Ṣukūk: A Panacea for Convergence and Capital Market Development in the OIC Countries

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1. Introduction

A phenomenon that has generated considerable interest in the Islamic finance industry in recent years is the emergence and growth of a form of Islamic securitization (*ṣukūk*) which has considerable abilities to offer innovative financial solutions. Not only is the product a genuine contribution to product innovation endeavours but also resonates well with other conventional capital market parallels. Many sovereign as well corporate issuers are, thus, actively considering this new alternative for their financing and investment needs.

Accordingly this discussion paper covers briefly various perspectives of the product including the following:

a. The origins of the product and its distinctiveness
b. An overview of the current *ṣukūk* industry
c. Attempts to explain the increasing popularity of *ṣukūk* among issuers and investors
d. Structural perspectives of the product
e. Some reflections on the developmental benefits which *ṣukūk* can offer to the countries of the Muslim world - including capital market development and institution building.

2. Origins and distinctiveness of *Ṣukūk*

It is a testimony to the totality of the Islamic system that Sharīʿah compliant alternatives shall always continue to exist as viable and legitimate substitutes to all non-Sharīʿah compliant activities Practised by human beings in all spheres of life. In this regard, Muslim scholars have over the years, given substantial thought to the matter of getting an Islamic alternative to conventional tradable financial instruments in view of the great potential of these form of instruments in the development and efficient workings of financial markets.

Sufficient empirical evidence appears to exist suggesting that *ṣukūk* were actually extensively used by the Muslim societies of the middle ages as forms of papers representing financial obligations originating from trade and other commercial activities.

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The words *Sakk*, *ṣukūk* and *Sakaik* are easily traceable in classical commercial Islamic literature. The words were particularly commonly used in international trade in the medieval Muslim regions along the words ḥawālah (representing transfer/remittance of monies) and *muḍārabah* (Partnership business activities)[1]

Nevertheless, a number of western writers on the history of medieval Arab/Islamic commerce have alluded to the conclusion that it is the word *Sakk* which has worked its way into the Latin voiced word of "cheque" or "Check" which is commonly used in contemporary banking.

Notwithstanding its historical perspectives and significance, the origins of the product in its contemporary context lies in one of the earlier decisions of the Islamic Jurisprudence Council (IJC) 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 *ṣukūk* consist of a majority of tangible assets".[2]

The ruling by the IJC, although not binding on any party, was however seen as a Sharīʿah breakthrough given the importance of this body in the Muslim world.

With such a backing from the IJC, and following a period of theory and model building, it was in the year 2001 that the earliest *ṣukūk* programs were launched in the market. The initiative by the Bahrain Monetary Agency (BMA) related to a short term (91 days) *salam ṣukūk* of US$ 25 Million launched in June 2001 and which was received very well in the market.

Bahraini followed its *salam ṣukūk* programme with longer dated ijārah *ṣukūk* before Malaysia (June 2002) and Qatar (2003) tapped the international market with mega sovereign *ṣukūk* offerings.

With the debut of this multi-million market, the pronouncement by the Bahrain based Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) of a Sharīʿah standard titled "Investment *ṣukūk*" in May 2003 was indeed important from an operational as well as a regulatory perspective.

The standard which became effective with effect from 1st January 2004 notes that "*ṣukūk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity…….".[3]

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[1] Udovitch, Abraham L. Partnership and Profit in Medieval Islam (Princeton: Princeton University Press, 1970), p. 86.
[2] Decision No. 5 of the 4th Annual Plenary Session of the OIC Fiqh Academy, held in Jeddah 18-23/6/1408H (6th – 11th February, 1988).
[3] AAOIFI Shariah Standard No. 17 – Clause No. 1 (Definitions).

The AAOIFI standard coming from an institution well respected both in the Islamic and conventional banking spheres was indeed timely as it offered an inevitable boost to the subject. For instance, it was quite helpful in terms of creating some Sharīʿah cross-border convergence in the Islamic world given that the standard was signed by 14 Muslim scholars comprising of top Sharīʿah scholars from the mainstream Muslim countries of the Middle East as well Malaysia, Pakistan and Sudan.

Nonetheless, the debut of *ṣukūk* has brought about a paradigm shift in the nature of Islamic finance products which were generally regarded as being illiquid and therefore lacked the qualities of market orientation.

A look at the general attributes of *ṣukūk* will reveal that *ṣukūk* have quite similar qualities to all other market oriented conventional financial assets including the following matters:

Exhibit 1:

Tradable	*Ṣukūk* Represent Actual Ownership Stakes In Defined Assets, Usufructs Or Business Activities And Can Therefore Be Traded At Market Prices.
Rateable	*Ṣukūk* Are Easily Rated By Regional And International Rating Agencies
Enhanceable	In Addition To The Underlying Assets Or Business Activities, *Ṣukūk* May Be Secured By Any Other Sharīʿ Ah Compliant Form Of Collateral(S).
Legal Flexibility	*Ṣukūk* Can Be Structured And Offered Nationally And Globally Under Difference Tax Regimes Including Regulations S And 144A
Redeemable	Structuring Of *Ṣukūk* May Allow For Redemption Possibilities

Source: Author’s own

It is in view of these similarities that *ṣukūk* have often been resembled to bonds and even to other conventional capital market products even though the product is quite distinctive in its nature as can be seen from the following few comparisons with some of the main conventional capital market instruments:

Exhibit 2:

Comparison With		
Bonds	Bonds Represent Pure Debt On The Issuer.	*Ṣukūk* Represent Ownership Stakes In Existing And/Or Well Defined Assets, Economic Activities And Services.
Shares	Shares Represent Ownership Stakes In The Entire Company	*Ṣukūk* Issued By A Company Will Represent Undivided Ownership Holdings In Specific Assets, Projects, Services And Activities Relating To The Company.
Derivatives	Derivatives Represent Multiple Generations Of Distinctive Contracts Created From The Basic Underlying Contract.	*Ṣukūk* Relate To Only One Contract And Maintain Asset Linkage At All Times.
Securitization	Securitization Generally Relates To The Converting Of Loans And Receivables Of Various Sorts Into Marketable Securities By Packaging The Loans Into Pools And Then Selling Shares Of Ownership In The Pool Itself.	*Ṣukūk* (As Defined By AAOIFI) Are Certificates Of Equal Value Representing Undivided Shares In Ownership Of Tangible Assets, Usufruct And Services …..

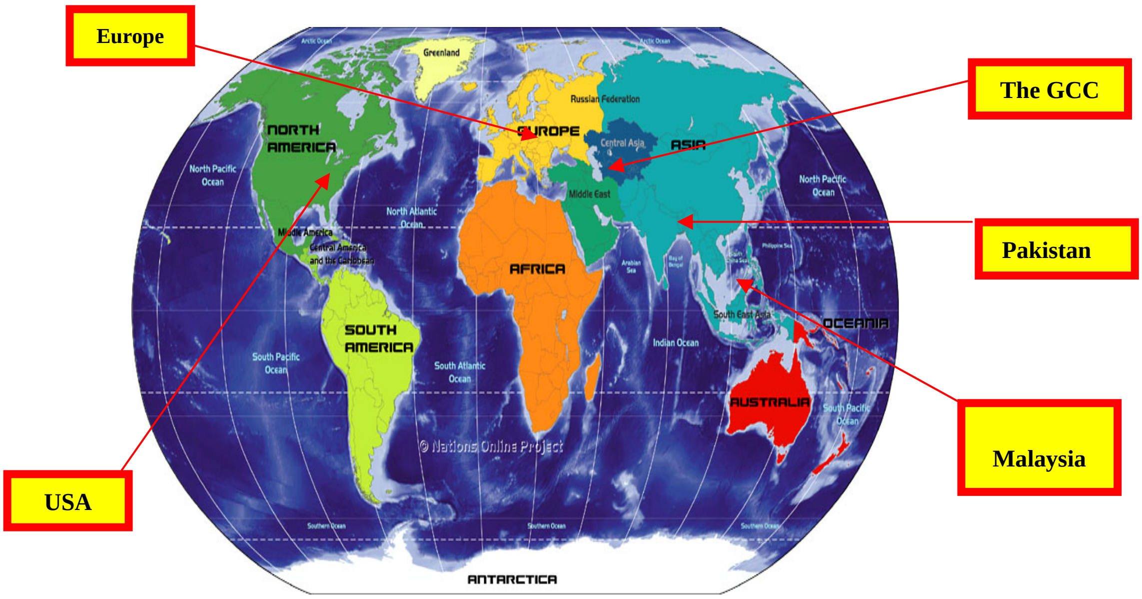
Source: Author’s own

3. Current Market Overview

Ever since the first *salam ṣukūk* of US$ 25 Million was launched by the BMA in 2001, interest in the product has grown tremendously and it has become increasingly popular among issuers and investors in different parts of the world.

Exhibit 3 below is representative of a continental overview of the actual *ṣukūk* Issuance domiciles so far:

Exhibit 3: Ṣukūk – a global product



Source: Author's own

3.1 Sovereign *Ṣukūk* Market

The exhibit below shows the size and dates of the international *ṣukūk* transactions so far issued by different sovereigns:

Exhibit 4:

ṢUKŪK BENEFICIARY	ISSUE AMOUNT	DATE ISSUED
Malaysia	$ 600 M	June, 2002
Qatar	$ 700 M	September, 2003
Bahrain	$ 250 M	February, 2004
State of Saxony-Anhalt, Germany	Euro 100 M	July, 2004
UAE - Dubai	$ 1.B	October, 2004
Sarawak State, Malaysia	$ 350 M	November, 2004
Pakistan	$ 600 M	December, 2004

Source: Author's own.

