

CRITICAL APPRAISAL OF SHARIAH ISSUE ON APPLICATION OF INCENTIVE FEE AND INVESTMENT MANAGER ARRANGEMENT IN *SUKUK MUSHARAKAH* AND *SUKUK MUDARABAH*

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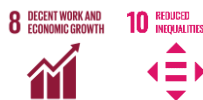
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SDG Elements:

Decent Work and Economic Growth, Reducing Inequalities



ABSTRACT

The Malaysian *sukuk* market has experienced significant growth and has become an integral component of the country's capital market. The market's increased dynamism is evident in the development of sophisticated *sukuk* arrangements that incorporate multiple Shariah concepts to cater to the needs of *sukuk* issuers. However, certain Shariah issues necessitate further examination to ensure compliance with Shariah. This paper focuses on the Shariah issues related to *sukuk musharakah* and *mudarabah*, particularly the application of incentive fees and investment manager arrangements within these two *sukuk* structures in Malaysia. Additionally, the paper includes case studies and references of existing *sukuk* in the Malaysian market. The study found that there is inconsistency in the approach taken when applying incentive fees and investment manager arrangements. This lack of consistency can have an impact on the practice of structuring *sukuk musharakah* and *sukuk mudarabah*, which is crucial in promoting inclusive and sustainable economic growth (SDG 8) and reducing inequalities in financial practices (SDG 10).

Introduction

One area in Islamic finance that has attracted and continues to attract a lot of interest from the business community worldwide is the global *sukuk* market. *Sukuk* represent one of the most significant instruments of the Islamic capital markets. *Sukuk* were initially introduced as an alternative instrument which serves the same purpose of providing long-term financing as conventional bonds, however, without compromising the requirements of Shariah (ISRA, 2013). *Sukuk* have been extensively used for raising government funds via sovereign *sukuk* issuances as well as obtaining funds for companies through corporate *sukuk* offerings.

The development of an active *sukuk* market is vital in providing alternative funding avenues for individuals, corporate entities and also the government. Tapping into the *sukuk* market allows a fundraising entity to reach a wider investor base, thus enjoying a larger funding amount at a competitive rate with the support from the government who provide tax incentive and other benefit for *sukuk* issuance. On the aspect of *sukuk* structure, the *sukuk* market continues to embrace innovative elements, as underlined by the launch of *sukuk* using various types of Shariah contracts such as *mudharabah*, *ijarah*, *musharakah* and *murabahah*. Although the development of *sukuk* market is a considerable achievement, some structures which attempt to behave and achieve the same economic outcome as conventional bonds have distorted Shariah principles.

This paper therefore aims to shed light on Shariah issues that arise in *sukuk* structure particularly with regards to the application of incentive fee in *sukuk mudharabah* and *sukuk musharakah* and also investment manager arrangement under *sukuk musharakah*. However, this paper will only focus on the *sukuk* in Malaysia market and will not make comparison with other *sukuk* structure in other countries. The analysis of the above Shariah issues will also refer to the Principal Terms and Conditions of several *sukuk* which already in Malaysia market.

The Concept of *Sukuk*

During the early stage of *sukuk* introduction in the market, *sukuk* are frequently referred to as Islamic bonds. This term may mislead the people to consider that *sukuk* are similar to bonds. In fact, some of the *sukuk* introduced in the market during that point of time were classified as Islamic bonds instead of *sukuk*. The term "*sukuk*" is derived from the singular form of the word "*sakk*" but its definition can also be approached from various perspectives, including linguistic, Islamic jurisprudence, and Islamic finance. Linguistically, the term "*sakk*" is believed to have Persian origins and signifies the collision of two objects with great force. In Arabic literature, "*sakk*" refers to "striking a seal on a document" and it generally encompasses all written documents (Sairally & Abdullah, 2017). Thus, literally *sukuk* means certificates. In its simplest form, *sukuk* are certificates of equal value that represent an undivided interest (proportional to the investor's interest) in the ownership of an underlying asset or business, usufruct, services or investments in particular projects or special investment activities (AAOIFI, 2008).

A similar definition is provided by the Islamic Financial Services Board (IFSB) which defines *sukuk* as certificates that represent the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset (IFSB, 2005). Through this concept, *sukuk* enjoy the benefit of being backed by assets, thereby affording the *sukuk* holders or investor a level of protection which may not be available in conventional debt securities or bond (BNM & SC, 2009).

In contrast, conventional bonds are normally issued to evidence debts or mirror loans on which interest is paid. Unlike *sukuk*, bonds do not represent ownership on the part of bondholders in the commercial or industrial enterprise for which the bonds are issued. Rather, it documents the interest-bearing debt owed to the holders of the bonds by the issuer, who is actually the owner of the enterprise (Dusuki & Mokhtar, 2010). Nonetheless, *sukuk* share some similarities with conventional bonds whereby both are similarly structured based on assets or businesses that generate revenue. The underlying revenue from these assets represents the source of income for the payment of profit on the *sukuk*.

The only difference is that conventional bonds are structured based on loan contract where the investors invest their money by way of giving loan with the expectation to gain profit (interest) generated from the business of the issuer. As for *sukuk*, it can be structured based on innovative applications of various Shariah contracts and principles such as sale, lease and partnership as the underlying relationship between the issuer and the investors to enable the latter to enjoy returns on their investment.

