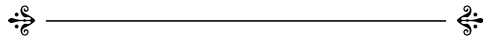


# SHARIAH-COMPLIANT SECURITIES, SUKUK AND ISLAMIC REITS IN MALAYSIA



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## **ABSTRACT**

The growth of Islamic capital market instruments has been very robust in recent years. Three of the most significant Islamic capital market instruments are the Shariah-compliant securities, sukuk and Islamic REITs. The discussion of this chapter centres on the Shariah issues pertaining to these instruments. Issues examined include disposal of securities, debt trading, purchase undertaking, liquidity facility and discounting of debt.

**Keywords:** Shariah-compliant securities, sukuk, debt trading, Islamic REITs.

## INTRODUCTION

The capital market is an important component of a financial system where long-term funds can be raised. This long-term investment can be implemented via a few short-term contracts or in the form of securities which allow the investor to enter or leave the business as they wish. Thus, capital market not only is an avenue for long-term investment but also provides possible liquidity for non-liquid assets. Furthermore, its secondary market allows determination of the value of assets on a continuous basis so as to avoid arbitrage and inefficiency (Ali, 2008).

In the Islamic finance industry, the Islamic Capital Market (ICM) is also an important Islamic financial component that mobilizes the economic resources efficiently. This market complements the investment role played by the Islamic banking and money market sectors. There are numerous products offered in the ICM either in Malaysia or abroad. In Malaysia, the earliest ICM product was the Shariah-compliant securities. Today, complementing the Shariah-compliant securities are a variety of long-term financial securities including sukuk, Islamic unit trust, Islamic real estate investment trusts (I-REITs), Islamic exchange traded funds etc.

This chapter examines the three most important products of the ICM: Shariah-compliant securities, sukuk and Islamic REITs.

## SHARIAH-COMPLIANT SECURITIES

Shariah-compliant securities are securities (ordinary shares, warrants and transferable subscription rights) of a Bursa Malaysia-listed company which have been classified as Shariah permissible for investment, based on the company's compliance with Shariah principles in terms of its primary business and investment activities. The Shariah-compliant securities list was introduced in June 1997 by the Shariah Advisory Council (SAC) of the SC. The list is updated twice a year, in May and November, by reviewing the listed companies' annual financial reports, and responses to a survey and specific inquiries aimed at obtaining detailed information of the respective company's management (Securities Commission, 2012).

In the process of determining the Shariah status of listed securities, the SAC established a standard Shariah screening process methodology comprising quantitative and qualitative assessments as follows (Securities Commission, 2006):

### Quantitative Assessment

For this quantitative assessment, the SAC received input and support from the SC. The SC gathered information on the companies from various sources, such as annual financial reports, company responses to survey forms and through inquiries made to the respective company's management. The SC, through the SAC, continues to monitor the activities of all companies listed on Bursa Malaysia on periodic basis based on such disclosures of information to determine their status from the Shariah perspective.

A standard criterion is applied in evaluating the activities of the companies listed on Bursa Malaysia. Companies will be classified as Shariah non-compliant securities if they are involved in the listed core activities below (Securities Commission, 2012) and vice versa.

- (a) Financial services based on *riba* (interest)
- (b) Gambling and gaming
- (c) Manufacture or sale of non-halal or related products
- (d) Conventional insurance
- (e) Entertainment activities, which are non-permissible according to Shariah
- (f) Manufacture or sale of tobacco-based products or related products
- (g) Stock broking or share trading in Shariah non-compliant securities
- (h) Other activities deemed non-permissible according to Shariah

The SAC also takes into account the level of contribution of interest income received by the company from conventional fixed deposits or other interest bearing financial instruments as well as dividends received from investment in Shariah non-compliant securities.

### Qualitative Assessment

Besides the quantitative assessment, the qualitative assessment is also considered by SAC for the company's activity whether it is allowed or not in terms of Shariah. Thus a company whose contribution is below the quantitative level required, but if its qualitative criteria are not met, is considered as non-Shariah compliant. The followings are two qualitative criteria considered by SAC in assessing the Shariah compliancy of a company:

- (a) public perception of the image of the company must be good; and
- (b) the core activities of the company have importance and *maslahah* (benefit in general) to the Muslim ummah and the country, and the haram element is very small and involves matters such as *`ulum balwa* (common plight), *`urf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

Realizing the importance of Muslims' involvement in companies with mixed activities; SAC has decided to accept the companies as Shariah-compliant on a case by case basis. This is because Islam does not want its followers to isolate themselves away from economic activities although mixing of *halal* and *haram* issues exists. For this reason, when evaluating a company, the composition of the activities must be taken into account. Therefore, SAC has established several benchmarks based on *ijtihad* (reasoning from the source of Shariah by qualified Shariah scholars) to determine the level of mixed contributions from permissible and non-permissible activities towards turnover and profit before tax of a company. If the contributions from non-permissible activities exceed a benchmark, the securities of the company will be classified as Shariah non-compliant.

