SBP Research Bulletin
Volume 3, Number 1, 2007

Fixed Income Securities Shari'a Perspective

Muhammad Imran Usmani•

1. Introduction

Fixed income securities have been popular around the world in raising finance for funding large developmental and capital expenditures. These are being widely used by Government authorities, Municipal authorities and corporate entities for meeting their funding requirements. Fixed income securities not only facilitate tapping the large investor base but also help in developing an efficient capital market.

Keeping in view the necessity of an efficient financial infrastructure for economic development, the importance and contribution of such securities cannot be argued upon. This paper evaluates the nature of conventional fixed income securities from the Shari'a perspective and outlines the reason for its impermissibility. An alternate to debt based securities, Sukuk, is gaining popularity these days in the financial markets for raising finance in a Shari'a compliant manner. This paper also discusses different types of Sukuk that can be issued in place of conventional fixed income securities for not only meeting funding requirements but also to develop an efficient Islamic capital market.

2. Fixed Income Security and Shari'a Perspective

An investment that provides a return in the form of fixed periodic payments and eventual return of principal at maturity is called 'fixed income security'. Unlike a variable-income security, where payments change based on some underlying measure such as short-term interest rates, the payments of a fixed-income security are known in advance[1]. Common examples of such securities are bonds and certificates of deposit.

Islamic Shari'a does not allow dealing in debt based securities where the underlying asset is an interest based loan. Any loan given out on interest or markup is strictly prohibited and invites the curse of Allah (swt). Interest or Riba can be defined as:

• Shariah Advisor of Meezan Bank, Pakistan.
[1] www.investopedia.com

كل قرض جر منفعة فهو ربوا

"Any Loan that draws profit is Riba"

From the above definition, it is quite clear that advancing loan cannot yield any kind of benefit or interest; rather it is considered as charitable behavior in Shari'a for which reward lies in the Hereafter.

2.1. Bai-Al-Dain *(Sale of Debt)*

Dain means 'debt' and Bai means 'sale', therefore *Bai-al-Dain* connotes the sale of debt. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at **par value**. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shari'a[2]. Therefore, trading of any debt based securities and interest paid thereon (as practiced in conventional debt markets) is not allowed in Islamic Shari'a.

2.2. Resolution of Islamic Fiqh Academy[3]

The Council of the Islamic *Fiqh* Academy, in its sixth session held in Jeddah, Kingdom of Saudi Arabia, from 17 to 23 Sha'baan 1410 H (corresponding to 14-20 March 1990), resolved the following concerning 'Bonds':

First: The bonds which represent an undertaking to pay its amount along with an interest related to its face value or to a pre-determined profit are prohibited in *Shari'a.* Their issuance, their purchase and their negotiation, are all prohibited because they are interest-bearing loans, no matter whether their issuing authority belongs to the private sector or is a public entity related to the State. The change in the nomenclature, such as calling the bonds "certificate" or investment securities" or "saving certificates" or calling the interest "profit" or "income" or "service charge" or "commission" has no effect on the aforesaid ruling.

---

[2] An Introduction to Islamic finance, M Taqi Usmani, p. 216

[3] Resolutions and recommendations of the Council of Islamic Fiqh Academy 1985 – 2000, Islamic Development Bank, p. 119-120

Second: The "zero coupon bonds" are also prohibited because they are loans sold at a price inferior to their face value, and the owners of such bonds benefit from the difference in their prices which is considered a discount on the bonds.

Third: Similarly, the "prize bonds" are also prohibited because they are loans in which a liability to pay a pre-determined profit or an additional amount is undertaken in favor of their bearers as a whole, or in favor of an undermined number of persons out of them. Moreover, these bonds have a resemblance with gambling ("Qimar").

2.3. Resolution of AAOIFI Shari'a Board[4]

The issuance of all kinds of bonds is prohibited when these bonds include stipulations for the return of the amount of loan and excess in any form, whether such excess is paid at the time of the satisfaction of the principal amount of loan, is paid in monthly or yearly installments or in another manner and whether this excess represents a percentage of the value of the bond, as in the case with most types of bonds, or a part of it, as is the case with zero-coupon bonds. Likewise, prize bonds are also prohibited. This applies irrespective of the bonds being private, public or governmental. Trading in bonds, both sale and purchase, is prohibited and so is their pledging and endorsement and so on. The Shari'a substitute for bonds are investment *Sukuk.*

3. Sukuk – Shari'a Compliant Alternative

Sukuk (plural of *Sak*) is an Arabic word which means 'certificates'. Sukuk are 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*[5].

