

# The definition and mechanisms of sukuk finance essay



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According to Islamic Invest Guide, a Sukuk is an asset based security that provides a relatively fixed constant flow of income without violating the Islamic laws on interest. Instead of interest payments, sukuk investors receive a pass-through of income generated by the underlying assets. Sukuk are a Syariah-compliant tool for raising capital and may be structured around a variety of Islamic contracts Such as: Al Musyarakha, Al wadiah, Al Bai' Bithaimal Ajil and Al Mudharabah to name a few.

According to UBS. com a Sukuk is an Islamic financial certificate, similar to a bond in Western finance. Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

## **Mechanism and trading and how Sukuk is traded**

There are different types of Sukuk Bonds that are being traded in the market. Having different forms as the sukuk bonds have, this means that they are traded in different ways.

Sukuk has many different types and depending on how the Islamic models of trading is used in its structure. The following are the more common as identified by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI):

## **Mudharabah Sukuk**

These are investment sukuk that represent ownership of units of equal value in the Mudharabah equity and are registered in the names of holders on the <https://assignbuster.com/the-definition-and-mechanisms-of-sukuk-finance-essay/>

basis of undivided ownership of shares in the Mudharabah equity and its returns according to the percentage of ownership of share. Mudharabah sukuk are used for enhancing public participation in big investment projects.

## **Features**

They symbolize the co-ownership, where one provides the financial investment and the other the entrepreneurial know-how with the profits being split between them

All information required by Shari'ah for the Qirad contract such as the source of start up funds, the ratio for profit dispersion and other conditions related to the issue, which must be Shari'ah compliant are to be listed in the company prospectus.

The Sukuk holder is given the right to transfer the ownership by selling the deeds in the securities market at his discretion. The sale of MS must follow the rules listed below:

If the capital is still in the form of money before the operations of the project, the trading of MS would be like exchange of money for money. In that case the rules of bay Al-Sarf would be applied.

If Muqarda capital is in the form of debt then it must satisfy the principles of debt trading in Islam

If capital is in the form of combination of cash, receivables, goods, real assets and benefits, trade must be based on market price evolved by mutual consent.

The Manager who receives the fund collected from the subscribers to Mudharabah Sukuk can also invest his own fund. He will get profit for his capital contribution in addition to his share in the profit as Mudarib.

Neither prospectus nor Mudharabah Sukuk should contain a guarantee, from the issuer or the manager for the fund, for the capital or a fixed profit, or a profit based on any percentage of the capital

It is permissible to create reserves for contingencies, such as loss of capital, by deducting from the profit

The prospectus can also contain a promise made by a third party, totally unrelated to the parties to the contract, in terms of legal entity or financial status, to donate a specific sum, without any counter benefit, to meet losses in the give project, provided such commitment is independent of the Mudharabah contract.

On the expiry of the specified time period of the subscription, the Sukuk holder is given the right to transfer the ownership by sale or trade in the securities market at his discretion.

## **Musyarakah Sukuk**

Musyarakah Sukuk is used for mobilizing the funds for establishing a new project or developing an existing one or financing a business activity on the basis of partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. These Musyarakah certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

## **Steps involved in the structure**

Corporate (as Musharik) contributes land or other physical assets to the Musyarakah

The Musyarakah appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musyarakah and sell/lease the developed assets on behalf of the Musyarakah

In return, the agent (i. e. the Corporate) will get a fixed agency fee plus a variable incentive fee payable.

The profits are distributed to the Sukuk holders.

The Corporate irrevocably undertakes to buy at a pre-agreed price the Musyarakah shares of the Special Purpose Vehicle (SPV)[1] on say semi-annual basis and at the end of the fixed period the SPV would no longer have any shares in the Musyarakah.