The benchmarks adopted from the year 1995 to October 2013 are as follows (Securities Commission, 2012):

**(a) The 5-percent benchmark**

This benchmark is used to assess the level of mixed contributions from activities that are clearly prohibited such as *riba* (interest-based companies like conventional banks), gambling, liquor and pork.

**(b) The 10-percent benchmark**

This benchmark is used to assess the level of mixed contributions from activities that involve the element of *umum balwa* which is a prohibited element affecting most people and difficult to avoid. An example of such a contribution is the interest income from fixed deposits in conventional banks. This benchmark is also used for tobacco-related activities.

**(c) The 20-percent benchmark**

This benchmark is used to assess the level of contribution from mixed rental payment from Shariah non-compliant activities such as the rental payment from the premise that is involved in gambling, sale of liquor etc.

**(d) The 25-percent benchmark**

This benchmark is used to assess the level of mixed contributions from the activities that are generally permissible according to Shariah and have an element of *maslahah* to the public, but there are other elements that may affect the Shariah status of these activities. Among the activities that belong to this benchmark are hotel and resort operations, share trading, stock broking and others, as these activities may also involve other activities that are deemed non-permissible according to the Shariah.

In 2012, the Securities Commission has revised the screening methodology in view of the current development and sophistication of the Islamic finance industry. In this new methodology, a two-tier approach has been adopted which comprises the quantitative assessment which applies the business activity benchmarks and the newly introduced financial ratio benchmarks. Apart from that, the qualitative assessment at the same time is retained. The newly adopted financial ratios are as follows (Securities Commission, 2012):

**i. Cash over Total Assets**

Cash will only include cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments will be excluded from the calculation.

**ii. Debt over Total Assets**

Debt will only include interest-bearing debt whereas, Islamic debt/financing or *sukuk* will be excluded from the calculation.

Both ratios, which are intended to measure *riba* and *riba*-based elements within a company's balance sheet, must be lower than 33%. Table 9.1 shows a comparison between revised Shariah screening methodology and current Shariah screening methodology.

**Table 9.1:** Comparison between Revised Shariah Screening Methodology and Current Shariah Screening Methodology

Quantitative Assessment	Current Shariah Screening Methodology	Revised Shariah Screening Methodology
Business activity benchmarks (%)	• 5	• 5
	• 10	• 20
	• 20	
	• 25	
Financial ratio benchmarks (%)	Not applicable	• 33

The contribution of Shariah non-compliant activities to the overall revenue and profit before tax of the company will be calculated and compared against the relevant business activity benchmarks. The outcome of the revised methodology will be reflected in the list of Shariah-compliant Securities by the SAC effective from November 2013 (Securities Commission, 2012).

Table 9.1 shows that the revised methodology adopted is more stringent than the previous ones. Only two benchmarks, 5% and 20%, are used compared to four benchmarks in the current methodology. Those activities under the 10% benchmark will be evaluated with a more stringent ratio of 5%, while those under the 25% benchmark will be assessed using a 20% benchmark. Furthermore, financial ratios are to be applied in evaluating a company’s balance sheet, a measurement that was not adopted previously. See Table 9.2 for the comparison between current business activity benchmark and revised business activity benchmark.

**Table 9.2:** Comparison of Revised Business Activity Benchmark and Current Business Activity Benchmark

Current Business Activity Benchmark		Revised Business Activity Benchmark	
5%	• Conventional banking	5%	• Conventional banking
	• Conventional insurance		• Conventional insurance
	• Gambling		• Gambling
	• Liquor and liquor-related activities		• Liquor and liquor-related activities
	• Pork and pork-related activities		• Pork and pork-related activities
	• Non-halal food and beverages		• Non-halal food and beverages
	• Shariah non-compliant entertainment		• Shariah non-compliant entertainment

(continued)

**Table 9.2:** Comparison of Revised Business Activity Benchmark and Current Business Activity Benchmark (*continued*)

Current Business Activity Benchmark		Revised Business Activity Benchmark	
10%	<ul style="list-style-type: none"> <li>• Interest income from conventional accounts and instruments</li> </ul>		<ul style="list-style-type: none"> <li>• Interest income from conventional accounts and instruments</li> </ul>
	<ul style="list-style-type: none"> <li>• Tobacco and tobacco-related activities</li> </ul>		<ul style="list-style-type: none"> <li>• Tobacco and tobacco-related activities</li> </ul>
	<ul style="list-style-type: none"> <li>• Other activities deemed non-compliant according to Shariah.</li> </ul>		<ul style="list-style-type: none"> <li>• Other activities deemed non-compliant according to Shariah.</li> </ul>
20%	<ul style="list-style-type: none"> <li>• Rental received from Shariah non-compliant activities</li> </ul>	20%	<ul style="list-style-type: none"> <li>• Rental received from Shariah non-compliant activities</li> </ul>
	<ul style="list-style-type: none"> <li>• Other activities deemed non-compliant according to Shariah.</li> </ul>		<ul style="list-style-type: none"> <li>• Hotel and resort operations</li> </ul>
25%	<ul style="list-style-type: none"> <li>• Hotel and resort operations</li> </ul>		<ul style="list-style-type: none"> <li>• Share trading</li> </ul>
	<ul style="list-style-type: none"> <li>• Share trading</li> </ul>		<ul style="list-style-type: none"> <li>• Stockbroking business</li> </ul>
	<ul style="list-style-type: none"> <li>• Stockbroking business</li> </ul>		<ul style="list-style-type: none"> <li>• Other activities deemed non-compliant according to Shariah.</li> </ul>

