

## **SUKUK-STRUCTURES**

### **AN ANALYSIS OF RISK-REWARD SHARING AND WEALTH CIRCULATION**

**Zohra Jabeen and M. Tariq Javed\***

#### **Abstract**

As Islamic business and finance flourishes, considerable progress is made in developing powerful and effective products that are practical as well as Sharia'h compliant. Sukuk appear to be one of such products. Its issuance is a relatively new trend, since its dawn on the global scene in 2002. The development of hybrid products is widespread in finance. The derivative securities' phenomenon and the process of disintermediation in the conventional (capitalist) financial system have important bearings on product development, worldwide. Sukuk too appears to be one of such hybrid products.

This paper shall attempt to discuss the sukuk dynamics, as a product of Islamic finance by examining its features and underlying structure, with the baseline of Sharia'h permissibility. From the perspective of its utility in Islamic Finance, and justice in the society, it picks a sample from the current sukuk structures for testing two basic questions/criteria, the risk & reward sharing and secondly, wealth concentration or circulation. Besides, the basis for picking these criteria is discussed.

**Keywords:** sukuk, Islamic Finance, securitization, risk and reward sharing, 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.

## SUKUK-STRUCTURES

### AN ANALYSIS OF RISK-REWARD SHARING AND WEALTH CIRCULATION

Zohra Jabeen and M. Tariq Javed

#### Introduction

The financial system of Islam lays down certain basic attributes for the Muslim society to follow, in order to form a society which is based on the principles of socio-economic justice and fair play, equitable distribution of wealth<sup>2</sup>, and likewise ensure socio-economic development in the long run.

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 and interest on debt (lending) is considered as the predominant basis and reward for lending money. On the other hand, Allah (SWT) has very clearly declared interest on loans (“*riba*”) as impermissible (“*haram*”) and the root cause of many evils<sup>3</sup>. The Holy Prophet Mohammad (PBUH) through his “actions sayings and preaching (called “*Sunnah*”) has practically clarified this interest or “*riba*” and given its types too, which are “*Riba al- Nasiyyah*” and “*Riba al- Fadl*”. Very briefly, *Riba Al Nasiyyah* is the type which arises in lending money (loans) while *Riba al – Fadl* arises in exchange of commodities<sup>4</sup>.

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 received little attention as compared to the issue of “*riba*” and the mechanisms of products. 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.

Islamic banking and finance has been attempting to start off individually in various countries of the world every now and then after seeing the decline of the Muslims science and research,<sup>5</sup>. With the spread of Western power and rule across the globe, Western Economics and accounting, based on a predominantly capitalistic school of thought emerged. They were considered as a proof of success of the western empires, and hence was accepted as THE solution and THE right way<sup>6</sup>. However, the capitalistic system too is wrought with problems. Two of the most prominent economic issues being the rising poverty and imbalance in distribution of wealth. A second

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<sup>2</sup> Chapra,U., (1985/1405H), Savharvi,H.,(2001),

<sup>3</sup> Al- Qura’n, Al- Baqarah- 2:275

<sup>4</sup> Usmani,A., (2002), Ahmed,A. (2001)

<sup>5</sup>with decline in Muslim *Ummah*’s social values, and in-fightings 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 colonialization 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.

<sup>6</sup> Even the Socialist School of Economic Thought eventually subdued amidst the weakening and subsequent fall of the Russian Superpower

indicator being that the western countries too, had to resort to government intervention in the form of taxation and welfare role in spite of the *Laissez Faire* principles of the market economy of the capitalistic system of economics. The constant tug of war between inflationary pressures and price levels, versus tightening or relaxing monetary policy and interest rates, plus economic activity considerations, 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 Muslims<sup>7</sup> (at least) to understand it clearly and give a practical solution in the society. To do so, they have to find innovative solutions that are practical in the current complicated settings of the world, yet based on the very principles of Quran and Sunnah, ensuring socio-economic justice and fair play. 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. In this quest although there are many issues to tackle, the interplay of three main issues is very important. Firstly, the issue of *riba*<sup>8</sup>, which is rampant in every nook and cranny of the world's capitalistic machinery and how to stay clear of *riba*, and secondly, how to produce practical yet marketable, *riba* –free competitive products based of Islamic principles. In addition, the concept of distribution and circulation of wealth<sup>9</sup> among the stakeholders and factors of production emanating from the variation in the definition of capital<sup>10</sup> in Islamic economics, is an important element in our analysis of the Islamic finance products. This shall be delved at in this paper.

