

## Case Study on *Sukuk Musharakah* Issued in Malaysia

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**Abstract:** This paper aim to provide the theoretical concept of *sukuk musharakah* and also to examine and analyse the compliancy of *sukuk musharakah* issued by Kuala Lumpur Sentral Sdn. Bhd. (KLSSB) according to Shariah law. Documentation method is used in collecting the data. In order to analyse the data, the inductive, deductive and comparative methods are applied. The study confirms that the *sukuk musharakah* issued by KLSSB has fulfilled the principles and conditions that has been set under *musharakah* contract.

**Key words:** *Sukuk* • *Musharakah* • Islamic bonds • Islamic capital market

### INTRODUCTION

Islamic Capital Market (ICM) is a component of the overall capital market especially in Malaysia. ICM refers to the market where activities are carried out in ways which does not conflict with the principles of Islam. The ICM represents an assertion of Shariah law in capital market transactions where the market is free from prohibited activities and elements such as *riba* (usury), *maisir* (gambling) and *gharar* (ambiguity) [1]. Its development is more tremendous compared to the conventional capital market [2]. This can be proven through the current trend in which most countries that have been practicing conventional systems are switching to the Islamic capital market which is more competitive and stable compared to the latter [3].

Globally, the *sukuk* market has experienced tremendous growth, averaging an annual growth of 40%. The *sukuk* market issuances declined in 2010 as a result of global market turmoil; however the long-term prospects for the *sukuk* market remain strong. *Sukuk* issued globally up 55% in second quarter 2012 from second quarter 2011 to reach USD 25 billion [4]. Malaysia leads the global *sukuk* market, represented by 69.8% of total global *sukuk* outstanding as at second quarter 2012 [4].

*Sukuk* is an instrument in the Islamic capital market which is applied in project financing and major undertakings. Its position as a strong and active instrument in the economic growth and financial stability has been long acknowledged. The existence of *sukuk* provides a new paradigm shift to obtain financing to support economic activity.

*Sukuk* is issued in accordance with Shariah principles, including the principle of *ijarah*, *mudharabah*, *musharakah*, *bai` bithaman ajil*, *istisna`* and others [5]. The year 2011 (until Q3) saw the issuance in Malaysia of more globally accepted *sukuk*, employing the concepts of *musharakah*. As in year 2011, 59% of *sukuk* issued were based on this principle as shown in Chart 1 [6].

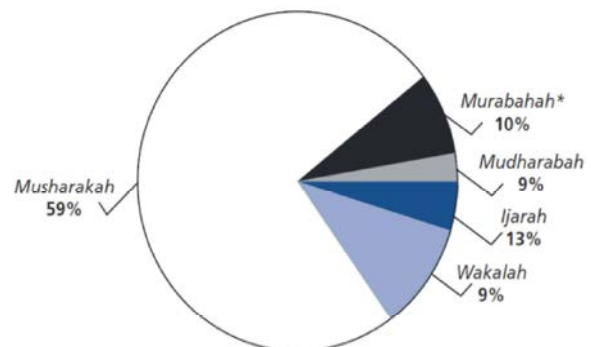


Chart 1: Size of *sukuk* approved in 2011 (Q1-Q3)

Nevertheless, in the development of *sukuk musharakah*, various Shariah issues occur in the structuring and issuance of *sukuk*. This is due to existence of elements of purchase undertaking and liquidity facility in structuring of *sukuk musharakah*. This paper will study the problems associated with issuance of *sukuk musharakah* to ensure it conforms with the Shariah principles.

### Definition

**Sukuk:** The term *sukuk* is originated from the Arabic word that is plural for the word *sak* which means certificate [7] or certificate of property [8]. Sometimes the term refers to *sukuk sanadat* and ownership [9] or Islamic bonds. According to Engku Rabiah Adawiah [10], *sukuk* is more general compared to bonds. This is so because bond is a certificate that proves a person's debt, while *sukuk* includes certificates evidencing financial responsibility (financial obligation) whether that responsibility is not in the form of debt or not.

Basically, *sukuk* refers to written certificate showing ownership rights over a project or investment on the underlying assets and partnership in the project [11]. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) [12] defines *sukuk* as the following:

"Certificates of equal representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity."

Wan Abdul Rahim [13] defines *sukuk* as:

"Certificates of equal value that represent an undivided interest (proportional to the investor's participation) in the ownership of an underlying asset (both tangibles and intangibles), usufruct, services on investment in particular projects or special investment activity."

