

INTRODUCTION TO IJARAH SUKUK: CURRENT STRUCTURES AND FUTURE PROSPECTS

Salman Syed Ali

(An extract from Salman Syed Ali (2005) "*Islamic Capital Market Products: Developments and Challenges*" Section 3.2, Jeddah: Islamic Research and Training Institute, Islamic Development Bank)

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3.2 IJĀRAH-ŞUKŪK:

Ijārah-şukūk are the latest product in the market that is rapidly gaining ground in the capital market. It has emerged as a different asset class among the Islamic financial products. It has gained acceptance among *Sharī'ah* scholars and high in demand by large investors and Islamic financial institutions. On the supply side, many governments have found it useful to raise funds for their fiscal needs and long-term financing of big projects. Corporate entities are also finding it useful to generate funds for their project specific needs. Initially, the cost of issuance was very high because of uncertainty of the untried product, large documentation requirements, rating expenditures, and various fees such as legal, underwriting, and investment banking services required in the issuance process. However, these expenditures have since come down because *ijārah-şukūk* has become a replicable product. Each new *şukūk* now is copy of the previous one with some changes to suit the needs of the issuer or the nature of the market.

The idea of *ijārah-şukūk* in the form of asset-*ijārah*-bonds was first proposed by Monzer Kahf in his various writings culminating in his important paper "The Use Of Assets *Ijārah* Bonds for Bridging the Budget Gap" published in *Islamic Economic Studies* as well as in Ahmed and Khan (1997) edited *Islamic Financial Instruments for Public Sector Resource Mobilization*. Usefulness of asset-*ijārah* bonds in long-term financing of non-revenue generating public projects was also suggested in *IIIE's Blueprint of Islamic Financial System* (1999) that was presented to the Shariat Appellate Bench of the Supreme Court of Pakistan during its deliberations on judgment on *ribā*. In the same publication ideas on some other forms of *şukūk* were also presented. However, the practical issuance of the *ijārah-şukūk* is the result of two factors. The first factor was the birth of the concept which was within *Sharī'ah* parameters and a forceful presentation of its viability as developed in the literature that has been cited above. The second factor had been the rise of the use of asset securitization in the financial markets. The concept of securitization had gained currency in 1980s in the conventional finance and by early 1990s it

had already been utilized in various structured financing deals by Islamic investment banks in the context of partnerships or projects however, not in structured *ijārah* finance. Because of such experience, both the finance professionals in Islamic banks and the *Shari‘ah* scholars were familiar to some extent with the securitization concept and its practical requirements. Thus the concept of asset-*ijārah* bond and the familiarity with operational details of asset securitization resulted in development of *ijārah-ṣukūk*.

There are some useful legal and economic characteristics of *ijārah* contract that distil into its securitization in the form of Asset *Ijārah* Bonds. It provides flexibility of sale and ownership of the underlying asset without affecting its *ijārah* contract, independence from synchronization of usufruct and payment flows, flexibility in setting the rent, its term, combination with other contracts, and initiation of the contract without the asset in place.

Legal and Economic Features of *Ijārah* contract and Asset *Ijārah* Bonds¹

<p>Asset <i>Ijārah</i> Bonds (AIB) Definition: “The AIBs are securities of equal denomination for each issue, representing physical durable assets that are tied to an <i>ijārah</i> contract as defined in the <i>Shari‘ah</i>”.</p>
<p>Economic features of <i>Shari‘ah</i> nominate <i>Ijārah</i> contract:</p> <ol style="list-style-type: none"> 1. Flexibility of sale: <i>Ijārah</i> contract in <i>Shari‘ah</i> does not restrict the right of lesser to sell the leased asset. 2. Independence of ownership: Persons who share the ownership of a leased asset can dispose of their property by, say, selling it to new owners individually or collectively as they may desire. 3. Flexibility in timing of inflows and outflows: It is not necessary that the flow of usufruct benefits should coincide with the timing of rent payments. 4. Flexibility in initiation: <i>Shari‘ah</i> does not require that the asset-subject of <i>ijārah</i> contract, should be in existence at the time of the contract. 5. Flexibility in length of term: The <i>ijārah</i> contract can be of any length as long as the asset which is the subject of the <i>ijārah</i> contract remains in existence and renders its usufruct. 6. Flexibility in determination of rent: In an <i>ijārah</i> contract, it is necessary that rent must be known. But it can be determined by a variety of flexible ways.

¹ Summarized from Kahf (1997).

7. Possibility of hybrid with *wakālah*: An *ijārah* contract is open for combination with the *wakālah* contract.
8. Restriction on liability for maintenance: Maintenance expenditures related to the basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be taken care of by the lessee.
9. *Ijārah* contract is amiable to securitization in the form of a bond. The idea of an *ijārah* bond stems from the ability of transforming leased assets into financial assets.
10. Decision No.5 of the 4th Annual Plenary Session of the OIC *Fiqh* Academy, held in Jeddah 18-23/6/1408H (6-11/2/1988G), asserts that (a) any combination of assets can be represented in a written note or bond, and (b) this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts. Furthermore, the decision clearly mentions that assets that can be grouped together for the purpose of securitization may consist of any combination of the following four types of assets:
- i) physical assets,
 - ii) financial rights (such as the usufruct in *ijārah*),
 - iii) interpersonal debts, and
 - iv) money.²

3.2.1 Structure of Existing *Ijārah Şukūk*:

There are different variants of *ijārah-şukūk* but a generic structure is as depicted in figure-1. There are three parties to the structure: the originator or (beneficiary) of *ijārah-şukūk*; the Special Purpose Vehicle (SPV) the issuer of *ijārah-şukūk*; and the investors (*şukūk* holders). A single or a group of assets that are admissible for *ijārah* contract are selected. The beneficiary (initiator) creates a Special Purpose Vehicle (SPV) [or Special Purpose Entity SPE] with separate independent legal personality to whom it sells the asset(s) with the understanding that the beneficiary will lease

² The OIC Islamic *Fiqh* Academy *Resolutions and Recommendations*, pp. 60-63. The above mentioned resolution requires that if the majority of securitized assets is in the form of money and debts, the negotiability of the representing security must follow the rules of currency exchange and transfer of debts as known in *sharī'ah*. This essentially means that debts and money can only be exchanged at a price equal to their face value.

back the asset from the SPV³. Rent is negotiated and a term specific lease contract is signed.⁴ The SPV then securitizes its assets by issuing *ijārah-ṣukūk* for sale to investors. These are certificates of equal value representing undivided shares in ownership of tangible assets. The *ṣukūk*-sale proceeds provide funds to SPV to pay for the asset(s) purchased from the beneficiary (originator). A rent-pass-through structure is adopted by the SPV to pass on the rents collected from the originator-cum-lessee to the *ṣukūk* holders. These returns along with low risk and exit possibility through secondary market (liquidity) constitute the incentives for investors to buy the *ṣukūk*.

