

## **Ṣukūk: Development and Challenges In Bangladesh Capital Market**

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*Ṣukūk products are very interesting and importing subject which offer a vast innovation and a large potential for the growth of Islamic Finance. This importance is due to the fact that Islamic Financial tools and instruments are replacing conventional financial tools and instruments and playing a competitive role in providing the liquidity to support the growth of Islamic debt market. However, Ṣukūk is one of the new issues in Bangladesh Capital market. There are Number of places where Ṣukūk fund can be instrumental in expending the Ṣukūk market and also providing for the needs of investors. This is because of various Sharī'ah issues, lack of good expert and economic issues. This paper discusses some of these important issues and challenges. Specifically, it deals with the issues of capital guarantee, contractual structures and their various forms. It also covers the harmonization of Sharī'ah rules and problems involved in defining the governing law for Ṣukūk issuance in Bangladesh Capital Market.*

**Kew words:** Ṣukūk, Development, Challenges, Islamic Finance

### **1. Introduction**

Within a broader context, Islamic finance has effectively functioned as an alternative market for capital seekers and providers, while at the same time Malaysia has amended its banking and financial institution Act 1989 to provide the laws and regulations of banking institutions. Then, Islamic finance and Banking act 1983 has included the regulations of Islamic banking along with the conventional financial banking as done in secular and industrialized countries like UK, Singapore, Japan, Hong Kong and France to become a developed country with the Islamic finance in the infrastructure development. On the other hand, Ṣukūk is one of the new issues at the capital market in Bangladesh. There are a number of countries where Ṣukūk

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funds can be instrumented in expanding the *Ṣukūk* market and also in providing for the needs of investors, whether high-net worth, institutional or the average Muslim retail investors. Bangladesh could be an important country of Islamic finance by focusing on *Ṣukūk*.

## 2. Background Of *Ṣukūk*

*Ṣukūk* is the Arabic term for bonds that are structured according to *Sharī'ah* principles. It is also referred to Islamic debt security or Islamic Trust certificates.

*Ṣukūk* is frequently referred to a more accurate translation of the Arabic word would be an Islamic investment certificate. The distinction being that, as it is simplest; a bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, under a *Ṣukūk* structure the *Ṣukūk* holders each hold an undivided ownership in the underlying assets. Consequently, *Ṣukūk* holders are entitled to share in the revenues generated by the *Ṣukūk* assets as well as being entitled to a share in the proceeds of the realization of the *Ṣukūk* assets.<sup>1</sup>

The Accounting and Auditing Organisation of Islamic Finance Institutions (AAOIFI) *Sharī'ah* standard no.17 on "Investment *Ṣukūk*" defines the term investment *Ṣukūk* as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in ownership of the asset of particular project or special investment activity. However this is true after receipt of the value of the *Ṣukūk*, the closing of subscription and the employment fund received for the purpose for which the *Ṣukūk* are issued.<sup>2</sup>

The Islamic Financial Board (IFSB) standard on Capital Adequacy Requirements for *Ṣukūk* securitizations and Real Estate Investment provides the following: "*Ṣukūk* (plural of *Ṣakk*), frequently referred to as "Islamic bonds", are certificates with each *Ṣakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *mudārabah*). These assets may be in a specific project or investment activity in accordance with *sharī'ah* rules and principles".<sup>3</sup>

## 3. Historical References Of *Ṣukūk*

Documentary evidence for the term *Ṣakk* appears to begin in the early Islamic histories and works its way into the Latin-voiced trade terminology of Europe as 'check' or 'cheque'.

<sup>1</sup> Tamara Box Asaria, Mohammed, "*Islamic Finance Market turns to securitization*". Islamic Finance Law, Review July, (2005):75-77.

