THE CONCEPT OF SUKUK

✧ Islamic finance has for sometime missed investment opportunities for Muslims that offer a predictable return with low risk. The majority of investment opportunities are based either on stock market with high volatility or on real estate transactions.

✧ Since fixed income, interest-bearing bonds are not permissable in Islam, *sukuk* are the alternative.

✧ *Sukuk* are asset-based securities while bonds are debt-based securities.

✧ *Sukuk* has developed as one of the most significant mechanisms for raising finance in the international capital markets through Islamically acceptable structures.

✧ The word “*sukuk*” is the plural term Arabic name “Sukk” which originated in converting precious metals to coins and later is used to mean a ‘written document’. The term “*Sukuk*” is now used for financial certificates that can be seen as an Islamic equivalent of bonds.

✧ *Sukuk* are asset-backed, stable income, tradable and *Shari’a* compliant trust certificates.

✧ They have similar characteristics to conventional bonds, the difference being that they are asset-backed and represent proportionate beneficial ownership in the underlying asset.

✧ The claim embodied in sukuk is not simply a claim to cash flow but an ownership claim.

✧ The return on the *sukuk* derives from the yield generated by the client’s lease of the asset. A properly made *Sukuk* limits the debt to the value of the underlying assets.

✧ *Sukuk* brings a new source of funds, generally at attractive rates. They are important to developing deeper and more liquid Islamic capital market.
The legitimacy of sukuk structures in Shari’a lie in the fact that they do not take advantage of interest rate movements.

Investing in sukuk issuances involve the funding of trade or production of tangible assets.

Sukuk are directly linked with real sector activities. Hence these will not create short-term speculative movement of funds and potential financial crises.

The primary condition of issuance of sukuk is the existence of assets on the balance sheet of the entity, which wants to mobilize the financial resources.

The identification of suitable assets is the first, and arguably most integral, step in the process of issuing sukuk certificates.

Shari’a considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts (e.g. murabaha, istisna).

**TYPES OF SUKUK**

Sukuk can be of many types depending upon the type of Islamic modes of financing and trades used in its structuring.

The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued standards for 14 different Sukuk types.

Sukuk can serve a variety of different needs to finance and at the same time meet the need of investors. As proper conventional portfolios of wealthy clients always comprise a percentage of bonds, so will be the portfolios of Islamic investors.

The most common sukuk are
Mudharaba Sukuk

✧ Mudharaba sukuk are used for enhancing public participation in big investment projects.
✧ Mudharaba sukuk represent common ownership and entitle their holders share in the specific projects against which the mudharaba sukuk has been issued.
✧ No guarantee from the issuer or the manager for the fund, for the capital or a fixed profit, or a profit based on any percentage of the capital.

Steps involved in the structure:
1. Company and Investors enter into a Mudharaba Agreement
2. SPV (managed by Trustee) issues Sukuk to raise funds
3. Mudharib enters into an agreement with project owner for construction / commissioning of project.
4. Investors make proportionate payments to account of Mudharaba capital
5. SPV issues sukuk to investors while using the gathered proceeds of the sukuk to make payment to account for mudharaba agreement
6. Any profits arising from the mudharaba project should be divided according to predetermined ratio
7. Any loss is dealt with according to Shari’a rules
8. Upon completion, Mudharib hands over the finished project to the owner.
9. It is permissible to create reserves for contingencies, such as loss of capital, by deducting from the profit.
10. On the expiry of the specified time period of the subscription, the sukuk holders is given the right to transfer the ownership by sale or trade in the securities market at his discretion.
11. Profit and Loss account of the project must be published and disseminated to mudharaba sukuk holders.
**Musharaka Sukuk**

✧ These are investment sukuk that represent ownership of musharaka equity.

✧ It does not differ from the Mudaraba sukuk except in the organization of the relationship between the party issuing such sukuk and holders of these sukuk, whereby the party issuing sukuk forms a committee from the holders of the sukuk who can be referred to in investment decisions.

✧ Musharaka Sukuk is used for mobilizing the funds for establishing a new project or developing an existing one or financing a business activity on the basis of partnership contracts.

✧ As in mudharaba sukuk, the certificate holders become the owners of the project or the assets of the activity as per their respective shares. These musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

**Steps involved in the structure:**

1. Corporate and the Special Purpose Vehicle (SPV) enter into a Musharaka Arrangement for a fixed period and an agreed profit-sharing ratio.