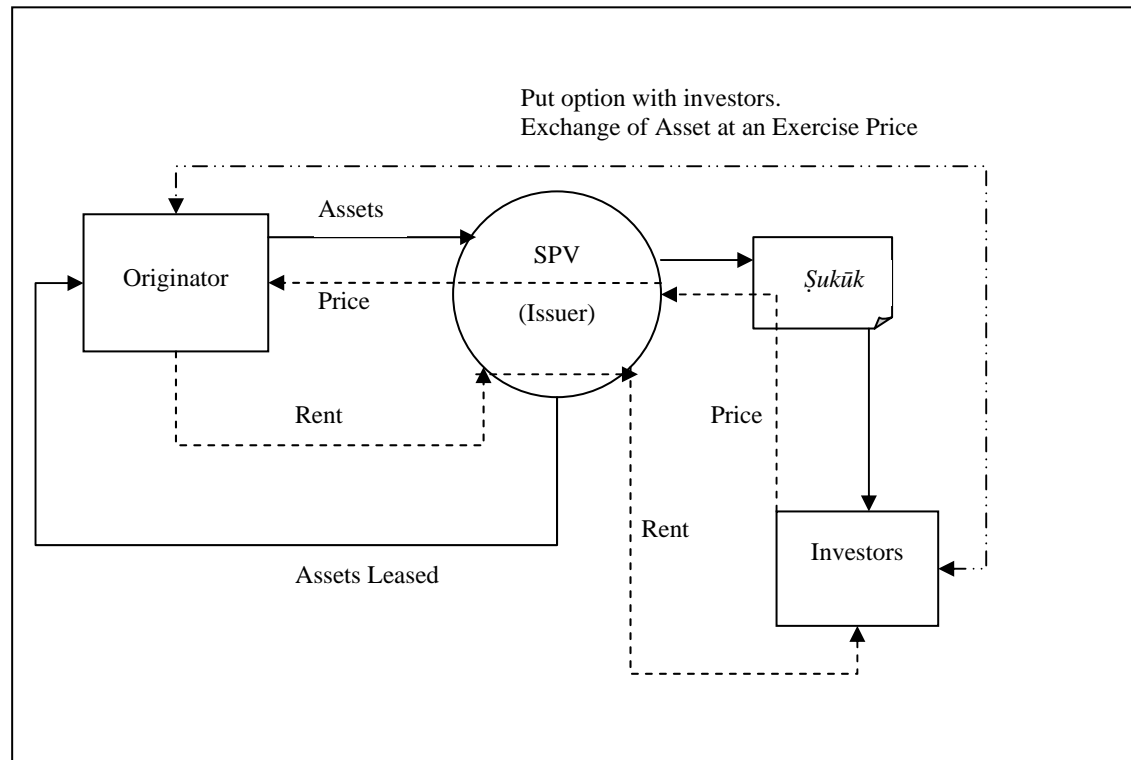
At the expiry (or termination) of the lease deed the flow of rents would stop and ownership of the asset pool would be with the *ṣukūk*-holders as a group. If the underlying asset has a market value the *ṣukūk*-holders can realize capital gain (or loss). However, if the underlying asset is a public good or if it has no ready market then the *ṣukūk*-holders are certain to incur capital loss. This would either discourage investment in *ṣukūk* or raise the cost of finance for the originator. Likewise, sometimes the originator is not interested in permanently parting away with his assets. Or the asset in question has strategic value to the *ṣukūk* originating governments. In these cases the supply of *ijārah-ṣukūk* will be discouraged. Therefore, to close the *ijārah-ṣukūk* structure with features attractive for both supply and demand the *ṣukūk* contract embeds a put option to the *ṣukūk*-holders that the originator is ready to buy the *ṣukūk* at their *face value* on maturity or dissolution date. However, there is a *Sharī‘ah* objection to this last arrangement. As per AAOIFI *Sharī‘ah* standard no. 17 para5/2/2

“In the case of negotiable *ṣukūk*, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however, it is not permissible for the issuer to undertake to purchase the *ṣukūk* at their nominal value.”

³ *Sharī‘ah* scholars in general are of the opinion that these two contracts (sale and *ijārah*) should be independent of one another. They accept the combination as long as they are legally two different contracts, however in substance they are interdependent. AAOIFI *sharī‘ah* standard no.9 (paragraph 9/8/8/1) on *Ijārah* calls for complete independence of the two contracts.

⁴ The *ijārah-bi-ḍimmah* contract can be signed between SPV and the beneficiary even before the sale of asset to the SPV.

Figure-1 Structure of a generic *Ijārah-Şukūk*



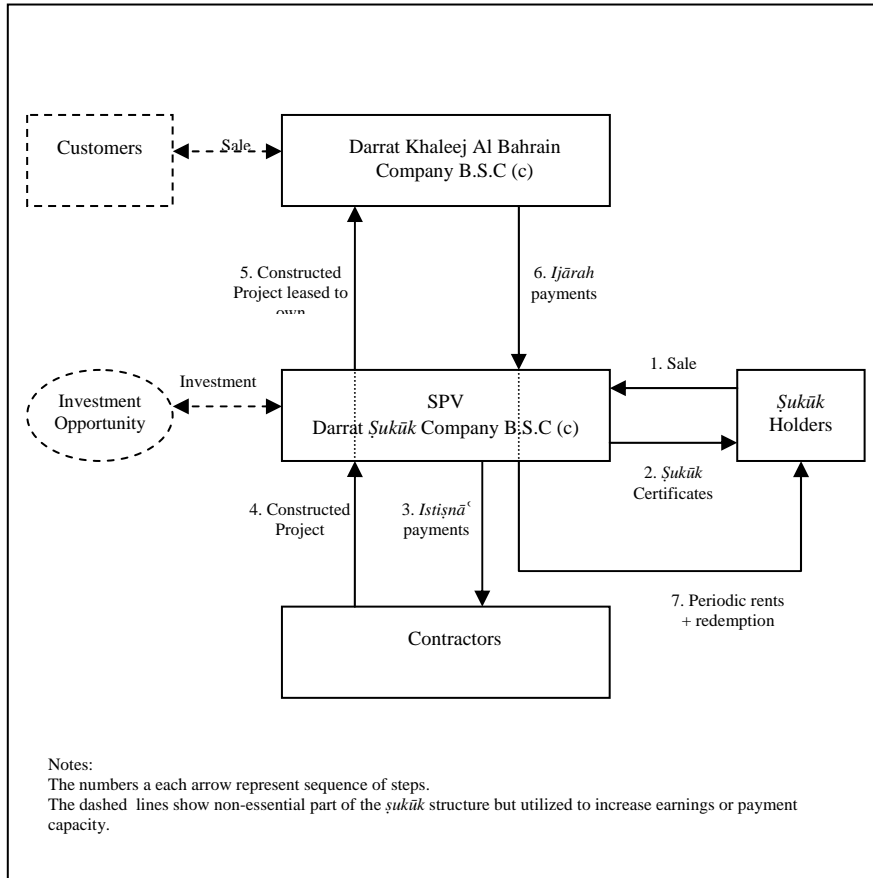
Most *ṣukūks* issued so far are similar to each other in their structures, however some are quite different in utilizing *ijārah*, *istiṣnāʿ* and *murābaḥah* to suit the needs of the originator. In the following we briefly discuss three such other structures:

