

# Sukuk Toolkit

A guide to Sukuk  
structures, market  
practices and trends



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# 1 Introduction

One of the main developments in the modern Islamic finance industry has been the advent of issuance of Sukuk – certificates that replicate the economic effects of conventional bonds. Following a slow-down earlier in the decade, the number of Sukuk issuances has increased year-on-year from 2016 to 2019, while forecasts for 2020 were positive before the outbreak of the Coronavirus. The increase in corporates and sovereigns issuing Sukuk from an increasing number of countries, including non-Muslim countries, has contributed to this growth, as a broader base of issuers and investors come to better understand the immense potential of the instrument. As the Sukuk moves ever closer to the mainstream, the appeal of Sukuk markets an attractive alternative means of raising finance becomes more apparent.

Sukuk are important financial instruments for a number of reasons. Sukuk are in demand by investors who wish to comply with Shariah principles. Tradable Sukuk issued by rated issuers are also essential for Islamic financial institutions to enable them to manage their short-term liquidity requirements.

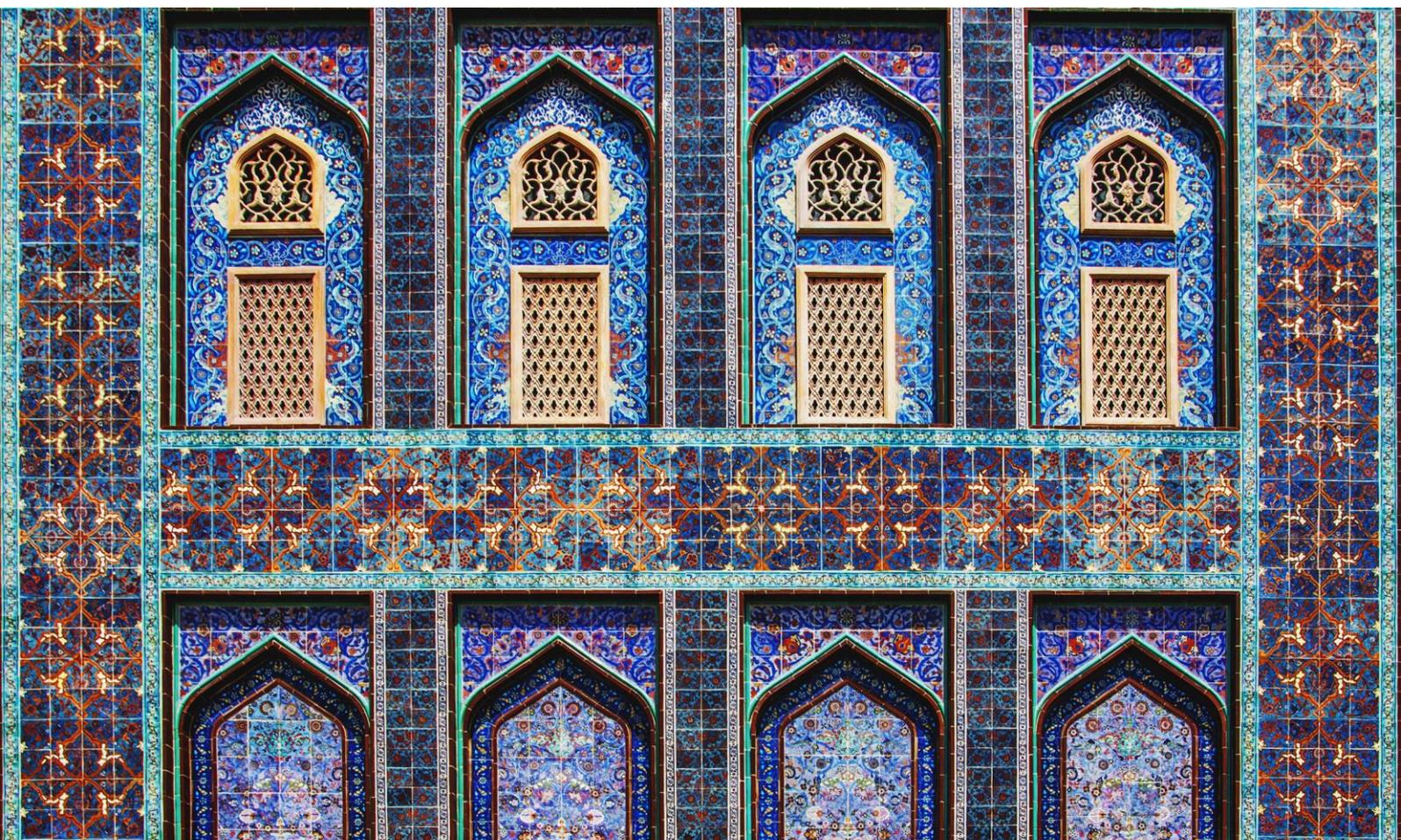
This toolkit has been designed to provide potential issuers of, and investors in, Sukuk with a detailed introduction to the instrument, analysis of how they differ from conventional bonds and a summary of the different types of Sukuk that can be issued.

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# Overview of the global Sukuk market

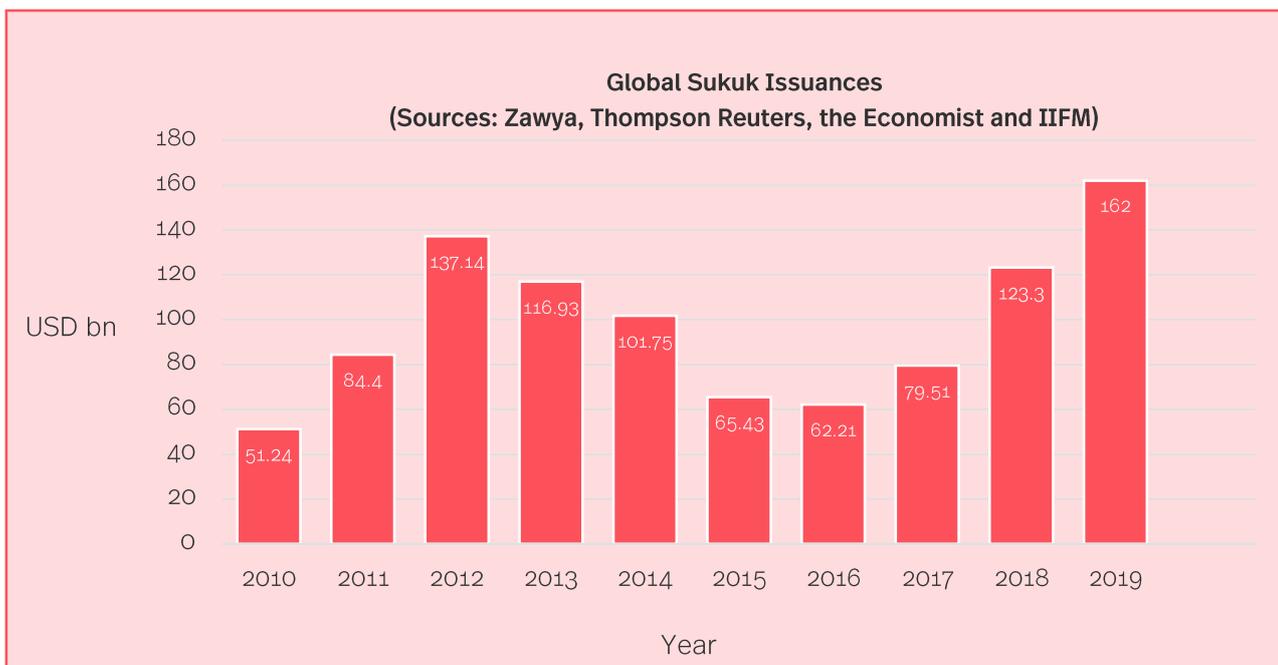
## 2 Overview of the global Sukuk market

