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# **Asset-based and asset-backed sukuk: structure and legitimacy**

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## **Abstract**

The main objective of this study is to elucidate and describe the significance of the Asset Based and Asset Backed on Sukuk legitimacy. The analyzing data was obtained from Shariah pronouncements between the years 2005 to 2015. An analysis of the quantitative data was then made using the Partial Least Squares (PLS). The research found that asset-backed Sukuk have differed from asset-based Sukuk in regard to legitimacy, where the asset-backed Sukuk has a greater impact with regards to legitimacy than asset-based Sukuk. In conclusion, there is a positive relationship between the type of structure and Sukuk legitimacy.

**Keywords:** Asset, Backed Sukuk, Structure, Legitimacy.

# Sukuk basado en activos y respaldado por activos: estructura y legitimidad

## Resumen

El objetivo principal de este estudio es dilucidar y describir la importancia de la legitimidad basada en activos y respaldada por activos en Sukuk. Los datos de análisis se obtuvieron de los pronunciamientos de la Shariah entre los años 2005 y 2015. Luego se realizó un análisis de los datos cuantitativos utilizando los mínimos cuadrados parciales (PLS). La investigación descubrió que los Sukuk respaldados por activos se han diferenciado de los Sukuk basados en activos en lo que respecta a la legitimidad, donde el Sukuk respaldado por activos tiene un mayor impacto con respecto a la legitimidad que el Sukuk basado en activos. En conclusión, existe una relación positiva entre el tipo de estructura y la legitimidad de Sukuk.

**Palabras clave:** Activo, Sukuk respaldado, Estructura, Legitimidad.

## 1. INTRODUCTION

In Sukuk issuance, rating agencies play a major part by offering the investors and other market participants important opinions needed to whip up their confidence in investment decisions (Ahmed et al., 2018). A declaration was made in late 2007 by the Chairman of the AAOIFI board of scholars, Usami, that some 85% of outstanding Sukuk had failed the Shariah-compliance test. They failed because they were asset-based and not asset-backed with the guaranteed return of the face value of the Sukuk on maturity without transfer in asset ownership to Sukuk holders. After the crisis of subprime mortgages, which caused several Sukuk to default, the ownership in the underlying

asset rose and the need of categorizing and rating for asset-backed and asset-based Sukuk came into picture (Ahmed et al., 2014).

The difference between Asset-Based and Asset-Backed Sukuk have since been made known by the rating agencies as shown by some of the chosen application of asset-backed security rating methodologies to Sukuk transactions. Sukuk are essentially asset-backed bonds and it is neither equity nor debt from the perspective of conventional capital markets. As such, there is a strong need to evaluate the content and structure of Sukuk to ensure that they comply with the principles of Shariah which serves as the foundation (Ahmed et al., 2018).

One of the factors that influence the legitimacy of Sukuk is related to the classification of the rating (Ahmed et al., 2014). Rating agencies place Sukuk into two categories: asset-backed and asset-based Sukuk. This classification has an effect on the legitimacy and compliance of Sukuk. Asset-backed Sukuk is significantly more compliant with Shariah principles in comparison to an asset-based. Asset-backed Sukuk is also less risky than asset-based Sukuk and backing an asset-based Sukuk could lead to a default of the Sukuk. According to Usmani (2008), about 85% of outstanding Sukuk in the market had failed the Shariah compliance test as they were found to be asset-based and not asset-backed with the guaranteed return of the face value of the Sukuk on maturity without transfer in asset ownership to Sukuk holders. Thus, the objectives of this research to elucidate and describe the significance of the Asset-Based and Asset-Backed on

Sukuk legitimacy. In addition, to determine the potential effects of Asset-Based and Asset-Backed on legitimacy of Sukuk.

### *1.1. Type of Sukuk Structure (Asset-Backed and Asset-Based)*

Customarily, an Islamic asset-backed transaction's underlying asset ought not to contain any elements that depart from the principles of Shariah. However, by simply pooling the non-interest-bearing assets alone, this scenario does not give rise to an Islamic securitization scheme automatically. In reality, each component of the program of Islamic securitization needs to be compliant with Shariah (Engku, 2005).

As an example, aside from the removal of the interest factor, an underlying asset would also be required to fully meet any other conditions set. This might well include the following: the existence of an asset or an assurance concerning its deliverability; that the asset is of benefit to the Muslim Ummah; that an asset is deemed as halal (lawful) in accordance with the principles of Shariah; the performance or availability of an asset at a nominated date in the future; that an asset can be provided free from encumbrances; that the seller has ownership of the asset; and that the principal subject matter can be adequately recognized, characterized or specified in the absence of any underlying ambiguity.

With respect to these specific guidelines, asset-based Sukuk (ABS) can be defined as structures that meet the requirement for being an asset-backed structure as assessed by a recognized external credit assessment institution (such as rating bodies). According to this guideline, it can be stated that the asset-based Sukuk constitutes two factors. The first factor is that in the event of any damage or deficiency in relation to the asset of the Sukuk, the user (the holder of the Sukuk) will suffer the loss. The second one is the main risk factor of the asset-based Sukuk which is the principal asset of the Sukuk. Consequently, the user or holder of the Sukuk originates the return and the risk out of the cash flows of the principal asset of the Sukuk. According to Hussin and Sariff (2010), there is another dimension of the Asset-Based Sukuk which the execution of the true sale is. In this dimension, there is an involvement of the transfer of the real asset from the creators to the users with the impact of liberating the assets from the balance sheet of the issuer to the investors.

