SUKUK STRUCTURES

26 JANUARY 2017

SPECIAL FEATURE

FAITH IN FINANCE - AN INTRODUCTION TO SUKUK STRUCTURES

FAITH AND FINANCE

Over the last decade, sukuk (singular: sak) have become an increasingly popular debt instrument in the international capital markets. Issuers ranging from sovereigns, quasi-sovereign entities and corporates as well as supranational organisations in the Muslim and non-Muslim world have either issued sukuk or have expressed an interest in issuing sukuk in the future.

BACKGROUND

Commonly referred to as Islamic bonds because they are seen as tradeable securities, similar to conventional bonds, sukuk denote ownership or financial certificates of assets or a pool of underlying assets. Sukuk can also provide holders the right to receive income generated from that business of the issuer.

Sukuk adhere to and are consistent with Islamic law known as Shariah. Shariah originates from the Qur’an, the holy text of Islam, and the Sunnah, social and legal customs and practices of Muslims stemming from the lifetime of the Prophet Muhammad. It provides Muslims with the legal framework for various day-to-day activities including politics, economics, banking, business, contract and social issues.

In order for sukuk to be Shariah compliant, they must comply with the principles of Islamic finance by Shariah scholars. It is worth noting that Shariah is interpreted differently across the Muslim world and that there is no single unified view of what is acceptable. Shariah scholars in various jurisdictions have differing opinions on debt, the use of debt or trading of debt.

As a result, whether a sukuk transaction complies with Shariah, is dependent upon the jurisdiction of the issuer and the discretion of the Shariah scholars within that jurisdiction. Sovereign issuers and larger banks tend to have in-house Shariah compliance boards, however the lack of a globally unified approach means that certain Western-style debt products are more amenable to being considered Shariah compliant in certain parts of the Islamic world.

Broadly, Islamic finance involves three key principles with which all sukuk must comply:

I. Riba (interest) – interest whether fixed, floating, simple or compound interest is prohibited because ‘no one should be able to earn an income from money alone’; and

II. Gharar (excessive or deceptive uncertainty or risk) – excessive risk or uncertainty that may void a transaction or contract, particularly with regard to future events and qualities of goods, also includes deceit; and

III. Maysar (gambling) – it is forbidden for one party to gain significantly at the expense of another. This includes borrowing money to speculate on currency movements or similar activities.

Moreover, in any Shariah compliant financial transaction, certain products are prohibited. For example it is forbidden to purchase, invest in, negotiate or trade with or in any way involve products related to alcohol, tobacco, pork, pornography, gambling or weapons.

Islamic versus Conventional Financing

In addition to Shariah compliance, a key difference between sukuk and conventional bonds is that that the former is based on the income of a tangible asset/s or rights to a business generating an income, which in turn is supposed to benefit the real economy as well wider society. Therefore there must be a sharing of risk, profit and loss between the parties.

“A key underlying aspect of sukuk that makes them different to conventional bonds is that they should be based on a tangible asset,” said Harris Irfan, Managing Director at Rasmala. “A key differentiator of Islamic versus conventional finance is that it is supposed to finance transactions in the real economy so that there is a one-to-one correlation with the financial economy.”

GROWING POPULARITY OF SUKUK

Whilst the concept of sukuk as a form of financing has existed throughout Islamic civilisation, its present day form only emerged in the early 1990s with the first sukuk issued in Malaysia, by Shell MDS Malaysia with a MYR 125m (USD 30m) issuance. Other jurisdictions such as Bahrain and Sudan have developed their own local markets and issued short-term domestic sukuk.

Following the 2008 financial crisis, issuers in several Muslim majority countries including Malaysia, the UAE, Saudi Arabia, Sudan, Pakistan, Bahrain, Iran and Qatar have turned to sukuk as an alternative source of financing.

For potential issuers, one of the key advantages of issuing sukuk is the cost-efficiency in structuring the deal. “From an issuer perspective it is cheaper to issue sukuk, despite the added documentation requirements” said Khalil Belhimeur, Director, Bonds Syndicate at Standard Chartered Bank in London. The pricing difference in sukuk is cheaper because of the investor profile and lack of supply for sukuk paper. “Sukuk yields and spreads are generally lower than conventional bonds due to the investor demand in the Gulf region and to a lesser extent from South East Asia,” said Belhimeur in London.

