukuk* to be issued and traded afterward on a large scale. In this respect, the Saudi primary market is active; however, the market cannot satisfy the demand. The Saudi government has to engage in the market along with corporations in order to achieve a better balance between demand and supply. In the next few years, the corporate *sukuk* market is predicted to rapidly increase, even with the current absence of a

developed regulatory and legal framework for the market. Saudi corporates are expected to issue more *sukuk* than bonds due to the wider range of investors who are restricted to Sharia-compliant borrowing according to their individual rules as well as other international investors who are becoming increasingly satisfied with *sukuk* investments. This expectation can be supported by the huge market appetite for *sukuk* as a fixed income product that has motivated private and public companies to focus on *sukuk* rather than on conventional lending instruments. Consequently, there has been a total absence of Saudi corporate bond issuances since 2013, while in 2014 *sukuk* issues reached a value of $7.8 billion (Augustine, 2015).

Moreover, there is a persistent need for a more robust secondary *sukuk* market to be built that would boost its appeal, particularly among active institutional investors. The lack of liquidity appearing in the secondary market is one of the critical risks associated with investing in the Saudi *sukuk* market. This illiquidity has discouraged a number of retail investors to consider participating in this market. In this respect, investors tend to claim a premium for participating in illiquid investments; however, the yields offered by the listed Saudi *sukuk* do not compensate for this illiquidity risk (Kawach, 2009). Currently, a key component of the further success of the *sukuk* market in Saudi Arabia would be to develop a more liquid secondary market rather than to compensate with higher returns. To encourage trading, it is vital for the Saudi capital market to adjust some of the current costs and commissions in such a way as to reduce the total costs of trading in order to encourage the involvement more players (Al-Hoymany, 2014). In addition, Saudi Arabia has to encourage the issuance of *sukuk* with varied credit qualities, risk profiles, maturities and currencies. This would offer investors a range of options in the market and promote retail participation. For example, the Malaysian *sukuk* framework permits the issuance of both ringgit and non-ringgit *sukuk*. Also, market makers and brokers should accept a greater role in the secondary *sukuk* market. Intermediaries are investment bankers, fund managers, and brokers who can facilitate secondary trading by underwriting and counselling on complex *sukuk* issuances (Mohammed, 2014).

It is also essential for Saudi Arabia to establish a uniform and adequate regulatory framework in order to keep pace with the rapid development of the *sukuk* market during

recent years (Alawi, et al., 2010). The major solution to the absence of a legislative structure for *sukuk* issuance would be to extend current regulations to cover a wider range of financial products, including *sukuk*, by issuing new regulations. Before issuing new regulations relating to *sukuk*, there are some vital points that have to be considered by the board of the Capital Market Authority. Firstly, any regulatory and legislative framework for issuing *sukuk* has to be compatible with the principles and provisions of Sharia. This is because the Basic Law of Governance in Saudi adopts these principles, as it stipulates that the constitution of the Kingdom of Saudi Arabia is the Holy Quran and the Sunnah (Council of Ministers, n.d.). Thus, any new regulations for *sukuk* have to consider Sharia law based on the Holy Quran and the Sunnah in order to prevent any conflict with the Basic Law of Governance. In addition, the new regulations for *sukuk* should be approved by a Sharia Committee whose members are appointed by the Saudi Sharia Advisory Council (SSAC). This step can ensure that the new regulations and legislation concerning *sukuk* are compatible with Sharia rules (Alesheikh & Tanega, 2011). Also, it is important to establish an independent central Sharia board to supervise and standardize Islamic banking activities, including issuing *sukuk*, and to institute a Sharia Committee comparable to the Sharia Advisory Council (SAC) in Malaysia. However, the Sharia committee or adviser can be appointed by the CMA until an independent body such as a Saudi Sharia Advisory Council (SSAC) is established. A general Sharia compliance board is for the banking and finance sector can ensure the uniformity of lending decisions in meeting Sharia law (Sidawi & Meeran, 2011). The establishment of this board is necessary with some level of authority in order to enforce its statements and to generate general rules and guidelines that should be taken into account by entities issuing *sukuk* in the Saudi market.

Also, the CMA should adopt guidelines and standards that are related to *sukuk* and published by regional and international institutions such as the International Islamic Financial Market (IIFM), the Islamic Financial Services Board (IFSB), and the AAOIFI. For instance, in 2008 the AAOIFI has issued six recommendations about how to structure *sukuk*, which dealt with issues of repurchasing, ownership and compliance (Al-Shamrani, 2014, p. 110). Undoubtedly, having a separate and robust regulatory framework for the issuance of *sukuk* would ensure high standardization and reduce the risk of difference of opinion between

Sharia scholars. For this, coordinated efforts have combined the achieves of key regulatory bodies such as the Finance Ministry, CMA and SAMA to improve the current situation. However, there is a recent applied factor that can spur the issuance of *sukuk* in Saudi Arabia in the medium-term, which that the CAM plans to modify the corporate debt market in order to make the regulatory approval of debt instruments easier. As declared, the plan includes making the procedure for structuring bonds that comply with Islam's ban on *riba* more straightforward, since most Saudi companies find it significantly easier to raise bank loans than issue *sukuk* in the public market (Augustine, 2015).

5.7 Summary

In Saudi Arabia, there is a large demand in the primary *sukuk* market which has some notable effects. For instance, the regular over-subscription of issuances has reduced the returns the Saudi issuances. The returns on SAR *sukuk* are much lower compared to those in other *sukuk* markets. This has reduced the total cost of issuing *sukuk* in Saudi Arabia, making the *sukuk* market more attractive for issuers. The total cost of issuing *sukuk* becomes, in some cases, lower than that of issuing bonds. Despite all of these key factors that can boost market growth, the Saudi market is still failing to adequately activate its *sukuk* market. The shortage in the primary market results in the prevailing presence of buying and holding strategies. Investors are motivated by the current situation to hold *sukuk* until their maturity. Consequently, the secondary market suffers from being illiquid and has become one of the least active markets in the region.

Despite regular *sukuk* issuances and a huge demand from the Islamic mutual funds in the country, there is no single piece of legislation specifically regulating the implementation of Islamic *sukuk*. This is a result of the lack of interest from in Saudi financial authorities in supporting Islamic finance. Therefore, in cases of *sukuk* disputes, there is no certainty about the jurisdiction of the court or the approach to be enforced. The current weakness of Saudi *sukuk* requires a well-structured and well-regulated market. The major solution to the absence of a legislative structure for issuing *sukuk* would be to extend current regulations to cover a wider range of financial products and to include *sukuk* by

issuing new regulations. Greater transparency is also required and along with the reform of regulations to establish an adequate regulatory framework.

Chapter 6: Research Design and Methodology

6.1 Introduction

The aim of this research is to analytically discuss *sukuk* based on assets and to critically examine the Sharia and economic aspects of some of the cases in Saudi Arabia. The previous chapters have served as the foundation for the research and provided the basis for the empirical chapters. Exploring in depth the concept of *sukuk* based on assets, the relationships with their counterparts in traditional markets were illustrated. Furthermore, the requirements for validity according to Sharia as well as their financial significance were also analysed in order to deliver an understanding of the risks and returns involved. During the discussion, emphasis was placed on the AAOIFI standards in respect of compatibility with Sharia, and the agency relevant relationship were considered in respect of risk allocation.

The main aim of this chapter is to describe the methodology of the current research. The following points are addresses: the research design, approaches used, and methods of data collections and analysis. These choices are determined in the light of the research problem and questions in order to achieve the aims and objectives of the research. Then finally, the chapter concludes by explaining the criteria for high quality research followed by a summary of the main decisions made as described throughout the chapter.

6.2 Research Philosophy

The research philosophy depends on the researcher's way of thought. It significantly influences the results of the research and thus needs to be considered carefully. The adopted research philosophy can be thought of as assumptions about the way in which the researcher views the world. These assumptions will support the strategy and the methods are chosen for the study in order to construct a robust research methodology (Saunders & Thornhill, 2003). There are two categories of research

philosophies; they include positivism philosophy and interpretisvism philosophy (Atherton & Elsmore, 2007).

Positivism is a philosophical theory that also knows as scientific philosophy. It is based on the concept that logical and mathematical treatments are the best sources for gathering any data. It considers that information collected from these sources is acceptable and authentic by all (McBurney & White, 2009). This is useful when the size of the sample is huge; however, in the present research this philosophy cannot be used since the sample size applied is not large. On the other hand, the interpretivism is the opposite theory of the positivism (Rowlay, 2012). The meaning of the Interpretivism according to Collis & Hussey is that "a paradigm that emerged in response to criticisms of positivism. It rests on the assumption that social reality is in our minds, and is subjective and multiple. Therefore, social reality is affected by the act of investigating it. The research involves an inductive process with a view to providing interpretive understanding of social phenomena within a particular context" (Collis & Hussey, 2012, p. 57). This philosophy relates to the study that is conducted by being present in the society rather than by gathering data from analysing the presence of mere objects. In fact, it is in favour of primary data collection or qualitative research method (Holden & Lynch, 2004). Therefore, inductive and deductive approaches are linked to opposite research philosophies, the inductive approach to interpretivism while the deductive approach to positivism (Saunders & Thornhill, 2003).

This research chooses the interpretive philosophy as it the best philosophy for the current study. This philosophy fits perfectly to the study since it deals and interprets the details of the current market of *sukuk* and evaluates how the cases are structured from Sharia and financial perspectives. It is applied as the sample size is small in the case, the data collected is not mathematical treated while it takes into consideration the information derived from *sukuk* prospectus which will provide ease to the research in the collection of the data.

6.3 Research Design

This research has an explorative nature as it is mainly related with matters that have not been clearly identified (Sekaran, 2000). This implies that the considering issues

are new at least in a particular context or case. According to Kotler et *al* (2006), exploratory researches are able to collect preliminary information to identify problems and suggest hypothesis. In fact, the adaptability and flexibility to change constitute a significant feature of exploratory researches and thus these researches can easily change the line of thought as result of new results that appear. However, Adams and Schvaneveldt (1991) indicted that the adaptability associated with exploratory research should not mean the loss of way to the inquiry rather it should be a mean to a narrower focus as the research progresses data are collected. In this research, the exploratory nature of the study helps to ask open questions to discover the situations and to gain insights about the current market of *sukuk*.

This research employs a case study design since every project requires an overall design, and a research study is no excluded and it also requires appropriately planned and designed activity (Braun & Clarke, 2013, p. 42). Bryman (2012, p. 66) considers the case study one of the main types of research design. He points out that some of the best-known studies in sociology are based on case study designs. Case study research provides the opportunity for the researcher to bring evidence together from many varied sources to support the issues at hand in ways that cannot be achieved in different forms of research (Braun & Clarke, 2013, p. 216).

Case study research examines and investigates in-depth a specific unit or a number of units that can be organisations, individuals, events, or communities. This design can draw upon a range of methods, such as interviews, observations, focus groups, and types of analysis, with a range of sampling techniques and purposes (Hmel, et al., 1993, p. 4). Case studies are distinguished from experimental research in that they are not conducted in controlled conditions and are not specially conducted for the purpose of comparisons. Also, case studies are distinguished from surveys in that they are principally conducted to study and investigate particular cases (David & Sutton, 2004, p.111).

Table 6-1 Case Study vs. Experiment and Survey

	Case Study	**Experiment**	**Survey**
Cases investigated	One case or a small number of cases	Relatively large number of cases	Relatively large number of cases

Variables analysed	Large number of features of each case	Small number of features of each case	Small number of features of each case
Object of study	Naturally occurring cases where the aim is not to control variables	Cases where the aim is to control the important variables	Naturally occurring cases selected to maximize the sample's representativeness of a wider population
Quantification of data	Not a priority	A priority	A priority
Methods used	Many methods and sources	One method	One method
Aims	To look at relationships and processes	To look at causation	To look for generalization

Source: (Braun & Clarke, 2013, p. 10)

A case study is not a method in itself; rather, it is a design that can draw on a variety of methods such as quantitative or qualitative methods. In fact, there is a tendency to associate the case study design with qualitative methods due to the nature of this design. It is undoubtedly true that proponents of this design often favour qualitative research methods, since these are beneficial in generating a detailed intensive study of the case considered. Conversely, if the examination extensively relies on a quantitative method, it might appear to be more of a cross-sectional design than case study research (Bryman, 2012, p. 67). Yen (2003, p. 6) suggests that case study research is best formulated for the study of contemporary events or situations using methods that operate naturalistically, such as to collect data in natural settings or through relatively open-ended questions in interviews. Also, it encourages the use of documents and the life histories related to the case in order to allow the case study researcher to conduct a qualitative exploration. Accordingly, this research attempts to critically examine some of the contemporary Saudi *sukuk* applications that are based on assets. Case study design assists this research in using qualitative methods since the data concerning these applications are collected from particular documents related to them. The research explores how *sukuk* are applied in Saudi Arabia in an attempt to find the critical issues in the applications and then to conduct interviews based on the issues identified. In fact, this design allows for a systematic method and links the data to be collected and the conclusions to be drawn with better coherence.

Case study research is about the particular and not the general. Thus, the aim is not to generalize but rather to investigate the cases chosen and then to present them in a more specific way (Thomas, 2011, p. 3). This study aims to describe, illustrate and explore specific *sukuk* cases from multiple perspectives in such a way that has relevance to other cases, rather than either assuming that the findings might be generalized or presenting them as a unique instance (Costley, et al., 2010, p. 90). The case study research, therefore, provides a richer picture of the cases involved with different kinds of insights being generated, and especially analytical insights from different angles along with different sources of information. The analytical process is important for this type of research (Braun & Clarke, 2013, p. 21). For this reason, the cases are analysed from different angles, using various theories and standards. The discussion relies on the two main Sharia and financial perspectives to explore aspects of the cases. The analytical discussion is generated from different benchmarks such as the AAOIFI standards, the theory of agency and the types of risks defined by the Basel Committee.

In case study research, it is important to highlight the purposes and objectives that motivated the research. This will determine the answer as to how the analytical framework to be used. This research has an evaluative purpose, which is one of the purposes of a case study. Here the researcher aims to see how well something is working, or has worked, which then helps in finding out what changes have occurred and if these have led to better or worse outcomes (Braun & Clarke, 2013, p. 100). Evaluating each case according to Sharia rules and risk/return allocations is necessary in order to determine the divergence between practice in applications are from the theory. Well-developed theories and standards are the basis for the evaluation.

Moreover, among different types of cases, the research will use critical cases. Bryman (2012) explains that the critical case study is research that has a well-built theory, and a case is selected on grounds which allows for a deeper understanding of the circumstances and situations in which a hypothesis or hypotheses will and will not hold (p. 70). Furthermore, in respect to the quantity of cases to be considered, Costley, et al. (2010) limits case study research to the details and intensive analysis of a single case, whereas most other authors including, Bryman (2012) widen this criterion to include the study of a single

or a relatively small number of cases. In this research, the aim is to deeply examine three *sukuk* applications in Saudi Arabia. The main practical advantage of this choice is that the small number of cases can produce a more profound understanding along with a more significant amount of information pertaining to the cases (Smith, et al., 1991, p. 35).

6.4 Research Approaches

The choice deductive and inductive approaches are mainly concerns whether observation or theory should come first. A deductive approach is when theory comes first and an inductive approach is when observation comes first. The deductive process represents the common view of the nature of the relationship between social research and theory. Bryman (2012, p. 24) explains that in deductive research 'the researcher, on the basis of what is known about in a particular domain and of theoretical considerations in relation to that domain, deduces a hypothesis that must then be subjected to the empirical scrutiny. Embedded within the hypothesis are concepts that will need to be translated into researchable entities'. The opposite direction of the relationship between theory and observation is represented in the inductive approach. It is simply the research approach that involves the development of a theory as a result of observing the empirical data (Saunders, et al., 2012, p. 672). Studies that use induction are more likely to work with qualitative data and to practice different methods to gather data in order to establish a variety of views of phenomena. (Eriksson & Kovalainen, 2008, p. 5). These studies are likely to be particularly concerned with the context in which such events were taking place. Data collection and analysis are sensitive to the context targeting a holistic understanding of the issues. Hence, examining a small sample of matters might be more suitable than a large number as with the deduction approach (Saunders, et al., 2012, p. 145-146).

In other words, deductive research aims to test a hypothesis, while inductive research aims to explore a topic, and thus the inductive method has an exploratory approach. In respect to the relationship between quantitative and qualitative research, qualitative methods are mainly associated with the inductive approach; whereas quantitative research associated with deductive approaches. However, this is not consistent as some inductive studies can be quantitative; whereas, some qualitative research can apply the deductive approaches by

starting from the formulation of hypotheses (David & Sutton, 2004). As this research works with qualitative data related to asset-backed *sukuk* aiming a holistic understanding of *sukuk* issues in order to establish different views on *sukuk* practices, this study can be safely classified as using the inductive approach. To be more precise, this research starts with specific observations regarding *sukuk* market to pave the way for the empirical chapters. Thus, the research will be able to draw conclusions after examining the three cases by using inductive method of reasoning.

6.5 Data Collection Method

Data collection methods comprise two terms; data and method. Data are the bedrock of the social knowledge and the sciences, where data are used to answer questions raised, and to generate useful and new understandings of phenomena (Braun & Clarke, 2013, p. 33). It is significant to point out that there is a distinction between evidence and data. Data is simply another word for information; whereas, evidence is a set of data mobilized in support of propositions (Braun & Clarke, 2013, p. 161). Although the terms methodology and method are in some cases used interchangeably, they are different (Miller & Dingwall, 1997, p. 27). A method simply refers to a technique or tool for data collection or analysis; for instance, surveys and interviews are methods for data collection whereas analysis of variance and thematic analysis are methods of data analysis. Methods are relatively specific and used in specific patterns, while methodology is a broader term which refers to the framework that the research is conducted within. Methodology is defined as the procedure related to a specific set of paradigmatic assumptions that lead to knowledge (O'Leary, 2004). Arbnor and Bjerke (2008, p. 3) explain that the methodology ‘contains a number of concepts, which try to describe the steps and the relationships needed in the process of creating and searching for new knowledge’. Methodology consists of practices and theories about the ways in which to conduct research. It consists of a package of assumptions about how the research is conducted as well as implying the appropriate methods to be applied. Methodology can be seen as a theory of how a study will proceed in order to produce valid knowledge and information with regards to the social and psychological world. It is all about making sense of the research in terms of the design and the process. Thus, a method is a concept as part of

the methodology that provides a clear framework for making a series of decisions regarding a specific research study (Braun & Clarke, 2013, p. 31).

However, the term 'data collection method' is simply defined by Bryman (2012, p. 46) as a technique for collecting data. Data collection methods are commonly divided into qualitative and quantitative methods. Quantitative research is mainly concentrated on the measurement of quantities. The process in this type of research often starts with data collection which is based on a hypothesis or experiment or theory, then followed by the usage of descriptive or inferential numerical methods. Accordingly, the research is mainly numerical and non-descriptive, using mathematics or statistics in an iterative process whereby evidence is evaluated and then the result of the research is generally a set of numbers that are usually conclusive (Rajasekar, et al., 2006).

On the other hand, the qualitative method is described by Maanen (1983, p. 9) as having 'no precise meaning in any of the social sciences. It is at best an umbrella term, an array of interpretative techniques which seek to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occurring phenomena in the social world'. Moreover, David and Sutton (2004, p. 35) perceive this method as 'a social method that employs no quantitative standards and techniques based on theoretical and methodological principles of symbolic interactionism, hermeneutics and ethnomethodology'. Accordingly, there are some essential features of qualitative research. It is mainly non-numerical and descriptive and uses words through the description of observed objects (Wicaksono, 2015). Also, it is usually exploratory and aims to derive meanings or feelings to describe a situation. It includes the use of specific instruments such as observation, questionnaires or structured interviews (Rajasekar, et al., 2006). In qualitative research, the data collected are mainly naturalistic in the sense that these data are not placed into pre-existing categories and are not pre-coded at the collection stage (Braun & Clarke, 2013, p. 33).

From the above, it can be noted that, while the quantitative method generates shallow and broad data, qualitative methods will generate narrow but rich data. Also, while quantitative method is fixed and it is harder to change focus during the collection of data, qualitative methods are less fixed and can accommodate a shift in focus in the same research.

Hence, qualitative research tends to take longer due to the absence of a clear formula (Braun & Clarke, 2013, p. 4). In this research, despite using some quantities in some parts such as showing the size of the *sukuk* market or deciding the percentage of Sharia compliance, the qualitative method is the principal type used. Bricki and Green (2007) considered how to decide if the qualitative approach is appropriate, and stated that 'if you want to: understand the perspectives of participants; or explore the meaning they give to phenomena; or observe a process in depth, then a qualitative approach is probably appropriate'. This research is based on understanding asset-backed *sukuk* in depth and observing the process of specific applications, and so the qualitative approach would be the most appropriate choice.

In respect of types of data, a division is conventionally drawn between secondary and primary data. Primary data collection comprises the use of research tools, for instance, interview and questionnaire, for the specific purposes of a particular research. However, secondary data has already been collected by other researchers, government departments, and organisations or for personal purposes (Clarke, 1999, p. 66).

This research is based on both primary and secondary sources. Available references are held in libraries, such as in books, journals, reports, conference and rules from the internationally-recognized Islamic financial authorities and institutions. The resolution of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) are one of the main references in this study. Moreover, websites are sometimes used as a source to find up-to-date or otherwise unavailable relevant information. Furthermore, some official documents are derived from private sources since not all of the prospectuses studied are available in the public domain. This means that the researcher has attempted to find private sources in order to gain access to the desired information. In particular, the Zamzam *sukuk* is not available to the public and all related documents have been received as confidential data, after meeting some members of Musha'at Co. in Kuwait.

6.5.1 Interviewing

Interviewing is simply defined by David and Sutton (2004, p. 87) as involving 'asking people questions, but it is equally about listening carefully to the answers given'. It is a professional conversation with the aim of discourse regarding the participants' perspectives and experiences plus capturing their concepts and language related to the topic

studied (Braun & Clarke, 2013, p. 77). Smith, et al., (1991, p. 71) pointed out that the interviewing in-depth has been considered to be the most fundamental instrument of all qualitative methods as it is the best tool for gathering certain types of information. Also, Costley, et al., (2010, p. 41) endorse this view, considering the interview instrument as a powerful method in investigating a subject, particularly as a qualitative method. Undoubtedly, interviewing is one of the most common methods of data collection within qualitative research (Braun & Clarke, 2013, p. 77).

Interviewing is useful for the understanding, exploration, perception and construction of the topic as determined through questioning (Braun & Clarke, 2013, p. 81). It provides rich access to individuals' opinions and personal views that enables further exploration of the topic concerned (David & Sutton, 2004, p. 91). While, the interviewing in qualitative research faces some complexity when designing targeted questions (Smith, et al., 1991). Interviewing can take a very long time, especially since re-interviewing is not unusual (Bryman, 2012, p. 496). Also, data transcription from interviews consumes plenty of time since a well-transcribed interview may take between three to six times longer than the time needed to record it (David & Sutton, 2004, p. 91).

There are a number of interview types, ranging from very detailed and structured to semi-structured schedules that use a topic-guide, and finally to less structured or unstructured interviews. The three main types are structured, unstructured and semi structured interviews. The structured interview aims to maintain a high level of repeatability and reliability, while the more unstructured interview aims to stress the depth and validity of data gained by allowing the interviewees to express their own views (David & Sutton, 2004, p. 87). However, semi-structured interviews have the advantages of both of these types, where the structure provides a specific list of issues or general questions to be covered rather than specific questions, and then there will be freedom to follow up these points. Due to this advantage, a semi-structured interview is the most commonly used kind of interview in social research (Braun & Clarke, 2013, p. 163).

In this research, semi-structured interviews are applied with a list of particular issues to be covered as an interview guide. Thus, the interview process is flexible and the

interviewee has a great deal of freedom in how to respond (Bryman, 2012, p. 471). Also, open-ended questions are used in order to generate theoretical insights on the research topic (David & Sutton, 2004, p. 80). Open-ended questions are specifically chosen to encourage participants to offer details and more in-depth answers to increase the depth and validity of each interview, as this enables the interviewees to express their personal views. The questions focus on the issues found in the case study applications in order to explore the participants' relevant views and experiences. This provides the research with rich data and will provide some explanation on *the* issues. The interviews were a professional conversation conducted with the most experts in the field of Islamic finance. Accordingly, the purpose was to evaluate the issues found in the empirical chapters. Conducting the interview after discussing the cases allows the research to discuss the identified practical problems and provides special information about the possible solutions. It also highlights the other views among scholars and shows the issues from different point of view.

The research employs content analysis to examine the transcripts of the interview responses. The questions were designed in English and received the supervisors' editing and comments to ensure they will achieve the research objectives. Then, these questions have been translated to Arabic by the researcher since all of the candidates' first language is Arabic. For a language-verification purpose, the translation stage involves, once needed, a review of the translation by a bilingual reviewer. During the interviewing, all interviews were recorded for a validity purpose. Then, the recoded interviews were fully transcribed and typed into Word by the researcher after each interview has taken place.

The researcher went through all of the textual data of the transcripts in a systematic way and coded the ideas, concepts and opinions. All data are coded from very basic codes to categories that reflect broader analytic themes to ensures comprehensive analysis to the content. The researcher proceeded from the detailed coding, to more generalised coding, which allowed at the final stage to create five separate analytical themes to manage the related topics with codes by using general

headings. This method used has resulted in some generalisation coding and helped to overcome the difficulties to establish generalised coding. It is finally yielded five major themes that best captured the critical issues discussed in the semi structured interviews. The first theme is the issues related to the guarantee of the securitized asset. Six questions were set to discuss the issues related to the guarantee of the assets, maintenance, insurance from agency, principle and periodical distribution and to bring the different interviewees' views in the aim of understanding the complexity of the structure. The second theme is the issues related to ownership which asks three questions to provide some details on limited possession, legal possession and the incentive fee. The third theme is issues related to the structure and three questions were asked to cover when not specifying the maintenance cost, not specifying agency costs and not separating transactions. Fourth theme is issues related to regulation which asks four questions about the regulation on *sukuk* prospectus, regulation implementing AAOIFI standards, regulation on Sharia board approval and the regulation on contradicting *Ijma'*. Last theme is issues related to the current *sukuk* industry which considers two main questions about issues related to the the importance of the current *sukuk* and issues related to Assessing the current *sukuk* market.

6.5.1.1 Sampling Strategies

Qualitative research tends to employ smaller sample sizes than in quantitative research. In some high-quality research, data from only a single participant or interviewee is studied and analysed in-depth. Although, there is no rule for sample size in qualitative research, a common size is between 15 and 30 individuals to be interviewed with the aim of identifying patterns across data. However, the sample size can be affected by the research aims and purposes, what will be useful for the analysis, what will increase credibility and also what can be achieved with the available resources and time (Patton, 2002, p. 244). Although statistical characterisation is not the aim, the sampling in qualitative research is often purposive. This means interviewees are chosen because they are expected to generate useful data for the research. To ensure that the interview sample is credible, one strategy is

to include a range of people that cover the main groups who can assist in gathering the specified information (Patton, 2002, p. 244).

The research aims for a purposive sample of 25 experts and participants in the field of *sukuk*. The interviewees are selected to represent the active members and experts in *sukuk* market. One factor which was considered in the selection of interviewees was their education and experience have to be related to Islamic banking. The interviewees hold different positions in Islamic banks or Islamic universities including members in a number of Sharia supervisory boards and AAOIFI institution. This strategy allowed the researcher to receive a valued views and opinions related to the discussed issues. The highly engaged members were not easy accessible since their office telephone numbers were usually tried with no answer. Finding their personal number was one of the research obstacles, snowballing was the most effective way to know the targeted contact information (Bryman, 2012, p. 202). At the end of each interview the interviewee would be asked to introduce a capable person with his personal contact information.

All of interviewees are male and under Saudi tradition the female researcher would find some difficulties to conduct a face to face interview. Thus, the researcher opted for telephone interviews as it is more appropriate according to the specified culture. The researcher uses an SMS to introduce myself, the aim of my interviewing and asking for their suitable time in order to conduct the interview. Mostly, there is no respond to my SMS expect 4 of the interviewees which raise another obstacle to find who would be interested in taking part in the interviews. Here, where the researcher sought some help from friends, relatives or even some of the interviewed who have links with the targeted experts. Eventually, 25 interviewees have been reached; among them was AAOIFI members, scholars who allow Sadara and also Zamzam *sukuk* as they represent the most related experts to current discussion. A summary of the respondents' experiences and coding is provided in the following Table.

Table 6-2 Features of Interviewees

Position	Location	Category	Code
Chairman and Member of IFIs' Sharia Supervisory Boards	Saudi Arabia	Sharia Board	S1
Council of Senior Scholars, Chairman and Member of IFIs' Sharia Supervisory Boards	Saudi Arabia		S2
Sharia Board Member at Islamic Bank	Saudi Arabia		S3
Chairman and Member of IFIs' Sharia Supervisory Boards	Saudi Arabia		S4
Head of Sharia at Islamic Bank	UAE		S5
Council of Senior Scholars, Sharia Board Member of Islamic Bank	Saudi Arabia		S6
Chairman and Member of IFIs' Sharia Supervisory Boards	Bahrain		S7
Chairman and Member of IFIs' Sharia Supervisory Boards	Kuwait		S8
Chairman and Member of IFIs' Sharia Supervisory Boards	Kuwait		S9
Member of Sharia Supervision Panel at Islamic Institution	Kuwait		S10
Sharia Board Member at Islamic Bank	Saudi Arabia		S11
General Secretary at AAOIFI	Saudi Arabia		S12
Former Head of Sharia committee at Islamic Bank.	Saudi Arabia	Sharia banking officer	B1
Head of Sharia committee at Islamic Bank	Saudi Arabia		B2
Senior Advisor at Islamic Bank	Saudi Arabia		B3
General Manager of Sharia committee at Islamic Bank	Saudi Arabia		B4
Secretary of Sharia Board at Islamic Bank	Saudi Arabia		B5
Senior Advisor at Islamic Bank	Saudi Arabia		B6
Senior Advisor at Islamic Bank	Saudi Arabia		B7
Secretary of Sharia Board at Islamic Bank	Saudi Arabia		B8
Faculty member at Sharia College, Islamic University	Saudi Arabia	Academic	C1
Former Professor of Principles of Jurisprudence at Islamic University	Saudi Arabia		C2
Former faculty member at International Islamic University in Malaysia, Senior Researcher of ISRA	Malaysia		C3
Professor of Economics at Islamic University	Saudi Arabia		C4
Manager of Islamic Financial Product Development Centre	Saudi Arabia		C5

As the aim was to discuss certain problems and issues in the market of *sukuk*, a guide to topics or general questions was carefully prepared and refined. This process can take a long time until it is completely satisfactory in terms of the structure and the validity of the questions. The questions are specifically designed as a result of examining the cases studied; where all of the critical issues found in the cases have been highlighted and presented to the interviewees who may have some useful knowledge and different attitudes. The plan is to ask the same questions with the same structure to the targeted interviewees. However, some flexibility is offered to allow the interviewee to express personal views and to clearly add a higher degree of confidence concerning the answers received since the questions require a good deal of thought. Then, comparisons are conducted between the different views related

to *sukuk* issues. This process will enable the researcher to determine the critical issues in the market and to establish attitudes towards them.

6.6 Data Analysis Method

The most important decisions in qualitative research are made at the stage of data analysis. Deciding how to integrate the analysis, with the processing of the data collected, to achieve the research objectives is critical (David & Sutton, 2004, p. 195). However, at this stage, the researcher can feel that the qualitative data set is very chaotic and confusing. This is considered to be one of the difficulties of qualitative research in that it rapidly generates a considerable, cumbersome amount of data. Due to the attractiveness of its richness, as well as its reliance on prose in the form of interview transcripts or documents, it is difficult to find the appropriate analytic path (Bryman, 2012, p. 565). Also, the analysis of quantitative data is imposed by an external structure, making the process of analysis more straightforward, while the analysis of qualitative data is not fundamentally a technical or mechanical matter (Smith, et al., 1991, p. 108). This research is built upon some external standards which helps to evaluate the analysis process. For example, using the AAOIFI standards enables the research to focus on well accepted standards instead of embarking upon juridical discussions. Without clear standards, it is difficult to decide appropriate rulings since these are likely to be controversial. Moreover, in the financial area, the research attempts to apply Basel Committee categories of risks as a guide to identify the financial risks involved. In this regard, some researchers have found more than thirty types of expected financial risks. However, by using the Basel classification as an external structure enables the research to focus on the most significant types of risks. Undoubtedly, using these external structures helps to mitigate the issue of the unlimited generation of information in such a quantitative research.

The qualitative data collection involves the accumulation of great amounts of mostly textual material, and an important stage of the analysis process is reducing the volume of data through the use of methods of organisation and selection (David & Sutton, 2004, p. 195). In this research, a number of different analysis methods are required in order to achieve the desired results in the case studies. A research methodology may adopt a combination of

different methods to achieve specific results, and this is known as triangulation. The choice of the combination of methods attempts to give the best insights into *sukuk* issues, as the main aim of using mixed methods is to gain the benefits from all of the methods applied. Triangulation is used to seek convergence of meanings from several methods in order to validate and enhance the results of the research (Lindlof and Taylor, (2002). It is simply an attempt to combine the best of all the available options (David & Sutton, 2004, p. 45).

6.6.1 Content Analysis

Content analysis is commonly used as a method to analyse qualitative research data (Hsieh & Shannon, 2005). It is a systematic approach to analysing qualitative data, such as that from interviews with key informants and focus groups that can generate considerable volumes of information in order to organize it into themes or categories so as to make sense of the data. Qualitative content analysis has been defined as: 'any qualitative data reduction and sense-making effort that takes a volume of qualitative material and attempts to identify core consistencies and meanings' (Zhang & Wildemuth, 2009, p. 2). Commonly, qualitative content analysis is used to analyse transcripts of interview in order to model or reveal pattern's in the information gained from interviewees. Content analysis starts with reading and then organizing the data in this study, the transcripts of the interview, followed by coding the data and placing them into different categories or themes. Coding serves as a method to compile, label and organize the data that allows the data to be summarized and synthesized. To link data collection with data interpreting, coding becomes the basis for developing an effective analysis. Thus, it is generally understood that 'coding is analysis' (Treiber, et al., 2013).