2. Also the corporate undertakes to buy Musharaka shares of the SPV on a periodic basis.

3. Corporate (as Musharik) contributes land or other physical assets to the Musharaka

4. SPV (as Musharik) contributes cash i.e. the issue Proceeds received from the investors to the Musharaka

5. The Musharaka appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharaka and sell/lease the developed assets on behalf of the Musharaka.

6. In return, the agent (i.e. the Corporate) will get a fixed agency fee plus a variable incentive fee payable.
7. The profits are distributed to the sukuk holders.
8. The Corporate irrevocably undertakes to buy at a pre-agreed price the Musharaka shares of the SPV on say semi-annual basis and at the end of the fixed period the SPV would no longer have any shares in the Musharaka.

Murabaha Sukuk

- The process of direct structuring of securities in the context of sukuq-al-murabaha involves creation of a special purpose vehicle (SPV) or a special purpose mudharaba (with a distinct identity) by the company in consultation with its investment bank for this purpose.
- The investment bank or the company may act as a mudharib of this SPV-mudharaba.
- The SPV-mudharaba invests the funds raised through sale of sukuq to investors in buying or producing an asset that would be sold to the company in murabaha-BBA basis.
- The company purchases the asset from SPV on a murabaha-BBA basis.
- The periodic installments paid by the company in future to SPV account for the repayment of the cost and a profit component.
- Since these future cash flows that are passed on to the investors can be predicted with reasonable degree of certainty and accuracy, the instrument yields a predetermined return on investment like the conventional debt instrument (bonds). The major point of difference however, is the asset-backed nature of the murabaha instrument.
- The structuring of sukuq-al-murabaha could be as the following:
  1. Company seeks advice from investment bank regarding issue of securities (sukuq in this case); an SPV is created for the purpose;
  2. SPV issues securities (sukuq) to investors;
  3. SPV collects funds from investors;
4. SPV pays to seller on spot basis for purchase of assets;
5. Company as agent of SPV takes delivery of assets;
6. Company purchases assets from SPV on deferred payment basis (spot price plus a profit margin, payable on installments over an agreed period of time) and makes payment of installments to SPV;
7. SPV passes them on to investors after deducting mudharib share/wakala fee for itself.

✧ A potential problem with sukuk-al-murabaha is that these cannot be traded in the secondary market at a negotiated price and hence, are not liquid. Murabaha receivables are in the nature of pure debt and hence the instrument that is an evidence of such debt (shahadat-aldayn) can be transferred only at its face value.

✧ The practice, however, has been found to be totally unacceptable in the Middle East and other parts of the globe. It has been rightly asserted that sale of debt at a negotiated price (price that is different from the face value of debt) or at a discount opens the gates of riba-based transactions. Only if investors hold on to the instruments till maturity, the yield on the instrument would constitute legitimate profit and not riba.

✧ The impermissibility of secondary market trading however, severely limits the liquidity and therefore, attractiveness of the instrument from investor’s standpoint. One should therefore, look for better alternatives that are free from controversy regarding their permissibility and at the same time, are liquid.

Ijara Sukuk

✧ Sukuk-al-ijara are sukuk that represent ownership of equal shares in a rented real estate or the usufruct of the real estate.

✧ These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable.
The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

*Ijara* sukuk are the securities representing ownership of well defined existing and known assets tied up to a lease contract, rental of which is the return payable to sukuk holders.

The rental rates of returns on these sukuk can be both fixed and floating depending on the particular originator.

The SPV-*mudharaba* issues *sukuk-al-ijara* to investors; raises fund and utilizes it for purchase of the assets (required for use by the company). The assets are then given on lease to the company in exchange for periodic rentals.

It is necessary for an *ijara* contract that both the assets being leased and the amount of rent are clearly known to the parties at the time of the contract.

If both of these are known, *ijara* can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract, provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee.

The *ijara* rentals when received by SPV-*mudharaba* from the company (as per the terms) are passed through to the holders of the *sukuk*. Unlike *murabaha*, the *ijara* instrument is not evidence of debt, but of a pro-rata (in proportion) ownership of the asset(s) that is on *ijara*.

*Ijara* sukuk are completely negotiable and can be traded in the secondary markets.

*Sukuk-al-ijara*, however, functions like any other debt instrument, since the periodic *ijara* rentals can be predicted with a reasonable degree of certainty.

