

Shariah Issues in the Application of Repurchase Undertaking in *Sukuk Mudarabah*

Ibraheem Alani Abdulkareem^{1*}, Mohd Sadad Mahmud¹, AbdulFattah AbdulGaniyy² and Ahmad Shukri Yazid¹

¹Faculty of Business and Management, Universiti Sultan Zainal Abidin (UNISZA), 23100, Gong Badak, Terengganu, Malaysia.

²Department of Accountancy, Federal Polytechnic, Kaura Namoda, Zamfara State, Nigeria.

ABSTRACT

The Malaysia Sukuk market has grown quickly over the past two decades which makes it an integral part of the Malaysia capital market. It keeps embracing innovative structure, as underlined by the dispatch of Sukuk utilizing the ideas such as ijarah, salam, musharakah and mudarabah. The higher level of dynamism in the market is reflected by the growth of sophisticated Sukuk arrangements that are now structured-based on numerous Shariah ideas to meet the needs of the customer (Sukuk holders). Owing to the foregoing, the objective of this paper is to show that there are few Shariah issues which require further discussion to guarantee compliance with Shariah (Islamic law). This paper discusses Shariah issues in Sukuk mudarabah and focuses on the application of repurchase undertaking in Sukuk mudarabah structure using Malaysia as a case study. The methodology applied for this study is based on previous studies and literature related to the topic which were gathered from different published articles, reports and several sources. This paper recommends that Shariah scholars across the globe should converge for harmonization of opinion to arrive at a given standard for the operation of Islamic products unification globally.

Keywords: *Sukuk, Mudarabah, Repurchase Undertaking, Shariah.*

1. INTRODUCTION

One of the important products in Islamic finance that has been attracting investors worldwide is *Sukuk*. *Sukuk* signifies one of the most important instruments of Islamic global market (COMCEC, 2018). Primarily, *Sukuk* was introduced to the market as an alternative to conventional bonds which serves the same objective. It is an option for mobilization of fund for long-term saving and investment from numerous investors as conventional bonds. Without mincing-words, *Sukuk* is required to be Shariah-compliant. Many countries have embraced *Sukuk* for the growth of infrastructure and development. The United Arab Emirate (UAE), Malaysia, Bahrain, United Kingdom (UK), Qatar and United State (US) are countries that are in the forefront of *Sukuk* application in their infrastructure growth and development (AbdulKareem and Mahmud, 2019; Abdul Rahim, 2013; Abdelkafi and Bedoui, 2016). The active *Sukuk* market development is essential in providing funds for the government, corporate and private entities. *Sukuk* market permits a fundraising entity to reach a broader investor base, thus, provides a larger funding amount at a competitive rate with government support as a result of tax incentive and other advantages for the *Sukuk* issuance (Abdul Rahim, 2013). On the side of the *Sukuk* structure, the global *Sukuk* market has continued to embrace new innovative in *Sukuk*, launching of various products of *Sukuk*. The most widely used *Sukuk* structures in the

*Correponding Author: ibraheemalani1@yahoo.com

market are *Ijarah Sukuk*, *Murabaha Sukuk*, *Istisna Sukuk*, *Mudarabah Sukuk*, *Sukuk Salam* and *Sukuk Musharakah* (Ahmed, Islam and Alabdullah, 2014).

According to Erkan and Altinay (2019), *Sukuk* has been recognized as the greatest Islamic finance product in the global market. Moreover, it accrues more funds across borders than what is obtainable in the local markets. Therefore, many countries are enjoined to embrace *Sukuk* for their development and growth programmes. After embracing *Sukuk*, these countries can extend Islamic finance functions by given it a universal development. *Sukuk* investment requires a fixed return with less risk and it should be *Shariah*-compliant. In addition, *Sukuk* ought to be issued for new industrial projects. If *Sukuk* is issued for businesses, it must be certified that the holders have complete ownership in real assets (Ahmed, Islam and Alabdullah, 2014). *Sukuk* is a financial tool that is utilized for raising funds and resource mobilization for both public and private segment. Even though the improvement of *Sukuk* market is a significant achievement, some structures were attempted to act and achieve the same economic objective as conventional bonds which compromise *Shariah* principles (IFN, 2016; Mohd, Hafizi and Shahida, 2010). Therefore, this paper sheds light on *Shariah* issues that have been raised in *Sukuk* structure especially with regards to the application of repurchase undertaking under *Sukuk* *mudarabah*. Notwithstanding, this paper focuses only on Malaysia's *Sukuk* structure and would not make a comparison with *Sukuk* structures in other countries. The analysis of the above *Shariah* issues also refers to the Principal Term and Conditions of Sunway Treasury *Sukuk* which is already offered in the Malaysia market.