1. **IDB *Ṣukūk*:** These *ṣukūks* are innovative in isolating and defining the underlying asset. The underlying asset of IDB *ṣukūk* is not a particular physical asset but a pool of real and financial assets; comprising of leased assets (*ijārah*)⁵ and receivables from *murābaḥah* and *istiṣnāʿ* contracts. Such that the portion of leased assets is dominant (more than 50 per cent) in the total asset pool separated for the *ṣukūk* issue. Dominance of non-financial assets make its *ṣukūk* admissible for trade in secondary market.
2. **Caravan *Ṣukūk*:** These are *ijārah ṣukūk* against existing moveable property –rental cars and trucks- and securitizes their receivables for the rent-a-car company. The innovative part is the use of IT technology to link the earnings from each automobile in the fleet to the rent passed through to the *ṣukūk* holders. Another distinguishing aspect was involvement of cross-border parties in issuance. The issuer and the underlying assets were in different countries.
3. **Darrat *Ṣukūk*:** These are innovative in several aspects. These are *ṣukūk* against assets which do not exist at the time of securitization. A combination of *istiṣnāʿ* and then *ijārah* is used in the structure of the contract to first create the asset and then to rent it back to the originator. There are four parties to the contract: originator, SPV, *ṣukūk* holders, and construction contractor. The lease contract employed between the SPV and the originator is the lease-ending-with-ownership of the originator (*ijārah muntahī bi-tamlīk*) contract. The proceeds of rents and by-out price instalments are passed on to the *ṣukūk* holders. The *ṣukūk* are initially pure debt hence not tradable until physical asset is created through *istiṣnāʿ* and delivered to the SPV. Further, the construction project is broken into several portions/segments/phases with separate *istiṣnāʿ* and the *ijārah* contracts for each portion under a master agreement, which generates an early income stream for *ṣukūk* holders and also enables the secondary market tradability of the *ṣukūk* as the project

⁵ Leased assets whose ownership was with the IDB at the time of sale of the asset pool to the SPV.

progresses. Lastly, the surplus cash proceeds of *ṣukūk* sales with the SPV waiting for *istiṣnāʿ* payment in the queue will be utilized in commodity *murābahah* and the earnings will become part of the *ṣukūk* capital.

Figure-2 *Istiṣnāʿ* based *Ijārah Ṣukūk* (Example of Darrat *Ṣukūk*)



3.2.2 Other forms of *Ṣukūk*:

Ijārah ṣukūk are only one form of investment *ṣukūk*, other forms and their variants are also possible. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its *Shariʿah* standard no. 17 has defined 'investment *ṣukūk*' as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment

activity, however this is true after receipt of the value of *ṣukūk*, the closing of subscription and the employment of funds received for the purpose for which the *ṣukūk* were issued.” The standard gives example of fourteen different types of investment *ṣukūk*:

1. Certificates of ownership of leased assets (*ijārah ṣukūk*)
2. Certificates of ownership of usufruct:
 - (i) of existing assets
 - (ii) of described future assets
 - (iii) of services of specified party
 - (iv) of described future services
3. *Salam* certificates
4. *Istiṣnāʿ* certificates
5. *Murābaḥah* certificates
6. *Mushārah* certificates
 - (i) Participation certificates
 - (ii) *Muḍārah* certificates
 - (iii) Investment agency *ṣukūk*
7. *Muzāraʿah* (share cropping) certificates
8. *Musaqāh* (irrigation) certificates
9. *Mughārasah* (agricultural/seed planting) certificates

Most of them are *Sharīʿah* admissible for trade in secondary market except the *salam*, *istiṣnāʿ*, and *murābaḥah* certificates; and in some particular cases of *muzāraʿah* and *musaqāh* certificates when certificate holder does not own the land.⁶

This shows that there is no dearth of possibilities in creating financial instruments suitable for capital markets. However, it would not be a good strategy of product development to try to replicate each product of conventional finance by stretching *Sharīʿah* principles. The philosophies of the conventional and Islamic system of finance are not the same therefore the financial instruments are bound to differ in their emphasis. A better approach is to design *Sharīʿah* compatible products according to the current and future needs of the market, keeping in view the objectives of Islamic financial system and a plan for the future market structure.

3.2.3 Current Size of *Ijārah* based *Ṣukūk* Market

At present *ijārah ṣukūk* are floated by governments as well as some corporate firms. These warrant separate discussion of the two.

⁶ For details see AAOIFI Shariah standard no. 17 paragraphs 5/2/14 to 5/2/18.

3.2.3.1 Sovereign *Ijārah* based *Ṣukūk*:

There has been so far eighteen such *ṣukūk* totaling to US\$5.650 billion over a span of past three and a half years. These are issued by Bahrain, Dubai, Malaysia and its states, Pakistan, Qatar, and Saxony-Anhalt state of Germany. Almost all the sovereign *ṣukūk* are rated and they were rated as the rating of the country. It is note worthy that initial *ijārah ṣukūk* issued by Government of Bahrain were non-rated and they were meant for the local market. It was however Malaysia that took the lead in launching first Global *Ijārah Ṣukūk* (GIS) with international rating. For the *ijārah ṣukūk* to have global appeal and secondary markets in multiple jurisdictions it is necessary that they follow some common standard in design, *Sharī'ah* validation rules, and investor protection. In order to provide a wider *Sharī'ah* acceptance to this issue Malaysia did not structure it on the usual *Murābahah* or *Bay' Bi-thaman Ājil* (BBA) principles commonly used in Malaysian domestic market but used the *ijārah* structure.

There has been oversubscription of almost all sovereign *ijārah* based *ṣukūk*. Further, there is a tendency of their buyers to hold them till maturity. No secondary market trade of any *ijārah ṣukūk* has been witnessed so far. These facts show that the supply is far shorter than the demand for such *ṣukūk*. This also raises the question whether the price of these *ṣukūk* is right? Given the sovereign backing, attached guarantees of performance, and over-collateralization these *ṣukūk* probably could have been offered at much lower rates of return than currently offered and still could clear the market. We are experiencing a *ṣukūk* trap phenomenon—to coin a term similar to liquidity trap. Whereby the supply of more *ṣukūk* is not pushing the price of *ṣukūk* down because its buyer financial institutions are just hoarding the *ṣukūk*. That is there is almost infinite demand for *ṣukūk* at the offered rates.

Another thing to note is that the rating of sovereign *ṣukūk* of each country is same as the rating of conventional sovereign bond of that country. This shows that isolation of specific assets through the SPV structure has no significant net effect on the rating of sovereign *ṣukūk*. This is a logical outcome of the facts that in almost all cases (i) the rents payable to *ṣukūk* holders are not necessarily generated from the use of *ṣukūk* assets but from general revenues and other earnings of the state enterprises; and (ii) therefore what matters is the aggregate payback capacity of the government given its existing obligations, political stability and commitment to pay. Which is essentially the sovereign rating.