This implies that a mixed company has to reduce the percentage of Shariah non-compliant activities to ensure and maintain its Shariah-compliant status.

From the above discussion, it can be concluded that the improvement made by the SAC will increase the confidence of the investors towards Shariah-compliant securities. In fact, their confidence level may increase since the application of the financial ratio benchmark will actually exclude any company involved in interest activities as they raise funds using conventional instruments. This is because, for a company to be classified as Shariah-compliant, the Shariah non-compliant activities must be less than the benchmarks mentioned above and the cash over total assets ratio or the debt ratio over total assets must be less than 33%. The revised methodology by adopting two-tier approaches would most probably decrease the number of Shariah-compliant securities in Bursa Malaysia.

## SUKUK

Sukuk the plural of *sakk*, is an Arabic word that means certificate. According to Wan Abdul Rahim, sukuk represents certificates of equal value that represent an undivided interest (proportional to the investor's participation) in the ownership of an underlying asset (both tangible and intangibles), usufruct, services or investment in particular projects or special investment activities. Sukuk is generally known as Islamic bond (Wan Abdul Rahim, 2008).

The definition given by Wan Abdul Rahim is in line with a statement in al-Ma`ayir al-Shar`iyyah of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which is as follows (AAOIFI, 2010, Standard no. 17, Article 2):

خدمات أو في موجودات مشروع معين أو نشاط استثماري خاص، وذلك بعد تحصيل قيمة أصدرت من أجله. وثائق متساوية القيمة تمثل حصصاً شائعة في ملكية أعيان أو منافع أو الصكوك وقفل باب الاكتتاب وبدء استخدامها فيما

The Securities Commission clarified how the sukuk is structured and how it differs from the conventional bonds as follows (Securities Commission, n.d.):

The sukuk are structured based on the specific contract of exchange of Shariah-compliant assets. Such contracts can be made through the sale and purchase of an asset based on deferred payment, leasing of specific assets or participation in joint-venture businesses. Hence, the issuance of sukuk is not an exchange of paper for money with the imposition of an interest but rather an exchange of Shariah-compliant asset for some financial consideration applying various Shariah principles, such as *bai' bithaman ajil* (BBA), *murabahah*, *ijarah*, *mudharabah* and *musarakah* that allow the investors to earn profits from the transactions.

According to above statement, it is clear that sukuk is structured using various Shariah contracts as underlying transaction (Securities Commission, 2011). Among the contracts used in the early stage of sukuk industry are *bai' bithaman ajil* (BBA), *murabahah* and *istisna`*. These contracts were widely applied until 2006 when sukuk has also been structured based on other Islamic contracts like *ijarah*, *musarakah* and *mudharabah*. In 2008, 27 from 64 or 42% sukuk issued were based on these additional new contracts (Shamsiah Mohamad & Mohd Fadhly, 2008).

### Several Important Rules Regarding Sukuk Issuance

There are several important rules formulated by SAC that should be taken into account by parties involved in structuring sukuk. Among the rules are as follows (Securities Commission, 2011, Khairun Najmi Saripudin et al., 2012):

#### i. Requirement of underlying asset

Under *`uqud mu`awadat* or contracts of exchange (such as *bai' bithaman ajil*, *murabahah*, *istisna`* and *ijarah*), an asset, whether tangible or intangible, must be made available for sukuk to be issued subject to the following:

- (a) The underlying asset and its use must comply with the requirements of Shariah. Therefore, any asset that does not meet this requirement cannot be used as an underlying asset. For example, any asset that is used for activities which are Shari`ah non-compliant, such as a building where major tenants

operate conventional banking could not be made an underlying asset of sukuk (Shamsiah Mohamad & Mohd Fadhly, 2008).

- (b) An encumbered asset, such as an asset charged to a financial institution, or an asset that is jointly owned with another party, can only be used as an underlying asset, provided the issuer has obtained consent from the chargee or joint owner.
- (c) Where receivables are used as the underlying asset, they must be *mustaqir* (established and certain) and transacted on cash basis (on spot).

**ii. Asset pricing**

Sukuk under *`uqud mu`awadat* involves the sale and purchase of underlying assets. When investors purchase the underlying assets, the purchase price must comply with the following SAC pricing guidelines:

- (a) The purchase price should not exceed 1.51 times of the market value of the asset
- (b) In cases where the market value of a particular asset could not be ascertained, a fair value or any other value must be applied.