2. METHODOLOGY

The methodology utilized in this study is a qualitative approach attempting to explore *Shariah* issues in the application of repurchase undertaking in *Sukuk mudarabah* in line with the objective of this research. This research paper focuses on the review of previous literature on the concept of *Shariah* issues governing the application of *Sukuk mudarabah*. The study gathered information from different published articles, reports and several sources that have discussed intensively the concept of *Sukuk*. As stated earlier, the focus of this study is on *Shariah* issues guiding the operation of *Sukuk mudarabah* and criticism against the application of repurchase undertaking arrangement.

3. THE CONCEPT OF SUKUK

At the inception of *Sukuk* into the market, *Sukuk* was often referred to as Islamic bonds. The term, Islamic bond gives the notion that *Sukuk* is synonymous to conventional bonds. However, the structures are unlike bonds and the structure of *Sukuk* requires *Shariah*-compliant with underlying assets. At the moment, the term *Sukuk* is not associated with the bond but it is *Shariah*-compliant financial certificate. Historically, *Sukuk* can be traced back to the period of Second Caliph Muslim, Umar bin Al-Khattab (May Allah bless him). During his lifetime, the selling of *Sukuk* was reported during the reign of Caliph Marwan bin Al-Hakam which was mentioned in *Al-Mawatta*, a famous book authored by Imam Malik (Abdul Rahim, 2013; ISAR, 2017; Zulkhibri, 2015). Furthermore, *Sukuk* originated from word of (صكوك) and its plural form is (صك) which means "Certificate, Islamic Investment Certificate and Legal Instrument". *Sukuk* is a form of conventional bonds that depend on profit and loss sharing among investors instead of giving a stable return to its investors (ISRA, 2017; Onagun, 2016).

The concept of *Sukuk* has been viewed differently by Islamic financial institutions (IFIs) and Islamic authorities. To attest to this, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines *Sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or; of the assets of a

particular project or specific investment activity” (AAOIFI, 2018; p. 468). The Islamic Financial Services Board (IFSB) defines *Sukuk* as “Certificates that represent proportional undivided ownership right intangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Shariah-compliant” (IFSB, 2018; p. 1).

In addition to the aforementioned, the Securities Commission Malaysia (SCM) defined *Sukuk* as a “financial document or certificate which represents the value of an asset evidencing an undivided pro-rata ownership of an underlying asset” (Ahmad and Abd Rahim, 2013, p.87). On the final note in presenting the definition of *Sukuk*, the International Islamic Financial Market (IIFM) stated that “*Sukuk* is an investment certificate of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity” (IIFM, 2015; p.4). To further elaborate on the concept of *Sukuk*, it enjoys the benefit of backing by the underlying asset, thereby providing for the investors or *Sukuk* holders certain protection which may not be available in conventional bonds (Dusuki, 2010). Although a general starting point in differentiating bond and *Sukuk* is to clarify the Shariah perspective, it is essential to discover the fundamental comparison between *Sukuk* and bonds instruments. It is comprehended that *Sukuk* is in tandem with Shariah laws, however, the conventional bond is unquestionably an interest-based (*riba*) in nature, owing to the fixed interest accrued to it (Ahmad, Ripain, Bahari and Shahar, 2015). Table 1.1 shows the general comparison between bond and *Sukuk*.