Sukuk Classification

Sukuk can be classified in various manners. Initially, *sukuk* were categorized as "trade or asset-based" and "equity or participation-based" depending on whether they are issued to finance trade or investment (Herzi, 2016). For instance, the IFSB defined the former as *sukuk* where the underlying assets provide fairly predictable returns to the *sukuk* holders, such as in the case of *salam*, *istisna*, and *ijarah*. The latter category was defined as *sukuk* where the returns are determined based on profit and loss sharing in the underlying investment, which does not offer fairly predictable returns (IFSB, 2005). However, after several default cases in the *sukuk* market in 2008 due to the global financial crisis, the issue of ownership in *sukuk* assets emerged. As a result, there was a growing trend to categorize *sukuk* into asset-based and asset-backed structures (Abdullah, 2012). These categories are based on the technical and commercial characteristics of the *sukuk*.

In the asset-based category, the underlying asset remains on the originator's balance sheet even after the *sukuk* is issued. In this category, the originator transfers only the beneficial ownership of the asset to the *sukuk* holders while retaining legal ownership. This means that legally, there is no true sale in an asset-based structure as the *sukuk* holders do not have ownership interest in the underlying asset. Consequently, the *sukuk* holders are unable to sell the asset to a third party and can only seek recourse from the originator/debtor. Conversely, an asset-backed *sukuk* refers to an Islamic security issued as part of a securitization transaction (Herzi, 2016).

However, it is important to note that the majority of *sukuk* are classified as "asset-based" rather than "asset-backed". In asset-based *sukuk*, the underlying assets are not actually owned by the special purpose vehicle (SPV), and in the event of default, the *sukuk* holders have recourse to the originator. It is worth mentioning that various types of *sukuk* are based on different structures of Shariah concepts (Abubakar et al., 2023). *Sukuk* can be classified by the underlying Shariah concepts used in the *sukuk* transactions. They include some common Shariah concepts such as *murabahah*, *ijarah*, *istisna*, *mudarabah*, *musharakah* and *wakalah*.

Securities Commission of Malaysia identifies 14 primary Shariah concepts that can be used in structuring *sukuk* together with 10 supplementary Shariah concepts to support the primary Shariah concepts (Guidelines on Islamic Capital Market Products and Services, 2024). Notwithstanding the various types of Shariah concepts, it is common that the bank as the principal adviser in arranging *sukuk* for the clients to structure *sukuk* based on the client's financial needs. This may include for the purpose of project financing (including contract financing), corporate finance-related such as mergers and acquisitions, debt restructuring or refinancing and lastly for general working capital of the client. Based on that, the principal adviser will review and apply Shariah contracts that best suit the *sukuk* structure according to client's needs after taking into account other related issues such as tax, asset ownership, etc.

In this paper, the author will not provide a detailed explanation of each Shariah concept and how it applies to *sukuk* structures. As mentioned earlier, the main focus of this paper is to highlight and discuss two significant Shariah issues related to *sukuk mudarabah* and *sukuk musharakah*. The detailed explanations of these two *sukuk* structures will be discussed in the following section.

Sukuk Mudarabah and Sukuk Musharakah

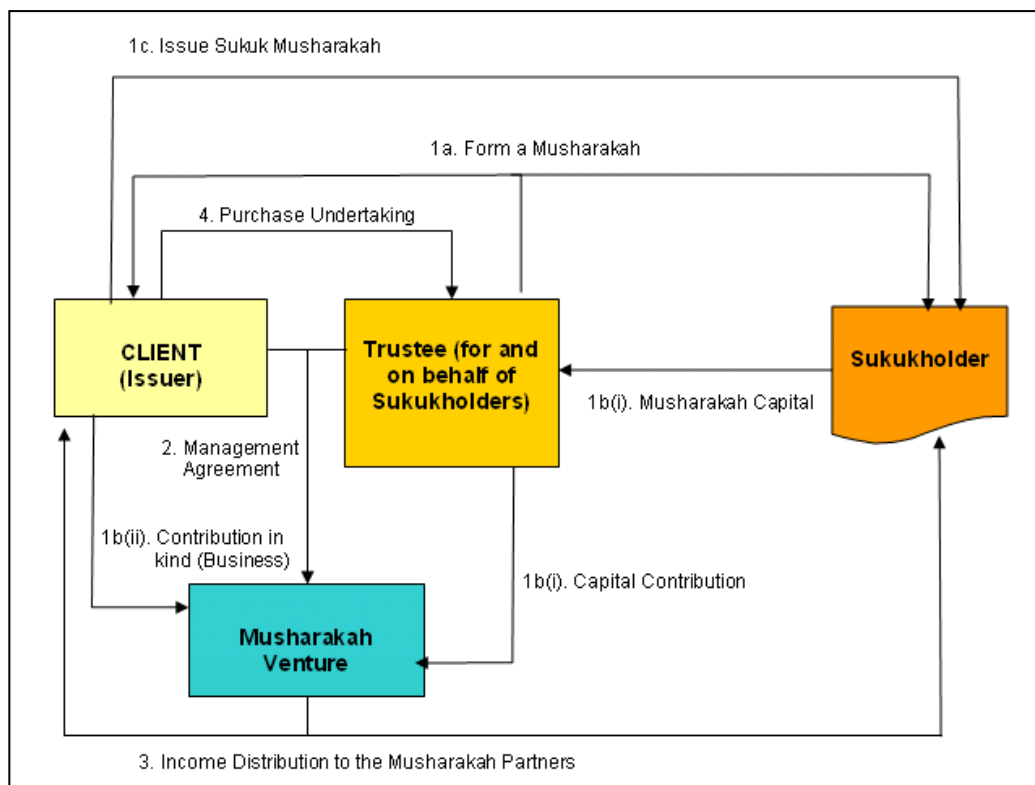
Musharakah is a form of partnership between two partners or more which is based on profit and loss sharing. In early literature of Islamic jurisprudence, the term *musharakah* was referred to as partnership. In the context of business and trade, technically, *musharakah* is a contract between the partners to contribute capital to an enterprise or a venture, whether existing or new, or to own an immovable or moveable asset, either on a temporary or permanent basis. Profits generated by that venture or real estate or asset are shared in accordance with the terms of the *musharakah* agreement, while losses are shared in proportion to each partner's share of capital.

