Chapter 2: Literature Review

2.1 Islamic Finance

Islamic finance is broadly defined as financial market transactions, operations and services which comply with Islamic rules, principles, philosophy and code of practices (SC, 2009). In other words, Islamic finance is the financial activities which are based on the principles of *Shariah* which is often translated into Islamic law and a way of life in an Arabic term (INCEIF, 2006; Ilias, 2009). *Shariah* is the fundamental of Islamic finance which covers all aspects of human life such as personal behaviour and manners, social, political, economic, intellectual matter as well as religion (INCEIF, 2006; SC, 2009; Ilias, 2009).

In particular, the components of *Shariah* could be classified into *aqidah* (belief), *fiqh* (legal ruling) and *akhlak* (morality). *Fiqh* is in turn divided into *ibadah* (the relationship of human being and Allah) and *muamalat* (the relationship of human being themselves) (SC, 2009). Islamic finance, *Shariah*-compliant finance, is mainly under the *muamalat* division. Hence, since *Shariah*- compliant finance follows the financial practices in accordance with *Shariah* there is, therefore, a manifest difference from conventional finance.

Among the salient features distinguishing Islamic finance from conventional finance are the prohibition of *riba* (interest), *gharar* (uncertainty) and *maisir* (gambling) ((INCEIF 2006; Ayub, 2007). Ilias (2009) demonstrated the risk and profit sharing as features of Islamic finance. Lahsasna (2010) added inequality (*ghubn*), deception (*taghrir*) and duress (*ikrah*). The study intends to describe about *riba*, *gharar* and *maisir* as key features as well as risk and profit sharing as these feature are mostly highlighted:

1. The prohibition of *riba*: *Riba* was prohibited by the primary sources of *Shariah*, i.e. *Quran* and *Sunnah*. Every interest paid by the borrower along with the loan principal belongs to *riba* and is prohibited in Islamic finance. At the same time, the prohibition of *riba* expands to specific commodities. In contrast, interest has been a critical motivator in making financial transaction and a main profit-source based on the income statement in conventional finance (INCEIF, 2006; Ayub, 2007).
2. The prohibition of *gharar*: A sale or any other business contract which includes an element of *gharar* is prohibited. *Gharar* refers to the uncertainty, ambiguity, deception and hazard caused by lack of clarity regarding the objects or the price in a transaction or contract. However, uncertainty cannot be avoided altogether in business because risk-taking is a ground of giving a profit in business on the other hand. Hence, the extent of uncertainty has not been clearly defined and so many areas still need *ijtihad* (INCEIF, 2006; Ayub, 2007).
3. The prohibition of *maisir*: *Maisir* is a form of *gharar* because the people put their money or wealth at risk where they might bring back a huge amount of money or lose all the money or wealth. Hence, *maisir*, and gambling, is prohibited and *Shariah* also prohibits investment in gambling-related activities such as lending for the construction of a casino or trading of alcohol ((INCEIF, 2006; Ayub, 2007; Khan and Omar, 2008).

4. Risk and profit sharing: Relevant parties involved in a financial transaction must share both risks and profits which depend on the performance. Earnings of profits or returns from assets are permitted so long as the business risks are shared by the lender and borrower (Ilias, 2009)

Islamic finance may broadly be classified into Islamic banking, Islamic wealth and assets management, *sukuk* and *takaful* (KFHR-GIFF, 2010). The scope of this study covers Islamic banking and *sukuk*. The reason being that this study selected Islamic banking is because banking activity is a core activity in finance and its market share accounts for 82% of total *Shariah*-compliant assets (KFHR-GIFF, 2010). At the same time, *sukuk* is relatively an easy means to penetrate the market and cover about 12% of the total market assets following Islamic banking (KFHR-GIFF, 2010).

2.2 Islamic Banking Principles and Products

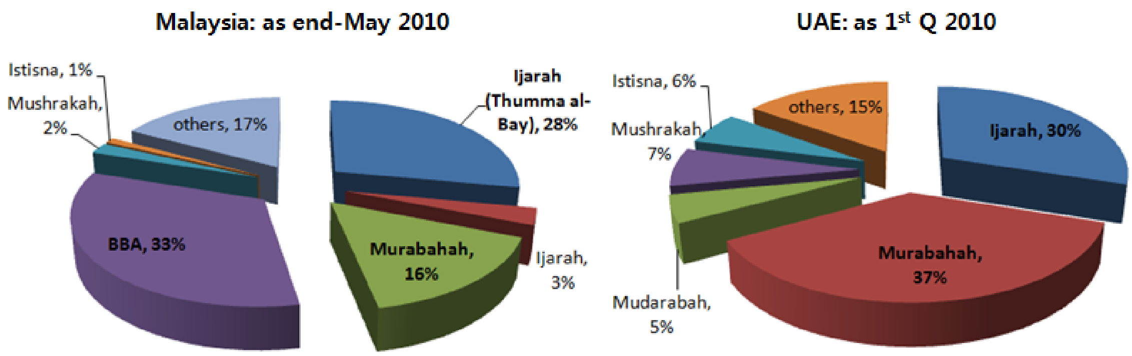
Islamic banks comply with the law of *Shariah*. Islamic banking is known for its interest free concept in the banking industry. Islamic banks also serve as intermediaries between the saving surplus and the deficit households/ business units. However, keeping in mind the prohibition of interest, the conventional instruments of interest must be replaced with alternative instruments. While conventional banks largely pay and charge interest for the purpose of business, Islamic banks must avoid interest in their operations and utilize *Shariah*-compliant instruments as the base of intermediary activities (Ayub, 2007).

Al-Jarhi and Iqbal (2001) have described the banking activities of Islamic bank in the following words (Ayub, 2007):

> "*An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes fund as the basis of Mudarabah or agency contract. It can also* accept demand de*posits. On the assets side, it advances funds on a profit-and-loss sharing or a debt-creating basis, in accordance with the principles of the Shariah.*"

Given that Islamic bank offers all conventional services and functions of an intermediary and at the same time their banking activities must be *Shariah*-compliant, deposit taking through current accounts, savings and investment accounts should and will be realized with the permissibility of *Shariah* principles. Furthermore, the mobilizing models should and will be based on sales models (*Murabahah*), leasing (*Ijarah*), partnership (*Musharakah*) or profit sharing (*Mudarabah*), etc. (Fikret and Džemal, 2009).

Figure 2.1: Financing by principles



Source: GIFF 2010 – Bank Negara Malaysia, Central Bank of UAE, Zawya, KFHR

This study demonstrates the main products of Islamic banking considering its market size as shown in the above figure to construct ideas for the interview guideline and to offer a better understanding to the relevant parties in Korea.

2.2.1 *Wadiah*

Definition

The term *wadiah* is literally to leave and so it is narrowed into leaving something in someone's custody. Technically Shafiis and Malikis suggested the definition of representation in keeping the possession of private goods in a specific way. The Majallah al-Ahkam al-Adliyyah had stated it as assets given to someone for safekeeping without any return (INCEIF, 2006; Lahsasna 2010). From the Muslim scholars' view, *wadiah* is a safekeeping or trust contract without any given compensation and the asset should be returned at the request of the owner.

Types of *wadiah*

There are two kinds of *Wadiah*, namely *wadiah yad al-amanah* and *wadiah yad al-dhamanah*. *Wadiah yad al-amanah*which is based on a custodianship. In fact *wadiah* can be said as amanah in its nature. *Wadiah yad al-dhamanah* is combined with the concept of guarantee for the return of deposit (*daman*).

When it comes to the salient differences between both, the custodian in *wadiah yad al-amanah*cannot utilize the deposit without the owner's consent. At the same time, since there is no guarantee, this type does not charge any liability on the custodian in case of loss or damage except for negligence. Meanwhile, the custodian in *wadiah yad al-dhamanah* is entitled to use the deposited assets for transaction and other profit purpose with risk-taking regardless of consent from the owner, but since any profit from this type belongs to the custodian, offering some portion of profit as a gift (*hibah*) is at the custodian's discretion. In particular, the *wadiah yad al-dhamanah* contract has similarities with the loan (*qard*) contract. And thus, this type follows the principles of the loan contract; no pre-determined excess/ benefit (INCEIF, 2006; Lahsasna 2010).

Application

Today, most Islamic banks employ the al-*wadiah* yad dhamanah (WAD) instrument which means safe-keeping with guarantee. Practically it can be expanded into al-*wadiah* yad dhamanah current account and al-wadinah yad dhamanah savings account. From the fact that no one will patronize Islamic bank if there is no guarantee for the return of deposits in current and savings accounts, *wadiah yad al-amanah*contract can be used for simple safe-keeping of valuable items rather than money (Rosly, 2005).