Whereas the Securities Commission Syariah Advisory Council (SAC) defines *sukuk* as a document or certificate, which documents the ownership of undivided pro-rated pledged assets. The Securities Commission (SC) also differentiates *sukuk* with conventional bonds as follows:

"*Sukuk* structured with a Shariah-compliant assets through the contract of certain exchanges. The contract can be created through the sale and

purchase of assets with deferred payment, leasing of assets or participation in the business of money involving interest. It uses various Shariah principles such as *bai' bithaman ajil (BBA)*, *mudarabah*, *ijarah*, *murabahah* and *musharakah* that allows investors benefit through the transaction [14]."

Malaysian International Islamic Finance Centre (MIFC) stated:

"*Sukuk* refers to trust certificates or participation securities that grant investors a share of the asset including the cash flow and risks that commensurate from such ownership. Similar to financial bonds in the conventional financial industry, *sukuk* are proof of ownership title and are utilised by financial institutions to raise cash. [5]"

**Musharakah:** Basically, in terms of language, *musharakah* is a word taken from the Arabic verb *sharika*. *sharikah* or *shirkah* [7] means mixing property or partnership [15] or sharing [7]. It also contains the meaning *ikhtilat*; the mixing of something with another that is mixing two parts so that it cannot be differentiated any more [16].

According to the Hanafi school of thoughts, it refers to a contract between two (or more) who shares capital and profits [17, 18]. This is a general definition that covers all *sharikah* categories whether property partnership, deeds and etc [19]. In Maliki school, *musharakah* is permission granted by a partner to another partner to manage their shared property with each member retaining the right to manage the partnership [20, 21]. Meanwhile, Shafi'i defines *musharakah* as a contract that gives the equal rights over things two or more [22, 23]. Hanbali scholars define it as coalition of two or more parties to obtain rights or *tasaruf* (power of management) [24, 25]. Right in this sense, refer to tangible rights such as inheritance, *hibah* (gift), *ghanimah* (gain taken from an enemy in war), wills, etc. and does not differentiable between *'ayn* (substance) and benefits [25].

In Guidelines on the Offering of Islamic Securities [26], *musharakah* is defined as "a partnership arrangement between two parties or more to finance a business venture in which all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profits derived from the venture will be distributed based on a pre-agreed profit sharing ratio but a loss will be shared on the basis of equity participation".

**Sukuk Musharakah:** Sukuk musharakah is a certificate of ownership over a project or activity under the principles of *musharakah* partnership whereby both the issuer and investors will contribute to the capital of the project [27].

Kotilaine [28] defines *sukuk musharakah* as:

"An agreement under which an Islamic bank provides funds which are mingled with the funds of an enterprise and maybe others. All providers of capital are entitled to participate in the management but are not necessarily obliged to do so. The profit is distributed among the partners in a pre-determined manner, but the losses, if any, are borne by the partners in proportion to their capital contribution. It is not permitted to stipulate otherwise."

*Sukuk musharakah* issuance is to get right, title, interest and benefits that have not been received over the payment needs [29]. The *musharakah* project is normally managed by either the issuer or a third party as the case may be [27]. *Sukuk musharakah* is issued for the purpose of using the funds to create a new project and develop a financing system for transaction-based business partnership. *Sukuk* holders who are involved in this partnership will be sharing profits and losses based on an agreement with an agreed ratio [2].

**Rulings for Issuance of Sukuk:** In issuing *sukuk*, there are several rules and procedures that need to be observed to in ensuring that the legitimacy of the *sukuk* does not contradict Shariah requirements.

In Middle East, AAOIFI [12] has issued Shariah Standards as a guide for issuance of *sukuk*. In Malaysia, the Securities Commission Shariah Advisory Council (SCSAC) has outlined several rulings relating to the issuance of *sukuk*. Every *sukuk* issued will be regulated and monitored to maintain its compliancy under the Shariah. Guidelines on the Offering of Islamic Securities were published in 2004 for the purpose of facilitating issuance of *sukuk* and aid development of innovative and sophisticated Islamic instruments. Procedures set by the Securities Commission provide flexibility to issuers to manage their financial needs using different bond structures and principles of Shariah [30].

