

Financial Sukuk: Concept, Legal Principles, and Types

Abstract

Sukuk, often referred to as Islamic bonds, represent a unique and innovative financial instrument within the realm of Islamic finance. Originating from the principles of Shariah law, Sukuk offer a distinct alternative to conventional bonds by adhering to Islamic principles that prohibit the payment or receipt of interest (Riba). Instead of interest-bearing debt, Sukuk are structured as investment certificates, granting investors a share in the ownership of tangible assets or services. This adherence to Shariah principles ensures that Sukuk are compatible with Islamic ethical and legal standards, attracting a diverse range of investors seeking financial instruments aligned with their religious beliefs. As Sukuk continue to gain prominence in global financial markets, they contribute to the development of more inclusive and diverse investment options, catering to both Islamic and non-Islamic investors alike. This research paper presents a thorough literature review of Sukuk in the Islamic economy and showcases their definition, typologies and other aspects. Sukuk, often referred to as Islamic bonds, play a significant role in the Islamic economy. These financial instruments comply with Islamic law (Shariah) principles, which prohibit the payment or receipt of interest (Riba) and promote risk-sharing and asset backing. Sukuk provide an alternative means for raising capital that aligns with Islamic finance principles. The study herein is of significance for researcher as well as postgraduate researchers in the areas of Islamic banking, economy studies and accounting.

Keywords

Finance, Islamic banking, Riba, Shariah, Sukuk.

Introduction

In language, "Sukuk" is the plural form of "Sakk," which refers to a document representing money or the like. In Arabic, it is said, "Sakkaha Sakkā," meaning to forcefully push or pay. In the Quran: "(So his wife approached with a cry and struck her face.)" - meaning she struck it in amazement. "Sakat al-bab" means to close the door. "Sakk" is an Arabic term referring to a document representing money or the like. Sukuk can be defined as: "Securities with a specific duration representing common shares in the ownership of assets, benefits, or services, granting their owner benefits and carrying responsibilities proportionate to their ownership". The definition begins by stating that Sukuk are a type of securities, eliminating the need to list the characteristics of securities in the definition, as brevity is essential. Among the prominent characteristics of securities, including Sukuk, are:

- Equal value at issuance: Sukuk have equal value when issued. This principle leads to equality in the rights granted by Sukuk, such as equal distribution of profits and equal obligations imposed by the Sukuk on their owner.
- Non-divisibility: Sukuk cannot be divided. This means that the ownership of a single Sukuk cannot be divided among multiple owners in the face of the issuer. If two or more individuals share ownership of a Sukuk due to inheritance, gift, or will, this shared ownership is not valid in the face of the issuer. Therefore, Sukuk owners must choose one representative to act on their behalf with official authorities. This representative assumes the rights associated with the Sukuk towards the issuer and is considered the sole owner of the Sukuk in dealings with the issuer.
- Tradability: This is one of the most important characteristics of Sukuk. This feature provides great flexibility to Sukuk in the financial markets, allowing the owner the freedom to transfer ownership to others. It facilitates easy liquidity without the need for acceptance or approval from the issuer or other governmental entities.
- Specific Duration: This term restricts shares, as shares are financial instruments with an unspecified duration. It's worth noting that this restriction does not apply to all types of

Sukuk in the market, although they represent a small percentage of the overall Sukuk market and are not of a specified duration at issuance.

- Representing common shares in the ownership of assets, benefits, or services, or a mixture thereof: This term excludes bonds, as bonds represent a debt obligation of the issuer.

The statement that Sukuk represent a common share in an asset, benefit, service, or a mixture thereof encompasses various types of Sukuk, such as lease-based Sukuk, investment agency Sukuk, and others. The assets of these Sukuk do not deviate from what is mentioned in this provision.

"Granting their owner benefits and carrying responsibilities proportionate to their ownership": This part of the definition explains the essence of Sukuk and their reality. The ownership of the Sukuk holder in a shared portion of an asset, benefit, service, or a mixture thereof aims to obtain returns resulting from this ownership. This ownership, being in a legal document and not an usurious bond, grants its holder the right to receive profits. However, it also imposes on the holder the responsibilities and duties arising from this ownership.

