



Sukuk (Islamic Bond): A Crucial Financial Instrument for Securitisation of Debt for the Debt-holders in Shari'ah-compliant Capital Market

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Abstract

This applied study is aimed at guiding practitioners and offering an insight to academicians, investors and interested parties in understanding the manner in which an Islamic bond be created. As such, all terms in respect of shari'ah-compliant were thoroughly observed and analysed in the stages of creation of such sukuk. As such, documentations and transactions involve in the dealings of this instrument are thoroughly explored. The simple model of sukuk in this study contributed in term of an innovation that offer an insight to the practitioners, academicians, investors and the interested parties of this shari'ah-compliant capital market instrument to facilitate the process of securitisation for the debt holders.

Qualitative method of research and descriptive approach to research method are employed in this study as they are appropriate in looking into the research issue understudied. [Mohd Nasir bin Mohd Yatim, 2009] Capitalising on the explored and examined instrument shall then become the basis in innovating more sophisticated models by future research efforts for multiplicity of instruments to be made available in the shari'ah-compliant capital market.

Keywords: Sukuk, Shari'ah-compliant, Securitisation, Shahadah al-dayn and gharar

1. Introduction

The Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) defines sukuk as certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity. In simple term sukuk is a right for both ownership and claim over the underlying asset or its usufruct substantiating the issuance of such sukuk. Sukuk has now becoming a preferred financing option for governments and corporate across the globe. This phenomenon led the international fraternity to jump on the Islamic finance bandwagon. [Anna Maria Samsudin, 2008]. Presently there is an ever growing global market for shari'ah-compliant bond term as sukuk. Basically, there are two types of sukuk, debt-based sukuk and equity-based sukuk. Both are created to facilitate financing for capital requirement of businesses and the governments. Subsequent to the issuance process, the sukuk shall then be readily securitised. Such duly created and issued certificate of debt could then be traded in the secondary market. This process is known as securitisation. This securitisation is facilitated by the shari'ah framework of shahadah al-dayn. Shahadah al-dayn simply refers to certificate of debt or sukuk issued evidencing the drawer's debt onto the drawee in a primary market. The criteria for issuance of sukuk includes firstly, there must not be any element of interest be it fixed or floating and secondly, its creation is based on an underlying permissible transaction whether a debt-based or an equity-based assets, utilising further shari'ah frameworks such as ijarah, bai' bithaman ajil, murabahah, musharakah mudharabah etceteras.

In conventional banking this tradable certificate or security is issued for a loan with interest to raise fund. In addition to this, annual coupon rate is introduced for the security; often serve as sweetener to the potential investors. The prime difference between sukuk and conventional bond is the absent of interest element and the existence of an underlying permissible transaction. There is no annual coupon rate attached to the sukuk and thus its characteristic is of zero coupon bonds. [Mohd Nasir bin Mohd Yatim and Amirul Hafiz bin Mohd Nasir, 2008]

2. Archival review

Sukuk is the form of certificate of debt which works under the shari'ah-compliant framework of shahadah al-dayn [Mohd Nasir bin Mohd Yatim, 2009]. It is just like an Islamic accepted bill (IAB), an al-dayn instrument created based on the framework of murabahah. Both sukuk and IAB are traded in the secondary market based on the principle of al-dayn or exchange of debt. Whilst, pricing of sukuk in its dealings in the secondary market is at a discount to the value payable by the issuer upon maturity. For instance, if a customer A owes RM100 million to Bank A, apart from the legal documents, an "I owe you" (IOU), a form of promissory note is created to evidence this debt. In this case, customer A draws the note onto Bank A. Bank A may then sell this debt to Bank B, Bank C or other interested institutions in the secondary market.

