TYPES OF SUKUK

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Sukuk Categories

- Istisna’a Sukuk
- Salam Sukuk
- Mudharabah Sukuk
- Musharakah Sukuk
- Sukuk al Murabahah
Istisnaá Sukuk

- Project financing can be undertaken through an Istisna’a contract, whereby funds are advanced to pay for the supplies and labor costs by an Islamic bank.
- Once the project is completed, the advances are repaid from the revenue derived from the project.
Istisnaá Sukuk

- To introduce bonds based on *istikhabár*, a parallel *istikhabár* contract is generally used where by the financier enters a contract with a subcontractor who actually builds the facility being financed.
- To use *istikhabár*, the public authority or private company commissioning the project provides details of the specifications and timing of the schemes.
- The financier then sets these out in the tender documents.
- Bids are subsequently invited from contractors who will specify how they intend to sell completed parts of the project over time and the amount of each payment instalment expected.
Istisnaá Sukuk

- These instalments will include an element of profit over the construction costs.
- As the financier is expecting a stream of payments over a specified period, certificates can be issued based on the income expected.
- It should be noted that as the deferred price certificates represent debt obligations, they cannot be traded for cash at below face value in a secondary market.
- They can, however, be used to purchase goods or services whose price is equal to the face value of the certificate.
Istisnaá Sukuk

- The purchase price of the goods may be less than the deferred price as this represents a trading transaction.

- Permission to transfer the debt contract from the financier to a supplier of goods and services must be sought from the original debtor, the public authority, or private company commissioning the project.
Istisna’a Sukuk

1. Sukuk proceed

2. Sell asset to SPV

3. Payments made by SPV

4a. Transfer title to assets

4b. Pay monthly instalments to SPV

5. SPV pays coupon to investors.

Contractor

SPV

End buyer

Sukuk holders
Sukuk al Salam

- The *salam* based contract is usually used for short-term financing of underlying assets and is based on spot sale (*salam*) and/or deferred payment sale (*bai al muajjal*) or deferred delivery sale (*bai al salam*) where the investor undertakes to deliver a specific asset, which will be sold to the client at an agreed profit margin.
- For example, a special vehicle is set up to buy petroleum on a spot price basis and the purchase price is entirely paid up front from the proceeds of the issue of sukuk certificates.
- The SPV will then sell the oil at a later date to the beneficiary of the oil on a certain designated delivery date.
Sukuk al-Salam

- Since salam sukuk results in a purely financial claim that is not linked to the underlying asset, the Shari’ah only allows such securities to be traded at par value.
- This affects its trading in the secondary market and investors are forced to hold this security until maturity.
- This contract resembles the conventional forward contract (which is not permissible in Shari’ah) except that in case of salam contract, payment is made in advance and in the case of the latter payment it is usually settled at the delivery date.
Sukuk al-Salam

The *salam* contract was allowed as a special case during the Prophet’s time to avoid farmers and traders being forced to take usurious loans.
Sukuk al-Salam

The concept of *salam* refers to a sale whereby the seller undertakes to supply a specific commodity to the buyer at a future date in return for an advanced price, paid in full on the spot.

Hence, the price is cash, but the supply of the purchased goods is deferred.
Sukuk al-Salam

ª Muslim farmers used salam to receive cash advances in order to meet immediate commitments until their crops were grown as they were not able to borrow on the basis of riba.

ª The attraction for the buyer of a salam contract is that the advance payment is usually less than the amount that would have to be paid if the buyer deferred his purchase and bought the same commodity spot in one or three months’ time.
Sukuk al-Salam

° *Salam* represents a type of forward contract, but such a contract is forbidden under *Shari’ah* law unless there are strict conditions attached that aim at the elimination of uncertainty (*gharar*).

° Firstly, the initial payment by the buyer must be paid in full, to ensure that there is no uncertainty over outstanding payments.
Secondly, salam can only be used for commodities that are standardized, and where the quality and quantity are measured exactly.

Originally, such contracts were used for the purchase of grains such as wheat, barley, and rice, but salam contracts could also be used for commodities such as oil, iron, or copper, or electricity supplies that can be measured in kilowatts.
Sukuk al-Salam

- How can certificates based on salam contracts be issued? The onus is on the purchaser who can finance advance payments by issuing certificates that are equivalent to the purchase price, which are then sold.

- The buyers of the certificates are entitled to the commodities for which the original purchaser contracted at the end of the one or three months, or whatever period was stipulated in the contract.

- For them the attraction is that they are purchasing the commodities at a discount, the difference between this and the eventual selling price of the commodities representing their return.
Sukuk al-Salam

- There has been some debate amongst Shari’ah scholars about whether it is legitimate to exchange the rights to commodities sold on a salam basis prior to delivery, or, in other words, to trade salam certificates.

- Ibn Taymiyyah ruled that such exchanges are permissible as long as when the certificates were sold to the seller it was not for a price higher than that agreed originally, as this might be seen as exploitation. Sales to third parties could be at any price that such buyers are willing to pay.