To be more precise, the research conducted a document content analysis. This analysis is done by produces rich descriptions and relevant interpretations of a single phenomenon, event, organisation, or programme. It is a systematic procedure for reviewing, examining and evaluating documents, of both electronic and printed materials, in such a way that empirical knowledge is produced and understanding is developed (Bowen, 2009). The analysis of documents is a valid research strategy with significant merits as a method used for the purposes of reform and evaluation. Documents are mostly reliable and valid sources

of background information in obtaining comprehensive and insightful views of a case. However, information in documents usually represents only one perspective and can sometimes be incomplete (Bowen, 2009). This research uses documents content analysis when analysing the official document of the published prospectuses. Although the prospectus documents provide a comprehensive understanding of a specific issuance of *sukuk*, it represents the view of only one party involved in the structure, the issuer. For example, the document might not disclose all possible financial risks for marketing purposes. Also, the prospectus might avoid mentioning some issues that contradict Sharia rules, which means that the analysis offered may be imprecise in some respects.

The analysis of the prospectuses involved a focused reading with an initial superficial examination to find pertinent data and relevant information and then to look across all the found data to identify the main themes that summarise *sukuk* issues (Miles & Huberman, 2003). By reducing the text to a number of themes, the research was able to focus on answering the questions. The discussion of this research is based on the three main questions that are related to Sharia compliance, financial risks and agency conflicts. Under Sharia analysis, two main themes are identified; (i) the theme of *sukuk* content is coded according to *sukuk* assets, *sukuk* ownership, *sukuk* principal, *sukuk* return, *sukuk* tradability and *sukuk* insurance and (ii) the theme of *sukuk* structure, different concepts are coded *inah* sale structure, *wafa* sale structure and lease to own structure. Similarly, the second category is financial examination which has also two main themes; (i) the theme of observed risk mitigation process is coded according the major risks; credit risk, market risk, liquidity risk, operational risk and Sharia risk and (ii) the theme of agency issues is coded according to moral hazards and adverse selections. In this research, the validity of the current content analysis refers to the correspondence of the categories, themes and coding. These patterns can be seen in the literature section especially in chapter 2 and 4 where the themes are clearly discussed. It has also explicitly appeared in the empirical study as well as in the conclusion chapter as the final results are drown under these categories.

6.6.2 Critical Analysis

Deconstruction is a way of interpreting various texts. It is a method of critical analysis of literary and philosophical texts. Deconstructive reading has to be done by carefully focusing on words and also the context of words in order to discover conflicts in texts (Kilduff, 1993). The reading is for breaking down the data into its component parts as a standard technique for analysis (Okafor, 2013). The purpose of deconstruction is to decouple the component to permit inspection of each in its own right. In other disciplines, this method is applied as a device for critical thinking, bypassing the possibly misleading picture conveyed by the whole. It is mainly used to prepare the data for other analytic processes such as summarization or manipulation, or even abstraction (Baty, 2009).

This research applies critical analysis in the meaning of deconstructing the available materials related to the cases studied. The structures of the cases have been unpacked by separating each procedure into their basic elements to see its constituents. This requires extra effort to break data down and deconstruct the structures in order to formulate a response to the research questions. It is a powerful method for exposing the issues in asset-backed *sukuk* market and then analyse them.

6.6.3 Secondary Analysis

Recently, the secondary analysis of qualitative data has attracted more interest and discussion, while this type of analysis in quantitative data has been for many years a staple of research. Secondary analysis is defined by David and Sutton (2004, p. 25) as 'any further analysis of an existing data set which presents interpretations, conclusions of knowledge additional to, or different from, those presented in the first report in the enquiry as a whole and its main result'. Furthermore, Hakim (2000, p. 24) defines this type of analysis as 'any re-analysis of data collected by another researcher or organisation, including the analysis of datasets collected from a variety of sources to create time series or area-based datasets, with qualitative data, secondary analysis is supposed to permit the researcher to mine data where new interpretations are possible or that were not studied by the original researchers (Bryman, 2012, p. 586). David and Sutton (2004, p. 25) further describe secondary analysis as simply

a broad term in which data is analysed by someone other than the original investigator. Secondary analysis is a feasible way to carry out the analysis of numerous already available reports (Hakim, 2000, p. 24). As this approach is considered to be relatively new in qualitative research, the current research aims to apply this method using the *sukuk* prospectuses. The prospectus is the best available primary source to the cases. Studying and examining the data available in the prospectuses conducted using an inductive textual approach. This approach enables the researcher to provide different kinds of analytical insights evaluating the cases and generating relevant findings.

6.6.3.1 Sharia Analysis of the Cases

This stage involves a number of procedures. First the Sharia problem is defined and the particular issue described with support from material in the prospectus. Then, the analysis mainly adopts the AAOIFI standards as a benchmark for the *sukuk* applications in their jurisdiction. The AAOIFI have issued a number of guidelines and standards to improve transparency, disclosure and governance of the fincial activites, including particular standards for *sukuk*.

In this study, the selection of AAOIFI standards as a benchmark depends on deciding the relevant standards. These relevant standards are chosen according to the type of *sukuk*, the contracts involved, the procedures found in each case. Considering only *sukuk* standards without other related standards in AAOIFI list will not provide an actual evaluation. This is because *sukuk* in the market are structurally sophisticated, as they include a number of transactions other than the main contract, such as agency, *wa'd*, and sale contracts. This means that each of these subordinate contracts has to satisfy all relevant AAOIFI standards.

This is supported by standard no. 17 clause 5/1/8/3, which states that 'the contract that forms the basis of the issue must be complete with respect to its elements and conditions not including conditions that conflict with its objectives and rules' (AAOIFI, 2008). According to this standard, all requirements of the basis of the *sukuk* have to be fulfilled, which means that this standard refers to other AAOIFI standards related to the contract that the *sukuk* are based on. Each prospectus has to detail the contract that the

sukuk are based on; for example, based on the contracts of *musharaka*, on *ijara* and must then follow all of its requirements. For instance, *ijara sukuk* typically involve four contracts that must be processed, agreed on and signed: the sale contract, *ijara* contract, the promise to buy and at final stage. Therefore, evaluating an issuance according to *sukuk* standards only is not sufficient, as a number of examinations have to be conducted to create confidence concerning compatibility with Sharia. The assessment is then transformed into a percentage score to determine the extent of the application's compliance with the AAOIFI standards. The analytical effort in this research aims to improve transparency related to Sharia compatibility since most of the supervisory authorities in the market lack knowledge of Islamic finance.

6.6.3.2 Financial discussion on the Cases

As indicated, the financial study is guided by the Basel risk types and agency theory. Under the standardized framework, the Basel Committee set clear types of risks, as illustrated earlier, and we have seen that *sukuk* structures differ from their conventional bond counterparts in terms of their risk exposure. The uniqueness of *sukuk* carries unique risks for different structures, even in regard to common risks.

Thus, the discussion aims to examine risks involved in the cases examined to find to what extent they differ from SBS risks. In addition, the principal/agent relationship will be examined to identify the agency roles performed in the applications. In agency risk, the unique nature of each application leads to different relationships and different allocation in terms of the agency problem. This requires an evaluation based on their specific risks and levels of exposure. The research analyses the cases on the basis of these two main criteria.

6.7 Criteria of the Research

The most prominent criteria in evaluating social research can be summarized in four points. These are construct validity, internal validity, external validity and reliability. These four design tests are well known in quantitative approaches. Most of researchers as Bryman (2012) and Morse (1994) consider these criteria for quantitative study only such. However, it is uncertain to what extent case study research can fulfil these criteria. The following

discussion attempts to explore how to achieve higher degrees of the four criteria in qualitative research and specifically in case study research.

As considered by Bryman (2012) validity is in many ways the most important criteria in assessing the quality of research. The validity of a qualitative study occurs through the audit such as examining the interpretations, findings and also recommendations to assure the integrity of the drawn conclusions generated (Bryman 2012, p. 47). However, in case study research construct validity is related to the establishment of an operational measure for the theoretical concepts involved. Case study research can satisfy this criterion if the study's general procedures and methods are defined explicitly in detail and if the study presents a complete picture of the cases including background information (Riege, 2003).

Various techniques can improve construct validity in case study research. Perakyla (1997) suggests that, during data collection, it is recommended to use multiple sources of evidence. For instance, documents, interview transcripts, reports and others can protect the study against bias. A second technique mentioned by Griggs (1987) is during the data collection stage to provide a chain of evidence used in the study with sufficient citations of specific sources. For example, during field trips, verbatim interview transcripts along with the notes of observations can be used. A further technique is considered by Yen (2003) where, during the writing stage, the drafts of case study reports or interviews are reviewed by research assistants or other key informants as part of the data analysis; then, any unclear aspects will be changed.

Internal validity refers generally to credibility. It is commonly referred to in quantitative research as the establishment of cause and effect relationships and is concerned with the question of whether or not a conclusion or finding includes a causal relationship (Bryman, 2012, p. 47). Case study research aims to find generative mechanisms that provide confidence in the inferences made about real life experiences. That is, the researcher does not only place emphasis on the major patterns of differences and similarities in the case studies, but also attempts to determine what components are important for the patterns studied and what mechanisms generated them. The questions concerned in case study research can involve; how meaningful and rich the descriptions provided are, and if the

findings and results are internally coherent as well as whether or not the concepts used in the research are systematically related (Riege, 2003).

A number of techniques can be applied in order to increase the internal validity of the research. One important tool described by David and Sutton (2004, p. 28) that during the data collections an in-depth interview and a well of observation help the research to achieve higher internal validity. Miles and Huberman (2003) suggest that, during the data analysis stage, the use of cross-nation or cross-case pattern matching within cases allows for greater internal validity. Also, during data analysis, the display of diagrams and illustrations can help in explaining of the research. Yen (2003) suggests that emphasis during the data analysis stage should be on the internal coherence of the findings. This can be achieved through cross-checking the results.

External validity refers to generalizability, and is mainly concerned with the specific findings of research being applied beyond the direct unit of analysis to a general picture. For example, in quantitative research applying surveys based on statistical findings helps to structure an externally valid research, and thus the main question will be whether or not the results can be generalized beyond the specific context (Bryman, 2012, p. 47). Case study research achieves this through the analytical generation that can result in analytical findings which can be generalized to some broader theory. A test of this criterion in case study research is whether or not the findings include enough thick descriptions for the reader to assess the potential appropriateness of transferability to their own settings (Riege, 2003).

To increase external validity, there are a number of techniques that can be used. Marshall and Rossman (1989) suggest that, during the research design stage, the definition of the boundaries and scope of the study can assist in achieving reasonable analytical generalizations instead of statistical generalizations for as in quantitative research. Then, during the analysis, contributions will clearly be outlined and generalized within the boundaries and scope of the research, and not to larger cases or populations (Yen, 2003). Also, David and Sutton (2004, p. 28) perceive external validity as not only based on gaining as large number of interviewees, respondents or cases as possible, but where a well-chosen and relatively small sample can be far more useful than a larger one with a badly chosen

sample. Simply, a well-chosen sample seeks to mirror reality and thus increase external validity.

Finally, reliability refers to dependability and is defined in qualitative research as if the procedures and operations of the study enquiry can be repeated by other investigators to reach similar results or findings (Riege, 2003). The basic question is whether or not the findings of a study are repeatable (Bryman, 2012, p. 46). This criterion is important because quantitative researchers are often interested in developing generalizable laws, and so seek to minimize the influence of the researcher which is a source of error or bias. This means that reliability may not been appropriate criterion for judging qualitative work or procedures. In case study research, problems also arise with this criterion since cases are not as static as measurements applied in quantitative research and thus, findings may differ. In fact, data from cases and events can vary and may not form one consistent picture (Riege, 2003). However, if we think of reliability more broadly as being about the trustworthiness or dependability of methods of data collection and analysis, then some measure of reliability will be applicable (Braun & Clarke, 2013, p. 279).

A number of techniques have been suggested to achieve reliability in its broad sense. LeCompte and Goetz (1982) suggest that giving full account of ideas and theories during each stage of the research can help in achieving better reliability. In the research design stage, Yen (2003) places extra emphasis on the assurance of congruence between the features of the study design and the research issues in order to ensure reliability. The use of a structured or semi-structured case study protocol has also been suggested by Yen (2003). Moreover, during the end of the data collection stage, Lincoln and Guba (1985) recommend the development of a case study database in order to provide a typical method of documenting and organizing the mass of data collected. Also, during data collection, Nair and Riege (1995) recommended that for data is recorded mechanically, for instance using video or audio taping. The current research should be incorporated the following criteria to enhance the quality of the chosen case study design. This helps the research to be more rigorous and reliable. Table 6-2 below shows the platform for the techniques applied in this research.

Table 6-3 Different Criteria for Case Study Research

Criteria	Stage	Technique Used	Research Process of the Techniques
Construct Validity	During data collection	Sources of evidence	In-depth interviews external reports, external Sharia standards (AAOIFI).
Internal Validity	During data collection	In depth interviewing	In-depth interviews to reveal the interviewee's views on asset-backed issues.
	During data analysis	Display of diagrams and illustrations Evaluation	Diagrams and tables where appropriate. Analysis does not rely on comparison only, but also evaluates the results.
External Validity	During design	Definition of the boundaries and scope of the study	Defining the boundaries and scope of the study, then the findings can be generalized within this scope.
	During data collection	Well-chosen sample	Purposive sampling of experts in the field of *sukuk*
Reliability	During data collection	Recording data mechanically	Recording all interviews conducted.

This research aims to increase construct validity by using the following techniques: the explanation of the methods applied and the procedures used, including the details of the research design, approaches and methods. In addition, each case study has been introduced with background information relevant to the case's circumstance, the issuer and value. Also, the study based on several primary sources such as in depth interview, external reports and external Sharia standard (AAOIFI). For internal validity, this research examines a number of concepts related to the field of *sukuk* in order to achieve systematic results. During data collection, in-depth interviews are used to discover individual views on the issues in the *sukuk* market. The interviews involve intensive individual conversation with only 25 respondents, exploring their perspectives on *sukuk* issues. In addition, the research, diagrams, tables, charts and illustrations are provided where appropriate. The analysis does not rely on comparison method only, but goes further to evaluate the results from different angles.

To increase external validity, the analysis in this research is mainly based on common issues among asset-based *sukuk*. The research findings involve detailed descriptions in order to the feature of transferability. The scope of the study has also been determined only

considering *sukuk* based on assets located in Saudi Arabia. It is important to note that the cases are carefully chosen to reflect different structures of *sukuk* related to assets. In addition, the choice of interviewees to be only these highly pertinent to Islamic banking is also conducted. For reliability purpose, some of this research's findings would be repeatable, if the same procedures were used. Determining the level of Sharia compatibility in each case is repeatable as long as the same standards and operations are applied. The researcher also recorded all the interviews to generate more credible findings for higher reliability.

6.8 Summary

The main aim of this chapter was to describe the methodology used in the current research. The chapter demonstrates the methodology determined for all of the research stages. The appropriate design, approach, methods of data collection and analysis were carefully selected. The study has been formulated as case study research using an inductive approach employing qualitative methods. Data are treated through secondary, content and document analysis. The analysis is conducted within the scope of the study and the conclusion is drawn in the light of the research questions in order to achieve the research objectives. The case study design allows the researcher to identify the current problems of asset-backed applications in practice and then to measure aspects of them in evaluation. Qualitative data collection methods were chosen as the most appropriate tools for this research. The cases of *sukuk* would build a data source to conduct the interview with Sharia scholars. Importantly, the chapter introduces the specific criteria used to assess case study research and highlights how the current study fulfils these criteria. Construct validity, internal validity, external validity and reliability are taken into account to ensure the rigour of the research.

Chapter 7: Saudi Electricity Company *Sukuk*

7.1 Introduction

The Saudi Electricity Company (SEC) was instituted in April 2000 as a Saudi Joint Stock Company with a paid principal of SAR 33.7 billion. The SEC is a public company that is 74% owned by the Saudi government and 7% by Saudi Aramco, resulting in 81% government ownership. In Saudi Arabia, the SEC is a dominant vertically integrated utility since it serves over 7.1 million customers. The company possesses 46 main plants with a total capacity of 58,462 megawatts. This capacity represents a considerable majority of Saudi's entire generating capacity. The SEC serves the public with power generation, distribution, transmission and customer services, either by the company itself or by its subsidiaries spread across the Kingdom (SABC, 2012).

During the *sukuk* issuance, SEC achieved a rating of A1/AA-/AA- (all Stable) by Moodys/S&P/Fitch (Deutsche Bank, 2012). The SEC *sukuk* credit worthiness and strength was significantly improved and underpinned by an over-collateralized reserve. The SEC to date has ended up with six series of outstanding *sukuk* worth $6,250,000,000. Two of the *sukuk* issued were in the local market in 2009 and 2010 and four in the global market; two series in 2012 and two other series in 2013 (SEC 2013, p.2). The discussion on this chapter focuses on the first global issuance in 2012. This discussion provides an analysis concerning Sharia and financial issues.

7.2 SEC *Sukuk* in 2012

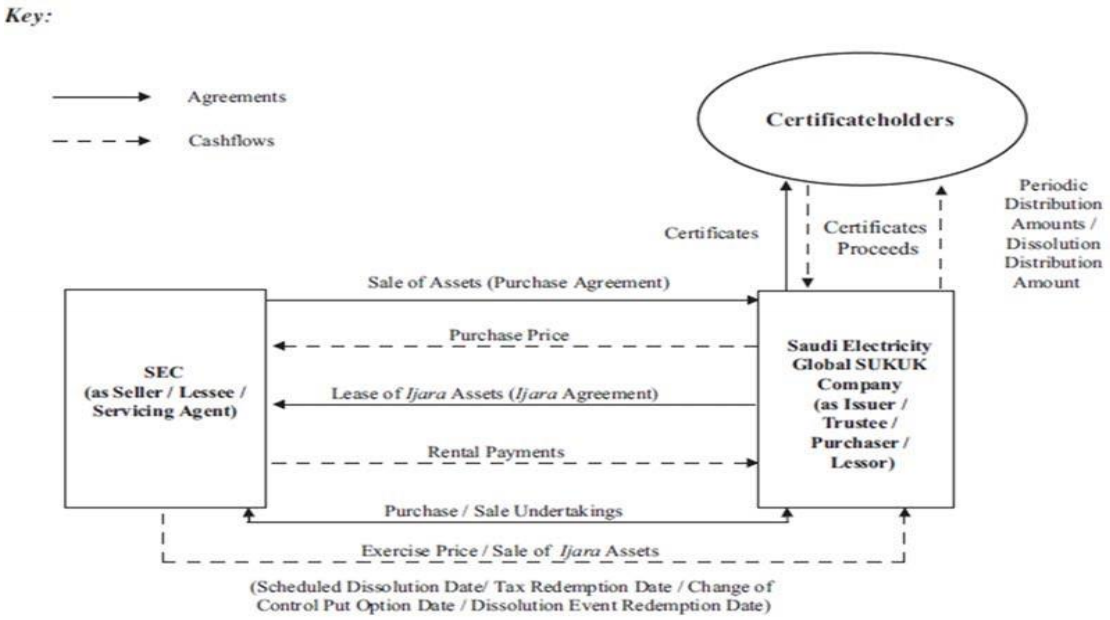
On 3rd April 2012, the SEC successfully closed the issuing of a dual-tranche *sukuk* for $1.75 billion. This issuance is the world's first international 30-year *sukuk* that has been divided into $500 million with 5 years to maturity (due 2017) and $1.25 billion with 10 years to maturity. These were managed by HSBC and Deutsche Bank to introduce the inaugural international *sukuk* by the SEC. They were sold to US investors and the issuance was well-received and produced payments from over 440 investors in excess of $17.5bn (Deutsche Bank, 2012). The success can partially explain by to the use of the *ijara* structure being more

recognized by international investors. The same structure was also applied in April 2014 for the Saudi Electric Company's issuance of $1.5 billion due in 2024 and $1 billion due in 2044 (Latham & Watkins, 2015).

As the SEC has a number of different issuances, there is a concern related to the structure if these issuances have the same or different SPVs? In other words, are these structures based on a one-off (stand alone) structure or a multi-seller structure? To determine the type of the 2012 SEC *sukuk* in respect of the type of SPV and structure, requires a general look at all of the SEC issuances. According to the offering circular (OC) for the 2012 issuance, the SPV named the 'Saudi Electricity Global *Sukuk* Company' is an exempted firm with restricted liability established on 20 February 2012 in accordance with the Companies Law. The company has been established solely in order to participate in the transactions required for the issuance. This means that there is no relationship between this SPV and the two previous local issuances in 2009 and 2010. According to the OC for the 2013 issuance, the SEC established a single distribution company to act as SPV and named it the 'Saudi Electricity Global *Sukuk* Company 2' (p.66). Thus, the 2012 SEC *sukuk* uses a stand alone structure with an independent SPV especially invented for this specific issuance. Despite this, the transaction expenses will be relatively higher, and this will increase the levels of protection, independence and flexibility to customize securitization in order to meet investors' desires.

7.3 Structure of 2012 *Sukuk*

Figure 7-1 SEC Sukuk Structure



Source: SEC *Sukuk* Prospectus.

The structure of the first international Saudi *sukuk* was based on *ijara* as follows. The SEC established an SPV named the 'Saudi Electricity Global *Sukuk* Company'. This was the issuer of the international *sukuk* and also the trustee for and on behalf of the investors. The cash received from investors was used to buy a rent-generating asset from the SEC. Once the SPV possessed the asset, it was leased back to the SEC; the SEC become the lessee and the SPV became the lessor for a period corresponding to the duration of the *sukuk*, which is for a 5-year term in respect of the 2017 *Sukuk* and a 10year term in respect of the 2022 *Sukuk*.

In both Series, the SEC will pay rent to the SPV on a semi-annual basis pursuant to the relevant *ijara* Agreement that is designed to finance the periodic distributional amounts payable by the SPV. The SEC undertook the agreement of being the servicing agent of the issuance to be liable for maintaining and insuring the *ijara* assets, concerning both series, paying taxes and performing all structural repairs and major maintenance. Lastly, according to a binding promise, the SEC at maturity date will purchase the invested asset at an agreed price which will then be used for the repayment of the principal to the investors.

SEC dual tranche *sukuk* structures are summarized in the following Tables 7-1 and 7-2.

Table 7-1 SEC First Tranche

Title	SEC *Sukuk*
SPV	Saudi Electricity Global
Structure Type	*Ijara*
Issue Size	$500,000,000
Issue Date	3-Apr-12
Maturity Date	3-Apr-17
Return	2.665
Fix or Variable	Fixed return
Return Frequency	Semi annual
Pricing	163.bp
Book Runners	Deutsche Bank , HSBC
Listing	London stock Exchange
ISIN RegS	XS0764883806

Table 7-2 SEC Second Tranche

Title	SEC *Sukuk*
SPV	Saudi Electricity Global
Structure Type	*Ijara*
Issue Size	$1,250,000,000
Issue Date	3-Apr-12
Maturity Date	3-Apr-22
Return	4.211
Fix or Variable	Fixed
Return Frequency	Semi Annual
Pricing	200.8 bp
Book Runners	Deutsche Bank , HSBC
Listing	London stock Exchange
ISIN RegS	XS00767862914

Accordingly, the SEC *sukuk* contains a number of documents with different obligations, as analysed in Table 7-3.

Table 7-3 SEC Sukuk Documents

Document	Parties	Summary/ Purpose
Sale and Purchase Agreement	SEC (as a Seller) and SPV (as a Buyer)	From the SEC's perspective, this is the document under which it receives the liquidity. From the SPV's perspective (on behalf of the Investors), this document provides the ownership of revenue-producing assets (*ijara* assets).
***Ijara* Agreement**	SEC (as a Lessee) and SPV (as a Lessor)	From the SEC's perspective, this document gives it the possession and use of the Assets and thus its principal project continues without any interruption. From the Trustee's perspective, this document generates a return from the received Asset.
Service Agency Agreement	SEC (as a Servicing Agent) and SPV (as a Lessor /Principal)	From the Trustee's perspective, this is the document that allows the Trustee to pass the liability for the Assets' repairs, major maintenance, insurance and paying taxes back to the SEC.
Purchase Undertaking (*Wa'd*)	Granted by the SEC (as an Obligor) in favour of the Trustee	From the Trustee's perspective, this is the document that allows the Trustee to sell the Assets back to SEC in the event of default or at the maturity date. In return, the SEC is required to pay all outstanding payments (through an Exercise Price) and then the Trustee will pay the *sukuk*-holders.
Sale Undertaking (*Wa'd*)	Granted by Trustee in favour of the SEC (as an Obligor)	From the SEC's perspective, this is the document that allows it to buy the Assets back from the Trustee in certain situation.
Substitution Undertaking (*Wa'd*)	Granted by Trustee in favour of the SEC (as an Obligor)	From the SEC's perspective, this is the document that allows it to substitute the Assets that might be needed for selling or disposal with other assets which have the same value or greater.

7.4 SEC *Sukuk* Rating

The SEC *sukuk* have been rated as A1 by Moody's, AA- by S&P and AA- by Fitch. Thus, the SEC *sukuk* have an adequate safety rating for the payment of financial obligations. Moody explained that 'the current ratings assume that SEC's low risk business profile, supported by its fully integrated operations, will be maintained' (Moody, 2012). However, this has raised concerns about their Sharia compliance. Generally, these three agencies do not comment on the transaction's compliance with Sharia law, as supported by S&P statement when discussing the rating of SEC *sukuk*: 'we have not evaluated whether the trust

certificates are Sharia-compliant' (Standard & Poor's, 2014). The issue raised is that the received ratings are based only on the issuer's creditworthiness without any evaluation of the assets involved. This may raise the issue of fictitious assets.

The SEC as a company has received a rating of A1 by Moody's, AA- by S&P and AA- by Fitch, which reflect the exact ratings received by the current issuance. Moody expressed that clearly, 'the rating agency's assignment of a provisional (P) A1 rating to the *sukuk* is in line with SEC's long-term issuer' (Moody, 2012). Also, the Standard & Poor agency stated that the rating is based on the SEC's creditworthiness: 'the ratings solely represent our opinion about the likelihood of full and timely repayment of the trust certificates issued under the program' (Standard & Poor's, 2014). However, the principle basis of the rating is not in line with Sharia, as it should be based on the quality of the assets to show a real link with them assets. Thus, according to Sharia, the rating assessment of *sukuk* should be dependent on the performance of the asset in generating the cash to meet the timely obligations. In this respect, the principle basis and the procedure of the SECs, international ratings are not in line with the financial principles of Sharia.

However, from a financial perspective, as the SEC aimed to gain access to international debt capital markets, there is no doubt that receiving such ratings or the *sukuk* allowed the issuance to be advertised in the international market. This SEC *sukuk* is its first USD-denominated *sukuk* after a number of years with only local currency denominated *sukuk* (Standard & Poor's, 2014). However, these *sukuk* were successfully concluded after a comprehensive roadshow covering key centres in Europe, Asia and the Middle East (Deutsche Bank, 2012). Based on the targeted investors, who are mostly less sensitive to Sharia compliance, receiving an investment grade from the three main rating agencies has a positive effect on the success of the issuance. Thus, this success has assisted in internationalizing the market for Saudi *sukuk* issuances.

7.5 Sharia Perspective Analysis

This analysis is divided into two main categories of issues related to analysing the content of the SEC *sukuk*, and issues related to analysing the structure. Each category is discussed through their main points; first demonstrating the situation with the SEC *sukuk*,

then supporting the demonstration with a statement from the OC, and finally presenting the Sharia assessment.

7.5.1 Critical Analysis of the Content

I. SEC *Sukuk* Assets

Situation	Statement	AAOIFI Standard
The assets of SEC are the relevant power generation assets which were available prior to the *sukuk* issuance.	'….to purchase from SEC all of the Seller's rights, title, interests, benefits and other entitlements in and to the relevant power generation assets' (p. 24).	Standard No. 9, clause 3/1, 'for the validity of an *ijara* contract concerning a specified asset, the lease contract should be preceded by acquisition of either the asset to be leased or the usufruct of that asset'.

The available assets in this structure meet the Sharia requirements and show the first type of difference from traditional bonds. This is because these power generation assets were owned by the SEC prior to the contract and are identified in the contract. All conditions related to the assets in an *ijara* contract are achieved in this situation. However, there is a question raised that SEC has issued 6 series of *sukuk*, while in Sharia the same assets cannot be used for more than one *sukuk* investment, and thus care must be taken to ensure that different series of SEC *sukuk* have used different tangible underlying assets. In fact, all other local *sukuk* are based on *istithmar sukuk*, whereas the currently discussed issuance was the company's first issuance that is based on *ijara*. *Istithmar sukuk* give the *sukuk*-holders the right to undertake connection services and levy connection charges for specific years and specific *sukuk* assets. However, the invested assets in the 2012 issuance are entirely different which represent the beneficial ownership of the power generation assets. Thus, the SEC *sukuk* assets belong to two different categories. The 2012 SEC *sukuk* represent the ownership in tangible assets; whereas the other local SEC *sukuk* represent the usufruct or the services.

II. SEC *Sukuk* Ownership

Situation	Statement	AAOIFI Standard
Sukuk transactions transfer only the beneficial ownership of the assets without the ownership of the real assets. This is because the invested assets are the public power generation of electricity and the SEC does want to lose the possession and use of the assets in order for its principal project to continue without any interruption.	'Each certificate evidences an undivided beneficial ownership interest of the certificate holders in the trust assets in respect of the relevant series' (p.28).	Standard No. 9, clause 3/1, 'for the validity of an *ijara* contract concerning a specified asset, the lease contract should be preceded by acquisition of either the asset to be leased or the usufruct of that asset'.

In *sukuk*, the investors have to become the legal owners of the assets, whether they are tangibles, usufructs or services, rather than being only nominal holders. This is clearly mentioned by the AAOIFI in Standard No. 18, clause 3/4, for a valid ownership, 'legal possession includes the registration of a mortgage of immovable … that is valid under the law'. However, the SEC actually intended to legally maintain the assets and then the *sukuk* transactions have been designed to that effect. Therefore, instead of offering real ownership, the SEC offers only the right of returns to the investors. Therefore, two Sharia issues arised with the ownership of the SEC *sukuk* as follows. The first is that only beneficial ownership is provided to the investors. It is essential on the basis of the *ijara* contract that it represents the real ownership of the leased assets rather than only the right to receive the rent. According to real ownership, investors have to jointly bear the risks related to the power generation assets. For instance, in the case of the total loss of the assets, each investor will bear the loss according to his extent of ownership in order to satisfy Sharia principles such as 'no reward without risk' and 'any benefit must be accompanied with liability'.

The second issue raised is whether or not SEC transfers the possession of the power generation assets from its balance sheet to the investors? The criteria for testing whether or not the ownership has been legally transferred is that if the SEC investors cannot resell or pledge the underlying assets, then the issuer is the controller. In that case, the whole arrangement would be a financing arrangement and merely a debt rather than a true sale of an asset. This means that if the investors are able to redeem the underlying assets in the event

of default or the bankruptcy of the project, then the transformation has been properly transferred. However, it has been stated in the OC that 'the certificates are limited recourse obligations and investors may not be able to seek full recourse for failure to make payments due on the certificates'. Therefore, such an ownership of the SEC *sukuk* is not real under the legal and Sharia perspectives. This right of disposal is a key issue that has received the attention of Sharia scholars. SEC must certify the transfer of ownership of the invested assets in its *sukuk* books to satisfy the Sharia requirements.

III. SEC *Sukuk* Principal

Situation	Statement	AAOIFI Standard
According to the purchase undertaking, on 3rd of April 2017 in respect of the 2017 *sukuk* and 3rd of April 2022 in respect of the 2022 *sukuk*, SEC will purchase *sukuk* from the Trustee on behalf of the investors at a nominal price which is pre-determined plus any related extra amount.	The statement under undertaking that 'the exercise price will be the aggregate of; (i) the outstanding face amount of the Certificates; (ii) any accrued but unpaid Periodic Distribution Amount … relating to such certificates' (p.27).	In clause 5[28], it is permissible for a lessee in a *sukuk ijara* to undertake to purchase the leased assets when the *sukuk* are extinguished for its nominal value, provided he (lessee) is not also a partner, *mudharib*, or investment agent.

The scenario of leasing is different from other transactions, whereby it is permissible for the issuer, as a lessee, to undertake the purchase of the leased assets for its nominal value, provided that the lessee is not a partner, *mudharib*, or investment agent. The concern here is that the SEC is the investment agent pursuant to the service agency agreement. According to AAOIFI standards, the purchase undertakings under *ijara sukuk* can be calculated by reference to the market value of the underlying assets. Thus, it is not permissible for the SEC to undertake the purchase of *ijara* assets at face value on the maturity dates. In addition, it is important to note that investors, according to Sharia also, have to bear the risk of the total loss of the asset. This means that, if the asset is destroyed in any circumstances, the SEC will

[28] Based on the AAOIFI pronouncement on *sukuk*, 13 and 14 February, 2008.

not be able to buy the assets whether at a nominal or market price. Thus, investors in SEC *sukuk* have to face the risk of capital loss in some circumstances.

IV. SEC *Sukuk* Return

Situation	Statement	AAOIFI Standard
SEC *sukuk* investors are paid twice a year with a fixed return of 2.665% in respect of the 2017 *sukuk* and 4.211% in respect of the 2022 *sukuk*.	Periodic distribution payable semi-annually, on the third day of each April and October in each year … calculated at the rate of (i) in the case of the 2017 Certificates, 2.665% per annum on the outstanding face amount of the 2017 Certificates …, and (ii) in the case of the 2022 Certificates, 4.211% per annum on the outstanding face amount of the 2022 Certificates (p.27).	Standard No. 9, clause 5/2/1, 'the rental must be specified, either as a lump sum covering the duration of the *ijara* contract, or by instalments for parts of the duration. It may also be for a fixed or variable amount'.

From the Sharia perspective, the lease contract in the SEC *sukuk* has created a financial obligation to pay the rental to the investors according to Standard No. 9, clause 5/2/2, 'the rental is made obligatory by the contract'. The SEC (as a lessee) has to make rental payments at regular intervals to the trustee (as a lessor) that must be specified in such a way as to prevent any possible dispute. Therefore, the SEC has to guarantee paying an obligation to the investors, who legally have the right to receive the rent, and it will be calculated by reference to a fixed rate.

However, if the net income generated from the assets is higher than the periodic payment to be made, access will be retained by the trustee as an incentive fee for the positive behaviour of management according to the statement in the prospectus of 'payment of the residual amount (if any) to SEC as an incentive payment' (2012, p.32). On the other hand, the structure does not show any guarantee of the rental payment from a third party. This means that given any inability of the SEC to pay the rental, then investors may face some loss of their return according to the statement in the OC that 'any such failure may result in a loss of revenue and increased costs and accordingly may have a material adverse effect on SEC's reputation, business, financial condition, results of operations and affect its ability to

satisfy its obligations to make the relevant payments under the Transaction Documents to which it is a party in order for the Issuer to pay amounts due on the Certificates'.