The global Sukuk market has developed significantly in the last 15 years, to the point where 2019 saw the highest ever global issuance by monetary value. Although Sukuk were widely used by Muslim traders in the Middle Ages as a form of promissory note, they have re-emerged and evolved as important financial instruments within the global Islamic financial market.

The first modern Sukuk was a USD 33m Bai Bithaman Ajil issuance in 1990 by Shell MDS Sdb Bhd in Malaysia. Many of the subsequent issuances and the evolution of Sukuk as modern financial instruments have taken place in Malaysia. Recent years have also witnessed a number of sovereign Sukuk issued by states mainly in the Middle East and South East Asia with the most notable example being the Kingdom of Saudi Arabia's programme establishment and subsequent issuances in 2017 and 2019. Increasing global liquidity, as well as efforts by governments and regulators to standardise Shariah interpretation are all contributing factors to the strong Sukuk market in 2020.

Prior to the Coronavirus outbreak, rating agency S&P Global stated that it expected the global Sukuk market's strong performance to continue in 2020, with a forecasted Sukuk issuance of around USD 170bn in 2020, representing a five per cent growth compared to the USD 162bn which was issued in 2019. The International Islamic Financial Market's ('IIFM') Annual Sukuk Report 2019 shows that USD 123.2bn of Sukuk were issued globally In 2018.

As illustrated by the diagram below, there had been a slight downturn in the use of Sukuk between 2013 and 2016 (attributable to the continued effects of the global financial crisis as well as challenging regional conditions). However, we can see that the global Sukuk market recovered in 2017 (thanks to Saudi Arabian and Malaysian issuances amounting to over USD 48bn). This recovery has continued year-on-year up to 2020.



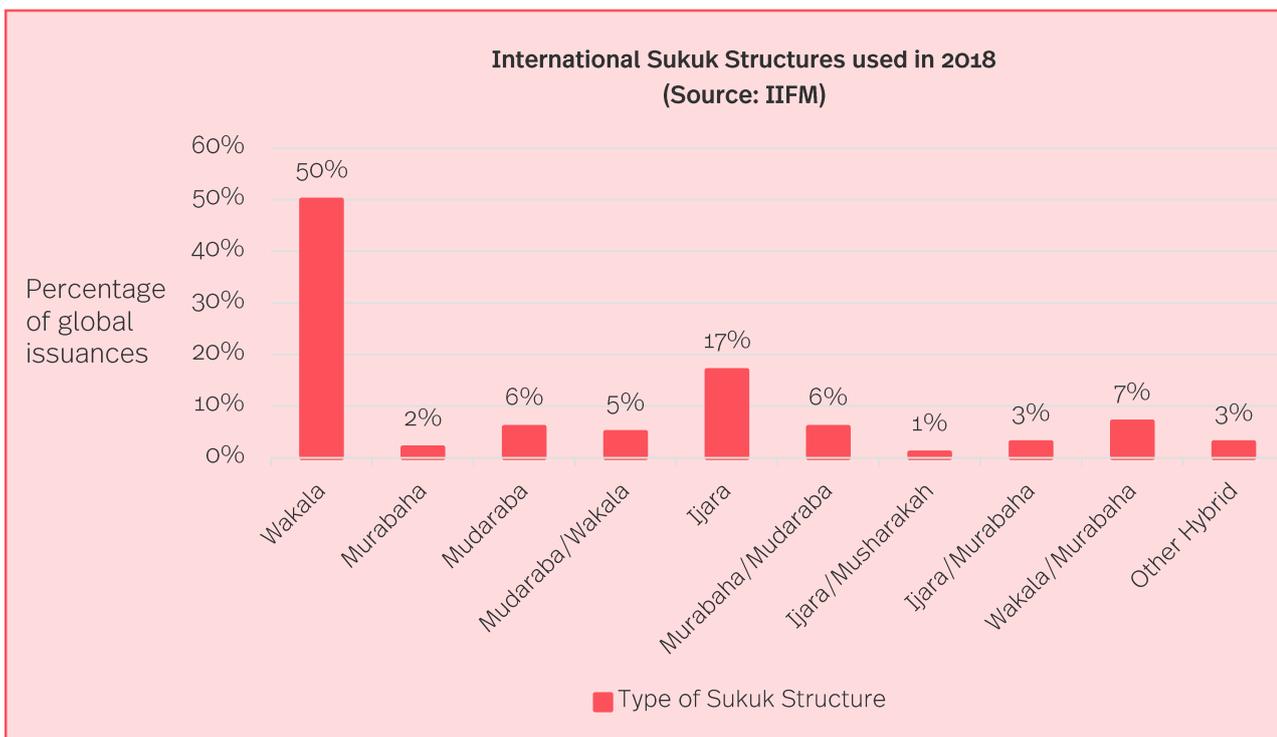
Nonetheless, the value of Sukuk issued has grown exponentially in recent years – with much of the growth driven by debut issuances in the MENA region, for example the Kingdom of Saudi Arabia’s landmark issuance discussed above, and the Kingdom of Morocco’s debut Sukuk issuance in 2018.

As Sukuk structures and documents become more standardised, and as sovereign issuances pave the way for domestic corporates to issue Sukuk, it is expected that the amount of Sukuk issued will continue to increase, as will the number of issuances from other states with majority Muslim populations. Also significant will be the issuance of Sukuk from states with minority Muslim populations, such as the United Kingdom, who issued their first Sukuk in 2014 (even amid market uncertainty) and announced in 2019 its intention to issue a further Sukuk. Luxembourg, Hong Kong and Singapore have all issued sovereign Sukuk while African nations such as South Africa, Nigeria and Ivory Coast have made legal and tax changes in recent years that would, among other things, facilitate Sukuk issuance.

