دار المراجعة الشرعيّة

SHARIYAH
REVIEW BUREAU

MEASURING SHARIA COMPLIANCE IN SENIOR & SUBORDINATED BONDS

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Summary

Bond investments are common, conventional fixed income instruments. The issuer promises to make regular interest payments to the investor until a specified date (the maturity date). Once the bond matures, the interest payments cease, and the issuer is required to repay the face amount of the principal to the investor. Bonds are effectively loans with interest. If a company defaults on its bonds and goes bankrupt, bondholders will have a claim on the company's assets and cash flows. The bond's terms determine the bond-holder's place in line, or the priority of the claim. Priority will be based on whether the bond is, for example, a secured bond, a senior unsecured bond or a junior unsecured (or subordinated) bond.

Whether a bond is senior or subordinated, conventional bonds are non-Shariah compliant. Practitioners in the Islamic finance industry have endeavoured to engineer alternative Shariah compliant products. Proposed alternatives to senior and subordinated bonds are senior and subordinated Sukuk. Sukuk in essence were designed to provide an Islamic alternative to a bond instrument. Tranching and subordination in Sukuk led to debatable Sukuk products. A concept known as Tanazul (wavering) is proposed by some Shariah scholars to develop subordinated Sukuk. Other Shariah scholars have raised concerns on such Sukuk structures and have proposed alternative and more acceptable methods to engineer Shariah compliant subordinated Sukuk.

This may be possible by utilising different profit and loss sharing models, splitting the underlying Sukuk assets into an equity and debt instruments in two different contracts forms. Such engineering can create tranching effects which do not contravene Shariah principles.

WHAT IS A BOND?

A bond is a type of investment that represents a loan between a borrower and a lender. Think of it as similar to getting a personal loan from a bank – except in this case you are the lender (known as the investor or creditor) and the borrower is generally a government or corporation (known as the issuer)[1]. With bonds, the issuer promises to make regular interest payments to the investor at a specified rate (the coupon rate) on the amount it has borrowed (the face amount) until a specified date (the maturity date).

Once the bond matures, the interest payments stop, and the issuer is required to repay the face amount of the principal to the investor. Because the interest payments are made generally at set periods of time and are fairly predictable, bonds are often called fixed-income securities

MAIN FEATURES OF A BOND

A bond has a par value of £100, a coupon rate of 6% (paid annually), and a maturity date of three years. These characteristics mean the investor receives a coupon payment of £6 for each of the three years it is heald. At the end of the three years, the investor receives back the £100 par value of the bond.

PAR VALUE = £100
COUPON RATE = 6%
MATURITY = 3 YEARS
COUPON PAYMENT = £6.00

Source: CFA (2017), Level 1: Fixed Income, Wiley

1 IIAC (2008), Bonds: An introduction to bond basic, Available from: http://iiac.ca/wp-content/themes/IIAC/resources/146/original/BondsEN.pdf

HOW ARE BONDS DIFFERENT FROM STOCKS?

Bonds are considered debt investments. On the other hand, a stock purchase is considered an equity investment because the investor (also known as the stockholder) acquires a beneficial interest and equitable ownership in the corporation. The issuers of stock or equity are typically companies; issuers of debt can be either companies or governments. While bonds generally don't provide an opportunity to share in the profits of the corporation, the stockholder is entitled to receive a portion of the profits and may also be given voting rights. Bondholders earn interest while stockholders typically receive dividends. Both may experience capital gains or capital losses if the price at which they sell their holdings is, respectively, higher or lower than the price at which they bought them.

Coupon rates are most often fixed – the rate of interest stays constant throughout the life of the bond. However, some bonds have variable or floating coupon rates (interest payments change from period to period based on a predetermined schedule or formula). Some bonds pay no interest at all until maturity. Because bondholders are creditors rather than part owners, if a corporation goes bankrupt, bondholders have a higher claim on assets than stockholders. This provides added security to the bond investor – but does not completely eliminate risk. Finally, bonds also trade differently from stocks. Bonds typically trade in the over-the-counter (OTC) market – for example, from a broker to a broker at another firm directly – instead of on a stock exchange.

