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6

Leasing, Securitization, and *Sukuk*

In recent years leasing has become increasingly popular as a vehicle for financing the purchase of various assets, as well as issuance of various financial instruments, from mortgage-backed securities to bond structures known as *sukuk*. The increased popularity of lease-based financing and securitization stems from the existence of underlying physical assets, the usufruct of which is being transferred under various leases or subleases. Those underlying assets ostensibly allow secondary markets for lease-based debt instruments to emerge, without violating the general prohibition of trading in debts to which most schools of jurisprudence adhere (with the notable exception of Malaysian jurists following a particular opinion within the Shafiʿi school). As we shall see later in the chapter, various jurists apply the physical-asset-backing interpretation of contemporary Islamic financial instruments with varying degrees of strictness.

6.1 General Lease Conditions

Retired Justice M. Taqi Usmani – one of the foremost leaders in Islamic finance, chairing multiple Shariʿa boards – argued that the sale of a lease-backed security transfers material ownership rights and obligations from one lessor to another, and hence the purchaser of such a security is entitled to collect rent thereof. Needless to say, conventional asset-backed securities, whether lease or sale based, are often merely financial claims, with little material distinction between the two. Thus, commenting on common legal structures of lease-backed securities, Justice Usmani wrote:

> It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue *ijara* certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset. It means that the holder of such a certificate has no relation with the leased

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asset at all. His only right is to share the rentals received from the lessee. This type of securitization is not allowed in Shari'ah.[1]

Of course, in practical implementations of jurists' restrictions and interpretations, legal and banking experts have a number of degrees of freedom through which they can address jurists' objections to the lack of "any kind of ownership in the asset." In this regard, constructive ownership through shares in bankruptcy-remote special purpose vehicles incorporated for the master lease has become increasingly common (with various additional SPVs put in place to handle repairs and other obligations of the supposed lessors). The aim in constructing those financial structures is simultaneously to satisfy market needs for regular debt instruments and jurists' insistence on material ownership of an underlying asset to justify the collection of coupon payments from the structured instruments. In this chapter we shall discuss the classical lease contract and its various conditions and interpretations in premodern jurisprudence, as well as contemporary jurists' adaptation of those conditions. Then we shall proceed to study contemporary advances in the area of Islamic financial securitization and various *sukuk* structures.

Binding Promises in Leasing

Classical jurists discussed both leasing of assets as well as hiring of workers under the common heading of *ijar* or *ijara*.[2] The object of a lease contract was viewed by the vast majority of classical jurists as a "desirable, known permissible and accessible usufruct," and rent was thus viewed as the price or compensation for that usufruct. However, one major and significant difference between leases and sales is that the majority of classical jurists allowed suspension and deferment of leasing.[3] This allows lease financing to overcome one of the most problematic aspects of double-sale-based financing (*murabaha* or *tawarruq*). In the latter type of financing, most Islamic banks require the customer to make a binding promise that he will purchase the property on credit once the bank buys it. This binding promise clause has been controversial, despite its adoption by most Islamic bank jurists in 1979, based on the minority opinion of the (relatively obscure) Maliki jurist Ibn Shubruma that promises may be made binding.[4]

In lease financing, the bank buys the property and then leases it to the customer, with monthly payments consisting of a rent component and a purchase component, most often reproducing the conventional amortization table that would also be used in *murabaha* financing. The main difference, however, is that it is not controversial to lease the property with a future starting date and prior to obtaining it.[5] Thus, the bank may proceed to acquire the property after having in hand a valid signed lease starting immediately or some time after the property is purchased.

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Another interesting application of binding promises in leasing allows jurists to justify lease-to-purchase arrangements. As we have seen in the introduction, most *sukuk* structures involve selling a property to an SPV and then buying it back or receiving it as a gift at lease end. Moreover, many retail Islamic banking customers who wish to finance the purchase of real estate, automobiles, equipment, and the like aim to purchase the property at lease end. Contemporary as well as classical jurists disallowed stipulating in the lease contract that the lessor must sell the property to the lessee at lease end, since that condition negates ownership rights of the lessor and violates the prohibition of "two contracts in one" or "two sales in one contract."[6] However, contemporary jurists allowed lease-to-purchase contracts by arguing that the lessor may make a unilaterally binding promise (which is not part of the lease contract itself) to sell the property, or to give it as a gift at contract end. Moreover, those contemporary jurists have argued that once the promise is made, it becomes binding upon the lessor, in each case using a majority or minority opinion as the need arises.[7]

The only two conditions imposed by those jurists are that the binding promise to sell the property at lease end, if the lessee wishes to do so, must be unilateral, and that it must not be made a condition of the lease (it must be recorded in a separate document). Naturally, if the lessee pays not only the return on capital, but also the return of capital used to purchase the property, as part of lease payments, his own interest will drive him to exercise that option. Similarly, since Islamic banking lessors are primarily financial intermediaries, who are not in the business of owning and leasing properties, exercising the option is in their best interest as well. Moreover, although the option may not be made a condition for the contract, it appears that the separate document obliging the lessor to sell or give the property as a gift at the end of the lease can be signed prior to signing the lease itself. Needless to say, that promise becomes nugatory if the lease is not concluded, but it is binding upon the lessor if the lease is in fact concluded and executed for its full term.