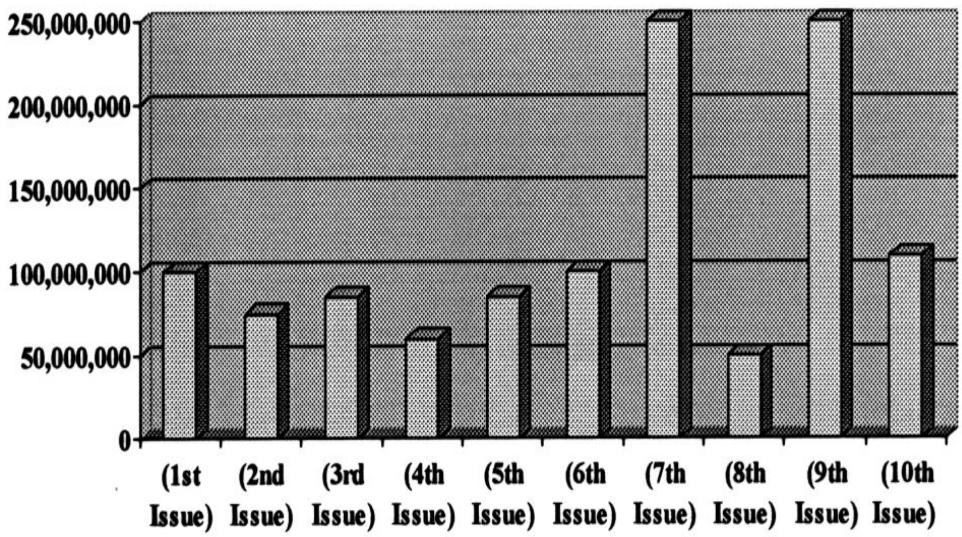
The Malaysian issue, which was the first *ṣukūk* offered internationally, was particularly of importance to the *ṣukūk* Market from a cross-border convergence perspective given the fact that earlier Islamic bond versions issued by the Malaysian Islamic Capital Market were predominantly not acceptable to the mainstream Islamic investor base in the Middle East because of divergence in certain Sharīʿah interpretations.

Accordingly, the deal which was offered in line with the AAOIFI standard was well received in the market and was oversubscribed by more than one and a half times and was largely taken by GCC institutional investors.

On the other hand, the Kingdom of Bahrain, even though its earlier issues were mostly local/regional market oriented, had shown an important commitment to the *ṣukūk* market development from its initial stages.

By January 2005 the Kingdom has issued *ṣukūk* Al ijārah worth more than US$ 1.3 Billion – the largest by far by any sovereign. *Ṣukūk* issuance is now an integral part of the Kingdom's strategy and it is noted that the country has undertaken a long term programme of converting its conventional issues to Islamically acceptable issues.[4]

Exhibit 5: BMA's *ṣukūk* Al ijārah Listed on Bahrain Stock Exchange as of January 2005.



Source: Islamic Finance Review; Issue No: 8 Published by Bahrain Monetary Agency January 2005.

[4] The Banker, 4th October 2004 Page 158 (Bahrain bolsters the Islamic finance industry).

It is also noteworthy that in addition to the ijārah *ṣukūk*, the BMA has continued with its rolling programme of monthly issuances of short term *salam ṣukūk* which has been in place since June 2001. By January 2005, the BMA had floated 44 issues of *ṣukūk* Al *salam* with a total value of US$ 1.1 Billion.[5]

The Saxony-Anhalt transaction was Europe's debut *ṣukūk* issue and added a new important geographic dimension to this burgeoning global market. The deal which was jointly managed by Citigroup and Kuwait Finance House was well received in the market with 60% of the issue taken up in the GCC and 40% to European investors.

4.2 The Corporate and Institutional *Ṣukūk* Market

Economically, *ṣukūk* financing replaces the need for financing from financial institutions, since the asset pool is sold to investors without necessarily involving financial intermediaries. This form of financing opens access to the capital markets for companies and institutions that on account of their ratings cannot obtain cost-efficient financing.

However, despite the clear advantages of *ṣukūk* to the corporate/institutional sector, it is notable that this sector has not tapped the *ṣukūk* market as much as it was originally thought. Various reasons can be advanced for the apparent slow development of the corporate *ṣukūk* market:

- Lack of product awareness and understanding
- Reluctance on the part of the corporates and institutions to provide proper transparency and the full disclosure of financials.
- Inability to pool the mass of Sharīʿah compliant assets to support a good sized issue in the market.
- Most companies are small and can only tap the *ṣukūk* market if supported by excessive credit enhancements.

However, despite the slow entrance of the corporate/institutional market, it is notable that the few corporate and institutional *ṣukūk* to hit the market so have represented a wide cross-section of business activities:

Exhibit 6: Corporate/institutional issues

Guthrie, Malaysia	US $ 250 M	December, 2002
FIIB, Bahrain	US $ 75 M	July, 2003
IDB	$ 400 M	August, 2003
Hanco, Saudi Arabia	US $ 26 M	February, 2004
Tabreed, UAE	US $ 100 M	March, 2004
Freddie Mac	US$ 200 M	March 2004
Emaar, UAE	US $ 65 M	June, 2004
Loehmann, USA	US $ 110 M	September, 2004
Durrat Al Khaleej, Bahrain	US$ 120 M	November, 2004

Source: Author's own

[5] Islamic Finance Review, Issue 8, Published by the Bahrain Monetary Agency, January 2005.

The IDB debut issue was particularly outstanding and was received in the market with a lot of interest. Not only was this because of IDB's position as the premier multilateral financial institution of the OIC but also because of other factors including the following:

- First ever AAA rated issue by any borrower in the OIC.
- Innovative - first to apply the 51:49 *khulta*[6] asset rule (i.e. Not 100% tangible assets but majority of tangible assets). Hence, deal was not asset backed but asset based.
- Yield fixation based on the five year mixed SWAP rate as opposed to the traditionally used LIBOR.
- Large interest from conventional institutions - 70% of the issue was taken by conventional institutions.
- Large interest among central banks of the Muslim countries - UAE central bank, Bank Negara Malaysia Saudi Arabian Monetary Agency, State Bank of Pakistan, Qatar Central Bank and Central Bank of Bangladesh.
- Global investor participation - 70% from the Middle East, 16% from the Asia-Pacific region and the remaining 14% from European institutions.

It is noted that in his closing remarks to the transaction, IDB chairman, H.E. Dr. Ahmed Mohamed Ali, said as follows: "Over the next 10 years we expect to raise US$ 4,000 million in the market."[7]

This statement was indeed taken on a welcome note by industry players given IDB's importance in the Islamic world in general and in the Islamic finance industry in particular.

In keeping true to the statement, it is noted that the IDB is now considering its second *ṣukūk* offering. Interestingly, it is noted that the forthcoming offering will not be based on ijārah but rather will be in the form of a series of Sharīʿah compliant Medium Term Notes (MTNs) which will be launched over the next year or so, and ranging from US$ 400 Million to US$ 1 Billion.[8]

Similarly, the Hanco transaction demonstrated an interesting deal for the market due to various reasons including the following:

- The first corporate *ṣukūk* from the Kingdom of Saudi Arabia (excluding IDB).

[6] Refers to mixture of different asset classes for the purpose of issuing acceptable securities such as mixing tangible assets with receivables for the purpose of issuing Sukuk Al Ijara. For most Jurists the proportion of the non-tangible assets should not exceed 30% although a much higher percentage of about 50% was seen in the case of IDB Sukuk.
[7] MEED Magazine, 1st August, 2003 – page 9.
[8] Islamic Banker, November/December 2004 issue – page 9.

- The first to be based on the receivables of leased movable assets – thus, not immovable assets as was the case in most other *ṣukūk* so far issued. The company is engaged in the business of vehicle leasing and rentals and the transaction was meant to securitize the receivables from the vehicles.
- The first *ṣukūk* by a family-owned business in the OIC countries. This is expected to open the way for more similar businesses as they migrate from private to public businesses.

Meanwhile, the issue by Freddie Mac (US Federal Home Loan Mortgage Corporation) was a breakthrough given that it was the first Islamic Mortgage Securitization in the USA. The deal was successfully concluded in co-operation with the Virginia based Guidance Financial Group. The offering was backed by Sharīʿah compliant real estate financed through declining balance co-ownership (*mushārakah*) programme run by Guidance Financial.[9]

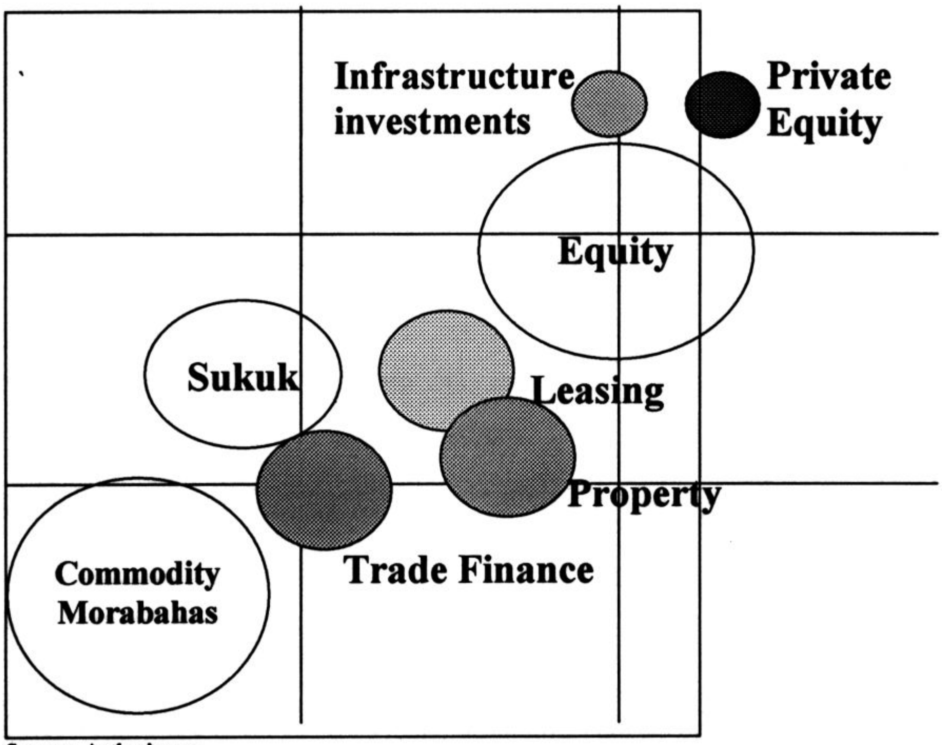
Likewise, the Durrat Al Khaleej *ṣukūk* was interesting in its own respect given that it was the first of its kind related to project financing. The proceeds were used for the basic infrastructural needs of the construction of a world class residential and leisure destination in the Kingdom of Bahrain.

