CIFE17, 18: UNDERSTANDING SUKUK – ISLAMIC SECURITIZATION

Sukuks are Islamic shares and we show you the main features walking you through the 8 step structuring process concluding with a study of Ijarah Sukuk. We continue our discussion on Sukuk with a look at Musharakah and Mudarabah Sukuk and the limitations of issuing using Murabaha, Salam and Istisna. We close with a case study of the IDB Sukuk.

Sukuk is the Arabic plural of the word Sakk which means certificate. Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services.

For instance, six partners invest in a business venture worth $60,000 by making an investment of $10,000 each.

In order to represent their shareholding they create certificates to divide the business into 60,000 units.

Each partner is allotted 10,000 shares.

Securitization is the process of issuing certificates of ownership against an asset or business. Securitization turns an ordinary asset into a tradable security.

If the securities represent a proportionate share of ownership in tradable assets, the trade of such securities is permissible.

Important to remember:

The asset portfolio must consist of 25% tangible assets because if the majority of assets are liquid and sold for any amount other than their face value, the transaction is analogous to riba.

The core contract used in the process of securitization to create Sukuk is the Mudarabah, based on a predetermined profit sharing ratio, where one party serves as an agent on behalf of the principal who is the capital owner.

The Mudarabah contract creates the Sukuk with the establishment of an independent legal entity known as a Special Purpose Vehicle or SPV.

In the case of Sukuk, the SPV acquires Shariah-compliant assets and issues ownership certificates against them.

8 Steps of Sukuk Issuance

1. The identification of assets to be securitized;
2. The creation of the SPV;
3. The transfer of the assets to the SPV;
4. The issuance of participation certificates against the identified assets;
5. The lease of the assets back to the seller;
6. The provision of a guarantee by an investment bank for future payments or to replace assets if and when required;
7. Periodic payments to investors where there is income from the securitized assets;
8. The termination of the SPV at maturity by the sale of the assets to the original seller at a pre-determined price and after paying any dues owed to the certificate holders or investors

Ijarah Sukuk

A Sukuk al Ijarah may be issued for 3 purposes:

1. To securitize ownership of a leased asset.
2. To securitize ownership of the usufruct of an asset.
3. To securitize ownership of the right to receive benefits from services.

Ijarah Sukuk issuance prerequisites

1. Ijarah Sukuk must represent the holder's proportionate ownership of the leased asset.
2. The Sukuk holder must assume the rights and obligations proper to a lessor to the extent of his ownership.
3. As the owner, the Sukuk holder has the right to receive rent proportionate to his ownership in the asset.
4. It is essential that the Ijarah Sukuk is designed to represent real ownership of leased assets, and not only a right to receive rent.

Ijarah Sukuk Advantages

Pricing

Rentals amounts that are eventually transferred to Sukuk-holders may be fixed or benchmarked against a known standard.

Reassignment

Ijarah Sukuk may be reassigned or sold to those seeking ownership in the secondary market provided the underlying assets represent a considerable portion of tangible assets.

Maturity

The Ijarah may be executed for any length of time mutually decided between the lessor and the lessee provided the subject matter of the Ijarah continues to exist.

Timing

The asset represented by the Ijarah Sukuk need not exist at the time of contract execution.

Equity Based Sukuk

Musharakah Sukuk

- Used to create new projects, develop existing projects and finance business activity on the basis of a partnership contract.

Mudarabah Sukuk

- Based on the Mudarabah contract for which capital is received from investors to finance a project.
- Sukuk are issued to investors to represent their proportion of ownership in the investment activity.
- The investors earn profit from the business venture and may even sell their ownership share in the secondary market.

Both Musharakah and Mudarabah Sukuk are bought and sold in the market where Sukuk-holders share profits by an agreed ratio and losses in proportion to investment ratios. In a Mudarabah the principal bears all loss.

To allow tradability, the asset portfolio of Musharakah and Mudarabah Sukuk should include 25% tangible assets. Sukuk issuer cannot guarantee profits.

Sale Based Sukuk

Murabaha Sukuk

- Sukuk investors provide issuer with funding to purchase assets
- Asset is purchased from supplier
- Asset is sold to the issuer for a deferred price
- Profit earned is distributed proportionately among the investors

Important to remember:

These Sukuk represent the investors' shares in receivables from the purchaser. And since these receivables are a debt, they cannot be traded in the secondary market.

Salam Sukuk and Istisna Sukuk

Salam and Istisna Sukuk are a useful investment tool for a variety of short, medium and long-term financings

For the issuance of Salam or Istisna Sukuk:

- An SPV is created, which buys a commodity such as crude oil in a Salam, or constructs infrastructure such as a highway in an Istisna.
- The SPV pays the price of the crude oil, or cost of construction of the highway at the time of the contract's execution with the income generated from the sale of certificates to investors.
- After executing the Salam or Istisna, a promise is obtained from the ultimate beneficiary of the deliverable to buy it from the SPV on the date that it is due.
- Since Salam Sukuk represent a debt in the form of Salam goods to be delivered at a specified date in the future, they may not be sold in the secondary market. Istisnas, on the other hand, gradually transform from a pure debt to a manufactured item, so once the item is substantially created, where the timing depends on the asset and the opinion of the Shariah board, the certificates are tradable.