This study will address the issuance of sukuk to offer a guide for future innovation of more sophisticated instrument for shari'ah-compliant capital market. In order to achieve the objective of this study, we began with looking into the regulation particularly related to the restrictions in exchange of sukuk in a setting of shari'ah-compliant financial and capital markets. The exchange dealings of sukuk in a secondary capital market usually were restricted to corporations with established reputation such as a takaful institutions, statutory bodies, and approved pension funds and government-linked-companies. The rationale is simply for the assurance in the repayments of the indebted party of such sukuk.

In revisiting the basics, in its exchange dealings a sukuk does not involve with physical delivery and it shall be deposited with the authorised depository or principal dealer of the facility. At this juncture, the responsibilities of the issuance and paying agent (authorised depository) have to be explored in order to ensure the efficient and effective operation of this instrument in its trade dealings. Amongst others, the responsibilities of the issuing agent include ensuring the correct quantity of the executed notes and this can be controlled by way of numbering the issuance with serial number noting the maturity date and the issuing date. Further, the issuing agent has to ensure that all notes be duly executed by the authorised signatories of the issuer and the agent. Finally, the issuing agent shall within ten business days of the issue date or date of cancellation or destruction of the sukuk, communicates with the issuer by issuing a certificate confirming the number of sukuk issued, the face value, serial number, the date of issue and maturity date of such notes, and notification on the number of sukuk being cancelled and destroyed (if any) and their serial numbers.

This exploratory study is not complete without looking into the responsibilities of the paying agent. Amongst others, the paying agent has to maintain promissory notes register containing full and complete records of all issuance, redemptions and cancellations. The paying agent too, is to ensure the issuer is instructed within two business days of any maturity date, to place the redemption amount in a designated account at the latest before noon on the maturity date. Further, the paying agent is to pay the face value of the notes to the owners of the notes as appeared on the promissory notes register on the maturity date and shall cancel and return to the issuer all notes paid and redeemed within 30 days of the date of cancellation. In addition to those, the paying agent shall only allow replacing notes which are mutilated or destroyed upon receipt of the cost of replacement, evidence of destruction or mutilation and submission of safe custody receipt. Finally, the paying agent shall track out of pocket expenses (legal, cable and postages) incurred and bill it onto the issuer.

Another important aspect in guiding the innovation of sukuk is to identify the responsibilities of the authorised depository agent which include duty to keep track of the security cover which shall be 130% of the security amounts at all times and to ensure customer to respond within 7 days of notice for additional security. They also act as market maker for the notes by providing a two way quotation at all times on inquiry by the public and help the note holder to dispose his notes in the event he decide to sell. In addition to those, the depository agent shall make known the availability of notes to other potential investors and to ensure that the total number of note holders does not exceed a certain number at any one time and be restricted to the following entities namely, banks and corporations gazetted by the ministry of finance, insurance companies, statutory bodies and approved pension funds [Companies Act of Malaysia, 1965]

3. Methodology

In designing a sukuk, the task is not only scratching beneath the surface. It needs to explore the product and mechanism of its dealings to avoid marketing gimmicks alone. Therefore, it needs efforts in navigating uncharted waters to arrive at a solid instrument. This study emphasised on qualitative research method and descriptive research approach as both are appropriate to look into the research issues under-studied. In addition, analytical and comparative approaches to research are also employed where appropriate. Exploratory and observation by visit and re-visiting approaches were also carried out. Scrutiny on relevant documentation with reasonable broad and in-depth study of the subject matter has been carried out to ensure coverage on the locus and focus of the issue under-studied respectively. Thus these could justify the holistic nature of the issue being focussed and the scientific characteristic of this study. Interviews were also carried out aimed at validating on the technicalities and looking into the perspectives of various parties on the understudied issues including the operators, users, regulators and both external and internal auditors.

In this study, it was hypothesized that innovation of sukuk is probable in shari'ah-compliant capital market. Therefore, the justification on such assertion has to be explored in order to ensure its shari'ah compliant and trueness of the assertion. Archival study was intensively studied and interactive exploration with selected above discussed respondent on related activities were carried out. Relevant documentations were scrutinised in detail to justify the validity and reliability of the outcome of the model being innovated in this study. A shari'ah-compliant banking activities are commercial activities as reported in the New Strait Times on Thursday dated 14th April, 2009 and therefore relevant guidelines are necessary to facilitate the industry, otherwise it impacts on the consumer and the integrity of both the shari'ah-compliant financial and capital market.

