# MODIFICATION OF ISLAMIC FINANCIAL CONTRACT IN HYBRID SUKUK

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***ABSTRACT:*** *Hybrid sukuk is a form of alternative structure of sukuk that aimed to complement the use of shariah compliant securities that entirely based on debt. Equally it is the combination of asset and debt securities, this financial instrument has vase potential to attract financing with lower monetary value, ability to acquire good credit equity, to mobilize funds to fix it more flexible as well as to cater various demands in investment. This instrument is widely accepted by Gulf Cooperation Council (GCC) countries since it consolidate more shariah compliant features compared to general sukuk which is solely based on debt due to involvement controversial contracts like bay al-'inah as well as problems related to selling of securities that based on debt in the secondary market at discounted price. Therefore, this paperwork is written to assess the adoption and application of Islamic rules and principles used in the issuance of such instruments. By using two methods of library research and interviews, the results show that the hybrid sukuk not has any clear and fixed specific definitions. The successes of hybrid sukuk in global markets indicate that the instrument has a good and bright future prospect in the capital markets especially the domestic market. The implication of this study will provide a clearer understanding of the leading hybrid sukuk, properties and structuring process. In summation, this work makes a renewal to the formation of novel ideas in making a more competitive financial instrument as easily as to diversify Islamic financial instruments.*

**Keywords:** Sukuk, Hybrid Sukuk, Shariah, Islamic Capital Market, Modification

## 1. INTRODUCTION

Shariah has set several principle and guidelines in financial-related activities and charging or paying interest (usury) as a source of earning profits is considered immoral. This principle 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 (maysir) and armaments, excessive uncertain trade contracts (gharar), tobacco, trading in debt contracts at discount, and gambling and chance based games (qimar). Therefore, in Islamic finance, a traditional debt market practices in daily banking and financial system cannot flourish, including enrichment of trade from debt and charging interest on loans as it represent interest-based transaction.

Recent innovations in Islamic finance have changed the dynamics of the Islamic finance industry. The Islamic financial contracts also require a combination of several contracts in one transaction to meet the market need. This combination of contracts or known as a hybrid contract has been discussed by many contemporary Muslim scholars with different term in many books of contemporary fiqh, and the most popular terms that is normally used in the contracts in Islamic are two, namely al-Uqud al-Murakkabah and al-Uqud al-Mujtamiah [1]. The term al-uqud 'al-murakkabah used by Nazih Hammad [2] in his book Al-'Uqud Al-Murakkabah fi al-Fiqh al-Islami, while the AAOIFI used the term al-jam'u bayna al-'uqud in the book Al-Maa'yir Al-Shar'iyyah (Shariah Standards).

The Islamic capital market in Malaysia has emerged as a significant area of growth. It has the full complement of products, infrastructure, institutions, intermediaries and investors that contributing to the development of the capital market (S.Shahida & Saharah Sapiyi, 2013) [3]. This phenomenon will continue to attract global investors and improve the depth and breadth of this relatively new sector. The use of sukuk has become increasingly popular in the last few years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through the offer of corporate sukuk. Sukuk also proved to be implemented during the economic downturn, or seeks to develop an economy [4]. Study by Abdullaah Jalil [5] suggest the development of Islamic bonds market should also utilize the various concepts of Islamic principles rather than picking those contracts that stimulate the conventional debt instruments. The sukuk market witnessed an even further deviation over time: in hybrid sukuk for example, even a minority of 30 per cent of tangible assets included in the pool of assets was accepted by the relevant shariah scholars. The pragmatic approach towards the modification of Islamic financial contract clearly evident in the evolvement of the market.

Method used in this paper is qualitative and explanatory research case study where data are collected within the scope of hybrid sukuk and focusing on the modification of Islamic financial contract in structuring hybrid sukuk. Qualitative method is used because of the limited time and data that can be pooled within this scope of study which is the modification of Islamic financial contract in structuring hybrid sukuk. Apart from having a face to face interview with scholars and practitioners in Islamic finance, resources are collected from written data sources include published (i.e. archival research) from Security Commission Malaysia, Rating Agency Malaysia (RAM), Malaysian Rating Corporation Berhad (MARC) and unpublished documents, reports, newspaper articles and company website as well as some references from the previous literature and author's analysis on the subject matter. This study is organized as follows. 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 features of hybrid sukuk. The discussion only focuses on the modifications of the Islamic financial contracts principle and concept that take place in only hybrid sukuk structuring based on the observation made on some of the sukuk.

