Short-term Shari'a-compliant Instruments: the Case of Sukuk

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Why are short-term Shari’a instruments needed?

- They are useful in a mixed conventional-Islamic financial system (some domestic systems and the international system).
- They are indispensable in a pure Islamic system.
- If they are in the form of securities (i.e., sukuk), they can be used:
  - By Islamic banks for effective liquidity management (LM)
  - By governments for public finance
  - By the private sector for treasury management and fund-raising
  - By the private sector for investment diversification
  - By central banks (CBs) for:
    - monetary policy and open market operations
    - financial stability tools (subject to Shari’a) to assist Islamic banks, through:
      - Eligible collateral arrangements
      - Securities lending/swaps
      - Repo arrangements

Why do short-term sukuk barely exist?

– Difficulties in creating in domestic markets
  – Difficult to structure
  – Require a framework and enabling infrastructure
  – Impediments under local law to sukuk in some countries
  – Shortage of appropriate assets from which to build them

– Difficulties in creating in the international market
  – All of the above
  – No natural issuer of a USD/EUR short-term sukuk
  – Hard to satisfy Sharia analysis everywhere
  – Hard to get uniform regulatory treatment by different central banks
  – Need a credit rating, and satisfying the rating criteria can make them uneconomical

Alternatives to short-term sukuk as LM tools

– In the international market, available choices have disadvantages:
  – Idle cash, with no return
  – Interbank deposits, with counterparty credit risk
  – Commodity murabaha (>US$1 trillion equivalent outstanding)
    – Not a security and not tradeable under Shari'a
    – High transaction cost, especially for short tenors
    – Counterparty credit risk
    – Significant Shari'a objections
    – Not widely offered by conventional banks
  – Long-term sukuk
    – Limited supply in primary or secondary market (<US$50 billion outstanding)
    – Very little supply of sovereign sukuk rated "A" or better (IDB, IFC, Qatar)
    – generally not eligible collateral (except perhaps IDB's)
    – Shari'a objections in some countries

The problem with the lack of appropriate LM instruments

– The Islamic Financial Services Board (IFSB) produced a report in 2008 identifying concerns with the absence of LM instruments:
  – Underdevelopment/absence of an organised Islamic money market
  – Low or zero return on alternatives penalises Islamic banks
  – Limited options for CBs for open-market type operations using Shari'a-compliant tools
  – Reinforces a buy-and-hold tendency of Islamic investors, which affects liquidity and mark-to-market pricing
  – Small number of market participants and small transaction sizes create market constraints
  – Limited secondary market trading hampers market growth

– The market is segmented between conventional and Islamic banks, so Islamic banks generally can't access the pool of conventional liquidity.
– Basel III's liquid asset requirements can make the problem worse.

The problem with the lack of appropriate LM instruments

– An Islamic Development Bank report (Islamic Finance and Global Financial Stability, 2010) developed during the financial crisis noted the potential for systemic risk in times of crisis and recommended development of national and international liquidity infrastructure in order to:
  – Reduce the cost of intermediation
  – Allow CBs to influence the level of liquidity in the financial system and management monetary policy
  – Preserve financial stability by allowing CBs to perform their lender of last resort (LOLR) function and provide liquidity to the market
  – Improve Islamic financial institutions' ability to handle a liquidity shortage

– An IFSB taskforce later recommended the creation of International Islamic Liquidity Management Corporation (IILM) to do this on an international level.

The design requirements for short-term sukuk

– Short-term sukuk should have the following design characteristics to function as LM instruments:
  – High credit quality
  – Wide Shari'a acceptance
  – Tradeable at market prices
  – Able to accommodate a wide range of underlying assets and tenors
  – Function as CB monetary policy instrument and financial stability tool
  – Should be attractive to conventional financial institutions as well
  – In case of an international sukuk, denominated in reserve currencies

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The framework required for short-term sukuk

– Short-term sukuk should benefit from the following framework to function as LM instruments:
  – Favorable CB/regulatory treatment
  – Effective price discovery and primary distribution mechanism
  – Secondary market infrastructure and actual liquidity
  – Shari'a compliant repo arrangements
  – Regular supply and issuances
  – Available supply of suitable underlying assets
  – Settlement infrastructure
  – Changes in law/regulation as required

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Short-term sukuk differ from long-term sukuk

- Short-term sukuk require different considerations and are more challenging to design than long-term instruments.
  - The issuer is generally not seeking short-term funding
  - The design requirements are different and more extensive
  - The required framework is more elaborate

Central bank / regulatory treatment

- Certain central bank / regulatory treatments are highly desirable for short-term sukuk and important to investors.
  - Central bank treatment:
    - Eligible for investment of the central bank's own funds and reserves
    - Acceptable collateral for short-term financing extended by the central bank (repo, standing facilities)
  - Regulatory treatment:
    - Appropriate risk-weighting for regulatory capital purposes
    - Appropriate treatment under the domestic liquidity framework

Shari’a acceptance

- There are some Shari’a objections to every sukuk structure. More common ones are (also relevant to designing short-term sukuk):
  - Objection to the purchase undertaking (wa’d) in ijara sukuk
  - Objection to the maximum portion of receivables that can be in a mixed asset pool which is backing tradeable sukuk (eg, wakala sukuk). Some accept no more than 49% receivables; some accept even 70%.
  - Objection to insurance arrangements in ijara sukuk
- Wide Shari’a acceptance among potential holders is essential to acceptance as a LM instrument. The risk of Shari’a objections must be reduced as much as possible.
- There must be discussions with the relevant Shari’a councils to understand their views and requirements.