Overview of Sukuk

Characteristics of Islamic Sukuk

Islamic Sukuk have distinctive features compared to other Sukuk. These general characteristics can be clarified as follows:

- Sukuk are documents issued in the name of their owner in equal value categories to prove their ownership rights in the assets issued through them.
- The trading of Sukuk is based on the conditions and Shariah regulations for trading in assets, benefits, and services represented by Sukuk.

- Sukuk represent common ownership shares in existing assets or those to be found, benefits, or services, and do not represent a debt on their issuer.
- Islamic investment Sukuk give their holder a share of the profit if it exists.
- Islamic investment Sukuk obligate their owner to bear the full risks of the investment.
- Islamic investment Sukuk allocate the proceeds of issuance to invest in projects or activities in accordance with the provisions of Islamic Shariah, usually predetermined.
- Sukuk are based on a legal contract that frames the relationship between the parties involved in the securitization process.

Types of Financial Sukuk and Their Rulings

Sukuk come in various types, and different structures can be synthesized to create new formats that align with Islamic Shariah principles. The Islamic Financial Institutions Review Board has identified fourteen types. Some of the types include:

1. **Ijarah Sukuk:** Ijarah Sukuk pertain to leased assets and carry equal values. They are issued by the owner of the leased property or their agent. The transaction involves selling the leased asset through Sukuk, making the holders both owners of the asset and beneficiaries of the rental income, proportional to the Sukuk portions each holds.

For example, a leased building generates monthly or yearly income, constituting the return for Sukuk holders who are considered partners in the ownership of the building. Additionally, Sukuk holders have the flexibility to sell their Sukuk. The value of the Sukuk depends on market factors such as supply and demand dynamics.

- **Supply and Demand Forces:** The value of the leased asset is influenced by supply and demand for that service in the market. If the demand for the service exceeds the supply rate, it leads to an increase in the value of the Sukuk, and vice versa.

- **Asset Lifespan:** The value of the asset is affected by its assumed lifespan or the remaining lease period. The shorter the remaining period, the lower the Sukuk value. The remaining duration influences the Sukuk value if the rate of increase in the service's value is greater than the rate of depreciation due to the expiration of part of the asset's life.
 - **Asset Performance Efficiency:** The efficiency of the asset's performance affects the Sukuk value and market price. Higher efficiency increases the Sukuk value, while lower efficiency has the opposite effect.
2. **Munafa'at Sukuk:** Munafa'at Sukuk carry equal values issued by the owner, lessee, or their agent for a specified asset in the possession or benefit of which the Sukuk holders are promised during the Sukuk's validity period. The Sukuk holders have the right to the revenue generated from leasing the service during the Sukuk's validity period.
 3. **Promised Benefits Sukuk for Designated Assets (Described in the Promise):** These Sukuk carry equal values and are issued by the owner, lessee, or their agent for a designated asset, with a promise to lease the asset. The Sukuk are issued at the moment of the promise to lease in the future, based on the principle that believers are bound by their conditions unless something forbidden is legalized, and the price is advanced in the contract for a described asset and a future date.
 4. **Service Sukuk from the Contractor:** These Sukuk carry equal values issued by a contractor committed to providing or selling described services. The services are sold in the form of Sukuk, making the holders owners of those services and earning returns from their sale in the markets. An example is providing educational or health programs in universities or hospitals. Sukuk holders contribute to financing educational or health programs until they are ready for beneficiaries, such as students or patients. The proceeds from selling these programs to beneficiaries constitute the return for Sukuk holders.
 5. **Available Services Sukuk:** These Sukuk carry equal values issued by a contractor or their agent who has available services for sale to Sukuk holders. The owners have the right to sell these services.