## 2. AN OVERVIEW OF THE SUKUK MARKET

The significant growth of the Islamic financial system and development of the economic situation has led to the growth of sukuk as an important means of investment. Sukuk is an Islamic bond and is based on the concept of securitization. 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.

Sukuk is an Islamic alternative for asset monetization, syndicate project financing, financing through asset backed securitization and public financing which are in compliance with shariah and its investment principles, which among others prohibit the charging or paying of usury. A sukuk represents proportionate beneficial ownership in the underlying asset. Sukuk represents a 'capital market corollary to a singular lender'. Sukuk investors receive a flow of income generated by the underlying assets. There are clear differences on sukuk as defined by AAOIFI and IFSB in the type of asset that can qualify under the global standard setting bodies compared to the SC's definition. The AAOIFI and IFSB do not recognize financial asset (i.e., receivables) as assets that would qualify to form the underlying assets of a tradable sukuk, such assets [6].

The Malaysian sukuk market has also grown to become more innovative and sophisticated to meet the diverse risk-return profiles and requirements of both issuers and investors. The proliferation of new types of instruments with extended maturity profiles have generated a diversified range of players, both local and foreign to participate in the market [4]. According to Abdullaah Jalil [7], the corporatization and privatization of major state-owned enterprises, notably public utility companies will be the main catalysts for the growth of the Islamic bond markets in Asia region. In 1990, Malaysia became the first country to issue sukuk, when Shell MDS (Malaysia) issued the world's first ringgit sukuk issuance worth RM150 million Bay Bithaman Ajil - Islamic Debt Securities. But starting from year 2001 after the first global corporate sukuk issuance by Guthrie Malaysia, the market begins to taking flight on the world. Hybrid sukuk started getting attention when the Islamic Development Bank (IDB) issued the first hybrid sukuk, IDB Trust Certificates in year 2003. This hybrid sukuk comprise of 65.8% sukuk al-ijarah, 30.73% of murabahah receivables and 3.4% sukuk al-istisna'. Being the first non-sovereign sukuk issued in the international market, it's required the IDB's guarantee in order to secure a rating and international marketability. The following is a list of some prominent hybrid sukuk that have been issued in the global market around the year 2006 to 2013:

**Table 1**: List of notable hybrid sukuk issuance

| Issuer | Country | Type | Contracts | Value (USD Mil) |
|---|---|---|---|---|
| Nucleus Avenue (Malakoff) | Malaysia | *Sukuk Musharakah Medium Term Note (MTN)* | Musharakah | 1,994 |
| The Dubai Ports, Customs & Free Zone Corporation (PCFC) | UAE | *Convertible Musharakah* | Musharakah | 3,500 |
| Rafflesia Capital | Malaysia | *Exchangable Sukuk into ordinary shares of Telekom Malaysia Berhad* | Musharakah | 750 |
| Sabana Treasury | Malaysia | *Convertible Sukuk into units of a Reit* | Musharakah, Ijarah & Wakalah | 65.7 |
| Aabar Sukuk | UAE | *Exchangeable Sukuk Mudharabah* | Mudharabah | 460 |
| Maybank | Malaysia | *Bay' Bithaman Ajil Subordinated Bonds* | BBA | 416 |
| AmIslamic Bank | Malaysia | *Subordinated Sukuk Musharakah* | Musharakah | 113 |
| GEMS MEA Sukuk Limited | UAE | *Subordinated Perpetual Certificates* | Mudharabah | 200 |
| Nakheel Development | UAE | *Convertible Sukuk Ijarah* | Al-Ijarah | 3,520 |
| Aldar Properties | UAE | *Exchangeable Mudharabah* | Mudharabah | 2,530 |
| Almarai Co | Saudi | *Corporate perpetual sukuk* | | 453.2 |
| Abu Dhabi Islamic Bank | UAE | *Perpetual Tier 1 Hybrid Sukuk* | | 500 |

Source: Collected from various sources

### *Innovation of Sukuk Instrument*

Sukuk offer a mechanism of partial ownership under a financial obligation (known as sukuk murabahah), business (sukuk al-musharakah), investment (sukuk al-istithmar), project (sukuk al-istisna'), and asset (sukuk al-ijarah). Ijarah and musharakah structures are the most popular sukuk structure [8].

