What are Sukuk?

‘Sukuk’ are a Shari’ah-compliant financial product and the Islamic equivalent to bonds in Western finance. Sukuk offerings are increasingly viewed by some European and US institutional investors as one of the best ways to diversify their portfolios and achieve higher returns through investment in the fast-growing emerging markets of Southeast Asia, the Middle East and North Africa.

Whereas conventional bonds evidence a debt owed by the issuer to the bondholders, sukuk certificates evidence the investors’ ownership interest in the underlying sukuk asset, which entitles them to a share of the income generated.

To structure sukuk, the entity seeking to raise finance (“originator”), will typically incorporate a special purpose vehicle (SPV), and transfer title to the assets it intends to finance through sukuk. The SPV will then issue sukuk and use the funds raised to pay the originator for the assets.

Sukuk Must Comply With the Principles of Islamic Finance

- The charging or receiving of interest is prohibited: Under Shari’ah, an investor should realise no profit or gain merely for the employment of money. The return to an investor must be linked to the profits of the assets purchased and derived from the commercial risk assumed by the investor.

- The underlying sukuk assets must be Shari’ah-compliant: The assets or businesses underlying the sukuk cannot be related to gambling, or the production or sale of alcohol or pork, amongst other things.

- Prohibition on uncertainty, speculation and exploitation of ignorance: All rights and obligations relating to an investment certificate must be transparent and clear.

The Growth of the Market

- The global sukuk market has seen rapid growth since the financial crisis. Global sukuk issuances reached US$116.4 billion in 2014\(^1\) and are estimated to reach over US$250 billion\(^2\) by 2020.

- Malaysia continues to dominate the sukuk issuance market, accounting for nearly 60%\(^3\) of outstanding global sukuk.

- The increasing depth of the global sukuk market is also demonstrated by its ability to provide longer-term financing. While most sukuk have a maturity of three or five years, in April 2013, Saudi Electricity Company (SEC) issued the first international 30 year sukuk and in April 2014, the Government of Dubai issued its first ever 15 year sukuk, the longest tenor for a sukuk issuance by an unrated issuer to date.
In July 2014, the UK Government issued a £200 million Sovereign sukuk, the first of its kind by a European sovereign state.

It is estimated that Dubai will spend US$8.1 billion\(^4\) in preparation for the World Expo 2020, and Qatar is expected to require significant external funding to finance the air-conditioned stadia and substantial infrastructure needed to stage the 2020 FIFA World Cup. This will likely result in a surge of sukuk issuances in the region as the market is poised to fill the funding gap left by the retreat of the European and US lending markets.

Sukuk have also typically been purchased by investors intending to hold the certificates to maturity, which has meant that the secondary market performance of sukuk trading prices has generally been more stable, despite the wider economic instability.

Most prospective issuers of sukuk are currently able to achieve more favourable pricing in the sukuk market as compared to an equivalent issue in the conventional bond market.

### Challenges to the Development of the Sukuk Market

**Legal Regime:** The transfer by the originator of assets underlying the sukuk to the SPV may give rise to additional taxes and stamp duties, putting sukuk at a disadvantage when compared with conventional bonds. One of the primary reasons that Malaysia accounts for a high percentage of global sukuk issuances is because its government has enacted tax, land transfer and registration laws that do not penalise sukuk issuances in comparison with conventional bond issuances.

**Standardisation:** As part of a sukuk transaction, a legal pronouncement is conventionally procured from Shari'ah scholars to provide issuers and investors with comfort that a sukuk instrument is Shari'ah-compliant. However these endorsements are subject to different interpretations and such differences in opinion can create volatility in the market. It is important that a guiding set of principles is developed with which the majority of Shari'ah advisors agree.

**Mechanics for Default:** It is essential for the development of a mature market that sukuk investors understand their rights and remedies in default scenarios. Many early investors viewed sukuk as secured instruments, benefiting from security in the underlying sukuk assets. However following some high profile defaults, investors learned the hard way that most sukuk instruments are not secured in the conventional sense. Scholars are seemingly encouraging a move towards asset-backed structures, in which the investors have actual recourse to the assets in the event of a default.

### Structuring Sukuk

There are a number of issues to consider in selecting an appropriate sukuk structure, including transfer of title, nature of the assets, tax and Zakat (a fixed portion of a Muslim’s wealth required to be donated to charity in accordance with Islamic law), tradability, and regional differences.

The top three most common sukuk structures are:

**Sukuk al-ijara**

The *ijara* sukuk is regarded by some commentators as the classical sukuk structure and has become the most commonly used structure since 2008. This structure's popularity is explained by its uncontested Shari'ah-compliance and its nature as a sale and leaseback agreement, which makes it suitable where the company has unencumbered assets that are commercially leasable, such as real estate, ships and aircrafts. The rental payments can be either fixed or calculated with reference to a market rate, such as LIBOR or EIBOR.

**Sukuk al-wakala**

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A *wakala* is an agreement between two parties whereby one party agrees to act on the other party's behalf, similar to an agency arrangement.

The principal (investor) appoints an agent (the *wakeel*) to invest funds in a pool of investments or assets that are purchased by the *wakeel* on behalf of the sukukholders. The *wakeel* then uses its expertise to manage the investments for an agreed period of time to generate an agreed profit return. The profit return will be used by the principal (usually an SPV) to fund the periodic distribution amounts payable by the issuer under the sukuk to the investors. On the maturity date, the investment manager liquidates the sukuk portfolio and pays the proceeds of the liquidation to the principal to fund the dissolution amounts payable by the issuer under the sukuk to the investors.

The *wakeel* selects and manages the underlying businesses or investments on behalf of the investor to ensure an agreed upon profit rate, and the principal can only receive up to the agreed upon profit return. The *wakeel*, on the other hand, may keep any profit in excess of this agreed upon profit return as an incentive fee.

**Sukuk al-murabaha**

A *murabaha* contract is an agreement between a buyer and seller for the delivery of an asset where the price includes the cost of the asset plus an agreed-upon profit margin for the seller. The buyer can pay the price on the spot or establish deferred payment terms (paying either in instalments or in one future lump sum payment).

Under a *murabaha* sukuk, the issuer of the sukuk will utilise the proceeds of the sukuk issuance to purchase commodities from a commodity supplier. The trustee will then on-sell the commodities to the originator of the sukuk at a deferred price, which reflects the purchase price plus profit for the trustee as compensation for its involvement in the transaction. The period for the deferred payments reflects the maturity of the sukuk. The instalments of the deferred price received from the originator are then used to make payment of the periodic distribution amount due to investors under the sukuk.

Even though *murabaha* account for a small fraction of the total number of sukuk issued, the structure is favoured for smaller deals involving buy-to-hold investors who are more likely to accept uncertainties with regards to the negotiability of their certificates.

1 Source: S&P
2 Source: Thomson Reuters
3 Source: Asian Bond Monitor (Asian Development Bank)
4 https://www.zawya.com/story/Forum_to_Boost_International_Investment_in_Dubai/ZAWYA2014032008115/