The market is currently loud with the talk of a large number of sovereign and corporate issues to be launched in the near future. New expected sovereign players include the Kingdom of Jordan while BEMO securitization of Lebanon (which structured the Hanco deal) is said to be finalizing a mandate to lead arrange a *ṣukūk* for a US corporate.[10]

Although the *ṣukūk* market is relatively new, but the deepening of the same is quite apparent as can be noted from the number , size and diversity of issues seen during the past 2 years. It is actually well appreciated that *ṣukūk* has established itself very well in the landscape of other Islamic finance products as can be seen from the following exhibit.[11]

[9] Ibid (as in comment No. 9 above).
[10] Ibid – page 9.
[11] Estimates of Failaka, HSBC Amana and Islamic Banker – December 2003.

Exhibit 7: Global Islamic investments landscape in terms of asset size



Source : Author's own

It is noteworthy from the above landscape that *ṣukūk* seem to have taken a much needed middle (balancing) position in the array of available Islamic finance products i.e. Between the low risk/low return *murābaḥah* commodities and high risk/high return equity instruments.

In fact, a celebrated western academician recently noted that "it is likely to be *ṣukūk* issues, rather than simply the growth of Islamic bank assets that will account for most of the development in the Islamic finance industry in the coming decade"[12]

4. Asset Types

A notable aspect of the product is its capability of wide application in different financing requirements as can be seen by looking at the 14 prototype contracts stipulated by the AAOIFI standard including the following:

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12 Professor Rodney Wilson,, an overview to Islamic Bonds, Euromoney Books, London – Page 16.

a. The owner(s) of an existing tangible leased asset may monetize such assets through *ṣukūk* Al ijārah (Lease backed *ṣukūk*).
b. The owner(s) of a tangible asset to be acquired and subject to a lease contract may mobilize the acquisition cost of such assets through *ṣukūk ijārah mowsufa bi-ḍhimmah* (i.e., *ṣukūk* of defined/described future assets subject to lease).

Indeed, the versatility of the product is such that it has even enabled the undertaking of mega developmental residential real estate projects. An outstanding example is the pioneering case of the the Zam Zam Tower project in the holy city of Makkah in which investors were enabled to buy the future usufruct (*manfaʿah*) of the project through *ṣukūk* (*ṣukūk al intifaʿ*) which entitles to the holders the right to short stays at the residential units of the property for stated periods every year for the next 24 years.[13]. Thus, the *ṣukūk* have enabled an accommodation methodology quite akin to the conventional time-sharing concept.

5. *Ṣukūk* Tradability

In structuring and offering of *ṣukūk*, it is imperative that a close scrutiny is made of the Sharīʿah aspects relating to tradability of the *ṣukūk* once issued. A simple test is to check whether the underlying contract is one that leads to some kind of ongoing ownership stake in the underlying asset or project or investment or is one that shifts ownership and creates a debt obligation (*dayn*) on a third party. The following table based on the AAOIFI guidelines[14] summarizes tradability aspects relating to some of the common Sharīʿah contracts on which *ṣukūk* can be structured:

Exhibit 8:

Ṣukūk Type	Tradability
Ṣukūk of Freehold Existing Assets (*Ṣukūk* Al Ijārah)	Acceptable
Ṣukūk of Existing Assets Subject To Head Lease	Acceptable
Ṣukūk of Future Tangible Assets	Not acceptable before the asset is ascertained
Ṣukūk of Existing Specified Services	Acceptable prior to sub-leasing (selling) such services
Ṣukūk of Described Future Services	Not acceptable before source of service is identified
Ṣukūk Al *Salam*	Not acceptable except on face value.

[13] Sukuk offering prospectus – April, 2003.
[14] AAOIFI Sukuk standard , Pages 305 – 307.

Ṣukūk Type	Tradability
Ṣukūk Al *Istiṣnāʿ*	Acceptable if funds converted into assets and before sale to party ordering the project
Ṣukūk Al *Murābaḥah*	Acceptable before sale of goods/commodity to the end buyer. Once the goods are sold then trading only acceptable on face value
Ṣukūk Based on *Muḍārabah*, *Mushārakah* And *Wakālah* Contracts.	Acceptable after commencement of activity for which the funds were raised

6. Implementation Perspectives

All forms of legal structures may be used for a *ṣukūk* offering provided that the sanctity of the Sharīʿah is respected throughout the life cycle of the deal. The Sharīʿah calls for the Fulfilment by the parties of *bona fide* transactions and the whole picture must, therefore, be looked at to determine whether the transaction is Sharīʿah-compliant including the nature of the assets being securitised and the scheme of arrangement between the beneficiaries (owners) of the assets and the issuer. For instance, under the prevalent asset sale-lease-back *ṣukūk*, the following are some of the matters which will not be countenanced by the Sharīʿah:

A transaction in which the lease term is for a very short period. This may be regarded as a stratagem (*ḥīlah*) for getting funds with no genuine underlying commercial intention to transfer the asset. According to most Muslim Jurists, sufficient period of time must pass between the lease contract and the final buy-back agreement. The period of time suggested is such as to allow for the physical deterioration of the underlying asset so that it gets the economic characteristic of a different asset.[15.]

Executing along with the *ijārah* (Lease) contract a binding sale contract (or undertakings binding on both parties) for the eventual transfer of the asset to the Lessee. This is tantamount to making one contract contingent on another and is explicitly prohibited by the Sharīʿah as two sales in one sale.[16]

In addition to the above, it is imperative that close consideration is given to various other matters including the following.

- That the prospectus document offering the *ṣukūk* should provide complete transparency with regard to all information relating to the offering and to

[15] AAOIFI Shariah Standard No. 9 – Ijarah and Ijara Muntahia Bittamleek – clause 8/5 page 146.
[16] Ḥadīth of the prophet (pbuh) reported by Ahmad, Al Nisai and authenticated by Al Tirmidhi (See Nayl Al-Awtar 5/248).

the underlying assets. This is important so as to avoid any forms of deception or confusion (jahala) or gambling (*gharar*).

- That the *ṣukūk* are not monetary documents relating to receivables but representing actual and legal ownership stakes in specified tangible assets, usufructs and services.
- That *ṣukūk* can only be accepted as valid negotiable securities evidencing ownership if issued after receipt of the value of the *ṣukūk*, the closing of the subscription and employment of the funds mobilized for the purpose for which the *ṣukūk* were issued.[17]
- That *ṣukūk* do not represent a debt owed by the Issuer to the certificate holder but rather the certificateholders share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates bought.
- That *ṣukūk* are issued and traded on the basis of Sharīʿah-nominated investment contracts and in accordance with the specific Sharīʿah rules that may govern such contracts.
- That none of the activities of the offering should be seen to involve any sale of an existing debt obligation (receivable), or sale of an expected cash flow or relating to any interest obligation.

7. Structuring *Ṣukūk* Products

Notwithstanding its distinctive nature and close regulation by Sharīʿah precincts, *ṣukūk* have appealed to all types of international investors because of their compatibility with conventional securities structures. Nevertheless, the versatility of the product is such that it can be applied on all kind of legitimate assets that can generate predictable income streams.

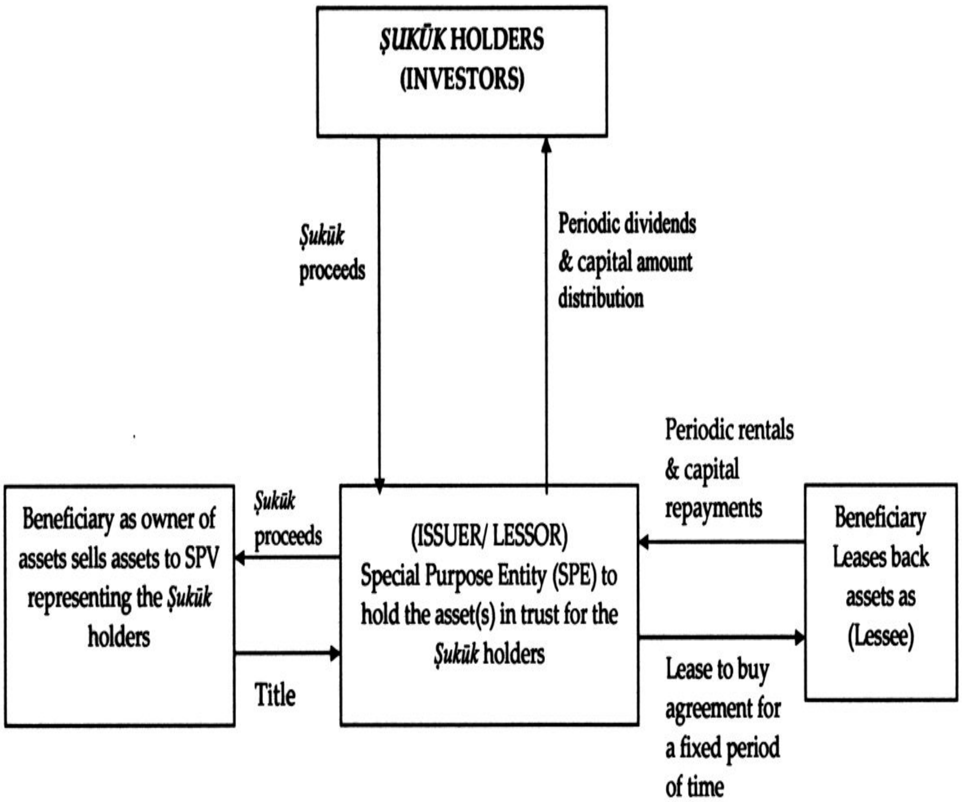
The following are brief discussions of some practical *ṣukūk* structures:

7.1 *Ṣukūk Al ijārah* (Leasing *Ṣukūk* Based on Asset Sale and Lease-Back)

This is the prevalent type of *ṣukūk* and exhibit 9 below shows a simplified overview of a generic *ṣukūk* structure.

