

Sukuk, An Economic and Shari'ah Examination

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Praise be to Allah the Cherisher and Sustainer of the Worlds. Blessings and salutations be to His Prophet Mohammed, his family and all his companions.

1. Introductory remarks

By way of introduction, we have to say a few words about Islamic finance before we delve into the subject of Sukuk.

The core of the financial sector, Islamic and otherwise, is the function of intermediation. It happened that individuals, corporate and government can't perfectly match their income with their spending. Hence, there is always those who have more money than they need now and those who need more money than they have now. Everyone will be happier if resources were pooled, whereby those who have more than they need now can make that surplus available to them who need it now.

Since they invented money, humans realized that by being a store of value money can also facilitate this process of intermediation.

Because money is essentially an "order" on real assets, the existence of an efficient system for savings and investment the real factors of production becomes more efficient. They work more.

Intermediation came a long way from the simple wheat silos of ancient Egyptians to Wall Street's commercial and investment banking. The basic idea, however, remains the same. It is simply making savings ready for investment in an efficient manner.

None of the above is contrary to Shari'ah (Shari'ah being Islamic Law). In fact we should use more affirmative language by saying it is desirable from Shari'ah point of view.

There are many indications, even in the Quran itself, to this end. The Quranic firm prohibition of hoarding money when money was gold and silver coins (intrinsic value) clearly leads to fostering a more liquid economy, and thus a more productive real sector.

What is objectionable from Shari'ah point of view is the *modus operandi* in contemporary finance. Within the western approach to financial intermediation the contract of "loan" is the foundation of the process of moving savings to investment.

Individuals lend their savings to banks who in turn lend them to users of funds. They charge interest and pay savers some of that. Alternatively, corporate and governments can cut the middle man and go directly to borrow from savers by issuing papers in the market thus paying less and giving more to savers. But it is simply a contractual arrangement: money for money with interest as a consideration.

This is where the conflict arise. In Islamic setting money (i.e. the medium of exchange) must remain a medium of exchange. It can't by itself be a profit generating asset. It is only when it is used against a real asset or service that return can be made. There is nothing un Islamic with the contract of loan except for the fact that profit can't be made in the context of borrowing and lending money. Thus it remains a tool for benevolent and charitable purposes. For investment other contractual arrangements are used.

Two things are now apparent. One is economic and other is legalistic.

Number one:

From an economic point of view it is clear that a restriction of this nature means that the dichotomy between the real sector and the financial sector will be suppressed in a fully functioning Islamic economy. It is only when you allow what we call in the Shari'ah jargon "money for money" transaction as a profit generating arrangements that such dichotomy becomes robust.

This is not confined to giving \$1000 today to contractually receive \$1050 a year from today. In fact the whole debt and money market machinery are nothing but examples of this money for money enterprise.

It has always been assumed by Islamic economists that a dichotomy between real and monetary sector is a bad thing, and that one of the superiority features of the Islamic system is that both real and monetary sectors are interlinked by the fact that Islamic law of contract does not allow the creation of pure inter-temporal monetary transaction for commercial purposes. When money is exchanged a real “thing” must also changes hands. I don’t know of any serious research on this particular point. It remains, therefore, that the ill effect of a dichotomy between the real and monetary sectors are not very obvious, except for the fact that such dichotomy causes trade cycles in capitalist system.

Many experts believe that, at the core of the current financial crises a process they termed the “financialization of the economy”; whereby the financial sector start sucking all the investable funds into a limitless “money for money” bubbles by offering an ever increasing rate of returns which is a mere book entry. Returns that are not supported by real sector productivity. It is claimed that this process, which brought havoc to world economy, started in the U.S. Circa 1970. The roots of this lies down in the financial sector insane expansion while the real sector shrinks because it can’t match the rates of return on investment generated to savers from debt trading and derivatives, and thus can’t compete for investable funds⁽¹⁾.

Number Two:

From Shari'ah perspective, deciding if a transaction is permissible or otherwise is based on the contractual relationships between the parties involved. Therefore, the legalistic aspect and point of view becomes essential.

Thus the outcome of sale contract involving a commodity against a deferred price with a mark-up for the deferment of the price may not look exceedingly different from an interest based loan from economic point of view. But vis the contractual relationship, i.e. legalistic, they certainly are not the same.

