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Q&A with Nomaan A. Raja

CHALLENGES TO THE DEVELOPMENT OF THE SUKUK MARKET

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Corporate, sovereign and government-related entities issued sukuk worth US$116.4 billion in 2014, according to Standard and Poor's. As more financial institutions around the world engage in the management, arrangement or trading of sukuk, we anticipate the market will develop at a significant pace.

While the sustained demand for sukuk is widely acknowledged, challenges relating to restrictive legal regimes, standardization and default mechanics could potentially impede its anticipated growth.

In this LW.com interview Latham & Watkins partner Nomaan Raja discusses the challenges the developing global sukuk market faces.

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What restrictions in legal regimes are inhibiting global sukuk growth?

Raja: At present, many legal regimes disadvantage sukuk as compared with conventional bonds. The issuance of sukuk often requires the issuing entity to create a Special Purpose Vehicle (SPV) and transfer the assets underlying the sukuk to such SPV. Additional taxes and stamp duties may be incurred as a result. Malaysia has set the global benchmark for enacting tax, land transfer and registration laws that do not penalize sukuk issuances in comparison with conventional bond issuances. Unsurprisingly, therefore, 70 percent of global sukuk issuances are attributed to the Malaysian market.

Can legislative change improve the competitiveness of sukuk?

Raja: The current asymmetries in the tax treatment of sukuk and conventional bonds is arguably hindering the development of the global sukuk market. Yet we have seen a number of countries enact legislation that has paved the way for sukuk issuances. Notably in 2014, the UK Government issued a £200 million sovereign sukuk, the first of its kind by a European sovereign state. This issuance was possible because of the UK's Finance Act 2009, which removed the tax barriers that had rendered Shari'ah-compliant financial products less tax-efficient than their conventional counterparts. Similarly, the Government of the Hong Kong Special Administrative Region followed suit and passed a comparable taxation framework in 2013. This legislative amendment led to the successful issuance of a US$16 billion sukuk in September 2014. These examples demonstrate how legal regimes may need to adapt in order for an Islamic finance market to emerge.

How will the sukuk market benefit from increased standardization?

Raja: Doubts relating to Shari'ah-compliance are likely to impact marketability and investor confidence and support. Sukuk transactions require a fatwa, or legal pronouncement — procured from Shari'ah scholars — in order to provide issuers and investors with comfort that a sukuk instrument is fully Shari'ah-compliant. Such endorsements, however, are subject to different interpretations. In late 2007 and early 2009, the sukuk market faltered slightly owing to a debate sparked by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI issued a divisive statement questioning the Shari'ah-compliance of some sukuk structures. Such uncertainty resulted in a noticeable decline in the sukuk market, which was already feeling the effects of the global financial crisis. Given the potential market volatility (as seen in 2007 and 2009), the majority of Shari'ah scholars agree that a guiding set of principles should be developed for future sukuk issuances.

Whether the GCC will follow Malaysia's standardization strategy is yet to be seen. The Malaysian government has established a centralized Shari'ah Supervisory Board which ensures all sukuk issued in Malaysia is compliant with nationally accepted Shari'ah principles. Increasing standardization stabilizes the market and safeguards investor confidence.

How can the sukuk market evolve to better protect investors?

Raja: The development of a mature market requires that sukuk investors understand their rights and remedies in default scenarios. Following some notable high-profile defaults, investors learned the hard way that most sukuk instruments are not secured in the conventional sense. Many early investors viewed sukuk as secured instruments, benefiting from security in the underlying sukuk assets.

Presently, the sukuk structure determines the level of investor protection in default circumstances. From a Shari'ah perspective, sukuk provides investors with an undivided share in the ownership of a pool of tangible assets, usufructs or services. In the event of a default, whether investors have a claim against these assets under the terms of the sukuk is entirely dependent on how the sukuk is structured.

The AAOIFI is seemingly encouraging a move towards asset-backed structures, in which the investors have actual recourse to the assets in the event of a default. While asset-backed sukuk structures exist, they are comparatively rare. Typically the asset originator conducts a nominal sale but not a true sale of the underlying assets to the SPV. Most sukuk in the market are designed to treat sukukholders in the same manner that holders of conventional unsecured bonds would be treated in a restructuring or an insolvency. The extent of investor protection, therefore, depends on the sukuk's structure.

More Information

For more information and case studies on the development and challenges of sukuk and Shari'ah-compliant structures, download the Sukuk Structuring Guide.

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