Readings in

Sukuk

Concept and Operation

Compiled, Classified & Edited by

Professor Dr. S. M. Ali Akkas

Dr. M Abdul Aziz

Bangladesh Institute of Islamic Finance (BIIF)

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Introduction

Innovations in Sukuk and their application, as the latest capital market instruments added to the policy dynamics of Islamic Economics and Finance, are of the origins dated back to Middle Age and reemerged and reintroduced in Nineties of the Twentieth Century. The last quarter of Twentieth and the first quarter of Twenty First Century have witnessed dreadful evidences of FC crash, Dot.com crisis and the longest ever recession of 2007-09 financial crisis ended with trillions of dollars of global GDP loss, massive bank failures and costly bailouts of the collapsed financial institutions from public exchequers being the global feature. Emergence of Islamic banking and financial institutions was thought to be a way out of the repeated collapse of interest-based conventional financial system. Development of sukuk provided an added ray of hope in coming out from theoretical and practical ramifications of conventional interest-based financial system. *Readings in Sukuk: Concept and Operation* attempts to present a structured thought and practices of the Islamic capital market instruments with a view to check their validities in terms of risk, rules, regulations and governance from the viewpoint of Shariah and its maqāṣid.

Need for developing a reading series on Sukuk is justified with the same reasoning of developing other readings materials on Islamic economics and finance. However, compared to the body knowledge developed on Islamic economics and banking during more than half a century starting from 1950s, conceptualization and operation of sukuk was rapid raising debates on their Sharīah validity in some of the cases. The current readings series on Sukuk tries to address adequately as much as possible.

A. Structure of the Readings Series-6

Previous series including this one are prepared following stylish standard syllabuses fit to the requirements of appropriate university level curricula particularly meant for undergraduate and graduate studies. The current series is comprised of sixteen chapters divided into six parts. Contents placed under each part and chapter vividly reflect depth and breadth, and structure of the reading series.

Readings in Sukuk: Concept and Operation, like other ones in the series, is a compilation of judiciously selected professional articles published in journals of international repute. While selecting the articles for a chapter from among host of similar articles, due attentions have been paid to authority of the author as well as standard and reputation of the journals in which these are published. An overview on the structure of the book below may provide instant sense of what the book is all about.

The book is consisted of six parts: Part I: Sukuk: An Overview; Part II: Framework of Sukuk Issuance; Part III: Structuring Sukuk by Shariah Contracts; Part IV: Sukuk Structuring Based on Commercial and Technical Features; Part V: Sukuk for Government and Corporate Financing, and Part VI: Sukuk: Market Risk, Default and The Way Forward.

B. B. Contents Covered

I. Sukuk: An Overview

Part-I, comprised of chapter 1& 2 of this Readings Series, starts with an introduction to sukuk and its historical development followed by classification of sukuk.

Introduction to sukuk

Obiyathulla Ismath Bacha (2002) explains that the Islamic Capital Market is formed and structured based on five main operational principles that is to prevent practice of usury, share risks, avoid events of speculation, equalize the *aqd* with the subjected contract and activities carried out must be legal from the Shariah perspective. In brief, Islamic capital market refers to a market in which activities are done through ways that are not contradicting with the principles of Islam.

Hossain, M. S. (2018) provides a systematic review of the existing literature on the pertinent qualitative and quantitative studies on sukuk mainly to identify the unknown research issues on sukuk and evaluate them in the context of corporate finance. Sukuk is ideally introduced as a new class of financial asset in the global financial market since 2002, he mentions. Haneef, R. (2009) attempts to trace the market development of *şukûk* structures from "asset-backed" to "asset-based" and "asset-light". He highlights how over time the requirement of having tangible assets to support *şukûk* structures became diluted as the Sharǐ'ah standards became more liberal in their interpretation of these structures. Ariff et al (2013) reports their findings from the study objective to determine whether securities issued by the same issuer i.e. with the same risk class, for the same period of time i.e. for the same duration or maturity, as ethical Islamic *sukuk* certificates and conventional bonds traded in the same market in Malaysia provide similar yields to maturity. In case the yields are the same for identical securities from both types, one may conclude that the existing valuation model for conventional bonds may be applicable also for such Islamic products i.e. *sukuk*, and that the two instruments are the same.

