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Comparative Analysis of Sukuk Issuance of US$ Tier 1 Capital Certificates Boubyan Bank and US$ Additional Tier 1 ADIB Capital Invest 1 Ltd

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Abstract

Purpose:

1. Analyze the reason why company issue Perpetual Sukuk
2. Analyze the reason why investors buy Perpetual Sukuk
3. Analyze to what extent the Perpetual Sukuk structure comply with AAOIFI Shariah Standard 2015

Design/Methodology/Approach: This study use the qualitative method which use content analysis to compare perpetual sukuk issued by Boubyan Bank and Abu Dhabi Islamic Bank PJSC ("ADIB") via ADIB Capital Invest 1 Ltd towards the Shariah principles and AAOIFI Shariah Standard 2015. **Findings**: This study have examined the perpetual sukuk Mudaraba issued by both ADIB and Boubyan. They are in accordance with AAOIFI standards in some features and other some are not really fit with standards which may raise Sharia issues in terms of perpetuity, profit distribution, capital guarantee and subordination. Shariah concerns highlighted here are common in both banks except in two cases, one in ADIB and another one in Boubyan. The perpetuity in Mudaraba contract does not give right of liquidation for certificate holders although the Mudaraba contract does not have any fixed maturity date. This is common in both banks. The option to indemnify the investors' capital when the banks exercise their option to liquidate the contract, implies the concern on guaranteeing capital in Mudaraba. Furthermore, in Boubyan the indemnification of profit also found in case of shortfall. The reinvestment of Mudaraba reserve also cater the issue of profit sharing ratio between the partners. Finally, in terms of subordination, mainly three issues have been found such as making sukuk holders liable for others debt, waiving the right before it is established and not to share in the loss after banks comingle their asset with Mudaraba. However, there is no issue on perpetuity of Mudaraba in general, determining a ceiling as expected profit and commingle the capital of Mudaraba with the Mudarib's other assets. **Research Limitations/Implications:** This research is limited to content analysis. However, this research does not provide any empirical findings. **Originality/value:** This paper discusses the comparative analysis between two Tier 1 sukuk issued based on Mudaraba and analyze the features of sukuk in terms of meeting the Tier 1 requisite and Shariah requirements.

Keywords: Sukuk Issuance, banking, Finance & Contract

1.0. Introduction

Sukuk is known as key capital market instrument which is used ranging from sovereigns, quasi-sovereigns, financial institution and corporation for project financing and infrastructure financing. In 2014, the issuance of sukuk achieved its highest level which accounted for USD 26.4 billion since its inception in 2001. However, it decreased to USD 20.88 billion on 2015 as shown in figure 1.1.

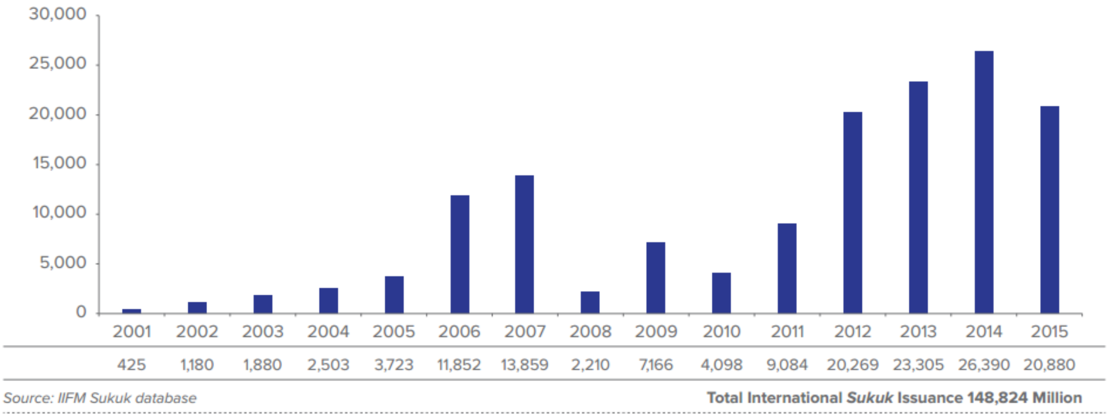


Figure 1.1. Total International Sukuk Issuances (Jan 2001 – Dec 2015)

Sukuk structures changed overtime from its basic and standard form. Hybrid sukuk appeared in its development. Issuers and investors were much interested because it is being equity-linked. The types of hybrid sukuk comprise of convertible, exchangeable and perpetual sukuk. Gradual enforcement of Basel III since 1st January 2013 force Islamic Financial Institution (IFIs) to issue Basel III compliant instruments which can fulfill the revised capital adequacy standards. The revision is on the capital structures which are Tier 1 (T1) comprising of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) instruments and Tier 2 (T2). The CET 1 instruments comprise of ordinary shares and reserves whereas AT1 capital is a layer of additional going-concern capital which is perpetual in nature. Up to 2014, according to MIFC (2014), it shows that there were three AT1 Basel III Compliant Sukuk issued which are ADIB Capital Invest 1 Ltd, DIB Tier 1 Sukuk Ltd, and Al Hilal Bank based on Mudarabah contract.