	DEBT SECURITIES	EQUITIES
TERM	Fixed term*	No fixed term
INCOME	Agreed schedule of interest payments for the term of the investment	No promise to pay dividends or schedule of dividends payments
RETURN	Specified rate of return: agreed schedule of interest payments for the term of investment	No specified rate of return: No promise to pay dividends or schedule of dividends payments
CAPITAL	Full capital repayment at the end of the investment term (subject to the borrower's ability to meet its obligations). If debt securities are sold prior to maturity a capital gain or loss may be realsed	Investors receive the market value of the shares when sold which may realize a gain or a loss on the initial investment
RANKING	In the event of insolvency, claims made by bondholders rank ahead of shareholders	In the event of insolvency, stakeholders usually rank behind all other claims

*With the exception of perpetuals, callable, convertible and extendable securties

SECURITISATION PROCESS[2]

In its most basic form, the process involves two steps: In step one, a company with loans or other income-producing assets—the originator—identifies the assets it wants to remove from its balance sheet and pools them into what is called the reference portfolio. It then sells this asset pool to an issuer, such as a special purpose vehicle (SPV)—an entity set up, usually by a financial institution, specifically to purchase the assets and realise their off-balance-sheet treatment for legal and accounting purposes. In step two, the issuer finances the acquisition of the pooled assets by issuing tradable, interest-bearing securities that are sold to capital market investors. The investors receive fixed or floating rate payments from a trustee account funded by the cash flows generated by the reference portfolio. In essence, securitization represents an alternative and diversified source of finance based on the transfer of credit risk from issuers to investors.

In a more recent refinement, the reference portfolio is divided into several slices, called tranches, each of which has a different level of risk associated with it and is sold separately. Both investment return (principal and interest repayment) and losses are allocated among the various tranches according to their seniority.

The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. The conventional securitization structure assumes a three-tier security design—junior, mezzanine, and senior tranches. This structure concentrates expected portfolio losses in the junior, or first loss position, which is usually the smallest of the tranches but the one that bears most of the credit exposure and receives the highest return.

2 Jobst, A. (2008), What is Securitisaion?, IMF. Available online from: https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf

WHAT HAPPENS IF A COMPANY GOES INTO BANKRUPTCY?

A bond is governed by a legal contract between the bond issuer and the bondholders. The legal contract is sometimes referred to as the bond indenture or offering circular. In the event that the issuer does not meet the contractual obligations and make the promised payments, the bondholders typically have legal recourse. The legal contract describes the key features of the bond. A typical bond includes the following three features: par value (also called principal value or face value), coupon rate and maturity date. These features define the promised cash flows of the bond and the timing of these flows. The par (principal) value is the amount that will be paid by the issuer to the bondholders at maturity to retire the bonds. The coupon rate is the promised interest rate on the bond.

If a company defaults on its bonds and goes bankrupt, bondholders will have a claim on the company's assets and cash flows. the bond's terms determine the bond-holder's place in line, or the priority of the claim. Priority will be based on whether the bond is, for example, a secured bond, a senior unsecured bond or a junior unsecured (or subordinated) bond.

In the case of a secured bond, the company pledges specific collateral—such as property, equipment, or other assets that the company owns—as security for the bond. If the company defaults, holders of secured bonds will have a legal right to foreclose on the collateral to satisfy their claims. Bonds that have no collateral pledged to them are Unsecured and may be called debentures. Debentures have a general claim on the company's assets and cash flows. they may be classified as either senior or junior (subordinated) debentures. If the company defaults, holders of senior debentures will have a higher priority claim on the company's assets and cash flows than holders of junior debentures.

Bondholders, however, are usually not the company's only creditors. the company may also owe money to banks, suppliers, customers, pensioners, and others, some of whom may have equal or higher claims than certain bond-holders. sorting through the competing claims of creditors is a complex process that unfolds in bankruptcy court[3].

3 SEC , What Are Corporate Bonds, Investor Bulletin [available online] Available from: https://www.sec.gov/files/ib_corporatebonds.pdf

SENIORITY RANKING IN BONDS

The bond contract gives bondholders the right to take legal action if the issuer fails to make the promised payments or fails to satisfy other terms specified in the contract. If the bond issuer fails to make the promised payments, which is referred to as default, the debtholders typically have legal recourse to recover the promised payments. In the event that the company is liquidated, assets are distributed following a priority of claims, or seniority ranking. This priority of claims can affect the amount that an investor receives upon liquidation.

