Sukuk Bond: The Global Islamic Financial Instrument

Shaikh, Salman and Saeed, Shan

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Salman Ahmed Shaikh[1] & Shan Saeed[2]

Abstract

Global financial markets are volatile right now and will remain so for the next 2-years. Equity markets are shaky. Investors risk appetite is suddenly moving to commodities. Bond market is precarious as Sovereign debt risk goes high. Global economy is slowly moving into recession which will be either U or W-Shaped. Recovery figures are questionable and are creating doubts among investors. So, where are we heading towards? As we navigate through treacherous times, Islamic financial market provides a new hope without speculation and exploitation of resources. The emergence of Sukuk Islamic Bond in the financial markets heralds a new era which can provide much needed financial stability and mitigation of risk in these arduous times. With advent of Sukuk in the financial world, the market players have got a new option to invest into this asset which hold considerable value and benefit for all. This bond promises to all investors an equitable return which is justifiable and above all safe for the strategic investment purpose.

1. Background

Global financial markets are volatile right now and will remain so for the next 2-years. Equity markets are shaky. Investors risk appetite is suddenly moving to commodities. Bond market is precarious as Sovereign debt risk goes high. Global economy is slowly moving into recession which will be either U or W-Shaped. Recovery figures are questionable and are creating doubts among investors. So, where are we heading towards? As we navigate through treacherous times, Islamic financial market provides a new hope without speculation and exploitation of resources.

In the last few years, Islamic finance industry experts have developed Shariah Compliant instruments for managing liquidity. Some of them are as follows:

a. Bai Salam in Bill Discounting.
b. Murabaha in Usance Bill Discounting.
c. Running Musharakah.
d. Musawamah for Short Term Liquidity Management.
e. Treasury Financing/Investments by way of Pool Management mechanism.

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[1] Salman Ahmed Shaikh is a visiting faculty member at Szabist and University of East and works as a Research Analyst for BMC Pakistan.
[2] Shan Saeed is an economist and financial expert and he did his MBA from University of Chicago.

f. Treasury Investments/Financings by way of Short Term Investment through Commodity Murabaha i.e. Tawarruq.
g. Shariah Compliant Asset Backed Securitization like Sukuk.
h. Development of Islamic Benchmark i.e. IIBOR and Islamic T-Bill is underway which will deepen and integrate the financial markets comprising Islamic Financial Institutions.

Islamic Finance is catering to the needs of all investors. Islamic finance apart from being Shariah Compliant also has ample potential to attract investors solely from the business point of view as well. Islamic Finance is growing in multiple dimensions and is now spreading in other financial sectors like insurance, structured finance, project finance, mutual funds, syndicated finance, investment banking etc.

Islamic Finance is now able to provide one stop solution to its customers. Shariah compliance also ensures Corporate Social Responsibility (CSR) and ethical compliance. Islamic banks do not conduct business with companies producing tobacco, alcohol or engaged in the business of gambling, casino, nightclubs, prostitution etc. This mechanism has given Islamic banking the name of 'ethical banking' in Europe.

Islamic Investments are not involved in Risk Arbitrage, Junk Bonds, Muni Bonds, Brady Bonds, Currency Options, Swaption, Swaps, Call/Put Options, Combinations or spreads of Options, Futures trading, Forward contracts, Credit Default Swaps, short selling, speculative insurance underwriting, subprime loans, debt swaps, rollover loans, CDOs, excessive leveraging etc.

The balance sheet of Islamic banks is capable of taking financial shocks. Islamic banks are not obliged to give fixed return to their depositors and general creditors. The creditors, shareholders and depositors share and participate in the bank's business. Therefore, incase, there is a shock on asset side (NPL increasing), Islamic banks will be able to share this loss with their depositors and shareholders.

Islamic banks cannot rollover loans. Therefore, the packaging and repackaging of loans and then issuing more and more debt securities on the back of these non performing loans cannot legally happen in Islamic Banks. Islamic banks are obliged to have backing of assets in all their investments. Therefore, Islamic bank's losses even theoretically cannot go beyond the value of the real asset.