Table 1.1 Basel III Compliant Sukuk Issued until 2016

Sukuk	Structure	Country	Issue Date	Tenure (Years)	Size	Type of Capital
ADIB Capital Invest 1 Ltd	Mudarabah	United Arab Emirates	19th Nov 2012	Perpetual Callable 5-years	USD1bln	AT1
DIB Tier 1 Sukuk Ltd	Mudarabah	United Arab Emirates	20th Mar 2013	Perpetual Callable 6-years	USD1bln	AT1
Al Hilal Bank	Mudarabah	United Arab Emirates	30th June 2014	Perpetual Callable 5-years	USD500mln	AT1
Boubyan Bank	Mudarabah	Kuwait	16th May 2016	Perpetual Callable 5-years	USD250mln	T1

Source: (Sairally, Muhammad, & Munjid, 2016) and Author's compilation

This paper will compare perpetual sukuk issued by Boubyan Bank and Abu Dhabi Islamic Bank PJSC ("ADIB") via ADIB Capital Invest 1 Ltd. It will discuss two objectives (i) the reason why company issue Perpetual Sukuk, (ii) the reason why investors buy Perpetual Sukuk and (iii) to what extent company comply with AAOIFI Shariah Standard 2015. The Shariah issues highlighted are perpetuity and bindingness of Mudaraba, guarantee the capital and return, profit distribution, and subordination.

2.0.Theoretical Background

2.1.Introduction of Sukuk

Sukuk is similar to the bond which complies with Shariah (ISRA, 2013). Sukuk reflect whole shares in the ownership of tangible assets relating to specific projects and particular investment activity. Sukuk is not represent a debt owed to the issuer of the bond but it has common share in the ownership of the assets linked to the investment. Under the sukuk structure, there is no interest to pay, it has undivided beneficial ownership in the underlying assets instead.

2.2.Features of Perpetual Sukuk

Hybrid sukuk is a security which are incorporate several elements of debt and equity, underlying assets comprise of the tangible assets ('ayn) and intangible assets (dayn), and incorporate the Shariah contracts on the structure (Furqani, 2014). Three types of hybrid sukuk which are consisted of convertible sukuk, exchangeable sukuk, and perpetual sukuk. Perpetual Sukuk has its own characteristics which are

a. Subordination

Subordination means the order of claims priorities among the sukuk holders. It depends on the certain terms of contract whereby it has provisions to determine the claim priority on the certain event.

Subordinated sukuk is ranked junior to senior unsecured sukuk and holders of subordinated sukuk usually rank senior to preferred and common equity holders. The main difference between corporate sukuk and financial hybrids sukuk is subordination. Hybrid sukuk which one of them is perpetual sukuk is subordinated on the liquidation or insolvency. The recovery rate of subordinated sukuk is usually lower than senior sukuk because senior sukuk will be settled first in case of insolvency then subordinated sukuk. In case of the bank as referred to Basel III regulation, the capital is divided into tiered which are Tier 1 which consist of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1) and Tier 2.

b. Deferral

Perpetual sukuk has a distinct characteristic whereby the issuer has the option to defer profit without stated default. This feature can be found on the common equity where the company/issuer can defer or cancel the dividend payment at the company's discretion. On the accounting perspective, perpetual sukuk can be recognized as an equity. On the provisions, this instrument has the deferral provisions which are non-payment event and non-payment election to defer the profit payments.

c. Extension

Perpetual sukuk has no maturity date or in other word has perpetual tenure. This will give flexibility to the sukuk holders to transform the sukuk certificates to equity ownership from the issuer/trustee. Conversion right will be implemented based on the specific conversion date or during a conversion period, at any time between two stipulated dates or at any time from the issuance date to the maturity time.

According to **Furqani (2014)**, practically, conversion date depends on the current share price and time. If the current share price is higher than the conversion price, it is worthy to convert from sukuk to equity. Otherwise it is not worthy for sukuk holders to convert it and better to wait until redemption time. Another condition of sukuk conversion depends on the sukuk issued with a put option whereby the redemption price available for the put. However, it will affect the sukuk holders to take early redemption at the premium than conversion into equity.

2.3. Basel III Regulation

Basel regulation reformation into Basel III strengthen the capital adequacy for financial institution to finance its operation and absorb the expected and unexpected losses. Basel III eradicated Tier 3 capital and change the composition of regulatory capital into Tier 1 (T1), which consist of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1), and Tier 2 (T2). T1 is aimed to absorb losses during the operation of financial institution and represent the bank's condition which is solvent. However, T2 has a role as gone concern capital to absorb further losses when bank face financial distress and attain the level of non-viability. According to BCBS (2010: 3), gone concern means apart from *"insolvency and liquidation" such that it "include(s) situations in which the puclic sector provides support to distressed banks which would otherwise failed"*. If bailout situation occurred, Basel III have anticipated by having bail-in feature of capital instruments i.e. write-off or conversion to common equity upon the occurrence of several trigger events. It is to make sure that regulatory capital absorbs losses first before public support assistance.

