

ISLAMIC CAPITAL MARKETS UNDERSTANDING SUKUK

This article introduces sukuk and discusses some of the structuring considerations in sukuk issuances.

Introduction

Sukuk, commonly known as Islamic bonds, have become synonymous with Islamic finance in recent years. The first modern sukuk was issued in 1990 by Malaysia Shell MDS Sdn Bhd worth RM 120 million. This was followed by the first US\$ 150 million international sukuk by another Malaysian company called Kumpulan Guthrie Berhad in 2001 and a USD 600 million sukuk by the Malaysian government in 2002. Today, the total sukuk outstanding globally have reached almost US\$ 350 billion. The global sukuk market has witnessed double digit annual growth over the last decade and a half, and continues to grow at an impressive pace as a shariah compliant alternative to traditional bonds. Despite significant growth, sukuk still represent a small proportion of global debt markets (the size of the global bond markets is estimated to be close to US\$ 100 trillion).

The year 2016 saw aggregate new sukuk issuances of around USD 75 billion, registering a small growth from the previous year despite difficult economic conditions in some of its core markets.

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Banking and Finance

There have been several large sovereign issuances in 2017, including from Saudi Arabia (USD 9 billion), Indonesia (USD 3 billion) and Oman (USD 2 billion). Pakistan also recently tapped the international market and managed to raise USD 1 billion at 5.625% a significant discount to its simultaneous USD 1.5 billion Eurobond which was priced at 6.875%.

Sukuk Defined

The question is often asked whether sukuk are the Islamic equivalent of a conventional bond? From a strict shariah perspective, the answer is clearly no, given there is no such thing as an Islamic bond due to the Islamic prohibition on interest (riba). A bond represents an obligation of the issuer / borrower to repay a certain sum of money on maturity along with periodic coupon or interest payments. Islam does not permit interest and therefore, a sukuk in that sense is not a bond.

However, in terms of economic effect, the answer is probably yes. Sukuk, as described in AAOIFI's shariah standard 17 are "*certificates of equal value which represent an interest in an underlying tangible asset, usufruct or service or (in the ownership of) the asset of particular project or special investment activity*". In theory, the repayment of a sukuk is linked to the return generated by the asset, project or investment activity underpinning the sukuk certificate. Accordingly, whereas an investor takes a

credit risk on the issuer's creditworthiness under a conventional bond, its exposure under a sukuk is against the performance of the underlying asset or business activity, in which the sukuk-holders have an interest due to their ownership of the sukuk.

In practice, the originator, or the entity, which provides the assets and 'borrows' the funds, will usually grant an undertaking whereby it is obliged to repurchase the assets on the occurrence of an event of default. The purchase undertaking ensures that the borrower is obliged to repurchase the assets is at a value equal to the principal and accrued profit, thereby guaranteeing principal and interest payments. In addition, the originator's repayment obligation will be backstopped by a third-party guarantee or liquidity facility, thereby transferring the credit risk back to the originator and the guarantor. In that respect, although structured differently, the economic effect of a sukuk is similar to that of a conventional bond.

Sukuk Structure

Sukuk are usually structured as securitisations, which enable the underlying assets to be transferred to a special purpose vehicle (SPV), which issues the sukuk certificates. The investors or arrangers enter into a subscription agreement with the issuer, usually an offshore SPV incorporated for this purpose, under which they agree to subscribe to the sukuk certificates. The

sukuk certificates themselves are constituted as trust certificates pursuant to a trust declared by the SPV (in its capacity as trustee) over the subscription proceeds, and its rights and interests in the underlying Islamic finance documentation, and all moneys received thereunder. The use of an SPV has become the preferred structure because the assets underpinning the sukuk need to be separated from other assets of the originator. These assets are therefore transferred to the SPV and form the basis of the Islamic finance transaction. In a sukuk issue, the SPV acts as both issuer and trustee.

The SPV enters into Islamic finance agreements with the originator whereby the subscription moneys are made available to the originator in a shariah compliant manner. The Islamic structure will usually take the form of an ijara, murabaha, wakala, mudaraba, musharakah, or any other shariah compliant structure, depending on the nature of the underlying assets. The originator is obliged to repay the SPV under the Islamic finance documents and all payments made by the originator to the SPV (as financier) are passed on by the SPV, as trustee, to the sukuk certificate holders, as the beneficiaries of the trust.

The SPV is established in a low tax jurisdiction (usually the Cayman Islands) to minimise taxes and other transfer charges. In addition, the SPV is incorporated as an orphan entity to be bankruptcy remote, meaning that the insolvency of the

originator has no effect on creditworthiness of the SPV.

Being a shell company, the SPV lacks the capacity to administer or enforce its rights under the transaction documents, and it will therefore typically appoint a professional trustee services company as a delegate. The delegate will exercise the rights and powers, and fulfill the obligations of, the SPV (as trustee) under the transaction documents. The delegate also acts on behalf of the sukuk certificate holders as a class to enforce their rights against the originator.

The SPV does not possess any assets other than its rights under the transaction documents, and the SPV's obligations towards the sukuk holders are limited to paying any sums received from the originator to the investors.

In a sukuk issuance, the SPV acts as both issuer and trustee, whereas under a conventional bond structure, the issuer and the trustee are separate entities. In a conventional bond, the trustee will declare a trust over (amongst other things) (i) the issuer's covenant to pay the trustee; and (ii) the issuer's undertaking to meet its obligations under the terms and conditions of the bond instrument. Unlike a sukuk, the investors in a conventional bond have direct recourse against the issuer, but for administrative convenience the trustee acts on their behalf. The trustee in a conventional bond will usually be a

professional trustee services company, which acts on behalf of the bondholders as a class and enforces their rights against the issuer on the occurrence of an event of default. This role is performed by the delegate under a sukuk.

As with a bond issue, a paying agent, transfer agent and possibly a registrar will be appointed to manage payments under, and transfers of, the sukuk instruments. Most sukuk are issued as global certificates with the custodian (usually a custodian bank such as BNY Mellon or Citi) sometimes assuming the additional role as the paying agent. Transfers are recorded through sub-accounts held with a clearing agent (such as Euroclear or Clearstream) but a separate register may also be maintained by a registrar in case of registered sukuk certificates.

Other Features

One of the key features of any capital markets instrument is liquidity. Whether a sukuk is tradeable depends on the underlying Islamic finance structure. Under AAOIFI guidelines, a minimum of 33% of the underlying interests represented by the sukuk must be tangible assets in order for the sukuk to be tradeable (at a value other than par). Other scholars place this limit at 50%. This restriction has its roots in the Islamic prohibition against interest. Where a sukuk is based on the murabaha or salam structures, the instrument represents an

interest in debt, and hence trading it at a value other than at par gives rise to interest, which is prohibited.

A common misconception about sukuk is that they are asset-backed securities with the investors having direct recourse to the underlying assets. Although the sukuk represent an interest in the underlying assets, they are structured such that on the occurrence of an event of default, the assets are sold back to the originator pursuant to a purchase undertaking; a claim over the assets is therefore replaced by a debt claim against the originator. As such, the ultimate risk under both sukuk and conventional bonds is against the originator/issuer. A few sukuk have, however, been issued as asset backed instruments, the Nakheel, East Cameron Partners and Pakistan motorway sukuk being the most prominent ones. The vast majority of sukuk issued in recent years are asset based with investors having no recourse to the underlying assets in case of a default.