Thus, to meet the demands of investors, the innovation of sukuk structure has further ahead with the hybrid sukuk, convertible sukuk and exchangeable sukuk in the market. The increasing in the number of sukuk structures is one of the factors that encouraged the participation of fund raisers to choose the appropriate sukuk structure to match their funding requirement [3].

Hybrid sukuk is among the favourable emerging type of sukuk in the Islamic capital market worldwide [9]. It is viewed as one of the innovative products in the Islamic capital market compared to the plain vanilla sukuk structures that were basic and standard, which didn't add value such as option to exchange or convert into equity at a specified time. Convertible sukuk has a standard feature of traditional sukuk in that the sukuk assets should be subject to one of the Islamic financial contracts such as al-ijarah, musharakah, or mudharabah and include profit return that is paid to the sukuk holders from the assets. The holders can convert the sukuk into shares of common stock in the issuing company or cash of equal value, at an agreed-upon price. Hence, in other word, a convertible sukuk is convertible to issuer's shares [9]. Exchangeable sukuk are straight sukuk with an embedded option to exchange the sukuk for existing shares of a company other than the issuer usually a subsidiary or company in which the issuer owns a stake) at some future date and under prescribed conditions.

In a hybrid sukuk structure, the underlying pool of assets can comprise of al-istisna', murabahah as well as al-ijarah contract, which allows for a greater deployment of Islamic financial contract. The distinct feature of a hybrid instrument is its combination features of debt and equity. Unlike the standard sukuk, a hybrid sukuk gives their holders the right, but not the obligation, at a future date to subscribe for equity [9]. Hence, the hybrid sukuk gives the possibilities to use financing contracts for refinancing means: it is a refinancing tool. It even shows similarities to a securitization structure, whereby debt receivables are sold to a Special Purpose Vehicle (SPV) over which the SPV issues conventional bonds. In structuring hybrid sukuk, several modification have been done to the underlying Islamic financial contract in order to establish a shariah-compliant securities that are appropriate to market conditions. The hybrid sukuk structure involves the following steps. First of all, the originator transfers tangible assets with underlying al-ijarah deals as well as murabahah and al-istisna' deals to the SPV. The SPV issues sukuk to the sukuk holders and receives sukuk proceeds from them, which are used to pay the originator.

***Shariah Guidelines in Structuring Sukuk***

Shariah scholars and expert has set a few basic guidelines and regulations that need to be observe in issuing sukuk and other financial instruments. The sukuk will be determined by the specific Islamic financial contract that being used to structure the sukuk instruments such as bay' bithaman ajil (sale and purchase of an asset based on deferred payment), al-ijarah (leasing of specific assets), musharakah (participation in joint-venture businesses) or wakalah (agency-based). But sukuk has always been characterized as asset-based instruments as to describe that is the specific feature of sukuk that is not on mere loans but the use of certain underlying asset to facilitate the transaction [6]. There is an important points about sukuk which is 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. Thus, in the case of sukuk that is backed by money or debt, there are possibility of riba occurrence if the sukuk is traded in the market at discounted price of which different from the original price.