[17] AAOIFI *Ṣukūk* Standard Clause 2 page 298.

Exhibit 9:



Source : Author's own

The overall transaction parameters may be summarized as follows:

a. Availability of a mass of eligible assets and their sale (segregation) by the owner (beneficiary). The underlying assets should exist in a form that is well defined and legally enforceable. The assets should also have volume which is sufficiently large and homogenous to facilitate statistical analysis.

b. Ensuring uninterrupted flow of profit and principal repayments to the *sukūk* holders during the life term of the transaction.

c. Eventual redemption of the *ṣukūk* and repayment of the *sukūk* holders and reversion of the asset(s) to the original owner.

In its simplest form the structure involves the following steps:

i. The owner (Beneficiary) of an asset (which is leased) sales the same to a "bankruptcy-remote," special purpose entity (SPE) in a manner that qualifies as a "true sale". From a Sharīʿah perspective, such sale may not have to be actual through an actual movement of title but could also be completed constructively through appropriate understanding of the documentation. Thus, transfer of registered title is not necessary, rather a collection of ownership rights that would allow the *ṣukūk* holders to perform duties related to ownership (if desired) or rights granting access (subject to notice) over the asset would be sufficient to comply with Sharīʿah.

ii. The issuance and sale is made by the SPE (Issuer), in either a private placement or public offering, of securities (*ṣukūk*) to *ṣukūk* holders - usually to institutional investors. The legal backing to the transaction would ensure that the *ṣukūk* are issued as "Pass-through" securities which enable direct participations for the investors in the pool of assets. In other words, the *ṣukūk* represent ownership interests in the underlying asset(s) and, thus, in the resulting cash flow. Principal and profit collected on the assets are "passed-through" to the *ṣukūk* holders. When the offering is "closed", funds are passed from the *ṣukūk* holders to the Issuer and from the Issuer to the Beneficiary. The *ṣukūk* holders, once the deal is closed, are at liberty to trade (sell) the *ṣukūk* in the secondary market or to retain them.

iii. The *ṣukūk* dividends (profits) and capital repayments (principal) are subsequently satisfied from the lease rentals to be received from the Lessees and from the eventual disposal of the asset(s) – if necessary. Thus, the purchased assets typically represent the principal source of cash to service the *ṣukūk*.

7.2 Project Finance *Ṣukūk* Structure

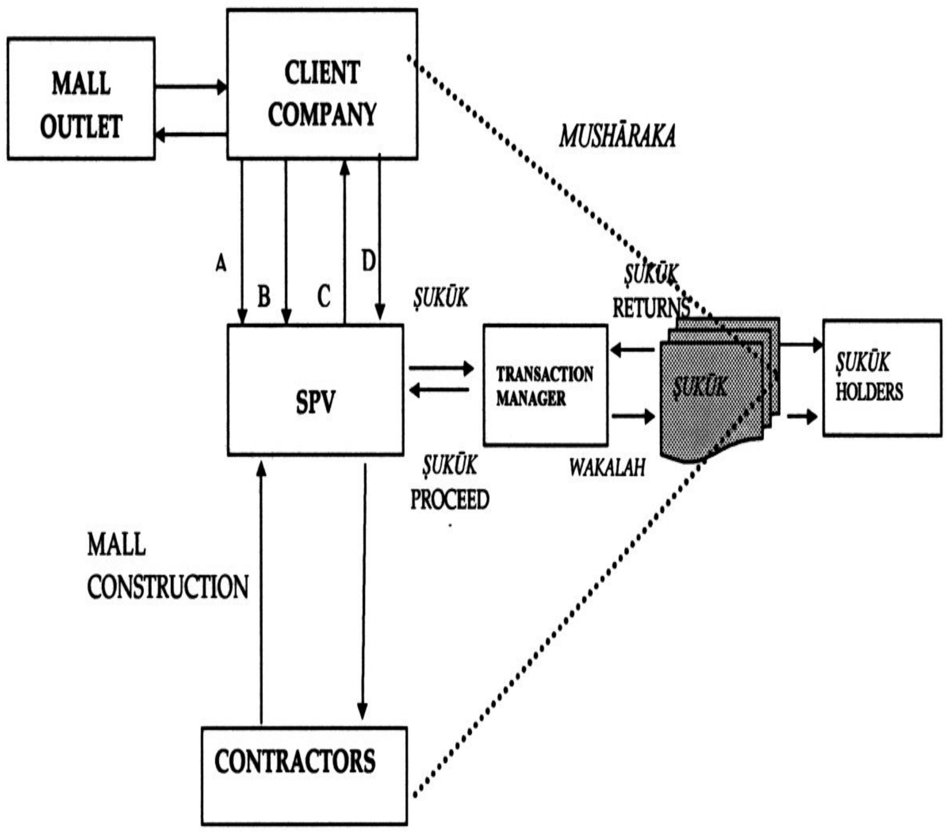
Not all *ṣukūk* structures are as simple as the asset sale-lease-back *ṣukūk* structure discussed above. Certain transactions may involve different and, in many cases, more complex execution arrangements. For instance, the following diagram represents *ṣukūk* offering for a project finance where funds are raised through *ṣukūk* for the construction of a Shopping Mall.

The outlets of the Mall are meant to be on-sold to interested buyers in which case some or all of the units may be pre-sold even before completion of the project. This will have the positive effect of reducing the overall investment horizon of the *ṣukūk*.

A number of contracts such as *wakālah*, *istiṣnāʿ*, and *ijārah* shall be applicable to such activities. Hence, structuring suck *ṣukūk* will require a more closer consideration of the Sharīʿah and legal implications involved.

Exhibit 10 :Project finance ṣukūk structure

A. *Istiṣnā'* contract; B. Security over property; C. Delivery of property; D. Repayment



7.3 Receivables Enhanced *Ṣukūk*

It is also interesting to note the possibility of *ṣukūk* applications in new frontiers such as *ṣukūk* enhanceable by receivables. For instance, basic industries with capability for export sales can benefit from such structures and thus generate much needed foreign currency. The exhibit below demonstrates an example of how, for example, the "Cotton Growers" of a country can raise foreign funding through *ṣukūk* enhanceable by the receivables from the foreign buyers of their produce.

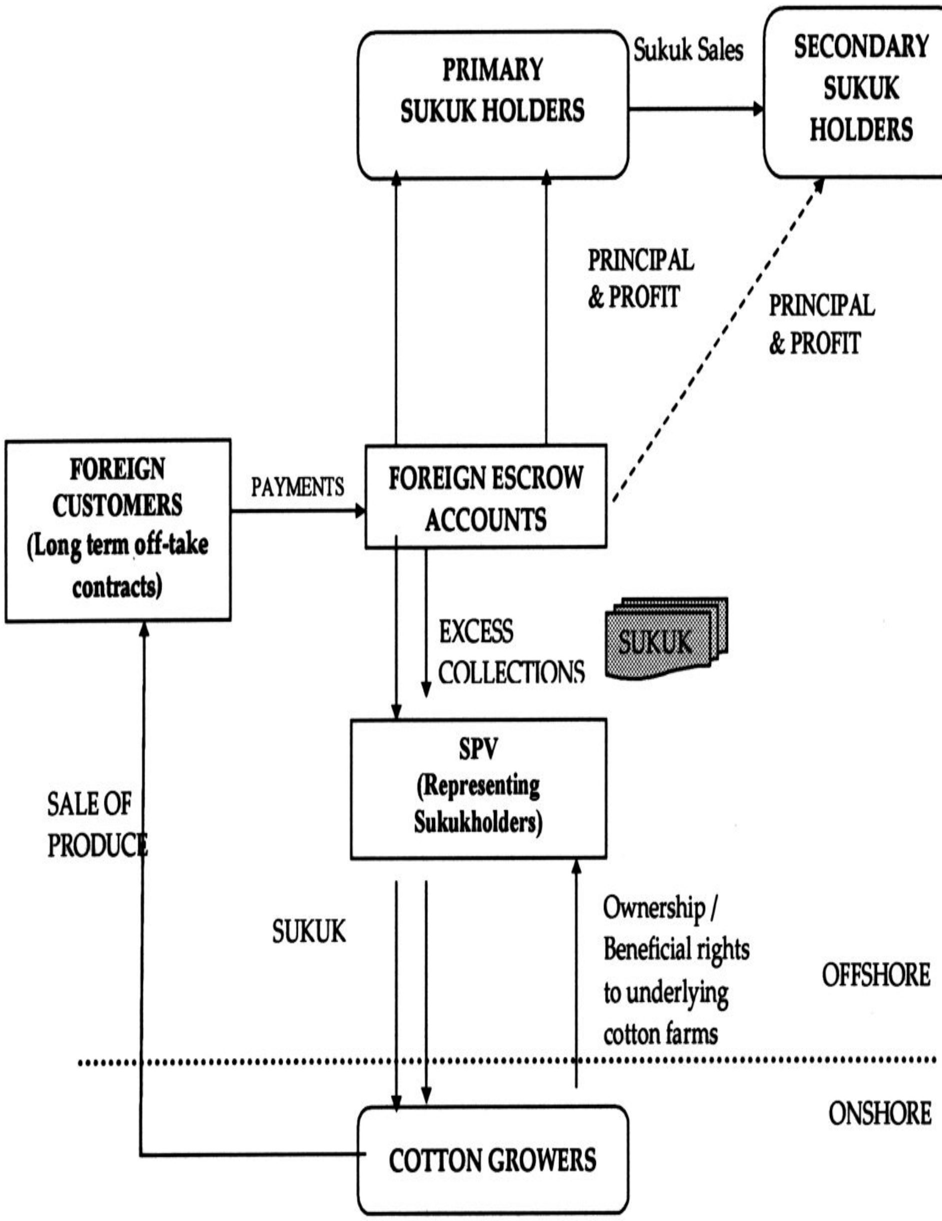
Through the structure, *ṣukūk* may largely be issued by the SPV to foreign persons and institutions interested in investing in the cotton production activity in the foreign country. The SPV will utilize the *ṣukūk* proceeds to fund the Cotton Growers against assignment of future revenues from the foreign buyers of the produce which is credited in a foreign escrow account. It is important, for the success of the transaction, that the future revenues assigned be sufficient enough to repay the original amounts invested by the *ṣukūk* investors together with acceptable returns. Of course, any excess proceeds after satisfying the amounts due to the *sukūk* holders shall be routed back to the farmers.