Historical development

Sukuk market has been exceptionally innovative since being first introduced in 1990 to the financial market. A basic requirement for *Shariah* compliance of any *sukuk* structure is that it shall be backed by tangible assets. Radz, R. M. (2018) describes in his study the changes in the *sukuk* structure and particularly in terms of from asset-backed to asset-based and ultimately to a blended *sukuk* structure. This development is mostly associated with the problem of insufficient physical assets when issuers demand to tap funds available in the Islamic financial market. In the meantime, *Shariah* requirements and solutions offered by *Shariah* advisors also play a role in shaping the issued *sukuk* structure. The financial community adopted and refined the concept of *sukuk* and expanded its scope to incorporate a wide range of commercial and financial activities.

Sukuk still depends heavily on government issuance to prop up markets. Corporations have recently tapped into the sukuk market to benefit from the high demand from Shariah-compliant investors and opportunistic buyers looking for diversification with good credit ratings and attractive yields (Ansari, R. 2017).

Classification of Sukuk

While theoretically, *sukuk* are not interest-bearing instruments while conventional bonds are, much debate has arisen on the nature of this instrument in practice. Renowned *Shariah* scholars back these concerns. According to Mohammad Taqi Usmani, practices of issuing *sukuk* replicate the structure of conventional bonds in terms of the lack of ownership, right to a fixed return, and the guarantee of repayment of the principal, thus in fact making most *sukuk* un–Islamic (Usmani, 2007). Some innovations which try to achieve the same economic outcome as conventional instruments resulted in *sukuk* structures being commonly criticized as deviations from Islamic finance. The issue here is the tension between legalistic forms and ignoring the substance of Islamic law (Abdullah, 2018).

Safari, M. (2013) proposes a classification for *Sukūk* contracts as pure debt, equity-based, and asset-backed based on the intrinsic nature and purpose of fund-raising. This classification has more practical use compared to existing classifications. Further, the contract peculiarities of the six instruments (*mudārabah, mushārakah, murābahah, ijārah, salam,* and *istisnāh*) are carefully specified for the first time. To start a discussion on how the economic behavior may be modeled for theory building, the potential cash flow pattern of each type of *Sukūk* contracts is specified in terms of basic behavioral characteristics.

Ratziz, R. M. & Muhamrd, N. A. (2019) emphasize review of the demand for a proper classification of *sukuk* from regulatory bodies and credit rating agencies, given that some contentious issues remain concerning the status of *sukuk* as debated in the literature and following default. They examine also to what extent the innovations in this Islamic instrument make it differ substantially from conventional bonds in practice.

II. Framework for Sukuk Issuance

Shariah Rules for Sukuk

Benaicha, M. et al (2019) explore the extent of Shariah compliance in the contracts underlying sukuk structures and their conformity to the objectives behind such contracts. It can be done by exposing the prevalent opinions to a maqasid matrix to judge their validity. The Shariah issues underlying sukuk structures are divided into four primary issues that pertain to a certain category of sukuk or most sukuk regardless of the category and focus on the most important and prevalent issues as identified by Islamic economists, jurists and other researchers. The most important findings are that the issues as they relate to important principles and elements of mu'âmalât or Islamic contracts law exist and are real including, but not limited to: possession and legal or beneficial ownership of assets, the debt nature of sale-based sukuk, lack of PLS considerations, and the loss of contact with the real economy. The literalists approach does not incorporate Shariah objectives as ideal standards for sukuk structuring, and similarly, the alternative approach features reductionist tendencies to certain principles. Their research provides a theoretical basis on which to judge, from an objective perspective, sukuk issuances and so does not provide practical steps to implementation. Their study, as they claim, takes a much-needed comprehensive look at sukuk structuring in light of the means and objectives of the structuring practice and is expected to provide an original dynamic alternative for scrutinizing structuring practice. Thereby, they recommend that a gradual transition to realizing all of the objectives highlighted if possible, and if not that an attempted transition to pure asset/equity- based sukuk setups, not be radical and trigger a frenzied flight to interest-based bonds for financing purposes since the demand for equity arrangements is quite limited and segmented as in Khan (1995). The feasibility of non-equity sukuk and acceptance is much greater for a slew of reasons and any sort of radical change may bring about unwarranted consequences such as losing the currently developed customer base. Alternatively, PLS-based financing may be adopted on a wider scale – since it is more morally ideal than debt – while maintaining limited risk levels by diversifying which reduces the risk of individual assets/projects. Moreover, a gradual move towards PLS arrangements bypasses the collateral requirement which may even give sukuk higher rating as in conventional banking in which a firm gets financing by virtue of its collateral. This may direct investors' attention away from rating towards efficiency of the issuer or underlying asset as is also discussed in (Chapra, 1985; Benaicha, 2019. ibid).

