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Emerging *Ṣukūk* Markets

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Islamic finance market is developing in some 18 financial centers across the world, including London. Ariff (2015, i.e., this issue) shares some valuable insights into the world of *ṣukūk* as an emerging type of debt instrument and offers an excellent review on the current debate. He elucidates the central issues relating to *ṣukūk* and presents arguments in a lucid and coherent style encapsulating the essence of the current debate. I find the article to be well-researched, well-structured and one which undoubtedly will be both appealing and beneficial to students, academics and practitioners internationally. The publication of his two books in the United Kingdom also attests to his expertise on this subject.

Ṣukūk have gained importance over the last decade and considerable interest is being generated globally. In particular, Western nations are taking every opportunity to champion the cause and, ironically, attempting to secure status as leaders in the Islamic finance. It is timely that Ariff draws attention to how *ṣukūk* are beginning to emerge in countries such as the UK, Germany, China, Russia, Kazakhstan and Australia to name a few and alludes to how the market will see other countries entering this ethical domain. The paper further articulates the common types of *ṣukūk* currently available such as the *mushārakah ṣukūk*, *murābaḥah*, *ijārah* or 'Vanilla' type *ṣukūk*, the variable pay-off *muḍārabah*, *Istiṣnā*ʿ and the *salam* type *ṣukūk* and how they can be used by both private and public sectors. Ariff also sheds important light on how *ṣukūk* can be categorized into different classes and how they can be utilized to accommodate variations in each types of *ṣukūk* as the market expands and develops.

The article also makes a distinct point in relation to asset-backing in *ṣukūk* markets and discerns between the current practice in conventional bond markets under which loans are made based on an implicit guarantee of the reputation of the borrower. The paper cogently argues that asset-backing makes lending more attractive and allows investors to conform to their side of the deal more resolutely than investors who are merely interested in accumulating returns irrespective of the outcome to the entrepreneur. Ariff elucidates that asset-backing prevents profligate debt overhang, and provides a useful example of how the world GDP is approximately US$ 80 trillion, but with a debt overload of US$ 160 trillion (Ariff et al., 2014). The paper further contends that under the asset-backing principle, no borrower can borrow more than the total worth of assets in place. Overall, Ariff's paper offers a useful contribution to the debate by also incorporating a discussion on the size of the Islamic financial debt markets, mobilizing funds via *ṣukūk* contracts, *ṣukūk* instruments and financial engineering and provides a persuasive outline of some present-day issues facing the *ṣukūk* market. He also offers some interesting suggestions in the conclusion.

Associated with the issues highlighted in Ariff's paper, I believe that it is important, first, to bring more clarity on Sharīʿah issues relating to product development, in particular, the debate surrounding *muḍārabah*, *mushārakah* and Diminishing *mushārakah* forms of *ṣukūk*. Second, an organized quest for Islamic market development in London is worth following up ardently.

In this context, it is well-understood that when structuring a *ṣukūk* issuance, the first stage is to analyze what exactly the business of an originator entails and what assets (if any) are available to support the issuance of the *ṣukūk*. If at the outset, it is not possible to ascertain a specific tangible asset for investment, the *muḍārabah ṣukūk* (a form of trust financing) may be a more viable alternative. *Ijārah ṣukūk* may also be employed.

The characteristics of the *muḍārabah* structure can be adapted for use as the underlying structure in a *ṣukūk* issuance as each investor's purchase of *ṣukūk* would represent units of equal value in the *muḍārabah* capital, and are registered in the names of the *ṣukūk* certificate holders on the basis of undivided ownership of shares in the *muḍārabah* capital. The returns to the investors would represent accrued profit from the *muḍārabah* business at a pre-agreed ratio between the *rabb al-māl* and the *muḍārib*, which would then pass to the investors according to each investor's percentage of investments in a *muḍārabah ṣukūk*.

The structure of a *muḍārabah ṣukūk* can be explained as outlined in the Dubai International *Ṣukūk* Guidebook, 2008 in the following points:

1. Issuer SPV issues *ṣukūk*, which represents an undivided ownership interest in an underlying asset, transaction or project. They also represent a right against Issuer SPV to payment of expected periodic return from *muḍārabah* profits.
2. The Investors subscribe for *ṣukūk* and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets or *muḍārabah* interests acquired using the proceeds) and thereby acts as Trustee on behalf of the Investors.
3. Issuer SPV and Originator enter into a *muḍārabah* Agreement with Originator as *muḍārib* and Issuer SPV as *rabb al-māl*, under which Issuer SPV agrees to contribute the Principal Amount for the purpose of a Sharīʿah compliant *muḍārabah* enterprise.
4. Originator, as *muḍārib* under the *muḍārabah* agreement, agrees to contribute its expertise and management skills to the Sharīʿah compliant *muḍārabah* enterprise, with responsibility for managing the *rabb al-māl*'s cash contribution in accordance with specified investment parameters.
5. Issuer SPV and Originator enter into the *muḍārabah* enterprise with the purpose of generating profit on the Principal Amount.
6. Profits generated by the *muḍārabah* enterprise are divided between Issuer SPV (as *rabb al-māl*) and Originator (as *muḍārib*) in accordance with the profit sharing ratios set out in the *muḍārabah* agreement but accrued for the duration of the *muḍārabah* enterprise