2. Overview of Islamic Finance

Islamic Finance is a growing industry which is constantly evolving and has been competitive to reach and sustain its growth momentum amidst even the Great Recession and beyond. Assets of the global Islamic finance industry are estimated to grow to around $1.6 trillion by 2012 (Source: Reuters). Some reports suggest that assets held by Islamic financial institutions may rise five-fold to more than $5 trillion (Source: Moody's Investor Service).

In Egypt, first Islamic savings bank was established based on the principle of profit-sharing at Mit Ghamr in 1963. The Islamic financial system in Malaysia was first introduced in 1963. It started from a humble beginning with the founding of the Malaysian Pilgrims Fund Board (Tabung Haji), to the setting up of the country's first Islamic bank, Bank Islam Malaysia Berhad (BIMB), which commenced business on July 01, 1983.

In 1975, the Islamic Development Bank was established to provide financing to projects in the member countries. Dubai Islamic Bank was the first modern Islamic commercial bank established in the same year. Indonesia's first Islamic bank was Bank Muamalat, which was founded in 1991. In Bahrain, first Islamic commercial bank was established in 1978.

In Pakistan, Meezan Bank was the first Islamic commercial bank established in 2002. Since then, Bank Islami, Dubai Islamic Bank, First Dawood Islamic Bank, Bank Al-Barakah and Emirates Global Islamic Bank have started their operations as full fledged Islamic banks. The branch network of 6 full-fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches-IBBs) increased to 528 branches by the end of June 2009. It is estimated that Islamic banking will achieve a market share of 12% by 2012 in Pakistan. (Source: SBP Strategic Plan for Islamic Banking 2009).

Total assets of Islamic banking in Pakistan reached Rs. 313 billion by June 2009. The financing and investment portfolio of Islamic banks reached Rs. 195.0 billion by June 2009. In terms of market share, total assets, financing & investment and deposits reached 5.1% and 4.2% and 5.2% respectively, at June 2009. The deposit base of Islamic banks reached Rs. 238 billion at end-June 2009. (Source: Business Recorder, September 09, 2009). Lately, the Vatican said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. (Source: Osservatore, March 04, 2009).

Islamic Finance industry is an emerging and growing industry. Islamic financial industry beyond banking has achieved financial deepening in Asset Management, Investment Banking, Public Finance, Structured Finance and Insurance. On the geographical level too, Islamic banking has grown from Middle East to Europe and now is well positioned in South Asian markets as well.

3. Introduction to Sukuk

Sukuk are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest. Sukuk investors receive a pass-through of income generated by the underlying assets. A Sukuk represents proportionate beneficial ownership in the underlying asset. The asset is then leased to the client using Ijarah or Diminishing Musharakah or sold to the client using trade based Islamic mode of financing like Salam, Murabaha and in case the asset needs to be manufactured, the Islamic mode of Istisna is used. The asset leased or sold yield the return on the Sukuk for the certificate holders. The return may be fixed or variable, but, the key point is that it can not be interest for lending money only.

AAOIFI, an Islamic body for accounting, auditing and financial regulation defines Sukuk as:

> "Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity".

Sukuk is an Islamic bond and is based on the concept of securitization. It is an Islamic alternative for asset monetization, syndicate project financing, financing through asset backed securitization and public financing.

4. Sukuk Structures

There are 14 ways to structure Sukuk as per the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). In what follows, the widely used Sukuk structures are briefly explained.

4.1 Mudarabah Sukuk

These represent ownership of units of equal value in the Mudarabah equity and are registered in the names of holders on the basis of undivided ownership of shares in the Mudarabah equity and returns are based on the ownership share. The owners of such Sukuk are the rabbul-maal. Mudarabah Sukuk are used for enhancing public participation in big investment projects.

4.2 Musharakah Sukuk

These are investment Sukuk that represent ownership of Musharakah equity. The only difference in Musharakah Sukuk from Mudarabah Sukuk is that in Musharakah Sukuk, the issuer forms a committee from among the holders of the Sukuk who can be referred to in investment decisions and need not be dormant partners as in the case of Mudarabah.

Musharakah Sukuk are used for mobilizing the funds for establishing a new project requiring heavy investment or developing an existing one or financing a business activity on the basis of partnership contracts. The certificate holders become the owners of the project or the assets of the enterprise as per their ownership share.

