

Sukuk Issuance and its Regulatory Framework in Saudi Arabia

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Abstract

This article aims to give a comprehensive and critical review of sukuk issuance in Saudi Arabia, and the extent to which the issuance of sukuk in Saudi Arabia is consistent with Shariah requirements. The article is divided into two sections. Accordingly, the first section of this article begins with an examination of sukuk in general, and includes the concept of sukuk, the basic principles of sukuk, common types of sukuk, and a critical analysis of the most important differences between sukuk and conventional bonds. The second section gives a critical analysis of how sukuk work in Saudi Arabia, offering the regulatory framework of the issuance of sukuk in the KSA, and the legal challenges from Shariah point of view, and provide recommendations to overcome these challenges.

Keywords: Sukuk issuance, Shariah, Saudi Arabia, Capital Market Authority

1. Introduction

This article aims to give a comprehensive and critical review of *sukuk* issuance in Saudi Arabia, and the extent to which the issuance of *sukuk* in Saudi Arabia is consistent with *Shariah* requirements. The article is divided into a number of sections. Accordingly, the first section of this article begins with an examination of *sukuk* in general, and includes the concept of *sukuk*, its basic principles, common types of it, and a critical analysis of the most important differences between *sukuk* and conventional bonds.

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The second section provides a critical analysis of how *sukuk* work in Saudi Arabia, presenting the regulatory framework of the issuance of *sukuk* in the KSA, and the legal challenges from the *Shariah* point of view, and providing recommendations to overcome these challenges. A summary is provided at the end of the article.

2. The Concept of Islamic Bonds (*Sukuk*)

The term *sukuk* is a plural Arabic name for Islamic financial certificates and is equivalent to a bond. The singular of this term is *sakk*. The term *sukuk* was used in Muslim societies during the Middle Ages, and refers to 'papers', which are undertaken for financial obligations originating from trade and other commercial activities. However, the concept of *sukuk* has undergone profound changes with regard to its conventional structure. In terms of market parlance, *sukuk* refers to negotiable financial instruments which do not consist of elements that have been prohibited in Islam.²

In May 2003, *sukuk* was defined officially by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as certificates of equal value, which represent an undivided pro-rate ownership of underlying assets, and the *sakk* can be freely traded at par premium or discount. In Islamic finance, *sukuk* represents a 'capital market corollary to a singular lender'.³ It refers to the bonds which are in compliance with *Shariah* principles. Due to Islamic religious beliefs, charging or paying interest (*riba*) as a source of earning profits is considered immoral. This belief has made it mandatory for financial institutions to earn a profit on the basis of real economic activity. *Shariah* law also prohibits investment in a number of sectors including alcohol, gambling and armaments, excessive uncertain trade contracts (*gharar*), tobacco, trading in debt contracts at discount, and gambling and chance-based games (*qimar*).⁴ This is because of the lessons of the Quran.

² Michael J. T. McMillen, 'Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years' *Wisconsin International Law Journal* (2010) 25(4) 707; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 58-59.

³ Noor Inayah Yaakub, Hafizuddin Shah, Wan Kamal Mujani, Kamaruzaman Jusoff and Mohamad Abdul Hamid, 'Asset Ownership and Investor's Protection under Sukuk Ijarah' *Middle East Journal of Scientific Research* [2011] 23.

⁴ Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' *Journal of Structured Finance* (2007) 13(1) 3; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 58.

Therefore, in Muslim-populated countries, a traditional debt market cannot flourish, as conventional bonds represent interest-based funding.

The law prohibits 'enrichment of trade from debt' and 'interest on loans'. Therefore, the sale of accounts receivables is not compatible with *Shariah* law, as it does not involve real assets. However, the law permits securitisation of non-financial assets, such as *ijarah* assets and *bai' salam* assets, and underlying assets pool within a *mudarabah* or a *musharakah* structure. It is permitted to securitise *ijarah*, as in this case, the underlying assets are the real collateralised *ijarah* and generate cash flows from lease payments. It is quite common to create a Special Purpose Vehicle (SPV) in an *ijarah* financing system, which can be used to issue a *sukuk-al-ijarah* or *ijarah* certificate to investors. The SPV (lessor) leases to a particular company (lessee) and this company utilises the assets in its production.⁵

The lessor SPV receives a periodic payment by the lessee company and the lessor provides a portion of the payment to the suppliers. The certificate holders also receive a portion of the proceeds as a predetermined return on investment. The sum of the periodic rental payments from which the return is secured is agreed between both parties, which are the lessor SPV and the lessee company; this is why the certificate is capable of giving its holder a predetermined rate on investment. However, the return on investment is low, because the *sukuk al-ijarah* fund is a low-risk fund with a minimum risk of capital loss.⁶

3. An Overview of the *Sukuk* Market

In 1990, Malaysia became the first country to issue *sukuk*, with a small amount of (Ringgit Malaysia RM120 million) (U.S. \$30 million) by Shell Malaysia. Over a decade and a half, the capital raised through *sukuk* has increased manifoldly. In 2004, it was U.S. \$6.7 billion, whereas in the first six months of 2005, the total reached U.S. \$6.2 billion.

⁵ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 60-61; Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' *Journal of Structured Finance* (2007) 13(1) 4-5; Mohamad Zaid Mohd Zin, Ahmad Asmadi Sakat, Nurfahratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 473.

⁶ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 59.

It is worth emphasising here that in the year 2007, about \$10.43 billion of *sukuk* was listed on the Dubai International Financial Exchange (DIFX), which was the highest of any exchange worldwide.⁷

An impressive rise in the amount of *sukuk* was observed during the year 2006-2007, when the global market value of *sukuk* reached \$51.5 billion in 2007; this figure was up by 90% compared to 2006. The data indicate that there had been a tremendous increase in the global *sukuk* market, and according to the International Monetary Fund (IMF), this boost was expected to build up an impetus in the days ahead. The volume of *sukuk* issued worldwide was equal to \$47 billion in 2007, which was 73% up from the figure of 2006. The volume of capital rose through *sukuk* in the Middle East, particularly in the countries of the Gulf Cooperation Council (GCC); it reached \$53 billion from \$38 billion in 2007. The total number of *sukuk* issued worldwide also saw a significant rise, reaching 207 in 2007, as compared to 199 in 2006 and 89 in 2005.⁸

4. Differences between *Sukuk* and Conventional Bonds

Sukuk bonds are differentiated from conventional bonds on the basis of contract legitimacy and *Shariah*-compliances.⁹ There are no such differences in terms of financial perspectives. The similarity of *sukuk* with conventional bonds has made it very popular in the conventional finance industry. *Sukuk* and conventional debt instruments share many common features, especially asset-backed bonds. When it comes to rating, default clauses, and coupon payments, Cakir and Raei see *sukuk* as parallel to conventional bonds.¹⁰

In the case of the bond, there is a contractual debt obligation under which the issuer is obliged to pay a certain interest on a specified date. On the other hand, *sukuk* enables the bondholder to claim an undivided beneficial ownership in the underlying assets.