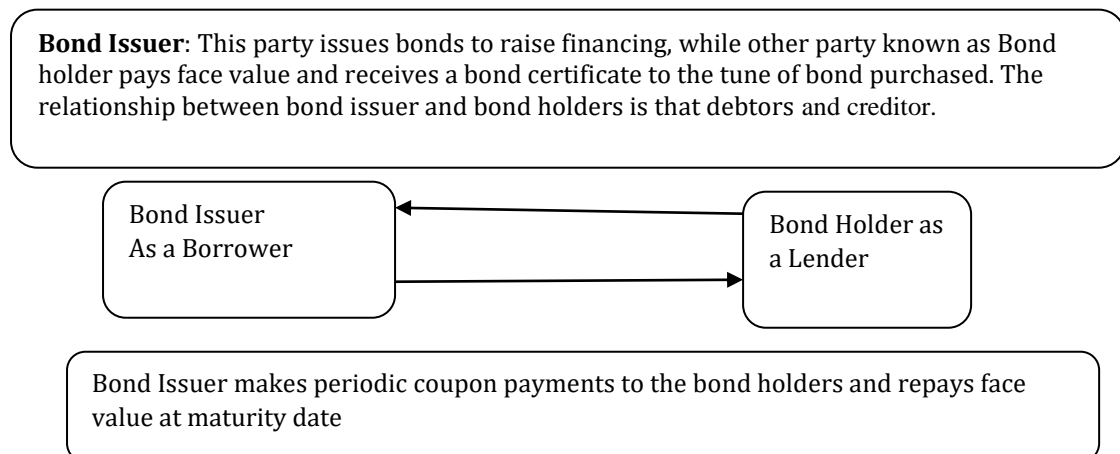
Table 1 Essential Differences between Bond and *Sukuk*

Bonds	<i>Sukuk</i>
Bonds represent a debt obligation.	<i>Sukuk</i> represents ownership of <i>Sukuk</i> asset.
The underlying asset of bonds may not comply with the principle of Shariah.	The underlying asset of <i>Sukuk</i> is compliant with the principle of Shariah.
Pricing of the bond is based on credit rating.	Pricing of <i>Sukuk</i> is rated by the value of the underlying asset that backs it.
The profits accrued from bonds correspond to fixed interest making it <i>riba</i> .	Profit of <i>Sukuk</i> can increase in value when the underlying asset of <i>Sukuk</i> increases in value.
Selling of bonds is the sale of debt.	Selling of <i>Sukuk</i> is selling the ownership of an underlying asset that backs the <i>Sukuk</i> .

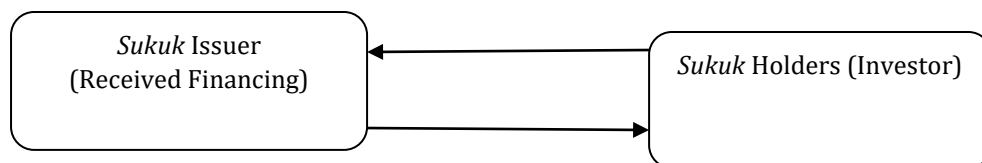
Source: ISRA, (2017), Ahmad, *et al* (2015).

Figure 1 presents the major differences in the relationship between the bondholder and the bond issuer as compared with *Sukuk* itself. It further reveals that bonds utilize a contract of loan to establish indebtedness between bondholder and bond issuer while *Sukuk* contains a category of contracts to create financial obligations between *Sukuk* holders and *Sukuk* issuer.

Bond: Lending Relationship



Sukuk: Relationship-based on Shariah Contracts such as Sale, Lease, Agency, and Partnership



ISRA (2017).

Figure 1. Diagrammatically Presentation of the Relationship between *Sukuk*/bonds Issuer and the *Sukuk*/bondholders.

3.1 The *Sukuk* Classifications

Sukuk can be categorized based on the underlying assets of contractual structures. All *Sukuk* represents a form of equity as they provide certificates of ownership of an asset or a pool of assets or claim cash flows to *Sukuk* holders. In practical term, *Sukuk* is categorised according to their risk and reward-related to the structure and profit, therefore, they are categorized into debt-based, lease-based, partnership-based, hybrid-based (which contain both equity and debt) and agency *Sukuk*. The total of *Sukuk* structures so far has reached 14 types, as recorded by AAOIFI (2003) Shariah standard 17 (ISRA, 2017, Safari, 2013). The purpose of this paper is not to elaborate in detail on every class of *Sukuk*, its structure and Shariah principle application. Rather, the key objective of this paper is to elaborate and discuss Shariah issues under *Sukuk mudarabah* in Malaysia context.