V. SEC *Sukuk* Maintenance

Situation	Statement	AAOIFI Standard
According to the *ijara* agreement, SEC bears the ordinary costs of maintenance and repair required for the regular usage of the Assets. According to the servicing agent agreement, the major maintenance and repair of the assets are transferred to SEC. Also, under the liabilities of *ijara sukuk*, it has been agreed in this *sukuk* that the lessee (SEC) will bear all the risks related to the total loss of the leased assets.	'The Lessee shall, at its own cost and expense, be responsible for the performance of all ordinary maintenance and repair required for the *ijara* Assets …. SEC (in its capacity as servicing agent) will be responsible for insuring the *ijara* assets relating to each Series, performing all major maintenance and structural repairs. Under the *ijara* Agreement, the lessee bears the entire risk of loss of or damage to the *ijara* assets…' (p.115).	Standard No. 9, clause 5/1/7, 'the lessor may not stipulate that the lessee will undertake the major maintenance of the asset that is required to keep it in the condition necessary to provide the contractual benefits under the lease'.

In this structure, the cost of ordinary maintenance, major maintenance and total loss are all borne by the SEC, while according to the AAOIFI only ordinary maintenance can be borne by the lessee. It is strictly forbidden to transfer the assets' liabilities to the lessee; however, transferring these liabilities through a separate agency agreement will not change the Sharia rules. As the SEC *ijara* contract includes a statement that the lessee, in capacity of agency, will bear all liabilities related to the leased assets, this makes the contract of *ijara* invalid according to the agreement among all four main schools of Islamic jurisprudence. However, the SEC *sukuk*, under the servicing agency agreement, can continue to service the leased assets and perform the major maintenance, while the expenditures have to be reimbursed by the trustee.

VI. SEC *Sukuk* Tradability

Situation	Statement	AAOIFI Standard
The SEC *sukuk* represent undivided beneficial ownership of the available power generation assets. Currently, SEC *sukuk* are traded in the secondary market in the London Stock Exchange under the name 'Saudi Electricity Global *Sukuk* Company 2.655% Certs 03/04/17 USD'.	Application has been made to the London Stock Exchange plc. for the Certificates to be admitted to trading on the London Stock Exchange plc.'s regulated market (p.32).	Clause 1[29], *Sukuk*, to be tradable, must be owned by *sukuk*-holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally.

According to Sharia, the assets must be tangible rather than a cash flow. If *sukuk* represents only the right to the cash flow, this may raise concerns over being in debt. The AAOIFI announcement emphasizes the ownership of *sukuk* assets, and the actual ownership of the assets is a pre-requisite for *sukuk* trading. It is clearly stated that '*sukuk*, to be tradable, must be owned by *sukuk*-holders'. The ownership includes all rights and obligations in real assets, whether tangible, usufructs or services. However, the SEC *sukuk* represents beneficial ownership of available assets and thus the trading of these *sukuk* will not show any indebtedness and would be permissible accordingly.

[29] Based on the AAOIFI pronouncement on *sukuk*, 13 and 14 February, 2008.

VII. SEC *Sukuk* Insurance

Situation	Statement	AAOIFI Standard
The SEC as a vital company in the Kingdom of Saudi maintains comprehensive insurance that covers the damage and the loss of its assets including sub-stations and power plants. Thus, in the case of the total loss of the underlying assets of the SEC *sukuk*, the SEC will ensure that all insurance proceeds are paid to the *sukuk*-holders. However, if the insurance company was unable to cover all the payments required, then the SEC undertakes to cover such a shortage.	'The servicing agent is responsible for ensuring that the *ijara* assets relating to each series …. Each servicing agency agreement provides that if the insurance proceeds …. are less than the full reinstatement value of the relevant insured relevant *ijara* Assets …, the servicing agent undertakes to pay any shortfall amount' (p.29).	Standard No.9, clause 5/1/11, 'it is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk… such as establishing an Islamic insurance fund with contributions of certificate holders, or by participating in Insurance (*takaful*)'.

The first concern is the type of insurance, where the traditional form of insurance is not permitted under Sharia. This is because Sharia considers such a deal to lie under the prohibition of substantial *gharar*. In addition, the coverage of any shortage from the insurance by the SEC is not permitted and is considered one of the major issues related to Sharia compliance. This results in the SEC guaranteeing the principal for the investors, which renders the transaction merely a loan rather than a Sharia-compliant instrument.

7.5.2 Analysing the Structure

I. *Inah* Sale Structure

Situation	Statement	AAOIFI Standard
The SEC sold only the beneficial ownership of the power generation assets to the investors. Then, investors sold the owned beneficial ownership to the SEC on a deferred payment basis at cost plus the received return.	SEC will sell to the trustee pursuant to the purchase agreement in respect of each series the relevant *ijara* assets … SEC will lease from the trustee the relevant *ijara* assets for a five-year term in respect of the 2017 Certificates and a ten-year term in respect of the 2022 Certificates (p.26).	Standard No.9, clause 8/5: 'if the leased asset was purchased from the lessee before it was leased back to the lessee on the basis of *ijara muntahia bittamleek*, a reasonable period of time, between the lease contract and the time of the sale of the asset to the lessee, must have expired, to avoid the contract of *inah*.

In the SEC *sukuk*, the issue of an *inah* sale may exist where the sale of an asset is followed by a buy-back at an increased price. The practice of *inah* sale purchases is not accepted by the majority of scholars and is also contrary to international Sharia standards such as those for the AAOIFI and the International *Fiqh* Academy. *Inah* sale has been regarded as a disguised loan with interest (*riba*). However, the AAOIFI avoid considering the current issuance as an *inah* sale. The reason for this is that an *inah* sale does not exist if the assets sold are repurchased after a period of time that can cause a change of the assets' condition and price. In SEC *sukuk* the usufruct remains in the investors' possession for 5 and 10 years which is long enough to expect changes in the power generation assets. Therefore, the SEC under the *ijara* basis avoids the issue of an *inah* sale.

II. *Wafa* Sale Structure

Situation	Statement	AAOIFI Standard
SEC sells its power generation to the investors with the undertaking from both parties to pay back the assets' nominal price and to receive the power generation assets through purchase and sale undertakings.	Redemption of the Certificates; pursuant to the purchase undertaking in respect of each Series, the Trustee … requires the SEC to purchase all of its rights, title, interests, benefits and other entitlements in and to the relevant *ijara* assets. Pursuant to the Sale Undertaking in respect of each Series, the SEC requires the trustee to sell to the SEC all of its rights, title, interests, benefits and other entitlements in and to the relevant *ijara* Assets (p.25).	Standard No.9, clause 8/2: A promise to transfer the ownership by way of one of the methods is a binding promise by the lessor. However, a binding promise is binding on one party only, while the other party must have the option not to proceed. This is to avoid a bilateral promise by the two parties which is prohibited in Sharia because it amounts in essence to a contract.

In the SEC *sukuk*, the sale of *wafa* can be noticed in the following features. The investors benefit from the assets bought through obtaining regular rental payments. Secondly, in spite of being owners, investors will not be responsible for the assets and for any damage caused. Finally, the bilateral promise involved in the structure turns out to be a clear version of a *wafa* sale. In fact, according to these features, the relationship between the SEC and investors becomes closer to a lender and borrower relationship rather than lessee and lessor. The loan here is the capital received by the SEC with the benefit for the investors of receiving a fixed return of rental payment. To avoid the *wafa* sale involved in the SEC *sukuk*, a binding promise could be provided from only one party to avoid the essence of the *wafa* structure.

However, an objection is raised in the study by Al-Marshadi (2013) that such *sukuk* are not *wafa* sales. This is because the buyers (investors) can sell the right of ownership to a third party through trading the SEC *sukuk* in the secondary market without referring to the seller (the SEC). The possible transfer of ownership to a third party is considered as a permissible way to avoid a *wafa* sale. This objection can be accepted only if the third party will not have any obligation to the main issuer (the SEC). Trading the SEC *sukuk* when third parties are involved will not result in any changes in the investors' obligations in returning

the assets at their par value. According to the current case, a third party is only a substitution of the previous investor and will act exactly as the previous party did without any minor changes. Indeed, the claimed third party included is a substitution party rather than an independent third party. As this is the case, even if all investors are changed in the secondary market, this will have no effect on SEC *sukuk* in all unlawful obligations.

7.5.3 Overall Rating

SEC *sukuk* have been analysed based on the AAOIFI standards in order to conclude with an overall rating. Tables 7-4, 7-5 and 7-6 show the assessment of the SEC *sukuk* according to all relevant standards of the AAOIFI; if the situation of SEC *sukuk* is compatible with the particular standard, a case will receive a rating of 1; if it is partially compatible, it will receive 0.5; if there is no clarification about the requirement, the case will receive a rating of 0 and finally if it contradicts the standard, it will receive -1.

Table 7-4 Results of SEC Sukuk According to Standard no.9

Standard no.	Clause no.	Compliance	Value
No.(9) *Ijara*	3/1	Compliance	1
	3/2	Contradiction	-1
	4/1/2	Compliance	1
	5/1/1	Compliance	1
	5/1/4	Compliance	1
	5/1/5	Contradiction	-1
	5/1/6	Compliance	1
	5/1/7	Contradiction	-1
	5/1/8	Contradiction	-1
	5/2/1	Compliance	1
	8/7	Contradiction	-1
No.(9) *ijara* Related to *Wa'd*	8/2	Contradiction	-1
	8/3	Contradiction	-1
Total	-1 out of 13		

Table 7-5 Results of SEC Sukuk According to Standard nos.17-18

Standard no.	Clause no.	Compliance	Value

No.(17) ***Sukuk***	5/1/8/1	Compliance	1
	5/1/8/2	Compliance	1
	5/1/8/3	Partial compliance	0.5
	5/1/8/4	Partial compliance	0.5
	5/1/8/5	Compliance	1
	5/1/8/6	Contradiction	-1
	5/1/8/7	Contradiction	-1
	5/2/1	Compliance	1
No.(18) Possession	3/4	Absent	0
Total	2 out of 8		

Table 7-6 Results of SEC Sukuk According to Standard no.23

Standard no.	**Clause no.**	**Compliance**	**Value**
No.(23) Wakala	3/1	Compliance	1
	3/2	Compliance	1
	3/3	Compliance	1
	4/2/C	Absent	0
	5/2	Contradiction	-1
Total	2 out of 5		
Aggregate Percentages Compliance: 3/26=11.5%			

The final results show a low level of compliance to AAOIFI standards, as only 11.5% of the requirements are fulfilled. The application is far away from the spirit of Sharia as most of the essential requirements are not fulfilled. As indicated previously, this issuance targeted US investors which may have motivated the issuer to imitate bonds rather than to follow the distinctive nature of *sukuk*.

7.6 Observed Risk Mitigation Process

This discussion focuses on the risk exposure among SEC investors. In the prospectus, there is a discussion related to the risk factors which is divided into risks related to the issuer, to the business, to the Kingdom, to the certificate, to enforcement, and finally additional risks. However, the following sector highlights risks associated with the Basel framework which is mainly found under the risks related to the certificate.

7.6.1 Risk Factors

I. Credit Risk

Relying on the credit risk of the SEC rather than the *ijara* assets can appear to be more attractive to global investors. In this respect, the SEC have received proper sound investment grade credit ratings, and is the only lessee without any other lessees involved. This means that credit risk would occur if the SEC fails to discharge the rental payment or the final purchase payment. Thus, the case of credit risk will be limited to the event of SEC bankruptcy.

The exposure to capital loss risk is mitigated by the purchase which is to be undertaken at the assets' par value. In fact, the purchase undertaking cannot be executed in the case of the total loss of the assets. However, this risk is relatively low because the SEC is obliged to cover any shortage in the assets' insurance. Based on Sharia, there should be higher exposure to the capital loss risk than is available with the SEC *sukuk*, since investors have to bear the risk of any damages or total loss of the *ijara* asset. For instance, if the asset is destroyed, the SEC will not be obligated to buy the asset or cover any insurance shortages, but rather this is the investors' obligation. In fact, the reason for applying such an unlawful procedure is that investors, especially internationally, typically seek an investment with higher guaranteed capital with less concern about to Sharia compliance.

II. Market Risk

The return in the SEC *sukuk* is based on the interest rate, which increases the exposure to the risk of fluctuations in the market. It is expected that the value of the *sukuk* would fall if the market interest rate rises. In fact, the SEC 4.211 % *sukuk* due in April 2022 has fallen in all but one of five recent months, among a broader sell-off of GCC *sukuk*. The yield on the *sukuk* advanced by 12 basic points during March 2013, which is the highest monthly gain since they were traded in 2012, to 3.28 per cent (Farazi, 2013).

Early redemption risk is also associated with interest rate risk. This risk is incurred when investing in a fixed rate *sukuk* due to the embedded call option**.** The SEC may redeem all, but not some, of the *sukuk* of any of the series after giving prior notice to redeem the scheduled maturity date. In this event, SEC investors will mainly be forced to reinvest the

proceeds at a lower rate of return. This possible risk among investors cannot be totally mitigated; however, it mainly depends on the interest rate in the market. In fact, the interest rate of these *sukuk* is relatively low, which lowers the exposure to prepayment risks.

As the SEC *sukuk* is a global issuance, the foreign exchange risk is mostly unavoidable. The share capital and reporting currency of the SEC is denominated in Saudi Arabian Riyals. Any cost incurred in the project of the underlying assets is calculated in SAR, which is different from the currency of the issuance. SEC will pay amounts due on the *sukuk* in US dollars; while most investors are located in Asia and Europe. This means that most of the investors measure their investment returns by reference to a currency other than US dollars. Therefore, the investment in these *sukuk* entails considerable foreign exchange risks for both the SEC and investors. Exposure to this risk is higher in the series with 10 years maturity since fluctuations in the exchange rate are expected. These fluctuations directly influence the SEC and investors, which may result in a loss by either the *sukuk*-holders or the issuer.

The SEC signed forward exchange currency contracts with local banks in order to fix the US dollar exchange rate against the Euro exchange rate aiming to protect the SEC from currency rate fluctuations and to cover the SEC's prospectus commitments (p.F-26). After that, the SEC is able to produce all US dollar obligations without any major estimated risk. However, investors are still greatly exposed to currency risk. From their perspective, being more liquid is a possible way to manage the currency risk. This means that the tradability of the SEC *sukuk* in the secondary market reduces exposure to this risk. Moreover, the currency risk can be managed by a multi-currency issuance. This can assist investors by mitigating the long exposure to the risk. For example, instead of issuing both of the series in dollars, one tranche can be denominated in USD and the other may be denominated in EU currency.

III. Liquidity Risk

The liquidity risk of the SEC *sukuk* is relatively under control, since these *sukuk* are based on available assets. In addition, the SEC's exposure to this risk has been mitigated by trading the *sukuk* on the London Stock Exchange. However, SEC *sukuk*-holders can be

exposed to some aspects of liquidity risk because the *sukuk* secondary market, in general, is less active in comparison with their counterparts in the traditional market. Thus, there is a possibility of the inability to sell SEC *sukuk* for the desired amount in some periods.

IV. Operational Risk

With SEC *sukuk*, the operational risk related to asset risks is minimized a result of segregating the investors from the ownership of the real assets. This means no that there is no direct influence of the misuse of assets or any failed internal processes, while the legal risk appears clear in the possibility of conflict between different laws. With the SEC *sukuk*, the *ijara* assets are located in Saudi Arabia, a Sharia incorporated jurisdiction, while the SPV (*sukuk* trustee) is located in the Cayman Islands, which is a secular jurisdiction that permits a choice of applicable laws for financial contracts. Then, the SEC *sukuk* are globally purchased by both Muslim and non-Muslim investors. In fact, these *sukuk* certificates and transaction documents are governed by English law. This is because the laws applied have to include those of the Sharia-incorporated jurisdiction (where the SEC and the *ijara* assets are located). Thus, SEC *sukuk*-holders share the added risk of courts not enforcing a foreign judgment in a country where *sukuk* assets exist (Raheem, 2014). Despite this, it is likely that the securities laws in Saudi Arabia are applicable under certain circumstances. In the OC, there are different statements that show the differences in the law applied. For example, it is stated that 'such sale agreement will be governed by Saudi law'; however, in other places that 'the trustee will enter into the sale undertaking on the closing date in favour of SEC, which will then be governed by English law' and also that 'the certificates and any non-contractual obligations arising out of or in connection with them are governed by English law'. To avoid any possible risk of law conflicts, the SEC *sukuk* give the English courts dominance in dispute situations, as it is stated that 'the English courts are valid under English law and is not restricted under Saudi Arabian law'. However, it has been pointed out that English law can sometimes contradict Sharia rules. This can explain the reason for the SEC OC including a clear statement that the issuance may be contrary to Sharia law in some of its possible future stages.

V. Sharia Risk

Although, the SEC *sukuk* have been revised and approved by both the HSBC Amanah Central Sharia Committee as well as Dr. Hussein Hamid Hassan, who is the Sharia advisor of Deutsche Bank AG, the issuance, as discussed previously, contains a number of Sharia issues. This was a result of following different standards rather than those of the AAOIFI, as some advisors approve other views related to specific issues. Therefore, such *fatwas* cannot be entirely relied on until investors have obtained their personal independent Sharia advice concerning compliance. This advice has been stated in the SEC OC, that 'potential investors should obtain their own independent Sharia advice as to the compliance of the transaction documents and the issue and trading of the certificates with Sharia principles'. This particular step can mitigate the exposure to Sharia risk and increase the investors' confidence concerning compliance, since each investor will abide by their independent advisor's ruling. However, it would be advantageous and more practical if the Sharia supervisory boards did not limit their *fatwa* to the direct compliance or non-compliance of the structure without giving details and evidence to bolster investor confidence in respect of its Sharia compliance, especially in controversial Sharia matters.

The conclusion that can be drawn from discussing SEC *sukuk* risks is that the major risks facing SEC *sukuk*-holders mainly refer to the issuer's creditworthiness rather than the assets in the pool. This is a typical consequence of investors not being the legal owner of the leased assets; thus, investors will not have any recourse to the assets in the case of insolvency. In this respect, critical issues related to agency theory can be highlighted.

7.6.2 SEC *sukuk* and Agency issues

In the SEC *sukuk*, a number of agency conflicts are accentuated due to the segregation between ownership and the assets' management. The costs can refer to the loss in the SEC *sukuk's* value caused by the SEC following their own specific interests rather than the best interests of the *sukuk*-holders. In this structure, several parties are involved, and the SEC as an originator, agent, lessee, and servicer means that there is a great exposure to agency problems. The following discussion attempts to identify the agency problems that can have a direct impact on the performance of the *sukuk*. Different aspects of informational asymmetry in favour of the SEC are the main cause of this problem.

An agency problem arises with Sharia-sensitive investors and the SEC concerning the compatibility of the issuance with Sharia. Usually, investors cannot evaluate accurately to what extent the issuance is consonant with Sharia rules. In this respect, the HSBC and Deutsche Bank Sharia advisors act as intermediaries to ensure compliance and thus mitigate the informational asymmetries between the SEC and investors. Although their *fatwa* contradicts some of the AAOIFI standards, the *fatwa* it does not provide any specific classification of its basis and evidence, but rather provides a general statement on being compatible with Sharia. On this issue, the SEC advises investors to not rely on the *fatwa* provided and to request independent advice. However, after the *fatwa* is published, SEC may benefit from the absence of Sharia supervisors. This is because Sharia advisors do not have any authority to supervise *sukuk* procedures after sale. This may result in a moral hazard due to the SEC not following all Sharia rules and requirements. The problem becomes more serious since Sharia advisors cannot perform any further investigation of the SEC's specific future performance due to limited access and monitoring. Thus, investors have to blindly rely on the initial *fatwa* provided by the HSBC and Deutsche Bank Sharia advisors without any attempt to confirm the compatibly of subsequent performance.

In the SEC *sukuk* structure, the rental payments generated from certain power generation assets is distributed to investors. However, investors face information asymmetries in assessing those assets, the services, quality and the lessee preceding the investment. Related to the assessment of the assets, an agency relationship occurs between the SEC and investors concerning the type of asset. Not all of SEC's power generation assets are securitized, according to the statement in the OC describing the securitized assets that they are 'certain power generation assets'. These particular assets include a considerable volume of non-public information that gives SEC the incentive to transfer only low quality assets and retain the best, causing an adverse selection. The incentive is to transfer the risky assets with their excessive risk to the investors in order to limit SEC's exposure to exogenous and endogenous risks. The problem becomes critical without sufficient monitoring, inadequate transparency and the presence of information asymmetries.

There is a further asymmetrical information issue which arises related to the value of the power generation assets. There might be no actual relationship between the cash received by the SEC and the value of these assets, caused by a sale that does not disclose the actual

value of the assets. Investors aim for a purchase with confidence that the cash paid reflects the value of the securitized assets because paying a higher price than the assets' value may affect the proceeds and the final purchase. For instance, if a partial loss occurs to the securitized assets, this directly leads to a reduction in the rental payment. Also when a total loss of the asset occurs, this means a total loss to the incoming returns and the principal. Added to this, there is no authorized access available for the investors to ascertain the quality of services, management and agency provided as to whether or not the actions taken were proper and adequate. As investors are unable to examine the competence related to these features, the quality of the securitized assets along with hazards of malpractice cannot be estimated. Therefore, investors do not have any access to assess the price of these securitized assets, which may result in adverse selection on the assets' value. This problem becomes more critical in the SEC structure due to the substitution undertaking. The composition of the SEC *sukuk* assets may change over the life of the *sukuk* pursuant to the terms of the substitution undertaking. In substitution, the SEC should be required to certify that the value of the new leased assets being placed into the pool is of an equal or greater value than the prior assets. With the current situation of no official access to examine and monitor the leasing assets, a circumstance of moral hazard over incentives arises.

In fact, the SEC retains some of the asset risk associated with the underlying assets. To illustrate this, the SEC buys insurance for the securitized assets. However, if the insurance company becomes unable to cover the assets, the SEC declared it will incur the shortage. Transferring the asset risks to the SEC would greatly motivate the incentives to be more compatible with the investors' interests and to mitigate risks arising from asymmetric information. This implicit risk sharing mechanism, with the issuer as a guarantor and investors as a source of return, bears critical importance to how investors rely on issuer's performance. Adding to this, the SEC *sukuk* structure aims to reduce the incentive to monitor and evaluate the securitized assets through two other vital procedures: the undertaking for the final purchase based on the nominal value, and that the cash flows from the securitized assets are fixed. The SEC undertakes to purchase the assets in the pool at their nominal value, which will encourage the SEC's performance to be in favour of the assets. This procedure also minimizes the incentive asymmetry between investors and the SEC related to the invested assets. This purchase undertaking shows a dimension of sharing between the SEC

and investors, resulting in an optimal mechanism to manage the incentives. Moreover, for better control of agency costs, there must be some commitment towards the proceeds from the assets under the *ijara* basis. In the SEC *sukuk*, the return is precisely determined as a rental payment, aiming for a better management of the agency costs. This commitment of the future cash intake mitigates the agency risks that result from the information asymmetry. Through these two mechanisms, investors become less concerned about the asset's performance and are only interested in the coupon payments since the SEC undertakes to buy the underlying assets according to their face value and not the market price.

7.6 Summary

In the SEC *sukuk* structure, the main critical issue is related to the guaranteed assets. No actual relationship exists between the investors and the assets, from different perspectives. Firstly; the total loss and partial loss risks have been transferred to the SEC. Secondly, all types of maintenance costs and liabilities of the assets are incurred by the SEC. This is a long with limited access to the assets and no possible recourse to them in the case of insolvency. These features can explain the reason for the SEC rating not estimating the quality and value of the assets in the pool, but rather only the SEC's creditworthiness. In fact, as the first global Saudi *sukuk*, the SEC *sukuk* succeeded in generating sufficient liquidity. However, the aim of *sukuk* transactions is the segregation of a specific set of cash flows from the power generation assets, to issue the *sukuk* based only on the cash flows. Thus, it can be said that the structure amounts to no more than a replication of a conventional fixed income product only, with the higher costs of the financial structuring and Sharia approval. In addition to that, some Sharia issues have not been justified according to the AAOIFI standards, and the structure was synthesized without altering the asset risks, market risks and credit risk. The investors receive semi-annual payments with estimated returns of 2.665% and 4.211%, without any link to the real market so that market fluctuations are reflected in in the prices.

Chapter 8: Sadara Chemical Company *Sukuk*

8.1 Introduction

Sadara is a joint stock chemical company that is incorporated under Saudi laws on 24th December 2012, which has strategic significance for Saudi Arabia (Sadara, 2013). The Sadara complex is located in Jubail Saudi Industrial City. It is planned to be one of the major integrated chemicals services facilities in the world. The complex will be the largest ever constructed in one phase, and will comprise of 26 totally-integrated industrial units (ICIS, 2013). The Sadara project will be developed on a tight schedule and is currently on track to deliver its first products during the second half of 2015, with full production estimated by the end of 2016 (SCC, 2013).

The Sadara Chemical Company released public *sukuk* certificates approved by the CMA on 13th of March 2013. Two days after that, the prospectus was published and recently the issuance took a place in April 2013. These *sukuk* were issued by an indirect subsidiary of Sadara, named the Sadara Basic Services Company (SBSC) which was established in October 2011 with limited liability, as a company to issue Sadara certificates with no operating history (Sadara, 2013, p. 54). The offering was limited to either the Saudi national investors or legal persons with a Saudi permanent establishment. The proceeds of the offering will be used to finance the construction and delivery of the Sadara complex (SCC, 2013, p. 12). The discussion in this chapter focuses on the Sadara *sukuk* structure in terms of both Sharia and financial issues.

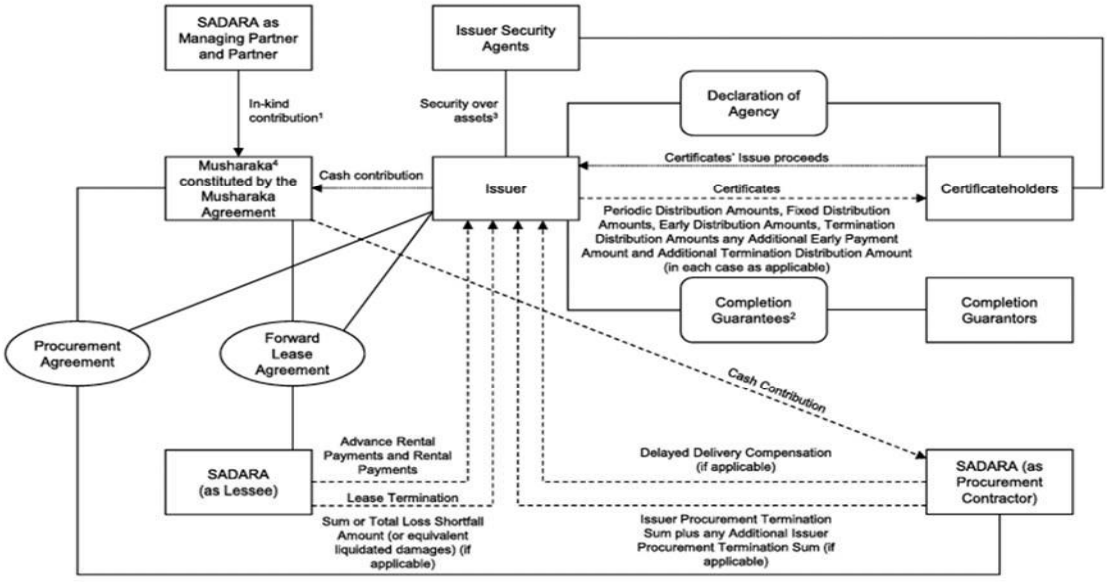
8.2 Public Offering of Sadara *Sukuk*

The Sadara *sukuk* were equivalent which would SAR 5.25 billion to fulfil part of the project cost since it requires an estimated total of SAR 72.4 billion ($19.3 billion) (Sadara, 2013, p. 12). In this respect, the Sadara Chemical Company declared that the closing of the Sadara *sukuk* was hugely successful, resulting in 2.6 times oversubscription with approximately $10.5 billion received (Fletcher, et al., 2013). To satisfy the strong demand from Saudi investors, Sadara enlarged the issuance from SAR 5.25 billion to SAR 7.5bln

(Rasameel, 2013). Thus, Sadara *sukuk* became the largest financing project ever in the Middle East (Dewar & Hussain, 2014). The reason behind this successful financial deal was the involvement a group of more than eight export credit agencies, and a range of various financial banks, Islamic commercial institutions and the Saudi Public Investment Fund (Milbank, 2013).

8.3 Structure of Sadara *Sukuk*

Figure 8-1 Sadara Sukuk Structre



Source: Sadara *Sukuk* prospectus.

The most notable features of the Sadara *sukuk* structure are its size, complexity and flexibility. The Sadara Company established the SBSC in order to issue the certificates and then to receive 100% of the issuing price. After that, according to the OC, a number of staged procedures were to occur as follows:

i. The first stage is the *musharaka* agreement (partnership agreement). The agreement is between Sadara and the SBSC. The SBSC contributed the price received from the issuance in cash as a capital contribution to the *musharaka*. Whereas, Sadara simultaneously contributed to the *musharaka* with an in-kind contribution. The in-kind contribution consists of all its benefits, entitlements and rights in and to the contribution

assets[30], with a valuation agreed among the partners of about SAR 202.7 million. Since *musharaka* is not a body capable of entering into any contract, both parties to the *musharaka* agreement assigned the Sadara Assets Leasing Company as a *musharaka* authorized agent to act on their behalf.

ii. The second stage is the *isistisna'* agreement (procurement agreement). The agreement was between the *musharaka* authorized agent (acting on behalf of the managing partner and other partners) with Sadara in its capacity as procurement contractor according to this agreement. The procurement contractor will receive the capital contribution of the *musharaka* agreement by depositing it into the project account. Then, the procurement contractor will involve the contractors to obtain the delivery of the project assets.

iii. The third stage is the forward *ijara* agreement. The *musharaka* authorized agent entered into a forward *ijara* agreement with Sadara as a lessee. In other words, the two parties involved are *musharaka* authorized agents who act on behalf of the co-lessors; Sadara as the issuer and Sadara as lessee. The co-lessors decide to lease the future assets to Sadara on a forward basis prior to the delivery date and the return is the advance rental payments. After the delivery date, the agreement will continue on an actual basis and the return will be the rental payments[34]. As the lessors are a joint enterprise between Sadara and the issuer, the lease assets will be limited to the issuer's proportional interest in and entitlement to the project assets. Thus, the issuer will be solely eligible to obtain both payments, the advance rental payments and the rental payments. These payments made by Sadara to the issuer will finance the payment of the periodic distribution amounts by the issuer to the Sadara *sukuk* investors.

iv. The fourth stage is the agency agreement. The managing partner on behalf of the co-lessors will appoint Sadara as the service contractor. The service contractor

[30] The land lease agreement with the Royal Commission for Jubail and Yanbu (Sadara, 2013, p. 15). [34] 'Advance Rental Payments and the Rental Payments paid under the forward lease agreement will be paid by the lessee to the issuer by payment directly to the transaction account' (Sadara, 2013, p. 18).

will agree to act as an independent service contractor for the co-lessors to perform and discharge certain services during the contract term.

v. The final stage is the maturity date. The forward *ijara* agreement is based on lease-to-own. For the lease-ending ownership, the project assets will finally be owned by Sadara and then all of the *sukuk* will be terminated. The investors' capital will gradually be paid by periodic distribution until it is finally redeemed.

As stated previously, the issuance is characterized as a complex structure, and the complication occurs when a Saudi Joint Stock Company looks for assets in order to issue Sharia-compliant *sukuk*. The Royal Commission for Yanbu and Jubail granted the industrial land lease contract to Sadara Chemical Company, since this land is required as a basis for the *istisna'* and forward *ijara* structures. This transfer underpins the issuance of these *sukuk*; however, there were some prohibitions on the assignment or transfer of the land to the SBSC. In order to design the structure around to avoid this complication, the agreement of *musharaka* was conducted to achieve an unincorporated partnership between SBSC and Sadara (IFN, 2014). The issuance of Sadara is generally summarized in Table 8-1:

Table 8-1 Sadara Sukuk Offering

Title	**Sadara *Sukuk***
Issuance Type	Domestic market- public issue
SPV	Sadara Basic Services Company
Structure Type	*Musharaka/ Ijara*
Issue Size	SAR 7.5 billion ($2 billion)
Issue Date	02-April-2013
Maturity Date	02-April-2029
Coupon Rate	6 month SAIBOR +) 95 bps
Fix or Variable Return	Floating
Return Frequency	Semi-annual

According to the above structure, the Sadara *sukuk* includes more than 12 documents that are mentioned in the OC. However, according to the structure, the four main documents are: the *musharaka* agreement, procurement agreement, forward lease agreement and service agency agreement, which are summarized in Table 8-2:

Table 0-2 Sadara *Sukuk* Documents

Table 8-2 Sadara Sukuk Documents

Document	Parties	Purpose
***Musharaka* Agreement**	Sadara (as a party in the partnership) and SBSC (as another party)	From Sadara's perspective, this document provides the eligibility to share the received capital with the SBSC. From SBSC's perspective, this document provides shared ownership on the assets.
Procurement Agreement	*Musharaka* authorized agent (as purchaser) and Sadara (as contractor)	From the *Musharaka* authorized Agent's perspective, this document provides the ownership of revenue generating assets at a future time. From Sadara's perspective, this is the document that provides the funding.
Forward Lease Agreement	SBSC and Sadara (as co-lessors) and Sadara (as lessee)	From the issuer's perspective, this document generates the return required for the *sukuk*. From Sadara's perspective, this is the document that provides Sadara with the possession and use of the future assets.
Service Agency Agreement	*Musharaka* authorized agent (as lessor) and Sadara (as servicing agent)	From *Musharaka* authorized agent's perspective, this is the document allows the liability for the underlying assets' major maintenance and repairs to pass to Sadara.

8.4 Critical Analysis from Sharia Perspective

In this discussion, the AAOIFI standards are used for the guidance in analysing the Sharia issues. To evaluate to what extent the Sadara *sukuk* are compliant with Sharia, a number of critical issues are addressed. The issues are discussed under two main categories; these related to the content of Sadara *sukuk* and those related to the structure.

The discussion in each category covers three elements; a demonstration of the Sadara *sukuk* situation, providing support from the OC to confirm the situation, and lastly the relevant standard from the AAOIFI in order to achieve an accurate Sharia assessment of this structure.

8.4.1 Critical Analysis of the Content

I. Sadara *Sukuk* Assets

Situation	Statement	AAOIFI Standard
The subject matter of the forward *ijara* contract in the Sadara *sukuk* is based on unavailable assets. The description and completion date of these assets have been clearly specified in the OC.	The project assets to be constructed are; (i) the butyl glycol ether and amines … plants; (ii) a plant to convert hydrochloric acid to chlorine... it will be implemented in four phases: program FEED – ended August 2010; project FEED– ended December 2011; EPC– expected to end October 2015; and commissioning and start-up expected to end June 2016 (p.8).	AAOIFI under Standard No.9 stated on defining *ijara* as it is 'a contract giving a legal title to legitimate and identified usufruct for a defined period of time in exchange for a legitimate and determined consideration.