For that reason, the insurance of the Asset-Based Sukuk should be supported by the original asset which symbolizes the ownership of the Sukuk and also includes the risks involved with the asset. On the contrary, according to Aziz et al. (2009), there is no involvement of the true sale transactions in the ABS, only the handover of the financial rights to the asset and the revenue originated from the obligations of the financial rights involved with the debt.

Table 1: Differences between Asset-Backed and Asset-Based Sukuk.

<b>Categories</b>	<b>Asset-Backed</b>	<b>Asset-Based</b>
<b>Source of Payment</b>	The source of payment comes from the revenue generated by the underlying asset.	The source of payment comes from the originator/obligator's cash flows.
<b>Presentation/Disclosure of the Asset</b>	The asset is separated from the originator's book.	The asset stays on the balance sheet of originator/obligator.
<b>Type of Sukuk Holders</b>	Legal ownership with right to dispose of the asset.	Beneficial ownership with no right to dispose of the asset.
<b>Recourse</b>	Sukuk holders only have recourse to the asset thus the asset plays a genuine role in defaults.	Purchase undertaking at par from the obligator is the ultimate recourse. The recourse is only to the obligator and not the asset.

Moody's created a special rating method for Sukuk. This rating method takes into account a Sukuk's dependency on assets in terms of the income generated from the underlying assets. The income can also be asset-based depending on the originator for payment through a repurchase undertaking, despite the fact that all transactions are likely to include a set of underlying asset risks which is shared by the issuer and the investors. Alsaeed and Sulaiman (2012) held a similar view with Moody's by stressing the consequence of the principal assets used to ascertain the Sukuk principal repayment and the applicable law .

### *1.2. Type of Structure and Legitimacy*

In general, in accordance with the IFSB guidelines No. 2, 2005, the structure of Sukuk can be classified into two differing categories: asset-based instruments; and equity-based instruments. The category of Sukuk structure is considered a significant factor impacting positively on the Sukuk. In accordance with the findings of Usmani (2008), 85 percent of the outstanding Sukuk had failed a test for Shariah-compliance. The Shariah-compliance failure was attributed to the fact that the Sukuk were not asset-backed; they were asset-based. Therefore, this asset-based Sukuk did not have a guaranteed return of the Sukuk's face value at maturity without a transfer of the ownership of the asset to the holders of the Sukuk. Following on from the financial crises in relation to subprime mortgages, this led to Sukuk default, and to a rise in the level of ownership in the underlying asset and for the requirement to categorize and rate asset-based and asset-backed Sukuk.

The rating agencies delineate and treat asset-backed and asset-based Sukuk differently further to a rating methodology for asset-backed security chosen application for Sukuk transactions. In a similar way to the conventional market bond benchmark, Sukuk does have exposure to credit risk. In relation to credit risk, this can arise further to the failure of the Sukuk holder to fully meet their obligations of the agreed terms in a timely manner. Credit risk also refers to the



probability of a loan or an asset becoming impossible to regain due to a delay in settlement or default. In examining the literature, previous studies have determined that the types of Sukuk structures differ significantly between the asset-backed and asset-based Sukuk both from a Shariah and a market standpoint with the ability to influence the level of positivity of the legitimacy of the Sukuk (Abdulmalik, 2013). In that regard, an enhancement of the legitimacy of Sukuk will have an added impact.

In addition, Haneef (2009) determined that the framework for an asset-based Sukuk appears only to satisfy the pattern of an agreement with a great deal of sophistication, which eventually points to an Islamic equivalent of an unsafe traditional bond. In the same vein, Haneef (2009) mentioned that the asset-backed Sukuk is more efficient when offered in comparison to asset-based ones. Khnifer (2010) examined three Sukuk issuances: the asset-based Tamweel Sukuk Limited (TSL); the asset-backed Tamweel residential mortgage-backed securitization (RMBS) and the asset-backed issuance of East Cameron Gas (ECG), which had defaulted. The findings indicated that asset-backed Sukuk have more risk and may lead to default. Hidayat (2013) examined the structures of the asset-based and asset-backed Sukuk from the Shariah perspective. It found that the asset-backed Sukuk structure is more compliant to Shariah both in form and substance than the asset-based structure (Sazesh & Siadat, 2018).

In the same vein, Alia et al. (2013) examined the performance between the Shariah residential mortgage-backed securities and the

conventional securities issued by Cagamas with the equal issuance year, rating grades and maturity period. This study found that Shariah mortgage-backed securities did indeed perform better than its conventional mortgage-backed securities with a much better rate of investment returns to the investors. Shabana (2013) examined both asset-backed and asset-based Sukuk operations (Nisawa, 2018).