Sukuk mudarabah played an important role in domestic *Sukuk* where it ranked as the second-largest *Sukuk* that has been structured around the world. *Sukuk mudarabah* is an equity-based *Sukuk* where profits and losses were shared between contractual parties. Moreover, investment from a Shariah perspective does not permit a fixed return as well as assurance principal amount invested at maturity date to the *Sukuk* holders. Moreover, in the matter of repurchase undertaking, as far as Shariah issue is concerned, discussions about the application of repurchase undertaking between *Sukuk* issuer and *Sukuk* holders are ongoing. The next section discusses the detail clarification of *Sukuk mudarabah* structure.

4. SUKUK MUDARABAH

Sukuk mudarabah refers to the certificate in which one of the partners as an entrepreneur is assigned to manage the activities or operation of *Sukuk*. The agreement is achieved when it comes to *Sukuk mudarabah* which occurs between the two parties. One of the two parties will provide the capital (*Rab-al mal*), while the other serves as an entrepreneur is referred to as (*mudharib*) who works with the laid down condition to ensure that the benefits ought to be shared between the two parties based on a predetermined ratio. The entrepreneur (*mudharib*) is the certificate issuer. The subscribers are the capital providers and the realised funds are the *mudarabah* principal. The certificate holder will hold a *mudarabah* asset (Sapuan, 2016). In addition, it is agreed that, if any, the share of losses and profits are borne by the capital provider only. Besides, the *Sukuk* holder as the owner of *Sukuk mudarabah* has the right to get his/her capital. A yearly percentage of the profits realised are given to the entrepreneur based on the agreement stipulated in the contract (Biancone and Shakhathreh, 2015).

Furthermore, *Sukuk mudarabah* represents the most common ownership and entitle their holders for shares in a certain project for which the *Sukuk* have been issued to finance. In addition, the *Sukuk* holder is qualified for all rights, which have been described by Shariah upon his ownership for *mudarabah Sukuk* in matters of the mortgage, sale, succession, gift, and others (Kamil, Abdullah, Shahimi and Ismail, 2010). To elucidate further, *Sukuk mudarabah* is an investment *Sukuk* that represents common ownership of a unit or equivalent value in the *mudarabah* equity. Therefore, in any *Sukuk* financed project, owners are qualified to hold a share. Moreover, *Sukuk* holders have the right to exchange the ownership of an asset by an offer for sale or trading in the security market at the point when the predefined period of expiration of the subscription (ISRA, 2011; Lahsasna, Hassan and Ahmad, 2018).

Safian (2017) stated that *mudarabah* is profit and loss sharing idea which is regarded as a legitimate alternative for Muslim customers as both the customer and Islamic finance institutions work together as a partner. He stressed further that a party would contribute the capital while the other party utilizes that capital to make a profit. The profit earned from the venture is divided between the customer and the Islamic finance institution. This idea is unanimously satisfactory by all Muslim scholars and henceforth it becomes the most common Islamic financial product.

More so, the SCM (2004) defines *Sukuk mudarabah* as:

“A contract which is made between two parties to finance a business venture. The parties are a rabbi al-mal or an investor who solely provides the capital and a mudharib or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital” (SCM, 2004, p. 3).

Furthermore, AAOIFI categorized *mudarabah Sukuk* as a certificate that represents ownership of units of equal value in *mudarabah* equity and registered in the names of *Sukuk* holders based on undivided ownership of shares in *mudarabah* equity and its profits is shared according to the percentage of ownership. This type of *Sukuk* gives its owner the privilege to get his capital at the time *Sukuk* is redeemed and a yearly portion of the realized profits as acknowledged in the issuance book (ISRA, 2011; Yusoff, Kamdari and Malik, 2016). Even though *Sukuk mudarabah* is a partnership contract that is proof by the issuance of certificates, an investor does not enjoy the same benefit and rights as equity holders, as the former is just qualified for a benefit share. Besides that, they also cannot participate in the meeting and allow to cast vote at the annual general meeting. The capital contributed can be either in cash or kind. If the capital contributed