4.3 Ijarah Sukuk

These are Sukuk that represent ownership of equal shares in a rented property or the usufruct of the property. These Sukuk give their owners the right to own the property, receive the rent and dispose of their Sukuk in a manner that does not affect the right of the lessee, i.e. they have an active secondary market. The holders of such Sukuk are owners of the leased property/asset and bear all cost of maintenance and risk of damage to the asset/property.

Ijarah Sukuk are the tradable securities representing ownership of identified assets tied up to a lease contract. Rentals from these assets are passed through to the Sukuk holders.

4.4 Murabaha Sukuk

In Murabaha Sukuk, the issuer of the certificate is the seller of the Murabaha commodity while the Sukuk holders are the buyers of that commodity. The certificate holders own the Murabaha commodity and bear risk of damage to the property until the asset/commodity is sold. Sukuk holders are entitled to the final sale price upon the re-sale of the Murabaha commodity. These Sukuk have no secondary market as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt for debt on a deferred basis with unequal amount and this difference is riba.

In Hybrid Sukuk discussed later, Murabaha Sukuk could be tradable if they are the smaller part of a portfolio of assets which also include Ijarah, Musharakah and Mudarabah. In South Asia especially in Pakistan, their use is avoided to safeguard from Bai-al-Dayn (Sale of debt for debt).

4.5 Salam Sukuk

In Salam Sukuk, the issuer of the certificates is a seller of the goods of Salam while the Sukuk holders are the buyers of the goods. In a Salam contract, the goods do not exist at the time of sale and hence it is regarded as an exceptional sale. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the Salam goods sold.

Salam Sukuk may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company in return for a promise to deliver the goods at a future date. SPV can appoint an agent to sale the same quantity of goods for the same date of delivery, but at a higher price due to small gap in time to maturity in Parallel Salam. The difference between the purchase price and the sale price is the profit to the SPV and it passes through to the holders of the Sukuk.

In Salam, it is necessary that buyer pays in full at spot and that the goods are standardized and remain available in the market from the date of sale to delivery date so that if goods can not be provided by the seller from an expected source, they can be provided by purchasing from the market.

4.6 Istisna Sukuk

In Istisna Sukuk, the issuer is the manufacturer while the Sukuk holders are the buyers of the goods which are required to be manufactured. The certificate holders own the manufactured goods and bear risk of damage to the goods until they are sold to a third party. They are entitled to the sale price of the product. Istisna Sukuk are quite useful for financing large infrastructure projects. A financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialized firm. These Sukuk have no secondary market.

4.7 Hybrid Sukuk

In a hybrid Sukuk, the underlying pool of assets can comprise of Istisna, Murabaha and Ijarah. Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds and diversification of asset class risk. Since Murabaha and Istisna contracts cannot be traded on secondary markets as securitized instruments, at least 51% of the pool in a hybrid Sukuk must comprise of Sukuk tradable in the market such as Ijarah Sukuk.

5. Analysis of Sukuk from a Finance Standpoint

Cakir and Raei (u.d) showed empirical evidence using the delta-normal approach and the Monte-Carlo simulation that Sukuk are different types of instruments than conventional bonds, as evidenced by their different price behavior. They argued that if an investor is ready to allocate certain amount of funds in the bonds of a certain issuer, diversification by including Sukuk in the investment portfolio could significantly reduce the portfolio's VaR compared to a strategy of investing only in conventional bonds of that issuer.

Although international issues of Sukuk are similar to conventional bonds when it comes to such features as rating, issuance and redemption procedures, coupon payments, and default clauses, correlations of Sukuk returns with returns on conventional bonds are much smaller than the correlations of returns on conventional bonds with each other. If an instrument is not perfectly correlated with other assets in the portfolio, by definition one should expect some reduction in VaR. Indeed, part of the reduction in VaR in their study was due to the benefits gained from diversification through simply adding another instrument to the portfolio with a different duration. Nevertheless, the reduced VaR was not just due to the inclusion of an extra instrument in the portfolio but rather is a result of the very different behavior of Sukuk prices in the secondary market compared to conventional bonds. The authors further substantiated their findings by quoting that in the case of Bahrain, where Sukuk and conventional bonds have similar durations, the correlation of returns is still close to zero.