**iii. Ibra' (Rebate)**

- (a) Provision for *ibra'* may be stipulated in the primary legal document provided that such provision shall not be part of the pricing section.
- (b) Through the application of *ibra'*, variable rate mechanism may be applied to sukuk BBA, *murabahah* and *istisna`* which may be benchmarked to the prevailing market rates.

**iv. Ta`wid (Compensation)**

- (a) *Ta`wid* is permissible under both *`uqud mu`awadat* and *`uqud ishtirak* only in the event of delay in payment. However, under *`uqud ishtirak*, *ta`wid* is limited to the failure of the issuer/obligor to distribute the realised profit on time. *Ta`wid* does not apply to expected profit.
- (b) The rate of *ta`wid* should be as prescribed by the SAC from time to time and is available on the Islamic Capital Market section of the SC website.

**v. Utilisation of proceed**

- (a) Funds which are raised from any issue, offer or invitation of sukuk must be utilised for Shariah-compliant purposes. Therefore, if the producer uses it to build a brewery, for example, it is prohibited (Shamsiah Mohamad & Mohd Fadhly, 2008).
- (b) Funds which are raised from any issue, offer or invitation of sukuk must be utilised by issuer in accordance with the purposes disclosed to the SC.
- (c) In situations where the funds are disbursed to the issuer for a project which will generate cash flows for payments to sukuk holders, the transaction documents shall provide for the relevant parameters, conditions, supporting documents and certificates for the sukuk trustee or facility agent, where applicable, to manage the release of the funds to the issuer.

All the regulations mentioned above will be monitored by the Department of Shariah (formerly known as Department of Islamic Capital Market) of the Securities



Commission as they review and scrutinise documents “Principal Terms & Conditions” tabled by the industry when they apply for approval to issue the sukuk.

## ISLAMIC REITs

Generally, REITs is a collective form of investment which has the characteristics of trust funds. REITs is an investment trust whose fund is collectively pooled from investors and is used to invest in real estate only. The investment is normally in the form of buying, managing, selling and leasing real estate or purchasing shares in public-listed real property companies or investing in debt securities of real property companies. Hence, an investor may receive returns in the form of either dividend or capital gain for the asset holding duration. As an investment, REITs combine the best features of real estate and stocks. It gives investors a practical and effective means to include professionally managed real estate in a diversified investment portfolio.

The Security Commission defines REITs as follows (Securities Commission, 2005):

An investment vehicle that proposes to invest at least 50% of its total assets in real estate, whether through direct ownership or through a single purpose company whose principal asset comprises real estate.

In essence, REITs operate like any other trust funds involving management companies, trustees and unit holders or investors. The management companies will gather funds from investors. This fund will be invested in real estate and assets related to real estate. Besides, the management company is also allowed to invest in non-property assets at a certain rate. The management company will appoint a real estate company to manage on its behalf. This company will receive a fee for its management services.

REITs are also required to have a trustee who acts as the custodian of the assets of the fund and safeguards the interest of the investors. The trustee earns trustee’s fees for its function in holding the asset for the benefits of the investor (Asyraf, 2008). Any profits made in investing in real estate in the form of either rentals or profit from property sales will be channelled back to investors in the form of dividends. Apart from this, investors may also receive capital gains from the increase in values of units held.

Fundamentally, the structures of Islamic REITs are very similar to conventional REITs. The difference between the two lies in how the incomes of the Islamic REIT are derived and how the fund is supposed to be managed. For Islamic REITs, these two aspects need to be based on the principles of Shariah. Generally, Islamic REITs provide a new investment opportunity for investors who wish to invest in real estate through Shariah-compliant capital market instruments. An Islamic REIT is an effective means of gaining investment exposure to large Shariah-compliant commercial properties. Investments in Islamic REITs provide opportunities to hold stakes in high-grade Shariah-compliant real estate which may otherwise have been difficult or impossible for a retail investor to hold.

## ISSUES IN ISLAMIC SECURITIES, SUKUK AND ISLAMIC REITS

### Islamic Securities

Among the Shariah issues that need attention is the changing of shariah status of listed securities. As mentioned before, the list of Shariah-compliant securities is announced twice a year, that is in May and November. Some listed companies classified as Shariah-compliant in May, may not be in the November list of Shariah compliant companies. If this happens, what shall the investor do? To help investors handle this, SAC has made the following decisions (Securities Commission, 2012):

#### i. Shariah-compliant securities which are subsequently considered Shariah non-compliant

This refers to those securities which were earlier classified as Shariah-compliant securities but due to certain reasons, such as changes in the companies' operations, are subsequently considered Shariah non-compliant. In this regard, if, on the date this updated list takes effect, the value of the securities held exceeds the original investment cost, investors who hold such Shariah non-compliant securities must liquidate them. Any capital gains arising from the disposal of the Shariah non-compliant securities made at the time of the announcement can be kept by the investors. However, any excess capital gains derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channelled to charitable bodies or *baitulmal*.