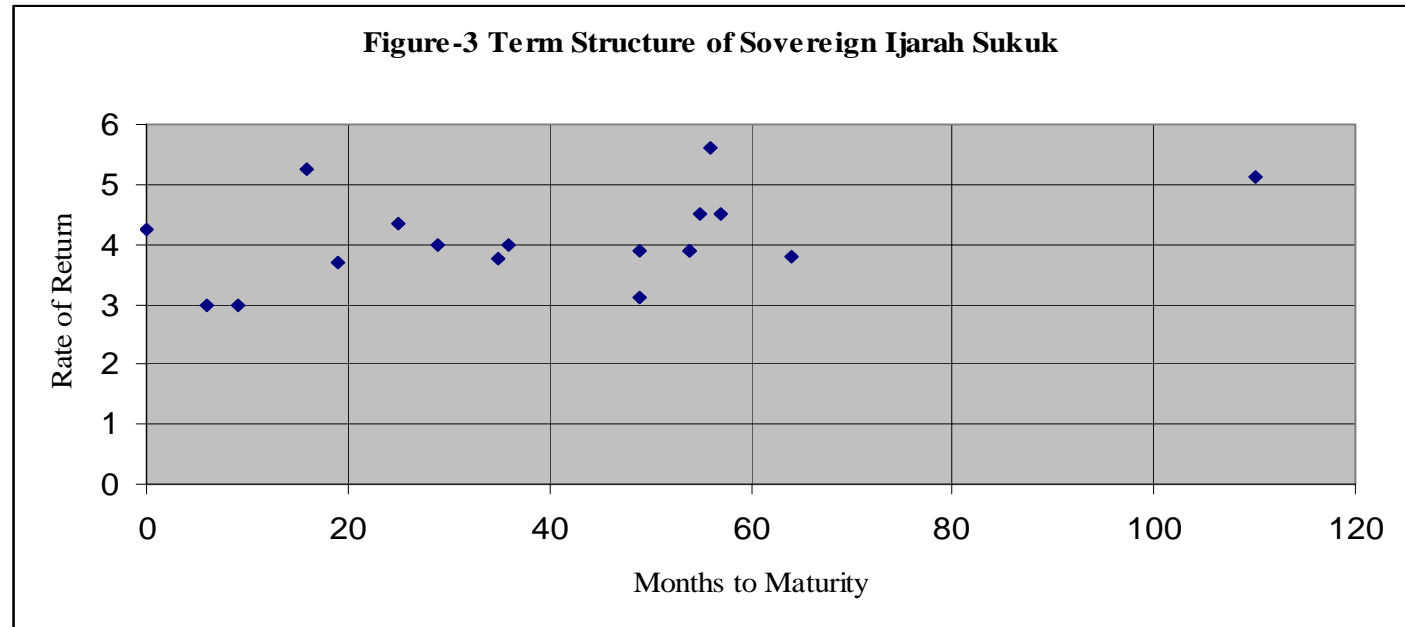
Table-6
Chronological List of Sovereign *Shukūk*

Issuer	Issue Date	Issue Size (Source currency MM)	Issue Size (US\$'MM equivalent)	Margin or Return	Tenor	Rating /Listing	Comments
Govt. of Bahrain - BMA	February 2005	BD 45	119	4.5% fixed	5 Years	S&P: A / Bahrain Stock Exchange (BSE)	Oversubscribed by 50%
Pakistan International <i>Shukūk</i> Co. Ltd. (Govt)	January 2005	USD 600	600	6m LIBOR + 2.2%	5 Years	S&P: B+ Luxembourg SE	Initial issue was for USD500 mil. Oversubscribed by 233% (USD 1.2 billion) M-East 47%, Asia 31%, & Europe 22%
Sarawak Corporate <i>Shukūk</i> (Govt)	December 2004	USD 350	350	6m LIBOR + 1.1%	5 Years	S&P: A- /	Three times oversubscribed
Dubai Global <i>Shukūk</i> (Govt)	November 2004	USD 1000	1,000	6m LIBOR + 0.45% /	5 Years	Govt. rating applicable	-
Dubai Civil Aviation (Govt)	November 2004	USD 1000	1,000	6m LIBOR + 0.45%	5 Years	Govt. rating applicable A2 implied	-

Govt. of Bahrain - BMA	July 2004	BD 40	106	5.125% fixed	10 Years	S&P: A- / Bahrain Stock Exchange (BSE)	-
Govt. of Bahrain – BMA	June 2004	USD 250	250	6m LIBOR + 0.45%	5 Years	S&P: A- / BSE, Luxembourg & Lubuan SE	Land Europe-offshore US 22%, Asia 12% &M. East 66%
Saxony-Anhalt State Properties (Govt) (Europe)	June 2004	Euro 100	145	EURIBOR + 1%	5 Years	S&P: AAA Fitch: AA /	-
Govt. of Bahrain – BMA	December 2003	USD 50	50	6m LIBOR + 0.30%	3 Years	S&P: A- / BSE	Oversubscribed by 60%
Government of Qatar	September 2003	USD 700	700	6m LIBOR + 0.4%	7 Years	S&P: A+ / Lubuan & Luxembourg SE	72% Middle East, 14% Asia, 13% Europe, 1% US offshore
Govt. of Bahrain – BMA	May 2003	USD 250	250	6m LIBOR + 0.60%	5 Years	S&P: A- / BSE	Airport Oversubscribed by 40%
Govt. of Bahrain – BMA	April 2003	USD 100	100	3.75% fixed	5 Years	S&P: A- / BSE	Oversubscribed by 13%
Govt. of Bahrain – BMA	February 2003	USD 80	80	3.00% fixed	3 Years	S&P: A- / BSE	-

Govt. of Bahrain – BMA	November 2002	USD 50	50	3.00% fixed	3 Years	S&P: A- / BSE	-
Govt. of Bahrain – BMA	August 2002	USD 80	80	4.00% fixed	5 Years	S&P: A- / BSE	Oversubscribed by 110%
Government of Malaysia Global <i>Ṣukūk</i>	June 2002	USD 600	600	6m LIBOR + 0.95%	5 Years	S&P: A- / BSE & Lubuan	Govt. property
Govt. of Bahrain – BMA	February 2002	USD 70	70	4.25% fixed	3 Years	Not Rated	Oversubscribed by 60%
Govt. of Bahrain – BMA	September 2001	USD 100	100	5.25% fixed	5 Years	Not Rated	-
Total Number of <i>Ṣukūk</i>	18		5,650				

Source: Liquidity Management Centre Website (with amendments and corrections by the author).