Sukuk structures are more commonly being amalgamated to offer greater flexibility to issuing entities.

The Ijara (sale and leaseback) structure has typically been the most commonly used Sukuk structure and is regarded as the classical Sukuk structure. The Ijara structure is popular because it is simple, widely accepted and is understood by both conventional and Sukuk investors (particularly important when accessing the U.S. capital markets) as well as by Shariah scholars and international rating agencies. However, the underlying tangible assets utilised for an Ijara structure must be unencumbered at the issue date of the Sukuk and their market value on the issue date must be equal to, or exceed, the principal amount of Sukuk being issued. We have therefore recently seen a movement away from Ijara as the preferred structure, at least for Middle Eastern issuers, towards a Wakala structure.

In its 2019 Sukuk Report, IIFM sets out data on international Sukuk issuances for the year 2018. As indicated in the table below, the Wakala and Ijara structures remain popular but combined or hybrid structures made up a significant portion of structures used on international issuances.



# Islamic finance overview

### 3 Islamic finance overview

The term 'Islamic Finance' refers generally to financings structured to comply with the principles of Islamic law (Shariah). 'Shariah' is understood to mean the primary rules and principles of Islamic law, derived from two main sources:

- **The Quran** – the sacred book of Islam that Muslims believe records the Words of God as revealed to the Prophet Mohamed.
- **The Sunnah** – the sayings and practices of the Prophet Mohamed, as recorded in Hadith – compilations of Sunnah narrated by the Prophet's companions.

Since the detail of Shariah can vary from the specific to the general and from the explicit to the implicit, it is subject to a secondary process of interpretation by Shariah scholars. The body of law resulting from interpreting the Quran and the Sunnah is known as Fiqh (Islamic jurisprudence). The Islamic finance industry is therefore concerned with Fiqh as opposed to Shariah, but for simplicity refers to Shariah.

The economic theory of Islam differs quite substantially from other economic theories. According to the contemporary scholar Dr. Muhammad Umer Chapra:

*"Wealth [in Islamic philosophy] does not actually belong to man. It belongs to God and its human owner is just a trustee, entrusted with it to realise the objectives of God, two of the most important of which are general human well-being and socio-economic justice."<sup>(1)</sup>*

Shariah principles in the context of financial transactions seek to reflect these objectives. They are quite broad and there are areas in which Shariah scholars have differences of opinion. Nonetheless, a large body of principles are generally agreed upon, thereby creating certainty for participants in the Islamic finance industry.

The prohibition of Riba, or interest, is perhaps the most well-known Shariah principle relating to financial transactions. The prohibition of Riba in Shariah is absolute and applies equally to those who receive it, those who pay it as well as the draftsman of and/or witness to the contract that gives rise to the obligation to pay Riba.

Other Shariah principles relevant to financial transactions include the following:

- **Hoarding** – the Islamic economy encourages the free flow of capital, hence the prohibition on hoarding in Shariah.
- **Maysir** – speculative instruments and/or gambling are prohibited under Shariah.
- **Gharar** – uncertainty or ambiguity as to the terms or subject matter of a transaction can make a contract invalid under Shariah.
- **Haram (prohibited) goods and services** – investments in activities or assets that are contrary to the ethical norms of Shariah such as arms, alcohol, pork, pornography, gambling institutions and conventional financial institutions etc. are prohibited.

The Accounting and Auditing Organisation for Islamic Financial Institutions ('AAOIFI'), established in 1990, publishes Shariah Standards on the main products and principles in Islamic finance and which have been agreed upon by many of the leading contemporary Shariah scholars specialising in Islamic finance. The AAOIFI Shariah Standards are increasingly used as a benchmark by the Islamic finance industry.

(1) Muhammad Umer Chapra, Towards a Just Monetary System



# Islamic finance contracts

## 4 Islamic finance contracts

The current Islamic finance industry can be characterised by an emphasis on contracts. Shariah recognises a number of different types of contracts that are permissible for financial transactions. These contracts can be applied or combined in a number of different ways in order to create a financial transaction. The different contracts that are relevant for the purposes of this guide are as follows:

Debt contracts	
<b>Ijara</b>	<p>A lease under which the right to use an asset is transferred for a period in return for a specified rent. It is essential that:</p> <ul style="list-style-type: none"> <li>● the lessor has title to the asset at the time that the lease becomes effective;</li> <li>● the asset being leased, and the intended use of that asset, is Shariah compliant;</li> <li>● the asset must be capable of being used without being consumed; and</li> <li>● rent is not payable by the lessee when the lessee does not have use of the asset.</li> </ul>
<b>Istisna</b>	<p>A contract for the manufacture of a specified asset in accordance with the buyer's specification, with delivery on a specified date for a specified and fixed price. It is essential that:</p> <ul style="list-style-type: none"> <li>● the assets do not exist at the time of the contract;</li> <li>● the specifications of the assets to be manufactured or constructed must be agreed;</li> <li>● the price payable to the manufacturer must be fixed at the start;</li> <li>● the assets to be manufactured are to be Shariah compliant; and</li> <li>● upon completion, title to the assets are transferred to the client, who is entitled to reject such assets if they do not conform with the agreed specifications.</li> </ul>
<b>Murabaha</b>	<p>A contract for the sale of assets where delivery of the assets is immediate and the cost to the seller is disclosed to the purchaser, thereby disclosing the profit of the seller. These contracts typically provide that the purchaser is to pay the sale price on a deferred basis and are therefore a type of credit facility, also referred to as Bai Bithaman Ajil (deferred payment sale) in some countries because of the deferred payment. It is essential that:</p> <ul style="list-style-type: none"> <li>● the seller owns the asset at the time of sale;</li> <li>● the initial price of the asset and the seller's profit margin are disclosed to the purchaser;</li> <li>● the assets being sold are Shariah compliant;</li> <li>● once sold, the price for the assets cannot be varied; and</li> <li>● title to the assets transfer immediately upon executing the Murabaha contract.</li> </ul>
<b>Salam</b>	<p>A contract for the sale of assets where delivery of the assets is deferred, but the payment of the purchase price is immediate. It is essential that:</p> <ul style="list-style-type: none"> <li>● the assets being sold are Shariah compliant;</li> <li>● the price for the assets cannot be varied; and</li> <li>● payment of the purchase price cannot be deferred.</li> </ul>