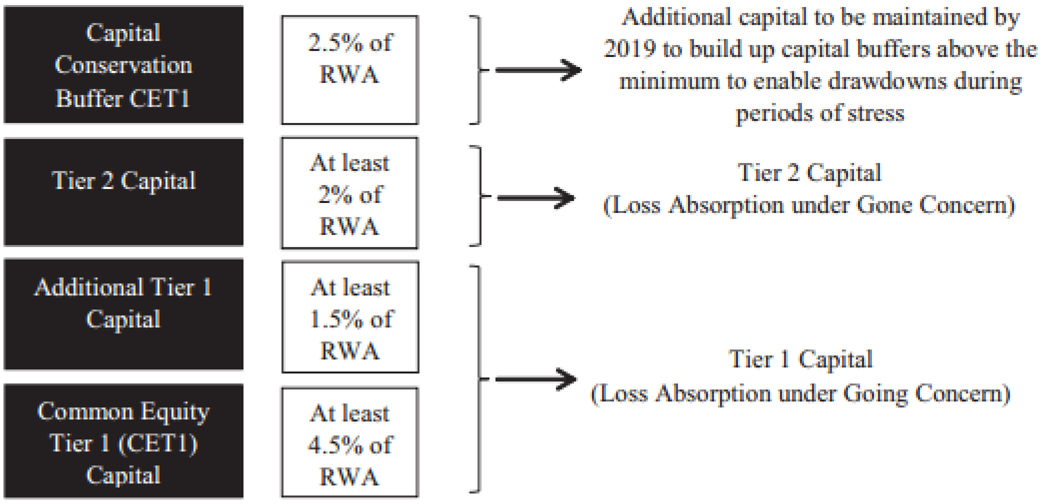


Figure 2.1. Capital Structure of Basel III

Source: (Sairally et al., 2016)

From the figure 2.1, it is implied that loss absorption start from CET1, followed by AT1 capital under going concern and further losses will be absorbed by T2 capital when the bank attain the non-viability level. Thus, the loss will be subtracted from the classification of the capital. Principally, depositors and general creditors will be the final sequence to bear losses in the event of liquidation. The ranking order promote the objective of Basel III whereby it ensures the bank to have ample capital in order to bear losses during the time of crises. In order to keep the bank's capital ample for the long-term basis, Basel III enforces banks to issue capital instruments to ensure the capital availability and having equity feature or at least convertible to common equity or have mandatory write-down features. In addition, these instruments have capability to absorb losses by having subordination other than other types of liabilities.

3.0.Research Methodology

This study use qualitative method which is content analysis to compare prospectus of perpetual sukuk issued by Boubyan Bank and Abu Dhabi Islamic Bank PJSC ("ADIB") via ADIB Capital Invest 1 Ltd towards the Shariah principles and AAOIFI Shariah Standard 2015.

4.0.Discussion and Findings

4.1.Issuance Rational for Investors'

Perpetual sukuk offer interesting risk and return in comparison with senior sukuk. By having investment in perpetual sukuk, investor creates risk implied by the key structural features of hybrid sukuk i.e. subordination, deferral and extension. The main attraction for investing in perpetual sukuk results from the yield pick-up compared with senior sukuk because of the incurred structural risk. The higher risk associated with subordination, deferral and extension bound the investor to have proper review and analysis on the underlying credit quality and business profile of perpetual sukuk issuer to lessen the default risk (Schaffner, 2010).

4.2.Issuance Rational for Issuers'

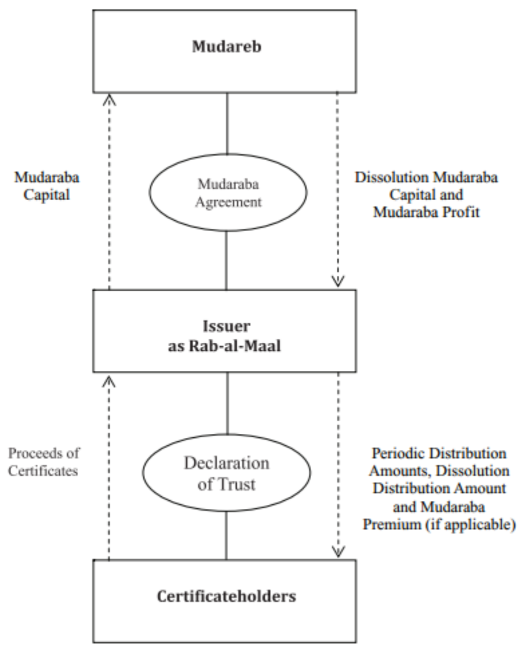
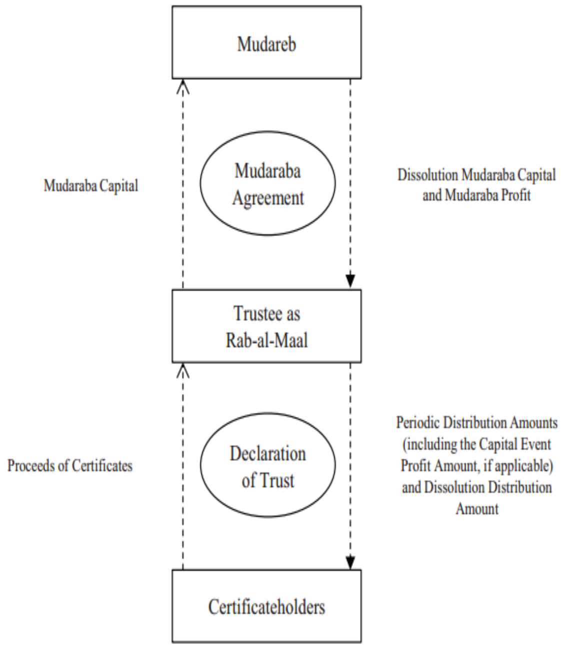
Perpetual sukuk assist the company to improve its credit profile whereby it provides the flexible alternative for the composition of capital structure and funding strategies (Larsen and Magnussen, 2010). It offers tax-deductible like debt on the cost of capital and equity feature whereby the credit rating agencies give partial equity credit. The acknowledgement of partial equity credit positively affect the issuer's overall rating and definitely will give impact to the prospective of refinancing cost.