Sukuk are certificates issued in the name of the owner or bearer in order to establish the claim of the certificate owner over the financial rights and obligations represented by the certificate.

Sukuk represent a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufructs, services or a mixture of all these plus intangible rights, debts and monetary assets. These Sukuk

---

[4] Shari'a Standard # 21- Financial paper (shares and bonds), Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), p. 371

[5] Shari'a Standard # 17- Investment Sukuk, AAOIFI, p. 298

do not represent a debt owed to the issuer by the certificate holder. The owners of these certificates share the return as agreed at the time of issuance and bear the losses in proportion to the certificates owned (held) by them.

The distinguishing feature between conventional bonds and Sukuk is that bond is a contractual obligation whereby the issuer is obliged to pay to bond holders, on certain specified dates, interest and principal. In comparison, under a Sukuk structure the Sukuk holders each hold an undivided beneficial ownership in the underlying assets. Consequently, Sukuk holders are entitled to share in the revenues generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of the underlying assets.[6]

Sukuk can be issued on a short-term, medium-term or long-term basis in accordance with the principles of the Shari'a. The Sukuk may also be issued without specifying a period depending upon the nature of the contract underlying the Sukuk issue.

4. Types of Sukuk

There are different kinds of Sukuk of different maturities that can be issued in a Shari'a complaint manner. Issuance of Sukuk is quite popular these days for raising long term finance and majority of the Sukuk that have been issued to date are based on the concept of Ijarah. However, there is a great potential still untapped in utilizing different Islamic modes for the issuance of Sukuk.

Some of the most commonly used types of Sukuk are discussed below:

4.1. Ijarah Sukuk

Ijarah (analogous to English term 'leasing') means transferring the usufruct of a particular property against consideration of periodic rentals.

The arrangement of Ijarah has a good potential for the issuance of Sukuk through securitization of the leased assets, which may help create a secondary market for the financiers. Since the lessor in Ijarah owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.

---

[6] Structuring Islamic finance transactions, Euromoney Books, p.154

The purchase of a proportion of the asset by third party may be evidenced by a certificate, which may be called 'Ijarah Sukuk'. This certificate will represent the holder's proportionate ownership in the leased asset along with the rights and obligations of the owner/lessor to that extent. Each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly, the certificate holder will also assume the obligations of the lessor to the extent of his ownership. Therefore, in the case of total destruction of the asset, he will suffer the loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.

It should be remembered, however, that the Sukuk must represent real ownership of an undivided part of the asset with all its rights and obligations. Ijarah Sukuk representing the holder's right to claim certain amount of the rental only without assigning any kind of ownership in the asset is not allowed in Shariah. The reason is that the rent after being due is a debt payable by the lessee and any security representing such debt is not a negotiable instrument in Shariah and is subject to the rules applicable to the disposal of debts.

It is, therefore, necessary that the Ijarah Sukuk are designed to represent real ownership of the leased assets, and not only a right to receive rent.

Different forms of Ijarah Sukuk that can be issued are discussed next:

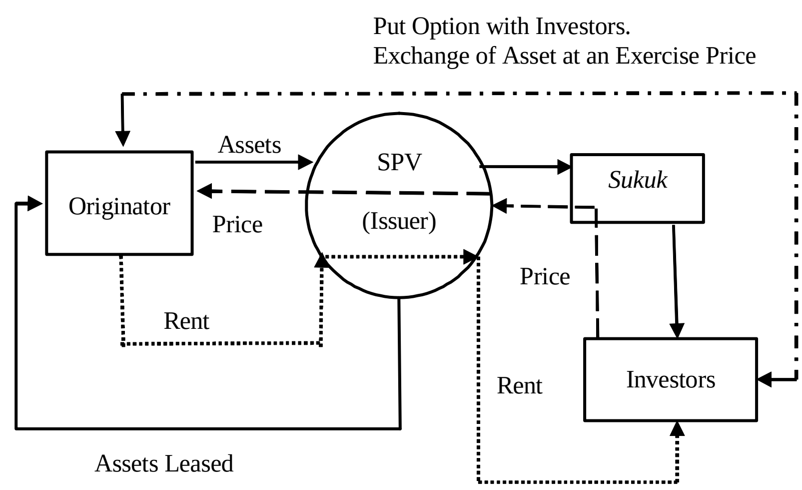
4.1.1. Sukuk of Ownership in Leased Assets