As for the WAD, the Islamic banks are entitled to use deposits for investment activities and have to guarantee the returns of the deposits. However, since this is interest-free deposit like the loan contract in Islam, Islamic banks cannot promise to offer fixed contractual or published income which is equivalent to *riba*. Even though Islamic banks assume that the main purpose of WAD is not investment and there is no promise of profit, the competition in real world requires Islamic banks to offer some portion of profit which is a gift (*hibah*), not pre-agreed profit or interest in its discretion (Rosly, 2005; Lahsasna, 2010). Moreover, Rosly (2005) stated that in terms of the reward it is also not necessary to assume that Islamic banks should be less profit-motivated compared to conventional banking. In fact, Islamic banks usually make periodic gifts at its discretion (INCEIF, 2006).

2.2.2 *Mudarabah*

Definition

According to the schools' perspective, the Maliki scholars define it as an agency for trading in delivered cash for a part of the profits. The Shafiis define it as an agreement whereby an owner hands over the capital to a worker who trades with it and the profit is to be shared between them. Hanbalis's definition is similar to the schools definition likewise. In particular, Hanafi school has more flexibility and defines *Mudarabah* as a partnership for taking part in the profit in which one side (*rabb al-mal*) provides capital, and the other side (*mudarib*) provides the labour or and skill (INCEIF, 2006; Lahsasna, 2010). AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) *Shariah* Standards 2008 defines *Mudarabah* as a partnership in profit whereby one party provides capital (*rabb al-mal*) and the other party provides the labour (*mudarib*).

Conditions of *Mudarabah*

The *rabb al-mal* should be qualified to appoint an agent and the *mudarib* must be qualified to accept the agency. Hence, the parties with absolute legal capacity can make a contract. As for the capital, it must consist of properties which can serve as the capital *Mudarabah* and the *rabb al-mal* should not have any control over the capital provided.

However, the provided capital cannot be guaranteed by *mudarib* because the *mudarib* is a trustee in respect of the capital and invest no capital. If there are losses in *mudarabah*, the losses must be borne by the capital provider *rabb al-mal* except in the case of breach of the requirement of trust such as misuse and negligence. In case of loss, *mudarib* cannot get compensation for his or her labour and time. At the same time, the profit distribution should be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of a pre-agreed percentage of the profit and not on the basis of a lump sum or percentage of the capital which fall into *riba* (AAOIFI, 2008; Lahsasna, 2010).

Types of *Mudarabah*

Mudarabah contracts are categorized into unrestricted and restricted *Mudarabah*. An unrestricted *Mudarabah* contract is a contract that *rabb al-mal* allows *mudarib* to manage a *Mudarabah* fund without any restrictions. Hence, *mudarib* holds a wide range of trade or business freedom on the basis of trust (AAOIFI, 2008).

On the other hand, in restricted *Mudarabah*, the capital provider restricts the actions of the *mudarib* i.e. in a manner of describing a range of operations (AAOIFI, 2008).

Application

Starting from the view of deposit, unrestricted *Mudarabah* contract is applied to the General Investment Account (GIA) of Islamic banking. GIA is of an absolute *Mudarabah* and the ratio of profit distribution is generally uniform and standard. Meanwhile, Specific Investment Account (SIA) is on the basis of restricted *Mudarabah* contract and *rabb al-mal* can require *mudarib* to administrate the funds in specific locations or trades.

At the same time, *rabb al-mal* can negotiate the ratio of profit sharing as SIA. While GIA's funds are commingled and managed on a poll basis, the funds in SIA are to be managed separately regardless of either short-term or long-term (INCEIF, 2006). Pursuant to *Mudarabah*'s principle for all cases, however, contractually the deposited amounts are not guaranteed, namely no capital protection and no pre-fixed rate of return.

In financing, the Islamic bank provides project financing utilizing *Mudarabah* contracts and *mudarib* acts as the manager of the project. One of the most well-known structures used in the issuance of Letter of Credit (LC) is based on *Mudarabah*, where the customer appoints a bank as *mudarib* (INCEIF, 2006).

2.2.3 *Musharakah*

Definition

The term *Musharakah*, as it is used in modern financing is confined to a contractual partnership. Jurists have given various terminological meanings for *Musharakah*. The Hanafi scholars define *Musharakah* as a contract between partners on both the capital and profit. The Shafii scholars define it as the confirmation of the rights of two or more people over a common property. According to Hanbali scholars, it is the amalgamation of the rights and the freedom to use. Meanwhile, Malikis define it as permission to transact where each of the partners permits the other to transact with the partnership property while at the same time retaining his own right to transact with the same property (INCEIF, 2006).

More specifically, the AAOIFI *Shariah* standard (2008) states that it is an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profits which are shared among parties (SC, 2009).

Conditions of Musharakah

Contracting is considered to be valid if made verbally or in writing. The subject matter of the contract, which is the capital, must fulfill the following conditions (Lahsasna, 2010):

- The capital contributed shall be in cash, gold, silver or its equivalent in value; and

- The capital may consist of trading assets such as goods, property and equipment. It may also be in the form of intangible rights such as trademark.

Differences between *Mudarabah* and *Musharakah*

Firstly; the investment or capital in *Musharakah* is contributed by all the partners, while in *Mudarabah*, the capital is the sole responsibility of *rabb al-mal*. Secondly; all the partners in *Musharakah* can participate in the management of the business and can work for it, while in *Mudarabah*, the *rabb al-mal* has no right to take part in the management. Thirdly, as for the loss, all the partners in *Musharakah* share the loss to the extent of the ratio of their investment, while in *Mudarabah* the loss is suffered by *rabb al-mal*, which means that the capital deposited by the depositor is not protected by any bank in Islamic banking. Moreover, in terms of ownership all the assets of the *Musharakah* are jointly owned by all the partners according to their proportionate investment. Hence, each one of them can benefit from the appreciation in the value of the assets. However, in *Mudarabah* all the goods or properties purchased by *mudarib* are only owned by the *rabb al-mal* and *mudarib* is not entitled to claim his share in the assets (SC, 2009).

Types of *Musharakah* (partnership)

Musharakah can be divided into two types: *inan* (unequal-shares partnership) and *mufawadah* (equal-shares partnership) (INCEIF, 2008; Lahsasna, 2010).

The *inan* contract simply means that two or more people commit themselves to paying a specified share into the capital, which is to be used in the trade and profit would be divided between them according to a specified rate agreed upon by them. It does not require equality in investment amount.

As for the *mufawadah*, each one of the partners has a share equal to that of his colleagues in capital, profit and freedom of disposal. It is the opposite of *inan* whereby equality in investment, personal status and distribution of profits and liabilities are required. Each partner enjoys full and equal authority to transact with the partnership capital. The Hanafis consider each partner as an agent for the partnership business and stands as surety or guarantor for the other partners.

Application

Musharakah is applicable in different modes of financing. Some of the modes are as follows (INCEIF, 2008; Lahsasna, 2010):

- Project financing: *Musharakah* is one of the tools that can be used in project financing. This concept can be utilized particularly if investment comes from different parties;
- Financing of a single transaction: *Musharakah* can also be used for financing a single transaction. The banks can also use this instrument for import financing. If a letter of credit is opened with some margin, the form of *Musharakah* can be used; and
- Financing of working capital: The capital of the existing business may be

evaluated with mutual consent. Apart from cash, non-liquid assets can also form part of the capital on the basis of evaluation. In this way, the value of the business can be treated as the investment of the person who seeks finance, while the amount given by a financier can be treated as his share of investment.

In terms of application, diminishing *Musharakah* or *Musharakah* mutanaiqisah is another form of *Musharakah* which was developed recently by the scholars. It is a *Musharakah* in which the Islamic bank agrees to transfer gradually the bank's share to the other partner, so that the Islamic bank's share decreases and the other partner's share increases until the latter becomes the sole proprietor of the venture (INCEIF, 2008; Lahsasna, 2010).

This arrangement is applicable to lease financing for a property like an *Ijarah* contract. The diminishing *Musharakah* allows the financier to claim rent according to his proportion of ownership in the property at initial phase and at the same time allows him periodical returns of a part of his principal through purchases of the units of his share. As the share of the financier is transferred to other party or customer, finally the party or customer holds the sole proprietary of the property (INCEIF, 2008; Lahsasna, 2010).

2.2.4 *Murabahah*

Definition

Murabahah is generally defined as the sale of a commodity at the price the seller purchased it plus adding a stated profit known to both the seller and buyer. It is a cost-plus-profit sale in which the seller expressly discloses the profit (INCEIF, 2008; Lahsasna 2010).

