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# Introduction

The Islamic financial industry has been growing at double-digit rates over the past decade. Conceptually, Islamic finance is appealing. Its main message has become particularly obvious and relevant after the Global Financial Crisis 2007-2009, the repercussions of which are still felt in the world. The disentanglement of finance from the real economy is at the root of the Crisis. Islamic finance specifically requires tight integration of the two domains from the ground up.

While the prospects of the Islamic financial industry in terms of size and volume seem promising, the pace of development of new products and instruments that translate the above paradigm into practical reality has been lagging behind. There are many challenges the industry understandably faces. These challenges however should not impede us from searching for new and innovative solutions to lead the industry into the 21<sup>st</sup> century.

This Report presents some new Sukuk designs that address important challenges facing the industry. They are the outcome of collaborative efforts with experts in various fields including Shariah, law, accounting, finance, and economics. The Financial Product Development Center has taken the lead in these new waters in the hope of advancing the discussion with new insights and prospects for the future of the industry. It is hoped that these new designs will promote healthy discussions and, subsequently, lead to better structures and performance of Sukuk markets.

## Acknowledgement

The Sovereign Sukuk model presented in Section II has been an outcome of collaborative effort with several partners. Neil Miller and his team at Linklaters law firm, have contributed to the structure in many respects, particularly from the legal side. Dr. Osaid Kailani, Abu Dhabi Islamic Bank; Dr. Abdul-Sattar Al-Khouildi, International Center of Arbitration and Reconciliation, Dr. Giath Shabsig, IMF, Mr. Osman Hamad, ex-CEO of Sudanese Financial Services Company, and Mr. Fahim Ahmed, International Islamic Rating Agency, all have contributed positively at various stages to the structure.

The Multi-layer Protection (MLP) Musharakah Sukuk, presented in Section III, is an outcome of a joint initiative of our partners: SABIC Chair for Islamic Financial Markets Studies of Imam University, Riyadh, International Sharī'ah Research Academy (ISRA), Malaysia, and Agha & Co law firm, Dubai.

Other experts also contributed positively to the structure, including: Prof. Simon Archer, University of Reading, UK, Dr. Osaid Kailani, Abu Dhabi Islamic Bank, among others.

The Exchangeable Sukuk, presented in Section IV, is the outcome of the efforts of the Mudarabah Sukuk Task Force at the Islamic Development Bank. It reflects the joint efforts of members from the Treasury Department, Investment Department, Finance Control Department, the Legal Department, the Group Risk Management Department, and, most importantly, the Shari'ah Committee.

Despite the immense efforts that has been invested in these structures over the past four years, we think that there is always a room for improvement and innovation. We therefore greatly appreciate valuable feedback from our respected readers.



# SECTION I: SUKUK SURVEY

## 1. Primary Market Growth

The Sukuk market started tentatively in the mid-nineties with small-sized issuances before expanding spectacularly over the next two decades with 2012 culminating in \$145bn new issuances. Although the first half of 2015 was relatively slow compared to 2014, market participants expect overall issuances to stay on course and realize around \$100-120bn by the end of 2015.

The Sukuk market is expected to carry on expanding as the low financing costs and liquidity abundance make the sector attractive to issuers and investors alike.

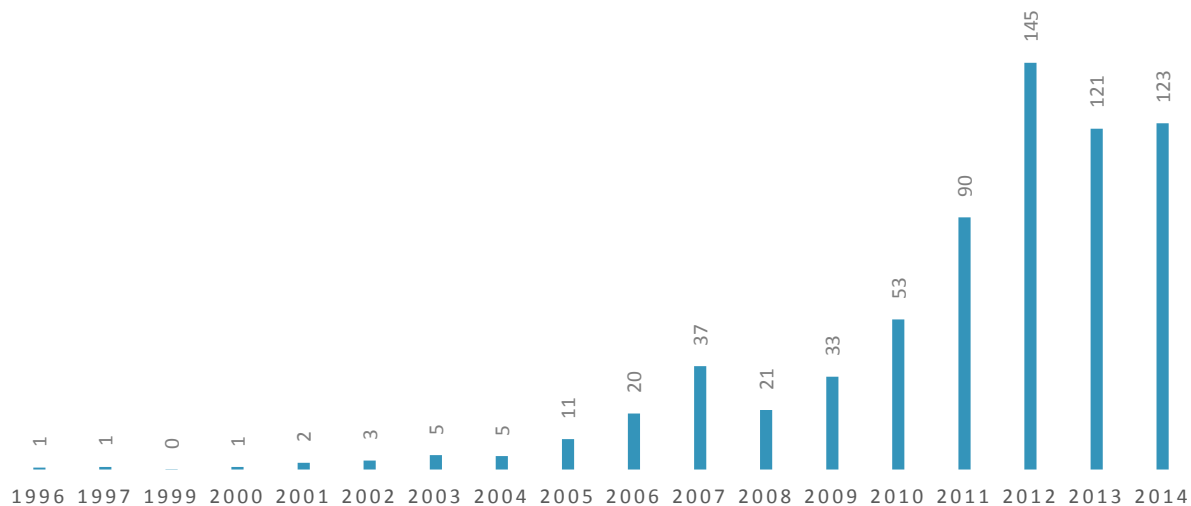


Figure 1: Primary Sukuk Issuances by year of Issuance  
Source: Zawya

## 2. Issuer Base Diversification

One notable manifestation of the increased Sukuk attractiveness is the diversity of the supply side profile with a large number of OIC (Organization of Islamic Cooperation) and non-OIC governments tapping Sukuk funding. The charts below show the gradual opening of the market to a global issuer base. Initially established by few pioneers, an increasing number of countries are now participating in the market with a record 19 countries issuing Sukuk in 2014.

The United Kingdom, Hong Kong, the United States, Senegal and South Africa are among the most significant new entrants to the market in 2014.



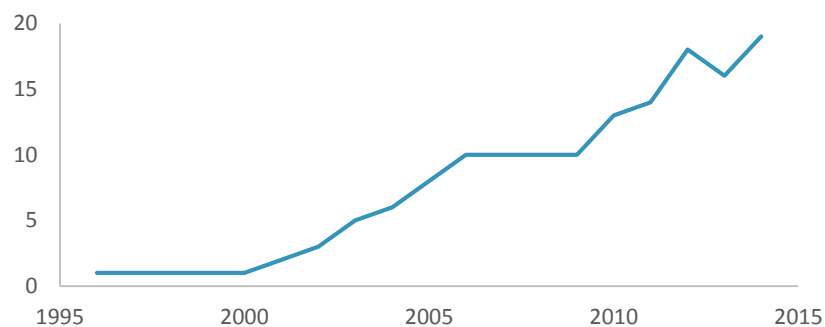


Figure 2: Number of Countries Issuing Sukuk  
Source: Zawya

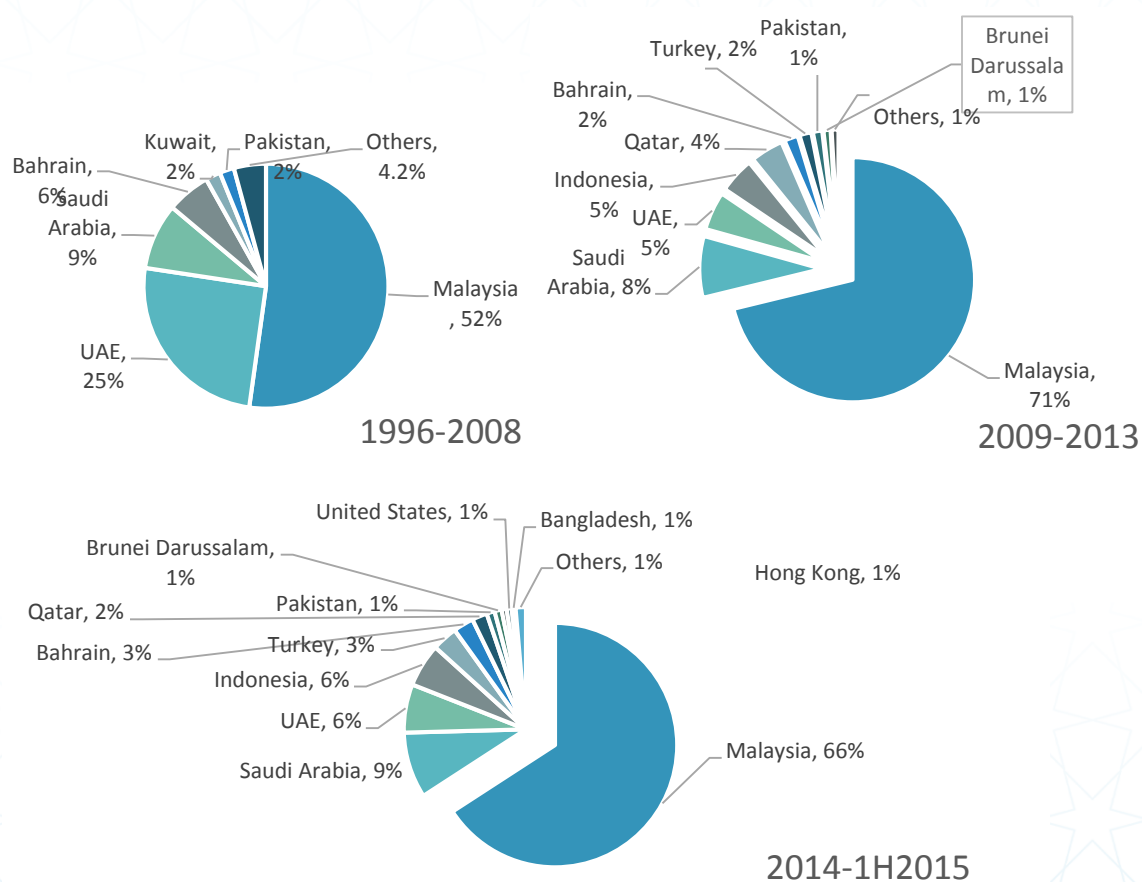


Figure 3: Sukuk Issuances by Country  
Source: Zawya

Malaysia maintains its status as a powerhouse in Sukuk with a stable 60%-70% primary market share. GCC comes next, although by a wide margin, with a combined 20% share.

2014 was celebrated as the year of non-OIC Sukuk as record issuances from Hong Kong (\$1bn) and the United States (\$1bn) helped non-OIC issuances to cross the historical bar of \$1bn.

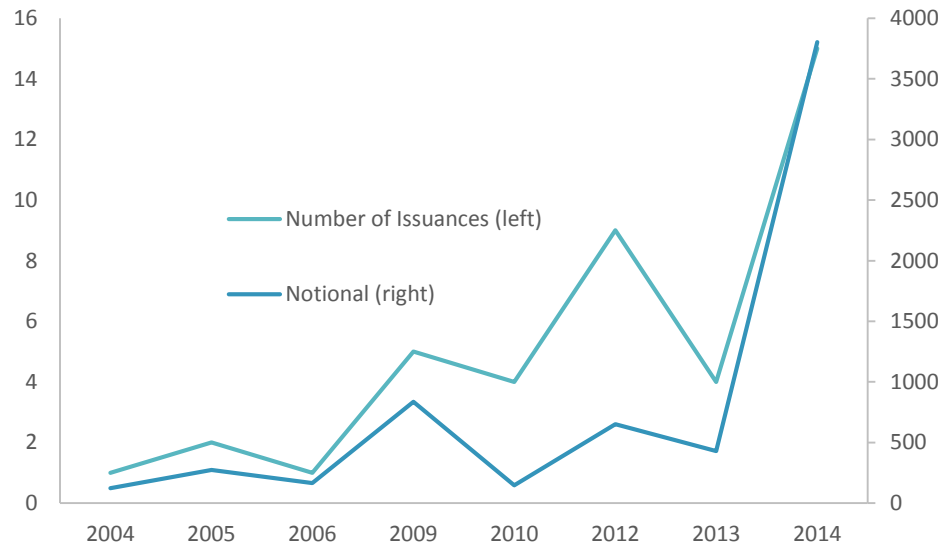


Figure 4: Issuances in non-OIC Countries  
Source: Zawya

### 3. Sovereign and Corporate Sukuk

With a consolidated share of 80%, the sovereign and quasi-sovereign sectors became the main driver of new issuances in the Sukuk market since the financial crisis. It should be noted however, that the public-private composition is significantly more balanced when looking at international Sukuk.