These are certificates issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the Sukuk become owners of the assets. The certificate holders jointly own the assets through an undivided ownership sharing the profits and losses on the basis of the partnership that exists between them. Such Sukuk are tradable and redeemable at the market price or at a rate agreed upon between the certificate holder and the issuer.

Case Study: WAPDA Sukuk
The Pakistan Water and Power Development Authority (WAPDA) acts as an autonomous body for the development and use of the water and power resources of Pakistan on a unified, multi purpose basis. WAPDA is responsible for the generation of electricity through Hydel power generating units and subsequent distribution to various parts of Pakistan

WAPDA required funding to finance (partially) Mangla Dam Raising Project in order to be more productive. WAPDA decided to raise finance worth PKR 8.0 billion from the local market through issuance of Sukuk based on Ijarah. This involved Sale & Leaseback of 10 hydel power generation units (Turbines) installed at Mangla Hydel Power Station.

The net proceeds from the issue of Sukuk were used by the WAPDA First Sukuk Co (WAPDA SPV) to purchase the Turbines from WAPDA. Each certificate represents an undivided beneficial ownership in Turbines. The assets were then leased back to the WAPDA for a period of 7 years under Ijarah Agreement. WAPDA agreed to pay Sukuk -holders semiannual rental payments against usage of Turbines. The rental payments by WAPDA are payable in arrears and are benchmarked against a base rate (KIBOR). The underlying assets will be purchased by WAPDA at the end of the lease term against fulfillment of unilateral undertaking to purchase Turbines. This way, Sukuk holders will get their investment back at the end of the term. The payment obligation of WAPDA under this arrangement is guaranteed by Government of Pakistan helping Sukuk to be SLR eligible for Islamic Banks.



4.1.2. Sukuk of Ownership of Usufructs of Assets

These are Sukuk issued by the owner of an existing asset (or owner of the usufruct of an existing asset (lessee)) with the aim of leasing the asset (or subleasing the usufruct) and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the Sukuk.

The sukuk holders become joint owners of the usufruct sharing its benefits and risks. It is permissible to trade in securities of ownership of usufructs of tangible assets prior to a contract for sub-leasing the assets. When the assets are sub-leased, the Sukuk represents rent receivables, which makes it a debt owed by the second lessor and thus becomes non-tradable.

4.1.3. Sukuk of Ownership of Services

These are Sukuk issued for the purpose of providing services through a specified provider (such as educational benefits in a nominated university) and obtaining the service charges in the form of subscription income so that the holders of the Sukuk become owners of these services.

It is permissible to trade in securities of ownership of services to be provided by a specified party prior to sub-leasing such services. When the services are sub-leased, the certificate represents rent receivables to be collected from the second lessee. In this case, the certificate represents a debt and is, therefore, subject to the rules and regulations of disposal of debts.

4.2. Musharaka Sukuk

Musharaka means ‘sharing’ of profit or loss by the partners of a joint venture. It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution.

Musharaka is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people can afford to subscribe. Every subscriber can be given a Musharaka certificate which represents his proportionate ownership in the assets of the venture. These Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the Musharaka venture are still in liquid form (i.e., in the shape of cash or receivables).

Musharaka Sukuk are issued with the aim of using the mobilised funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts. The certificate holders own the assets of partnership with the accompanying profits and losses and are entitled to their share in the profits of the partnership, if any. Each owner of a certificate participates in the profit at an agreed ratio and bears a loss in proportion to the financial value represented by his certificates.

Different forms of Sukuk that can be issued on the mode of Musharaka are discussed below.

4.2.1. Participation Certificates

These are certificates representing projects or activities managed on the basis of Musharaka by appointing one of the partners or another person to manage the operation.