On the other hand, *mudharabah* is a contract made between two parties to enter into a business venture. The parties consist of the *rabb al-mal* (capital provider) who shall contribute capital to finance the venture, and the *mudharib* (entrepreneur) who will manage the venture. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the *rabb al-mal*, unless the loss is due to negligence or mismanagement of the *mudharib* in managing the venture.

In the context of *sukuk* for investment activities funded through *musharakah* or *mudharabah*, the *sukuk* represents *sukuk* holder's undivided interests in the specific investments. *Sukuk musharakah* is used to raise funds for projects on the basis of partnership contracts. *Sukuk musharakah* is a certificate over a project or activity under the principles of *musharakah* whereby both the issuer and investors will contribute to the capital of the project hence, *become* the owners of the project, in proportion to their respective shares (Saripudin et al., 2012). Profits are distributed according to a pre-agreed proportion while losses are pro-rated according to their equity share.

As for *sukuk mudharabah*, it represents projects or activities based on a *mudharabah* (partnership based on trust) contract. The issuer of this *sukuk* is the *mudharib* (the managing partner); the subscribers are the capital owners (*rabbul mal*) and the mobilised funds are the *mudharabah* capital. The certificate holders own the assets of *mudharabah* and share the profit as per the agreement. They are also the capital providers and bear the losses if any (Shahimi et al., 2022). The details structure of *sukuk musharakah* and *sukuk mudharabah* are explained in the following figure:

Figure 1. Sukuk Musharakah Structure



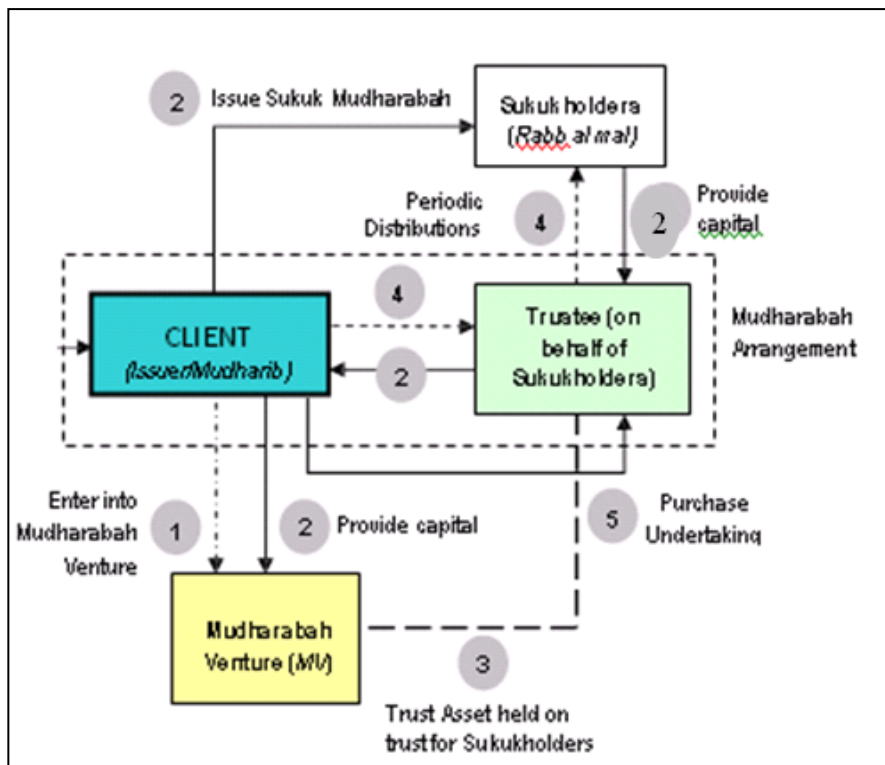
The above diagram illustrates the common structure applicable for *sukuk musharakah* in Malaysia. Under (1a), prior to the formation of *musharakah* arrangement, the issuer will identify the business which will be used for the *musharakah* venture. *Sukuk* holders shall via the trustee, form a *musharakah* arrangement with the issuer to invest directly into the business (*musharakah* venture). Concurrently under (1b), each party shall provide capital contribution to the venture whereby the capital contribution of the *sukuk* holders to the *musharakah* venture shall be the proceeds raised from the *sukuk musharakah* whereas the issuer will contribute the business into the *musharakah* venture (1b).

