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SUKUK-Structures: An Analysis of Risk-reward Sharing and Wealth Circulation

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Scheme of the Paper

The subject of the paper is arranged as follows. Firstly, the basic description of *sukuk*, its attributes and benefits, followed by the prevailing dominant types of *sukuk*, the pros and cons and issues at hand in certain cases. Alternatives and close parallels to *sukuk* are also drawn where considered necessary.

INTRODUCTION

The financial system of Islam is based on the Sharia guidelines, emanating from the Holy Qura'n and *Sunnah.*[1] It is an integral part of the socio-economic system, meant to form a society based on the principles of socio-economic justice, fairness and equitable distribution of wealth.[2]

While businesses can be funded from various sources, the debt-based funding has become the nucleus of the capitalist economic system prevalent in the world. Interest on debt (lending) is considered as the predominant basis and reward for money lending. On the other hand, Allah (SWT) has very clearly declared interest on loans or debt (called "*riba*") as impermissible ("*haraam*") and the root cause of many evils.[3] The Holy Prophet Mohammad (PBUH) through his *Sunnah* has practically clarified this interest or "*riba*" and categorised it in two basic forms known as "*Riba al- Nasiyyah*" and "*Riba al-Fadl*". *Riba Al Nasiyyah* is the *riba* which takes place in money lending (loans) while *Riba a –Fadl* occurs in commodities' exchange transactions.[4]

The issue of circulation of wealth and the equitable distribution of wealth among the stakeholders also lies at the core of Islamic socio-economic system but this has

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Authors' Note: The views expressed by the authors are the authors' own, and not necessarily those of their institutions or of the conference organisers.

[1]The actions, sayings and preaching of The Holy Prophet Mohammad (PBUH) are called "Sunnah".

[2]Chapra (1985/1405H), Savharvi (2001).

[3]Al- Qura'n, Al-Baqarah-2:275.

[4]Usmani (2002) and Ahmed (2001).

received little attention as compared to the issue of "*riba*" and the products' mechanisms. This issue bears some similarities with that of agency issue in conventional finance, but is more deep rooted than the regulatory approach to the agency issue.

Practice of Islamic banking and finance has been seen in various countries of the world every now and then, since the decline period of the Muslims' science and research.[5] With the spread of Western power and rule across the globe, Western economics and accounting, based on a predominantly capitalistic school of thought emerged. Perceived as a proof of success and political power of the western empires, this school of thought received widespread acceptance and adoption as the recipe for success.[6] However, the capitalistic system too is wrought with problems. Two of the most prominent economic issues are the rising poverty and imbalance in distribution of wealth. Another second indicator of its deficiencies being the fact that western countries too had to resort to government intervention in the form of taxation and welfare role in spite of the *Lasseiz Faire* principles of the market economy of the capitalistic system of economics. The constant tug of war between inflationary pressures, price levels, and tightening or relaxing monetary policies and interest rates, plus other economic activity generation considerations, like unemployment levels is still a practical dilemma and causes many a senior economists, their jobs, if caught at the wrong end of this rigmarole.

Islam is a complete code of life and provides the basis for solutions to all the problems of humanity, including the economic issues. It is up to the people or Muslims[7] (at least) to understand the principles clearly, interpret correctly and provide practical solutions to the society. In this process, innovative solutions that are practical, yet based on the very principles of Quran and Sunnah, ensuring socio-economic justice and fair play, are required.[8] In this quest although there are many issues to tackle, the interplay of three main issues is very important. Firstly, the issue of *riba*,[9] and how to stay clear of riba which is rampant in every nook and cranny of the world's capitalistic machinery, and secondly, how to produce practical yet marketable, riba-free competitive products based of Islamic principles (not necessarily replicas of conventional finance). Thirdly, the concept of distribution and circulation of wealth[10] among the stakeholders and factors of production emanating from the variation in the definition of capital[11] in Islamic economics is an important element. Hence, we have picked up these three basic principles in choosing a product or mechanism for analysis.

[5]With decline in Muslim *Ummah's* social values, and in-fighting among the Muslims. Politically, this phenomenon coincides with the decline and final fall of the Ottoman Empire in the beginning of the nineteenth century, and the rise of the colonial powers of the West. With the colonialisation of most of the world by the colonial powers of the west, the indigenous operational setup were crippled and replaced by the western capitalistic system.

[6]Even the Socialist School of Economic Thought eventually subdued amidst the weakening and subsequent fall of the Russian Superpower.

[7]Researchers, scholars, and Sharia scholars.

[8]Hence, for Muslims to practice their economic part of living according to the tenets of Islam, learning through re-discovering the roots of practical operations of Islamic economics and finance during the peak age of the Islamic Sultanate and following the guiding principles laid down by the Quran and Sunnah are very important.

[9]Usmani (2002).

[10]Chapra (1995).

[11]Mirakhor (2004).

