

SUKUK (Islamic Bonds)

A. Definition of Sukuk

Islamic bond or sukuk is well described as 'Trust Certificates' or 'Participation Securities' that grants the investor a share of an asset along with the cashflows and risk commensurate with such ownership. The central merit of the sukuk structure is that it is based on real underlying assets. This approach discourages over-exposure of the financing facility beyond the value of the underlying asset, given that the issuer cannot leverage in excess of the asset value.

AAOIFI defines Sukuk as being: "Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity".

B. Comparison with Bonds

A bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal, whereas, the sukuk holders claims an undivided beneficial ownership in the underlying assets. Consequently, sukuk holders are entitled to share in the revenues generated by the sukuk assets as well as being entitled to share in the proceeds of the realization of the sukuk assets.

A distinguishing feature of a sukuk is that in instances where the certificate represents a debt to the holder, the certificate will not be tradable on the secondary market and instead is held until maturity or sold at par.

C. Kinds of Sukuk

- Sukuk representing ownership in tangible assets (mostly based on Sale and Lease back or direct lease)
- Sukuk representing Usufructs or Services (based on sub lease or sale of services)
- Sukuk representing equity share in a particular business or investment portfolio (based on Musharakah/ Mudarabah)
- Sukuk representing receivable or future goods (based on Murabaha or Salam or Istisna').

D. The Relation Between Parties Involved

- The issuer and the subscribers are the main parties to the underlying contract.
- The SPV is a legal entity for a common representation of the subscribers.
- The underlying contract defines who is who.
- The relation between the issuer and the subscriber is governed by the rules of the original contract.

E. Tradable and Non-tradable Sukuk

- **Tradable Sukuk:** Sukuk representing tangible assets or proportionate ownership of a business or investment portfolio are tradable. For e.g. Sukuk of Ijarah or Musharakah / Mudarabah
- **Non-Tradable Sukuk:** Sukuk representing receivables of cash or goods are non-tradable. For e.g. Sukuk of Salam or Murabaha.

F. Types of Sukuk

1. Mudaraba Sukuk

These are investment sukuk that represent ownership of units of equal value in the Mudaraba equity and are registered in the names of holders on the basis of undivided ownership of shares in the Mudaraba equity and its returns according to the percentage of ownership of share. The owners of such sukuk are the rabbul-mal. Mudarba sukuk are used for enhancing public participation in big investment projects.

2. Musharaka Sukuk

These are investment sukuk that represent ownership of Musharaka equity. It does not differ from the Mudaraba sukuk except in the organization of the relationship between the party issuing such sukuk and holders of these sukuk, whereby the party issuing sukuk forms a committee from the holders of the sukuk who can be referred to in investment decisions

3. Ijara Sukuk

These are sukuk that represent ownership of equal shares in a rented real estate or the usufruct of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

4. Murabaha Sukuk

In this case the issuer of the certificate is the seller of the Murabaha commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the Murabaha commodity and are entitled to its final sale price upon the re-sale of the Commodity. The possibility of having legally acceptable Murabaha-based sukuk is only feasible in the primary market. The negotiability of these Sukuk or their trading at the secondary market is not permitted by shariah, as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt on a deferred basis, which will result in riba.

5. Salam Sukuk

Salam sukuk are certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to the ownership of the certificate holders. The issuer of the certificates is a seller of the goods of Salam, the subscribers are the buyers of the goods, while the funds realized from subscription are the purchase price (Salam capital) of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any.

6. Istisna Sukuk

Istisna sukuk are certificates that carry equal value and are issued with the aim of mobilising the funds required for producing products that are owned by the certificate holders. The issuer of these certificates is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realised from subscription are the cost of the product. The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel Istisna, if any. Istisna Sukuk are quite useful for financing large infrastructure projects. The suitability of Istisna for financial intermediation is based on the permissibility for the contractor in Istisna to enter into a parallel Istisna contract with a subcontractor.

Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialised firm.

7. Hybrid Sukuk

Considering the fact that Sukuk issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified Sukuk - hybrid or mixed asset Sukuk - emerged in the market. In a hybrid Sukuk, the underlying pool of assets can comprise of Istisna, Murabaha receivables as well as Ijara. Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds. However, as Murabaha and Istisna contracts cannot be traded on secondary markets as securitised instruments at least 51 percent of the pool in a hybrid Sukuk must comprise of Sukuk tradable in the market such as an Ijara Sukuk. Due to the fact the Murabaha and Istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