Perpetual sukuk has call option feature which it has an option to redeem the perpetual sukuk subsequent to the expiration of an initial non-call protection period. Due to this feature, on the issuance date until first call date, perpetual sukuk pay with fixed profit rate. After the first call date, step-up profit will exercise by changing the prior profit rate. It aims to give incentive for the issuer in order to exercise the right of call option on the first call date. Besides, the issuer can defer profit without being in default. This is the same characteristic with equity whereby it absorb losses before other creditors when issuer's financial condition going down.

4.3.Shariah Issues in Perpetual Sukuk

On this part, Shariah matters will be discussed relating to the issue on perpetuity and bindingness of Mudaraba, guarantee the capital and return, profit distribution, subordination of Mudaraba. BOUBYAN Tier 1 CAPITAL SPC LTD US$ Tier 1 Capital Certificates and ADIB Capital Invest 1 LTD US$ Additional Tier 1 Capital Certificates are issued Mudaraba Sukuk.

4.3.1.Sukuk Structures

<table>
<tr><td>ADIB Capital Invest 1 LTD
US$1,000,000,000 Additional Tier 1
Capital Certificates</td><td>BOUBYAN Tier 1 CAPITAL SPC LTD
US$250,000,000 Tier 1 Capital
Certificates</td></tr>
<tr><td>
</td><td>
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In both structures, there are three main sequences i.e. payments by the certificate holders and the issuer, periodic payments by the trustee, and dissolution payments, redemption and variation by the issuer and the mudarib. For the periodic payments, ADIB Capital Invest 1 Ltd stipulated the profit sharing ratio 90 percent to the Rab-al-Mal and 10 percent to the Mudarib. However, Boubyan Tier 1 Capital SPC Limited has an agreed profit sharing ratio 99 percent to the trustee (Rab-al-Mal) and 1 percent to the Mudarib.

The highlight structure of ADIB Perpetual AT1 Sukuk 2012 as follows:

1. The issuer will issue the certificates which will be perpetual and not have a pre-defined termination date to investors and collect the proceeds. Then, the issuer pursuant to declaration of trust declare a trust in favour of the certificate holders over the proceeds, all of rights, title, interest and benefit, present and future over the mudaraba assets and under transaction documents.
2. ADIB as Mudarib and the trustee as Rab-al-Maal, proceeds contributed by the Trustee become an initial capital (Mudaraba Capital) for investment in accordance with the terms and conditions of Mudaraba Agreement.

3. Mudaraba capital pursuant to the investment plan set on the Mudaraba Agreement invested on an unrestricted co-mingling Mudaraba basis. The investment will be conducted on Bank's general activities implemented through General Mudaraba Pool.
4. Mudarib may elect to pay mudarabah profit generated by the mudarabah asset to the Rab-al-Maal at its sole discretion.
   - If the mudarib elects for payment of the mudarabah profit, on each periodic distribution date, the Rab-al-Maal will distribute the profit generated by the mudaraba to both the Rab-al-Maal and mudarib in accordance with an agreed ratio of 90:10. The issuer then applies its share of profit (if any) generated by the mudaraba on each periodic distribution date to pay the periodic distribution amount due to sukuk holders on such date.
   - If the mudarib elects for non-payment of the mudaraba profit, such mudaraba profit will be credited into the reserve account. The mudarib has no obligation to make any subsequent payment in respect of any mudaraba profit which is not paid in accordance with the mudaraba agreement. To the extent which the profits under the mudaraba are not distributed, the mudarib will not be able to declare any dividends to the ordinary shareholders, or make payments to securities holders or other obligations which rank *pari passu* or junior to the AT1 perpetual sukuk issued as mudarib until two consecutive payments due under the mudaraba have been paid in full (or equivalent amounts have been set aside for the benefit of the Rab-al-Maal).
   - If the actual profit is more than the expected profit (6.735%), the mudarib will credit it into the reserve account whether the profit distribution is made to the Rab-al-Maal or not.
   - If the actual profit is less than the expected profit for the first 6 years, and the mudarib elects to pay the profit distribution, the mudarib needs to cover the shortfall using either the funds in the reserve account or the mudarib account.
5. Subject to certain conditions set out in the mudaraba agreement, the mudarib may choose to liquidate the mudaraba in whole, but not in part, on the basis of an actual liquidation of the mudaraba in the following circumstances: (a) on the first call date or any periodic distribution date after the first call date; or (b) on any date on or after the issue date (whether or not a periodic distribution date): (i) upon the occurrence of a tax event; or (ii) upon the occurrence of a capital event. If the dissolution the mudaraba capital is less than the Rab-al-Maal initial mudaraba capital, the mudarib is required to either:
   - Continue investing such capital in the mudaraba and accordingly no distribution of liquidation proceeds will occur; or
   - Indemnify the Rab-al-Maal by meeting the mudaraba capital shortfall, using it own funds, in order to liquidate the mudaraba.

