

# Innovation in the Standard of Globalization Sukuk

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## Abstract

The purpose of this paper is examination the several of Current Islamic Sukuk models and approaches in Islamic finance. In the aftermath of the financial crisis of 2007–2008, the fundamental stability of the conventional financial system has been seriously questioned. Excessive leveraging, combined with an inherent asset-liability mismatch, exposes institutions to unsupportable risk, and threatens the overall soundness of the financial system. An alternative to the current model is one traditionally advocated by Islam. Islamic finance eliminates debt financing and instead promotes equity or direct asset financing, which allows for risk-sharing instead of risk-shifting. Financial institutions serve their traditional role as intermediaries between savers and investors, but with no debt on their balance sheets, eliminating the potential for excessive risk. The stability of the international financial system would be enhanced if reliance on debt were reduced: the global financial system would rely more heavily on risk-sharing, equity finance, and genuine asset securitization, linking the payoffs of financial securities to the underlying assets that are financed.

**Keywords:** Islamic finance, Sukuk, bond

## 1. Introduction

The demand for financial services conducted in accordance with Islamic financial principles has increased significantly in recent years, attracting the attention of financial markets worldwide.<sup>1</sup> In fact, as the Islamic sector has emerged, so too have different standards and challenges appeared within the industry.<sup>2</sup> During the past decade we have experienced unprecedented imbalances in the financial sector due to the lack of regulation and effective laws. The need for regulation and better legislation, including laws that apply across borders, was underscored by the economic disorder and affected systems in the UK, US, Scandinavia, East Asia, Russia and Japan, which caused some markets to collapse and others to weaken drastically.<sup>3</sup>

Criticism of usury (*ribā*) has increased; this is not a new phenomenon. Denunciation of interest has a long history in Judaism, Christianity and Western thought.<sup>4</sup> However, it has become an increasingly sophisticated analysis in the area of Islamic finance and economics. The traditional banking system suffers from recurring ailments<sup>5</sup> and its painkillers<sup>6</sup> are no longer sufficient; there must be a serious attempt to rescue and reorganise the global financial system.

One scholar noted that 107 crises have occurred within the past 4 decades.<sup>7</sup> According to Barberton and Lane, the anticipated explosion has just become a reality.<sup>8</sup> Many prominent economists today view the current

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<sup>1</sup> Roula Khalaf, "Islamic finance seeks independence from politics", *Financial Times*, 18/11/2007, (accessed 16/6/2012). <http://www.ft.com/cms/s/0/30effdf0-95eb-11dc-b7ec-0000779fd2ac.html>

<sup>2</sup> Talal Malik, "Scholar urges Islamic finance standardisation", *Arabian Business*, 15/4/2008, (accessed 18/6/2012). <http://www.arabianbusiness.com/scholar-urges-islamic-finance-standardisation-50746.html>

<sup>3</sup> D. Sornette. *Why Stock Markets Crash* (Princeton University Press, 2004) p. 15.

<sup>4</sup> Paul S. Mills & John R. Presley. *Islamic Finance: Theory and Practice* (Palgrave, New York, 1999), p. 3.

<sup>5</sup> The ailments are interest and risk.

<sup>6</sup> Examples of economic painkillers include printing money and lowering interest rates.

<sup>7</sup> World Bank, *Finance for Growth: Policy Choice in a Volatile World* (Oxford University Press, 2001) p. 75.

financial crisis as the most severe to have befallen the world economy, even when compared with the Great Depression of the 1930s.<sup>9</sup>

At the present time, the world has become one and globalisation,<sup>10</sup> in particular at the level of trade, should be urgently redeveloped on the foundation of common standards agreed upon by the international community. These standards, in order to be acceptable, must be fair to all and established in the interest of global trade and economic growth.<sup>11</sup> This forces us to look into the original principles underpinning morality, which can contribute to the development of standards that will form a legal harmonisation as the foundation for a just and globally beneficial economic environment.<sup>12</sup>

## 2. Islamic Sukuk

*Sukuk* is the plural of ‘*sakk*’ – the Arabic name which can be referred to as a document that demonstrates entitlement to a particular property.<sup>13</sup> This property can be either tangible- such as land, a house, or a vehicle- or intangible, such as a patent, copyright, or any other intellectual property. As a financial instrument, Sukuk can be defined as a commercial document that proves the holder has ownership over the underlying asset as well as any profits in accordance with this ownership. In this case, this issuer should identify existing assets to sell to the investors through the Special Purpose Vehicle (SPV). Sukuk can be traded at par, premium, or discount values and can be listed in financial markets. It is also rateable by specialist agencies and financial experts.<sup>14</sup>

According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI): “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued”.<sup>15</sup> This definition corrects the essential mistakes made by many authors who confuse conventional bonds as debt instruments and Sukuk notes as financial instruments.