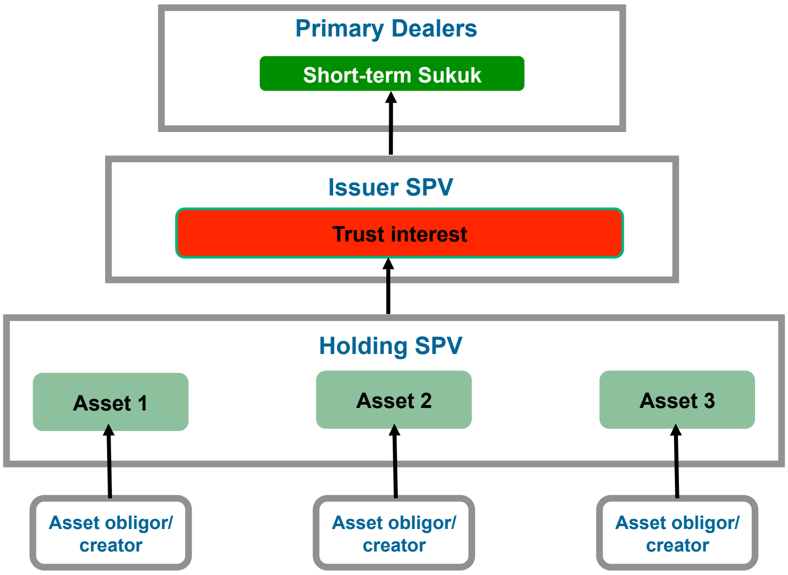
Primary distribution and secondary market trading

- A primary dealer network for short-term sukuk would ensure primary distribution and a secondary market.
  - Both government bonds and the commercial paper (CP) market use dealers (though with differences).
- Distribution to the primary dealers would provide a price discovery / setting mechanism.
- There should be a mechanism to ensure that the sukuk being offered at each auction are taken up.

Primary distribution and secondary market trading

- Allocation can be either at a single price to all successful bidders, or it can be to each successful bidder at its own individual bid.
- An primary platform as well as a secondary market platform will be required for the dealers
  - It does not need to include an infrastructure for trading, which can take place over-the-counter (OTC).
- Primary dealers would enter into a Dealer Agreement with the issuer.
- Primary dealers would have exclusive access to auctions.
- Investor education will be important in developing the secondary market.

An illustrative issuance structure – subject to local laws



Illustrative structure – parties

- Holding SPV
  - SPV, activities limited to participating in the structure
  - Incorporated in an appropriate jurisdiction with independent directors
  - Holds a pool of various assets in trust and issues a trust interest to the Issuer SPV
  - Applies the proceeds received from Issuer SPV on each issuance of short-term sukuk by the Issuer SPV to purchase assets
- Issuer SPV
  - SPV, activities limited to participating in the structure
  - Incorporated in an appropriate jurisdiction with independent directors
  - Holds the trust interest issued by Holding SPV in trust and from time to time issues short-term sukuk in series to the primary dealers.
  - Applies the proceeds received from the primary dealers on each issuance of short-term sukuk to pay Holding SPV.

Illustrative structure – basic terms

- Issuance in series
  - Issuer SPV can issue short-term sukuk in series from time to time, with market-responsive terms, and sell them to primary dealers.
  - The series can differ in maturity date, profit rate and size.
  - All series are backed by the same Asset Pool and of similar credit quality.
- Tenors
  - The short-term sukuk can have tenors from one week to one year.
  - Each series of short-term sukuk will have a stated maturity date.
  - Maturities will be set to establish a yield curve.
- Profit rate
  - Each Series of short-term sukuk would bear a fixed profit rate.
  - Payment of profit would be targeted but not guaranteed.

Illustrative structure – basic terms

- The short-term sukuk would be held through a clearing system and transfers and settlement would be in accordance with the usual rules of the clearing system.
- The short-term sukuk would not be listed.
- If governed by English law, in legal form the short-term sukuk are trust certificates constituted by a declaration of trust and evidencing a beneficial interest in the assets of a trust declared by the Issuer SPV.

Illustrative structure – Shari’a aspects

- The short-term sukuk would be structured as wakala, with the Issuer SPV acting on behalf of sukuk holders.
- The structure allows for periodic issuance of new sukuk backed by the same Asset Pool, and addition of new assets to the Asset Pool.
- The structure allows for the payment of profit at a fixed rate.
- The structure allows for the return of initial investment at maturity.
- The sukuk would be freely tradable in the secondary market, as long as the Asset Pool has no more than 49% receivables.