Wilson (2008) noted that the use of LIBOR in Sukuk pricing is not preferable as argued by Islamic scholars as well. He suggested that Corporate Sukuk could be benchmarked against indicators relating to the performance of the companies being financed. He argued that share prices would be an inappropriate indicator, as this would blur the distinction between Sukuk securities (akin to debt and yielding fixed and regular income) and equity investment. However, he proposed that the use of dividend or profit indicators would be entirely appropriate, which could be the basis for a new type of Sukuk based on a Musharakah partnership structure (which is one of the most preferable and distinctive Islamic underlying asset among Islamic scholars). He further noted that Sovereign Sukuk could be priced using monetary indicators such as Nominal GDP.

Armen (2008) analyzing the challenges facing the growth of Sukuk explained that lack of standardization, higher costs and structuring complexities are some of the key challenges faced by the Sukuk market. He proposed the creation of an authentic third party that acts as an Islamic clearing agent and fulfills the role of an independent central Islamic trustee that could be used by many issuers.

Working on a behavioral finance perspective, Christophe & et al. (2010) used a market-based approach to investigate whether investors react differently to the announcements of issues of Sukuk and conventional bonds and found that the stock market is neutral to the announcement of conventional bonds. Nevertheless, they observed a significant negative stock market reaction to the announcement of Sukuk. They explained this different stock market reaction using the adverse selection mechanism, which favors Sukuk issuance by lower-quality debtor companies. They concluded by saying that differences exist between Sukuk and conventional bonds because the market is able to distinguish among these securities.

6. Controversy in Sukuk

The controversy regarding Sukuk got heated up when Maulana Taqi Usmani critically commented on unscrupulous Sukuk issuance. Maulana Taqi Usmani is reported to have said that 85% of the Sukuk issued worldwide are unislamic. (Source: BBC News, December 11, 2009).

Aldrin (2010) cautioned that due to the absence of appropriate Sukuk pricing model, industry currently uses same pricing benchmark for both conventional and Sukuk Islamic bond i.e. LIBOR. Hence, high correlation between the two instruments is no surprise; rather it must be a signal for industry to make a distinctive benchmark for itself.

Andreas & et al. (2008) critically analyzing industry practices in Sukuk argued that compared to the replication efforts made, less research and efforts were made on how to innovate and develop purely Shariah based products.

Shaikh, Salman (2010) analyzing the tendency of proponents of Islamic finance who argue that the demise of financial institutions in developed markets was due to excessive securitization wrote:

“But, securitization in Islamic finance is also possible and is used frequently in recent times. The argument that Asset backed nature of financing would ensure effective risk management is also weak as CMOs, MBS, ABS etc were instruments with mortgage loans as their underlying assets. The problem was with excessive leveraging and lax regulation and not with securitization per se. Securitization in Islamic finance as in Sukuk also suffered a setback in Dubai Crisis in 2009/10. Asset backed financing also lacks the potential to provide need based loans for education, marriage, financing to pay short term debt, salaries, other accrued expenses to 3rd parties etc." (p. 152)

7. Future Outlook for the Sukuk Islamic Bonds

Global Sukuk sales are expected to reach $25-27 billion in 2010 compared with $23.3 billion in 2009. Fear of a double dip recession and fiscal chaos in euro zone bode negatively for global Sukuk issuance going forward. Rising Sukuk defaults, debt restructuring difficulty in Dubai and lack of liquidity in some financial markets is also hampering in growth in issuance. Global sales stood at $34.3 billion in 2007, $14.9 billion in 2008 and improved to 23.3 billion in 2009. UAE and Malaysia are still the two main countries of Sukuk issuance. Massive infrastructure projects in the Gulf are going to require huge amounts which could be financed through Sukuk issuance. Banks can also tackle maturity mismatch between liabilities and assets through the issuance of Sukuk.

Governments facing fiscal imbalances can also opt to issue Sukuk as the Government and sovereign issuances dominated the majority of the amount raised in the first half of 2010, with around $17.2 billion raised through issuance of Sukuk comprising 71% of the total amount raised.

The emergence of Sukuk Islamic Bond in the financial markets heralds a new era which can provide much needed financial stability and mitigation of risk in these arduous times.

With advent of Sukuk in the financial world, the market players have got a new option to invest into this asset which hold considerable value and benefit for all. This bond promises to all investors an equitable return which is justifiable and above all safe for the strategic investment purpose.

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