## Equity contracts

<b>Mudaraba</b>	A limited partnership where one partner (the Rab al Maal) provides the other (the Mudarib) with assets or property to be managed by the Mudarib. The profits are shared between the Rab al Maal and the Mudarib as per their agreement but losses are borne by the Rab al Maal in the absence of any breach of terms, negligence or fraud by the Mudarib.
<b>Musharakah</b>	A partnership where profits derived can be shared as per the agreement of the partners, but losses must be borne in proportion to their respective capital contributions. There are two general types of Musharakah: <ul style="list-style-type: none"> <li>● Shirkat al Aqd – a contractual partnership; and</li> <li>● Shirkat al Milk – a partnership of co-ownership in a tangible asset.</li> </ul>
<b>Wakala</b>	An agency contract whereby the principal (the Muwakkil) appoints another (the Wakil) as its agent to manage assets or property on behalf of the Muwakkil. In the context of financings, the Wakala is structured as a Wakala Bil Istithmar (investment agency), whereby the cash or assets are managed by the agent for the purpose of generating a profit. It is essential that: <ul style="list-style-type: none"> <li>● the investments underlying the arrangement are Shariah compliant; and</li> <li>● the Wakil does not guarantee the profits or capital of a Wakala.</li> </ul>



# Sukuk principles

## 5 Sukuk principles

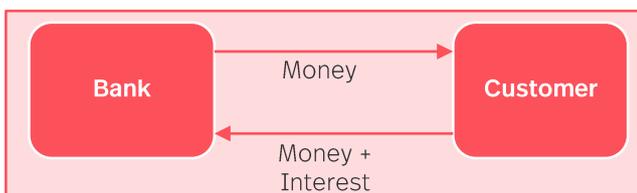
While Sukuk are commonly described as ‘Islamic bonds’, this is not an accurate description. Sukuk (a plural of Sakk) are instruments representing a proportionate ownership in underlying assets or usufructs, entitling the holders of such instruments to a proportionate share in the proceeds of such assets or usufructs.

AAOIFI defines Investment Sukuk as follows:

“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,”<sup>(2)</sup>

Essential to an understanding of the concept of Sukuk is an appreciation of how Islamic finance differs from conventional finance.

- A number of industry practitioners describe the distinction between Islamic and conventional finance as follows:



- Under an Islamic financing, the ‘lender’ provides goods and/or services to the obligor. The obligor pays for the provision of such goods and services, which would include a profit margin for the lender:



### 5.1 Characterisation as a debt or equity instrument

The classification of Sukuk as either debt or equity instruments depends on the nature of the assets underlying the Sukuk. For example, a Sukuk issuance may be characterised as an equity instrument where the underlying assets of the Sukuk are a business (Sukuk al Musharakah). In contrast, a Sukuk issuance may be characterised as a debt instrument where the underlying assets of the Sukuk are receivables from deferred payment contracts (Sukuk al Murabaha).

In practice, Sukuk tend to be structured to have debt-like characteristics. Nonetheless, the AAOIFI Shariah Standards state that the Sukuk certificates themselves do not represent a debt owed by an issuer to the Sukukholder.<sup>(3)</sup>

### 5.2 Types of Sukuk

The different types of popular Sukuk structures are examined in more detail in Section 6 (Sukuk structures). The AAOIFI Shariah Standards describe 14 different types of Sukuk as permissible. Not all of these different types have been commonly used in the public markets, and some types are unlikely to be applied in the modern Islamic finance market (for example, Musaqqa certificates, where the issuer owns land that consists of trees and the Sukukholders are responsible for paying for the irrigation of the land but are entitled to share in the produce of the trees).

In practice, Sukuk are identified by their underlying assets. Sukuk al Ijara are therefore Sukuk under which the returns for Sukukholders are generated by an underlying Ijara (lease). Similarly, Sukuk al Musharakah are Sukuk where the returns are generated by a Musharakah (business partnership).

<sup>(2)</sup> Paragraph 2, Shariah Standard No. 17 on Investment Sukuk, AAOIFI Shariah Standards, November 2017

<sup>(3)</sup> Paragraph 4/2, Shariah Standard No. 17 on Investment Sukuk, AAOIFI Shariah Standards, November 2017



### 5.3 Tradability

One important characteristic of Sukuk in the modern Islamic financial market is their tradability. Whether or not a Sukuk can be traded depends on the type of assets underlying the Sukuk. According to the majority of Islamic schools of thought, a contract for the sale of a debt receivable (Bai al Dayn) is prohibited unless the debt is sold for its face value. The reasoning for this is that a discounting of debt receivables would recognise the time value of money, which is effectively interest or Riba and which is prohibited under Shariah. This principle has been adopted by most Islamic financial institutions and their Shariah boards in the Middle East. However, some Shariah scholars following the Shafi'i school of thought believe that debt receivables can be traded at a discount to their face value. The Malaysian authorities, which generally follow the Shafi'i school of thought, have permitted the trading of debt at a discount.<sup>(4)</sup>

Following certain controversial market practices, AAOIFI issued further Shariah Standards on Sukuk in February 2008. The background to this is summarised in Section 7.2 (AAOIFI Statement on Sukuk, February 2008). AAOIFI reiterated that Sukuk representing receivables or debts cannot be traded (although not stated in the resolution, it is presumed that the prohibition applies to the trading at a discount to the face value of such Sukuk).<sup>(5)</sup> AAOIFI also resolved that the relevant proceeds of a Sukuk issuance should be applied in a Shariah compliant manner.<sup>(6)</sup>

### 5.4 A smart guide to structuring Sukuk and ensuring Shariah compliance

Because of the way that Sukuk are structured, a Sukuk issuance often is not as straightforward as a conventional bond issuance. A Sukuk issuance would typically require the identification of assets or business areas that can support payments under a Sukuk, and in many cases the transfer of such assets or businesses to a special purpose vehicle (typically incorporated in an offshore jurisdiction such as the Cayman Islands or the British Virgin Islands).

In our experience, the most efficient process for considering the issuance of a Sukuk is to start with preparing a structure paper in cooperation with the relevant advisers. The structure paper would identify whether there are assets suitable for a Sukuk issuance. The structure paper would also help to clarify whether there are any impediments to the transfer of such assets to an offshore special purpose vehicle, such as under any applicable laws (see Section 7.1 (Asset-backed and Asset-based Sukuk)) or if the originator has agreed to negative covenants in its outstanding facilities.

Also important is ensuring that the Sukuk issuance complies with Shariah principles. Typically the arranging bank would have its own Shariah board that would review the structure paper and the documents supporting the Sukuk issuance. Where the originator itself complies with Shariah principles (such as an Islamic financial institution), its own Shariah board would review the structure paper and the documents supporting the Sukuk issuance.

