ABSTRACT

Basel III has reformed regulatory capital requirements for banking institutions in order to further strengthen the banking sector’s resilience, by increasing the minimum capital levels to be maintained by banks as well as redefining the criteria for qualifying regulatory capital instruments. Inevitably, Basel III regulations have an impact on Islamic banking institutions (IBIs). The main concern is whether the Basel III capital instruments are acceptable from the Shari’ah perspective. This research thus compares the qualifying AT1 and T2 capital instruments under Basel III. Furthermore, it examines Shari’ah issues related to subordination, arising in both equity-based and exchange-based contracts when used for structuring AT1 and T2 capital instruments. The study relies on the content analysis of the classical and contemporary literature as well as case studies of musharakah and mudarabah sukuk issued for meeting regulatory capital requirements under Basel II and Basel III.

The study finds that there are two possible approaches to comply with Basel III and Shari’ah requirements. First, to avoid the Shari’ah issues related to the issue of subordination, it recommends musharakah instruments for both AT1 and T2 capital whereby CET1, AT1 and T2 will all be ranked pari passu with one another. This approach would still be compliant with the philosophy of Basel III which in substance aims to strengthen the resilience of the banking sector by increasing the total equity of the Risk Weighted Assets (RWA). The second approach is to use musharakah sukuk for AT1 and convertible murabaha or ijarah sukuk for T2 instruments to achieve the effect of subordination among CET1, AT1, T2 and current and saving accounts and general creditors during going-concern and gone-concern scenarios. However, the Shari’ah issues surrounding the current structures of these exchange-based contracts need to be resolved first before this approach can become a reality.

Keywords: Basel III, Capital Adequacy Requirements, Additional Tier 1, Tier 2, Subordination

1. INTRODUCTION

The Basel III regulatory framework has set out new capital and liquidity standards for banking institutions. In particular, Basel III has increased the minimum capital levels to be maintained by banks and redefined the criteria for qualifying regulatory capital instruments to be included under Tier 1 (T1) and Tier 2 (T2) capital. The overall objectives of the reforms are to enhance the banking sector’s ability to absorb shocks arising from financial and economic stress and reduce the risk of spillover from the financial sector to the real economy (BCBS, 2011: 1).

The revised definition of regulatory capital by Basel III has in turn raised some key questions concerning the capital raising exercise of Islamic banking institutions (IBIs). It is asked whether the Basel III capital instruments are equally acceptable from a Shari’ah perspective – in terms of contracts and characteristics – and in terms of

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meeting the objective of strengthening the resilience of IBIs in the event of economic and financial stress. Accordingly, regulatory bodies such as Bank Negara Malaysia (BNM) and standard setting bodies such as the Islamic Financial Services Board (IFSB) have issued guidelines for IBIs on the maintenance of regulatory capital in compliance with Basel III regulations. The Capital Adequacy Framework issued by BNM (2012) is applicable to IBIs in Malaysia; while Exposure Draft-15 issued by IFSB (2012) – which is still going through the process of revision based on public consultation and expected to be finalized by the end of 2013 – provides guidance to regulators and IBIs worldwide on the maintenance of high-quality regulatory capital components which comply with Shari’ah rules and principles.

Currently discussions about suitable instruments which will meet both Shari’ah requirements and the objectives of Basel III are not yet settled. This research accordingly looks into the regulatory capital instruments for IBIs and in this respect, has set out the following main objectives: (i) to examine the key criteria for classifying capital instruments under Additional Tier 1 (AT1) and Tier 2 (T2) capital under Basel III; (ii) to discuss the current subordinated sukuk issued by IBIs worldwide for meeting regulatory capital requirements; (iii) to examine the Shari’ah issues relating to the capital instruments of IBIs arising in both equity-based and exchange-based contracts; and (iv) to deliberate on the most suitable Shari’ah-compliant contracts for raising regulatory capital by IBIs that will meet the objectives of Basel III.

Accordingly, the research is organized as follows: Section 2 examines the definition of capital and criteria of the instruments from Basel III perspective. Section 3 thereafter examines the current subordinated sukuk issued by IBIs for meeting regulatory capital. Section 4 then deliberates on the Shari’ah issues arising from the consideration of equity-based and exchange-based contracts to structure AT1 and T2 capital instruments. In particular, this section focuses on the issue of subordination and conversion of the capital instruments. In the light of the discussions, Section 5 deliberates on the Shari’ah-compliant structures most suitable for meeting regulatory capital requirements of IBIs. Section 6 finally concludes the discussion.

2. CAPITAL: BASEL III PERSPECTIVE

The need for good quality capital is essential during times of crisis. Basel III effectively aims to ensure that banks have sufficient regulatory capital to meet their obligations in the event of losses and thus reduce the need for bail out by the public sector – as was the case during the last financial crisis. This section examines the definition of regulatory capital under Basel III, delineates the criteria set out by Basel III for classifying instruments under T1 and T2 capital, and summarizes the type of instruments that will meet Basel III criteria for T1 and T2 capital.

2.1. Definition of Regulatory Capital: From Basel II to Basel III

It is noted that Basel II classified capital under Tier 1, Tier 2 and Tier 3. While total regulatory capital has been maintained at 8% of risk-weighted assets (RWA) under Basel III (similar to Basel II), Basel III abolished Tier 3 and classified regulatory capital under only T1 and T2. The components of T1 and T2 have also been changed from 4% each under Basel II to T1 being 6% and T2 being 2% under Basel III. Common Equity Tier 1 (CET1) under Basel III has been increased from 2% under Basel II to 4.5% to improve the quality of the capital base. Moreover, a Capital Conservation Buffer CET1 of 2.5% has been added which is to be attained by 2019. This will increase total regulatory capital to 10.5% as compared to the current 8% of RWA. These changes are depicted in Figure 1.
As indicated above, Basel III has distinguished between going-concern (where the bank is still solvent and continuing operation) and gone-concern (where the bank is insolvent and will be wound-up) scenarios and has thus specified the type of capital instruments that will be affected by adverse economic conditions based on the stage at which the crisis happens. T1 capital, which comprises Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1), will absorb losses during going-concern. T2 refers to gone-concern capital, which will absorb further losses when the bank reaches the point of non-viability (but may not be necessarily wound up).

Given the distinction between going-concern and gone-concern capital, it means that losses will be deducted from respective capital components in certain specific order: first, it will be borne by CET1; then followed by AT1 capital; ultimately, further losses will be absorbed by T2 capital when the bank reaches the point of non-viability. In principle, depositors and general creditors will be last to bear losses in the event of liquidation. This ranking of the capital instruments supports the overall objective of Basel III which aims at ensuring that the bank has sufficient capital to bear losses during times of crises. Hence, the strategy adopted by Basel III is for banks to issue capital instruments which make capital available on a long term basis and which are equity-like in principle – or at least be convertible to common equity or has mandatory write-down features – such that they have the ability to absorb losses by being ranked below other categories of liabilities.

2.2. Criteria for Regulatory Capital

According to Basel III, the key criteria for the instruments issued by banks to meet the CET1 (particularly common shares), AT1 and T2 capital requirements are summarized in Table 1.