The AAOIFI *Shariah* standard (2008) defines *Murabahah* as selling a commodity as per the purchasing price with a prescribed and agreed profit mark-up. Besides, it is saying '*Murabahah* to the purchase orderer' in terms of more practical facet, whereby its definition is the sale of an item by the institution to a customer at a pre-agreed selling price, which includes a pre-agreed profit mark-up over a cost price, specifying the customer's promise to purchase.

Condition of *Murabahah*

Since it is a cost-plus-profit contract, a buyer must know the cost at which the seller obtained the object of sale. In relation to this, if the initial price is not known during the contract session, the sale results in defect. Next, the profit margin should be known; otherwise it will not be regarded as *Murabahah* and would rather fall into bargaining sale.

In addition, the seller must lawfully own and possess goods or property according to *Shariah* requirements. If the product is acquired through forgery, then the seller or financier is not the valid owner of the item. Lastly, *Murabahah* prohibits the trading of goods or properties among which are six *riba*wi items such as gold, silver, dates, barley, salt and wheat.

Application

Murabahah is a dynamic instrument that can be applied to several products offered by Islamic banks. Among the salient application are as follows:

- Letter of Credit: A customer requests a bank to open a letter of credit to import goods providing all the necessary details and information. The customer also acts as an agent on behalf of the bank in importing goods. After the confirmation of the bank's ownership of the goods in question through the acquisition of relevant documents, the bank sells the goods to the customer at the cost price plus mark-up; and

- *Murabahah* to finance the purchase of goods: It is utilized in financing the purchase of goods such as cars. When a customer hand in an application to a bank requesting the purchase of a motor car, the bank issues an invoice to the dealer to purchase under the bank's ownership. The bank sells the car to the purchaser, with the registration in the name of the purchaser, after getting an appropriate guarantee. It can be combined with deferred payments.

In practice, financing taken through *Murabahah* cannot be rolled over for a further period. Moreover, even though customer defaults in payment of the price at the due date, the price cannot be increased. In *Murabahah* financing, once the price is fixed, it cannot be increased.

2.2.5 *Bai bithamin al ajil* (BBA)

Definition

BBA is a sale contract in which the payment of the price is deferred and payable at a certain particular time in the future. In the Middle East the same practice of BBA is used under the term *Murabahah*. BBA can be implicated in any sales contract including *musawamah* and *Murabahah*. Therefore, BBA is not a kind of sales contract, and rather it is a manner of payment via a deferred payment basis (INCEIF, 2006).

Application

BBA financing is employed by the bank to provide medium to long term financing to clients who intend to acquire items such as houses/shop houses, land, motor vehicle, consumer goods or shares in Malaysia. There are two kinds of agreements which are property sales agreement and property purchase agreement. A bank purchases a property which a customer wants to purchase through property purchase agreement on a cash basis and at the same time the bank sells the same property to the customer through a property sale agreement for deferred payments (Lahsasna, 2010).

However, practically the customer sells the property, which he or she buy from the developer, to the bank and buys back the property from the bank. Such a sale and buy back transaction has brought up the issue of *bai al-inah* which is regarded as transaction for a loan. The difference between two transactions is equal to interest, *riba* (Hanafi and Kasim, 2006). It is not the intention of this section to discuss the issue of the legitimacy of *bai al-inah*. It will be reviewed again in section 2.6.

2.2.6 *Istisna*

Definition

The majority of jurists considered *Istisna* as part of *salam*, in which a price is present but the goods will be delivered at a later agreed period, and therefore the price must be paid at the time of contract as in the case of *salam*. According to Hanafi, *Istisna* is another type of contract which is different from the contract of *salam*, whereby the price can be paid later, not at the time of contract (INCEIF, 2006; Lahsasna, 2010). AAOIFI *Shariah* standard (2008) has accepted the Hanfi's opinion and defines *Istisna* as a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or contractor to deliver them to the customer upon completion.

Condition of *Istisna*

The conditions placed by scholars for validity are summarized into four categories. Firstly; the subject matter to be manufactured must be identified according to its kind, type, measure, quality and quantity or related specifications. Secondly; in particular the subject matter must be goods that can be manufactured according to the convention, but don't exist at the time of contract. Thirdly; the manufacturer undertakes to construct the goods with his or her own material. Lastly, the price of the subject matter of *Istisna* is known at the time of the conclusion and may be deferred or paid in instalments but is not subject to be increased or decreased (INCEIF, 2006, AAOIFI, 2008).

Types of *Istisna*

According to AAOIFI *Shariah* standard (2008) and other literatures, there are two types of *Istisna*. One is ordinary *Istisna* and the other is called parallel *Istisna*. Parallel *Istisna* takes effect through two separate contracts. The first contract, for example, is a contract between a bank and a customer whereby the bank acts in the capacity of a manufacturer, builder or supplier. In the second contract, the bank acts in the capacity of a purchaser and concluded another *Istisna* with a manufacturer, builder or supplier in order to fulfil its first contract.

Application

Istisna or parallel *Istisna* provide a *Shariah* compliant instrument for financing, especially for the house financing sector, specifically for houses under construction, which is related to the issue of possession and ownership when a bank sells the property which is under construction or in the development stage with other contracts such as BBA (Lahsasna, 2010). Hence, it can be utilized to avoid a sale and buy back transaction whereby a delivery of property before completion is made (AAOIFI, 2008). At *Istisna* the bank will deliver the property to the customer upon completion and the customer will pay the cost plus profit on a cash basis or deferred payment basis (Hanafi and

Kasim, 2006).

2.2.7 *Ijarah*

Definition

The AAOIFI *Shariah* standard (2008) defines *Ijarah* as the leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration. One thing being careful is if a contract offers both service such as usufruct of factory and material for manufacture, it falls into the *Istisna* contract, because *Ijarah* is confined to providing services only (AAOIFI, 2008).

Conditions of *Ijarah*

The benefit shall be the use of the usufruct of a specified asset. The benefit must be something that has value and is possible to be utilized. Hence leasing a demolished house or a house that is not fit for occupation is disallowed for *Ijarah* as it does not serve the purpose of the contract (INCEIF, 2006).

Besides, since a lessor has the ownership of the property concerned the lessor is obliged to maintain the property: namely all risk should be borne by the lessor. The jurists agree that the leased property is a trust in the hand of a lessee. Therefore, if the leased property is impaired without omission, violence of which is permitted, or negligence in keeping the property intact, then the lessee is not liable for such impairment because the lessee is permitted to enjoy the benefit of the property by contract (INCEIF, 2006).

Types of *Ijarah*

A typical *Ijarah* contract is the leasing of the immovable properties such as land or premises for a specific purpose with the rental amount for a specific duration. Meanwhile, since *Ijarah* literally delivers the sense of both hire and lease, a type of *Ijarah* is the hiring of services or labour such as hiring of an engineer, designer or tailor to carry out a specific task (INCEIF 2010).

A salient form of *Ijarah* used by Islamic financial institutions is *Ijarah Muntahia Bittamleek*. This is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of *Ijarah* period or by stages during the term of the contract, such transfer of the ownership being executed through one of the means specified in the standard (AAOIFI, 2008). In Malaysia, al- *Ijarah* thumma al-bay (a contract of leasing which ends with a sale) is popularly implemented named as *Al-ijarah* thumma al-bay (AITAB), but it has some issues because basically the law of Hire-Purchase Act 1967 governs the contract AITAB along with conventional contract and it is doubtful that AITAB is an alternative to conventional products (Abdullah, 2006).

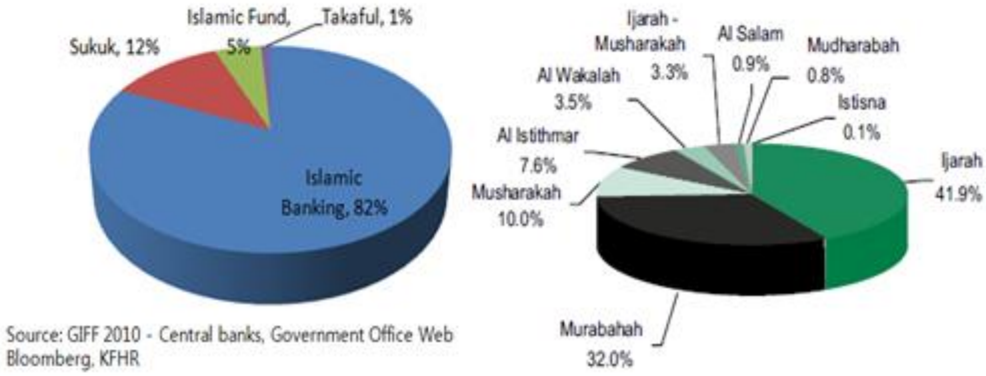
Application

The operating lease transactions are suitable for properties requiring high cost, i.e. aircraft or ship. The de facto operating lease is not popular because the bank has to own and maintain the properties or equipments. This is a big burden to the bank in terms of cost and accounting. Hence, the bank prefers *Ijarah Muntahia Bittamleek* which ends with the ownership of lessee. The ownership will be transferred with either no consideration or a token of consideration (INCEIF 2006).