The Figure-3 shows pseudo term structure of sovereign *ijārah sukūk*. For the purpose of construction we assumed that:

1. sovereign rating of all *sukūk* issuing countries is the same, and
2. that all sovereign *sukūk* are available for investment to global investors.
3. For the floating rate benchmarked *sukūk* we used 6 month LIBOR= 3.408 and 6m EURIBOR=2.103 in May 2005.
4. Time to maturity is calculated from May 2005 on the existing *sukūk*.

3.2.3.2 Corporate Ijārah based Şukūk:

So far there has been eleven issues of *ijārah şukūk* by corporate and non-government sector institutions amounting to US\$1.601 billion. Except for the IDB *şukūk*, Ample Zone (Malaysia) *şukūk*, and Ingress (Malaysia) *şukūk* none have been internationally rated; and still all of them were oversubscribed. Unlike sovereign *şukūk* each of the corporate *şukūk* have some innovative structure differentiating it from the other. This shows not only the potential but viability of various other structures in the market.

Table-7
Corporate *Ijārah* based *Ṣukūk*

Issuer	Issue Date	Issue Size (Source currency MM)	Issue Size (US\$'MM equivalent)	Margin or Return	Tenor	Rating /Listing	Comments
IDB (Corporate)	April 2005	USD 500	500	Fixed rate	5 Years	S&P: AAA Fitch: AA /	1st stage of \$1BN program
Bahrain Financial Harbour (Corporate)	March/April 2005	USD 170	170	TBA	5 Years	Not rated	-
Durrat Al Bahrain <i>Ṣukūk</i> (Corporate)	January 2005	USD 152.5	152.5	3m LIBOR + 1.25%	5 Years	Not Rated	Oversubscribed by \$32.5 MM
Ample Zone Berhad (Corporate) (Malaysia)	January 2005	RM 150	39.5	6% - 9% fixed	2 – 7 Years	MARC: AAA MARC: AA MARC:A	-
First Islamic Investment Bank (Corporate)	October 2004	EURO 76	103	1.25% + EURIBOR	2 Years	Not Rated	General Corporate use Oversubscribed by €26 MM
Tajeer (Saudia) <i>Ijārah Ṣukūk</i>		USD 1.6	1.6	Floating 5% net IRR	2 years	Not listed	
Emaar (Corporate) (UAE)	July 2004	USD 65	65	6m LIBOR + 0.7%	5 Years	Not Rated	Initially the issue was for US\$50mm and then increased to \$65MM. Related to financing for commercial buildings.

Ingress <i>Ṣukūk</i> Barhad (Corporate) (Malaysia)	July 2004	RM 160	42.1	6.45% - 7.6% fixed	3 Years	MARC: A+	-
Caravan 1 Limited (Corporate) (UK)	March 2004	SAR 102	27.3	6% fixed	3 Years	Not Rated /	-
Tabreed (Corporate) (UAE)	January 2004	USD 100	100	6% fixed	5 Years	Not Rated / Luxembourg SE	-
IDB (Corporate)	July 2003	USD 400	400	3.738% fixed	5 Years	S&P: AAA Fitch: AA / Lubuan & Luxembourg SE	Initially issue was for US\$300MM and then has been increased to US\$400MM 1/3 of <i>ṣukūk</i> placed in UAE FI's – Others included central banks of Saudi, Bahrain, Pakistan, Qatar & Kuwait
Malaysian Global First Guthrie Co., (plantation company)**		USD 150		Floating reference rate on underlying <i>Ijārah</i>	5 years		
Total Number of <i>Ṣukūk</i>	11		1,601				

Source: Liquidity Management Centre Website (with amendments and corrections by the author).

** This *ṣukūk* is listed as *ijārah ṣukūk* in the literature (e.g. Tariq 2004) but the issue documents does not reflect such. Our understanding is that this is a *murābaḥa* based, not *ijārah* based, *ṣukūk*. Therefore, not counted in aggregation in last row.

3.2.4 Players (originators and holders)

Originators:

Most of the *ṣukūk* originators are governments while only few are originated by corporates. In terms of amount raised through *ṣukūk* the ratio is 3.5:1 between sovereign and corporate *ṣukūk*. The market is currently accessible for floatation to only very large companies owing to high costs of rating, contract documentation, investment banking and distribution fee involved in such issue.

Islamic banks are not among the *ṣukūk* originators, except two banks, including IDB. This is the case because a large proportion of the assets of Islamic banks are in short-term *murābahah* and *istiṣnā'* receivables. *Ṣukūk* against these assets, if issued, are not tradable at prices other than the face value. Thus *ṣukūk* option is not attractive to majority Islamic banks. Moreover, these banks have surplus liquidity.

IDB on the other hand possesses substantial tangible/tradable assets on its balance sheet. It also wants to increase its funding for expanding the developmental operations. The securitization of its tangible/tradable assets is therefore a suitable option for generating such funds.

Investment banking and other service providers in ṣukūk:

Most of the investment banking, underwriting, lead managing, and book making services for the *ṣukūk* are currently provided by Islamic banks in cooperation with conventional banks that have Investment banking arm and Islamic window operations. It is felt that there are only few full-fledged Islamic Investment banks.

Subscribers and investors in ṣukūk:

The subscribers of these *ṣukūk* are large financial institutions like central banks, private sector Islamic banks and non-bank financial institutions. These institutions are flush with surplus liquidity that does not have alternative places for parking. Therefore they tend to hold these *ṣukūk* dearly, so much so that no secondary market is forming in *ijārah ṣukūk*. Secondary market trade occurs due to heterogeneity in the nature, opportunities, information and beliefs/expectations of the players. Therefore, an alternate way to create a secondary market in *ijārah ṣukūk* is to increase its distribution to a wider class of investors by creating a special *ṣukūk* class for ordinary investors which the banks are not allowed to hold. Yet another way is to lower the returns on the *ijārah ṣukūk*.

3.2.5 Risk Factors of *Ṣukūk*

Ṣukūk carry certain types of risks and at the same time they also help in mitigating and managing other types of portfolio risks. *Ṣukūk* transform different kinds of assets and contracts into financial certificates therefore each *ṣukūk* structure can have different risk transformation properties which depends upon the type of underlying contracts; the nature and composition of underlying assets; and whether within or cross jurisdiction services are provide.

3.2.5.1 Risks in *Ṣukūk*:

For the purpose of analysis risks can be classified in various ways. In terms of their implication for the system it can be classified as systemic risk and idiosyncratic (firm specific) risk). In terms of the sources of risk it can be classified in various other components. Tariq (2004) discusses risks inherent in various kinds of *ṣukūk* structures which are summarized in Table-8. He classified risk according to its source as market risk (comprising of rate of return risk, foreign exchange risk, price risk); credit risk; and other risks (such as liquidity risk, *Shari'ah* compliance risk, and infrastructure rigidity risks).

In fact the *ṣukūk* risks depend on:

- a) Fixed or flexible return structure in the contract between issuer and investor.
- b) Nature of fixed or flexible rate contract between issuer and originator.
- c) Time to maturity.
- d) The composition and nature of the underlying asset.
- e) Put or call option given to the originator or the investor.
- f) Payment capacity of the originator or its guarantor.
- g) Tradability and liquidity of the *ṣukūk*.