On the other hand, investors are allowed to hold their investment in the Shariah non-compliant securities if the market price of the said securities is below the original investment costs. It is also permissible for the investors to keep the dividends received during the holding period until such time when the total amount of dividends received and the market value of the Shariah non-compliant securities held equal the original investment cost. At this stage, they are advised to dispose of their holding.

In addition, during the holding period, investors are allowed to subscribe to:

- (a) any issue of new securities by a company whose Shariah non-compliant securities are held by investors, for example, rights issues, bonus issues, special issues and warrants (excluding securities whose nature is Shariah non-compliant, e.g. irredeemable convertible unsecured loan stock [ICULS]); and
- (b) securities of other companies offered by the company whose Shariah non-compliant securities are held by the investors, on condition that they expedite the disposal of the Shariah non-compliant securities. For securities of other companies (as stated in [b] above), they must be Shariah-compliant securities.

#### ii. Shariah non-compliant securities

The SAC advises investors who invest based on Shariah principles to dispose of any Shariah non-compliant securities which they presently hold, within a month of knowing the status of the securities. Any gain made in the form of capital gain

or dividend received during or after the disposal of the securities has to be channelled to charitable bodies or *baitulmal*. The investor has a right to retain only the original investment cost

Decisions made by the SAC on disposal of the Shariah-compliant originally then declared Shariah-compliant is a sensible decision. In fact, the ownership of any declared Shariah-compliant securities are deemed as halal, including any benefit received from the ownership like dividend payments to the holders of securities. Hence, investors can hold on to that law as long as there is no evidence to suggest otherwise. It is based on a juristic method of *istishab* which refers to an act of maintaining an existing law as long as there is no evidence to change it (Zaidan, 1979). However, when the announcement was made by the SC that the status of particular Shariah-compliant securities has changed to Shariah non-compliant, then an investor should immediately dispose of the securities held. The announcement of the SC in this case is clear evidence that has changed the original law.

- Allowance to investors to hold their investments in Shariah-compliant securities if the market price of such securities is below the original investment cost is derived from the principles outlined in the Quran. Surah al-Baqarah, verse 279, states, "If you do it not, take notice of war from Allah and His Messenger: But if you repent, you may have your principal - [thus] you do no wrong, nor are you wronged." Based on the above verse, those who repent from dealing in *riba* (interest) are entitled to recover the amount of capital that has been invested. Although the above verse specifically describes guidelines on *riba* properties, in general it can be applied to the concept of purification of wealth. Thus, the investor is entitled to hold the securities and received dividends equal to the original investment cost. This is consistent with the concept of property care (*hifz al-mal*) in which the property was one of five basic things (*al-daruriyyat al-khams*) that must be preserved in accordance with Islam.

## SUKUK

There are several Shariah issues debated either at the local or at the international level. These issues are closely related to the transaction of sukuk in the secondary market (*tadawul al-sukuk fi al-suq al-thanawiyah*), a buy-back of the sukuk or the purchase undertaking and liquidity facility. Among the main issues discussed are as follows:

### (a) Sale of Debt (*bai` al-dayn*)

In Malaysia the SAC has decided that *bai` al-dayn* is allowable (Securities Commission, 2006). SAC has also decided that the selling of debt shall be done in cash. This means that the buyer shall pay in cash. This is to avoid *bai` al-kali' bi al-kali'* (sale of a debt for a debt) which is prohibited by the Prophet (s.a.w).

What has been practised in Malaysia has been vehemently opposed by the jurists from the Middle East in particular. Their opposition is not because they oppose

the *bai` al-dayn* in total, but what is practised in Malaysia, in their view, is not in line with the Maliki school, which happens to be the basis of SAC allowing *bai` al-dayn*. The writer is of the view that they do not oppose *bai` al-dayn* in total. This is because in *al-Ma`ayir al-Shar`iyyah*, which is published by AAOIFI, it is said that they permit the exchange of financial notes (*al-dayn*) with ascertained goods on the following basis (AAOIFI, 2010, Standard no. 16):

بيع الدين لغير من هو عليه بالعين، وهو جائز على مذهب المالكية، على أن يكون ذلك بعد العالم الإسلامي مستند مشروعة جعل الورقة التجارية ثمناً لسلمة معينة أن ذلك من قبيل: القبض لنئلا تؤول إلى تأجيل البدلين. وقد صدر بشأن ذلك قرار المجمع الفقهي الإسلامي لرابطة

On the basis of above statement, they themselves allowed *bai` al-dayn* based on Maliki school when the debt is exchanged with *`ayn* (ascertained goods) and not with currency.