Framework for Sukuk Issuance

Qizam, I. & Fong, M. (2019) focus on examining the determinants of financial disclosure quality (FDQ), and on employing proxies of the short-term financial information quality in the context of capital market, and the down-trends of *sukuk* ratings and bond ratings amid the rapid growth of *sukuk* that are presumably related to the financial disclosure quality. Given that their research is intended to re-investigate the determinants of financial disclosure quality, either through its attributes of relevance and reliability, but also through fundamental risks or accounting-based risks (ABRs), not in the context of capital market, but that of *sukuk* and bond market. The research examines whether or not FDQ that appears as relevance and reliability in *sukuk* market (through credit rating) is empirically priced thereof; whether ABRs also affect *sukuk* ratings; whether the identified FDQ as moderating variable also affects the relationship between accounting-based risks and *sukuk* rating, and whether differentiating between *sukuk*-issuing firms (using samples from Indonesia and Malaysia) versus bond-issuing firms (using sample of Australia) leads to an effect on the influence of ABRs toward credit ratings, and on the moderating effect of FDQ on the relationship between accounting-based risks and *sukuk* rating. This is in contrast to the approach commonly taken by the value relevance studies that generally base their inferences on pooled samples (Brown, Lo, & Lys, 1999; Cohen, Dey, & Lys, 2004; Rajgopal & Venkatachalam, 2005).

Qizam & Fong (Ibid), in their research, demonstrate comparability from different rating groups in a multi-country setting (*sukuk*-issuing firms from Indonesia's and Malaysia's samples and bond-issuing firms from Australia's sample) to yield new insight on the inter-relationship among *sukuk* and bond ratings, FDQ, and accounting-based-variables (accounting fundamentals). Given these arguments and objectives, the research of Qizam & Fong contributes to, *firstly* expanding previous empirical evidence of financial disclosure quality from the stock market to which accounting-fundamental studies are mostly devoted to a wider context of *sukuk* and bond market. In addition, understanding how two sources of financial information attributes (relevance and reliability) regarding FDQ is very important to measure the information risk developed from the long-run series of financial information, which in turn can be used as comprehensive inputs in developing quality indices of firms' financial information, especially when applied in the context of debt market (*sukuk* or bond) to set their ratings. The downward trends of the *sukuk* and bond ratings, that are presumably related to FDQ, are expected to be upgraded to the appropriate level with which the sell-side and buy-side of *sukuk* and bond might utilize (see Graham, Harvey, & Rajgopal, 2005). This will also boost the increased decision usefulness of financial information for investment decision making, creditworthiness assessment, the standard setting improvement through harmonizing between Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), and International Financial Reporting Standards (IFRS) (Rahman, 2003). Hence, this is a ‘new’ attempt to expand the existing issues of FDQ determinants, i.e., accounting-accrual quality, information content, and more other accounting quality ones.

Secondly, the apparently decreased value-relevance of FDQ in relation to credit ratings (Blume et al., 1998; Jorion et al., 2009; Rajgopal & Venkatachalam, 2005) should be equated with the increased attempts to explore determinants driving the long-run and comprehensive benefits of financial information and its evolving environments. Hence, this research explores the extent to which FDQ attributes, related to relevance and reliability on ABRs, are of great importance for *sukuk* and bond rating policy. They utilize ABRs as alternative determinants of FDQ in a wider context of debt market, so as to predict potential (long-run) default risks more accurately, rather than to apply ‘superficial’ analysis of short-run financial information.

Third, their study would provide empirical evidence on how information risk can be built by exploring more deeply the FDQ attributes, namely relevance and reliability and ABR variables that are expected to be useful for developing risk-relevance or value-relevance theory, which was previously triggered by Beaver, Kettler, and Scholes (1970). In addition, the results of their research are expected to contribute to the development of information risk measurement standards originating from financial information risk attributes that further reveal the potential risks more comprehensively, and in the long term, to be utilized to the greatest extent in rating determination, especially *sukuk* and bond ratings.