Thus, the farmers do not have to wait until they receive payment of the receivables to obtain funds to continue their business and generate new export sales. Obviously, such structures can only be accomplished successfully in circumstances where the beneficiaries have a strong track record and are engaged in businesses with a high likelihood of continuing at profitable levels. In addition, it will require the involvement of creditworthy foreign buyers whose risk can readily be accessed and accepted by the *sukūk* holders even though buyers risk can be mitigated through L/Cs from investment grade banks.

Through the structure, some major cross-border risks are mitigated including sovereign currency transfer and convertibility risks.

The sukuk holders in addition to the comfort of the foreign rentals also remain the "beneficial owners" of the underlying businesses i.e. Segregated cotton farms in the foreign country for the agreed period of time. It is also notable that the *ṣukūk* thus created are negotiable instruments which can be on-sold by the primary buyers to secondary market buyers . The tradability aspect is brought about by the *sukūk* holders owning the underlying assets (i.e. the segregated farms) and not the receivables, which only represent additional collateral. Thus, unlike conventional securitization, *ṣukūk* in such cases is based on the underlying assets and not the receivables which from a Sharīʿah perspective represent debts (obligations owed by third parties) and cannot, therefore, be traded.

Exhibit 11: Receivables enhanced ṣukūk



Given the excellent risk mitigation capabilities of this structure, such transactions can be rated even higher than the ratings of the host countries thereby attracting even a larger investor base than if it was the sovereign country itself issuing the *ṣukūk* directly. Where it happens that a better rating is granted to the structure than the host country, this has the positive effect of reducing the overall cost of the offering to the beneficiary as compared to if funds were sourced from local banks. .In addition, the beneficiary would usually act as a Servicer and would receive a fee for its services.

Thus, the development of such *ṣukūk* structures can indeed prove to be very beneficial to most countries of the OIC member states who seem to have a large number of basic industries that have good capabilities of earning foreign currency. This is particularly more significant when the industries involved are relatively of long term nature such as Airline and Telephone companies whose foreign revenues can easily be used to enhance the credit profiles of the *ṣukūk*.

It is also notable that many of the OIC countries such as Egypt, Jordan, Pakistan, Sudan and Syria have a large number of their nationals working abroad – particularly in the GCC states. Hence, these nationals may be encouraged to take investment stakes in development projects back in their home countries particularly where such projects are based on structured offshore *ṣukūk* offerings of the type discussed.

7.4 Risk Participation *Ṣukūk*

Unlike lease-backed *ṣukūk* which can be structured to yield pre-determined dividends, risk participation *ṣukūk* are those which, by contract, cannot yield pre-determined dividends (returns). Such *ṣukūk* would normally be based on the risk sharing contracts of *muḍārabah* and *mushārakah* and it is, of course, notable that the same have not been seen in the market as yet apparently because of implementation difficulties and moral hazard issues relating to the transactions.

Despite their virtual inexistence, however, *muḍārabah* and *mushārakah* represent (according to the opinions of many) the most desirable ways of financing investment and business because of their requirement for attaching risk-to-reward and their ability, therefore, to generate much higher risk-adjusted returns. In fact, even in the context of *ṣukūk* it was in the name of *muḍārabah* that the ball was first set rolling on the back of the initial Sharīʿah approval about the acceptability of trading Muqarada (*muḍārabah*).[18]

Risk participation *ṣukūk* would preferably relate to specific (single-purpose) projects and an analysis of the prevalent structures in the conventional fixed income instruments shows that such *ṣukūk* resemble the Municipality Revenue Bonds which are payable from specific sources of revenue without involving the full faith and credit of an issuer. Such bonds are payable only from specifically identified sources of revenue and the pledged revenue will mostly be derived from the operations of the financed project. However, despite this overall structural resemblance, it should be realized that predetermination of project returns under a risk participation contract is repudiated by the Sharīʿah.

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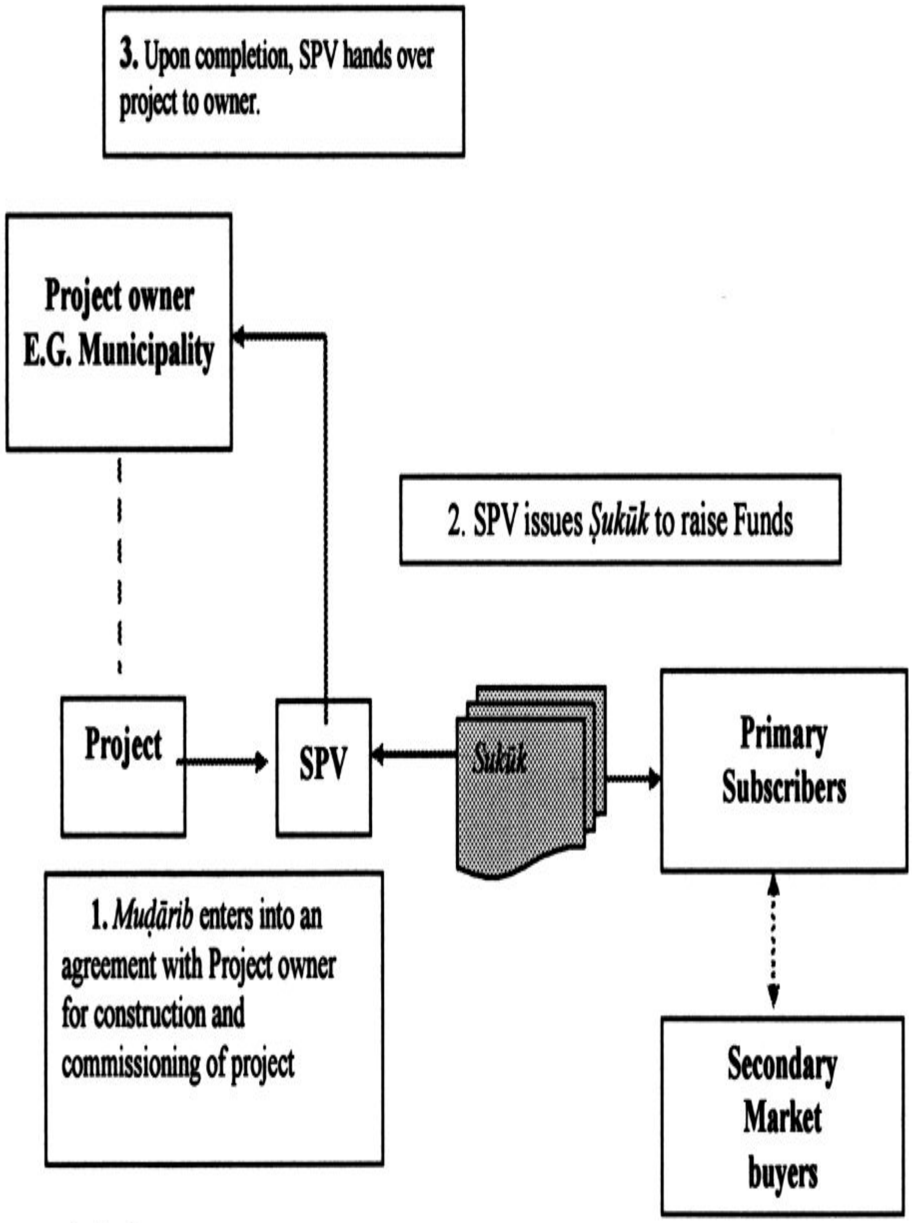
[18] Ibid (as in comment 3).

According to the Sharīʿah, funds for projects to be undertaken are taken by the entrepreneurs with a view to earning future unknown profits. In this regard, the uncertainty of future earnings from the project nullifies the case for predetermined fixed returns on the amounts invested. Hence, the logic promulgated by the Sharīʿah is one that advocates the rewarding of capital not in the form of a predetermined return but in the form of a probable rate of return to be earned by both parties sharing the risk and rewards of a bona fide economic activity.

Nevertheless, the methodology and spirit of funding under such modes is that their successful implementation does not require anything more than the prudence and due diligence needed to be undertaken by a conventional venture capitalist on a business being acquired. Interestingly, venture capitalists seldom require current income (i.e. Interest or dividends) on investments. Capital appreciation is their primary goal and is usually realized through a sale of the company to a strategic buyer or an initial public stock offering.