The main challenge in modern Islamic finance is how to design financial products that can deliver the same economic outcome of the conventional (non Islamic) products but only within the Shari'ah permissibility. Because the basic function of financial intermediation is not contrary to Shari'ah (only the means that is questionable) all we need to do is to design contractual arrangements that are Shari'ah approved bearing comparable level of risk and reward compared to the conventional, yet with the rules of contract of Shari'ah. Sukuk is a good case in point.

(1) Nothing exemplify this more than the fact that for years GM and Ford Motor companies were generating most of their income from finance not car production to the point that some commentators described GM as a “Bank” making cars.

2. Sukuk:

We are all familiar with bonds (of all types) or what is sometimes called fixed income securities. Those are important papers because they meet the needs of issuers and investors. For investors a paper that compared to the alternative (time deposit, equity...) have its advantages. We will not go over why fixed income securities constitute the bulk of the investment market, suffice it to say that we need something similar to bonds in the Islamic sphere.

What is Sukuk:

“Sukuk” is the plural of the Arabic word “SUK” which means in classical Arabic: a certificate evidencing financial obligation. Modern Sukuk can be defined as:

Tradable certificates that offer predictable return at relatively lower risk.

There are those who refer to Sukuk as Islamic bonds. This is not correct. Bonds are debt instruments creating lender-borrower contractual relationship. They are interest based. They guarantee the payment of a coupon as well as principal at maturity.

Sukuk represent an undivided ownership in an income generating asset.

Therefore, from legalistic point of view Sukuk are different from bonds. They represent ownership of assets and their income is generated from that asset. They include the commercial risks embedded in the assets. However, it is quite obvious that Sukuk are designed to have a similar risk of the bonds and behave in the market in a similar way. There is nothing in Shari'ah against managing risks as long as such management doesn't included an non Islamic procedures. Nor that a paper that behaves in the market in a manner similar to conventional fixed income securities, would be prohibited just for this reason.

The legal setting of Sukuk.

Sukuk are certainly the product of Muslims desire to have a Shari'ah based paper. However, the fact of the matter is that most Sukuk were issued under common law though abiding by Shari'ah. There are reasons for this:

- i) There is a similarity between Shari'ah and common law in that they both provide a wider freedom to contract and place the will of the parties supreme.
- ii) Because the majority of Sukuk were issued in common law countries such as Malaysia.
- iii) Because courts of England are the choice in this area of world for dispute settlement in financial agreements for well known reasons like efficiently and high qualification judges.

It is only natural, therefore, to design Sukuk in line with the basic tenants of common law, so that courts of England can be even more expedient.

iv) Last but clearly not least is that law offices of Anglo-American origin are the most active in the Islamic banking business and naturally they are experts in common law.

Sukuk benefitted from the standard asset securitization structure which was, again, born and groomed in a common law environment.

The standard Sukuk issuance program include basic elements which are now standard and were drawn from the securitization book. For example:

- The Trust or Special Purpose Vehicle (SPV).
- Separating title from beneficial (or equitable) ownership.

Challenges in issuing Sukuks under civil law:

It is now apparent that Sukuk involves the ownership by Sukuk holders of an income generating real asset. In Ijarah Sukuk for example the real estate or equipment that generates income must be owned by Sukuk holders. This ownership can only be effected through a true sale contract. If we are to go into the standard procedures of sale and ownership registration this makes the process extremely costly and may not be attractive to both issuers and investors. This is because it will involve stamp duty, other taxes and costly registration problems.

Worse yet, since Sukuk holders interest in these assets is not permanent, a second round of the same costly and complicated procedures render the Sukuk issuance infeasible. However, through the separation of title from beneficial ownership, none of the above will be much of consequence.

Although the basic idea of such separation finds its lineages in English law, there is nothing contrary to Shari'ah in such conception. When it comes to contracts the basic Shari'ah rule is that what really counts in contracts is fact and reality. Therefore, if an offer and acceptance results in transfer of ownership that can be enforced in a court of law, Shari'ah requirements are satisfied. This is fulfilled in the common law set-up of separating title from beneficial ownership.