Fourth, their research is to re-confirm whether a comparison between FDQ, occurring in *sukuk*-issuing (sharia-compliant), and bond-issuing (non-sharia-compliant) companies is worth verifying as confirmed by previous empirical results of Farooq and AbdelBari (2015) and Wan Ismail, Kamarudin, and Sarman (2015), who finds robust evidence that Sharāʾah-compliant firms have significantly higher earnings quality relative to non-Sharāʾah compliant firms.

III. Structuring Sukuk by Shariah Contracts, Structures and Pricing

Razak, S. R., Saiti, B. & Dinc, Y. (2019) think the existing literature focuses only on the contacts and structures of sukuk, and the pricing of sukuk is largely ignored. Their study examines the contracts, structures and pricing mechanism of sukuk. More specifically, their study examines several sukuk instruments, reviews the existing structures, demonstrates sukuk pricing mechanisms and discusses critical issues of each type of sukuk. Their research also considers possible solutions for those issues discussed in the study. By doing so, they think, the readers are then able to understand the important technical elements of sukuk and can differentiate sukuk from the conventional bonds and appreciate the spirit of Islamic finance.

They conclude that *Sukuk* have successfully performed throughout the challenges faced. They admit that along the journey, all the obstacles gave impacts to the instrument and slow their growth. However, *sukuk* instruments managed to maintain their development in the financial market, in fact, it is expanding over the world gradually. The awareness of *sukuk* has increased, not only among Muslims but also among non-Muslims. Non-Muslims are able to relate to the application of *sukuk* as the instruments are akin to the conventional bond with respect to cash flows and risk. Nonetheless, it is different in certain basis which makes it better compared to conventional bond (Bhuiyan, Rahman, Saiti, & Ghani, 2018; El Mosaid & Boutti, 2014; Shahar & Jamlus, 2014).

Sale-Based Sukuk

Structuring sale-based sukuk rely basing on sales mode, i.e., murabahah, istisna, salam, bay al-inah.

Ijārah-sukuk

Ijārah-sukuk are the latest product in the market that is rapidly gaining ground in the capital market. It has emerged as a different asset class among the Islamic financial products. It has gained acceptance among Shariʾāh scholars and high in demand by large investors and Islamic financial institutions. On the supply side, many governments have found it useful to raise funds for their fiscal needs and long-term financing of big projects. Corporate entities are also finding it useful to generate funds for their project specific needs. Initially, the cost of issuance was very high because of uncertainty of the untried product, large documentation requirements, rating expenditures, and various fees such as legal, underwriting, and investment banking services required in the issuance process. However, these expenditures have since come down because Ijārah-sukuk has become a replicable product. Each new sukuk now is copy of the previous one with some changes to suit the needs of the issuer or the nature of the market.

Partnership-Based Sukuk

Financing modes can be distinguished according to the nature of the financing in different techniques. The modern banking and financial system has come into being to meet human needs for services and financing. Generally, there are two main types of financing, which are equity financing and debt financing. Islamic banking has its own laws in the form of profit-sharing contracts through which the customers (Muslims) can fulfil their needs for equity financing.

In Islamic banking there are two major contracts in equity financing: *Al-Musharakah* (joint-venture profit-sharing) and *Al-Muḍārabah* (trustee profit-sharing). Therefore, concepts of partnership from the Islamic legal thought merely same with the conventional practiced. However, they differ from Islamic perspectives from the rules of *Shari'āh* law which point out some limitations on the partnership in their business. Some of the differences are:

(i) The business must be accordance to the *Shari'āh*. Type of purchase and sale or business such as *Riba* base, gambling (casino), and liquor, and other business which not permitted with *Shari'āh* are considered Haram and prohibited (Warde, I. 2000).

(ii) The contract for this type of transaction must be free from *Gharar* (uncertainty). According to *Shari'āh* law (Islam) prohibited any transaction which dealing with uncertainty and speculation. Such of uncertainty elements are sale of an unborn calf in its mother wombs, sale of fish in the river and others (Remali & Nor' Azurah, 2014).

