Readings in Sukuk

Concept and Operation

Compiled, Classified & Edited by

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Introduction

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

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

A. Structure of the Readings Series-6

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

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

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

B. B. Contents Covered

I. Sukuk: An Overview

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

Introduction to sukuk

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

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

Historical development

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

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

Classification of Sukuk

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

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

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

II. Framework for Sukuk Issuance

Shariah Rules for Sukuk

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