The certifications from the relevant Shariah board would typically be disclosed in the relevant offering document with certain qualifications. The disclosure would generally state that the certification by the relevant Shariah board is only an expression of the view of that Shariah board and is not binding. It would also state that no representations are made as to the tradability of the issuance in accordance with Shariah and that differences in opinion are possible in respect of the compliance of the issuance with Shariah. Sukukholders would be advised to obtain their own independent Shariah advice as to whether the structure meets their individual standards of compliance and to make their own determination as to the future tradability of the relevant certificates.

(4) Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia, 2nd Edition, p.16

(5) Second Resolution, AAOIFI Resolutions on Sukuk, February 2008

(6) Sixth Resolution, AAOIFI Resolutions on Sukuk, February 2008



## 5.5 Comparison between Sukuk and bonds

Below is a table identifying the key differences between Sukuk and conventional bonds:

Characteristics	Sukuk	Bonds
Rights of holders	A proportionate share in the proceeds of the underlying assets or usufructs.	Interest-based debt
Principal amount	Depends on the type of the underlying contract. For example, Sukukholders have a certainty of capital in a Sukuk al Ijara and a Sukuk al Murabaha but are not meant to have certainty of capital in a Sukuk al Musharakah.	Bondholders have certainty of capital
Rate of Return	Depends on the type of the underlying contract. For example, Sukukholders have a certainty of return in a Sukuk al Ijara and a Sukuk al Murabaha but are not meant to have certainty of return under a Sukuk al Wakala or a Sukuk al Musharakah.	Bondholders have certainty of return
Claims	Since issuers of Sukuk are typically special purpose vehicles, the main claim that Sukukholders would have will be against the originator (through the claims a special purpose vehicle has) and in some cases against the security provided in respect of the Sukuk.	Bondholders have a claim against the issuing/borrowing entity, and in some cases against the security provided in respect of the bond
Tradability	<p>This depends on the type of underlying contract and the prevailing Islamic school of thought.</p> <p>Sukuk al Ijara are generally tradable as they do not represent a debt but rather ownership share in real assets, usufruct and services.</p> <p>Sukuk al Mudaraba and Sukuk al Musharakah are generally tradable as long as a significant portion of the underlying assets are in illiquid form.</p> <p>Sukuk al Murabaha and Sukuk al Istisna are generally not tradable except at face value.</p>	Tradable in conventional markets
Taxes	Unless returns are characterised as interest, they may be taxed as profit. Legislative changes may therefore be necessary in some jurisdictions to ensure that returns from Sukuk are taxed on the same basis as coupons from bonds.	Coupons are generally tax deductible



# Sukuk structures

## 6 Sukuk Structures

### 6.1 Sukuk al Ijara

The returns for Sukukholders from a Sukuk al Ijara are generated by rent payable on an Ijara. Typically, the Originator would have an existing pool of assets that it would sell to the Issuer then lease those assets back from the Issuer. To be suitable for use in a Ijara structure, an asset must be tangible. Real estate, sea vessels and aircraft, for example, are all suitable assets. However, as referred to above, the requirement that such assets be unencumbered can cause difficulties (given the requirement that the assets be of a value at least equivalent to the principal amount of Sukuk being issued).

#### Essential steps

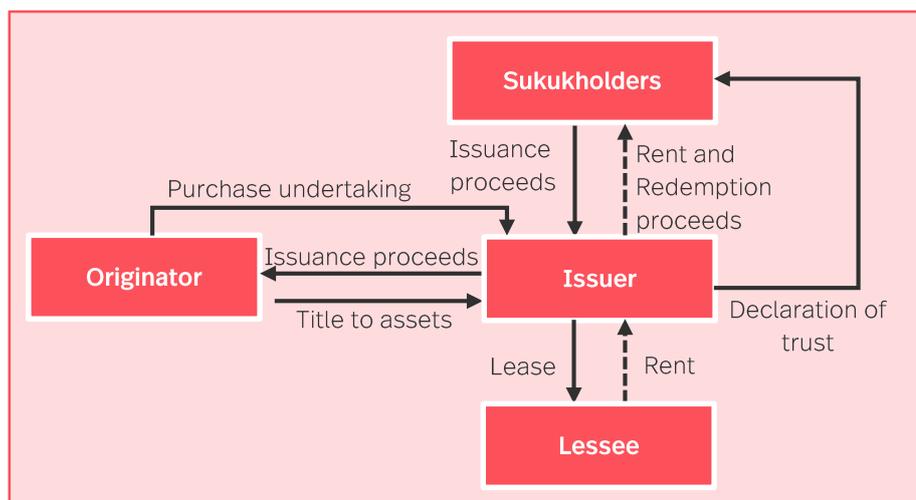
The principal steps for the issuance of a Sukuk al Ijara are as follows:

- The Issuer issues Sukuk certificates to Sukukholders.
- The Originator sells certain assets to the Issuer. The Issuer pays for the assets (the Ijara Assets) using the issuance proceeds.
- The Issuer holds title to the assets on trust for the Sukukholders.
- The Issuer leases the assets back to the Originator for a fixed period of time, in return for which it receives rental payments. The rent payable by the Originator under the lease is distributed by the Issuer to the Sukukholders to support the profit payable under the Sukuk.
- The Originator promises to purchase title to the assets from the Issuer at maturity or following the occurrence of an event of default. The price payable by the Originator represents the redemption proceeds.

The principal documents used in a Sukuk al Ijara are as follows:

- A Sale and Purchase Agreement between the Originator as seller and the Issuer as purchaser, pursuant to which the Originator would sell assets to the Issuer in return for the issuance proceeds.
- An Ijara (lease) Agreement between the Issuer as lessor and the Originator as lessee, pursuant to which the Originator leases the assets from the Issuer for a specified term and for a specified rent.
- A Service Agency Agreement between the Issuer as principal and the Originator as service agent. Under Shariah, the owner of an asset is responsible for major maintenance, structural repair and insurance of the asset. In practice, the owner of an asset in an Ijara Agreement would appoint the lessee as its service agent to undertake major maintenance, structural repair and insurance on its behalf.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the relevant Ijara Assets from the Issuer upon the occurrence of an event of default and on the maturity date.
- A Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell the relevant Ijara Assets to the Originator upon the occurrence of certain debts, such as a note buyback or redemption for tax reasons.

Although the typical payment terms under an Ijara mirror conventional debt payments, and the payment obligations of the Originator under the Purchase Undertaking can be characterised as a debt, a Sukuk al Ijara can be traded other than at face value according to all the main Islamic schools of thought.



## 6.2 Sukuk al Musharakah

The returns for Sukukholders from a Sukuk al Musharakah are generated by an underlying business. They are no longer common following a pronouncement by AAOIFI in 2008 (see Section 7.2 (AAOIFI Statement on Sukuk, February 2008)). There are two types of Musharakah: a Shirkat al Aqd (a contractual partnership) and a Shirkat al Milk (a partnership of co-ownership in a tangible asset).

