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Fixed Income Investment (*Sukuk*) in Islamic Finance

Sabri Ulus*

Abstract

Recently many books, newspaper articles and research papers have been written under the heading of “Sukuk”. In this article we will try to provide a brief explanation of the meaning of Sukuk and its presence in the global financial markets.

New Sukuk issuance worldwide could once more exceed \$100 billion this year (2013), according to S&P (March 2013) due to support from tight yields and innovative structures. Funding needs and large infrastructure investments in the Organization of Islamic Cooperation countries (OIC), combined with better global investor sentiment, lie behind today’s momentum in the Sukuk market.

The Gulf Cooperation Council countries (GCC) and Asia will remain the key engines for growth of the Sukuk market.

Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia regarding Sukuk rules, opening the door to a much wider pool of investors. However, structures are still not standardised, and some Gulf-based Shariah scholars have objected to certain structures used in Asia, a region that has proven to be more flexible in its transactions.

Keywords: *Riba, Sukuk, SPE, OIC, IIFM, MENA, MYR.*

Introduction

The high-profile growth and prevalence of Sukuk in the Islamic finance industry over recent years has rendered the term, “Sukuk” synonymous with Islamic capital markets. This Shariah-compliant alternative to interest-bearing investment certificates or fixed-income securities has led

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to the product being commonly referred to as an “Islamic bond” in recognition of its ability to offer Islamic investors a means of subscribing to certificates which represent a right to receive a share of profits generated by an underlying asset base and that is capable of being traded on the secondary market.

Debt instruments such as coupon or zero-coupon bonds in conventional capital markets cannot be used in Islamic Finance due to the element of *riba* (interest) present. However, fixed-income type instruments are sought by investors seeking exposure to different risk factors or asset classes as part of their efforts to diversify their investment portfolio. Fixed-income type instruments that provide a steady stream of regular cash flows in the future are advantageous for liability management.

This has made Sukuk an attractive product to sovereign and corporate issuers alike who have used Sukuk to access a wider range of financing sources for their increasingly sophisticated financing and investment purposes.

There is anecdotal evidence¹ to suggest that Sukuk structures were used within Muslim societies as early as the Middle Ages, where papers representing financial obligations originating from trade and other commercial activities were issued.

What is Sukuk?

The word, “Sukuk”, can also be traced back to classical commercial Islamic literature. It was used in reference to certificates for goods or groceries (“*sakk al-bada’i*”) as the method of paying the salaries of government officers, who would later redeem these certificates in line with their day-to-day consumption of such goods or groceries. However, the Sukuk, as understood in its contemporary form, lies in a decision of the Islamic Jurisprudence Council (the “IJC”) dated 6-11 February 1988² which stated that, “any combination of assets (or the usufruct of such assets) can be represented in the form of written financial instruments which can be sold at a market price provided that the composition of the group of assets represented by the Sukuk consist of a majority of tangible assets.”

Global Sukuk Market

There were early attempts to issue Islamic bonds (*Muqaradah* bonds related to project financing) in the late 1970s in Egypt and Jordan. Pak-

istan and Malaysia also attempted to develop a market for such bonds. However, development did not really pick up until the growth of securitization in the conventional capital markets suggested a way ahead for the Islamic markets. In the late 1990s, asset-backed bonds (securities) known as Sukuk were developed in Bahrain and Malaysia. The Sukuk framework avoids interest payment through the use of classical Islamic contracts, such as ijara (leasing) contracts. The availability of long-term funding at competitive rates for investments and infra-structure development is crucial to an economy. For Sukuk markets to thrive, it is imperative that Sukuk meet the needs of companies and governments who raise capital and the investors who possess capital. Issuers (companies and governments) seek competitive cost of funding as well as liquidity of funding for the maturity that they need. Investors, on the other hand, seek attractive risk-return profiles for their investments and exposure to wider classes of assets for diversification purposes.

In a similar manner to a securitization, a Sukuk certificate is issued against a pool of assets. Sukuk certificates represent ownership in the assets. Cash flows from the assets will be used to pay investors of Sukuk certificates. The performance, as well as risks, of Sukuk is tied to the asset pool. The assets are linked to underlying physical objects and are permissible. For example, the assets may be ijara (leasing) contracts or salam contracts which have physical assets as underlying factors. These contracts are related to the funding or purchase of permissible assets. The assets need not be in existence at the time of securitization. For example, the Sukuk issuance may be used to fund the development of an infrastructure project such as a bridge or a factory. Depending on the types of assets and financing contracts, different forms of Sukuk may be issued. Some examples include Sukuk al-Ijarah, Sukuk al-Musharaka, Sukuk al-Mudaraba, Sukuk al-Salam, Sukuk al-Istisna, Sukuk al-Murabaha, Sukuk al-Istithmar and Sukuk al-Wakala. In a manner similar to securitization in conventional finance, a Sukuk issue may involve a Special Purpose Entity (SPE).