6. **Salam Sukuk:** Salam Sukuk carry equal values issued by a seller of Salam products or their agent. The capital for the Salam is obtained, making the Salam commodity owned by the Sukuk holders. The full value of the agreed-upon commodity is paid in advance for future delivery, based on agreed-upon time and specifications. Providing full financing to the producer helps in funding production operations, ensuring the supply side of the commodity, and reducing the price on the demand side. This contributes to economic prosperity by increasing production and lowering prices, benefiting both the buyer and the seller. There is also what is called parallel Salam, where the buyer contracts with another party to sell the agreed-upon product in the initial Salam agreement.
7. **Manufacturing Sukuk:** Manufacturing Sukuk carry equal values issued by the manufacturer, contractor, or their agent for a specified product in the promise. The issuer receives the Sukuk's value and proceeds to manufacture the product according to agreed-upon specifications, delivering it within the specified period. Different financing structures, such as installment payments, can be arranged between the manufacturer and the issuer. The Sukuk holders become owners of the manufactured product. The concept of parallel manufacturing exists, where the contractor contracts with another party to manufacture a product for them. The contractor then delivers the required product to the buyer at the agreed-upon time.
8. **Murabaha Sukuk:** Murabaha Sukuk carry equal values issued by a trader or their agent for the purpose of purchasing a certain commodity, then selling it with a known markup, such as equipment needed within a manufacturing contract. For example, machinery is purchased through Murabaha, and the Sukuk holders become the owners of the equipment. The selling price is determined with a Murabaha markup.
9. **Participation Sukuk:** Participation Sukuk carry equal values issued by the contractor or their agent to fund a project or projects. Sukuk holders become owners of these projects, similar to shareholders in joint-stock companies. This type is similar to conventional equity financing.
10. **Mudaraba Sukuk:** Mudaraba Sukuk carry equal values issued by the organizer for the

purpose of organizing and managing a proposed project for funding. Sukuk holders become capital owners in the project, and the project remains a partnership between them and the organizer. Profit and losses are shared based on agreed-upon percentages.

11. **Muzara'a Sukuk:** Muzara'a Sukuk carry equal values issued by the owner of agricultural land to finance the costs of cultivation under a sharecropping agreement. Sukuk holders share in the produced crops based on the agreement stipulated in the contract.
12. **Musaka'a Sukuk:** Musaka'a Sukuk carry equal values issued by the owner of trees under a contract for financing irrigation and care. Sukuk holders share in the produced crops under the Musaka'a contract.
13. **Participation Sukuk in Investment Agency:** Participation Sukuk carry equal values issued by an investment agent, representing projects or activities assigned to the investment agent as a Mudarib. The agent manages the investment on behalf of Sukuk holders, receiving a percentage of the profit.
14. **Mugharasa Sukuk:** Mugharasa Sukuk carry equal values issued by the landowner under a cultivation contract to finance the costs of planting. Sukuk holders share in the trees that have been planted and in the land where the planting has taken place according to the terms of the contract.
15. **Diminishing Ownership Sukuk for Assets and Services:** Diminishing Ownership Sukuk for assets and services carry equal values issued by the idea owner under a construction contract to finance a project. The arrangement concludes with the ownership of assets or services being transferred to the idea owners or founding partners after a specified period. The idea owners become partners in the project, either through labor, capital, or a combination of both. The partner may be an active participant entitled to compensation for their work or a working partner who starts repaying the project's value to Sukuk holders from their share of the profit. In this way, the share of Sukuk holders diminishes, and the working partner's share increases as they repay, ultimately leading to the ownership of the asset or service. This structure combines elements of Mudarabah

and diminishing partnership or ownership Sukuk. It integrates features of leasing Sukuk for a specified period for assets or services.

These examples illustrate additional Sukuk types, each serving specific purposes within the framework of Islamic finance. It's important to note that these descriptions provide a broad overview, and the actual structures may involve additional details and considerations. Additional Sukuk types further demonstrate the versatility of Islamic finance instruments, catering to various financing needs while adhering to Sharia principles. Keep in mind that the specific details and structures may vary based on legal and market considerations.