The highlight structure of Boubyan Perpetual AT1 Sukuk 2016 as follows:

1. The issuer will issue the certificates which will be perpetual and not have a pre-defined termination date to investors and collect the proceeds. Then, the issuer pursuant to declaration of trust declare a trust in favour of the certificate holders over the proceeds, all of rights, title, interest and benefit, present and future over the mudaraba assets and under transaction documents.
2. Boubyan bank as Mudarib and the trustee as Rab-al-Maal, proceeds contributed by the Trustee become an initial capital (Mudaraba Capital) for investment in accordance with the terms and conditions of Mudaraba Agreement.
3. Mudaraba capital pursuant to the investment plan set on the Mudaraba Agreement invested on an unrestricted co-mingling Mudaraba basis. The investment will be conducted on Bank's general activities implemented through General Mudaraba Pool.
4. Agreed profit sharing ratio are ninety-nine percent (99%) payable to the Rab-al-Maal and one percent (1%) payable to the Mudarib. The trustee will use the Rab-al-Mal Mudaraba Profit to pay distribution amounts to the certificate holders. Periodic distribution amounts will be payable and subject with the conditions on the outstanding face amount of the certificates the issue date to 16 May 2021 at a rate of 6.75 percent per annum from amounts of Rab-al-Maal Mudaraba Profit and Rab-al-Mal Final Mudaraba Profit.

   If the certificates are not redeemed or purchased and cancelled in accordance with the Conditions on or prior to the first call date, periodic distribution amounts will be payable from the First Call Date subject to and in accordance with the conditions at a fixed rate, to be reset on the First Call Date and every five years thereafter, equal to the relevant five year reset rate plus margin 5.588 percent per annum.
5. Payment of Rab-al-Maal Mudaraba Profit by the Mudarib are at sole discretion of the Mudarib which may elect not to distribute the Mudaraba Profit nor pay the Rab-al-Maal Mudaraba Profit to Rab-al-Maal on any Mudaraba Profit Distribution Date (Non-Payment Election).
6. If Mudarib do not pay Rab-al-Maal Mudaraba Profit on the Mudaraba Profit Distribution Date as result of either (i) Non-Payment Event or (ii) save in the case of Rab-al-Maal Mudaraba Profit payable on the Mudaraba End Date, Rab-al-Maal have no right to claim for payment of any such Rab-al-Maal Mudaraba Profit. Any profit for the relevant period which is not paid to the Rab-al-Maal in such circumstances will be credited to a reserve account.
7. If Mudarib do not pay Rab-al-Maal Mudaraba Profit on the Mudaraba Profit Distribution Date as result of Non-Payment Event or Non-Payment Election, the bank will be prevented from declaring or paying distributions, dividends, profit and/or any other payment on, liquidation amount (subject deduction of any Shortfall Cover Amount to be recovered by the Mudarib) to the Rab-al-Maal on the Mudaraba End Date and any liquidation proceeds remaining after such payment shall be paid to the Mudarib as an incentive fee for its performance under Mudaraba Agreement.

8. Write down at the time of non-viability. Non viability event will occur if the Central Bank notify the bank which Trigger Event has occurred. It is relevant to mudarib under Mudaraba Agreement whereby it will be subject to write down in whole or in part. A write down will occur on the date specified in the and directly or indirectly redeeming, purchasing, cancelling, reducing or otherwise acquiring, the certificates or any shares or securities which rank *pari passu* or junior to the certificates, unless or until two consecutive payments of Rab-al-Maal Mudaraba Profit have made in full.
9. If Rab-al-Maal Mudaraba Profit payment is any Mudaraba profit period is bigger than the expected return based on the Mudaraba Agreement, any surplus amount will be retained by the Mudarib and credit to reserve.
10. If Rab-al-Maal Mudaraba Profit payable to the Trustee on any Mudaraba Profit distribution date is less than distribution amount payable, the mudarib can (i) utilize available amount in the Mudaraba reserve, (ii) may choose to cover such shortfall from its own resources and recover these at a later date from the Mudaraba reserve and liquidation proceeds.
11. Mudarib may on its sole discretion liquidate the Mudaraba in whole but not in part with some circumstances i.e. (i) on the first call date or any Mudaraba Profit Distribution date after the first call date, (ii) Date or after date of tax event occurs, (iii) on any date or after date of the Mudaraba agreement if a regulatory capital event occurs. In the case of whole final liquidation, the proceeds will be at least similar to the required liquidation amount which equal to (i) face amount of the outstanding certifcates, (ii) Non-payment event has occurred, (iii) Shortfall cover amount.

4.3.2. Perpetuity and Binding of Mudaraba

The first salient feature of Mudaraba perpetual Sukuk issued by ADIB stated that trust certificate shall not have pre-defined maturity date. The scholars have different opinions on fixing maturity date for Mudaraba partnership in Shariah point of view. Some scholars disagree with fixing maturity for Mudarbah while others permit it. Ellias, Haron, Kadir and Salim (2015) cited the views of Imam Al Sahrbini and Hanbali schools of law saying that determination of time for Mudaraba partnership will make the contract null and void. Therefore, based on this view the Mudaraba is not a binding contract. They further cited the views of Hanafi jurists allow maturity period for Mudaraba on which Mudaraba become binding contract.