⁷ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 59.

⁸ Ibid.

⁹ Muhammad Al-Amine, 'Sukuk Market: Innovations and Challenges', Islamic Economic Studies (2008) 15 (2) 8.

¹⁰ Selim Cakir and Faezeh Raei, 'Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk?' International Monetary Fund (2007) WP/07/237, 3-4.

Sukuk holders are entitled to share the profits generated through underlying assets with regard to their contribution.¹¹ This can be expressed as one of the major distinctions between *sukuk* and conventional bonds.

The following differences have been identified by Thomas and Adam¹² between *sukuk* and conventional fixed income products:

a) The Issue of Ownership

The ownership of *sukuk* is consistent with the laws of *Shariah*, and symbolises an ownership which is characterised by originating the cash flows/revenues for funding those projects that add genuine value to the economy, and therefore, the community. In terms of their characters and application, the underlying assets must show compliance with *Shariah* laws. The values of underlying assets are not subject to appreciation or depreciation of market values, until the end of the investment cycle. This form of financing is quite helpful in highlighting the importance of genuine assets and assists in minimising the extent of speculation. However, in the case of standard conventional bonds, the authorised borrowers owe the debt to the bond holders, and are contractually obliged to repay the amount of the principal along with interest on maturity.¹³

As regards the principles of Islam, this scenario of the bond is a case of social and economic exploitation. The ownership of a bond is not supported by the value of the underlying assets; rather it is solely supported by the creditworthiness of the issuers. Moreover, the minimal transparency associated with bonds is considered an unhealthy practice which intensifies the volatility in the capital market.

¹¹ Abdul Karim Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (Routledge 2011) 101; Mohamad Zaid Mohd Zin, Ahmad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; *ibid* 458.

¹² Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2004) 52-53.

¹³ *Ibid*.

In Islam, those sources are considered unethical and exploitative which ensure the return of interest as well as principal.¹⁴ According to Justice Taqi Usmani, a noted *Shariah* scholar, bond-holders in conventional financial institutions are nothing more than sponsors of enterprise, and the interest charged on their loans can be described as a percentage pegged to the price of interest in the market. It is worth noticing here that a bond can be issued for a wide range of projects, irrespective of its compliance with *Shariah* law.¹⁵

b) The Risk/Return Issues

There is a natural tendency by investors to try to minimise their risks, while maximising their return. In this regard, the inherent quality of Islamic finance, which promotes a profit-loss sharing purpose on underlying assets, rather than interest on principal, can be described as the basis of participatory and cooperative joint ventures. Due to the high volatility in return, many investors perceive that bonds are a conservative source of investment. However, the overall return with regard to a bond is subject to many financial variables including interest risks and downturn in the bond prices.¹⁶

Moreover, the absence of collateral and risk of defaulters are considered to be major risks associated with bonds. When these issues are compared with *sukuk*, it can easily be observed that in terms of risk/return structures, *sukuk* are broadly analogous to bonds. It has been argued by Usmani¹⁷ that *sukuk* are indistinguishable from bonds in terms of their return from the projects, on the basis of the London Interbank Offered Rate (LIBOR) benchmark.

¹⁴ Ibid.

¹⁵ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 35.

¹⁶ Aniss Boumediene, 'Is credit risk really higher in Islamic banks?' *The Journal of Credit Risk* (2011) 7 (3) 99; Khadidja Khaldi and Amina Hamdouni, 'Islamic Financial Intermediation: Equity, Efficiency and Risk' *International Research Journal of Finance and Economics* [2011] 65, 149; Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 399-400.

¹⁷ Sheikh Muhammad Taqi Usmani is one of the contemporary scholars who have a significant role in applying Islamic law to finance. He is an expert in the fields of Islamic Jurisprudence (*fiqh*) and economics, and currently leads the International *Shariah* Council for the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain. He is also deputy chairman of the International Islamic *Fiqh* Academy of the Organization of the Islamic Conference, one of the highest legal bodies in the Muslim World. Usmani is on the *Shariah* advisory boards of HSBC, Dow Jones and Abu Dhabi Islamic Bank, to check that their activities comply with *Shariah*.

The inclusion of mandatory underlying assets to reduce risk exposure makes a better risk profile in the case of *sukuk* than in that of bonds.¹⁸

The most important difference between *sukuk* and conventional bonds can be identified with regard to the future flow of money. In the case of conventional bonds, investors are assured a fixed rate of return or interest at the maturity of bond. This can be illustrated by an example: an investor who subscribes for bonds worth about £1000 at the rate of 10% will be given the benefits of £100 until the maturity. In other words, the methods for calculating profit for *sukuk* and conventional bonds are the same, except that *sukuk* ensures the benefits on underlying assets rather than on future cash flows. The financial structure of *sukuk* is based upon the exchange of those assets that have been approved with a few scales, instead of the exchange of money with the certificates alone. The *sukuk*-based transactions thus enable investors to receive profits with regard to their investments.¹⁹

The second major difference can be recognised in terms of financial situations where a bond issuer cannot repay the debt and interest to the investors; in these financial circumstances, a bond holder may lose his/her investment, as the contractual obligations of a bond do not guarantee the security of recovering the principal investment. In the case of *sukuk*, investors can claim some of their investment through collateral to the *sukuk* contract. In addition to this, it ensures that in the case of money raised from investors which has been used to buy a property, the benefits of the assets are distributed among the investors.²⁰

¹⁸ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2004) 54; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 58-59.

¹⁹ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 204.

²⁰ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Noor Inayah Yaakub, Hafizuddin Shah, Wan Kamal Mujani, Kamaruzaman Jusoff and Mohamad Abdul Hamid, 'Asset Ownership and Investor's Protection under Sukuk Ijarah' *Middle East Journal of Scientific Research* [2011] 27.

Table 4.1 Islamic *Sukuk* versus Conventional Bonds

Conventional Bonds	Islamic <i>Sukuk</i>
From the issuer's point of view, it represents a debt obligation to the investors.	It represents stakes of ownership in underlying assets.
Regardless of the compliance with Islamic and non-Islamic purposes, bonds can be issued.	The issuance of <i>Sukuk</i> must be consistent with Islamic financial laws.
It establishes a relationship which can be characterised as that of lender/borrower, with the purpose of earning money on money.	The contractual obligations of <i>Sukuk</i> are permissible Islamic contracts and reflect the characteristics of undertaking business between the <i>Sukuk</i> holders and the originator.
It enables fixed or variable rates of interest on investments.	The tangible assets or services of <i>Sukuk</i> represent legal/beneficial interest in projects.
The sale of a bond is equivalent to a sale of debt.	It enables the sale of a share from the underlying assets.
The creditworthiness of the bond holder is the most important factor in the issuance of conventional bonds, and bond holders do not rely directly on specific assets.	The value of <i>Sukuk</i> prices are driven by and dependent upon fluctuations of market in terms of appreciation and depreciation of the market value of the underlying assets.