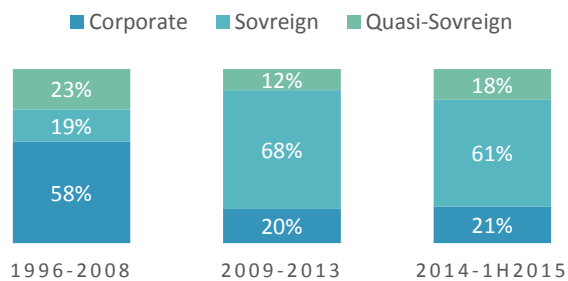


Figure 5: Sukuk Issuances by Issuer Type  
Source: Zawya

Global corporate Sukuk are not distributed evenly. Indeed, the GCC countries in particular are mobilizing more Sukuk for corporate financing. In 2014, about half of GCC issuances were corporate Sukuk compared to a quarter globally.

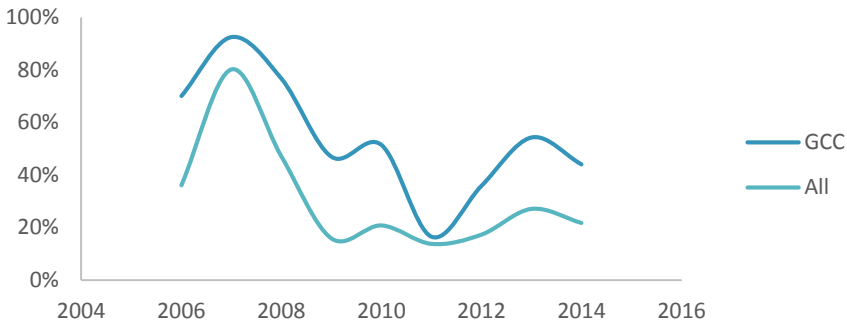


Figure 6: Percentage of Corporate Sukuk in overall Issuances. Comparison of GCC Global markets  
Source: Zawya

## 4. Sukuk Denomination

The charts below analyze the composition of the Sukuk market by currency denomination. It is clear that most Sukuk are denominated in Malaysian Ringgit (MYR). This is due to the important Malaysian market share, combined with the fact that Malaysian Sukuk target almost exclusively domestic investors as shown the next chart.

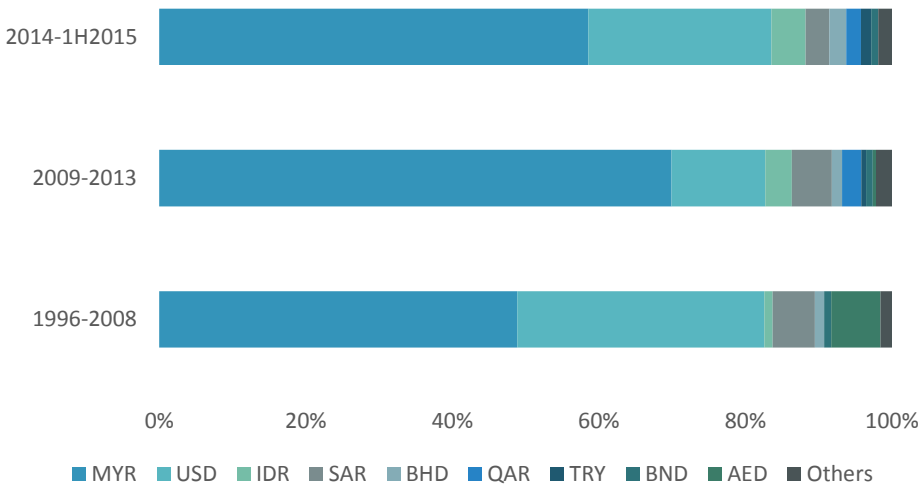


Figure 7: Issuances by Currency  
Source: Zawya

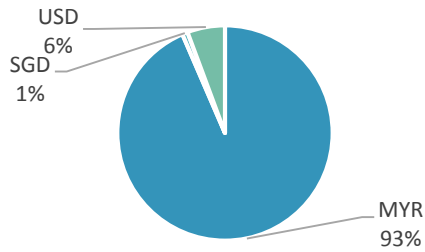


Figure 8: Currency Composition of Outstanding Malaysian Sukuk  
Source: Zawya

Indonesian Rupiah is noticeably more present thanks to the recent activity in the Indonesian Sukuk market. On the other hand, fewer Sukuk are issued in Emirati Dirham as the UAE shifts its Sukuk to USD denomination.

US Dollar is the second largest denomination of Sukuk and constitute one quarter of the global issuances. The US Dollar is consistently the preferred denomination for international Sukuk.

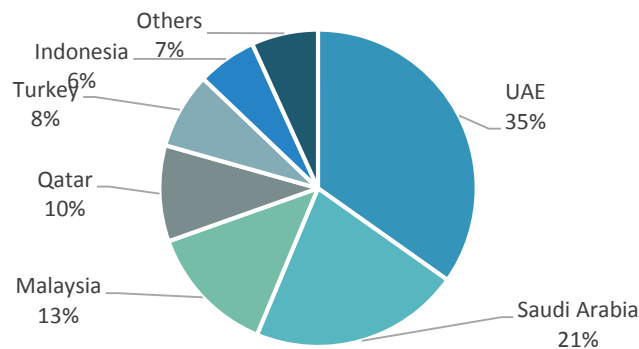


Figure 9: Country Composition of USD Denominated Sukuk  
Source: Zawya

## 5. Sukuk Tenors

Primary Sukuk market underwent a shift in the maturity profile during the last five years. The chart below highlights a substantial increase of the very short-term financing most likely used for liquidity management. Almost half of new issuances are less than one year. On the other hand, longer than 10 years issuances which once were the debut Sukuk instruments are now less popular with a mere 7% of total volume.



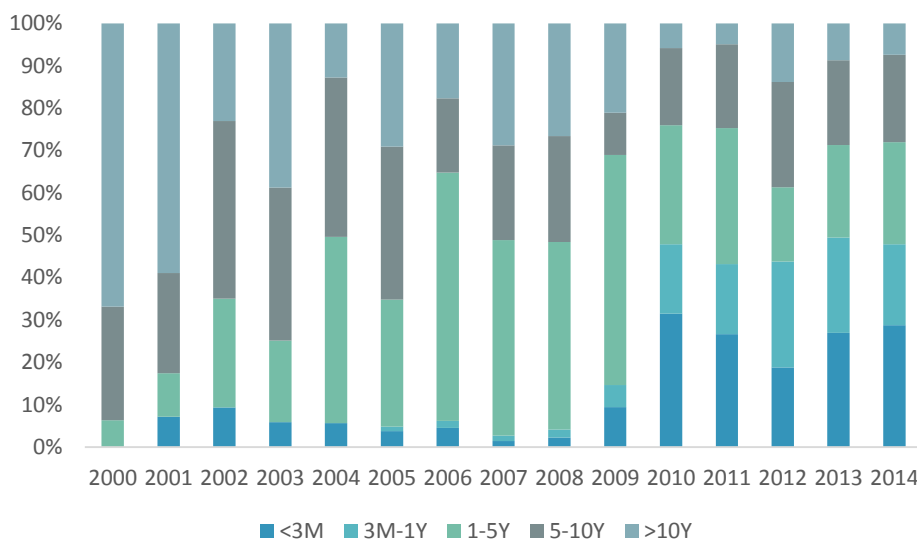


Figure 10: Composition of Issuances by Sukuk Tenor  
Source: Zawya

The notional weighted average tenor<sup>1</sup> of new issuances has been steadily decreasing in the last five years from an average of 11.5 years in 2007 to 4.5 years in 2014.



Figure 11: Evolution of Notional Weighted Tenor  
Source: Zawya

The shortening of the Sukuk tenor is probably due to two factors. First, the corporate sector is less present in the market and hence sovereign issues are driving market volumes. Second, governments and central banks are overwhelmingly using the Sukuk as short-term liquidity papers. Taking the example of Malaysia, the chart below shows how the contribution of the corporate sector to short-term Sukuk issuances has

<sup>1</sup> Notional weighted average tenor =  $\frac{\sum \text{Notional} \times \text{Tenor}}{\sum \text{Notional}}$

spectacularly shrunk after the financial crisis. Malaysian sovereign issuances are about 75% shorter than 1Y compared to 8% for corporates.

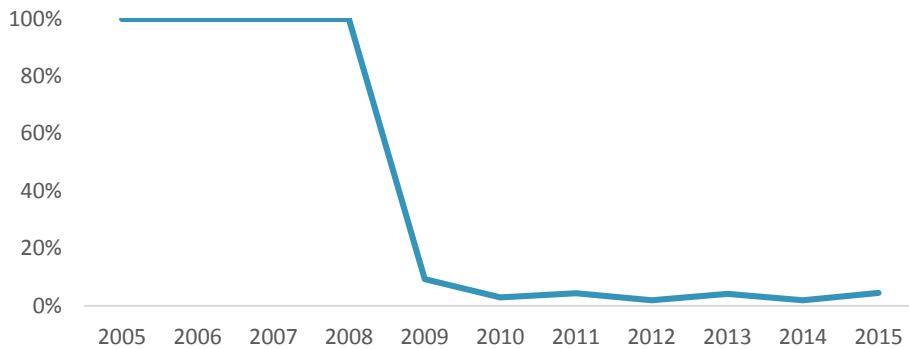


Figure 12: Shares of the Corporate Sector in Malaysian Short Term Sukuk  
Source: Zawya

Figure 13 shows the share of short-term issuances in corporate issuances as well as sovereign ones.

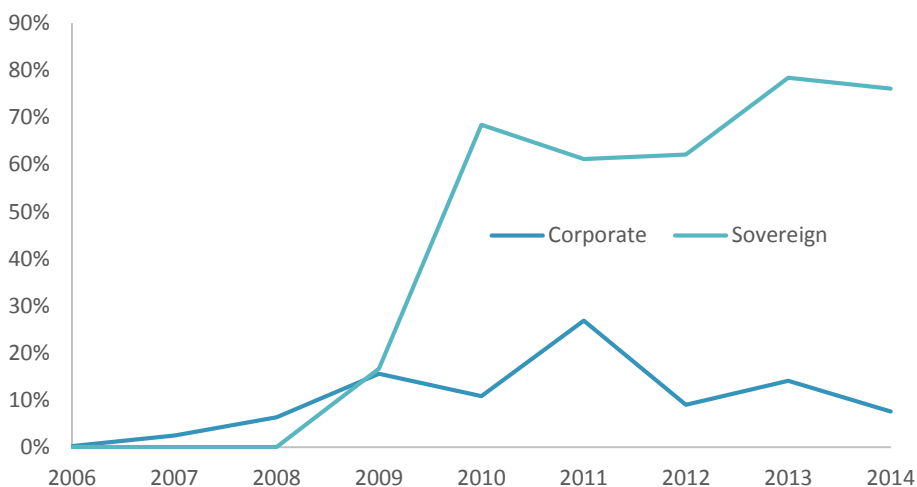


Figure 13: Share of Short Term Issuances in Malaysian Sukuk

## 6. Sukuk Base Contracts

Almost half of the new issuances are based on Murabahah contracts. The industry has been steadily moving in the past five years away from the Musharakah and Mudarabah-based Sukuk into more fixed income-like contracts such as Murabahah and Ijarah.

The share of Ijarah Sukuk in the primary market has been stable around 20% since the first steps of the Sukuk despite the shifts in Sukuk structures over time.