Agency-Based Sukuk

Ali, E. R. A. et al (2019) focus on exploring alternative financing modes for HLIs through Socially Responsible Investment (SRI) sukuk and Social Impact Bonds (SIBs). The methods utilized in this study are critical review of literature, case study analyses and interview sessions with experts. Their study recommends two SRI sukuk models: firstly, in the situation where the proceeds are used for income-generating activities, sukuk based on wakalah is proposed; while secondly for non-income generating activities, a cash-waqf sukuk with temporary and permanent features is suggested. In term of the structure of the sukuk, the returns and repayments of both sukuk are dependent on key performance indicators (KPIs) being achieved. In both cases, it is recommended that the sukuk be issued by a consortium consisting of a number of different universities in order to lower the cost of issuance and fund management, as well as efficiently utilizing resources. They also recommend that the sukuk is guaranteed by a third party, preferably by the government.

Perpetual, Convertible and Exchangeable Sukuk

Perpetual *ṣukūk* are commonly defined as hybrid *ṣukūk* which– like perpetual bonds–have features of both debt and equity capital (Schaffner, 2010: 3). Schaffner (2010) further deliberates that perpetual *ṣukūk* have the features of "permanence" and "loss absorption", which means that the *ṣukūk* carry a perpetual tenure and are subordinated to debt and other liabilities of the issuer of such *ṣukūk*. Perpetual *ṣukūk* are an innovative form of debt instruments (from a legal standpoint) with equity-like features that typically rank senior only to common equity.

Zolfaghari, P. (2017) aims to introduce and examine Sukuk in comparison with other securities of various aspects so that the concept and nature of Sukuk would be more tangible and easier to understand for the reader. In other words, the differences or similarities between Sukuk and other securities in terms of the bankruptcy of intermediary, the concept of intermediary, the concept of asset and securitization and also other concepts will be looked into. He wants as well to compare Sukuk and hybrids and express instances of Sukuk which are similar to hybrids so that understanding of Sukuk as a hybrid, are more tangible.

Asset-Based and Asset-Backed Sukuk

Herzi A. A. (2016) compares between asset based and asset backed sukuk structures and their compliance to the Sharāʼah. The study intends to figure out the motives that asset based sukuk structure is the most dominant in the sukuk market in the face of the critics that have been elevated by many scholars since 2007. The two structures of Asset backed and Asset based Sukuk are compared in their technical and commercial features using literature-based methodology, which is a qualitative approach. It is highlighted that asset backed sukuk structure is more compliant to the Shariah compared to Asset based Sukuk in a form and substance. Herzi found that there are three reasons that could be explained why asset based sukuk structure was the most dominant in the market up to 2014, namely Shariʼāh, legal framework and market demand.

IV. Sukuk for Government and Corporate Financing

Kahf, M. (1997} discusses need for a Shariʼāh compatible fixed-return financial instrument in an Islamic economy. He proposes ijārah-bonds as marketable Islamic financial instruments for resource mobilization in the public sector as well as an instrument for monetary policy. Private corporate bodies can equally use the ijara- bonds for resource mobilization.

V. Sukuk Market Risk, Default and Way Forward

Barqawi, Q. A. B. (2018) observes Shariʼāh financial products is currently developing in Indonesia, one of them is Sukuk which is the instrument of long-term securities letter based on the Islamic principles given by the issuer to the holders of Islamic bonds. His study aimed at describing sukuk and its development in Indonesia using descriptive analysis method. To him Sukuk instruments that have been widely traded in Indonesia until now are sukuk Ijārah and Mudârabah. The difference between the two lies in the distribution of rewards in the form of fees for Sukuk Ijārah and principles of dividing the results to Sukuk Mudârabah. There are risks embedded in sukuk instruments such as systematic risk and idiosyncratic risk. These risks are associated with the type and schemes of various sukuk. Currently, the pricing and assessment of sukuk is still using valuation models such as the assessment of conventional bonds. This concept is the basis for the authors in conducting further research on the design process for reasonable pricing model Sukuk Ijārah and Mudârabah.