<sup>2</sup> Accounting and Auditing Organization of Islamic Finance Institutions (AAOIFI) *Sharī'ah* standard no.17 on "Investment *Ṣukūk*"

<sup>3</sup> IFSB, *standard on Capital Adequacy Requirements for Ṣukūk securitizations and Real Estate Investment*, standard 7, January 2009

According to scholars of medieval commerce, such as Walter Fischel and Abraham Udovitch. The term was used interchangeably with the term *saftajah* to represent financial obligations coming out of trade, lending (*qurud*) and partnership (*Mudārabah*) activities. Udovitch cites Jacob Schacht to distinguish between written business contracts (*Ṣakk*)<sup>4</sup>, Letter of credit (*suftajah*) and conveyances of debt (*hawala*)<sup>5</sup>

Classical references such as the shafī'i analysis *Reliance of the Traveller* that discuss *hawala* do not cross the definition with that of *Ṣakk*.<sup>6</sup> For instance, *hawala* relates to settlement of debts on a non-recourse basis through their settlement between creditors subject to the rules of *riba* and the debts are homogenous in type amount and valid obligations. Intriguingly, the rules governing *hawala* seem to relate broadly to those governing bonds even if their primary use today relates to currency exchange

The earliest evidence of the term *Ṣakk* found by western researchers comes during the first century of Hijri, within one hundred years of the prophet's (Peace be upon him) migration to Medina from Mecca<sup>7</sup>. In the emerging trade patterns of the latter Middle Ages, a *ṣakk* or cheque referred to a payment obligation transferred between trustworthy parties on behalf of the primary counterparties to a long distance trade transaction. Often crossing borders and cultures, which were hostile to one another. Socioeconomic scholar of the Renaissance, Fernand Braudel remind us that the classical concept of a cheque was a stop or hold on real assets to be collected later and that the term relating to the transfer to financial claims only came into English in the middle of the 18<sup>th</sup> century.<sup>8</sup> Elsewhere Braudel points out that word cheque comes directly from *sakk* and was transmitted to Europe as term and concept along with *saftajah* or 'bill of exchange' by Jewish merchants from the Muslim world.<sup>9</sup> Evidence of these instruments is preserved.

Although Schacht and Udovitch draw firm lines between *Ṣukūk*, *saftajah* and *hawala*. It is clear that *Ṣukūk* is the broadest term and one may reasonably view the latter two as forms of *Ṣukūk*. This observation is drawn from the hadith and provides a clear linkage to the application of *Ṣukūk* to represent financial debts as well as the monetization of non-financial assets.

<sup>4</sup> Udovitch, Abraham L. *Partnership and Profit in Medieval Islam*, (Princeton: Princeton University Press, 1970).

<sup>5</sup> *Ibid.*

<sup>6</sup> Keller, Nuh Ha Mim, tr. *Al misri*, Ahmed Ibn Naqib, *Reliance of the Traveller* (Sunnah Books: Evanstone, Illinois, 1994), pp. 412-413.

<sup>7</sup> Fischel, Walter J, *Jews in The Economic and Political Life of Mediaeval Islam*, (London: the Royal Asiatic Society for Great Britain and Ireland, 1968).

<sup>8</sup> Vraudel, Fernand, *The Structures of everyday life: Civilization and capitalism 15-18 century*, (New York: William Collins sons and co., vol 1, 1985).

<sup>9</sup> Vraudel, Fernand, *The Mediterranean and the Mediterranean world in the Age of Philip 2*, (New York: William Collins sons and co., vol 1, 1973).

The positive prescription relating to *Ṣukūk* comes with the options of the famous Islamic scholar Abu Hanifah and his respected student Abu Yusuf; they permitted the sale of real Property prior to possession by the seller. Although they did not intend their ruling to movable property.<sup>10</sup> The theory applied in these views is that the property is capable of being reliably defined, its ownership subjected to being recorded in some form, most like *Ṣukūk* and the items are eligible for inspection which may be certified by a reliable party. Herein are the foundations upon which the modern industry of *Ṣukūk* is built.