The main distinction is in the aspects of trade-ability of sukuk in the market. AAOIFI specify that sukuk issued based on the rights and interests in an investment so that it can only be traded after the commencement of business or utilisation of the fund whereas Malaysia ruled out that the sukuk can traded at any time. The Shariah Board of the AAOIFI, in view of the increased use of sukuk worldwide, has issued guidelines on sukuk issuance. It includes six rulings dealing with several shariah issues related to sukuk:

i. Tradable sukuk should represent ownership or holdings of the sukuk holders, with all rights and obligations in real assets that may be legally acquired and sold, be it tangible, usufruct, or services and in line with shariah rules and procedures. The sukuk manager whether in his capacity as a mudharib (investment manager), sharik (partner), or wakil (investment agent), is not allowed to offer loan to sukuk holders in order to cover any shortage that may arise between expected and realized profit. 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, or to obtain project financing on account of the sukuk holders.

ii. The mudharib, sharik or wakil should not undertake or repurchase the assets from the sukuk holders or their representatives at face value at the time of sukuk are extinguished (at maturity date). However, it is permissible to undertake the purchase on the basis of net asset value, market value, cash equivalent value or any price agreed upon the time of purchase, knowing that the sukuk manager guarantees the capital at face value in cases of negligence or violation, whether that manager a mudharib, sharik, or wakil; On the other hand, if the musharakah, mudharabah, or wakalah-bil-istismar sukuk are of lesser value than the leased assets of al-ijarah muntahiyah bittamlik, the sukuk manager may undertake to buy these assets – at the time of sukuk extinguishing - for the remaining rental value of the remaining assets; since it actually represents its net value.

iii. A lessee may purchase the leased assets when the sukuk are extinguished for its nominal value, provided that such a lessee is not a mudharib, sharik or wakil.

iv. The Shariah Supervisory Board should not limit themself in issuing fatwa on sukuk structuring. They are required, as well, to verify all contracts and relevant documents, monitor their applications, and assure that the process – throughout all its stages – is in compliance with stipulations and requirements as defined by shariah standards. The proceeds of sukuk – and all assets acquired by thereby – should be invested in shariah – compliant modes of investment. Furthermore, the board should advises Islamic financial institutions to decrease their involvements in debt-related operations and to increase true partnerships based on profit and loss sharing, in order to achieve the objectives of the shariah.

## 3. ANALYSIS AND DISCUSSION

The features of hybrid sukuk have attracted the attention of both issuers and investors. Hybrid sukuk provides investors with an attractive method of investment as an alternative or supplement to the debt and equity products in their investment portfolio. The modification of Islamic financial contract is needed in certain areas to cater the need of modern financial transactions. Nevertheless, the structuring of hybrid sukuk poses greater challenges due to their complexity. Hence, the number of sukuk issuance using hybrid structure is not as extensive as straight/plain sukuk in the Islamic capital market [9]. Although, initially there were pros and cons from among the shariah scholars on such modifications, it is clear that the new elements have already been embedded in the production and structuring of sharia-compliant securities. Shariah does permits securitisation of non-financial assets, such as al-ijarah (leasing) assets and bay' as-salam (sales by order) assets, and underlying assets pool within mudharabah (profit sharing) or a musharakah (profit-loss sharing) structure. Several issues occurred in sukuk issuance and the modification applied will be discussed in this paper.

***Pre-Determine Maximum Profit Rate***

If we look back at the theory and concept of mudharabah and musharakah classic contract about the distribution of profit and loss, the profit rate depends on the agreed ratio by the parties involved or based on the amount of capital contribution respectively. Profit rate cannot be determined with fixed value as well as it is not promised upon. The total profit that will be obtained depends on the success of the implemented project and not limited to the rate of profit allowed by every party in the agreement. Even so, based on latest practice in structuring sukuk mudharabah and musharakah, estimated profit rate is given as early update to the investor. In any other words, the investors' maximum or ceiling rate of allowed profit is fixed, whereas this does not occur in the classic practice of mudharabah and musharakah. This can be seen in the structuring of AmIslamic Subordinated Sukuk Musharakah. The circumstances and situation of financial markets and corporate world which are exposed to various risks such as possibility of fraud in payment, company's failure resulting in loss of millions of ringgit and others will cause investors to focus more on their capital safety. Thus the ceiling limit has been introduced and applied in the practice of mudharabah and musharakah to address the risks.