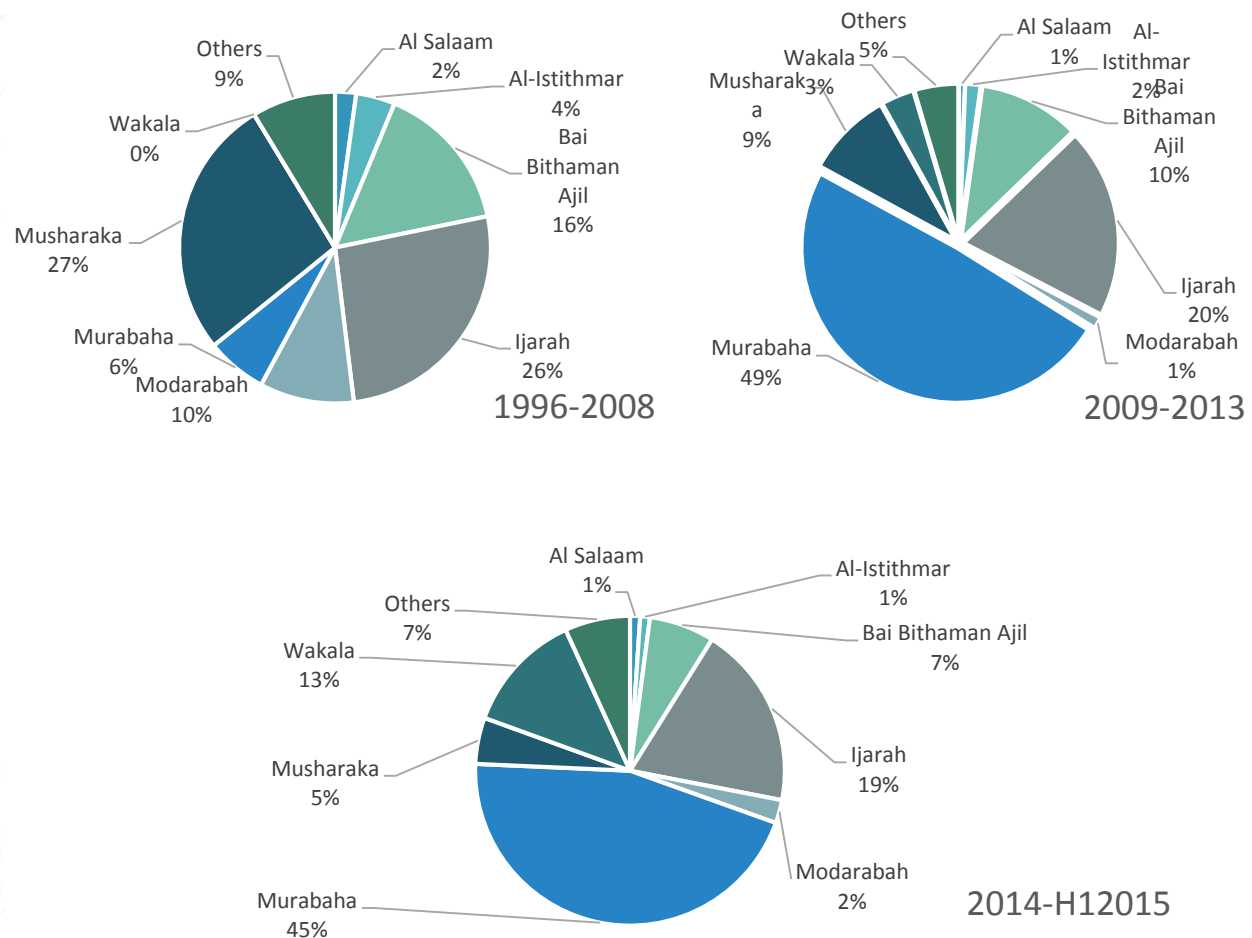


Figure 14: Composition of Sukuk Issuances by Base Contract  
Source: Zawya

## 7. Sukuk Ratings

Most of the Sukuk issuances are not rated, the share of unrated Sukuk is almost constant at 70% in the last five years.

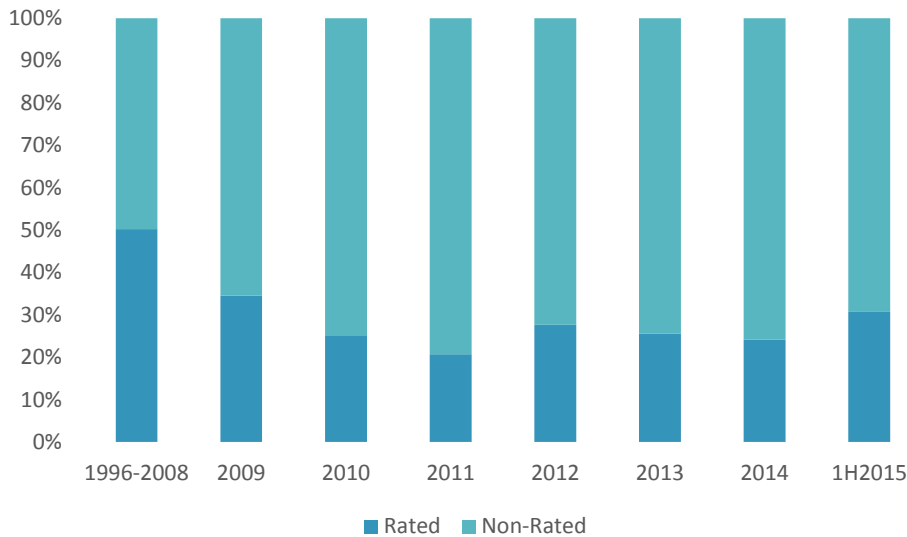


Figure 15: Evolution of Rated Sukuk Percentage.

Source: Zawya

The major four rating agencies for Sukuk are Malaysian Rating Corporation Berhad (MARC), Rating Agency Malaysia Berhad (RAM), Moody's and Fitch. They have been sharing market parts evenly in the last five years.

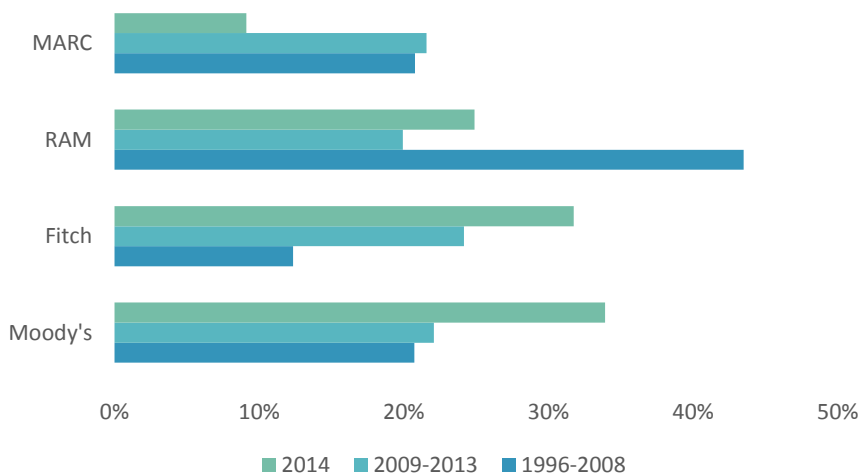


Figure 16: Rating Agencies' Market Share<sup>2</sup>

Source: Zawya

<sup>2</sup> Some Sukuk are rated by more than one agency. Hence, participation ratios do not add up to 100%.



The distribution is different when looking at AAA-rated Sukuk as MARC and RAM seem to be the agencies consistently rating AAA issuances.

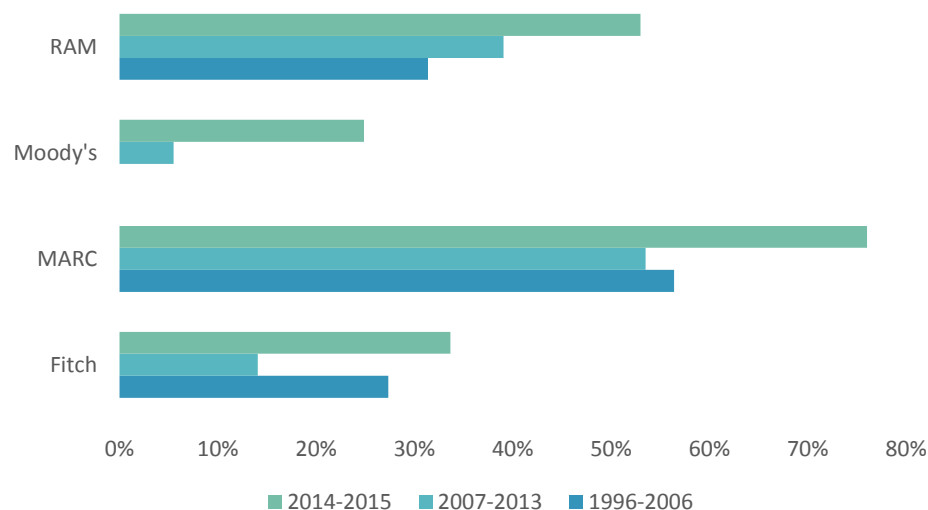


Figure 17: Rating Agencies' Participation in AAA Sukuk.  
Source: Zawya

## 8. Conclusion

The Sukuk market is the fastest growing sector in Islamic Finance. It is expected to continue on this upward trajectory in the coming years thanks to the collective efforts to make Sukuk a viable alternative to conventional financing avenues. Last year's unprecedented geographical reach, especially in non-OIC countries, is a clear affirmation of Sukuk's growing status and a manifestation of the trust of international financial markets'.

During the last decade, the market converged into the Fixed Income-like contracts. This concentration of risk profile highlights the pressing need for more product innovation in order to sidestep any structural hurdles hindering the applicability of the most risk-sharing Sukuk types. The recent development of perpetual Sukuk is a good sign of the willingness of the market to accept new structures with different risk profiles. The following two sections of this paper outlines the Islamic Development Bank's newly developed product paradigms that serve sovereigns as well as corporates to issue Sukuk efficiently and consistently.

Even if Islamic Finance fared a great deal better than the conventional sector, the financial crisis left a subtle mark on the Sukuk market in particular. Governments and quasi-sovereign issuers stepped more into the market to fill the financing gap left by the hurt corporate sector. The trend doesn't show any sign of reversing as the corporate share of the market oscillates around 20%. The GCC's corporate sector is an exception, however. With almost as much as government and quasi-sovereign issuances combined, it is the most active region for corporate Sukuk.

As sovereign issuances drive the market, usage of Sukuk as liquidity papers has surged in the last five years leading to a shortening of the average tenor from 11.5 years in 2007 to 4.5 years in 2014.

Given the weight of the sovereign sector, we believe more efforts are needed to make future issuances sustainable. The next part proposes a novel framework for sovereign issuances that would achieve pipeline sustainability in addition to operational and financial efficiency.

# SECTION II: SOVEREIGN SUKUK

## 1. Introduction

With the steady growth of the Sukuk market, issuers are increasingly looking for more flexible and more efficient structures. This is particularly true for sovereign Sukuk, which comprises the majority of domestic Sukuk issuances.

Sovereign Sukuk represent more than 70% of all Sukuk for 2009-2014 (see Section I). Yet, the prevailing structures used to issue sovereign Sukuk might not be sustainable. This section proposes an institutional framework for issuing sovereign Sukuk efficiently and credibly. The framework allows governments to issue Sukuk regularly to finance ongoing economic activities using a variety of Islamic modes of finance. It is based on Sharī'ah resolutions of the OIC Fiqh Academy, as well as the Sharī'ah standards of AAOIFI, and can be easily adopted in different jurisdictions.

## 2. Issues in the Prevailing Sukuk Model

One of the most common structures of Sukuk currently involves the sale of a tangible physical asset to a Special Purpose Vehicle (SPV), on the condition that the asset is leased back to the seller (who needs financing) with the undertaking to buy it back at maturity at nominal value. The certificates issued by the SPV represent the Sukuk, which pay regular income reflecting the rental payments of the leased asset.

This model has the advantages of being simple and allows the issuance of tradable Sukuk due to ownership of the tangible asset. The rental payments help to classify these Sukuk among fixed income instruments. From a practical perspective, however, a number of obstacles emerge.

### 2.1. Asset Ownership

First is the transferability of the ownership of a sovereign asset to investors, particularly if they are non-citizens. This leads to complex legal procedures for the Sukuk issuance in order to avoid the “true ownership” of such assets. Hence, Sukuk were transformed from being “asset-backed,” i.e. representing true and legal ownership of the underlying assets, to being “asset-based,” whereby Sukuk holders do not fully and legally own the underlying. The underlying assets therefore, became of marginal value in the structure, if any. This can be seen from the clauses common in Sukuk documents stating that:

*“No investigation or enquiry will be made, and no due diligence will be conducted in respect of any of the constituent assets”*

*“In particular, the precise terms of any of the constituent assets will not be known”*

*“No steps will be taken to perfect any transferor any of the relevant constituent assets”*



These statements obviously are inconsistent with basic Shari'ah requirements of a valid sale transaction. As a result, such Sukuk are not fundamentally different from conventional bonds. They are explicitly described in the Sukuk documents as “unsecured” papers, which is inconsistent with the purchase and ownership of the underlying assets.