Source: An Overview of Islamic *Sukuk* Bonds (2009).

5. Common Types of *Sukuk*

There are different types of *sukuk*, which can be arranged and ordered in the form of different financial transactions. Conventional bonds involve assurance about the repayment of a loan, while *sukuk* offer a mechanism of partial ownership under a financial obligation (known as *sukuk murabaha*), business (*sukuk al musharaka*), investment (*sukuk al istithmar*), project (*sukuk al istisna*), and asset (*sukuk al ijarah*).²¹

5.1 Ijarah *Sukuk*

Ijarah sukuk constitute the financial arrangement for durable assets associated with an *ijarah* contract, which includes securities having equal value.

²¹ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic *Sukuk* Bonds', The Journal of Structured Finance [2009] 60.

They constitute the framework of leased assets and do not establish an association among *sukuk* holders and any company. *They are freely tradable at par, premium, or discount in both primary and secondary markets as determined by market forces.* A total of three parties are involved in *ijarah sukuk*, namely the originator or beneficiary, the SPV (special purpose vehicle) and *sukuk* holders (investors). It is essential for the terms of agreement to be clearly defined in *an ijarah* contract.²²

The structure of *ijarah sukuk* involves the following steps. The originator delivers the assets to the SPV on a specified and defined purchase price. *Sukuk* certificates are issued by the SPV for raising funds, which are handed to the originator. With a pre-defined time, the SPV and originator enters into a lease agreement in which the originator acts as lessee by giving back the assets. Regular rental amounts are received by the SPV from the originator, which are dispersed to the *sukuk* holders. The SPV sells back the assets on maturity at their pre-defined value.²³

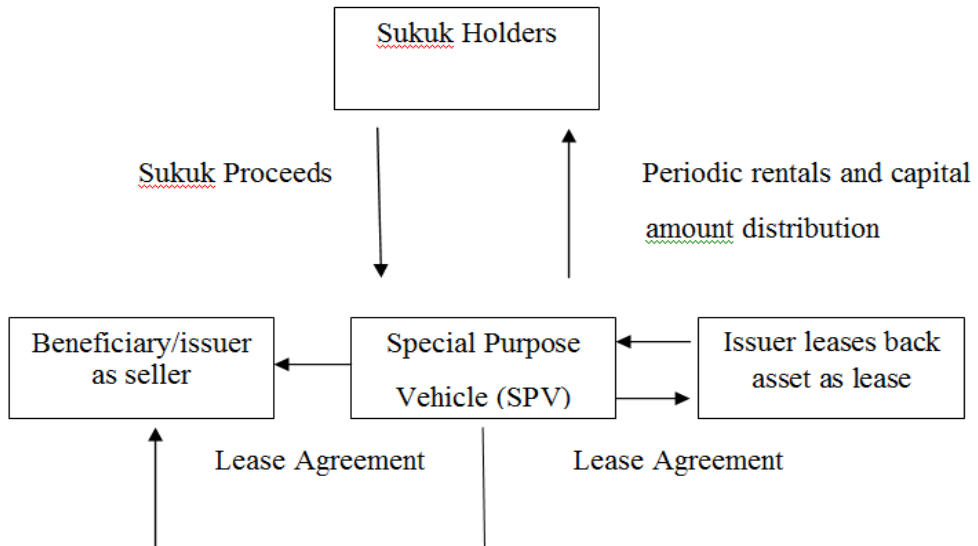
An example of *ijarah sukuk* is Qatar Global *Sukuk*. In October 2003, the Qatar Global *sukuk* were introduced into the market, with a value of \$700 million, and were redeemable in the year 2010. The securities were distributed at a minimum value of \$10,000 with a maturity period of 7 years. Returns on investment have been variable under these securities; these are evaluated in terms of dollar funds London Interbank Offered Rate (LIBOR) and 40 basis points annually. Returns are included as rents on real inherent assets (leased piece of land).²⁴

²² Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' *Journal of Structured Finance* (2007) 13 (1) 20; S.R. Vishwanath & Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 60.

²³ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 49.

²⁴ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 61.

Figure 4.1: The Structure of *Ijarah Sukuk*



Source: An Overview of Islamic Sukuk Bonds (2009).

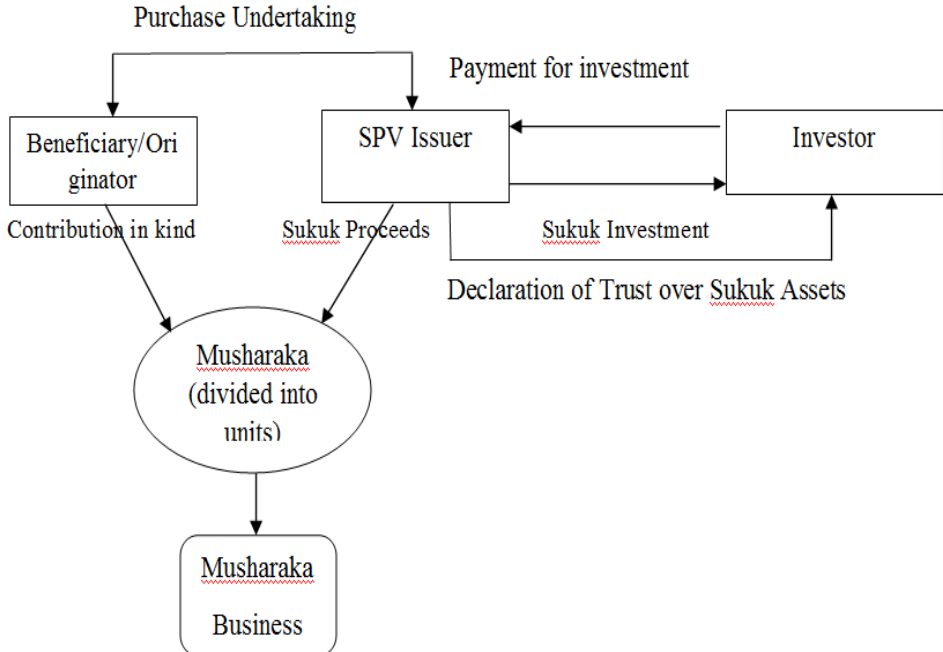
5.2 Musharakah Sukuk

Musharakah sukuk are issued in the market for the mobilisation of funds, so as to facilitate the establishment of new projects, make improvements in existing projects and finance the activities of business (with certificate holders as owners). These are documents with equal value, which are considered to be negotiable instruments that can be traded in secondary markets. Under this mechanism, the originator and SPV participate to form an agreement which is based on a specific period (5 to 7 years) and a pre-defined profit-sharing ratio. *Musharakah* shares are purchased by the corporation at regular intervals from the SPV. The corporation contributes its assets to the agreement and *sukuk* proceeds are contributed by the SPV. The corporation acts as the key agent for the development of land with the funds available from the *musharakah*, so as to sell them on obtaining fixed amount of fees and a variable incentive fee. Profits obtained from this mechanism are disseminated among the *sukuk* holders. In a *musharakah*, by the end of the specified period, there are no shares with SPV.²⁵

²⁵ Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization', *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 395-396.