The rate of return risk is faced in all fixed rate *ijārah ṣukūk* and affects the investor and originator in opposite ways. The severity of this risk is directly proportional to the change in market rents and the term to maturity of the *ṣukūk*. In case of flexible rate *ijārah ṣukūk*⁷ where the returns are tied to LIBOR, an increase in the benchmark rate will increase the payment obligations of the originator which may or may not be

⁷ A genuine *shari'ah* compatible flexible rent contract is essentially periodic revision or re-contract with revised rents combined with an exit opportunity to the lessee and the lessor (which ever is the effected party).

sustainable. This is more pronounced when the paying capacity of the originator depends largely on income from a pool of assets with substantial proportion earning fixed returns. For example, when the underlying assets comprise a substantial portion (say the maximum 49 per cent) of *murābahah*, and *istiṣnā'* contracts.

3.2.5.2 Risk Management Properties of *Ṣukūk*:

Ṣukūk also have risk management potential in various ways for the investor and the originator, some of these possibilities are listed below.

From the perspective of originator:

1. *Ṣukūk* mitigate liquidity risk of an otherwise illiquid asset.
2. If an SPV serves multiple originators by buying their individual isolated relatively small assets, pooling them and then securitizing the pool. It can reduce the cost of finance to the originators, mitigate the liquidity risk of their assets, and provide new source of funding for them thus reducing the funding risk. In this sense it works as a reverse bank: collecting fragmented investment opportunities consolidating them into a sizeable pool and delivering them to the providers of fund (investors) for investment.
3. *Ṣukūk* takes the assets off the balance sheet of the originator while providing it its use through *ijārah*. Therefore, if appropriate assets are isolated for securitization through *ijārah ṣukūk* it can, without loss of its use to the originator, serve as a tool for streamlining the balance sheet: by matching the assets and liabilities of the originator to minimize risk in maturity mismatch, currency mismatch risk, liquidity risk etc.

From the perspective of the investor:

1. If the underlying assets in the pool is denominated in terms of multiple currencies it reduces the foreign exchange risk of the investor.
2. Likewise, if the underlying assets are a pool of diversified assets (or have heterogeneous risk factors) then the diversification reduces the earnings risk of the investor particularly in case of *muḍārabah ṣukūk*.
3. As opposed to conventional bond the tradability feature of *ṣukūk* stems not from the rental returns that *ṣukūk* holder is entitled to but from the ownership in the underlying asset. This is an added protection which can enhance liquidity of *ṣukūk*. Moreover, the risk characteristic of rentals (a credit risk of the originator) may be different from the risk characteristic of the underlying asset in which *ṣukūk* holder possesses an undivided joint ownership. The

two risks may have different sensitivities to external factors which contribute to reduction of risk faced by the investor.

3.2.6 Advantages and Disadvantages of *Ṣukūk*

1. Increase the liquidity of the originator and investor. This will reduce risk premium in the other products of the capital market and hence contribute to lower cost of funding to entrepreneurs.
2. Increase the flow of funds to the securitized asset market
3. Can tap new and diversified source of funding through the capital market. Institutional investors and passive investors would find it more attractive.
4. Can help development of capital markets by allowing thinly capitalized market players who may have specialization in securitization and issuance to participate in the capital market.
5. With development of *ṣukūk* markets specialized issuers for different kinds of *ṣukūk* in different kinds of asset/contract pools will emerge which will again lower the cost of funding.
6. At the moment *ṣukūk* have become an avenue for parking of the excess liquidity available with Islamic banks. By this the buyers directly participate in some useful economic activity generated through their finance. The facility is for relatively long term with an option to exit at any time through secondary market. It is a better economic alternative than the commodity *murābaḥah* used by Islamic banks. In commodity *murābaḥah* the bank purchases some metal in bulk on spot payment from a metals exchange and sell these to another trader on deferred price marked-up by a percentage over the cost. This is a very inefficient way of earning on its liquidity by indulging in an trade that is neither needed by the bank nor by its client. It therefore has gross productive and allocative inefficiency.
7. The *ijārah ṣukūk* are limited use liquidity management instruments, at least until a large supply with periodic issuance becomes the norm and a secondary market in them develops. Because as opposed to commodity *murābaḥah* that (in vibrant metals and commodity market) can be initiated at the will of the Islamic bank the *ijārah ṣukūk* route has to wait until an issue is offered by the issuer. A way to develop *ijārah ṣukūk* based liquidity management instruments for Islamic banks is to offer some *ijārah*

ṣukūk series specially for the Islamic banks with periodic issues spaced at regular interval on or before maturity of each issue.

8. The initial structuring and issuance cost of *ijārah ṣukūk* at the moment is quite high. It requires a large size of isolatable assets, upfront legal, rating, and investment banking fee, as well as lots of documentation. Only large, credible, and more transparent institutions are so far able to participate in *ijārah ṣukūk* deals.

3.2.7 New Potential *Ṣukūk* Structures

Credit Enhancing Structured Ijārah Ṣukūk for Project Financing:⁸

As known and in practice, *ijārah ṣukūk* can be issued by a sovereign country on the basis of its own capacity to meet the obligations of rent, and the commitment to buy back the asset. If the underlying asset is marketable and productive enough to generate the rent obligation then the *ṣukūk* can be issued on more favourable terms and lower cost. Another way for a country to raise funds through *ṣukūk* is to use a third party guarantee of another country or a multilateral institution like Islamic Development Bank (IDB) to enhance the credit rating. Again lowering the cost of funds.

Islamic Development Bank (IDB) is mandated to contribute in the development needs of its member countries. For this purpose it has started issuing *ijārah ṣukūk* by isolating some of its assets. The objective of this securitization is to increase the pool of funds that the IDB will use to help finance development projects in its member countries through other Islamic modes of finance such as *murābahah*, *istiṣnāʿ*, and *ijārah*. In raising money by *ṣukūk* it is usually the better assets which are utilized; as their use can reduce the cost of funds. However, in *ijārah ṣukūk* process the same better quality assets of IDB get tied up for the duration until maturity. These assets are also taken off from its balance sheet until they are bought back. The funds raised indeed increase the liquidity of the bank but the *ṣukūk* process also increases the off-balance sheet commitments of the bank. Moreover, the composition and risk profile of the asset side will also change, more likely towards deterioration. Therefore, the *ṣukūk* issue process has its own limits, while the development needs of the member

⁸ The structure is proposed in Khan (2005). Other alternate structure based on *ṣukūk* on donated assets can also be found in that note.

countries are large. The funds issued by existing *ṣukūk* process are not earmarked for specific projects.

An alternative proposal for financing specific development projects in a member country is to use some good assets of the member country requesting finance, along with some assets of the IDB to form the asset pool of a SPV. This asset pool is securitization through *ijārah ṣukūk* for utilization of funds in that specific project.