What is questioned by the Middle East is that the sukuk in Malaysia is structured using deferred transaction like BBA and *murabahah* is representing a debt. When it is sold in the secondary market, it is changed with currency whilst the Maliki School does not allow payment to be in currency similar to debt (*dayn*), and if from a similar type, the rate must be equal to avoid *riba*. What is practised in Malaysia is sukuk is sold at a discount. Sukuk with a face value of RM500 million, for example, can be sold at RM450 million. According to the Middle Eastern jurists, this is tantamount to *riba*.

Anyway, SAC has decided that sukuk is a *haq maliy* (financial right) and it is not similar to currency. Therefore it can be sold at a discount. In other words since it is not involved in interest the condition of *al-tamathul* (equal) and *al-taqabud* (taking possession) need not be met. The writer is of the view that a more detailed study needs to be made to determine if sukuk is a new asset class that cannot be equated to loans or currencies it represents.

#### (b) Mixed underlying asset

When a particular sukuk represents a mixed asset (tangible or intangible) like services and other assets like debts and currency, what needs to be scrutinized is the percentage of debt or currency compared to tangible assets like buildings, land and others.

In Malaysia, the mixed asset is not an issue because *bai` al-dayn* is allowed. This means that if the percentage of debt is higher than the value of another asset such as building, then there is no problem to trade it in the secondary market. However, AAOIFI has specified that if the shares of a corporation represent mixed assets, it can only be traded in the secondary market if the total market value of assets, benefit and right are not less than 30% of the total assets value of the corporation, including all assets, benefits, rights and cash liquidity. The text concerned is as follows (AAOIFI, 2010, Standard no. 21, Article 3/19):

حكم تداول أسهمها بحسب الأصل المتبوع وهو غرض الشركة ونشاطها المعمول به، فإذا القيمة السوقية إذا كانت موجودات الشركات مشتملة على أعيان ومنافع ونقود وديون فيختلف فإن تداول أسهمها جائز دون مراعات أحكام الصرف أو التصرف في الديون شريطة ألا تقل حكمها (أي ديون الشركة على كان غرضها ونشاطها التعامل في الأعيان والمنافع والحقوق من إجمالي موجودات الشركة الشاملة للأعيان والمنافع والحقوق والسيولة النقدية وما في مقدار السيولة النقدية والديون لكونها حينئذ تابعة للأعيان والمنافع والحقوق عن النسبة 30% الغير وحساباتها الجارية لدي الغير والسندات التي تملكها وتمثل ديونا) بصرف النظر عن

Although the above statement is relating to the shares, the rules also apply in sukuk. This means that AAOIFI only allows sukuk to be traded without being bound by the rules of *al-sarf* or transactions in debt if the total market value of assets, benefit and right is not less than 30% of the total assets value represented by the sukuk, including all assets, benefits, rights and cash liquidity.

#### (c) Selling of debt at a discount

AAOIFI states that any sukuk that represents currency or debt cannot be traded in secondary market other than at its face value (*qimah ismiyyah*) (AAOIFI, 2010, Standard no. 21, Article 5/2/1). This means that discount sales are prohibited. This is because in their view, whenever sukuk represents currency or debt, each is subject to the rule of *al-sarf* (currency exchange) or dealing with debt. So if the sukuk is exchanged with currency especially in the same currency of debt, *riba* will happen if sold at a discount. This is because there is no equality in quantity as specified as a condition in the transaction involving *ribawi* items which have similar *`illah* (legal reason) and type.

In Malaysia, transaction with discounts here is related to *da` wa ta`ajjal* (debt discounting). The following text explains this matter.

Generally, the *da` wa ta`ajjal* principle is important in developing Islamic corporate bonds in a secondary market. Islamic bonds issued are based on the concepts of *ijarah*, *istisna`*, *murabahah*, *musharakah*, and *mudharabah*. To enable the trading of these bonds in the secondary market, securities holders will sell them at a lower price based on the concept of *da` wa ta`ajjal*. (Securities Commission, 2006)

The difference in views between the Middle East jurists and the SAC originates from the different *takyif fiqhi* (juristic basis) for the sukuk itself. In view of the fact that the Middle East jurists view sukuk structured based on BBA, *murabahah* and *istisna`* represent debt, so it is subject to the rules of dealing with debts. On the contrary, SAC considers sukuk as a *haq maliy* that cannot be equated to currency. When there is no

similarity between the two, the sukuk can be traded without being tied to the rules of trading *ribawi* items.

However, authors personally are of the view that even if sukuk is considered as a *haq maliy*, the *haq maliy* is still closely related to debts. The issue is, if the *haq maliy* is closely related to debts, is it bound by the rules of dealing with debts? The point here is when the sukuk represents the investor's right to obtain the payment of debt of RM20 million, for example, can this right be considered completely unrelated to currency? This requires a detailed study so that the concerns of the Middle East jurists can be addressed harmoniously.

