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Sukuks – Routes To The Islamic Bond Market

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Behold! In the creation of the heavens and the earth; in the alternation of the night and the day; in the sailing of the ships across the ocean for the profit of the mankind...

- (here) indeed are Signs for people that are wise.

(Al Quran - Al Baqarah)

Bonds

- Bonds are important part of overall financial system.
- Well developed bond markets ensures stable financial system as it minimize over-reliance on financing from the banking sector.
- The development of the bond market allows for access to funding with the appropriate maturities, thus avoiding the funding mismatches. It also allows for the diversification of risks by issuers and investors.
- Islamic investors need to diversify their investment portfolios. Need for an Islamic bonds to fill the gap in Shariah-compatible fixed income tradable instruments.

Impermissibility of Bonds

- Dealing in Bonds is not permissible according to Shariah because of two aspects.
- Bonds represent a portion of Debt payable by the issuer. Earning any kind of profit falls under the category of RIBA as defined in the Hadith

كل قرض جر منفعة فهو ربا

“Every loan that draws any premium is Riba”.

Hadith is reported by Hazrat Harith ibn Abi Usamah in his Musnad.

Impermissibility of Bonds

- Second aspect pertains to the trading of Bonds.
- Shariah prohibits trading of debts (Bai Dayn).

The Development Of The Islamic Bond Markets

- Historical records show that in the 7th century AD, public servants were issued with Sukuk al-Badai (commodity coupons similar to warehouse receipts) by the Umayyad government.
- Imam Malik in his Muwatta has recorded that Sukuk al-Badai which evidences entitlement to certain amount of commodity (like grain) from the treasury was seen traded prior to maturity.
- Malaysia introduced Islamic bonds in the 1990's and they were termed as Bai Bithaman Ajil Bonds.
- In the Middle East, Bahrain introduced the Sukuk al-Ijara instrument to the Islamic market in September 2001 and Malaysia pioneered the global Sukuk al-Ijara issue in June 2002.

Sukuk

- Sukuk are defined by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as
 - “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services”

Nature of a Sukuk

- A 'Sukuk' is a Shariah-compliant variant of a conventional bond - investor returns are derived from legal or beneficial ownership of a business/assets rather than interest-based debt obligations
- Economic characteristics similar to that of a conventional bond, key difference being that a Sukuk is not a debt instrument.
- It represents a proportionate beneficial ownership in the underlying asset, giving the holder the right to the benefits of the income stream of the underlying asset.

Nature of a Sukuk

- The yield is usually linked to a return on an underlying asset through an Islamic structure e.g. lease.
- It is priced, listed and rated as a bond, although it is more akin to a participation in a collective investment scheme.
- Pricing can be at a fixed or floating rate benchmarked against LIBOR, etc.
- Sukuk can be listed or unlisted, rated or unrated
- Increasing tendency for obligors to seek rating of Sukuk to widen investor base

What Is Sukuk?

- Trust declared over the assets, held for the benefit of Sukuk holders who are thereby entitled to returns generated from those assets
- Sukuk usually rank pari-passu with other senior obligations of the obligor.
- Trade of Sukuks is permissible, because it will be equivalent to the sale/ purchase of holder's proportionate share in the assets.
- However, trading of Murabahah and Salam Sukuks is not permissible.

Underlying Product Structures

Structures

- AAOIFI currently recognises 14 types of Sukuk
- Most commonly adopted structures are:
 - Sukuk al-Ijara
 - Sukuk al-Musharaka
 - Sukuk al Isthithmar (Wakala)
 - Sukuk al-Mudarabah

Recent Controversy

Real Ownership- Legal vs. Nominal

Sukuk must represent ownership for Sukuk holders, with all of the rights and obligations that accompany ownership. The manager of a Sukuk issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.

Lending incase of Shortfall

It is not permissible for the manager of Sukuk to undertake to offer loans to Sukuk holders when actual earnings fall short of expected earnings. Permissible to establish a reserve to cover shortfalls.

Recent Controversy

Buy Back Guarantee Void – Musharakah, Mudaraba and Wakala Sukuk

Impermissible for the Issuer; mudarib (investment manager), sharik (partner), or wakil (investment agent), to promise to buy back assets at face value at maturity.

Allowed is to agree to purchase the assets at their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase.

Greater Role of Shariah Supervisory Boards

Way Forward

1. Increased Difficulty to issue – Pradigm shift, Higher cost.

Due to Global credit crisis sale of sukuk dropped to \$ 856 million this year - \$ 4.7 billion last year.

2. Paradigm Shift: Sukuks Asset Backed than Asset Based.

Assets must be tangible rather than cash flows.

3. Sharing of profit and losses from transactions.

Structuring now towards more risk sharing structures than guaranteed returns.

4. Comfort to investors

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