- The Maliki School of Islamic jurisprudence stipulated that salam contracts relating to foodstuffs should not be traded, as this could be interpreted as speculating on necessities.
Sukuk al-Salam

- Sami Homoud states that it is not permissible to resell the commodity covered by a salam contract before receiving it, but this does not preclude the recipient from reselling the commodity by another contract parallel to the first one.
- The aim of such a parallel or back-to-back salam contract is to ensure that the financier, usually a bank, is not left with a commodity that it has no expertise in trading.
- However, creating salam certificates could also be viewed as a way out of this dilemma for a bank.
Sukuk al Salam

Payment against future delivery of assets

Issuer

Delivery of asset at maturity

SPV

Reimbursement of cash plus a mark-up on maturity

Cash

Certificate of participation

Surrender of certificate at maturity

Islamic investor
Sukuk al Ijarah

- Sukuk based on sale and lease back are questionable.
- As an alternative, it is possible to lease productive assets or equipments for a portion of revenues or diminishing musharakah.
Sukuk al Ijarah

- The sukuk are based on the underlying tangible assets that the SPV has acquired rather than being debt securities, which is the case with the issuance of conventional bonds.

- Instead, the sukuk al-ijarah structure uses the leasing contract as the basis for the returns paid to investors, who are the beneficial owners of the underlying asset and as such benefit from the lease rentals as well as sharing in the risk.
Sukuk al-Ijarah

- The structure commences with a party who is in need of financing, here referred to as the originator.
- The originator will establish an SPV, a separate legal entity with the sole purpose of facilitating this transaction.
- Next, the SPV purchases certain tangible assets from the originator at an agreed pre-determined purchase price, which will be equal to the principal amount of the sukuk.
Sukuk al-ijarah

- In order to finance the purchase of the assets, the SPV issues sukuk to sukuk holders.
- These sukuk holders are investors looking for Shari’ah compliant securities.
- The SPV uses the sukuk proceeds to pay the originator the purchase price of the tangible assets.
- The SPV will also declare a trust over the tangible assets and hold the assets as a trustee for the sukuk holders, who are the beneficiaries.
Sukuk al-ijarah

- Next, the originator and the SPV will enter into a lease agreement for a fixed period of time. Under this lease agreement, the SPV (lessor) leases the assets back to the originator (lessee).

- Consequently, the SPV receives periodic rentals from the originator for the use of the underlying tangible assets.
Sukuk al-ijarah

- The SPV uses these amounts to pay the periodic return to the sukuk holders, since they are entitled to these payments as the beneficial owners of the tangible assets.

- The lease payments from the originator to the SPV and the periodic payments from the SPV to the sukuk holders will continue until maturity date.
Sukuk al-ijarah

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Sukuk al-ijarah

Although in a sukuk al ijarah structure, the sukuk holders must acquire the ownership rights over the tangible assets from a Shari’ah perspective, from a practical perspective, this is often not possible due to legal impediments in most jurisdictions such as the impossibility to register under the sukuk al ijarah structure that the SPV holds the tangible assets in trust for the sukuk holders.

This means that the legal ownership of the tangible assets will remain with the SPV and the sukuk holders merely acquire the beneficial ownership of the underlying tangible assets.
Sukuk al-ijarah

- In practice, difficulties arise in meeting the ownership requirements of the sukuk holders.
- Additional transfer taxes and restrictions on the disposal of governmental assets made it almost impossible for several originators even to transfer the title of the assets to the SPV.
- As a result, in practice the legal ownership of the assets is not even transferred to the SPV.
- The sukuk holders are, consequently, one step further from the underlying tangible assets.
Sukuk al-Ijarah

The combination of the absence of transfer of legal ownership of the assets from the originator to the SPV with purchase undertakings and other forms of guarantees given by the originator to the SPV and, consequently, the sukuk holders recourse to the originator instead of recourse to the underlying tangible assets represents a move from the asset-backed to asset-based sukuk.
Sukuk al Ijarah

1. The Sukuk Holders feed the SPV (Issuer of the Sukuk) with their investment.
2. The Originator sells the Asset to the SPV in return for the Sukuk Proceeds (investment).
3. The SPV leases the Asset to the Lessee (can be the Originator — and cashes the rent, the Nett Amount of which is passed on to the Sukuk Holders (fixed income).
4. At maturity, the Asset is sold (often back to the Originator — who at start often promised to buy back at certain price at maturity or default of the Lessee) and the proceeds of that sale are distributed to the Sukuk Holders as repayment investment.
Sukuk al-Mudarabah

- Sukuk al Mudarabah is structured through the *mudarabah* contract, with one party looking for *Shari’ah* compliant financing, the originator.
- The originator will establish the SPV and enter into a *mudarabah* contract with this SPV.
- Both the originator and the SPV will be partners to the *Mudarabah* contract.
- The originator will act as the managing partner, the entrepreneur of the *mudarabah* venture.
Sukuk al-Mudarabah

° As the *mudarib*, the managing partner will contribute his labor, skills, and expertise.