2.3 *Sukuk*

Sukuk deals were few and far between until 2001, which saw the world's first USD-denominated international corporate *sukuk* by a Malaysian corporate, Kumpulan Guthrie Bhd. It was an *Ijarah*-based *sukuk* of USD150 million with five years maturity. This was followed closely by sovereign *sukuk* from the government of Bahrain in 2001 (USD150 million, five years maturity), Government of Malaysia in 2002 (USD600 million, five years maturity) and Government of Qatar in 2003 (USD700 million, seven years maturity). Now we see that the global *sukuk* market has grown by 10 % to 15% annually to reach the USD100 billion marks as at the end of 2009 (KFHR, 2010). In 2009, *sukuk* hold around 12% of the total market of Islamic finance.

Figure 2.2: Breakdown of *Shariah*-compliant Assets Worldwide, year 2009



From the viewpoint of principle types, *Ijarah* remained the preferred Islamic instrument, accounting for 41.9% of total *sukuk* issues in 2009. This was followed by *Murabahah* at 32% and *Musharakah* at 10% (KFHR, 2010).

2.3.1 Definition

'*Sukuk*' is the plural of 'sakk', which means to strike or to hit; the meaning is related to strike one's seal on a document (Al-fairuzabadi, 2007, as cited in Lahsasna and Ahmed, 2009). It means also a 'legal instrument, deed, or cheque'. It is translated literally as a 'written document' or certificates. The term of sakk is derived from striking one's seal on a document or tablet representing a contract or conveyance of right, obligations and or monies (Nathif and Thomas, 2004). However, the term '*Sukuk*' is today employed as the Islamic equivalent of conventional bonds (Lahsasna and Ahmend, 2009). Technically, *sukuk* refer to Islamic securities, notes, papers or certificates (SC, 2009).

According to AAOIFI *Shariah* standard (2008), *sukuk* is defined as certificates of equal value representing undivided shares for the ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity. *Sukuk* are issued with the aim of using the mobilized funds for establishing a new project, developing an existing project, or financing a business activity as per respective shares (Anwar, 2009).

Based on the above mentioned definition, *sukuk* can be further defined as a commercial paper that provides an investor with the ownership for an underlying asset. It seems asset-backed trust certificates evidencing ownership of an asset or its usufruct (earnings or fruits). It has a stable income and complies with the principle of *Shariah* (IIFM, 2009). AAOIFI, in its standard no. 17 covers the various types of *sukuk* such as *Ijarah sukuk* (leased assets, usufruct, services), *Salam*, *Istisna*, *Murabahah*, *Musharakah*, *Mudarabah*, sharecropping, irrigation, and agricultural partnership.

2.3.2 The difference between *sukuk* and bond

Sukuk were first introduced as the Islamic alternative to bonds, but later developed its own characteristics that made them to be different from bonds in several of ways.

Bonds are issued to evidence debts. An issuer is technically a borrower who issues the bonds in order to fund sources from the subscribers who are the investors. Hence, bonds behave like an ‘IOU’ (I owe you), with a promise to pay the debt (financial obligation) at the maturity date. In other words, bonds primarily represent a loan contract to create debts (SC, 2009).

Conventionally, bonds are structured as debts with fixed income. Basically a bond consists of loan plus interest. In bonds structured with coupon, the loan plus interest are normally termed as principle plus coupon. Even zero coupon bonds include in-built interest component in the issuing value which are issued at a discount. Technically, from the explanation above, bonds evidence indebtedness only. They are loans with interest which is prohibited in Islam (SC, 2009).

Moreover, bonds are considered to be liquid instruments. In a bond issuance, the issuer’s obligation to pay the debt to the bondholders is evidenced by the bonds that can be traded in the secondary market. These bonds are considered as liquid instruments because the holders can easily sell them off on the secondary market to the other interested investors whenever they need to liquidate their positions (SC, 2009).

In contrast, *sukuk*’s issuer is not a borrower in a loan contract between the lenders or investors. The relationship between the issuers of *sukuk* and their holders is not a relationship between debtors and creditors on a loan-based contract like conventional bonds, where interest charges are applied as a reward for granting a loan. Instead, the issuer (obligor) can be either a buyer in a sales contract or a lessee in a lease contract or partner in a partnership contract (SC, 2009). Unlike conventional bonds, *sukuk* need to have an underlying tangible asset transaction either in ownership or in a master lease agreement (IIFM, 2009).

2.4 Legal System

There are a variety of definitions for a legal system. Merryman (1985) defined the legal system, as the term is used, as an operating set of legal institutions, procedures, and rules (as cited in Tetley, 2003). David and Brierley (2008) stated that each law in fact constitutes a system: it has a vocabulary used to express the concepts, its rules are arranged into categories, it has techniques for expressing rules and interpreting them, it is linked to a view of the social order itself which determines the way in which the law is applied and shapes the very function of the law in that society (as cited in Tetley, 2003). In this respect, legal system seems to be said as a collective set of ways or view in the operating rules for a society.

Hence, a legal system plays a critical role in introducing and implementing Islamic finance as a new concept, because it will determine if the legal system effectively accommodates the intricacies of the Islamic finance and facilitates its development. The existing legal definitions of banking and financial services in non-Muslim countries often do not recognize Islamic finance, due to the nature of Islamic finance as trade and investment vehicles. If the particular country's existing laws are to be applied directly to Islamic financial transactions, potential conflicts and adverse legal effects will be protruded (Thani and Othman, 2008).

With this respect, it is worth going through different broad kinds of legal systems as the basic understanding of legal system will contribute how candidates for Islamic finance make their first step to approach Islamic finance. Thani and Othman (2008) described broad categorization based on the survey and jurisdictions; fully secular-based systems, partial *Shariah*-based legal system (dual system) and fully *Shariah*-based system. Tetley (2000) explained the fully secular-based system can be classified into the civil law and the common law.

2.4.1 Civil and common law (fully secular-based system)

Civil law is a legal system which codified is in a constitution or by legislation and mainly derived from Roma. It is also called Continental European law in development. Civil law is highly systematized and structured and relies on declarations of broad, general principles, often ignoring the details (Tetley, 2000). One of the clear characteristics in civil law is deemed to be an unequivocal codification or legislation to apply to.

The civil law family is traced back to the Roman Empire, the first society with secular and statuary law. Its modern offsprings are divided into French, German and Scandinavian branches. While French civil law had been developed in the aspects of the approach requiring a high degree of procedural formalism to reduce the discretion of judges, German legal history shed a much more favourable light on jurisprudence (Beck and Levine, 2003). When Bismarck decided 'to codify and unify the whole of private law, Germany had a long history of 'deliberations that illustrated how courts weighted conflicting statutes, resolved ambiguities, and addressed changing situations' (Graff, 2008).

The legal tradition of Korea falls within the German civil law branch (Graff, 2008), and thus it is said that the laws have shared particular characteristics of the family; codification and jurisprudence.

In contrast to civil law, common law is a legal system which evolved in England and whose sources are the decisions in cases by judges, usually of high court. The common law is generally even more detailed in its prescriptions through juridical precedent than the civil law, which considers legislature enactments legally binding (Tetley, 2000). In terms of legal formalism, English law typically imposes less rigid and formalistic requirements. "*The English common law tradition is almost synonymous with judges having broad interpretation powers and with courts melding and creating law as circumstances change . . . rather than adhering to the logical principles of codified law"* (Beck and Levine 2003, p. 9f.) (Graff, 2008).

While civil law is the foundation of European countries such as France, Germany and Asian countries such China, Korea, Japan etc., common law is the ground of England, Wales, 49 U.S. states, Malaysia, Singapore, Hong Kong, etc. (Graff, 2008).

According to Graff (2008), the theory of the adaptability mechanism predicts a ranking of the legal systems in terms of appropriateness to promote financial development in which common law is superior, German and Scandinavian civil law are intermediate, and French civil law is inferior. The 'theory of law and finance' argues that the common law system provides a better framework for economic growth and financial development compared to the civil law tradition (Graff, 2008).