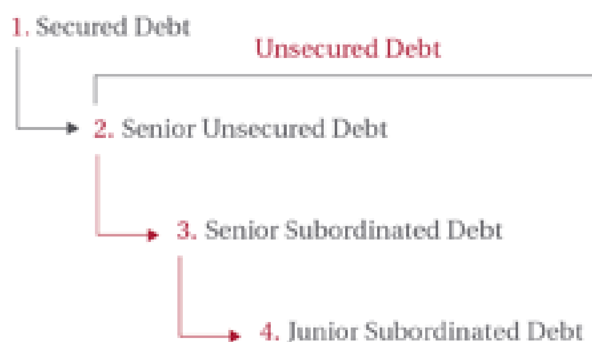
The par value (principal) of a bond plus missed interest payments represents the maximum mount a bondholder is entitled to receive upon liquidation of a company, assuming there are sufficient assets to cover the claim. Because debt represents a contractual liability of the company, debtholders have a higher claim on a company's assets than equity holders. But not all debtholders have the same priority of claim: borrowers often issue debt securities that differ with respect to seniority ranking. In general, bonds may be issued in the form of secured or unsecured debt securities.

When a borrower issues secured debt securities, it pledges certain specific assets as collateral to the bondholders. Collateral is generally a tangible asset, such as property, plant, or equipment, that the borrower pledges to the bondholders to secure the loan. In the event of default, the bondholders are legally entitled to take possession of the pledged assets. In essence, the collateral reduces the risk that bondholders will lose money in the event of default because the pledged assets can be sold to recover some or all of the bondholders' claim (missed coupon payments and par value).

Thus, senior bonds are a class of debt whose rights with respect to payment of interest and repayment of principal rank ahead of (are senior to) other classes of debt and over all classes of equity by the same issuer. Senior debt is typically backed by a charge over various assets of the debtor.

Unsecured debt securities are not backed by collateral. Consequently, bondholders will typically demand a higher coupon rate on unsecured debt securities than on secured debt securities. A bond contract may also specify that an unsecured bond has a lower priority in the event of default than other unsecured bonds. A lower priority unsecured bond is called subordinated debt. Subordinated debtholders receive payment only after higher-priority debt claims are paid in full. Subordinated debt may also be ranked according to priority, from senior to junior.

SENIORITY RANKING OF DEBT SECURITIES



Source: CFA (2017), Level 1: Fixed Income, Wiley

BONDS FROM A SHARIAH PERSPECTIVE

As illustrated above, a bond is a debt obligation for which the issuer pays a pre-determined rate of return to the bond holder. There is no investment in any underlying asset; rather, the issuer has a personal right and a liability on his legal personality. A repayment of debt with interest is due to the bond holder. The payment for the bond is effectively a loan (Qard) from a Shariah perspective.

In Islam, a loan (Qard) is considered a gratuitous contract, and it is commendable for a lender to provide a loan to a borrower who is in need of money. Both the Qur'an and Sunnah promise reward to a lender who provides a loan to a person in need. The fact that the Shariah prohibits the lender to derive any conditional benefit from the loan further emphasises its gratuitous nature. It also implies that the loan contract should not be used for profiteering purposes. Thus, any profit or additional return in lieu of the loan is impermissible and non-Shariah compliant. Both the Qur'an and the Sunnah have prohibited the lender from charging the borrower any additional amount. The Qur'an emphasises that the lender is entitled to receive the principal amount. It states:

"O you who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from Allah and His Messenger. But if you turn back, you shall have your capital sums: Deal not unjustly, and you shall not be dealt with unjustly" (al-Qur'an, 2:278-279).

A famous juristic maxim states:
"Any loan which draws an increment is Riba" (Ibn Abi Shaybah).

Riba is more than just simple interest and compound interest; Riba is an unjustified excess in a bilateral contract which is stipulated for one of the two transacting parties and is without consideration. To elaborate, there are two types of Riba:
Shariah has not considered money to be a commodity but a medium of exchange. When money of the

1) **Riba al-Nasi'ah**
is the advantage and excess gained without consideration by deferring delivery of any homogenous counter exchanges. This excess manifests upon default or delay in payment where time is factored as a consideration.