All guidelines issued will be monitored by the Shariah Department, Islamic Capital Market Division of the Securities Commission (formerly known as Department of ICM) in the process of reviewing the "principal terms and conditions" (PTC) submitted by the parties seeking

to issue *sukuk* [31]. In Malaysia, among the rulings that need to be emphasized by the parties involved in structuring *sukuk* are as follows:

**Ruling on Underlying Assets:** SCSAC has decided that any asset that is used as an underlying asset for the issuance of *sukuk* based on *'uqud mu'awadat* or contracts of exchange (such as *bai' bithaman ajil*, *murabahah*, *istisna'* and *ijarah*), an asset, whether tangible or intangible e.g. fixed assets or receivables [32], must be made available for *sukuk* to be issued subject to the following [26]:

- The underlying asset and its use must comply with the requirements of Shariah. Therefore, any asset that does not meet this requirement cannot be used as an underlying asset, for example, any asset that is used for activities which are Shariah non compliant such as a building where major tenants operate conventional banking [33].
- An encumbered asset, such as an asset charged to a financial institution, or an asset that is jointly-owned with another party, can only be used as underlying asset provided that the issuer has obtained consent from the chargee or joint-owner.
- Where receivables are used as the underlying asset, they must be *mustaqir* (established and certain) and transacted on cash basis (on spot).

**Ruling on Utilization of of Sukuk Proceed:** SCSAC decided that any proceed obtained from *sukuk* must be utilised for Shariah-compliant purposes [26, 33]. Therefore, if the *sukuk* issuers use the proceed to build a wine factory, for example, then it is not allowed [33].

**Ruling on Selling Debt (Bay' Al-dayn):** According to SCSAC's decision, *bay' al-dayn* is permissible and it must be made in cash. This is to avoid *bay' al-kali' bi al-kali'* (sale of debt for a debt) which is prohibited [26, 34]. This is admittedly not in agreement with AAOIFI's stand that *bay' al-dayn* is not permissible in any form of transaction due to the existence of usury in the debt sale [35].

**Ruling on Mixed Underlying Asset:** These assets represent mixing between tangible and intangible assets such as real benefits, services and other assets such as debt and currency. In Malaysia, the co-mingling of assets is allowed if the underlying debt is of higher percentage than the value of assets such as buildings or otherwise [26, 31, 32]. Therefore, it can be traded in the secondary market.

Again, this opinion is different from that stipulated by AAOIFI which has set that *sukuk* representing mixed underlying assets can only be traded in secondary market if the market value of asset in the form of 'ayn, benefits and rights are not less than 30% of the total value of assets including debt and currency [35].

**Ruling on Selling of Debt at a Discount:** SCSAC has allowed sale and purchase of debt at a discount as associated with *dha' wa ta'ajjal* (debt discounting) as stated below:

“Generally, the *dha' wa ta'ajjal* principle is important in developing Islamic corporate bonds in a secondary market. Islamic bonds issued are based on the concepts of *ijarah*, *istisna'*, *murabahah*, *musharakah* and *mudharabah*. To enable the trading of these bonds in the secondary market, securities holders will sell them at a lower price based on the concept of *dha' wa ta'ajjal*.”

The SCSAC described *sukuk* as a *haq maliy* (financial right) that cannot be equated with money. If the equation does not exist between them, *sukuk* can be traded without being bound by the rules and *mu'amalat* laws pertaining to *ribawi* goods [31].

Based on Sharia Standards set by AAOIFI, any *sukuk* that represent currency or debt cannot be traded in secondary market otherwise than with face value (*qimah ismiyyah*). Based on the determination made, sales at a discount are not allowed because the said *sukuk* represents the currency or debt owned. Such sales will result in usury as there do not exist (are no) similarities in the types and *'illah* (legal reason) in transactions involving *ribawi* goods [35].

**Ruling on Promise to Buy Back Sukuk (Purchase Undertaking):** Purchase Undertaking (PU) is a promise between issuers and investors to buy back the ownership of the *sukuk*. In Malaysia, this PU is exercised:

- At the maturity of the *sukuk* or during the subsistence of the *sukuk*; or
- When events of defaults (EoD) occur

PU clauses are stipulated by the issuer in the trust deed and the document containing the main terms and conditions (PTC). This clause is intended to provide the issuer a buy back right of the *sukuk* / underlying asset at the end of maturity of the *sukuk* or throughout the

subsistence of the *sukuk* concerned. Purchases are normally made at a price agreed between investors and issuers [31].

Repurchase is intended to dissolve the contract relating to the *sukuk* whereby the *sukuk* issuers buy back all of the *sukuk* from the investor and the investor will recover his principal investment. In Malaysia, it is permissible to undertake to purchase the assets from the *sukuk* holders or from one who holds them, for its nominal value. This is based on all *musharakah sukuk* issued in Malaysia which PU are being included at nominal value [32]. However, AAOIFI [34] has issued a decision relating to PU:

“Fourth: It is not permissible for the *mudarib* (investment manager), *sharik* (partner), or representative (agent) to undertake (now) to re-purchase the assets from *sukuk* holders or from one who holds them, for its nominal value, when the *sukuk* are extinguished at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI Shariah Standard (12) on *sharikah* (*musharaka*) and Modern Corporations and Articles (2/2/1) and (2/2/2) of the AAOIFI Shari'ah Standard (5) on Guarantees.”