To clarify this distinction between Sukuk and conventional bonds, it is necessary to analyse the definition of current conventional bonds then proceed to compare this definition with that of Sukuk a mention above. Bonds or so-called fixed income securities are certificates that create a relationship between the issuer (debtor) and the bondholder (creditor); the debtor obtains a certain amount of finance in return for the bond, and is obliged to pay back this amount with interest, to the bond holder at the end of the maturity.<sup>16</sup>

Beside this difference, there are a number of other differences that provide additional clarification of the distinction between Sukuk and conventional bonds. This issuer of the Sukuk does not guarantee the principal and its return, which increases the level of risk that is associated which such in investment, whereas in bonds, the issuer guarantees both the principal and the return, and its this guarantee makes conventional bonds non Shariah-compliant.<sup>17</sup>

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<sup>8</sup> Miranti Kartika Dewi & Ilham Reza Ferdian, *Islamic Finance: A Therapy for Healing the Global Financial Crisis* (Barborton & Lane, 1999) (accessed 16/8/2011).

<sup>9</sup> Roy Davies & Glyn Davies, *A History of Money from Ancient Times to the Present Day* (1996) stated that before their book was published, more than 20 crises had occurred in the world, all of them financial.

<sup>10</sup> The process by which businesses or other organisations develop international influence or start operating on an international scale. See [oxforddictionaries.com/definition/globalization](http://oxforddictionaries.com/definition/globalization) (accessed 16/6/2011).

<sup>11</sup> The role of statistical method in economic standardisation (<http://www.scholar.google.co.uk/scholar>) scholar (accessed 16/8/2011).

<sup>12</sup> C. Menger, *Principles of Economics* (Duke University, 2007) p. 93; “Standardisation Process of Systems Technologies: Creating a Balance between Competition and Cooperation”; [arno.unimaas.nl/show.cgi?fid=18303](http://arno.unimaas.nl/show.cgi?fid=18303) (accessed 16/8/2011).

<sup>13</sup> Mervyn K. Lewis. (2010). In what ways does Islamic banking differ from conventional finance? *Journal of Islamic Economic, Banking, Finance*, 40(83-84), 18.

<sup>14</sup> Brian Kettell, *Islamic Finance In A Nutshell*, John Wiley & Sons, West Sussex, 2010, p.229.

<sup>15</sup> Shari’a Standards, 1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions, p298.

<sup>16</sup> Alon Brav(1991). Global Financial management: Bond Valuation. <http://www.exinfm.com/training/pdf/Bonds.pdf>. Accessed on 20 October 2012.

<sup>17</sup> Adam, Nathif J. and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*, (London:

Still, conventional bonds and Sukuk share a number of similarities that would be the main source of confusion surrounding the two. Both instruments are traded in financial markets and can be transferred from one holder to other. Furthermore, Sukuk and conventional bonds can be analysed by financial analysts and are rated in accordance with risk level. Moreover, conventional bonds and Sukuk involve similar parties in the transaction, including the obligator, the lead manager, the credit enhancement provider and the auditor.<sup>18</sup>

Thus, despite the similarities between Sukuk and conventional bonds, a discussion of the major differences between the two highlight the fact that Sukuk are financial instrument based on the ownership of a particular property, while conventional bonds are based on debt.

### 3. The Issue of Currently Islamic Sukuk

The term Islamic finance encompasses any type of financial activity that is undertaken in accordance with Islamic law. Sukuk are a generic term used to include a broad range of financial instruments designed to conform to the principles of Islamic law. Although many sukuk structures are designed to replicate the economic function of conventional bonds, their legal structures tend to be different. However, many sharia scholars argue that the structure of sukuk is not complying with Islamic law.

According to Mufti Taqi Usmani<sup>19</sup> “about 85% of Gulf Islamic bonds do not really comply with Islamic law, the body which sets standards across the Middle East and Western Countries”.<sup>20</sup> However, Sukuk under existing regulatory framework still poses many challenges in the UK and other jurisdictions.

Currently, there are no global sharia standards. Those issued by the AAOIFI have a broad appeal, but differences in interpretation still remain.<sup>21</sup> The need for global standards was highlighted when AAOIFI issued a statement on sukuk in February 2008 amid criticism that the majority of sukuk were structured in such a manner that they were not in strict compliance with the Islamic teachings. Because risk/reward sharing fits well with Islamic teachings, equity-like structures in socially responsible businesses are likely to be seen as compliant.

