Ṣukūk: An Overview

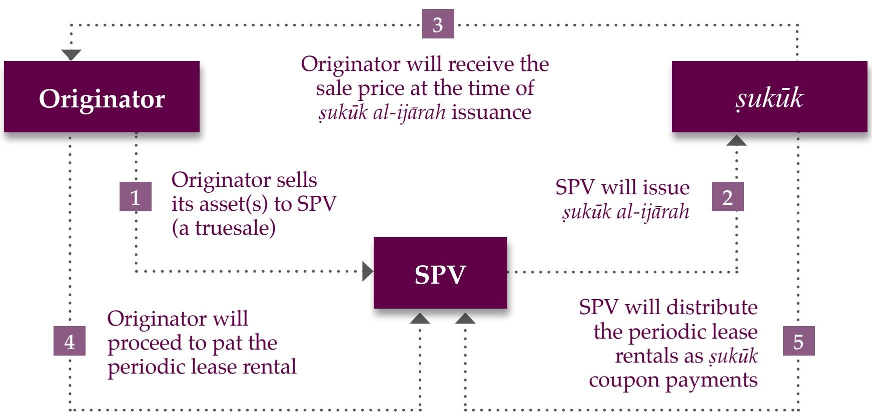
By Shabana M. Hassan
Researcher, ISRA

The development of *ṣukūk*, though recent, has progressed spectacularly. The first-of-its-kind ṣukūk was initially launched in the year 2000 at the 11th Islamic Development Bank Annual Symposium. The main reason for the issuing of the ṣukūk at that time was to assist both sovereigns and corporates to have an access into the Islamic capital markets. From then onwards, it has been widely accepted that the ṣukūk industry has emerged as one of the main apparatuses of the Islamic financial system and has increasingly become an essential subset of the international financial system. Over the years, the ṣukūk market has grown by 10% to 15% annually to reach an estimate of USD 100 billion, and it contributed to 12% of the global Islamic finance assets in 2009. For 2010, the general market anticipated the global ṣukūk issuance reaching an estimated USD 30 billion, especially with more prospective issuers being anticipated including potential debuts from Europe, Japan, Thailand and the emerging economies.

Ṣukūk, also known as Islamic bonds, are more accurately termed 'Trust Certificates' or 'Participation Securities'. Through *ṣukūk* the investor will be awarded a share of an asset along with the cash flows and risk that correspond with such ownership. (This definition is more suitable for "asset-backed" *ṣukūk*.) *Ṣukūk* can also be defined as transferable certificates signifying a share in the ownership of assets or business endeavours that enable the *ṣukūk*-holders to receive periodic fixed returns and full redemption at the date of the *ṣukūk*'s maturity. Interestingly, *ṣukūk* are not a new creation of the Islamic finance industry. Instead, the notion of *ṣukūk* has been a part of the Islamic world since the early inception of Islamic civilisation. This is evidenced in Imam Malik's work *al-Muwaṭṭa'*, in which he recorded the first historical account of *ṣukūk* being used as a tradable instrument during the Umayyad period.

However, contemporary *ṣukūk* structures have certainly evolved over time, with accompanying controversies over Sharī'ah issues. The evolution has progressed from "asset-backed" to "asset-based" and on to "asset-light" *ṣukūk* structures. These structures, along with their attendant Sharī'ah issues, will be further highlighted here. In an asset-backed *ṣukūk*, in the event that the issuer defaults or becomes insolvent, the *ṣukūk*-holders would be able to mitigate their exposure by taking charge of and ultimately realising the value from the asset(s). However, the approach differs in an asset-based *ṣukūk*. In this scenario, the *ṣukūk*-holders have no special rights over the asset(s). Instead, they rely solely on the creditworthiness of the originator for repayment, either from its refinancing abilities or derived from its internal resources. In the case of asset-light *ṣukūk*, they are structured based on the concept of *khulṭah*, where the Sharī'ah-compatible component is combined with the non-Sharī'ah-compatible component in a single portfolio, and the entire portfolio can then be sold at some price. This concept of *khulṭah* has been further adapted based upon a more liberal view of some Ḥanafī scholars. No fixed percentage or quantity has been allocated; instead, it has been left to be decided on a case-by-case basis. With this liberal view being adopted, there are even some occasions where the non-Sharī'ah-compatible component comprises more than 49%, yet the product is still being called wholly Sharī'ah compatible. However, most Sharī'ah scholars agree that the proportion of the Sharī'ah compatible component should be higher than the non-Sharī'ah compatible component. Thus, *ṣukūk* structures have become steadily diluted as more liberal interpretations of Sharī'ah standards were adopted in the structures. This approach that is becoming manifest with continuous developments on *ṣukūk* may pose future danger to the sustainability of the Islamic finance industry.

The first development of *ṣukūk* structure, i.e., asset-backed *ṣukūk*, evoked relatively few Sharī'ah issues, as elements of securitisation like true sale, bankruptcy remoteness, and enforceability of security are present. A simple illustration of the *ṣukūk al-ijārah* structure is provided below.