is in kind, it ought to be valued in monetary terms at the time of entering into the contract. The investor is not allowed to utilize debt claimed by time as his capital contribution. *Sukuk mudarabah* has been utilized and commonly recognized in the capital market for quite a while due to its straightforwardness which makes it friendly to both issuers and investors, especially those issuers without an asset base can be readily utilized as an underlying *Sukuk* asset (ISRA, 2017; Safari, Ariff and Mohamad, 2014; SA'AD, 2018). Thus, Figure 2 below shows the structure of the *Sukuk mudarabah*.

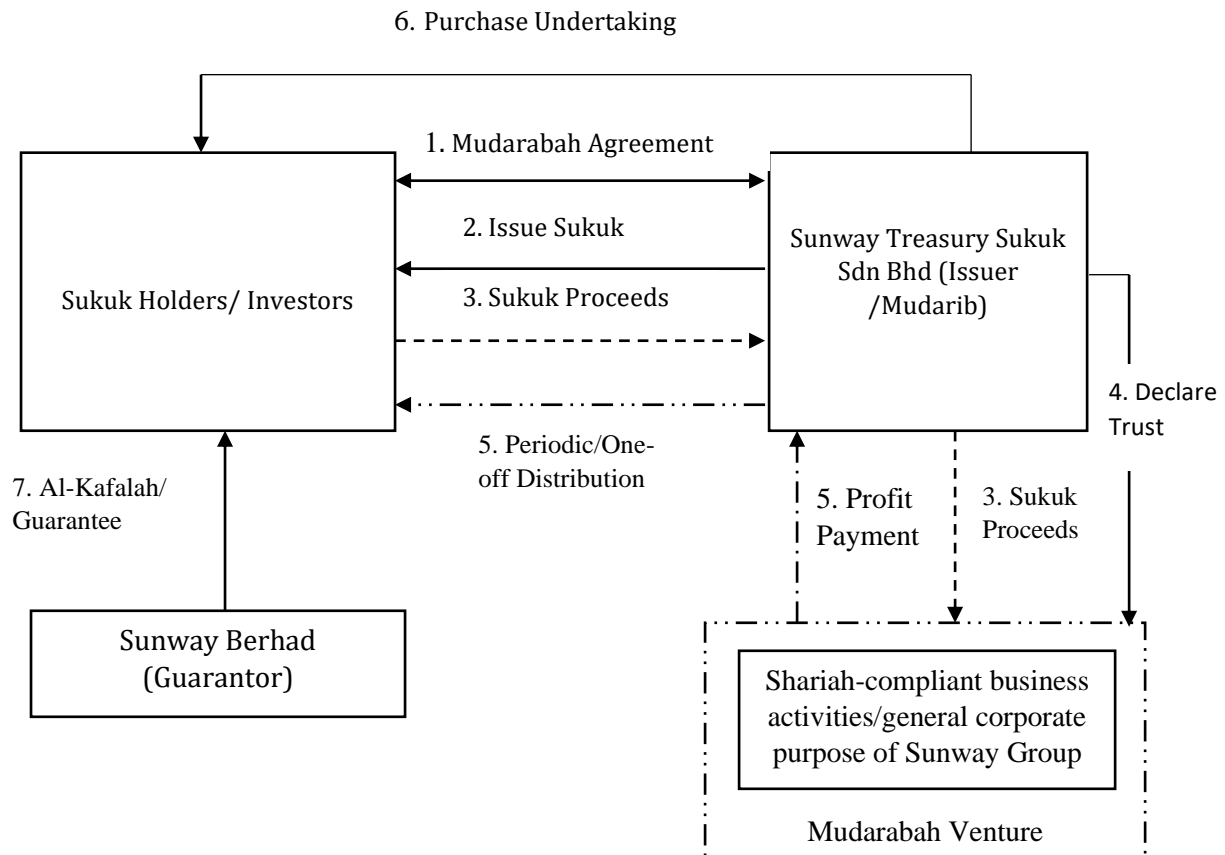


Figure 2. Sunway *Sukuk Mudarabah* structure.