Another note on the issue of binding promises is in order at this stage. Justice Usmani's analysis, as referenced above, implies that a unilateral promise to give the property as a gift at lease end is equally binding to a promise to sell the property at lease end. However, this position seems potentially controversial in light of classical juristic analysis of uncompensated gifts (*hiba*) and offers (*ji*ʿ*ala*) discussed below.[8] Classical rules in this regard seem to agree with common-law provisions, which lean toward making uncompensated transactions nonbinding.[9] It would thus be more appripriate to use a unilateral promise to sell the property at lease end for some financial consideration, even if minimal or symbolic, and despite concerns regarding same-item sale-repurchase (*bay*ʿ *al-*ʿ*ina*), as we shall see later in the chapter.

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Flexible-Rate Financing

Contemporary jurists have also found lease contracts to be particularly useful for flexible-rate financing. In this regard, *murabaha* financing requires that the amount of debt established upon the buyer is fixed at contract inception, hence restricting the contract to financing at fixed or predetermined interest-rate schedules. In contrast, with the exception of Shafiʿi jurists, most jurists allowed long-term leasing on month-to-month or other periodic bases. In this regard, Shafiʿi jurists based their ruling on the conditions of sale, which would require that the entire lease period (during which usufruct, the object of sale, may be consumed) must be specified at contract inception. However, jurists of other schools argued that lessor and lessee can agree to a longer-term periodically renewable lease, whereby the lease is binding on both parties for each period that it is extended with mutual consent.[10]

The mutual consent provision, however, could have been problematic for juristic arguments in the long term, since lessor and lessee have conflicting interests as interest rates rise or fall. To avoid such problems, contemporary jurists took the additional (somewhat heroic) step to link the rent to a flexible-rate benchmark (e.g., LIBOR + spread),[11] ignoring the fact that classical jurists who allowed automatic renewal of lease, possibly at different mutually acceptable rents, did not make the lease binding on any one party. In contrast, Justice Usmani seemed to argue that – in contemporary financial terms – both parties are exposed to interest-rate risk, and hence the demarcation criterion for permissibility may be ex ante acceptance of the benchmark, rather than ex post agreement at each renewal period.

Subleasing, Repairs, and Insurance Costs

The Fiqh Academy of the OIC ruled in 1988 that a lessee is entitled to sell his right to future usufruct either to the lessor or to a third party (sublessee) at any mutually agreed-upon rate. Classical jurists imposed some conditions that limit the lessee's ability to sublease to third parties who may use the property differently, requiring the lessee to obtain the lessor's permission in that case. Conversely, the lessor is allowed to sell the property, provided that the lessee's rights are not compromised. Thus, subleasing and securitization of leases seemed similar in contemporary practice and classical jurisprudence, to an extent that allows leasing to serve multiple functions in Islamic financial structures.

However, as we have already noted, some jurists continued to impose strict conditions to ensure that any party that receives compensation through a lease-based structure has material ownership of the leased property. Thus, Justice Usmani

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rejected modern financial tools such as head leases and various other forms of financial leases.[12]

In addition, most jurists have insisted that material ownership of the leased property requires assigning all repair costs (beyond routine maintenance and damages caused by lessee abuse or negligence), insurance costs, and the like to the lessor. This is in fact the classical Hanafi opinion,[13] which was codified in the Ottoman *Majalla* and to which most contemporary jurists continue to appeal. It is a very reasonable opinion for simple leases, and it does in fact follow naturally from lessor ownership: Since the lessor suffers losses if the property were to perish, he should bear the cost of insurance, nonroutine maintenance repairs, and so on.

However, as practiced today, most lease financiers are in fact legally constructed (as opposed to natural or human) lessors, with property ownership by SPVs created for the purpose of financing. Those financiers would not have material ownership of the underlying assets were it not for the financing, and they cannot retain ownership thereof past the financing period. Hence, the customer/lessee in fact bears all the costs of repairs, insurance, and the like through carefully calculated increases in rent and side contracts with other SPVs that cover various provisions. This complicated structure increases transaction costs unnecessarily, and the conditions on which jurists insist – and which result in those increased transaction costs – were not derived directly from Islamic canonical texts, but rather from customary practice (ʿ*urf*) in the times and places wherein the classical jurists lived. In fact, classical references are full of statements such as "customary practice (ʿ*urf*) carries substantial weight in determining the conditions of *ijara* and *murabaha*."[14]

However, contemporary jurists seem to insist on costly (and possibly anachronistic) symbols of material ownership of the underlying asset, whether in double-sale (*murabaha*) or lease (*ijara*) financing, to maintain the fiction that interest (collected as price mark-up or rent, respectively) is in fact a return based on risk associated with ownership of a physical asset. This was explicitly the justification given in the 1979 decision in Dubai, which required Islamic banks engaged in *murabaha* financing to obtain full ownership of a property – and the risks associated with it – prior to selling it. The fact that exposure to this risk – to the extent that any remained after insurance – lasted for only a very short period of time was ignored. On the other hand, there is evidence in later juristic opinions, such as the Rajhi Shariʿa board ruling on parallel-*salam* financing quoted in the previous chapter, that jurists are progressively recognizing that Islamic banks – like conventional ones – in fact collect interest as compensation for deferment and credit risk. To the extent that transaction costs can be reduced significantly by following contemporary conventions rather than customary practices of premodern times, jurists are likely progressively to abandon some of the current anachronistic conditions, as has been evident in recent *sukuk* issuances.

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6.2 Asset-Backed Securities

Contemporary securitization is a decades-old technology in conventional structured finance, which allowed financial institutions to create financial instruments from other financial assets, ranging from mortgage loan to credit card receivables. Its implementations in Islamic finance have been severely limited by jurists' aversion to synthesizing new debt instruments from existing ones, lest one would in fact be selling debt. The sale of debt to third parties has been an active topic of study in classical jurisprudence, and we shall review classical and contemporary juristic views on the topic shortly. First, we provide a very brief review of leasing and securitization for readers who may not be familiar with the topic.