7. In addition to its profit share, the Originator (as *muḍārib*) may be entitled to a performance fee for providing its expertise and management skills if the profit generated by the *muḍārabah* enterprise exceeds a benchmarked return. This performance fee (if any) would be calculated at the end of the *muḍārabah* term and upon liquidation of the *muḍārabah*.
8. Issuer SPV receives the *muḍārabah* profits and holds them as Trustee on behalf of the Investors.
9. Issuer SPV (as Trustee) pays each periodic return to Investors using the *muḍārabah* profits it has received under the *muḍārabah* agreement

However, on maturity of the *muḍārabah ṣukūk*, the *muḍārabah* enterprise would be dissolved in accordance with the terms of the *muḍārabah* Agreement and the Trustee would exercise a purchase undertaking to call on Originator to buy the *muḍārabah* interests from the Trustee at market value so that the proceeds can be used to service the outstanding amounts due to the Investors. The Investors would be entitled to a return comprising their pro rata share of the market value of the liquidated *muḍārabah* capital and the profit generated by the *muḍārabah* enterprise and accrued during the term of the *ṣukūk* issuance.

Upon maturity, the assets of the *muḍārabah* enterprise would be liquidated and the proceeds would be applied: firstly, in the return of the capital initially contributed by Issuer SPV; and secondly, in the distribution of any remaining dissolution returns between Issuer SPV and Originator in accordance with the same profit sharing ratios. Issuer SPV (as Trustee) then pays such dissolution returns to the Investors redeeming the *ṣukūk* certificates. In time to come, I am of the view that this form of potential liquidating equity-like fund may prove of great benefit to firms that do not want to dilute its ownership control by issuing a perpetual equity (*mushārakah*) issue.

Before the AAOIFI Statement of 2008, it was possible for the Originator to grant a purchase undertaking in favor of the Trustee whereby the exercise price would be a fixed amount determined in accordance with a formula that would ensure that the exercise price would:

- In the event of a default or on maturity of the *ṣukūk*, be equal to the par value of the *ṣukūk* plus any accrued but unpaid *muḍārabah* profits;
- In the event of a shortfall between any amount actually received by the Trustee from the *muḍārabah* enterprise and the profits received by the Trustee and the distribution amount due to the Investors, be equal to the shortfall. A formula may be used to determine the market value of the assets of the *muḍārabah* enterprise. The use of such purchase undertakings, in effect, ensured that the Investors were almost certain to receive their principal investment in *ṣukūk* plus profit (subject to the usual risks such as insolvency present in any *ṣukūk* or conventional bond structure).

It must be emphasized that under the 2008 AAOIFI Statement, Sharīʿah scholars take the view that it is not permissible for an Originator to grant a purchase undertaking to the Trustee to purchase the *muḍārabah* assets for any amount other than the Trustee's share of the market value of the *muḍārabah* assets at the time of sale. The premise for this ruling has been that *ṣukūk al-muḍārabah* are analogous to equity-based instruments and therefore the partners in the *muḍārabah* must take the risk of both profit and loss. Determining the value of the *muḍārabah* assets by reference to the par value of the *ṣukūk* (or by reference to a shortfall amount) is akin to a guarantee of profit and principal which, unless given by an independent third party (a party other than the Originator), is not permitted under Sharīʿah. This ruling is another reason why the *ṣukūk* market has not seen a revival of the *ṣukūk al-muḍārabah* structure.

Prior to the AAOIFI statement in 2008, one of the more commonly used *ṣukūk* structures was that of a *mushārakah ṣukūk*. In its simplest form, a *mushārakah* arrangement is a partnership arrangement between two (or more) parties, where each partner makes a capital contribution to the partnership (i.e., to the *mushārakah*), in the form of either cash contributions or contributions in kind. Essentially, a *mushārakah* is akin to an unincorporated joint venture but may, if required, take the form of a legal entity. The *mushārakah* partners share the profits of the *mushārakah* in pre-agreed proportions and share the losses of the *mushārakah* in proportion to their initial capital investment. The key features of the underlying structure are outlined below:

- Managing Agent must operate the *mushārakah* business and invest the *Mushārakah* Assets in accordance with the *mushārakah* business plan that will have been agreed between the partners and will have been tailored in accordance with the principles of Sharīʿah;
- The ratio of profit sharing must be agreed at the outset and, unlike losses, does not have to be in proportion to each partner's capital contribution. However, it is not permissible to agree a fixed profit amount for either Originator or Trustee;
- Losses of the *mushārakah* must be shared by the partners in proportion to their capital contributions to the *mushārakah*;
- Any profit distributed prior to maturity or termination of the *mushārakah* is deemed to be in advance and is treated as an "on account" payment which shall be adjusted to the actual profit Originator and Trustee are entitled to at that time;
- The *mushārakah* must have a degree of tangibility and this tangibility (or asset- backing ratio) can vary between 33% and 50%, depending on the Sharīʿah scholars involved;
- There is a possibility that the profits received by Trustee on or prior to any periodic distribution date are less than the relevant Periodic Distribution Amounts. Appropriate mechanical enhancements can be incorporated into the *mushārakah* structure to mitigate this risk. For example, surplus profits on any Periodic Distribution Dates can be held in a reserve account and amounts held in such reserve account can be drawn to fund any shortfalls in future Periodic Distribution Amounts or in the Exercise Price (as discussed above). Secondly, the provision of third-party, Sharīʿah-compliant liquidity funding can be accommodated into the structure to also cover any such shortfalls; although, it is important to note that any such third-party provider can only have the right, and must not be obliged, to provide such Sharīʿah-compliant liquidity funding. The Trustee will be under an obligation to repay the Sharīʿah-compliant liquidity funding from any proceeds remaining after the *ṣukūk* have been redeemed in full; and
- Both the Originator and Trustee can, from a Sharīʿah perspective, terminate the *mushārakah* at any time after giving notice. On

> termination of the *mushārakah*, and provided that the Purchase Undertaking has not been exercised by Trustee, the tangible assets comprised in the *mushārakah* will be liquidated and, together with the intangible assets, be distributed between Originator and Trustee in proportion to the units (or capital contribution) held by each party in the *mushārakah*.

A prominent form of a *mushārakah* structure is where a *ṣukūk* is structured to be amortizing, then a diminishing *mushārakah* arrangement can be implemented. In relation to this form of arrangement, both the Originator and Trustee must jointly own the asset and on any date on which the amortization is to occur, Trustee would sell some of its units or part of its co-ownership interest in the *mushārakah* asset(s) to Originator. As a consequence of such sale, Trustee's units or ownership interest (as the case may be) in the *mushārakah* asset(s) decreases over the life of the *ṣukūk*. Essentially, a diminishing *mushārakah* structure can be used to design self-liquidating common-stock like funding which can provide more yields for investors, thus stretching the *ṣukūk* market in a direction which is likely to attract more money to the market. This would enable firms not to lose control except over the life of the diminishing *mushārakah*.

Again, before the 2008 AAOIFI Statement, it was possible for the Originator to grant a purchase undertaking to the Trustee and for the Exercise Price to be a fixed amount determined in accordance with a formula (and not by reference to the market value of the *mushārakah* assets). The exercise price would therefore typically have been, in the event of a default or maturity, equal to the face value of the *ṣukūk* plus any accrued but unpaid Periodic Distribution Amounts. The Investors were therefore 'guaranteed' to receive their principal investment and profit (subject to the usual risks, such as insolvency, present in any *ṣukūk* or conventional bond structure). However, under the AAOIFI Statement, Sharīʿah scholars have taken the view that it is not permissible for an Originator to grant a purchase undertaking to the Trustee to purchase the *mushārakah* assets for any amount other than the Trustee's share of the market value of the *mushārakah* assets at the time of sale. The premise for this ruling has been that *ṣukūk al-mushārakah* are analogous to equity-based instruments and therefore the partners in the *mushārakah* must take the risk of both profit and loss. Determining the value of the *mushārakah* assets by reference to the face value of the *ṣukūk* (or by reference to a shortfall amount) is akin to a guarantee of profit and principal, which, unless given by a third party (i.e., anyone other than the Originator), is not permitted under Sharīʿah. This ruling has resulted in a significant decline in the number of *ṣukūk al-mushārakah* issuances in 2008 and 2009.

In summary, the two of the most common *ṣukūk* types – the *muḍārabah* and *mushārakah* do not conform to the Sharīʿah. This is because while the *muḍārabah* and *mushārakah* forms of *ṣukūk* are equity-type instruments, the market uses certain techniques such as repurchase agreements (at maturity or specified default events) to guarantee the return of the *ṣukūk*. This goes against Islamic principles, where profits should be shared and interest is prohibited.