Based on the above result, issuers of *sukuk musharakah* and *mudharabah* are not allowed to make agreements to buy back the *sukuk* for its nominal value because it considered as a guarantee for repayment of *musharakah* and *mudharabah* capital. However, if the PU is made at market value or fair value or any price agreed upon the buy back agreement (implementation of the buy back agreement, then it is allowed [31].

**Ruling on Liquidity Facility (LF):** Based on practices in structuring of *sukuk musharakah* in Malaysia, if the profit derived is lower than expected, the issuer will usually make good the deficit through a facility [32]. However, AAOIFI rejects this view and does not permit LF in issuance of *sukuk*. It is based on the following decision:

“Third: it is not permissible for the manager of the *sukuk*, whether the manager acts as *mudarib* (investment manager) or *sharik* (partner), on the representative (agent) for investment or undertake to offer loans to *sukuk* holders, when actual earnings fall short of expected earnings. 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, in accordance with article (8 / 8) of the AAOIFI Shari'ah Standard (13) on *mudaraba*, or to obtaining project financing on account of the *sukuk* holders [35]".

**Case Study at Kuala Lumpur Sentral Pvt. Ltd. (KLSSB):** Kuala Lumpur Sentral Pvt. Ltd. (KLSSB) has issued *sukuk musharakah* in 2006 with a total of RM 720 million. Based on PTC, Kuwait Finance House (Malaysia) Ltd. (KFHMB) is a Shariah Advisor for the *sukuk* issued.

The transaction flow of the above *Sukuk Musharakah* is as follows:

- KLSSB enters into a *musharakah* agreement for the purpose of undertaking a *Musharakah* Venture with eligible investors invited to provide capital contribution through subscription of the *sukuk*. In this respect, interests of the investors in the *Musharakah* Venture are represented by KLSSB in its capacity as agent (*wakil*) and initial trustee for the investors. KLSSB as agent of the Investors will issue *sukuk* to the investors.
- The respective stakes of KLSSB and the Investors in the *Musharakah* Venture based on their respective capital contribution (*Musharakah* Capital) are as follows:

- (a) KLSSB - 26% in kind (RM254 million)
- (b) Investors - 74% (RM720 million)

- Distributable profits shall be shared between the *musharakah* partners on the following basis (Profit Sharing Ratio):

- (a) Sukukholders: 1% (to be capped at RM1,000 p.a.)
- (b) KLSSB: 99%.

- KLSSB will then use its portion of the distributable profits and/or repayment proceeds of its advances to the *Musharakah* Venture to purchase the *sukuk* holders' share in the *Musharakah* Venture in accordance with a pre-agreed 6 monthly schedule (each instalment payable by KLSSB is referred to as a "Share Installment"). Such obligation of KLSSB will be evidenced by a deed of undertaking to be executed by KLSSB in favour of the Issuer and Trustee ("Purchase Undertaking").

In identifying the *sukuk* issued is in line with the *Shariah*, we analyse the KLSSB *sukuk* based on the following issues:

#### Fulfillment of *Musharakah* Terms and Conditions:

According to research made, the underlying principle used to structure the KLSSB *sukuk* is *musharakah mutanaqisah*. In term of fulfillment of the *musharakah* terms and conditions, this *sukuk* has completed the requirements. This is clear from what has been stated in the PTC pertaining to the following matters:

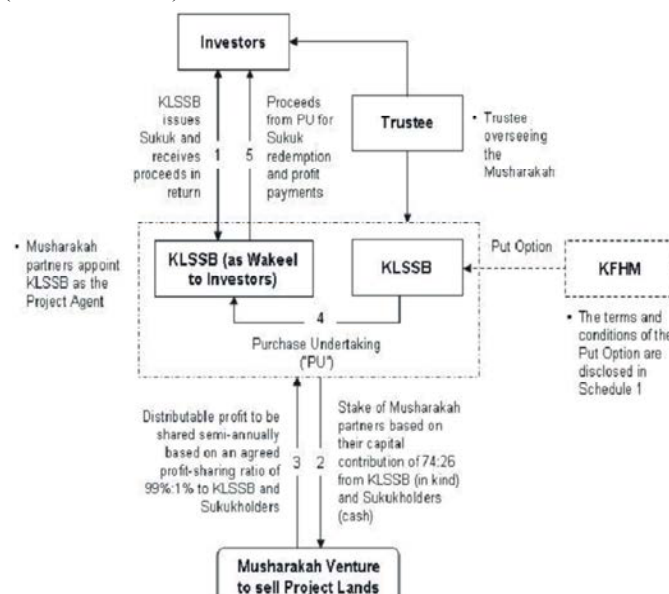


Fig. 1: Structure of KLSSB *Sukuk Musharakah* [36]

