

## **The Appeal of *Ṣukūk* as Asset-backed Financing**

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Recent initiatives to make financial systems more resilient and stable, especially the banking system, have opened opportunities for market-based finance. As the new regulatory environment aims to make banking safer through de-risking measures, there is also a call for more market driven finance through capital markets. Furthermore, policy makers are encouraging asset-based finance where the financing and the asset being financed are closely coupled. Drive for market-driven financing and linking finance with underlying assets are two key trends which could become significant stimuli for *ṣukūk* markets.

*Ṣukūk* is a relatively young market and it is important to know all the intricacies of this structured market. It is critical that one has to distinguish between the theory behind *ṣukūk* and the current practice of *Ṣukūk*. This distinction is very important to understand the merits and risks of *Ṣukūk* and how it could become an emerging source of secured and stable funding. First of all, treating *Ṣukūk* as a debt security sends different signals to the market. A pure debt security implies an obligation to make periodical payments or rents on capital borrowed followed by redemption of the capital. The debt could be secured or un-secured or collateralized or uncollateralized. The term debt itself denotes a commitment to pay pre-determined return on pre-determined capital irrespective of the outcome of how the capital was utilized.

Whereas I appreciate and agree with the key messages of Ariff (2015, i.e., this issue), I have a different view on one aspect, i.e., the treatment of *ṣukūk* as a pure debt security which has become a source of

confusion in academia and industry. In my view, as opposed to debt, the basic concept of structuring *ṣukūk* is to mobilize funding through investment certificates which represent some form of ownership on the asset or the pool of assets being financed or developed. In this respect, by theoretical construct, *ṣukūk* are not a debt security but represent a co-ownership agreement and therefore, have the element of risk-sharing conforming to the core teachings of Islamic finance. One could argue that an *ijarah* (lease) based *ṣukūk* has similar payoffs to debt security and therefore could be treated as debt but a closer look will reveal the differences. The underlying idea of structuring *ṣukūk* is similar to the concept of securitizing a pool of homogenous assets in conventional finance. Whereas the mechanism of structuring *ṣukūk* and securitization are similar the resultant security and its risk-return profiles are different due to the nature of contract between investors and borrowers. However, it is true that while in theory *ṣukūk* are based on the principles of avoidance of renting capital through interest, linkages with real assets, and following risk-sharing, unfortunately the majority of *ṣukūk* structures currently practiced in the market are not necessarily fully compliant with these principles. Instead, the emphasis is on replicating the risk-return profile of a conventional debt security. This is done through implicit or explicit guarantees and purchase-back contracts at pre-determined prices. This alarming trend is the source of divergence between the theory and practice of *ṣukūk* which should be of concern for the stakeholders of Islamic finance.

It is a common misconception to equate *ṣukūk* with conventional Asset Backed Securities (ABS). Both are applications of securitization techniques but there are differences which arise depending on how each structure is designed. *Ṣukūk* are applications of securitization with necessary adjustments to comply with Sharī‘ah principles. The securitization technique has been criticized in the conventional system in the aftermath of the financial crisis of 2007–08 where securitized securities with complex embedded derivatives led to the meltdown. A serious post-mortem of the crisis will probably exonerate the process of “securitization” as such and will put the blame elsewhere.

Table (1) summarizes the key differences and provides three-way comparison—conventional ABS versus theoretical *ṣukūk* versus common structures practiced in the market. In the case of a conventional ABS

security, the resultant security is a collateralized debt security with a predetermined stream of coupon payments and principal is guaranteed (often through formal credit guarantees). In the case of a theoretical *ṣukūk* security as advocated by the Islamic system, the security's cash flow stream will depend on that of the underlying asset and the principal will not necessarily be guaranteed at par. It is possible that in some cases, depending on the underlying asset, the security owner may have a high certainty of full repayment of principal but it may not be guaranteed. First, the comparison is made between typical conventional ABS and an "asset-backed" security as envisioned by the researchers and scholars which fully comply with the core principles of Islamic finance, i.e., risk-sharing<sup>(1)</sup>. Second comparison is made between the first two securities and the *ṣukūk* security as practiced in the market today.