Leasing and Securitization

Securitization methods have come under intense scrutiny in recent years, primarily because of high-profile corporate scandals, but more significantly because of the potential misinformation about corporate assets and liabilities made possible by such securitization methodologies.[15] The very definition of securitization (transforming one type of financial exposure into another) suggests the myriad of ways that it can be abused. A particularly troublesome use of securitization is the procedure of hiding corporate debts by moving them off-balance-sheet, which can also be accomplished through simple leasing. Interestingly for Islamic finance, structured leasing has been a particularly popular way of taking conventional debt off-balance-sheet (in part to show lower debt-to-asset ratios, thus increasing desirability for company stock among investors).

Needless to say, not all off-balance-sheet deals are done to disguise or hide debt. For instance, a company may decide to refinance some of its conventional on-balance-sheet debt by selling some asset (through an SPV) and leasing it back at better interest rates (possibly repurchasing the asset at lease end, as usually done also in the context of *sukuk* structures). However, higher degrees of transparency and disclosure may be required to minimize the possibility of abuse or misinforming investors in such cases.

Since lease-based securitization is the most popular vehicle in Islamic finance, we now focus on that case. In conventional finance there are two types of leases: capital (or financial) leases and operating leases. Under standard accounting rules, a capital or financial lease (where the lessee is the ultimate purchaser) is treated like a purchase, with the leased-to-purchase property appearing on-balance-sheet as an asset and rental payments appearing as liabilities. Interestingly, this type of lease structure (where material ownership of the leased asset passes to the lessee at lease inception) is disallowed by most contemporary Islamic finance jurists.

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According to those jurists, material ownership of the asset by the lessor is the only justification for collecting rents, otherwise the lease would be considered a loan contract, and rent/interest would be thus deemed forbidden *riba*.

Financial and Operating Leases

Consequently, securitization of financial leases is also deemed inadmissible by contemporary jurists who have shaped Islamic finance:

> As explained earlier ... the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in Shari'ah, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality, and if the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated.[16]

We shall review the classical juristic basis of this approach below and discuss the loopholes introduced by contemporary jurists, which allow trading in debt instruments to take place, albeit in a convoluted manner. In other words, the lease conditions imposed by contemporary jurists create yet another Shariʿa arbitrage opportunity, from which industry practitioners – including those jurists – are the primary beneficiaries.

First, we turn to the second type of leases, which are allowed by contemporary jurists: operating leases. In that type of lease, the lessor (an SPV or other type of entity) retains ownership of the leased asset. In such cases, the amount of debt for rent typically does not appear on-balance-sheet, since operating lease expenses are generally reported as operating expenses. Keeping the liability for all lease-to-purchase payments (which are naturally larger in sum than the current market asset value of the leased property) off-balance-sheet, the company can show lower debt ratios, higher return on assets, and the like. Interestingly, as we shall argue in the next chapter on Islamic or "Shariʿa-compliant" equity investment, a private equity outfit can exploit this Shariʿa-arbitrage opportunity by buying companies, "Islamizing" their debts by refinancing them through operating leases, and then selling the companies at a much higher price. This harms investors who do not perform any "before-and-after" analysis to examine the justification of higher market value for the company.[17]

Trying to get the best of both worlds, companies may resort to synthetic leases, which give the lessee some benefits of ownership (e.g., deductibility of interest component of lease payments, property depreciation) while retaining some substantial ownership rights. Technically, a synthetic lease is an operating lease and thus permissible according to contemporary Islamic finance jurists. At the same time it allows the lessee to exercise control over the property without reporting its corresponding assets and liabilities on its balance sheet, the benefits of which we

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have discussed in the previous paragraph. In Islamic financial practice, bankers and lawyers who are active in structuring such deals negotiate with jurists the (minimum) acceptable level of ownership interest on the part of the lessor, with different jurists and Shariʿa boards applying different standards.

Receivable Securitization and Sale of Debt

The most common types of securitization in conventional finance are applied to receivables (from mortgages, credit card balances, etc.). In this regard, Islamic banks and financial institutions that engage in pure debt financing, such as through *murabaha*, would wish likewise to manage their financial risks by securitizing their receivables. However, we have also seen that contemporary jurists – with the exception of some in Malaysia – have forbidden trading in liabilities and debts. It is worthwhile at this point to review the grounds on which the majority of classical jurists based this general prohibition. This will allow us to develop a better understanding of potential directions that contemporary jurists might take, as well as potential means of synthesizing securitization of *murabaha* receivables and other liabilities generated in Islamic finance.

