Sukuk: Shariah Guidelines for Islamic Bonds

Presented By:

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Overview on Sukuk

Fundamental Shariah Requirements

Sukuk Structure

Example of Sukuk Structuring and Shariah Issues

Sukuk Trading

Bank Islam and Amana Bank Involvements in Sukuk Structuring
Overall economy are divided into:

- **Real sector** – produces the nation’s output of goods and services
- **Financial sector** – providing financing needed to fund the real sector

Source: Adopted from Professor Dr Obiyathulla Ismath Bacha (2010)
Introduction to Sukuk (Islamic securities) and Sukuk Market

- **Sukuk** market is one of the fastest growing segments of the Islamic capital market (“direct funding market”).

- Usually translated as Islamic bond is the most active Islamic debt market instruments (in addition to Islamic equity market).

- Provide alternative funding avenue for corporate entities and the government, besides the bank funding.

- Benefits of **sukuk**:
  - Larger funding amounts
  - Provide liquidity to the investors as they can trade it in the secondary market.

- Islamic financial system expanded into capital market since the late of 1990s.

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Definition and Origin of Sukuk

- Originates from the Arabic word **sukuk** (صكوك) i.e. plural of sak (صك)

- Islamic Financial Services Board (IFSB-2) defines:
  
  “Certificates that represent the holder’s proportionate ownership in an undivided part of the underlying asset, where the holder assumes all rights and obligations to such asset.”

- Medieval Times – the word “cheque” or “check” derived from “sak”
### Why Shariah Prohibits Conventional Bond?

- The main issue in the conventional debt market is the interest-bearing loan transaction.
- In case of a zero-coupon bond, investors will receive accumulated interest at maturity, making the bond haram.

<table>
<thead>
<tr>
<th></th>
<th>Conventional Bond</th>
<th>Asset Backed Securities</th>
<th>Sukuk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary Level Relationship</strong></td>
<td>Lending and borrowing transaction (loan); thus <em>haram.</em></td>
<td>Sale of debt or income generating asset</td>
<td>Variety underlying Shariah contracts (<em>’uqud</em>)</td>
</tr>
<tr>
<td><strong>Return to Investors</strong></td>
<td>Interest on loan.</td>
<td>Income generated from underlying asset</td>
<td>Profit elements in underlying contracts (sale, lease or partnership)</td>
</tr>
<tr>
<td><strong>Recourse</strong></td>
<td>To issuer</td>
<td>To asset</td>
<td>To the rights and obligations of the contracts.</td>
</tr>
<tr>
<td><strong>Tradability in Secondary Market</strong></td>
<td>Sale of debt</td>
<td>Sale of debt or income generating asset</td>
<td>Depends on nature of underlying assets. Majority scholars allow sale of tangible assets, some intangible asset and interest in ventures, except issues on receivables.</td>
</tr>
</tbody>
</table>
Usage of sukuk can be traced back to the 1st Century AH during the Umayyad Caliphate under the rule of Khalifah al-Marwan ibn al-Hakam as recorded by Imam Malik in Al-Muwatta’, Book 31, Number 31.19.44

Example of sukuks to raise funding – In 1775, the Ottoman Empire issued esham to fund its budget deficit after its defeat by the Russians. The government securitised the tobacco custom collection, in which the investors received annuity (variable return) for the rest of their life. The government may buy back the sahim at their discretion (Ref: Professor Murad Cizakca – 2009)
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1. Funds raised must be used for **Shariah compliant** (halal) activities.

2. Fund raised may be used to **finance needed tangible assets**. Specificity of assets is important, since **Sukuk** unlike conventional bonds cannot be used for general financial needs of the issuer.

3. Income received by **sukukholders** (investors) must be **derived from the cash flows** generated by the underlying.

4. **Sukukholders** have a **right to the ownership** of the underlying asset and its cash-flows.

5. **Clear and transparent** specification of rights and obligations of all parties to the transaction, in particular the originator (customer) and **sukukholders**.

6. **No fixity** in returns.
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Structuring Sukuk

- Indebtedness/ obligation must be created first between the issuer and the investors. It must be originate from one of the nominated Shariah contracts (‘uqud al-musamma).

- Normally, the names or types of sukuk is determined by the Shariah contract into which both the issuer and investor entered into at the first place.
**Sukuk Structures**

- Most common *sukuk* classification is based on underlying *Shariah* contracts.
- From *Shariah* perspective, there is no preference for the usage of one contract over the other.