As the Sadara *sukuk* assets are unavailable, there are two essential AAOIFI requirements. The first is the detailed description of the future assets and the second is the specification of the delivery date. As seen previously, these two requirements have been applied in the Sadara *sukuk*. Moreover, the AAOIFI Standard No.9, clause 3/5, adds that the future assets have to be delivered during the contract: 'an *ijara* contract may be executed for an asset undertaken by the lessor to be delivered to the lessee … In this case, an agreement is reached to make the described asset available during the duration of the contract'. Sadara *sukuk* is compatible with this requirement as the specified delivery date is in 2016 while the maturity date is in 2018.

However, the concern that may arise is related to the description of the Sadara assets. It is required that the asset be described precisely using certain specifications in a manner that does not result in any future controversy or ambiguity. The AAOIFI Standard No. 9, clause 3/5, states that 'an *ijara* contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications'. The question raised here is whether or not the description of the Sadara *sukuk* assets is adequate according to Sharia requirements. In other words, has the description provided been specified in a way that will eliminate any future dispute at the delivery date? Are the investors (as lessors) able to decide whether or not the asset received meets the specifications? In fact, as the Sadara *sukuk*

inventors are not well informed about the future assets, the OC gives the procurement contractor (Sadara) the responsibility to judge the delivered assets. It is stated that 'upon delivery, the procurement contractor will be responsible for ensuring the project's assets: (a) to comply with the agreed technical specifications (as set out in the procurement agreement); (b) that they are in good condition and satisfactory for the purposes contemplated by the Forward Lease Agreement …'. Accordingly, the point raised point cannot be agreed on for a number of reasons. Firstly, the decision on the delivered assets has been transferred to Sadara, due to its experience with such assets, and not due to insufficient information being received by investors. Secondly, the criteria to decide the suitability and compatibility of the assets delivered have been mentioned in the OC in both the procurement and forward *ijara* agreements. Thus, the investors are well-informed in the OC about the future Sadara assets along with all criteria required for the adequacy of the assets. Therefore, the Sadara *sukuk* can be safely categorized with no Sharia concerns related to the future assets as they are sufficiently described along with the delivery date during the life of the *sukuk*.

II. Sadara *Sukuk* Ownership

Situation	Statement	AAOIFI Standard
The investors own only the interests, rights, benefits in, to and under the leased assets and thus each *sukuk* shows the beneficial ownership of the underlying assets.	Prospective certificate holders should note that they do not have physical	Standard No. 9, clause 3/1, 'for the validity of an *ijara* contract concerning a specified asset, the lease contract should be preceded
According to that, holding these *sukuk* does not enable investors to any physical possession of the Sadara future assets.	entitlement to the project assets (p.45).	by acquisition of either the asset to be leased or the usufruct of that asset'.
According to this particular ownership, Sadara investors will not have any recourse to their owned assets in the case of Sadara's insolvency and any other cases.	No certificate holder shall have any recourse to the leased assets…' (p.66).	Standard No.18, clause 3/4 provides more requirements for a valid ownership that has to fulfil the 'legal possession includes the registration of a mortgage of immovables… that is valid under the law'.

To validate the contract of *ijara*, an ownership is required, either of the asset or the usufruct. However, Sadara provides only beneficial ownership with considerable restriction to the assets according to statement that 'the rights of the issuer to sell, assign, transfer or dispose of the contribution assets … are strictly limited'. More critical is the legal registration of the assets under the investors' ownership. This is because the AAOIFI in the above Standard specifics the legal registration of a mortgage of immovables as a requirement for valid ownership. In the OC of the Sadara *sukuk*, there is no clear statement in respect of the legal registration of the assets under the investors' possession. However, if the assets are legally registered under the investors' possession, this will no doubt provide the investors with access to the assets in the event of insolvency. In fact, Sadara investors have no recourse to the assets except under the purchase undertaking. This restriction applied to the Sadara investors and upon the assets, means that the assets are registered under the investors' ownership. As discussed, the restriction has three aspects; investors do not physically own the assets nor the usufructs and they only receive beneficial ownership. In addition, their beneficial ownership is restricted to certain commercial behaviour that has been specified in the OC. Finally, Sadara investors are not eligible to any recourse to Sadara assets in the case of insolvency. As a result of these aspects, investors are not the legal owners of the Sadara assets and Sadara *sukuk* offered only an illegal ownership to overcome some of Sharia requirements.

III. Sadara *Sukuk* Principal

Situation	Statement	AAOIFI Standard

The capital of the Sadara *sukuk* is entirely guaranteed in two situations: the first is following the scheduled termination date of the *sukuk*, where the principal will be redeemed gradually starting with the first repayment date on around 15th December 2018 and ending with the final repayment date.	The issuer will partially redeem the certificates pro rata in an aggregate amount … The termination distribution amount will be either: (i) the aggregate outstanding face amount of the certificates at the relevant time (taking into account any partial redemption … (p.4).	According to AAOIFI Clause 5 [31], 'it is permissible for a lessee in a *sukuk ijara* to undertake to purchase the leased assets when the *sukuk* are extinguished for its nominal value, provided he {lessee} is not also a partner, *mudharib*, or investment agent'.
The second situation is when the event of total loss occurs, and any shortage in the principal, after insurance costs, will be covered by Sadara (as a lessee).	If such a lessee termination sum is not paid within 60 days of the occurrence of the total loss event … the lessee shall be obliged to pay any total loss shortfall amount immediately (p.19).	Standard No. 9, clause 5/1/8, 'the leased asset is the responsibility of the lessor throughout the duration of the *ijara*, unless the lessee commits misconduct or negligence. The lessor may take out permissible insurance on it whenever possible, and such insurance expenses must be borne by the lessor.

In general, the capital received from the *sukuk* cannot be guaranteed in any cases or circumstances. However, the scenario of the lease-to-own *sukuk* is different, as it is permissible to re-buy the assets at their nominal value and thus the AAOIFI permits such a purchase provided that the lessee is not a partner, *mudharib*, or investment agent. In fact, the lessee in this structure is a partner under the *musharaka* agreement. Thus, it would not be permissible for the lessee to purchase the assets at their nominal value. The principal received has to be redeemed for the Sadara *sukuk* according to the market value or fair value of the assets under the mutual agreement between Sadara and the issuer at the time of execution. In the case of the total loss of the assets, the capital cannot be guaranteed by the lessee unless the damage occurring was due to negligence. According to the OC, Sadara can voluntarily

[31] This is based on the AAOIFI pronouncement on *sukuk*, 13 and 14 February, 2008.

pay any total loss shortfall amount in the case of total damage, which shows that the capital received from investors is not guaranteed in this situation. This is an important step towards a more Sharia-compliant instrument.

IV. Sadara *Sukuk* Return

Situation	Statement	AAOIFI Standard
Sadara investors are entitled to receive a semi-annual return of 6 months SAIBOR plus 95 basic points per annum. This periodic amount will be paid by Sadara to the SBSC as an advanced rental payment and then as a rental payment.	Prior to and including the lease commencement date, the advance rental payments made by Sadara to the issuer will fund the payment by the issuer to certificate holders of the periodic distribution amounts (p.8).	Standard No. 9, clause 5/2/1, 'the rental must be specified, either as a lump sum covering the duration of the *ijara* contract, or by installments for parts of the duration. It may also be for a fixed or variable amount'.
Prior to the completion date, if Sadara fails to pay the advance rental payments, the payments will be guaranteed by Aramco and Dow.	'The completion guarantors are two parties; divided as follows: 65% from Saudi Aramco and 35% from Dow and is limited to the period up to the lease commencement date … The completion guarantees guarantee the timely payment of all amounts due in respect of the *sukuk* facility until the project completion date' (p.114).	Standard No. 9, clause 5/2/2 'the rental is made obligatory by the contract'.

In an *ijara* contract, it is essential to specifically determine both the amount and the time of the rental payments. The Sadara *sukuk* have met both requirements since the OC precisely clarifies both elements of the rental payments. In addition, the situation given failure to pay the return of the Sadara *sukuk* is generally in line with Sharia principles. This is because Sharia does not guarantee the investment's return except if it is a rental payment. Rental payments are a strict obligation in Sharia. However, after the project completion date, there is no assurance or guarantee that the periodical distribution amounts will be paid, and the only available source would be Sadara's activities. This is according with the OC which

states that 'the termination of the completion guarantees the project completion date, these assets, including receipts from the operating revenues of Sadara, will be the sole source of funds available to Sadara to meet its obligations to make payments to the issuer'. This phase of the project does not show any contradiction with Sharia rules.

V. Sadara *Sukuk* Maintenance

Situation	Statement	AAOIFI Standard
It is the responsibility of Sadara as a lessee to bear the cost of routine maintenance.	Routine maintenance required in respect of the lease assets will be the responsibility of the lessee, and it will bear the cost of such routine maintenance (p.299).	Standard No.9, clause 5/1/7, 'the lessee should carry out operating or periodical (ordinary) maintenance'.
The responsibilities for major maintenance have been transferred to Sadara as the service contractor under the service agreement. However, the cost of such maintenance will be reimbursed by the managing partner on behalf of the co-lessors.	The services will mirror the responsibilities of the managing partner under the forward lease agreement. Specifically, they will include performance of the following tasks; major maintenance …. The managing partner will then be required to reimburse the service contractor each service charge (p.301).	Standard No.9, clause 5/1/7 'the lessor may delegate to the lessee the task of carrying out such maintenance at the lessor's cost'.

According to the Table above, the Sadara *sukuk* appear to be in line with the Sharia rules related to both types of maintenance. However, there is a statement in the OC to 'set off the services charges: The obligation of the managing partner, acting on behalf of the co-lessors, to pay the service charges to the service contractor will be set-off against the obligation of the service contractor (acting in its capacity as lessee) to pay the equivalent service charge as a supplementary rental payment under the forward lease agreement or, as the case may be, as part of any lessee termination sum under the forward lease agreement'. Service charges include major maintenance costs, meaning that the costs will be finally transferred back to Sadara under the payments of the supplementary rental. Thus, a concern still exists regarding not fulfilling the Sharia requirement.

VI. Sadara *Sukuk* Tradability

Situation	Statement	AAOIFI Standard
In April 2013, the CMA has accepted Sadara *sukuk* to be traded in the Saudi Stock Exchange (Tadawul).	The application has been made, and all requirements have been met, for the certificates to be admitted to listing on the Saudi Stock Exchange … There is currently no established secondary market for the *sukuk*, and there can be no assurance that one will develop after the certificates are issued' (p.53).	Standard No.17, clause 5/2/8, 'it is not permissible to trade in certificates of ownership of usufructs of a described asset before the asset from which usufruct is to be made available is ascertained…'

In the Sadara *sukuk*, there are two main stages: when the assets are under construction and when the assets become available. There is no doubt of the permissibility of trading the *sukuk* when the assets are delivered; however, the issue arises in the first phase. According to the AAOIFI, it is generally prohibited to trade *sukuk* that are based on debt, such as forward *ijara sukuk*. However, the Sadara *sukuk* do not only involve debt, as they include the share of the invested land under the *musharaka* contract. The OC states that the '*musharaka* assets, such as the contributions by the partners (including the in-kind capital contribution by Sadara of its rights, benefits and entitlements in and to and under the industrial land lease contract)'. This was specifically studied by the Sharia board to ensure that the value of the land equals more than one-third of the value of the *sukuk* in order to validate trading as indicated by S4[32] (2016).

VII. Sadara *Sukuk* Insurance

Situation	Statement	AAOIFI Standard
The construction, development and also the operation of the Sadara project involves numerous risks prior to and after the project completion date. Thus, Sadara maintains operational insurance, asset	'Insurance means operational and third party insurance and such other insurances relating to the lease assets' (p.382).	Standard No.17, clause 5/1/8/7, 'it is, however, permitted to an independent third party to provide a guarantee free of charge'.

[32] S4 is one of the interviewees in Chapter 10.

insurance and third party insurance.		
It is important to highlight that the insurer of the Sadara *sukuk* has specific aspects. There are now two insurers who have ratings of A- or above from S&P, these being Tawuniy whose rating is A-, and The Mediterranean and Gulf Insurance and Reinsurance Company whose rating is A-'.	A permitted insurer is deemed to have a rating of at least A- by S&P or an equivalent rating from AM Best, Moody's or Fitch (p.585).	Standard No.9, clause 5/1/11, 'it is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk … such as establishing an Islamic insurance fund with contributions of certificate holders, or by participating in Insurance (*takaful*).

In Sadara's insurance, the third party insurance is accepted in Sharia rules; however, the insurer has to be independent and the guarantee has to be free of charge. In the Sadara *sukuk*, there is no statement that indicates the existence of any charge. However, the statement that 'the Saudi Aramco shareholder and the Dow shareholder agreed to subscribe to equity interests in Sadara Company of 65% and 35%, respectively' thus raises the concern of third party independence. In fact, Aramco and Dow guaranteed the advance rental payment and the delivery of the constructed assets. This particular insurance can be provided by the lessee, as discussed in the rental issue, or any other relevant party. In addition, the operational insurance is covered by two specific insurers. These are, Tawuniya whose rating is A-, and The Mediterranean and Gulf Insurance and Reinsurance Company. In this case, the Islamic version of *takaful* has been applied, which is a step towards a more Islamic instrument. However, the Mediterranean and Gulf Insurance and Reinsurance Company appear to be a commercial insurance company, which raises Sharia concerns about applying non-Islamic insurance.

8.4.2 Critical Analysis of the Structure

I. Lease-to-Own Structure

Situation	Statement	AAOIFI Standard

Forward *ijara* agreement under Sadara *sukuk* is based on 'lease to own'. In this structure, the assets will be possessed by the lessee when Sadara (as a lessee) has paid of all the advance rental payment and the rental payment.	'Forward lease agreement will terminate automatically on the scheduled lease termination date… and on such date, the colessors will agree to sell to the lessee all of the issuer's (as a colessor) ownership interests in, to and under, the lease assets. On the scheduled termination date, the lessee will have paid all the advance rental payments and rental payments … on a (lease to own) basis' (p.20).	Standard No.9, clause 8/3, 'in all cases of transfer of ownership by way of gift or sale, it is necessary, when the promise is fulfilled, that a new contract be drawn up, since the ownership to the property is not automatically transferred by virtue of the original promise document that was drawn up earlier'.

According to AAOIFI Standard, when transferring the leased asset's title to the lessee, it is not permissible to structure the contract of forward *ijara* to conclude automatically with the possession of the item that includes the benefit. However, this can become permissible if it is conducted in a separate document from the document of forward *ijara*. In this respect, the Sadara *sukuk* include to an automatic exercise of ownership, while the statement of the automatic practice will be related to the termination of the lease. The ownership of the leased assets will be transferred back to Sadara after the final instalment is paid with a separate contract but not on an automatic basis (S4, 2016). This means that Sadara *sukuk* have two separate stages; firstly, the provisions and terms governing the forward *ijara* until the end of the contract which will be automatically terminated, and secondly Sadara possesses the asset in a new separate purchase document.

II. *Inah* Sale Structure

Situation	Statement	AAOIFI Standard
The Sadara *sukuk* structure involves a situation where the investors as buyers lease the underlying assets to Sadara, and after a specific period re-sell them back to Sadara.	The business plan requires funding to lease the Issuer's proportional interest in and entitlement to them to Sadara (as lessee) on a 'lease to own' basis (p.87).	Standard No.9, clause 8/5, 'if the leased asset was purchased from the lessee before it was leased back to the lessee on the basis of lease to own, a reasonable period of time, between the lease contract and the time of the sale of the asset to the lessee, must

		have expired, to avoid the contract of *inah*'.

According to the AAOIFI, the permissible way to overcome the *inah* issue is by observing the lapse of a period of time in order to make physical or value changes to the underlying assets during the specified period. This period has to be long enough so that the leased assets or their value could have changed. In the Sadara *sukuk*, there exists a relatively long-term basis, with tenure of approximately 16 years, and even early termination can only be triggered after the 5th anniversary, which is long enough for the assets to change in value in the market.

It seems that Sadara have followed a new structure to overcome such an *inah* issue. To illustrate this, *inah* contains two main transactions: buying assets and then reselling the same assets. The Sadara *sukuk* contain these two main transactions; however, with two different assets. The first payment received from the investors is to cover the partnership contract to engage in investing in the land: 'on the closing date, the issue price of the certificates will be paid to the Issuer. The Issuer will then pay the contribution … of the *musharaka* Agreement in-cash as a capital contribution to the *musharaka'*. Then, under the *musharaka*, the non-existing assets will be constructed. The second transaction is to lease-to-own the assets and considers the unavailable assets, while the first transaction dealt with the available land. Two transactions are conducted with two different assets, which can be seen as a device invented to overcome the issue of *inah*.

8.4.3 Overall Rating

The following Tables show the assessment of the Sadara *sukuk* according to the AAOIFI standards. As mentioned, a score of 1 point is for a Sharia compatible situation; 0.5 points is for partial compatibility; 0 points is for the unclarified requirement and -1 is for a non-compatible situation.

Table 8-3 Results of Sadara Sukuk According to Standard no.9

Standard no.	Clause no.	Compliance	Value
	3/5	Compliance	1
	3/6	Compliance	1

No.(9) ***Ijara***	4/1/2	Compliance	1
	4/1/3	Compliance	1
	5/1/1	Compliance	1
	5/1/4	Compliance	1
	5/1/5	Compliance	1
	5/1/6	Compliance	1
	5/1/7	Compliance	1
	5/1/8	Compliance	1
	5/2/1	Compliance	1
	8/1	Compliance	1
	8/6	Compliance	1
	8/5	Compliance	1
	8/7	Contradiction	-1
No.(9) *ijara* Related to *Wa'd*	8/2	Contradiction	-1
	8/3	Compliance	1
Total	15 out of 17		

Table 8-4 Results of Sadara Sukuk According to Standard nos.17-18

Standard no.	Clause no.	Compliance	Value
No.(17) ***Sukuk***	5/1/8/1	Compliance	1
	5/1/8/2	Compliance	1
	5/1/8/3	Partial compliance	0.5
	5/1/8/4	Compliance	1
	5/1/8/5	Compliance	1
	5/1/8/6	Contradiction	-1
	5/1/8/7	Contradiction	-1
	5/2/8	Compliance	1
No.(18) Possession	3/4	Absent	0
Total	5.5 out of 8		

Table 8-5 Results of Sadara Sukuk According to Standard no.23

Standard no.	Clause no.	Compliance	Value
No.(23) ***Wakala***	3/1	Compliance	1
	3/2	Compliance	1
	3/3	Compliance	1
	4/2/C	Absent	0
	5/2	Compliance	1

Total	4 out of 5
Aggregate Percentages Compliance in: 24.5/30=81.7%	

The aggregate compliance of Sadara *sukuk* is far higher than that of the SEC *sukuk*. The Sadara *sukuk* have achieved 81.7% while the SEC *sukuk* achieved only 11.5%. Both issuances are from Saudi Arabia; however, the Sadara *sukuk* are domestic while SEC *sukuk* are international. This is because the unprecedented features involved in the former's structure are more harmonious with AAOIFI standards and highlight better the distinctive nature of *sukuk*, and thus it can be said that these *sukuk* have made a remarkable step forward in the primary market. But although the overall result is a positive step towards SBS, there are still some critical issues that require more attention to further improve the final result[33].

8.5 Observed Risk Mitigation Process

As discussed, the risks associated with the Basel framework mainly involve credit risk, market risk, liquidity risk and operational risk. Consideration of these risks is accompanied by the discussion of the Sharia risk.

8.5.1 Risk Factors

I. Credit Risk

As the Sadara *sukuk* are based on unavailable assets, there is a risk of a delay in delivery. It is possible that the constructed assets may not be complete on the project completion date. However, to mitigate this risk, Sadara (as a procurement contractor) will pay to the issuer compensation for any delayed delivery with respect to each delay period. According to this agreement, the delayed delivery compensation amounts have to be reasonable, fair and a genuine pre-estimate of losses born by the issuer as a consequence of Sadara's failure to fulfil the delivery strictly according to the terms of the agreement. The delayed delivery compensation will fund the issuer's payment of the periodic distribution amounts. This is specified in the OC as follows: 'In the circumstance in which Sadara has not constructed all of the Project Assets, such failure would lead to a non-delivery under the Procurement Agreement, causing: (i) payments of Delayed Delivery Compensation being

[33] These issues are discussed in chapter 10 in interviews chapter with prominent scholars.

due from Sadara on a periodic basis if such non-delivery continues after the date specified as the Target Completion Date'.

In addition, there is a possible risk that the Sadara Company will fail to discharge the advance rental payment obligation, which would lead to financial loss for the *sukuk*-holders. In addition, there is a possible risk related to the purchase undertaking, as Sadara may fail to pay back the nominal value. This means that the credit risk in these *sukuk* is limited to the failure or bankruptcy of Sadara as it is the only party who is responsible for the obligations. Sadara states in the OC concerning the possibility of such a failure that 'any such material adverse effect could materially reduce the funds available to meet its obligations to make payments to the Issuer under the *sukuk* transaction documents'. However, Sadara attempts to minimize the credit risk through investing in financial institutions with reliable credit ratings. It limits itself to the institutions with ratings by Fitch Ratings Agency of 'A –'or better. Also, the insurance provided for the leased assets, operational costs and advance rental payments give some protection from this risk.

II. Market Risk

Typically, as with all other securities, Sadara investors are exposed to interest rate risk. However, the nature of the Sadara *sukuk* limits the exposure to such risk because the returns on Sadara *sukuk* are adjusted regularly to reflect changes in short-term interest rates (LIBOR). The floating rate offered in *ijara* appears more appropriate and desirable considering the changing market and economic conditions, especially as the Sadara *sukuk* lifetime is relatively long. This is because, if the benchmark interest rates rise, the Sadara *sukuk* will pay higher returns, resulting in investors bidding up the prices of these *sukuk*.

The Sadara *sukuk* are structured with a floating rate of return to insure against rising interest rates and to protect investors if the rates rise. Also, when rates fall, the Sadara investors maintain the advantage of interest rate clearance. In reality, the SBSC as an issuer and not the investors will pay a premium for this protection from rising interest rates. For this reason, the SBSC enters into a number of interest rate contracts in order to lower funding costs and the exposure of interest rate risk related to obligations. Under these contracts, the SBSC agrees with other parties to exchange, at particular intervals, the difference between the floating and fixed interest amounts measured on an agreed amount.

An early termination risk can be caused by the interest rate risk in favour of the issuer. There is a possible risk in the Sadara *sukuk* that they will be terminated before the maturity date pursuant in whole, but not in part, at the option of the issuer. Facing this risk is possible on any periodic distribution date after the 5th anniversary of the closing date, or following a tax event, or following an inter-creditor event. In the case that the early termination of the forward *ijara* agreement takes place before the delivery date, the co-lessor will pay to the lessee 'the lessor termination sum'. This sum includes the aggregate of all advanced rental payments received by the lessor up to the termination date. However, if the forward *ijara* agreement is terminated after the delivery date, the lessee will pay to the issuer 'the lessee termination sum'. The lessee termination sum includes the unpaid rental payments and any other obligated amounts often and including the date of termination, since early termination may not be a favourable situation for the investors in the Sadara *sukuk*. To mitigate such a risk, the issuer is required to pay a profit on early termination. The payment is considered under the forward *ijara* agreement as an applicable additional early payment amount. Also, for mitigation purposes, the issuer of the Sadara *sukuk* is required to provide notice within a specified period of not less than 30 or more than 60 days to the *sukuk*-holders.

In addition, market risks involve the risk of changes in currency exchange rates. The currency risk cannot be predicted due to unexpected currency fluctuations. However, the Sadara *sukuk*-holders will not face this risk because the Sadara *sukuk* are locally distributed to Saudi national investors and denominated in Saudi Riyals. Moreover, Sadara's activities are also denominated principally in Saudi Riyals. Thus, the Sadara Company at present does not have major exposure to currency risk and Sadara is not required to adopt any hedging programme for currency risk.

III. Liquidity Risk

Sadara *sukuk* exposure to liquidity risk is high because they are based on unavailable assets. The uncertain liquidity caused by unavailable assets has been insured by Aramco and Dow. In addition, despite these *sukuk* being based mainly on debt (unavailable assets), the Sadara *sukuk* have been listed on the Saudi Stock Exchange for the purpose of managing liquidity risk. However, the Sadara *sukuk* cannot be traded quickly enough to prevent any predicted loss. This is because of the lack of an active Saudi secondary market, which may

result in the inability to sell the Sadara *sukuk* at a reasonable time and reasonable price. As this is the case, it is difficult or impossible to isolate the liquidity risk; however, it can be managed through regular monitoring to observe the availability of sufficient funds to meet any future desire for liquidity. The monitoring includes the observation of future net cash flow on a regular basis; then, any period which shows a sizeable negative net cash flow will be taken under consideration. This assessment of the liquidity of the Sadara *sukuk* can be considered as a supplementary tool in managing this risk.

IV. Operational Risk

Sadara *sukuk* may face operational risk that affects the assets partially or totally. The partial loss of the assets means any partial damage or destruction of the leased assets due to any occurrence or event. In the case of partial damage of the production facility assets, there would be no possibility to transfer production to different assets, which would force the suspension of manufacturing. This may influence the investors' returns which at this stage are based on Sadara's activities, so that 'any such material adverse effect could materially reduce the funds available to meet its obligations to make payments to the issuer under the *sukuk* transaction documents'. However, if Sadara were to suffer a total loss of the production facilities, the *ijarah* of the leased assets would be terminated, and then any shortfall amount could be optionally covered by Sadara as previously discussed. With partial loss, no hedging programme is adopted by the issuer to mitigate the risk which is mainly transferred to Sadara using specific techniques.

With regards to the legal risk, the Sadara *sukuk* are governed by two different sets of law: the Saudi law and English law. These two legal frameworks will govern different areas in this issuance. For example, the payment administration, the *musharaka*, the forward *ijara*, procurement, and service agency agreements are governed by Saudi law, while the completion guarantees, undertaking agreement, and the issuer's security agency agreement are governed by English law. Here, legal risks arise since more than one law governs the issuance, and in addition these laws have to operate in line with Sharia. In fact, Saudi law seems to face no problem of contradicting Sharia as it is itself based on Sharia law; however, the English law applied may face such a risk. English law presents a particular problem when in conflict with Sharia. English law always prevails over the Sharia law when there are

disputes, but the Sadara *sukuk* provides a management tool to overcome such an issue. Sadara state clearly in the OC that the liabilities predicated on English law will only be enforceable if they do not contravene Saudi law and Sharia principles.

With regards to the law in Saudi Arabia, there are a number of possible risks that can occur which have been indicated in the OC. The first is that the enforceability of Saudi law is not fully developed. Also, the judicial precedents from Saudi courts are not binding on subsequent decisions. Furthermore, Saudi court decisions are generally not recorded. These three factors create additional judicial uncertainty and a greater exposure to legal risk. The second problem is that interpretations concerning the Sharia compliance of the Sadara *sukuk* documents may vary among different Saudi courts. For example, a court in the Kingdom may decide that the *musharaka* agreement is invalid and thus the contract is void. Then, the Saudi court may consider the investors' interests in the *musharaka* as merely a debt claim on the underlying leased assets. In this case, the court may render the Sadara *sukuk* void, as a not-tradable *sukuk,* in order to be compliant with Sharia since the sale of debt is mainly prohibited under Saudi law. Another possible situation for the Sadara *sukuk* is that a court in the Kingdom may take into account the invalidity of conducting two transactions in one agreement concerning the same asset. Therefore, there is a possible legal risk for the 'lease-to-own' in the forward *ijara* agreement to be invalid as well as the forward *ijara* agreement, which may be considered unenforceable in the case that the Saudi court adapts the previous view. If that is the case, the issuer would not be able to force Sadara to pay the amounts due, according to the forward *ijara* agreement, leaving the issuer without adequate cash to provide the obligated payment due under the *sukuk*.

V. Sharia Risk

The Sadara *sukuk* have received approval from different groups of scholars. These are the joint Sharia committee formed by Alinma and the Albilad Investment Company, the Deutsche Bank Sharia Advisor and the Sharia Committee of Riyadh Capital. These three groups consist of different scholars, which add more strength to the Sadara *sukuk*. This has resulted in a higher level of assessed compliance and also a number of regular Sharia issues in the *sukuk* market have been mitigated or even eliminated.

Although, the Sadara *sukuk* have achieved a high level of compliance, there are still some unresolved issues. For example, the ownership and principal issues are still not fully in compliance with Sharia, as previously discussed. Also, there is the issue of lease-to-own and the existence of two sales, where one for which it has been stated clearly in the OC, that 'there is a risk that the forward lease agreement could be unenforceable if it is held to constitute two transactions in one agreement concerning the same asset, right, or service' (Sadara, 2013, p. 43). For this reason, to overcome such an issue, the OC has states that 'prospective certificate holders should note that different Sharia advisors, and courts and judicial committees in the Kingdom, may form different opinions on identical issues and therefore prospective certificate holders may wish to consult their own legal and Sharia advisors to receive an opinion as to the compliance or otherwise of the certificates and the *sukuk* transaction documents with Sharia principles, if they so desire'. In the fact, Sadara *sukuk* can be considered to be highly Sharia-compliant in comparison with most other *sukuk* in the market.

Having discussed the Sadara *sukuk* risk, the conclusion is that there is a special exposure to assets risk. In the case of the total loss of the assets and inadequate with insurance, Sadara may choose not to cover such a shortfall, resulting in a loss incurred by investors. This particular risk is a step forward towards a real link between investors and the underlying assets, since this exposure is a typical consequence of investors being the legal owners of the leased assets. However, there are critical issues related to the agency relations between Sadara and the investors, as examined in the following discussion.

8.5.2 Sadara *sukuk* and agency issues

A number of types of moral hazard and adverse selection problems are inherent to the Sadara *sukuk* structure. The presence of informational asymmetries is more harmful to Sadara *sukuk* investors as they are more exposed, after delivery, to credit and asset risks compared to other securities based on *ijara*. In the Sadara *sukuk*, agency relationships appear when Sadara is an originator, a contractor, a lessee and a servicer, showing an inherent exposure to the agency problem. Firstly, there is a possible conflict between Sadara as an originator and the investors caused by the asymmetrical information concerning the value of

the invested land and assets. As the Sadara *sukuk* reached around $3 billion in value, this raises the concern on that the cash paid is greater than the value of the invested assets. Investors do not have access so as to measure and evaluate the current and future Sadara assets. However, in this respect, the Sharia board asks for a neutral third-party estimation to ensure the actual relationship between the cash received and the invested assets. Involving a neutral third party aimed to reduce the risk of adverse selection caused by the information asymmetry that is in favour of Sadara. This relationship also has a Sharia dimension because it is important to present a true link between investors and assets.

In addition, Sadara, as a contractor of the leased asset with investors as owners, has eliminated the agency conflict that may arise in this case. This is because Sadara and the investors are parents under the *musharaka* agreement. Investors, as owner of the assets, seek well-constructed assets to increase the value of their investment. Sadara, as a partner, has the same incentive towards the lease assets, resulting in a situation where the contractor has sufficient motivation to perform well. In spite of that, Sadara investors have no access to monitor the contractor, but the partnership involved has reduced the need for monitoring. Therefore, investors can be more confident that they are investing in reliable future assets. In addition, after delivery, investors have no authorized access to ascertain the quality of the assets owned and whether or not Sadara's actions have been in favour of the assets. However, due to co-ownership, investors can more certain that Sadara will maintain a high quality of service, management and performance. Although there is a possibility of the misuse of the principal or the asset revenues, the Sadara *sukuk* structure involves two hedging procedures to reduce the moral hazard. These are the undertaking about the final purchase based on the face value and the cash flows from the lease assets. Sadara undertakes to buy the assets at their face value, meaning that Sadara will be the final owner of the assets, which benefits the lessee's performance to be in favour of the assets. This purchase undertaking presents a dimension of sharing between Sadara and their investors, aiming for a better mechanism to manage the incentives. Also, in the *ijara sukuk* the return is determined, which minimizes the moral hazard. This commitment about the proceeds from the assets on the *ijara* basis can be seen as a control over the agency costs. The return is determined as an advance rental payment and a rental payment that can mitigate the agency risks resulting from the information asymmetry. As a consequence of these two mechanisms, investors are less

concerned with the lessee's performance and are only interested in the coupon payments since Sadara will pay a specific return and buy the leased assets at maturity at their face value. Therefore, investors have little incentive to monitor the asset's revenues or the invested cash.

It is important to highlight that the risk of the total loss of the asset is incurred by the investors, which is a distinctive feature of this structure. This means a loss to investors of the incoming returns and the principal. Transferring the assets' risks to the investors results in a conflict between the investors' interests and those of Sadara as a lessee. Sadara as a lessee can bear the loss of the assets only in the case of neglect. In the case of a total loss, Sadara has an incentive to show no negligence in performance so as to transfer the loss to the investors. The problem becomes more critical in the case of high levels of information asymmetry. Sadara, as an originator, contractor, lessee and agent, is in a position to receive all information related to the assets and their loss, while investors have no official access to evaluate or measure the loss. This particular procedure satisfies Sharia rules; however, agency conflicts arise.

8.6 Summary

In this chapter, the Sharia implications and the financial basis for the Sadara *sukuk* have been examined. The main issue, based on the AAOIFI Standards, is that it appears certain that prevalent contradictions in the *ijara* contract relate to ownership of the Sadara assets. In the Sadara *sukuk*, the *ijara* agreement might have some characteristics of an *ijara* contract because the transaction involves the right to use the usufruct of the asset; however, the ownership provided is still a concern. Sadara *sukuk* do not provide a sufficient ownership since the assets at all time, are in the possession of Sadara, during both stages of the transaction.

However, this structure has a number of distinctive features that helps it to be more compliant with Sharia and to be a more effective financial instrument. Firstly, the *inah* structure is eliminated by specifying two separate assets with two different contracts: the *musharaka* agreement and the forward *ijara* agreement. Secondly, the partnership featured in the *musharaka* agreement has eliminated a number of possible hazards in the investment.

This agreement reduces the risks caused by the information asymmetry between Sadara and their investors. The Sadara *sukuk* structure is a step forward in the *sukuk* industry to satisfy both financial and Sharia demands.