While the verdict on *riba* is now very clear and many prominent economists and Sharia'h scholars have dealt on the subject very clearly and at length<sup>11</sup>, the second issue of practically running the financial machinery under these guidelines while remaining competitive in the predominant conventional capitalist system remains a big challenge and requires a great deal of hard work and innovative acumen within the bounds of the guiding principles. Similarly, little attention seems to be paid to the issue of distribution and circulation of wealth in the Islamic financial operations, whether at institutional level or at regulatory level. Due to these reasons, the current paper focuses on the "sukuk" (singular *sak*) which is growing by leaps and bounds since its global appearance (2002) to date (2007). The Sukuk are Sharia'h 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 being 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. It recorded a mammoth growth during the years 2005, 2006 and continues through 2007, with increase in the size as well as volume of transactions. During 2007 the volume of Sukuk issued globally rose by 73% 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

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<sup>7</sup> researchers, scholars, and Sharia'h scholars

<sup>8</sup> Usmani, T., (2002)

<sup>9</sup> Chapra, U. (1995)

<sup>10</sup> Mirakhor, A. (2004)

<sup>11</sup> Usmani, T., (2002), Ahmed, A. (2001)

sukuk in 2007, with 20 Sukuk issued as compared to four sukuk issues in 2006<sup>12</sup>. The year 2007 has seen The dynamics of the underlying transactions have also seen tremendous innovation so far.

## What SUKUK are?

Sukuk are called Investment sukuk and defined 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”*

Shari’a Standards, 1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions, p298

The standard mentions that the sukuk have been designated as Investment sukuk in order to delineate them from shares and bonds.

In simple terms, sukuk are entitlement scrips with each suk representing a fractional ownership in a an underlying asset or project, which may be an investment project like a motorway project<sup>13</sup>, or a property development project<sup>14</sup> 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<sup>15</sup>). 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 Shari’a Standards<sup>16</sup> have to be real assets and /or *Ijara’h* rentals 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 analyzed and understood.

To begin from the investors side first, the investors in the present day financial markets , that would like to give their funds/money today , in return for a) equity stake like common equity, and returns of dividend and /or capital gains, b) a periodic and assured rate of return and a maturity value payment , as in the bond markets and 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 another type could be those with hedging and the insurance motives but we shall exclude them 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 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. There are some debates revolving around the similarities between some sukuk structures and conventional bonds. However, we shall re-address this issue later. As explained in the previous paragraph, the three main types of investors can be the probable sources of sukuk investors.

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<sup>12</sup> 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>

<sup>13</sup> Pakistan International Sukuk Company, ( PISC)Offering Prospectus, (2005)

<sup>14</sup> .e.g. Lagoon City Sukuk, December 2006

<sup>15</sup> securitization of assets of financial institutions

<sup>16</sup> Shari’a Standards, 1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions

The investors who invest their money for equity stake and 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 the sukuk). The type of investors described in point b) above are bond investors and they cannot be given a return based on interest although their requirements are very close to the sukuk structures' outflows and returns. It seems that this particular type of investors have been the target investors for prospective sukuk issues, especially by the sovereign Ijara'h based sukuk<sup>17</sup>. Some modifications have been made, to make Sukuk move away from typical conventional bonds, and with the real assets as underlying assets. 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. Point no. c) gives 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 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 securitization of real assets. The utility of this function of sukuk is discussed briefly in the end under "Sukuk as instruments of securitization for Islamic financial institutions".

## Types of Sukuk

The types of sukuk enumerated by the Shari'a Standards of AAOIFI<sup>18</sup> 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

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<sup>17</sup> 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.

<sup>18</sup> Shari'a Standards, 1424-5H/2003-4 Accounting and Auditing Organization for Islamic Financial Institutions

Al Musharika and two tiered sukuk .Discussion would comprise basic description of the generic form and noteworthy examples of some variations.

## **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 Organization for Islamic Financial Institutions (AAOIFI) “Certificates of ownership in leased assets” are<sup>19</sup>, “... certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by 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<sup>20</sup>. Another sub-type falling in the Sukuk Al-Ijara’h category, represents certificates of ownership of usufruct of described future assets<sup>21</sup>. 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<sup>22</sup>.

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%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.