Sukuk and other structured finance transactions have often utilized SPEs established in offshore jurisdictions. These have been partly established for tax purposes, but also due to uncertainties in the legal framework and enforcement process in the courts in relation to structured finance in the Organization of Islamic Cooperation countries (OIC).

The income stream from the asset is used to pay the management fees and the investors. The role of the trustees is to safeguard the interest of

the investors and to make sure that the assets are managed in a responsible manner and in compliance with the terms and regulations in the prospectus. At the end of the investment period, the assets may be sold at a predetermined price to the original owner and the proceeds from this sale will be used to pay the principal sum on the Sukuk.

Investor appetite is pushing Sukuk into the mainstream. New Sukuk issuance worldwide may exceed \$100 billion again this year, according to S&P (March 2013) supported by tight yields and innovative structures³.

Funding needs for large infrastructure investments in Malaysia and the GCC, combined with better global investor sentiment, are behind today's momentum in the Sukuk market.

Global Sukuk issuance increased 64% in 2012, to USD138 billion – the fourth consecutive year of growth. It is widely accepted that sovereign and sovereign-related issuance, arising from funding and infrastructure investment needs, will continue to dominate, shape, and underpin the market. Government-linked companies/entities' issuance reached a record \$115 billion globally in 2012, comprising about 80% of total issuance for the fourth year in a row.

Profits paid by Sukuk issuers globally have been declining, and even fell below those based on conventional debt models. We should also consider in this context the strong domestic appetite for Islamic finance and ample liquidity as well as the greater political willingness to move ahead with sizable infrastructure projects. The demand for Islamic fixed income products such as Sukuk is on an upward trajectory for the foreseeable future.

It is expected that a number of banks will come onto the market, needing to refinance their existing debt and seeking larger amounts of capital to match the credit needs of their corporate clients, especially in project finance.

The Malaysian Ringgit (MYR) is becoming the currency of choice. For the first time last year, the amount issued in ringgit worldwide exceeded the amount provided by Malaysian issuers in all currencies. The strength of the Malaysian model for Islamic finance is an alluring proposition for issuers and investors alike, especially in the OIC, further strengthening Asia as a primary force in this sector.

Positive growth in Sukuk has been attributed to the rapid geographical expansion of products and services in Islamic securities that have enjoyed remarkable growth in key markets across Europe, Asia Pacific, Middle East and Africa (MENA) and the Central Asian states.

Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia over Sukuk rules, thus opening the door to a much wider pool of investors. Hence, the Asian and OIC Sukuk markets are becoming more interdependent, notably those denominated in Malaysian ringgit.

The past year, however, has seen a number of cross-regional Sukuk, mostly by Gulf issuers accessing Malaysia's highly liquid market, the world's largest for Sukuk issuance. Malaysia's sovereign wealth fund has also launched a Sukuk product denominated in Chinese Yuan.

The development of Shariah-compliant hedging tools is making it easier for issuers to invest in foreign currency assets. The launch of the Tahawwut (Hedging) Master Agreement (TMA) in March 2010 by the Bahrain-based International Islamic Financial Market (IIFM) in cooperation with the International Swaps and Derivatives Association, Inc. (ISDA) equips the global Islamic financial industry with the ability to trade Shariah-compliant hedging transactions such as profit-rate and currency swaps, which are estimated to represent most of today's Islamic hedging transactions. As such, it is premature to suggest that the Tahawwut Master Agreement "is applicable across all jurisdictions where Islamic finance is practiced" because it would clearly be subject to the vagaries of the legal and political governance process across various jurisdictions.

Voluntary adoption of standards in the financial sector by Muslims countries is very underdeveloped and, very often, national practice takes precedence over the less well-established international organizations especially in the nascent Islamic finance space. In addition, in markets such as Malaysia, they have developed local Shariah-compliant hedging techniques including profit-rate and currency swaps quite some time ago⁴.