**Factors for considering a Sukuk structure:**

- Economic objectives of the Issuer.
- Availability of assets.
- Level of debt that the company has.
- Credit rating of the Issuer.
- Legal framework.
- Tax implication of a structure.
AAOIFI has specified several categories of permissible sukuk i.e. securitization of:

<table>
<thead>
<tr>
<th>No</th>
<th>Securitization of/ Purpose</th>
<th>Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Existing or to be acquired tangible asset</td>
<td>Ijarah</td>
</tr>
<tr>
<td>2</td>
<td>Existing or to be acquired leasehold asset</td>
<td>Ijarah</td>
</tr>
<tr>
<td>3</td>
<td>Presale of services</td>
<td>Ijarah</td>
</tr>
<tr>
<td>4</td>
<td>To fund construction</td>
<td>Istisna’</td>
</tr>
<tr>
<td>5</td>
<td>Presale of the production of goods or commodities at a future date</td>
<td>Salam</td>
</tr>
<tr>
<td>6</td>
<td>To fund the acquisition of goods for future sale</td>
<td>Murabahah</td>
</tr>
<tr>
<td>7</td>
<td>To fund capital participation in a business or investment activity</td>
<td>Mudarabah/Musharakah</td>
</tr>
<tr>
<td>8</td>
<td>To fund various asset, goods or services acquisition which are then entrusted to an agent to manage on behalf of the owners.</td>
<td>Wakalah</td>
</tr>
<tr>
<td>9</td>
<td>To raise funds for agricultural land cultivation, land management and orchard management activities</td>
<td>Muzara’ah</td>
</tr>
</tbody>
</table>
### Distinctions Between Sukuk Based on Shariah Structure

<table>
<thead>
<tr>
<th>Nature of Sukuk</th>
<th>Contract</th>
<th>Feature</th>
</tr>
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<tbody>
<tr>
<td>Represents ownership of asset, its usufruct or services (the “Underlying Asset”)</td>
<td>Ijarah</td>
<td>the sukuk are akin to trust certificates bearing undivided ownership in the leased asset and the rights to the cash flow stream arising from it as well as proceeds from sale of the assets</td>
</tr>
<tr>
<td>Evidences of indebtedness arising from sale of asset</td>
<td>Murabahah</td>
<td>the claim is on the obligations arising from the applied contract of exchange.</td>
</tr>
<tr>
<td></td>
<td>and Istisna’</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>In this case, the sukuk does not represent ownership on the physical asset as the ownership of the asset has been transferred to the obligor, though in certain cases, depending on the credit strength of the obligor, assets are provided as collateral or security to the indebtedness.</td>
</tr>
<tr>
<td>Represents ownership of units of equal value in the equity and are registered in the names of holders on the basis of undivided ownership of shares in the scheme</td>
<td>Mudharabah</td>
<td>Returns due to the holders as owners of capital are distributed according to the percentage of ownership.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Losses are borne in totality by the sukuk holders in accordance to percentages of the shares owned unless the losses are attributed to the negligence and/or wilful misconduct of the mudharib, who will be responsible for the same.</td>
</tr>
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<td>Represents ownership of units of equal value in the equity and are registered in the names of holders on the basis of undivided ownership of shares in the scheme</td>
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Sukuk Ijarah - Overview

- Under this structure, the Issuer must have taken a particular “asset” from the Investor on lease (Ijarah). Normally, this asset is originally that of the Issuer, and sold to Investors (normally intermediated by a SPV), before being leased back to the Issuer for a rental.

- The lease contract has created a financial indebtedness/obligation i.e. obligation to pay the lease rental. To evidence this, the Issuer issue Sukuk Ijarah to the Investor. The Investor may sell the Sukuk to the secondary market based on selling of debt which is backed by a tangible asset.

1. Sale of assets by SEV to the Financier for RM 522 million
2. Financiers lease back assets to SEV in return for Ijarah rental streams
3. SEV issue RM522 million Sukuk Ijarah as documentary evidence of lease rental arrangement
4. Sale of Sukuk Ijarah

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Sukuk Ijarah

1. Sells “beneficial interest” in land parcels to SPV for USD600 million (transfer of beneficial title)

2. SPV enters into a Master Ijarah Agreement with GOM (lease of land parcels)

3. SPV issues Sukuk representing undivided proportionate ownership in the underlying land parcels which gives rise to rights to a share in the rental payment in the Master Ijarah arrangement.

4. Payment of proceeds from sale of Sukuk

5. Proceeds

6. Periodic payment of rentals

7. At maturity, SPV sells the land to GOM at an agreed price.

8. GOM pays cash to SPV

9. Payment of rental and at maturity pay cash for sukuk redemption

SPV (Malaysia Global Sukuk Inc.)

