

SUKUK-Islamic Bond

Definition

- *Sukuk* is the Arabic name for a financial certificate or an Islamic bond. It is not a fixed-income, & not interest-bearing bonds.
 - Arabic forms are "sakk" (singular) and "sukuk" (plural).
- *Sukuk* are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest
- *Financial assets* that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Sukuk...

- Sukuk refer to **securitization**, a process in which ownership of the underlying assets is transferred to a large number of investors.
- Different in nature from **stocks of companies**. These are certificates of equal redeemable value representing undivided share in ownership of tangible assets of particular projects or specific investment activity and services.
- Details about types of Sukuk as suggested by AAOIFI

Sukuk.....

- In the modern Islamic perspective, sukuk lies in the concept of asset monetization – or also called securitisation - that is achieved through the process of issuance of sukuk.
- Its great potential is in transforming an asset's **future cash flow into present cash flow**. Sukuk may be issued on existing as well as specific assets that may become available at a future date.

OBJECTIVE SUKUK

- to enable organizations (1) to raise capital in a Shariah-compliant fashion, whilst at the same time (2) expanding the investor base and (3) offering investment opportunities to new groups.

Shariah Bases of Sukuk Issue

- Equity Based: Essentials of Musharakah and Mudarabah;
- Salam based – salam Rules
- Ijarah based – Rules of Ijarah
- Murabaha based ? No / Yes
- Mixed portfolio Sukuk – Ratio of cash and receivables?

SUKUK

- While a conventional bond is a promise to repay a loan, sukuk constitutes *partial ownership* in a **debt** (Sukuk Murabaha), **asset** (Sukuk Al Ijara), **project** (Sukuk Al Istisna), **business** (Sukuk Al Musharaka), or **investment** (Sukuk Al Istithmar).
- Sukuk structures replicate the cash flows of conventional bonds, and are listed on exchanges and made tradable through conventional organisations like Euroclear or Clearstream.

SUKUK

- From a Sharia perspective, **certificates of debt are not tradable** (although a different view is held by many in Malaysia), and certain structuring elements for Sukuk Al Musharaka, Sukuk Al Mudaraba and Sukuk Al Istithmar faced severe criticism in late 2007 by Sheikh Taqi Usmani, followed by a meeting of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).
- The most accepted structure, which is tradable, is thereafter the **Sukuk Al Ijara**. Debt certificates can be only bought before the finance occurs and then held to maturity from an Islamic perspective, which is critical on debt trading at market value regarding any difference to be like the prohibited Riba (interest on money).

SUKUK in Secondary Market

- Sukuk securities tend to be bought and held and, as a result, little of the securities enter the secondary market (allowing them to be traded).
- Furthermore, only public Sukuk are able to enter this market, as they are listed on stock exchanges

Sukuk – Guiding principles

- Islamic certificates of investment referred to as Sukuk involve structuring of pools of Shariah' compliant assets
- Investors have an undivided interest in the underlying assets and are therefore entitled to share jointly the related returns
- Could take place through application of various Shariah' principles such as Ijarah, Salam, Musharakah, Mudaraba and mixed pools.
- Provision for credit enhancement and/or liquidity enhancement features
- From credit perspective, investors expect the Sukuk issue to represent the same credit risk as that of the ultimate issuer/guarantor.

Sukuk (Contd)

- Sukuk - 'hot issue' in Islamic finance, are gaining popularity as alternative source of funding.
- Growth has been fuelled by strong demand for Sharia' compliant assets.
- Malaysia and Middle East have emerged as key Sukuk centres
- Also issued in Germany, Britain, Japan, Philippines, Pakistan
- Ijarah concept is the most popular amongst issuers of global Islamic securities

Key Players in Sukuk Market

Originators:

- Sukuk originators are mostly **governments**; also **Corporate firms**
- High costs of rating, contract documentation, investment banking and distribution fee
- Sukuk option is not attractive to most Islamic banks due to high proportion of short term assets

Investment banks:

- Investment banking, underwriting, lead managing and book making services for Sukuk are provided by Islamic banks in cooperation with conventional banks having Islamic windows.
- Subscribers of these Sukuk are mostly central banks, private sector Islamic banks and NBFIs
- Tightly held resulting in absence of secondary market
- A wider class of investors essential for active trading

Issuing Sukuk

- Sukuk have to be structured, on one side, on the principle of Mudarabah or, to a lesser extent, Wakalah.
- On the other side, business could be conducted through participatory or fixed return modes / instruments. Thus, the rates of return on Sukuk will be either variable (in case the modes on second leg are participatory) or quasi-fixed (in case of modes with fixed return).
- Mudarabah as a Basis: It is not permissible for the issuer to guarantee the capital of the Mudarabah.
- Prospectus to the issue can contain a promise by a third party to donate a specific sum, without any counter benefit, to meet losses in a given project, provided such commitment is independent of the Mudarabah contract.