Chapter 9: Zamzam Towers *Sukuk* as a Case Study

9.1 Introduction

The Zamzam *sukuk* is the first implementation of an Islamic time-share financing in the *sukuk* market. The proceeds will fund the infrastructure of Zamzam Tower, which is a part of Abraj al-Bait complex within the King Abdul-Aziz endowments. The project of the Zamzam Tower has been secured by an affiliate of the Kuwait-based International Lease Investment Company called Munsha't Company. The total project is one of the largest construction projects in the world, measuring around 1.4 million square metres and it is the fourth tallest freestanding structure in the world reaching 480 m high (Riazat, 2006).

In December 2003, Munsha't Co. issued a $390 million Zamzam *sukuk* for a tenure of 24 years to finance the construction (Mohieldin, et al., 2012). The project is a 31 storey building and includes 1240 residential units on land adjacent to the Holy Mosque in Makkah (Al-Zoubi, 2003). The Zamzam issuance during the first two weeks, according to Al-Ameri, the managing director of Munsha't Co., was over-subscribed by 135 per cent (Al-Mine & Al-Bashir, 2012). Then, at the end of June 2006, the issuance achieved success with total cash of $900 m (Merrill Lynch International, 2008). This is because these timeshare *sukuk* are for project located in a high-demand area in Makkah according to the Riyadh Chamber of Commerce and Industry. Investment during the last three decades has reached $75 billion, and in Makkah land can cost up to $65,700 per square metre, which is more expensive than Manhattan or Mayfair (Riazat, 2006). In fact, around 3 million people visit Makkah during Ramadan and around 4 million during Hajj. Typically, the monthly rental for a tiny 33 sq. metre apartment with a view of the Ka'ba view, costs around $123,000 during the Hajj period; whereas a studio with a city view in low season costs roughly $4,500 for one week (Riazat, 2006). The holders of the Zamzam *sukuk* will own the lease of an apartment completed in September 2006 that ranges from a studio to a royal suite. A studio apartment costs $5,000 for one week in the off peak season during the 24-year period; however, the

cost of the same apartment rises to $22,000 during the first two weeks of Ramadan; and up to $80,000 during the last 10 days of Ramadan (Arab news, 2004). The same formula for prices extends to and applies to all the other classes units, as these *sukuk* were priced according to view, unit size and season. The Zamzam *sukuk* are comprised of 57040 certificates that represent a fractional ownership of the right to utilize a specific part of the building for a specific time per year over 24 years.

9.2 Origin and Process of the Zamzam *sukuk* Structure

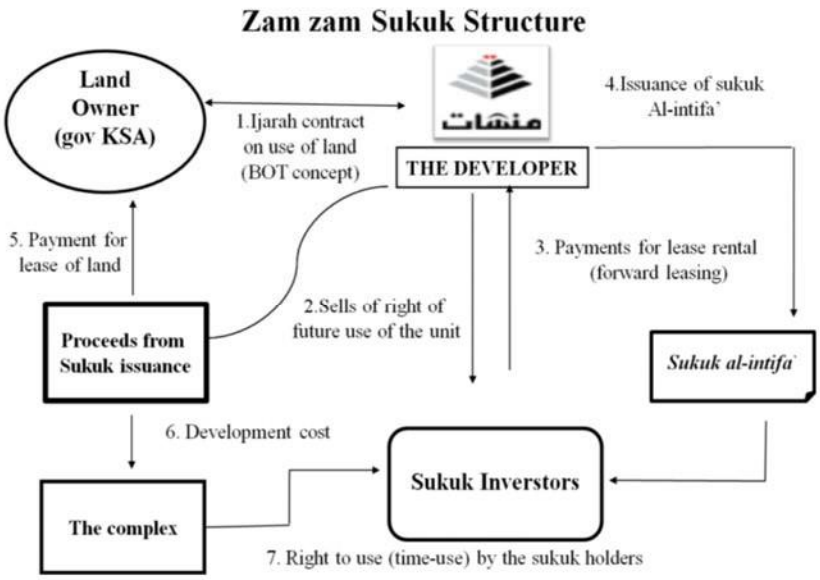
The Zamzam *sukuk* are an example of an innovative type of security that includes a number of concepts to satisfy both Sharia standards and Saudi law. In Saudi Arabia, the law does not allow for any foreigner to own a property located in the country. This was the main obstacle facing Munsha't Co. when commencing the project, since non-Saudi investors are barred from the project. Therefore, Munsha't Co. searched for a product that could comply with Saudi Arabian law as well as Sharia law (Amer & Radenarmad, 2012). The company studied the demand for short-term accommodation in Makkah along with its prices according to the Islamic calendar to develop a product that applies the concepts of time-sharing, fractional ownership, and forward *ijara* under the framework of 24-years reversionary ground lease (Shamsiah, 2010, p. 82). By combining these concepts, Munsha't Co. issued the *sukuk intifa'* which allowed, for the first time, both
local and foreign investors to invest in and own real estate in Makkah.

The structure of the Zamzam *sukuk* involves forward *ijara sukuk* in a special sense. To illustrate this, the King Abdul-Aziz endowments signed the *ijara* contract with the Binladin Group on the basis of a BOT (build-operate-transfer) agreement for 28 years. According to this agreement, the Binladin Group will construct four towers, a shopping complex, and a hotel for the King Abdul-Aziz endowments as payment. Secondly, the Group as an originator, in turn, appoints Munsha't Co. as an SPV to fund and operate the construction and then to transfer it back to the Group at the end of the lease period. Thirdly, the Binladin Group subcontracted the construction and signed a forward *ijara* contract with Munsha't Co. to build the construction, and thereafter the company packages the assets of the forward *ijara* into *sukuk* for investors. In the forward *ijara* framework, Munsha't leased

the assets under construction to investors for 24 years, who paid the advance rental in one lump sum, through *sukuk intifa'* that generate the

required finance proceeds valued at $390 million. The investors subscribed for future benefits, and then Munsha't Co. disburses the proceeds to the contractor[34] and consultants who were to deliver the completed asset to Munsha't Co. on behalf of the investors by September 2006. After delivery, investors have the right to use the property or invest this right by selling or sub-leasing it to a third party (Amer & Radenarmad ،2012). Therefore, it is important to note that the ground belongs to King Abdul-Aziz endowments; the buildings belong to Munsha't Co. with the proviso that the long-term ownership of the buildings would eventually transfer to the endowments. The *intifa'* or benefit of the units belongs to the *sukuk*-holders for 24 years.

Figure 9-1 Zamzam Sukuk Structure



Source: (Amer & Radenarmad, 2012)

According to the above structure, the Zamzam *sukuk* include the following documents summarized in Table 9-1 below:

[34] The contractor and developer of the project is the Saudi Binladin Group, the Sauid's largest construction company (Arab news, 2004).

Table 9-1 Zamzam Sukuk Documents

Document	Parties	Purpose
***Ijara* Agreement**	Munshaat Co. (as a Lessee) and Binladin Group (as a Lessor)	From the Munsha't Co.'s perspective, this is the document that provides a 24-year reversionary ground lease with the endowment. From the Binladin Group's perspective, this is the document that obligates the subcontractor to build a high-quality service facility.
Constructing Agreement	Munsha't Co. (as a Purchaser) and Binladin Group (as a Contractor)	From the Munsha't Co.'s perspective, this is the document that provides the ownership of revenue generating assets at a future time. From the Binladin Group's perspective, this is the document that provides the funding.
Forward *ijara* Agreement	Munshaat Co. (as a Lessors) and Investors (as a Lessee)	From the Munsha't Co.'s perspective, this document generates the return required for the constructing the project. From the investors' perspective, this is the document which provides them with the possession and use of future assets.
Service Agency Agreement	Investors (as a Lessor) and Munshaat Co. (as a Lessee)	From the investors' perspective, this is the document that allows them to pass the liability for periodical maintenance and management of the property. From Munsha't Co.'s perspective, this document generates return to cover the assets' expenses.

9.3 Sharia Perspective Analysis

For the Zamzam *sukuk*, from a Sharia perspective, an analysis is required of both the content and the structure, aiming to provide an overall assessment. The analysis and the final assessment would be mainly based on the AAOIFI standards. As the Zamzam *sukuk* did not provide a prospectus for the issuance, the analysis proceeds according to the information stated in the documents of the *sukuk* and the annual reports of Munsha't Co.

9.3.1 Critical Analysis of the Content

I. Zamzam *Sukuk* Assets

Situation	Statement	AAOIFI Standard
The *sukuk* are based on unavailable assets. September 2006 is the agreed date for delivery. The assets are specifically identified to the investors.	'The deed owner acknowledges that he had inspected the specifications of the tower and housing units with all furniture included'[35].	Standard No.9, clause3/5, 'an *ijara* contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications'.

The information provided about the unavailable asset to Zamzam *sukuk* investors satisfies this standard. As stated, all of the details of the unit's location descriptions of the furniture were clarified in a way that prevents any future dispute. With regard to the delivery date, AAOIFI in Standard No.9, clause 3/5 provides for the forward *ijara* contract that 'an agreement is reached to make the described asset available during the duration of the contract'. The Zamzam *sukuk* were estimated to deliver the project within three years from the issuance date and then the beneficiary investors would be able to utilize the unit for the remaining term. In fact, the Zamzam *sukuk* have no Sharia criticism related to the future asst. This is because, in principle, future usufruct can be securitized as an existing asset without any concern from AAOIFI, according to Standard No.17, clause 3/2/2, it allows for the securitization of un-available usufruct and this is considered to be one of the *sukuk* types represented by the 'certificates of ownership of usufructs of described future assets' (AAOIFI, 2008).

[35] Note that the prospectus is of only one page and thus all of the following statements refer to the same page.

II. Zamzam *Sukuk* Ownership

Situation	Statement	AAOIFI Standard
The Munsha't Co. through this issuance transfers a residential usufruct to the investors with open commercial behaviour. Investors physically possess a share of the future project; they receive a fractional ownership of the right to use a definite part of the Zamzam project over 22 years. However, there are some agreed limitations on the behaviour towards the real ownership of the residential units.	'The deed owner shall have the right to assign, sell, grant, donate, bequeath or lease the deed to a third party after completion. The beneficiary may not make any alteration or addition to the said residential unit'.	Standard No. 9, clause 3/1, 'for the validity of an *ijara* contract concerning a specified asset, the lease contract should be preceded by acquisition of either the asset to be leased or the usufruct of that asset'.

The AAOIFI requires physical ownership, either to the asset or the usufruct, to validate the *sukuk*, while the Zamzam *sukuk* does not represent any physical ownership to the asset but rather of the usufruct. More importantly, the fractional ownership has to take the form of a legal transfer according to Standard No.18, clause 3/4 which indicates that valid ownership involves a 'legal possession that includes the registration of a mortgage of immovable … that is valid under the law'. Although there is no clear statement in the contract regarding the legal registration of the usufruct, the holders are able to elect a number of different preferences from which to profit. They can specify exchange periods via a specialized affiliate of the Munsha't Co. called Mas Co., or to sub-lease the contracted period to an agreed tenant who desires to visit Makkah, or even just to re-sell the security to an interested buyer. This shows that the holders have direct access to their owned usufruct. If the Munsha't Co. becomes bankrupt, as a consequence of economic downturn or a severe financial distress, this should not affect the investors in the of Zamzam project since they have leveraged the investment for 'right-to-use' the product; however, there remains a risk if the Munsha't Co. becomes insolvent since it may cease to operate the project which would

result in the loss of the benefits enjoyed by *sukuk*-holders. It can be concluded that the investors received an acceptable level of ownership that satisfied the standards of the AAOIFI despite the risk issue.

III. Zamzam *Sukuk* Principal

Situation	Statement	AAOIFI Standard
The principal was paid according to the unit size, season and view. At maturity, investors will transfer their usufruct back to the issuer without any cash in turn because the paid price was for the rent that has been utilized. However, the only situation where payment would be guaranteed by the Munsha't Co. is when the asset is not delivered. It is the responsibility of the Munsha't Co. to bear the refund risk of the initial purchase price paid to the investors as compensation.	'If the project is not completed 'he shall have the right to recover the amounts paid by him for the period during which he has not got any benefit'.	Standard No. 17, clause 5/1/8/7, 'the prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence'.

Zamzam *sukuk* represents no guarantee of the principal during the project. The capital received from the investors is not guaranteed unless the issuer fails to provide the future usufruct. This is compatible with the AAOIFI Standard which states that Zamzam *sukuk* investors have to bear the risk of capital loss unless delivery is postponed. It is also mentioned in Standard 9, clause no.4/1/3 that, 'if the lessor fails to deliver the asset to the lessee on the date specified in the *ijara* contract, no rental is due for the period between the contract date and the date of actual delivery'. Thus, the Zamzam *sukuk* appears to be compatible with AAOIFI standards in respect of the principal received.

IV. Zamzam *Sukuk* Return

Situation	Statement	AAOIFI Standard
There is no expected return until the asset is delivered. After delivery, investors can receive, further to their personal benefits, return generated from the asset.	'The deed owner shall have the right to … lease the deed to a third party after completion and handing over of the tower, in condition that	Standard No. 9 clause 5/1/8/7 states that 'the prospectus must not include any statement to the effect that the issuer of the certificate

However, it is important to note that annual, marketing fees and other additional fees will be deducted by the issuer from the income.	the procedure shall be taken with the knowledge of Munsha't Co. or its respective'.	… guarantees a fixed percentage of profit'.

Related to the returns, the Zamzam *sukuk* are compatible with Sharia in two critical aspects. Firstly, the profit is not guaranteed, and secondly the return is linked to the real market for both the investors and issuer. Investors can sub-lease the units to other Muslims from all over the world for a rent that is based on market value. The return of the Zamzam *sukuk* depends on the demand for hotel rooms in Makkah, which varies according to the seasons. Some months are more popular than others; however, the pattern of demand has been reflected in the *sukuk* prices. The return for investors would be the differences between the advanced rental payment and the rental received based on the market price. This return is not guaranteed; however, prospective purchasers are informed that they can expect an average rental return of between 10% and 15% per year which is a high return in comparison with the prevailing rates in the real estate sector (AlMine & Al-Bashir, 2012). This high rate of return reflects the significant risk born by the investors, as a negative situation can be expected when there is no demand for the property or it generates low rental payments that are not sufficient to provide a net income.

On the side of the issuer, the Munsha't Co. estimates the return from the rent to be the difference between the rate paid to the Binladin Group and the rate received from investors. The Munsha't Co. expects a 26% rate of revenue from this project (Ahmed, 2004). It also believes that demand for these *sukuk* will be very high and predicts return from the investment in excess of $800 million in the first three years (Al-Mine & AlBashir, 2012). According to the second Munsha't Co. report, the company achieved great financial results within the initial years, since its revenue in 2004 soared from 1.5 million Kuwaiti Dinar at 31 fils per-share to reach 11.8 million dinar at 142 fils per-share in 2005 (Kettell, 2014).

V. Zamzam *Sukuk* Maintenance

Situation	Statement	AAOIFI Standard
The Zamzam *sukuk* involve annual fees for maintenance whether the asset is utilized or not. These fees not only cover the costs of ordinary maintenance, but also include the expenses for the property's management. The fees are contractually payable annually by the investors. However, the annual fees may not be sufficient to meet all the expenses. In such a case, the *sukuk*-holders will pay additional amounts in subsequent years to cover the shortfall.	'The deed owner undertakes to pay his shares in the estimated expenses to cover management and the cost of periodical maintenance'.	Standard No. 9, clause 5/1/7, 'the lessee should carry out operating or periodical (ordinary) maintenance'.

In the Zamzam *sukuk*, the maintenance structure generally satisfies Sharia rules, as investors as lessees are only responsible for periodical maintenance. However, the concern raised is the *gharar* involved in the maintenance cost. Generally, according to AAOIFI Standard No.9, clause 5/1/7, the rental payments in the long term have to be adjusted to prevent any dispute afterwards: 'in case the rental is subject to changes (floating rental), it is necessary that the amount of the rental of the first period of the *ijara* contract be specified. It is then permissible that the rentals for subsequent periods be determined according to a certain benchmark. Such benchmark must be based on a clear formula which is not subject to dispute'. Similarly to the rental payment, the maintenance cost payment has to be measured with a clear formula in order to enhance the holders' confidence and prevent any possible dispute. It is essential in Sharia to overcome excessive *gharar*, uncertainty and hazard in increasing the maintenance costs for other hidden purposes. Thus, linking the annual fees of the Zamzam *sukuk* with a clear benchmark or a clear percentage of rates is necessary to avoid disputes and satisfy Sharia.

VI. Zamzam *Sukuk* Tradability

Situation	Statement	AAOIFI Standard
No trading is possible prior the delivery; whereas, after delivery the issuer allows for trading these *sukuk* with some fees.	'The deed owner shall have the right to sell … to a third party after completion'.	Standard No. 17, clause 5/2/8, 'it is not permissible to trade in certificates of ownership of usufructs of a described asset before the asset from which usufruct is to be made available is ascertained'.

The trading feature of the Zamzam *sukuk* shows compliance with Sharia rules. These *sukuk* cannot be traded until the assets are delivered because this would be tantamount to the trading of a debt instrument. After delivery to the owners' satisfaction, the Zamzam s*ukuk* represent an available asset that can be traded. However, trading the Zamzam *sukuk* inherits a risk associated with demand for the unit. The level of this risk depends on the season, even if the project is overall in a high-demand location, since some *sukuk* represent weeks in the off-peak season. In addition, the secondary market for these *sukuk* is not well-developed, which is discussed below in terms of the liquidity risk.

9.3.2 Critical Analysis of the Structure

I. Forward *Ijara* Structure

Situation	AAOIFI Standard
In this forward structure, investors paid the rental in advance as a lump sum.	Standard No. 9, clause 3/5, 'it is not a requirement of this lease that the rental should be paid in advance as long as the lease is not executed according to the contract of *salam*'.
The contract of the Zamzam *sukuk* does not include any clarification with regard to the case that the units received differ from their description.	Standard No. 9, clause 3/5, 'should the lessee receive an asset that does not conform to the description, then he is entitled to reject it and demand an asset that conforms to the description'.

The Munsha't Co. failed to complete the Zamzam project by the end of September 2006 and extended the period for another two years. Thus, the Munsha't Co. paid compensation rather than providing a similar unit according to the contract (Radenarmad, 2015).	Standard No. 9, clause 4/1/3, 'if the lessor fails to deliver the asset to the lessee on the date specified in the *ijara* contract, no rental is due for the period between the contract date and the date of actual delivery, and the rental should be reduced accordingly'.

Although, the AAOIFI show some flexibility in this regard, as long as no indication of *salam* is mentioned, these *sukuk* have been structured with an advance rental payment for the purpose of generating funds. On the other hand, the AAOIFI has a strict attitude towards a case where the asset received differs from the description. Despite the contract not clarifying such a case, it would be the investors right to reject the asset.

If the delivery is postponed, the scholars are agreed that the lessor has to pay the compensation, as the AAOIFI has stated, by reducing the rental received accordingly. In fact, the Munsha't Co. failed to complete the assets by the end of September 2006 and the company applied a consensus ruling rather than providing similar units. However, regarding the delay, the contract promised 'to provide a similar unit and no compensation will be paid unless if such a situation continues for three consecutive years'.

II. Timeshare Structure

Situation	AAOIFI Standard
The Zamzam *sukuk* involve the timeshare structure since these *sukuk* allow the holders to utilize the assets for a specified time for a number of years according to the amounts mentioned on the contract.	In Standard No. 9, clause 4/2/3, 'an *ijara* contract may be signed with several lessees being entitled to the same specified usufruct of a particular asset and duration of rent…This case is one form of timesharing in benefiting from the usufruct'.
Although this was the first attempt to apply this structure in the market of *sukuk*, no Sharia boards monitored and maintained adherence to Sharia.	Standard No. 17, clause 5/1/8/4 related to *sukuk* states that 'there is a Sharia board that approves the procedures of the issues and monitors the implementation of the project throughout its duration'.

The structure of timeshare is considered under the *ijara* contract, according to the AAOIFI. This was the first timeshare *sukuk* to be issued and the Munsha't Co. received an

ISO prize for the uniqueness of this structure (Munsha'at, 2005). Despite that, there were no Sharia boards involved. In fact, the Zamzam *sukuk* were monitored by a Sharia scholar who worked for Munsha't Co. rather than a particular Sharia board for the specific issuance. The Munsha't Co. has appointed a reliable Sharia controller named Dr. Anwar Shuaib, who monitors all the activities, documents and procedures of the Munsha't Co. and updates his *fatwa* annually. In all the published *fatwa* since 2004 until 2015, all of the activities of Musha'at were, including Zamzam *sukuk*, compatible with Sharia (Munshaat, 2015). The Sharia complaint level of this structure reaches a high position in comparison with other issuance of *sukuk*, but there is a concern related to the excessive risks involved in the investment without informing the investors. The concern is related to the amount of *gharar* involved, and whether it is substantial or minor, since the only *gharar* that can cause the financial transaction to be declared null and void according to the AAOIFI is substantial *gharar*. It has been stated in Standard 31, clause no. 4/2 that '*gharar* violates the transactions when it satisfies four conditions …. If it is excessive in degree'. Thus, the transaction can be null and void according to the amount of risk that has been concealed. The amount of risk borne by Zamzam *sukuk*-holders is discussed in the next section to decide the extent of *gharar* taken by investors.

9.3.3 Overall Rating

The research has analysed the Sharia issues related to the Zamzam *sukuk* with the support of statements from official documents in order to conclude with an overall rating based on AAOIFI principles. The Tables above have shown the evaluation of the Zamzam *sukuk* according to all relevant standards of the AAOIFI. As indicated, if the situation of the Zamzam *sukuk* is compatible with the standard, the issuance will receive a score of 1, partial compatibility will receive 0.5 points, absent receives 0 and finally contradictions of the standards receives -1 point.

Table 9-2 Results of Zamzam Sukuk According to Standard no.9

Standard no.	Clause no.	Compliance	Value
	3/1	Compliance	1
	3/3	Compliance	1
	3/5	Compliance	1

No.(9) ***Ijara***	4/1/2	Compliance	1
	4/1/3	Compliance	1
	4/2/1	Compliance	1
	4/2/2	Compliance	1
	4/2/3	Compliance	1
	5/1/1	Compliance	1
	5/1/2	Compliance	1
	5/1/4	Compliance	1
	5/1/5	Compliance	1
	5/1/6	Compliance	1
	5/1/7	Absence	0
	5/1/8	Compliance	1
	5/2/2	Compliance	1
	7/1/6	Compliance	1
Total	16 out of 17		

Table 9-3 Results of Zamzam Sukuk According to Standard nos.17-18

Standard no.	Clause no.	Compliance	Value
No.(17) ***Sukuk***	5/1/8/1	Partial compliance	0.5
	5/1/8/2	Compliance	1
	5/1/8/3	Compliance	1
	5/1/8/4	Partial compliance	0.5
	5/1/8/5	Compliance	1
	5/1/8/6	Compliance	1
	5/1/8/7	Compliance	1
No.(18) Possession	3/4	Compliance	1
Total	7 out of 8		

Table 9-4 Results of Zamzam Sukuk According to Standard no.23

Standard no.	Clause no.	Compliance	Value
No.(23) Wakala	3/1	Compliance	1
	3/2	Compliance	1
	3/3	Compliance	1
	4/2/C	Absent	0
	5/2	Compliance	1
Total	4 out of 5		
Aggregate Percentages Compliance: 27/30=90 %			

As mentioned, the Munsha’t Co. aimed to achieve total satisfaction of the AAOIFI Standards in this specific issuance. However, the Tables show that, from a total of 30 AAOIFI Standards, these *sukuk* are compatible with only 24 Standards. Nevertheless, the high result for aggregate compliance cannot be ignored as they achieved 90% which is the highest percentage among the three applications in this study. This high result is attributed to the real ownership of the assets, meaning that there is no guarantee of the principal or the returns.

9.4 Observed Risk Mitigation Process

The discussion focuses on the risks involved in the structure of the Zamzam *sukuk*. It is an important part of the study since the inherent risks have not been addressed by Munsha’t Co. in their presentation to the public. This may be attributed to the fact that Zamzam *sukuk* have been issued via a contract document. This does not usually mention the risk factors. Therefore, the holders of these *sukuk* will be involved in an investment without a full understanding of the risks that they may be exposed to especially with such a new product in the market. In the short term, not clarifying the risk factors in the investment may enable effective marketing; however, in the long term, this can affect these *sukuk* negatively. After completing the project, there may be a loss of the confidence about these *sukuk* due to the earlier misunderstanding between the issuer and investors about the possible risks. In the following, sections highlight the risk factors based on the specific innovative structure of these *sukuk*.

9.4.1 Risk Factors

I. Credit Risk

Each *sukuk* involves credit risks in activities where success depends on a counterparty. This means that if one party to the Zamzam *sukuk* fails to discharge an obligation this causes the other party to bear a financial loss (Munsha'at, 2005). Accordingly, credit risk includes the possibility that the Munsha’t Co. as a borrower and the investors as counterparties will fail to meet their annual obligations in accordance with the agreed terms. Thus, the credit risk fot the Zamzam *sukuk* involves various unique aspects that include the obligations of both parties. Firstly, parties to Zamzam *sukuk* can default on their annual

payments. Maintaining cash flow is essential for a smooth and viable project; however, a situation of default can lead to short falls in the project's cash flow and then to the financial losses. When a substantial proportion of *sukuk* members default, this can seriously affect the funds required for ongoing expenditures, causing extra losses of revenue as well as increase in costs, particularly marketing expenses. The large number of individual investors increases the possibility of default as the project will be influenced by an individual's wishes, financial status and ability to meet obligations. Adding to that, the long tenure of 24 years adds an extra pressure on these *sukuk* since the credit risk during 24 years related to investors' creditworthiness is less predictable.

Cases of default by Zamzam investors could be caused by a number of factors, such as an overall downturn in the economy or the financial distress of a specific individual that may have an impact on the investors' capacity to maintain their payment obligations. Members may also decide to default if the annual levies raised are perceived as unjustified. They may also decide to default if the quality of the received service, maintenance, experience or confidence in management is not satisfactory. Thus, if the Munsha't Co. chooses to default on its obligation and provides poor service, this will undoubtedly have a negative impact on the members and may result in default or possibly termination. Therefore, it is important to address the other aspect of credit risk, where the Munsha't Co. fails to provide a satisfactory quality of real estate. Failing to provide the Zamzam assets with a high quality of service can lead to financial loss since the decline in Zamzam members' satisfaction levels or even that of their guests is a key risk to be considered by the Munsha't Co.

Because it is a key risk, the contract of the Zamzam *sukuk* addresses an agreement related to default risks of both the Munsha't Co. and the investors. On the investors' side, the document stated that 'if violation by the deed owner for the conditions stated in the deed became frequent, Munsha't Co. or its authorized representative shall have the right to consider the deed as null and void and resell it in order to be refunded. The refunded price is in proportion with the number of years remaining from the utility period and attributed to the price of the above deed deducing thereof any due amounts from him'. The Munsha't Co. has the right to resell the *sukuk* and be compensated for any financial loss caused by the

investor to mitigate the negative impact of such a risk. On the other hand, the document for the issuer states that 'if events beyond the control of Munsha't Co. prevented the deed owner to use the first period, the date of use starts shall be carried forward to the second year then Munsha't Co. undertakes to enable owner to utilize either the residential unit or provide similar unit. In case such an event continued for three consecutive years… he shall have the right to recover the amounts paid for the period during which he has not benefited'. Both statements include an agreement in the case of frequent default concerning when the default procedures should be initiated. For instance, if an investor fails to pay the annual fee, the issuer can exercise the right to resell the *sukuk* and cover the unit's expenses but only in the case of frequent defaulting. Also, in the event that the Munsha't Co. fails to fulfill its obligation, the certificate holder can exercise the right to take legal action and force the issuer to refund their payment after three years.

The Zamzam *sukuk* issuer can manage this risk in the following ways. The first is by providing high quality assets, facilities and services. The credit risk can also be minimized through engaging only members with high liquidity which requires more efforts during marketing stage. However, it will have a positive effect in mitigating the credit risk and thus protecting the project from incidents of financial distresses. Also, increasing the annual fees is typical in any timeshare structure; however, to avoid default, a number of strategies can be implemented. Increasing the annual fees should be implemented wisely in order to maintain the satisfaction of investors' by explaining in the contract the possibility of such increase. A more practical strategy is to control annual fees by pegging the annual costs as a percentage of rack rates. This measure can enhance the investor's confidence in the justice of the annual payment. For instance, the system of maintenance costs for a resort project in Egypt adjacent to the Red Sea was between 10% to 15% of rack rates when the property was leased on a short-term basis (E.Hawk, 1985). This system of annual costing allows for cost escalation[36] by Munsha't Co. while simultaneously providing a measure to satisfy Zamzam *sukuk*-holders. It is also possible to consider the maintenance and management costs when selling these *sukuk* by adding these costs to the purchase payment in order to avoid any

[36] Cost escalation refers to the changes in the cost or price of specific assets, goods or services in a particular economy over a period.

possible risk of future increases Zamzam members. For example, some operators in this field add the expected fees during with the selling price (Hovey, 2002). This procedure can help the the Munsha't Co. to maintain a high quality service without undue financial pressure being placed on Zamzam members.

Capital Loss Risk

Zamzam *sukuk* holders are subject to high capital loss risk since these *sukuk* can only be resold at market value, and not at the purchased price. Typically, timeshare bonds lose their market value immediately after purchase since they are counted as real estate paid in advance and not as an investment in real estate. This is in addition to the loss of marketing costs that represent a significant percentage of the final timeshare price, amounting to at least 43 per cent which is a considerable proportion compared to the figures for print, television and electronic media costs worldwide accounting for around only 10 per cent of sales (Powanga, 2008). This means that the Zamzam *sukuk* do not reflect the actual price of the asset, it but include a sizeable percentage of marketing costs. Thus, it is inevitable that their nominal value will decline immediately after purchase. In fact, this particular risk makes Zamzam *sukuk* less attractive as an investment product and more appropriate for personal use, since investors mainly look for a deal with a greater level of capital guarantee.

II. Market Risk

Market risk refers to the possibility of the value of Zamzam *sukuk* fluctuating over a short period of time. The Zamzam *sukuk* are based on real estate, which is typically less volatile and this in turn lowers the exposure to this type of risk. In addition, the holders are less exposed to this risk as the asset is located in a high-quality area. The value of the Zamzam *sukuk*, therefore, will not sharply change as a result of fluctuations in market prices. This is true even though the resale prices are expected to be lower than the fair price, since the lower price, as discussed[37], is reasonably predictable and is not caused by market volatility. However, there are two aspects of the Zamzam *sukuk* that may intensify the market risk. Firstly, the *sukuk* may be exposed to this risk due to difficulties in measuring the market

[37] Previously, in capital loss risk.

risk for a project under construction. Secondly, the long maturity of 24 years plays a role in increasing the potential impact of this risk.

Market risk also includes interest rate risks. As far as the Zamzam *sukuk* are concerned, interest rate risks can be considered as the rate of return risks since the value of these *sukuk* is not related directly to fluctuations in benchmark interest rates but rather to the actual value of the underlying assets. This means that due to the nature of these *sukuk*, investors are exposed to the risk of fluctuations in the return rate based on the asset's value in the market. Despite this, the rate of return depends on the quality of the time, view and size of the *sukuk*, and so drastic changes are unlikely. Thus, the Zamzam *sukuk* are subject to a low risk of changes in the return rate.

Moreover, foreign exchange rate risk is another component of market risk. This is the risk that the value of the Zamzam *sukuk* will fluctuate due to changes in foreign exchange rates. The Zamzam *sukuk* are denominated in the contract in US Dollars and consequently there is a currency mismatch. The issuer, Munsha't Co., is a Kuwaiti company that records all its transactions in Kuwaiti Dinars; whereas, investors are globally widespread using various currencies. Thus, any unfavourable exchange rate fluctuations can negatively influence the value of these *sukuk*, where any appreciation of the US Dollar against the Kuwaiti Dinar will invariably result in a loss. However, currency exchange rate changes can often result in profit for the issuer. For example, the recent weakness of the US Dollar relative to the Kuwaiti Dinar has been in favour of the Munsha't Co. For this reason, the company chose US currency which does not fluctuate significantly against the Kuwaiti Dinar in order to maintain this risk at an acceptable level (Munshaat, 2004, p. 12). The foreign exchange risk is mostly unavoidable from the investors' perspective. If the base currency of the investors is other than in US Dollars, the return to Zamzam *sukuk*-holders will be influenced by changes in the value of the currency.

III. Liquidity Risk

In timeshare markets, the highest risk exposure is associated with liquidity (Hovey, 2002). Investors in the Zamzam *sukuk* are highly exposed to liquidity risk as a result of two main factors that enhance illiquidity. The first is that these *sukuk* are issued on an unavailable project that was predicted to be completed within three years. During the construction period,

the uncertainly about liquidity is higher because of the failure possibility of failure. Despite this, the asset is guaranteed by Munsha't Co. until delivered, and the *sukuk*-holders will bear some of the risk since they will not be able to gain access to their assets to compensate for their capital loss if the issuer becomes bankrupt at this stage. The second aspect of Zamzam liquidity risk is the absence of an organized secondary market, and this risk is also enhanced by the inactive primary market. The Zamzam *sukuk* are negatively influenced by the limited issuances of timeshare *sukuk* in the Islamic financial market. Adding to this, an organized secondary market through the Internet where investors individually trade their *sukuk* is not available, as it is in some of international timeshare bonds. More importantly, selling Zamzam *sukuk* at their fair price and within a reasonable time seems unachievable because it is typical for timeshare bonds to lose some of their value after purchase (Hovey, 2002). This is because the ownership in a timeshare is different from ownership in traditional real estate because timeshares represent the advance purchase of a property where aggressive advertising and promotion has been used (Powanga, 2008). Furthermore, the reselling process of the Zamzam *sukuk* occurs through the appointment of Mas Co., which receives a percentage for their marketing effects that will further reduce the final price received by the investor.

Due to the above situation, it is difficult or impossible to avoid liquidity risk; however, it is important to take into account that this risk can be mitigated by efficient marketing and a good reputation. As the timeshare *sukuk* market is less active in comparison with their counterparts in the traditional market, these two mitigation processes have to be efficiently managed. The lack of marketing or a bad repetition can result in the loss of investor confidence so that these *sukuk* become illiquid. For this reason, the Munsha't Co. appointed the Mas Co. in order to market these *sukuk* across the Muslim world. During the first stage, the Mas Co. achieved a high sales percentage exceeding 70% which was above expectations (Munsha'at, 2005). This success proved that the level of demand for the properties was one of the highest in the world (Riazat, 2006). However, during the marketing stage, there was no adequate transparency concerning the potential risks of the investment. The liabilities in the selling document were indicated without any explicit indication of the risks involved. In spite of this, timeshare *sukuk* are exposed to greater risks than other types of *sukuk*, and almost all *sukuk* issuances disclose their risk factors. Unfortunately, the

Zamzam *sukuk*, therefore, received a negative reputation that may have a detrimental influence on investors at a later stage. This negative reputation is reflected in the content of some public websites. A great number of complaints have been published on social networking sites with claims about the issuer's misleading[38]. This seriously will negatively influence the liquidity and marketability of these *sukuk*.