4. Discussion on a simple model of sukuk

For the purpose of clarity this discussion on a simple model of sukuk be categorised into five steps which deal with assessment of the issuer, obtaining mandate of the potential issuer, outlines the principal terms and conditions of sukuk facility, finalising the material and legal aspects with execution of documentations and finally computation of face values of both primary and secondary sukuk and working on their issuance. The discussion on designing a model of sukuk issuance shall include the steps and procedures involve in the innovation. The first step that a bank should look into is of the reputation of the corporate customer which normally a listed corporation. Apart from this the principal business of the corporation is looked into including the currently on-going projects for the justification of the type and amount of funds required. Assuming (1st assumption) in this case a corporation requires RM30 million working capital funds to complete a project. Next, assuming (2nd assumption) also this customer is negotiating with one bank to save time and costs for the issuance of sukuk.

In the second step, the bank shall obtain a mandate from this customer to arrange for the facility. This mandate is usually in the form of a resolution of meeting of the board of management or board of directors of the corporation where appropriate. The implication of insisting this mandate on the part of the bank is that, should the facility be aborted, then the bank can seek a remedy to recover its expenses from the customer. In the next discussion, we identify the characteristics of sukuk, which can suit the capital requirement of this customer. The objective of liberalising the characteristics is none other than to provide convenience in attracting both the local and international investors in investing with the corporation issuing the sukuk. Efforts in liberalising the characteristics include issuance of sukuk in foreign currencies outside the issuer's country. This can be facilitated by making available the shari'ah and legal framework and conducive tax incentive

The third step, the bank shall then negotiate the principal terms and conditions of the facility with the customer. Such terms and conditions of the facility shall then be the characteristics of this facility which usually include the tenor of this facility, the collateral of facility, the yield of this facility, the mode and related subject matter of the permissible underlying transaction to accommodate the basis for the issuance of the sukuk. In furtherance of the process of issuance of sukuk, it is further assumed (3rd assumption) that this customer requires the financing facility for a tenor of five years. This customer is also offering its shares in a listed subsidiary as collateral and at the same time the subsidiary's assets are used to facilitate a trade transaction on the basis of al-bai' bithaman ajil (4th assumption).

In order to determine the acceptable yield, both the bank and the customer will take a view of what shall be the cost of financing or market rate that will prevail in the next five years from now. One must bear in mind that, the customer would not want a yield that would be too high, if market rate is going to drop over the next five years. On the other hand, the bank would not want a yield that would be too low, if market rate is going to rise over the next five years. As such, in determining what would be the anticipated market rate over the next five years requires some knowledge, skill, experience and element of intuition that could be offered by market analysts or specialise consultants or even the banker and the customer themselves. It might be after some negotiation, the bank and customer will agree to a determinable yield. Assuming in this case the agreed yield for this facility is 8.75% p.a. (5th assumption). This is actually what would be the internal rate of return (IRR) for the bank's investment.

In step four, the bank shall device the following final principal terms and conditions which may basically be exhibited as example for this case as depicted in Exhibit 1. The final step is the computation of face value of secondary notes. In this regard, all computations shall be finalised and all notes shall be issued within three months after the date of the share sale agreement. The date of notes issued shall be the date of the disbursement of the purchase price of the shares. The following computation is based on the above discussed assumptions. In concluding these discussions on the modelling of a simple sukuk, a summary in Exhibit 1 provides the information relating to the characteristics of the assumed sukuk. In exhibit 2, shows the computation of the total profit of the facility for the 5 years tenor.