2) **Riba al-Fadhl**
is a contractually agreed excess in units without any consideration in an exchange of homogeneous goods.

same genus is exchanged, it must be in the same trading session and in equal quantity. Exchanging different amounts at different times brings into effect both forms of Riba : Riba al-Nasi`ah and Riba al-Fadhl. Jabir stated that Allah's Messenger cursed the accepter of interest and its payer, and also one who records it and the two witnesses, and he said, "They are all equal." (Sunan Abu Dawud)

Only a person who has a need borrows money. The need can be economic, business related or personal. Thus, lending is an act of charity helping those in need. Shariah has deemed lending as charity and not a form of business. Hence, profiting from lending by means of getting more in return of lending is totally prohibited as need is being commodified and thus, the borrower is exploited and disadvantaged. This conflicts with one of the fundamental principles of Islamic commercial law, namely, equal opportunities (musawat). The commodification of need is oppression and wickedness fuelled by greed. Where capitalism thrives on commodification, Shariah on the other hand, prohibits unrivalled and unrestricted commodification. Such behaviour at a macro level creates wealth inequality and disparity. Furthermore, the mass availability of credit with cost promotes debt and debt creation – unhealthy at a micro and macro level.

The distribution of wealth in a society becomes inequitable due to interest. Interest is an overhead charge which does not form part of any factor of production. Interest is received by the capitalist who continues the use his wealth to earn more wealth. This causes an unjust distribution of wealth in the society. In this way due mainly to interest, the rich in the society get richer and the poor, poorer.

واحل الله البيع وحرم الربوا

INTRODUCTION TO SUKUK

Sukuk (plural of sakk) are sometimes referred to as 'Islamic bonds' but a more favourable translation is, 'Islamic Investment Certificates'. Under Sukuk structure, the Sukuk holders (investors) enjoy beneficial interest and rights to cash flow from the performance of the "Sukuk assets'. The risk and return associated with underlying assets and there cash flows are passed to Sukuk holders. These assets may be tangible or intangible, existing or described with deferred delivery, usufruct or services. Under Sukuk structure the investors - Sukuk holders - each hold an undivided beneficial ownership in the underlying assets.

SENIOR AND SUBORDINATED SUKUK

Proposed alternatives to senior and subordinated bonds are senior and subordinated Sukuk. Sukuk in essence was designed to provide an Islamic alternative to a bond instrument. Sukuk can be classified in varying ways; Sukuk can be categorised in respect to the contract used in Sukuk, the type of issuer, or in terms of priority upon liquidation or bankruptcy. Senior (unsubordinated) Sukuk and subordinated Sukuk are categorisations in respect to the liquidity management and priority rights to the cash flows from the Sukuk. A senior Sukuk is a type of Sukuk structure in which Sukuk holders get paid in full before other claim holders. This is because the "senior" Sukuk holders have a high-ranking claim over the underlying assets in the event of default or redemption. Seniority means the Sukuk holder's claims rank superior vis-à-vis others against the issuer, and the Sukuk holders of the same rank (tranche) have similar rights and rank pari passu among themselves.

Subordinated Sukuk are a type of Sukuk structure in which Sukuk certificates give Sukuk holders residual claim over the assets financed by their funds. This claim ranks after the claims of other creditors and unrestricted profit sharing investment accounts. Contrary to the conventional sense of subordination, subordinated Sukuk do not represent creditor claims that rank after those of other creditors as this would be inconsistent with Shariah principles and precepts. Subordinated Sukuk allow Islamic banks to strengthen their Tier 2 capital.

Structuring multiple tranches of securitisation to cater to investors of different levels of creditworthiness is common practice in conventional securitisation. However, replicating the same in a Sukuk structure is a real challenge because of Shariah requirements that all investors are treated equally[4].

Tranching and subordination are risk reduction tools by the use of multiple class of securities. This mechanism is possible where beneficial interest and ownership in the seucritised asset are divided into tranches and parts. The investors holding the senior tranche would have first entitlement to payment and so limits its potential loss The other junior or subordinate tranche holder would have to wait until the senior tranche payments were made. It is not uncommon for the de facto borrower organiser to hold the subordinate tranche[5].

4 Iqbal, Z & Mirakhor,A. (2011), An Introduction to Islamic Finance: Theory and Practice, Wiley: Singapore
5 Ariff, M et al. (2012), The Islamic Debt Market for Sukuk Securities, Edward Elgar Publishing Ltd

ISSUES WITH TRANCHING IN SUKUK

Tranching refers to the practice of slicing capital structure in Sukuk issuance and it is done via subordination where there is prioritisation process through which losses are allocated to different layers of investors. Tranching also involves the practice of time tranche where sukuk holder's certificates have different time of maturity. The former involves subordination where different investors are divided into different layers based on their capital contributions, the risk that they are willing to absorb and the different return that they expect. Careful examination of Shariah contracts show that such practice is not allowed especially in equity. Shariah scholars had discussed the issue of subordination in shares and the majority had disallowed it. Such a ruling was based on the legal maxim: "Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment."