The current paper focuses on the "*sukuk*" (singular sak) which has shown tremendous growth since its global appearance in 2002. The *sukuk* are Sharia permissible, financial instruments of global appeal. They made their debut global appearance in the year 2002 with the first Global *sukuk* worth US$ 600 million issued by the Malaysian government. This break-through was followed by more sovereign Global *sukuk* being issued gradually by various countries. They included the Bahrain Government *sukuk*, The Government of Qatar *sukuk* in 2003, The Pakistani Government-backed *sukuk* PSIC, in 2005, alongside the local currency *sukuk* issued in Malaysia, Bahrain and other countries. The State of Saxony in Germany too, was one of the initial issuers of *sukuk*. After a gradual growth of the *sukuk* from 2002 to 2005, *sukuk* issuance gained momentum, with widespread acceptance and popularity on the global investment scene. Starting from the US$600 million debut global *sukuk* in 2002, the *sukuk* market gained momentum, and later recorded a mammoth growth during the years 2005, 2006 and continued through 2007, with increase in the size as well as volume of transactions. During 2007 the volume of *Sukuk* issued globally rose by 73 percent to US$47.1 billion. This growth in percent terms is lower than previous years but the volumes have increased remarkably. Pakistan registered one of the fastest growth in *sukuk* in 2007, with 20 *sukuk* issued as compared to four *sukuk* issues in 2006.[12] The dynamics of the underlying transactions have also seen tremendous innovation so far.

WHAT ARE *SUKUK*?

The Sharia Standard on *sukuk* [AAOIFI (2003-4)] classifies the *sukuk* as Investment *sukuk* in order to delineate them from shares and bonds. It defines it 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 the* sukuk, *the closing of subscription and the employment of funds received for the purpose for which the* sukuk *were issued*".
>
> (Sharia Standards, 1424-5H/2003-4 Accounting and Auditing Organisation for Islamic Financial Institutions, p. 298.)

In simple terms, *sukuk* are entitlement scrips with each sukk (scrip) representing a fractional ownership in a an underlying asset or project, which may be an investment project like a motorway project,[13] or a property development project[14] or a collection of underlying assets (e.g. real assets like a factory's inventory or vehicles held under Ijara'h scheme of financial institutions).[15] In other words, an item is bought or financed in such a manner that each investor contributes a certain amount to its price and operations, and in turn becomes owner of the proportion contributed, by holding the *sukuk* scrips of that value. The underlying assets as given in the Sharia Standards[16] have to be real assets

[12] Ahmad, Moussa, "*Sukuk* issuance slowing down despite record year, says IFIS", 11 February 2008, Business Intelligence , Middle East, http://www.bi-me.com/main.php?id=17237&t=1&c=36&cg=4.

[13] Pakistan International *Sukuk* Company, (PISC)*Offering Prospectus* (2005).

[14] e.g. Lagoon City *Sukuk*, December 2006.

[15] Securitisation of assets of financial institutions.

[16] Sharia Standards, 1424-5H/2003-4 Accounting and Auditing Organisation for Islamic Financial Institutions.

and/or usufructs. So far the dynamics are simple to understand and accept, passing the litmus test of Islamic postulates. What follows next in this complicated world of financial jugglery, is to be carefully analysed and understood.

To begin from the investors' side first, the investors in the present day financial markets, who would like to "invest" their funds/money today in return for either:

(a) equity stake like common equity, and returns of dividend and /or capital gains,
(b) a periodic, assured rate of return and maturity value payment, as in the bond markets, and/or
(c) venture capitalists who invest in an innovative or promising project with the expectation of reaping the benefits in future, by risking their initial capital investment.

Yet other types could be those with hedging and insurance motives but we shall exclude them from our current analysis for the sake of simplicity and restrict our discussion to the above three types mainly.

Sukuk investors (contributors of funds) cannot be lenders of "money" as the lenders require a return, and this "return" on debt is the very "*riba*" which is impermissible (*Haram*) in Islam. Similarly the return on bonds, are also ruled out as bonds are debt instruments. The three main types of investors explained above can be the probable sources of *sukuk* investors.

The investors who invest their money for equity stake and its return in the form of capital gains and dividend are most suitable for the *sukuk* investment, if the investors are willing to put an equity stake and hold the funds till the projects mature (the life of a *sukuk*). Regarding any equity investment, the regular IPO is required and then with the backing of the stock market (which is a secondary market), investors are encouraged to invest in equity (IPO as well as stocks in secondary market) according to their own risk and reward preferences. However, investment in *sukuk* may not be akin to this kind of equity investment. Its secondary market is now developing. (and its secondary market dynamics too are different). The bond investors described in point (b) above usually invest and hold their investment till maturity, or trade it in the secondary market. However, although *sukuk* investors can be paid periodic returns and a maturity value, they cannot be paid on the lines of bonds, where the return is based on interest on money lent. It seems that this particular type of investors have become the target investors for prospective *sukuk* issues, especially by the sovereign Ijara'h based *sukuk*.[17] In this context, sale and lease-back agreements have been predominantly used due to the suitability of the ensuing periodic Ijara'h rent flows, which can be determined before—hand and in the absence of any clear verdict to the contrary, the rents offered can be benchmarked to LIBOR rates with added basis points representing the sovereign risk factor. Type (c) investors give the possibility of scouting venture capital investments as a source of funding through *sukuk* scrips. This avenue does not seem to have been explored yet although it is probable, depending upon the nature of the projects and the search for venture capital investors. Most of the *sukuk* issues to date are large scale investments amounting to millions or billions of US Dollars or equivalents, although small scale