1. First Rule: Common Ownership:

- Sukuk represent a common share in the project for which they were issued for construction or financing.
- This ownership continues throughout the project and includes all rights and actions stipulated by Sharia for the owner.

2. Second Rule: Contract Terms:

- Contract terms are defined in the issuance prospectus.
- Subscription represents the positive act, and acceptance represents the approval of the issuing party.

3. Issuance Prospectus:

- The issuance prospectus must include all required data according to Sharia in the contract represented by the sukuk.
- All conditions must comply with Sharia provisions.

4. Third Rule: Tradable Nature:

- It is preferable for sukuk to be tradable after the specified subscription period.

- Trading cases vary based on the nature of the components, whether pure cash or a mixture of assets, cash, and debts.

5. Trading in the Case of Predominance of Cash and Debts:

- A decision regarding this case has not been issued yet and has been postponed pending the release of explanatory regulations.
- There is disagreement among scholars and researchers regarding the Sharia rules and guidelines in this case.

First Rule: Trading Sukuk:

In the case where the assets of sukuk consist of goods, benefits, cash, or debts, or a mixture of them with the predominance of goods and benefits, there is consensus among jurists and Islamic economists on the permissibility of trading in this situation. The details are as follows:

1. Trading Sukuk with Predominance of Cash:

- If the proceeds of the sukuk intended for trading remain as cash and have not been used for the purchase of goods or benefits, selling them in this situation is conditional on meeting the conditions of exchange, such as consensus in the council and equivalence between the selling price and the face value of the sukuk. This is because, at this stage, sukuk still represent cash.

2. Trading Sukuk with Goods and Benefits:

- If the assets of sukuk are goods, benefits, or a mixture of cash, debts, goods, and benefits, with the predominance of goods and benefits, trading is permissible in this case under normal sale conditions.

3. Trading Sukuk with Specified Goods in Debt:

- If sukuk represent goods specified in a debt, trading is not permissible in this case because it involves selling something not yet acquired.

4. Trading Sukuk with Pure Debts:

- If the sukuk assets, after being sold, turn into pure debts, dealing with them is subject to the rules of trading in debts. Selling them is allowed only after meeting the conditions for selling debt.

5. Trading Sukuk with a Mixture of Cash, Debts, Goods, and Benefits, with Predominance of Goods and Benefits:

- If the assets are a mixture of cash, debts, goods, and benefits, with the predominance of goods and benefits, trading is permissible, similar to the case where sukuk represent goods or benefits.

In conclusion, the permissibility of trading sukuk depends on the nature of the assets, and the scholars have provided clear guidelines for each situation, ensuring compliance with Sharia principles.

The ruling on trading in sukuk, when its components consist of a mixture of cash, debts, assets, and benefits, with predominance of cash and debts, has been a matter of debate. It has been previously stated that the previous decision of the council deferred the ruling on whether the components of stocks or sukuk become a mixture of cash, debts, assets, or benefits. If cash and debts predominate or both are present, until an explanatory regulation is issued. However, such a regulation has not been issued so far. The council's indecision on this matter for over a quarter of a century has sparked disagreements among scholars, researchers, and experts in the economic field, regarding the determination of the Sharia rules to be followed when trading in such cases.

The controversy revolves around the balance between hedging against engaging in usury for those who see the necessity of hedging in usury-related matters, arguing that cash and debts are intended for the buyer in this case. On the other hand, there is the facilitation of transactions, based on the view that cash and debts are not intended in this transaction. This is done by considering the interests of institutions, shareholders, and sukuk holders, aiming to prevent the halt of trading in securities in Islamic financial institutions, which often have assets in the form of cash and debts due to their reliance on Murabaha and Tawarruq.

This difficulty arises from the application of exchange and debt sale conditions when considering

economic interests. The question arises: should we overlook the conditions of debt and cash sale in this case, claiming the permissibility of the sale for economic interests at the expense of legitimate interests without a clear reason? Alternatively, should we apply the rules of cash and debt sale, even if it leads to the suspension of trading due to the absence of conditions, in accordance with previous decisions of the council based on the principle of predominance?