Illustrative structure - advantages/disadvantages of wakala

– Advantages:
  – can be supported by a pool or portfolio of underlying assets, as opposed to a specific asset or type.
  – The portfolio can include a broad range of Shari’a-compliant assets such as murabaha contracts, istisna contracts, Shari’a-compliant shares or other sukuk.
  – The portfolio can include up to 49% (or perhaps 70%) pure receivables (such as murabaha and istisna contracts), combined with tangible assets (such as ijara and Shari’a-compliant shares).

– Disadvantages:
  – Must monitor receivables percentage in order to preserve tradeability

Introduction of sukuk structures

Structure	Year introduced	Country
Ijara	2001	Many
Mudaraba	2003	Kuwait Qatar UAE
Ijara-Istisna’	2005	KSA
Musharaka	2005	Kuwait Qatar UAE
Wakala Bil-Istithmar	2006	UAE IDB
Manfa'a	2007	KSA
Wakala Bil-Istithmar	2010	Malaysia Qatar KSA Turkey UAE
Wakala-Ijara	2011	Turkey
Wakala-Mudaraba	2011	UAE

Source: Zawya

Sukuk structures by year

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
Ijarah	2	4	6	5	10	6	10	3	8	4	3	8	**69**
Ijarah-Istisna'					1	1							**2**
Istisna'						1							**1**
Manfa'a							1						**1**
Mudaraba			1			1	7						**9**
Murabaha					1	1					1		**3**
Musharaka					3	10	7	2		2	1	3	**28**
Salam	7	12	12	11	12	12	3						**69**
Wakala										2	4	3	**9**
Wakala Bil-Istithmar						1			1	1	1	1	**5**
Wakala-Ijarah											1		**1**
Wakala-Mudaraba											3	2	**5**
Total	**9**	**16**	**19**	**16**	**27**	**33**	**28**	**5**	**9**	**9**	**14**	**17**	**202**

Source: Zawya

The difficulties with ijara sukuk

- Needs appropriate assets
  - Requires 100% tangible assets
  - Must have legal ownership
  - Cannot have any encumbrances – mortgages, leases, etc
  - Sukuk issuance amount must correspond to asset valuation
  - Must be capable of transfer and lease
    - Sometimes there are legal or tax impediments to transfer. There are potential solutions (such as a head lease, transfer of beneficial title or a double SPV, but each has its conditions)
- Government issues
  - Transfer of ownership of government property; nationality requirement
  - Procurement rules when contracting with government entities
  - Concern about recourse to assets on default
  - SPV incorporation

The difficulties with ijara sukuk

– May need operational flexibility to dispose or renovate assets
– Recognition of trust, or a substitute arrangement
– Potential tax issues
  – Stamp duty on each transfer of assets
  – Taxable gain on disposition of asset at maturity
  – Withholding tax on payments of rent or on Sukuk distributions
  – Taxable income in the Issuer
  – Treatment of Sukuk distributions in the hands of investors
– Wa'd not always accepted
– Insurance arrangements not always accepted
– Existing covenants (eg, negative pledge, non-disposal, sale-leaseback) in other financings may prevent it
– Basis for principal return is a problem in short-term issue

Underlying asset examples in tradeable sukuk

Assets	Issuers
Real estate	Germany – Saxony-Anhalt, Indonesia, Malaysia
Factories	Dubai Department of Finance
Plants	Dubai Electricity & Water Authority, Petronas
Terminals	Dubai Civil Aviation Authority, Dubai Department of Finance
Equipment	Sarawak, International Finance Corporation
Power generation assets	Saudi Electricity Company
Vehicles	Nomura, GE Capital
Ijara contracts (together with underlying assets), property and non-property	IDB, Abu Dhabi Islamic Bank, Tamweel, Kingdom Instalment Company, Qatar Islamic Bank, Kuveyt Turk Bank
Sukuk (together with underlying assets)	IDB, Almana Group
Shares (Shari'a-compliant)	Malaysia, IDB
Istisna'a receivables (part of a pool – not tradable by itself)	IDB, Tamweel, , Kingdom Instalment Company
Murabaha receivables (part of a pool – not tradable by itself)	IDB, Qatar Islamic Bank, Kuveyt Turk Bank, Malaysia, HBME Bank
Salam assets (part of a pool – not tradable by itself)	Abu Dhabi Islamic Bank
Rights under Marketing Agreements	Saudi Basic Industries Corp
Investment in business activities	International Investment Group, National Industries Group, Dubai International Financial Centre, Dana Gas, Aldar

Benefits of the structure

- For financial institutions:
  - Cost competitive liquidity management
  - Collateral for use with CBs and other financial institutions, including conventional
  - Tradeable instrument, with accompanying market infrastructure
  - Eliminates need to seek suitable counterparties, especially in market stress

Benefits of the structure

- For central banks:
  - Monetary policy instrument and financial stability tool
  - Can improve LM and profitability of regulated Islamic banks
  - Stimulates development of domestic Islamic interbank market and private short-term market
  - Provides more investment choices to investors
- For governments:
  - New public finance source
  - Flexibility to switch between short and long funding, and transform long into short
  - Flexible tenor funding
  - Attractive funding cost
  - Can use pure receivables to create sukuk

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