[17]Ijara'h-based *sukuk* or Ijara'h *sukuk*, are *sukuk* structures in which the underlying assets represent rent from Ijara'h contracts or are based on the sale and—leaseback agreements.

sukuk are also possible if the costs and benefits involved in its issue can be managed productively.

From conventional finance perspective, *sukuk* can be used for securitisation of real assets. The utility of this function of *sukuk* is discussed briefly in the end under "*Sukuk* as instruments of securitisation for Islamic financial institutions".

TYPES OF *SUKUK*

The types of *sukuk* enumerated by the Sharia Standards of AAOIFI[18] are as follows:

1. Certificates of ownership in leased assets.
2. Certificates of ownership of usufructs.
    a. Certificates of ownership of usufructs of existing assets.
    b. Certificates of ownership of usufructs of described future assets.
    c. Certificates of ownership of services of a specified party.
    d. Certificates of ownership of described future services.
3. Salam certificates.
4. Istisna'a certificates.
5. Murabaha certificates.
6. Musharika certificates.
    a. Participation certificates.
    b. Mudaraba certificates.
    c. Investment agency *sukuk*.
7. Muzara'a (sharecropping) certificates.
8. Musaqa (irrigation) certificates.
9. Mugharasa (agricultural) certificates.

In this paper, some of the popular types of *sukuk* that have been issued to date would be discussed. We shall first describe the most commonly used type, which is the Ijara'h–based *sukuk* or *Sukuk* Al-Ijara'h conforming to type 1 and 2 above. Other types would include *Sukuk* Al Musharika and two tiered *sukuk*. Discussion would comprise basic description of the generic form and noteworthy examples of some variations. The issue of distribution or concentration of wealth as a result of the *sukuk* dynamics would be collectively discussed under a separate heading.

***Sukuk* Al Ijara'h**

Sukuk Al-Ijara'h are Investment *sukuk* in which the underlying asset contracts are based on the principle of Ijara'h. More specifically, they are investment certificates representing ownership in leased assets or ownership rights in lease rentals. In the words of The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) "Certificates of ownership in leased assets" are,[19] "… certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by

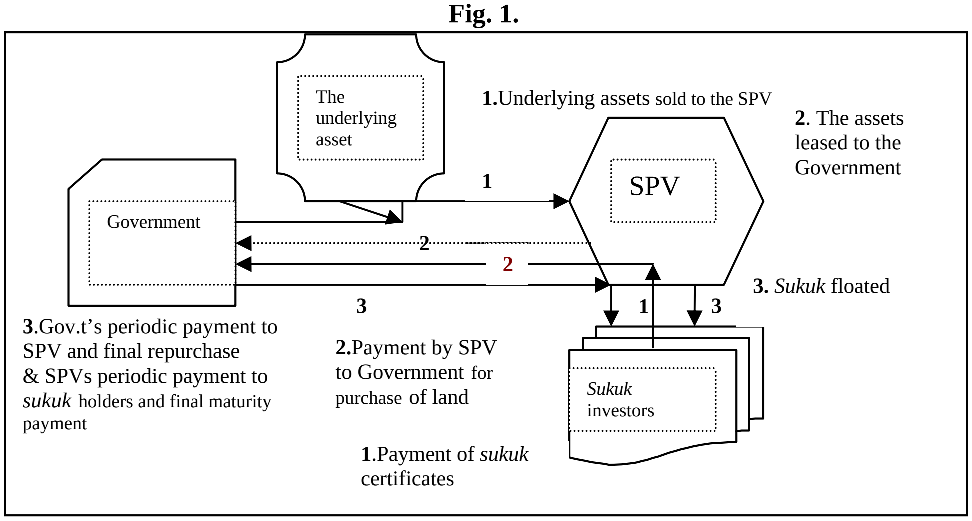
[18]Sharia Standards, 1424-5H/2003-4 Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

[19]AAOIFI Sharia Standard No. 17, Investment *Sukuk*.

promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the assets and recovering its value through subscription so that the holders of the certificates becomes owners of the assets." Another type of *Sukuk* Al-Ijara'h is described as "Certificates of ownership of usufruct of existing assets". It represents an existing owner of assets' issuance of rights (lease certificates) to lease (let) the assets. Hence the usufruct rights of the underlying assets gets transferred to the holders of the certificates, who can then sub-let them in return for Ijara'h rent. Hence the owners of the certificates (*Sukuk* Al-Ijara'h) become the owners of the usufruct of the assets, of the duration of the *sukuk* issue.[20] Another sub-type falling in the *Sukuk* Al-Ijara'h category, represents certificates of ownership of usufruct of described future assets.[21] Through these *sukuk*, the usufruct of the described future (tangible) assets passes(gets transferred) into the ownership of the holders of the certificates. They are issued for the sake of leasing out tangible future assets and rental collection from the subscription revenue. Another type, described as certificates of ownership of services of a specified party can also be issued in this category of *Sukuk* Al-Ijara'h.[22]

Examples of *Sukuk* Al-Ijara'h include the US $ 600 million Malaysian Global *Sukuk*, issued on 03 July 2002 due 03 July 2007 at Libor plus 0.95 percent p.a, Qatar Global *Sukuk* (QGS) floated US$700 Million worth *sukuk* in 2003, due 201, priced at six-month U.S. dollar LIBOR plus a margin of 0.40 percent, the US$600mn, Trust Certificates (*sukuk*) by the Pakistan International *Sukuk* Company, at 6 month Libor + 2.2 basis points.

Fig. 1.



Source: Jabeen Z. "Significance of *Sukuk* Securitisation for Banks, Structuring for Risk Regulation and Pricing", *Conference Proceedings* [IICiBF (2007)].

Sukuk Al-Ijara'h-Critique

While the *Sukuk* Al-Ijarah modes of financing have been popularly employed in various global and local *sukuk* issues, they have been criticised too. In addition to the

[20](AAOIFI), Sharia Standard No. 17, Investment *Sukuk*, p. 298.
[21]*Ibid*. (para 3/2/2).
[22](AAOIFI), Sharia Standard No. 17, Investment *Sukuk*, p. 298.

criticism that their structure bears close resemblance to debt based conventional bond issues, there are currently two main reasons for the criticism in the Islamic finance circles; the sale and lease-back arrangement being close to the Bai Al-Inah and the non-acceptance of major schools of thought except the Shafa'i school of thought (in Malaysia) and secondly, criticism over the fixation of return.

The Matter of Risk and Reward Sharing and Equitable Distribution of Wealth

The return to *Sukuk*-Al-Ijara'h investors (*Sukuk* holders) is a fixed "rent" paid which is benchmarked to the conventional inter bank rates like LIBOR (London Interbank Offer Rates) and KIBOR (Karachi Inter bank Offer Rates). It is not based on the return from the underlying business but to inter bank money market rates (LIBOR or KIBOR plus a sovereign risk). Irrespective of the absence of a clear Sharia verdict to the contrary, one thing is certain that these returns are not in line with the outcome of the underlying business or project/s.[23] In addition, the guarantee ensuring payments as they fall due to *sukuk* investors, provided by the originators to the issue and third party guarantee is also debated, from the point of views of Muslim scholars (for and against).[24] The Islamic Fiqh Academy describes the conditions of permissibility in the case of Muqaradah *Sukuk* (Resolution No. 30 (3/4)). The crux of the matter is that the guarantor and the issuer must be legally separate entities, and that no monetary considerations taken for the guarantee. This point has also been described with the help of an example,[25] and with the commentary that the SPV and the issuers are 100 percent owned by the originators but from their financial liability perspective, they are autonomous, and these are legal entities independent from the guarantors, these transactions are permissible.

Although technically speaking, what the above author is saying and what the proponents are saying is correct, a 100 percent owned subsidiary or an SPV, is a legal loop with a very different effect from regulatory perspective. Looking at the essence and effect of the transaction structure is very important.[26, 27] When analysing this guarantee under discussion, and its effect on the substance of the transaction, the guarantee becomes a contingent claim on the guarantor, like a performance guarantee, even if no monetary payment is taken for it, as described as a condition by the Islamic Fiqh Academy Resolution (No. 30, 3/4).

Due to the above reservations about the guarantee[28] there is apprehension that the resulting product becomes almost the same as that of conventional bonds and even more secure for the investors.[29]

Other Types of *Sukuk*

While *Sukuk* Al-Ijara'h have been the most commonly used type, *sukuk* development has now seen other types of *sukuk* also. For instance, the multifaceted *sukuk*

[23]Jabeen and Khan (2007).
[24]Al- Bashir (2007).
[25]Al- Bashir (2007), p. 5, 6.
[26]Basel II, Securitisation Framework, BCBS (2004).
[27]Jabeen (2006).
[28]Regarding periodic payments, maturity value payment as well as the undertaking to repurchase residual assets by the originators.
[29]Jabeen (2006).

and those with underlying equity participation, and some *sukuk* leading to the option of IPO upon redemption.