Under (1c), the issuer shall then issue *sukuk musharakah* and the *sukuk* holders shall subscribe to the *sukuk musharakah* issued by the issuer where the *sukuk musharakah* shall represent the *sukuk* holders' undivided proportionate interest in the *musharakah* venture. The *musharakah* partners shall also agree that the issuer will be the manager to manage the *musharakah* venture via a management agreement (refer to item 2). Income from the *musharakah* venture shall be distributed to each partner based on a profit-sharing ratio which will be determined prior to the issuance of the *sukuk musharakah*. Any losses incurred in the *musharakah* venture shall be borne by each partner in proportion to each partner's respective capital contribution in the *musharakah* venture (refer to item 3).

Under item 4, the issuer shall issue a purchase undertaking to the trustee (for and on behalf of the *sukuk* holders) wherein the issuer undertakes to purchase the *sukuk* holders' undivided proportionate interest in the *musharakah* venture from the trustee at the relevant exercise price upon the declaration of a dissolution event or upon maturity of the *sukuk musharakah* (Saripudin et al., 2012). Upon exercising such purchase, the *musharakah* venture will subsequently be dissolved and the *sukuk* holders shall not have any further rights or interests in the relevant *musharakah* venture. Thereafter, the respective *sukuk musharakah* shall be cancelled, upon satisfaction in full of the exercise price.

As for *sukuk mudarabah*, each *sukuk mudarabah* holder or investor, holds equal value in the *mudarabah* equity. Profits will be shared on a pre-agreed ratio between the *mudarabah* investor and the *sukuk* issuer while any loss will be borne solely by the *mudarabah* investor as *rabbul mal*. The details structure of *sukuk mudarabah* is explained as per following figure:

Figure 2. Sukuk Mudarabah Structure



The above diagram illustrates the common structure applicable for *sukuk mudarabah* in Malaysia. Under item 1, the trustee on behalf of the sukukholders shall enter into a *mudarabah* venture in its capacity as capital provider (*rabb al-mal*) with the issuer in its capacity as a manager (*mudarib*). The *mudarabah* venture shall be a Shariah compliant business. Under the *mudarabah* venture, the sukukholders as *rabb al-mal* shall contribute 100% capital via subscription of the *sukuk mudarabah* issued by the issuer.

The *sukuk mudarabah* issued by the issuer shall represent the *sukuk* holders' undivided proportionate interest in the *mudarabah* venture to be managed by the issuer; hence entitling the *sukuk* holders to receive its profit portion (refer to item 2). Subsequently, under item 3, the issuer shall make a declaration of trust in favour of the *sukuk* holders over all the issuer's interests in the *mudarabah* venture. Any profit in the *mudarabah* venture shall be shared with the *sukuk* holders in accordance with an agreed profit sharing ratio of the *sukuk mudarabah* but in the event the *mudarabah* venture makes a loss, the loss shall be borne solely by the *sukuk* holders (refer to item 4) (Shahimi et al., 2022). Under item 5, pursuant to the purchase undertaking, the issuer shall purchase the *sukuk* holders' interest in the *mudarabah* venture at an exercise price upon the declaration of a dissolution event or upon maturity of the *sukuk mudarabah*. Upon purchase of the *sukuk mudarabah*, the *mudarabah* venture shall then be dissolved (Abdulkareem et al., 2020).

From the foregoing explanations, we can summarise that both *sukuk musharakah* and *sukuk mudarabah* structure have almost similar characteristic whereby it involves elements of capital contribution, sharing either the profit or loss and also requirement to have a specific venture where the capital will be invested. However, both structures may also raise Shariah issues particularly on the appointment of manager and also the application of incentive fee arrangement. These two issues will be discussed in the next part of this paper.

Shariah Issues Related to *Sukuk Musharakah* and *Sukuk Mudarabah*

Sukuk musharakah and *sukuk mudarabah* are widely utilized in the global *Sukuk* market, not just limited to Malaysia. However, these *sukuk* structures have faced criticism from certain Shariah scholars. The main concerns and objections raised against *sukuk musharakah* and *sukuk mudarabah* revolve around the issues of purchase undertaking and top-up payment, which could potentially imply a guarantee of capital and profit. These features resemble those found in fixed-income instruments, such as bonds (Abubakar et al., 2023). Typically, the issuer will make a top-up payment to the *sukuk* holder if the actual return falls below the expected return of the *musharakah* or *mudarabah* venture. Furthermore, the use of a purchase undertaking may appear to guarantee the capital, as the issuer is obligated to purchase the *sukuk* holder's asset in the venture at a price equal to the initial capital contribution made by the *sukuk* holder (Abdulkareem et al., 2020).

Despite the aforementioned concerns, it is important to highlight that the majority of *sukuk* issued in Malaysia and approved by the Securities Commission have implemented the aforementioned structure. However, this does not imply that these *Sukuk* are not compliant with Shariah principles. These are areas where scholars have differing opinions and cannot reach a consensus. With all due respect to the scholars, the author believes that there are other aspects that have not been thoroughly analysed which reflects in inconsistency of practice when structuring a *sukuk*, such as the appointment of managers and the arrangement of incentive fees. To illustrate these issues, the author will refer to several Principal Terms and Conditions (PTC) of *sukuk* that have been issued in the Malaysian market as reference and case study.