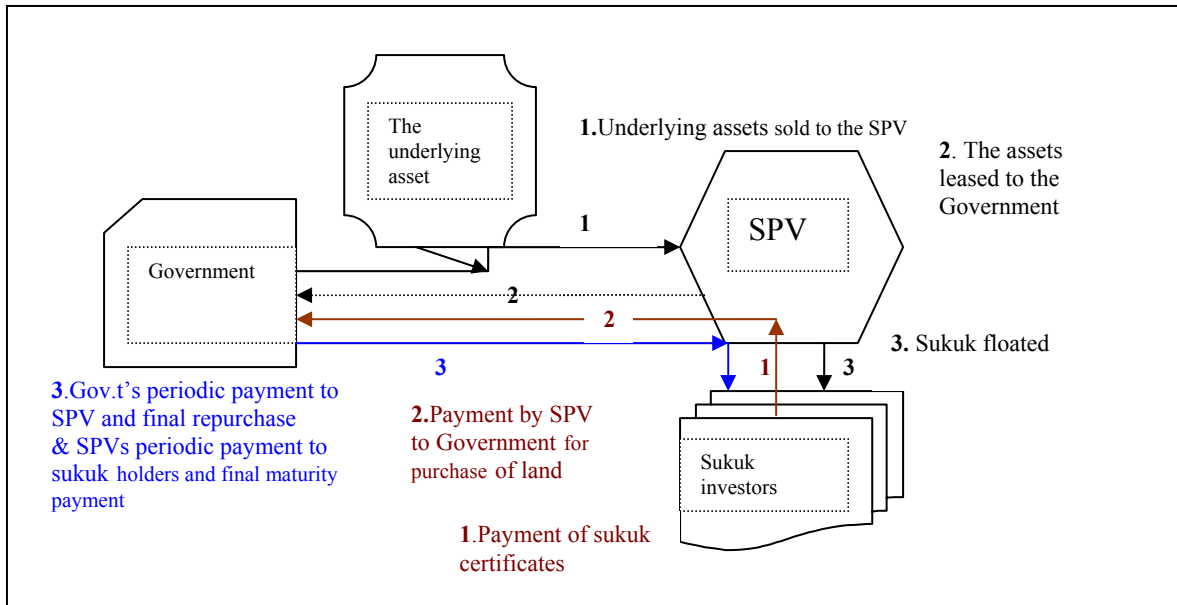
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<sup>19</sup> AAOIFI Shari’a Standard No. 17, Investment Sukuk,

<sup>20</sup> (AAOIFI), Shari’a Standard No. 17, Investment Sukuk, pg298

<sup>21</sup> ibid. (para 3/2/2)

<sup>22</sup> (AAOIFI), Shari’a Standard No. 17, Investment Sukuk, pg298



Source: Author, "Significance of Sukuk Securitization For Banks, Structuring for Risk Regulation and Pricing", Conference Proceedings, (IICiBF, 2007)

### Criticism on Sukuk Al-Ijara'h

While the Sukuk Al-Ijarah modes of financing have been popularly employed in various global and local sukuk issues, they have been criticized too. In addition to the 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 fixed "rent" paid which is benchmarked to the conventional inter bank rates like LIBOR ( London Interbank Offer Rates) and KIBOR (Karachi Interbank Offer Rates) instead of return from the underlying assets. The returns to Sukuk- Al-Ijara'h investors (Sukuk holders), too are not tied to the outcome of 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'h 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<sup>23</sup>. Thirdly, the guarantee 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)<sup>24</sup>. 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<sup>25</sup>, and with the commentary that the SPV and the issuers are 100% owned by the originators but from their financial liability perspective, they are autonomous, and these are independent legal entities from the guarantors, these transactions are permissible.

However, in my opinion, although technically what the above author is saying and what the proponents are saying is correct, a 100% owned subsidiary or an SPV, is a legal loop with a very different effect from regulatory perspective. From an angle of regulatory perspective, looking at

<sup>23</sup> Jabeen, Z., and Memoona, R, K., 2007.

<sup>24</sup> Al- Bashir,M., 2007

<sup>25</sup> Al- Bashir,M., p5,6., 2007

the essence and effect of the transaction structure is very important<sup>26,27</sup>. When analyzing 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<sup>28</sup> there is apprehension that the resulting product becomes almost the same as that of conventional bonds and even more secure from investors' perspective<sup>29</sup>.

## **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 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<sup>30</sup> 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 wasrequired of the 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%

### **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'h 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

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<sup>26</sup> Basel II, Securitization framework, BCBS,2004