4.2.2. Mudaraba Sukuk

These are certificates that represent projects or activities managed on the basis of Mudaraba by appointing one of the partners or another person as the mudarib for the management of the operation.

The issuer of these certificates is the Mudarib, the subscribers are the owners of capital, and the realised funds are the Mudaraba capital. The certificate holders own the assets of Mudaraba in proportion to the financial value of the certificates they own. The certificate holders and the Mudarib are entitled to an agreed ratio of profit whereas the loss is solely borne by the subscribers of the Sukuk.

4.2.3. Investment Agency Sukuk

These are certificates that represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation on behalf of the Sukuk holders.

The issuer of these certificates is the investment agent, the subscribers are the principals and the realised funds are the entrusted capital of the investment. The Sukuk holders own the assets represented by the certificates with its benefits and risks, and they are entitled to the profits, if any. The investment agent is entitled to an agency fee irrespective of the profit or loss of the business.

Case Study: Musharaka Term Finance Certificates

The Sitara Group, one of the high profile conglomerates in Pakistan formally decided to free its balance sheet from all conventional financing and restructure its balance sheet in line with Shariah. The Sitara Chemical Industries, a part of Sitara Group and the largest producer of Caustic Soda in the country, decided to issue Term Finance Certificates to meet part of the cost of expansion of its Caustic Soda plant. Over the course of the last few years, the company issued two successful Musharaka based term finance certificates (MTFC) worth a total size of PKR 510 million. These were both privately placed and listed on the Karachi Stock Exchange.

The certificates carry a fixed tenor with profit payments linked to the operating profit or loss of the Chemical division of the company. The profit sharing ratio has been structured in a slightly unconventional way. The level of yearly operating profit is divided into two broad tiers under the heading of Level 1 Profit and Level 2 Profit. Level 1 Profit is categorized as the first PKR 100 million of operating profit of the Chemical division out of which investors earn at a profit rate of 12% of the outstanding principal. The rate of percentage of profit entitlement shall be proportionately reduced if operating profit is less than PKR 100 million. Level 2 profit is categorized as the operating profit over and above the first PKR 100 million out of which investors earn at 2% of the outstanding principal on each subsequent PKR 100 million operating profit. If the operating profit falls below the slab of PKR 100 million, the certificate holders will be entitled to the proportionate ratio of profit.

The profit sharing ratio was worked back according to the projected profitability results of the company and the expected level of internal rate of return (IRR) that the company is willing to provide to the investors. Semi annual profit is paid on account (provisional) on the basis of projections irrespective of profit and loss and the final profit payment is determined on the basis of annual audited accounts of the company. If the final profit payment determined on the basis of annual audited accounts is in excess of the on-account profit payments that have already been made to the TFC holders then the excess amount will be paid along with next six monthly on-account profit payments. However, if the on-account payments that had already been made for the year were in excess of the final profit share of the TFC holders then the excess will be adjusted.

To mitigate the risk of loss for the MTFC holders, the company created and maintained a Takaful reserve, contributed both by the issuer and investor that run till the entirety of the issue. TFC holders’ contribution shall be in the form of 25% (1/4) of their level II profit on a year to year basis during the tenor of the TFC. If upon finalization of the annual audited accounts a loss has been incurred then the share of loss attributable to the TFC holders will be set off against the takaful reserve. However, if the amount available in the takaful reserve is insufficient to absorb the entire loss attributable to the TFC holders then at the time of redemption of principal amount, the unabsorbed losses will be adjusted against the principal amount. As TFCs matures, the proportionate balance of the Takaful reserve relating to that, if positive, will be paid out to TFC holders and to the company in accordance with their respective shares in the balance of Takaful reserve.

In the event of genuine business losses and continuous dismal performance of the company, verified by the separately appointed auditors, the investors bear the risk of losing their investment. Under such circumstances, the investors will have no recourse to the security, which is hypothecated in their favour, the call of which is only warranted in case of fraud and negligence proven in the banking court.

4.3. Salam Sukuk

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. Here the price is cash, but the supply of the purchased goods is deferred. The permissibility of Salam was an exception to the general rule that prohibits the forward sales.