However, sukuk is by no means mutually exclusive to issuers in the Muslim world, issuers from outside of the Muslim world can and have issued sukuk.

For some issuers, like corporates, (particularly non-Islamic ones) issuing sukuk presents them with the opportunity to reach investors from the oil-rich Persian Gulf countries and Malaysia seeking Shariah-compliant investments. “For non-Islamic issuers,
sukuk is a form of investor diversification,” Belhimeur in London explained. For example, in November 2009, General Electric, a major US company, sold USD 500m five year of ijara sukuk to attract investment particularly from Islamic investors in the Middle East and Asia.

Moreover, some non-Muslim sovereigns have also tapped the market and issued sukuk. “Shariah-compliant financing is becoming popular with a lot of issuers, particularly sovereigns not just in the Muslim world, but also globally,” said a regional market participant. “It opens a new investor base and new sources of finance for the issuer,” he added. Examples of non-Muslim jurisdictions issuing sukuk include the governments of the United Kingdom, Luxembourg, Hong Kong and South Africa.

Others explain sukuk is important for Islamic banks to manage their liquidity. “Sukuk are a way for Islamic investors to invest in yielding Shariah-compliant investments, and in particular for Islamic banks to manage their liquidity through liquid assets without taking equity risk,” said Hani Ibrahim, Managing Director Head of Debt Capital Markets at QInvest in Qatar.

Investors have also commented on the benefits of investing in sukuk. “From an investor perspective there is a good level of transparency underlying a Sukuk transaction as compared to conventional bonds,” said Abdelhak El Kafsi, Managing Director at Islamic Finance Consultants in Bahrain. “This is because the sukuk being asset backed, the deal is ring fenced for the purpose of the transaction,” he explained.

To further highlight the growth of sukuk as a mainstream fixed income asset class, last October, JP Morgan included eight sukuk into their Emerging Markets Bond Index (EMBI). This exposure will likely expand investor interest beyond the traditional sukuk investor pool.

“In the GCC, sukuk tend to be priced tighter, whereas in Turkey or Indonesia sukuk are usually priced wider than conventional bonds due to the investor profile,” added Belhimeur at Standard Chartered. “Investors in Turkey are usually US and European and investors in Indonesia are indeed very global as well; however, given the recent inclusion of Sukuk in the JP Morgan Emerging Market Bond Index [EMBI], we have seen the pricing differential tighten notably’.

**CONSIDERATIONS**

There are different sukuk structures such as equity, agency or joint-venture-like, which issuers can use. Others structures are more debt focused, or mixture of the two (hybrids) as well as newer structures which enable sukuk holders rights to assets, among others.
“It’s important to take into consideration the type of issuers, the nature of their funding needs are and the type of market they’re operating in,” said El Kafsi in Bahrain.

Asset availability is an important consideration for any potential sukuk issuer. “The two biggest factors affecting the type of Sukuk structure applied are the industry or sector of the issuer and the type and availability of assets,” said Hani Ibrahim at QInvest. “Another key consideration in Sukuk structuring is the taxation on the assets being used in the transaction,” he added.

Islamic finance practitioners explain that tax regulations in different jurisdictions can make it difficult for sukuk issuers to structure the transaction. “There are certain challenges for issuers regarding how assets used in sukuk and are treated from a tax perspective in different jurisdictions,” said Issam Al Tawari at Managing Partner at Newbury Consulting in Kuwait. “Different jurisdictions have different definitions of what is understood as a normal buy and sell transaction. Some countries may not have specific rules and regulations around assets used in sukuk and therefore this remains a challenge,” he added.

**SUKUK STRUCTURES-A BREAKDOWN**

**Ijara**

Ijara is a lease financing structure whereby a bank or financial institution purchases an asset or item (usually property or real estate) on behalf of the customer and leases it to them for an agreed sum over a specified period of time, transferring ownership of the asset or item upon maturity. Ijara is the most well known and most widely accepted sukuk structure in the Islamic finance industry.