### 4. Conclusion

The investor has to use hedging tools, such as diversification of assets and asset classes, and seek to align the flows of financial rights and obligations.<sup>22</sup> To resort to the sale of risks, namely the toxic mortgages that spurred the 2008 Financial Crisis, to a third party is a type of risk that casts a shadow on the whole of society, as we saw in America, a domestic economic crisis may evolve into a global one.<sup>23</sup>

The concept of risk represents a significant challenge to the financial industry. In spite of all of the creative tools that financial institutions have created to manage risk, the problem of risk exposure is still one that is recognized by Islamic jurists.<sup>24</sup> Global economic crises, financial meltdowns and perpetual volatility remain a constant threat.<sup>25</sup>

Writers of financial regulation and standardization should look to fundamental market drivers and laws as opposed to placing emphasis on marginal derivative products; this would permit players in the financial markets

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Euromoney Books), 2004, pp. 54-56

<sup>18</sup> Ibid,p 53.

<sup>19</sup> He is generally known as one of the leading Shariah scholars active in the field of Islamic finance. For more than a decade he has served as chairman or member of Shariah supervisory boards of a dozen Islamic banks and financial institutions in various parts of the world. He presently serves as Chairman of the International Shariah Council for the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain. [http://www.muftitaqiusmani.com/index.php?option=com\\_content&view=article&id=2&Itemid=5](http://www.muftitaqiusmani.com/index.php?option=com_content&view=article&id=2&Itemid=5). (Accessed on 20<sup>th</sup> October 2012).

<sup>20</sup> <http://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html>. (Accessed on 20<sup>th</sup> October 2012).

<sup>21</sup> Shari'a Standards, 1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions, pp. 295-298.

<sup>22</sup> Hedging in Islamic Finance. <http://www.straightwayethical.com/papers/Swailem-Hedging.pdf>. Accessed 22/8/2011.

<sup>23</sup> The real effects of financial constraints: Evidence from a financial crisis. Accessed 22/8/2011. <http://www.sciencedirect.com/science/article/pii/S0304405X10000413>.

<sup>24</sup> Hedging in Islamic Finance. <http://www.straightwayethical.com/papers/Swailem-Hedging.pdf>. Accessed 22/8/2011.

<sup>25</sup> The Financial Crisis in Islamic Finance. <http://suwailem.net/books-187.htm>. Accessed 21/8/2011.

to manage their assets and liabilities with transparency. This would also allow the economy to operate with openness and make way for more efficient market institutions. Islamic finance can contribute to the treatment of the disorder, not with pain-killers, but with a radical remedy for the eradication of inconsistency the current financial system has exposed the world to. The people left to write about financial regulation and standardization should be ones who are well grounded in Islamic law and who are knowledgeable in financial systems and principles, rather than being ones who specialize in one or the other field.

A major benefit of Islamic financial principles is with regards to Ijtihad and Ikhtilaf, rather than having a rigid set of rules, there is a limited leeway of variance that is allowed.<sup>26</sup> This does not mean that you pick and choose nor does it mean that there are not a set of fundamental principles. It means that there are fundamental principles, where Ijtihad and Ikhtilaf are forbidden, but there is room for opinions in certain cases and certain minor principles.<sup>27</sup>

Islamic economics presents the basic principles agreed upon by the biggest religions in the world, such as the prohibition of usury, and has changed the lending system, so that a failure to repay loans does not accrue interest on the individual but rather the lender is encouraged to give the borrower time to repay the loan.<sup>28</sup> It also offers systems which support the poorest people in society, such as Zakat<sup>29</sup> and Islamic Insurance (Takaful)<sup>30</sup>.

Islamic Financial Law is rich in solutions and concepts necessary to avoid the disaster of recession, as well as dealing with the effects of economic decline. Yet the transfer of these concepts to the principles of economic policy requires the combined efforts of Islamic jurists and financial professionals in order to develop standards in sync with the complexities of today's reality.<sup>31</sup>

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<sup>26</sup> Aktlaf Alfokha, IbnJareerAltabari, AltabaAlthanyah, Bayroot.

<sup>27</sup> Aalam Almoaqeen An RabAlalmeen, IbnAlqumAljozi, Maktabt Riyadh.

<sup>28</sup> Paul S. Mills, John R. Presley (1999). *Islamic Finance: Theory and Practice*. Palgrave, New York, 1999. (pp. 1-10).

<sup>29</sup> Zakat is a compulsory payment of 2.5% of a person's wealth which is distributed to the poor through charities.

<sup>30</sup> Takaful in Islamic Finance is a similar to an insurance in Western Finance. Accessed 22/8/2011. <http://www.pwc.com/gx/en/financial-services/islamic-finance-programme/takaful-growth-opportunities.jhtml>.

<sup>31</sup> *The Global Finance Crisis*. [http://www.isdbforum.org/presentationPapers/5-M\\_Umer\\_Chapra.pdf](http://www.isdbforum.org/presentationPapers/5-M_Umer_Chapra.pdf). Accessed 22/8/2011.