Source: Uddin, Sultan, Hosen & Ullah (2015).

Steps involved in Sunway *Sukuk* structure.

- i. Setting up a *mudarabah* venture, the issuer shall invite *Sukuk* holders to participate in *mudarabah* venture. Under this venture, the issuer shall be the entrepreneur (*mudarib*) whereas *Sukuk* holders shall be the capital provider (*rabul al-mal*).
- ii. The issuer shall issue *Sukuk mudarabah* to the *Sukuk* holders.
- iii. Proceeds from *Sukuk mudarabah* represent 100% of *Sukuk* holder's capital contributed to the venture.
- iv. The issuer shall subsequently make a declaration of trust ("Declaration of Trust") over the undivided rights and entitlement of *Sukuk* holders under the *mudarabah* venture ("Trust Assets") for the benefit of the *Sukuk* holders. The *Sukuk mudarabah* hence represents each of the *Sukuk* holders undivided beneficial interests in the *mudarabah* venture.

- v. Profit generated from the *mudarabah* project will be shared and distributed between capital provider and entrepreneur according to a pre-agreed sharing ratio (PSR) of 99:1, while losses will be borne solely by the capital provider. In respect of *Sukuk mudarabah* with periodic distributions, the payment of profit shall be distributed semi-annually or such other period to be agreed ("Periodic Distribution (s)") to the *Sukuk* holders. In respect of *Sukuk mudarabah* without Periodic Distribution(s), the payment of profit shall be distributed to the *Sukuk* holders on a one-off basis (the "One-off Distribution") on the respective maturity dates of such *Sukuk mudarabah*.
- vi. The issuer shall undertake to purchase the Trust Assets from the Trustee (who is acting on behalf of *Sukuk* holders via a purchase undertaking upon the occurrence of the earlier of the respective maturity dates of *Sukuk mudarabah* or declaration of a Dissolution Event or on Early Redemption.
- vii. Sunway Berhad (as "Guarantor") shall guarantee the obligation of the issuer under the purchase undertaking. The guarantor shall enter into a separate *Kafalah* Agreement with the issuer to provide the guarantee, which is an independent arrangement from *mudarabah* agreement (Uddin *et al.*, 2015).

4.1. Criticism Against Repurchase Undertaking In *Sukuk Mudarabah*

Repurchase undertaking is a promise or agreement made between the two parties involved i.e. (the issuer and the *Sukuk* holders) to buy the underlying asset of *Sukuk*. However, this repurchase undertaking has been criticised by some Islamic Shariah scholars. Some of the complaints against the *Sukuk mudarabah* are the issue of its repurchase undertaking. Utilizing repurchase undertaking might be viewed as an element of capital guarantee. The issuer makes the obligation to purchase an underlying asset of *Sukuk* holders in the project at the same price to the capital invested by the *Sukuk* holder. Contrarily, this practice has been viewed as controversial given that repurchase undertaking practice is like a guarantee of the capital invested by the *Sukuk* holders which are not permitted in Shariah bearing in mind the nature of this contract (Van Wijnbergen and Zaheer 2013; Zakaria and Aziz, 2013).

Nevertheless, taking the practice of *Sukuk* in Malaysia as an example considering the issues that require clarification, it is worth to mention that most of the *Sukuk* issued in Malaysia must obtain approval by Shariah Advisory Council (SAC) and SCM before the public offer is made. Though, authors are not condemning those *Sukuk* issued in the country positing that it does not go in line with the Shariah principle, but there are still critical areas where Islamic scholars have divergence opinions.

Dusuki (2010) stated that repurchase undertaking is another formula whereby the issuer will make a promise that in the event of default or maturity such will repurchase the underlying asset of *Sukuk* back from *Sukuk* holders at a face value irrespective of whether the asset value exceeds face value or not. For instance, if the *Sukuk* was issued at RM700 million and the profit expected is 5% each year with five years of maturity. At the end of fifth years maturity, the issuer will repurchase the underlying asset of *Sukuk* back from *Sukuk* holder at the original price of (RM700 million) plus 5% return. Dusuki (2010) further observes that utilizing the strategy of repurchase undertaking in *Sukuk* structure resembles the features of conventional bonds which does not conform with the objective of Shariah. Based on AAOIFI declaration, it is improper for the *mudarib* to commit to repurchase asset at face value unless in the case of *mudarib* negligence or breach of contract condition thus makes it a permissible. The alternative is that repurchase must be undertaken at market value or agreed with price at the time of repurchase by the issuer (Elmalki and Dennis, 2010).