A Two-step *Sukuk* with Combination of Istisna'a and Ijarah

National Central Cooling Company, (Tabreed) PJSC / UAE *sukuk* has been a two step corporate *sukuk* composed of Istisna'a based contract initially followed by the second phase of Ijara'h of the assets manufactured. This *sukuk* has been the first rated *sukuk* by a corporate in the Middle East and the first *sukuk* listed on London Stock Exchange, and hence the first ever listed on the regulated markets in Europe[30] This structure had a number of added / innovative features. Firstly in order to be rated as Investment grade from Standard and Poors, on the date of Issue , certain part of the *sukuk* proceeds were invested in those Islamic capital protected deposits, complying with a pre-agreed investment criteria. This fund investment shall be kept till the time Tabreed delivers the underlying product(district cooling plants). In addition, a commodity trade future was also set up /created, as it was required of the issuer to hold tangible assets equivalent in value to a minimum of one-third of the aggregate face amount of the *sukuk*. This was required for the tradability from Islamic perspective.

Nakheel Development *Sukuk* (November, 2006) used an Ijara'h *sukuk* structure prior to its (expected) IPO. It was priced at LIBOR +1.2 percent.

Sukuk Based on Equity Participation

Some *sukuk* have an element of Shirkat-ul-Aqd or Shirkat-ul-Milk either at an initial stage and yet others have a conversion into equity (shares) feature as the next step. Theoretically speaking, the Musharika base can provide a return related to the risk and return of the Musharika undertaking, unlike the rent-based fixed percents above Interbank market rates (e.g. LIBOR, KIBOR, SIBOR and others) seen in *Sukuk* Al-Ijara'h.

Equity participation and profit and loss sharing among investors is regarded as a better alternative if practicable too. In other words, it is a sort of "ideally" Sharia permissible investment mode in Islamic economics and finance. It is considered that through contribution in capital in the form of equity puts the equity holders on a more equal footings regarding profit sharing and loss or risk-sharing. Secondly the new equity investors, too are serious about the underlying business, instead of the intent of "skimming" the profit through an investment undertaking (as in stock market "buying-selling operations) and getting a pre-determined return, irrespective of the outcome of the business, as in debt-based investments.

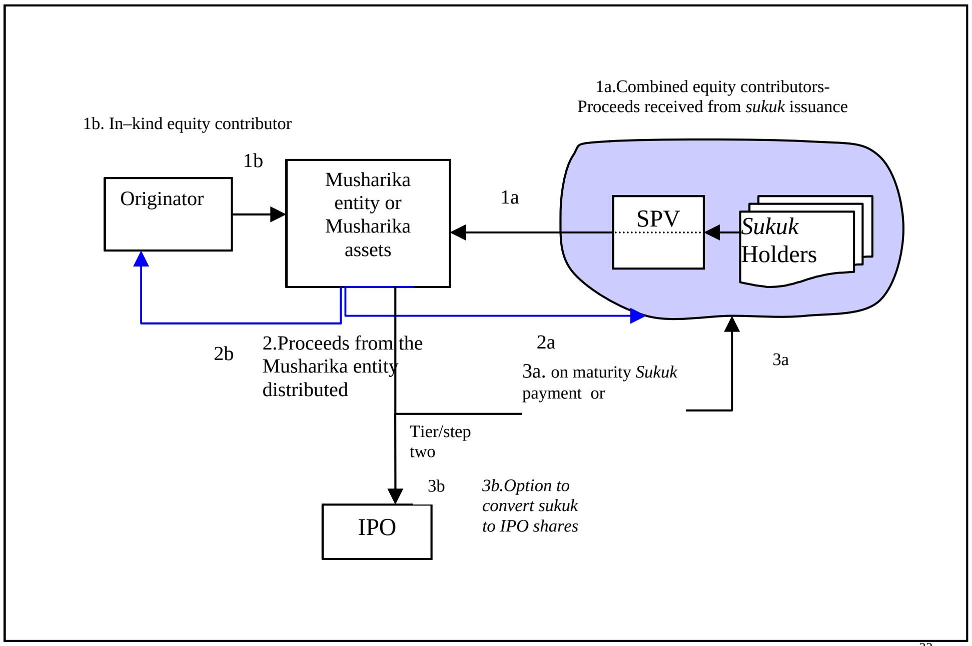
Musharaka or Shirkat-al-Aqd, means contractual partnership.[31] *Sukuk* based on the Musharika concept in financial terms are called Musharika *Sukuk*. They are defined as certificates of equal value, which are issued for utilising the funds for establishing or development or financing a project or a business activity on the basis of any of partnership contracts. The certificates give them ownership entitlement in the underlying project, and its assets in proportion to their respective shares. The Musharaka

[30]Ameinfo.com, news: Tuesday, July 25, 2006.