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4 In between the situation of financial health during going-concern and the winding-up scenario during gone-concern is also the situation of non-viability where the bank is still running but faces times of financial stress. Often, measures are taken at this point to ensure continuity in the operations of the bank so that it is not necessarily wound-up.
### Table 1: Key Criteria for Classifying Capital Instruments under Basel III

<table>
<thead>
<tr>
<th>Common Shares</th>
<th>AT1</th>
<th>T2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued and paid-in</td>
<td>Issued and paid-in</td>
<td>Issued and paid-in</td>
</tr>
<tr>
<td>Most subordinated claim in liquidation of the bank</td>
<td>Subordinated to depositors, general creditors and other holders of subordinated debt of the bank (i.e. it must be senior only to common equity)</td>
<td>Subordinated to depositors and general creditors of the bank (i.e. it must be senior to AT1 and common equity)</td>
</tr>
<tr>
<td>Absorb losses on going-concern basis and pari-passu within the highest quality of capital</td>
<td>Absorb losses on going-concern basis</td>
<td>Absorb losses on gone-concern basis</td>
</tr>
<tr>
<td>Principal is perpetual (i.e. has no scheduled repayment/maturity date) and never repaid outside of liquidation.</td>
<td>Perpetual in nature (i.e. has no scheduled repayment/maturity date) and has no step-up or other features which provide incentives to redeem</td>
<td>Minimum maturity shall be at least 5 years and has no step-up or other features which provide incentives to redeem</td>
</tr>
<tr>
<td>Bank does not create an expectation at issuance that instrument will be bought back, redeemed or cancelled</td>
<td>Any repayment of principal (through repurchase or redemption) must be with prior supervisory approval</td>
<td>Investor has no right to accelerate repayment of future scheduled payments (coupon or principal) except in bankruptcy and liquidation</td>
</tr>
<tr>
<td>Dividend is fully discretionary and non-cumulative. Non-payment is not an event of default.</td>
<td>Dividend/coupon is fully discretionary and non-cumulative. Non-payment is not an event of default.</td>
<td></td>
</tr>
<tr>
<td>Distributions paid only after all legal and contractual obligations have been met and payments on more senior capital instruments made.</td>
<td>Distribution of profits should not be linked to the credit rating of the bank.</td>
<td>Distribution of profits should not be linked to the credit rating of the bank</td>
</tr>
<tr>
<td>Classified as equity for accounting purposes</td>
<td>Instruments cannot contribute to liabilities exceeding assets</td>
<td></td>
</tr>
<tr>
<td>Bank cannot directly or indirectly have funded the purchase of the instrument.</td>
<td>Neither the bank nor a related party to the bank can purchase the instrument.</td>
<td>Neither the bank nor a related party to the bank can purchase the instrument.</td>
</tr>
</tbody>
</table>

Instruments can be issued indirectly

Instrument can be issued indirectly
Based on the criteria set out in Table 1 above, AT1 and T2 capital instruments should in principle be:

(i) Long-term in nature with maturity of at least 5 years for T2 instruments and perpetual for AT1 instruments (although AT1 instruments may be callable after minimum of 5 years at the initiative of the bank subject to certain conditions). This criterion limits the redemption of the instruments, hence assuring the availability of the capital raised through the issuance of these instruments on a long-term basis.

(ii) Subordinated instruments that can be ranked junior in right and priority of payment compared to other creditors and would be able to absorb losses in the event of non-viability. In the case of T2 instruments, they will absorb losses only under gone-concern scenarios. T2 instruments rank junior in their rights of payment compared to deposit liabilities and general creditors and senior vis-à-vis AT1 instruments. On the other hand, AT1 instruments will bear losses in even going-concern scenarios and will rank junior to T2 instruments. Nonetheless, both AT1 and T2 instruments will rank senior to common equity (CET1).

(iii) Unsecured in nature (i.e. not backed by any collateral or covered by any guarantee of the bank). This ensures that there is no security to rely upon for repayment of the capital raised through the instrument during times of losses and consequently the instrument will be able to absorb losses.

(iv) In the case of AT1 capital instruments, debt instruments must have principal loss absorption capacity through mandatory conversion to common shares or write-down at a pre-specified trigger point. Conversion of debt instruments to equity structures at some trigger point ensures that the instrument will not have its capital guaranteed (or represent liabilities) and thus is able to absorb losses (by representing equity).

Therefore based on the above criteria for classifying capital instruments, CET1, AT1 and T2 capital can take the form as described in Table 2. Table 2 further compares the capital instruments with those under Basel II.

<table>
<thead>
<tr>
<th>Basel II</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 3</td>
<td>Tier 3</td>
</tr>
<tr>
<td>• Short term subordinated debt</td>
<td>• Abolished</td>
</tr>
<tr>
<td>Tier 2</td>
<td>Tier 2</td>
</tr>
<tr>
<td>• Undisclosed reserves</td>
<td>• Long term instruments (of at least 5 years maturity) which behave like debt in principle, are unsecured and can be subordinated or ranked junior to other debts (e.g. depositors and general creditors) in terms of their right and priority of payment.</td>
</tr>
<tr>
<td>• Asset revaluation reserves</td>
<td>• This subordinated debt will however rank senior to AT1 instruments and CET1 (Classified as liability for accounting purposes).</td>
</tr>
<tr>
<td>• General provisions/loan-loss reserves</td>
<td></td>
</tr>
<tr>
<td>• Hybrid (debt/equity) capital instruments e.g. Perpetual cumulative preference shares; Long term preference shares; Perpetual debt instruments</td>
<td></td>
</tr>
<tr>
<td>• Long term subordinated debt</td>
<td></td>
</tr>
<tr>
<td>• Fixed term subordinated securities</td>
<td></td>
</tr>
<tr>
<td>• Perpetual subordinated debt</td>
<td></td>
</tr>
<tr>
<td>Innovative Tier 1</td>
<td>Additional Tier 1</td>
</tr>
<tr>
<td>• Innovative tier 1 instruments</td>
<td>• Perpetual Instruments which are equity in nature, e.g., perpetual non-cumulative</td>
</tr>
</tbody>
</table>

Source: BCBS (2011)
preference shares (classified as equity for accounting purposes).
• Perpetual instruments (or at least long term with minimum of 5 years maturity) which are equity-like in nature, are unsecured, and can be subordinated or ranked junior to T2 instruments, depositors and general creditors. AT1 instruments will however rank senior to CET1 (classified as equity for accounting purposes).
• Debt-based instruments which are convertible to common equity or be written down at some pre-specified trigger event (classified as liability for accounting purposes).

<table>
<thead>
<tr>
<th>Core Tier 1</th>
<th>Common Equity Tier 1 (CET1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Paid up share capital</td>
<td>• Common shares issued by the bank</td>
</tr>
<tr>
<td>• Disclosed reserves</td>
<td>• Stock surplus</td>
</tr>
<tr>
<td>2%</td>
<td>• Retained earnings</td>
</tr>
<tr>
<td></td>
<td>• Other comprehensive income and disclosed reserves</td>
</tr>
<tr>
<td></td>
<td>• Common shares issued by consolidated subsidiaries of the bank and held by third parties</td>
</tr>
<tr>
<td>4.5%</td>
<td></td>
</tr>
</tbody>
</table>

Sources: BCBS (2006); Gleeson (2010: 46); Authors’ Own

3. SUBORDINATED SUKUK ISSUED BY IBIs AS REGULATORY CAPITAL

This section examines the types of sukuk which have been issued by IBIs for meeting regulatory capital requirements. It is noted that so far only two sukuk have been issued worldwide based on Basel III capital requirements – notably, the subordinated, perpetual mudarabah sukuk issued by Abu Dhabi Islamic Bank (ADIB) in 2012 as AT1 capital; and the issuance of a USD 1 billion AT1 perpetual sukuk by Dubai Islamic Bank (DIB) in March 2013.