#### 4. Main Characteristics Of *Ṣukūk* *Ijārah Ṣukūk*

According to Paragraph 1 of the Decision 137 (3/15) of the Islamic Fiqh Academy of the OIC issued in March 2004, The concept of “rental *Ṣukūk*” is based upon the principle of securitization (taskik, tasnid or tauriq), i.e, the issuance of financial certificates amenable to circulation (isdar auraq maliyab qabilab li-tadawul), based upon an investment project producing a revenue stream. The aim of “rental *Ṣukūk*” is conversion of tangible assets and the utility arising from them that are associated with leasing contracts into financial certificates (sukuk) that can be traded in secondary markets. It is further stipulated in paragraph 2 that “rental sukuk” do not represent a fixed amount of money (*la yumattilu Ṣakk al-igara mablagan mubaddidan min an-nuqud*) nor are they debts wa-la buwa dain) owed by a certain entity – neither a natural nor a legal entity.

Under a typical *Ṣukūk al-ijāra* structure, the obligor incorporates a special purpose vehicle (SPV) – often in a tax efficient<sup>11</sup> off-shore jurisdiction – and transfers an asset<sup>12</sup> or a class of assets to the SPV whose sole purpose is to participate in that specific *Ṣukūk* transaction. The SPV is a separate legal entity that may or may not be affiliated to the obligor. By transferring the assets to this special entity, the assets is taken off the obligator’s balance sheet and is remote to any financial distress the obligor may face in the future<sup>13</sup>. In a first step. The SPV uses the proceeds raised from the investors to pay the asset (e.g. real estate or other cash generating asset) purchased from the obligor. The SPV then leases the asset back to the obligor for a period that corresponds with the term of the *Ṣukūk* certificates. The *Ṣukūk* certificates represent data ownership in the asset. Consequently, each investor is entitled to a share in the returns generated by the underlying asset. Therefore, the returns (e.g. rental payments due under the lease agreement between the obligor and the issuer SPV) are

<sup>10</sup> Op.cit.,ñ Al-Ak,p. 282.

<sup>11</sup> khaleq, A.Richardson, C., *New Horizons for Islamic Securities: Emerging Trends in sukuk offerings*, (Chicago: Journal of International Law, 2006-7).

<sup>12</sup> The underlying assets cannot be connected with activities deemed harām in Islam.

<sup>13</sup> Zamri, I. Mirakor, A., *An Introduction to Islamic Finance: Theory and practice* , p. 178.

periodically distributed to the investors.<sup>14</sup> The rental payment may be either a lump sum or benchmarked against an interbank interest rate plus margin, depending on whether the sukuk certificates represent fixed rate or floating rate obligations.<sup>15</sup>

### ***Musharakah Ṣukūk***

The *Ṣukūk al-musharakah* structure is based on the *musharakah* partnership transaction. The underlying transactions work similar to the *Ṣukūk al ijārah* structure presented above. The advantage of a *musharakah* structure is that while the insurance volume is restricted to the underlying asset in an *ijārah* structure, the underlying *musharakah* transaction in a *Ṣukūk al-musharakah* is more flexible.<sup>16</sup> It is suitable for big projects requiring huge amounts of capital or for working capital as well as build-operator-transfer projects.<sup>17</sup> In this joint venture, the SPV is one of the partners to the *musharaka*.

Pursuant to the AAOIFI Sharia standard 17, sukuk al-*musharakah* are:

“Certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners to the project or the assets of the activity as per their respective shares, with the *musharakah* certificates being managed on the basis of participation or *muḍārabah* or an investment agency”

The funds required by the SPV for contribution to the *musharakah* joint venture are provided by the sukuk holders (via an SPV). The SPV divides its *musharakah* share in equal units and issues *Ṣukūk* certificates to the *Ṣukūk* holders. The originator’s contribution to the partnership (as the other partner) typically consists of either an asset or an asset pool. In the *musharakah* agreement, the partners agree on the ratio of their shares in the partnership. The SPV, on behalf of the *Ṣukūk* holders, is typically a sleeping partner with no management rights.<sup>18</sup> In practice, the originator acts as management agent. The profits generate by the (Sharī‘ah compliant) business activity of the joint venture are divided according to the pre-agreed ratio between the originator and the SPV. The SPV then pays to the *Ṣukūk* holders as investors their share in the profits. The profit or loss distribution follows the general rules of *musharakah*. At maturity, the *Ṣukūk* holders sell the units in the partnership to the other partner (obligor). Any surpluses after the payment of the redemption price and the profits to the investors are kept by the originator.