However, there are sukuk which have mentioned the term Tanazul in their tranching practices such as Tamweel sukuk. This is a new concept that requires further discussion.

It is argued that Tanazul is only valid when one has actually received the return or seen the extent of the loss that he has to suffer, then only will Tanazul shall take effect. One cannot waive something that he does not know or possess. It results in uncertainty (gharar)[6]. Similarly, Ibra', a concept similar to Tanazul, requires that the subject matter of waiver needs to be in existence before Ibra' can
be executed.

6 Laldin, A. (2012), Sukuk in Various Jurisdictions: Shariah and Legal Issues in Journal of Islamic Business and Management (2) 1, Available online: http://jibm.org/sites/default/files/files/Sukuk%20in%20Various%20Jurisdictions-Akram%20Laldin-JIBM%20Vol_2%2C%20Issue_1.pdf

It seems that the concept of tranching is not Shariah compliant and bears some resemblance to the concept of preference in shares. The relationship among the Sukuk is that of Musharakah or partnership and therefore, each one has an undivided ownership in the asset of the Sukuk. Based on this relationship the allocation of profit must be made in a manner that gives each partner an undivided percentage of the profit, not just a sum of money or a percentage of the capital. It should also be noted that, in principle, the shares of losses must be proportion to the percentage of each partner's contribution to the Musharakah capital. However, it may be possible that a form of tranching can be developed without contravening Shariah principles in the following manner[7]:

1. The partners may agree that the profit sharing should proportionate to their contributions to the capital, provided that the additional percentage of contribution to the capital is not in favour of the sleeping partner. If a partner does not stipulate a condition that he will be a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work. It is a requirement that the proportion of losses borne by the partners be commensurate with the proportions of their contribution to the Musharakah capital.

2. It is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling, the distribution will be in accordance with their agreement[8].

3. It is not permitted therefore, to agree on holding one partner or a group of partners liable for the entire loss or a percentage of loss that does not match their share of ownership in the partnership. It is however; valid that one partner takes without any prior condition, the responsibility of bearing the loss at the time of the loss.

4. Another solution is to slice up Sukuk into sub-Sukuks. The underlying assets in the project can have different profit sharing ratios with different assets. According to the risk-profile or other factors, the profit sharing ratios can differ. This can create a tranching effect in the Sukuk.

5. A final solution is to have a Sukuk with sub-Sukuks again. However, some forms of the Sukuk can be debt instruments whilst other can be equity-based. The riskier investment can take the form of equity. Obviously, a Sukuk structure which creates a Shariah compliant debt must be used such as Sukuk al-Murabahah etc.

7 Al-Amine, M. (2012), Global Sukuk and Islamic Securitisation Market, Brill
8 AAOIFI (2017), Shariah Standard no.12 on Musharakah in AAOIFI Shariah Standards, Bahrain: AAOIFI

Conclusion

Bonds are non-Shariah compliant investments and consist of Riba. Tranching in bonds is done via subordination where there is prioritisation process through which losses are allocated to different layers of investors. The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. Conventional bonds and conventional tranching in such securities is non-Shariah compliant. The proposed alternative of senior Sukuk and subordinated Sukuk can be Shariah compliant if they are structured correctly. The concept of Tanazul proposed by some Shariah scholars needs further research in this area. A few proposals to slice up the Sukuk in terms of different profit sharing ratios is a more acceptable manner to distribute risk allocation among investors.

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We've been preparing our clients for a new world in which Shariah Advisory rapidly becomes the currency of choice. From faster Certification programs, to direct Shariah Supervisory access, and perhaps most critically, navigating through the economic structures of clients offerings within a matter of days. We've have been working hard to help clients like you capitalize on opportunities in global Islamic financial markets.

Today, scores of institutions across nations, covering public and private businesses, commercial and corporate funds, Sukuks and Islamic equity markets, IPO's and Investment Banking Practices rely on us to run their companies, funds and transactions.

The future of Shariah Advisory and Audit is exciting and we are very lucky to be a part of this business!

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Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyze, comment and build upon the arguments expressed.

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