Classical jurists bundled many different types of liabilities together under the name "*dayn*," including such things as unpaid prices of purchased properties, debts ensuing from loans, due rental payments, and the object of a *salam* sale. All of those liabilities take the form of obligations on the debtor to pay or deliver a monetary or fungible property to the creditor. Jurists considered the sale of such liabilities to the debtor himself or to a third party and for each case considered selling the liability for an immediate or deferred price.[18]

In general, classical jurists forbade the sale of debt either to the debtor or to a third party for any deferred price. They based that prohibition on the same grounds that they used to forbid conventional forward contracts, which are envisioned as trading a liability for the price in exchange for a liability for the object of sale. Both prohibitions are based on a weak tradition: "The Prophet forbade trading one deferred liability for another."[19]

The canonical mode of exchanging one deferred liability for another, which featured prominently in classical jurists' analyses, is the pre-Islamic mode of *riba*, wherein the debtor asked the creditor for further deferment of his debt, in exchange for increasing the amount of the debt. This is contrasted with the case wherein the debtor and creditor agree to settle the debt through some immediate exchange of property, in which case the transaction is valid. On the other hand, classical jurists ruled – subject to appropriate conditions – that it is valid to cancel one debt against another of equal amount and maturity (*maqassa*), as well as to forward a debt to a third party (*hawala*).[20]

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The majority of premodern jurists allowed selling a liability to the debtor, as well as forgiving it partially or totally. Interestingly, the price in that case was allowed to be a deferred (albeit briefly) liability in another numeraire. The opinion was based on the Prophetic tradition wherein the Prophet allowed Ibn ʿUmar to trade camels in Baqiʿ, with the price denominated in gold and collected in silver or vice versa, provided that the compensation was determined at the spot rate.[21] This permitted practice was seen as trading a liability for the agreed-upon price (denominated in gold) in exchange for another liability denominated in silver.

In this regard, jurists had disallowed general trading of one liability for another because of *gharar*, in the form of uncertainty about delivery of either compensation. However, they argued, when a liability is already established on one party, trading it for another liability implies dropping the original debt, which means that at least one of the compensations has been implicitly delivered. Moreover, since the Prophetic tradition restricted the practice to trading at the spot rate, this ensured that the practice cannot be used as a means of increasing the liability for further deferment. As a consequence, it was deemed permissible to sell a debt to the debtor either at face value (denominated in the same genus, or determined by the spot rate of the genus used as price) or a lower price (the difference being a partial gift or forgiveness of debt). This general analysis culminated in a contemporary ruling by the Fiqh Academy of the OIC at its seventh session in Jeddah (May 9–14, 1992) regarding the practice known as "*ḍaʿ wa taʿajjal*" (reduce the amount of debt for prepayment):

> Reduction of the amount of a deferred liability to facilitate prepayment, whether initiated by the debtor or creditor (*ḍaʿ wa taʿajjal*), is legally permissible, and not considered a form of forbidden *riba*, provided that: (i) it was not stipulated as a prior condition [before initiation of the debt], and (ii) the relationship between the debtor and creditor is binary, otherwise if a third party is involved, the transaction would inherit the ruling for discounting of commercial papers [which is forbidden].

Thus, contemporary jurists restricted the permission to the case of selling the debt at or below its face value to the debtor himself, arguing that a bank or financial institution serving as an intermediary in debt discounting would thus be committing *riba*. However, as we shall see in Chapter 8, some of those intermediation practices were made possible through agency contracts. Also, debt discounting was allowed only as an ex post voluntary practice by the creditor and disallowed as a stipulation in the contract (e.g., in *murabaha*), thus potentially limiting the ability to mimic mortgage and other financial structures completely. Fortunately for Western customers of Islamic banks, secular regulations prevent the Islamic banks from insisting on collecting interest on credit – which is thus characterized as early repayment penalties.

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Finally, most classical jurists forbade the sale of liabilities to third parties. Thus, the Hanafis and Zahiris forbade the sale of debt to a third party as a corollary of the general prohibition of sale of undeliverable items. Similarly, classical Hanbali jurists – with the notable exception of Ibn Qayyim – forbade the sale of debts, or offering them as gifts, to any party other than the debtor. In contrast, Maliki jurists and some Shafiʿis permitted selling a liability at its face value to a third party subject to strict conditions to exclude the possibility of *riba* and minimize the incidence of *gharar*. That being said, jurists of most schools have been quite lenient on forwarding of debts (*hawala*), which makes practices such as parallel *salam* (executed in collaboration with metal dealers to whom debts are transferred) more practical. The forwarding of debt from one creditor to another, possibly with cancellation of that debt against an existing debt on the first creditor, is in fact tantamount to selling that debt at face value, as allowed by some jurists.

Bundling Asset-Based and Debt-Based Securities: A Paradox

Based on the set of classical opinions summarized in the previous section, contemporary jurists concluded that existing liabilities (debt-based securities) may be sold to the debtor only at or below par value, or forwarded to a third party at face value. This restriction was deemed by Justice Usmani to be the primary reason why purely financial assets were not eligible for securitization from a legal or practical point of view. Thus, *murabaha* certificates were deemed non-negotiable:

> Murabahah is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in a secondary market. . . . If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like musharakah, leasing, and murabahah, then this portfolio may issue negotiable certificates subject to certain conditions.[22]

The concluding part of this quotation introduces an interesting, and paradoxical, twist. The condition imposed on such a negotiable security is that its majority should represent "tangible asset"–based liabilities:

> This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. . . . [Otherwise] the Fund must be a closed-end Fund.[23]

We have already addressed contemporary jurists' use of ostensible material ownership of an underlying tangible asset to justify earning a rate of return on lease-based structured securities. Indeed, when HSBC introduced home financing in New York state, initially restricted to *murabaha* financing for practical and legal

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reasons, its officers stated explicitly that they had hoped eventually to introduce *ijara* financing as well, so that a mixture of *ijara* and *murabaha* receivables may be securitized (with a majority of the former) for secondary market trading.