<sup>14</sup> The periodical distributions are comparable to conventional coupon payments paid to bond holders.

<sup>15</sup> Frankhauser, R. Rankin, D. (n. 191).

<sup>16</sup> Gassner, M./ Wackerbeck, p. (n. 77).

<sup>17</sup> Adam, N.J. Thomas, A. (n. 168).

<sup>18</sup> Schoon, N. (n. 79).

Certificates based on musaraka (and also mudaraba) can be bought and sold in the secondary market, provided that the portfolio of musaraka comprises non liquid assets valuing more than 50%.<sup>19</sup>

### **Muöórabah Şukök**

These are certificate that represent projects or activities managed on the basis of mudārabah by appointing one of the partners or another person as a mudārib for the management of the operation. *Şukūk* based on muđārabah are among the *Şukūk* structures to hit the international market especially in the years preceding the recent AAOIFI guidelines which have to some extent curtailed these structures due to the presence of purchase undertaking at nominal value. Some example of *Şukūk* al muđārabah is Aabar *Şukūk*, DIFC *Şukūk*, and Aldar *Şukūk*.<sup>20</sup>

### **Wakālah Şukūk**

These are certificates that represent projects or activities managed on the basis of investment agency by appointing an agent to manage the operation on behalf of the certificate holders.<sup>21</sup>

### **Al Salóm Şukök**

“These are certificate of equal value issued for the purpose of mobilizing salam capital so that goods to be delivered on the basis of salam come to be owned by the certificates holders”.<sup>22</sup> The Bahrain monetary Agency (BMA) renamed as the Central Bank of Bahrain (CBB) seems to be one of only a few institutions that have made use of this type of *Şukūk*. The CBB has been issuing *Şukūk* al-Salām since 2001 as Islamic treasury bills. These are non-tradable instruments and therefore, not part of the global *Şukūk* market and are not discussed detail in the present work. The basis for inter permissibility of trading in Salam certificates is that the certificates represent a share in the Salam debt in which case the certificates are subject to rules of debt trading.<sup>23</sup> Besides Bahrain, the Sudan and Gambia have also issued Salam *Şukūk*.<sup>24</sup>

### **MurōbaĤAh Şukök**

“These are certificates of equal value issued for the purpose of financing of goods through MurābaĤah contract so that the certificates holders become the owner of the MurābaĤah commodity”<sup>25</sup>

<sup>19</sup> Ayub (n, 197), p. 400.

<sup>20</sup> Gieraths, Christine, ‘Pakistan: main participants and financial products of the Islamisation process’, *Islamic Financial Markets*, Wilson, Rodney (ed.) (London: Rutledge, 1990).

<sup>21</sup> Ibid.2/6/2.

<sup>22</sup> AAOIFI, *sharĤĤah* standards n. 17 Investment Sukuk 3/3.

<sup>23</sup> Muhammad Al-Bashir Muhammad al-Amine, “*The Islamic Bonds Market: Possibilities and challenges International Journal of Islamic Financial services*, Vol. 3, No. 1, 2001.

<sup>24</sup> Omar M. El Quda and others, “*Sukuk a new dawn of Islamic Finance Era*” *Global Investment House*, January 2008.

<sup>25</sup> Yasseri, Ali, ‘The experiences of the Islamic Republic of Iran in *musharakah* financing’, *Arab Law Quarterly* (1999).

They are not tradable instruments according to the majority of Muslim scholars based on the prohibition of sale of debt for debt. This is based on the fact that will be securities in murābahah *Ṣukūk* are the price of the commodity sold which is in fact a debt. In contrast, the majority of Malaysian scholars, uphold the permissibility of the sale of debt, therefore, allow the trading on *Ṣukūk* al-murābahah. As with the salām *Ṣukūk*, these *Ṣukūk* are typically considered to be for the local market and therefore, not covered in the present study.