Dusuki and Mokhtar (2010) examined that purchase undertaking issue in asset-based *Sukuk* is an assurance of capital plus unpaid profit for the *Sukuk* holder. He further postulated that when promise considered an independent element in *Sukuk*, at this point it fulfils the Shariah

prerequisites. *Sukuk mudarabah* is based on a structure where profits and losses are shared between investors and issuers. Furthermore, this investment from the Shariah perspective does not permit a fixed return as well as the guarantee of the capital at the maturity of the investment, thus the periodic returns were always fixed. Furthermore, in the case where the expected return realized is less than what is expected, the issuer will provide fund, whereas when the expected profit exceeds the expectation, then the issuer would take it as an incentive. These characteristics are against the concepts and nature of *mudarabah* where losses were to be borne by the issuer (Razak, Saiti and Dinc, 2019).

In the Malaysia context, it is acceptable to undertake repurchase of an underlying asset of *Sukuk* from *Sukuk* holders or whoever holds it at nominal value. This is based on *Sukuk mudarabah* which is issued in the country with repurchase undertaking are being at nominal value (Saripudin, Mohamad, Razif, Abdullah and Rahman, 2012). Arguably, Malaysia position on the repurchase undertaking revealed that in *Sukuk* transaction, a purchase undertaking is a guarantee made by the issuer or originator to repurchase the asset upon the maturity date or any default event. The objective is to give a greater score in credit ratings so that the investors will be sure to invest because of that guarantee. It further suffices that the investors will not be reluctant to invest their capital since they will realize their invested sum back at the maturity date by the purchase undertaking through either issuer or originator. The purchase undertaking is an essential rating factor in *Sukuk* transaction as it changes the risk associated with the transaction and fundamental shifts the credit risk driver to the entity providing the undertaking (Saiti, Wahab and Ahmad, 2017; Saripudin *et al.*, 2012). However, it is not acceptable for the *mudharib* to repurchase the underlying asset of *Sukuk* from *Sukuk* holders or whoever holds it at the nominal value at the end of maturity. Contrary to the Malaysia view stated above, another school of thought has it that, to be acceptable to undertake the underlying asset of *Sukuk* at fair value, net value, market value or price that is agreed by both parties at the time of actual purchase according to the AAOIFI Shariah standard (Dhiraj, Nazarov, Ahmat and Arif, 2019; Radzi, 2018).

5. CONCLUSION AND RECOMMENDATION

From the above discussion, one can summarize that despite the development and growth of *Sukuk* market worldwide, there is no doubt that there are still controversial issues that require quick resolution to sustain growth and development of *Sukuk* market industry. There is a need for cooperation among Shariah scholars and Islamic financial experts; more so discussion and interaction among Shariah boards on either side is sought. This is essential to certify that Islamic finance products will be internationally accepted by not only Muslim countries but also by non-Muslim countries. This will also make Malaysia the hub for Islamic finance in the world for many years a reality. In addition, it is observed that from different schools of thought, educational background, culture, and environment in areas Shariah scholar operate and legal/authority requirement in different jurisdiction create divergent opinions among Shariah scholars in one Shariah issue. In addition, it also makes it difficult for investors and public to differentiate *Sukuk* and conventional bonds in the market. This creates a negative effect on the growth of *Sukuk* worldwide. We additionally observed that there are opportunities when there is a convergence of these opinions among Shariah scholars, harmonization of Islamic finance products and services if all Islamic countries can create a unified global international Shariah advisory council to set up international basic requirements for Islamic finance in their respective countries/state level, create international researchers and development centre in the field of Islamic finance which would educate and serves as the training ground for Islamic bankers.

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