Interestingly, a recent World Bank report entitled '*ṣukūk* Markets: A Proposed Approach for Development' (December, 2014) highlights that conventional derivatives meet the needs of only a portion of the *ṣukūk* investor base, and thus development of Sharīʿah-compliant swap structures is needed. Ensuring the availability of both conventional and Sharīʿah-compliant derivative instruments is important to support *ṣukūk* market development. Standard-setting institutions such as the IIFM have made progress in developing standards for certain types of derivatives transactions and have a pipeline of derivatives standards under development. The acceptability of certain derivative products is still under consideration as scholars forbid most conventional derivative products because of their speculative nature. The challenges in finding broad acceptance may put Islamic investors at a disadvantage as compared with conventional investors who have more tools available to hedge and manage risks of their investments through the use of conventional derivatives

The report suggests that "active policies to build derivatives instruments for *ṣukūk* market development will yield better results after progress in other areas is observed. Cash and derivatives markets are closely interconnected, but the development of cash markets usually comes first. Progress in critical areas such as money markets and the construction of a reference curve would facilitate implementation and growth of derivative products.

In relation to my second intended comment regarding *ṣukūk* market development in London, the aspirations of the UK Government since 2003 to develop London as a hub for Islamic finance in the West is no secret. The UK Government provided tax incentives and made regulatory changes with the aim of appealing to international investors and issuers. The result was that the London Stock Exchange (LSE) has currently *ṣukūk* listed valued at approximately US$36 billion with over 50 *ṣukūk* quoted on the LSE. The LSE also enjoys a listing cost advantage as it does not charge annual fees to issuers for debt securities and *ṣukūk*.

In advancing its cause, the UK Government in 2007/2008 initiated legislation for a framework for *ṣukūk* regulation. This was termed as "Alternative Finance Investment Bonds" (AFIS) which aligned treatment of *ṣukūk* with that of conventional bonds. Though this was seen as equal treatment with its conventional counterpart, the Islamic paper was still classified to be under the Collective Investment Scheme (CIS) classification making it a greater burden for issuers thus making it problematic in relation to the SPVs in *ṣukūk* issuances. However, in 2008 a consultative paper was issued in 2008 which exempted these instruments from the CIS regulations and established a new "specified investment" leading to the improvements in the listing process for *ṣukūk*. Furthermore, in 2009 the UK Finance Bill removed the Stamp Duty Land Tax (SDLT) from issued *ṣukūk* and further amended the Capital Gains Tax (CGT) rule to allow *ṣukūk* issuers to retain capital allowances in relation to land related transactions. This perhaps explains the reason why a large proportion of deals on the LSE are for corporate *ṣukūk*, mainly listed by companies from the GCC.

Despite the notable efforts by the UK Government to list *ṣukūk* in 2008, this was not possible due to the then financial crisis. However, London entered the *ṣukūk* listing market in August 2014 with issuing a £200m five-year *ijārah ṣukūk* which attracted healthy investor interest; ten times the amount it was planning to sell and was seen as the first step in encouraging wider investment from the region to the City of London. The *ṣukūk* issue was priced to give a profit rate of 2.036 per cent, the same as the yield on Britain's benchmark five-year government bond, or gilt GB5YT=RR. That is less than the premium of up to 2 basis points over the conventional bond that was initially indicated, reflecting substantial demand.

The structure adopted was for a special purpose vehicle (SPV) acting as the agent of the government to collect the *ṣukūk* proceeds from investors who receive *ṣukūk al-ijārah* (certificates) in exchange. The SPV purchases the asset from the government. The SPV, holding the asset (or pool of assets) on trust, then leases the asset back to the government. The government as lessee is liable for maintenance. In case of default the asset reverts to the government due to the operation of a purchase undertaking. The commercially agreed rent paid by the government and transferred by the SPV to the *ṣukūk*-holders is the equivalent of the periodic coupon payments in a conventional bond. In contrast with some other Sharīʿah-compliant contracts, in an *ijārah ṣukūk* these payments may be fixed, as can the value of the asset for re-purchase at maturity – which will probably be in the three-to-five year range; a shorter-term bill-like *ṣukūk* was considered but rejected.

At the time, the UK Chancellor of the Exchequer stated that "it would help make London the undisputed center of the global financial system". In fact, currently, more than 20 banks offer Islamic financial products and services in the UK which is more than any other Western country with the prospect of this number increasing further. Nevertheless, a closer scrutiny of the types of *ṣukūk* that are currently listed on the LSE suggests that it is the international *ṣukūk* that takes the highest share of overall value with domestic *ṣukūk* being non-existent. It seems that no matter what, for the foreseeable future at least, the LSE and the UK Government will be dependent on international players to continue to inspire its Islamic finance and *ṣukūk* industry for a long time to come. The UK Government has certainly opened its doors and welcomed this alternative form of finance but it is now up to the market players to take full advantage of these efforts.

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