Sweder Van Wigenbergen & Sajjad Jaheer (2014) focus in their study the resolution process following default, not on the reasons why the default was triggered to begin with. They analyze the recent *sukuk* (near) defaults from an Islamic finance perspective. Specifically, after providing basic information on each *sukuk* (issuer, arranger, SPV, term period, rate of return etc.), they present an exposition of the underlying contracts of each *sukuk*, their structure, reasons for defaults and restructuring process thereafter. Finally, they provide a discussion on the critical issues related to *sukuk* structures namely ownership of underlying *sukuk* assets, rights of the investors including recourse, if any, to core assets in case of distress, risk factors including legal and *Shariʼāh* risks regarding *sukuk* structures, purchase undertakings and credit enhancements. These clarifications are crucial if access to the capital markets is to be continued through *sukuk*. The recent turmoil in the conventional financial sector adds to the relevance of the topic.

Abu Umar Faruq Ahmad, Aishath Muneeza, Rashedul Hasan (2018) provide a critical evaluation of Sukuk default cases in a post-default environment and restructuring process thereafter, while offering innovative investment solution for post-default restructuring of Sukuk that complies with the requirements of the Shari'āh using restructuring. Their study also briefly examines in some occasions factors that led to Sukuk defaults in any jurisdiction.

Sukuk: Issues, Challenges and Future Direction

Hanefa, M. M., Noguchi, N. & Muda, M. (2013) discuss the importance of Sukuk as a financial instrument in the global financial markets and issues concerning valuation, measurement and disclosures according to the IFRSs and the AAOIFI standards. Naifar, N. & Hammoudeh, S. (2016), on the other hand, investigate how major uncertainty indices in different financial markets and economic sectors shape the GCC sukuk return distributions. The indices include the global financial distress as represented by the Cleveland financial stress index (CFSI), the stock market uncertainty as captured by the CBOE volatility index (VIX), the global bond market uncertainty as arrested by the Merrill Lynch option volatility estimate (Move) index, the economic policy uncertainty as defined by the US economic policy uncertainty (EPU) index, and the commodity market uncertainty as represented by the CBOE crude oil volatility index (OVX) and the gold price uncertainty index (GZV). More specifically, they address the following unanswered questions. Does dependence exist between the GCC sukuk returns and the global uncertainty factors? Does the dependence structure change across quantiles? Is dependence symmetric or asymmetric? Are the GCC sukuk returns more affected by the global uncertainty factors than by the global sukuk index? Can the GCC sukuk provide international investors with more alternatives for hedging and diversification purposes? This study differs from and add to the related literature on sukuk markets in two important ways. First, they investigate the GCC sukuk return dynamics with several major global financial, economic policy and uncertainty risk factors across different distribution quantiles. Second, they compare the sensitivity of the GCC sukuk returns and global sukuk returns to that of the global uncertainty factors. This comparison, according to them, allows to investigate the different investment alternatives and portfolio diversification opportunities between sukuk indices.

Bandar et al (2019) explore the extent of Shariah compliance in the Contracts underlying sukuk structures and their conformity to the objectives behind such contracts. They did this by exposing the prevalent opinions to a maqasid matrix to judge their validity. The Shariah issues underlying sukuk structures are divided into four primary issues that pertain to a certain category of sukuk or most sukuk regardless of the category and focus on the most important and prevalent issues as identified by Islamic economists, jurists and other researchers. The most important findings of their study are that the issues as they relate to important principles and elements of mu'amalat or Islamic contracts law exist and are real including, but not limited to: possession and legal or beneficial ownership of assets, the debt nature of sale-based sukuk, lack of PLS considerations, and the loss of contact with the real economy. The literalists approach does not incorporate Shariah objectives as ideal standards for sukuk structuring, and similarly, the alternative approach features reductionist tendencies to certain principles. This approach provides a theoretical basis on which to judge, from an objective perspective, sukuk issuances and so does not provide practical steps to implementation.

Thus, Bandar et al takes a much-needed comprehensive look, as they claim, at sukuk structuring in light of the means and objectives of the structuring practice and is expected to provide an original dynamic alternative for scrutinizing structuring practice (Bandar et al, 2019).

Finally, we hope that the current Reading Series-6 i.e., *Sukuk: Concept and Operation* would bring forth some of the genuine answers to the questions in regard to real strengths the sukuk possess over conventional bonds, if any, while facing defaults and managing risks in the capital markets.

The Editor