AAOIFI Sharia Standard 2015 stated that

(4/3) The general principle is that a Mudaraba contract is not binding, i.e. each of the contracting parties may terminate it unilaterally except in two cases;

4/3/1: Where Mudarib already commenced the business in which case the Mudaraba contract become binding up to the date of actual or constructive liquidation.

4/3/2: When the contracting parties agree to determine a duration for which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of designated duration, except by mutual agreement of the contracting parties.

The aforementioned AAOIFI standard 2015 on Mudaraba clearly stated that setting a maturity period for Mudaraba contract is only optional not obligatory. Therefore, ADIB's Mudaraba based on perpetual Sukuk does not contradict the rules. On the other hand, if there is no predetermined end date, the contract is not binding and each partner is entitled to terminate the contract if they want to do so. However, in both ADIB's Tier 1 Capital as well as Boubyan Tier 1 Capital Trust Certificate, only the Mudarib of ADIB and Boubyan have rights to terminate the contract (liquidate the certificate) although there is no pre-determined end date.

It has been stated in the prospectus (ADIB Prospectus p.21, Boubyan Prospectus p.50) of both banks that "*the Certificates are perpetual securities and accordingly do not have a fixed or final redemption date. The certificates may be redeemed in whole but not in part, or the terms thereof may be varied by the Trustee but it is only occurred upon the instructions of ADIB and Boubyan (acting in their sole discretion)",* "*The Trustee is under no obligation to redeem the Certificates at any time and the Certificate holders have no right to call for their redemption unless a Bank Event occurs*". Therefore, ADIB and Boubyan reserve the right to liquidate on their discretions, certificate holders or trustee cannot demand for liquidation. It is contradict situation against the nature Mudaraba as it is described in AAOIFI standard 2015.

4.3.3. Guarantee the Capital and Return

The prospectus stated that there is no guarantee in respect of either of the Mudaraba capital or Mudaraba profit unless at the event of breach of condition or negligence by the Mudarib. However, there is no appropriate mechanism or platform to verify the negligence of the bank and the breach of conditions in respect of their investment and business conducts. Therefore, it has become the unsolved issue in Islamic financial instruments especially in equity based contracts, not only in Mudaraba but also in Musharakah as well as Wakalah Bil Istithmar. However, at the time of liquidation of Mudaraba in whole on the first call date or periodic distribution date or upon the occurrence of a tax event or upon the occurrence of a capital event. If the capital to the Trustee is less (any such shortfall) than the Mudaraba capital, Mudarib may exercise his option to liquidate the Mudaraba, the Mudarib shall either continue investing dissolution capital accordingly no liquidation occur, or indemnify the Trustee in respect of shortfall in which case there will be an actual liquidation occur." (ADIB Prospectus p. 107, Boubyan Prospectus p. 138) (Emphasis added).

The aforementioned paragraph in both banks prospectus mean that if there is any shortfall in Mudaraba capital or profits both ADIB and Boubyan will not liquidate and continue investment or indemnify the shortfall and liquidate. The issue can be raised here is that if the shortfall occurred because of real business activities without any negligence from Mudarib and Mudarib indemnify the shortfall, somehow they guarantee the capital and profit which is against the principles of Mudaraba where no any partner can guarantee the capital and revenue.

4.3.4. Profit Distribution

The profit distribution mechanism shows the number of unusual practices which are normally not exist in Mudaraba contract which is practiced in the banks. The Mudarib has a discretion to decide whether to pay profit or defer it. It is also become a criticism on Mudaraba based perpetual sukuk. However, ADIB and Boubyan have declared that the event of non-payment occurs to due amount shall be credited to Mudaraba reserve and subject to final payment at the time of liquidation. *"If the Mudarib makes Non-Payment Election or a Non-Payment Event occurs, then the Mudarib shall give notice to the Trustee, the Delegate and the Certificate holders, in each case providing details of such Non-Payment Election or Non-Payment Event (due to its being credited to the Mudaraba Reserve"* (ADIB prospectus, p.106), and "*All amounts of Mudaraba Capital, Rab-al-Maal Mudaraba Profit, Rab-al-Maal Final Mudaraba Profit and/or other amounts due to the Trustee on termination of the Mudaraba Agreement in accordance with its terms and the terms of the other Transaction Documents"* (Boubyan Prospectus, p.137).

According to AAOIFI Standard 2015, the payment of profit can be deferred and revised at the time of liquidation, stated as follow 8/7: "*No profit can be recognized or claimed unless the capital of the Mudaraba in maintained intact. Whenever a Mudaraba operation incurs loss, such losses stand to be compensated by the profits of the future operation of the Mudaraba. The losses brought forward should be set against the future profits. All in all, the distribution of profit depends on the final result of the operation at the time of liquidation of the Mudaraba contract*" (AAOIFI, 2015).

It is permissible to anyone of the partners in Mudaraba to enjoy the excess in the profit if they agreed any ceiling rate on profit as expected profit and the total profit yielded more than the ceiling. It had been discussed in AAOIFI "… where if the parties agree if the profit is over a particular ceiling then on of the parties will take the additional profit if the profit is below or equal to the amount of ceiling the distribution of profit will be in accordance with the agreement" (8/5, AAOIFI 2015).