Risk participation *ṣukūk* can be applied very well to projects such as water facilities, toll roads and many others which are a perfect fit for *ṣukūk* because of their ability to generate good predictable cash flows on a standalone basis.

Exhibit 12: Example of project finance ṣukūk al muḍārabah structure



Source : Author's own

The steps represented in the chart typically involve an agreement for the construction of a project which is to be financed by *ṣukūk* investors through a *Moḍārib* (SPV). The *ṣukūk* shall be tradable in the market until liquidation of the *muḍārabah* when the project will be sold (passed over) to the beneficiary.

It is worth mentioning that, despite the overall prohibition by the Sharīʿah of predetermining returns under such contracts, it is however, possible to distribute to the *sukūk* holders in advance (while the project construction/commissioning is on-going on) part of the returns expected from the project; but on the strict understanding that such a profit is provisional and is made "on account". Thus, final take away will be determined when actual valuations and audited accounts are made at the end of the project and any necessary adjustments will be made accordingly.[19]

The underlying agreement will be drafted in such a way as to cover the matter very well and to clarify to the investors that any amounts paid to them as provisional profits shall be deducted from their capital in the event of the project realizing a loss upon final valuation.

8. Legal Issues in *Ṣukūk* Structuring

There are a number of key legal issues which arise in most *ṣukūk* issuances; but of all the issues, the single biggest legal risk considerable under a *ṣukūk* transaction relates to the proper segregation of the assets from the original owner. It is imperative that once the sale and transfer of the assets to the SPV has been effected, it cannot be challenged, voided or otherwise reversed in an insolvency of the original owner (or any other party for that matter). This is what is known as title risk and the need, therefore, to have a "true sale" scenario (or its legal and equivalent) for the passage of the assets from the original owner to the SPV.

Nevertheless, whether a transaction constitutes a true sale under the applicable law of the original owner's country (notably, whether it will be recognized as such by the competent courts of the original owner's country) can at best be deduced by looking at previous cases. However, given the infancy of *ṣukūk* in general and the lack of any precedence in this regard, the only option available would be to undertake a thorough legal analysis of the transaction. This would, therefore, call for the proper perfection of legal interest in the assets and to ensure the distinctiveness of the SPV along the following lines:

- That the SPV is a separate legal entity and there is no ownership/shareholding relationship between the original owner of the assets and the SPV.
- That the SPV has paid off the price for the purchased assets in consideration for the transfer of ownership/title.

[19] AAOIFI Sharaīʿh Standard No. 13 Mudaraba 8/8.

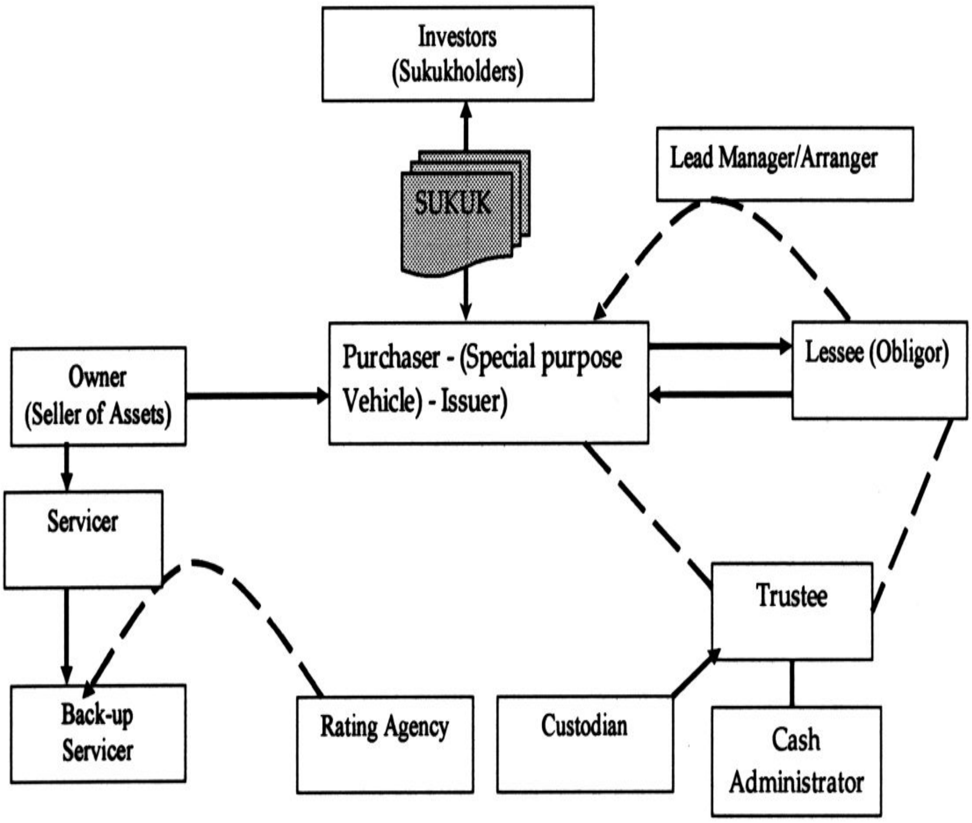
- That the SPC was/is not managed by the original owner of the assets.

Nevertheless, appropriate Legal opinions need to be taken from reputable legal firms for the legal and structural aspects of the transaction for the successful offering of the product to the market place.

9. Counterparties in *Ṣukūk* and their Roles

There are various parties that come to play in any *ṣukūk* transaction. For instance, the following are some of the key parties involved in a *ṣukūk Al ijārah* transaction even though further parties may be involved depending on the respective requirements of the individual transaction:

Exhibit 13:



Owner/Seller: These are the governments, municipalities, corporates, financial institutions and others that own the assets to be offered for the *ṣukūk* offering. The owner sells the assets to the SPV representing the *sukūk* holders.

Purchaser: a Special Purpose Vehicle (SPV) which purchases the assets. The Purchaser funds the purchase price by issuing asst-backed *ṣukūk* into the capital markets (in this capacity, the Purchaser is also referred to as the Issuer). It is usually located in a tax efficient offshore jurisdiction. Choice of appropriate jurisdiction with strong legal infrastructure is important. The trust is a passive entity and has the sole purpose of owning the assets relating to the transaction. It cannot engage in any other activity whether profitable or non-profit oriented.

Servicer: services the assets of the *ṣukūk* by, for example, collecting and administering the rentals. Usually, the original Owner of the assets retains this role on the basis of a distinctive service agreement.

Back-up servicer: will service the assets in the event, for instance, of the Servicer's bankruptcy or in the event the Purchaser exercises its right to remove the Servicer.

Investors: Purchasers of the *ṣukūk*. In the past, most *ṣukūk* investors were major institutions (both Islamic and non-Islamic) including banks, insurance companies, central banks and corporates. Thus, not many retail oriented offerings have come to the market as yet. However, in *ṣukūk* distributions a close watch is imperative on whether the investor base is qualified or unqualified under the offering memorandum. This will be determined by the distribution format adopted for the offering (e.g. Whether its under regulation S or 144 A).

Lead Manager : The arranger and structurer of the transaction. The Lead Manager is often the primary distributor of the transaction. This may be done together with other parties acting in the capacity of co-Managers;

Rating Agencies : rate the *ṣukūk*. Standard & Poor's has so far been the main institution to rate *ṣukūk*.

Cash Administrator : provides banking and cash administration services for the Issuer;

Security Trustee : acts on behalf of the *sukūk* holders;

Trustees : usually a bank or other entity authorized to act in such capacity. The Trustee, appointed pursuant to a Trust Agreement, holds the assets (including rental /repayment proceeds) and makes payments to the *sukūk* holders.

Custodian : an entity, usually a bank, that actually holds the assets as agent and bailee for the Trustee.

10. *Ṣukūk* Rating Methodology and Role of the Rating Agencies

Rating Agencies provide; in the context of the *ṣukūk* market, a credit rating of the *ṣukūk* to be offered to the investor base. A credit rating is (usually) an opinion on the likelihood that the issuer will be able to pay full principal and interest on the rated security in a timely manner in accordance with the terms of the security. Nevertheless, rating Agencies play an integral role in such transactions (at least those that are rated) and have a considerate degree of input with respect to how cash flows and the legal framework is structured in a *ṣukūk* transaction.

Ṣukūk issues meant to attract capital from the international market place will usually seek to be rated by international rating agencies to enhance their attractiveness to investors and provide a guideline for their pricing. Obviously, the higher the rating a *ṣukūk* achieves the wider the potential investor base and the lower the coupon (rentals) that the obligor (Lessee in the case of *ṣukūk* Al ijārah) pays on the *ṣukūk*.