However, the "majority" rule seems paradoxical. Consider the case wherein an Islamic financial provider wishes to securitize a large portfolio of receivables, of which 36 percent are lease-based and 64 percent are *murabaha*-based. According to the "majority rule" of mixed securitization, one can bundle all of our lease-based receivables with half of the *murabaha*-based receivables and sell the mixed portfolio at a negotiable (market) price. One can then use the same structuring principles to strip the leasing-based component of the portfolio and buy it back at market price, only to bundle with the remaining half of the *murabaha*-based receivables, which can thus be sold at market price. The net result is that the 51 percent rule, articulated above, has been synthetically used to generate a 36 percent rule. With additional steps (and clearly wasteful legal and transaction costs), the rule can be diluted further, bundling a small amount of ostensibly "tangible" – as opposed to financial – assets repeatedly with generic financial assets, with the 51 percent rule satisfied at each step. Hence, the rule serves only the purpose of creating another efficiency-reducing Shariʿa-arbitrage opportunity.

6.3 Asset-Backed Leasing Bonds (*Sukuk*)

We now turn to the basic mechanics of a typical lease-backed bond (*sukuk*) issuance. As an example, we shall consider the largest issuance in 2003: that of the seven-year, $700 million Qatar global *sukuk*. The basic structure of that transaction was illustrated in December 2003 by Mr. Robert Gray, chairman of HSBC's (co-lead manager for the issuance) Debt Financing Advisory, as shown in Figure 6.1.[24]

The steps of this transaction are essentially the same as those of the Tabreed structure discussed in the introduction, with the exception that the underlying asset (in this case a parcel of land) is not sold back at lease end, but given back as a gift. In general, the SPV, in this case a trust, utilized for issuing lease-backed securities needs to obtain short-term funding in one of two basic ways: (1) by obtaining a bank loan or some substitute thereof, including the possible deferment of price payment until proceeds are collected from *sukuk* buyers, or (2) by selling the *sukuk* prior to purchasing the property to be leased back. The rest of the transaction is straightforward, with lease payments (in this case covering both principal and interest) passed through to *sukuk* investors. The other potentially thorny issue is the bindingness of a unilateral promise to give the property (land parcel) back as a gift at lease end, which we shall discuss later in greater detail.

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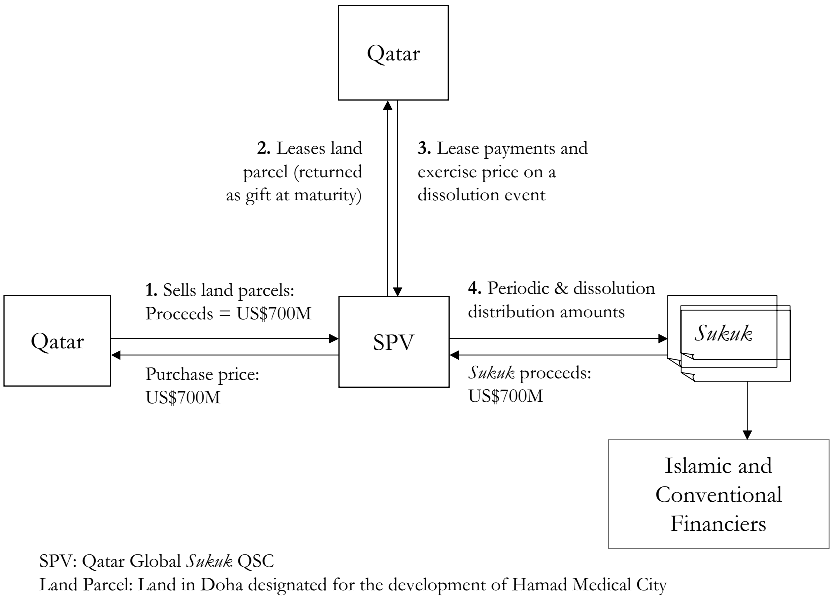

Fig. 6.1. Structure of Qatar Global *Sukuk*

Credit-Rating Issues

The official offering document for the Qatar Global *Sukuk* issuance stipulated that "It is a condition of the issuance of the Certificates that they be rated 'A+' by Standard & Poor's Ratings Services."[25] On page 9, the *sukuk* rating is linked directly to that of its sovereign issuer: "The ratings of the Certificates will be based primarily on the credit rating of Qatar." In addition, the "ratings" section of the offering listed familiar caveats regarding ratings not being recommendations to buy or sell financial instruments, and lack of guarantees that ratings will remain constant for any period of time.

In Standard and Poor's own publication regarding its rating of the Qatar Global *Sukuk*, the rating agency justified the rating as follows:

The 'A+' rating on QGS's floating rate trust certificates reflects the long-term rating on the State of Qatar for the following reasons:

- All claims due to QGS, including the lease rentals payable by the government of the State of Qatar to QGS under the master 'Ijara' agreement, which will fund the periodic distribution payments on the trust certificates, are a direct, unconditional, unsecured, and general obligation of the government of the State of Qatar and will rank at least

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pari passu with all other unsecured and unsubordinated obligations of the government of the State of Qatar. The lease rental payments are irrevocable.