Government of Malaysia (GOM)

Federal Land Commissioner

Sukuk Ijarah Owners

Amāna Bank
Sukuk Ijarah – Shariah Requirements

1. The rental payments maybe structured such that it comprises of (i) profits on the rental and (ii) redemption amount on the principal.

2. Sukuk Ijarah does not represent debts; but undivided proportionate ownership of the leased asset (participatory certificates).

3. Because the Sukuk Ijarah are not debts nor monetary, the issue of sale of monetary-debts with a discount do not arise. Hence Sukuk Ijarah maybe traded in the secondary market freely.

✓ Segari Venture (Malaysia)
✓ Guthrie Sukuk Ijarah (Malaysia)
✓ Government of Bahrain Sukuk Ijarah
✓ Government of Malaysia’s Global Sovereign Sukuk
✓ Qatar Sukuk
✓ Caravan Sukuk
Sukuk Istisna’ - Overview

- Structured to finance projects which will be completed in the future e.g. power plant, highways etc.

- Under “parallel Istisna”, the Issuer, being awarded the project by awarding party, will enter into Istisna 1 with the Investors i.e. Investors to deliver the completed project to the Issuer and the Issuer is supposed to pay the Istisna’ Price + Profit Margin to the Issuer, to be paid deferred at an agreed maturity date.

- The Issuer, being indebted to the Investors, will issue Sukuk Istisna’ to the Investors.

- The Issuer will create an SPV for project management purposes

- The Investor will then enter into Istisna’ 2 with SPV where the payment of the purchase price (equivalent to construction cost) is paid by Investor based on the contractually agreed terms e.g. progressive payment, one lump sum etc.
Under this structure, Sukuk Istitina’ represent the sale price under Istitina’ 1 (securitization of the obligation to pay the Istitina’ sale price).

Thus, it can not be traded because it will tantamount to trading of Istitina’ debt (bay’ al-dayn), which is not yet established until the Istitina’ asset is completed and delivered to the satisfaction of the buyer (Issuer).

Shariah Advisory Council of Securities Commission Malaysia’s Decision (2003):  

Contractual guarantee of payment of Istitina’ Sale Price by the Issuer is sufficient to establish the debt against the Issuer in favour of the Investor (sukukholders); despite the nature of Istitina’ contract that originally depends on successful construction of the Istitina’ asset in order to confirm the Istitina’ Price.
Both the Issuer and Investors (represented by SPV) contribute to the project being managed by either the Issuer or third party (as the case maybe).

The Issuer will issue Sukuk Musharakah evidencing the capital contribution of the investors and the “indicative rate of profit.” Profit, if any, will be shared between the Issuer and Investors at an agreed sharing ratio. Financial loss will be born by both proportionate to their respective investment.

1. MUIS contributes land and $35 mil (waqf land)
2 (b). SPV contributes cash (Proceeds received from Investor)
3. MUIS appointed as Musharakah’s agent to develop the land. MUIS receives fixed agency fee.
5. Leased for 5 years with guarantee. Rental will be shared proportionately
6. Profits distributed to Sukukholders. MUIS irrevocably undertakes to buy at a pre-agreed price the Musharakah shares of SPV/Investor on semi-annual basis (mutanaqisah).
Sukuk Murabahah (Tawarruq)

- Tawarruq (Monetisation) is applied by Cagamas (Malaysia's national mortgage corporation) to purchase receivables from Islamic assets (house financings, hire purchase and leasing) of financial institutions.
Hybrid Sukuk

1. IDB sells the Assets (Ijarah assets US$264 mil i.e. 65.5%, Murabaha assets US$123 mil & Istisna assets US$14 mil) to IDB for US$400 mil

2. ICD sells the Assets to SPV for US$400 mil

3. SPV creates a trust in respect of the Assets and issues 5-Year Sukuk to raise US$400 mil

4. SPV appoints ICD as agent to collect receivables from the Assets

5. SPV “delegates” the agency role to IDB

6. IDB provides certain guarantee in respect of the Assets and Purchase Undertaking
Hybrid Sukuk (IDB) – Shariah Requirements

1. Shariah Board of IDB viewed that IDB can sell a mixed portfolio of tangible assets (Ijarah properties) and receivables (murabahah and istisna’) given that the Ijarah properties are at least 51%.