However, the yield on some forms of *ijara* instruments may not be predetermined, since there might be some maintenance and insurance
expenses that are not perfectly predictable in advance. Consequently, in such cases, the amount of rent given in the contractual relationship represented by the instrument represents a maximum return subject to deduction of this kind of maintenance and insurance expenditure.

✧ *Ijara* sukuk offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, awqaf or any other asset users, private or public can issue these Sukuk. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.

✧ The structure of *sukuk-al-ijara* could be as the following:

1. Company seeks advice from Investment Bank regarding issue of securities; an SPV is created for the purpose;
2. SPV issues securities to investors;
3. SPV collects funds from investors;
4. SPV pays to Vendor for purchase of Assets;
5. Company as agent of SPV takes delivery of Assets;
6. Company takes Assets from SPV on *ijara* and makes payment of *ijara* rentals to SPV;
7. SPV passes them on to investors after deducting mudharib share/wakala fee for itself.

✧ You may note here that holders of *ijara sukuk* are part-owners of underlying assets and as such, are exposed to risks associated with ownership of the assets.

✧ They are also required to maintain the asset in a manner that the lessee is able to derive the expected benefits from it.

**Salam Sukuk**

✧ *Salam sukuk* are certificates of equal value issued for the purpose of mobilizing *salam* capital so that the goods to be delivered on the basis of *salam* come to the ownership of the certificate holders.
The issuer of the certificates is a seller of the goods of salam, the subscribers are the buyers of the goods, while the funds realized from subscription are the purchase price (salam capital) of the goods.

The holders of salam certificates are the owners of the salam goods and are entitled to the sale price of the certificates or the sale price of the salam goods sold through a parallel salam, if any.

Salam-based securities may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date.

SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the sukuk.

Salam sukuk obviously involve market risk as the price of the underlying asset may go down instead of moving up in future.

The market risk or price risk for the investors can be mitigated if a third party makes a unilateral promise to buy the commodity at a predetermined price at a future time.

This third party may be one of the prospective customers of the company. The unilateral promise is binding on this customer.

Once the rights resulting from the promise are transferred to the SPV, it assumes the role of seller to the third party customer at the specified future date. The SPV is able to realize a higher predetermined price without participating in the market.

The risk mitigation can some times come through sovereign guarantees, as is the case with recent issue of sukuk-al-salam by the Bahrain Central Bank.

All standard Shari’a requirements that apply to salam also apply to salam sukuk, such as, full payment by the buyer at the time of signing the contract, standardized nature of underlying asset, clear enumeration of
quantity and quality, specification of date and place of delivery of the asset and the like.
✧ One of the Shari’a conditions relating to salam, as well as for creation of salam sukuk, is the requirement that the purchased goods are not re-sold before actual possession at maturity. This constraint renders the salam instrument illiquid and hence somewhat less attractive to investors.
✧ Thus, an investor will buy a salam certificate if he expects prices of the underlying commodity to be higher on the maturity date.

*Istisna’ Sukuk*
✧ *Istisna’ sukuk* are certificates that carry equal value and are issued with the aim of mobilizing the funds required for producing products that are owned by the certificate holders.
✧ The issuer of these certificates is the manufacturer (supplier/seller),
✧ the subscribers are the buyers of the intended product, while the funds realized from subscription are the cost of the product.
✧ The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel istisna, if any.
✧ *Istisna sukuk* are quite useful for financing large infrastructure projects. The suitability of *istisna* for financial intermediation is based on the permissibility for the contractor in *istisna* to enter into a parallel *istisna* contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialized firm.
✧ Shariah prohibits the sale of these debt certificates to a third party at any price other than their face value. Clearly such certificates cannot be traded in the secondary market.
Hybrid/Pooled Sukuk
✧ Considering the fact that Sukuk issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified sukuk - hybrid or mixed asset sukuk - emerged in the market.
✧ The underlying pool of assets can comprise of Istisna’, Murabaha as well as Ijara.
✧ Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds. However, still at least 51 percent of the pool must comprise of Ijara assets.
✧ Due to the fact the Murabaha and Istisna’ receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

Embedded Sukuk
✧ These could be sukuk whether zero-coupon, Ijara or hybrid, with the embedded option to convert into other asset forms depending on specified conditions.