Rafe Haneef (2009) provides an overview of the developments of Sukuk since 2000, and concludes (p. 110):

*Today, almost all Sukuk offerings are asset-based securities. The Sukuk will have Shari'ah-compatible underlying assets but the Sukuk holders will not have any security interest over the assets. The asset-based Sukuk are treated as senior unsecured securities similar to unsecured conventional bonds.*

## 2.2. Limitations of Physical Assets

Secondly, Sukuk issuance is constrained by the existence of unencumbered, physical, Shari'ah-compliant assets with an aggregate value which is at least equal to the nominal amount of the Sukuk being used to support each issue of Sukuk. Such assets may not be possible in all cases, nor as regular as needed. Consequently, the structure does not give the flexibility to sovereigns to issue Sukuk on regular and predictable basis.

## 2.3. Accounting Issues

From an accounting perspective, the assets used to issue the Sukuk are not transferred from the balance sheet of the obligor or the seller, because of the undertaking to buy them back at nominal value. This undertaking is a debt obligation on the obligor. With this debt on the balance sheet, the assets cannot be transferred from the seller's balance sheet. But the presence of these assets on the obligor's balance sheet is inconsistent with a true and genuine sale transaction.

## 2.4. Alignment of Finance and Economic Activities

Finally, the structure does not align Sukuk issuance with economic activities. The sale and lease transactions are applied to assets of no economic contribution. Hence, the financing and economic values are disconnected. This might lead to unproductive build-up of debt.

## 2.5. Shari'ah Rulings

Due to the Shari'ah-related problems facing this model of Sukuk, the International Islamic Fiqh Academy, in its 20th conference in 2012, issued Resolution no. 188 prohibiting stipulated sale-and-lease-back that ends up in obtaining money spot in exchange for more money in the future. The Resolution states:

*“It is not permissible to sell an asset at a cash price on the condition that the seller leases back this asset with a promise to own, at a total price, including the rent and the price, that exceeds the cash price, regardless of whether this condition is expressed or implied, because this is a form of ‘Einah that is prohibited by Shari'ah. Accordingly, it is not permissible to issue Sukuk based on this formula”.*

This is in line with the Ijarah Standard issued by the Shari'ah Board of AAOIFI. The Standard states that it is not permissible to stipulate the lease-back in the sale contract. Paragraph 3/2 of Standard (9) states:



*“It is permissible to acquire an asset from a party and then lease it to that party. It is not permissible however to stipulate the lease as a condition in the sale contract by which the institution acquired the asset.”*

Given these resolutions, and the above-mentioned difficulties, there is a serious need for a sound and credible alternative that meets the needs of sovereigns in raising funds, meanwhile comply with the principles of Islamic finance.

### 3. Features of the Proposed Framework

What governments need in order to issue Sukuk is a model with the following characteristics:

1. Flexibility with respect to assets: the model proposed below does not require a particular physical asset for each Sukuk issuance, since such assets may not be always available.
2. Flexibility with respect to Sukuk ownership: The model allows non-citizen investors to own Sukuk without complications related to ownership of sovereign assets.
3. Flexibility in the selection of the mode of financing, so that it is not limited to *ijarah*, but may also utilize various suitable Islamic modes of financing.
4. Efficiency in issuance procedures, so that the costs of issuance are reasonably lowered, thereby reducing the financing burden and enhancing returns.
5. Regularity of issuance so as to allow the government to plan its financial needs and enable the financial market to manage liquidity in a more robust manner.
6. Scalability of financing volume. The proposed model can accommodate the needs of the government as long as it is able to honor its obligations.
7. The most important characteristic is compliance to the rules and objectives of Shari'ah in a transparent and productive manner.

### 4. The Sovereign Finance Corporation

The model proposed hereunder has been developed by the Financial Product Development Center of the Islamic Development Bank, in collaboration with international experts in Shari'ah, law, finance, as well as officials from Member Countries. In brief, the model can be summarized as follows. The detailed description will follow.

1. The government establishes a Sovereign Finance Corporation (SFC) that will be responsible for financing government economic activities in a Shari'ah compliant manner.
2. The SFC is a fully-fledged financial institution, with a dedicated professional management team as well as its own Shari'ah Board and auditor.
3. The SFC issues two types of shares:
  - a. Management shares, to be owned by the government (Ministry of Finance and the Central Bank);
  - b. Participatory shares, to be owned by investors via Sukuk certificates.
4. The SFC establishes a Special Purpose Vehicle (SPV) and transfers the Participatory Shares to the SPV.

5. The SPV issues Certificates (Sukuk) to investors, backed by the Participatory Shares.
6. Proceeds of the Sukuk are used by the SFC to finance economic activities of the government. These activities can be financed by any of Islamic modes of finance classified as fixed-income instruments: *Murabaha*, *Ijarah*, *Istisna'a*, *Salam*.
7. The SFC finances only government activities, and therefore its assets are sovereign assets. Furthermore, since the instruments used are fixed-income, the government guarantees the payment as per the terms of the contract. Hence, the risk of SFC's assets is primarily and predominantly sovereign risk.
8. The Sukuk Certificates are redeemable in a defined period of time (say 5 years). The redemption is performed at par but is contingent on the performance of the underlying assets. Thus, capital is not absolutely guaranteed. Strictly speaking, the undertaking to redeem is not a legal debt on the SFC. It is a contingent liability subject to the performance of the underlying assets.
9. However, since the underlying assets are obligations against the government, this means the SFC will fail to redeem only if the government fails to pay its obligations. Sukuk Certificates, therefore, are exposed mainly to the sovereign risk.

In this manner, the government has flexibility in selecting the suitable Shari'ah-compliant modes of finance as long as it creates a fixed income obligation, as above. Also, financing is not limited by the availability of physical sovereign asset of the required value. This means that the government, via the SFC, can issue Sukuk on regular basis to meet its economic targets to achieve development.

Thus, the above-mentioned features can be achieved by the proposed model of the SFC. The following sub-sections elaborate on the details of the structure.

## 5. SFC: The Assets Side

The objective of the SFC is to finance Shari'ah-compliant economic activities of the government. The SFC will finance only the government or government entities, not private entities/corporations.

Like any Islamic bank, the SFC will use ordinary Islamic modes of finance to serve these needs of the government. To provide predictability of the cash flow of the SFC, the modes of finance used will be restricted to those that create fixed-income assets: *murabaha*, *ijarah*, *istisna'a*, and the like. This also serves the objectives of Sukuk holders, who usually prefer fixed-income investments. As we will see later, the SFC Sukuk are not bonds or bond-like, but by structuring the assets of the SFC as fixed-income assets, the Sukuk will have the properties of fixed-income investments.

The SFC shall have a clear and rigorous governance structure that specifies how to provide financing to government entities. Governance is critical to control and manage operational and reputational risks. This is also important to ensure Shari'ah-compliance of the activities of SFC, and to protect Sukuk holders who are investors in the SFC.

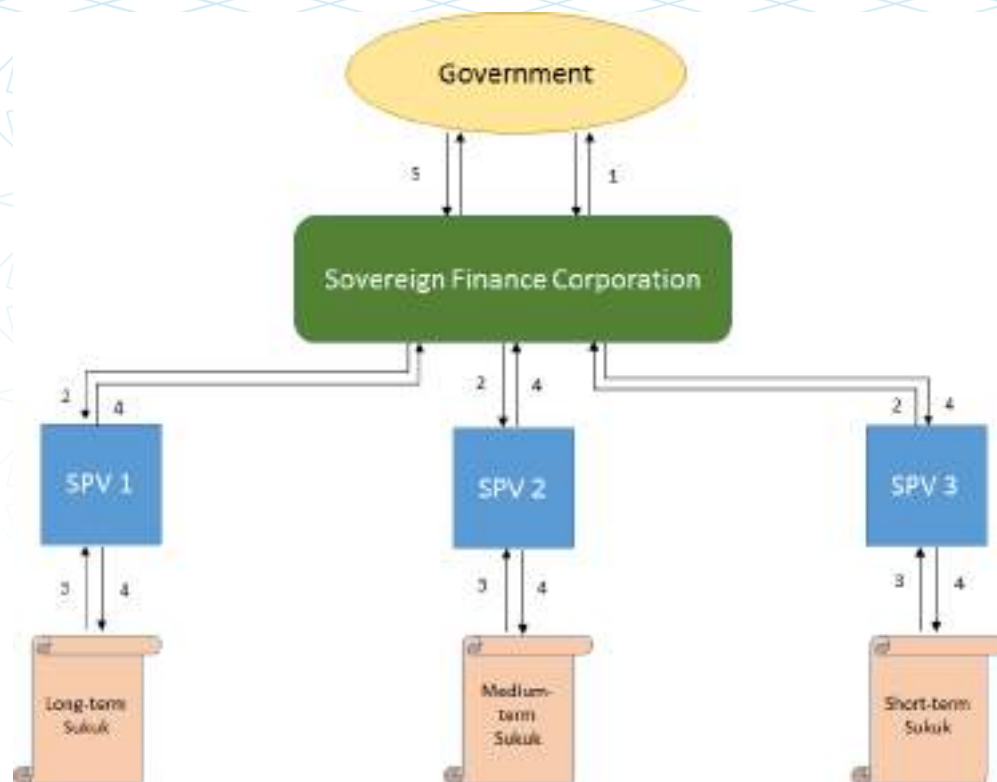


Figure 18: SFC Sukuk Structure:

1. SFC issues Management shares to the government, in exchange for in-kind investments.
2. SFC issues Participatory shares that are transferred to the SPVs
3. SPVs issue Sukuk of different maturities.
4. Cash proceeds of the Sukuk are transferred to the SFC.
5. SFC uses the proceeds to finance government activities using Shari'ah-compliant modes of finance.

With a proper governance structure, the assets created by the SFC are sovereign, fixed income assets, the risks of which are essentially sovereign risk. The exposure of investors in the SFC, therefore, will be limited primarily to sovereign risks. In this manner, SFC Sukuk retain the major attributes of fixed-income instruments, despite being a share rather than a debt instrument.

This is not too far from investment funds that invest mainly in *Murabaha* or leasing instruments. Although fund units are shares in the fund's assets, the underlying risks are mainly fixed-income or credit risks. The SFC is different in that it is a full-scale financial institution owned by the investors. As we will see later, this ownership of the institution plays an important role in tradability of the shares and therefore of the Sukuk.

Furthermore, investors in the SFC will be better protected because they have a certain level of control over the institution to protect their rights and to ensure that the SFC is fully abiding by the agreed governance structure.



## 6. SFC: The Liabilities Side

### 6.1. Shares

The SFC, as pointed out earlier, issues two types of shares:

1. Management shares: These are owned by the government, e.g. Ministry of Finance and the Central Bank.
2. Participatory shares: These are non-voting shares that will back the Sukuk issued to investors.

The government will preferably pay for Management shares in-kind: For example, it shall transfer some of its profitable investments to the SFC in exchange for the Management shares. This will enhance the value of the Corporation and improve the cash flow, as we will see later.

### 6.2. Sukuk Issuance

Participatory shares are permanent or perpetual. Sukuk certificates, in contrast, are redeemable. To reach this structure, the SFC needs to establish (one or more) SPV. The Participatory shares are transferred to this SPV. Accordingly, the SPV will issue Sukuk certificates backed by these shares. These Sukuk certificates are redeemable, as we will see later.

The SFC can issue Participatory shares of a volume sufficient for its expected financing needs over the coming 10 years, say. These shares can be held either within the SPV or with the treasury of the SFC. Then, Sukuk will be issued on regular basis according to the needs of the government. This will help the government plan its financing needs ahead of time. In case of any unexpected needs that may arise, the SFC can issue additional Participatory shares to meet such needs. However, it must be observed that the volume of the participatory shares has to be in line with the economic activities of the government. Over-issuance of shares and thus of Sukuk, will undermine the credibility of the SFC and hence will result in higher costs of financing.

Since shares are issued prior to the commencement of financing activities of the SFC, there will surely be a gap between Sukuk issuance and generating returns. This gap can be filled by the returns from the investments the government has contributed in exchange for the Management shares at the start. As long as Sukuk are issued based on carefully designed plans for the government's needs, this gap will be negligible.