Issue on Appointment of Manager in Sukuk Musharakah

Generally, under *musharakah* contract, it is important to differentiate between *shirkah al-aqd* and *shirkah al-milk*. Some people get confused between these two types of *musharakah*. *Shirkah al-milk* (partnership in joint ownership) refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under *shirkah al-milk*, each partner's ownership is mutually exclusive. In this regard, one partner cannot deal with the other partner's asset without the latter's consent (Policy Document on *Musharakah*, 2015). On the other hand, *shirkah al-aqd* (contractual partnership) refers to a contract executed between two or more partners to venture into business activities to generate profit. Under *shirkah al-aqd*, a partner is an agent for the other partners. In this regard, the conduct of one partner in the ordinary course of business represents the partnership (Policy Document on *Musharakah*, 2015).

Among the feature which distinguish *shirkah al-aqd* and *shirkah al-milk* are that the former originates from a contract between two parties which involves offer and acceptance whereas this characteristic is absent in the latter since as in the case of inheritance or bequest for instance, the asset is shared between two or more parties without execution of specific contract. Furthermore, the subject of *shirkah al-milk* is

only the asset itself, without any agreement upon how to invest it through joint action. As far as *shirkah al-aqd* is concerned, it is established by the agreement to invest the capital or work together and share the profit. The word “*al-aqd* (contract)” means here the contractual partnership which seeks profit. As for *shirkah al-milk*, if it originates from a contract, it would be a contract of purchase or gift or bequest and not a contractual partnership. That is because, it is neither for business nor to generate profit; rather it is only to share or acquire asset.

With regard to *sukuk* structure using *musharakah* contract in the market, it is important to determine whether it falls under the category of *shirkah al-aqd* or *shirkah al-milk*. The issuance of *sukuk* under *musharakah* contract is based on *shirkah al-aqd* and not *shirkah al-milk*. The reason is because *sukuk musharakah* is a joint investment vehicle between *sukuk* holders and issuer. Based on that, there is a contract between them in order to establish the partnership in investment. Furthermore, the objective of such partnership is to generate profit which to be shared between them (Abu Ghuddah, 2008). As far as *sukuk musharakah* is concerned and as practiced in Malaysia market, normally the *sukuk* holders will appoint the issuer as manager to manage the *musharakah* venture. Some examples of *sukuk* that implement this arrangement are as follows:

Table 1. Examples of *Sukuk*

| No. | <i>Sukuk</i> Issuer | Statement in Principal Terms & Conditions |
|-----|--|---|
| 1 | Perpetual <i>Sukuk Musharakah</i> Programme of RM700 million issued by LBS Bina Group Berhad | The <i>Sukuk</i> holder(s) shall appoint the Issuer as the manager to manage the <i>Musharakah</i> Venture (“Manager”). |
| 2 | Perpetual Islamic Notes Programme of RM2.0 billion issued by IJM Land Berhad | The <i>Sukuk</i> holder(s) shall appoint the Issuer as the manager to manage the <i>Musharakah</i> Venture (“Manager”). |
| 3 | <i>Sukuk Musharakah</i> Programme of up to RM15.0 billion issued by Sarawak Energy Berhad | The Issuer shall be appointed as the manager (“Manager”) to manage the <i>Musyarakah</i> Venture. |
| 4 | Perpetual <i>Sukuk</i> Programme of RM2.0 billion issued by Tropicana Corporation Berhad | The <i>Sukuk</i> holder(s) shall appoint the Issuer as the manager to manage the <i>Musharakah</i> Venture (“Manager”). |
| 5 | UMW Holdings Berhad | UMW Holdings shall be appointed as the manager (“Manager”) to manage the <i>Musharakah</i> Venture. |

From the foregoing *sukuk* structure, both the issuer and also the *sukuk* holders are partners in the *musharakah* contract. It is clearly stated in its Principal Terms and Conditions that the issuer will be appointed as the manager by the *sukuk* holders to manage the *musharakah* venture. The issue here is whether it is really required to have a separate arrangement to appoint the same partner in the *musharakah* to manage the venture since as explained earlier; in a normal *sukuk* structure, it is classified under *shirkah al-aqd* where the agency roles is already embedded.

From another perspective, there is a view presented by AAOIFI that allows for such a structure based on the premise that the appointment is made through a separate and independent contract. In this view, the partner who is appointed as the manager to oversee the partnership becomes an employee of the partnership venture, rather than acting in the capacity of a partner (AAOIFI, 2008). Additionally, the manager is entitled to receive a fee for their role. In addition, Securities Commission allows one of the partners or issuers or a third party to be appointed as manager to manage *musharakah* venture in *Sukuk* structure (Securities Commisison, 2024).

However, the author respectfully disagrees with this perspective, stating that even though the appointment is made independently, the party appointed as the manager is still the same party, i.e., the partner themselves. The main reason for prohibiting such a structure is the potential conflict of interest that may arise. Furthermore, the arrangement in question bears similarities to the concepts of *wakalah* (agency) or *ijarah al-amal* (service with wages) contracts. Under these contracts, the agent or service provider is entitled to receive a fee for the services rendered.

However, this may contradict the nature and essence of the *musharakah* contract, particularly the *shirkah al-aqd*, which entails elements of partnership where each partner acts in the best interest of the partnership, and profits or losses are shared accordingly. Additionally, the ruling mentioned should be considered in conjunction with a condition that allows for the dismissal of the appointed manager from their role at any time, without the need to amend or terminate the existing *Musharakah* contract (AAOIFI, 2008).