In theory, *ṣukūk* should be structured such that the investors or security holders have ownership interest in the underlying asset which means that as the joint ownership, the investors have ownership rights and have full recourse to underlying assets in case of insolvency such that the ownership can be transferred to the certificate holder. In addition, the cash flows of underlying assets are passed-through to the *ṣukūk* holders. If a *ṣukūk* structure has these features, then one could label such *ṣukūk* as "**asset-backed**" to indicate that the certificates are fully backed by the underlying asset because of ownership rights. Due to several reasons beyond the scope of this paper, the majority of *ṣukūk* structures currently offered in the market do not qualify as "asset-backed" securities. Instead, these structures are "**asset-based**" which means that the underlying asset only acts as collateral and the certificate holders do not have ownership right and/or recourse to underlying assets. In addition, payoffs on the majority of these structures do not reflect the payoffs of underlying assets. For example, *ṣukūk* is paying coupon based on LIBOR as a reference rate but the underlying asset's returns or revenues in no way depend on or linked to LIBOR. These structures are similar to *senior sub-subordinated collateralized debt* securities which is not what Sharī'ah envisions<sup>(2)</sup>.

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(1) See Askari, Iqbal, Krichene, and Mirakhor (2012) who discuss risk-sharing aspects of Islamic finance and discuss how securities can be structured backed by an asset and based on the principle of risk-sharing.

(2) Due to such practices, the Chairman of the AAOIFI Sharī'ah Board raised concerns in 2007 that the majority of *ṣukūk* structures are not fully compliant with the Sharī'ah.

Whereas some *ṣukūk* structures could be developed using contracts like *ijarah* that replicate payoffs of conventional debt securities, such structures are risk-shifting structures and therefore are counter-intuitive to the core principle of risk-sharing in Islamic finance. It is hoped that with the advancement in understanding of Islamic finance, new *ṣukūk* structures will emerge in the market which reflect “asset-backed” securities and the risk-sharing principles of Islamic finance.

**Table (1). Three-way Comparison of Conventional ABS, Theoretical *Ṣukūk* Structure and Practice of *Ṣukūk*.**

	<b>Conventional Asset-Backed Security (ABS)</b>	<b>Theoretical <i>Ṣukūk</i> Security (Asset-backed)</b>	<b><i>Ṣukūk</i> (as practiced in contemporary markets) (Asset-based)</b>
<b>Security type</b>	Fixed-income (debt-based)	Hybrid depending on the contract and underlying assets. Could be quasi fixed-income or risk-sharing or both.	Predominantly, fixed income. Bond like security that comes either in fixed or floating rate interest rate.
<b>Ownership</b>	Security holder does not own the asset but owns a security against the pool of assets.	Security holder has ownership interest in the underlying asset. The ownership control in an asset-linked security will be higher. The asset ownership is also determined by how much recourse the security owner has to the underlying asset.	Very limited or no ownership control of the investor. In most cases, the asset stays on the balance sheet of the issuer.
<b>Recourse</b>	Security holder does not have recourse to the asset in the event of distress.	Security holder has recourse to the underlying asset in the event of distress	Limited or no recourse.
<b>Linkage with the cash flows of securitized asset</b>	No direct link to the cash flows or the market value of the underlying asset. Indirect variables such as loan-to-value (LTV) ratio are used as proxy.	In general, final or other payoffs should be linked to market value of the underlying asset depending on the structure used to design the security.	No link with the cash flows or the market value of underlying assets. Often the coupon payment is based on LIBOR instead of cash flow of the underlying assets.
<b>Principal protection</b>	Principal is protected irrespective of the value of underlying assets.	Principal is linked to market value of underlying asset.	Most <i>ṣukūk</i> are still unsecured, based on a pool of underlying assets (like covered bonds) with principal guarantee provided by the issuer via a repurchase agreement while coupons (“periodic distribution amounts”) are protected by a liquidity provision.