An example of *musharakah sukuk* is the Emirates *sukuk*. They were issued by Wings FZCO at a value of approximately \$550 million at the rate of 75 basis points on LIBOR, having a maturity of 7 years. The key objective for the *musharakah* was to establish a new headquarters and engineering centre in Dubai. Regular payments for *sukuk* certificates were made from the rental money obtained from the *musharakah*.²⁶

Figure 4.2: The Structure of *Musharakah Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

²⁶ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 46.

5.3 Mudarabah Sukuk

Mudarabah sukuk, as described by the AAOIFI, refers to a certificate issued in the holder's name and represents the units owned by the holder in the *mudarabah* equity. The holders of the certificate are known as *Rabbul Maal* and the returns of shares in the *mudarabah* equity depend upon the ownership of shares.²⁷

A formal conclusion of a legally created *mudarabah* contract forms the basis of the *mudarabah sukuk*. It includes the labour and capital provided by both parties, while the division of profit between the parties is predefined. The *mudarabah sukuk* enable their holder to obtain his capital, as and when the *sukuk* are submitted, and also to collect a fixed proportion of profits declared in the issuance publication. The prime purpose of issuing *sukuk* is to provide monetary support to a finance-generating project or any activity distinct from the general business activities. The profit generated from these separate business activities is distributed according to the agreed percentage. The contract may specify the proportion of the company's earnings that are to be given to the *sukuk* holders in order to return their investments in instalments. It may also mention *sukuk* that are to be retired in the future, along with their market price.²⁸

Mudarabah sukuk are a significant method of investment, aimed at raising funds. They refer to a document that is given to the holder against the amount of funds paid to the owner of the project. However, *sukuk* do not entitle their owner to make claims with respect to any annual interest. In other words, *mudarabah sukuk* can be regarded as shares with varied returns, accumulated periodically, in accordance with the profits of the project. It is essential for the *mudarabah sukuk* to entitle their owner or holder to shares, as specified in the *sukuk*. The holder of the *sukuk* is entitled to various rights determined by *Shariah* at the time of forming the *mudarabah sukuk* with respect to mortgage, sale, succession, and gifts.

²⁷ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market', *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 473; Karmila Kamil, Marlina Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization', *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

²⁸ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 63.

Subscription for the *mudarabah sukuk* implies approval on behalf of the issuer and an offer on behalf of the investor. It is necessary for the *mudharabah* contract to be in accordance with the *Shariah*.²⁹

The *sukuk* holder has the right to sell or transfer his ownership in the securities market on the expiration of a certain pre-determined time period from the time of subscription.³⁰ However, the sale of *sukuk* must comply with the following conditions. Trading of *sukuk* involving the transfer of *mudarabah* capital in terms of money should be in accordance with the rules of exchange of money (*Sarf*). If the *mudarabah* capital is in the form of debt, the transfer should be in accordance with the principles of Islamic debt trading. If the *mudarabah* capital is in the form of money, debt, benefits or assets, trade should be conducted according to the market price determined by mutual consent.³¹

An example of *mudarabah sukuk* is the National Bonds Corporation and the Saudi Hollandi Bank. The National Bonds *mudarabah* is an open-ended investment fund, developed by the National Bonds Corporation. The bonds represent the funds that have been collected from the bond holders. These funds are held, managed and invested by the National Bonds Corporation as *mudarib*, in compliance with the rules and regulations of *Shariah*. A National Bond does not represent any specific interest of the holder in any division of the *mudarabah* assets. However, it does represent the holder's undivided share and entitlement to a part of the distributable profits in the *mudarabah* assets.

The National Bonds Corporation acts as an investment manager and manages the *mudarabah* assets for the investors or bond holders. The bond holders do not have the right to take part in the supervision of the *mudarabah* assets.

²⁹ Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

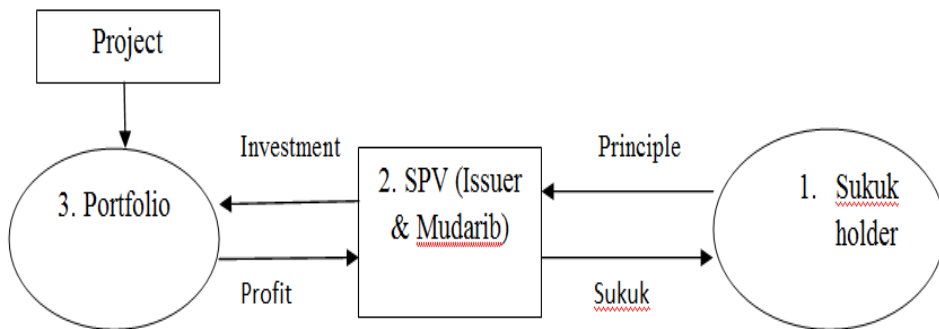
³⁰ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfaahatul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 474.

³¹ Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

The profits that are to be distributed are divided in the ratio of 80:20; and on the basis of a feasibility study, 60% of the *mudarabah* assets are to be invested in the pre-decided new projects and 40% in other investments, according to the rules of *Shariah*.

Development projects and infrastructure constitute 60% of the *mudarabah* assets, while shares, portfolios and funds constitute the remaining 40%. The profits projected for the former part of the investments range from 15% to 25% per annum, while the latter part are from 4% to 6% per annum. The overall investment of the National Bonds *mudarabah* capital would be intended to achieve a 15% rate of return per annum. The distribution of profits in the 80:20 ratio between the National Bonds Corporation and the bond holders would result in a 3% rate of profit for the bond holders.³²

Figure 4.3: The Structure of *Mudarabah Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

5.4 Murabaha Sukuk

Murabaha sukuk is circulated in the market for the mobilisation of funds, so as to facilitate the trading of products (with certificate holders as owners). These are certificates with equal value, whose issuer is a supplier to the *murabaha* community. The key subscribers are the purchasers of the offered financial product.

³² S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 63-65.