### 6.3. Redemption

The Sukuk usually are of a defined maturity. The SFC may issue short term Sukuk (1 year, say), medium term (3 years), and long term (5 or 7 years). For this, the SFC will establish 3 SPVs, one for each maturity.

The SFC promises to redeem the Sukuk, i.e. buy them back, at par, subject to the performance of the underlying assets and the generated cash flow. The SFC therefore issues a Purchase Undertaking (PU) to buy back at nominal value, but this undertaking is conditional on the performance of the assets. Put differently, the SFC issues a PU to redeem the Sukuk at par or at fair value, whichever is lower. This means that the PU does not guarantee the principal of the Sukuk.

The PU, therefore, is **not** a debt obligation on the SFC. There is no guarantee by the SFC to the Sukuk holders to buy back their Sukuk at par. In fact, there is no added value by this guarantee even if it is issued. The reason is simple: Sukuk represent shares in assets that are already guaranteed to be paid by the government, based on the fixed-income instruments utilized, as discussed earlier. Thus, Sukuk holders do



not need any additional guarantee. In fact, the guarantee on the Sukuk will add no value; if the government fails to pay its obligations on the assets, it will also fail to honor its Sukuk guarantee.

The only case in which the SFC will redeem Sukuk at below par is when the underlying assets underperform. And this can happen only if the government does not pay its obligations on time. But this is the sovereign risk that investors are willing to accept from the start.

However, Sukuk holders may need liquidity support given the possible mismatch between the maturity of the Sukuk and that of government obligations. This can be provided by the Central Bank. The Central Bank will provide a line of financing to the SFC. This can be done using an interest-free loan for example, from the Central Bank to the SFC, and the Central Bank agrees to offset the resulting obligation of the SFC with the assets which SFC holds against the government (the Ministry of Finance). Alternatively, the Central Bank could purchase the Sukuk from investors, then exchange the Sukuk for assets of the SFC. In all cases, the Central Bank is able to fill in the mismatch in maturities between the SFC Sukuk and SFC assets. From Sukuk holders' point of view, it is all sovereign risk.

#### 6.4. Dividend Payment

Sukuk holders get dividends (coupon payments) based on the generated cash flow from the underlying obligations of the government.

Sukuk with different maturities will have different dividends or coupon payments; for example, short-term Sukuk will have smaller dividend amounts than long-term Sukuk. While the proceeds of all Sukuk series will accumulate into a single pool, that of the SFC financing government activities, the dividends paid to each series can be adjusted to fit the maturity of the Sukuk. This can be structured by setting different sharing ratios between Sukuk holders and the SFC as the manager of the SPV issuing the Sukuk certificates. This ratio will be in line with the maturity of the Sukuk. For example, for short term Sukuk, the share of the SFC will be higher than its share in case of long-term Sukuk.

#### 6.5. Tradability

Since the SFC is a fully-fledged financial institution, its shares will be treated like the shares of any Islamic banks. In principle, there are two views on the tradability of such shares:

- (1) They are tradable following the Principle of Subordination (قاعدة التبعية) in Sharī'ah.<sup>3</sup> This principle implies that the institution as an entity is responsible for creating the underlying financial assets. The entity, as a fully functioning corporate, is a set of tangible assets through which the entity is able to function, create assets and generate returns. The set includes the legal license, management, fixed assets and equipment, and similar productive assets. Since shares represent an undivided ownership in this set, shares are tangible by implication. The financial assets created by the institution are subordinated to the set that creates such assets. Hence, as long as shares represent ownership in a genuine fully-operational institution, the shares are tradable irrespective of the particular percentage of physical assets in the total assets of the institution. In the absence of such subordination, the minimum of physical assets and usufructs, according to the OIC Fiqh Academy, is 51%.

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<sup>3</sup> OIC Fiqh Academy Rulings no. 180 and 196.

- (2) The other view requires the institution to have no less than a pre-specified percentage of tangible (non-debt) assets. Usually this percentage is set at 51%, as indicated earlier, but it varies from one Shari'ah Committee to another. Some Shari'ah Committees set the threshold at 30%. The Sukuk Standard of Dubai Financial Market (DFM) requires a minimum of 10%.

#### 6.6. Legal System

As a new entity, the SFC will very likely require a separate new legislation to provide the necessary legal environment to the entity for smooth operations and protection of its rights.

### 7. Conclusion

The Sukuk market has been growing steadily since the Global Financial Crisis. Yet, the prevailing structure, particularly for sovereign Sukuk, is apparently not sustainable. This section presented an alternative that was developed by an international team led by the Financial Product Development Center of the Islamic Development Bank.

The proposed Sovereign Finance Corporation aims to address many difficulties facing the prevailing structures of sovereign Sukuk. We can see how the SFC allows governments to achieve the objectives and features set out in the beginning of the section.

The SFC is an institutional model for government financing. It has the potential to provide financing to government activities on a regular basis, with high degree of transparency and good governance.

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# SECTION III: MULTI-LEVEL PROTECTION SUKUK

## 1. Introduction

Islamic Finance went through an extraordinary expansionary phase during the last decade. Investors turned to Islamic Finance as it presented a safe alternative market that weathered the financial crisis relatively unscathed. The underlying principles of Islamic Finance echoed favorably with the financial community as investors became disheartened with the practices that caused the great recession. Already an integral part of OIC economies, Islamic Finance started making giant strides globally with non-OIC countries also participating regularly in Islamic financial markets.

However, the sector has the opportunity to grow even faster only if products are more diversified. Taking Sukuk as an example, market diversity actually shrank to a quasi-monotone product offering, overwhelmingly composed of Murabahah and Ijarah Sukuk. It is essential that Islamic Finance diversifies away from fixed income-like markets and into more innovative areas that are in accordance with its value proposition: Risk sharing and Sharī'ah compliance. Such product innovation and diversification will undoubtedly gear up the proven benefits of regulatory and institutional development. It will also attract new type of investors and hence unlock so far untapped areas of growth.

The Sukuk structure presented here, Multi-Level Protection Sukuk is one innovative product which is expected to provide Islamic Financial Institutions with an additional structuring dimension.

## 2. Product Description

The Center started an initiative to develop a financial instrument that applies principles of Musharakah while at the same time provides a variety of risk mitigation techniques to meet the diverse risk preferences of investors. The outcome, Multi-level Musharakah Protection Sukuk (MLP Sukuk for short) is an innovative structure that allows investors to diversify and issuers to tap potential new markets. MLP Sukuk enjoys the following features:

- It provides a general-purpose, sustainable source of funding for corporates and Islamic financial institutions.
- It represents non-debt financing to corporates, with multiple levels of protection and risk mitigation to investors.
- It enjoys comparable levels of seniority as bonds.
- It provides an additional layer of protection through a “capital cushion,” which represents an Islamic alternative to “over-collateralization” in conventional finance.
- The structure is consistent in principle with OIC Fiqh Academy resolutions and AAOIFI Sharī'ah standards.
- The MLP Sukuk is a kind of “hybrid” securities, and as such it does not necessarily require legislating new laws or regulations.



## 2.1. Structure Overview

The transaction can be summarized in the following four steps:

- 1) A company interested in raising corporate financing (the “Corporate”), issues hybrid Sukuk securities.
- 2) Sukuk holders share in the Corporate’s assets but not the liabilities.
- 3) Sukuk holders, in principle, have the right to monitor the management and performance.
- 4) The Corporate promises to redeem the Sukuk of investors from its share of aggregated profits generated by the company.

In this manner, investors have a senior claim against their share of the assets, comparable to that of senior creditors.

## 2.2. Risk Mitigation via Capital Cushion

To attract investors, Corporate could offer investors a “discount” via additional Sukuk certificates, e.g. 10-15% of their capital contribution. This cushion will result in the first 10-15% of loss being absorbed by the Corporate. It plays a similar role of “over-collateralization” in conventional finance.

This cushion can be proportional to the value of the asset or a fixed amount. It could also be built over time by pledging “collateral” gradually.

## 2.3. Risk Mitigation via Third Party Protection

Risk-averse investors may obtain additional protection for their investment from a third party. This is done as follows:

The Third Party (e.g. a Takaful company, an investment bank, or any other financial institution) shall establish a fund, e.g. Sukuk Protection Fund, whereby Sukuk-holders trade in their Sukuk for units in the Fund. The Fund shall invest in a variety of Sukuk and Islamic investments.

In addition, the Third Party shall invest some of its own capital in the Fund on a longer term horizon, such that units of the Third party will be effectively “permanent,” while units of the investors are redeemable. In this manner investors’ units become layered with protection and are buffered with additional capital cushion. This mechanism offers an additional layer of protection, over and above diversification offered by the Fund.

The Third Party would monitor the performance of the Sukuk and would act as an agent on behalf of investee Sukuk-holders to oversee the performance of the Corporate. Naturally, returns on the Fund’s units would be lower than returns on Sukuk issued directly from the Corporate on account of the Third Party’s being responsible for establishment of the fund, transaction management, agency function and reserves allotment.

# 3. Senior Musharakah: Best of two worlds

An important aspect of the MLP Sukuk is the seniority of its holders with respect to the underlying assets. This sub-section aims to clarify this feature, and to show how Sukuk holders compare to creditors of the Corporate, or bond holders in conventional financing. In corporate finance, senior creditors have the first



claim to the assets of the Corporate. All other investors (subordinated debt holders, preferred shares holders, and common shareholders) are subordinated to senior debt holders. In MLP Sukuk, we aim to put Sukuk holders at an equal level of seniority with respect to the underlying assets as of that of senior debt holders. This is outlined below.

### 3.1. Process

The MLP Sukuk will be issued as a hybrid security. Hybrid securities in general are instruments that combine aspects of fixed income and equity. They have a range of seniority rankings and can be as senior as secured debt. Hybrids can also absorb risk on an ongoing concern, i.e. while the corporate is still operating, as well as on gone-concern basis, i.e. when it defaults and ceases to operate.



Figure 19: Hybrid Seniority and Risk

The table below compares the characteristics of the most common hybrid securities along with the MLP Sukuk.

Feature	Simple Bond	Convertible Bond	Indexed Bond	Subordinate Bond	Preferred shares	Equity	MLP Sukuk
Value	Fixed	Fixed	Variable (inflation)	Fixed	Variable (net assets)	Variable (net assets)	Variable (assets)
Maturity	Fixed	Usually fixed	Fixed or perpetual	Fixed or perpetual	Fixed or perpetual	Perpetual	Perpetual (callable)
Seniority	1	1	1	2	3	4	1
Risk-absorbance	—	—	—	—	+	+	+

Table 1: MLP Sukuk Characteristics Compared to Common Hybrid Securities

As Table 1 above shows, conventional markets offer a variety of securities with different characteristics, e.g. convertible bonds, indexed bonds, preferred shares, etc. Securities might be senior, have a fixed or variable par value, absorb risks on an on-going-concern basis, or on a gone-concern basis. The MLP Sukuk offers a unique set of features that are lacking in both the conventional and Islamic financial industry. As we will see later, the features of the MLP Sukuk add value to both issuers and investors that current securities do not offer.

### 3.2. Profits

The Corporate and investors share profits as agreed. Investors get their agreed share of profits periodically as dividends/coupons. It can be agreed that, if the share of investors in profits exceeds a certain level, excess returns are put into a reserve account to give investors protection for fluctuations in future returns. According to AAOIFI Standard no. 12 on Musharakah, clause 3/1/5/9, if the profit realized is above a certain ceiling, it is permissible to agree that the profit in excess of such a ceiling belongs to a particular partner. The share of the Corporate in aggregate profits shall be used to redeem the Sukuk held by investors, as below.

### 3.3. Redemption

In principle, the Sukuk can be perpetual, as it is the case with some of the Sukuk issued recently by Islamic banks and other corporations. Or it can have an agreed maturity. For the MLP Sukuk, the Corporate issues a promise to redeem the Sukuk held by investors if the Corporate's accumulated share in aggregated profits is adequate to accomplish such redemption. If this is the case, the Corporate shall redeem the Sukuk at nominal value. If, however, the accumulated share of the Company in profits is not sufficient, the Corporate is under no obligation to redeem, although it might decide voluntarily to redeem from other resources. Hence, the promise to redeem is not a debt obligation on the Corporate. It is conditional upon realization of sufficient profits. In this manner, the Sukuk are a genuine partnership in the underlying assets. There is no guarantee by the Company that investors will get back their capital. If the Company decides to redeem at nominal value, then investors agree to sell their Sukuk to the Company. Investors agree to give up any capital gain in return for the liquidity provided by redemption.