Mudarabah Sukuk (certificates)

- Mudarabah certificates or Sukuk represent **projects** or activities managed on Mudarabah principle by **appointing any of the partners or any other person as Mudarib** for management of the business. They entitle their holders share in the specific projects. Sukuk holder can transfer the ownership by selling the deeds in the securities market at his discretion subject to certain rules.

Trading:

- If the Mudaraba capital is still in the **form of money**, the trading of MS would be like exchange of money for money and it must satisfy the rules of Bay al Sarf.
- If Mudaraba capital is in the **form of debt**, it must be based on the principles of debt trading in Islamic jurisprudence.
- If capital is in the **form of combination of cash, receivables, goods, real assets and benefits**, trade must be based on the market price evolved by mutual consent.

SUKUK – Al Ijara

- A key technique to achieve **capital protection without amounting to a loan** is a binding promise to repurchase certain assets, e.g. in the case of **Sukuk Al Ijara**, by the issuer. In the meantime a rent is being paid, which is often benchmarked to an interest rate like LIBOR (which is disliked by Sharia Scholars).

Ijarah Sukuk

- Ijarah Sukuk represent ownership of existing or defined and known assets tied up to a lease contract, rental of which is the return payable to Sukuk holders.
- Expenses related to the corpus of the leased asset are the responsibility of the owner. Therefore, the expected return flow from such Sukuk may not be completely fixed and determined in advance.
- As the lessor can stipulate the rentals in advance, the rentals on Sukuk issue can be indicated in advance with possibility of very small variation that might be possible due to payment of ownership-related un-predictable expenses by the lessor or possibility of any default by the lessee.

Examples of Sukuk: IJARAH fund

- The subscription amounts are used to purchase assets like real estate, motor vehicles, or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users.
- These rentals are the source of income for the fund which is distributed pro rated to the subscribers.
- Each subscriber is given a certificate to evidence his subscription and to ensure his entitlement to the pro rated share in the income

Ijarah fund

- These certificates may be preferably called "sukuk" -- a term recognized in the traditional Islamic jurisprudence.
- Sukuk represent the pro rated ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market.
- Anyone who purchases these sukuk, replaces the sellers in the pro rated ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him.
- The price of these sukuk will be determined on the basis of market forces, and are normally based on their profitability.

Ijarah Sukuk (Cont'd)

- Flexibility in rules of Ijarah and Securitizing the Ijarah contracts are key factors in solving liquidity management problems and for financing the public sector.
- Payment of rentals can be unrelated to the period of taking usufruct by the lessee, i.e. it can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide. - Although rentals become due when
- Rental could be constant, increasing or decreasing by benchmarking or relating it to any well known variable like inflation rate, any periodically announced price index, or otherwise by any settled percentage subject to a proper floor and cap.

Istisna 'a Sukuk

- Istisna can be used for financing the manufacture or construction of houses, plants, projects, bridges, roads and highways. By way of parallel Istisna contract with subcontractors, Islamic banks can undertake the construction of any asset and its sale for a deferred price, and sub contract the actual construction to any specialized firm.
- Full ownership of the constructed item is immediately transferred to the purchaser against the deferred sale price that covers not only the construction costs but also profits which could legitimately include, *inter alia*, the cost of tying funds for the duration of the repayment period.

Salam Sukuk

- Salam Sukuk being issued in Bahrain and used for SLR
- Salam sale is attractive to the seller whose cash flow is enhanced in advance and to the buyer as the Salam price is normally lower than the prevailing spot price giving him a profit margin.
- The possibility of having negotiable Salam certificates is yet to be decided. So far, scholars are not inclined to accept it. It needs sound analysis of reselling goods purchased under Salam before taking possession by the original buyer in the situation wherein he maintains inventory of that kind of goods in which case banks would be selling those goods out of the stock maintained by them without specifying any units of the goods. If it is allowed, the Salam Sukuk could be negotiable.