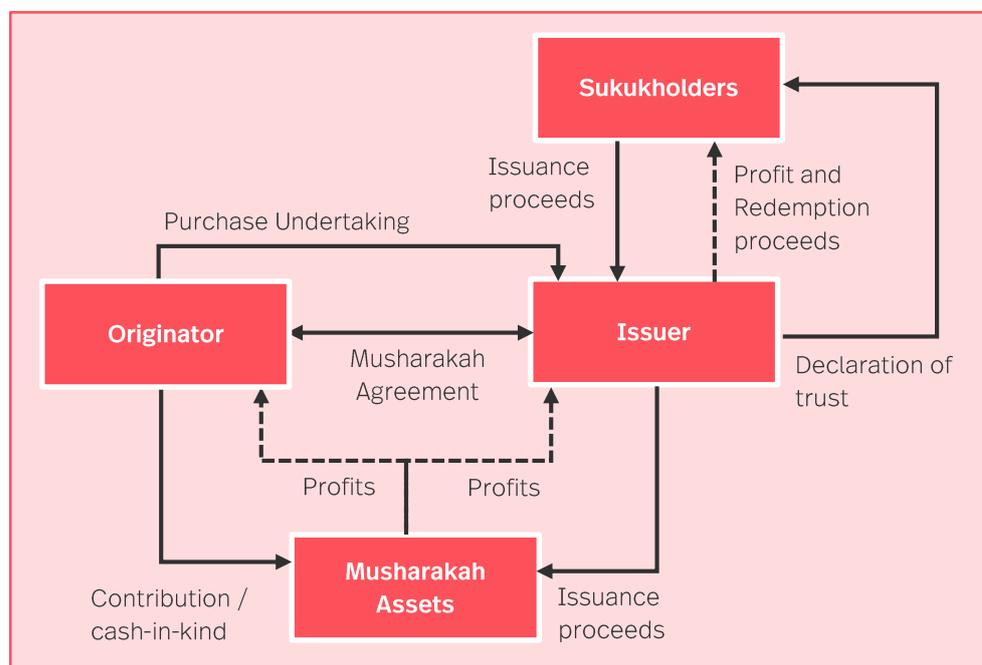
### Essential steps

Summarised below are the principal steps for the issuance of a Sukuk al Musharakah based on Shirkat al Aqd:

- The Issuer issues Sukuk certificates to Sukukholders.
  - The Issuer enters into a Musharakah Agreement with the Originator. The Issuer contributes the issuance proceeds into the Musharakah and the Originator contributes its own cash (together, the Musharakah Assets), and each receive units in a specified business in proportion to their respective capital contributions.
  - The Issuer declares a trust over its share in the Musharakah Assets in favour of the Sukukholders.
  - On each agreed distribution date, the Originator pays to the Issuer an agreed percentage of expected profits generated by the Musharakah Assets. Losses are borne by the Originator and the Issuer in proportion to their respective capital contribution to the Musharakah Assets.
- The Originator promises to purchase the Issuer's share of the Musharakah Assets at maturity or following the occurrence of an event of default. The price payable by the Originator for the Issuer's share of the Musharakah Assets has been subject to some controversy. Prior to the announcement by AAOIFI in 2008 (see Section 7.2 (AAOIFI Statement on Sukuk, February 2008)), it was common to see in such issuances that the amount payable by the Originator was equal to the value of the original issuance proceeds although this is now generally not permissible.

The principal documents used in a Sukuk al Musharakah are as follows:

- A Musharakah Agreement between the Originator and the Issuer, pursuant to which they agree to create a Musharakah, contribute to the assets of the Musharakah and agree the distribution of profits and losses.
- A Management Agreement between the Originator and the Issuer, pursuant to which the Issuer appoints the Originator to manage the Musharakah Assets.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer's share in the Musharakah Assets (representing the redemption proceeds for the Sukukholders) upon the occurrence of an event of default.
- Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell its share in the Musharakah Assets at or prior to the relevant maturity date.



### 6.3 Sukuk al Mudaraba

Similar to a Sukuk al Musharakah, returns for Sukukholders from a Sukuk al Mudaraba are generated by an underlying business, which in this instance, is managed by a Mudarib.

#### Essential steps

The principal steps for the issuance of a Sukuk al Mudaraba are as follows:

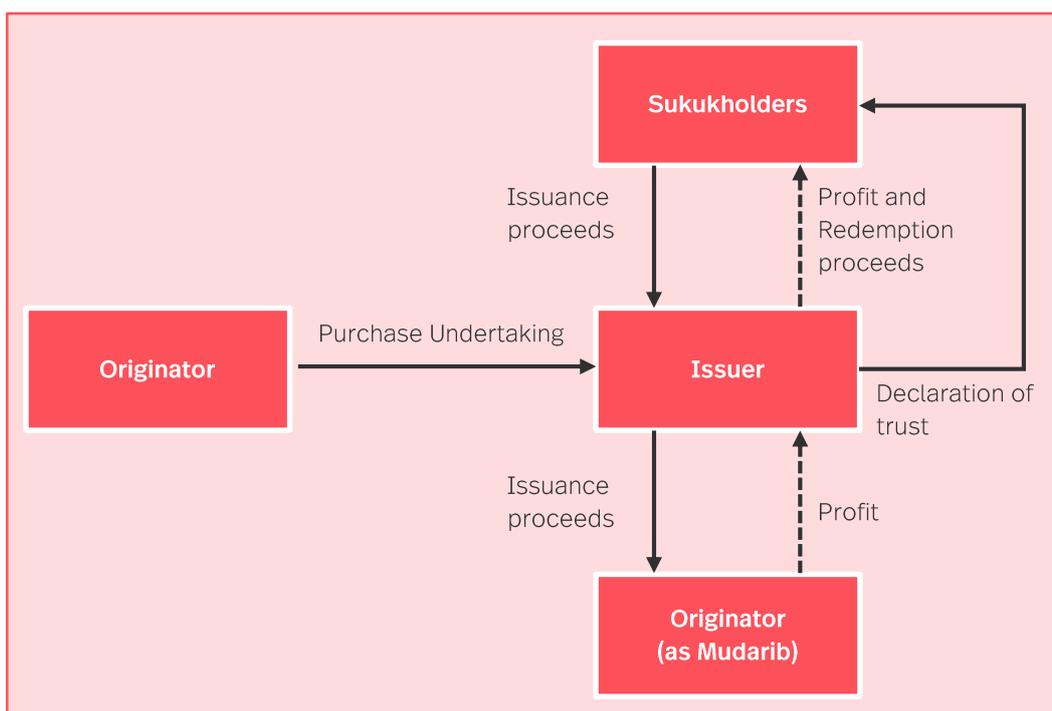
- The Issuer issues Sukuk certificates to Sukukholders.
- The Issuer (as Rab al Maal) appoints the Originator (as Mudarib). The Issuer contributes the issuance proceeds as the capital of the Mudaraba which will be managed by the Originator in a specified manner.
- The Issuer declares a trust over its interest in the Mudaraba in favour of the Sukukholders.
- On each agreed distribution date, the profits from the Mudaraba are shared between the Originator and the Issuer in agreed percentages based on their respective capital contributions. The Originator as Mudarib is however typically entitled to all profits in excess of a specified rate of return as an incentive.