The following exhibit shows the ratings granted by Standard & Poor's to the different sovereign *ṣukūk* so far rated by them:

Exhibit 14: International ṣukūk issues by sovereigns

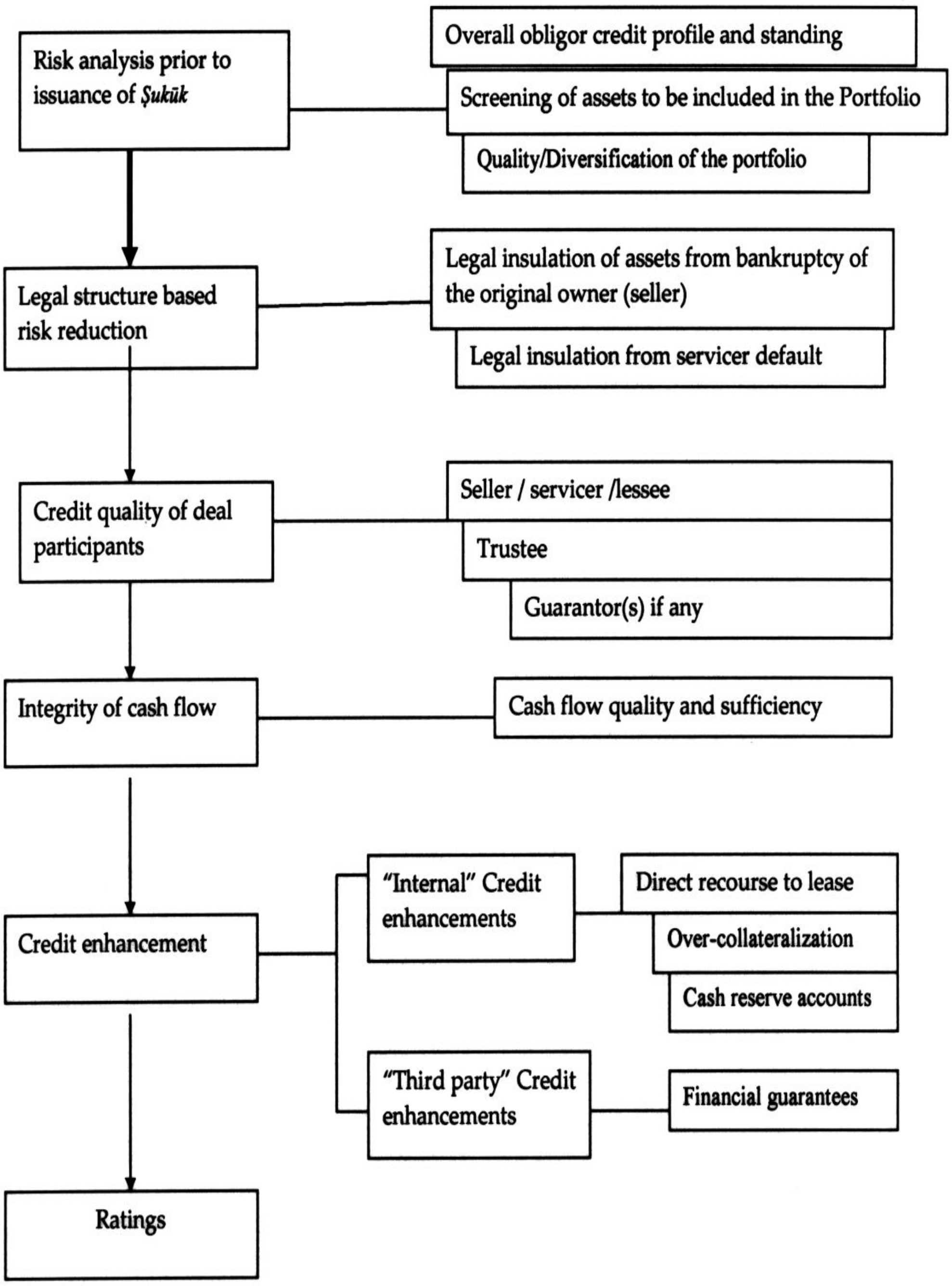
ṢUKŪK BENEFICIARY	ISSUE AMOUNT	DATE ISSUED	RATING GRANTED
Malaysia	$ 600 M	June, 2002	A-
Qatar	$ 700 M	September, 2003	A+
Bahrain	$ 250 M	February, 2004	A-
State of Saxony-Anhalt, Germany	Euro 100 M	July, 2004	AA-
Sarawak State, Malaysia	$ 350 M	November, 2004	A-
Pakistan	$ 600 M	December, 2004	B+

Source : Author's own

The rating process is quite involving and the rating agencies will closely examine various matters including the legal structure of the transaction (notably, the true sale element), the quality of the asset pool and the ability of the Lessee (in the case of asset sale-lease-back *ṣukūk*) to meet the lease rental obligations; the structure of the transaction and the repayment mechanism; the risks in the transaction (including market, counterparty, sovereign and legal risks) and the availability and quality of any credit enhancements.

The rating analysis usually flows through a comprehensive criteria as follows:

Exhibit 15: Şukūk rating analysis considerations

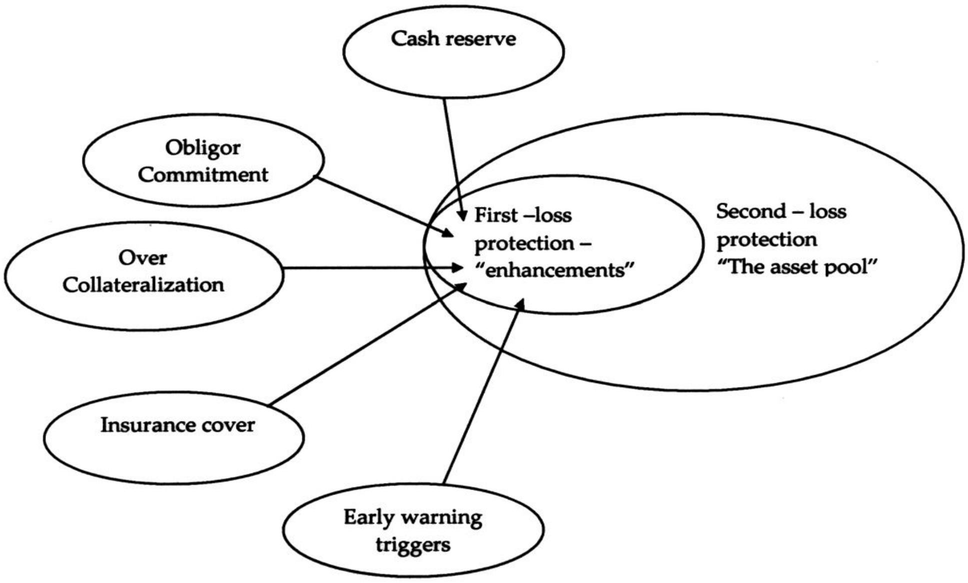


Source : Author's own

11. Credit Enhancements in *Ṣukūk*

Credit enhancements are collateral aspects which may be sought for a *ṣukūk* transaction in addition to the underlying assets. The purposes of credit enhancements is to reduce the risks to the Investors and to increase the rating of the *ṣukūk*. They could be internal and/or external and the following exhibit shows various types of enhancements which may be possible under a *ṣukūk* transaction:

Exhibit 16: Types of possible credit enhancements



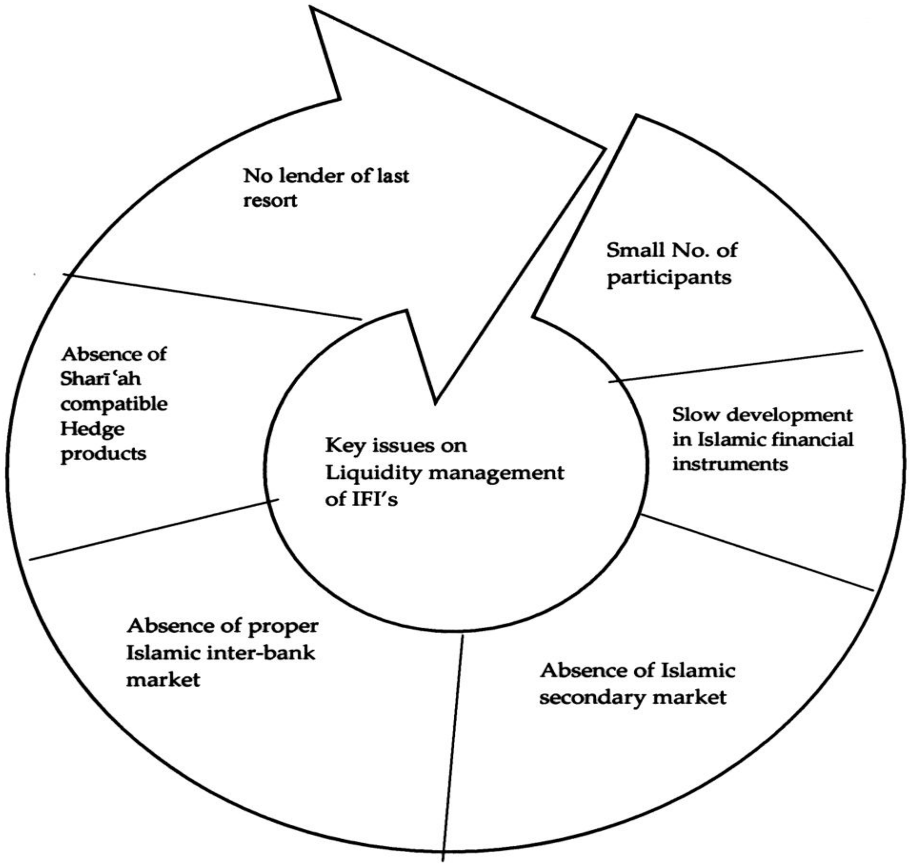
Source: Author's own

- Over-collateralization – The assets sold would have value greater than the value for which they were bought for by the SPV.
- Early Warning Triggers – Requirement for the obligor (Lessee in the case of asset sale-lease-back *ṣukūk*) to abide by certain conditions agreed upon as part of the documentation , the failure of which will trigger possibilities of defaults.
- Cash Reserve Account – excess monies deposited in an agreed upon account with the Trustee to be used as a back-up for the rental proceeds

12. IFIs and the Potential of *Ṣukūk* in Balance Sheet Management

Balance sheet restructuring is an exercise undertaken by even the biggest banks quite often. Nevertheless, Islamic banks in particular have unique funding shortcomings because of various internal and external factors some of which are summarized in exhibit Seventeen.

Exhibit 17: Funding difficulties facing Islamic financial institutions (IFI'S)



Source: Author's own

It is in view of this circumstances that *ṣukūk* can be used efficiently by IFIs to monetize/liquidate some of the asset holdings in their balance sheets as and whenever necessary.

At least one Islamic bank - First Islamic Investment Bank of Bahrain (now known as ARCAPITA) – has so far tapped the market by securitizing a portion of its balance sheet by successfully offering *ṣukūk* for US$75 Million in July 2003. The *ṣukūk* were based on a mixed pool of real estate and other assets on the bank's balance sheet.