This will have the advantage that (i) IDB will be able to spare some of its good assets from getting tied-up for long period. (ii) The member country asset will be securitized which may not be liquidate-able on stand alone basis at low cost. (iii) The member country will directly participate in the fund raising which will create better incentives to utilize the funds efficiently so as to pay the obligation and get back its assets.

Another way to achieve same goal is for the member country to first transfer some good quality unencumbered assets to the IDB balance sheet. The IDB then securitize it in a pool of its assets. Thus the *ijārah ṣukūk* is issued on the full balance sheet strength of IDB. This second procedure has all the advantages of the previous proposal with the addition that (iv) the credit enhancement role of IDB is further played out. Thus more cheaper funds can become available. However, the proposal hinges on sovereign members willingness to transfer some of their assets to IDB or to a SPV.

Other alternative structures are also possible on similar lines involving assets obtained on donation. For details the reader is referred to Khan (2004).

3.2.8 Development of Infrastructure for *Ṣukūk*

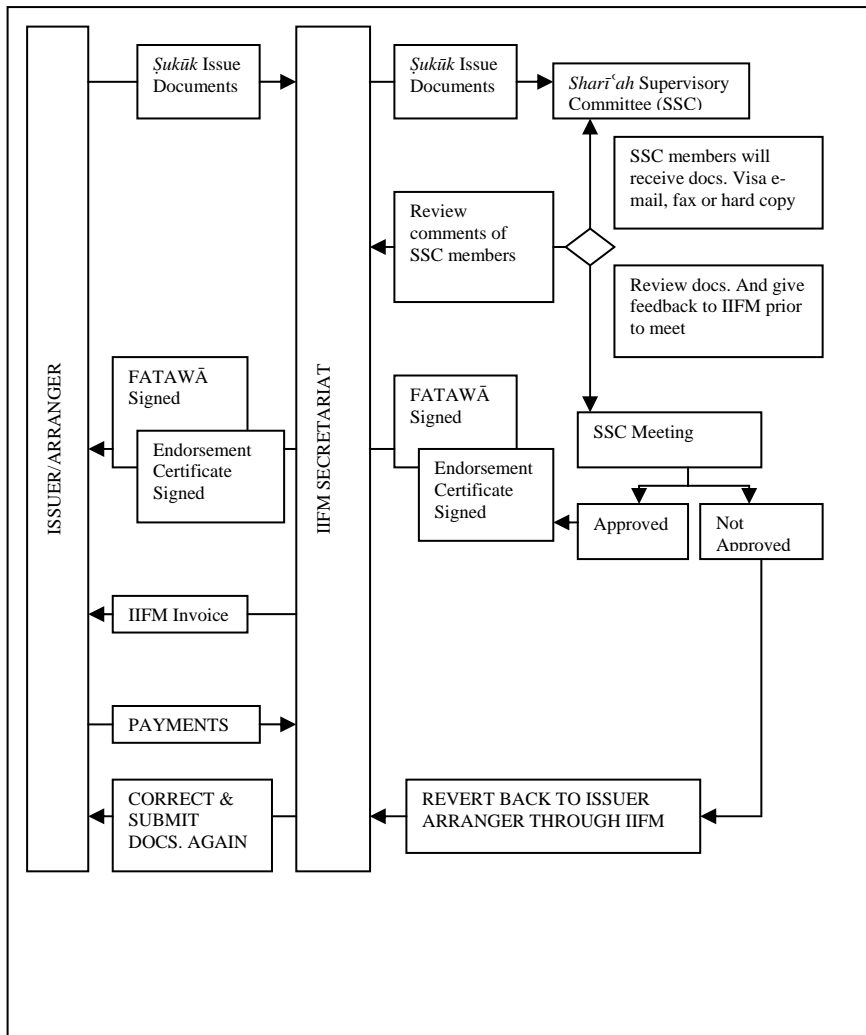
- There are complex legal and other infrastructure requirements for securitization of tangible assets through *ṣukūk*. These requirements further increase if securitization of usufruct or services is involved. In general, the laws must specify rights of each party, cover each stage of transaction, and enforcement must be strong. Some degree of standardization is needed in the underlying assets, its valuation process, rating process, *Shari'ah* approval process, and in the documentations that are required at each stage. Similarly, servicing standards have to be considerably standardized. These elements speed up the securitization process, save costs, help valuation of instruments,

avoid ambiguities, help coordinate the expectations that build confidence of all parties in the market and the instruments.

- In the context of currently available legal infrastructure for *ṣukūk* it may be noted that many steps involved in *ijārah ṣukūk* are covered by local laws in many of the jurisdictions that have issued *ṣukūk*. It is however the trust law (the law that covers the issuance and relation of the SPV with the originator) which is often chosen to be governed under English law as implemented in the jurisdiction of issue; which in most cases is a foreign market. A partial reason for this is the underdeveloped state of trust laws in the local market. Some degree of standardization is appearing in the structure of sovereign *ṣukūk* partially because it is a copy able product and one model is replicated by others. And also because the same set of investment banks and legal firms are involved as advisors and underwriters in most of the issues. However, given the few number of issuances, the contracts and processes at various stages of the *ṣukūk* issue have not converged yet.
- Importance of starting on the right foot in terms of product types, characteristics and standards for each type, and international acceptance.
- AAOIFI *Shari‘ah* standards for investment certificates cover *ṣukūks*. A positive development.

Shari‘ah supervision in *ṣukūk* issuance and monitoring overtime through its different stages is initiated by the originators. A positive step. For greater acceptability and investor confidence they are also involving *Shari‘ah* boards of other parties to the contract. For example, *Shari‘ah* board of the underwriters, of arrangers, as well as of institutional investors. This is also positive. A better and cost effective way will be to create shared institutions. One such *Shari‘ah* authentication institution is IIFM. Another step would be to streamline, standardize (not necessarily unify), and write out the *Shari‘ah* authentication and monitoring procedure. IIFM has done it as follows, and created a benchmark of practice.

Figure-4 IIFM *Sharī'ah* Authentication Process



Source: IIFM Website

3.2.9 *Sharī'ah* Issues in *Ijārah Sukūk*

Sharī'ah scholars have discussed *Sharī'ah* compatibility of various kinds of *sukūk*, including *ijārah sukūk*, with qualifying conditions for each.⁹ However, *sukūk* as a new product has acquired some controversial features during its development phase that were not part of the original asset-*ijārah* bond. These features induce the risk that the *Sharī'ah* acceptance of the *ijārah-sukūk* may become shaky in future if the product is perceived by the public to be contradicting *Sharī'ah* rules.

The most controversial feature in most of the *sukūk* is the buy-back arrangement in explicit form or in implicit form as a unilateral promise by the originator.

The purpose of SPV in conventional securitization involving private sector business is to create:

- (i) a limited liability device for the investors who will provide funds and
- (ii) a commitment device for the company that it will use the funds in the particular way it has announced.

