Sukuk Products

9.1. Introduction – Islamic debt capital instruments (sukuk)

Sukuk (1), or Islamic debt security, is generally thought of as the Shari'a-compliant alternative to bonds. Indeed, it was originally created for that purpose: to offer an Islamic alternative to mobilising medium to long-term debt capital. Over a period of time, however, efforts to standardize the industry have also sought to give sukuk a more distinctive Islamic identity, in part by basing them on the principle of risk-sharing, something that has led some observers to compare certain proposed structures to preference shares. Sukuk are different from conventional bonds in the sense that they provide ownership in an underlying asset or project to the investors, unlike conventional bonds, which merely represent a promise by the issuer to repay the loan amount to investors. The issuer of a sukuk provides a financial certificate to investors who are given proportionate ownership of the underlying asset for a pre-defined period. In fact, recent efforts to standardise the market sought to ensure that sukuk have a concrete underlying asset. Moreover, unlike conventional bonds, which provide a fixed interest to bond holders, the sukuk issuer agrees to provide a return to investors in the form of payments that are linked to cash flows generated from the underlying asset for which capital is mobilised. Sukuk issuance can be broadly categorized into:

- Murahaba sukuk

This type of sukuk is based on the murahaba form of contract for the sale and purchase of an asset using the cost plus (mark-up) method. It is widely used for short-term financing in trade finance. In the murahaba form of contract, an agreement is signed between the special purpose vehicle (SPV) and the customer according to which the SPV undertakes to buy the asset required by the customer. The SPV then issues sukuk to investors and buys commodities on spot basis from the sukuk proceeds. After that, the SPV sells the commodity to the customer at the spot price plus a profit margin on an instalment basis over an agreed period of time. The sukuk certificate represents a monetary-debt payable by the customer to sukuk holders, the amount of which is agreed initially. Consequently, the secondary trading of murahaba sukuk is not permissible as its transfer to a third party will mean transfer of debt which, according to Shari'a law, can only be exchanged at par value.

- Ijara sukuk

This type of sukuk is based on the ijara form of contract for the lease of an asset to a customer. The customer pays a lease fee and agrees to pay the lessee the ownership in the asset in instalments. The lessee can then sell the asset back to the lessor or use it as collateral for a loan. This type of sukuk is primarily used in project financing.

(1) Interestingly, sukuk or waqf is not a new invention of the Islamic finance industry. The concept of sukuk has been with the Islamic world since the early days of Islamic civilization. Imam Malik has recorded the first historical account of sukuk in his famous treatise al-Muwatta. It is stated that in the 1st century Hijri (corresponding to the 7th Century AD) the Umayyad Government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of sukuk al-badai, which has been translated as “commodity coupons” or “grain permits.” See, Hashim Kamali, Islamic Commercial Law: An Analysis of Futures and Options (Cambridge: Islamic Texts Society, 2000). Malik’s Al-Bayan Anas, Al-Muwatta 296 (Mohamed Rahman, trans., Kuala Bharu 5th ed. 2000). The holders of the sukuk were entitled to present the sukuk on its maturity date at the treasury and receive a fixed amount of commodity, usually grains. Some of the holders used to sell their sukuk to others for cash before the maturity date. Although the validity of this trade was questioned by scholars of that period, it shows that the concept of sukuk al-badai as a tradable instrument has been known to the Islamic world for a very long time.
Under the istisna’ sukuk contract, the SPV issues sukuk.

Hybrid sukuk are the combination of istisna’, murabaha receivables and ijara sukuk. Hybrid sukuk facilitate greater mobilization of funds as they comprise a portfolio of different classes of assets. However, since murabaha receivables and istisna’ contracts cannot be traded on secondary markets as securitized instruments, at least 51% of the pool in a hybrid sukuk must comprise tradable sukuk such as ijara sukuk.

9.2. The concept of sukuk as an asset-backed security

Any asset-backed sukuk issuance starts with the identification and segregation of a pool of underlying Shari’a-compliant assets on the balance sheet of the company seeking the finance. Tangible assets such as properties and land are naturally eligible as Shari’a-compliant assets. In addition, most Shariah advisory bodies have also recognised the eligibility of expected asset-related receivables, not fully identified at the time the sukuk are issued. Ownership rights attached to the pool of assets are then transferred to an ad hoc economic entity, in the form of an issuing SPV that has no capital and seeks to isolate the underlying assets from the “borrower.” The SPV will usually purchase the assets with the investor’s funds, and ultimately the SPV constitutes the capital of the sukuk.