- The dissolution amount payable on the trust certificates upon dissolution event is also dependent on an obligation of the government of the State of Qatar. This obligation is the irrevocable undertaking of the government of the State of Qatar to purchase from QGS the land parcel at the agreed exercise price upon a dissolution event occurring, which also represents the dissolution date of the trust. The exercise price will be used to fund the dissolution distribution payment that is payable to certificate holders. The exercise price payable by the government of the State of Qatar will be the purchase price less the aggregate of all amortization payments paid under the master Ijara agreement.
- The issuer, QGS, is a special purpose company with the single objective of participating in this transaction, which should ensure that all payments made by the government of the State of Qatar to QGS would in turn be available to make payments to certificate holders.[26]

This interesting summary analysis was followed by a detailed description of the transaction structure, which concluded the following:

The government of the State of Qatar (the lessee) agrees that it will not claim to be entitled to pay a lesser amount of the rentals provided in the master Ijara agreement by virtue of any circumstance. ... Upon a dissolution event, the lease agreement will be terminated and thereupon, pursuant to a legally robust purchase undertaking, the government of the State of Qatar is required to purchase the land parcel from QGS at the agreed exercise price, the purchase price less the aggregate of all amortization payments paid under the master agreement.[27]

Having established beyond any doubt that the *sukuk* are essentially unsecured debt instruments backed by the full faith and credit of the state of Qatar, in which the leased land plays a ceremonial role, it was clear to the analysts that the credit rating of the *sukuk* should be identical to the credit rating for the country's other sovereign debt. Thus, the remainder of the document concentrated on the analysis of economic prospects for the economy and debt exposure of the government.

Needless to say, that analysis also illustrates that the juristic characterization of *ijara sukuk* structures is questionable. For instance, as the S&P analysis has shown, there are mutually binding conditions that violate the essence of a lease with material lessor ownership of the leased property. In this regard, we have seen that the unilaterally binding condition, which forces the SPV that is totally owned by the government to give the property back as a gift to the government at lease end, is deemed acceptable by contemporary jurists.

However, it is not clear that the SPV (or, by inference, the trust certificate holders) ever owned the property. The fundamental test of ownership in classical and contemporary Islamic jurisprudence is the risk of loss in case of property destruction (hence the various conditions on insurance payment, etc.). In that regard, the master lease agreement for QGS stipulated that on any dissolution

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event (including destruction of the leased property), the lessee will still be bound to purchase the property at the agreed-upon exercise price. In other words, the sale and lease are merely fiction, and the substance of the structure is that of a conventional bond. Sadly, this is also a very costly fiction, with various legal fees for incorporation of the main trust, as well as all the side contracts on repairs and maintenance, required to exploit the Shariʿa-arbitrage opportunity created by economically incoherent juristic views.

Benchmarking Revisited

Based on the above analysis of credit risk, the variable interest component of rent payable on the Qatar Global *Sukuk* was directly linked to LIBOR:

> The Issuer will make a Periodic Distribution (as defined herein) to Certificate holders (as defined herein) an amount which is calculated on the basis of (i) LIBOR (as defined herein) plus 0.40 per cent. per annum, calculated on the outstanding principal amount of the Certificates as at the beginning of the relevant Return Accumulation Period (as defined herein) on an actual/360 basis plus (ii) beginning with the Periodic Distribution Date falling in April 2006, an Amortization Payment (as defined herein) of one-tenth of the initial principal amount of the Certificates.[28]

Since the issued debt was essentially identical to other unsecured debt by the issuing government, there are no gains to be made from securing the debt with physical assets (by restricting borrowing to the value of the government's assets), or in terms of enhanced ability to borrow at lower interest rates (by marking the implied interest rate on the lease bonds to market rents of the underlying property). Without either of those potential economic advantages, the additional transaction costs of an *ijara sukuk* issuance must be viewed as deadweight efficiency losses from the viewpoint of the issuing entity, were it not for potential buyers who are restricted to this type of debt instrument. One can hope that jurists will eventually realize that the purpose of Islamic jurisprudence should not be the imposition of such inefficiency-inducing transaction costs. However, we have seen that Shariʿa-arbitrage rent-seeking behavior, and general acceptance of form-above-substance in Islamic financial jurisprudence by the public, are likely to continue for the medium term. The best we can hope to accomplish is to introduce some economic substance in the current practice, such as by using *ijara sukuk* structures to revitalize stalled privatization plans in various Islamic countries through bona fide sales of public property, as discussed in Chapter 10.

Reward Pledges and Gifts Revisited

We now turn to the promise to give the property as a gift at lease end, as stipulated in the structure of the Qatar Global *Sukuk* issuance discussed above. This

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unilaterally binding promise may be analyzed from the point of view of one of two contracts that were studied by classical jurists. The first contract is the gift (*hiba*) contract, and the other is the reward-pledge (*ji ʿala*) contract.[29] Although the first contract appears to be closer to the language used in the *sukuk* structure, in fact, *ji ʿala* (which is usually discussed by jurists as an analog for *ijara*) may be the more appropriate characterization. For both types of contracts, we shall discuss issues like bindingness conditions to determine the ideal means to return the property to its initial and ultimate owner (the lessee under *ijara sukuk*).

Problematic Binding Gift Promise

The first issue we need to consider is the de facto conditionality of the unilaterally binding gift offer in the *sukuk* structure. As we have seen in the previous section, the contract stipulated conditions under which the lease will be dissolved and the lessee will be bound to purchase the property at the properly adjusted exercise price. Consequently, the gift promise is in fact conditional upon completion of the full lease period. The issue of conditional gifts was raised by the earliest classical jurists within the context of a pre-Islamic practice, wherein the owner of some property pledged it as a gift to another in case he (the donor) died first. It is easy to see how this type of conditional gift could have been used as a means of, for example, circumventing inheritance rules or consolidating ownership of partnerships.