Conclusion
✧ The market for sukuk is now maturing and there is an increasing momentum in the wake of interest from issuers and investors. sukuk have confirmed their viability as an alternative means to mobilize medium to long-term savings and investments from a huge investor base.
✧ We have reviewed various methods of creating fixed income debt securities based on the classical Islamic contracts of BBA, murabaha, ijara, salam and istisna’ that are free from riba.
✧ Of all these, salam sukuk seem to be too restrictive in scope. Istisna-based instruments are quite useful for financing large infrastructure projects.
✧ While murabaha and BBA based instruments are useful for financing
trade, both, however, involve sale of debt or receivables and hence suffer from the restrictions on their negotiability. A secondary market in these instruments is almost ruled out.

✧ Compared to these, *ijara*-based instruments are free from all these constraints. *Ijara* seems to offer maximum flexibility in terms of negotiability, management of price risk etc. and hence *sukuk-al-ijara* are expected to play a significant role in development of an Islamic debt market.

✧ Although less common than Ijara sukuk, other types of sukuk are also playing significant role in emerging markets to help issuers and investors alike to participate in major projects, including airports, bridges, power plants etc.

✧ Creation of wider investor base because of its acceptability by the global investing community.

✧ Islamic sukuk plays an important role to place Islamic Banks and Financial Institutions on the map to show how innovative they can be by combining different Islamic principles to create Shari’a compliant products.
ASSET SECURITIZATION

✧ Investment bankers may create securities through a process called asset securitization.
✧ This process involves pooling of existing assets of a company and then issuing of securities against these assets.
✧ The process begins with identifying income-generating assets of a company and estimating the nature and quantum of expected cash inflows from these assets.
✧ The assets are then transferred into the hands of a special purpose vehicle (SPV) organized as a *mudharaba* that is specifically created for this purpose.
✧ The investment banker may perform the role of mudharib in the SPV-*mudharaba*.
✧ Against these assets and expected income from them, the SPV issues securities that are sold to investors.
✧ The income stream in future is passed on to the security holders after deducting a certain percentage for the mudharib.
✧ Securitization is attempted mostly for creation of fixed-income securities. We therefore discuss the process in the context of *murabaha* and *ijara* alone.
✧ An issue that is of utmost significance in the process of securitization involves sale and buy-back (*bay’-al-einah*) as compared to sale and lease-back.
✧ Another forbidden mechanism relates to sale or transfer of receivables or debt at a discount or at a negotiated price (*bay’-al-dayn*).
✧ What is to be noted in the above process is the use of sale and buy back (*bay’-al-einah*) which effectively amounts to riba-based borrowing.
✧ The mechanism therefore, is not acceptable in the Islamic framework. Nevertheless, it has been widely used by investment bankers in Malaysia.
✧ The *sukuk-al-murabaha* created through the aforesaid mechanism can now
be traded freely at any mutually negotiated price

шение process of securitization can be described as the following:

1. Company seeks advice from Investment Bank regarding securitization; assets are identified and pooled together;
2. Company creates SPV; sells existing assets to SPV
3. SPV issues securities to investors against these assets;
4. SPV collects funds from investors;
5. SPV pays to Company the sale price of Assets;
6. Company buys back Assets on deferred payment basis;
7. SPV receives payments by company in future;
8. SPV passes on payments by company to investors after deducting mudharib share. (that is invariably lower due to discounting of debt).
9. The end outcome of such practice is the emergence of a vibrant market in bonds that is Islamic in name, but conventional in every other sense.

ший process is taken care of in *ijara*-based securitization. It should be noted that while sale-and-buy-back is adjudged equivalent to riba-based borrowing, while sale-and-lease-back is not. The process of *ijara*-based securitization is as the following

1. Company seeks advice from Investment Bank regarding securitization; assets are identified and pooled together;
2. Company creates SPV; sells existing assets to SPV
3. SPV issues securities to investors against these assets;
4. SPV collects funds from investors;
5. SPV pays to Company the sale price of Assets;
6. Company takes Assets on *ijara*;
7. SPV receives *ijara* rentals by company in future;
8. SPV passes on *ijara* rentals to investors after deducting mudharib share.

ший type of securitization involves transfer of ownership and
consequently, all risks and rewards of ownership of existing assets of the company to the SPV representing investors.

✧ Each investor now becomes a part-owner of the group of assets. The assets are then given on *ijara* against future rental payments. What makes this mechanism different from the earlier one is that the investors continue as owners of the assets. The investors are exposed to risk associated with ownership of assets and also to risks associated with rental payments. At times, a third party is willing to bear or share in such risks, as is the case with the *sukuk-al-ijara* issued by the Central Bank of Bahrain.