A list of subordinated sukuk issued by various IBIs as T2 capital under Basel II is provided in Table 3. It is to be noted that the criteria for T2 capital under Basel II align with the need to issue subordinated capital instruments under Basel III. Accordingly, the sukuk issued in compliance with Basel II are still deemed relevant to the discussion of this paper.
<table>
<thead>
<tr>
<th>IBIs</th>
<th>Programme</th>
<th>Issued Amount</th>
<th>Issuance Date</th>
<th>Shari'ah Structure</th>
<th>Maturity</th>
<th>Profit Rate</th>
<th>Type of Capital</th>
<th>In Compliance with</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIMB Islamic Bank</td>
<td>RM 2,000 mil</td>
<td>RM 550 mil</td>
<td>25 Sep 2009:</td>
<td>Musharakah</td>
<td>25 Sep 2025</td>
<td>5.85%</td>
<td>T2</td>
<td>Base 1 II</td>
</tr>
<tr>
<td></td>
<td>CIMB Islamic Bank</td>
<td></td>
<td>21 Apr 2011:</td>
<td>Musharakah</td>
<td>21 Apr 2021</td>
<td>4.20%</td>
<td>T2</td>
<td>Base 1 II</td>
</tr>
<tr>
<td>Maybank Islamic</td>
<td>RM 1,000 mil</td>
<td>31 Mar 2011</td>
<td>Musharakah</td>
<td>31 Mar 2021</td>
<td>4.22%</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
<tr>
<td>Bank Muamalat Malaysia</td>
<td>RM 400 mil</td>
<td>15 June 2011</td>
<td>Musharakah</td>
<td>15 June 2021</td>
<td>5.15%</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
<tr>
<td>Am Islamic Bank</td>
<td>RM 2,000 mil</td>
<td>RM 600 mil</td>
<td>30 Sept 2011</td>
<td>Musharakah</td>
<td>30 Sept 2021</td>
<td>4.40%</td>
<td>T2</td>
<td>Base 1 II</td>
</tr>
<tr>
<td>Bank Al Jazira</td>
<td>SAR 1,000 mil</td>
<td>29 Mar 2011</td>
<td>Mudarakah (51%) and Murabahah (49%), callable after 5 years</td>
<td>29 Mar 2021</td>
<td>SIBOR +170 bps</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
<tr>
<td>Saudi Hollandi Bank</td>
<td>SAR 775 mil</td>
<td>2009</td>
<td>Mudarakah callable after 5 years</td>
<td>2019</td>
<td>SIBOR + 190 bps</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
<tr>
<td>Saudi British Bank</td>
<td>SAR 1,500 mil</td>
<td>2012</td>
<td>Senior 2008 SR1,705 million SABB notes</td>
<td>2017</td>
<td>-</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
<tr>
<td>Bank Syariah Mandiri</td>
<td>IDR 275 bil ($29,972,752) and IDR 150 bil ($16,348,773)</td>
<td>19 Dec 2011</td>
<td>Mudarakah (callable after 5 years)</td>
<td>19 Dec 2021</td>
<td>10%</td>
<td>T2</td>
<td>Base 1 II</td>
<td></td>
</tr>
</tbody>
</table>
In general, the following key features were observed about the sukuk issued by IBIs for raising regulatory capital:

### i. General Obligation Sukuk

In practice, IBIs have been issuing general obligation sukuk whereby the sukuk is linked neither to any specific project nor to any underlying asset. No specific assets are also purchased with the sukuk proceeds; instead, the sukuk proceeds (total or partly) are co-mingled in the general Shari’ah-compliant financial services business of the obligor (IBI). Under this type of sukuk, the obligor will have a general obligation to pay the sukuk holders.

The appropriate Shari’ah structure suitable for issuing general obligation sukuk is in fact unrestricted equity-based contracts, which do not require a specific underlying asset to be associated with the issuance (Mokhtar, unpublished). Indeed, from Table 3, it is noted that most of the sukuk issued have been structured using the musharakah or mudarabah principles. The musharakah sukuk in some cases referred to (i) a partnership being established among the sukuk holders (investors) (e.g. AmIslamic bank, CIMB Islamic bank) and (ii) in other cases represented a partnership established between the sukuk holders and the IBI (e.g. Maybank Islamic, Bank Muamalat Malaysia). The first form essentially works like a wakalah, with the sukuk holders (investors) representing the principal (muwakkil) and the IBI representing the agent/manager (wakil); yet the structure has been recognized as a musharakah sukuk on basis of the partnership formed among the sukuk holders. The second form is a musharakah which is formed between the issuer (IBI) which contributes its share of the business and the sukuk holders who invest their share of capital to the partnership venture.

Even when the sukuk has been called a mudarabah sukuk, essentially the sukuk represented a musharakah structure, with the partnership formed between the sukuk holders and the IBI. One such case is the mudarabah sukuk issued by the Saudi Hollandi Bank where both the musharakah and mudarabah principles apply; the bank, in this case represented a mudarib (manager) of and a musharik (partner) in the ownership of the portfolio of assets (Elgari, n.d.). The forms of musharakah and mudarabah subordinated sukuk issued in practice are as depicted in Figure 3 below.
**Figure 3: Forms of Mudarabah and Musharakah Subordinated Sukuk issued in Practice**

<table>
<thead>
<tr>
<th>Mudarabah Sukuk</th>
<th>Musharakah Sukuk</th>
<th>Musharakah Sukuk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank (as mudarib-managing the venture)</strong></td>
<td><strong>Bank (as a manager of the musharakah venture)</strong></td>
<td><strong>Bank (as one side of the partnership)</strong></td>
</tr>
<tr>
<td><strong>Sukukholders (represent investors as rabb al-mÊl)</strong></td>
<td><strong>Sukukholders (where the musharakah is among the sukukholders)</strong></td>
<td><strong>Sukukholders (representing the other side of the partnership)</strong></td>
</tr>
</tbody>
</table>

(Essentially a *musharakah* between bank the bank and sukukholders sukukholders) but called a *mudarabah*

Source: Authors’ Own

**ii. Subordinated Sukuk**

Overall, the principle of subordination has been applied to the equity-based *sukuk* issued. In general, the ranking of the subordinated *sukuk* vis-à-vis other obligations of the issuer follows the order as below: (i) Deposit liabilities and other liabilities; (ii) Senior Creditors; and (iii) Subordinated *Sukuk* ranked *pari passu* with other Subordinated debt of issuer.

The Principal Terms and Conditions (PTC) of most of the *sukuk*, however, do not specify the ranking of the *musharakah* or *mudarabah sukuk* vis-à-vis ordinary share capital. AmIslamic Bank is the only exception which clearly specifies that the *Musharakah Sukuk* will rank senior to ordinary share capital.

**iii. Unsecured Sukuk**

The *sukuk* represented unsecured obligations of the issuer and no collateral is given to back their repayment. In the case of the Malaysian *sukuk*, although no collateral was used as security for the *sukuk*, the elements of Purchase Undertaking and Sale Undertaking (PU and SU) were present to ensure purchase of the trust assets by the obligor. It is noted that according to the practice in Malaysia, it is allowed to include a PU to repurchase the assets from the *sukuk* holders at nominal value at maturity (Saripudin et. al., 2012). According to Securities Commission Malaysia (2012: 161), PU is not considered a condition in the contract between the issuer and the investors as it is not included in the main *sukuk* contract. In form, therefore, it is not deemed as representing the guarantee of capital repayment of the *sukuk*.

**4. SHARI’AH ISSUES RELATING TO CAPITAL INSTRUMENTS FOR IBIs**

According to Basel III, some instruments would have to be ranked senior or junior to others to enable them bear losses either under going-concern or gone-concern scenarios (e.g. T2 bears losses only under gone-concern and is ranked senior to AT1; AT1 bears losses even during going-concern scenario and is ranked senior to common equity). This therefore necessitates the issuance of subordinated instruments by banks for their capital raising purposes. Subsequently, the questions asked are: What is meant by subordination? Would the issuance of subordinated instruments by IBIs implicate any issues from the Shari’ah perspective? This section will discuss
the issue of subordination in relation to both equity-based and exchange-based instruments, along with discussing the issue of conversion of capital from the Shari’ah perspective. This is because AT1 instruments under Basel III can either be converted into common equity upon some trigger event to enable them bear losses or be written-down.

4.1. What is Subordination?

The key characteristic to achieve loss absorbency is through subordination. Subordination is “a transaction whereby one creditor (the subordinated or junior creditor) agrees not to be paid by a borrower or other debtor until another creditor of the common debtor (the senior creditor) has been paid” (Wood, 2007: 177). According to FSA (2007: 6), subordinated instruments act as a buffer to absorb losses during a gone-concern situation thus providing protection to all senior creditors, especially depositors.

4.2. Subordination in relation to Equity-based Instruments

As elaborated in Section 3, most of the IBIs have so-far raised regulatory capital via equity-based sukuk such as musharakah and mudarabah structures to meet both Basel II and Basel III requirements. Although some of the equity-based sukuk are structured using mudarabah, the structure is essentially a musharakah whereby a partnership is formed between the sukuk holders and the IBI as the capital raised from the sukuk holders (investors as rabb al-mal) is co-mingled with that of the issuer (IBI as mudarib who manages the musharakah venture) and used for the general obligation of the IBI. In theory, the rabb al-mal in mudarabah subordinated sukuk has an ownership claim over the proportion of the assets financed by his mudarabah funds. However, in practice, once the assets have been used by the IBI for its general obligation (not for a specific asset), the mudarabah funds of the rabb al-mal can no longer be distinguished from the IBI’s assets. Hence, although the structure is called mudarabah, in essence it takes the ruling of musharakah.

Meanwhile, there are two forms of musharakah subordinated sukuk issued by IBIs as regulatory capital under Basel II: (i) partnership between the issuer (IBI) and the investors (sukuk holders); and (ii) partnership among the investors, where the issuer acts as a manager/agent (wakil) of the venture and investors become principal (muwakkil).