As a result, more effort is essentially required in order to improve the liquidity risk. In practical terms, the Mas Co., on behalf of the Munsha't Co. has to develop a sufficient secondary market programme under its management that allows Zamzam investors to sell their units as they could with other international timeshare bonds (Powanga, 2008). The market introduced would have to be managed by Mas Co. in order to monitor the prices and to control supply and demand. For example, it can be organized through the Internet using any online facility to mitigate the expected illiquidity.

Involving investors in marketing can increase their confidence in the product and mitigate some of the pressure upon Mas Co. as an international marketing company. This may also reduce the amounts paid by investors for marketing the Zamzam *sukuk*. In fact, enhancing the ability to individually sell Zamzam *sukuk* will, in turn, have a positive impact on the project overall by increasing liquidity, confidence and reputation.

IV. Operational Risk

Zamzam *sukuk* involve operational risks, since any negative incident in operating the project can put the holders at risk. There are many inherent operational risks within the activities and processes of the Zamzam project, such as business risk, risk of operational losses, human resources risk, tangible asset risk and the risk of major unexpected deterioration. Operational risk may also arise if the sub-contractor fails to provide investors with the asset according to the specifications identified, quality and date. According to the Zamzam contract, this risk of failure has to be transferred to the Munsha't Co. and an equivalent unit or refund should be provided to the *sukuk*-holders.

[38] There was a campaign on Facebook against the Zamzam *sukuk* issuer that received around 1389 'likes' and more than 700 comments to indicate about the issuer's misleading.

Also, two other stages in the Zamzam *sukuk* face the operational risk. During the marketing stage, there was a risk for Zamzam *sukuk* concerning finding the required number of investors. Failure in this could have led cost escalation that in turn would increase the level of financial distress. In such a situation, investors may face an additional cost risk; however, this possible situation was avoided by the Munsha't Co.. The company stated in its 2005 report that 'sales in cooperation with MAS Co. reached 70% of the units offered for sale. This percentage exceeds by far the targeted sales as per the plan … The funds have enabled the company to meet all expenses without the need to make further calls from the Investors in the Zamzam Project' (Munsha'at, 2005). The last statement shows the risk of additional costs where the investors in Zamzam *sukuk* would be called when the project failed to redeem all expenses. In addition, the investors have been informed in the contract that 'the deed owner undertakes to pay his shares in the estimated expenses for to cover management and the costs of periodical maintenance'. Thus, during the period of 24 years, investors can expect additional cost each year whether for maintenance or management costs.

During the second stage, where the project has been delivered and is functionally operating, there is a risk concerning the exchange facility that may face the investors. Zamzam members have a chance to postpone their right for one year according to the agreed contract. Although, this facility is an attractive feature for Zamzam *sukuk*-holders, the service is not free of charge and is naturally subject to the availability risk and cannot be guaranteed. Thus, the holders can encounter a situation where they lack access to the facility, which was considered an advantage when the decision was made. Moreover, the investors are strongly influenced by the risk of low quality operations due to them being permanent lessees for 24 years. Any failure because of poor operations can directly influence the holders and may increase the fees for the of Zamzam *sukuk*, decrease the value of the *sukuk*, and increase the risk of exposure to the defaulting members. However, efficient management is a key aspect to mitigate operational risk, since the failure in that can have a significant bearing on the operation of the scheme. In addition, it would be useful to perform an operational review which would provide insight into the Zamzam project process. The review should also provide an assessment of the quality of the Zamzam properties and their amenities along

with the management capabilities. This process can then guide the issuer concerning the operational strengths, weaknesses and threats related to the Zamzam project.

Asset Risk

Zamzam Towers are subject to risk of partial or total destruction. It is possible for the project to face major or minor destruction due to any event such as a fire in the complex. In the case that the asset is totally destroyed, Munsha't Co. as a lessor is obligated to bear the total risk according to both Sharia and the contract. The company has to provide a similar alternative to the assets or the contract will be terminated and will be also compensated for the non-utilized period. On the other hand, for the risk of partial loss, the Munsha't Co. as a lessor has to incur the total actions and costs unless the destruction was caused by the investor's neglect. The company considers the costs of impairment and damages of assets annually. According to the report, 'the Group assesses at each reporting date whether there is an indication that an asset may be impaired' (Munshaat, 2006). Despite the fact that, the asset risks are incurred by the Munsha't Co., there is a concern about increasing the annual fees paid by investors due to the destructive events, especially in the case of the Zamzam *sukuk* which have no external supervision and no precise indicators.

Legal Risk

All Zamzam *sukuk* agreements come under Saudi law and also have been scrutinized by Saudi law firms. The Zamzam *sukuk* are regulated by Saudi timeshare law and it is stated in the document that 'any dispute related to this deed shall be subject to the justification of the courts of the Kingdom of Saudi Arabia' (Zamzam contract, undated). The Zamzam *sukuk* agreements are generally in line with Sharia, since the rights, risks, and returns provisions included, as discussed, do not show any clear contradiction with Sharia principles. This has a positive impact on mitigating the legal risk that may occur due to the conflict between Saudi law and the practice of non-Sharia compliant *sukuk*. Although Saudi legal regulations operate in a Sharia-incorporated jurisdiction, there are some negative features. The enforceability of Saudi law is not fully developed as the judicial precedents from Saudi courts are not binding on subsequent decisions. This may result in some loss of the investor's

rights as they are the weaker party. This creates further judicial uncertainty and also more exposure to legal risk, especially concerning the rights of investors.

Also, the main obstacle facing the Munsha't Co., as mentioned, is the Saudi law which does not allow foreigners to own any property or land located in Makkah city. Although the issuer, as discussed, successfully overcame this legal problem, there is a legal risk that may occur due to changes in Saudi legal regulations. The timeshare market is a developing sector that can change their regulations occasionally as the Saudi timeshare industry aims to work tirelessly in order to protect the market from the adverse influence of any threats. Therefore, with 24 years tenure, it is relatively high for these *sukuk* to face some changes in the regulations. The Saudi regulations have been updated several times after the first decree was issued in 2006 in which consumer protection was the focus. This means that any changes are more likely to benefit the consumer more than the issuer, and thus to be in favour of Zamzam *sukuk*-holders.

In this regard, time-sharing has become a common activity since 2005, especially in the two Holy cities of Makkah and Medina, and the Saudi government has withdrawn the ability to engage timesharing practices for non-Saudis in these cities. The Saudi embassy attributes this decision to the intensive infrastructure construction projects commenced by the Saudi government, which involve the construction of a considerable number of new hotels to meet the high demand in the two cities. The decision was made with immediate effect; however, it includes units in the two cities of Makkah and Medina only and other than through inheritance (Saudi Embassy, 2014). Moreover, the decision was made in order to protect the parties involved in timesharing from the intentional or unintentional misuse (Timeshare Elimination, 2014). In this respect, the Zamzam *sukuk* are purchased globally by different Muslim investors all over the world according to the previously applicable law; however, the immediate effect of the decision will be to target the activities of the reselling and marketing of the project, except for inheritance, that can be practiced with non-Saudi parties. Undoubtedly, this has had a negative impact of the liquidity of these *sukuk* due to the decrease in demand.

V. Sharia Risk

Each *sukuk* issuance needs to be approved by the Sharia board as a Sharia compliant investment. Also, the Sharia board has to revisit the process occasionally to eliminate any possible contradictions that may occur afterwards. In the Zamzam *sukuk*, there is no explicit indication in the contract that emphasizes the compatibly of these *sukuk* with Sharia and there is no specific official approval published by a Sharia board to assert that the issuance is consistent with Sharia principles. Typically, the issuance includes decisions of a Sharia committee that consists of different scholars to add more strength to these *sukuk* as Sharia-compliant products. However, the Munsha't Co. received only overall approval for the activities and practices. Dr. Anwar Shuaib expressed in Munsha's 2010 report that 'in our opinion, the contracts and transactions executed by the company during Financial Year ending 31.12.2010 that we have reviewed were Sharia compliant (Munshaat, 2010). The revision process is also updated annually at issuer level, and not at the level of the issuance under the reports of Munsha't

Co. which up to the year of 2015 were approved with total compliance with Sharia (Munshaat, 2015). More specifically, the structure of Zamzam *sukuk*, as discussed, has achieved a high level of Sharia compliance. A number of *sukuk* matters have been overcome, such as the critical issues of ownership, the principal and returns which are generally in line with Sharia standards. This particular issuance satisfied the AAOIFI standards and thus there is no great Sharia risk subject to the issuer and investors.

9.4.2 Zamzam *sukuk* and agency issues

The conclusion that can be drawn from the study of the risks involved in the Zamzam *sukuk* is that the major risks that face the Zamzam *sukuk*-holders mostly refer to the project rather than the creditworthiness of Munsha't Co. since the structure is backed with a real asset. This is a typical consequence of the investors being the legal owners of the invested assets; thus, Zamzam investors, if the issuer defaulted, are able to access recourse to the assets. Despite the advantage of full recourse to the assets, this structure is not the optimal choice for investors. To prove that, the agency theory can highlight the critical financial issues found in the structure.

In the Zamzam *sukuk*, agency problems can refer to loss of the investment as a result of Munsha't Co. following their interests rather than the optimal interest for the *sukuk*-holders. In this structure, a number of agency relations are involved, with Munsha't Co. as an issuer, manager, servicer, and contractor. Prior to the investment, potential investors faced information asymmetries in assessing the unavailable assets, unavailable services and unavailable management. Munsha't Co., or its representative, may not provide the assets with adequate management and services that would severely affect the value of the *sukuk*. Revenues from Zamzam assets vary according to the quality of the assets' management, services and conditions. Low quality, poor service and the worsing conditions of the assets would mean expectations of lower return. In such a case, investors may lose their returns and become unable to sub-lease or re-sell units because of the adverse selection problem.

In fact, there is an adverse selection problem that appears during the marketing stage. These *sukuk* have been advertised as a personal investment product. As a result, a number of individuals hold more than one *sukuk* to obtain higher returns. The Munsha't Co. and its affiliated company, the Mas Co., had the incentive to cover the investment risks and show only the great return expected. Their incentive was to have better advertising and marketing and to rapidly exclude these units and their excessive risks from their books. This can explain the reason for not clarifying the possible risks; although most *sukuk* issuances do indicate the risks factors to the investors. Adding to this, the structure was relatively new with no prior application, and this misled some investors who invested inappropriately[39].

In addition, there is another dimension of agency conflict that occurs between Zamzam *sukuk*-holders and the Munsha't Co., or its representative, as a contractor. The asset's value will be influenced by the contractor's effort, capability, inherent skills and other aspects that cannot be observed. These unobserved aspects can have a direct influence on the final value of the Zamzam units. Adding to this, the investors in the units are not able to monitor the contractor, resulting in a situation where the contractor has no sufficient incentive to perform well. Consequently, investors can be misled to invest in poorly

[39] According to unofficial sources, situations were described where investors were misled to invest in four units and ended with no cash returns for several years (http://www.aqarcity.com/t757713.html).

constructed units. Moreover, after delivery, the Munsh'at Co. is responsible for maintaining a high quality of service; however, an incentive to provide a low quality of service may arise. Munsha't Co. as a manager may misuse the units, misuse the fees and spend them on its own interests rather than to maintain adequate performance. In this respect, if the annual fees are increased, the manager is expected to provide better periodical maintenance and performance. However, the higher annual fees received by Munsha't Co., or its affiliate, means that it is more likely for investors to suffer greater agency costs.

Another critical issue is related to the uncertain costs inherent in the structure and incurred by the investors. The annual fees, that include the cost of managing the project by the Munsha't Co. or its representative, are subject to change. The company determiners the costs along with a situation of information asymmetry between the determiner and the provider. As a result, investors in this project have to realize that the actual outcome is unverifiable because the net income from sub-leasing is calculated after deducting the variable fees. The net profit is severely influenced by annual fees, especially when there is no specific indicator to rely on and the amount is totally determined by the agency which is also a beneficiary of the payment. The Munsha't Co. allows for itself to receive a periodical fee for the management from the investors, and that becomes more harmful to the latter given the information asymmetry in favour of the company. The investors are considered as merely silent or sleeping partners with no right to oversee and monitor the activities of the entrepreneur throughout the contract period without the company's consent. This can explain some of the complaints published by investors on Facebook that the annual fees have reached a level almost equal to the re-rental price (Facebook, 2014). It is possible for the investors in this case to face a type of moral hazard problem of the over-reporting of annual costs that can be counted as one of the main problems concerning these *sukuk*. This is because the structure does not include any strategy to mitigate this problem.

Given the critical information asymmetry that appears in the structure, there are a number of mechanisms that have been used to limit agency costs. Establishing a compensation agreement, prior to delivery, in favour of investors[40] makes the structure more

[40] If the agent fails to deliver the project.

effective in reducing the agency risks. This can motivate the Munsha't Co. to act in the investors' best interests. Also, after the project is delivered, if some of the risk associated with the investment is retained by Munah'at Co, this can reduce the degree of the moral hazard and adverse selection problems generated by the information asymmetry. The default risk of members will be incurred by Munsha't Co. as it receives more information and can deal efficiently with the risks better than investors. The information asymmetry favours the Munsha't Co., and it is more sensible for this party to bear the risk of default. This will induce the Munsha't Co. to provide the best quality service in order to prevent any possible risk of defaulting. In this structure, the better services provided mean the safer it is for the Munsha't Co. to maintain the management and maintenance fees. On the other hand, from the point of views of the investors' obligations paying the fees means consistent access to advantages of the *sukuk*. Although, investors do not bear the default risk of the members, they have an incentive to maintain their obligations on order to have access to the securitized assets. Thus, the structure of the Zamzam *sukuk* has some devices to stimulate a high level of effort provided by both the principal and the agent in order to maintain the Zamzam project.

Although the structure of the Zamzam *sukuk* shows a balanced distribution of the default risk according to the level of information held, investors bear other excessive risks related to liquidity, capital loss and operational risk. It is typical that the yield on the investment is based upon the risks taken; however, the associated costs are significantly higher for the achievement of a capital gain. The return of Zamzam *sukuk* involve a number of liabilities that can lead to inadequate profit. The re-rent price will be subject to four times deductions; first the cost of the unit, then the marketing fees, the fees for the Mas Co. changing the tenant and finally the annual fees for maintenance and management. Thus, the actual level of risk taken by investors is not rewarded with sufficient return on the investment, as these *sukuk* involve relatively low rates of return with significant risks borne. The adverse selection and moral hazard problems are not merely a theoretical risk; they, however, can cause instability in, and even failure of, the return to investors as discussed. Therefore, the agency problems inherent in the Zamzam *sukuk* structure show the main cause of reluctance on the part of investors to invest in such a type of *sukuk*. The presence of

asymmetric information, agency costs and risktaking can be considered as a major reason as to why Zamzam *sukuk* have not been preferred as a mode of finance.

9.5 Summary

The Zamzam *sukuk* is an implementation of Islamic time-sharing finance. It is an example of an innovative security that includes a number of concepts to satisfy both Sharia standards and the Saudi government. This investment achieves a high level of compliance with Sharia rules. It did not contradict any consensus opinion, but rather shows better harmony with the rules. This positive result provides these *sukuk* with a distance from Sharia risks, since being more compatible with Sharia reduces the exposure to Sharia risks. The Zamzam *sukuk* involve a higher exposure to all other types of risks, and particularly credit risks. There is no assurance to receive any cash return on these *sukuk* except the right-to-use. These major risks that face Zamzam *sukuk* investors mainly refer to the business rather than to the issuer's creditworthiness, because the structure is backed with real assets.

Although the investment involves critical risks that may cause it to lose its competitiveness as a financial instrument, it is important to note that, if the Munsha't Co. becomes insolvent as a result of any financial distress or an economic downturn, this will have no direct influence upon the Zamzam *sukuk*-holders. This is because investors have leverage in their investment, principally for the right-to-use. This is a typical result of the investors becoming the legal owners of the underlying assets.

Chapter 10: Qualitative Analysis of the Struggle for Sharia Compliance within the *Sukuk* Market

10.1 Introduction

Semi-structured interviews were carried out with 25 specialists in Islamic finance to discuss the critical issues that face the *sukuk* industry as identified in the case studies. By analysing the views of practitioners, academics and experts, the aim was to highlight the scholars' views with their evidence of adopting conservative or liberal opinions on the issues. The qualitative findings can highlight insights into the causes of disputes among Sharia boards on particular issuances. The findings may also provide suggestions on how to harmonize or encourage the convergence of views on the market. More importantly, this chapter also provides an understanding of how the participants deal with Sharia restrictions. This will be of service in finding practical solutions to apply in the market to satisfy both Sharia and financial sides on critical matters. The chapter further attempts to offer a qualitative assessment of the contemporary *sukuk* market from various perspectives. By discussing the assessments of experts, this may assist in understanding current strengths and failures which can pave the way for positive reforms and future developments.

The respondents included Sharia scholars, members of Sharia Boards, members of the AAOIFI institution, employees in Islamic banks, Sharia academics and Islamic economists. The designing of the questions was guided by the issues discovered in the three case studies in order to explore the respondents' views, basic evidence, approaches and experience with these matters. The lengths of interviews varied depending on the participant; however, the interviews, they lasted on average for 40-60 minutes. For analytical purposes, the vivo coding and initial coding were applied in the first phase, followed by focused coding.

10.2 Critical Issues Related to the *Sukuk* Industry

Based on the cases studies presented, five main themes are categorized to cover all the critical issues related to: the guarantee, ownership, structure, regulation and the current market. These are discussed below.

10.2.1 Issues Related to the Guarantee

Different aspects of the guarantee are the main issue that faces the Islamic financial industry. The concept of risk-taking is an essential requirement for any Islamic investment while the market is reluctant to incur any further risks. Each of the cases discussed earlier has provided information on different aspects of the guarantee. The following highlights the critical aspects of guarantees in the *sukuk* market.

I. Issues Related to the Guarantee of the Securitized Asset

Sukuk involve granting the investor a share of a tangible asset along with a corresponding share of the total risk, while the SEC *sukuk* and Sadara *sukuk* have secured freedom for their investors from the risk of the loss or damage to the physical assets.
Table 1 shows the responses of interviewees towards bearing the risk of damage.

Table 1: Issues related to the guarantee of the securitized asset

Research Question Q1: In the case of the assets' deterioration, what is the ruling if the issuer bears the loss instead of investors? How to justify the investors' ownership from Sharia point of view?	
Focused Coding	**Sub-theme/Remarks**
1	In total loss, it is not allowed for the issuer to incur the loss.
2	In partial loss, it is controversial to maintain the exact rental payment.
Concluding theme:	The association between the investors and the securitized asset is crucial to indicate a real investment.

Two situations were highlighted by the respondents with different views. The total loss received more rigorous views than the partial loss, as illustrated in Tables 1.1 and 1.2.

Table 1.1: Focused Coding No. 1 for Research Question 1

Sub-theme	In total loss, it is not allowed to incur the loss by the issuer.
Interviewees	**Remarks**
S4, S7, S12, B2, B5	Transferring this risk to the issuer is invalid unless in circumstances of negligence to specify a sufficient insurance company.
S3, C3, C4	The issuer is allowed to voluntarily undertake the repair without any prior obligation.

In *sukuk*, referring to the asset's insurance to cover the loss is the usual action. However, the concern is that when the insurance company defaults on covering the entire obligation, who would bear the risk? Sharia banking officers and most of the scholars adopt the view that transferring this risk to the issuer leads to the lessee incurring the asset risk, which contradicts Sharia principles. However, academics and one scholar allow the issuer to voluntarily guarantee to repair the asset, but he is not permitted to pay the expected return while the assets are damaged. As stated by C3, guaranteeing the asset with its expected return is prohibited by *ijma* as it is an explicit *riba*, while the only permissible action is to compensate for the assets voluntarily.

Table 1.2: Focused Coding No. 2 for Research Question 1

Sub-theme	In partial loss, it is controversial to pay the exact rentals when the loss has occurred.
Interviewees	**Remarks**
S5	With partial loss, the rental payment has to be minimized to prevent any risk borne by the lessee.
B2, B5	In the dispute, courts have the authority to resolve the issue.
S7, B4	It is permitted for the rental payment to be equal, more or less than the average rentals.
S10	The assets can be substituted with equivalent.
S4, S8, B8	The excess amount can be placed under an account to be paid to investors at the final purchase.

Partial loss of the asset means a reduction in the rental payment that would negatively influence the distribution amount in *sukuk*. That decreasing the rent confirms a genuine relationship between the assets received support from a Sharia scholar. However, the concern

raised is how to deal with such a loss in accordance with Sharia rules. Two ways are suggested. One way suggested by only one scholar is to substitute the assets, and the more practical suggestion offered by a Sharia banking officer and a number of scholars is to retain the excess payment in an account until the issuer pays the nominal value plus all the cash in the account.

II. Issues Related to the Guarantee of Maintenance

Essential maintenance is a type of guarantee of the assets that has to be borne by the investors (lessor). Investors in the Zamzam *sukuk* have to pay annual fees for maintenance. In the SEC and Sadara *sukuk*, on the other hand, major maintenance and repair are transferred to the lessee through the service agent agreement. In the Sadara *sukuk*, the additional step is added that the cost of such maintenance will be reimbursed by the managing partner on behalf of the co-lessors. Table 2 shows the responses of the interviewees concerning transferring this maintenance cost to the issuer.

Table 2: Issues Related to the Guarantee of the Securitized Asset

Research Question Q2: What is the ruling when the maintenance of *sukuk* assets is borne by the issuer? How can this influence the issuance?	
Focused Coding	**Sub-theme/Remarks**
1	It is unlawful to transfer the maintenance costs to the originator who is the lessee.
2	In practice, there are some lawful ways to transfer the maintenance.
Concluding theme:	There is no doubt that the maintenance cost is incurred by the investors; however, the discussion raised is on finding some ways to transfer the cost to the issuer.

It is illegal to transfer the major maintenance costs to the originator who is the lessee. However, the respondents attempted to provide some practical solutions, as illustrated in Table 2.2.

Table 2.1: Focused Coding No. 1 for Research Question 2

Sub-theme	It is unlawful to transfer the maintenance costs to the originator.

Interviewees	Remarks
S1, S5, S11, C3, C4	It is permitted for the issuer to only perform the maintenance, but all related expenses should be incurred by the investors.

Maintaining the assets is a part of the investors' ownership duties, while transferring the maintenance cost to the issuer may raise the issue of fictitious ownership. The issuer may perform the maintenance on behalf of the investors without incurring any expenses. This method was proposed by a number of scholars but does not seem to be practiced in the market.

Table 2.2: Focused Coding No. 2 for Research Question 2

Sub-theme	In practice, there are some lawful ways to transfer the maintenance.
Interviewees	**Remarks**
S6, S8,C2	The maintenance cost can be transferred to the issuer through an agreed stipulation.
S7, B2, B5, B6, B8	The maintenance cost can be transferred to the issuer through supplementary payments.
B4, S4, S3	All the maintenance cost can be covered by the issuer through the final purchase as a purchase payment.

Some scholars allow the transfer of maintenance costs through an agreed stipulation, because in contemporary times such costs become easier to accurately specify, meaning that no unidentified payments would be required. In addition, Sharia takes into account the prevalence of commercial customs which accept such a stipulation. However, a number of Sharia banking officers provided a more practical method of using the supplementary payment. To illustrate that, the supplementary payment is a further rental payment that covers the assets' costs for the previous period. At each interval, for instance three months, the parties will renew their contract and adjust the supplementary payment to cover any prior expenses incurred by the investors. In this respect, a direct transfer of the expenses to the lessee would result in unknown payments, while adjusting the rental at every interval to cover certain prior expenses would mean a specified payment. The effect is to avoid any reduction, resulting from the maintenance costs, of the periodical amount distributed to the investors. While most Sharia boards accept such a justification, S5 objected to this practice

and considered it an unlawful way to evade the rules. Finally, some scholars working as Sharia banking officers suggested that paying for all the assets' expenses should take place in the final purchase payment. This means that all the costs would not be incurred by the issuer as a lessee rather as a purchaser.

III. Issues Related to the Guarantee of the Asset Insurance

Sukuk assets usually involve commercial insurance. The SEC maintains comprehensive commercial insurance that covers damage to and the loss of its assets and Sadara also uses some commercial insurance. There were two main views on its permissibility as highlighted by the respondents and illustrated in Table 3.

Table 3: Issues Related to the Guarantee of the Asset Insurance

Research Question Q3: If *sukuk* involve non-Islamic insurance, how can this affect the issuance?	
Focused Coding	**Sub-theme/Remarks**
1	Commercial insurance is totally allowed in all situations.
2	Commercial insurance is prohibited; however, *sukuk* mostly involve reasons to justify commercial insurance.
Concluding theme:	Although, most *sukuk* discussions don't indicate the issue of commercial insurance, it is essential to elaborate on this matter as the prevalent *fatwa* prohibit dealing with it.

In practice, as stated by B5, most prospectuses do one of the following: either mentioning that the insurance is co-operative (Islamic), or that it is only co-operative when possible, or mentioning the insurance without any specification. Table 3 shows the issue of including commercial insurance when structuring *sukuk*, as most issuances apply this. All of the responses led to acceptance of the current practice of commercial insurance; however, while one view totally accepted it without any justification, as shown in Table 3.1 while the others limited their acceptance to only when it is needed, as illustrated in Table 3.2.

Table 3.1: Focused Coding No. 1 for Research Question 3

Sub-theme	*Sukuk* mostly involve reasons to justify commercial insurance.
Interviewees	**Remarks**

S2	Non-Islamic insurance is permissible in all cases.

Only one scholar endorsed the acceptance of all types of insurance, including commercial insurance. All types of insurance are permissible, as it represents compensation for the commitment. This means that, when structuring *sukuk*, commercial insurance would be accepted even when the Islamic version is available.

Table 3.2: Focused Coding No. 2 for Research Question 3

Sub-theme	Commercial insurance is prohibited; however, *sukuk* mostly involve reasons to justify commercial insurance.
Interviewees	**Remarks**
S1, S3, S4, S6, S7, S8, S9, S10, S12, B4, B5, B6, B7, B8, C2	Non-Islamic insurance is forbidden unless sufficient Islamic insurance is not available.

Most Sharia scholars and a number of Sharia banking officers believed in the prohibition of commercial insurance. However, they showed flexible views related to commercial insurance since the basis of its prohibition is *gharar*. *Gharar*, unlike *riba*, can be tolerated in some cases of an insistent need and when there is no doubt that when such a need is overcome the ban will be restored. Therefore, it is essential for the Sharia advisor to ensure that no sufficient Islamic insurance is available prior to accepting any issuance.

In the *sukuk* market, mitigating risks through insurance is a critical function, while the available Islamic insurance institutions are not sufficient to cover the considerable risks involved in most issuances. Islamic insurance companies are relatively limited in the scope of their tolerance and also in their prevalence, as it is not available in several countries. In addition, securitized assets tend to be insured prior to the issuance, which means that any adjustment may become problematic. Adding to this, insurance is a subsidiary contract not directly intended, since the deal is principally designed for financial investment. Therefore, most Sharia boards do not examine in detail the type of insurance included.

IV. Issues Related to the Guarantee from the Agency

Table 4 shows the respondents' views on adding the guarantee feature to the agency contract, whether the guarantee is for the principal or the assets. For instance, the agents in

the SEC and Sadara *sukuk* are responsible for paying the maintenance costs, which is an aspect of guaranteeing the asset.

Table 4: Issues Related to the Guarantee from the Agency

Research Question Q4: What is the ruling if the *sukuk* agent undertakes to pay any shortfall amount to the investors?	
Focused Coding	**Sub-theme/Remarks**
1	Some issuances assign the agent as a third party.
2	The agent typically, in most of issuances, is the issuer.
Concluding theme:	In *sukuk*, guaranteeing has several aspects and one of the dominant ones is through agency.

When the responses were studied, two different situations are highlighted with different views which are indicated in Tables 4.1 and 4.2.

Table 4.1: Focused Coding No. 1 for Research Question 4

Sub-theme	Some issuances assign the agent as a third party.
Interviewees	**Remarks**
S3, S8, B4, B5, C3	It is permissible to include a guarantee from a third party.

If the agent differs from the issuer, then a number of Sharia banking officers, scholars and academics would accept such a guarantee.

Table 4.2 Focused Coding No. 2 for Research Question 4

Sub-theme	The agent typically, in most of issuances, is the issuer.
Interviewees	**Remarks**
S1, S5, S6, S8, S10, S12, B4, B7, B8, C1, C2, C3	It is not allowed for the agent to incur any guarantee feature.
S9	The issuer can be a grantor under a separate contract from the contract of *ijara*.

Most of the scholars and a number of Sharia banking officers and academics believed that it is not permissible for the agent as an issuer to provide a guarantee or pledge for the investors, unless such a stipulation is restricted to cases of negligence, misconduct or breach of the contract. This is because the agent acts to service the asset, while the guarantee is

related to the owners. Despite this it is not permissible for the issuer to provide any guarantee feature; and a view presented by one scholar accepts guarantees under a separate independent contract as an agency. The result is that the issuer will have two characters; one as a lessee and the other as a grantor in the capacity of agent.

V. Issues Related to the Guarantee of the Principal

Guaranteeing the principal is a key controversial subject in this field. The Zamzam *sukuk* structure did not involve any guarantee aspect to the principal while in SEC and Sadara *sukuk*, according to the purchase undertakings, the originator is obligated to purchase *sukuk* from the investors at the nominal price. In particular, the *ijara sukuk* structure has two contradictory views, each with a support from Sharia international institutions, as noted in Table 5.

Table 5: Issues Related to the Guarantee of the Principal

Research Question Q5: What is the ruling if *sukuk* explicitly provide the guarantee of the principal by the issuer?	
Focused Coding	**Sub-theme/Remarks**
1	Other than *ijara sukuk*, the situation is permissible.
2	Guaranteeing the principal in *ijara sukuk* is controversial.
Concluding theme:	No guarantee for the principal is one of the key aspects that *sukuk* are based on.

Examining the respondent's views shows two circumstances raised which are presented in Tables 5.1 and 5.2 which highlight some flexibility on structuring *ijara sukuk*.

Table 5.1: Focused Coding No. 1 for Research Question 5

Sub-theme	Other than for *ijara sukuk*, the issue is agreeable.
Interviewees	**Remarks**
S1, S3, S5, S6, S10, S12, B5, B7, C3	The issuer of those *sukuk* cannot bear any guarantee of the principal.

A group of Sharia banking officers, scholars and academics support the view that guaranteeing the investors' principal at maturity is not permissible according to Sharia principles. This point is a particularly critical issue that results from imitating bonds.

Table 5.2: Focused Coding No. 2 for Research Question 5

Sub-theme	Guaranteeing the principal in *ijara sukuk* is controversial.
Interviewees	**Remarks**
S11	The purchase based on the nominal value shows a resemblance to bonds.
S10, B2, B5, B6, B7, B8, C2	It is permitted to return the principal of *ijara sukuk* based on the purchase undertaking.
S5, S6, S7, B4	It is permissible provided that the lessee is not the agent, *mudharib* and partner. Also, in the case of asset loss, no guarantee can be provided.

Only one scholar decided that the purchase undertaking at par value was unlawful, since this would result in an explicit guarantee of the capital, a point that leaves no doubt as to its prohibition. S11 stated that this view is endorsed by the IIFA while the AAOIFI supports permissibility. Also, the view of permissibility receives support from a group of scholars, Sharia banking officers and an academic. However, it is important to note that guaranteeing the principal is not permissible even under *ijara sukuk*. However, the structure of the *ijara* can lead to recovery of the initial payment through the purchase undertaking according to the nominal value, meaning that if the asset is destroyed there would not be any guarantee. This is attributed to the permissibility of the lease to own structure with any agreed payments that may equal the principal. In addition, it is important to highlight that permissibility is based on the basis of the undertaking, and not on the basis of obligation. The contract of the pledge is binding on the issuer side since he provides the promise.

VI. Issues Related to the Guarantee of the Periodical Distribution

In the market, *sukuk*-holders are paid a guaranteed periodic return. For instance, if Sadara, prior to the completion date, fails to pay the advance rental payments, the payments will be guaranteed by Aramco and Dow. However, Table 6 shows the two main views highlighted in responses concerning this issue.

Table 6: Issues Related to the Guarantee of the Periodical Distribution

Research Question
Q6: What is the ruling if *sukuk* explicitly provide the guarantee of return from the issuer?

Focused Coding	Sub-theme/Remarks
1	Guaranteeing the distribution amounts other than the rental payment.
2	When the periodic distribution amount is rental payments.
Concluding theme:	Guaranteeing the periodic distribution amount is one of the controversial issues.

The views of the respondents almost achieved consensus on banning such a guarantee in other than the *ijara sukuk* structure, as shown in Table 6.1, while for *ijara sukuk* the views become more flexible on this issue, as illustrated in Table 6.2.

Table 6.1 Focused Coding No. 1 for Research Question 6

Sub-theme	Guaranteeing the distribution amounts other than the rental payment.
Interview No.1	**Remarks**
S1, B4, B6, B7, B8	It is not accepted to guarantee such a distribution by the issuer.
C3	Guaranteeing the distribution amounts is worse than guaranteeing the principal.

Specifying the distribution amounts has to be based on the expected revenues without any guarantee. All responders agree on this matter; however, C3 asserts that this specific guarantee is the worst aspect of *sukuk* structures. This is because this feature shows an evident resemblance to *riba*. Typically, a liquidity facility can assess in maintaining the distribution amounts to mitigate the risk arising from not providing any guarantee aspect. In this regard, it is important to highlight the differences between guarantee and credit enhancement to the payments. Credit enhancements are permissible to mitigate the risk while the guarantee is an obligation upon the issuer to avoid the risk.

Table 6.2: Focused Coding No. 2 for Research Question 6

Sub-theme	When the periodic distribution amount is rental payments.
Interviewees	**Remarks**
S5	It is permitted as long as the assets are not destroyed.
S8, B6, B7, B8, C4	Paying the rental by the issuer is a strict obligation and any shortage or delay is not accepted in Sharia.

The interviewees, including scholars, Sharia banking officers and an academic, agree on the permissibility of paying a determined rental payment to the investors. However, it is important to note that the amount paid is not a guarantee for the *sukuk* return, but rather it is an obligation on the rental payment under the *ijara* basis. Thus, if total loss occurs to the asset, no payment would be distributed to investors. Partial loss will receive the same views as in Table 1.2.

