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# *Ṣukūk*: Challenges and Prospects

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With the steady growth of the *ṣukūk* market, issuers are increasingly looking for more flexible and more efficient structures. This is particularly true for sovereign *ṣukūk*, which comprise the majority of domestic *ṣukūk* issuance. Sovereign *ṣukūk* represent more than 70% of domestic *ṣukūk* over 2009-2014 (IIFM, 2014). Yet, the prevailing structure used to issue sovereign *ṣukūk* is not sustainable. This paper proposes an institutional framework for issuing sovereign *ṣukūk* efficiently and credibly. The framework allows governments to issue *ṣukūk* regularly to finance ongoing economic activities using a variety of Islamic modes of finance. It is based on Sharīʿah resolutions of the International Islamic Fiqh Academy, Jeddah, as well as the Sharīʿah standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and can be easily adopted in different jurisdictions.

## Issues in the Prevailing *Ṣukūk* Model

One of the currently common structures of *ṣukūk* involves the sale of a tangible physical asset to a Special Purpose Vehicle (SPV), on the condition that the asset is leased back to the seller (who needs financing), with the undertaking to buy it back at maturity at nominal value. The certificates issued by the SPV represent the *ṣukūk*, which pay regular income reflecting the rental payments of the leased asset. This model has the advantages of being simple and allows the issuance of tradable *ṣukūk* due to ownership of the tangible asset. Being based on rental payments, these *ṣukūk* are classified among fixed income instruments. From a practical perspective, however, a number of obstacles emerge.

### *Asset Ownership*

First, there is the issue of transferability of the ownership of a sovereign asset to investors, particularly if they are non-citizens. This leads to complex legal procedures for *ṣukūk* issuance in order to avoid the "true ownership" of such assets. Hence, *ṣukūk* were transformed from being "asset-backed," i.e., representing the true and legal ownership of the underlying assets, to being "asset-based," whereby *ṣukūk* holders do not fully and legally own the underlying asset. The underlying assets therefore, become of marginal value in the structure. This can be seen from the clauses common in *ṣukūk* documents stating that:

> *"No investigation or enquiry will be made, and no due diligence will be conducted in respect of any of the constituent assets" ...*
>
> *"In particular the precise terms of any of the constituent assets comprised in the Portfolio will not be known" ...*
>
> *"No steps will be taken to perfect any transferor any of the relevant constituent assets comprised in the Portfolio".*

This obviously violates the basic Sharīʿah requirements of a valid sale transaction. As a result, such *ṣukūk* are not fundamentally different from conventional bonds. They are explicitly described in the *ṣukūk* documents as "unsecured". This contradicts the claim of "purchase" and "ownership" of the underlying assets.

Haneef (2009) provides an overview of the developments of *ṣukūk* since 2000, and concludes (p. 110):

> *Today, almost all ṣukūk offerings are asset-based securities. The ṣukūk will have Sharīʿah-compatible underlying assets but the ṣukūk holders will not have any security interest over the assets. The asset-based ṣukūk are treated as senior unsecured securities similar to unsecured conventional bonds.*

### *Limitations of Physical Assets*

Second, *ṣukūk* issuance is constrained by the existence of unencumbered, physical Sharīʿah-compliant assets with an aggregate value at least equal to the nominal amount of the *ṣukūk* be used to support each issue of *ṣukūk*. Such assets may not be possible in all cases, nor as regular as needed. Consequently, the structure does not allow sovereigns to issue *ṣukūk* on a regular and predictable basis.

### *Accounting Issues*

From an accounting perspective, the assets used to issue the *ṣukūk* are not transferred from the balance sheet of the obligor or the seller, because of the undertaking to buy them back at nominal value. This undertaking is a debt obligation on the obligor. With this debt on the balance sheet, the assets cannot be transferred from the seller's balance sheet. But the presence of these assets on the obligor's balance sheet is inconsistent with a true and genuine sale transaction.