5. Conclusion

The prerequisites in the success of an innovated instrument lie on having good financial infra-structure, full-range system and good regulatory system. [Kamal Bayramov, 2009] Thus a valid and reliable innovated product has to go through exploratory processes at its designing stage. Verification and testing activities were conducted to achieve the

aim of wide acceptance of this innovation. The duly discussed innovation is about a simple model of sukuk for both primary and secondary shari'ah-compliant capital market. Based on the above discussion relating to this innovation, the hypothesis, that innovation of sukuk is probable in shari'ah-compliant capital market is validated and therefore a reliable financial instrument for investors. The instrument is reliable for use by the investors in shari'ah-compliant capital market as there is no element of usury (riba) involve both at the stage of its issuance as well as in its trade dealings. The instrument is also created free from element of ambiguity (gharar) as all material facts are made clear in both its documentation as well as the instrument. Further, there is no element of gambling (maisir) in its trade dealings.

Since its permissibility is of probable in nature, therefore it is worthy to look at the advantages of issuance of sukuk so as to encourage more players both the issuer and the investors involve in it and thus benefiting the economic well being of the society (ummah). Such advantages include facilitating an alternative to conduct business financial affairs according to the dictates of Islam and hoping for the blessings in the form of al-falah and help in boosting the frontier of the Islamic capital market. In country such as Malaysia, there is incentive in the form of cost saving in term of stamp duties exemption on issuance of Islamic private debt securities including sukuk. Sukuk is therefore a securitised facility and thus is more attractive in term of its marketability compared to a syndicated facility which is a non-securitised. The underlying transaction for the issuance of sukuk has the ceiling limit in term of its pricing. This will enable a customer to prepare budgets and projections with certain degree of certainty. It can be issued and floated internationally and thus enabling access to international Islamic funds. It can be issued in foreign currency too. Since sukuk is issued on a yield to maturity, therefore it is known to be issued on the basis of deep discount and thus giving full grace to the issuer. It can be listed on the stock exchange and this offers an opportunity for capital gains to interim investors which are suitable for the behavioural need of a capital market. It is a pre-requisite that a Sukuk to be made as a bank guaranteed facility, in order to ensure confidence on the instrument and to ensure wide acceptance of it. For this reason, big investors such as Employee Provident Fund and Government-Linked Companies (GLC) are readily available in accepting as the drawee party to the sukuk.

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Exhibit 1

1	Customer/ Issuer	Corporate client								
2	Nature and amount of facility	<p>Syndicated al-bai' bithaman ajil with notes issuance facility of Currency:30 million (The facility)</p> <p>Under this facility, the financiers shall first purchase from corporate client's subsidiary's shares at agreed purchase price.</p> <p>These same shares shall then be sold to the corporate client at a selling price which shall be made up of the original purchase price and a profit margin to be imposed by the financiers.</p> <p>The corporate client is to settle the selling price by instalments.</p>								
3	Arranger / agent	The corporate client's named banker								
4	Authorised depository	The corporate client's named banker								
5	Financiers	Financial or other institution acceptable to the arranger and the issuer								
6	Purpose	To refinance the shares belonging to corporate client and the proceeds to be utilised for its working capital requirements.								
7	Purchase price	Currency30.0 million								
8	Availability	<p>The facility shall be made available in one trench in the following manner.</p> <table border="0" style="margin-left: 40px;"> <thead> <tr> <th style="text-align: left;">Trench</th> <th style="text-align: center;">Amount/ price (Currency million)</th> <th style="text-align: center;">Purchase in</th> <th style="text-align: center;">Tenor of notes (years)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">1</td> <td style="text-align: center;">30</td> <td></td> <td style="text-align: center;">5</td> </tr> </tbody> </table>	Trench	Amount/ price (Currency million)	Purchase in	Tenor of notes (years)	1	30		5
Trench	Amount/ price (Currency million)	Purchase in	Tenor of notes (years)							
1	30		5							
9	Disbursement	Disbursement of the purchase price of the shares shall be against acceptable documentary evidence.								
10	Selling price	Currency43.125 million								
11	Instalment period	5 years								
12	Payment of selling price/ Notes Issuance	<p>The selling price shall be payable by 10 semi-annual instalments of Currency:1.3125 million per instalment for the first nine instalments.</p> <p>The last instalment shall be Currency: 31.3125 million. Thus, this facility is structured on a bullet basis with the cost portion payable in one lump sum at the end of the tenor.</p> <p>The profit margin added to the purchase price shall be Currency: 13.125 million representing a yield of 8.75% per annum.</p> <p>The selling price of the shares shall be satisfied by the notes issuance of shari'ah compliant based on the principle of al-bai' bithaman ajil. Those notes shall represent the issuer's unconditional obligation to settle the selling price of the shares in the following manner.</p> <p><u>Primary notes</u></p> <p>60 primary notes of Currency: 500,000 each, representing the cost portion of the selling price which will mature and be payable by the issuer at the end of the tenor of the facility.</p> <p><u>Secondary notes</u></p> <p>Each primary note shall be supported by 10 secondary notes of Currency: 21.875 each of six monthly maturities commencing six months from the released of purchase price. Those notes</p>								