From the foregoing statement, in most *sukuk musharakah* structure, there is a condition that allows the *sukuk* to be terminated if there is a default or dissolution. This means that if the issuer (who is also the *musharakah* manager) fails to fulfil their obligations as stated in the relevant documents, the *sukuk* will be redeemed by the *sukuk* holders, effectively ending the *musharakah*. An example of this is seen in UMW Holdings Berhad *Sukuk Musharakah*, where if the issuer fails to fulfil their obligations under any of the transaction documents or the *sukuk musharakah*, the *sukuk* holders have the right to redeem the *sukuk* which leads to termination of the *sukuk musharakah*.

Breach of other obligations under the Transaction Documents: default is made in the performance or observance of any other obligations of UMW Holdings under or in respect of the *Sukuk Musharakah* Programme and the Transaction Documents...

Upon occurrence of a Dissolution Event, the Trustee may or shall (if directed to do so by the *Sukuk* holders by extraordinary resolution) declare that a Dissolution Event has occurred and may take such proceedings against UMW Holdings as it may think fit to enforce the Transaction Documents in the following sequence:

- (a) to invoke the Purchase Undertaking;
- (b) thereupon, the exercise price will be due and payable; and
- (c) the *Musharakah* Venture will be dissolved.

This condition of termination in the event of default or dissolution is clearly inconsistent with the requirement mentioned earlier, which states that the dismissal of the manager should not affect the status of the *musharakah* contract. As an alternative, it is possible to appoint one of the partners as the manager under a separate and independent contract, provided that it complies with the requirements set out by AAOIFI. It is important that there are no clauses in the legal documentation that stipulate the redemption of the *sukuk* and the cancellation of the *musharakah* contract if the issuer (partner) fails to fulfil their role as the manager. Instead, the *musharakah* contract should remain and continue, and the partners should agree to appoint another party as the manager to fulfil the managerial responsibilities of the *musharakah*.

In addition, the appointment of manager can also be done outside the *musharakah* arrangement such as appointing a third party to manage the venture. For example in *Sukuk Imtiaz*, the *sukuk*holders who form a *musharakah* amongst themselves appoint a third party (the issuer) which is not the *musharakah* partner, as manager to manage the *musharakah* venture.

The holders of the *Sukuk Musharakah* ("*Sukuk* holders") shall form a *Musharakah* amongst themselves from time to time, which is a partnership amongst the *Sukuk*holders (each a "partner" and collectively the "*Musharakah* Partners"), to invest in the Business ("*Musharakah* Venture") via the subscription of the *Sukuk Musharakah* to be issued by the Issuer. There will be at least two investors for each *Sukuk Musharakah* issuance.

Pursuant to the management agreement to be entered into between Bank Rakyat and the Issuer (acting on behalf of the *Sukuk* holders) ("*Management Agreement*"), the Issuer shall appoint Bank Rakyat as the Manager ("*Manager*") of the *Musharakah* Venture.

Incentive Fee

Another issue which requires further deliberation and analysis is on the application of incentive fee arrangement under *sukuk musharakah* and *sukuk mudarabah*. As required under tenets of *musharakah* and *mudarabah* contract, all the contracting parties must come into agreement on the profit-sharing ratio which to be used as mechanism in determining the amount of profit to be shared. This is a requirement

set out by Shariah to eliminate uncertainty and any possibility of dispute. Under a common *sukuk musharakah* structure, the partners shall agree on certain expected return of the *musharakah* venture.

In the event the prevailing return exceeds the expected return of the venture, the excess shall be passed to the partner who manages the *musharakah* venture and such excess is considered as incentive fee. This structure actually relates to the first issue as discussed earlier. In order to apply the incentive fee arrangement, there must be one manager to manage the venture so that the manager will be entitled to receive the incentive fee. Some examples of *sukuk musharakah* that implement this arrangement are as follows:

Table 2. Examples of *Sukuk Musharakah*

| No. | Sukuk Issuer | Statement in Principal Terms & Conditions |
|-----|---|--|
| 1 | <i>Sukuk Musharakah</i> Programme of up to RM15.0 billion issued by Sarawak Energy Berhad | The <i>Sukuk</i> holders shall agree that any profit in excess of the Expected Periodic Distribution (as defined below) shall be retained by or paid to the Manager as an incentive fee. |
| 2 | UMW Holdings Berhad | The <i>Sukuk</i> holders agree that any excess of the profits from the Periodic Distribution Amount shall be retained by the Manager as an incentive fee. |

This may raise Shariah issue since from Shariah perspective; it is not permissible to specify a fixed remuneration or fee for a partner who contributes in managing the *musharakah* venture or provides any form of services (AAOIFI, 2008). The basis of this prohibition is because it may be tantamount to guaranteeing the capital of the partner (manager) and it violates the nature of *musharakah* since the partner is not being exposed to risk of loss in proportion to his capital contribution. By right, the partner who manages the venture can only receive a greater share of profit than it would receive from the profit-sharing ratio agreed earlier.