FIIB as an investment bank with specific portfolios of long dated assets was probably well based to lead the market in this regard. However, depending on the mix and quality of available assets and subject to proper cost/benefit analysis, *ṣukūk* could be a simple, cost-effective, alternative funding mechanism which remains available to all types of IFIs.

Another institution, Amlak Finance, an Islamic mortgage finance company based in the UAE issued in June 2005 *ṣukūk* worth US$ 200 Million. The exercise was to free up funds for the further expansion of the company's mortgage activities.[20].

Some of the benefits that can be attributed to *ṣukūk* issuance for the IFI include the fact that it creates immediate funding for the institution. Thus, the bank does not have to wait for long dated assets to mature. This would in turn ease out some of the gross asset/liability mismatches found in the balance sheets of most Islamic banks.

The first exercise for an Islamic bank which may consider offering *ṣukūk* on its balance sheet assets is to identify the pool of assets which can be availed for the *ṣukūk* exercise. In this regard, suitability of the assets from a capital market perspective is an important consideration for the bank before embarking on the exercise. For instance, *muḍārabah* and *mushārakah* based assets (if any) will not be quite appealing to the investor base because of their contractual inability to structure fixed income dividends. On the other hand *murābaḥah* assets which represent the bulk of assets on the balance sheets of Islamic banks may not be securitized as they represent debt (*dayn* which, thus, will prohibit the paper from tradability.

This, therefore, leaves the Islamic banks only with *ijārah* based assets and other tangible assets such as properties which can comfortably be securitized. But even then, the pool of assets to be considered for the issue will need to meet certain criteria such as a stable credit history in terms of defaults, delinquencies, prepayments and so forth

Following identification of the appropriate assets, consideration will be given to the structuring aspects of the deal. Where fixed real estate assets or other tangible assets is to be used as a backing of the offering, then the simple *ṣukūk* Al ijārah mode may be adopted. Similarly, where the offering is to be based on long dated ijārah financing contracts then the offering may be structured on the basis of redeemable *ṣukūk* Al ijārah which will have shorter terms than the underlying contracts.

Alternatively, depending on marketability perceptions, the bank may issue *ṣukūk Al wakālah* on certain identified assets or activities on its balance sheet in which case the investors will share the risks and rewards of the same with the bank.

[20] Traced at AME info June 2nd 2005.

Meanwhile, other external matters to be considered by the bank include regulatory and accounting issues.

Finally, to serve as a source of liquidity for the bank and to maximize the benefits of *ṣukūk*, the IFIs may need to undertake *ṣukūk* offerings on a continuous basis. The once-off *ṣukūk* transaction may be used to restructure the balance sheet in order to improve liquidity ratios or to bring temporary liquidity relief, but it may not offer a continuous source of liquidity. Hence, a continuous Programme may be necessary to lead to a true diversification of liquidity sources. Once-off transactions are also more expensive than a continuous Programme, since the initial set-up costs remain the same in both circumstances.

Meanwhile, it is notable that many of the IFIs are small banks that may not have large pools of assets for *ṣukūk* offerings. Hence, a probable suggestion is the concept of a "multi-seller" transaction under which a number of Islamic banks will pull assets together and would have a communal SPV to which the assets will be sold. The *ṣukūk* thus, issued by the SPV may have the critical mass needed to enable listing on the stock exchange so as to be accessible to a wider investor base, which a small bank may not have been able to achieve on its own.

13. *Ṣukūk* and Development of the Capital Markets of the OIC Countries

By all standards *ṣukūk* is one of the most significant financial innovations and additions to the Islamic Finance industry product range in the recent past. The *ṣukūk* market, although small, has taken off very well and could indeed represent the new blood that has long been waited to inject life into the capital markets of the entire Muslim world.

Ṣukūk, which itself is a by-product of the fast growing Islamic finance industry, has confirmed its viability as an alternative means to mobilize long-term savings and investment from a huge investor base which is keen to invest in formats compliant with the Islamic Sharīʿah. This development has been fuelled not only by the desire to raise funds in a Sharīʿah-compliant methods but also by the other excellent attributes of the product as already discussed.

The growth of the *ṣukūk* market may also be attributed to its potential for liquidity management - this is one of the key elements identified as necessary for the future development of the Islamic banking and finance industry. Presently only a small proportion of *ṣukūk* are traded, with most investors taking a buy-and-hold approach. As more *sukūks* are issued, investors are likely to begin trading their holdings to generate greater returns on capital invested.

It is also quite encouraging that a number of industry building institutions have been created over the past few years to offer certain services needed for the success of the product and, thereby, contribute to the creation of the much needed Islamic Capital Market. Notable among such institutions are the following:

- Liquidity Management Centre (LMC)
- International Islamic Financial Market (IIFM)
- International Islamic Rating Agency (IIRA)

Admittedly, however, with all the progress made, the *ṣukūk* market is far from realizing its full potential and the idea of a fully Islamic secondary market remains a distant away. The cumulative value of *ṣukūk* issues outstanding is only a fraction of the market demand. For instance, *ṣukūk* Al ijārah which has been the dominant type of *ṣukūk* so far is only one of the 14 asset classes that has been approved by the AAOIFI standard. In fact *ṣukūk Al ijārah* has its own shortcomings including the fact that it may not always be easy pooling sufficient quality unencumbered assets to support a good issue in the market.

Hence, concentration on *ijārah sukūks* only may not be able to generate sufficient vigour to create the critical mass needed for the growth of the *ṣukūk* market. This is particularly true with regard to mobilizing domestic long-term capital needed badly by the Islamic countries for the financing of infrastructure and development projects so as to reduce dependence on external debt resources.

It is also worth noting that *ṣukūk Al ijārah* proceeds may not necessarily be used for the execution of any new developmental projects as the cash once raised on the existing assets can be used for meeting of recurring expenses or for repayments of maturing obligations. As a comparison, the risk participation *ṣukūk* are project specific and the proceeds once generated will be used to fund new projects and business activities; i.e. new assets are added to the economy. Long-term funding is essential for infrastructure projects and, it is, therefore, imperative that the next generation of products should aim at developing other *ṣukūk* products particularly those that are able to support infrastructure and development projects.

In the absence of developed domestic markets, it is unfortunate that most Islamic countries will continue with their dependence on external resources. But even then, external funding may not always be forthcoming for many necessary projects due to various reasons including the following:

The absence of mature legal and regulatory frameworks for the capital markets of most countries will be a hindrance particularly to private long-term foreign capital.

Projects that are typically local currency generators (utilities, toll roads, etc.) will have difficulties in attracting long-term foreign capital because of the inherent currency risk.

Many countries of the Muslim world have credit ratings below investment grade. This will discourage international investors coming forward even if the transaction was issued in foreign currency.

Hence, given the huge developmental requirements of most Islamic countries, it is, therefore, to the interest of the governments of these countries to encourage the development of the *ṣukūk* market which may appeal to a large cross-section of private investors within these countries.

Indeed it is unfortunate that most OIC countries are missing to tap the liquidity in the Islamic market within their countries through *ṣukūk* which also could prove a cheaper method of funding than foreign loans. No doubt, there are sufficient investors in the Muslim world to warrant the attention the product has received so far. In any case, investor confidence in the product is also quite high telling from the response to all the *ṣukūk* so far issued which have received overwhelming response and were hugely oversubscribed.

In particular, potentially large groups of investors in *ṣukūk* include the Islamic institutional groups such as pension funds, *zakāh* funds, Pilgrimage funds, the endowment groups (*awqāf*) and Islamic insurance (*takāful*) institutions. The global figures for these Islamic institutions are currently not compiled; however, based on scant statistics in some of the Gulf countries, it is believed that these institutions have substantial assets and long-term liabilities and have a natural demand for long dated Sharīʿah compliant investment avenues.

On the other hand, it has been proved beyond doubt that the Islamic investment market is not necessarily averse to risk sharing contracts given the huge monies invested by Islamic investors in Mutual Funds such as equity Funds and venture capital Funds. These Funds (most of them investing outside the Islamic world) can all generally be regarded as high risk asset classes. Yet capital has always continued to flow into these Funds. At their peak, early in 2000, the number of such funds were close to 100 and managed approximately US$ 5 billion in assets.[21]

Nevertheless, unless good domestic capital markets offering long-term investment opportunities are developed by the OIC countries, then the Behaviour of Islamic investors may not change substantially from previous prototypes. Thus:

Investors will consume their current income instead of saving. Such a scenario although it may be good for local and regional trade, is not however, healthy over the long-haul as it will tend to increase inflation which in turn will decrease real returns thereby causing retardation in the overall growth of the economy. This unfortunately is the case in most OIC countries at the moment.

Investors will place their surpluses in the property/real estate sector. The direct consequence of this is to cause oversupply of residential and commercial property thereby depressing rental incomes and thus deviating investment from other sectors with higher added value. This could in turn have a negative impact on banks and other institutions that financed these properties. This trend is, unfortunately, also rampant in many Islamic countries.

[21] Failaka International report March 2002.

Investors will speculate excessively on the stock exchanges of their countries. This may eventually have negative consequences for these exchanges.

Investors will look for investment opportunities and productive ventures outside their countries- a phenomena already witnessed in a big way. The USA and other OECD countries are rife with examples of Arab and Islamic wealth chasing investments in these countries.

14. Conclusion

Ṣukūk as an Islamic finance product has apparently been born as a success story and appears to have a lot of potential for the boosting and/or growth of the domestic capital markets of the Muslim world. Hence, it is only imperative that governments of the OIC member states come off the wait-and-see approach and garner the necessary political will and direction for the further and fast development of this useful product. Needless to say, but the first step towards that should be to see more countries creating the necessary legal and regulatory infrastructures as well support institutions required for the growth of the product.

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COMMENTS

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