Sukuk: Definition & Types

I: Defining Sukuk

The emergence of Sukuk has been one of the most significant developments in Islamic capital markets in recent years. Sukuk are financial products whose terms and structures comply with sharia, with the intention of creating returns similar to those of conventional fixed-income instruments like bonds. Sukuk are asset-based securities, not debt instruments and represent ownership in a tangible asset giving the legal right of using and enjoying the fruits or profits of an asset, service, project, business, or joint venture.

Unlike a conventional bond (secured or unsecured), which represents the debt obligation of the issuer, a sukuk technically represents an interest in an underlying funding arrangement structured according to sharia, entitling the holder to a proportionate share of the returns generated by such arrangement and, at a defined future date, the return of the capital.

Although a common starting point for explaining sukuk is to use bonds as a comparison point, it is important to understand that there are certain fundamental differences.

There are five important differences between sukuk and traditional bonds:

1. Sukuk indicate ownership of an asset. Bonds indicate a debt obligation.

2. The assets that back sukuk are compliant with Shariah. Assets backing bonds may include products or services that are against Islam.

3. Sukuk are priced according to the value of the assets backing them. Bond pricing is based on credit rating.

4. Sukuk can increase in value when the assets increase in value. Profits from bonds correspond to fixed interest, making them Riba.

5. When you sell sukuk, you are selling ownership in the assets backing them. The sale of bonds is the sale of debt.
The main advantage of sukuk over traditional bonds is that their value increases in relationship to the assets backing the sukuk certificate. If the asset raises in value, then the value of the ownership of that asset, backed by the sukuk, increases. Bonds do not have this characteristic. It is not possible to raise the main debt in a bond and increase in revenue from a bond is the direct result of the fixed interest rather than in any kind of tangible increase in value or productivity.

This is not to say that bonds and suiuk are not similar in certain ways. Both can be turned into cash by selling them on the secondary market. Based on the strength of their backing, both bonds and sukuk can be ranked by ranking institutions. There is also similar variance in bond and sukuk designs and issuers, allowing consumers to have a variety of options when looking into these financial instruments.

The overall risk profile and economic return for the investor is similar to a conventional bond where the bondholder is a debtor of the issuer. Sukuk instruments act as a bridge by linking their issuers with a wide pool of investors, many of whom are seeking to diversify their holdings beyond traditional asset classes. In this way, funds raised through Sukuk can be allocated in an efficient and transparent way to infrastructure initiatives and other deserving projects. Both domestic and foreign investors buy Sukuk having various structures approved by Shari’ah boards of Islamic scholars.

II: Types of Sukuk

The sukuk issued in global capital markets have been predominantly structured as trust certificates, typically governed by English law. Some civil-law jurisdictions that do not recognise the concept of trust have sometimes issued sukuk structured as participating notes under legislation similar to that used for asset-backed securities.

2.1. Trust certificates

In a typical trust certificate transaction, the entity trying to raise funds (the obligor) will establish an orphan offshore special-purpose vehicle (SPV)\(^1\) in a suitable jurisdiction.

\(^1\) An orphan structure is a financing term referring to a company whose shares are held by a trustee on a non-charitable purpose trust. The company is said to be an "orphan" as it is not beneficially owned by anyone.
The SPV issues trust certificates to investors and uses the proceeds to enter into a funding arrangement with the obligor, and the rights of the SPV as financier are held under an English law trust in favour of the certificate holders.

The most common structures for funding arrangements in the Islamic market include: a sale and leaseback (ijara) structure, a form of trade finance (murabaha) and a joint-venture equity investment (musharaka).

2.2: Alternative civil-law structures

The trust certificate structure above requires the concept of a trust to be recognized in the relevant jurisdiction where the obligor is located. In many jurisdictions, particularly those from the civil-law tradition, this is very rarely the case. As such, alternative structures have begun to emerge so as to allow for sukuk transactions to be carried out in accordance with local laws.

An interesting example of such a trend is exemplified by Turkey, which has passed specific legislation to enable the use of the sukuk. This legislation allowed for the formation of asset-leasing companies, which themselves are a form of SPV regulated by the Capital Markets Board of Turkey.

These asset-leasing companies are specifically incorporated so as to be able to issue certificates under an ijara structure to investors, thereby allowing the asset-leasing companies to purchase assets and lease them back to the obligor.

Effectively, the asset-leasing company finances the acquisition of such assets using funds raised by the issuance of certificates, and the lease-rental payments from the obligor mirror the profit distributions due under the certificates. The cash flows from the lease rentals, therefore, are used to service such profit distributions to certificate holders.

This model is best compared to loan participation notes, which have been in the market for several decades.

2.3: Investors’ credit exposure

Despite the fact that the sukuk is issued by an orphan SPV, typically the investor will not be bearing an exposure solely to the credit risk of that SPV. On the contrary, today’s
typical sukuk transactions are instead primarily intended to allow the investor to be exposed to the credit risk of the obligor.