### *Alignment of Finance and Economic Activities*

Finally, the structure does not align *ṣukūk* issuance with economic activities. The sale and lease transactions are applied to assets of no economic contribution. Hence, the financing and economic activities are disconnected. This might lead to an unproductive build-up of debt.

### *Sharīʿah Rulings*

Due to the Sharīʿah-related problems facing this model of *ṣukūk*, the International Islamic Fiqh Academy, in its 20th conference in 2012, issued resolution no. 188 prohibiting stipulated sale-and-lease-back that ends up in obtaining money spot in exchange for more money in the future. The resolution states:

> *"It is not permissible to sell an asset at a cash price on the condition that the seller leases back this asset with a promise to own, at a total price, including the rent and the price, that exceeds the cash price, regardless of whether this condition is expressed or implied, because this is a form of 'Einah that is prohibited by Sharīʿah. Accordingly, it is not permissible to issue ṣukūk based on this formula".*

The *Ijārah* Standard issued by the Sharīʿah Board of AAOIFI ruled that it is not permissible to stipulate the lease-back in the sale contract. Paragraph 3/2 of Standard (9) states:

> *"It is permissible to acquire an asset from a party and then lease it to that party. It is not permissible however to stipulate the lease as a condition in the sale contract by which the institution acquired the asset."*

Given these resolutions, and the above-mentioned difficulties, there is a serious need for a sound and credible alternative that meets the needs of sovereigns in raising funds and complies with the principles of Islamic finance.

## Features of the Proposed Framework

In this section we propose a model that can meet the needs of governments to issue *ṣukūk*. The proposed model has the following characteristics:

1. Flexibility with respect to assets: the model proposed below does not require a particular physical asset for each *ṣukūk* issuance, since such assets may not be always available.
2. Flexibility with respect of *ṣukūk* ownership: The model allows non-citizen investors to own *ṣukūk* without issues related ownership of sovereign assets.
3. Flexibility in the selection of the mode of financing, so that it is not limited to *ijārah*, but may utilize other suitable Islamic modes of financing.
4. Efficiency in issuance procedures, so the costs of issuance are reasonably low which reduces the financing burden and enhances returns.
5. Regularity of issuance to allow the government to plan its financial needs and enable the financial market to manage liquidity in a more robust manner.
6. Scalability of financing volume: The proposed model can accommodate the needs of the government as long as it is able to perform its obligations.
7. The most important characteristic is compliance to the rules and objectives of Islamic Sharīʿah in a transparent manner.

## Sovereign Finance Corporation: An Alternative Framework

The model proposed hereunder has been developed by the Financial Product Development Center at the Islamic Development Bank, in collaboration with international experts in Sharīʿah, law, finance, as well officials from IDB Member Countries. The model can be summarized as follows. (The detailed description follows).

1. The government establishes a Sovereign Finance Corporation (SFC) that will be responsible for financing government economic activities.
2. The SFC is a fully-fledged financial institution, with a dedicated professional management team as well as its own Sharīʿah Board and audit arrangements.
3. The SFC issues two types of shares:
    a. Management shares, to be owned by the government (Ministry of Finance and the Central Bank);
    b. Participatory shares, to be owned by investors via *ṣukūk* certificates.
4. The SFC establishes a Special Purpose Vehicle (SPV) and transfers the Participatory Shares to the SPV.
5. The SPV issues Certificates (*ṣukūk*) to investors, backed by the Participatory Shares.
6. Proceeds of the *ṣukūk* are used by the SFC to finance economic activities of the government. These activities can be financed by any Islamic modes of finance classified as fixed-income instruments: *murābaḥah*, *ijārah, istiṣnāʿ, salam*.
7. The SFC finances only government activities, and therefore its assets are sovereign assets. Further, since the instruments used are fixed-income, the government guarantees the payment as per the terms of the contract. Hence, the risk of the assets is primarily and predominantly sovereign risk.
8. The ***Ṣukūk*** Certificates are redeemable in a defined period of time (say 5 years). The redemption is performed at par but is contingent on the performance of the underlying assets. Thus

capital is not absolutely guaranteed. Strictly speaking, the undertaking to redeem is not a legal debt on the SFC. It is a contingent liability subject to the performance of the underlying assets.