To answer this, contemporary scholars in Islamic economics have proposed various approaches based on jurisprudential and economic considerations:

1. **The First Approach:** Considers the permissibility of trading based on the predominance of components. If goods or benefits are predominant, they can be sold accordingly. If cash is predominant, it follows the rules of cash exchange. If debts are predominant, it follows the rules of debt sale. This approach aligns with the decision of the Islamic Fiqh Council, which stated that trading in Mudarabah sukuk is permissible when the predominant elements are goods and benefits, but if cash or debts predominate, the relevant Sharia rules should be observed, as explained in the forthcoming explanatory regulation.
2. **The Second Approach:** Asserts the impermissibility of trading in stocks, sukuk, and investment funds if their components are mixed with cash, debts, assets, and benefits, with cash or debts being predominant. Advocates of this approach align with the opinion expressed in the first Sharia conference held at the Shura Center for Sharia Consultations in Kuwait.

In conclusion, while the council's previous decision may not have conclusively settled the matter, it indicates an inclination towards the principle of predominance in determining the trading rules in various cases. Referring to the explanatory regulation mentioned in the decision does not imply a deviation from the principle of predominance but rather aims to specify its limits, the time of its realization, and the application of relevant Sharia rules. The trading in the latter case, where cash or debts predominate, is conditional on applying exchange conditions in the case of cash predominance and debt sale conditions in the case of debt predominance, as clarified in the statement: "Considering the Sharia rules that will be specified in the explanatory regulation...". This is also consistent with the second approach proposed in the conference on Islamic sukuk:

Presentation and Evaluation.

The guide for this approach is as follows:

1. **Trading in case of cash predominance:** It leads to engaging in cash-for-cash exchange without fulfilling the necessary Sharia controls, as explicitly prohibited by the decision of the International Islamic Fiqh Academy No: (30/5/4). According to this decision, trading in such a situation is considered a form of prohibited exchange (riba).
2. **Trading in case of debt predominance:** It results in selling debt without a valid reason, as stated in the decision of the International Islamic Fiqh Academy No: 101 (4/11). The decision emphasizes that selling deferred debt to a non-debtor for immediate cash, whether of the same kind or different, is not permissible.
3. **Consistency with the Second Approach:** The discussion acknowledges that the second approach in the recommendations aligns with the principle of predominance relied upon in the previous decision of the council.

Discussion of this approach includes the following points:

1. **Interpretation of "Kathrah" (Abundance):** The term "kathrah" in Arabic may refer to what is considered abundant without necessarily specifying a percentage (e.g., exceeding 50%). The discussion points out that the Arabic language uses the term "kathir" to denote abundance without necessarily implying a majority percentage. It emphasizes the need to consider the cultural and linguistic nuances in interpreting the term.
2. **Neglect of Legal Personality:** The approach neglects the legal personality of the company and its significant moral rights.
3. **Ownership of Securities:** The ownership of cash, debts, and assets through ownership of securities is treated as direct ownership, although the ownership of the shareholder or investor in the company's assets is derivative. The discussion questions this perspective.
4. **Qualification of the Term "Kathrah":** The discussion emphasizes the need to qualify

the term "kathrah" and considers whether the assets, benefits, and moral rights reach or exceed one-third.

The discussion concludes by referencing the findings of Dr. Ahmed Abdel-Aleem Abdel-Latif Abu Al-Yosr in his research presented at the 20th session of the International Islamic Fiqh Academy conference titled "Trading in Stocks and Sukuk and its Sharia Controls." The conclusions include:

1. **Conditions for Trading in Cash-Backed Securities:** If the proceeds from stocks or sukuk intended for trading are still in the form of cash and have not been used to purchase assets or benefits, their sale requires adherence to the conditions of exchange, convergence in the council, and similarity between the selling price and the nominal value of the security.
2. **Trading in Securities Issued for Assets or Benefits:** If the securities represent assets and benefits and have been issued in exchange for existing assets or purchased assets, trading is permissible, subject to ordinary sale conditions.
3. **Trading Prohibition for Securities Issued for Specified Goods:** If the sukuk intended for trading have been issued in exchange for specified goods, trading is not permissible because it involves selling what has not been received.
4. **Debt-Like Nature of Traded Securities:** If the securities become debts after being traded, they are subject to the rules of debt transactions. Selling them for cash is not allowed, as it involves selling debt for immediate cash, which is considered impermissible.
5. **Mixed Nature of Securities:** If the securities' components become a mixture of cash, debts, assets, and benefits, with predominance of assets or benefits, trading is permissible because the securities represent these assets or benefits.
6. **Mixed Nature with Predominance of Cash or Debts:** If the components of securities become a mixture with predominance of cash or debts, the scholars have different opinions on the rules to be followed in such cases, necessitating further research and discussions in scientific forums.

Possible Directions

Direction One: Consideration of the permissibility of trading is based on the predominance of components in assets. This direction is built on the principle that judgment is based on the majority in the components of assets. If goods or benefits are predominant, there is a ruling on the sale of goods or benefits. If money is predominant, there is a ruling on the sale of currency. If debts are predominant, there is a ruling on the sale of debts. This is because trading in the predominance of money leads to engaging in cash-for-cash transactions without fulfilling the necessary Sharia conditions. Trading in the predominance of debts leads to selling debts to those who are not obligated.

Direction Two: Consideration of the permissibility of trading for legal personality or the financial liability of the company. This is based on the idea that financial instruments represent a part of the legal personality of the company and are not shares in its assets because the legal personality owns the assets, not the shareholders.

Direction Three: Consideration of the permissibility of trading in the company's activity absolutely (the authenticity and subsidiary rule). This direction is based on the idea that the purpose of buying shares or financial instruments is the investment activity and its profits. Therefore, trading is permissible when money and debts are predominant, without considering the conditions of currency exchange and debt sale. This is because debts and money within the investment entity are inherently subsidiary and not intended by the traders.

Direction Four: Consideration of the authenticity and subsidiary rule. This direction is based on making the company's activity, work, and stated purposes in the basic system the followed origin and the subsidiary assets. If the company's purpose and activity involve trading goods, benefits, and rights through legal contracts such as Mudarabah, manufacturing, leasing, etc., then debts or money resulting from it do not affect the trading of its shares except at the beginning before the activity or at the end during liquidation. If the company's purpose is to deal with money, gold, or silver, trading in these cases requires fulfilling currency exchange conditions. If the company's purpose is dealing with debts, trading requires fulfilling debt sale conditions. Advocates of this direction impose conditions, including specifying the company's purposes through trade,

investment, industry, or agriculture contracts, not limiting the company's or fund's assets to money and debts only, and ensuring that sales, purchases, and manufacturing are the primary intended activities while debts or money are subsidiary.

Direction Five: The consideration in the permissibility of trading is the intention of the buyer. In this direction, the researcher believes that what matters in this case is the buyer's intention. If the buyer's intention is money or debts, trading is not valid in the predominance of debts or money due to their prohibition. If the buyer does not intend money or debts, trading is permissible. The challenge arises in determining the buyer's intention, which is internal and not directly observable. However, the researcher argues that the intention can be inferred from the nature of the activity. If the investment entity's activity is productive, such as industrial, agricultural, or animal production, trading is permissible. The condition is that the exchange occurs during the production stage, not before purchasing production tools or after liquidation.

Conclusion

In conclusion, Sukuk represents a significant innovation in Islamic finance, providing a Sharia-compliant alternative to conventional bonds. As a tool for raising capital, Sukuk has gained popularity globally, contributing to the diversification of financial markets and fostering the growth of Islamic finance. Its unique structure, based on asset-backed principles, aligns with Islamic principles and attracts a diverse investor base. Despite its growth, challenges such as standardization and regulatory frameworks remain, requiring ongoing efforts to enhance transparency and ensure the continued development of Sukuk as a viable and ethical financial instrument in the global economy.

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