		represent part of the profit portion of the selling price.
13	Issue of notes	The notes shall only be issued by the issuer upon; Firstly, satisfactory completion of all legal documents and compliance with all conditions precedent to the facility. Secondly, receipt of seven business days prior written notice to the agent.
14	Trading of notes	The primary notes together with the respective supporting secondary notes shall be tradable in the secondary market based on willing buyer-seller basis. However, in Malaysia, the trading is subject to the certain restrictions.
15	Security	The shares to be refinanced shall be pledged to the financier under a memorandum of deposit with readily executed blank transfer forms. The total market value of the shares pledged shall not be less than 130% of the total amount outstanding under the facility at all times.
16	Principal pre-disbursement and other conditions	According to the standard practices.
17	Approval and rating	The facility shall be subject to the approval of central bank and security commission and be rated by applicable rating agency.
18	Taxation	All payments under the facility shall be made free and clear of all present and future withholding and other taxes. In the event that any such taxes are in future imposed, the issuer shall make the necessary deduction for payment to the relevant authorities and shall furnish the holder with the relevant official receipt.
19	Documentation	The facility shall be evidenced by the following principal documents. i. Share purchase agreement ii. Share sale agreement iii. Islamic financing notes issuance agreement iv. Memorandum of deposit of shares v. Share certificates and readily executed blank transfer forms vi. Deed of covenant vii. Issuing and paying agency agreement viii. Depository letter of agreement ix. The primary and secondary notes and other appropriate documents which shall reflect the terms and conditions herein stated and other conditions, warranties, covenants, events of default etceteras currently adopted for facilities of this nature.
20	Other conditions	The facility shall be at all times be governed by rules and instructions whether persuasive or in operative in nature required or imposed on the financier, the manager and/ or agent by the central bank or other appropriate authority.
21	Arrangement fee	As agreed between the issuer and the arranger.
22	Agency fee and authorised depository fee	As agreed between the issuer and the agent/ authorised depository.
23	Legal fees, costs and other expenses	For the account of the issuer
24	Governing law	The country's applicable law.

Exhibit 2

Purchase price	Currency:30.0 million
Number of primary notes for each	Currency:500,000 <u>Currency:30.0 million</u> Currency:500,000 = 60 pieces of primary notes
Tenor of facility	5 years
Maturity of secondary notes	Every six monthly basis
Number of secondary notes supporting each primary note for the tenor of five years	$5 \times 2 = 10$
Total profit of facility for 5 years	Currency:30 million x 8.75% p.a. x 5 years =Currency:13.125 million
Portion of profit per primary note	<u>Currency:13.125 million</u> 60 =Currency:218,750
Portion of profit per secondary note	<u>Currency:218,750</u> 10 Currency:21,875