2. IDB undertook that the Ijarah contract proportion in the sukuk asset will not fall below 25%.

3. Based on the above, the sukuk can be freely tradable in the secondary market.
Hybrid Sukuk (Istisna’ + Ijarah)

- Structured to finance the construction of a cooling plan in Abu Dhabi, UAE.
- In order for the sukuk to be tradable (during construction), Shariah Board required that at least 1/3 of the sukuk was in the form of tangible assets. The completed plant during issuance of the sukuk represented only 20% of the sukuk asset. To achieve this, additional tangible asset was introduced in the asset pool i.e. Tabreed (SPV) bought palladium worth US$26 mil.

2. Istisna’ Agreement. Tabreed to deliver the cooling plan & pay security amount

3. Upon delivery of plants, Tabreed leases the plant (for 5 years)

4. Periodic rental payment

5. Pursuant to Purchase Undertaking; upon maturity, Tabreed purchase the plants from SPV.
AGENDA

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Tradability of Sukuk

Shariah scholars unanimously agree that sukuk can be sold and purchased except some differences regarding Sukuk al-Murabahah and Salam Sukuk.

- AAOIFI (Shariah Standard No 17, para 5/2/15) on Sukuk Murabahah:
  - The sukuk is acknowledged
  - It can be traded after purchasing of asset and before selling it to the buyer.
  - It can not be traded after the delivery of the asset to the buyer.
  - Reason: The subject matter is considered as financial asset (receivable). Issue on sale of debt (bay’ al-dayn)

- Shariah Advisory Council of Securities Commission, Malaysia:
  - Can be sold at a discount in a securitization exercise.
  - Bay’ al-dayn is adopted based on the views of some scholars (Malikis & Shafiites) who allowed this principle subject to certain conditions.
  - In capital market, these conditions are met with a transparent regulatory system which can safeguard the interest of the market participants
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Bank Islam and Amana Bank Involvements in Sukuk Structuring
Amana Bank Limited is the first full fledged Islamic bank in Sri Lanka.

Bank Islam Malaysia, the first Islamic bank in Malaysia is one of the strategic shareholders of Amana Bank with 20% shareholding.

Since its inception in July 1983, Bank Islam has not only become the symbol of Islamic banking in Malaysia, it has also played an integral role in setting the stage for a robust growth of the country’s Islamic financial services industry.

Today, Bank Islam parades a wide-ranging list of more than 50 innovative Islamic financial products and services as well as a fast growing network of 122 branches and more than 1000 self-service terminals nationwide.

In recognition of its prominence in the industry, Bank Islam was awarded the Reader’s Digest Platinum Award for being the Most Trusted Brand for Islamic Financial Services for three consecutive years, namely in 2009, 2010 and 2011.
Bank Islam’s Notable Sukuk Transactions

- **USD 150.0 million**
  - Sukuk Al Ijarah
  - First Global Sukuk Inc
  - Sole Lead Arranger

- **RM 1.0 billion**
  - Istisna'
  - Projek Usahasama Transit Aliran Ringan
  - Joint Arranger & Shariah Advisor

- **RM 1.5 billion**
  - Al-Ijarah Muntahiyah Bit-Tamlik
  - Kumpulan Guthrie Berhad
  - Structuring & Shariah Advisor

- **USD 600.0 million**
  - Sukuk Al Ijarah
  - Malaysia Global Sukuk Inc
  - Co-Arranger

- **RM 2.2 billion**
  - BaiDS
  - KL International Airport Berhad
  - Sole Lead Arranger

- **RM 1.28 billion**
  - BaiDS
  - SAJ Holdings Sdn Bhd
  - Joint Lead Arranger/Lead Manager & Shariah Advisor

- **RM 752.2 million**
  - Mudharabah Sukuk
  - Manfaat Tetap Sdn Bhd
  - Shariah Advisor

- **RM 200.0 million**
  - BBA CPs
  - Syarikat Bekalan Air Selangor Sdn Bhd
  - Joint Lead Arranger & Shariah Advisor

- **RM 3.0 billion**
  - BBA MTNs
  - Malaysia Debt Ventures Berhad
  - Joint Lead Manager

- **RM 1.5 billion**
  - Islamic Medium Term Notes Programme
  - TH Plantations Berhad
  - Joint Lead Arranger & Shariah Advisor
Bank Islam’s Notable Sukuk Transactions

- **Ijarah deal of the year 2009** – Islamic Finance News
- **Qatar deal of the year 2009** – Islamic Finance News
- **Best Islamic Structured Financing** – The Asset “Triple A” Islamic Finance Awards 2010
The information contained in this presentation may be meaningful only with the oral presentation and is of the personal view of the presenter and does not necessarily represent an official opinion of Bank Islam Malaysia Berhad and Amana Bank Limited.

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