It is noted that in principle, wakalah contract can also be used to raise regulatory capital to meet Basel III requirements for AT1 as under this contract, the loss is borne solely by the principal (investors) and the profit also belongs to him. As such, the element of subordination is inherently embedded. Nonetheless, similar to the mudarabah structure, the wakalah sukuk is also essentially a musharakah as the capital raised will be used for the general obligations of the IBIs, not for investment in a specific asset. Even though in theory the muwakkil of the wakalah fund has the ownership claim over his proportion of assets, once his funds are co-mingled with the manager’s assets, the segregation between both funds are quite impossible. Thus, even though the structure is called wakalah, in essence it works like musharakah.

Therefore, the paper is of the view that only musharakah sukuk can be used for structuring AT1 instruments for meeting Basel III requirements. Other equity-based structures such as mudarabah and wakalah sukuk (either restricted or unrestricted) cannot be considered for AT1 under Basel III for the capital raised thereof should be used for specific assets, similar to the investment account holders (IAH) account, thus cannot be calculated as part of the IBIs’ capital.

Given the above facts, the discussion on subordination in relation to equity-based instruments will focus on the concept of subordination in the musharakah contract. Accordingly, this section looks in detail whether ordinary shareholders can be subordinated to equity-based sukuk holders despite musharakah is the underlying contract for both, or should each ordinary shareholders and equity-based sukuk holders be ranked pari passu with one another in terms of payment. The section also examines the need to achieve loss absorbency via the conversion of equity-based sukuk into ordinary shares.
4.2.1 Subordination in Musharakah Contract

In principle, under a musharakah contract, it is not possible for one partner to be subordinated vis-à-vis another partner, whereby one partner has a priority in receiving payments (i.e. the expected profit on the periodical distribution date and capital in the event of winding up) based on the following two fundamental rules of a musharakah contract: “Profit is based on the agreement of the parties, but loss is always subject to the capital contribution [of investment]” (Al-San'ani, 1403H, 8: 248).

Profit and Loss Sharing among Musharakah Partners

The above rule underlines how profit is to be distributed and loss is to be shared among partners in a musharakah contract. Although jurists unanimously agree that each musharakah partner should bear losses in proportion to their capital contribution only (Al-Sarakhsi, 1993, 11: 156), they have different opinions regarding the bases for entitlement to profit. Hanafis and Hanbalis view that partners are entitled to profit based on three factors: wealth, work and liability for bearing loss, relying on the following principle: “The entitlement to profit is either due to wealth (mal) or work ('amal) or liability for bearing loss (daman)” (Al-Kasani, 1986, 6: 62)

Accordingly, they allow for musharakah partners to agree on the profit to be in proportion to the capital contribution or in excess of it based on stipulation. Hence, they permit excess profit for excess work, except that Hanbalis allow the excess of profit to be merely based on stipulation, regardless whether the partner is a working or sleeping partner (Ibn Qudamah, 1968, 5: 23); while Hanafis argue that if partners stipulate that only one partner will manage the musharakah venture, then the sleeping partner will not get more than his capital contribution (Al-Sarakhsi, 1993, 11: 154).

The AAOIFI (2010: 208) also adopts the opinion of Hanafis where the Shari'ah standard on musharakah provides that: In principle, the shares of profit must be in proportion to the percentage of each partner’s contribution to the Sharika capital. Nevertheless, the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided that the additional percentage of contribution to the capital is not in favour of a sleeping partner. If a partner did not stipulate a condition that he 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.

Malikis and Shafi’is, on the other hand, opine that the proportion of profit, similar to the sharing of loss, should conform to the capital contribution (Al-Madani, 1994, 3: 605; Al-Sharbini, 3: 227).

While the above arguments indicate that there are differences of opinion among schools of thought with regard to the percentage of profit due to each partner, no discussion is found in the fiqh literature on whether it is possible to give priority of payment to one partner in a musharakah venture before another partner is paid.

Nonetheless, some contemporary scholars have allowed subordination in musharakah, through the concept of tanazul. The resolutions of the Securities Commission Malaysia Shari’ah Advisory Council (2007: 92-93) provide that non-cumulative preference shares are permissible based on the concept of tanazul, which refers to “surrendering the rights to a share of the profits based on partnership, by giving priority to the preference shareholders”. This tanazul is willingly given upfront by the ordinary shareholders to the preference shareholders during the Annual General Meeting (AGM) of a company.

The definition, at a first glance, indicates that tanazul connotes the same meaning with isqat al-haq (relinquishment of one’s right), which is normally discussed in the context of ibra’. Yet, ibra’ itself has been
defined by jurists in two ways, either as *isqat* (relinquishment of one’s right) or *tamlık* (transfer of ownership), or both as in the case of providing *ibra’* for outstanding debts.⁵

Nevertheless, a closer look at these terminologies, i.e. *isqat al-haq* and *ibra’*, reveals that they are related to something which has been established, or the causes for entitlement have already existed, while *tanazul* in the context of *musharakah* is related to something which is yet to exist (Hasan, 2010). In other words, when one partner forgoes his right to be ranked *pari passu* with other partners in receiving payments, neither the profit nor the causes for his entitlement to profit (i.e. the investment) have yet existed.

Hasan (2010) suggests that this kind of *tanazul* can be considered a gift for something which is not in existence (*hibah bi al-ma’dam*), based on the view of Malikis who allow one partner to willingly give more profit to another partner on a charitable (*tabarru’*) basis. Al-Khurashi (n.d, 6: 45-46) mentions:

> “Profit and loss are based on the capital contribution, which means that when the capital of partnership gains profit or loss, it is compulsory to distribute it among the partners according to their capital contribution, which can be equal or variant, whether they stipulate it or are silent about it. Similar to profit and loss, work shall also be proportionate to capital. The sharikah is void when any variance is stipulated, as each partner is entitled to a fee for the work done for the other partners. This means the sharikah is void when variance to the profit is stipulated in the contract… Nevertheless, one of the partners can make a voluntary donation, give a loan or a hibah after the contract. In other words, he can donate a portion of the profit or the work to his partner after concluding the contract [emphasis added]. He can also give him a loan or gift him something [from the profit] after concluding the sharikah contract, because what comes after the [conclusion] of contracts is different from what is included in them.”

The above quotation indicates that Maliki jurists allow the percentage of profit distribution to be in excess of the capital contribution (i.e. different from the percentage of capital contribution) if it is voluntarily given via *tabarru’* or *hibah* after the conclusion of the contract, not before or in the contract. For instance, if A contributes 30% and B contributes 70% of capital, in the contract, A and B shall receive 30% and 70% profit respectively (whether it is stipulated or otherwise), as profit should be proportionate to the capital contribution. Nevertheless, after the conclusion of the *musharakah* contract, both can negotiate to amend the percentage of the profit where B can voluntarily give 10% of his profit percentage to A, and thus the new percentage of profit shall be 40% for A and 60% for B.

By saying this, Malikis do not in any way indicate that one of the partners can have a priority in getting the profit or the capital as embodied in the concept of subordination. Therefore, it is inaccurate to claim that *hibah bi al-ma’dam* can be a basis for allowing *tanazul* of right that has not been acquired or established, as Malikis’ opinion in this context is similar to that of Hanafis’ and Hanbalis’ on permitting variance of profit from the capital contribution, as mentioned earlier, except that the former do not allow for a stipulation in the contract unlike the latter.

In line with this, AAOIFI (2010: 204) rules that the determination of the percentage of profit due to each partner should not be deferred until the realization of the profit; rather to be determined at the time of concluding the *musharakah* contract. However, partners may mutually agree to amend the percentage of profit sharing on the

⁵ Ibn Humam (n.d, 4: 389) defines *ibra’* as “waiving the ownership that is in one’s liability”, while Al-Khurashi (n.d, 4: 7) defines it as “considering one’s debt to be a gift to [the debtor]”. Accordingly, the Hanafis and an opinion of the Malikis and the Shafi’is and the preponderant view of the Hanbalis refer to *ibra’* as an act of relinquishing one’s right. On the other hand, some Malikis, Shafi’is and Hanbalis consider *ibra’* as an act of transferring the ownership of one’s right. Other jurists such as Ibn Nujaym are of the view that *ibra’* can refer to both meanings, as in the case of providing *ibra’* for outstanding debt. See: Al-Mawsu’ah Al-Fiqhiyyah (1983, 1: 148-149).
date of distribution. A partner may also relinquish a portion of the profit that is due to him in favour of the other partners on the date of distribution.