In current asset-backed sukuk, the underlying assets are sold (usually back to the originator at maturity), and the proceeds of this sale are used to pay back the sukuk principal, usually at a predetermined price. During the life-span of the sukuk, coupons are served to investors on the basis of the expected returns extracted from the pool of underlying assets. Should there be a gap in the income generated by the underlying assets and the payments made to sukuk holders, the remaining balance is either absorbed by the issuer or by way of consequence their ratings have been equalised with the originators’ issuer ratings. So far, very few subordinated sukuk have been issued and rated.

Secured asset-backed sukuk, on the contrary, are subject to an analytical treatment similar to that applicable to bond classes emanating from securitisation transactions. This means that the ratings on these secured asset-backed sukuk, like those on securitisation tranches, essentially depend on the economic and financial attributes of the pool of underlying assets, as well as the creditworthiness of their originator. One of the many benefits of Islamic securitisation transactions giving birth to secured asset-backed sukuk is the ability of the originator to issue sukuk rated higher than the originator’s issuer credit ratings.

9.4. The intrinsic history of sukuk

Although the concept of sukuk has been discussed in the Islamic finance literature for over a decade, the first modern sukuk prototype was only pioneered in 2000, at the 11th Islamic Development Bank Annual Symposium.

• The ijara sukuk structure essentially requires the corporate to sell certain physical assets to a SPV, which would then lease the assets back to the corporate for a

The main analytical feature of unsecured asset-based sukuk lies in the fact that both coupons and principal represent an unconditional and irrevocable obligation of the originator. In cases where the underlying assets generate insufficient cash flows to pay the coupons (periodic distribution amounts) to sukuk investors, the originator, as asset manager and guarantor, makes up the shortfall and serves coupon payments to sukuk holders.

At the sukuk maturity, the originator repurchases the sukuk underlying assets at a predetermined price, equivalent to the sukuk principal. In this case, the sukuk ratings crucially depend on the creditworthiness of the originator, senior or subordinated, depending on the rank of the guarantee. Most of the rated sukuk in this category constitute senior unsecured obligations of originators’ issuers, and by way of consequence their ratings have been equalised with the originators’ issuer ratings. So far, very few subordinated sukuk have been issued and rated.

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For more details as to the inclusion of legal risks in our methodology for rating sukuk, see Moody’s Approach to Unsecured Corporate Sukuk and Moody’s Approach to Rating RMBS in Emerging Markets – EMEA. A complete list of all relevant documents published by Moody’s in the field of Islamic finance can be found at the end of this report.

In this respect, please refer to Moody’s analysis report issued on 25 June 2007 providing our opinion on the Islamic securitisation transactions initiated by Dubai-based Tamweel Tamweel Residential ABS (I) LTD.
Sukuk Products

Global Islamic Finance Report (GIFR 2019)
In 2003, the Islamic Development Bank (IDB) seized the opportunity to test the viability of the “blended assets” sukuk structure, and successfully issued a US$400 million sukuk. Like all financial institutions, the IDB had less leverage to test the viability of the “blended assets” sukuk approach as a result of the prevailing Sukuk structure which was heavily constrained by the asset requirements for Islamic sukuk issuance. With the help of a few Shari’a scholars, a new sukuk structure was conceived and launched out of the IDB. The sukuk was called the “Asset-light” sukuk.

US$ 400 MILL SUKUK BY THE IDB: MINIMUM 51% ASSETS

In the sukuk shown in figure 60 above, the Dubai Metals and Commodity Exchange (DMCE) and the Special Purpose Company (“SPC”) enter into a Mudarabah arrangement for a period of 5 years. Profit-sharing ratio is between the SPC and the DMCE is 80:20. DMCE acquires assets comprising not less than 30% of the total proceeds of the issuance, with each musharaka owning a share of the DMCE.

SUKUK ISSUANCE PROGRAMME BY THE IDB: ONLY 30% ASSETS

Dubai Metals and Commodity Exchange (DMCE) needed US$ 300 million to develop a land that it owned. DMCE and the SPV formed a musharaka where DMCE contributed capital in the form of land worth US$ 48 million. The issuer contributed capital in equal cash to US$ 300 million and issued a musharaka sukuk to the investors to raise the required funding.

In return for the capital contributions, each musharaka was allocated a number of musharaka units equal to the value of its capital contribution. DMCE used these musharaka units to raise additional capital from the market. The musharaka then appointed DMCE to use the US$ 300 million cash contribution to develop three offices and residential towers on the land with the musharaka business plan.