Thus on one hand SPV creates bankruptcy remoteness from the many other businesses of the originator company, and on the other hand increases the credit-worthiness or trust in the company: both features which will attract investors and allow for cheaper funds. But in case of a sovereign like a government an SPV is not a credit enhancer because unless a more credible multilateral institution or a more credible foreign government is the trustee the bankruptcy remoteness is as high as possible in the given country for a private investor in the government projects. Similarly, the SPV structure in case of government projects is also not a proper commitment device. Other kinds of commitment devices such as constitutional amendments, curtailment of executive powers and enhancement of judiciary's authority and independence, enhancement of collective decision making etc are the right commitment devices in case of governments. Thus the use of SPV in Islamic financing of government projects becomes only a device to create a buy-back arrangement without explicitly statement.

By creating an SPV and selling rentable assets to it with a unilateral promises that government is ready to buy back the asset at face value after a certain period if the SPV so wishes (giving put option to SPV)

⁹ AAOIFI Shariah standard no. 17 is an example of such conditions.

government ensures that the assets are reverted back to it on maturity. Since the SPV is creation and dependent of the government itself, therefore it is obliged to exercise the option of selling the asset to the government at face value even if the market price of the asset at maturity date were higher than its face-value.

The problem can be highlighted with following extreme example. If the unilateral promise has binding implications then a very simple and more efficient structure can be devised without the SPV. To see this suppose we drop the SPV and let the government sell a mundane asset like a barren mountain, a garbage dump, or a barren piece of small land at inflated price to the public and offer to lease it back on a inflated rent (which can be tied to LIBOR with periodic revisions on each extension of the lease). At the same time it gives a unilateral firm promise to buy the asset at face value from whoever is willing to sell it at a certain future date (maturity date). Since the asset is of lesser market value than its face value at maturity (in fact throughout the contract period) this is in-the-money put option for the investors and they will always exercise it on maturity. Thus the government does not have to worry about loosing any strategic asset. Hence an *ijārah šakk* can be devised without involvement of any useful asset to meet the financial needs of the government.

Some *ijārah šukūk* have rightly stated that the originator unilaterally promises to buy the asset at its market value that will prevail at the time of maturity. But in case of public good nature of the underlying asset (or a specific purpose asset), which is the case in most of the sovereign *šukūk*, its market may not exist. How to evaluate the fair value of such underlying asset and who will do it is not clear, as those *šukūk* which stipulate this condition have not matured yet.

Another *Shari'ah* issue in some *ijārah-šukūk* is that they put all maintenance expenditures on the lessee while it should have been the responsibility of the lesser. To see this let us examine the terms of a typical sovereign *šukūk* contract:

The master lease agreement stipulates the parties agree to execute consecutive semi-annual leases of the property between the start and dissolution period of *šukūk* and lessee pay rents semi-annually. Being a lease contract it states that the “Ordinary Maintenance and Repairs” cost will be borne by the lessee (Gov.) while “Major Maintenance” costs will be borne by the lesser (Issuer). But effectively it is the lesser who is incurring both types of costs because:

(i) the amount of rental payment by the lesser into the Transaction Account is defined in the contract as the amount what is *equal to* the amount of Periodic Distribution to Certificate holder from the Transaction Account.

(ii) And, the first priority in distribution from Transaction Account is given to the Certificate holders.

By implication there remains nothing in the account for major maintenance.

Such *Shari'ah* issues in the existing *şukūk* structures are a source of legal uncertainty needing the attention of finance professionals and *Shari'ah* scholars. In order to streamline the practices in *şukūk* issuance, their secondary trade, and their retirement a *Shari'ah* audit system is necessary. It is particularly important because the *şukūk* products are in their formative period which will set precedence and standards for the future of *şukūk*.

Table-8
Summary of Risk Characteristics of *Ṣukūk*

<i>Types of Ṣukūk</i>	<i>Description of Ṣukūk structure</i>	<i>Credit Risk</i>	<i>Rate of return (Interest rate risk)</i>	<i>FX risk</i>	<i>Price risk</i>	<i>Other risks</i>
<i>Zero coupon Ṣukūk</i>	<i>Istisnā^c, Murābahah</i> debt certificates – non-tradable	Unique basis of credit risks exist, see, Khan and Ahmed (2001)	Very high due to fixed rate, remains for the entire maturity of the issue	If all other conditions are similar, FX risk will be the same for all cases of <i>ṣukūk</i> . However, those <i>ṣukūk</i> which are liquid or which are relatively short term in nature will be less exposed. The composition of assets in the pool will also contribute to the FX risk in different ways. Hence this can be very useful tool to overcome the FX risk by diversifying the pool in different currencies.	Price risk relates to the prices of the underlying commodities and assets in relation to the market prices. <i>ijārah ṣukūk</i> are most exposed to this as the values of the underlying assets may depreciate faster as compared to market prices. Maintenance of the assets will play an important part in this process. Liquidity of the <i>ṣukūk</i> will also play an important part in the risk. <i>salam</i> is also exposed to serious price risks. However, through parallel contracts these risks can be overcome	Liquidity risk is serious as far as the non-tradable <i>ṣukūk</i> are concerned. Business risk of the issuer is an important risk underlying <i>ṣukūk</i> as compared to traditional fixed incomes. Sharīḥ compliance risk is another one unique in case of <i>ṣukūk</i> . Infrastructure rigidities , i.e., non-existence of efficient institutional support increases the risk of <i>ṣukūk</i> as compared to traditional fixed incomes, see Sundarajan, & Luca (2002)
<i>Fixed Rate Ijārah, Ṣukūk</i>	Securitized <i>Ijārah</i> , certificate holder owns part of asset or usufructs and earns fixed rent – tradable	Default on rent payment, fixed rate makes credit risk more serious	Very high due to fixed rate, remains for the entire maturity of the issue			
<i>Floating Rate Ijārah, Ṣukūk</i>	Securitized <i>Ijārah</i> , certificate holder owns part of asset or usufructs and earns floating rent indexed to market benchmark such as LIBOR – tradable	Default on rent payment, floating rate makes default risk lesser serious – see previous case	Exists only within the time of the floating period normally 6 months			
<i>Fixed rate Hybrid/ Pooled Ṣukūk</i>	Securitized pool of assets; debts must not be more than 49%, floating rate possibility exists – tradable	Credit risk of debt part of pool, default on rents, fixed rate makes credit risk serious	Very high due to fixed rate, remains for the entire maturity of the issue			
<i>Mushārahah Term Finance Ṣukūk (MTFS)</i>	Medium term redeemable <i>mushārahah</i> certificate based on diminishing <i>mushārahah</i> – tradable as well as redeemable	<i>Mushārahah</i> has high default risk (see Khan and Ahmed 2001), however, MTFS could be based on the strength of the entire balance sheet	Similar to the case of the floating rate. This is however, unique in the sense that the rate is not indexed with a benchmark like LIBOR, hence least exposed to this risk			
<i>Salam Ṣukūk</i>	Securitized <i>salam</i> , fixed-rate and non-tradable	<i>Salam</i> has unique credit risk (see Khan and Ahmed 2001)	Very high due to fixed rate			

Source: Tariq (2004)