Moreover, if one of the partners is given priority in receiving payment either through stipulation in the contract or through a promise after the contract, this will go against one of the muqtada al-‘aqd (nature and implication of the contract) and objective of musharakah which is about the making of profit and sharing it among the partners. Al-Sarakhsi (1993, 11: 156) states:

“This contract is a trust-based contract, and its objective is to gain profit, which is attained through the conscientious discharge of fiduciary duties. The amount of capital contributed by each partner should be made clear because, when it comes time to distribute the profit, each partner’s capital contribution must be accounted for in order to determine the profit.”

Similarly, with regard to loss, jurists unanimously agree that each musharakah partner should bear losses in proportion to their capital contribution only. Indirectly, it can be said that jurists do not agree on giving conditional priority to others in receiving payment so that loss is borne by one partner only. Accordingly, AAOIFI (2010: 204) provides:

“It is not permitted, therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for 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 loss at the time of loss”.

Based on the above arguments therefore, it can be summarized that: (i) Hanafis and Hanbalis agree that the ratio of profit sharing can be equal to capital contribution or in excess of it based on the agreement among the partners in the contract; while Malikis allow for voluntary renegotiation of the profit sharing ratio in excess of capital contribution after the conclusion of the musharakah contract; (ii) there is no discussion among jurists that one of the partners can have a conditional priority in getting the profit or the capital as embodied in the concept of subordination; (iii) jurists unanimously agree that losses should be borne by each partner in proportion to capital contribution and thus no partner can be ranked junior to absorb more losses. Nevertheless, one partner can voluntarily bear the loss at the time of loss without any prior condition.

Unilateral Promise (Wa’ad) for Isqat al-Haq

Although as mentioned above, it is not possible for tanazul to be based on hibah bi al-ma’dum, one possible mechanism of structuring subordinated equity-based instruments is via wa’ad bi isqat al-haq, commonly known as wa’ad bi tanazul (promise to relinquish one’s right). According to AAOIFI (2010), a wa’ad (promise) is not considered an integral part of a transaction and as such would not lead to a combination of two contracts in one. However, since wa’ad is legally binding according to Hanafi (Ibn Nujaym, 1999: 247) and Maliki scholars (Ibn Rushd, 1988: 15: 318) if it is contingent upon a condition or related to a cause (in our case, the cause being the loss in the event of non-viability), the promisor (equity sukuk holder) has no option but to forgo his right to receive the profit or capital. Accordingly, the inclusion of the wa’ad will lead to violation of the muqtada al-‘aqd of the musharakah contract, which is about sharing profit and loss. Therefore, this paper is of the view that subordination of equity holders via wa’ad is a hilah (legal stratagem) and should not be adopted.

Knowing the fact that Muslim jurists unanimously agree that musharakah partners rank pari passu in terms of loss, can we still rank musharakah sukuk holders above ordinary shareholders in order to meet Basel III requirements? This issue will be deliberated in the following sub-section.

4.2.2. Subordinating Ordinary Shareholders vis-à-vis Musharakah Sukuk holders
Under Basel III, ordinary shareholders (CET1) are considered the lowest in rank compared to AT1 and T2 capital instruments. Shari’ah issues therefore arise if AT1 and T2 instruments were structured using musharakah contracts which usually represent sukuk whose proceeds are invested in the general financial business of the IBIs. In substance therefore these general obligation musharakah sukuk are similar to ordinary shares and should be ranked pari passu. However, based on the argument provided in Section 4.2.1, where some scholars have allowed for subordination of one partner vis-à-vis another on the principle of tanazul, ordinary shareholders can be subordinated in ranking vis-à-vis musharakah sukuk holders (whether AT1 or T2) if they agree that they are the last in rank to receive payment and agree to waive their right of receiving payment on the basis of tanazul. In other words, the musharakah sukuk holders will be given priority to receive payment compared to ordinary shareholders.

However, based on the justifications given earlier, this paper is of the view that subordination of CET1 vis-à-vis musharakah sukuk is not possible. From a Shari’ah viewpoint, they should be ranked pari passu and be treated equally in terms of loss absorption.

Accordingly, from the Shari’ah perspective, it is not possible to maintain Basel III’s ranking order of CET1 (ordinary shares) representing the most subordinated claim in the event of liquidation, to be followed by AT1 and then T2 capital, if both AT1 and T2 are structured using musharakah contracts (unless legal stratagem like wa’ad bi tanazul is applied). Nonetheless, if the IBIs would like to comply with the philosophy of Basel III which in substance aims to increase the percentage of total equity in 8% of the RWA, they can issue musharakah subordinated sukuk for both AT1 and T2 instruments (as an additional capital) without making any distinction between going-concern and gone-concern capital.

4.2.3. Conversion of Equity-based Sukuk into Ordinary Shares

If equity (musharakah) sukuk holders and ordinary shareholders are ranked pari passu, the question asked is whether it is necessary for equity-based sukuk to be converted into ordinary shares in the event of loss?

From the Shari’ah perspective, as argued earlier, both ordinary shares and the general obligation equity-based sukuk are categorized equally and thus will bear losses equally in the event of loss or liquidation. Hence, there is no need to ‘convert’ equity-based sukuk into ordinary shares per se to make them absorb losses. In addition, if the musharakah sukuk issued by the IBIs is classified as non-voting common shares or Class B shares – like in conventional finance – the sukuk holders are ranked pari passu with the ordinary shareholder in the event of loss. Yet, both can mutually agree that equity sukuk holders may receive a higher profit rate compared to the shareholders. This is permissible based on the opinion of Hanafis, Hanbalis and AAOIFI standard mentioned earlier regarding profit and loss sharing, provided that equity sukuk holders do not stipulate a condition that they are sleeping partners even though they do not actually work.

Nonetheless, from a practical perspective, it can be argued that these equity-based sukuk after all represent a different legal form, especially in the case of Malaysia where generally equity-based sukuk include features such as purchase undertaking (PU) or sale undertaking (SU) which, in substance, provide some form of guarantee of capital to the sukuk holders. As such, their conversion into ordinary shares is necessary to make them actually bear losses.

It should also be noted that although Basel III suggests that AT1 instruments can be written down, such mechanism for the equity-based sukuk cannot be adopted as it is not in line with the nature of equity contracts which are inherently loss absorbent.

4.3 Subordination in relation to Exchange-based Instruments

This section discusses the possibility of structuring AT1 and T2 using exchange-based contracts. The discussion will focus on two main issues: (i) subordinating AT1 to T2 capital instruments and (ii) subordinating T2 capital instruments to depositors and other creditors of the IBI.
4.3.1 **Subordinating AT1 to T2 Capital Instruments**

There are two possible scenarios that can be discussed in relation to the subordination of AT1 to T2 capital instruments: (i) subordinating equity-based AT1 to exchange-based T2 capital instruments; and (ii) subordinating exchange-based AT1 to exchange-based T2 capital instruments.

As for the first scenario, it can be said that subordinating holders of AT1 capital instruments to holders of T2 capital instruments is justified since the holders of the equity-based AT1 instruments are considered partners of the IBI’s shareholders and as a result, they are exposed to losses whilst the IBI is still in operation. On the other hand, the holders of exchange-based T2 instruments represent liabilities and are entitled to receive payments of their outstanding debt, with their right of payment being unaffected by the normal losses borne by the IBI during the course of its operations. Therefore, T2 capital instruments remain immune from bearing any losses during the going-concern scenario. The same rule applies when the IBI reaches the point of non-viability (gone-concern scenario), because all the outstanding debts resulting from T2 capital instruments are a liability that must be settled as long as the IBI is still in operation regardless of whether it reached the point of non-viability or not. Finally, in the event of the IBI declaring its bankruptcy T2 exchange-based capital instruments will still be senior to AT1 equity-based instruments. Therefore, the debt claims of such instruments must be settled first before holders of AT1 equity-based capital instruments and common shareholders can receive their share of whatever remains of the IBI’s assets.