The musharaka business plan stated that the various institutional and market participants to tap the sukuk capital markets, others found the prevailing sukuk structure constraining and unviable. These corporations either could not meet the physical assets requirement or they did not have any Shari’a-compatible receivables. Many of these corporations were in an expansion mode fuelled by the massive economic boom in the Middle East. The corporations were keen to tap the growing and liquid Islamic finance market and were severely constrained by the asset requirements for the sukuk issuance. With the help of a few scholars, a new sukuk structure was conceived and launched out of the Dubai. The new sukuk was called a musharaka sukuk, and was structured as follows: In the sukuk structure shown in figure 60 above, the Dubai Metals and Commodity Exchange sukuk...
9.7.1. Is the musharaka sukuk tradable?

One of the Shari’a requirements for trading sukuk at premium or discount to face value is that the sukuk must represent corporate ownership of assets. What amount of substantial assets has varied over the years from 100% in Bahrain, Qatar and Malaysia, to 30% in the US and UK? If we compare the Shari’a standard and add in used in Islamic equity investments, the total receivables and cash in a company must not be more than 33% of the total share capital. The US and UK have more than 33% cash or 33% asset receivables, the equity of the company will be considered as non-Shari’a compliant. The rationale behind this is that if the company has more than 33% cash or asset receivables, the shares of the company will essentially represent cash or debt (dependant on the nature of the contract, a cash or non-cash asset) and not the underlying asset itself. The standard applies equally for sukuk which is also a tradable instrument.

In the DMCE sukuk, the musharaka venture had US$ 48 million worth of physical assets and US$ 300 million of financial assets. The value of the venture at any time was US$ 348 million and according to the ratio of cash to total assets was around 88% of the total in all likelihood. The profit, the DMCE sukuk stated that 80% of the annual profit will be divided equally among the two parties. In the DMCE sukuk, the DMCE should be solely responsible for such loss. There is no guarantee of the profit share of another partner. Any lawsuit against DMCE for the sum of US$ 30 million worth of musharaka units of the issuer every 6 months and all the musharaka units of the issuer will be transferred to DMCE.

The above sukuk structure raises the following Shari’a considerations:

### 9.7.2. Is it permissible for DMCE to undertake to buy from the issuer the musharaka units at par value every 6 months?

In musharaka and mudaraba arrangements, it is a well known principle that it is impermissible to divide the return of principal or the share of profit of the other partner. The rationale behind this rule is that if, part-i.e. DMCE, has paid for services rendered, the partner A will establish-an in a court of law—that he was neither negligent nor in default, then there will be no indemnity from partner B. Both partners will bear the losses in proportion to the capital contributed.

However, a deeper analysis of the asset-light sukuk documentation reveals the following:

The sukuk investors are not privy to the business plan and in reality, pay hardly any attention to the business plan.

Whilst the undertaking by DMCE to buy the issuer’s musharaka venture is irrevocable and involves the presumptive negligence of or default on the part of DMCE there should be no losses in the musharaka venture. Any such a presumption can be rebutted by DMCE. For example, if say DMCE had completed the three towers fully and paid all the expenses of the project, DMCE will be entitled to the profit from the project. Further, if the ongoing global financial crisis, failed to sell or lease the ending units as set out in the business plan. In such an eventuality, the musharaka partner is unlikely to be liable and DMCE will be an irrevocable undertaking to buy US$ 30 million worth of musharaka units of the issuer at par value every six months. The undertaking is irrevocable and legally enforceable by the issuer regardless of whether or not the underlying asset was contributed.

The documentation does not provide any opportunity for DMCE to rebut the presumption and avoid being held accountable for non-performance. The presumption is clearly not permissible under Shari’a. The Shari’a requirement for physical assets had created a lot of potential problems with the issuance of multi-billion dollar sukuk. The DMCE sukuk did not address this aspect of the Shari’a at all.

The Shari’a requirement for physical assets had created a lot of potential problems with the issuance of multi-billion dollar sukuk. The DMCE sukuk did not address this aspect of the Shari’a at all.

### 9.8. Is the musharaka sukuk compliant?

The above reasoning does appear rather convincing. The documentation does not provide any opportunity for DMCE to rebut the presumption and avoid being held accountable for non-performance. The presumption is clearly not permissible under Shari’a. The Shari’a requirement for physical assets had created a lot of potential problems with the issuance of multi-billion dollar sukuk. The DMCE sukuk did not address this aspect of the Shari’a at all.

### 9.9. Is it permissible for DMCE to provide irrevocable undertaking to the Issuer not to transfer the property to any third party?