“Ijara is the most straight forward structure for sukuk,” said Debashis Dey, Partner at White & Case in Dubai. “It is the most acceptable structure from a legal and Shariah perspective, as long as the issuer has enough tangible assets,” he added. “However, one of the biggest challenges for issuers, particularly sovereigns in issuing ijara sukuk is the availability of sufficient assets of the right value and eligibility for an Ijara structure.”

**Murabaha**

Murabaha is a financing agreement whereby one party purchases an asset or item and sells it on a deferred basis for an agreed marked-up rate, to cover cost and profit margins.

Murabaha is to be subject to much scrutiny as to whether it is acceptable sukuk structure or not. In Malaysia, Murabaha is a popular and widely used sukuk structure. However, in the Gulf and Pakistan, where the Shariah interpretation of debt and the trading of debt is different from Malaysia; Murabaha is not used as a single sukuk structure.
“Although Murabaha is a widely used as a financing tool by Islamic banks across the world, in the Gulf it is not used as a standalone sukuk structure primarily because it is not tradable in the secondary market (unless at par). The Shariah interpretation on debt and the trading of debt is more conservative than in Malaysia,” said the regional market participant.

The Bahrain based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), an Islamic finance standards body, considers Murabaha not to be Shariah compliant as a standalone sukuk structure unless used as part of a hybrid sukuk structure, of which 51% must be tangible assets.

“Murabaha has at times been a controversial contractual structure in the industry,” said Irfan. “Whilst all scholars accept it is a valid contractual structure, in practice some forms of murabaha have been used by some bankers as a proxy for loan financing, in ways that many scholars have expressed reservations,” he added.

**Musharaka**

Musharaka is an Islamic joint venture or partnership, limited to a particular purpose or project. Benefits include the pooling of resources and capital and in particular, the sharing of risk, profit and losses. This is more of an equity type investment.

**Mudaraba**

Mudaraba is a financing structure between two parties, whereby one party provides the capital for the other party who manages the project. The profit is determined by a pre-agreed ratio. However, if the project encounters losses, the party providing the capital is solely responsible for those losses. “Mudaraba and Musharaka are equity-based risk from the perspective of Shariah and require higher risk appetite for investors,” noted Dey of White & Case.

**Wakala**

Wakala is a contract between two parties in which a principal nominates or hires an agent to manage and/or work on a project.

“Wakala is more favoured by financial institutions because they appoint an agent to manage projects or investments,” said Dey. “They don’t have to own buildings or similar leasable assets but have income generating business lines.”

Hani Ibrahim at Qinvest notes, “Islamic banks and financial institutions tend to apply Wakala and Mudaraba structures frequently”. He adds, “Musharaka and Mudaraba structures are closer to equity type risk and Mudaraba in particular is used for subordinated perpetual Tier 1 Sukuk”.

**Hybrids**

Hybrid sukuk structures offer a combination of debt and equity by enabling two or more structures to be put together. It allows issuers to diversify their investor pool if their do not have enough tangible assets in their portfolio.

The debt-to-equity ratio of any hybrid sukuk structure is contingent on the jurisdiction of the issuance and on the interpretation by Shariah by scholars and school of Islamic interpretation in that jurisdiction.

“In hybrids, where debt-like and equity-like underlying assets co-exist, many scholars require there to be at least 51% of the underlying portfolio to be composed of what are deemed to be tangible assets such as ijara (lease) contracts,” said Harris Irfan at Rasmala in London. “Some banks looking to raise capital through sukuk are actively seeking to incorporate a majority tangible portfolio of assets in order to ensure the sukuk instrument is tradable in the secondary market,” he added.

However, some jurisdictions have a more moderate [or different] interpretation and allow hybrid sukuk structures with a higher debt to equity ratio. “In some jurisdictions it allows for 33-35% asset backed, and securities can be used in the rest in the transaction,” said El Kafsi in Bahrain. “In hybrids for example, one-third can be asset backed, while the rest can be in securities such as shares in Shariah-compliant investments and sukuk,” he added.