An example of Musyarakah Sukuk in practice is the US\$550 million Sukuk transaction for Emirates airline, the seven-year deal was structured on a Musyarakah contract. The Musyarakah or joint venture was set up to develop a new engineering centre and a new headquarters building on land situated near Dubai's airport which will ultimately be leased to Emirates. Profit, in the form of lease rentals, generated from the Musyarakah venture will be used to pay the periodic distribution on the trust certificates.

## **Al-Ijarah Sukuk**

These are sukuk that represent ownership of equal shares in a rented real estate or the usufruct of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i. e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

## **Features**

It is necessary for an ijarah contract that the assets being leased and the amount of rent both are clearly known to the parties at the time of the contract and if both of these are known, ijarah can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee. The lessor can sell the leased asset provided it does not hinder the lessee to take benefit from the asset. The new owner would be entitled to receive the rentals.

Rental in ijarah must be stipulated in clear terms for the first term of lease, and for future renewable terms, it could be constant, increasing or decreasing by benchmarking or relating it to any well-known variable.

As per shariah rules, expenses related to the basic characteristics of the assets are the responsibility of the owner, while maintenance expenses related to its operation are to be the responsibility of the lessee.

As regards procedure for issuance of ijarah sukuk, an SPV is created to purchase the asset or assets that issues sukuk to the investor, enabling it to make payment for purchasing the asset. The asset is then leased to third party for its use. The lessee makes periodic rental payments to the SPV that in turn distributes the same to the sukuk holders.

Ijara sukuk are completely negotiable and can be traded in the secondary markets.

### **Steps involved in the structure**

The obligator sells certain assets to the SPV at an agreed pre-determined purchase price.

The SPV raises financing by issuing sukuk certificates in an amount equal to the purchase price.

This is passed on to the obligator (as seller).

A lease agreement is signed between SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee.

SPV receives periodic rentals from the obligator

These are distributed among the investors i. e. the sukuk holders

At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the Ijara sukuk.

An example of this is US\$350 million sukuk Trust Certificates by Sarawak Corporate Sukuk Inc. (SCSI) Sarawak Economic Development Corporation (SEDC) raised financing amounting to US\$350 million by way of issuance of series of trust certificates issued on the principle of Ijara sukuk. The certificates were issued with a maturity of 5 years and under the proposed structure, the proceeds will be used by the issuer to purchase certain assets from 1st Silicon (Malaysia) Sdn Bhd. Thereafter, the issuer will lease assets procured from 1st Silicon to SEDC for an agreed rental price for an agreed lease period of 5 years.

## **Murabaha Sukuk**

In this case the issuer of the certificate is the seller of the Murabaha commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the Murabaha commodity and are entitled to its final sale price upon the re-sale of the Commodity. The possibility of having legally acceptable Murabaha-based sukuk is only feasible in the primary market. The negotiability of these Sukuk or their trading at the secondary market is not permitted by shariah, as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt on a deferred basis, which will result in *riba*.

Despite being debt instruments, the Murabaha Sukuk could be negotiable if they are the smaller part of a package or a portfolio, the larger part of which is constituted of negotiable instruments such as Mudaraba, Musharaka, or Ijara Sukuk. Murabaha sukuk are popular in Malaysian market due to a more

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liberal interpretation of fiqh by Malaysian jurists permitting sale of debt (bai-al-dayn) at a negotiated price.

## **Steps involved in the structure**

A master agreement is signed between the SPV and the borrower

SPV issues sukuk to the investors and receive sukuk proceeds.

SPV buys commodity on spot basis from the commodity supplier.

SPV sells the commodity to the borrower at the spot price plus a profit margin, payable on installments over an agreed period of time.

The borrower sells the commodity to the Commodity buyer on spot basis.

The investors receive the final sale price and profits.

## **Salam Sukuk**

Salam sukuk are certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to the ownership of the certificate holders. The issuer of the certificates is a seller of the goods of Salam, the subscribers are the buyers of the goods, while the funds realized from subscription are the purchase price (Salam capital) of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any.

Salam-based securities may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the Sukuk.