[31]"Sharika (Musharaka) and Modern Corporation, Sharia Standard No. 12, pp. 197-226, "Sharia Standards", Accounting and Auditing Organisation for Islamic Financial Institutions, 1424-5 H/2003-4.

certificates' structure can be on the basis of participation or Mudaraba or investment agency. (AAOIFI, Sharia Standards, 1424-5H, 2004-3).[32]

Fig. 2. Musharika *Sukuk*—Basic Structure



Source: Zohra Jabeen "*Sukuk*—Structure, Principles and Developments". *Conference Proceedings* (2007).[33]

Like an Ijara'h *sukuk* and other *sukuk* forms, in a Musharika *Sukuk* structure, the Originator forms an independent Special Purpose Vehicle (SPV) for the purpose of floating the *sukuk* and for managing a project, a musharika entity or musharika assets. However, the point of divergence from other *sukuk* like Ijara'h *sukuk* lies in the fact that the underlying business activity is run on the basis of profit and loss sharing between the SPV (on behalf of the *sukuk* holders) and the originator. The SPV issues *sukuk* certificates for the purpose of musharika-based participation in the project. The proceeds of the *sukuk* are used as the equity contribution of the SPV (and *sukuk* holders), along with the (usually) in-kind contribution of the originator in the musharika project or entity. The Musharika entity is run/managed separately from the main business of the originator. However, if the expertise of the originator is required, the originator serves as manager and agent of the partners too. The proceeds (profit and loss) from the business are shared among the originator and the SPV on the basis of a pre-agreed ratio and terms of the contract. The SPV further distributes the proceeds among the *sukuk* holders on the basis of the terms of the contract. At the end of the *sukuk* term (maturity) which usually coincides with the maturity /or completion of the musharika business/project, the project

[32]"Sharia Standard No. 17, Investment *Sukuk*", pp. 299, " Sharia Standards", Accounting and Auditing Organisation for Islamic Financial Institutions, 1424-5H, 2003-4.

[33]*Source*: Zohra Jabeen, *Conference Proceedings.* October 2007.

is wound up and the proceeds distributed and sold according to the terms of the contract. If it is a two tiered *sukuk*, the option to redeem or convert *sukuk* into IPO shares according to the terms given, is available to the *sukuk* holders. This provides a further opportunity to the *sukuk* holders to avail an equity conversion facility, usually at rates, that are better than the market rates at that time. To re-iterate, if the musharika business is such that it cannot be wound up, or the originator wants to continue running it, it is only feasible to launch an IPO or ascertain its value at which the originator can purchase the contribution made by the *sukuk* holders. Example of the above-mentioned musharika-based *sukuk* include the PCFC (Dubai Ports) *sukuk* (i.e. The PCFC Development FZCO *sukuk* of Dubai**,** issued on 23rd January 2006), a combination of pre- IPO (Initial Public offering) along with the Musharika *sukuk* structure; Caravan 1 Limited (2004) a two- tier structure with *sukuk* and redeemable participatory shares issued involved securitisation of Automobiles (Inventory), as well as two SPVs in two different jurisdictions, (Saudi Arabia and Jersey).[34]

Non-voting Participating Shares in *Sukuk*

Another type of *sukuk* in the shape of non-voting Participating Shares appears in the example of Sanad Investment Company Limited. It issued non-voting participatory shares in Sanad Investment Company Limited at a par value of $0.01 per share. The company mentioned that the expected return would be above LIBOR, but without any assurance that the Fund Company will achieve such projected returns. The mentioned risks associated with such investment pointed out the possibility of a diminution in the principal amount invested. The sole placement agent of the Participating Shares is Encore Fund Management Co. Ltd. It is mentioned that the Fund Company's strategy is that of creating and managing a portfolio of Islamic "debt" transactions mentioned as *Sukuk* (around 75 percent) and other Islamic debt instruments but no equities.

Sukuk with profit and loss participation element are looked upon as the new hope to consider *sukuk* as purely Islamic and clearly Sharia permissible. (The guarantee issue, if any, in these *sukuk* too, is to be assessed likewise as explained in the matter of Ijara'h *sukuk*).

Musharika *Sukuk* Critique

It is only natural to expect that the *sukuk* based on Musharika principle shall be providing a return to the *sukuk* holders, based on the performance of the underlying project or musharika based business. Any other arrangement like agreeing to a fixed percentage profit rate or the basis of the inter-bank market rates (like LIBOR plus sovereign or corporate risk) would be open to debate but needs to be seen from the practical aspects and possibilities.[35] It is hoped that the tier two, conversion to equity

[34]Caravan I, *Offering Prospectus* (2004).

In addition to the pre-IPO Musharika *sukuk* structures, Ijara'h *sukuk* Pre–IPO structures also exist. One of the very large sized (US$ 3.52 Billion), Nakheel Development *Sukuk* (November 2006) used an Ijara'h *sukuk* structure prior to its (expected) IPO. It was priced at LIBOR +1.2 percent.