° The SPV will act as the silent partner, the *rabbul mal* of the *mudarabah* venture.

° As the *rabbul mal*, the SPV contributes in the form of financial investment.
Sukuk al-Mudarabah

- The SPV will issue sukuk certificates to the sukuk holders.
- The sukuk proceeds will be used to make the financial investment in the mudarabah.
- The SPV will declare a trust over all the units it is holding in the mudarabah in favor of the sukuk holders according to an agreed percentage of the realized revenues.
Sukuk al-Mudarabah

- The participation in the *mudarabah* will continue until maturity date.
- At maturity date, the managing partner will buy the units in the *mudarabah* from the sukuk holders through the SPV.
- The managing partner will pay an amount to the SPV to purchase the units in the *mudarabah*.
- That amount is used by the SPV to pay the sukuk holders their capital back, so that the sukuk certificates can be redeemed.
Sukuk al-Mudarabah

- This structure is an equity-based sukuk structure where profits and losses are shared between the partners.
- Therefore, the periodic payments to the sukuk holders cannot be fixed returns; neither can their principal amount be guaranteed at maturity.
- However, in practice several instruments were used to fix the periodic returns over the sukuk and to guarantee the principal amount of the sukuk holders.
Sukuk al-Mudarabah

- The periodic returns were often fixed returns; when the actual profits realized were less than the promised returns, the originator provided for funding, while in the case of excess profits any surplus was for the originator as an incentive fee.

- This limited the equity character of these securities, since the losses were borne by the originator and the periodic returns to the sukuk holders were fixed, regardless of the performance of the underlying projects.
Sukuk al-Mudarabah

- At maturity, pursuant to a purchase undertaking, the assets were bought back by the originator for a price equal to the principal amount of the sukuk holders.
- The purchase undertaking guaranteed the principal amount of the sukuk holders, regardless of the possible appreciation or depreciation of the assets.
- These structural features practically turned the equity-based profit-and-loss sharing arrangements into fixed-income instruments.
- This can be considered another deviation from Shari’ah.
Sukuk al-Mudarabah

1. Upon completion, SPV hands over project to owner

1. SPV enters into an agreement with project owner for construction of project

1. Sukuk

1. SPV issues Sukuk to raise funds

1. Mudarib collects regular profit payments and final capital proceeds from project activity for onward distribution to investors

Project owner

SPV (Mudarib)

Sukuk

Subscribers (Rabb al-maal)
Sukuk al-Musharakah

- Musharakah involves establishing a partnership or company to provide financing with the participants sharing in the profits in relationship to the size of their investment share.
- Notes can be issued on the basis of such financing and both Sudan and Iran have launched such securities.
- In practice, these have been very similar to mudarabah certificates rather than being a distinct asset class.
1. The *Sukuk* Holders feed the SPV (Issuer of the *Sukuk*) with their investment that is relayed to the Partnership (can be Joint Venture / SPV) and so does the Originator (both are the Partners) – depending on the *Mazhab* (school of thought), the Originator may contribute in species only and / or in kind (with expert valuation).

2. The Partnership enters into its business and generates profits / losses that are distributed to the Partners (Originator and SPV) – the part of the SPV in the profit / loss gets relayed further down to the *Sukuk* Holders.

3. At maturity, the capital gets re-distributed to the Partners (Originator and SPV), where the part of the SPV gets relayed further down to the *Sukuk* Holders.
Sukuk al Murabahah

- Any paper representing a monetary obligation arising out of a credit sale transaction by banks cannot create a negotiable instrument.
- A **negotiable instrument** is a document guaranteeing the payment of a specific amount of money, either on demand, or at a set time, with the payer named on the document. More specifically, it is a document contemplated by or consisting of a contract, which promises the payment of money without condition, which may be paid either on demand or at a future date.
- **Murabahah** receivables cannot fetch any return and their assignment has to be at face value.
- **Murabahah sukuk** are more likely to be used in respect of purchases of goods by the public sector.
- In case the government needs items of huge price, it may purchase them through credit sale by paying in installments.
Sukuk al Murabahah

◦ The government will issue certificates according to the number of installments.

◦ Each certificate with maturity date represents the property right of the seller that can change hands provided the amount of the claim does not change.

◦ The seller or the original certificate holder can transfer his collection rights to another party against payment that would be equal to the face value of the certificate minus collection cost at the transferee’s end.
Sukuk al Murabahah

Any *murabahah* funds can also issue *murabahah sukuk* proceeds of which could be used for sale of pre-specified and general assets on the basis of *murabahah* to give a quasi-fixed return to the *murabahah sukuk* holders.
Murabahah Sukuk

Diagram: *Murabaha* Sukuk

1. Pay issue price
2. Issue Certificate
3. Pay asset price
4. Title to assets
5. Re-sell the asset at cost+Profit
6. Installment Payment
7. Periodic installment including principal repayment
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THE END