10.2.2 Issues Related to Ownership

Actual ownership of assets by investors in *sukuk* is a controversial issue when it comes to the bankruptcy. While courts have broadened the scope of ownership beyond actual possession, the topic is still problematic among scholars. This issue is analysed to identify the views on *sukuk* ownership from the Sharia perspective.

I. Issues Related to the Ownership of Restricted Assets

No actual possession offered to *sukuk*-holders can be proved inferentially through restricted access to assets. The Zamzam *sukuk* investors physically possess a share of the future project with some agreed limitations on behaviours towards the real ownership of the residential units, while the SEC and Sadara *sukuk* investors own only the interests, rights, benefits in, to and under the assets and thus each *sukuk* shows only a beneficial ownership of the assets. The limited ownership of the owned asset creates a dispute as shown in Table 7.

Table 7: Issues Related to the Ownership on Limited Possession

Research Question Q7**:** In the case of insolvency, what is the ruling if investors do not have recourse to their assets?	
Focused Coding	**Sub-theme/Remarks**
1	It is permitted to sell assets with some restrictions.
2	Applying any restriction upon the owner's behaviour involves some critical issues.
Concluding theme:	The discussion on this issue is attributed to a wider problem related to restrictions upon the owner.

Most of the issuances provide a wider statement that the investors do not have any recourse to the securitized asset except through the purchase undertaking. Thus, investors are obligated to only re-sell the assets back to the originator, but if the originator was bankrupted, can investors sell them to other parties? According to the restricted ownership in the SEC and Sadara *sukuk*, there is a possible resource to the underlying assets other than selling them to the bankrupted originator. The views of respondents on the issue are presented in Tables 7.1 and 7.2.

Table 7.1: Focused Coding No. 1 for Research Question 7

Sub-theme	It is permitted to sell assets with some restrictions.
Interviewees	**Remarks**
S3, B1	No direct possession of the assets is an analogy to the case of equity.
B6	Such a restriction is analogous to the land plan by the authority.

A couple of Sharia banking officers and only one scholar supported the view that accepts the limitation of commercial behaviours upon the owners. This is because, in equity investment, investors have a shared ownership in the company but without any liability to sell the company. In addition, if an authority specifies the land as a health facility, it would not be permissible for the owner to use it for other than that specification. This is similar to the *sukuk*, as it is specified to be sold under the purchase undertaken, and it would not be permissible to violate this agreement.

Table 7.2: Focused Coding No. 2 for Research Question 7

Sub-theme	Applying any restriction upon the owner's behaviour involve some critical issues
Interviewees	**Remarks**
S5, S8, B4, C3	The manner of the restriction in *sukuk* confirms the fictitious ownership of the asset.
S10, S11, C5	Such a restriction can be justified individually; however, with all other *sukuk* justifications would result in impermissible actions.
S1, B7, B8	It is not permissible to prevent investors from selling their assets if the issuer is bankrupted, and at least to be treated as pledged assets.
B3	Legally, the stipulation is invalid and the owner will have recourse to their assets.

The majority of interviewees, that including scholars, Sharia banking officers, and academics, do not accept the type of ownership provided in the *sukuk* market. The ownership involves an authority over the assets while the securitized assets do not provide any authority to the investors. By preventing investors from having access to their assets, this means that the mortgage contract has more control on assets than the investors' ownership. In their case, if the issuer became bankrupt, he would be obligated to pay the purchase amount as compensation. At the final stage, bondholders and *sukuk*-holders are treated equally without taking into account the ownership involved, as it was only a fictitious. In fact, the aim is to achieve the status of bonds and all other transactions are not intended. This point is evident in the prospectuses that describe the *sukuk* as unsecured obligations that have no actual link to the asset. In principle, Sharia would accept such transactions if these are intended; however, the reality confirms that they are only to evade the rules.

II. Issues Related to Ownership and Legal Possession

Holding SEC *sukuk* or Sadara *sukuk* does not enable their investors to any physical possession, as there is no legal registration offered to them. Table 8 shows the respondents' views on the issue of legal possession from the Sharia perspective.

Table 8: Issues Related to Ownership and Legal Possession

Research Question Q8: According to *qabd* (taking into possession), *sukuk* have to include the registration of the asset, which is absent in most of the issuances. What is your view of these *sukuk*?	
Focused Coding	**Sub-theme/Remarks**
1	There is constructive possession that has the same effect as physical possession.
2	The absence of legal registration is a controversial matter.
Concluding theme:	Sharia possession and legal possession are associated with different considerations in the *sukuk* applications.

The respondents agreed that the practices show constructive possession, and not physical possession; however, they differed in views of the forms of this possession as highlighted in Table 8.1.

Table 8.1: Focused Coding No. 1 for Research Question 8

Sub-theme	There is constructive possession that has the same effect as physical possession.
Interviewees	**Remarks**
S5, S7, B5	Constructive possession is achieved through the SPV
S1, S3, S4, B4, B6	Possession is achieved through the official documents.

The respondents believed that there is constructive possession in the *sukuk* issuances. This is because various features in the *sukuk* confirm the possession of the asset from a Sharia perspective, with some differences on the feature that confirm the possession.

Table 8.2: Focused Coding No. 2 for Research Question 8

Sub-theme	The absence of legal registration is a controversial matter.
Interviewees	**Remarks**
B3, B8	Legal registration in not essential from the Sharia perspective, rather merely constructive possession is sufficient.
S11, S12, C5	The absence of legal registration raises the issue of fictitious ownerships particularly in the case of the insolvency.

Sharia banking officers do not believe that the legal registration of the securitized assets is important. This is because, in Sharia, the main point is the ability to utilize from the asset, even if the physical possession is absent. In *sukuk*, investors receive their distribution amounts as a result of owning the assets. However, without legal transfer, investors will not be able to utilize the asset if the issuer becomes bankrupt. Concern was raised by a number of scholars about this issue, as even if legal registration is not a Sharia requirement this may result in investors being prevented from using their assets, which is a Sharia matter.

III. Issues Related to the Ownership and the Incentive Fee

Based on their ownership, all returns generated from the securitized assets belong to the investors. Transferring some of the profits to the originator as incentive fees may indicate non-genuine ownership. For example, the SEC *sukuk* prospectus mentions that any payment of the residual amount (if any) belongs to the SEC as an incentive payment.

Table 9 shows the responses of interviewees on this issue.

Table 9: Issues Related to the Ownership on the Incentive Fee

Research Question Q9: What is the ruling if the excess of the asset's profit is retained by the issuer as incentive fees? What is the Sharia justification for withholding all of the profits from investors?	
Focused Coding	**Sub-theme/Remarks**
1	The incentive fee is permitted.
2	The incentive fee, in fact, is a means to imitate conventional bonds.
Concluding theme:	Most issuances involve the incentive fee in order to maintain the exact distribution amounts to the investors.

In general, the respondents agreed with the permissibility of the incentive fee; however, some highlighted a concern about imitating bonds by such a lawful means, as indicated in Tables 9.1 and 9.2.

Table 9.1: Focused Coding No. 1 for Research Question 9

Sub-theme	The incentive fee is permitted.
Interviewees	**Remarks**
S1, S3, S6, S7, S10, B3, B4, B5, B7	Investors have the right to waive some of their profits.

The Sharia banking officers and the majority of scholars support the permissibility of the incentive fee which is similar to the views of Sharia boards. The investors are the owners of the profits generated from the asset, and thus they are free to deal with them according to their desire to motivate the issuer to improve the performance levels and more efficiently serve the assets.

Table 9.2 Focused Coding No. 2 for Research Question 9

Sub-theme	The incentive fee, in fact, is a means to imitate conventional bonds.
Interviewees	**Remarks**
S11, S12, C3	The incentive fee is a lawful means to achieve an unlawful structure.

A couple of scholars and an academic highlighted the purpose of the incentive fee as being to maintain the returns according to the interest indicators as in the case of conventional bonds. In fact, in Sharia, the rule concerning a single action is that it can be

permitted even while there may be concern about compound actions which may be prohibited due to the final unlawful structure.

10.2.3 Issues Related to the Structure

The complexity in structuring *sukuk* creates various requirements. However, the following discussion highlights some of the prospectus requirements that have been omitted in the cases in order to identify the impact of Sharia on the issuances.

I. Issues Related to the Structure when not Specifying the Cost

Identifying the cost and expenses is crucial for preventing any future disputes. However, the following tables highlight some issues founded in the case studies when such clarification is missing. For example, in the Zamzam *sukuk* the maintenance cost is transferred to the investors without any specification of the average amount. In Tables 9.1 and 9.2, the responses of interviewees show the impact of such neglected elements on the entire *sukuk* issuance.

Table 10: Issues Related to the Structure on Not Specifying the Maintenance Costs

Research Question Q10: What is the ruling if the *sukuk* transfer the periodical maintenance costs to the investors without specifying any indication of the costs?	
Focused Coding	**Sub-theme/Remarks**
1	There is no prohibited *gharar* in such a case.
2	The structure may raise the issue of *gharar*.
Concluding theme:	In certain *sukuk* the periodical maintenance costs is held by the investors as lessees.

There is no doubt that the lessee bears the cost of periodical maintenance; however, the concern raised is when the lessor acts on the lessee's behalf without specifying the costs, the views on this are clarified in Tables 10.1 and 10.2.

Table 10.1: Focused Coding No. 1 for Research Question 10

Sub-theme	There is no prohibited *gharar* in such a case.
Interviewees	**Remarks**
S10	There is only a minor *gharar* that has no effect.
S1, S5	There is no need for the costs to be based upon indicators.

S11	Such a case is permissible and any dispute which arises will be dealt with in the courts.

Most scholars agreed that there is no prohibited *gharar* when there is no indication of the periodical maintenance cost. The expenses for periodical maintenance should be open to cover any incidental costs. No indications are required and no considerable *ghara* may occur. This is because the average expenses related to periodical maintenance are recognized by the *urf*, and thus only minor *gharar* exists.

Table 10.2: Focused Coding No. 2 for Research Question 10

Sub-theme	The structure may raise the issue of *gharar*.
Interviewees	**Remarks**
S6, S8, B4, B6, B8, C1	The costs have to be based upon any clear indicator; otherwise a considerable *gharar* and possible dispute may occur.

Sharia banking officers and a couple of scholars raised the issue of *gharar* in the case of no specification of the periodical maintenance cost. Without any such basis, this may allow the possibility of fraud concerning the actual expenses. Examples of indications that can be provided are receipts, documents or relevant reports.

II. Issues Related to the Structure when Not Specifying Agency Costs

In the prospectuses of the *sukuk* cases studied, there are some agency contracts that do not specify fees. The views of the respondents on this issue are presented below.

Table 11: Issues Related to the Structure when Not Specifying Agency Costs

Research Question Q11: What is your opinion on not specifying the fees for the agent, how can this influence the total issuance?	
Focused Coding	**Sub-theme/Remarks**
1	There is no Sharia concern about specifying the fees in agency contracts.
2	In the market, such a practice is not accepted.
Concluding theme:	Most *sukuk* prospectuses include a *wakala* contract as a key element to efficiently serve the securitized asset.

When the responses were examined, two types of answers were found. The first is based on theory, as highlighted in Table 11.1, relating to general rulings according to Sharia.

The second type is based on the practice according to the prevailing law, as indicated in Table 11.2.

Table 11.1 Focused Coding No. 1 for Research Question 11

Sub-theme	There is no Sharia concern about specifying the fees in agency contracts.
Interviewees	**Remarks**
S1, S5, S8, B2, S12, S6	*Wakala* originally is a contract to donate with no compulsory fees.
B7, S10	*Wakala* becomes a compulsory obligation when fees are specified.

The majority of scholars along with a couple of Sharia banking officers agreed that *wakala* has two patterns; one with a fee and the other without. However, adding the payment will transform it into a compulsory obligation where no party has the right to withdraw from the contract.

Table 11.2 Focused Coding No. 2 for Research Question 11

Sub-theme	In the market, such a practice is not accepted.
Interviewees	**Remarks**
B4, B5, C4	For regulation purposes, the agency fee has to be specified.
B8	The specification may not appear in the prospectus but rather in the non-public documents.
S3, S7, B2, B4, B6	Most practices include a minor fee.

Most Sharia banking officers attempted to provide more practical answers, as they mentioned that all issued *sukuk* have specified fees either in the prospectus or in other documents. Due to there being no direct link with the structure, the fee is usually determined in the documents attached. This is because prospectuses provide only a summary of the agreement, not all of the details. In practice, even if the parties agreed to work without fees, they would have to specify any amount to satisfy the regulator. Even with a minor fee, regulations would aim to determine the agency in a compulsory contract to prevent any future dispute. Some cases provided only 10 riyals for the agent, and the agent would accept such a fee since he would benefit from the total cash received. Although some *sukuk* transactions may be considered as fictitious, the agency relationship truly exists and involves genuine obligations.

III. Issues Related to the Structure when not Separating Transactions

Having two separate transactions is significant to avoid any potential doubt about validity of the issuance. However, the SEC sold beneficial ownership of the power generation assets to investors with the obligation of selling them back to the originator. Table 10 demonstrates the respondents' views on combining two transactions from a Sharia point of view.

Table 12: Issue Related to the Structure when Not Separating Transactions

Research Question Q12: What is the view in executing a number of contracts in *sukuk* structure?	
Focused Coding	**Sub-theme/Remarks**
1	There is a concern related to multiple contracts.
2	No Sharia concern with combining the contracts.
Concluding theme:	*Sukuk* structures essentially involve a number of transactions.

Table 12 indicates the issue of combining multiple contracts according to the principles of Sharia. When the responses were examined, two contradicting views became evident. The first view, highlighted in Table 12.2, relates to being more suspicious about such *sukuk* structures.

Table 12: Focused Coding No. 1 for Research Question 12

Sub-theme	There is a concern related to multiple contracts.
Interviewees	**Remarks**
S5	It tends to lead to prohibited activities.
C2	*Sukuk* may be included under the *hadith* of prohibiting two sales in one.

The minority, including one scholar and an academic, raised a concern about the multiple contracts in *sukuk.* Certain combinations of contracts, which do exist in *sukuk*, raise some concerns. According to the AAOIFI Standard 25, Clause no.4, clear rules are set for combining contracts that must not lead to *riba* or to any prohibited activities (AAOIFI, 2008). In *sukuk*, however, some existing practices are designed to sidestep Sharia law. For instance, it is required in the *ijara* contract that the costs of maintenance, major repairs, and insurance are borne by the lessor; however, the issuer combines this with other contracts

aiming to avoid these rules. Most of the respondents limit the *hadith* of prohibiting two sales in one to *inah* sales. *Sukuk* in current practice can be included, as *inah* sale exists and therefore the *sukuk* will not be excluded from the prohibition in the *hadith*.

Table 12: Focused Coding No. 2 for Research Question 12

Sub-theme	There is no Sharia concern about the combination of contracts.
Interviewees	**Remarks**
S3, S1, S8, S9, B2, B4, B5, B6, B8, C4	*Sukuk* involve separate independent contracts.

It should be noted that this view has been adopted by most of the Sharia boards, Sharia banking officers and scholars to open the way for more innovative structures and creative financial instruments. Although a number of transactions deal with, certain assets, *sukuk* are systems where all of the contracts are separate, independent and have various purposes. Each contract must satisfy all of the specific Sharia requirements to ensure its individual validity. Also, these combined contracts are complementary in the service of the main contract. For example, *ijara sukuk* usually involve a *wakala* contract in order to transfer the obligations concerning the assets to the most informed party with the more adequate skills. In this regard, *sukuk* type is determined according to the contract that generates the distribution amount. In addition, *sukuk* involve *ijara*, *wakala* and *musharaka* contracts; however, they do not target the specific assets. When targeting the same asset, as in leasing the *ijara* asset followed by a purchase, the subsequent purchase agreement was only a pledge, and not a binding contract. In finance, a contract which creates obligations for both parties differs from a binding promise where the obligation is only on the provider's side. In Sharia, not all combinations of contracts are prohibited, but only those where the combination leads to unlawful activities.

10.2.4 Issues Related to Regulation

Certain rules and guidelines are compulsory in governing any *sukuk* investment, while the issues below concern recommendations for improving regulation and mitigating systemic risks. The following discussion shows these issues from a Sharia perspective, aiming to highlight the interviewees, attitudes towards such supervision.

I. Issues Related to the Regulation on *Sukuk* Prospectus

The prospectus embodies the current regulatory framework for *sukuk* issuances. Some issuances neglect certain essential points, for example, the Zamzam *sukuk* did not explain rights and obligations of all participants and, more importantly, did not clarify the substantial levels of risk involved. When these elements are not disclosed, different attitudes were found during the interviews, as shown in Table 13.

Table 13.1: Issues Related to Regulation and the *sukuk* Prospectus

Research Question Q13: What is the ruling if a *sukuk* investment prospectus/contract does not explain the rights and obligations of all participants?	
Focused Coding	**Sub-theme/Remarks**
1	This absence will not influence the issuance.
2	The absence would raise sharia concerns about *jahala* (ignorance).
Concluding theme:	In *sukuk*, it is important to highlight the relationship between disclosure and Sharia.

Table 13.1.1: Focused Coding No. 1 for Research Question 13

Sub-theme	This absence will not influence the issuance.
Interviewees	**Remarks**
S1, S3, B2, B4,	The main concern is the legality of the contract, and then any dispute will be dealt with in court.
S10	In Sharia, total disclosure is not required.

The majority of Sharia scholars agreed that only the essential obligations are required to be disclosed; however, not all of the rights and obligations need to be disclosed.

Table 13.1.2: Focused Coding No. 2 for Research Question 13

Sub-theme	The absence would raise Sharia concerns about *jahala*.
Interviewees	**Remarks**
S8, B3, B6, B7	It is important to disclose all relevant issue to avoid any future dispute.
S10, B5, B7	It depends on the subject ignored, as it may influence the issuance.

The majority of Sharia banking officers maintained that, in practice, some requirements are legally essential irrespective of the Sharia rules. However, if the issuance ignores what is required by Sharia, this would negatively influence the issuance. In principle, Sharia rules that, in any contract, knowledge of the subject matter is necessary to avoid future dispute and thus in *sukuk* all relevant information that may lead to a dispute has to be disclosed. Respondent S7 clarified that the absence of information in the contract will be checked according to the general Sharia rules and then against commercial customs, and if the disclosure is, accordingly, required and the contract omits the information but with no later dispute appearing among the parties, this will not nullify the contract. This is because *gharar* and *jahala* are prohibited in the possible dispute; if whereas, disputes do not arise, no nullifying risk will arise.

Table 13.2: Issues Related to Regulation and the *Sukuk* Prospectus

Research Question Q14: What is your opinion if an issuance of *sukuk* involves a substantial amount of risks that have not been disclosed to the investors?	
Focused Coding	**Sub-theme/Remarks**
1	It is significant to disclose all potential risks.
2	It is not required to disclose all relevant risks.
Concluding theme:	In *sukuk*, it is important for the relationship between disclosure and Sharia to be highlighted.

It is important to note there is no doubt that Sharia encourages the disclosure among the parties. However, the concern is to what extent an absence of disclosure will influence the issuance, as shown in Tables 13.2.1 and 13.2.2

Table 13.2.1: Focused Coding No. 1 for Research Question 14

Sub-theme	It is significant to disclose all possible risks.
Interviewees	**Remarks**
S10, B4, C1	If all risks are not disclosed, this may be considered to be deception and cheating.

In fact, this matter is related to governance issues; however, from a Sharia perspective, it is considered to be unlawful action. This strict view is supported by a minority of interviewees; only one scholar, Sharia banking officer and academic. It is prohibited to

conceal the risks; however, they believe such a practice cannot make the entire contract invalid.

Table 13.2.2: Focused Coding No. 2 for Research Question 14

Sub-theme	It is not required to disclose all relevant risks.
Interview No.1	**Remarks**
S5, S9, B5	No Sharia impact on not disclosing the risks.
S6, S7, S11, B8	There is no need for the issuer to disclose all possible risks, as this is the investors' task.

Although it is compulsory in Saudi law to disclose all possible risks, this is not a Sharia requirement. The majority of scholars agree that not disclosing all of the involved risks has no impact on the issuance from a Sharia perspective, as long as all other Sharia requirements are fulfilled. In Sharia, the only requirement is to disclose the risks that are considered most important according to prevailing commercial customs.

II. Issues Related to Regulation Implementing AAOIFI Standards

The current diversity in the market of *sukuk*, as shown in the earlier cases studied, is attributed to the lack of standardization and the absence of official Sharia regulation. Table 14 shows the interviewees' views on regulating the market with AAOIFI standards, aiming to answer to what extent the current standards are suitable for the contemporary market from the points of view of practitioners and researchers.

Table 14: Issues Related to Regulation Implementing AAOIFI Standards

Research Question Q15: What is your opinion about making the AAOIFI standards obligatory in the *sukuk* market?	
Focused Coding	**Sub-theme/Remarks**
1	It is a recommended procedure to officially apply AAOIFI standards in the market.
2	It is not the optimal choice to make the AAOIFI standards obligatory.
Concluding theme:	The s*ukuk* market essentially requires more regulation and one of the methods is to use the AAOIFI standards.

It is common in the literature to recommend applying the AAOIFI standards officially. Tables 14.1 and 14.2 show the opinions on this regard among the different respondents.

Table 14.1: Focused Coding No. 1 for Research Question 15

Sub-theme	It is a recommended procedure to officially apply AAOIFI standards in the market.
Interviewees	**Remarks**
S4, S5, S6, S8, S10, S11, S12, B4, B6, C4.	This procedure is necessary in the current *sukuk* market.
S7, B8	The procedure is recommended and then any contradictions in the standards would have to be considered according to the evidence.

As there is no regulation related to Sharia requirements, the practices in the market are very diverse. On the other hand, the AAOIFI is an international institution that has received global acceptance and has involved scholars from most Sharia boards in the industry. Therefore, most of the responders, including the majority of Sharia scholars, recommend the application of the AAOIFI standards in *sukuk* markets. Following the AAOIFI standards would be an intermediate stage with general rules that need to be followed by a Sharia board in assessing the details of an issuance from a Sharia perspective. However, if any violation is found in a *sukuk* structure according to the AAOIFI standards, their Sharia basis has to be clarified. By such a practice, *ijtihad* will remain open in the industry to provide more creative instruments and *sukuk* activities would remain under control.

Table 14.2: Focused Coding No. 2 for Research Question 15

Sub-theme	It is not the optimal choice to make the AAOIFI standards obligatory.
Interviewees	**Remarks**
S1 , C1, C3	Current AAOIFI standards are not sufficient to regulate *sukuk* market.
C5	AAOIFI standards are not applicable in the current market.
S9, B7	No standards should be made compulsory.

In fact, the AAOIFI standards only offer general guidance, and are not suitable to be regulations. In addition, there is a considerable gap between these standards and real practice.

Since 2008, significant developments have occurred in the market without any change to the standards. However, some interviewees disagree with the idea of making any standards obligatory, as the Sharia board may adopt different Sharia views according to differences in customs, circumstances, time and place.

III. Issues Related to Regulation and Sharia Board Approval

To what extent receiving Sharia board approval is essential, as the Zamzam *sukuk* were issued without such approval. Table 15 shows the interviewees' attitudes towards non-approved issuances.

Table 15: Issues Related to Regulation and Sharia Board Approval

Research Question Q16: What is your opinion on considering Sharia board approval as a requirement for issuing *sukuk*? What about an issuance with no such approval or approved from only one scholar?	
Focused Coding	**Sub-theme/Remarks**
1	It is acceptable to issue *sukuk* without Sharia board approval.
2	It is necessary to involve a Sharia board
Concluding theme:	Involving a Sharia board which cannot have less than three members is an AAOIFI requirement.

Issuing *sukuk* without a Sharia board needs clarification from experts in the field, as shown in Tables 15.1 and 15.2.

Table 15.1: Focused Coding No. 1 for Research Question 16

Sub-theme	It is acceptable to issue *sukuk* without Sharia board approval.
Interviewees	**Remarks**
S1, S6	Sharia board is not essential as long as the purpose from the Sharia board will be achieved in other methods.

Only a couple of the scholars would accept *sukuk* without Sharia board approval. This is because its importance is related to the nature of the structure rather than appointing a Sharia board. Undoubtedly, it is recommended to appoint a Sharia board but most significant point is actual compliance with Islamic rules.

Table 15.2: Focused Coding No. 2 for Research Question 16

Sub-theme	It is necessary to involve a Sharia board
Interview No.1	**Remarks**
S4, S5, S11, S12, B3, B7, C1, C3	It is a compulsory process in any issuance to involve a board and not only a single scholar.
S10	A Sharia board is essential and accepting one scholar approval in a repeated structure.
S8, B2, B4	The board is required, as the critical issue is to check the documents and not only the structure.

The majority of the respondent among scholars, Sharia banking officers and academics asserted that it is compulsory to involve a Sharia board in order to prevent any breach of Sharia rules. Not involving a Sharia board means that the investment is not Islamic, since there is no proof of its Sharia compliance. This is because *sukuk* issues are usually not related to the structure, but only to the details in the documents.

IV. Issues Related to the Regulation on Contradicting *Ijma'*

While there is no controversy about *ijma'*, Table 16 illustrates the interviewees opinions on *sukuk* contradicting *ijma'*.

Table 16: Issues Related to the Regulation on Contradicting *Ijma'*

Research Question Q17: What is the ruling if an issuance of *sukuk* contradicts a consensus opinion?	
Focused Coding	**Sub-theme/Remarks**
1	*Sukuk* contradicting *ijma* seem not to exist.
2	The investment becomes prohibited.
Concluding theme:	Contradicting *ijma'* is critical and there cannot be any doubt that it is forbidden.

When *sukuk* contradicts a consensus ruling, two main views were expressed, which are highlighted in Tables 16.1 and 16.2.

Table 16.1: Focused Coding No. 1 for Research Question 17

Sub-theme	*Sukuk* contradicting *ijma* seem not to exist.
Interviewees	**Remarks**
S7, S10, B4, B8	*Ijma'* issues are limited and s*ukuk* issuances seem not to involve any violation of *ijma'*.

A number of scholars and Sharia banking officers believed that the practice of *sukuk* does not contradict the *ijma* cases. This is because *ijma'* cases are limited to a number of specific situations that do include any of *sukuk* issues.

Table 16.2: Focused Coding No. 2 for Research Question 17

Sub-theme	The investment becomes prohibited.
Interviewees	**Remarks**
S5, B3, B7, C1, C4	The *sukuk* issuance becomes totally forbidden.
S1, B6	It depends on the type of violation. As long as the issuance can be modified according to *ijma'*, the issuance can be accepted.

Some believed that the entire issuance becomes prohibited, while others would aim to modify the issuance according to *ijma'* in order to maintain validity.

10.2.5 Issues Related to the Current *Sukuk* Industry

Although *sukuk* have emerged as an innovative instrument to fill a gap in the capital market, current practices show critical faults. The following section identifies the assessments of academics and practitioners concerning the current market.

I. Issues Related to the Importance of the current *Sukuk*

The respondents were asked if current *sukuk* market practices show actual innovation in the global market. Table 17 shows the respondents' assessments of to what extent the *sukuk* market fills gaps in the market.

Table 17: Issues Related to the Importance of Current *Sukuk*

Research Question Q18: Is there a need for *sukuk* for the development of the economy in general and Islamic finance in particular?	
Focused Coding	**Sub-theme/Remarks**
1	The *sukuk* market positively enhances Islamic finance.
2	There are some negative features in the *sukuk* market.
Concluding theme:	The effect of *sukuk* at the macroeconomic level is significant when assessing current practice.

The respondents' assessments on the *sukuk* market are shown in Tables 17.1 and 17.2.

Table 17.1: Focused Coding No. 1 for Research Question 18

Sub-theme	The s*ukuk* market positively enhances Islamic finance.
Interviewees	**Remarks**
S1, C3	The importance of *sukuk* to the Islamic finance is comparable to that of bonds to Western finance.
B4, B8	Imitating bonds is a positive method as long as Sharia rules are fulfilled
S6, S8, S10, S11, B7	*Sukuk* provide Islamic finance with an alternative method to increase liquidity.

Several scholars and Sharia banking officers endorse the positive effect of *sukuk* in Islamic finance. In Islamic finance, there is a marked need to provide a financial instrument as a substitute for bonds. Imitating bonds can be a positive method to design the instrument of *sukuk* as an acceptable substitute. *Sukuk* have become the best instrument to provide Islamic finance with better liquidity. In addition, *sukuk* facilitate infrastructure growth, industrial project development and public service evolution. It is important to note that these points do not relate to the quality of Sharia compliance.

Table 17.2: Focused Coding No. 2 for Research Question 18

Sub-theme	There are some negative features in the *sukuk* market.
Interviewees	**Remarks**
S5, C1, C5	*Sukuk* in the industry are not sufficient in their Sharia quality.
B4	*Sukuk* involve considerable weaknesses that negatively influence Islamic finance.
S10	Only minor value is added by *sukuk* to the global economy.

Sukuk are immature as instruments and have been treated in the global market as bonds. This is because most practices are based upon debt rather than the actual sharing. The actual practices involved contradict Sharia rules. It is important to note that respondent S5 highlighted that benefits involving finance, such as enhanced liquidity, do not mean that *sukuk* are permitted under Sharia since it is mentioned in the Quran that ‘when they ask you about wine and gambling. Say, ‘In them is great sin and [yet, some] benefit for people. But their sin is greater than their benefit’. Even if the *sukuk* market improves the Islamic finance, it still uses unlawful means that require a higher compliance level.

II. Issues Related to Assessing the Current *Sukuk* Market

Saudi Arabia's *sukuk* market is relatively conservative compared to the Malaysian market; however, the responses of interviewees highlight several issues and challenges concerning practice, as shown in Table 18.

Table 18: Issue Related to Assessing the Current *Sukuk* Market

Research Question Q19: What are your criticisms of Saudi *sukuk* market?	
Focused Coding	**Sub-theme/Remarks**
1	Criticisms at the market level.
2	Criticisms related to the issuances.
Concluding theme:	*Sukuk* are immature instruments that have been subject to a number of important criticisms.

The Saudi *sukuk* market has been the target of some criticism concerning both the market and issuances, as shown in Tables 18.1 and 18.2.

Table 18.1: Focused Coding No. 1 for Research Question 19

Sub-theme	Criticisms at the market level.
Interviewees	**Remarks**
S1	The illiquidity of the secondary market is a result of an inactive primary market.
S1, S10	The *Sukuk* market targets only institutions and not individuals.
S4, B4	More regulation at this level is essential.

The Saudi *sukuk* market remains modest and comparatively inactive. Its scope is also restricted to institutional investors. More severe is the absence of specific regulation of the market. No clear conditions and standards exist, resulting in chaos evident in this field. At the Sharia level, an authoritative body is recommended to review and control practice.

Table 18.2: Focused Coding No.2 for Research Question 19

Sub-theme	Criticisms related to the issuances.
Interview No.1	**Remarks**
S5, S10	It is considered as a fixed income instrument.
S10, B7, B8	More Sharia supervision until maturity.
S3, S6	Lack of Sharia compliance.

A number of scholars criticized the fact that most structures focus on fixed income rather than on actually sharing profit, resulting in critical violations of Sharia rules. For this reason, it is important to ensure continuous Sharia-compliance through an independent Sharia supervisory board, as asserted by a couple of Sharia banking officers.

10.3 Summary

The current dispute on *sukuk* issues mainly reflects the earlier jurisprudential arguments. However, earlier disputes had wide ramifications for the relevant issues whereas current disputes have become more focused and are easier to identify. There is no doubt that the AAOIFI has a role in harmonizing current scholars' views through the meetings and discussions prior to the publishing of standards. The AAOIFI has adopted some standards which require specific procedures in order to be applicable in the market.

In this regard, some recent practices were found to satisfy the Sharia standards and the financial requirements. In general, Sharia scholars showed some flexibility during the interview on a number of Sharia issues, while Sharia banking officers tended to be more practical. The responses of Sharia banking officers appeared to link the AAOIFI standards and the current market since they provided practical suggestions to satisfy requirements of the standards.

To summarize the practical findings; a way out to reduce rental payments as a cause of partial loss is that the assets can be substituted with an equivalent. Another lawful approach is to maintain the excess amount of the rental in an account to be paid to investors at final purchase. Another issue related to total loss can be solved by assigning the issuer to nominate the insurance company. In the event that of the company being unable to cover the total loss, the issuer would then be responsible for covering any shortfall due to misconduct in the decision, and furthermore the maintenance cost can be lawfully transferred through an agreed stipulation. In addition, the costs can be added in the next leasing interval under a supplementary payment. Also, it may be possible to cover all maintenance costs in the final purchase.

Moreover, for guaranteeing the principal, the return and the assets of the issuance are critical. The principal can be lawfully repaid on the basis of lease-to-own. The final purchase

can be equivalent to the nominal value taking into account that the contract pledge is only binding on the provider, and not on both sides, otherwise it becomes impermissible. In addition, the periodical distribution amount can be strictly guaranteed by the issuer as obligated rentals. It is a strict obligation that the issuer as a lessee pays the rent. However, making the issuer a grantor in the capacity of the lessee for the asset is illegal, while some agree that the issuer can become a guarantor with a separate contract from the contract of *ijara*.

It is agreed that the current Saudi *sukuk* market requires further improvements and developments to the current regulations. However, making the AAOIFI standard a part of the mandatory regulatory requirements in the market is a controversial idea. While proponents strongly agree that such regulation could be used to ban the current unlawful activities, others consider it as a negative approach that would lead to closing *ijtihad*.

Chapter 11: Summary of the Findings and Conclusion

11.1 Introduction

The study shows that *sukuk* issuance in Islamic finance is comparable to the asset securitization in Western finance. Asset securitization has been described as 'alchemy', since it generates value in the conventional market that did not exist earlier. In this respect, the research highlights the considerable value generated by *sukuk* that enables the study to describe *sukuk* as 'alchemy' in the Islamic financial market. The comparability between these instruments raises question related to the differences in their characteristics and level of exposure to risk. A common claim in the literature on *sukuk* risks is that they are very similar to the risks in bond investments. The questions that the study aimed to answer were 'What are the differences between the risks in bonds and in asset-backed *sukuk*?' and 'To what extent are the current practices of *sukuk* different from the theoretical literature?' To accomplish the aims, the research first concentrated on the main differences found in risk exposure that distinguish *sukuk* investments from investing in conventional system. This research examined the differences between SBS and conventional bonds and found various fundamental variations, proving that these two types of securities provide different solutions in the market. These theoretical assertions were then examined in the applications in three specific case studies.

11.2 Summary of the Results

The summarization includes three categories that reflect the research questions; issues related to risks, issues related to agency problems and issues related to Sharia compliance.