Countries which allow more non-tangible assets than tangible assets in hybrid sukuk structures include Turkey and Malaysia, whereas more conservative jurisdictions such as the Gulf and Pakistan require a higher proportion of the tangible assets in the transaction.

**Other structures**

In addition to traditional structures like ijara, mudaraba and murabaha, there are other structures which issuers can adopt to access financing if they lack sufficient or quality tangible assets.

“Depending on the industry, corporates can use structures like the Manafae Sukuk to avoid the need to sell tangible assets into the Sukuk as the Manafae structure is based on rights to an activity or service” said Ibrahim in Qatar. “For example telecom firms can avoid using their buildings, equipment and vehicles, instead using non-physical assets such as rights to use airtime or data on their network to raise a Sukuk.”

A prime example of a Manafae structure is Qatar’s Ooredoo sukuk in 2013. Ooredoo sold USD1.25bn 2018 with a 3.039% profit rate using this structure. The Manafae structure enabled investors to receive income generated from the sale of the telecom provider’s minutes on its service.
Despite the growth and development of the sukuk market, some challenges remain, such as the lack of cross-border standards for sukuk. For example, whilst some sukuk structures may be acceptable in one country, they may not be acceptable in another jurisdiction from a legal and Shariah perspective.

“More work is needed in further developing Islamic finance standards,” said Bashar Al Natoor, Global Head of Islamic Finance at Fitch Ratings in Dubai. “There needs to be more standardisation and more harmonisation of sukuk in terms of legal structures and Shariah compliance. Whilst lots of new debt issuers also have the potential to issue sukuk, it will take time to develop the market and infrastructure on a domestic and international level,” he added.

Others have accused sukuk of being modelled on conventional bonds and forsaking the spirit of the Shariah principles of Riba, Gharar and Maysar.

“Although the sukuk market has grown significantly over the last few years, there has been little focus on the social and moral impact on the economy and society”, said Mehmet Asutay, Professor of Middle Eastern and Islamic Political Economy & Finance at Durham University Business School.

“The Islamic finance industry has not addressed key challenges such as the inner workings of sukuk structures and their impact on economic development including UN Sustainable Development Goals as well as issues related to legal, regulatory, Shariah and accounting standards,” he said. “The market-driven nature of Islamic finance has impacted the development trajectory of sukuk market resulting into lesser appreciation of fundamental Islamic moral economy principles in the construct, issuance, practice and impact of sukuk,” he added.

Investors have also expressed concerns the challenges over the recourse of underlying assets used in more equity-based sukuk structures, as a key risk factor.

“The recourse to the physical assets underpinning the sukuk structure is a key consideration for investors. The vast majority of sukuk issuance is asset-based rather than asset-backed,” said Doug Bitcon, Head of Fixed Income Funds and Portfolios at Rasmala in Dubai. “There is no recourse to the sukuk assets embedded in the structure, particularly national or sensitive assets. In a liquidation scenario, investors are expected to rank pari passu with senior unsecured conventional bond investors. Primary market sukuk transaction aren’t priced as asset-backed transactions, rather they are priced as unsecured liabilities of the obligor” he said.
In addition to the recourse of assets, investors also note the inability to trade certain sukuk structures is a drawback. “Sukuk tradability is important to many investors and there are certain constraints in Islamic finance,” Bitcon explained. “For example, Islamic investors cannot trade murabaha sukuk in the secondary market other than at par,” he added.

“Sukuk buyers don’t have the risk appetite for risk on equity structure investments like Musharaka and Mudaraba they have risk for debt investments. Therefore, the majority of sukuk are debt based,” explained the regional market participant. Others point to the fact that investors need further persuading before investing in other sukuk structures.

“In order for equity-based sukuk to be more popular, investors need to be convinced that they are running a low possibility of loss,” said Dey at White & Case. “Conventional bond investors typically have a different risk profile to Islamic investors. The conventional bond holder typically is only assessing a debt risk,” he added.

Hassan Jivraj, Reporter, MENA
Debtwire CEEMEA