9. However, since the underlying assets are obligations against the government, this means the SFC will fail to redeem only if the government fails to pay its obligations. ***Ṣukūk*** Certificates therefore are exposed mainly to sovereign risks.

In this manner, the government has flexibility in selecting the suitable mode of finance as long as it creates a fixed income obligation, as above. Furthermore, financing is not limited by the availability of physical sovereign assets of the required value. This means the government, via the SFC, can issue *ṣukūk* on regular basis to meet its economic targets to achieve development.

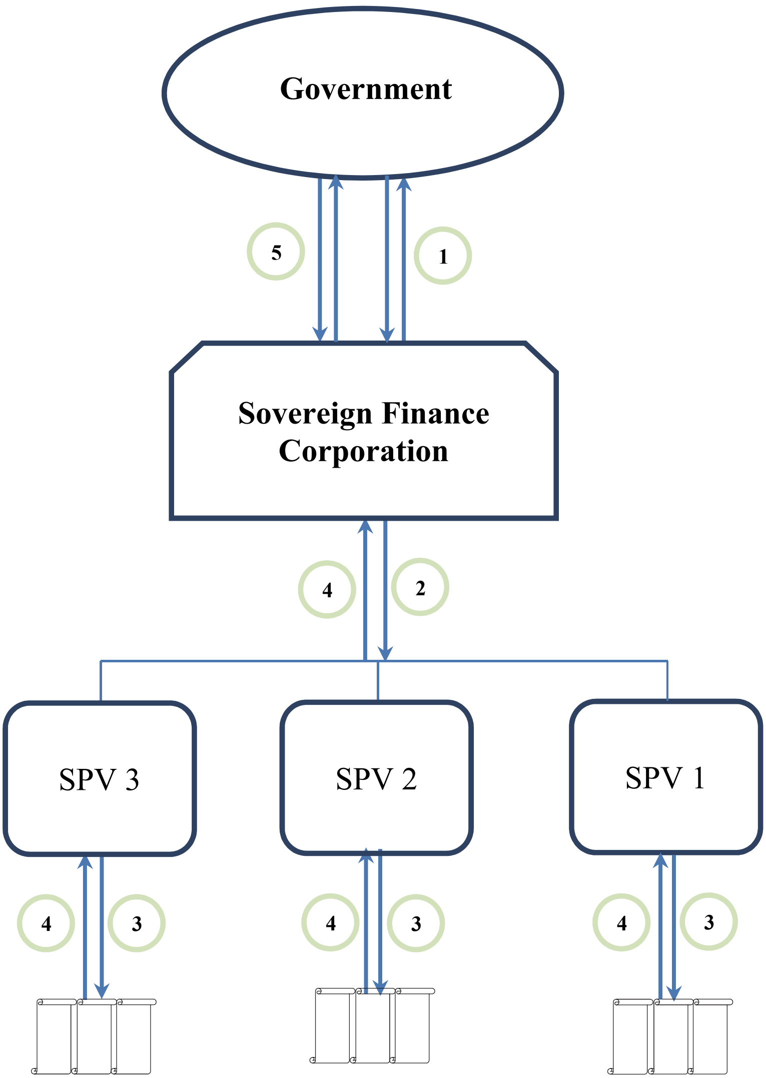
Hence, the above-mentioned features can be achieved by the proposed model of the SFC. The following sub-sections elaborate on the details of the structure.

**SFC: The Assets Side**

The objective of the SFC is to finance Sharīʿah-compliant economic activities of the government. The SFC will finance only the government or government entities, not any private entity.