Since the partners can agree to allocate profits beyond a certain level to one partner, as above, investors can agree to give up capital gain if total profits are such that the Corporate's share equals or exceeds the nominal value of investors' Sukuk. Note that, by the conditional promise, there is an implicit priority of Sukuk holders over the Corporate in realized profits. The Corporate has to give up its share in profits to buy investors' Sukuk, which means that investors are getting the profits up to the nominal value of their Sukuk. This gives an additional layer of protection to investors. However, since profits are not guaranteed, investors are not guaranteed their capital.

### 3.4. Loss

If the Corporate's share in aggregate profits is not sufficient to redeem Sukuk held by investors at nominal value, the Corporate might offer investors one of two options. One is to redeem at loss. The other is to keep the Sukuk as perpetual Sukuk. The MLP Sukuk therefore are perpetual Sukuk callable by the Corporate at the agreed maturity date. The call however, is mandatory if the Corporate's share in aggregate profits equals or exceeds the nominal value of investors' Sukuk. Otherwise, the call is not obligatory, and Sukuk will be perpetual.

### 3.5. Shari'ah Aspects

The idea of sharing assets without sharing liabilities has been known in Fiqh for quite some time. In discussing Mudharabah arrangements, the capital provider (Rabb-ul-maal) has the right to require the Mudharib not to buy on credit, and that if the Mudharib decides to do so, only the Mudharib is responsible for such a debt (الموسوعة الفقهية، مضاربة). The Shari'ah Committee of the Islamic Development Bank has approved the concept whereby investors provide funds to the issuer or the Islamic bank, such that investors share the assets of the bank (Mudharib) but not the liabilities (Ruling 26-2008). The idea was

discussed in the Islamic Financial Services Board (IFSB) while preparing the revised draft of its Capital Adequacy Standard (IFSB-15, Dec. 2013), whereby the Standard notes that Rabb-ul-maal (investors) “would not be liable for the general liabilities of the IIFS (and notably for the amount owed to current account holders)” (p. 8, ftn 12). These findings consider this arrangement as part of Mudharabah, not Musharakah whereby investors share the assets and liabilities of the issuer. The latter however, might be better described as “equity” as they end up with the same rights and obligations of equity shareholders.

### 3.6. Tradability

Since the MLP Sukuk represent a genuine partnership with the Corporate, they are tradable irrespective of the composition of the assets (debts, cash, tangible assets, usufructs). This is in accordance with the principle of “Subordination” in Shari’ah (see Section II). According to this principle, assets are subordinated to the company’s legal entity, management and tangible capital used for managing the entity. Since Sukuk holders share of the ownership of these components, Sukuk are tradable regardless of the nature of the underlying assets. The OIC Fiqh Academy adopted a resolution supporting this view at its 21<sup>st</sup> session in 2013.

### 3.7. Management

If the performance of the appointed management team becomes of concern, Sukuk holders have the right, by a certain proportion of votes, to request the Company to replace the management team and/or review its strategy and policies. However, the Company as such shall remain the manager of the assets.

The right to intervene in management gives investors an additional layer of protection. Unlike creditors, investors supervise and monitor the performance of the Company so that, in principle, they can act before signs of underperformance become apparent.

## 4. Illustrative Example

To make things concrete, suppose, Company XYZ (the Corporate) has three assets: Receivables, Office equipment, and a Factory. Total value of the assets is \$100 million. Further, the Company has debt obligations of \$60 million. Thus, total equity of the company is \$40 million.

Assets (\$millions)		Liabilities (\$millions)	
Receivables	25	Debt	60
Equipment	15		
Factory	60		
		Equity	40
Total Assets	100	Total Liabilities & Equity	100

The Company needs to expand its productive capacity by building a new factory, and needs say additional \$100 million to do so. For this purpose, the Company will issue MLP Sukuk worth \$100 million.

Assets (\$millions)		Liabilities (\$millions)	
Receivables	25	Debt	60
Equipment	15		
Factory	60		



Factory 2	100	Sukuk	100
		Equity	40
Total Assets	200	Total Liabilities & Equity	200

Investors now are partners in the Company; they share 50% of the assets of the Company as per their contributions. Seniority however, is achieved by having the Sukuk held by investors protected from the creditors of the Company in case the Company defaults. So in principle, creditors of the Company and investors are at the same level of seniority with respect to the assets.

Although investors have a senior claim against their share in the assets of the Company, they are still taking the risk of the assets, since assets may for any reason fail to perform as expected.

To elaborate, suppose the assets of the Company lose 20% of its value. Then Total Assets = 160. Since Sukuk holders own 50% of Total Assets, their share of the Total Assets = 80. The remaining 80 is enough to pay the creditors their debt of 60. The remaining of 20 goes to shareholders.

Assets (\$millions)		Liabilities (\$millions)	
Receivables	20	Debt	60
Equipment	12		
Factory	48		
Factory2	80	Sukuk	80
		Equity	20
Total Assets	160	Total Liabilities & Equity	160

It is important to emphasize that the MLP Sukuk do not affect creditors' rights. Without the MLP Sukuk, the 20% loss would have still allowed creditors to get 80 of total assets, which is enough to pay their debt. Sukuk holders get their share of total assets, which is what they have contributed in the first place. They therefore have a senior claim on their share, but they are exposed to the risk of assets, however. The next paragraph discusses how to mitigate this risk.

## 5. Capital Cushion

The basic idea of a Capital Cushion is to offer investors a cushion against losses up to a certain limit. The concept is close to that of "over-collateralization" in conventional finance. However, over-collateralization usually applies to debt-based instruments, while capital cushion applies to equity and Musharakah based instruments, rather than debt-based instruments. A capital cushion effectively plays the economic role of a "guarantee" without being a guarantee. From an economic point of view, a guarantee simply means that the guarantor is pledging additional assets to the creditor/beneficiary. Equity, in contrast, offers no additional assets. For Sukuk, an issuer may offer investors additional certificates, which will give investors protection comparable to that of a guarantee, without being legally a guarantee. But there are important differences between the two instruments:



1. A capital cushion does not lead to default or bankruptcy of the issuer in case of loss beyond the additional protection. In case of debt, in contrast, the debtor must cease operations, leading to economic and social losses. Thus, cushion capital serves essentially the same objective of a guarantee, but without the negative costs associated with default and bankruptcy. To some extent, it combines the best of both: debt and equity.
2. A capital cushion is specified and assigned upfront to Sukuk holders. A guarantee, in contrast, does not assign any specific portion of assets to investors. Since the company may borrow and/or issue guarantees to several different parties, the ultimate portion of assets backing each of these obligations will not be specified to investors upfront.

To apply capital cushion in MLP Sukuk, investors are offered the option to own additional Sukuk certificates, at no upfront cost. (Obviously, the return they get will be reduced accordingly) The option to own the additional Sukuk is to be exercised at maturity. In case the Company fails to redeem the principal Sukuk certificates, investors have the right to liquidate their Sukuk in the market. In this case, they can use the additional Sukuk to recover any possible losses. However, if the Company redeems the Sukuk at par, then investors give up the right to own the additional Sukuk. That is, investors have the right to own the additional Sukuk only in case the Company does not redeem their certificates at par.

## 6. Determinants of MLP Sukuk profit rate

The MLP valuation is akin to a non-recourse secure financing. The investment is backed by a real pool of assets and investors do not have recourse beyond their share of assets (including the cushion). The following factors are the main determinants of the fair price of Sukuk certificate.



Figure 20: Determinants of MLP Sukuk profit rate

Next, we elaborate on how exactly they influence the value of MLP Sukuk.

### 6.1. Quality of the asset

MLP Sukuk being backed by a pool of assets, their value is naturally dependent on the quality of the latter. More specifically, assets determine Sukuk returns in two ways: Expected cash flow generation and asset value in case of default.

#### Expected Cash Flow Generation

Returns of a Musharakah contract are generated from the activity of the Musharakah “entity”. In our example, the pool of assets generates an income that will be used to distribute returns to Sukuk holders. As a result, the remuneration of Sukuk holders is highly sensitive to the expected cash flows to be generated by the asset.

#### Asset Value in Case of Default

The value of assets backing the Sukuk will, in general, be impacted by the default event. The extent of this impact is, however, dependent on the nature of the company and the industry it operates in. For example,

Sukuk of a company with a large ratio of intangibles such as goodwill may be impacted more than Sukuk of a company with easily tradable assets.

## 6.2. Quality of the Issuer

The issuer plays three roles in the MLP Sukuk structure. First, it is a partner and the manager of the Musharakah. Second, it operates as a liquidity provider in the secondary market if enough profit is generated. Third, the issuer has the ability to trigger default of the Sukuk through the default of the Company. We will examine how each of these roles contributes to the value of the Sukuk.

### Issuer as Manager

The Issuer is contributing with tangible and intangible assets to the Musharakah. It also acts as manager of the Musharakah. The assessment of the issuer's ability to successfully manage the Musharakah, apart from being an important due diligence point, will also determine the management fee that Sukuk holders will pay to the issuer in his capacity as a manager.

### Issuer as Liquidity Provider

Investors would expect a premium for the illiquidity of any investment. The MLP Sukuk, being tradable assets, would actually be impacted positively compared to non-tradable debt-based Sukuk. In addition, the issuer volunteers to provide a secondary market under pre-specified conditions. This additional liquidity should reduce the price of the Sukuk.

### Issuer as Default Trigger

MLP Sukuk default if the Issuer defaults. In such a scenario, the Sukuk are impacted through

- Illiquidity
- Asset liquidation value
- Default costs

As a result, it is clear that the credit rating of the Issuer, as a metric for its default probability should be taken into account when determining the profit rate of the Sukuk.

## 6.3. Capital Cushion

Risk mitigation via capital cushion would intuitively imply that the expected return of the Sukuk should move inversely with the size of the cushion. The Issuer would expect to pay less having provided recourse to a larger share of the asset.

## 6.4. Upside Incentive to the Issuer

Sukuk holders might give up income beyond a pre-defined rate. That income will serve as an incentive to the Issuer in his capacity of manager. This means that Sukuk holders would expect to be compensated for it through other favorable terms e.g. high capital cushion.

# 7. Third Party Protection

Sukuk investors vary in their abilities and propensities to take risk. Although the MLP Sukuk structure so far provides for several layers of protection, there is room to offer a general mechanism for mitigating Sukuk risks. There have been some proposals for "Sukuk insurance" based on the concept of Takaful. However, given the size of the Sukuk market, it might not be feasible to offer blanket insurance to

hundreds of billions of Sukuk. We can learn from the bonds insurance industry. After the crisis, almost all of bond insurers went out of business after guaranteeing billions of dollars' worth of subprime debt that soured during the financial crisis (Financial Times, Mar. 18, 2012). A more resilient and transparent model is presented below.

### 7.1. Sukuk Protection Fund

An entity willing to provide protection to Sukuk holders (an insurance company, an investment bank, or any other financial institution) establishes a Sukuk Protection Fund. Investors who prefer to get additional protection on their Sukuk exchange their Sukuk certificates for units in Fund. The Fund shall accept only Sukuk of a certain quality and with sufficient diversity. In this manner, Sukuk holders are able to diversify their investments. In addition, the Third Party shall contribute from its own resource 5-10% say of the Fund assets. The contribution of the Third Party is long term or permanent, and thus cannot be liquidated ahead of other investors. Hence, the 5% contribution plays the same role of a capital cushion as discussed earlier. It provides a cushion to Sukuk investors against possible losses in the underlying Sukuk issues. Also, the Third party shall allocate a certain percentage of the returns on the Fund as a reserve account to provide additional protection to investors. Furthermore, the Third Party works as an agent for MLP Sukukholders, representing them in the management of the Corporate. The Third Party naturally has an interest that none of the Sukuk of the Fund fails or loses money. Hence, the Third Party has a direct interest in monitoring the Corporate and assuring that assets are managed as planned. As an institutional investor, the Third Party is better able than small investors to play this role. The role of the fund here will reduce the moral hazard risk. In return for these services, the Third Party gets a percentage of the returns on the underlying Sukuk of the Fund.