	Conventional Asset-Backed Security (ABS)	Theoretical <i>Ṣukūk</i> Security (Asset-backed)	<i>Ṣukūk</i> (as practiced in contemporary markets) (Asset-based)
<b>Risk-shifting</b>	Due to multiple layers of origination and credit enhancements, the risks are transferred to a third party in the event of default. The risk-sharing is minimized and investors are protected from the performance of underlying assets but are still exposed to the creditworthiness of the guarantor.	Risk-sharing through symmetrical pay-offs between the borrowers and the investors. Further risk-sharing through diversification of assets in the securitized pool.	Risk-transfer. The risk-sharing is minimized and investors are protected from the performance of underlying assets but are still exposed to the creditworthiness of the guarantor.
<b>Agency Issues</b>	Securitization can create considerable agency costs if agents (borrowers, originators, issuers, arrangers, investors, servicers, credit rating agencies, and third-party guarantors) are tempted to pursue their own economic incentives. For example, valuation uncertainty about the quality of securitized assets could lead to <b>moral hazard</b> by originators if they have limited liability on downside risk. The information advantage of the originator with regard to the quality of borrowers and the historical performance of individual asset exposures could also give rise to <b>adverse selection</b> when security selection favors originator rather than the investors. Finally, uncertainty about the true quality of securitized assets creates a <b>principal-agent</b> problem between asset managers and investors. Ultimately, investors end up bearing these costs <sup>(3)</sup> .	Moral hazard is minimized as the asset managers do not have opportunities to create leverage. Trust-based Islamic contracts such as <i>muḍārabah</i> , limit the liability of the asset manager ( <i>muḍārib</i> ) to cases of negligence, misconduct, or breach of contract (representations and warranties). Other contracts such as partnership ( <i>mushārah</i> ) with pre-determined profit-loss-sharing ratios, and principle/agent ( <i>wakālah</i> ) with fixed management fees minimize incentive problems. (Jobst, 2009). Sharī'ah requirements to maintain high moral values and ethics by the stakeholder would discourage practices such as "predatory lending" or "walking away."	Current <i>ṣukūk</i> structures are theoretically subject to similar agency problems present in conventional ABS. However, one would expect that requirements to comply with Sharī'ah principles and actual scrutiny by Sharī'ah Board approving the structure may help reduce but not totally eliminate some of these problems.

(3) See Jobst (2009) for an excellent discussion of agency issues with conventional and Islamic securities. He raises valid issues such as since arrangers underwrite the sale of asset-backed securities (ABS), they might choose a particular composition of the reference portfolio and the design of the transaction structure to optimize their own payoffs (rather than the ones of ultimate investors).

	<b>Conventional Asset-Backed Security (ABS)</b>	<b>Theoretical <i>Ṣukūk</i> Security (Asset-backed)</b>	<b><i>Ṣukūk</i> (as practiced in contemporary markets) (Asset-based)</b>
<b>Pricing variables</b>	Based on expected yields, current interest rates, and other variables influencing the asset owner's decision-making to prepay or refinance. Creditworthiness of asset owner or the guarantor influences prices	Based on expected cash flows of the underlying asset, yields, current levels of returns, market value of underlying assets, and expected value of the underlying asset at maturity.	Priced like a regular fixed income bond using discounting pre-determined cash flows.