#### **Istisna Ṣukūk**

“These are certificates of equal value issued with the aim of mobilizing funds to the employed for the production of goods so that the goods produced will be owned by the certificates holders”

As with the case of Murābahah *Ṣukūk* or Salām *Ṣukūk*, istisna *Ṣukūk* are not tradable except at par value. However, it should be noted salām *Ṣukūk*, istisna *Ṣukūk* and murābahah sukuk can be traded if they are part of a portfolio whereby the non-debt asset components of portfolio are equal or more than 51%.<sup>26</sup>

#### **Muzōrañah Certificates (Share Cropping)**

These are certificates of equal value issued for the purpose of using the funds mobilized through subscription for financing a project on the basis of muzāra‘ah so that the certificates holders become entitled to a share in the crop according to the term of the agreement. No *Ṣukūk* have been issued under the structure so far.<sup>27</sup>

#### **Musōqah (Irrigation) Certificates**

These are certificates of equal value issued for the purpose of using the funds mobilized through subscription for the irrigation of fruit bearing trees and undertaking the work and expenses required by such plantation so that the certificate holders become entitled to a share in the crop as per agreement. No sukuk have been issued this structure so far.<sup>28</sup>

### **5. Governing Law In Ṣukūk Structures**

Business contracts generally include commercial and technical points agreed between contracting parties. Satisfactory details are discussed before the final drafting of the contract is reached. In each business contract, there are businesses as well as legal issues. Legal issues to be agreed upon include the applicable governing law in case of dispute between the parties.

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<sup>26</sup> Muhammad al-Amine, Muhammad al-Bashir, ‘The Islamic bonds market: possibilities and Challenges’, *International Journal of Islamic Financial Services* (Volume 3, Number 1, 2001).

<sup>27</sup> Shuaa Asset Management, *Analysis of the Sukuk Market*, (Dubai, April 25, 2007).

<sup>28</sup> Shuaa Asset Management, *Analysis of the Sukuk Market*, (Dubai, April 25, 2007).

Each party is free to propose certain law to be applicable, which would govern the contract under discussion. However, this proposal normally requires the consent of the other party.

As a general rule, it is very important, for both parties, to choose a governing law that is well known to the parties. The applicable governing law could either be the local law of a contracting party or the law of a foreign country. According to the Rome Convention on contracts, the contracting parties is supposed to agree on a certain law to govern their contract.

The legal and *Shari'ah* framework is a vital pillar in the sustainable development of Islamic finance. It provides the legislative framework that unambiguously defines the conduct of Islamic financial institutions. It also gives due protection to the consumers of Islamic finance, ensures the enforceability of Islamic financial contracts and provides an effective mechanism for legal redress.<sup>29</sup>

For an Islamic legal financial framework to be considered effective, it has been argued that it should be able to uphold the rule of law, certain formal, institutional and procedural criteria, and generally incorporate the following three elements:

- The presence of legally binding rules. These substantive rules should be promulgated and communicated to the public in advance and be clear, stable and coherent. Modification of these rules should be guided by law according to disclosed and fair procedures.
- The existence of appropriate processes for rule making, rule enforcing and rule changing. There should be clear procedures on how laws and rules are being enacted, enforced and changed.
- The existence of well-functioning public institutions applying the laws fairly and independently.

Thus even if the parties structure their agreements according to a classical Islamic legal form, the laws that govern the interpretation and enforcement of these agreements usually are wholly ignorant of that form. It is simply impractical for parties to incorporate into their agreements all the relevant Islamic rules, but many of the rules omitted are often important just as much as the outcome of Islamic principles, such as the ban on interest (*riba*) and excessive risk and uncertainty (*gharar*). Thus the government national law may apply principles that contradict Islamic Law, such as the payment of interest even against the losing party's contention that the contract is unIslamic. As the same time, if the parties have agreed on terms that are questionable under Islamic law but allowed under local law, the local legal

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<sup>29</sup> Zeti Akhter Aziz, "A strong legal and *Shari'ah* framework as a pillar to Islamic finance" Governor Remark at the Third IFSB Seminar on Legal Issues Survey of Legal and Shariah Issues in the Islamic Financial Services Industry, (Kuala Lumpur: 28 March 2007, BIS Review 35/2007).



system will almost certainly enforce it, enabling parties to push the limits or even evade Islamic law.<sup>30</sup>

## 6. Development Of The *Ṣukūk* Market

One of the sign of the development of an emerging financial market is the creation of a capital market that covers both equity and debt products. This does not happen overnight, but builds slowly until it reaches maturity. The recent development of the *Ṣukūk* Market is hoped to set the foundations for developing the debt market in the Middle Eastern region, the debt market is very thin both the conventional type of debt instruments and *Ṣukūk*.