[35]Authors' opinion, based on explanation given regarding LIBOR-based pricing in *Sukuk* Al-Ijara'h. The mentioned *sukuk* were priced as follows: PCFC *sukuk* of Dubai (Jan2006)=fixed 7.125 percent (QPO redemption date)-10.125 percent (if final or mandatory redemption), and Caravan 1 Limited, (2004)= March 2004=6 percent fixed.

should take care of smoothing out any initial pricing anomaly by providing opportunity to *sukuk* investors to reap eventual benefits from expected capital gains and commensurate share in long term growth of the company. The choice to invest in the *sukuk* of a company or project and the equity stake (IPO conversion) is the business risk which such *sukuk* investors make.

Sukuk as Instruments of Securitisation for Islamic Banks

It is the author's observation that since the Islamic banks have to deal with many Ijara'h contracts and Murabaha (deferred Murabaha) contracts on behalf of their clients, and the ownership rights of the assets under these contracts lie with the banks, in proportion to the principal payments made by the clients, it becomes necessary for the Islamic banks to sell off these real asset portfolios to shred off some extra long–term asset weight off their balance sheets. This can be achieved through the *Sukuk*-Al-Ijara'h *sukuk*, with the Bank's Ijara'h based, and Murabaha based tangible asset ownership being transferred to the *sukuk* holders, in return for the Ijara'h rent. Under a blanket agreement, one tranche can be replenished by another tranche, with flexibility for the terms according to the terms agreed with the bank clients.[36]

SUKUK, TFCs, and REITs

Sukuk bear similarity to Real Estate Investment Trusts (REITs) and to Term Finance Certificates (TFCs). Term Finance Certificates issued in Pakistan in many instances, by companies and corporates which needed funding. The certificates are purchased by the financial institutions as quasi-equity scrips, in the companies till the expiry of the TFCs.[37] The Real Estate Investment Trusts are also a concurrently popular product and is specific to financing of property development and management activities through unit trusts. To my observation, these three products, namely *sukuk*, Real Estate Investment Trusts (REITs) and Term Finance Certificates (TFCs) are very similar products, especially the *sukuk* and Real Estate Investment Trusts (REITs). Further discussion on TFCs and REITs is beyond the scope of the current study.

Assessment of *Sukuk* for Risk and Reward Sharing and Equitable Distribution of Wealth among the Stakeholders

(a) Investors' Role in Economic Development of the Host Country

The positive development seen in fund generation through *sukuk* is that of cross country or cross region investments, are taking place especially in infrastructure development projects. However, there are three issues in the current practice of risk-reward sharing with investors. First, the return pattern in *sukuk* issuance is not linked to the expected returns from the underlying projects but to the country risk (in examples of international *sukuk*).[38] Secondly, the *sukuk* instead of sharing the business risk of the

[36] Jabeen, *Conference Proceedings* (2006).

[37] Examples include Sitara TFCs and others.

[38] See for example LIBOR+2.2 for Pakistan's International *sukuk*, LIBOR, +0.5 for Qatar's International *sukuk* , and LIBOR 0.95 for Malaysia's International *sukuk* . All of them were Ijara'h *sukuk* of very similar pattern.

underlying assets and projects, are virtually risk free because they are guaranteed their periodic returns and principal by the originators. Thirdly, the Musharika *sukuk* examined for the study, revealed a fixed rate of return to the *sukuk* holders. This is contrary to the Sharia standards regarding the rules of Musharika-based contracts as well as Musharika *sukuk*.[39]

Let us examine the economic implications of this existing pattern of risk and return dissemination in the *sukuk* under discussion. Take the case of Pakistan's Global Ijara'h *sukuk* [PISC (005)]offering LIBOR +2.2 to *sukuk* holders. The *sukuk* was floated to finance the motorway project.(underlying project).Take two situations. In one situation , the expected returns pattern from the motorway project are also on the pattern of LIBOR +2.2, of course allowed for a margin for covering costs and exigencies of the project. In this situation, the *sukuk* would have equitably benefited all stakeholders; the issuers/originators, the investors and has long term qualitative benefit to the economy through infrastructure development. In the other situation, suppose the return from the project is below the rate agreed with the investors. In that case the negative impact will be felt by the whole economy, with negative economic growth when the cost of outflows exceeds the inflows. The economy faces net loss and the investors take the benefit from the project to their own regions. Similarly if alternate sources of investment are available at lower costs (and hassles), then too, a costly *sukuk* would harm the economy too, especially when the LIBOR rates take an upswing.

When the returns from medium to long term projects, like the infrastructure projects, follow much later but the *sukuk* investors are paid before any returns from the actual underlying projects start. It is advisable to tie the rewards and risk sharing between investors and issuers according to the returns pattern and capacity of the underlying projects. Since, the *sukuk* investors are paid from the exchequer in government sponsored projects, the project's benefits have to be weighed against other imminent needs of the economy and alternative projects as candidates for investment.