In comparing the English common law and the civil law, Rahail (2009) provides the various advantages of the English common law as follows:

- Providing the concept of trust which allows for direct ownership of or in interest in the *sukuk* assets
- Concept of 'equity' to allow the separation of legal and beneficial ownership
- Assignment of current, as well as future, intangible assets
- Declaration of trust

Hence, given such a difference between civil and common law, English law (and other common law systems derived from it) seems familiar and preferred in Islamic finance, especially *sukuk* at least, allowing for *Shariah* requirement repeatedly emphasized by the AAOIFI in the recent (Rahail, *SUKUK*, 2009).

Unlike the English law, the Korean law may be less favourable towards Islamic finance as it is basically based on the civil law.

2.4.2 Partially *Shariah*-based system (dual system)

Bahrain, Malaysia, Indonesia and Pakistan can be considered as good illustrations of a partially *Shariah*-based system (Thani and Othman, 2008).

As for the Bahrain, Prudential Information and Regulations for Islamic Banks (PIRI), which covers areas such as capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management, is a primary regulation under the Central Bank of Bahrain for Islamic financial service institutions. The not-for-profit Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991 and issues standards on accounting, auditing, governance and *Shariah* practices, with which players in Bahrain are required to comply (Thani and Othman, 2008).

Unlike Bahrain, BNM has established a very comprehensive framework for Islamic financial service institutions. Under Bank Negara Malaysia, the Central Bank of Malaysia, Malaysia have set up the Islamic Banking Act 1983[4], *Takaful* Act 1984 and Banking and Financial Institutions Act 1989 (Thani and Othman, 2008). As for the capital market, one of the most important special

---

[4] Islamic Banking Act 1983 at Article 2 defines "Islamic banking business means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam."

regulations under the Securities Commission Malaysia is the Guidelines on the Offering of Islamic Securities 2004 which is to regulate the *Shariah* compliance of the Islamic securities (SC, 2009).

However, even though these countries have developed a legal system to facilitate Islamic finance, potential and outstanding conflicts still occur. Cases caused by Islamic banking and financing fall within the jurisdiction of the civil court and not *Shariah*-based court. That means documents or instruments to be used in Islamic finance transaction have to be compliant with Islamic law, existing secular laws (civil or common laws) and structured in such a way in order to be enforceable in the civil court (INCEIF 2006).

However, Malaysia had promulgated the Central Bank Act (CBA) of Malaysia 2009 to moderate such legal conflicts. Section 51 and 56 of CBA 2009 stipulate the *Shariah* Advisory Council and its ruling as follows:-

> "*Section 51, The Bank may establish a Shariah Advisory Council on Islamic Finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business."*
>
> *"Section 56, (1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall—(a) take into consideration any published rulings of the Shariah Advisory Council; or (b) refer such question to the Shariah Advisory Council for its ruling."*

Therefore, the judges are expected to consult the *Shariah* Advisory Council on the matters relating to *Shariah* before judgment. This can be an idea to harmonize two heterogeneous systems in even non-Muslim country as well as dual system countries.

2.4.3 Islamic law

Pervez (1994) stated that Islam is a comprehensive way of life which is about a vast and integrated system of laws, a culture, an economic system and commercial norm, a society and family matter, etc (as cited in Taylor, 2003). More specifically, it is said that Islamic law is a religious law based on *Quran* and *Sunnah* and governs all aspects of life (Bilal, 1999, as cited in Taylor, 2003; SC, 2009). Mark (2008) contended that Islam is rooted in an eschatology that constitutionally requires adherence to a set of precepts delineated, specifically in the *Quran* and the *Sunnah*. Hence, the *Quran* and *Sunnah* are deemed to be the major primary sources of Islamic law which is a religious law. In more general terms, *Shariah* is described as Islamic law, which is based on the *Quran* and *Sunnah* as the primary source (SC, 2009).

The salient features of *Shariah* are as follows; comprehensive (governing all aspects of life), universal and permanent (being suitable for all human kind irrespective of origin, age, generation), close relationship with and obedience to Allah, originating from the divine source, realistic and practical (SC, 2009). *Shariah* is categorized into belief (aqid), practical legal ruling (*fiqh*) and ethic (*akhlak*). Among the components of *Shariah* is *fiqh* which consists of ruling on the relationship of human beings with Allah (*ibadah*) and the relationship among human beings (*muamalat*) (SC, 2009). Islamic finance de facto falls into the *fiqh muamalat*. *Fiqh muamalat* is an obviously distinguished religious law from the above legal systems, for *fiqh* muamlat's basic sources are the *Quran* and the *Sunnah*. Its secondary sources consists of the consensus of Muslim scholars (*ijma*), the personal judgment of Muslim scholars in accordance with the instruction of *Quran* and *Sunnah* (*ijtihad*), juridical analogy (*qiyas*), stronger evidence over analogy (*istihsan*), something of benefit (*maslahah*), etc (INCEIF, 2006).

Relating to its secondary sources, especially in terms of speculative (zanni) text, the fact that *fiqh* is allowed to be produced by the interpretations of *Shariah* scholars means there could be different interpretations between scholars about *Shariah* opinions. Hence, IDB and IFSB (2007) in its 'Ten Years Framework and Strategies' pointed out that Islamic financial service needed to be standardized by IFSB, AAOIFI or other standard-setting organizations in order to harmonize the *Shariah* interpretations with other legal systems such as common law and civil law (IDB and IFSB, 2007).

However, a separate committee is also essential for the *Shariah*-compliant judgment of the new products and transaction in an ever-changing market as the standard based on international framework cannot cover all the different counties' cases. *Shariah* supervisory board (SSB) should be established in an organization to examine if it is *Shariah* compliant (FSA, 2007). According to

AAOIFI *Shariah* standard 2008, SSB is defined as: a SSB is an independent body of specialized jurists in *fiqh* al-*muamalat* (Islamic commercial jurisprudence). However, the SSB may include a member other than those specialized in *fiqh* al-*muamalat*, but who should be a professional of Islamic finance (Lahsasna, 2010). SSB issues their opinions as fatwa for the proposed transaction for the particular institution (Nicolas, 2009). In non-Muslim countries, a regulatory body is not a religious body and thus the role of SSB is very critical, but then again the regulatory body needs to understand the role of SSB (FSB, 2007).

2.4.4 Legal considerations from definitions and law traditions

The model of Islamic economics and finance have basically highlighted justice and focused on clarity and lack of ambiguity (FSA, 2007; Ayub, 2007). A practical example of the concept is the prohibition of *riba*. It is described as the illegality of the gain and profit which is not as a result of effort and unearned from speculative and risky transaction (McMillen, 2001, as cited in Taylor, 2003). Islamic financial institutions have actually developed the principles for the accomplishment of the *Shariah*-compliant concept (Taylor, 2003). Now this study is able to create a partial set of guidelines from the above literature review.

From the literature review, several salient features of Islamic finance can be derived:

- No guarantee of deposited amount, no pre-fixed return and profit sharing

& loss taking in Islamic deposit (*Mudarabah* account);

- Financing based on exchanges including purchase and sales of assets between parties (*Murabahah*, BBA, *Istisna*, etc.);
- Profit and loss sharing - partnership (*Mudarabah* and *Musharakah*);
- Possession of assets of financial institutions for financing;
- Leasing financing; and
- *Sukuk* definition different from bonds of conventional finance.

As for the legal system, this study finds that the Korean legal system falls within the family of German civil law which can be less flexible or familiar compared to common law. Moreover, Islamic law is the religious law, but the Korean legal system did not have the history considering such traits which shown up in religious faith. As Thani and Othman (2008) mentioned, the existing legal definitions of banking and financial services under different legal system often do not recognize Islamic financial transactions, due to their nature as trade and investment vehicles. Hence, many constraints are to be expected if the country's general laws are to be applied directly to Islamic financial transactions (Thani and Othman, 2008).

An interview guideline (as provided in Appendix) is established from the review of the extant literature to identify whether the Korean legal environment is conducive and favourable towards introducing and implementing Islamic finance in the Korean market.

2.5 Selected Cases

In recent years, a genuine interest in Islamic banking products and services among the country's Muslim and non-Muslim communities alike has caused market forces to take over and steer the growth. Linked with this, the Islamic banks have been established in UK, Germany, Singapore, Thailand, etc. which are non-Muslim countries (KFHR-GIFF, 2010). Such establishments would be impossible without legal consideration. As an example, without Islamic banking laws, the enforcement of contracts in courts may fail to articulate the intention of contract and need much more time (Ahmad 2004). And thus Ahmed (2004) stated that banking and company laws in some countries require appropriate modifications to serve a level playing field with conventional banking. In fact, the laws or regulatory framework of conventional banking are set up to support and monitor loan-based financial transaction on an interest-based debtor-creditor relationship (Ahmad and Hassan, 2009). This is because Islamic finance and conventional finance are different in their underlying philosophies.