***Pre-Determine Dissolution Term***

In mudharabah contract and musharakah contract, there is no resolution or condition to determine the minimum or maximum duration to operate an industry. Involved parties freely manage the industry and also not bound by limitation of time. Partnership through mudharabah and musharakah will be voided when there are cases like the goal of the business is achieved, business partner dies, transition to other project or industry, mutual agreement to dissolve the partnership and others. Company's dissolution can happen in a short or long period of time without limitation to span of time. However, at present, determination of allowed period to implement dissolution has been practiced in contacts based on equity.

***Awarding Excess Profit to Fund Manager***

This stipulation is a string from the determination of maximum profit rate which is explained above. If the profit earned exceeds the estimated profit rate, the surplus will be awarded to fund manager. This matter is explained initially in the contract between the originator, fund manager and investor. By using the concept of tanazul, sukuk holders agree to award the surplus of the profit to (if any) to fund manager as incentive on the accomplishment in managing the formed partnership. This element is included in the issued sukuk by using mudharabah principle and musyarakah principle.

***Promise to Buy and Sell Back Securities***

Element of obligation to deliver promises are included in the structuring of the sukuk based on the principle of wa'd (unilateral promise). Element of promise is not applied in the practice of classic Islamic financial contracts. This element is included in sukuk structuring to guarantee investors position and the securities ratings itself. This approach is made based on some of Maliki Islamic scholars' opinion which stated that it is mandatory to fulfil promises that have been said if the promisee has issued cost and to bear liability because of the agreement. If the promisor fails or refuses to fulfil their promises, the court has the right to force the promisor to honour the promise or pay compensation to the promise.

***Dissolution due to Failure to Make Profit or Late Payment***

If revision is made to the attribution of classic mudharabah contract and musharakah contract, profits are generated from industrial activities. Profit rate is dependent to the extent of the successfulness of the industry. Failure to make profit does not lead to dissolution of the partnership formed. Partnership through mudharabah and musharakah will be voided when there are cases like the goal of the industry is achieved, business partner dies, transition to other projects or industries, mutual agreement to dissolve the partnership and others. The practice of classic mudharabah contract and musharakah contract do not stipulate any limitation in determining profit rate or loss that need to be achieved or resolved until the partnership dissolution can occur if fails to achieve the rate.

Factors such as the need for more effective risk management and investor appetite that want to ensure that their contributions and capital will not suffer maximum loss has led to some changes and modifications to the practice of classic Islamic financial contracts in order to keep pace with urf (tradition) and practice of modern finance. Application and use of the principles and concepts of shariah in modern financial instruments today may be a little different from the practice of classic Islamic financial contracts.

## 4. CONCLUSIONS

This article has provided a comprehensive review of hybrid sukuk including its concept, principles and practices. This article has also examined whether the current uses of hybrid sukuk that are compatible with the principles of Islamic financial contracts. The issuance of sukuk is country-regulated and supervised by the respected Shariah Supervisory Board. The study found that the issuance of hybrid sukuk in Malaysia is consistent with shariah and Islamic financial contracts principles. This is due to the support through comprehensive legislative and regulatory framework of sukuk issuance, and also there are proper standards and guidelines on the shariah governance framework for institutions offering Islamic financial services. Modification made shows that hybrid sukuk is built on clear principles and foundation. The modification allows the hybrid sukuk to be more stable and stronger in order to compete in the capital market. At the same time it is made to adapt products to the market conditions and the nature of dual financial system in Malaysia. Thus, it is able to attract investors and manage investment risk properly. In reality, Islamic financial contracts principles and concepts has been developed without ignoring the set foundation and occurred flexibility does not contain the element of betrayal concept even though it looks different on the surface compared to classic products and concept as highlighted by early Islamic scholars. The source of rulings based on urf plays very important part to ensure product flexibility is in line with Islamic and market needs. In conclusion, it is evident that hybrid sukuk is viewed as an innovative shariah compliant product. It is expected that more hybrid sukuk will be issued in the market. In order to assist the development of hybrid sukuk, the regulatory environment within which the convertible, exchangeable and perpetual sukuk are issued must be supportive enough to encourage its growth and pave the way for its enhancement and innovative offerings.

## 5. APPRECIATION

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