All standard shariah requirements that apply to Salam also apply to Salam sukuk, such as, full payment by the buyer at the time of effecting the sale, standardized nature of underlying asset, clear enumeration of quantity, quality, date and place of delivery of the asset and the like.

One of the Shariah conditions relating to Salam, as well as for creation of Salam sukuk, is the requirement that the purchased goods are not re-sold before actual possession at maturity. Such transactions amount to selling of debt. This constraint renders the Salam instrument illiquid and hence somewhat less attractive to investors. Thus, an investor will buy a Salam certificate if he expects prices of the underlying commodity to be higher on the maturity date.

### **Steps involved in the transaction**

SPV signs an undertaking with an obligatory to source both commodities and buyers. The obligator contracts to buy, on behalf of the end-Sukuk holders, the commodity and then to sell it for the profit of the Sukuk holders.

The Salam proceeds are passed onto the obligator who sells commodity on forward basis

SPV receives the commodities from the obligator

Obligator, on behalf of Sukuk holders, sells the commodities for a profit

Sukuk holders receive the commodity sale proceeds.

The following is an example of the Salam Sukuk –

Aluminum has been designated as the underlying asset of the Bahrain Government al Salam contract, whereby it promises to sell aluminum to the buyer at a specified future date in return of a full price payment in advance. The Bahrain Islamic Bank (BIB) has been nominated to represent the other banks wishing to participate in the Al Salam contract. BIB has been delegated to sign the contracts and all other necessary documents on behalf of the other banks in the syndicate. At the same time, the buyer appoints the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution. The Government of Bahrain provides an additional undertaking to the representative (BIB) to market the aluminum at a price, which will provide a return to al Salam security holders equivalent to those available through other conventional short-term money market instruments.

### **Istisna Sukuk**

Istisna sukuk are certificates that carry equal value and are issued with the aim of mobilising the funds required for producing products that are owned by the certificate holders. The issuer of these certificates is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realised from subscription are the cost of the product. The

certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel Istisna, if any. Istisna Sukuk is quite useful for financing large infrastructure projects. The suitability of Istisna for financial intermediation is based on the permissibility for the contractor in Istisna to enter into a parallel Istisna contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialised firm.

Shariah prohibits the sale of these debt certificates to a third party at any price other than their face value. Clearly such certificates cannot be traded in the secondary market.

## **Steps involved in the structure**

SPV issues Sukuk certificates to raise funds for the project

Sukuk issue proceeds are used to pay the contractor/builder to build and deliver the future project.

Title to assets is transferred to the SPV

Property/project is leased or sold to the end buyer. The end buyer pays monthly installments to the SPV.

The returns are distributed among the Sukuk holders.

The following are examples of Istana Sukuk in practice –

Tabreed's five-year global corporate Sukuk (on behalf of the National Central Cooling Company, UAE) provided a fixed coupon of 5.50%. It is a combination of Ijara Istisna and Ijara Mawsufah fi al dhimmah (or forward leasing contracts). The issue was launched to raise funds to retire some existing debt, which totals around US\$136 million, as well as to finance expansion.

The Durrat Sukuk will finance the reclamation and infrastructure for the initial stage of a broader US\$ 1 billion world class residential and leisure destination known as 'Durrat Al Bahrain', currently the Kingdom of Bahrain's largest residential development project. The return on the Sukuk is 125 basis points over 3 months London Interbank Offered Rate (LIBOR) payable quarterly, with the Sukuk having an overall tenor of 5 years and an option for early redemption. The proceeds of the issue (cash) will be used by the Issuer to finance the reclamation of the land and the development of Base Infrastructure through multiple project finance (Istisna) agreements. As the works carried out under each Istisna are completed by the Contractor and delivered to the Issuer, the Issuer will give notice to the Project Company under the Master Ijara Agreement and will lease such Base Infrastructure on the basis of a lease to own transaction.