Salam has become a liquidity management tool for Islamic banks by providing short term investment opportunities in Salam Sukuk. It has provided an alternative to the conventional Treasury Bills in few Islamic countries.

The issuer of the Salam Sukuk is a seller of the goods of salam, the subscribers are the buyers of the goods, while the funds realised from subscription are the purchase price (salam capital) of the goods. The holders of salam Sukuk are the owners of the salam goods and are entitled to the sale price of the certificates or the sale price of the salam goods sold, if any.

It is not permissible to trade in Salam Sukuk during the term of the Sukuk since the underlying asset is a debt created through advance payment of the sale price. Such debt will only be converted into a tangible asset at the end of the maturity when the Salam subject matter is delivered.

4.4. Istisna' Sukuk

"Istisna'" is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific

Case Study: Sukuk al-Salam

The Bahrain Monetary Agency has issued a series of Islamic financial instruments designed to broaden the depth and liquidity of the market. One of the instruments is the short-term government bills structured based on the mode of Salam, having generally a maturity of 91 days. Aluminium has been designed as the underlying asset (subject matter) of the salam contract. The Government of Bahrain sells aluminium of standardized specifications to the Islamic banks (buyers) in exchange of the advance payment and undertakes to supply a specified amount of aluminium at an agreed future date. The Islamic bank(s) appoints the Government of Bahrain as an agent to receive delivery of commodity and market the quantity of aluminium through its channels of distribution. Through this agency contract, aluminium is sold in the market and a competitive rate of return is relaized by Islamic banks. However, Salam sukuk are not tradable instruments and can only be held to maturity.

commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods. It is necessary for the validity of Istisna' that the price is fixed and that necessary specification of the subject matter is fully settled between the parties[7]. It is not necessary in Istisna' that the price is paid in advance, rather it may be deferred to any time according to the agreement of the parties.

Istisna' Sukuk are issued with the aim of mobilising funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders. The issuer of Istisna' Sukuk is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realized from subscription are the cost of the product. The Sukuk holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel Istisna', if any.

It is permissible to trade in or redeem Istisna' certificates if the funds have been converted, into assets owned by certificate holders. If the realised funds are immediately paid as a price in a parallel Istisna'a contract or the manufactured item is submitted to the ultimate purchaser, then trading in Istisna' certificates is subject to rules of disposal of debts.

The instrument of Istisna' may be used for project financing or building a bridge or a highway. The modern BOT (Buy, Operate and Transfer) agreements may also be formalized on the basis of Istisna'. Istisna' Sukuk may be issued to raise finance for the construction of highways, motorways, airports etc.

4.5. Murabaha Sukuk

'Murabaha' is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic Financial Institutions as a mode of financing. Murabaha involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on deferred payment basis. Under this arrangement the financier discloses its cost and profit margin to the client.

Murabaha Sukuk are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that the certificate holders become the owners of the Murabaha commodity. The issuer of the certificates is the seller of the Murabaha commodity, the subscribers are the buyers of that commodity and the realized funds are the purchasing cost of the commodity. The Sukuk holders own the Murabaha commodity and are entitled to its sale price.

[7] An Introduction to Islamic finance, M Taqi Usmani, p. 195

Murabaha is a transaction, which cannot be securitized for creating a negotiable instrument to be sold and purchased in the secondary market. The reason is that in case of Murabaha, as undertaken by present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. So, Murabaha Sukuk/certificate only represents a monetary debt receivable from the client in the form of Murabaha price which is non-negotiable as per the rules of Shari'a. Because, transfer of the Sukuk to a third party will mean transfer of money and money can only be exchanged against money at par value. This restricts the possibility of creating a secondary market for Murabaha Sukuk. However, trading of Murabaha certificates is permissible after purchasing the Murabaha commodity and before selling it to the buyer.

5. Conclusion

Fixed income securities, as present in today's conventional market, are not permissible under Shari'a. However, an alternative (in the form Sukuk) can be used effectively for meeting funding requirements. The issuance of Sukuk will not only help in replacing conventional interest based financing with Islamic Financing but will also develop an efficient and diversified capital market institution.

May Allah grant us courage and sincerity to work for the establishment of Islamic Economic System.