Like any Islamic bank, the SFC will use ordinary Islamic modes of finance to serve the needs of the government. To provide predictability of the cash flow of the SFC, the modes of finance used will be restricted to those that create fixed-income assets: *murābaḥah*, *ijārah, istiṣnāʿ* and the like. This also serves the objectives of *ṣukūk* holders, who usually prefer fixed-income investments. As we shall see later, the SFC *ṣukūk* are not bonds or bond-like. However, by structuring the assets of the SFC as fixed-income assets, the *ṣukūk* will have the properties of fixed-income investments.

The SFC shall have a clear and rigorous governance structure that specifies how to implement financing to government entities. Governance is necessary to control operational and reputational risks. This is important to Sharīʿah-compliance of the activities of SFC, and to protect *ṣukūk* holders who are investors in the SFC. Following figure shows the structure of issuance of *ṣukūk* by the SFC.




With a proper governance structure, the assets created by the SFC are sovereign fixed income assets, the risks of which are essentially sovereign risk. The exposure of investors in the SFC, therefore, will be limited primarily to sovereign risks. In this manner the SFC *ṣukūk* maintain the major attributes of fixed-income instruments, despite being a share rather than a debt instrument.

This is not too far from investment funds that invest mainly in *murābaḥah* or leasing instruments. Although fund units are shares in the fund's assets, the underlying risks are mainly fixed-income or credit risks. The SFC is different in that it is a full-scale financial institution owned by investors. As we shall see later, this ownership of the institution plays an important role in tradability of the shares and therefore of the *ṣukūk*.

Furthermore, investors in the SFC will be better protected because they have a certain level of control over the institution to protect their rights and to insure that the SFC fully abides by the agreed governance structure.

## SFC: The Liabilities Side

### *Shares*

The SFC, as pointed out earlier, issues two types of shares:

1. Management shares. These are owned by the government: Ministry of Finance, and the Central Bank.
2. Participatory shares. These are non-voting shares that will back the *ṣukūk* issued to investors.

The government will preferably pay for Management shares in-kind: For example, it shall transfer some of its profitable investments to the SFC in return for the Management shares. This will enhance the value of the Corporation and improve the cash flow, as we will see later.

### *Ṣukūk Issuance*

Participatory shares are permanent or perpetual. *Ṣukūk* certificates, in contrast, are redeemable. To reach this structure, the SFC needs to establish (one or more) SPV. The Participatory shares then are transferred to the SPV. The SPV accordingly will issue *ṣukūk* certificates backed by the shares. These *ṣukūk* certificates are redeemable, as we shall see later.

The SFC can issue Participatory shares in a volume sufficient for its expected financing needs over the coming 10 years, say. These shares can be held either with the SPV or with the treasury of the SFC. Then, *ṣukūk* will be issued on regular basis according to the needs of the government. This will help the government plan its financing needs ahead of time. In case unexpected needs arise, the SFC may issue additional Participatory shares to meet such needs. However, it must be observed that the volume of the participatory shares has to be in line with the economic activities of the government. Over-issuance of shares and thus of *ṣukūk*, will undermine the credibility of the SFC and hence will reflect into higher costs of financing.

Since shares are issued prior to the financing activities of the SFC, there will be a gap between *ṣukūk* issuance and generating returns. This gap can be filled by the returns from the investments the government has contributed in exchange for Management shares. As long as *ṣukūk* are issued based on carefully designed plans for the government's needs, the gap will be negligible.

***Redemption***

The *ṣukūk* usually are of a defined maturity. The SFC may issue short term *ṣukūk* (1 year, say), medium term (3 years), and long term (5 or 7 years). For this the SFC will establish 3 SPVs, one for each maturity.

The SFC promises to redeem the *ṣukūk*, i.e., buy them back, at par, subject to the performance of the underlying assets and the generated cash flow. The SFC therefore issues a Purchase Undertaking (PU) to buy back at nominal value, but this undertaking is conditional on the performance of the assets. The PU therefore is *not* a debt obligation on the SFC. There is no guarantee by the SFC to the *ṣukūk* holders to buy their *ṣukūk* at par. The reason is simple: *ṣukūk* represent shares in assets that are already guaranteed to be paid by the government, based on the fixed-income instruments utilized, as discussed earlier. Thus *ṣukūk* holders do not need any additional guarantee. In fact, the guarantee will add no value; if the government fails to pay its obligations on the assets, it will also fail to honor its guarantee.