The *Ṣukūk* Market is emerging in an environment dominated by an underdeveloped bond Market, overloaded with a number of shortcomings and a lack of regulations. However, despite the obstacles, the emergence of the *Ṣukūk* market is considered to be timely and well overdue. For almost three decades, Islamic finance has been completely relying on primary instruments. For the development of the industry in global terms, there needs to be an active Islamic capital market and robust secondary market trading.

The present international Islamic capital market and *Ṣukūk* market in particular, are recent phenomenon. Their roots trace back to the Malaysian government's inaugural *Ṣukūk* issue in 2002. Since then the market has grown exponentially and the cumulative issuance outstanding topped the symbolic bar of \$100 billion.<sup>31</sup> It represents "one of the most important developments in the international capital market in recent times".<sup>32</sup> The *Ṣukūk* market represents a key component of the Islamic financial system. The recent decade has seen the accelerated development of this market and its role in strengthening the evolution of Islamic finance.

The global development of the Islamic capital market is particularly important in the current challenging environment. It will contribute significantly to enhancing the effectiveness and efficacy of the mobilization and allocation of funds within national and international financial systems. Encouraging development of the *Ṣukūk* market will also have an important role in enhancing the links between international financial markets as it fascinates cross-border flows of capital in the global financial system. The *Ṣukūk* market, as an important source of financing for large scale investment projects, can play a key role in facilitating the economic development process. It will provide investors with greater potential for diversification into

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<sup>30</sup> Nick Norsrul Thani, "Islamic Law Implementation" paper presented for Gloval Finance INSEIF, Gloval Forum, (Kuala Lumpur August 30, 2007).

<sup>31</sup> Mohamed Damak, christian Esters, "the *Ṣukūk* Market is likely to show steady Growth in 2010", *Islamic Finance Outlook 2010*, Standards & poor's.

<sup>32</sup> Rahil Ali, Rustam shah, "*Ṣukūk-Cooperate Issues and Opportunities*" *Islamic Finance review 2005/6*, Euromoney Yearbooks.

new asset classes. The bond market in general and the *Şukūk* market in particular, are both seen as key factors in meeting the funding needs for both the public and private sectors.<sup>33</sup>

There are many positive indications regarding the global sukuk market such as over subscription for issues, broad geographical distribution, involvement of conventional financial institutions and the participation of Islamic banks in the management and arrangement of these sukuk issues. The market has attracted a lot of interest from the business community worldwide. Indeed “Islamic bonds” or *Şukūk* are one of the fastest growing segments in the financial market.<sup>34</sup> It is clear that the market is continuing its explosive growth filled by huge investment and financing need notably in the countries of the Gulf and Asia. However, *Şukūk* have become a global phenomenon, attracting more issuers from a large pool of diverse countries.<sup>35</sup>

## 7. Challenges In The Development Of The Global Islamic Capital Market

Zeti Akhtar Aziz has pointed out in her paper with title of “The challenge for a Global Islamic Capital Market – Strategic Developments in Malaysia” (2007)

A vital ingredient for the development of capital markets, including the Islamic capital market, is the creation of a secondary trading platform for the capital market instruments. This will provide investors with the flexibility in managing their liquidity requirements. In this respect, more needs to be done in terms of the creation of a continuous supply of Islamic papers and instruments that would promote the secondary trading of instruments and add greater depth to the market.