The funds gained from the subscribed contribution are recognised as its cost.³³ The *sukuk* holders possess the right to the selling price of the *murabaha* commodity. A non-negotiable monetary debt receivable symbolises the *murabaha sukuk*, which has to be obtained from the client at the *murabaha* price. The below-mentioned steps indicate its structure:

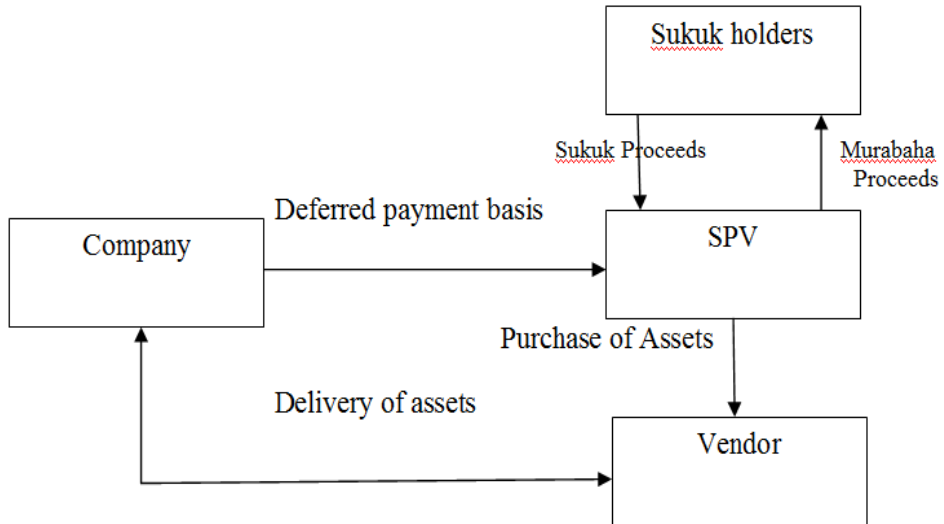
The SPV and borrower enter into a contract on mutual agreement. *Sukuk* are issued by the SPV to investors on receiving the proceeds. The SPV purchases a *murabaha* commodity from the supplier on the basis of the options available on the spot. The SPV sells the commodity to the purchaser for the spot price and a profit margin, which can be paid in the form of instalments. Investors obtain profits by recovering the selling price.³⁴

An example of *murabaha sukuk* is the Arcapita Bank. It issued multicurrency *sukuk* known as FIRSAN by following the *murabaha* structure on the basis of instalments from 2003 to 2005 of \$100 million (in 2003), \$75 million (in 2004), and \$801 million (in 2005). It held the *sukuk* for 5 years with an estimated price of 175 basis points and LIBOR (3 months).³⁵

³³ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfaahratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 474.

³⁴ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65.

³⁵ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 52; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65.

Figure 4.4: The Structure of *Murabaha Sukuk*

Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

5.5 Salam Sukuk

Salam sukuk is circulated in the market for the mobilisation of funds, so as to deliver the goods (with certificate holders as owners). These are certificates with equal value, whose issuer is the supplier of goods (covered under *salam*). Key subscribers are purchasers of the offered goods. The funds gained from the subscribed contribution of goods are recognised as its cost (*salam* capital). The certificate holders possess the right to the selling price of the *salam* goods. Despite this, it is non-tradable and is recognised as a receivable. *Shariah* obligations of *salam* such as quality, quantity, place of asset deliverance are applicable to *salam sukuk*.³⁶

Prior to maturity, the purchased goods are not sold off again. These transactions have a relative magnitude that is equal to exchange of debt, which makes them less appealing to investors. Therefore, they are purchased by an investor in the case where the estimated price of a commodity is expected to reach a higher level by the time of maturity.

³⁶ Rodney Wilson, 'Innovation in the structuring of Islamic sukuk securities' *Emerald Group Publishing Limited* (2008) 24 (5) 173; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65-66.

In order to source the purchases and commodity, the SPV guarantees the agreement with an originator. On the part of the *sukuk* holders, the originator purchases the commodity and resells it in order to make a profit from the investment. The below-mentioned steps indicate the structure of *salam sukuk*:

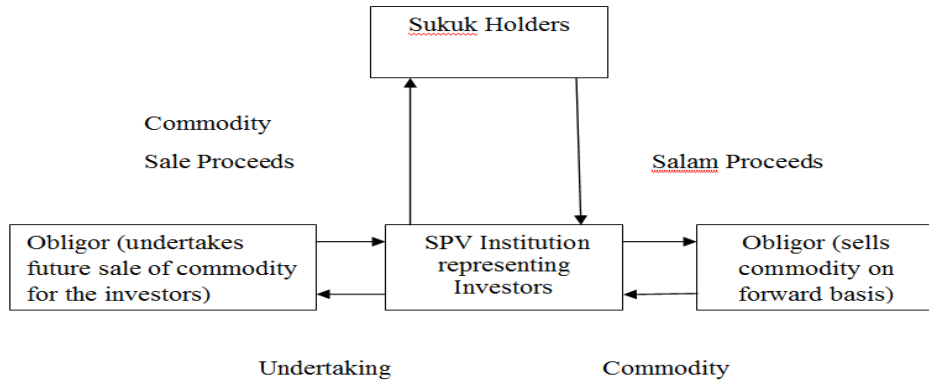
SPV obtains the proceeds of the *sukuk* and provides them to the investors. The proceeds are handed over to the originator, who is responsible for selling the commodity by using a forward contract. The commodities are received by the SPV from the originator. The originator resells the commodities in order to make a profit. The sales proceeds from the commodity are received by the *sukuk* holders.³⁷

An example of *salam sukuk* is the Bahrain Monetary Agency Salam Sukuk. Aluminium was specified to be a fundamental asset of the *salam sukuk* contract with the government of Bahrain.³⁸ The Bahrain Islamic Bank (BIB) was assigned the responsibility of managing the contract with other banks and guaranteeing the deal as a syndicate authority. At the same time, the buyer appoints the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution. In addition to this, the Government of Bahrain provides an additional undertaking to the representative BIB to market the aluminum at a price that will provide a return to *salam* security holders equivalent to those available through other conventional short-term money market instruments.³⁹

³⁷ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2010) 49; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65-66.

³⁸ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 66.

³⁹ *Ibid.*

Figure 4.5: The structure of *Salam Sukuk*

Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

5.6 Istisna Sukuk

Istisna sukuk is circulated in the market for the mobilisation of funds, so as to produce products (with certificate holders as owners). These are certificates with equal value, whose issuer is the supplier. The key subscribers are the purchasers of the offered financial product, and the funds gained from the subscribed contribution are recognised as its cost.⁴⁰

The certificate holders possess the right to the selling price of the *Istisna* certificates. It is an important financial tool for managing the financing arrangements of large infrastructure projects. It facilitates financial intermediation on the basis of giving permission to the contractor for participation in another *Istisna* contract. Therefore, financial institutions can opt for guaranteeing a contract on a deferred price by subcontracting the authentic structure to a specified firm.⁴¹

⁴⁰ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 473; Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2010) 51.

⁴¹ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 54; Mohamed Ariff, Munawar Iqbal and Shamsheer Mohamad, *Islamic Debt Market for Sukuk Securities: The Theory and Practice* (Edward Elgar Publishing 2012) 55-56.