The AAOIFI standard confirmed that in case of shortfall in the expected profit or ceiling no any partner can top up the difference in order to make other partner enjoy the expected return. However, in the case of Boubyan, such shortfall will be credited using Mudaraba reserve if the shortfall exist after reaccredit using reserve the bank may use its own cash "(*after re-crediting amounts to it in accordance with the terms of the Mudaraba Agreement if there is any such shortfall) and, if a shortfall still exists following such re-credit, it may (at its sole discretion) elect (but shall not be obliged) to make one or more* *payments from its own cash resources in order to cover such shortfall"*. (Boubyan prospectus, p.138). Even though, it is not compulsory for the bank to top up the difference using its own cash, this statement against the muqtaḍā al-ʿaqd (nature and implication of the contract) and guaranteeing the investors' share from the loss as it is discussed above.

On the other hand, on ADIB perpetual sukuk, if the profit higher than corresponding profit distribution amount, the additional profit has been credited in Mudaraba reserve. The Mudarib shall be entitled to deduct the amounts standing to the credit of the Mudaraba reserve (at its sole discretion) at any time prior to the Mudaraba End Date, and to re-invest these in the same manner as it invested in the Mudaraba Capital for and on behalf of the Trustee in accordance with the investment plan (ADIB Prospectus, p.106). However, there is an ambiguity whether the additional amount of profit is considered as investors' capital or Mudarib's capital and the ratio of profit distribution on this re-invest amount.

Furthermore, both ADIB and Boubyan prospectus declared that if "*Mudarib did not pay amount of Mudaraba profit to Rab-al-Maal as a consequence of a Non-Payment Election or a Non- Payment Event, then from the date of such Non-Payment Election or Non-Payment Event (the Dividend Stopper Date), the Mudarib shall be prohibited from declaring or paying certain distributions or dividends, declaring or paying profit or other distributions on certain of its securities, or redeeming, purchasing, cancelling, reducing or otherwise acquiring certain of its share capital and securities, until two consecutive payment disbursed to Rab-al-Maal in full or an amount equal to that amount has been duly set aside or provided for in full for the benefit of the Trustee*"(ADIB Prospectus p.107, Boubyan Prospectus p.138). The question can be raised up here that Mudaraba sukuk and other securities and shares are different contracts made in different circumstances, how non-payment event or non-payment election of the Sukuk Mudaraba can prohibit the payment of other independent contracts in line with Shariah?

4.3.5. Subordination of Mudaraba

ADIB Additional Tier 1 and Boubyan Tier 1 Mudaraba Sukuk is a subordinated and unsecured Sukuk because the payment obligation under the Mudaraba Agreement are unsecured and no collateral is or will be given by ADIB and Boubyan in relation there to. Therefore, at the time of winding up or dissolution of the company the senior debt will be prioritized and the Trustee will agree unconditionally and irrevocably to waive any right of set-off. This practice is called as subordination. Subordination have been defined by a research group citing (wood,2007) as a transaction whereby one creditor (the subordinated or junior creditor) agrees not to be paid by the borrower or other debtor until another creditor of the common debtor (senior creditor) has been paid. In line with the above definition, the payment obligation of Mudarib under the Mudaraba agreement in the above two Mudaraba sukuk are subordinated to the claims of senior creditors.

4.3.5.1 Settlement of Banks Debt using Mudaraba Capital along with the Profit

As per the general rule in Mudaraba investors as Rab-al-Maal, they have a right to claim their profits and the capital at the time of liquidation of the contract. Mudarib as an entrepreneur employ his effort and skills in the business and share in the profit as agreed. Mudarib has no any right to use share of the investors along with the capital to his settle his own liabilities. Sairally et al. (2013) argue that Mudaraba sukuk holders have ownership claims over their asset and portion of profit and they would be liable for the loss arising only from their asset unless other liabilities of the banks.

They further argue the assets financed by the sukuk holders' funds cannot be used to meet the claims of depositors and general creditors of Islamic banks during going concern or gone concern scenarios because they should not be made liable for losses that are not affecting their Mudaraba venture. This practice might trigger Shariah issues as it may affect the muqtada al aqd of Mudraba which is profit sharing where the sukuk holder in its capacity as Rabb al mal have no right to claim such profits (Ellias et al., 2015). Therefore, Mudaraba contract should be an independent contract not be contingent with any other contracts and liabilities of the Mudarib. If the payment of Rabbul mal subordinated to other creditors of the banks that is merely against the nature of the Mudaraba contract.

4.3.5.2 Co-mingling Mudarabah Capital with Mudarib's Other Assets

The capital for the Mudaraba comes from investors by the proceeds of certificates. ADIB and Boubyan co-mingle their own assets with the Mudaraba capital as it is stated in prospectus. There is no issue if Mudarib combines or co-mingle his own asset with the Mudaraba capital. AAOIFI 2015 paragraph 8/9 approved the Mudareb to commingle any of its own assets and share the profits from two commingled assets proportionately. However, it is argued by (Sairally, B.S, Muhammad, M, & Mustafa, M.M, 2013) if Mudarib commingle Mudaraba capital which were not linked with any specific project or investment plane with the general business of the bank, that sukuk would have been called as Musharaka sukuk though it named as Mudaraba sukuk. Thus, all the rules related to Musharaka can be applicable here particularly in case of subordination. According to general rule of Musharaka Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.