In summary, the Sukuk Protection Fund offers several layers of protection:

1. Diversification
2. Reserves
3. Capital cushion

## 8. Conclusion: Advantages of MLP Sukuk

It is helpful at this stage to compare the three kinds of financial instruments: bonds, equity, and MLP Sukuk. The following table summarizes the comparison.

Feature	Bonds	MLP Sukuk	Equity
Priority over assets	+	+	-
Intervention in management	-	+	+
Upside gain (potential)	-	+	+
Cushion against loss	+	+	-
Risk sharing	-	+	+

Table 2: MLP Sukuk Comparison to Bonds and Equities



MLP Sukuk share with bonds the most two important features of debt financing: priority over assets, and cushion against losses through capital cushion. However, beyond the cushion, Sukuk holders share the risk with the Corporate. Unlike debt, losses do not cause the Corporate to default and declare bankruptcy. Bankruptcy is a dead-weight loss to all parties, and it is in the interest of all parties to avoid it as much as possible. For this reason, MLP Sukuk holders have the right to intervene in the management of the Corporate to overcome any mismanagement or malpractice, in order to save their investments and allow it a better opportunity to recover. This feature is absent from bonds but is an important feature of equity. Since MLP Sukuk imposes no debt burden upon the Corporate, it is a kind of risk sharing that the Corporate would prefer over borrowing or debt financing. Overall, MLP Sukuk combines aspects of both debt and equity such that it offers a unique set of features to both issuers and investors.

### 8.1. Versatile Risk Profile

MLP Sukuk provide a versatile structuring tool. Indeed, risk mitigation features allow the fine-tuning of this product's risk profile in order to fit investors and issuers' demands.

One can design defensive Sukuk that provide a maximal protection. Such product would be popular with risk-averse or fixed income type investors. On the other hand, investors with more risk appetite would prefer to participate in assets' capital gains and would not mind taking some losses. The structure can also accommodate this type of investors via Sukuk that have minimal capital cushion and a substantial potential upside.

### 8.2. MLP Sukuk vs. Prevailing Sukuk

It is also helpful to compare MLP Sukuk with some of the common forms of Sukuk. Most Sukuk structures end up in a debt obligation on the Company, hence the common description as "Islamic bonds." As already pointed out, MLP Sukuk create no debt obligation upon the Company, and are a genuine partnership arrangement. In addition, the MLP Sukuk structure is more efficient and transparent than the prevalent Ijarah structures. The table below summarizes the main aspects of the two.

Ijarah Sukuk	MLP Sukuk
Investors own specific tangible asset(s)	Investors share in the general pool
Represent a debt obligation	Represent a share in assets—no debt
Issuance is limited by availability of tangible assets	Issuance is limited by productivity of the Company

*Table 3: MLP Sukuk Comparison to Ijarah Sukuk*

The MLP Sukuk structure avoids the main Sharī'ah issues in some Ijarah Sukuk structure, namely the undertaking to buy back. The buy-back undertaking is essentially a debt obligation, and it is the basis for rating the Sukuk, if a rating is provided. The buy-back undertaking gives the traditional Sukuk transaction



the same risk profile as a bond. As discussed, MLP Sukuk offer contingent redemption based on the generated profits. Ultimately, it is the quality of the underlying assets that gives investors the assurance of their investment. The rating of the MLP Sukuk therefore, is based primarily on the quality of the underlying assets. Capital cushion offers an additional enhancement of the Sukuk. From an economic point of view, MLP Sukuk involves no “redundant” assets going back and forth for no reason except to obtain financing.

Further, as there is no one-time structure involved; the process can be used for regular and sustainable issuance of Sukuk. The prevailing Sukuk structure, in contrast, is designed as a one-time solution only. Judging by the substantial costs of issuance, a one-time issue is highly inefficient. MLP Sukuk holders are partners in the Corporate, and thus own both assets and management rights. Hence, the composition of the assets of the Company is not a constraint on issuance, as discussed earlier. In this manner, the Company is able to share (“securitize”) any of its assets, tangibles and non-tangibles. This gives corporates great flexibility for issuances. In short, MLP Sukuk are more efficient, more flexible, and serve the objectives and parameters of Shari’ah in a manner that is more credible than some of the prevailing Sukuk structures.

# SECTION IV: EXCHANGEABLE SUKUK

## 1. Introduction

The ideal model of Sukuk, according to which many of the early Sukuk issuances were structured, is for Sukuk to be asset-backed securities. Investors had legal ownership of the underlying asset and the coupons were generated by the asset's performance. The industry however, moved gradually over the years into structures where the asset plays a mere secondary role. In many cases, asset value is unrelated to the Sukuk notional and Sukuk holders are not the real owners of the securitized asset which frequently stays on the issuer's balance sheet.

In addition to inherent Shari'ah issues with these type of Sukuk, an issuer's ability to raise capital is considerably constrained by the availability of unencumbered assets or the sensitivity around strategic assets. We present in this section a concept product that is being developed in IDB that addresses the aforementioned issues. The product is an asset-backed Sukuk where investors are the legal owners of the asset. Moreover, this new concept does not require the pre-existence of tangible assets on the issuer's balance sheet; Shari'ah-compliant tangible assets can be obtained from the market. In addition, the structure is credit-enhanced to provide a better rating of the Sukuk.

## 2. Exchangeable Sukuk Structure

In very simple terms, the exchangeable Sukuk structure is done in two steps:

### Step 1: Acquisition of a new asset by the issuer

Issuer purchases a Basket of Shari'ah-compliant shares for a Deferred Price plus a Premium. The Basket is purchased (via SPV) from an Original Asset Seller (OAS, for example an investment bank) on *wa'ad* basis, i.e. the right of the buyer to put back the Basket to the OAS.

### Step 2: Issuance of asset backed Sukuk

Issuer uses the Basket of Shares to issue Sukuk to investors.

### What happens at maturity?

If the Basket underperforms, Sukuk holders have the right to exchange the Basket for the Deferred Price of the issuer. This Deferred Price sits within the SPV from inception. In this manner, the principal (and the return) of the Exchangeable Sukuk are backed by the payment obligation of the issuer.

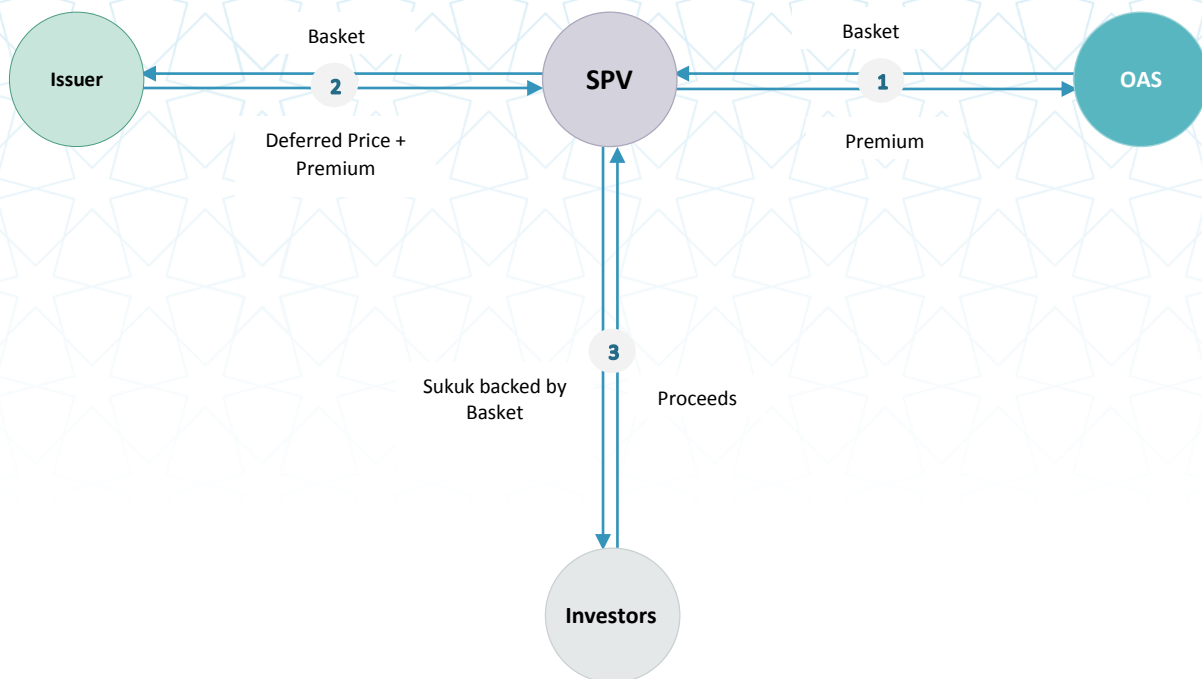


Figure 21: Exchangeable Sukuk Structure

### 3. Shari'ah Compliance

Sukuk issuances are generally based on the sale of issuer's assets to Sukuk holders. The current industry practice of adding an unconditional re-purchase undertaking to the sale operation entails the persistence of the sold assets on the issuer's balance sheet, even after Sukuk issuance. This point is much debated as it poses potential Shari'ah issues vis-à-vis the validity of the sale operation. Because Exchangeable Sukuk are truly asset-backed, the legal ownership of the underlying asset is completely transferred to Sukuk holders at Sukuk issuance. Moreover, the structure does not involve any Purchase Undertaking by the issuer at maturity. As a result, the assets will be genuinely off the balance sheet of the issuer once the Sukuk are issued.

The structure does not involve *'einah*, since the cash price of Sukuk is paid by investors, not by the OAS. The OAS only provides a hedge mechanism to take back the basket and net out the payment obligations. There is no implicit loan between the issuer and the OAS.

Further, the structure does not involve *gharar*, where one party wins at the expense of the other. If the Basket performs, all parties win, and that is the objective of the structure. For this reason, the Basket has to be thoroughly evaluated and assessed, such that it is more likely to generate expected returns than otherwise. The issuer, as an arranger and advisor to investors, will get a share of the upside of the Basket. This share is used to offset the Premium associated with the structure. This makes the structure a genuine investment whereby the returns play a vital role in facilitating the structure.



## 4. Tradability

The Exchangeable Sukuk represent the legal ownership of a Shari'ah compliant tangible asset and as such to do not have any element that prevent tradability of the Sukuk on the secondary market.

## 5. Credit Risk Protection

It is worth noting that Sukuk holders are fully insulated from OAS's credit risk. The only credit risk exposure Sukuk holders have is that of the Sukuk issuer. Moreover, by virtue of their legal ownership of the underlying asset, Sukuk holders have the extra credit protection from direct recourse to the assets. In this sense, Exchangeable Sukuk are a safer investment compared to Sukuk where investors do not have direct recourse to the assets. Issuers would expect to pay a lower financing cost due to this credit enhancement.

## 6. Target Investors

The Sukuk market is traditionally geared toward "fixed-income" investors. In order to accommodate the traditional Sukuk investor base, the exchangeable Sukuk, by way of the OAS's *wa'ad*, can provide full protection of the Sukuk.

The issuer on the other hand, will be compensated for arranging the transaction by benefiting from the full appreciation of the assets as Sukuk holders are mainly interested in the capital protection.

The investment assets can be adequately lined up with the issuer's activity and market views. From the perspective of the issuer, the above structure can thus play the dual role of firstly, financing and secondly, investment or hedging.

## 7. Numerical Simulations

We illustrate in this section the respective cash flows at maturity in different asset performance scenarios. We take an example \$100 structure.

### Scenario I: Asset value is unchanged

In the case where the asset did not appreciate nor depreciate, the cash flows at maturity are summarized in the following table.

#### *Cash flows at maturity*

Issuer Deferred Price	Asset Value	OAS	Sukuk	Issuer Upside
\$(-105)	\$100	\$100	\$105	-

- Issuer pays deferred price of \$105 to SPV.
- OAS receives \$100 from asset sale.
- Sukuk holders get \$105 from SPV.

#### *Relative Return*

Asset Value	Sukuk
0%	5%

Table 4: Scenario I Cash Flows



Scenario II: Asset value appreciates 10%

In the case where the asset appreciates by 10%, investors will give up the appreciation to the benefit of the issuer. The cash flows at maturity are summarized in the following table.