The second scenario as we have mentioned above involves the subordination of AT1 exchange-based capital instruments to T2 exchange-based capital instruments. Such a scenario is unlikely because having AT1 capital instruments structured using exchange-based contracts is not in line with the Basel III requirements, which requires that such instruments should be perpetual in nature and no debt instrument can have such characteristic. Therefore, there is no need to look into such a scenario from Shari’ah perspective, since it is impossible for such a scenario to exist in reality.

4.3.2 **Subordinating T2 Capital Instruments to Deposit Liabilities and General Creditors**

This sub-section addresses the issue of subordinating T2 capital instruments to current and saving accounts and general creditors of the IBI during the going-concern, gone-concern (non-viability) and liquidation scenarios.

Since we have already established in the previous sub-section that it is not possible to issue exchange-based AT1 capital instruments, the only plausible scenario is having AT1 equity-based capital instruments and T2 exchange-based capital instruments along with current and saving accounts and general creditors of the IBI. In such a scenario, AT1 capital instruments rank lower than the debt claims of T2 capital instruments, current and saving accounts and general creditors of the IBI during the going-concern, gone-concern (non-viability) and liquidation scenarios. This is due to the reasons mentioned in the previous sub-section. However, the debt claims of T2 capital instruments cannot be ranked junior to the debt claims of current and saving accounts and those of the general creditors of the IBI during the gone-concern and liquidation scenarios. In other words, all debt claims must be ranked *pari passu* with one another in terms of their right to receive payment. The Shari‘ah evidence for such position can be seen in various Hadiths that call upon the debtor to repay his creditor without giving preference to one creditor over the other. Among these hadiths is the saying of Prophet Muhammad - peace be upon him - (Al-Bukhari, 1422 A.H., 3:124-125, Hadith No. 2387) in which he stated: “Whoever takes the money of people with the intention of repaying it, Allah will repay it on his behalf, and whoever takes it in order to spoil it, then Allah will spoil him”

The above-mentioned Hadith is general in nature and call upon debtors to pay their creditors without giving priority for some creditors over others, as all of the creditors have equal rights in terms of receiving payment of their outstanding debts.

4.3.3 **Mechanisms to Subordinate Exchange-Based T2 Capital Instruments**
As mentioned earlier, Basel III suggests that AT1 instruments can be subordinated either through write-down mechanism or conversion to common shares at a pre-specified trigger point. Thus, the main issue of discussion in this sub-section is to find out whether these two mechanisms which were suggested to subordinate AT1 capital instruments, can also be used to achieve the effect of subordination for T2 exchange-based capital instruments without contravening the rules and principles of Shari’ah.

**Write down Mechanism via Ibra’**

The first mechanism suggested by Basel III to achieve the effect of subordination is the use of a write-down mechanism, whereby a portion of the outstanding debt will be written-down at a pre-specified trigger point. Therefore, we have the scenario of using *murabaha* and *ijarah sukuk* for structuring T2 capital instruments. In this regard, the main question is: can the use of write-down mechanism achieve the desired effect of subordinating T2 exchange-based capital instruments to current and saving accounts and general creditors of the IBI during the gone-concern and liquidation scenarios.

Before attempting to provide an answer to this question, it is essential that the mechanism of write-down be briefly discussed from the Shari’ah perspective. In this regard, it can be said that the mechanism of write-down is linked to the concept of *ibra’*, which can be defined either as *isqat* or *tamlik*, or both as in the case of providing *ibra’* for outstanding debts.

i. **Classical Jurists’ Views on Ibra’**

The general ruling concerning *ibra’* is that it is recommended because it is a type of *ihsan* (benevolence), since it involves relinquishing one’s right to receive one’s outstanding debt from an insolvent debtor and even if the debtor is solvent, then providing *ibra’* will strengthen the relationship between the creditor and the debtor (Al-Mawsu’ah Al-Fiqhiyyah, 1983, 1:147). This view is based on the Qur’an (2: 280) when Allah says: “And if the debtor is in a hard time (has no money), then grant him time till it is easy for him to repay, but if you remit it by way of charity, that is better for you if you did but know.”

Furthermore, the Prophet (Al-Tirmithi, 1975, 3:591, Hadith No. 1306) mentioned the great rewards that await those who give respite to insolvent debtors as he said: “He who gives respite to someone who is in straitened circumstances, or grants him remission, Allah will shelter him in the shade of His Throne, on the Day of Resurrection, when there will be no shade except His shade.”

Having said that, it is important to note that Muslim jurists did not discuss the issue of providing *ibra’* as a condition that can be stipulated in the initial agreement, rather they discussed the issue of having a conditional *ibra’* that takes place after the initial agreement has been executed (Al-Attram, 2006: 345, 355). In this regard, they discussed its pillars, conditions, types and various other issues related to it without deliberating on the issue of including it as a condition in an exchange-based contract. One reason could be due to the prohibition of combining an exchange-based contract with a charitable one. The prohibition of such combination is based on a Hadith by the Prophet (Abu Daud, n.d., 3: 283, Hadith No. 3504) in which he said: “It is not permissible to combine a loan and sale in one contract, or two conditions in one contract of sale, or gaining profit from an item not in your ownership, or to sell what you do not possess.”

In this regard, Ibn Taymiyyah (2003, 29: 62-63) affirmed the prohibition of combining an exchange-based contract with a charitable contract as the inclusion of the latter is done to facilitate the execution of the exchange-based contract and is not done solely for the purpose of charity. The logic behind such prohibition can be attributed to the fact that the essence of an exchange-based contract is based on the principle of justice, which is reflected through the equivalency of the two counter values (Al-Sarakhsi, 1993, 13:197; Al-Kasani, 1986, 5: 187). On the other hand, a charitable contract is based on the principle of benevolence, since one party does not get anything in return for what he gave the other party. Therefore, combining an exchange-based contract with a charitable one is not permissible as each one has its own purpose.
Furthermore, jurists are of the opinion that *ibra’* is a type of contract that must be issued in a form that is not appended to the future, regardless of whether the time in the future is specified or not. In other words, the effects of the contract must take place immediately as long as its pillars and conditions are fulfilled (Al-Mawsu’ah Al-Fiqhiyyah, 1983, 1:166).

Based on the above arguments, it can be summarized that: (i) jurists considered *ibra’* a type of charitable contract. Therefore, combining it with an exchange-based contract is not permissible since each type of contract has its own unique purpose. As such, including a charitable contract in an exchange-based transaction will not be for the purpose of charity; and (ii) jurists unanimously agree that *ibra’* is a type of contract whose effects must take place immediately and cannot be appended to a time in the future.

### ii. *Ibra’* in Contemporary Applications

At this point, it is important to note that contemporary scholars debated the issue of including *ibra’* as a condition in a financing agreement, whereby an IBI provides *ibra’* for the early settlement of an outstanding debt due by the customer. In this regard, it was the opinion of the Shari’ah Advisory Council of BNM that the inclusion of such a clause is permissible (BNM, 2010: 123). On the other hand, the Council of the Islamic Fiqh Academy prohibited the inclusion of such a clause in the financing agreement (OIC Islamic Fiqh Academy, 1985-2000: 135).

However, it is to be noted that the above-mentioned resolutions by the SAC of BNM and the Council of Islamic Fiqh Academy are not directly related to the issue of providing *ibra’* by the sukuk holders to the IBI. This is because in the case of the IBI providing *ibra’* to the customers, such an *ibra’* is given in the case of early settlement (or implicitly when the customer defaults given the fact that the total outstanding debt becomes due), whereby the IBI waives the unearned profit from the liability of the customer. However, in the case of sukuk holders providing *ibra’* to the IBI, they are being requested to waive not only their unearned profit but also their principal amount at a pre-specified trigger point.

Moreover, it can be argued that *ibra’* in a financing agreement is a mechanism to ensure that the principle of justice is achieved in the transaction, since the IBI is being asked to waive its unearned profit for the remaining duration of the contract only. This mechanism is justified since the profit arises because of the deferment and since the debtor was able to settle his debt before its due time. As such, the IBI cannot request the customer to pay the full price and if it does, then the IBI is taking that portion of the price without counter-value. In this regard, Ibn Abideen cites the case of a person purchasing an asset for ten on a spot basis and then selling it to another party for twenty on a deferred payment basis, the deferral period being ten months. If the buyer settles the debt or dies after five months, the seller shall take five as profit and leave the other five (Ibn Abideen, 1992, 6: 757). Based on this, if the customer settles his debt before its due time, the IBI should be compelled to forgo its unearned profit, without the need to mention this as a condition in the agreement (Al-Attram, 2006: 361). On the other hand, in the case of the sukuk holders, they are being asked to forgo their principal, which gives strong ground to assume that it is a genuine case of combining an exchange-based with a charitable contract.

