PDF generated on: Thu, Nov 05, 2009

Backgrounder to Sukuk

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) gives the following standard for Sukuk

'Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity.'

This means that the Sukuk must be backed by assets that are subject to Shari'ah compliant contracts. These might be:

- Ijarah contract (similar in structure to a standard lease)
- Salam contract (payment in advance for goods to be delivered at a date in the future)
- Murabaha contract (asset financing)
- Modarabah contracts
- Istisna'a contract
- BBA contracts
- Intifaa

There are similarities between Sukuk and conventional asset backed securities structures. Both effect a transfer of the ownership of assets and the rights to the cash flows derived from those assets to the holders of the securities. Both allow the originator to raise finance on the assets without giving up equity in the originator itself. The assets are transferred to an SPV and as long as the transfer is characterised as a true sale, the financing of the SPV isn't treated as debt on the balance sheet of the originator.

There are two requirements for this to be successful. The first is that they should generate stable cash flows of income and of principal which can be readily predicted and which can be used to service the obligations of the Sukuk being issued under the securitisation programme. The second is that they must carry a predictable and low level of risk.

A properly constructed Sukuk limits the debt to the value of the underlying assets.

Each type of contract is different in structure. The following is an outline of the major types of Sukuk contract.

Ijarah Sukuk

Ijarah Sukuk are issued on standalone assets identified on the balance sheet. The assets can be land to be leased or equipment (aircraft, ships) to be leased. The rental rates of returns on these Sukuk can be both fixed and floating depending on the particular originator.

Salam

Salam contracts are issued when payment is made in cash at the point of contract but the delivery of the asset purchased is deferred to a pre-determined date.

Murabaha

Murabaha contracts are those that cover the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved. The settlement for the purchase can either be settled on a deferred lump sum basis or on an installment basis and is will be specified in the contract.

Modarabah

Modarabah contracts are used to finance a business venture between twp parties. The parties are an investor who solely provides the capital and an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss ll be borne solely by the provider of the capital.

Istisna'a

These tend to be used in project finance. Such contacts are not tradable securities since the underlying asset does not yet exist. Scholars accept a security as tradable as long as the underlying tangible assets are 51% of the market value. The proceeds of such an issue would typically be used to construct the base infrastructure through multiple Istisna'a agreements. As the base infrastructure projects for each Istisna'a are completed and delivered to the issuer, the issuer gives notice to the project company under the master Ijarah agreement and will lease the infrastructure on the basis of a lease to own transaction.

Mixed Ijarah Sukuk

Under such a contract the underlying assets can comprise of Istisna'a or Murabahahreceivables in addition to Ijarah. This allows for a greater variety of funds to be used since previously inaccessible Murabaha and Istisna'a assets can be used in the portfolio. *A minimum of 51 percent of the mix must be Ijarah.* Involving Murabahah and Istisna'a'receivables in the mix means that the returns must a pre-determined fixed rate.

Bai Bithaman Ajil (BBA)

BBA sukuk contacts refer to the sale of goods on a deferred payment basis. Goods or equipment requested by the purchaser are paid for by the financial institution which subsequently sells the goods back to the purchaser at an agreed price which includes the financial institution's fee. While this form of Sukuk is predominant in the Malaysian market, it goes unrecognised either as a Sukuk or indeed as an Islamic finance instrument in the Middle East. This stems from the fact that the contract results in a debt and therefore cannot be traded other than at face value since debt and money cannot change value with the passage of time.

Intifaa

This contract involves 'right of use'. Buying the sukuk allows the user the right of use of the asset (for instance a property) at predetermined times. It has many similarities with the timeshare concept used in residential property.

ENDS

© Banker Middle East 2005

Article originally published by Banker Middle East 01-Jan-05

Copyright © 2009 ABQ Zawya Ltd. All rights reserved. PDF provided by www.zawya.com