**Distribution of Profit and Lost:** Profits and losses are shared according to the agreement made at the beginning of the contract as per stated below:

Distributable Profits shall be shared between the *musharakah* partners on the following basis (Profit Sharing Ratio):

- (i) Sukukholders : 1% (to be capped at RM1,000 p.a.)
- (ii) KLSSB : 99%

If losses are incurred, the loss shall be allocated in accordance with the outstanding Capital Contribution Ratio which is on a basis Diminishing Pursuant to the share installment schedule."

**Capital Contribution:** Capital is the basis for the development of a project. In the *sukuk* issued by KLSSB, investors contribute capital required of up to RM720 million in cash and KLSSB provide a form of land valued at RM 254 million. In the PTC, under Facility Description clause, it is mentioned that [36]:

"This arrangement is effected via the Shariah-approved financing concept of *musharakah* whereby the Investors will provide the capital required of up to RM720 million in cash and KLSSB will contribute capital in kind to the *musharakah* venture."

As mentioned above, the issuer contributes capital in kind al-Kasani [17] said that all *fuqaha*' are unanimous that providing capital in cash or money is permissible. However, there is a different opinion among the jurists if the capital is in-kind. According to Abu Hanifah, Malik and Ahmad [25, 37], if the in-kind can be valued, the contract is allowed. Both AAOIFI and SCSAC have adopted this view [30]. Otherwise, Imam Shafi'i views that the in-kind should not be attributed to the capital because the value is not known [38].

The preferred view on this matter is that the capital can be in cash as well as in kind provided that the in kind needs to be valued upon the execution of the contract. In fact, the basis for the requirement that the capital contribution be properly determined is that failure to do so will lead to ambiguity in respect to the capital. It is not permissible that the capital of *musharakah* be ambiguous since certainty as to the amount of the capital is a benchmark for sharing profit. But if the value of capital contribution can be determined at the conclusion of

*musharakah* contract, then what is concerned by jurists are no longer relevant then the element of *gharar* will no longer be significant. Therefore it can be concluded that the KLSSB *sukuk* complies with the Shariah principles.

**Purchase Undertaking (PU):** According to studies made over KLSSB *sukuk*, it is found that there is a PU feature. This feature is mentioned in the PTC of KLSSB *sukuk* as follows:

KLSSB will then use its portion of the Distributable Profits and/or repayment proceeds of its advances to the Musharakah Venture to purchase the *sukuk* holders' share in the Musharakah Venture in accordance with a pre-agreed 6 monthly schedule (each instalment payable by KLSSB is referred to as a "Share Instalment"). Such obligation of KLSSB will be evidenced by a deed of undertaking to be executed by KLSSB in favour of the Issuer and Trustee ("Purchase Undertaking").

There are several views regarding to this issue because this *sukuk* was based on *musharakah* principle. AAOIFI [35] stated that it is not allowed to make an agreement to buy back the *sukuk* with face value (nominal value) as mentioned before and on the other hand, the SCSAC allowed to re-purchase the assets from Sukuk holders or from one who holds them, for its nominal value [39].

In conclusion, the KLSSB *sukuk* is consistent with SCSAC resolution even though it is different with the rulings made by the AAOIFI. We are in the opinion that this *sukuk* comply with the Shariah because the buy back of the *sukuk* for its nominal value is not considered as a guarantee of the capital as the PU is from the originator not the issuer.

**Capital Guarantee:** Based on the research made, we found that KLSSB created capital guarantees on investors by creating a special fund to meet the repayment of capital. SCSAC has allowed guarantee on *musharakah* capital by way of a third-party guarantee, with or without imposition of fee [26]. According to AAOIFI standard, this view is the same as SCSAC resolution stated as follows:

It is permissible for a third party, other than the *mudharib* or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the *mudharaba* financing contract or investment agency contract.

Our view on this matter is that the guaranteed capital formed by KLSSB coincide with the jurist's views on the issues of capital guarantee. This sukuk structure does not contain guarantee from the party who has connection whatsoever with the contract and this adhered to the guidelines made by the SCSAC and AAOIFI.

## CONCLUSION

The principle of *musharakah* is one of the Shariah principles which has been approved by most of the Muslim jurists. It is used to structure the *sukuk musharakah* to fulfill the local and global market. According to the results, it show that the product has met the principles and conditions of *musharakah* contract and has not contain any prohibited elements such as guarantee from the party who linked to the *musharakah* contract.

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