The legal considerations in Islamic banking influence *sukuk* instruments alike as the underlying principles used in *sukuk* are all the same. One thing for certain, is the taxation issues (ITR, 2009).

Many researchers have tried to examine the legal considerations in order to test the feasibility of Islamic finance in their countries whose majority of population is non-Muslim. Taylor (2003) aimed to examine the American regulatory framework affecting the establishment and operation of an Islamic banking. Ahmad and Hassan (2009) described that the goal of their paper is to examine the regulation of Islamic finance in Australia in terms of Islamic finance transactions. Hence, this section carries out the legal considerations with practical examples of cases from non-Muslim countries which construe how they work out conflicts with conventional finance. Following this, the study will make some guidelines for interviews taking into account those cases.

2.5.1 France

France, whose legal system is the civil law system with indigenous concepts (KFHR-GIFF, 2010), has a Muslim population of about 10% of the total population (ITR, 2009). And thus, the France financial markets regulatory authority on 2 July 2008 introduced significant tax and regulatory changes which are aimed at boosting Islamic finance. These changes facilitate the listing of *sukuk* in France and the tax treatment of Islamic finance transactions even though there is no full-fledged Islamic financial institution in the homeland. While UK has steadily developed Islamic finance for nearly two decades, France's first discussion began only a few years ago before the announcement and things changed very rapidly (ITR, 2009).

However, such changes came from neither the revamps of law nor the promulgations of new law, but from instructions by regulatory bodies such as the Minister of Economy and Finance, French Tax Authorities, etc. (Smith, 2009; KFHR-GIFF, 2010). A similar case is observed in Germany whereby the Federal Financial Supervisory Authority accepted the participating bank to offer non-interest banking service and the Deutsche Bank launched a specific banking brand called Bankamiz for its Turkish customers (Guski, 2009; KFHR-GIFF, 2010).

In particular, the authorities in France have made a lot of efforts to facilitate *Murabahah*, *Mudarabah* and *sukuk* as noted below:

- Application of real estate dealer regime for Tax neutrality (*Murabahah*)
  - Stamp Duty: a financier is liable for a decreased rate of 0.715% in an initial purchase, and an investor is subject to 5% stamp duty on the share of a real estate company (Smith, 2009).
  - VAT: the purchase of real estate assets or shares is subject to VAT, but the profit of *Murabahah* is regarded as interest and thus there is virtually no VAT (Marc, 2009; Smith, 2009).

- Corporate tax (*Mudarabah*, *Murabahah*)
  - Recognition of the profit based on an accrual basis, for deferred payment: profit is realized over the duration of the contract and is distributed over the life regardless of when the amounts are reimbursed (Marc, 2009; Smith, 2009).
  - If the financier is not a resident and its customer is a resident for tax purpose, *Murabahah* profit will be exempted from French withholding

(Marc, 2009; Smith, 2009).

- On determining the taxable gain, *Murabahah* profit will be deducted from the sale price of the property or the shares: the profit will be excluded in the basic cost of a property of the investors, because it is regarded as interest (Smith, 2009).
- The assets purchased by a financier are booked to inventory, not to fixed asset, in order to avoid being subject to business taxation (Marc, 2009; Smith, 2009).

- Taxation and trust structure for *sukuk*
  - Identification of *sukuk* as debt instruments, comparing its senior ranking vice versa shareholders rights, etc. in terms of debt characterization (Smith, 2009).
  - Reimbursement of *sukuk* depends on the value of the transfer asset on maturity, but then the reimbursement can occur in a lower value but not a value higher than the initial nominal value (Marc, 2009)
  - For issuers, the compensation paid on the *sukuk* is treated just like interest on a traditional bond offered for tax purpose, and is a deductable income (KFHR-GIFF, 2010) and not treated as capital gain (Marc, 2009; Smith, 2009).
  - For investors, the compensation paid to non-resident *sukuk* holders is exempted from withholding tax in France, regardless of whether the offering is governed by French law or the laws of the another country(KFHR-GIFF, 2010).

- Because of the non-existence of trust under French law, the structure in the tax bill supporting *Sukuk* uses fiduciary which is the closest to trust in the French framework (Gintzburger, 2011).

2.5.2 Singapore

Singapore, whose legal system is based on the English common law, has around 15% Muslims of the total population (KFHR-GIFF, 2010). The Islamic windows of certain banks provide *Shariah*-compliant banking services since 1998. Singapore believes that as a financial hub, it will be able to offer Islamic financial services with extra capability (KFHR-GIFF, 2010). With this regard, “Singapore is becoming a convenient stopover for GCC investors and capital flows bound for Asia," DBS Chief Executive Jackson Tai said at the interview with Wall Street Journal in 2007.

In 2006, the Monetary Authority of Singapore (MAS) carried out a review of the financial and banking regulations and this brought the tax framework to review. The MAS has established banking regulations for Islamic finance contracts such as *Murabahah* interbank placement, *Ijarah*, and diminishing *Musharakah*. At the same time, Singapore will continue to prop up the development with a neutral stance to all religious relief and support educational plan through close tie with universities in Malaysia, Indonesia, Australia, UK and US. Such an educational initiative for public awareness is conducted by *Majlis Ugama* Islam (the Islamic Religious Council) which supports the promotion of religious, social, educational, economic and cultural activities regarding *Shariah* (KFHR-GIFF, 2010). The results of such efforts in Singapore have created specific foundations and brought forth outstanding results as follows:

- The expansion of *Murabahah* financing in the banking activities: the approval of non-financial activities such as commodity trading to facilitate *Murabahah* contract from MAS (Khan and Omar, 2008; KFHR-GIFF, 2010).

- Tax (Khan and Omar, 2008)
  - Waiving double stamp duty related to real estate.
  - Same tax treatment, which are applicable to conventional bonds, on the payouts from *sukuk*.
  - 5% concessionary tax rate introduced for *Shariah*-compliant lending, fund management, *takaful* and retakaful activities.
  - Remission of stamp duty on immovable property [5]

- Products diversification (Khan and Omar, 2008)
  - Introduction of *Shariah*-compliant deposit (savings account and term deposit) in 2005 & 2006
  - Launch of *Shariah*-compliant pan-Asian equity index in 2006
  - *Shariah*-compliant exchanged trade fund (ETF) in 2008

---

[5] Ng, Nam Sim, Executive Director, MAS, Opening Remarks at the IQPC Islamic Finance, Singapore 2006.

2.5.3 United Kingdom

The United Kingdom (UK), whose legal system is based on common law tradition, has around 2.7% Muslim of the total population (KFHR-GIFF, 2010). At present five full-fledged *Shariah*-compliant banks are witnessed in UK. Tens of *sukuk* are listed on the London Stock Exchange. Besides, the market includes off-exchange trading in commodity-based agreement linked to the London Metal Exchange.

The UK's philosophy toward Islamic finance is to expedite the level playing field by equal treatments in dealing with the applications from conventional and Islamic firms. This was clearly articulated by Sir Howard Davies in his speech in Bahrain in September 2003. The Financial Services Authority (FSA)'s approach can be summed up as '*no obstacles, but no special favours'* to Islamic finance (Davies, 2003). Given that the UK, specifically London, is one of the leading international financial gateways, UK believes that London can be a global hub of Islamic finance through the building of a level playing field for the Islamic financial services market (FSA, 2007).

The proactive approaches are attractive basically in terms of authorization for Islamic business, tax-deductibility, transfer taxes, and VAT (FSA, 2007; Nicolas, 2009). Hence, further legislations were necessary, but rather than direct stipulations of *Shariah* law UK have introduced new concepts such as the alternative return, and the alternative finance investment bond in related laws (Nicolas 2009, FSA, 2009). In particular, the issue of tax-deductibility was one of big challenges. It requires that each of the Islamic contracts should be defined through the characterization of debt finance or equity finance; e.g. whether *Murabahah* financing falls into debt finance or equity finance (Mohammed, 2006).