There also needs to be greater diversity in the type and maturity of the *Şukūk* in the market for Islamic financial institutions and portfolio managers to manage their funds effectively. As part of the efforts to address these issues, the Malaysian government regularly issues *Şukūk* with different maturities in order to create a benchmark yield curve. Since the year 2000, the government has developed an auction calendar for both the conventional and *Şukūk* government issues. In 2005, the government commenced issuing shorter term Islamic treasury bills and longer-dated *Şukūk*, with a maturity of 10 years, to further diversify the instruments available to investors. In the Malaysian *Şukūk* market, Islamic private debt securities now account for 50 per cent of the total private debt securities market.

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<sup>33</sup> Zeti Akhter Aziz, *The challenge for a Global Islamic Capital Market: Strategic Development in Malaysia*. (2011)

<sup>34</sup> Fitch Rating, “Demystifying Corporate *Şukūk*” March 5, 2007, [www.fitchrating.com](http://www.fitchrating.com).

<sup>35</sup> Mohamed Damak & Emmanuel Volland, “*The Şukūk Market Continue to Soar and Diversify Holt Aloft by Huge Financing Needs*”, Standard & poor’s March 11, 2008.

Another challenge to the growth of the market concerns pricing issues. For the Islamic security to be efficiently priced and credible, further initiatives need to be undertaken to develop its own indicator. For example, if *Sukūk* is issued based on the Ijarah principle, and uses the property as its underlying asset, the actual rate of rental may be explored to be used to determine the rate of return on the instrument. It would then fluctuate depending on the demand and supply for that property. It will then give a true reflection of the price of the underlying asset.<sup>36</sup>

## **8. Challenges Of Islamic Finance In Bangladesh**

Abdul Awwal Sarker has stated in his paper “Islamic Banking in Bangladesh: Achievements & Challenges” (2007) that Islamic banks in Bangladesh have been encountering numerous challenges.

Firstly, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. They face the same problem in financing consumer loans and government deficits.

Secondly, the risk involved in profit-sharing seems to be so high that almost all of the Islamic banks in Bangladesh have resorted to those techniques of financing, which bring them a fixed assured return. Presently 60%-70% investments of Islamic banks are made on mark-up basis (*Murabahah* and *Bai-Muajjal* etc.). As a result, the ideal modes of investment (*Mudārabah* and *Mushārahah*) are quite absent in their practices. Concentration of Islamic banks' investment in short-term trade is a pertinent problem in Islamic banking. Islamic banks are heavily dependent on *Bai Muajjal/Murabaha* in their operations. This is due mainly to two reasons. Their orientation is mainly towards short term financing of trade transactions for which *Bai Muajjal/Murabaha* appear to be more convenient devices compared to the system of profit-loss sharing.

Thirdly, they are in competition with interest-based banks and are therefore anxious to earn at least as much on their investments as will enable them to give a return roughly comparable to prevailing interest rates to their investment account holders. This is easier to achieve by engaging in *Bai Muajjal/Murabaha* transactions as "mark-up" can be fixed in a manner which more or less assures the required return. For that reason, the Islamic banks are reluctant to invest under *Mudaraba* or *Musharaka*, the true Islamic financial mechanisms. There is a genuine concern among Islamic scholars that if interest is largely substituted by a device like "mark-up", it would represent a change just in name rather than in substance, and the new system would not be any different from the interest-based system so far as equity is

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<sup>36</sup> Zeti Akhtar Aziz, “The challenge for a global Islamic capital market – strategic developments in Malaysia”, London, June 2007. BIS Review 74/2007.

concerned. It is also emphasized that apart from equity considerations, the prohibition of interest in Islam is meant to stimulate overall production, which is the mainspring of growth.<sup>37</sup>

### 9. The Possible Solutions For The Issues That Might Arise From *Ṣukūk* Issuance.

One of the widely used solutions is to qualify the governing law clauses by including expressions that restrict the applicability of English law or even the local law to the extent that it does not contradict with *Sharī'ah* principles. Thus, expression such as “as long as it does not contradict *Sharī'ah* principles” or “subject to the glorious *Sharī'ah* rules” or without prejudice to the Islamic *Sharī'ah* Principles “are added to the governing law clause. Will these qualifications have any effect in the judgment of any court? The probability seems to be very remote and the Shamil case is just to make their stand and objection clear, and also, on moral grounds, to stress the fact that this is what is possible under the present circumstances