Source: Author and Iqbal (2015)

One of the major differences often not discussed is due to the variables used in the pricing of conventional ABS, theoretical *ṣukūk* and *ṣukūk* in practice. In a conventional ABS the typical pricing model uses variables such as probability of prepayment or refinancing, which depend on the expected interest-rate levels in the future, loan-to-debt ratios, the credit rating of the borrower, and so on. Since principal is guaranteed through credit-enhancing mechanisms, the security is priced like a coupon-bearing debt security with an early prepayment option (similar to a callable bond). In the case of a theoretical *ṣukūk* security, however, the price would depend on typical variables determining the expected periodic cash flows in future but would also have to factor in the expectation of the future market value or the residual value of the underlying asset. In the absence of any guarantee of the principal, the redemption value of the security will depend on the expected market value of the asset at the time of maturity of the security. On the other hand, *ṣukūk* in practice are priced just like a fixed-income security by discounting future cash flows by an appropriate discount rate incorporating the credit worthiness of the issuer and not the asset quality.

There are two key challenges at this time. First, how to develop an enabling environment for structuring *ṣukūk* close to the essence of Islamic finance, i.e., risk-sharing. Second, how to ensure that current practices do not lead to any crisis that could be detrimental to further growth of the industry. Several issues concerning the *ṣukūk* market have been raised showing that (i) investors are mainly exposed to the credit risk of the *ṣukūk* issuer—reiterating the point made earlier about the effect of current structures being asset-based; (ii) the need for the development of a robust insolvency regime to clarify confusion about the rights of certificate

owners, (iii) complexity in determining tradability due to underlying contractual agreement; and (iv) investors' appetite for risk-sharing structures closer to the principles of Islamic finance is limited<sup>(4)</sup>.

Here are some issues that need to be addressed:

### **1. Underdeveloped capital markets and financial sector**

Capital markets in several Muslim countries interested in issuing *ṣukūk* securities are not very developed and even if the markets are developing, the legal environment these are not very securitization-friendly. Due to the lack of a developed infrastructure for capital markets and legal restrictions and uncertainties, the attempt of structuring a *ṣukūk* becomes a frustrating exercise. For example, the transfer of ownership to foreign investors is not readily accepted in many jurisdictions. Similarly, due to under-developed capital markets, facilities such as hedging, credit enhancements, and insolvency procedures exacerbate the structuring issues of *ṣukūk*.

There is well-established linkage between the degree of financial sector development and the economic growth of a country. A well-developed financial sector further promotes development of efficient capital markets. Key ingredients of robust financial sectors are transparency, full disclosure of information, implementation of standards, sound corporate governance, and a prudent risk management framework. In addition, the existence of a business-friendly legal system, protection of investors' rights, property rights, speedy dispute resolutions, and clear insolvency laws are essential for a robust financial sector and ultimately for banking and capital markets. Many countries, which are keen to issue *ṣukūk*, are suffering from an under-developed financial sector and particularly under-developed capital markets.

Given that Islamic financial systems promote risk-sharing products, having a robust financial sector is even more important for risk-sharing products to succeed. In the absence of transparency and good governance, businesses are unable to attract investors who are interested in engaging risk-sharing or Islamic products. Many Islamic countries keen in getting active in Islamic finance and the *ṣukūk* market are not realizing the importance of well-developed financial sectors and capital markets.

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(4) See Iqbal (2015), Haneef (2004) and Haneef (2009)

## 2. Lack of “risk-sharing” structures

An absence of risk-sharing from *ṣukūk* structures in the market can be attributed to two issues—one due to lack of a full understanding of risk-sharing requirements of Sharī‘ah and the other due to the general mind-set of both the issuers and the investors who feel more comfortable with conventional fixed-income-like securities and therefore shy away from structures with embedded risk-sharing. The lack of risk-sharing products is an industry-wide problem and the industry has been criticized heavily for not promoting products based on risk-sharing<sup>(5)</sup>. The second issue, which is interrelated with the first, is the general mind-set and attitude in the Islamic finance industry concerning risk-sharing products. As an issuer of *ṣukūk*, the borrower would prefer to minimize the cost of capital and therefore would not like to share profits with investors. By issuing non-risk-sharing products, the issuer is able to take advantage of leverage due to the lower overall cost of capital. On the other hand, investors are risk averse and do not like to agree with a risk-sharing or profit and loss sharing arrangement with the fear that they may end up sharing losses. This fear stems from lack of transparency and governance in capital markets and lack of proper monitoring of borrowers.