- Authorization of Islamic finance
  - Permission of Islamic windows by conventional banks without separate authorization; e.g. HSBC and Standard Charted bank in UK
  - Permission of new full-fledged Islamic institutions, as long as it fulfils generally applicable threshold conditions detailed in the FSA The Handbook pursuant to Financial Service Market Act (FSMA); examples are Islamic Bank of Britain (established in 2004, retail), European Islamic Investment Bank (2006, wholesale), Principle Insurance Holdings Limited (2008, *takaful*), and etc. As for the Islamic deposits of Islamic Bank of Britain, an issue happened at initial stage relating to the definition of deposit:
    - Given that a deposit's legal definition is said as a 'sum of money paid on terms under which it will be repaid either on demand or in circumstance agreed by the parties', depositors are guaranteed to get full repayments in UK (FSA 2007). This definition conflicts with the 'no capital protection' of Islamic deposit based on *Mudarabah*.
    - In order to solve the issue, however, FSA created an idea that customer has the right to choose between deposit protection and *Shariah*-compliant profit sharing and loss bearing according to his or her religious faith (FSA, 2007).

- Legislative changes for a level playing field
  - Relief to remove multiple payment of Stamp Duty Land Tax (SDLT) in SDLT legislation in 2003 for *Shariah* compliant mortgage (Nicolas 2009).
  - Alternative finance arrangements
    - Alternative finance arrangements were designed in the Finance Act 2005 and 2006 to define four products which are common Islamic financing; purchase and resale (*Murabahah*), diminishing shared ownership (diminishing *Musharakah*), deposit (*Mudarabah*) and profit share agency (Wakala). The main purpose is to support situations where individual customer raises finance from financial institutions. This law can also be extended to *sukuk* (Finance Act 2005& 2006; Nicolas 2009)
    - Alternative returns and profit share return from these arrangements are regarded as interest for a variety of tax purpose in UK (Finance Act 2005/2006; Nicolas 2009).

- Alternative Finance Investment Bonds (AFIBs)
  - Legislative changes aiming at regulating *sukuk* is an equivalent treatment with conventional bond through consultation process (FSA, 2009).
    - AFIBs are referred as a subset of the *sukuk* market (FSA, 2009); the legislation don’t cover all types of *sukuk* such as equity-based *sukuk*

- Introduction of reasonable commercial return for the additional payment of AFIBs in order to capture debt-like return; *‘the amount of the additional payments does not exceed an amount which would, at the time at which the bond is issued, be a reasonable commercial return on a loan of the capital’* from 77A. (2). (e) of FSMA 2000 RAO 2010.
- Exempting AFIBs from Collective Investment Scheme (CIS) regime considering *sukuk*’s economic and risk characteristics, tax treatment and listing purpose (FSA, 2009).
- *Sukuk* holders would be taxed as if they invest on debt instruments and since AFIBs should be listed on a recognized stock market, income outlay can be made without withholding (Nicolas, 2009).
- Issuer can benefit from tax relief, because AFIB’s are treated as debt instruments, but there is still an ambiguous aspect of underlying the asset’s ownership; regarded as owned beneficially by the issuer (Nicolas, 2009).

· For SDLT regarding *sukuk*, the Schedule 61 of Finance Act 2009 basically states ‘*alternative finance investment bond” means arrangements within section 48A of FA 2005 (alternative finance investment bond: introduction)’* to serve relief from provisions of SDLT cause relating to land in UK

2.5.4 United States of America

In the US, whose legal system is common law system (Graff, 2008), has a

Muslim population of about 5 to 7 million (Ilias, 2009). Current USA laws and regulations might be broad enough to facilitate certain aspects of Islamic finance. In 1997, the Office of the Comptroller of the Currency (OCC) issued guidelines regarding *Ijarah* and in 1999 the OCC recognized the *Murabahah* product (Ilias, 2009). Especially, interesting is the establishment of an Islamic banking institution as the savings association. This is because the savings associations are capable of entering into a joint venture and own property through its subsidiary servicing company; in particular *Murabahah*, *Istisna* and *Ijarah* (Taylor, 2003).

Even though US tax code does not stipulate Islamic finance separately, the rules are applicable by the way it facilitates Islamic transactions (ITR, 2009). One of the biggest advantages in US codes is that a special purpose vehicle (SPV) can be built up and thought as disregarded entity and utilized as a tax efficient deal; e.g. at *Ijarah* structure (ITR, 2009). However, the banking system regulatory framework is still complex involving a dual state-federal chartering system and a plethora of institution-type-specific restrictions specifying banking activities (Taylor, 2003). A few salient features are as follows (Abdullah, 2009);

- Permission of *Ijarah* and *Murabahah* by regulatory authorities
- *Sukuk* are treated as traditional debt securities or asset-backed securities under the applicable 33 Act of Securities and Exchange Commission
- Dow Jones Islamic Market (DJIM) Indexes launched in 1999 and Dow Jones Citigroup *Sukuk* Index launched in 2006, which monitor the

Shariah-compliant market internationally (Abdullah, 2009; GIFF, 2010).

2.5.5 Korea

Having gone through the 2008 global financial crisis, Korea started to explore the diversification of raising funding (GIFF, 2010). In 2009, the Ministry of Strategy and Finance (MOSF) designed a bill as an initial movement to facilitate the issuance of *sukuk* overseas by foreign-currency-denominated. The bill for tax neutrality had been put to the National Assembly, but the bill was delayed at the end of 2010 once and rejected on Feb of 2011 again (IFN, 2011). Allegedly, the MOSF continues to make the efforts in facilitating tax neutrality for *sukuk*. The followings are the feature of the bill (Special Tax, 2009):

- The purpose of the bill is aimed at facilitating *Ijarah* and *Murabahah* (*Tawarruq*) *sukuk*
- The profit of Islamic bond, which are issued by foreign currencies from SPV located overseas, is treated as interest and thus the income and corporate taxes are exempted in equivalent manner with foreign currency denominated bonds.

Looking through the legal or regulatory supports from some countries, the study presents that the appropriate changes of legal framework and tax neutrality are needed. Regardless of the legal systems such as common and civil, suitable amendments or interpretations in laws or regulations to facilitate a level playing field within each situation seems to be essential (IRTI and

IFSB, 2007). Moreover, a series of efforts will vary pursuant to its strategic aims like UK case. Now the study can make 7 - 12 guidelines about *sukuk* and taxation for interviews based on the cases.

2.6 Considerations from *Shariah* Issues

In November 2007, Sheikh Muhammad Taqi Usmani, Chairman of the *Shariah* board of AAOIFI, sent out shockwaves throughout the global Islamic capital market as he declared that 85% of *sukuk* from the Gulf Co-operation Council countries are not *Shariah*-compliant. This is because huge amounts of *sukuk* actually reflect the conventional bonds and do not present true ownership (KFH, 2009). Here, the study reviews selected issues such as underlying assets, debt-based *sukuk* and asset-based vs. asset-backed considering the current bill which was prepared by the Korean government.

2.6.1 Underlying asset

The underlying assets of *sukuk* issuance can vary in the types. However, such assets must be *Shariah* compliant. For example, if the major tenant operates a conventional bank, since the activity is not permissible in Islam, the building is not eligible as an underlying asset (Shamsiah and Mohd, et al., 2009). Especially, when it comes to *sukuk* issuers related to mixed activities and its underlying assets, this issue becomes more intricate. For example, the activities can be commingled with liquor, entertainment, transportation etc.

Korea is purely a non-Muslim country and can be dubious about the underlying assets in investments. Of course, according to Asmadi (2009), there is a set of rules; namely investment to companies screened using the minimum *Shariah* criteria, with no provision for purification of non-hahal income such as 33% per cent benchmark (SC, 2009) application for company with interest-based debt. However, given that investors can choose the market, it is still doubtful whether Korea is seen as an attractive market.

2.6.2 Debt-based *sukuk*

Debt-based *sukuk* can be categorized as *Murabahah sukuk*, *Istisna sukuk* and *Tawarruq sukuk*. Until 2007, the most popular Malaysian *sukuk* issued were debt or *dayn* instrument based on bai bithaman ajil or *bai al-inah*.

Murabaha has been the workhorse of Islamic finance. The applications of *murabahah* have been very distinct between Malaysia and GCC with four major approaches to the concept being applied: business, consumers and trade finance by installment sales; metal and community buying and selling; working capital by *bai al-inah*; and working capital by *tawarruq* (Shabnam and Abdulkader, 2009). While in *tawarruq* at least three parties are involved in sales to acquire cash through buying on credit and selling on the spot (Muhammad Ayub, 2007), the *bai al-inah* is the sales and buy back agreement for the same asset between two parties. From an Islamic legal prospective bay al-inah seem to be a doubtful interest-bearing loan-making tool (Rosly and Sanusi, 1999).

All of the above contracts ultimately result in debts, which is normally not permissible to trade in *Shariah*. For example, when the SPV in the structure of

Murabahah sukuk sells an asset to the company, the *sukuk* represents receivables of the selling price. Receivables are viewed by a majority of *Shariah* scholars as a claim on money.