11.2.1 Issues Related to Risks

Ramasamy et al. (2011) in their study shows that Islamic *sukuk* have lower exposure to risks. Their empirical analysis confirms that *sukuk* are moderately risky when compared to the bonds market. Their research indicated that the popularity of *sukuk* and the lower yield

support their less risky nature. By contrast, Wicaksono (2015) believes that *sukuk* and bonds are exposed to the same level of risk since they have the same reaction to the market's sentiments. Although, Wicaksono (2015) study agrees that *sukuk* and conventional bonds have fundamental differences in their structures, the study concluded that they have the same level of risks. On the other hand, this study adopts that there is a higher exposure to the financial risks in *sukuk* cases than in bonds structure. *Sukuk* investors are highly exposed to risks related to the Sharia risk, legal risk and liquidity risk. More important is the credit risk in *sukuk* cases is more exposed than in bond investments.

The credit risk that refers to the risks related to the principal and distribution payments, and *sukuk* are more exposed to these risks than bonds since any loss in the assets has to influence both the distribution amounts and the purchase undertaking. According to the AAOIFI, the return and the principal for *sukuk* cannot be guaranteed by the originator except if the loss occurs due to misuse or negligence. This increases the investors' exposure to such risk. Bonds are less exposed to financial risks since there is no link to the assets but rather to the originator's creditworthiness and thus the return and the principal are guaranteed by the originator. In practice, however, the SEC and Sadara *sukuk* show no actual relationship to the assets and the structure provides different levels of guarantee for both obligations, resulting in a great reliance on the originator's creditworthiness rather than the circumstances of the assets. These *sukuk* involve a purchase undertaking at the assets' par value with insurance for the assets. However, if the insurer fails to cover the loss, two different practices are found: one with compulsory coverage of any shortfall in the assets' insurance by the originator, as applied in the SEC *sukuk* and which aims for the same exposure as appears with bonds. The other practice, as seen in the Sadara *sukuk*, provides voluntary coverage of the loss by the originator, so that investors retain a higher exposure to such a risk. The second practice satisfies the Sharia framework as provided in the literature, since there should be enough exposure to capital loss risk compared to the risk available in bonds. It is the investors' obligation to cover any shortages in insurance related to the assets. With regards to distribution, both cases show that, if the originator fails to generate rental payments, investors will face a loss without any guarantee for the distribution. This is a positive step towards a more harmonious instrument according to the spirit of Sharia, but it

involves an additional risk that does not exist in bond investments. This means the *sukuk* provide different levels of exposure to credit risk than exists in bond investment.

Although the cases considered show higher exposure to credit risk than in bonds with no guarantee of a return, they do not offer legal ownership to the investors which means that there is no recourse to any of the underlying assets in the case of default on the part of the originator. However, SBS investors incur higher credit risk with the advantage of their recourse to the assets. A defect in practice is that only some of the Sharia requirements and features of SCS are applied rather than being totally in conformity with SBS. As the current practices diverge from the paradigmatic version, these *sukuk* lose the distinctive features and tend to be less attractive than conventional bonds. This is attributed to the considerable risks involved without a compensating return. The return issue appears greater in Saudi *sukuk* market because the market featured with lower return compared to others. Saudi *sukuk* cases do not compensate effectively with higher financial risks. For instance, Sadara *sukuk* were priced at 95 basic points above the six-month Saudi interbank offered rate, making a profit rate of just under 2%. There is no doubt that Sadara *sukuk* have more sophisticated structures than those of bonds. A number of transactions are involved in these *sukuk*, including selling, purchasing, leasing and agency contracts that require a great deal of documentation. The result is that Sadara *sukuk* investors are exposed to higher risks since there is no guarantee of a return, as seen also in SEC *sukuk*, and in turn the uniqueness of having recourse to the underlying assets is loss. The outcome is that a number of Saudi applications have high degree of risks along with the loss of *sukuk* uniqueness.

The research furthermore discussed market risks related to changes in the assets' value, interest rates and currency risks. Risk associated with assets value does not confront bonds investors, while *sukuk* investors bear these risks as a result of being owners of the underlying assets. However, this exposure is limited by the purchase undertaking at par value, meaning that no loss will be incurred if the asset's value changes in the market. Through this procedure, this risk has been transferred to the originator rather than being borne by investors, aiming to reduce the degree of association between the investors and their assets and being more compatible with bond structures. Moreover, interest rate risk affects the value of bonds directly while, as appropriate Sharia-based instruments *sukuk* are less

exposed to such changes in the market. This is because their returns depend on the actual revenues from the assets and are calculated based on real incomes from the assets in the pool, resulting in the avoidance or significant reduction of this risk. This was only applied in the Zamzam *sukuk*, as the return was linked to the real estate market, resulting in lower exposure to interest rate risk. On the other hand, the periodical distributions of the Sadara *sukuk* were semi-annual with an expected return of 6 month SAIBOR plus 95 basis points per annum. As in conventional debt, this direct link between returns and SAIBOR increase the exposure to reinvestment risk due to the fluctuation of interest rates in the market.

Both *sukuk* and bondholders are similarly exposed to currency exchange risks since any unfavourable changes in the exchange rates leads to possible loss. In practice, the foreign exchange risk is mostly unavoidable in international issuances due to unanticipated currency fluctuations, while this type of exposure is not present with local issuances. The study furthermore looked at the liquidity risk that is related partly to the inactive secondary *sukuk* market. *Sukuk*-holders are highly exposed to these risks due to the Sharia restrictions on trading debt, while bonds are more active and better standardized. The nature of *sukuk* means that some Sharia limitations operate in their trading; however, actual practice adds another dimension to the illiquidity of *sukuk*. The limited issuances in the primary market and then the exercise of 'buy and hold' leads to a higher exposure to the liquidity risks. These risks were given attention in the prospectuses in the case studied. For instance, for Sadara *sukuk* it was indicated that their investment cannot be traded quickly enough to prevent any predicted loss due to the lack of an efficient Saudi secondary market, which may result in the inability to sell the *sukuk* at a reasonable time and reasonable price. As this is the case, it is difficult or impossible to remove liquidity risk from any *sukuk* investment.

In addition, the research discussed the operational risks, which refer to the risks related to negative event affecting the assets. This is an additional risk incurred by *sukuk* investors and does not exist in bond investment. *Sukuk* are exposed to this risk due to the real ownership of the assets and the degree of this exposure depends on the nature of the assets. For instance, this risk in the Sadara *sukuk* was significant during construction as the assets were as yet unavailable. Nevertheless, in the cases the risk of partial loss was mainly transferred to the originators. Originators incur any expenses related to partial damage to the

assets using different procedures. Moreover, the originator bears the insurance and maintenance costs and the partial loss of assets results in weakening the link between the investors and their invested assets. This means that there is no direct influence on the distributions to the investors due to misuse of the assets. However, this does not comply with *sukuk* from a Sharia perspective as the investors have to show a higher level of exposure to asset liabilities.

Finally, the research studied the legal risks in *sukuk* investment. *Sukuk* investors are more exposed to this risk than investors in bonds. One of the problems facing the *sukuk* market is the absence of a proper legislative basis. Thus, in *sukuk* attempts are made to use English law to cover such a shortage, resulting in the possibly of conflict between English law and Sharia rules. For instance, the certificates and transaction documents for the SEC *sukuk* are governed by English law. As, English law in some cases contradicts Sharia rules, this means that there may be legal inconsistency in *sukuk* investments. This could explain the reason for the SEC prospectus starting that the issuance may be contrary to Sharia law in some of their possible future stages of the *sukuk*. Thus, the court may consider the relationships involved SEC *sukuk* as creditor and borrower rather than lessee and lessor, according to some of the clauses in the prospectus, which represents an obvious departure from Sharia law.

Also, when applying Saudi Arabian law, there is a risk that the interpretation of the Sharia compliance may vary among different Saudi courts. For example, the Sadara *sukuk*, which apply Saudi law, may face the risk that courts in Saudi Arabia may decide that the musharaka agreement is invalid and consider the investors' interest in the musharaka as a debt claim in the leased assets. Although the Sadara *sukuk* have received a pronouncement confirming compatibility with Sharia, such a statement cannot be binding on a judicial committee. Both cases show higher exposure to legal risks resulting from the lack of a standardized legal framework for *sukuk* investment.

Sharia risks involve the possibility of the *sukuk* issuance contradicting Sharia rules. Bonds show no exposure to this risk because no relationship exists between bonds and Sharia principles. However, if *sukuk* adhere to AAOIFI standards this would limit such an exposure. This is because AAOIFI standards show better harmonization with Sharia requirements, which in turn leads to a better management of this risk. This means that the possibility of

changes in the approval of the issuance, for example receiving disapproval from another scholar or to be judicially treated as a non-Islamic instrument, are less expected with *sukuk* meeting AAOIFI standards.

Although the three cases considered have been reviewed and approved by reliable scholars, they show a different level of contradictions with AAOIFI requirements. The aggregate percentage compliance of the SEC was only 11.5%, Sadara *sukuk* was 81.7% and Zamzam *sukuk* achieved 90%. The great dissimilarity in the results is because Sharia supervisory boards do not limit their *fatwa* to the AAOIFI point of view. This increases the exposure to the risk of changes in approval, being disapproved by another scholar or for the *sukuk* to be judicially treated as a non-Islamic instrument. This particular risk is mentioned in the prospectuses of the case studies along with the legal consequences of being unenforceable due to being not Islamic. While most aspects of Sharia risk can be reduced by a strict adherence to Sharia financial law with great transparency on the basis of *fatwa*, the actual practices show less compliance and a lack of transparency. Sharia boards limit their *fatwa* to the overall compliance or non-compliance of the structure without giving details and evidence that provide investors with sufficient confidence related to Sharia compliance especially in controversial Sharia matters. For instance, the approval of the three cases appears in official documentation without any evidence, reasoning or explanation of the view given. However, the best financial practice necessitates greater transparency in order to protect the reputation of the *sukuk* and to maintain investor confidence, especially given their current distance from AAOIFI standards.

As, *sukuk* cases have a higher exposure to the financial risks, investors are presumed to have the advantage of the recourse to their *sukuk* assets. However, the case studies only provide beneficial ownership without any recourse to the assets. In SBS, there are considerable risks in the investment; however, with a recourse to the assets. In this respect, most *sukuk* investors believe that they have received such an advantage. Lukonga (2015) examined a number of defaulting *sukuk* and found that the majority of their investors were not aware that there was no recourse to the underlying assets and that, subsequently, no sale of the underlying assets could be made in the event of default. This indicates that the practices have fault in their structure that could arise in the case of insolvency. Zaheer and

Wijnbergen (2013) found that the experience of default episodes indicates clearly that the advantages of *sukuk* can only be succeeded in accessing a broader investor base if their *sukuk* structure strictly complies with the rules prescribed by Sharia. The strict following of Sharia rules would have minimized the incidence of defaults. These rules need *sukuk* to be asset-backed and free of *gharar*, gambling and interest.

Another important point is that *sukuk* are typically designed to incur higher exposure to risks, while the case studies have shifted a number of these risks to the originator. To make the practices a true investment *sukuk*, investors have to incur additional risks in order to achieve the status of SBS. These additional risks are mainly related to the underlying assets in order to make a true investment *sukuk* according to the spirit of Sharia. However, the Sadara investors incurred higher risks related to both credit risks and asset risks than the SEC investors. This is, as discussed, because of the feature of no guarantee for the assets in the case of total loss. Thus, the Sadara *sukuk* can be considered as a step forward toward a true investment *sukuk*.

11.2.2 Issues Related to Agency Problems

The thesis also examined some of the agency costs embedded in asset-backed *sukuk* investments and tried to identify the principal/agent conflicts that appear in different applications of *sukuk* investment. The study found that the *sukuk* structure involves a number of critical agency conflicts. *Sukuk* are embedded with a variety of different agency relationships depending on the positions taken by the originator, such as being as a manager, a lessee, an issuer, a servicer, and a contractor, leading to higher exposure to agency problems. Aljifri & Khandelwal (2013) concludes in their study that Islamic financial activities have less agency problems than their conventional counterparts. On the contrary, this research pointed out that the higher level of the responsibility undertaken by the originator in *sukuk* issuance confirms the greater exposure to the agency issues. This research examined the agency conflicts that arise according to the type of assets concerned. Originators have an incentive to use risky assets when structuring asset-backed *sukuk* in order to exclude them from their books and to transfer the excessive risk to the investors. However, the case studies show that the securitized assets have not been entirely transferred

to the investors and, in fact, assets remain in the originator's book. Despite Sharia concerns about ownership, this practice has minimized the agency conflicts that may arise.

The study also found that there is an agency conflict related to the value of the underlying assets. As investors look for *sukuk* that reflect the value of the underlying assets, originators have an incentive to overstate their value to receive more cash. This issue is critical, as *sukuk* assets are sold at the market price, and also in the case the insolvency investors, have recourse to their assets to compensate for the loss. In addition, the practices show another dimension to this issue caused by the substitution undertakings. The securitized assets may change over the life time of the *sukuk* and investors may have no official access to monitor their invested assets, creating a circumstance of moral hazard. Here, the research found no evidence in the prospectuses of the SEC and Sadara *sukuk* related to the value of the underlying assets except what was mentioned by the Sadara Sharia board. The board asked for a neutral third party estimation to validate the actual relationship between the cash received and the value of the invested assets. This specific action helps to reduce the adverse selection in favour of Sadara. Moreover, the SEC and Sadara *sukuk* involved procedures that eliminating this conflict, as both cases applied the purchase undertaking. The originator as a manager/agent undertakes to purchase the underlying assets at their nominal value. This agreement manages the agency conflicts since the repurchase agreement shows a dimension of sharing between the originator and investors of the securitized asset that would reduce the agency costs. More importantly, this device allows the conflict that arises as a consequence of the originator being the lessee to be managed. The lessee may misuse the leased asset since the investors as owners cannot perform adequate monitoring. However, the purchase undertaking at par value would lead the originator's performance to act in favour of the assets.

Also, the cases show that the purchase undertaking solves the agency conflicts caused by the originator being the servicer. In these cases, there was no access for the investors to ensure that the servicer's actions are in favour of the assets. However, as the originator is the final owner of the assets, investors can become less concerned about the servicers' performance. The undertaking device has reduced incentive asymmetries in various ways. In fact, the Sadara *sukuk* use a further device to manage these conflicts by using the concept

of co-ownership. Under the musharaka agreement, the originator and the investors become co-owners of the securitized assets which will increase the investors' confidence that the originator, as co-owner, will maintain a high quality of service, management and performance.

Moreover, the research found that the *musharaka* agreement and purchase undertaking in the Sadara *sukuk* have minimized the agency costs due to the originator being the contractor. In this respect, the value of the assets is influenced by the contractor's efforts, actions, inherent talent and other factors that are unobserved along with the information asymmetry concerning assets however, causing a possible moral hazard. Therefore, Sadara applied the hedging processes of the musharaka agreement and a purchase undertaking which reduce the asymmetry of incentive. Investors seek well constructed assets to raise the value of their investment, and also Sadara, as a partner and final purchaser, has the same incentive towards the leased assets, resulting in a situation where the contractor has sufficient motivation to perform well. In fact, both hedging methods ensure that the contractor has a compelling incentive to perform well and the investors can become more confident that they are investing in reliable future assets.

The study additionally examines the agency costs caused by the originator misusing the surplus. The originator as manager may misuse the surplus and spend it unwisely rather than maintaining it in the receivables account to meet any forthcoming obligations. Hence, the greater the access that the originator has to the earnings generated from the underlying assets, the more likely the investors are to suffer from agency costs. The practices of *ijara sukuk* show a hedging procedure to reduce this moral hazard. *Ijara sukuk* cases precisely determine the earnings as a rental payment and thus the cash flow generated from the assets becomes more definite and specified, resulting in a better management of the agency costs. Both cases have committed future cash intake to investors, aiming to reduce the agency costs and also to protect future cash flows from mismanagement. The research also discusses the adverse selection problem that may arise between the originator and Sharia-sensitive investors. Each case receives a *fatwa* that shows the compatibility of the issuance with Sharia in order to eliminate the originator's incentive to structure a non-compatible issuance. This

fatwa enables investors to become more confident as they have no access to accurately evaluate the extent of the issuance being harmonious with Sharia rules.

All of the hedging programmes applied limited the agency costs and made the structure more effective in reducing agency risks. These mechanisms have reduced the degree of moral hazard and adverse selection generated by the quality and extent of information asymmetries. Despite *sukuk* originators typically having better status concerning information on the assets being utilized, the practices show effective programmes to reduce the possible risks and mitigate the 'lemon' problem. However, the hedging programmes made investors less concerned about the asset's performance and more interested in coupon payments. Also, they became less interested in how the assets were serviced and managed and how the proceeds were spent as a result of the incentives and risks in the relationships between the originator and investors becoming less asymmetric.

In studying the literature of Islamic finance, other theories may arise such as stakeholder theory. Stakeholder theory is one of the predominant theories that is used to understand various types of relationships in business and provide a means to explain business challenges. This theory is broader than the agency theory view as it understands the concept of capital to involve all stakeholders rather than just shareholders parties and it is often used to outline the interests of shareholders, employees, customers, the public and vendors (Mohamed & Faouzi, 2014). The theory is considered appropriate to support the implementation in Islamic finance to enhance better Sharia compliance activities (Zamil, 2014). It is proper to Islamic finance since it can help to support and develop the Islamic sharing economy, pirticulary risk sharing and PLS concept. Islam adopts a stakeholder approach which considers claims from all stakeholders as equally valid and acknowledges that the owners of businesses or financers have the right to earn profits. This approach supports equity based financing that depends on PLS as it is significant to share risks between the financiers and the owners (Belal, et al., 2015). The notion of shared risk makes the stakeholder link to value creation more explicit. As a result, the financial risks would not be shifted rather shared between equal parties. Each stakeholder would obtain profits, rights and bear risks, in accordance with their proportionate stake (Aribi & Arun, 2012).

11.2.3 Issues Related to Sharia Compliance

The thesis aims to precisely identify the compliance of the three cases with AAOIFI standards. The following table shows the aggregate percentage compliance of the SEC, Sadara and Zamzam *sukuk*.

Table 11-1 The Aggregate Percentage Compliance of SEC, Sadara and Zamzam Sukuk

***Sukuk* Issuance**	**SEC *sukuk***	**Sadara *sukuk***	**Zamzam *sukuk***
The aggregate percentage compliance	11.5%	81.7%	90%

The following table shows that the aggregate percentage compliance of SEC *sukuk* was only 11.5%, Sadara *sukuk* was 81.7% and Zamzam *sukuk* achieved 90%. Notably, the lowest score of the compliance is recorded for SEC *sukuk* while the highest is achieved by Zamzam *sukuk*. Sadara *sukuk* also achieve a high score but slightly lower than Zamzam case. Sadara and Zamzam *sukuk* involves higher exposure to the financial risks than in SEC *sukuk*. SEC *sukuk* explicitly provide a full of guarantee in the case of total loss assets that is not provided in Sadara and Zamzam *sukuk*. This is because, based on earlier discussion, being more compatible with Sharia involves naturally higher exposure to the financial risks. The total results show that the Saudi *sukuk* market is considerably vary on their Sharia compliance. This would confirm that AAOIFI standards are not officially adopted in the market. A case has achieved 11.5% while the other 90% which can indicate the chaos exists among Saudi applications related to their Sharia compatibility. These varied results are an outcome of not specifying rules for *sukuk* in the country. There is no single piece of legislation precisely regulating the implementation of sukuk including rules surrounding Sharia compliance.

SEC *sukuk* use a plain vanilla *ijara* structure; whereas, Sadara and Zamzam apply a more sophisticated and efficient structure. In the market of *sukuk*, simple and direct *ijara* structure means lower compatibly with Sharia and higher similarity to the bonds. On the other hand, Zaheer & Wijnbergen (2013) found that strict adherence to Sharia rules would considerably simplify structuring *sukuk*. They support their opinion by stating that Sharia

compliance involves a clear allocation of property rights. In fact, this study adopts the opposite view that structuring complex *sukuk* is one of the feature to develop a better compliance issuance. Both Sadara and Zamzam sukuk have involved a number of efficient, complex and unprecedented features in order to avoid a number of Sharia issues and thus to achieve better Sharia compatibility. Sadara *sukuk* have achieved its successful complicated structure by the involvement of a range of various Islamic scholars and financial experts. It is important for both Sadara and Zamzam *sukuk* to be compatible with Sharia as they mainly target Muslim investors whether local or international. Muslim investors pay more attention to the the religious values while foreign investors in general have less concer with this regrd.

Meanwhile, developing a better Sharia compliance structure according to AAOIFI does not mean a better social and moral consequences. Zamzam *sukuk* achieved the highest score in terms of the compatibility with AAOIFI standards; on the other hand, the project confronts a plenty of issues related to the social and moral implications. One of the main issues is the damage to the environment and the historicity of the holiest place in the Muslim world and the focal point of the prayer. Zamzam towers were built to provide up-market luxurious residence for high-net-worth pilgrimages. The project undermines equal opportunity in the holy place, diminishes its historicity and spirituality, and harms its environmental nature (Asutay, 2012). Despite, their high result, Zamzam Towers can be considered as an example of social failure. This confirms that Sharia compliancy in the form of AAOIFI standards do not endogenise social consequences in their construct.

The research asks about the critical Sharia issues that face asset-backed *sukuk*. In conclusion, the analysis found that the key requirements are mostly related to guarantees, ownership, the principal, rent and maintenance. The AAOIFI bans the issuer as a manager from offering any guarantee for the assets. However, the interview data show differentiation between the total loss and partial loss. In total loss, some allowed to voluntarily take the repair without any compulsory statement in the contract. This procedure was applied in the Sadara *sukuk* as the issuer may voluntarily cover any shortage in the insurance of the assets. However, the SEC has been obligated to cover the shortfall in the asset insurance. This difference resulted in the Sadara *sukuk* becoming more harmonious with Sharia. However, partial loss was treated with a more relaxed attitude towards the issuer's guarantee. The interviews highlight

two possible ways to cover the loss by the issuer. The first is the substitution of the assets, and the second is maintaining the excessive rental under an account in order for investors to receive it at the final purchase. There is no clear clarification in the cases related to this issue; however, the SEC *sukuk* involve a substitution undertaking in order to substitute the assets if necessary. Moreover, the AAOIFI framework requires true ownership of the securitized assets when structuring asset-backed *sukuk.* However, the cases show that investors received the right of return with considerable restrictions on commercial behaviours with respect to the assets. The interviews highlighted other views in the market to accept or restrict the owner's commercial behaviours. Their views are supported by analogical reasoning based on the case of equity since investors, in both situations, have no direct possession of the assets.

Also, the research shows the AAOIFI acceptance for the lessee, in *sukuk ijara*, to undertake to purchase the assets at their par value, provided that the issuer is not a partner, *mudharib*, or investment agent. The interviews show another view that the purchase undertaking at nominal value is unlawful as it would result in an explicit guarantee of the principal, a point about which there is no doubt concerning its prohibition. However, it is important to note that the scenario of *ijara sukuk* involves the permissibility of purchasing at nominal value, which is different from guaranteeing the principal. The structure of *ijara* can lead to recovery of the initial payment through the purchase undertaking at par value, meaning that if the asset is destroyed there would be no guarantee. However, in these cases, the purchase undertaking does not satisfy AAOIFI standards, since these standards set a number of conditions to permit the undertaking and neither practice complies with the requirements. More importantly, the final purchase is attributed to a one-party undertaking, as the contract of the pledge is binding on the issuer's side since he provides the promise. However, providing a two-party undertaking is illegal, and would turn the contract into an obligation rather than a pledge. In fact, the Sadara structure was more harmonious with Sharia as it provides a one-party undertaking while the SEC provides a two-party undertaking.

Moreover, the study discusses the rental issue, as the AAOIFI assert that the rental has to be paid to the lessor as a strict obligation, and any shortage or delay is not acceptable. However, it is important to note that the amount paid is not a guarantee for *sukuk* returns, but rather it is an obligation on the rental payment under the *ijara* basis. The cases also show an

effective commitment from the issuer to pay the rental and, more importantly, without any guarantee of return. The SEC and Sadara, regardless of advance rental, do not guarantee the rent in cases where their activities do not generate any liquidity. For instance, if total loss occurs to the asset, no rental payment would be distributed to the investors.

In addition, the study highlights that the AAOIFI emphasizes that the responsibility for maintenance and insurance fall under the lessor's liabilities as the owner of the asset. In this respect, the interviews show some practical solutions to overcome this issue. The maintenance costs can be transferred to the issuer through an agreed stipulation, through supplementary payments, or it can be covered by the issuer through the final purchase as a purchase payment. In fact, the SEC *sukuk* transferred the maintenance costs to the issuer as an agent through an agreed stipulation, while Sadara covered them through supplementary payments. The point of transferring these costs is that the property's ownership will be devolved finally to the issuer.

The study highlighted some practical solutions in order to achieve a high level of Sharia-compliant *sukuk* along with a consideration of minimizing the financing costs and maximizing the profits of both parties. Significance is derived from maintaining a commitment to Sharia requirements as well as enhancing the investment allocation to satisfy both spiritual and financial criteria. However, the research concluded that the most critical Sharia issue that remain unsolved is related to ownership. *Sukuk* investors must have complete ownership of the underlying assets throughout the tenure with evidence from proper book entries and relevant documents. This is to give reasonable assurance to the *sukuk*-holders that they will be able to recover a main part of their investment if the originator defaults. Any legal ownership involves authority over the assets; however, the securitized assets do not provide any authority for the investors. For instance, the state of Bahrain tested *ijara sukuk* in 2001, and although it was hugely successful, the major defect was ownership. These *sukuk* are no more than the buying of earnings and returns from shares, which is not legal from the Sharia perspective (Usmani, 2008). Also, the Saudi cases studied prevented investors from having access to their assets, which results in something like a mortgage contract towards the assets rather than ownership. This is because, if the issuer is bankrupted, there is no access to the assets but rather the issuer has to pay the purchase amount as

compensation. At the final stage, bondholders and *sukuk*-holders are treated equally without taking into account the ownership involved, since it is merely fictitious. In fact, this point is evident in the prospectus of Saudi cases, as it describes sukuk as unsecured obligations whose holders have no actual ownership of the assets. However, to achieve a true *sukuk* investment, Saudi applications have to move away from the design of unsecured structures towards secured, asset-backed *sukuk*.

11.3 Concluding Remarks

The research is bounded to investigate three main cases applied in Saudi Arabia. This is because Saudi Arabia is the second largest Islamic finance economy internationally with total assets of $ 270 billion. Also, it has the largest Islamic banking market with assets worth $ 217 billion and also it is home to a number of dedicated Islamic Banks (Zehri & Mbarek, 2016). In the Kingdom, the essential system which should be followed is the Islamic finance system, because it is classified as an Islamic country. Therefore, this market should show better interaction with Sharia principles and standards.

The discussion on Saudi applications adopted agency theory since it provides unprecedented attention on information system, outcomes uncertainty and risk. Agency theory's explanatory power, particularly with regard to relationship dynamics, provides robust basis for recognizing the behaviour surrounding contractual relationships (Fayezi, et al., 2012). This theory is significant for establishing effective management control devices and also has a broad ability to capture different control mechanisms applied in specific structure. Despite, the significance and relevance between this theory and *sukuk* issuances as they structured with one party (the principal) delegates authority in terms of control and decision, this area has not received attention among academic literature.

Moreover, the Sharia dissuasion adopted AAOIFI standards since AAOIFI formulates specific standards for *sukuk* market. AAOIFI governance standards provide detailed guidance on Sharia supervision and compliance performs. More important is that these standards have received a wide acceptance as they are officially adopted by a number of central banks to increase the investor’s confidence. In addition, some countries have been

made them as a part of mandatory regulatory requirement in jurisdictions while others have used them voluntarily as basis of internal guidelines by leading Islamic financial institutions.

Indeed, there are some areas that need further explanation and clarification particularly in term of theoretical framework of the agency theory. In this research, the discussion on agency was limited to asset-backed *sukuk*. This study has examined these *sukuk* focusing on their agency relationship and analysing the issues that may arise and studying their effective management control devices. The investigation can also be carried on other types of *sukuk* that based on debt, services and equity in order to generate further evaluation on different *sukuk* structures. Equally important that the research needs to be further extended by studying the the relation between *sukuk* and other related theory such as stakeholder theory. It is important to discuss stakeholder theory from a broader point of view to explore the implications of the risk-sharing notion within stakeholder oriented theory and to highlight the foundation, significance and relevance of this theory in Islamic economic system and supports that a stakeholder theory has strong roots in the economic system in Islam.

The findings of this research, however, are based on the selection of *sukuk* cases found in Saudi Arabia. It has achieved a determine score to identify each case position in terms of Sharia principles. Given the expansion in the global market for *sukuk* there is a need to examine *sukuk* issuances from Sharia perspective to ensure they maintain their essential requirement. The same method can be applied to evaluate other main cases available in the market to measure their Sharia compliance level since *sukuk* are issued without showing in detail their Sharia issues.

Appendix I: English version of the Interview questions

Interview Questions:

Thank you for agreeing to answer some questions about Islamic finance particularly *sukuk* market. The questions aim to find answers on a determined issue found in some cases of *sukuk*.

1. What is the ruling when the maintenance of *sukuk* assets is borne by the issuer? How can this influence the issuance?

2. What is the ruling if *sukuk* explicitly provide the guarantee of return from the issuer?

3. In the case of insolvency, what is the ruling if investors do not have recourse to their assets?

4. In the case of the assets' deterioration, what is the ruling if the issuer bears the loss instead of investors? How to justify the investors' ownership from Sharia point of view?

5. What is the view in executing a number of contracts in *sukuk* structure?

6. What is the ruling if the *sukuk* transfer the periodical maintenance costs to the investors without specifying any indication of the costs?

7. What is the ruling if the sukuk agent undertakes to pay any shortfall amount to the investors?

8. What is your opinion on not specifying the fees for the agent, how can this influence the total issuance?

9. If *sukuk* involve non-Islamic insurance, how can this affect the issuance?

10. What is the ruling if the excess of the asset's profit is retained by the issuer as incentive fees? What is the Sharia justification for withholding all of the profits from investors?

11. What is the ruling if *sukuk* explicitly provide the guarantee of the principal by the issuer?

12. According to *qabd* (taking into possession), *sukuk* have to include the registration of the asset, which is absent in most of the issuances. What is your view of these *sukuk*?

13. What is the ruling if a *sukuk* investment prospectus/contract does not explain the rights and obligations of all participants?

14. What is your opinion if an issuance of *sukuk* involves a substantial amount of risks that have not been disclosed to the investors?

15. What is your opinion on considering Sharia board approval as a requirement for issuing *sukuk*? What about an issuance with no such approval or approved from only one scholar?

16. What is the ruling if an issuance of *sukuk* contradicts a consensus opinion?

17. Is there a need for *sukuk* for the development of the economy in general and Islamic finance in particular??

18. What are your criticisms of Saudi *sukuk* market?

19. What is your opinion about making the AAOIFI standards obligatory in the *sukuk* market?

Thank you for your time and comments.

Appendix II: Arabic version of the Interview questions

أسـئلـة الـمقابـلـة:

أشكر لكم الموافقة على قبول الإجابة على هذه الأسئلة المتعلقة بمجال التمويل الإسلامي، وخصوصا موضوع الصكوك الإسلامية. تركز هذه الأسئلة على عدد من القضايا التي ظهرت أثناء دراسة عدد من التطبيقات المعاصرة في سوق الصكوك، وهي كالتالي:

1. ما حكم الصكوك التي يكون فيها تكليف المستأجر بالصيانة الأساسية للأصل؟

2. ما حكم الصكوك التي يضمن فيها المصدر قدرا ثابتا من الربح للمستثمر؟

3. في حاله إفلاس الُمصدر للصكوك، هل يحق له أن يمنع المستثمرين من بيع أصولهم؟

4. إذا هلك الأصل كليا، وتحمل المصدر كامل الخسارة عن المستثمرين، فمالحكم برأي فضيلتكم؟

5. ما حكم الصكوك التي تجمع عقدين معا، مثلا عقد البيع، مع عقد الإجارة؟ هل يدخل هذا ضمن النهي عن بيعتين في بيعه؟ معيار الآيوفي (لايجوز التمليك بإبرام عقد البيع مضافا إلى المستقبل، مع إبرام عقد الإجارة)؟

6. ما حكم الصكوك التي تلزم المستأجر بالصيانة التشغيلية، لكن التكلفة يحددها المؤجر في بداية كل عام، هل يعد هذا من الغرر؟

7. ما حكم تعيين وكيل عن المستثمرين في الصكوك، وهذا الوكيل يكون ضامن لرأس المال؟ فهل يجوز الجمع بين الكفالة والوكالة؟

8. ما حكم تعيين وكيل عن المستثمرين في الصكوك، وهذا الوكيل لم تحدد له الأجرة؟ هل يعتبر هذا انتفاء لأحد شروط العقد، وهو العلم بالأجرة؟

9. ما حكم الصكوك التي يكون فيها تأمينا تجاريا غير إسلامي؟

10. إذا اشترط المصدر بأن ما زاد من الأرباح، فهو يعود إليه (بصفته وكيل) لا إلى المستثمرين، فمالحكم فضيلة الشيخ؟

11. ما حكم الصكوك التي يكون فيها ضمان للقيمة الاسمية للصك؟ هل هذا الضمان يحول الصكوك إلى سندات؟

12. ما حكم الصكوك التي لم يحصل فيها تقابض حقيقي للأصل؟

13. مالحكم إذا أخلت نشرة الإصدار بتوضيح كل الالتزامات والحقوق لجميع الأطراف؟

14. ما حكم الصكوك التي يكون فيها قدر عال من الخطورة، ولم توضح هذه الخطورة في العقد، حيث تتعمد بعض الجهات في مرحلة التسويق إبراز الأرباح وعدم ذكر أي نوع من المخاطر؟

15. ما رأي فضيلتكم حول الصكوك التي تصدر من غير الرجوع إلى هيئة شرعية، أو تعتمد على موافقة عالم شرعي واحد لا على هيئة شرعية متعددة الأعضاء؟

16. ما هو حكم الإصدار إذا خالف أحد الأحكام التي أجمع عليها علماء الأمة؟

17. هل هناك حاجة إلى الصكوك من أجل تطوير الاقتصاد عموما، والتمويل الإسلامي على وجه الخصوص؟

18. ما رأي فضيلتكم حول سوق الصكوك الحالي، هل من انتقادات أو اقتراحات للتطوير؟

.19 ما رأي فضيلتكم حول إلزام مُصدري الصكوك بالالتزام بالأحكام الصادرة من هيئة المراجعة والمحاسبة الإسلامية (الآيوفي)؟

أشكر لكم بذل نصحكم ووقتكم الثمين

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