However, potential investors need to consider whether the sukuk only gives recourse to the obligor, or also to a separate segregated estate represented by the assets subject to the funding arrangement underlying the sukuk. In the current sukuk market the answer to this fundamental question may sometimes not be obvious.

2.4: Asset-based vs asset-backed

In an asset-based sukuk structure, the overriding reliance of investors is on the credit strength of the obligor rather than the underlying assets. This allows the obligor to simplify its reporting and segregation in relation to the assets, as the obligor knows that the investors are really relying on the obligor credit strength alone.

For example, in an ijara transaction, where there is a sale by the obligor of an underlying asset to the SPV that will then be leased to the obligor, if the sukuk is structured as a typical asset-based structure, it becomes irrelevant for an investor to fully analyse the sale value of the asset in question or the potential value of the lease if leased to third parties, as the investors will rely only on the credit strength of the obligor as sole or principal lessee of the asset in question.

In an asset-backed sukuk, the profit return and return of capital are ultimately based on the assets themselves. Unlike in an asset-based structure, investors can be expected to want to try to assess the value of the assets (and the related underlying transaction) themselves.

III: Advantages and disadvantages of sukuk

- For a corporate or a sovereign, some key advantages of tapping the sukuk market include:
- There is a potential marketing benefit for issuers active in Islamic markets, should they be seeking investments in those markets.
- The investor base represented by Islamic compliant investors is still largely untapped and there has traditionally been significant unmet demand for products such as sukuk.
• There is potential for crossover into other financial markets, such as the broader ethical investment market, that may provide a reputational benefit.

Some disadvantages of the sukuk market include:

• As the key element for attracting investors is the credit standing of the obligor, it may be difficult to tap this market for corporates or sovereigns with an inadequate credit rating.

• A sukuk whose underlying funding arrangement is based on ijara will necessarily require the obligor to have at its disposal suitable (halal) income-producing assets on which to base the transaction. In addition, unless the correct mechanics are included within the documentation, the substitution of similar assets into and out of the structure would be impossible. This could limit the obligor’s ability to sell or deal with the asset during the life of the transaction.

• Unlike the conventional bond market, the standardisation of documents for sukuk issuance has been slow to develop and this can have adverse cost implications.

• From transaction to transaction, to the extent that the structure used for the sukuk departs from the typical structures already well recognised in the market, the involvement of the sharia scholars is necessarily required. This can add some additional cost and an element of unpredictability to the transaction structuring process.

• As sharia scholars have differing views as to how compliant the structures are, there is no absolute unified and settled body of opinion on these issues.

• The tax treatment of sukuk may be dissimilar to conventional bonds in certain jurisdictions.

IV: Sukuk Market in Dubai

Dubai has overtaken other financial centres in listing Islamic bonds on its exchanges, and is mounting a global drive to attract more listings while developing new channels to trade sukuk. Demand for Islamic financial products still exceeds supply and there are very few financial products for which this is true. The NASDAQ exchange is working on ways to sell sukuk directly to retail investors, expanding the
primary market beyond institutional buyers, and designing a
sharia-compliant repurchase agreement.

Sukuk listings are not the only indicator of health for an
Islamic finance centre. Another is sukuk trading turnover; 
this remains low on Dubai's exchanges, as many institutions 
hold instruments to maturity or trade them over-the-counter.

In some ways, Malaysia has a much more vibrant sukuk market 
than Dubai, with more small corporate issuers. About $69 
billion of sukuk were issued in Malaysia last year, though 
many were not listed, regulatory data shows.

A sharia-compliant version of the short-term loans of 
securities which banks use to adjust their liquidity -- could 
also encourage more active use of sukuk.

Dubai NASDAQ exchange is discussing a proposed template with 
local and international banks and hopes to introduce it late 
this year or in 2016, providing it wins the endorsement of 
religious scholars. So far, only Malaysia, Indonesia and 
Bahrain have taken major steps to develop Islamic repos.

Early last year, Nasdaq Dubai introduced a platform for 
murabaha, another form of Islamic liquidity management in 
which one bank buys merchandise and another agrees to buy it 
at a mark-up. It aimed to grab some of this business from the 
London Metal Exchange.

Unlike Europe, Dubai has a stable of local state-linked firms 
which can be encouraged to issue sukuk and list them locally. 
Noor Bank listed $500 million on Nasdaq Dubai in 2016; Dubai's government owns over a quarter of the bank.

While 56 percent of Dubai's listed sukuk are from United Arab 
Emirates issuers and 22 percent are from Saudi Arabia and 
continues to attract high levels of listings from the Gulf 
Cooperation Council region, both Islamic-based and 
conventional finance. Following a total of seven Sukuk 
listings this year by regional and international issuers, the 
total value of Sukuk currently listed in Dubai has reached 
$42.61 billion, the largest amount of any listing centre in 
the world.

The latest listing is from Dubai Islamic Bank (DIB), which 
listed a $500 million Sukuk on Nasdaq Dubai on March 31, 2016. 
This brings DIB’s total Sukuk listings on the region’s
international exchange to $3.25 billion, underlining the rapid expansion of Dubai as the global capital of the Islamic Economy.