

Comments of

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on

**Securitization, *Ṣukūk* and Fund Management Potential to be
Realized by Islamic Financial Institutions**

by

Muhammad Ayub

Paper by Muhammad Ayub discusses importance of *ṣukūk* for Islamic banks and fund management. The purpose of the present comments is to bring forth the strengths of the paper and point out some shortcomings that needs to be improved. Taking one step forward, these comments will also attempt to further advance the issues discussed in the paper as well as some neglected topics in securitization and *ṣukūk*.

Usefulness and need for securitization methods and process is undeniable. It is true particularly for Islamic banks which are less able to undertake longer-term investments on account of various reasons; predominant among them are the problems due to moral hazard and limited risk matching capacities. Islamic banks are predominantly using short-term *murābahah* financing contracts. This helps them reduce the liquidity risk they face in providing withdrawal (liquidity) service to their depositors. However in competitive environment, the short-term *murābahah* brings low returns to the banks; while in non-competitive situations *murābahah* increases cost of financing from Islamic banks. Long-term *murābahah* are not favoured by these banks as such contracts increase credit and liquidity risk to them. The end result is accumulation of excess un-utilized liquidity with the Islamic banks. Various kinds of *ṣukūk* provide a way for securitization of long-term assets thus allowing better possibilities of risk management for Islamic banks and allowing them to undertake longer term investments and projects at lower degree of liquidity and credit risks.

Securitization through *ṣukūk* also have particularly important use in public sector financing and project financing through Islamic means. Governments in Bahrain, Malaysia, Qatar, Sudan, Pakistan, and UAE have issued different kinds of *ṣukūk* for varying purposes during the last few years.

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Contributions:

The paper by Muhammad Ayub is timely and useful. It discusses the importance of *ṣukūk* for Islamic banks (and fund management) in enabling them to take longer-term investments. To some extent it also discusses potential use of *ṣukūk* by financial institutions like the Central Banks to control money supply. However, it does not deal with potential use of *ṣukūk* for public finance and the issues involved therein except a brief mention in sub-sections 4.4 and 4.5. There are two main contributions of the paper. First, it points out that a number of *ṣukūk* issues are deficient in Sharī‘ah compliance, which may lead to loss of integrity and credibility of the Islamic finance industry. Therefore, careful structuring of *ṣukūk* for Sharī‘ah compliance is very important. Second, it discusses areas of real and sizeable potential of *ṣukūk* in development of Islamic finance.

First important contribution: Sharī‘ah non-compliance comes about due to some institutional deficiencies. For example, difference in the nature of full-fledged Islamic banks and of the Windows in their operations and Sharī‘ah compliance process: The former institutions may have Sharī‘ah board oversight in all stages of product development to documentation and dealing with clients, while the later operators may have at the most occasional advisory role of Sharī‘ah scholars. The violations also come about due to double taxation in the process of trade-related modes of finance (in some countries) and due to uneven playing field compared with that available to conventional financial institutions. In order to avoid these extra costs, Islamic banks resort to doubtful practises. The author is correct in stating that “The policy, nature and the level of regulation and supervision as also the legal frameworks have important bearing on the size, growth, Sharī‘ah compliance and integrity of Sharī‘ah based finance discipline.” (Sec 2.4).

These are many important things that are covered in a sentence but not elaborated in the text. Growing literature on Law and Finance has traced a strong relation between legal development and financial development with ultimate affects on overall economic development.¹ Availability of support institutions (infrastructure institutions) helps by reducing the cost of transactions and by providing stability to the system in many ways one of which is reduction in the number of mistakes. In the current environment Sharī‘ah violations also come about by lack of dual trained finance professionals with enough Sharī‘ah knowledge so that they could take on-spot Sharī‘ah complaint decisions during the negotiations and deal making. The present process of Sharī‘ah vetting is useful for overall guidance but not an efficient method for operations. Therefore, Sharī‘ah and Islamic finance training of finance professionals is an important need of the time. The task is quite large and no single institution can handle it. There is a need for close cooperation and coordination between various banks, and education and training institutions within each country and across countries. At present we have

¹ See for example, Demirgüç-Kunt (1998); Beck and Levine (2003); and Khorana (2005).

Sharī'ah Sheiks on one hand, and Finance Gurus on the other. The need of the hour is Wall Street Sheiks.

The second important contribution of the paper is in its discussion of areas of real and sizeable potential of *ṣukūk* in development of Islamic finance. It points out that, if *ṣukūk* concept is used correctly it can promote the ideals of equity and efficiency forwarded by the early proponents of Islamic finance. Various kinds of *ṣukūk* along with other modes of finance can provide better risk management and earning possibilities allowing the Islamic financial sector to grow and contribute to economic development. The paper advocates the need for structural changes in the Islamic banking business through diversification of their activities; and changes in the legal and the regulatory framework by the political authorities. These changes will promote development of Islamic finance.

Two important proposals are made towards the end of Section 5.5.