Abu Hanifa and his associate Al-Shaybani ruled generally that if a person makes a conditional gift offer, the property is deemed lent to him, and the donee thus may demand it at any time. They based this ruling on a weak Prophetic tradition, but also on the prohibition of substantial uncertainty. More generally, the Hanafi general principle on gifts was codified into Article #837 of the Ottoman *Majallat Al-Ahkam Al-ʿAdliyya*: "A gift contract is concluded through offer and acceptance, and it is executed with receipt." This rule was supported by the Hanafi judge Abu Yusuf as well as Shafiʿi and Hanbali jurists, who ruled that once the potential recipient of the conditional gift takes possession of the gift object, it is considered an immediate and permanent gift. One of the principal textual proofs on which this ruling was based is the Prophetic tradition "There are no temporary or conditional gifts, thus the recipients of such gifts become their owners, alive or dead."[30] The Malikis forbade conditional gifts on similar grounds, concluding similarly that a gift is executed upon receipt.

Although the main context for those canonical texts and juristic analyses pertained primarily to a particular type of conditional gifts, the texts and logic appear much more general. Moreover, the codified legal provision in the *Majalla* is clearly quite general. When applied to the case at hand, once the binding promise to give the land back as a gift to the state of Qatar is made, and once the state of Qatar

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is in possession of the property by virtue of the lease, it should be automatically declared the recipient of a gift and thus would not be obliged to make any further payments. However, as we have seen in the Standard and Poor's analysis, the legal structure clearly indicates that the state of Qatar must make the payments unconditionally, which is incompatible with the binding promise to give the property back as a gift.

Moreover, the bindingness of a promise to give a gift is itself questionable in light of a Prophetic tradition: "The donor is more worthy of keeping his property, as long as he was not compensated for it."[31] In other words, a gift promise is not binding if the donor had not received compensation, and binding if he had. This can be a source of legal problems, since a group of investors may gain ownership of all the trust certificates and then argue that it is contrary to Shariʿa rules to force them to give the gift when the lease expires. In that case, as in the two cases brought before English courts in recent years, the Shariʿa provisions are likely to be overruled, undermining the legitimacy of Islamic financial structures. Perhaps that is one of the reasons that this "gift" structure has been quite rare in *sukuk* issuances, with most structures stipulating a sale at lease end. Of course, whether or not the binding promise to return the property is characterized as a sale or a compensated gift, the result would be the same: In both cases, Shariʿa and secular legal conditions will be in agreement on bindingness of the promise based on receipt of consideration.

Equally Problematic Binding Reward Pledge

Another form of conditional promise to give a gift or reward that was approved by many classical jurists is known by the Arabic name *ji ʿala*. In this contract a donor promises to pay a reward or gift, known as *juʿl*, to anyone who performs a certain task. The most common classical applications included rewards to whoever returned lost property or prizes to winners of various contests, for example. Maliki, Shafiʿi, and Hanbali jurists permitted the contract based on the story of Joseph: "They said: we miss the great beaker of the king, and for him who produces it is the reward of a camel load; I will be bound by this promise" [12:72], as well as Prophetic traditions wherein similar promises of rewards were approved.

Although Hanafi jurists deemed the contract impermissible as an *ijara* (hire contract) with substantial *gharar*, they approved it based on juristic approbation in certain circumstances. However, this contract was deemed by Shafiʿis and Hanbalis to be nonbinding, and thus they allowed the donor to pay a larger or smaller *juʿl* than specified in the unilateral promise. This gives rise to the same problem we faced in the case of gifts, wherein certificate holders may collectively decide not to fulfill the promise to give the property back. Hence, it appears that compensated resale is the only viable option. However, as we have seen in previous

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chapters, that approach also raises the very real danger of violating the rules of ʿ*ina* (same-item sale-repurchase).

Two solutions may be provided for this problem. One is to strip ownership of the underlying asset from ownership of the usufruct, structuring the entire transaction on the basis of long-term fixed-rate leases and short-term fixed- or variable-rate subleases. This structure has in fact been used under the name *sukuk al-manfaʿa* (usufruct *sukuk*), which we shall discuss in the following section. A second alternative would be to avoid the sale of the property or usufruct by building the entire bond structure on agency contracts similar to the ones discussed in Chapter 8, in the context of financial intermediation.

6.4 Usufruct *Sukuk*

In August 2004 the German state of Saxony Anhalt issued a €100 million five-year bond, which was rated AAA, in line with the state's credit rating. The bonds thus paid a rate of interest equal to EURIBOR. The deal was comanaged by Citigroup and Kuwait Finance House and fully subscribed, with 60 percent of the issue sold to GCC investors in Bahrain and UAE, and the other 40 percent sold in Europe.[32] The structure relied on a trust in the Netherlands, which paid a lump sum (bond price) as rent in a long-term lease of property owned by the Ministry of Finance. Thus, holders of certificates of the trust ostensibly owned the usufruct of those properties for a five-year period. The Ministry of Finance then paid back those certificate holders, through the trust SPV, short-term floating-rate rent benchmarked to Euribor.

This structure avoids the characterization of "head leasing" that was rejected by contemporary jurists:

> In [head-leasing], a lessee sub-leases the property to a number of sub-lessees. Then, he invites others to participate in his business by making them share the rentals received by his sub-leases. ...This arrangement is not in accordance with the principles of Shariʿah. ...The lessee does not own the property. He is entitled to benefit from its usufruct only. That usufruct has passed on to his sub-lessees. ...Now he does not own anything, neither the corpus of the property nor its usufruct.[33]

The Saxony Anhalt structure avoids this problem by reversing the order of steps in the transaction. The government first leases property that it owns long term, thus giving ownership of the usufruct to the SPV trust. Only then does it turn around and sublease the property back short term, paying the variable interest rate (benchmarked to EURIBOR) as rent. Hence, at each stage, the party that receives funds receives them in exchange for transferring ownership of well-defined usufruct that it owns.