Another solution is to include a clause to the effect that the parties agree that the agreement shall be in compliance with *Sharī'ah* principles without governing law, Sometimes the governing law is drafted to include expressions such as “subject to the terms and conditions of transaction or the agreement” (which are, in principle, *Sharī'ah* compliant) the agreement will be governed by English Law.<sup>38</sup>

It is also sometimes stated that: “This agreement shall be governed by, and shall be construed in accordance with, English Law”. However, a sub-clause to the effect of the following is added: “Notwithstanding the provision of the above clause, the parties recognize and agree that the principle of the payment of interest is repugnant to *Sharī'ah* law and accordingly to the extent that the law would but for the provisions of this clause impose (whether by contract or by statute) any obligation to pay interest, each party hereby irrevocably and unconditionally waives and rejects any entitlement to recover interest from the other party. It should also be noted that sometimes and instead of drafting the above as a sub clause of the governing law it is drafted as a separate clause under the heading, “Waiver of interest”

It is also suggested that to avoid some of the complications of subjecting an Islamic agreement to a non-Islamic court or jurisdiction, one of the solutions may be that when drafting clauses that subject the laws of a country to *Sharī'ah*, the parties could identify the specific governing principles of *Sharī'ah* that will apply to the contract, such as the exclusion of Riba. This has not yet been tested but would seem a sensible solution to enhance the

<sup>37</sup> Awwal sarkar, Abdul, “Islamic Banking in Bangladesh: Achievements & Challenges” International Journal of Islamic Financial Services Vol. 1 No.3, 2009.

<sup>38</sup> Muhammad al-Bashir Muhammad al-Amine, Global *Ṣukūk* and Islamic Securitization Market Financial Engineering and product Innovation, P.285.

chance of such an appendix of relevant governing principles be incorporated in a country whose law is chosen<sup>39</sup>

Adoption of such an appendix of foreign law principles is subject to the judge's discretion and the case suggests that such adoption of foreign principles needs to be capable of being sensibly applied in the country. Some commentators have noted that if the foreign law is incorporated into the terms of the subject contract, it would mean no more than the court applying English law where certain black letter laws of a foreign jurisdiction were incorporated. Such measures should be helpful in the incorporation of Islamic principles in the foreign adjudication. Furthermore, even though Islamic law would not prevail in the event of a conflict, such judgments would inevitably be accorded lesser scrutiny, depending on the circumstances in Islamic forum.<sup>40</sup>

## 10. Conclusion

Standard-setting body found that Bangladesh has developed a sizeable Islamic finance industry but a lack of sharia-compliant instruments such as *Ṣukūk* is limiting further growth of the sector.

With a predominantly Muslim population of 160 million, Bangladesh has developed Islamic finance with only marginal regulatory adjustments; the industry has doubled in size in the past four years.

The central bank has a small short-term *Ṣukūk* (Islamic bond) program which issues six-month tenors to help Islamic banks manage their liquidity, but a wide range of tenors is not available and there are no corporate *Ṣukūk*.

The Malaysia-based Islamic Financial Services Board (IFSB) said that *Ṣukūk* would help to diversify funding sources and make up for the limited scope of the Islamic money market, but issuance of *Ṣukūk* would require more specific rules, "The larger policy issue in Bangladesh is the adequacy and scope of the legal and regulatory framework in providing an appropriate enabling environment,"

Thus, the Government of Bangladesh can work on it through cross-border "*Ṣukūk*" transaction to raise required fund under syndication process. The Government should address key issues pertinent to the country's Islamic financial market, Challenges & Opportunities in Bangladesh Islamic Finance Sector, Possibilities and Opportunities for Diversification of Islamic Products, facilitating *Shari'ah* compliant investment flows in Bangladesh.

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<sup>39</sup> Oliver Ali Agha and Claire Grainger "Analysis: *Ṣukūk* when a Default not Really a Default" Risk.net Financial Risk Management news and Analysis, [www.Risk.net](http://www.Risk.net), December, 11, 2009.

<sup>40</sup> Ibid

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