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In the structure illustrated above, the Special Purpose Vehicle (SPV) will sell back the asset(s) to the originator at the original sale price (not the market or fair value) upon maturity. With that, the asset(s) will then be returned back to the originator. Although this ṣukūk structure is found to be clear and concise, several challenges may arise in the issuance of this type of *ṣukūk*. The major challenge is a deficiency of suitable assets for the underlying *ijārah* transactions. In September 2001, Bahrain became the pioneer country to test the ṣukūk waters by proposing the inaugural *ṣukūk al-ijārah* in its domestic market. Ever since then, the composition of government Islamic local currency instruments has steadily increased vis-á-vis the conventional local currency instruments. In the first half of the year 2010, the Bahraini government's Islamic instruments represented 45.2% of the total public debt, a tremendous increase of 21.6% from 2001. However, the Bahrain inaugural *ṣukūk al-ijārah* was not listed, rated or cleared through any clearing house. This is because its *ṣukūk* documentation did not comply with the international bond standards. The Bahrain *ṣukūk al-ijārah* was then left to be subscribed by the domestic investors only.

This and other major legal constraints led to the movement towards asset-based *ṣukūk*. Under the revised *ijārah ṣukūk* structure, in order to comply with the Sharī'ah requirement of asset ownership under the *ijārah* principles, the *ṣukūk*-holders must be able to attain beneficial ownership of the asset(s) assumed through the *ṣukūk* trustee. However, in case of a default by the originator, the *ṣukūk* trustee's sole recourse to the asset(s) would be to dispose it to the originator only and not to any other third party. The *ṣukūk* trustee will then proceed to seek payment from the originator. Once this has been established, the *ṣukūk*-holders under the purview of the law would be deemed as unsecured creditors. Although the *ṣukūk* has underlying assets that are interpreted as affirming its compliance with the Sharī'ah, the underlying asset(s) only function in the structure is to provide it with the seal of Sharī'ah compliance. There is no establishment of a 'True Sale' securitisation as there is no association in the income streams with the actual rental and market value of the asset(s). This structure, which is deemed as the next best alternative solution in the present usage in the Islamic banking industry, is viewed by many as non-ideal as it raises queries about real adherence to the Sharī'ah.

The latest evolvement in the *ṣukūk* structure has been the development of the "blended-assets" *ṣukūk*, also known as asset-light *ṣukūk*. Due to an insufficient amount of appropriate physical assets(s), which are needed to act as the underlying asset(s) for the *ijārah-ṣukūk* structure, a new structure based on the concept of *khulṭah* was recommended. In this new proposed structure, a certain proportion of both Sharī'ah-compatible and non-Sharī'ah-compatible components will be packaged together and sold as a single portfolio at a certain price. The viability of this blended-assets *ṣukūk* structure was tested by the Islamic Development Bank (IDB) in 2003. Due to the overwhelming response it received from the market, IDB then debuted another blended-assets *ṣukūk* structure. However, a more liberal view of the *khulṭah* principle was adopted this time. An illustration of views of Sharī'ah scholars on the permissible ratio of the non-Sharī'ah-compatible component in the blended-assets *ṣukūk* structure, as adopted by IDB, can be found below.

As illustrated below, with the passage of time, a more and more liberal view on the *ṣukūk* structure was adopted. Sadly, adoption of this liberal view will not help move the *ṣukūk* industry towards the right direction. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in February 2008 effectively banned the *ṣukūk* structure based on blended-assets after analysing the various controversial Sharī'ah issues it raises. However, AAOIFI's ban has not been taken into serious consideration due to its lack of clarity, poor drafting, and insufficient evidence.

The future demise of the blended-assets *ṣukūk* is highly recommended and needed to ensure the future survival of the global *ṣukūk* industry. Even though the AAOIFI ban has not been taken seriously by many parties, it is hoped that it will at least call attention to the importance of shifting the market away from the blended-asset *ṣukūk* innovations. Most of the successful *ṣukūk* issuances have been asset-based, not asset-light. Even though the former may not be the best form of *ṣukūk*, it is still a much more viable and attractive option as compared to the latter. Asset-based *ṣukūk* may also act as a platform in helping the industry to move towards a Sharī'ah-based financial system. Although the *ṣukūk* industry has achieved spectacular developments so far, the reality is that it is still at its embryonic stage. Therefore, the future path has to be clearly oriented in the right direction. Shifting away from asset-light *ṣukūk* is one of the possible solutions.

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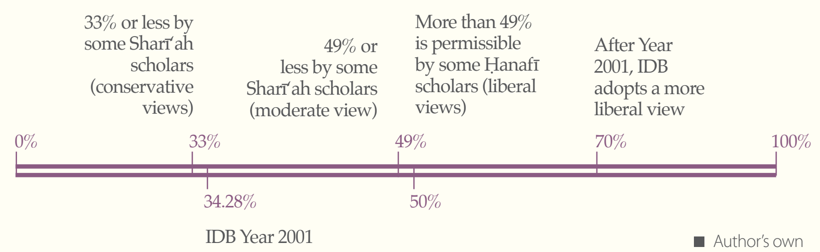
Non-Sharī'ah-Compatible Component



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