Nonetheless, there are also several *sukuk musharakah* structures that apply different approach while still maintaining incentive fee arrangement. For this structure, any excess from the *musharakah* venture will be parked as a reserve and will only be given to the manager as an incentive fee upon dissolution of *sukuk musharakah*. Some examples of *Sukuk Musharakah* that implement this arrangement are as follows:

Table 3. Examples of *Sukuk Musharakah*

| No. | Sukuk Issuer | Statement in Principal Terms & Conditions |
|-----|--|--|
| 1 | Perpetual Islamic Notes Programme of RM2.0 billion issued by IJM Land Berhad | Any excess income from the relevant <i>Musharakah</i> Venture shall be retained by the Manager as a reserve ("Reserve") on behalf of the <i>Sukuk</i> holders. Upon dissolution of the relevant <i>Musharakah</i> Venture pursuant to the Redemption Events and/or Enforcement Events and if there is positive balance in the Reserve, such amount in the Reserve will be given to the Manager as an incentive fee. |
| 2 | Perpetual <i>Sukuk Musharakah</i> Programme of RM700 million issued by LBS Bina Group Berhad | Any excess income from the relevant <i>Musharakah</i> Venture shall be retained by the Manager as a reserve ("Reserve") on behalf of the <i>Sukuk</i> holders. Upon dissolution of the relevant <i>Musharakah</i> Venture pursuant to the Redemption Events and/or Enforcement Events and if there is positive balance in the Reserve, such amount in the Reserve will be given to the Manager as an incentive fee. |
| 3 | Perpetual <i>Sukuk</i> Programme of RM2.0 billion issued by Tropicana Corporation Berhad | Any excess income from the relevant <i>Musharakah</i> Venture shall be retained by the Manager as a reserve ("Reserve") on behalf of the <i>Sukuk</i> holders. Upon dissolution of the relevant <i>Musharakah</i> Venture pursuant to the Redemption Events and/or Enforcement Events, such amount in the Reserve (if any) will be given to the Manager as an incentive fee. |

As for *mudarabah* contract, the same ruling shall apply where the distribution of profit must be based on the agreed profit-sharing ratio. It is not permissible to earn a share of profit in addition to a fee in *mudarabah* contract (AAOIFI, 2008). Furthermore, under the Policy Document on *Mudarabah* issued by BNM, it is also stated that a *mudharib* is only entitled to profit for works which are integral to the *mudarabah* venture and shall not earn any additional fee for such works (Policy Document on *Mudarabah*, 2012). However, some of *sukuk mudarabah* in Malaysia have applied the incentive fee arrangement. Some examples of *sukuk* that implement this arrangement are as follows:

Table 4. Examples of *Sukuk Musharakah*

| No. | <i>Sukuk</i> Issuer | Statement in Principal Terms & Conditions |
|-----|---|--|
| 1 | <i>Sukuk Mudarabah</i> Programme of up to RM700.0 million issued by Besraya (M) Sdn Bhd | Any amounts in excess of the Expected Return shall be given to the <i>Mudharib</i> as an incentive fee for successfully managing the business. |
| 2 | <i>Sukuk Mudarabah</i> Programme of up to RM1 billion issued by Leong Hup Capital Sdn Bhd | Any amount in excess of the Expected Return shall be given to the <i>Mudharib</i> as an incentive fee for successfully managing the <i>Mudharabah</i> Venture. |

In the author's opinion, the application of an incentive fee arrangement in *sukuk mudarabah* contracts may not be consistent with the principles of *mudarabah*. This is because, in a *mudarabah* contract, it is already established from the outset that the *mudharib* is obligated to manage the venture and is entitled to a share of the profits according to the agreed profit-sharing ratio. Introducing an incentive fee arrangement in this context could be seen as redundant and similar to a *jualah* contract, where a party is rewarded with a fee as a performance-based reward. This may deviate from the intended structure and spirit of a *mudarabah* contract, which is based on a profit-sharing partnership rather than a fee-based arrangement. Therefore, careful consideration should be given to the compatibility of an incentive fee arrangement with the principles of *mudarabah*, and it may be necessary to consult shariah scholars and industry experts to ensure that any such arrangement aligns with Shariah and avoids any potential conflicts or deviations from the intended contract structure.

On that note, when *sukuk*, whether structured with a *mudarabah* or *musharakah* contract, include the "excess profit arrangement", it is suggested that the concept of *tanazul* (waiver) be highlighted as an alternative to the incentive fee arrangement. *Tanazul* means surrendering the rights. It is also known as *isqat al-haq* in Islamic jurisprudence (Securities Commission, 2009). It is found that *isqat al-haq* is closely related to the concept of *ibra'* (rebate). Thus, in order to have a clear idea of *tanazul*, the concept of *ibra'* should be discussed. The term *ibra'* literally means elimination, release, removal and acquittal from something. In Islamic jurisprudence, the term refers to an act by a person to withdraw his rights from a person who has the obligation to repay the amount borrowed from him (Haron et al., 2015).

With regard to *sukuk mudarabah*, the issuer includes a condition in the agreement that states if the actual profit of the *sukuk* exceeds certain expected percentage rate, then all the excess is given to the *mudharib* (*sukuk* issuer) as an incentive for good management. Therefore, at this stage, the capital providers (*rabbul mal*) set aside their right to claim an amount exceeding the expected profit (Haron et al., 2015). If either party needs to determine a specific amount of profit on their own, the *mudarabah* will become invalid. However, this prohibition does not apply to the agreement made by both parties that if the profit exceeds a certain percentage, then one of the parties will receive the excess and the distribution will follow what has been agreed upon by both parties (AAOIFI, 2008).