## 3. Benchmarks and Benchmarking

Having a benchmark security to determine the fair price of other securities in the market is an integral part of modern capital markets. In conventional markets, sovereign bonds issued by governments serve as a benchmark for pricing risk and bonds issued by other institutions. In this respect, the *ṣukūk* market suffers from the lack of frequent sovereign issues. In particular, high-quality sovereign issues, which play an important role in the development of all capital markets, and serve the critical purpose of a building a benchmark yield curve for the market, are largely absent from this market<sup>(6)</sup>. Without a benchmark yield curve, it is difficult for other issuers and investors to access the market with confidence.

Floating-rate *ṣukūk* are often linked to a conventional interest-rate benchmark such as the London Inter-Bank Offer Rate (LIBOR). When it comes to pricing, *ṣukūk* compete directly with the conventional bonds in

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(5) Askari, Iqbal, and Mirakhor (2009).

(6) Bennet and Iqbal (2011). Triple-A rated *ṣukūk* issuance has to date been dominated by only one issuer, the Islamic Development Bank (IsDB).



the level of relative spreads. From the conventional borrowers' point of view, there is no inherent cost advantage to be gained from tapping into *ṣukūk* markets, since the terms available are mostly derived from competitive pricing levels in the more liquid and cheaper conventional bond market. Borrowers, therefore, need to formulate a comprehensive, long-term and strategic view on how to reduce the overall funding cost by tapping into Islamic markets, rather than focusing on a single transaction.

#### 4. Sharī'ah-Governance

Whereas attention has been paid and efforts have been made to address Sharī'ah-governance issues of Islamic banks, similar initiatives are absent for Islamic capital markets and especially for *ṣukūk* markets. With the growing complexity of *ṣukūk* structures, there is need to have a standardized approach to address the issues of Sharī'ah governance. For example, investors are often exposed to uncertainties arising due to Sharī'ah treatment of unresolved issue during any dispute or insolvencies. Each *ṣukūk* structure goes through scrutiny by Sharī'ah scholars but once the *ṣukūk* is issued, there is no standard mechanism of ensuring compliance with Sharī'ah during the life of the *ṣukūk*.

#### Concluding Remarks

*Ṣukūk* markets offer both opportunities and challenges. Opportunities are through developing truly asset-backed securities which could serve as a bridge between conventional and Islamic finance that could lead to integration of the two markets. However, the challenges come in the form of risks due to current practices which are replicating conventional debt securities as opposed to developing "asset-backed" securities.

Current practices and structures in *ṣukūk* market are considered and called "Sharī'ah-compatible" because their objective is to comply with the letter of the Law but not necessarily the essence of Sharī'ah. These structures may be compatible with Sharī'ah in their form but not in substance. It is important to make a distinction between Sharī'ah-compatible and Sharī'ah-based. Such a distinction draws attention to divergence of practice from theory. This divergence could expose the industry to serious reputational and ethical risks in the long-run. In addition, closer analysis of several *ṣukūk* structures would reveal a very weak adherence to *Maqasid-al-Shariah* mainly because of the above

mentioned divergence. More needs to be done to develop fully “**Shari‘ah-based**” structures reflecting the essence and substance of Shari‘ah, i.e., through risk-sharing rather than “**Shari‘ah-compliant**” *ṣukūk* structures complying with the letter of the law but leading to risk-transferring structures.

If the essence of Islamic finance is to reduce debt-based contracts and encourage risk-sharing (“asset-backed”) finance that will promote fairness, justice, society first, and non-repressiveness, we have significant work to do to achieve that state.

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