The following steps are used for issuing *istisna sukuk*: For raising funds to meet the financial requirements of a project, *sukuk* certificates are issued by the SPV. Proceeds collected from the issuance of the *sukuk* are delivered to the contractor and used for future projects. The SPV takes the title to the assets. The project is rented or traded to the final purchaser, who pays monthly installations or make a deferred lump-sum payment when the project is completed to the SPV. Returns obtained from this issuance are disseminated within the group of *sukuk* holders.⁴²

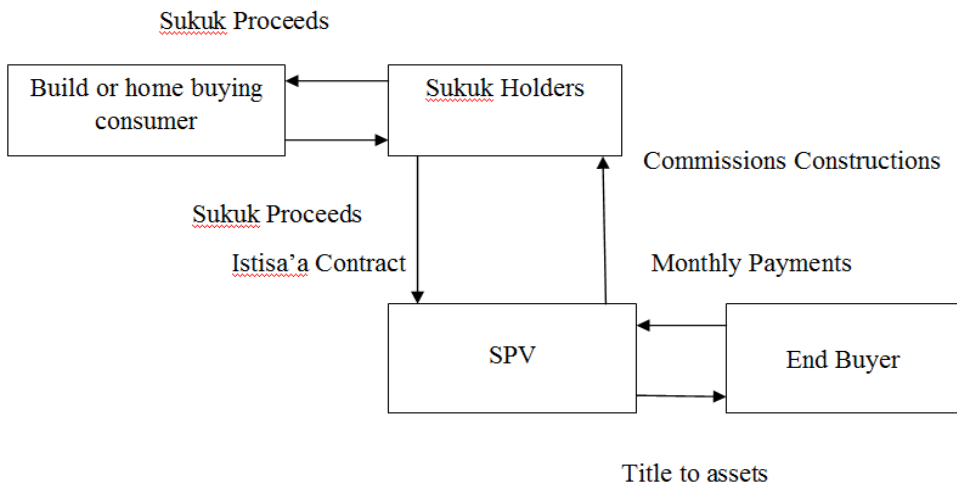
This example illustrates the structure of *istisna sukuk*. Under the guarantee of the National Central Cooling Company, in 2004 Tabreed offered global corporate *sukuk* of 5 years which were based on a fixed coupon rate of 5.5%. The offer included a combined arrangement of *ijarah Istisna* and *ijarah Mawasufah fi al Dhimmah* (forward leasing contracts). It was introduced in the market for the elimination of active debt of approximately US \$ 136 million and the expansion of financial arrangements.

The Durrat *sukuk* financed the reclamation and infrastructure for the initial stage of a broader US \$ 1 billion world class residential and leisure destination known as 'Durrat Al Bahrain', currently the Kingdom of Bahrain's largest residential development project. The return on the *sukuk* is 125 basis points over 3 months LIBOR payable quarterly, with the *sukuk* having an overall tenure of 5 years and an option for early redemption.

The proceeds collected were utilised for establishing the project on the basis of agreements considering *istisna*. On completion of the individual *istisna*, the contractor delivered it to the issuer, who was responsible for notifying the company undertaking the project (as per the *ijarah* agreement).⁴³

⁴² Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 55.

⁴³ M. Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking*, Edward Elgar Publishing Limited, UK, 2007, p. 389; Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 55-56.

Figure 4.6: The Structure of *Istisna Sukuk*

Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

5.7 The Hybrid *Sukuk*

As an effective mode of investment and raising funds, the issue and trading of *sukuk* plays a vital role in fulfilling the diverse requirements of the investors. Therefore, the hybrid *sukuk* or mixed-assets *sukuk* have been introduced in the market. The inherent combination of assets considered in the hybrid *sukuk* can include receivables based on *murabaha*, *ijarah* and *istisna* financing options. Hybrid *sukuk* are comprised of a set of assets taken from different categories, which should include at least 51% of the tradable assets.⁴⁴

The structure of the *hybrid sukuk* involves the following steps. The assets and Murabaha deals should be transferred by the Islamic finance instigator to the SPV. The certificates of participation are issued by the SPV to the holders of the *sukuk* on receiving the funds, which are further utilised by the Islamic finance instigator.

⁴⁴ Mohammad Nejatullah Siddiqi, 'Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art' *Islamic Economic Studies* (2006) 13 (2) 11; Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 474.

The pool of assets is purchased by the Islamic finance instigator for a specific period of time from the SPV. Returns from the invested assets are obtained by the investors in the form of fixed payments.⁴⁵

The first hybrid *sukuk* were issued by the Islamic Development Bank (IDB) in 2009, and were comprised of a set of assets (Ijarah contracts 65.8%, Murabaha receivables 30.73%, and Istisna 3.4%). With the aim of obtaining assured rating and marketability in the international market, the issuance of hybrid *sukuk* necessitated a guarantee from IDB.

Solidarity Trust Services Limited (STSL) also issued hybrid *sukuk* of US \$ 400 million. In this issue, ICD (the Islamic Corporation for the Development of the Private Sector) remained engaged as an intermediary for buying the assets from IDB and trading them to STSL. The overall return on the investment was measured at the rate of 3.625 per annum for a fixed payment that was planned to be disseminated twice in a year and paid off by the month of August in 2008.⁴⁶

6. The Regulatory Framework of Sukuk in Saudi Arabia

In the KSA, where the *sukuk* market is new and immature, the first issuance of *sukuk* was in 2004 on behalf of HANCO Rent-A-Car. The product was named the Caravan *sukuk*, and structured on an *ijarah* basis for three years.⁴⁷ The researcher believes that this delay in the issuance of *sukuk* in the KSA was due to the lack of an independent body governing the issuance of securities.

⁴⁵ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 56-57.

⁴⁶ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 474; Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 57.

⁴⁷ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010) 128.

In 2003, the Saudi government established the Capital Market Authority (CMA) as a separate regulatory body under Article 4 of the CML in accordance with Royal Decree No. (M/30) dated 2 July 2003 to regulate and develop capital market activities in Saudi Arabia.⁴⁸

Although there is no specific framework for the issuance of *sukuk* in Saudi Arabia, the CMA regulates and monitors the issuance of *sukuk* side-by-side with the issuance of shares and debt instruments under the CMA Listing Rules and the CMA Offer of Securities Regulations. The Listing Rules were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 3-11-2004 dated 4 October 2004 based on the Capital Market Law issued by Royal Decree No. M/30 dated 2 July 2003, amended by a Resolution of the Board of the Capital Market Authority Number 1-36-2012 dated 25 November 2012.⁴⁹ The Offer of Securities Regulations were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 2-11-2004 dated 4 October 2004 based on the Capital Market Law issued by Royal Decree No. M/30 dated 2 July 2003, amended by Resolution of the Board of the Capital Market Authority Number 1-28-2008 dated 18 August 2008.⁵⁰ Therefore, the Listing Rules and the Offer of Securities Regulations are the regulatory measures that control the issuance of *sukuk* in Saudi Arabia.⁵¹

The researcher found that all Saudi securities laws and regulations, such as the CML, Listing Rules and the Offer of Securities Regulations did not mention Islamic law (*Shariah*) or Islamic bonds (*sukuk*) in their articles even though Article 1 of the Basic Law of Governance in Saudi Arabia stipulates that the Constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.⁵²

⁴⁸ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 190. See the official website of the Capital Market Authority (CMA), <<http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/CH2Article4.aspx>> [Accessed 11 December 2013].

