Sukuk on the world stage

SHARIA-COMPLIANT, FIXED-INCOME CAPITAL MARKETS INSTRUMENTS ARE PROVING AN INCREASINGLY ATTRACTIVE INVESTMENT. DEBASHIS DEY EXPLAINS HOW THEY WORK

Generally known by their Arabic name, sukuk, and often incorrectly referred to as 'Islamic bonds', sharia-compliant, fixed-income capital markets instruments have steadily increased their share of global markets over the past decade. Initially developed exclusively in jurisdictions with majority Muslim populations, the global market for sukuk has seen considerable development over the past 10 years, with a number of high-profile corporate issuances and a number of sovereigns tapping the market.

Sukuk are financial products whose terms and structures comply with sharia, with the intention of creating returns similar to those of conventional fixed-income instruments like bonds. Unlike a conventional bond (secured or unsecured), which represents the debt obligation of the issuer, a sukuk technically represents an interest in an underlying funding arrangement structured according to sharia, entitling the holder to a proportionate share of the returns generated by such arrangement and, at a defined future date, the return of the capital.

Broadly speaking, compliance with sharia means that: (i) any profits derived from these funding arrangements must be derived from commercial risk-taking and trading only; (ii) all forms of conventional interest income is prohibited; and (iii) the assets that are subject to the funding arrangement must, themselves, be permissible (halal). The overall risk profile and economic return for the investor is akin to a conventional bond where the bondholder is a debtor of the issuer.

Types of sukuk

The sukuk issued in global capital markets have been predominantly structured as trust certificates, typically governed by English law. Some civil-law jurisdictions that do not recognise the concept of trust have sometimes issued sukuk structured as participating notes under legislation similar to that used for asset-backed securities.

Trust certificates

In a typical trust certificate transaction, the entity trying to raise funds (the obligor) will establish an orphan offshore special-purpose vehicle (SPV) in a suitable jurisdiction. The SPV issues trust certificates to investors and uses the proceeds to enter into a funding arrangement with the obligor, and the rights of the SPV as financier are held under an English law trust in favour of the certificate holders.

The most common structures for funding arrangements in the Islamic market include: a sale and leaseback (ijara) structure, a form of trade finance (murabaha) and a joint-venture equity investment (musharaka).

Alternative civil-law structures

The trust certificate structure above requires the concept of a trust to be recognised in the relevant jurisdiction where the obligor is located. In many jurisdictions, particularly those from the civil-law tradition, this is very rarely the case. As such, alternative structures have begun to emerge so as to allow for sukuk transactions to be carried out in accordance with local laws.

An interesting example of such a trend is exemplified by Turkey, which has passed specific legislation to enable the use of the sukuk. This legislation allowed for the formation of asset-leasing companies, which themselves are a form of SPV regulated by the Capital Markets Board of Turkey. These asset-leasing companies are specifically incorporated so as to be able to issue certificates under an ijara structure to investors, thereby allowing the asset-leasing companies to purchase assets and lease them back to the obligor. Effectively, the asset-leasing company finances the acquisition of such assets using funds raised by the issuance of certificates, and the lease-rental payments from the obligor mirror the profit distributions due under the certificates. The cash flows from the lease rentals, therefore, are used to service such profit distributions to certificate holders.

This model is best compared to loan participation notes, which have been in the market for several decades.

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Investors' credit exposure

Despite the fact that the sukuk is issued by an orphan SPV, typically the investor will not be bearing an exposure solely to the credit risk of that SPV. On the contrary, today's typical sukuk transactions are instead primarily intended to allow the investor to be exposed to the credit risk of the obligor. However, potential investors need to consider whether the sukuk only gives recourse to the obligor, or also to a separate segregated estate represented by the assets subject to the funding arrangement underlying the sukuk. In the current sukuk market the answer to this fundamental question may sometimes not be obvious.

Understanding the real nature of the connection between the funding arrangement and the asset to which it relates is central to understanding the economic risk of the sukuk and its risk allocation. It is therefore important for a potential investor to know whether the asset underlying the funding arrangement has been permanently transferred to the SPV. Either the investor will have legal recourse to the underlying asset (what is generally referred to as an asset-backed sukuk) or, alternatively, even though the transfer of the asset may be valid as between the obligor and the SPV, the investor only has recourse against the obligor because that transfer is not as effective against third parties or the insolvency estate of the obligor (what is generally referred to as an asset-based sukuk).

Asset-based vs asset-backed

In an asset-based sukuk structure, the overriding reliance of investors is on the credit strength of the obligor rather than the underlying assets. This allows the obligor to simplify its reporting and segregation in relation to the assets, as the obligor knows that the investors are really relying on the obligor credit strength alone.

For example, in an ijara transaction, where there is a sale by the obligor of an underlying asset to the SPV that will then be leased to the obligor, if the sukuk is structured as a typical asset-based structure, it becomes irrelevant for an investor to fully analyse the sale value of the asset in question or the potential value of the lease if leased to third parties, as the investors will rely only on the credit strength of the obligor as sole or principal lessee of the asset in question.

In an asset-backed sukuk, the profit return and return of capital are ultimately based on the assets themselves. Unlike in an asset-based structure, investors can be expected to want to try to assess the value of the assets (and the related underlying transaction) themselves.

Advantages and disadvantages of sukuk

For a corporate or a sovereign, some key advantages of tapping the sukuk market include:

- There is a potential marketing benefit for issuers active in Islamic markets, should they be seeking investments in those markets.
- The investor base represented by Islamic compliant investors is still largely untapped and there has traditionally been significant unmet demand for products such as sukuk.
- There is potential for crossover into other niche financial markets, such as the broader ethical investment market, that may provide a reputational benefit.

Some disadvantages of the sukuk market include:

- As the key element for attracting investors is the credit standing of the obligor, it may be difficult to tap this market for corporates or sovereigns with an inadequate credit rating.
- A sukuk whose underlying funding arrangement is based on ijara will necessarily require the obligor to have at its disposal suitable (halal) income-producing assets on which to base the transaction. In addition, unless the correct mechanics are included within the documentation, the substitution of similar assets into and out of the structure would be impossible. This could limit the obligor's ability to sell or deal with the asset during the life of the transaction.
- Unlike the conventional bond market, the standardisation of documents for sukuk issuance has been slow to develop and this can have adverse cost implications.
- From transaction to transaction, to the extent that the structure used for the sukuk departs from the typical structures already well recognised in the market, the involvement of the sharia scholars is necessarily required. This can add some additional cost and an element of unpredictability to the transaction structuring process.
- As sharia scholars have differing views as to how compliant the structures are, there is no absolute unified and settled body of opinion on these issues.
- The tax treatment of sukuk may be dissimilar to conventional bonds in certain jurisdictions.

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