The only case in which the SFC will redeem *ṣukūk* at below par is when the underlying assets underperform. This can happen only if the government does not pay its obligations on time. But this is the sovereign risk that investors are willing to accept from the start. However, *ṣukūk* holders may need liquidity support given the possible mismatch between the maturity of the *ṣukūk* and that of government obligations. This can be provided by the Central Bank. The Central Bank will provide a line of financing to the SFC. This can be done using interest-free loan for example from the Central Bank to the SFC, and the Central Bank agrees to offset the resulting obligation of the SFC with the assets the SFC holds against the government (the Ministry of Finance). Alternatively, the Central Bank would purchase the *ṣukūk* from investors, then exchange the *ṣukūk* for assets of the SFC. In all cases, the Central Bank is able to fill in the mismatch in maturities between the SFC *ṣukūk* and SFC assets. From *ṣukūk* holders' point of view, it is all sovereign risk.

### *Dividend Payment*

*Ṣukūk* holders get dividends (coupon payments) based on the generated cash flow from the underlying obligations of the government. *Ṣukūk* with different maturities will have different dividends or coupon payments; for example, short term *ṣukūk* will have smaller dividends than long-term *ṣukūk*. While the proceeds of all *ṣukūk* series will accumulate into a single pool, that of SFC financing government activities, the dividends paid to each series can be adjusted to fit the maturity of the *ṣukūk*. This can be structured by setting different sharing ratios between *ṣukūk* holders and the SFC as the manager of the SPV issuing the *ṣukūk* certificates. This ratio will be in line with the maturity of the *ṣukūk*. For example, for short term *ṣukūk*, the share of the SFC will be higher than its share in case of long-term *ṣukūk*.

### *Tradability*

Since the SFC is a fully-fledged financial institution, its shares will be treated like the shares of any Islamic banks. There are in principle two views on the tradability of such shares:

(1) They are tradable following the Principle of Subordination (قاعدة التبعية) in Sharīʿah[1]. This principle implies that the institution as an entity is responsible for creating the underlying financial assets. The entity, as a fully functioning corporate, is a set of tangible rights, properties, and usufructs, through which it is able to function and

(1) OIC Figh Academy Rulings no. 180 and 196.

generate returns. The set includes the legal license, management, fixed assets and equipment, and similar productive assets. Since shares represent an undivided ownership in this set, shares are tangible by implication. The financial assets created by the institution are subordinated to the set that creates such assets. Hence, as long as shares represent ownership in a genuine fully-operational institution, the shares are tradable irrespective of the precise percentage of physical assets in the total assets of the institution. In the absence of such subordination, the minimum of physical assets and usufructs, according to the OIC Fiqh Academy, is 51%.

(2) The other view requires the institution to have no less than a pre-specified percentage of tangible (non-debt) assets. Usually this percentage is set at 51%, as indicated earlier, but it varies from one Sharīʿah committee to another. Some Sharīʿah committees set the threshold at 30%. The *Ṣukūk* Standard of Dubai Financial Market (DFM) requires a minimum of 10%.

***Legal System***

As a new entity, the SFC will very likely require separate new legislation to provide the necessary legal protection to the entity and its smooth operation.

## Conclusion

The *ṣukūk* market has been growing steadily since the Global Financial Crisis. Yet, the prevailing structure, particularly for sovereign *ṣukūk*, is not sustainable. This paper presents an alternative that has been developed by an international team led at the Financial Product Development Center, at the Islamic Development Bank.

The proposed Sovereign Finance Corporation aims to address many difficulties facing the prevailing structures of sovereign *ṣukūk*. We can see how the SFC allows governments to achieve the objectives and features set out at the beginning of the section.

The SFC is an institutional model for government financing. It has the potential to provide financing to government activities on a regular basis, with a high degree of transparency and good governance.

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