(b) Distribution of Wealth—Large Investors vs. Small Investors

Sukuk are offered to investors who are doing bulk investments of large sums of money. If these risk-reward patterns for investors are more favorable than that offered to medium to small scale investors, it means that more benefits are going to the large investors as compared to others. If the rates of return and the risk terms offered to these large scale investors are better than that available to the small investors, or the banks' average depositors (in the case of banks-originated *sukuk*) this has another very negative connotation in terms of imbalance in the distribution of wealth (and rewards and risk) in the society, which is contrary to the socio-economic principles of Islam. *Take for example the rates of return on National Saving Certificates (NSC) and the average rates of return on the medium term deposits and compare them with the rates of return offered to investors of local currency sukuk of comparable tenure.* If the rates of return for *sukuk* are higher than the rest, this is leading to the creation of an investment niche which costs the exchequer more than the other comparable alternatives and which is benefiting a certain high net worth class of investors in the economy.

[39]AAOIFI, Sharia Standards (2002) "Sharika", and Musharika *Sukuk*.

When *sukuk* are being offered to banking institutions are favorable terms, i.e. *Sukuk* investment by banks qualifying as Special Deposit Receipts, the excess liquidity in banks which is created mainly through deposits, is used to fund *sukuk* . This means that the banks as intermediaries are able to take the spread and their operating costs out of the *sukuk* returns and then paying a lesser amount to depositors. It is suggested that the banks' spread in this regard should be narrowed down so that more wealth trickles down to the small depositors, instead of the shareholders of banks. Another alternative may be the creation of *sukuk* SPVs as intermediaries, in direct contact with the small depositors to generate funds for *sukuk* from depositors, so that risk and rewards are more spread out and shared with the households.

CONCLUSION

The development of Islamic Financial products that provides impetus to the economic machinery of a country are no doubt a pleasant initiative. Whether the new Ijara'h based and Murabaha-based trading contracts have led the Islamic financial institutions to introduce Islamic financial dealings in banking, or the fine tuning of these and other transactions to ensure Sharia compliance, these are welcome signs. *Sukuk* as equity scrips simply, open huge possibilities to explore and adapt, with the Sharia permissibility (of course, inclusive of fair play and justice to the parties involved). Though currently operating mostly at institutional and sovereign level, with the volumes of transactions breaking the previously set records, quite often, these can also be utilised for small scale investment needs, if the operational costs can be met easily. *Sukuk* have the flexibility to mould the financial requirements and investment opportunities according to the Sharia requirements, as well as meeting the requirements of investments (demand and supply side). More importantly, these instruments have provided an alternate choice to the market in the form of non-debt based (like Ijara'h *sukuk*) and equity-based and other quasi-equity investments that can also be availed productively. However, because of their bond-like structures, in the conventional finance perspective, many of the *sukuk* structures are still considered as "Islamic Debt structures", especially in the regulatory treatment. It is felt that if the target investors for *sukuk* become venture capitalists and those investors who want to invest in equity capital for medium to long term, instead of the bond market investors, the risk-return pattern of the *sukuk* would change according to the returns on equity. They would no more resemble bonds.

Currently the *sukuk*'s risk and return are comparable to the bond market rates and pattern, and most of them, especially Ijara'h *sukuk* offer LIBOR plus a margin, while protecting the returns and the final maturity payment for the *sukuk* holders. When their risk-returns distribution pattern is aligned to the risk-return of the underlying project, this development would make true investment *sukuk* according to the spirit of Sharia. In addition it would benefit the host country's economy because it cause *sukuk* holders (investors) to take part in that country's growth by sharing its business risk and drawing returns according to the (expected) returns from the underlying projects. Such a course of action would be equitable usage and distribution of wealth.

Despite all the short comings discussed, it is not surprising to know that *sukuk* are flourishing. When the target investors are Muslims for whom Sharia permissibility is an important element in their decision-making, such products are growing and there is still a huge latent market waiting for them. With the rise in oil prices, more money is available for investment from the oil rich countries, particularly in the Middle East region. In order to attract this investment to their own countries and regions, non-Muslims countries of the west and east and Europe too are tapping the target market utilising these tools (*sukuk* in particular), as long as they are financially safe and sound and adequate regulatory safeguards are in place. However, their adjustments in *sukuk* to meet the rating agencies' demands cause *sukuk* structures to converge with bond structures instead of the AAOIFI prescribed *sukuk*. However, as explained earlier, *sukuk* designed for risk and reward sharing based on underlying assets and projects, according to the Sharia standards, would promote distributive justice, aligned with economic growth and it would be a major achievement in history. Not only would it enable the Muslim Ummah to rid itself of the yoke of riba and debt-based financing, but it would also develop the practice for risk and reward sharing in the economy, which in turn would lead to a balance in the society through equitable and just distribution.

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