## Hybrid Sukuk

Considering the fact that Sukuk issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified Sukuk – hybrid or mixed asset Sukuk – emerged in the market. In a hybrid Sukuk, the underlying pool of assets can comprise of

Istisna, Murabaha receivables as well as Ijara. Having a portfolio of assets  
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comprising of different classes allows for a greater mobilization of funds.

However, as Murabaha and Istisna contracts cannot be traded on secondary markets as securitised instruments at least 51 percent of the pool in a hybrid Sukuk must comprise of Sukuk tradable in the market such as an Ijara Sukuk. Due to the fact the Murabaha and Istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

### **Steps involved in the structure**

Islamic finance originator transfers tangible assets as well as Murabaha deals to the SPV

SPV issues certificates of participation to the Sukuk holders and receive funds. The funds are used by the Islamic finance originator.

Islamic finance originator purchases these assets from the SPV over an agreed period of time.

Investors receive fixed payment of return on the assets.

An example of this type of sukuk is when Islamic Development Bank issued the first hybrid Sukuk of assets comprising 65. 8% Sukuk al-Ijara, 30. 73% of Murabaha receivables and 3. 4% Sukuk al-Istisna. This issuance required the IDB's guarantee in order to secure a rating and international marketability. The \$ 400 million Islamic Sukuk was issued by Solidarity Trust Services Limited (STSL), a special purpose company incorporated in Jersey Channel Islands. The Islamic Corporation for the Development of Private Sector (ICD) played an intermediary role by purchasing the asset from IDB and selling it

to The Solidarity Trust Services Limited (STSL) at the consolidated net asset value.

## **Bond valuation**

**Bond Definition** – According to [www.investorwords.com](http://www.investorwords.com), a Bond can be defined as a debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing.

**Valuation definition** – According to [www.investorwords.com](http://www.investorwords.com) valuation can be defined as the process of determining the value of an asset or company

**Bond Valuation** – According to an online dictionary Bond Valuation can be defined as the process of determining the fair price of a bond. As with any security, the fair value of a bond is the present value of the stream of cash flows it is expected to generate. Hence, the price or value of a bond is determined by discounting the bond's expected cash flows to the present using the appropriate discount rate.

## **Pricing of Sukuk Bonds with Embedded Options**

Embedded option bonds can be valued similar to the valuation of options on equities implementing binomial trees. In conventional bond issuance the value of the underlying assets will depend on the level of interest rates. In Islamic contracts interest rates are substituted with the rate of return on the underlying assets. We can analyse the valuation of embedded options using altering scenarios in a tree diagram.

Assume that future one-year rates of return develop as follows:

The represented tree can be utilized to value zero coupon certificates of various maturities. For example, the value of a 1-year zero coupon bond at time 0 is

$$B(0, 1) = 1/1.065 = 93.89\% \text{ of par value}$$

The value of a 2-year certificate at time 0 can be determined using the same discount mechanism. The value of a 1-year zero coupons at time 0 can be calculated as:

$$\text{If } r = 7.00\% \rightarrow 1/1.07 = 93.45\% \text{ of par value}$$

$$\text{If } r = 6.00\% \rightarrow 1/1.06 = 94.34\% \text{ of par value}$$

The valuation of callable bonds will invoke an adjusted method as the callable bond is essentially a portfolio of a non-callable bond and an American call option written with the non-callable bond as the underlying and a strike price that is given by the call price.

Accordingly, at each node of the tree the value of the bond can be given as follows:

$$P = 1 + C \text{ at maturity}$$

$$P = \max [ CP, (1+C)/(1+r) ] \text{ one year prior to maturity}$$

$$)] 1(\}) (5.0, \max [ \{r+C \div Pd + Pu + CP - P\} ] = \text{more than one year to maturity}$$

$$CP = \text{price of the option}$$

$$C = \text{coupon}$$



$r$  = rate of return

$P_u$  = value of the certificate in one year if return goes up

$P_d$  = value of the certificate in one year if return goes down