- The Originator promises to purchase the Issuer's interest in the Mudaraba at maturity or following the occurrence of an event of default.

As with Sukuk al Musharakah, the price that is payable by the Originator for the Issuer's interest has been clarified by AAOIFI. Whereas previously it was common to see that the amount payable was fixed at the value of the issuance proceeds, following AAOIFI's pronouncement in 2008 it was clarified that the price payable should be the market value of the Issuer's interest in the Mudaraba at the time of sale. As with Sukuk al Musharakah, where the promise to purchase is granted by a third party, the price payable for the Issuer's interest in the Musharakah Assets may be equal to the value of the issuance proceeds.

The principal documents used in a Sukuk al Mudaraba are as follows:

- A Mudaraba Agreement between the Originator and the Issuer, pursuant to which the Issuer as Rab al Maal appoints the Originator to act as Mudarib and contributes issuance proceeds to the Mudaraba.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer's interest in the Mudaraba (representing the redemption proceeds for the Sukukholders) upon the occurrence of an event of default.



## 6.4 Sukuk al Murabaha

The returns for Sukukholders from a Sukuk al Murabaha are generated by the synthetic trading of commodities.

### Essential steps

The principal steps for the issuance of a Sukuk al Murabaha are as follows:

- The Issuer issues Sukuk certificates to Sukukholders.
- The Issuer uses the issuance proceeds to purchase a specified quantity of commodities. The commodities are typically metals other than gold or silver.
- The Issuer enters into a Murabaha Agreement with the Originator to sell such commodities for spot delivery but typically at a higher price with a profit margin (the Sale Price) on deferred payment terms.
- The Originator on-sells the commodities that it has purchased from the Issuer to another broker to realise their cash value.
- The Originator pays the Sale Price to the Issuer in instalments on each agreed distribution date.

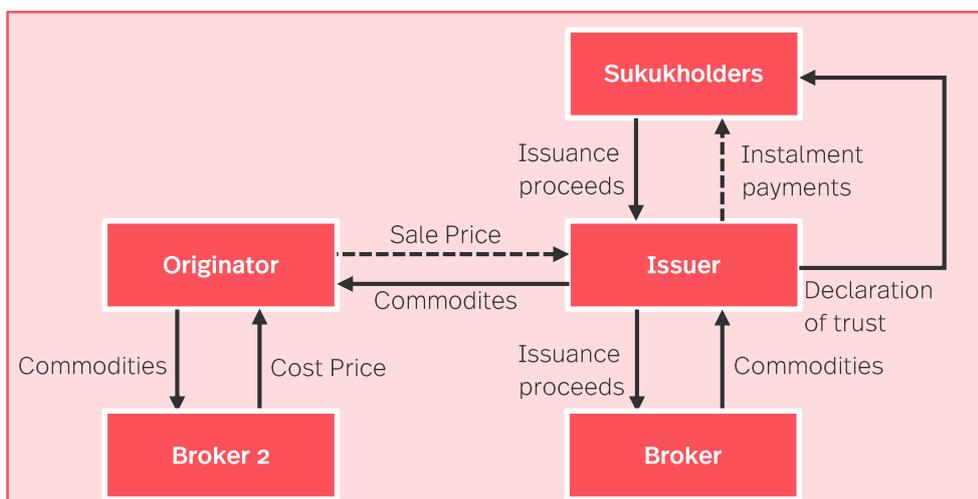
The principal documents used in a Sukuk al Murabaha are as follows:

- A Commodity Purchase Agreement between the Issuer as purchaser and a commodity broker as seller, pursuant to which the Issuer may purchase commodities from the commodity broker using the issuance proceeds from time to time.

- A Murabaha Agreement between the Issuer as seller and the Originator as purchaser, pursuant to which the Issuer may sell the commodities that it has purchased from the commodity broker to the Originator from time to time.

The above arrangement is also known as Commodity Murabaha or Tawarruq. Although widely used in Islamic treasury, working capital and capital markets products, the arrangement is considered controversial by a number of authorities. For example, according to the AAOIFI Shariah Standards,<sup>(7)</sup> Commodity Murabaha should only be used by an Islamic financial institution where it faces a liquidity shortage that could interrupt its operations. The OIC Fiqh Academy at its session in April 2009 described it as 'deception' that contained elements of Riba.<sup>(8)</sup> The Central Bank of Oman, in its Islamic Banking Regulatory Framework, permits Commodity Murabaha transactions only in very limited situations, such as where an institution's survival is genuinely threatened.<sup>(9)</sup>

Furthermore, as noted in Section 5 (Sukuk principles), the trading of debt receivables at a discount to their face value is not widely accepted under Shariah. Accordingly, Sukuk al Murabaha are viewed by Shariah scholars in the Middle East as instruments that should either be held to maturity or may only be traded at their face value without a discount or a premium. Nonetheless, such restrictions do not apply in jurisdictions such as Malaysia where Bai al Dayn is a permissible transaction. This explains why Sukuk al Murabaha tend to be issued by originators located in Malaysia.



(7) Paragraph 5/1, Shariah Standard No. 30 on Monetization, AAOIFI Shariah Standards. November 2017

(8) <https://ifresource.com/2009/05/14/oic-fiqh-academy-ruled-organised-tawarruq-impermissible/>

(9) Section 2.5.5, Title 9: Liquidity Risk, Islamic Banking Regulatory Framework, Central Bank of Oman



## 6.5 Sukuk al Salam

The returns for Sukukholders from a Sukuk al Salam are generated by the disposal of assets delivered to the Issuer by the Originator on agreed dates.