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A second, more straightforward, usufruct certificate structure was imposed by legal constraints, rather than desire to structure conventional bonds in a "Shariʿa-compliant" manner. In the project known as "Manazel Al-Haramain" (housing near the two holy mosques in Makka and Madina), roughly 6,000 housing units were built in towers adjacent to the two holy mosques. Because of religious and legal requirements, ownership of the land had to remain with the state of the Kingdom of Saudi Arabia. Consequently, the state leased the property long term to property developers, who then sold smaller segments of the usufruct (resembling timeshares) to certificate holders, through the usual SPV structures. In principle, those certificates could be treated as financial instruments tradable on a secondary market. However, given the large number of Muslims who each spend at least one week a year on religious tourism, most of those certificates are likely to be held to maturity by their initial or secondary buyers.

Identification of Unidentified Usufruct Shares

When financial assets such as usufruct certificates are converted into physical usufruct, a process of identification of previously unidentified shares in the overall usufruct of the property is required. In this context, the Ottoman *Majallat Al-Ahkam Al-ʿAdliyya*, Article #1114, defined property division (*qisma*) as "specifying portions of a jointly owned property for ownership by each partner, i.e., separating the shares through measurement by size weight, or volume." In this regard, it is easy to define timeshare units in terms of the number of certificates necessary for conversion into weekly usufruct of each specific unit, and then assign the shares on a first-come first-served basis. Since those rules for converting the abstract shares in usufruct represented by *sukuk al-manfaʿa* can be listed in certificate documents, all conversions of certificates into actual usufruct of specific units during specific time periods are deemed to take place by mutual consent of all certificate holders (partners in overall usufruct).

6.5 *Sukuk Al-Salam*

A number of bond structures could be synthesized from the *salam* contract. The most prolific issuer of *salam* bonds to date has been the Bahrain Monetary Agency, aiming to provide Islamic banks liquidity management tools. At a presentation by Sheikh Salman Bin Ahmed Al Khalifa, director of Banking Services at the BMA, at the International Islamic Finance Forum in Istanbul, Turkey, September 27–29, 2004, the structure of the BMA *sukuk al-salam* structure was illustrated as shown in Figure 6.2. In this structure the government of Bahrain undertakes to sell aluminum on the basis of *salam* (prepaid forward contract) and sells corresponding certificates for receipt of aluminum through Bahrain Islamic Bank, which acts as

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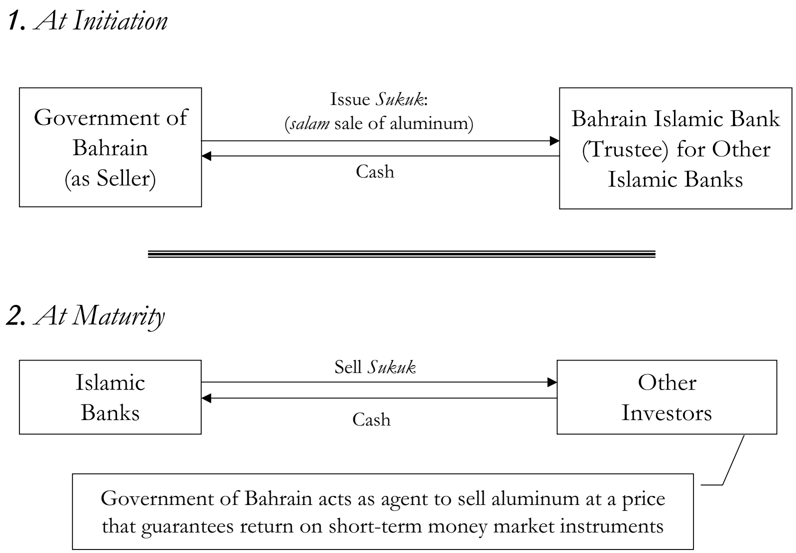

Fig. 6.2. Structure of BMA *Sukuk Al-Salam*

a trustee. At maturity, the government, which is obligated (as *salam* seller) to deliver aluminum to the certificate holders, acts as a selling agent for those holders, guaranteeing a price equal to the announced principal plus interest. This raises an interesting issue based on the rules of agency: As seller, the government would hold the aluminum in a possession of guaranty, but as an agent for the buyers, it would hold it in a possession of trust. This switch from possession of guaranty to possession of trust is perhaps accomplished through some notification system, but that was not made clear in the disclosed structure.

After receiving the aluminum as the certificate holders' agent, the government of Bahrain promised to sell it at a price equal to the principal paid by the certificate holders plus the return on short-term paper.[34] The full structure can be implemented easily through side agreements with an aluminum dealer, from whom the aluminum will be purchased by the government at maturity, and then to whom the aluminum will be sold again on behalf of the certificate holders.

The actual spot and forward prices of aluminum are quite irrelevant to the transaction. Thus, neither certificate buyers nor the government are exposed to any commodity risk, and the aluminum is used merely as a degree of separation to justify receiving the principal (*salam* price) at initiation, and paying principal

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plus interest at maturity (ostensibly as an agent-guaranteed spot price for the aluminum). We shall discuss agency conditions in greater detail in Chapter 8, where our focus will be on using agency contracts to allow banks to act as financial intermediaries in financing bona fide deals. Of course, the BMA *salam sukuk* structure described here can be used alternatively to generate any interest-bearing loans, including unsecured ones. In fact, this bond structure looks like a mirror image of *tawarruq*, which we have already identified as one of the most egregious results of rent-seeking Shariʿa arbitrage in Islamic finance.