*Cash flows at maturity*

Issuer Deferred Price	Asset Value	OAS	Sukuk	Issuer Upside
\$(-105)	\$110	\$100	\$105	\$10

- Issuer pays deferred price of \$105 to SPV.
- OAS receives \$100 from SPV.
- Sukuk holders receive \$105 from asset sale.
- Issuer gets the remaining proceeds in the SPV of \$10.

*Relative Return*

Asset Value	Sukuk
10%	5%

Table 5: Scenario II Cash Flows

Scenario III: Asset value depreciates 30%

In the case where the asset depreciates by 30%, Sukuk holders will be protected from this depreciation. The cash flows at maturity are summarized in the following table.

*Cash flows at maturity*

Issuer Deferred Price	Asset Value	OAS	Sukuk	Issuer Upside
\$(-105)	\$70	\$70	\$105	-

- Issuer pays deferred price of \$105 to SPV.
- Sukuk holders put back the asset to the SPV.
- Sukuk holders receive \$105 from SPV.
- SPV puts back the asset with a value of \$70 to OAS.

*Relative Return*

Asset Value	Sukuk
-30%	0%

Table 6: Scenario III Cash Flows

## 8. Flexibility of the Exchangeable Sukuk Structure

The structure provides a great degree of flexibility and can be adapted to fit the needs of specific issuers and target investors. The cost structure of the aforementioned model could be expensive for Islamic Financial Institutions (IFIs) who do not have any investment needs or IFIs with investment targets order of magnitudes lower than financing needs.

In order to lower the cost for the issuer, several viable avenues are available. One possibility is for the OAS' *wa'ad* to cover only a predefined level (say 30%), so that the Basket is hedged only up to a drop of the market of 30%. This will reduce the cost and lower the premium. We can then construct two classes of Sukuk: Class A and Class B.

Class A Sukuk holders are typical fixed-income investors. They own 30% of the Basket, and are hedged 100%. Class B Sukuk holders are risk-taking investors looking for above-average returns. They are protected only up to 30% loss. Beyond that, they are exposed to market risk. Class B investors are compensated for this partial hedge with a higher participation in the profits from the Basket.

The result is a lower cost Sukuk issuance with two Classes of Sukuk targeting two types of investors.

## 9. Conclusion

The Exchangeable Sukuk concept is a novel idea that aims to solve the asset-scarcity issue faced by many Sukuk issuers and prospective issuers. It also provides a cleaner Shari'ah and accountancy treatments of the Sukuk transaction as it allows the underlying assets to genuinely leave the issuer's balance sheet.

The structure permits the potential alignment of investment and funding objectives. It could also be used for hedging purposes when the underlying asset and the issuer activity have opposite business cycle sensitivities for example.

The generalization of such Sukuk, especially Class B Sukuk, will engage a new investor base and ultimately improve the depth and liquidity of the global Sukuk market.

Finally, by virtue of credit enhancement through collateralization, the Sukuk will allow a larger spectrum of prospective issuers to tap the Sukuk market.

# CONCLUSION

Sukuk have demonstrably been the Islamic Financial industry's instrument of choice for access to capital markets. The sector enjoyed a rapid growth in the last decade thanks to a propitious environment for development. On one hand, Islamic Finance Infrastructure Institutions have set the stage via framework standardization. On the other hand, Islamic Finance practitioners strived to use the framework in ingenious ways in order to reach investors.

There are, however, some well-known gaps in the current Sukuk offerings. Ijarah and Murabahah constitute the overwhelming majority of Sukuk contracts, relegating genuine profit and loss sharing contracts such as Musharakah and Mudarabah to niche market status. Moreover, the industry lacks a generic and sustainable Sukuk issuance model. The majority of Sukuk programs seemingly rely on the hardly sustainable case-by-case asset identification approach.

This Report introduced two novel ways to structure Sukuk; Musharakah Sukuk: Multi-Level Protection Sukuk and Exchangeable Sukuk. The first one is a hybrid security that enjoys the best of both equity and fixed income worlds. Investors are participants in issuer's assets but not in its liabilities and hence benefit from the same level of seniority as debt holders in case of default. It is, to the best of our knowledge, a completely new instrument in both Islamic and conventional finance. The second structure is a versatile framework for resource mobilization without pre-ownership of tangible assets. Thanks to the true sale operation involved, investors benefit from a direct recourse to the asset in case of default. In addition, common Shari'ah and accounting issues are mitigated since the securitized asset does not subsist on the issuer's balance sheet after the sale operation.

On the sovereign financing side, this Report proposed an institutional solution for a robust and efficient Sukuk issuance program. With a fully-fledged Islamic financial institution dedicated to sovereign financing, the Sovereign Finance Corporation (SFC) model constitutes a leap in terms of efficiency and regularity when compared to existing practices. Issues relating to sovereign asset availability and the sensitivity of ownership transfer are elegantly resolved in the proposed model.

Each of these structures, needless to say, can borrow from the other two, resulting in a wide variety of additional structures that might suit the needs of different issuers in different circumstances. By this, we hope that the Report helps to open the door for a new era for Sukuk and Islamic capital markets.



# APPENDIX

## 1. What are Sukuk?

Sukuk is the plural of the Arabic word Sakk (صك). They are the resulting ownership certificates from the securitization of an economic asset. In addition to commensurate ownership rights, Sukuk holders benefit from the returns generated by the economic activity of the securitized asset. More precisely, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defined of the Sukuk in Standard 17 as:

*(...) Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (in the ownership of) the assets of particular projects or special investment activity; however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued.*

## 2. Sukuk Types

Sukuk are structured around various Islamic contracts. The table below summarizes the characteristics of the most common types of Sukuk based on the underlying Islamic contract involved.

<b><i>Ijarah</i></b> (Certificate of ownership in leased asset)	<ul style="list-style-type: none"><li>• These are certificates that carry equal value and are issued either by the owner of a leased asset or an asset to be leased by promise, or by his financial agent, the aim of which is to sell the asset and recover its value from subscription, in which case the holders of the certificates become owners of the assets.</li><li>• These securities would suit the classification of asset-based because the leased asset will be transformed into units of proportionate ownership to be subscribed by the investors.</li></ul>
<b><i>Manfa'ah</i></b> (Certificate of ownership of usufructs of existing assets)	<ul style="list-style-type: none"><li>• Certificates of equal value issued by the owner of an existing asset either on his own or through a financial intermediary with the aim of subleasing the usufruct and receiving the rental from the revenue of subscription so that the holders of the certificates become owners of the usufruct.</li><li>• These are also part of asset-based securitization though the asset is in the form of usufruct and services.</li></ul>
<b><i>Intifa'</i></b> (Certificates of ownership of usufructs of	<ul style="list-style-type: none"><li>• These are documents of equal value issued for the purpose of leasing out tangible future assets and for collecting the rental from the subscription revenue so that the usufruct of the described future asset passes into the ownership of the holders of the certificates.</li></ul>

described future assets)	<ul style="list-style-type: none"> <li>These are deemed to be part of asset-based securitization although the underlying asset is the services that are to be provided in the future.</li> </ul>
<i>Milkiyyat Al-Khadamat</i> (Certificates of ownership of services of a specified supplier)	<ul style="list-style-type: none"> <li>These are documents of equal value issued for the sake of providing or selling services through a specified supplier (such as educational programs in a nominated university) and obtaining the value in the form of subscription income, in which case the holders of the certificates become owners of the services.</li> <li>Similar to the other <i>Ijarah</i>-based securities, these securities come under the purview of asset-based securitization.</li> </ul>
<i>Al-Khadamat Al-Mawsufah fi Al-Zimmah</i> (Certificates of ownership of services to be made available in the future as per description)	<ul style="list-style-type: none"> <li>These are documents of equal value issued for the purpose of providing future services through described provider (such as certain prescribed educational benefits from university without naming the educational institution) and obtaining the fee in the form of subscription income so that the holders of the certificates become owners of the services.</li> <li>Services, although to be provided in the future, are deemed as an asset thus making this security a type of asset-based securitization.</li> </ul>
<i>Salam</i> ( <i>Salam Certificate</i> )	<ul style="list-style-type: none"> <li>These are documents of equal value issued for the purpose of mobilizing <i>Salam</i> capital so that the goods to be delivered on the basis of <i>Salam</i> basis come to be owned by the certificate holders.</li> <li>The <i>Salam</i> Sukuk represent the ownership of the investors in the asset to be delivered in the future.</li> <li>These <i>Salam</i> Sukuk can be issued but are not traded even on the basis of par value because the <i>Salam</i> asset which is represented by the <i>Salam</i> Sukuk cannot be sold to another party without the initial buyer taking possession of the asset.</li> </ul>
<i>Istisna'a</i> ( <i>Istisna'a Certificates</i> )	<ul style="list-style-type: none"> <li>These are certificates of equal value issued with the aim of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders.</li> <li>This definition refers to the Sukuk that represent the proportionate ownership in the asset to be constructed. This is an asset-based structure until the asset is delivered to the buyer.</li> <li>As practiced in some jurisdictions like in Malaysia, <i>Istisna'a</i> Sukuk refers to debt securitization that is the receivables owing to the contractor. This type of issuance, from an international Shariah standpoint, cannot be traded freely as it reflects debt-trading instead of asset-trading.</li> </ul>
<i>Murabahah</i> ( <i>Murabahah Certificates</i> )	<ul style="list-style-type: none"> <li>These are certificates of equal value issued for the purpose of financing the purchase of goods through <i>Murabahah</i> so that the certificate holders become the owners of the <i>Murabahah</i> commodity.</li> <li>Similar to <i>Istisna'a</i> Sukuk, this definition refers to an activity of pooling monies to purchase a commodity to resell the same to another party under <i>Murabahah</i> sale. This Sukuk, if issued, is an asset-based securitization.</li> <li>However, as practiced in Malaysia, <i>Murabahah</i> Sukuk may refer to the securitization of the seller's receivables. This issuance cannot be traded except on face value principal in accordance with AAOIFI Shariah standards</li> </ul>

	because <i>Murabahah</i> receivables connote debt or financial obligation which is deemed to be money in character.
<b><i>Musharakah</i></b> Certificates	<ul style="list-style-type: none"> <li>• These are certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares.</li> <li>• There are three modes of issuing securities based on Musharakah concept:               <ol style="list-style-type: none"> <li>(1) <b>Musharakah Sukuk</b> (Participation Certificates). These are certificates representing projects or activities managed on the basis of Musharakah by appointing either one of the partners or another person to manage the operation.</li> <li>(2) <b>Mudharabah Sukuk</b> (Issuer is the mudharib or manager). These are certificates that represent projects or activities that are managed on the basis of Mudharabah by appointing the mudharib for the management of the operation.</li> <li>(3) <b>Wakalah Sukuk</b> (Investment agency Sukuk). These are certificates that represent projects or activities that are managed on the basis of investment agency by appointing an agent to manage the operation on behalf of the certificate holders.</li> </ol> </li> </ul>
<b><i>Istithmar</i></b>	<ul style="list-style-type: none"> <li>• These are Sukuk which are hybrid in nature. They combine both financial assets such as Murabahah receivables and tangible assets such as Ijarah (leased) asset according to a proportion of 70:30 respectively.</li> <li>• The issuance of these securities which was initiated by the Islamic Development Bank was a breakthrough in addressing the issue of receivables securitization.</li> <li>• These securities have been deemed as asset-based securitization and therefore are tradable in the secondary market.</li> </ul>

Table 7: Sukuk Types

Source: INCEIF, Rasameel.

## References

Rasameel, Quarterly Global Sukuk Report, July 2014.





The Financial Product Development Center (FPDC) was established in Muharram 1432H (December 2010G). Its main purpose is to enhance the leadership of the Islamic Development Bank Group in the development and promotion of innovative Islamic financial products within the framework of the Maqasid al-Shariah. This is accomplished while further strengthening the financial soundness and relevance of the IDB Group.

The Center is the focal point for the development of new and innovative financial instruments at IDB Group, and for this purpose it also collaborates with various institutions in the Islamic financial industry.

### **Strategic Objectives**

The Center has three major strategic objectives:

- ❖ Developing Business Process for new product development.
- ❖ Building capacity of product developers.
- ❖ Designing new financial products.

These three objectives are summarized by the “3Ps” that the Center works along: Process, People, and Products.

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