Under French law (civil law) ownership includes rights of use (usus), and enjoy (fructus) and right to dispose (abusus). However, ownership right can only be held by one person. Attempts to issue Sukuk in France against leased assets came up against this stumbling block. No Shari'ah approval can be granted without transfer of ownerships that is enforceable in courts. This is not achievable under French law.

In the absence of trust law, the current structure of Sukuk issuance may not be conceivable.

3. The basic structure of Sukuk

In the basic structure of Sukuk we have the issuer where a corporate or a sovereign entity, this is the party that needs finance and would alternatively borrow on interest basis. Then we have the manager who is usually an investment bank making all the arrangements especially being an agent for Sukuk holders. We will also have the trust or special purpose vehicle (SPV) whichever is available within the going legal infrastructure.

The agent will receive the proceeds from Sukuk holders and act on behalf of them to enter into a contract with the issuer. If we are talking about Ijarah Sukuk, then he will purchase an asset from the issuer, such as a building and lease it back to him with a promise to sell at end of contract. The building is now owned by the Sukuk holders and the coupon generated from the rentals.

A Mudarabah Sukuk holder advances the capital of the Mudarabah to the manager who will enter into a Mudarabah contract with issuer who will become the Mudarib. Mudarabah is a profit sharing partnership between financier and manager. If such funds are to be utilized in a separate project this will be pure equity. However, it is more interesting if Mudarabah capital is commingled with the rest of assets of this corporation and used in its operations. To apply the rules of Mudarabah we at the end of the year, have to see if value is created over and above the day one value of the company, then this is profit in the meaning of Shari'ah which must be shared in accordance with the ratio agreed upon in the Mudarabah agreement. If the corporation loses money, the Mudarabah Sukuk holders will get no profit. However, they will not lose their capital except when all the equity of the company is wiped out. Since the Mudarib is the legal person, loss will eat in the Mudarabah capital only if equity of the corporation is wiped out. This gives the Sukuk holders a position in the capital structure of the corporation not too different from the position of conventional bond holders thus creating the low risk features of the Sukuk without the purchase undertaking. We saw in the Ijarah Sukuk.

4. Some milestone Sukuks.

As we can see sukuk are still evolving. In the following I am going to briefly highlight some of the sukuk that, in my view, represent a milestone in the brief annals of Sukuk.

i- Government of Bahrain Sukuk:

In the year 2001 the first Sukuk were issued by the government of Bahrain. The government sold parts of the Manama Airport to an SPV which represent the Sukuk holders, which in turn leased the same back to the government of Bahrain. The sale price was paid cash, while lease payments were made semi annually. The lease contract included a promise (undertaking) to buy-back these assets at the same sale price, as well as a promise to purchase issued by the lessee (i.e. government of Bahrain). Although the above structure was approved by a Shari'ah

committee, some members of that Shari'ah committee took exception to some aspects of those sukuks. Until, today this undertaking to buy back at the same sale price (which is actually the face value of the Sukuk) present a point of debate. Many Shari'ah scholars will not approve a structure with such reciprocal undertaking.

ii) SABIC Sukuk:

The first Saudi Sukuk were issued by the Saudi Basic Industries Corp (SABIC). SABIC is a holding company, which holds a dozen subsidiaries each is a world class petrochemical vendor. However, none of them has the right to directly market its products. This is held by SABIC. Subsidiaries as JV's with major multinational petrochemical companies. That "right" to market which is sealed long term agreements with these subsidiaries, was the asset on which Sukuk were issued. Hence, the SPV purchased this right from SABIC for cash and appointed SABIC as agent to manage the right, i.e. to render the marketing service to the subsidiaries for a fee. Evaluating this right was quite a challenge, but through the engagement of several auditing firms, a fair price was reached. To avoid the disputed point of purchase undertaking, the term was made to be 20 years with an option to retire after each five years, at the discretion of Sukuk holders. The promise to purchase is never at the same sale price.

SABIC made 3 successful issues of Sukuk on the same structure.

iii) Mobily Sukuk:

Mobily is the holder of the second GSM license in Saudi Arabia. To issue Sukuk you need an asset to sell to Sukuk holders. In its early days the only asset it has is the license itself. Legal councils confirmed that the terms of the concession doesn't allow such sale.