⁴⁹ See the official website of the Capital Market Authority (CMA),

<<http://www.cma.org.sa/En/Documents/Listing%20rules.pdf>> [Accessed 13 December 2013].

⁵⁰ See the official website of the Capital Market Authority (CMA),

<<http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx>> [Accessed 11 December 2013].

⁵¹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵² See the official website of the Bureau of Experts at the Council of Ministers,

<<http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>> [Accessed 12 October 2013].

In this regard, Hasan says that despite 15 *sukuk* issuances from 2000 to 2008 and huge Islamic mutual funds in Saudi Arabia, there is no single piece of legislation specifically regulating the implementation of Islamic *sukuk* in the KSA.⁵³

Therefore, there remain some regulatory difficulties between the CMA and the Ministry of Commerce and Industry concerning the issuance of *sukuk*. This is due to the fact that the Offers of Securities Regulations do not refer specifically to *sukuk*, and therefore they must be defined as debt instruments even though *Shariah*-compliant *sukuk* do not create a debt obligation on the issuer.⁵⁴

7. Critiques and Recommendations of Current Sukuk Issuance Practice in Saudi Arabia

After reviewing the present regulation and supervision of *sukuk*, it is clear that the issuance of *sukuk* in Saudi Arabia is suffering from heavy regulation and supervision drawbacks, which need to be identified in order to resolve the problems of regulation and insufficiency of supervision. The researcher believes that there are two major drawbacks regarding the issuance of *sukuk* in Saudi Arabia from both the regulatory and supervisory aspects. The researcher will provide appropriate recommendations and suggestions for overcoming these drawbacks.

One of the major drawbacks is the absence of a legislative and regulatory structure for *sukuk* issuance in Saudi Arabia. According to Al-Elsheikh & Tanega, the financial regulations in Saudi Arabia do not include specific rules for the issuance of *sukuk*.⁵⁵ They argue that most of the articles in the Offers of Securities Regulations and the Listing Rules mention financial instruments as securities in general or refer to debt instruments (bonds) or stocks in some cases.⁵⁶

⁵³ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97.

⁵⁴ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 193.

⁵⁵ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵⁶ *Ibid.*

They conclude that the issuance of *sukuk* in Saudi Arabia is not being regulated, issued or operationalised from within a framework that takes account of the nature of *sukuk* as distinct from conventional debt instruments, which means that *sukuk* in Saudi Arabia are issued as debt instruments.⁵⁷ This argument is supported by Hasan, where he says that there is no single legislation specifically regulating the implementation of *sukuk* issuance, even though there were 15 *sukuk* issuances in 2000–2008 and huge Islamic mutual funds in Saudi Arabia.⁵⁸

Although there are differences between *sukuk* and conventional bonds, the Offers of Securities Regulations and the Listing Rules do not provide a clear distinction between *sukuk* and stocks, nor between *sukuk* and conventional bonds, thus possibly generating confusion between *sukuk*, bonds and shares.⁵⁹ Moreover, Al-Elsheikh & Tanega believe that the current regulations of securities issuance in Saudi Arabia do not provide an efficient mechanism for setting up and maintaining transaction-specific special purpose companies. This creates considerable obstacles, thereby hindering investors' ability to gain access to capital markets.⁶⁰ Sheikh Taqi Usmani (chairman of the AAOIFI Shariah Board) has argued that most of the *sukuk*, especially those with a *musharaka* or *mudaraba* structure, are not lawful from a *Shariah* perspective because the assets in the *sukuk* may be shares of companies that do not confer true ownership but which merely offer *sukuk* holders a right to returns.⁶¹

The key solution to the absence of a legislative and regulatory structure for *sukuk* issuance in Saudi Arabia would be to extend the present regulations in order to cover a wider range of financial investment instruments, such as *sukuk*, through the issuance of a new regulations.⁶² The Board of the Capital Market Authority is the authority responsible for issuing such regulations, including in relation to Islamic bonds. When issuing new regulations concerning *sukuk* issuance, there are some essential points that must be considered by the Board of the Capital Market Authority:

⁵⁷ Ibid.

⁵⁸ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97.

⁵⁹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁶⁰ Ibid.

⁶¹ Muhammad Taqi Usmani, 'Sukuk and their Contemporary Applications' <<http://www.kantakji.com/fiqh/Files/Markets/f213.pdf>>, 2011, [accessed 13 December 2013].

⁶² Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 195.

The first is that any legislative and regulatory framework for *sukuk* issuance in Saudi Arabia must comply with the provisions and principles of Islamic law. Article 1 of the Basic Law of Governance in Saudi Arabia endorses this where it stipulates that the constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.⁶³ Therefore, any new regulations of *sukuk* must take into account the principles of Islamic law (the Holy *Quran* and the *Sunnah*) so that there is no conflict with the Basic Law of Governance in the KSA, which derives its authority from the provisions of *Shariah*.

The second point is that the new regulations of *sukuk* must be confirmed and approved by a *Shariah* Committee whose members are appointed by the proposed Saudi *Shariah* Advisory Council (SSAC) in order to ensure that the new regulations of *sukuk* comply with the principles of *Shariah*. The current financial regulations in the KSA which cover the issuance of shares and debt instruments do not consider *sukuk* because of the absence of a *Shariah* Committee or *Shariah* Adviser.⁶⁴ Currently, there is no independent central *Shariah* board to regulate and supervise Islamic banking activities and also to appoint a *Shariah* Committee like the *Shariah* Advisory Council (SAC) in Malaysia. However, a *Shariah* Committee or *Shariah* Adviser could be appointed by the CMA until the establishment of an independent body called the Saudi *Shariah* Advisory Council (SSAC).

The final point is that the CMA should adopt standards and guidelines that are published by international and regional institutions such as International Islamic Financial Market (IIFM), AAOIFI, and the Islamic Financial Services Board (IFSB) for the issuance of *sukuk*. For example, in 2008, the *Shariah* Board of AAOIFI has issued six recommendations on how *sukuk* should be structured, which dealt with matters of ownership, repurchasing and compliance. Although these standards are not binding, some countries such as Malaysia consider them. The Malaysian *Shariah* Advisory Board of the Securities Commission and Bank Negara Malaysia's *Shariah* Advisory Council (SAC) encompasses the opinions adhered to by the AAOIFI.⁶⁵

⁶³ See the official website of Bureau of Experts at the Council of Ministers, <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25> [accessed 14 December 2013].

⁶⁴ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 195.

⁶⁵ Kabir Hassan and Mervyn Lewis & Michael Mahlknecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 325.

In addition, the CMA should consider resolutions and recommendations of the Council of Islamic Fiqh Academy (IFA), and the Council of Senior Scholars in Saudi Arabia regarding the issuance of *sukuk*.