"الربح على ما اصطلحا عليه والوضيعة على قدر المال" (Usmani, 1998)

Therefore, all the equity based sukuk holders including the above sukuk investors should be treated at pari passu and no one cannot be prioritized in terms of profit sharing.

However, if the Mudhrabah Mushtharakah has been used in the above Sukuk structure it might be unconcerned from the Shariah point of view where by the agreement between certificate holder and trustee considered as Mudharabah and the agreement between trustee and ADIB or Boubyan considered as Musharakah. ADIB and Boubyan get the proceedings of certificates from the trustee as Musharaka capital to mix it with their own asset and therefore this capital can be absorbed loss of the ADIB and Boubyan extent to the portion of capital contribution and be ranked pari passu with other Musharakah based certificate such as shares and stock of the banks.

4.3.5.2 Waiving the Right Before It is Established

The instrument for permitting subordination in Mudaraba sukuk is Tanazul which means waiving rights. “The concept of tanazul can be defined as an act of waiving certain rights of claim in favour of another party in a contract. In Islamic finance, tanazul is typically applied when the right to share some portion of the profits is given to another party” (Noor, Haron, & Mohammad, 2011).

The application of tanazul in order to have subordination in Mudaraba sukuk Tier 1 capital and Mudaraba sukuk Additional Tier 1 shall cater mainly two sharia concerns. Firstly executing Tanazul before the underlying right is established and secondly such waiving in Mudaraba contradict with the Muqtada al Aqd which is profit sharing.

Noor et al. (2011) illustrated after the lengthy discussion on scholars’ opinion on tanazul that upfront waiving before the right is established not lawful based on the majority view and anything which change the *muqtadaa al Aqd* cannot be acceptable. Furthermore, Sairally et al. (2013) claimed that “permitting one partner to give voluntarily a portion from his profit to the other partner using hibah or Tabarru only after conclusion of the contract not before or in the contract. Therefore, it is not accurate to claim that Hiba al ma’dum gift for something not in existence) can be a basis for allowing Tanzul of right that has not been acquired or established.”

4.4. Non-Viability

Basel III Tier I or Tier 2 instruments have the element of either written-off or converted into common equity if the regulator determine non-viability event occurred. Accordingly, if a Non-Viability event occurs Boubyan Tier 1 Mudaraba sukuk will be written off in whole (cancelled) or write down in part on pro rata basis (Prospectus, Boubyan P: 14). However, ADIB has adopted Basel II at the time of issuing Tier 1 Mudaraba sukuk in compliance with guidelines set by the Central Bank. Thus, the non-viability event had not been discussed in the terms and conditions of the ADIB prospectus. However ADIB prospectus has claimed that if Basel III reform taken place in UAE legislation on loss absorbency at the point of non-viability may have adverse effects for Certificate holders. From Shariah point of view, Mudaraba is an equity contract in nature. Thus, conversion from sukuk to ordinary shares for the purpose to comply with Basel III requirement does not affect the Shariah ruling to the instruments (Ellias et al., 2015).

5.0. Conclusion

Gradual enforcement of Basel III since 1st January 2013 force Islamic Financial Institution (IFIs) to issue Basel III compliant instruments in order to fulfill the revised capital adequacy standards. The perpetual sukuk is an innovative approach in Islamic finance which can replace perpetual bonds. There is nothing wrong to take the concept from the western thinking based on the following Hadeeth of prophet (Peace be upon Him) "Wisdom is the lost property of the believer, so wherever he finds it then he has a right to it" الحكمةُ ضالةُ المؤمنِ حيثما وجدها فهو أحقُّ بها (Sunan At-Tirmidhi, 2687). However, the concept should ensure the conformity with Shariah requirements or should be adjusted accordingly.

This study have examined the perpetual sukuk Mudaraba issued by both ADIB and Boubyan and found it in accordance with AAOIFI standards in some features and other some are not really fit with standards which may raise Sharia issues in terms of perpetuity, profit distribution, capital guarantee and subordination. Shariah concerns highlighted here are common in both banks except in two cases, one in ADIB and another one in Boubyan. The perpetuity in Mudaraba contract does not give right of liquidation for certificate holders although the Mudaraba contract does not have any fixed maturity date. This is common in both banks. The option to indemnify the investors' capital when the banks exercise their option of liquidate the contract, implies the concern on guaranteeing capital in Mudaraba. Furthermore, in Boubyan the indemnification of profit also found in case of shortfall. The reinvestment of Mudaraba reserve also cater the issue of profit sharing ratio between the partners.

Finally, in terms of subordination, mainly three issues have been found such as making sukuk holders liable for others debt, waiving the right before it is established and not to share in the loss after banks comingle their asset with Mudaraba. However, there is no issue on perpetuity of Mudaraba in general, determining a ceiling as expected profit and commingle the capital of Mudaraba with the Mudarib's other assets. However, concerning the above mentioned issues, this study recommends the involvement and commitment of Shariah experts in Islamic finance to restructure the underlying contract of perpetual sukuk in order to ensure Shariah compliance.

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