Based on the above general discussion, it can be said that the use of the write-down mechanism for T2 *murabaha* and *ijarah* capital instruments can achieve the desired effect of subordinating the claims of the holders of such instruments to the claims of current and saving accounts and general creditors of the IBI during the gone-concern and liquidation scenarios. However, the use of the write-down mechanism is not in line with Shari’ah rules and regulations because it will lead to the combination of an exchange-based contract with a charitable contract. This is because when the holders of the *murabaha* or *ijarah sukuk* agree to write down the *murabaha* outstanding debt or outstanding rental payment they are in effect combining *ibra’* which is a charitable contract with *murabaha* and *ijarah* both of which are exchange-based contracts.
As a result there is a strong ground to argue that the inclusion of an ibra’ clause in the agreement will have an effect on the pricing of the instrument. In other words, the inclusion of such a clause will be in return for an increase in the rate of return of the instrument – in the case of murabaha, increase in the mark-up and in the case of ijarah, increase in the rental payment – which is why such a combination is prohibited. Moreover, the ibra’ clause will be appended to an unknown time in the future, which is the time when a pre-specified trigger point is reached.

Write-down Mechanism via Wa’ad bi Ibra’

The use of a unilateral binding promise (wa’ad) given by the holders of the sukuk to write down the outstanding debt or outstanding rental payment can be an alternative mechanism that can achieve the effect of subordination for T2 capital instruments. In this regard, since the wa’ad is not considered an integral part of the contract, the issue of combining an exchange-based contract with a charitable one will not arise. However, since the wa’ad is binding on the sukuk holders if it is contingent upon a condition or related to a cause (in our case, the cause being the trigger of non-viability, then the promisor (i.e. the sukuk holder) will have no option but to relinquish his right to receive the principal amount of the outstanding debt. Therefore, the inclusion of the wa’ad – although it resolves the problem of combining an exchange-based contract with a charitable contract – will not lead to the equivalency of the counter-values being exchanged between the buyer and the seller, as the sukuk holders will still be required to waive their right to receive their outstanding debt. In other words, when we look at the transaction in its entirety, the result would be the same as compared when the write-down mechanism is included in the agreement via a clause, which means that in essence the whole arrangement is in fact a combination of an exchange-based contract with a charitable contract. As such, this paper is of the view that the use of the write-down mechanism via wa’ad bi ibra’ should not be adopted.

Conversion into Ordinary Shares

With regard to T2 exchange-based capital instruments, there is the possibility of converting the outstanding debt resulting from murabaha sukuk or the outstanding rental payment resulting from ijarah sukuk.

One possible way to look at the issue of converting the outstanding debt into ordinary shares is by considering it a form of selling debt to the debtor. In this case, it can be said that such sale falls under the sale of a confirmed debt (principal plus outstanding installments) to the debtor. An example of such type of confirmed debt is the price of an already purchased item, or the compensation for a usufruct that has already been utilized. In these two

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6 Ibn Taymiyyah (1995, 29:62-63) stated that combining tabarru’ contract with mu’awadah contract is done to facilitate the mu’awadah transaction and not for the purpose of charity. Therefore, the charitable contract becomes part of the price. To illustrate this point he gave the example of a person who gave another person a loan of 1000 and sold him an asset worth 500 for 1000. In this example, the seller agreed to lend the 1000 to the buyer only because of the higher selling price of the asset and the buyer agreed to pay the higher price of the asset only because of the loan he is going to receive from the seller. Thus, in reality the seller gave the buyer an asset and 1000 in return for 2000 from the buyer. It is clear from this example that the inclusion of the tabarru’ contract had an effect on the pricing of the asset, which was sold by the seller for a price higher than the market price. In the case of the sukukholders, they are agreeing to forgo their principle itself in case the IBI reaches the point of non-viability. Therefore, if receiving a loan from the seller can have an effect on the pricing of the sold item, receiving an ibra’ for the entire outstanding debt at the point of non-viability will definitely have the same effect on the pricing of the instrument. As a result, the commodities will be sold to the IBI for a mark-up higher than the normal mark-up in the market in the case of murabaha sukuk, or the asset will be rented for a higher rental than the normal rental in the market in the case of ijarah sukuk.

7 This is similar to the practice of tranching in sukuk whereby investors subscribe to a single sukuk issuance that has multiple classes with different ratings (e.g. Class A – AAA; Class B – AA; Class C – BBB, etc.). In such a mechanism, subscribers to Class A tranche will receive a lower rate of return and face a lower probability of loss; while subscribers to Class C will receive a higher rate of return and face a higher risk of loss.
examples the debt has already been established on the liability of the debtor, which is why it is called a confirmed debt.

The majority of jurists permitted the sale of confirmed debt to the debtor. (Al-Kasani, 1986, 5:148; Ibn Rushd, 2004, 3:215; Al-Nawawi, n.d., 9:275; Ibn Qudamah, 1968, 4: 37-38). Thus, the creditor can sell the debtor the confirmed debt, which is established on the debtor’s liability for its repayment in kind. This group of jurists relied on the following Hadith (Al-Taylasi, 1999, 3:393, Hadith No. 1980) which is narrated by Abdullah Ibn Umar who said:

“I used to sell camels at al-Baqi for dinars and take dirhams for them, and sell for dirhams and take dinars for them. I would take these for these and give these for these. I went to the Apostle of Allah (peace be upon him) while he was about to enter the house of Hafsah. I said: Apostle of Allah; I sell camels at al-Baqi’. I sell (them) for dinars and take dirhams and I sell for dirhams and take dinars. I take these for these, and give these for these. The Apostle of Allah (peace be upon him) then said: There is no harm in taking them at the current rate so long as you do not separate leaving something to be settled.’’

The underlying reasoning for allowing such sale of debt is the fact that the debtor is already in possession of what is established on his liability. Therefore, if he pays the price of such liability to the creditor, then this sale will be akin to a normal sale whereby the two counter values are exchanged at the same time (Al-Zuhaili, 1997, 26).

It is important to note that Muslim jurists regarded the issue of selling debt to the debtor as a mechanism that can be used in reducing the overall amount of debt in the society and at the same time enabling the creditor to obtain an asset in return for his outstanding debt. In other words, the issue of selling debt to the debtor was not discussed in the context of providing a loss absorbing mechanism; whereby the IBI can convert a debt into ordinary shares and by doing so subordinate the claims of holders of T2 capital instruments to saving and current accounts and general creditors of the IBI. Nevertheless, this does not mean the use of such mechanism is not Shari’ah compliant, because its use still achieves the same purpose envisaged by Muslim jurists, when they allowed the sale of debt to the debtor, which is the reduction of the overall debt in the society. Thus, converting outstanding debt into ordinary shares is tantamount to changing the method of paying the outstanding debt from using cash to using ordinary shares. As a result, the relationship between the IBI and the sukuk holders would not end upon the sale of the outstanding debt as in the case of the classical sale of debt to the debtor; rather it would change from that of a debtor and creditor relationship to a partnership. This means that the creditors of the IBI have become its new partners and they can share the losses of the IBI on a pro rata basis.