The company offered to sell "airtime". Therefore SPV representing the Sukuk holders purchased airtime from Mobily and appointed Mobily as agent to sell the same to its customers. This structure became a standard for telephony companies in many Muslim countries.

v) Saudi Hollandi Sukuk

Saudi Hollandi is a JV bank in Saudi Arabia. Most of the bank activities are done Islamically. They wanted to issue Sukuk that can qualify as tier two capital for the bank. They ended up with the following design which was approved by their Shari'ah board.

The bank will issue Sukuk Mudarabah. Mudarabah is a form of partnership between a financier and a manager (or entrepreneur) who provides management and share in the profit generated. The bank has already built a sizable portfolio of Islamic assets generated from sale (on installment basis) and leasing of cars and houses.

Though they were called Sukuk Al-Mudarabah they actually involve both a contract of Mudarabah where SHB is the mudarib (manager) and a contract of Musharakah where SHB and Sukuk holders shares in the ownership of a portfolio consisting of the assets already created and the ones that are going to be created using the proceeds of the Sukuk. Profits generated in the pool are firstly divided into two parts one for SHB as co-owner of the pool and the other to Sukuk holders prorata to shares in the pool. Then the Sukuk holders portion of profit will then be also divided into two portions one for SHB as manager and the other belongs to the Sukuk holders.

vi) Aljazirah Sukuk:

Rating is very important for Sukuk. Most investors rely completely, when it comes to making sure about the quality of any paper, on rating agencies.

While theoretically it is possible to rate any paper effectively, rating agencies only rate credit risk, i.e. the likelihood of an obligor (borrower) meeting his obligation to pay principal and coupon.

Islamic Sukuk faced a problem because as Ijarah, Mudarabah or Musharakah Sukuk are suppose to represent ownership of an asset not a “loan”.

For Sukuk alijarah, the undertaking to purchase which is issued by the issuer (as lessee) approximate an obligation that relies on the credit worthiness of the obligor. It can be rated.

This innovation structure done by bank Aljazirah, leads itself to credit rating in a way not too different from conventional bonds.

From Shari'ah point of view creating a debt obligation via a commodity sale contract where price is deferred or paid on installment basis is not objectionable. However, with such thing is done through Sukuk that traded in the market problems arises. This because trading a paper that represent a debt obligation (receivables) is prohibited and considered “usurious”.

However, wealth a paper boils down to a debt obligation or represent a real asset (like ownership or real estate or machinery) depends on what the paper actually represent. In Shari'ah, there is an established maxim which says that “rule is based on the majority not minority”. So when two things are mixed and they are both “Halal” but the rule change due to the mixing then the judgment depends on the majority.

Therefore, if we have a pool or real and financial assets represented by a paper and we want it to be traded we look, based on the first component, it can be traded but based on the second, it can't.

The judgment, however, will be based on majority. If the real asset represent 51% or more, then the real asset rule will apply. In this Aljazirah structure, a pool consisting of 51% or more leased autos and houses and 49% a Murabaha (deferred payment sale contract) creating a receivable equal to 49% or less of the face value of the Sukuk.

The interesting thing is that the profit in this Murabaha is calculated in such a way that at maturity, the issuer is obliged to pay an amount equal to 100% of the face value. Hence, the Sukuk starts as non-debt but end up so. Thus, a credit rating will be most fitting.

5. Sukuk facts

Some useful current statistics:

1) Geographical distribution of issues:

- Malaysia	31.6%
- Cayman Island	10%
- Indonesia	3.7%
- Saudi Arabia	2.9%
- Qatar	2.1%
- United Arab Emirates	1.3%

2) Listing of Sukuk:

- Bourse Malaysia	27.4%
- London Stock Exchange	20.6%
- Luxembourg	2.5%

3) Local / non local:

- Domestic Sukuk	86%
- Global Sukuk	14%

4) Issuers:

- Sovereign	75%
- Corporate	15%
- Quazi Sovereign	10%

5) Top Lead Managers:

- i) Deutsche Bank.
- ii) AM Merchant
- iii) HSBC Amanah
- iv) CIMB
- v) Citi Islamic Investment Bank

- 6) Investors:
- Central Banks and Governments 25%
 - Asset Managers 23%
 - Islamic Banks 20%
- 7) Geographical Distribution of Investors:
- Middle East 47%
 - Asia 31%
 - Europe 22%