The first proposal is to encourage Islamic Financial Institutions (IFI) to get themselves involved in trading on *murābaḥah* and leasing business by actually maintaining the inventory of goods. Each IFI can specialize in one or a limited set of goods and develop expertise in its trade as whole-seller or a specialized supplier and facilitator. This, according to the author, will enable unit trading of *murābaḥah* funds. While such arrangements are possible for few products under framework of non-bank financial institution,² it may be difficult to practise it on economy wide basis and when finance is needed for a variety of commodities.

The second proposal is about use of *ijārah ṣukūk* by Central Banks to control money supply. That the Central Bank buy the entire offering of some *ijārah ṣukūk* in bulk and then auction them in tranche to affect money supply. I would suggest the author to look into Sudan's experience where a variant of it is already in practise. There are some general issues in devising of instruments pertaining to government finance and for controlling of money supply that I have discussed elsewhere (see Ali, 2005).

Deficiencies:

The paper promises a "journey towards securitization" in Section 3, but provides no account of it in that section. Instead, it gives the various categories (kinds) of possible *ṣukūk* that are given in AAOIFI's Sharī'ah Standard No.17 along with the Sharī'ah requirements of each. This discussion is useful for those who do not have access to AAOIFI's work, otherwise a repetition.

From the title of Section 4 one expects to learn about issues in term structure of *ṣukūk*. By definition, term-structure in context of bonds and securities refer to relationship between rate of return and time to maturity. But there is no discussion of 'term-structure' in this section. Rather, it contains a discussion of terms and

² Such trade and leasing companies already exists for products like cars, grains, etc.

conditions of various *ṣukūk*. The title of this section therefore needs to be changed to “Issues in the terms and the structures of *ṣukūk*”. Four different issues or terms of agreement found in various *ṣukūk* are discussed and their Sharī‘ah compatibility is discussed in this section sometimes without distinguishing the type of *ṣukūk* under discussion. This creates confusion, because the Sharī‘ah conditions would vary by the type of underlying assets and type of contract stipulated in the *ṣukūk*. For example in section 4.1 criticising Sharī‘ah incompatibility of a condition in some *ṣukūk* the author writes “... return rates on most of the *ṣukūk* are conclusively pre-agreed even without any provision for the 3rd party guarantee.” One is left only to guess which *ṣukūk* type is under discussion. The point raised is not a valid objection in case of *ijārah ṣukūk* where the rent is pre-agreed and the cost of asset servicing is almost certain. However, the objection is valid if *muḍārabah ṣukūk* are under discussion.

The point about *bay‘ al-‘īnah* is correct in some *ijārah ṣukūk* where the asset sale-back to the originator is a binding condition on the *ṣukūk* holder as well as its originator. In case of unilateral promises for sale- or purchase-back of the underlying asset by the holder or the originator some *fuqahā’* (such as Taqī Usmani, Nizam Yaqubi etc.) consider it valid. While others (such as Rafic al-Masri) consider unilateral promise at par with two sided promise if it is a binding promise. Interesting cases of stretching the laws from the history of financial laws among the Jews and Christians can be highlighted (see Knoll, 2004) which shows similarity of the debates and issues that prevailed among them in the past and among Muslims in the present era.

While discussing sale-and-lease-back in subsection 4.3 it is mentioned that the *ijārah* contract should not be executed unless and until the Islamic financial institution has acquired the asset. This is true in general, however, *ijārah bi-zimmah* (lease obligation) of a described asset is also permissible.

A recurrent problem in the paper is non-substantiated assertions here and there. For example:

- (1) “Islamic banking assets in Indonesia are expected to reach US\$4.1 billion or 1.8% of total assets by end of this year.” (Sec 2.1, p.3).
- (2) “instruments/*ṣukūk* other than those *shirākah* based in local currencies are being used since 1992.” (Sec 2.3, p. 4) [What are those instruments and where used?]
- (3) “The finalization of Sharī‘ah compliance inspection manual...” (Sec 2.5, p. 5) add some details/reference which institution prepared it etc for information of readers].
- (4) “*ṣukūk* were extensively used by the Muslim societies of the Middle Ages ...” (Sec. 3.1, p.5) add some reference].

(5) “Some attempts were made in 1980s to develop tradable Islamic instruments ...” (Sec 3.2, p.11) [Which attempts? Not clear].

(6) “... other countries like Sudan, Iran, Saudi Arabia, UAE, Philippines, Germany, and Pakistan have developed some ‘Sharī‘ah compliant’ and tradable securities / *ṣukūk*. (Sec 3.2, p.12) [Which *ṣukūk* are developed by the governments in Iran, Saudi Arabia, Philippines? Is it about private sector?]

(7) “... Sale-and-lease-back technique does not create any Sharī‘ah related problems as considered by some writers on the subject.” (Sec 4.3, p.13) [Who are those ‘some writers’ and where they wrote it? Some reference is needed].

(8) “...the way Islamic finance movement is heading, it may be a zero-sum game and end in total loss to its credibility.” (Sec 5.1, p.15) [This is not the definition of zero-sum game. Some elaboration is needed why Islamic finance is zero-sum game].

Overall the paper is a welcome addition to the growing literature on *ṣukūk*.

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