Based on the above the sukuk holders (creditors) will sell their debt owed by the issuer (IBI) in return for ordinary shares. It can be argued that this arrangement can be included as a clause in the sukuk agreement and will not be considered a form of combining two contracts, because converting outstanding debt into ordinary shares is a method of payment and not a new contract. This argument is plausible given the fact that the conversion will only take place when the IBI becomes financially stressed upon reaching the point of non-viability. Thus, if the Shari’ah encourages creditors to give grace period to debtors who are in financial difficulty, then it becomes obvious that the Shari’ah will not have an objection to changing the method of payment for the insolvent debtor from paying in cash to paying in ordinary shares via the sale of the outstanding debt by the creditor. Thus, it is envisaged that the sukuk holders will enter into an exchange-based contract, which is based upon the principal of equivalency of the two counter values. This exchange-based contract, be it murabaha or ijarah, will include a clause to convert the outstanding debt into ordinary shares only if a pre-specified trigger point is reached. This means that if the IBI does not face financial difficulties, it is obliged to pay the debt using the traditional method of payment. However, if the point of non-viability is reached then the method of payment will automatically change, whereby a conversion formula is used to determine the number of ordinary shares that the creditor deserves for his outstanding debt. However, it must be noted that the use of the conversion formula must have the intended objective of giving the creditor the equivalent value of his outstanding debt in the form of ordinary shares.
It is important to note that the murabaha sukuk based on the concept of *tawarruq* will raise serious Shari’ah objections as to the legitimacy of such structure. This is because the OIC Fiqh Academy in its 19th session has declared the use of both types of *tawarruq* (organized and reversed) to be not in line with Shari’ah principles. Thus, this can be an obstacle for the use of the contract in structuring exchange-based T2 capital instruments. Moreover, *murabaha sukuk* are not tradable in the international market which will make it less attractive to potential investors. As for *ijarah sukuk* the outstanding rental payment may not be enough to the extent that its conversion at the point of non-viability can be a viable option. The only remaining option would be for the sukuk holders of *ijarah sukuk* to convert the *ijarah* assets under their ownership into ordinary shares. In other words, the *ijarah sukuk* agreement would contain a binding unilateral *wa’ad* to convert the *ijarah* assets into ordinary shares at the point of non-viability. In other words, this type of convertible *ijarah sukuk* would be similar to the normal type of *ijarah sukuk* with the only major difference being the use of conversion mechanism to convert the value of the *ijarah* assets into ordinary shares instead of using cash as in the case of normal *ijarah sukuk*. At this point, it is important to note that the conversion of the *ijarah* assets would obviously not fall under the issue of selling debt to the debtor, because the assets being converted are owned by the *sukuk* holders and are not debts owed to them by the IBI.

The first issue that we encounter with the use of *ijarah sukuk* is the fact that asset-backed *ijarah sukuk* cannot be used in structuring T2 capital instruments, since such type of *sukuk* can be classified as secured in nature, which in turn will not be in line with Basel III requirements of issuing unsecured capital instruments. Therefore, the only option is to use asset-based *ijarah sukuk*, whereby the legal ownership stays with the IBI and the beneficial ownership is transferred to the sukuk holders. However, just like in the case of *murabaha sukuk*, the use of asset-based *ijarah sukuk* has come under strong Shari’ah criticism, which was culminated with the OIC Fiqh Academy prohibiting the current structure of *ijarah sukuk*, as it is a form of *inah*.

Based on the above, it can be concluded that the use of both *murabaha* and *ijarah sukuk* for structuring T2 capital instruments will raise serious Shari’ah concerns, which must be adequately addressed if exchange-based contracts are to be used in structuring T2 capital instruments.

5. SHARI’AH-COMPLIANT STRUCTURES MOST SUITABLE FOR MEETING REGULATORY CAPITAL REQUIREMENTS

In the light of the Shari’ah issues associated with both equity-based and exchange-based regulatory capital instruments and given the trend in the market about the kind of regulatory instruments being issued by IBIs, the following question is asked: what are the most suitable Shari’ah-compliant structures that will meet Basel III capital requirements? As discussed, the key Shari’ah concern related to meeting Basel III requirements is about subordinating the instruments so that the ranking of CET1, AT1 and T2 is maintained and accordingly, ensuring that CET1 and AT1 will bear losses under going-concern scenario while T2 instruments bear losses only in the event of non-viability or gone-concern.

The following deliberates on the most appropriate Shari’ah contracts for structuring AT1 and T2 capital instruments:

1. In order to develop perpetual, subordinated, unsecured AT1 instruments, the most appropriate Shari’ah contract would be *musharakah*. However, if AT1 instruments are thus structured, they would rank pari passu with CET1 (ordinary shares) in the event of loss given the capital raised through the instruments would be

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8 The OIC Fiqh Academy in its 20th session has declared the impermissibility of selling an asset on a cash basis with the stipulation that the seller leases the asset via a lease ending with ownership, whereby the total rental payments and repurchase price [paid by the sukuk issuer] would be more than the cash price [paid by the sukukholders]. Such stipulation is impermissible regardless of whether it is mentioned explicitly or implicitly, because this would be a form of *inah* and therefore sukuk cannot be issued using such structure.
co-mingled in the general financial business of the IBI. Accordingly, as partners in the IBI’s business, losses would have to be borne in proportion to capital contribution and no partner can be ranked junior to another to absorb more losses, unless ordinary shareholders voluntarily agree to bear the loss when it occurs or legal stratum like wai’ad bi tanazul is applied. Whether or not AT1 musharakah sukuk would have to be converted into ordinary shares at the point of non-viability would be a matter of complying with (conventional) legal requirements to change the status of the musharakah sukuk into ordinary shares. Conversion of the AT1 instruments into ordinary shares would not affect the Shari’ah ruling applicable to the instruments. However, if the musharakah sukuk is similar to non-voting shares or Class B shares of conventional finance, no conversion is required as both equity sukuk holders and ordinary shareholders are ranked pari passu in terms of loss. However, ordinary shareholders can agree on giving a higher profit rate to the musharakah sukuk holders because from the Shari’ah perspective, there is no objection of having a different profit sharing ratio from their capital contributions.

2. AT1 capital instruments structured using exchange-based contracts is not in line with the Basel III requirements, which requires that such instruments should be perpetual in nature and no debt instrument can have such characteristic.

3. If T2 capital instruments are also structured using musharakah contract, then CET1, AT1 and T2 capital instruments will all be ranked pari passu with one another in the event of loss. As such, it will not be possible (i) to make a distinction between going-concern and gone-concern capital, (ii) for CET1 to represent the most subordinated instruments, and (iii) to rank T2 senior to AT1 and CET1 as per Basel III requirements. This means that it will not be possible for IBIs to comply technically or in form with Basel III requirements.

4. If, on the other hand, T2 capital instruments are structured using exchange-based contracts in the form of murabahah and ijarah sukuk, this will enable exchange-based T2 capital instruments to be ranked above musharakah AT1 capital instruments during going-concern scenario without causing any Shari’ah concerns. As for subordinating exchange-based T2 capital instruments vis-à-vis current and saving accounts and general creditors, conversion of the exchange-based T2 capital instruments into ordinary shares at the point of non-viability is a possible option. However, serious Shari’ah concerns are raised in regards to the use of tawarrug in the structuring of murabahah sukuk and the use of sale-and-leaseback mechanism followed by repurchase of the asset in ijarah sukuk. Both of these structures have been prohibited by OIC Fiqh Academy resolutions, which mean that their use in structuring convertible exchange-based T2 capital instruments is not viable unless the Shari’ah issues surrounding them are resolved.

6. CONCLUSION

This research examines the regulatory capital requirements under Basel III and deliberates on the qualifying AT1 and T2 capital instruments that can be issued by IBIs to meet both Shari’ah requirements and Basel III criteria and objects. In this respect, the subordinated sukuk which have been issued under Basel II and Basel III have been examined. Moreover, the Shari’ah issues, especially related to the aspect of subordination, arising in both equity-based and exchange-based contracts when used for structuring AT1 and T2 capital instruments have been examined.

It may be concluded that there are two possible approaches to comply with Basel III and Shari’ah requirements. First, to avoid the Shari’ah issues related to the issue of subordination altogether and instead recommend musharakah instruments for both AT1 and T2 capital whereby CET1, AT1 and T2 will all be ranked pari passu with one another. This approach will still be compliant with the philosophy of Basel III which in substance aims to strengthen the resilience of the banking sector via increasing the total equity of the RWA, and thus enable IBIs to absorb losses in the case of financial stress. The second approach is to comply fully with the ranking order as required by Basel III by using exchange-based contracts in the form of murabahah and ijarah sukuk for structuring.
T2 capital instruments along with the use of conversion mechanism to achieve the effect of subordinating T2 capital instruments to current and saving accounts and general creditors. However, the Shari’ah issues surrounding the current structures of exchange-based contracts namely *murabaha* and *ijarah sukuk* need to be resolved first before this approach can become a reality.

REFERENCES


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