The Attraction to Turkey

The Turkish Sukuk Market is expected to become even more attractive starting in 2013 and moving into 2014 due to the elevation of Turkey's credit rating and the willingness of government and financial authorities to transform Turkey into one of the main Islamic Financial Hubs. The Turkish Undersecretariat of the Treasury in conjunction with the Capital Markets Board of Turkey is finalizing new regulations, which would widen the type of Sukuk structures that can be used. At present, only Sukuk Al-Ijarah originations are used, in addition to Sukuk Al-Murabaha⁵.

Conclusion

To conclude, despite the unfavorable market conditions throughout 2012 to 2013, the emergence of numerous new major issuances emanating from the UAE, Malaysia, Saudi Arabia, Turkey, Qatar and Indonesia mean that it will most likely prove to be an extremely interesting year in the field of international Sukuk.

Growth in cross-border Islamic bond issues points to greater convergence in an industry that has been divided by tensions between the Middle East and Asia over Sukuk rules, opening the door to a much wider pool of investors. However, structures are still not standardized, and some Gulf-based Shariah scholars have objected to certain structures used in Asia, a region which has proven to be more flexible in its transactions.

Glossary

Ijarah: Letting on lease. Sale of defined usufruct of any asset for a defined period in exchange for a specific rent; only those assets can be leased the corpus of which is not consumed with use or the form/shape of which is not entirely changed with use. For example, cotton, yarn, fuel, milk, money can be sold/bought, but not leased against rentals. This is because the lessor has to bear the risk related to the ownership of the asset, and this is possible only if the leased asset remains intact and the lessor gets reward in the form of rental against taking risk.

Istisna'a: Order to manufacture (for purchase). It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or future payment and future delivery. Istisna'a can be used to provide facilities for financing the manufacture/construction of houses, plant, projects, bridges, roads and highways.

Mudarabah: A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while any loss is borne by the provider of the capital.

Muqaradah: The term "muqaradah" has been taken from the fiqh concept with reference to its synonym "mudarabah" which is commonly used by the Hanafi and Hanbali schools of thought. An agreement between two parties by which one of the two parties provides capital for the

other to work with on the condition that the profit is to be shared between them according to an agreed ratio.

Murabaha: Literally, this means a sale on mutually-agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. Islamic banks have adopted this method of sale as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank executes this request for a definite profit over the cost.

Musharakah: Partnership between two parties, who both provide capital towards the financing of a project. Both parties share profits on a pre-agreed ratio, but losses are shared on the basis of equity participation. Both parties carry out management of the project. However, the partners also have a right to forego the right of management/work in favour of any specific partner or person. There are two main forms of Musharakah: 'Permanent' Musharakah and 'diminishing' Musharakah.

Riba: Literally, an excess or increase. Technically, it means an increase over the principal in a loan transaction, over a debt or in exchange transactions, accrued to the lender/creditor or a party to exchange without giving an equivalent counter value or recompense ('iwad) in return to the other party.

Salam: Salam, in this context, means advance payment against deferred delivery of goods. Salam (also referred to as Bai Salam, Al-Salam, Bai al-Salam) is an ancient form of forward contract wherein the price is paid in advance at the time of making a contract of sale for goods to be delivered at a future date.

Sukuk: Certificates of equal value representing undivided share in ownership of tangible assets of particular projects or specific investment activity, usufruct and services.

Sukuk al-Istithmar: An Arabic term for investment Sukuk. These are certificates (Sukuk) of equal value which are issued and sold to investors (as owners or bearers) who, by virtue thereof, have proportional claims over the financial rights underlying these certificates. Likewise, investment Sukuk holders will also be proportionately liable for obligations arising from these certificates. In this sense, investment-related Sukuk represent common shares in the pool of assets made available for investment, of whatever type (physical assets, non-tangible assets, usufructs, services, receivables, or any combination of these types).

However, these Sukuk are not bonds or fixed-income securities, as they do not represent debts owed to the issuer by Sukuk holders. Holders share Sukuk returns and proceeds according to percentages stated in the prospectus, and bear losses in proportion to the number of certificates (Sukuk) held by them.

Tahawwut: A master hedging agreement developed by IIFM and ISDA.

Wakalah: Contract of agency; this can be commutative or noncommutative.

ENDNOTES

- 1 Source: Standard & Poor's "Investor Appetite is Pushing Sukuk into the Mainstream (March 2013)
- 2 Dubai Financial Centre Sukuk Guidebook
- 3 Bloomberg, KFH Research and Standard & Poor's "Investor Appetite is Pushing Sukuk into the Mainstream (March 2013)
- 4 www.financialislam.com
- 5 www.spk.gov.tr

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