**(d) Promise to buy back sukuk (purchase undertaking)**

Among the important features in structuring sukuk especially for the *musyarakah* and the *ijarah* sukuk is “purchase undertaking.” Its purpose is to strengthen the investors' confidence to the value and strength of the sukuk instrument. *Purchase undertaking* (PU) can be exercised in two situations:

- i. **at the maturity of the sukuk or during the subsistence of the sukuk; or**  
PU clauses are stipulated by the issuer in the trust deed and the document of principle terms and conditions (PTC). This clause is intended to provide the issuer a right to buy back the sukuk/underlying asset at the end of maturity of the sukuk or throughout the subsistence of the sukuk. The purchase price (exercise price) is normally based on a pre-agreed formula between investors and issuer. The buyback right is intended to dissolve the contract relating to the sukuk whereby the investors will get back their principal investment.
- ii. **when events of defaults (EoD) occur**  
Just as above, the PU clauses are stipulated by the issuer in the trust deed and the document of principle terms and conditions (PTC). In this situation, PU gives the issuer a right to buy back the sukuk/underlying asset in the event of default on the part of the issuer or other situations categorized as event of default.

In early 2008, the world was shocked by the statement of Syeikh Muhammad Taqi Uthmani – the Chairman of the Advisory Council of AAOIFI – who stated that 85% of sukuk in the market is in contradiction to Shariah. Following this, the AAOIFI had a special conference, which resulted in the following decision (AAOIFI, 2008):

Fourth: It is not permissible for the Mudarib (investment manager), sharik (partner), or wakil (agent) to undertake {now} to re-purchase the assets from Sukuk holders or from one who holds them, for its nominal value, when the Sukuk are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI Shari'ah Standard (12) on Sharikah

(Musharaka) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI Shari'ah Standard (5) on Guarantees. It is known that a Sukuk manager is a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether the manager is a Mudarib (investment manager), Sharik (partner) or Wakil (agent) for investments.

On the basis of decision, the issuer of sukuk *musyarakah* and *mudarabah* either as *mudharib*, *musyarik* or agent is not allowed to make agreements to buy back sukuk at face value. This is because it is viewed as a guarantee for the payment of the *musyarakah* and *mudarabah* capital.

However, if the PU is at the market price or at a fair value or at any price agreed upon exercising the PU, then it is permitted. Buy-back at a nominal or face value can only be done if there is some negligence and misconduct on the part of the issuer.

**(e) Liquidity facility**

According to the practice in structuring the sukuk *mudarabah* and *musyarakah*, if the profit derived is lower than expected, the issuer will usually make good the deficit through a facility called liquidity facility. In the *mudarabah* sukuk, for example, it is in the form of advanced payment made by *mudharib* to ensure that the investors get the expected profit. In implementing the PU, any advanced payment paid by *mudharib* will be set-off against the exercise price of PU.

However, AAOIFI rejects this view and does not permit a clause allowing a liquidity facility in issuance of sukuk. The ruling states:

Third: It is not permissible for the Manager of Sukuk, whether the manager acts as Mudarib (investment manager), or Sharik (partner), or wakil (agent) for investment, to undertake to offer loans to Sukuk holders, when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. It is not objectionable to distribute expected earnings, on account, in accordance with Article (8/8) of the AAOIFI Shari'ah Standard (13) on Mudaraba, or to obtaining project financing on account of the Sukuk holders.

In Malaysia, liquidity facility is permissible because it does not contain a guarantee from the *mudharib* or the partners as the advanced payment made by the issuer will be set-off against the exercise price when the issuer exercises the PU.

In the writer's view, whether a special fund is established as allowed by AAOIFI or by advance payment by some parties, both do not contravene Shariah. What is important is as long as the advance is not a guarantee of

the expected profit, then it is permissible. That is why in Malaysia, any advanced payment must be set-off against the exercise price when the PU is implemented.

## ISLAMIC REITs

To ensure that Islamic REITs is in line with Shariah, SC has issued Guidelines on I-REITs in 2005. The I-REITs Guidelines were set as the global benchmark for the development of I-REITs. The thrust of the I-REITs Guidelines is to provide clear guidance on any new investment opportunities in collective real estate investments through a Shariah-compliant capital market instrument. The criteria outlined in the guidelines are followed (Securities Commission, 2005):

### (a) The use of conventional insurance to insure real estate in Islamic REITs

Guidelines for Islamic REITs have stated that “an Islamic REIT must use the Takaful schemes to insure its real estate. If the Takaful schemes are unable to provide the insurance coverage, then the Islamic REIT is permitted to use the conventional insurance schemes.”

The aforesaid criteria has considered that Islamic REITs can only choose conventional insurance when takaful companies are not able to serve the coverage required by the Islamic REITs. This approval is justified and reasonable because applying for insurance scheme is mandatory in the REITs industry. If this flexibility is not provided in the event of inability of takaful company to provide protection, then Islamic REITs are not able to grow and compete with conventional REITs. Consequently, this may retard efforts to develop Islamic products which are against Islamic teachings that in turn require Muslims to practise Islam in all aspects of life. In fact, permissibility of conventional insurance under necessity is in line with the following *fiqh* maxim *al-darurah tubih al-mahzurat* (necessity makes forbidden things permissible) and *iza daqa al-amr ittasa`a* (latitude should be afforded in the case of difficulty) (al-Suyuti, 2004).