<sup>27</sup> Jabeen, Z., 2006

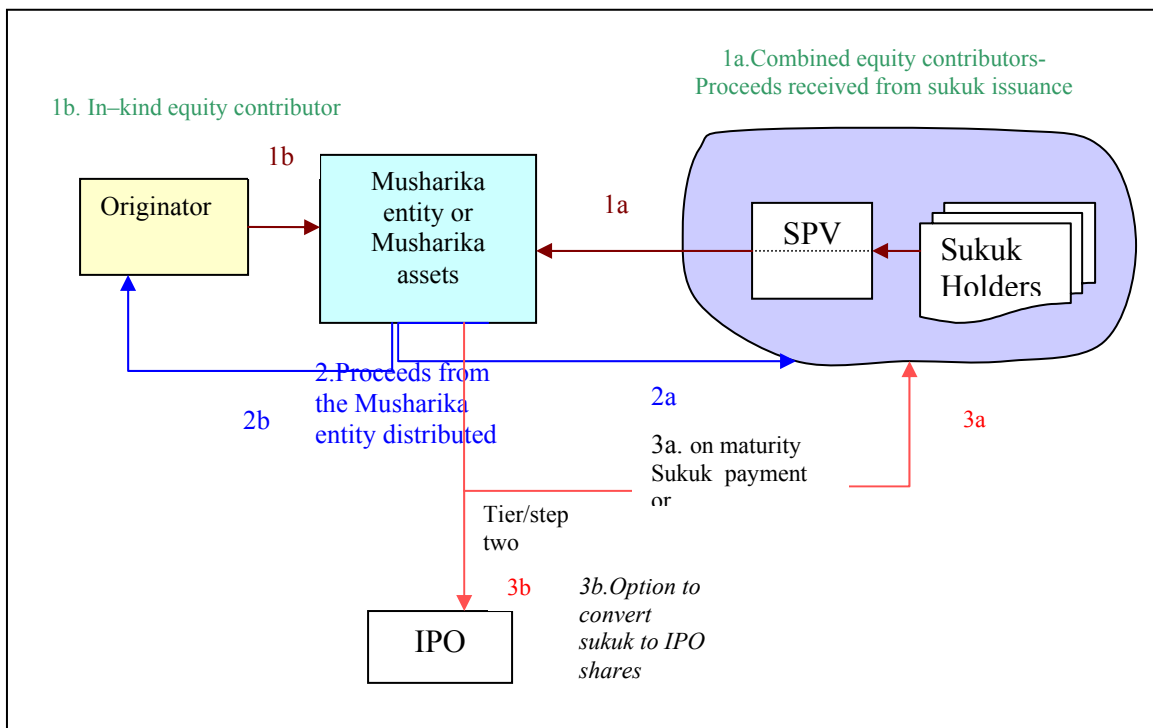
<sup>28</sup> regarding periodic payments, maturity value payment as well as the undertaking to repurchase residual assets by the originators.

<sup>29</sup> Jabeen, Z., 2006

<sup>30</sup> Ameinfo.com, news: Tuesday, July 25 - 2006

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<sup>31</sup>. 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 utilizing 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 certificates’ structure can be on the basis of participation or Mudaraba or investment agency. AAOIFI, Sharia Standards, 1424-5H, 2004-3<sup>32</sup>).



**Figure 2: Musharika Sukuk - Basic Structure**

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

<sup>31</sup> “Sharika ( Musharaka) and Modern Corporation, Shari’a Standard No. 12, pages 197-226 , “Sharia Standards”, Accounting and Auditing Organization for Islamic Financial Institutions, 1424-5 H/2003-4

<sup>32</sup> “ Shari’a Standard No. 17, Investment Sukuk” , pp 299, “ Shari’a Standards”, Accounting and Auditing Organization for Islamic Financial Institutions, 1424-5H, 2003-4.

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 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 securitization of Automobiles (Inventory), as well as two SPVs in two different jurisdictions, ( Saudi Arabia and Jersey)<sup>33</sup>

### **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 mentioned 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 (75% mostly) 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’h permissible. (The guarantee issue, if any, in these sukuk too, is to be assessed likewise as explained in the matter of Ijara’h sukuk).

### **A word on Returns from Musharika sukuk**

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<sup>34</sup>. It is hoped that the tier two,

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<sup>33</sup> 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%.

<sup>34</sup> Author’s own 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% (QPO

conversion to equity 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 securitization 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 shed 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<sup>35</sup>.

### **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<sup>36</sup>. 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.

## **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'h compliance, these are welcome signs. Sukuk as equity scrips simply, open huge possibilities to explore and adapt, with the Sharia'h 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 utilized 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'h 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 Ijarah sukuk) and equity –based and other quasi-equity investments that can also be availed productively. However, in the conventional finance perspective, many of the sukuk structures are still considered as an “Islamic Debt structure”, especially in regulatory treatment.

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redemption date)-10.125% (if final or mandatory redemption), and Caravan 1 Limited, (2004)= March 2004=6% fixed

<sup>35</sup> Author, conference proceedings, (2006)

<sup>36</sup> Examples include Sitara TFCs and others

Not surprisingly, when the target investors are Muslims and knowing that Sharia'h permissibility is an important element in their decision-making, such products would flourish and there is still a huge latent market waiting for it. This product is not confined to the Muslim world alone. 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 utilizing these tools (sukuk in particular), as long as they are financially safe and sound and adequate regulatory safeguards are in place. If sukuk enable the Muslim Ummah to rid itself of the yoke of riba and debt-based financing, and develop the taste for risk and reward sharing, this would be considered as a major achievement in history.

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