Murabaha Sukuk

- Murabaha Sukuk are more likely to be used in respect of purchases of goods by the public sector. In case the government needs items of huge price, it may purchase them through credit sale by paying in installments. The seller will amortize his cost and return over the period of installments. Any 'Murabaha Funds' can also issue Murabaha Sukuk proceeds of which could be used for sale of assets on the basis of Murabaha to give quasi fixed return to the Murabaha Sukuk holders.

Mixed Portfolio Securities / Sukuk

- Banks may securitize a pool of Musharakah, Ijarah and some Murabaha, Salam, Istisna, and Joa'alah contracts.
- Return on such securities will depend on chosen mix of contracts. e,g. IDB's Solidarity Trust Sukuk for US\$ 400 million issued in 2003 and recently issued medium term notes based on mixed portfolio comprising assets leased by IDB and installment payments under Murabaha and Istisna contracts which the IDB had entered into with its clients.

Controversial bases for Sukuk Issue

- Sukuk are also issued on the basis of Bai al Inah of underlying asset and the concept of Tabarrue while their trading in secondary market takes place through Bai al Dayn.
- However, Sukuk based on the principles of **Bai al Inah** and **Bai al Dayn** are not acceptable to mainstream juristic opinion and majority of Shariah experts.

Secondary Market of Sukuk

- **Shirkah based and Ijarah Sukuk; Marketing based on the market signals and forces.**
- **Murabaha, Salam and Istisna'a Sukuk only at face value (Hawalah rules as unsecured debts / obligations cannot be sold)**
- **Instruments representing a pool of different categories are subject to the rules relating to the dominant category in the pool.**

List of Sukuk Approved by SC-2007

- Naim Cendera Holdings Bhd
Musharakah 500
- Cerah Sama Sdn Bhd *Murabahah*
600
- Nilai Terbilang Sdn Bhd
Musharakah 3,000
- Projek Lebuhraya Utara-Selatan
Bhd *Istisna`* 3,550
- Binariang GSM Sdn Bhd
Musharakah 19,000
- Tradewinds Plantation Capital Sdn
Bhd *Musharakah* 210
- Tradewinds Plantation Capital Sdn
Bhd *Ijarah* 190
- Tanjung Offshore Bhd *Murabahah*
400
- Perisai Petroleum Teknologi Bhd
Murabahah & Istisna` 150
- Syarikat Pengeluar Air Sungai
Selangor Sdn Bhd (SPLASH)
Murabahah 600
- DRIR Management Sdn Bhd
Murabahah 850
- Binariang GSM Sdn Bhd *Ijarah*
3,150
- Sunrise Bhd *Musharakah* 400
- Pendidikan IndustriYS Sdn Bhd
Murabahah 150
- MRCB Southern Link Berhad *BBA*
230
- MRCB Southern Link Berhad *Istisna`*
900
- Manfaat Tetap Sdn Bhd *Istisna`* 752

List of Sukuk Approved by SC-2008

- Westports Malaysia Sdn Bhd
Musharakah 800
- WCT Engineering Berhad
Musharakah 300
- WCT Engineering Berhad
Musharakah 300
- Hong Leong Industries Berhad
Musharakah 500
- Stratavest Sdn Bhd *Ijarah 120*
- New Pantai Expressway Sdn Bhd
Musharakah 900
- The Export-Import Bank of Korea
(PN2A) *NA 3,000**
- Cosmo-Jupiter Berhad *Ijarah 600 9*
- Lingkaran Trans Kota Sdn Bhd
Musharakah 1,145
- Lingkaran Trans Kota Sdn Bhd
Musharakah 300
- Lingkaran Trans Kota Sdn Bhd
Musharakah 100
- Industrial Bank Of Korea (PN2A)
*Ijarah, Musharakah, Mudharabah &
Istisna' 3,000**
- Tanjung Langsat Port Sdn Bhd
Musharakah 250
- Tanjung Langsat Port Sdn Bhd
Musharakah 135
- Muhibbah Engineering Berhad
Mudharabah400

Conclusion

- A variety of target-specific Sukuk can be issued return on which will be either variable or quasi-fixed, not absolutely fixed, as the SPVs or the Fund Managers have to bear the ownership related expenses / risks and distribute the net proceeds from the businesses among the Sukuk holders. However, there is provision of any 3rd party guarantee.
- Sukuk are widely regarded as controversial due to their perceived purpose of evading the restrictions on Riba. Conservative scholars do not believe that this is effective, citing the fact that a Sakk (Islamic bond) effectively requires payment for the time-value of money .
- Need to ensure the investment of sukuk are based on halal activities and no riba transaction.

END OF LECTURES