Another major criticism is the absence of a central *Shariah* supervisory board. According to Al-Elsheikh & Tanega, the absence of such a board that specialises in Islamic finance is considered one of the major issues facing the Islamic financial sector in Saudi Arabia, as it could lead to declining public trust in securities that are provided as Islamic products.⁶⁶ These authors argue that although some IFIs have their own *Shariah* supervisory boards and follow the principles and guidelines that are published by international and regional institutions such as the IIFM, AAOIFI, and the IFSB, it is necessary to establish a central *Shariah* supervisory board to enforce its decisions and to create general guidelines and rules that should be taken into consideration by IFIs and the CMA in Saudi Arabia.⁶⁷

This absence of a central *Shariah* supervisory board raises the probability of conflict in opinions (*fatwas*) between Islamic scholars about the issuance of *sukuk* in Saudi Arabia. These differing opinions between Islamic scholars may result in significant damage to the issuer of *sukuk* in addition to a loss of confidence among investors.⁶⁸ An example of this conflict is the initial public offering of the Yanbu National Petrochemical Company (YANSAB) where the opinions of Islamic scholars are divided into two groups with different points of view. These differences of opinion arose because the company borrowed money from a conventional bank with an interest rate. The first opinion is represented by the opinion of Dr Yusuf Alshubaili, who stated that the main activities of the company were *Shariah* compliant and that contributing to YANSAB's initial public offering (IPO) was permitted even if the company was involved in non-*Shariah*-compliant activities such as borrowing small amounts of money from conventional banks. The other opinion is represented by Dr Yusuf Alahmad, who adopted the view that contributing to the IPO of the company was not permitted, due to the involvement of the company in a non-*Shariah*-compliant activity.⁶⁹

⁶⁶ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁶⁷ Ibid.

⁶⁸ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁶⁹ Ibid.

The researcher recommends the establishment of a *Shariah* Advisory in the CMA called the Securities Commission Shariah Advisory Council (SCSAC) to regulate and supervise the issuance of *sukuk* in Saudi Arabia. The SCSAC is appointed by the CMA and the proposed Saudi *Shariah* Advisory Council (SSAC). For more details about how to establish an independent central *Shariah* board, and how to enact laws and regulations related to Islamic finance in Saudi Arabia, the researcher will provide a proposed legislative and regulatory framework for Islamic banking and finance in Saudi Arabia, including the issuance of *sukuk*. This will be covered at the end of Article Six (Derivatives in Islamic Finance and their Applications in Saudi Arabia).

Regarding the securities disputes, the Committee for the Resolution of Securities Disputes (CRSD) is the body responsible for looking into such disputes, under the Regulating Procedures for Resolution of Securities Disputes, issued by the Board of the Capital Market Authority under Resolution No. (1-4-2011) dated 23/01/2011.⁷⁰ Although the issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA, the Regulating Procedures for Resolution of Securities Disputes do not mention anything about the resolution of *sukuk* issuance disputes.⁷¹

The researcher recommends currently amending the present Regulating Procedures for Resolution of Securities Disputes to cover disputes of *sukuk* issuance until specialised commercial courts can be established to look into commercial issues including the issuance of *sukuk*. These courts should take the opinion of the proposed SSAC in the Islamic banking and finance issues in order to avoid any conflict of opinion between them. The researcher will deal with this in more depth in Article Six.

Therefore, the issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA under the Offers of Securities Regulations and the Listing Rules without any legislative and regulatory frameworks of *sukuk* issuance, and also without standards and guidelines on the *Shariah* governance system. They are also issued without obtaining the approval of the *Shariah* board because there is no *Shariah* board in the CMA in Saudi Arabia.

⁷⁰ See the official website of the Committee for the Resolution of Securities Disputes (CRSD), <<http://www.crsd.org.sa/En/Documents/RPRSD-En.pdf>> [Accessed 16 December 2013].

⁷¹ Ibid.

In contrast, in Malaysia, the issuance of *sukuk* is regulated by the Securities Commission Malaysia under section 212 of the Capital Markets and Services Act 2007,⁷² and Guidelines on *Sukuk* are issued by the Securities Commission Malaysia (SC) under Section 377 of the Capital Markets and Services Act 2007 (CMSA).⁷³ *Sukuk* issuance is regulated through the framework provided under the Islamic Securities Guidelines (*Sukuk* Guidelines). The structure of *sukuk* is based on the specific contract of exchange of *Shariah*-compliant assets, and it must be confirmed and approved by an independent *Shariah* Adviser who is appointed by the Securities Commission Malaysia or a *Shariah* Committee attached to a financial institution that operates Islamic banking activities approved by Bank Negara Malaysia.⁷⁴

8. Summary

This article has provided a comprehensive and critical review of *sukuk* issuance in Saudi Arabia, including its concept, mechanism, principles, practices and models as an Islamic alternative to conventional bonds. This article has also examined whether the current uses of *sukuk* provided by the CMA are compatible with the principles of Islamic law. The research question of this article has discussed to what extent the issuance of *sukuk* in Saudi Arabia is consistent with *Shariah* requirements.

The issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA side-by-side with the issuance of shares and debt instruments under the Offers of Securities Regulations and the Listing Rules. The researcher found that the issuance of *sukuk* in Saudi Arabia is not consistent with *Shariah* requirements. This is due to the lack of legislative and regulatory framework of *sukuk* issuance, and also there are no standards and guidelines on the *Shariah* governance system for institutions offering Islamic financial services. In addition, there is no independent central *Shariah* board to regulate and supervise the issuance of *sukuk* in Saudi Arabia, and also there are no specialised commercial courts to look into *sukuk* issues in Saudi Arabia.

⁷² Capital Markets and Services Act 2007, Art. 212.

⁷³ See the official website of Malaysia's Islamic finance marketplace, <<http://www.mifc.com/index.php?ch=39&pg=97&ac=247&bb=attachpdf>> [accessed 16 December 2013].

⁷⁴ See the official website of Malaysia's Islamic finance marketplace, <http://www.mifc.com/index.php?ch=ch_kc_definitions&pg=pg_kcdf_overview&ac=229> [accessed 16 December 2013].

The researcher recommended amending the present regulations for the offering and issuance of securities in Saudi Arabia in order to cover a wider range of financial investment instruments, such as *sukuk*. The researcher also recommended the establishment a *Shariah* Advisory Council in the CMA called the Securities Commission *Shariah* Advisory Council (SCSAC) to regulate and supervise the issuance of *sukuk* in Saudi Arabia. The SCSAC would be appointed by the proposed SSAC to ensure that the issuance of *sukuk* is in compliance with *Shariah* principles.

The researcher recommended adopting standards and guidelines that are published by international and regional institutions such as AAOIFI, IFSB and IIFM until the establishment of the proposed SSAC. The researcher also recommended amending the present Regulating Procedures for Resolution of Securities Disputes to cover disputes of *sukuk* issuance until specialised commercial courts are established to look into commercial issues including the issuance of *sukuk*. The researcher recommended transferring the Malaysian experience in the field of *sukuk* to Saudi Arabia with some modifications that are commensurate with the nature of the Saudi regime.