### (b) Forward sales or purchase of currency for hedging and risk management

An Islamic REIT is permitted to participate in forward sales or purchases of currency, and is encouraged to deal with Islamic financial institutions. If the Islamic REIT deals with Islamic financial institutions, then it will be bound by the concept of *wa`d* (only one party is obligated to fulfil his promise/responsibility). The party that is bound is the party that initiates the promise. However, if the Islamic REIT deals with conventional financial institutions, it is permitted to participate in the conventional forward sales or purchases of currency.

The above clause in the guidelines is desirable because SAC has set a requirement to use a number of hedging products for the purpose of risk management (Securities Commission, 2006). Generally, permission granted by the SAC is intended to limit the use of conventional hedging products. This is because the above clause



also grants permission to use conventional hedging products due to the lack of Islamic hedging product offered by Islamic institutions in catering to the need of investors. This is consistent with the *fiqh maxim al-darurah tubih al-mahzurah* (necessity makes forbidden things permissible) (al-Suyuti, 2004). However, such permissibility should be limited to exceptional circumstances. For example, if there is no Islamic hedging product that can manage certain form of risk, then investment managers are allowed to invest in conventional hedging products. This is in line with the following *fiqh maxim al-darurah tuqadar biqadariha* (Necessity is determined by the percentages revealed thereof) (al-Suyuti, 2004).

**(c) Purchase of real estate in which all the existing tenants operate non-permissible activities**

As well known, rental payments are a source of income for Islamic REITs. So if an Islamic REIT wants to purchase a property that already has tenants and the activity in the building does not meet Shariah guidelines such as conventional banking, then the Islamic REIT cannot purchase the property. This is stated clearly in Islamic REITs guidelines as follows (Securities Commission, 2005):

However, an Islamic REIT is not permitted to own real estate, for example, a building, in which all the tenants operate non-permissible activities, even if the percentage of rental from that building to the total turnover of the Islamic REIT is still below the benchmark (20%). This is to protect the image of the Islamic REIT.

**(d) Purchase of real estate with existing tenants and some of them operate non-permissible activities**

According to the guidelines issued by the SC, the Shariah advisor or Shariah committee appointed must make an evaluation of the property that the Islamic REIT plans to buy in terms of its compliance with Shariah. In this case, the management of the Islamic REIT must determine the total number of activities that are Shariah non-compliant and compare it to the total rental of the Islamic REIT for the latest financial year.

The benchmark for compliance is 20% as specified by the Advisory Council for the Security Commission. If it exceeds 20%, then the Shariah committee/advisor shall advise the Islamic REIT not to proceed to invest in the property.

The guideline also clarifies the method to compute the proportion of Shariah non-compliant rental from tenants that involve in mixed activities. This means that the tenant for a space like a supermarket where liquor is sold besides halal products, the proportion of Shariah-compliant to the non-compliant can be determined by using the floor area devoted to the halal and non-halal business. This ratio is used to determine the ratio of non-halal rental of the total rental paid by the tenant. For activity that is not related to floor space like services, then the calculation will be based on the Shariah advisor or Shariah committee's advice.

Benchmark 20% set out in the I-REITs Guidelines as a percentage of rental contribution from Shariah non-compliant activities is acceptable. This is based on a

*fatwa* concerning silk mixed with common thread. In Islam, silk cloth is prohibited to be worn by men based on a hadith of the Prophet s.a.w. (al-Nasa'i, 1996). However, it can be worn by men if the ratio of silk thread mixed with the common thread does not exceed 50% (al-Suyuti, 2004). Thus, the benchmark concerning such a mixture is 50%. This benchmark is suitable for application in the context of mixed rentals. Notwithstanding, SAC has determined 20% benchmark of total turnover of the Islamic Reits for the rental contribution from non-permissible activities which is more stringent.

## CONCLUSION

Shariah compliant shares, sukuk and Islamic REITs are among the Islamic Capital Market products that provide lots of opportunities to investors to invest their money according to Shariah. With the existent of the supervisory bodies for the capital market like Shariah Advisory Council of the Securities Commission Malaysia, the Islamic capital markets' products are able to compete with the conventional products. In fact, they are able to give confidence to Muslims that these products are approved only after SAC's review.

## FOOD FOR THOUGHT

- What are the two methodologies adopted in evaluating the Shariah-Compliant Securities in Malaysia?
- What should investors do if they invest in Shariah-compliant securities, whose status is subsequently changed to non-compliant?
- What are the Shariah principles that can be applied in structuring sukuk?
- Can an Islamic REIT own real estate in which all the tenants operate non-permissible activities?

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