The documentation does not provide any opportunity for DMCE to rebut the presumption and avoid being held accountable for non-performance. The presumption is clearly not permissible under Shari’a. The Shari’a requirement for physical assets had created a lot of potential problems with the issuance of multi-billion dollar sukuk. The DMCE sukuk did not address this aspect of the Shari’a at all.

### 9.10. Is the musharaka sukuk tradable?

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### 9.11. Is the musharaka sukuk tradable?

The above reasoning does appear rather convincing. The documentation does not provide any opportunity for DMCE to rebut the presumption and avoid being held accountable for non-performance. The presumption is clearly not permissible under Shari’a. The Shari’a requirement for physical assets had created a lot of potential problems with the issuance of multi-billion dollar sukuk. The DMCE sukuk did not address this aspect of the Shari’a at all.
The Sukuk Industry

9.9. Back to basics

In the first half of 2009, the sukuk market witnessed some green shoots emerging. The Republic of Indonesia successfully issued its inaugural US$ 500 million jaya sukuk which was oversubscribed to the tune of US$ 3 billion. The Kingdom of Bahrain also returned to the market to successfully issue another jara sukuk which closed at US$ 650 million. And in August 2009, Petronas, the Malaysian national oil company also successfully issued its debut benchmark jara sukuk issue. The Petronas sukuk was launched at US$ 1.5 billion and was five times oversubscribed. Interestingly, all three sukuk issues were structured as asset-based jara sukuk and carried fixed rental rates. Hopefully, the AAOIFI ban had played a key role in shifting the market away from asset-light sukuk. However, it is still too early to declare the demise of the asset-based sukuk and only time will tell whether the market has taken the AAOIFI ruling seriously. The success of the Indonesian, Bahrain and Petronas sukuk issues clearly demonstrated that the asset-based sukuk is still the most viable and attractive option to issuers. The shift to asset-based sukuk will certainly add more credibility to the sukuk market and help the industry to gradually progress towards a Sharia-based financial system. The sukuk industry is still at an early stage and has a long way to go. Hopefully, its future path will be clear of asset-light sukuk issues.

CHAPTER 10
The Sukuk Industry

10.1. Key sukuk data

The first sukuk ever was issued by Shell MDS in 1990 for MYR125 million (US$ 33 million). Since then, the progress of the market depended heavily on efforts of the Malaysian government that had made the world’s first sovereign US$ 600 million sukuk issue in 2002. Malaysia’s Cagamas MBS has issued US$ 450 million worth of residential mortgage-backed securities. Malaysia has also seen issuance by corporations, including a pioneering US$ 2.6 billion issue by the PLUS highway concessionaire in 2006. The government’s investment arm, Khazanah Nasional, issued the first exchangeable sukuk the same year.

Emulating the Malaysian example, other Islamic countries started issuing sovereign sukuk. Bahrain issued a sovereign sukuk worth US$ 100 million in 2001. Qatar issued a global sukuk of US$ 700 million in 2003, and Pakistan came out with US$ 600 million sukuk issue in 2005. In the Gulf, Bahrain remains the most active sukuk market. The country regularly issues short-term sukuk for liquidity management. In 2002, Islamic Liquidity Management Centre was established in Bahrain in order to boost sukuk issuances. The world’s first global corporate sukuk issue for US$ 150 million was made by Kumpulan Guthrie, a Malaysia-based company, in 2001. Since then, sukuk have not only grown in size but in product sophistication and structure. In the last half of 2008, it witnessed the most popular form, accounting for 77% of total issuances in 2001. However, efforts aimed at standardization, notably by AAOIFI, have now made jara the dominant structure. Sukuk have attracted considerable attention in recent years. Although the onset of the financial crisis and efforts to standardize the market temporarily reversed the progress, restrictions on bank credit and depressed stock markets have renewed attention. Global sukuk issuance grew from US$ 5.8 billion in 2003 to US$ 33 billion in 2007. The strong growth in sukuk issuance can be attributed to sukuk being perceived as a ‘less risky’ investment proposition when compared to conventional bonds, in part because they are backed by physical collateral. Moreover, the huge public and private investments being undertaken in the Middle East, particularly in infrastructure, have boosted funding requirements.

Leading Middle Eastern sukuk issuers include companies such as the petrochemical giant SABIC and the Saudi Electricity Company, as well as a growing number of real estate developers.

The progress made in recent years was abruptly reversed in 2008 when total global sukuk issuances declined to US$ 15 billion, as debt markets dried up globally. In terms of types of sukuk issuances, corporate