In summary, AAOIFI *Shariah* standard (2008) clearly describes that "*as for debts owed as a liability, it is not permissible to securitize them for the purpose of trading" and "as for the trading it is necessary to observe the rules of the contract of Sarf"*". Furthermore, given a situation that Korea has prepared the bill for *Ijarah* and *Murabahah sukuk*, there could be an issue in considering trading of the *sukuk* in secondary markets.

2.6.3 Ownership transfer

AAOIFI *Shariah* standard (2008) clearly announced that all tradable *sukuk* must represent the genuine ownership of the *sukuk*-holders with all their relevant rights and obligations before put into the secondary market. It is clearly stated that "*Sukuk, to be tradable, must be owned by sukuk holders*". The genuine requirement of the real transfer of ownership is technically brought for the ownership issue. Hence, underlying assets of *sukuk* must not be kept as issuer's own asset, but sukukholders'. It is not acceptable to keep the asset in the book of the *sukuk* issuer (Lahsasna and Umar, 2008).

However, even though one outstanding feature of *sukuk* is the ground of underlying asset, so far it is true that many *sukuk* have been issued as asset-based not asset-backed, which could bring up the legal ownership issue in the insolvency of issuers (Shabnam, Saad, el at., 2009)

According to Moody's (2008), for the rating of the asset-based securities, since there is no bankruptcy remoteness, specific asset-based *sukuk* rating is equalized with the issuer rating assigned to the originator. In this case, the *sukuk* amounts to an obligation ranked with the originator's guarantee; namely no transfer of assets. At the end of the analysis, most asset-based *sukuk* structures often turn out to replicate the risk and return characteristics of a fixed income bond (Howladar, 2009, as cited in Bill, 2010). To clarify it, the features of two categories are summarized in the table below.

Table 2.1

Comparison between asset-based and asset-backed *sukuk*[6]

Category	Analytical characteristics
Unsecured asset-based *sukuk*	The issuance principal is effectively "guaranteed", in most cases by the originator, via a purchase undertaking agreement, i.e. a commitment to buy back the underlying assets at the *Sukuk* maturity. The coupons (periodic distribution amounts) are protect ed by a liquidity provision, i.e. the commitment of the originator/guarantor to provide sufficient liquidity to mak e up for any shortfall between asset returns and perio dic distribution amounts.
Secured asset-backed *sukuk* (Islamic securitization)	Neither the principal nor the coupons are subject to formal guarantees. *Sukuk* performance is asset driven and the effective legal transfer of assets to investors is critical. Credit enhancement mechanisms are intrinsic to the structure of risk repackaging.

6 Moody's (2008). Islamic banks and *sukuk*: Growing Fast, but Still Fragmented, Moody's Global Banking, April 2008

In summary, the issue here attributes to bankruptcy remoteness in question, but then the device for bankruptcy remoteness or true sale have been actually developed in securitization law. The existence of such the concept has not been well developed and rather unclear in many Muslim countries (Shabnam, Saad, el at., 2009).

In terms of the feasibility of Islamic finance in Korea, the study can derive three guidelines (13-15) for interviews from the above issues to clarify if the issues can be still worked out or is problematic in Korea.

2.7 *Sukuk* and Risk Mitigation

In conducting business, the risk presence cannot be avoided. There are two kinds of risks: business risk and financial risk. Business risk is related to the uncertainty of future sales or the price of inputs, whereas financial risk carries out the uncertainty of interest rates, exchange rates, stock prices, and commodity prices. The measures of hedging financial risk are generally called derivatives in the conventional market. By employing derivatives, companies and individuals can transfer any undesired risk to other parties who want to offset or who want to take that risk (Chance, 2004).

In the last decades, derivatives in conventional market has accelerated rapidly in growth. However, it is true that the Islamic capital falls short of researches that examine the Islamic principles for building derivatives. Different *Shariah* interpretations about whether it is considered permissible or not according to

Islamic law remain a big challenge until now (Nevi and Agatha, 2009). The reviews of arguments regarding permissibility of derivatives in Islamic capital market are helpful in identifying how much the risk management will face challenges. In particular, although Korea could accept *sukuk* issuance as an initial step, the risk hedging might come to another obstacle.

2.7.1 Futures and forward contract

The main issue in the *Shariah* compliance of forward/futures contracts is the deferment of both the price and asset to a future date (SC, 2009). This is a future (mudhaf) sale. This mudhaf sale is prohibited since it means *gharar* (uncertainty) in it. The *gharar* component is presently related to time and the condition of the sold object (Nevi and Agatha, 2009).

Al-Saati (2002) also suggests that futures contracts hold the *gharar* component since a party sells products which he or her do not have on their hands or is a nonexistent sale at the spot. An acceptable transaction therefore has to incorporate a real component, e.g. products, utilities or services. In other words, money for money instruments is not permissible if performed for profit from continuous price changes (Al Suwailem, 2006). Non-intended products delivery, namely cash settlement, shows that most of the participants are speculators (Bacha, 1999; Salehabadi and Aram, 2002). The excessive speculation is prohibited in Islam (Nevi and Agatha, 2009).

Majma al *Fiqh* ruled that the practice of closing out in futures market is not permissible, because this allows both hedger and speculators to play by the price swings (SC, 2009). According to Chance (2003), *"most farmers start speculating after two years or so of hedging."* Thus what starts out as a hedging or risk-trading activity can lead to pure speculation. Studies estimate that more than 97% of the derivatives are currently being used for speculation rather than hedging purposes (Ghoul, 2008)

2.7.2 Option

Majma al *Fiqh* argued that the subject matter of conventional options are neither *mal* (property), *manfaah* (usufruct), nor *haq maliy* (financial right) that may be recovered or waived, thus ruling it as not permissible from a *Shariah* point of view (SC, 2009). Bacha (1999) stated that option involves *gharar* because neither buyer nor seller is certain that the sale will take place. Moreover, the intended transaction is primarily based on speculative behaviour. *Gharar* and excess speculation are induced due to no physical delivery or cash settlement (Bacha, 1999)

Ahmad (1986) suggested that options are prohibited since their maturity dates are beyond three days (as cited in Bacha, 1999). Thus, they cannot be considered as khiyar-al shart (option of stipulation). Moreover, in these contracts, the buyer has many more benefits than the seller, in the sense that the seller has potentially unlimited risk but limited benefit. Furthermore, the buyer has potentially unlimited benefits and limited risk. This is considered to be oppressive and unjust.

Option contract results in an exchange of a liability, for example a loss on a stock or currencies. This is prohibited in *Shariah* law since contracts has to be linked to real transactions. According to Summa (2003), at Chicago Mercantile Exchange, for the period 1997-1999, 76% of all options was not exercised, and ended up worthless.

2.7.3 *Shariah*-compliant derivatives

As is reviewed from the above, there are many arguments from *Shariah* scholars about conventional derivatives. However, in Islam the risk mitigation or risk minimization has been encouraged through various process and means. One of the evidences is "*Do not sell what you do not own*"[7] from the prophet Mohammad (Al-Sheahabi, 2009). In fact, the existing principles in Islamic finance can be a basis of alternative Islamic derivative products (SC, 2009). Some representative alternatives are as follows; Bai *Salam*/parallel *Salam*, Bai *al-istisna*/ parallel *Istisna*, *Urban* sale with option, *Bai al-Istijrar* with embedded option as recent idea, etc. Besides these alternatives, there are some innovative Islamic derivatives such as the utilization of commodity murabaha to manage currency risk, Islamic Profit Rate Swap to deal with the return fluctuation.

Even though there are *Shariah*-compliant alternatives, this does not mean that

---

[7] Sunan al-Tarmizi, kitab al-Buyu', hadith no.1236, vol 3; Sunan abi Dawud, Kitab al-Ijarah, hadith no.3503, vol.3.

these alternatives can cover the hedging demand sufficiently like the conventional derivatives market. And thus Islamic financiers should try to structure their own *Shariah* compliant instruments, but innovative products might only be structured if *Shariah* issues can be dealt with (Mohamad, 2008), which can come to non-Muslim countries with a bigger challenge.

As for Korea, when companies in Korea plan to issue foreign-currency-denominated *sukuk*, they need to mitigate currency fluctuation to repay *sukuk* at the scheduled dates as their revenue may be based on local currency, Korean Won. In this case, they may be in a dilemma in deciding between the *Shariah*-compliant derivatives and conventional derivatives due to the higher cost and availability of *Shariah*-compliant derivatives. In considering with such an issue, this study will refer to guidelines 16-18 which include the questions of the risk aspects arising from the issuance of sukuk.