## **2. METHODOLOGY**

The quantitative method is the basic design for this study. The population size in this study consists of 82 Sukuk approved by the SC and registered in the Bursa Malaysia, and this represents a full sample for eleven consecutive years. The quantitative data were collected from the shariah reports of the identified Sukuk. The analyzing data obtained from secondary data between the years 2005 to 2015. An analysis of the quantitative data was then made using the Partial Least Squares (PLS).

## **3. RESULTS**

### *3.1 Descriptive Statistics*

Based on the results of descriptive statistics, the dependent variable, which is Sukuk legitimacy, showed that the level of

legitimacy of Sukuk was 62% representing the average of Sukuk with Shariah disclosure, with a standard deviation of .189. Furthermore, the minimum and maximum value indicated that Sukuk legitimacy is 33% and 89%, respectively. In addition, the descriptive analysis for variable shows that type of structure having an average of 58.5% with a standard deviation of .495. This result showed that there is a positive relationship with Sukuk legitimacy  $P < 0.05$ ,  $t = 1.614$ . This result indicates that the more compliant the structure is with Shariah, (i.e. asset-backed) the higher the legitimacy of Sukuk. Table 1:3 shows that the type of Sukuk structure in the Islamic Financial Institutions was 41.5 percent for the Sukuk-based (i.e. 34 Sukuk), and 48.5 for the Sukuk-backed (48 Sukuk), respectively. The descriptive statistics showed that most of the Islamic Financial Institutions in Malaysia have a majority of Sukuk-backed.

Table 2: Types of Structure

Types	Frequency	Percent
Based	34	41.5
Baked	48	58.5
Total	82	100.0

### *3.2. The Impact of Type of Structure on Sukuk Legitimacy*

Based on the literature, the types of Sukuk structures differ significantly between the asset-backed and asset-based Sukuk both from a Shariah and a market standpoint with the ability to influence the level of positivity of the legitimacy of the Sukuk (Abdulmalik, 2013).

The result shows that there is a significant relationship between the type of structure (asset-based and asset-backed Sukuk) and legitimacy ( $t = 0.109, P < 0.01$ ). The results showed that asset-backed Sukuk have differed from asset-based Sukuk in regard to Shariah compliance, where the asset-backed Sukuk has a greater impact with regards to legitimacy than asset-based Sukuk. This finding is in line with the objective of the study. This implies that asset-backed Sukuk are more in line with the Shariah and provide more protection to the Sukuk holders in the event of a default. This result is consistent with some of the previous studies Abdulmalik (2013) that investigated the relationship between the type of structure and Sukuk legitimacy.

For instance, Hidayat (2013) investigated the relationship between asset-backed and asset-based Sukuk structures with Shariah compliance and found that there was a positive relationship between the type of structures and Shariah-compliant Sukuk. Similarly, Shabana (2013) found a different relation between the type of structure (asset-backed and asset-based Sukuk) and true ownership. Also, Alia et al. (2013) reported that Shariah mortgage-backed securities have provided a higher rate of return on the investment to the investors. Furthermore, in another study by Abdulmalik (2013) affirmed that asset-backed Sukuk are more in alignment with the principles of Shariah and thus allow increased levels of protection to the holders of Sukuk in the event of default. Haneef (2009) asserted that, in asset-based Sukuk, the frameworks only satisfy the pattern of an agreement with too much sophistication, which eventually points to an Islamic equivalent of unsafe traditional bonds (Millanei & Khalili, 2016).

In the same tone, Haneef (2009) mentioned that asset-backed Sukuk is more efficient when offered than asset-based ones. Accordingly, as confirmed by a study done in the Malaysian context by Ahmed et al. (2015), the type of structure is an important element that has an impact on Sukuk. The study found that asset-backed Sukuk have more impact on Sukuk legitimacy enhancement and have shown to be more complying with the Shariah rules in increasing the legitimacy of Sukuk than compared to an asset-based Sukuk. Overall, the result of the direct relationship between the type of structure and Sukuk legitimacy shows that type of structure is an important mechanism to enhance the level of legitimacy. This result is consistent with the objective of the present study that there is a positive relationship between the type of structure and Sukuk legitimacy. That is to say that the type of structure is an important factor of determinants to improve the level of Sukuk legitimacy.

#### **4. CONCLUSION**

This study has made a unique contribution to the body of literature concerning the influence of the type of structure on the Sukuk legitimacy by using the population of Sukuk listed under an exempt regime in Bursa Malaysia for the period of 2005-2015. The results of this study have found that the level of legitimacy of Sukuk in Islamic financial institutions in Malaysia is generally high. The findings confirmed that there is a positive relationship between the type of structure and Sukuk legitimacy. Furthermore, the study is

intended to increase public awareness on Sukuk legitimacy and the importance of Shariah compliance not only in the form but also in substance.

In addition, this study will give more benefits for IFIs in the sense that they should amend some of their regulatory frameworks to push the Sukuk market investors to move towards asset-backed structures. Finally, this study contributes to both academic and practitioner individuals. The findings may have some policy implications with regards to Sukuk legitimacy and governance policy (Shariah advisory council, IFI management).

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