Therefore, *tanazul* can be applied where a party is to waive his right to the profits, if any, to the other contracting party on the basis of *tanazul* on the date of distribution of profit (Policy Document on *Mudarabah*, 2012). The permissibility to waive any partner's right to the profit is based on the fact that a partner who has agreed to a certain profit-sharing ratio may agree to waive the rights to profits to be given to another partner on the basis of *tanazul* at the time of profit realization and distribution.

For *sukuk musharakah*, the *sukuk* holders can agree to receive their share of profits at the predetermined and agreed-upon rate (expected profit rate), and if it exceeds what is set, then the *sukuk* holders will waive (*tanazul*) it and give it to the issuer. This principle of *tanazul* is to waive the right to obtain the stipulated profit as stated in the contract (Haron et al., 2015). The above structure is allowed based on the resolution

by AAOIFI where it is permissible to agree that if the profit realised is above a certain ceiling (expected return), the profit in excess of such 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 the agreement (AAOIFI, 2008).

In addition, the resolution of Shariah Advisory Council of BNM had also resolved that it is allowed for any partners under *Musharakah* contract, to stipulate a condition whereby any partners to the contract may waive (*tanazul*) his right on the profit and it to be passed to another partner should the prevailing profit exceeded certain ceiling (BNM, 2010). Further, the concept of *tanazul* has been approved by Shariah Advisory Council of Securities Commission to be used for preference shares under the Companies Act 1965 where the ordinary shareholders will *tanazul* their entitlement to the profit in favour of the preference shareholders in the annual company meeting (Securities Commission, 2009).

Nonetheless, some of *sukuk musharakah* and *mudarabah* in Malaysia had already used the *tanazul* arrangement and stated in their Principal Terms and Conditions. This evidences the inconsistency in applying "excess profit arrangement" when structuring *sukuk musharakah* and *mudarabah*. Some examples of *sukuk* that implement *tanazul* arrangement are as follows:

Table 5. Examples *Sukuk* that Implement *Tanazul* Arrangement

| No. | <i>Sukuk</i> Issuer | Statement in Principal Terms & Conditions |
|-----|---|---|
| 1 | <i>Sukuk Mudarabah</i> Programme of up to RM 745.0 million issued by Projek Lintasan Shah Alam Sdn Bhd | The <i>Sukuk Mudharabah</i> Holder/ <i>Rab al-mal</i> shall grant waiver / <i>tanazul</i> : a. in receiving any Distributable Profit for the first seventeen (17) years from the first issuance date of <i>Sukuk Mudharabah</i> ; and b. in receiving any Distributable Profit entitlement above the internal rate of return ("IRR") of 7.00%. Any excess thereon shall be distributed to PLSA as incentive in its capacity as the <i>Mudharib</i> . |
| 2 | Islamic Commercial Paper/Medium Term Note <i>Sukuk Mudarabah</i> Programme of RM10.0 Billion issued by Sunway Treasury <i>Sukuk</i> Sdn Bhd | Under the <i>Mudharabah</i> Venture, the <i>Sukuk</i> holders have agreed upfront that they shall receive profits up to the Expected Return. Any amounts in excess of the expected return shall be given to the <i>Mudharib</i> as an incentive fee for successfully managing the <i>Mudharabah</i> Venture. A partner may waive his right under the Shariah principle of <i>Tanazul</i> (Waiver of rights) on the profit payments from the <i>Mudharabah</i> Venture, if he desires so. |
| 3 | Islamic Commercial Paper / <i>Sukuk Mudarabah</i> Programme of RM150.0 Billion issued by Titijaya Land Berhad | Under the <i>Mudharabah</i> Venture, the <i>Sukuk</i> holders have agreed upfront that they shall receive profits up to the Expected Return. Any amounts in excess of the Expected Return shall be given to the <i>Mudharib</i> as an incentive fee for successfully managing the <i>Mudharabah</i> Venture. A partner may waive his rights under the Shariah principle of <i>Tanazul</i> (Waiver of rights) on the profit payments from the <i>Mudharabah</i> Venture, if he so desires. |
| 4 | Islamic Medium Term Notes <i>Sukuk Musharakah</i> of RM100.0 million issued by TSH <i>Sukuk Musharakah</i> Sdn Bhd | In the event that the distributable profits generated from the <i>Musyarakah</i> Venture are greater than the Expected Return, pursuant to " <i>Tanazul</i> " (waiver) granted from the onset, the Trustee (for and on behalf of the <i>Sukuk</i> holders) shall undertake to waive its right on the excess distributable profits from the <i>Musyarakah</i> Venture to the Issuer. |

Conclusion

Despite the positive growth and progress of the *sukuk* market, it appears that there are still contentious issues that require immediate solutions to sustain its development. Based on the preceding discussion, there is a lack of consistency in the application of incentive fees and investment manager arrangements. While there have been deliberations and decisions made by Shariah scholars and regulators, this inconsistency can impact the structuring of *sukuk musharakah* and *sukuk mudarabah*. Therefore, it is crucial to foster close cooperation between financial experts and Shariah scholars, as well as encourage more interaction and discussion among the Shariah scholars themselves. The focus of the Islamic capital market should not solely be on raising funds, creating innovative products, and gaining acceptance from international financial institutions, although these objectives are important. Ensuring Shariah compliance

should be the top priority, as it will also contribute to the growth of the real economy and the socio-economic development of society.

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