### Essential steps

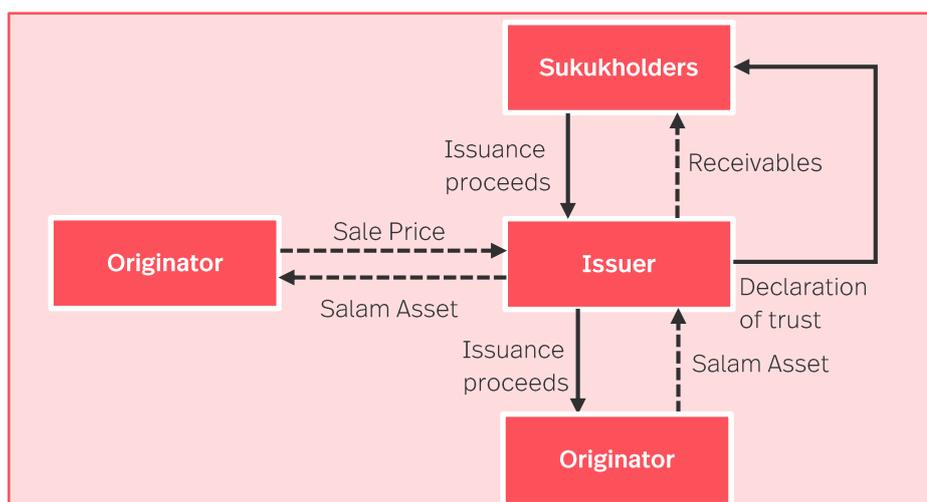
The principal steps for the issuance of a Sukuk al Salam are as follows:

- The Issuer issues Sukuk certificates to Sukukholders.
- The Issuer enters into a Salam Agreement with the Originator, pursuant to which the Originator agrees to sell specified assets (the Salam Assets) to the Issuer for immediate payment but deferred delivery. The Issuer would pay the issuance proceeds to the Originator upfront as payment for the Salam Assets.
- The Salam Assets would be delivered periodically, with dates aligned with periodic payments dates applicable to the Sukuk issuance. The periodic delivery of the Salam Assets would reflect a proportion of the total Salam Assets, and the balance would typically be delivered at maturity.
- On each periodic payment date and at maturity, the Originator would deliver the agreed quantity of Salam Assets to the Issuer. Pursuant to a Purchase Undertaking, the Originator would buy the Salam Assets back from the Issuer for a higher price (the Sale Price). The difference between the price paid by the Issuer for the Salam Assets on the issue date and the price paid by the Originator on the relevant date would be fixed and would represent the profit for the Issuer.
- The buy-back arrangement by the Originator (Bai al Inah) is, like Bai al Dayn, not widely accepted amongst Shariah scholars. In the Middle East, the difference between the original purchase price and the subsequent sale price is considered to have elements of Riba. The Malaysian authorities have however permitted Bai al Inah.<sup>(10)</sup>
- The Issuer declares a trust over its interest in the receivables under the Salam Agreement and the Purchase Undertaking in favour of the Sukukholders.

The principal documents used in a Sukuk al Salam are as follows:

- A Salam Agreement between the Issuer as purchaser and the Originator as seller, pursuant to which the Issuer agrees to purchase Salam Assets from the Originator with the Salam Assets delivered in instalments.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator agrees to purchase the Salam Assets back from the Issuer on each periodic payment date, at maturity or following the occurrence of an event of default.
- A Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell the Salam Assets to the Originator following early delivery of the Salam Assets (representing voluntary early settlement of the Sukuk) for an amount equal to the amount of issuance proceeds outstanding.

As with Sukuk al Murabaha, the Sukuk in a Sukuk al Salam represents a debt receivable. Accordingly, Sukuk al Salam cannot be traded by institutions that conform to the view that Bai al Dayn is not permissible.



<sup>(10)</sup> Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia, 31 December 2019, p.8

## 6.6 Sukuk al Istisna

In practice, Sukuk al Istisna combine Ijara and Istisna structures and are particularly well suited for project financings. The returns for Sukukholders are generated from the Ijara structure.

### Essential steps

The principal steps for the issuance of a Sukuk al Istisna are as follows:

- The Issuer issues Sukuk certificates to Sukukholders.
- The Issuer enters into an Istisna Agreement with the Originator, pursuant to which the Issuer commissions the Originator to construct specified assets (the Istisna Assets) in return for the payment of the issuance proceeds to the Originator. At the end of the construction period, the Issuer receives title to the assets.
- Under an Islamic forward lease (Ijarah Mawsufah fi al Dhimma) granted by the Issuer as lessor to the Originator as lessee, the Originator pays rent to the Issuer on the relevant periodic distribution dates. The rent payable under the following lease is staged as follows:
  - during the construction period, the Originator pays Advance Rental to the Issuer; and
  - following delivery of the assets, the Originator pays Rental to the Issuer.

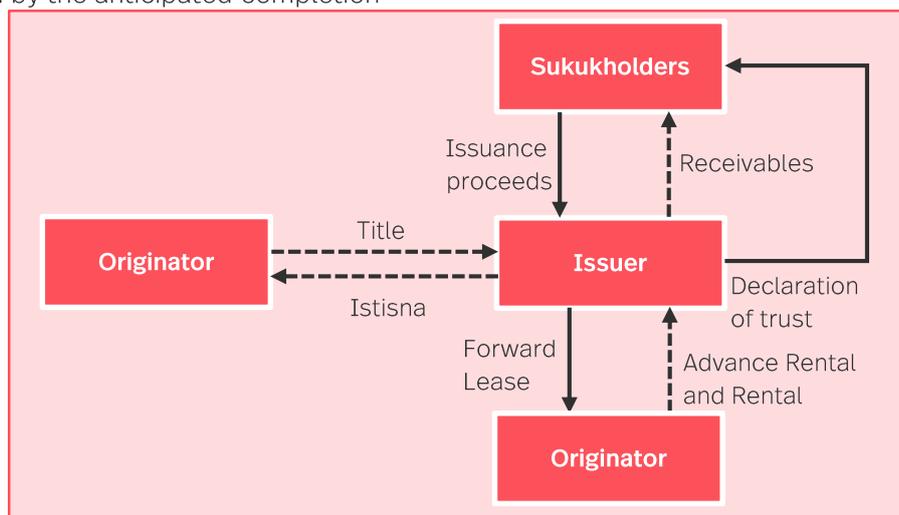
Where the assets are not delivered by the anticipated completion date, it is a Shariah requirement that the Advance Rental paid by the Originator would need to be reimbursed by the Issuer. In practice, the Istisna would provide for liquidated damages so that the Originator would make a payment to the Issuer where the assets are not delivered by the anticipated completion

date. The amount of liquidated damages payable by the Originator would take into account the Advance Rental that would have been returned by the Issuer to the Originator.

- The Issuer declares a trust over its interest in the receivables under the Istisna and the forward lease in favour of the Sukukholders.

The principal documents used in a Sukuk al Istisna are as follows:

- An Istisna Agreement between the Issuer and the Originator, pursuant to which the Issuer commissions the Originator to construct the Istisna Assets.
- An Ijarah Mawsufah fi al Dhimma (forward lease) Agreement between the Issuer as lessor and the Originator as lessee.
- A Service Agency Agreement between the Issuer as principal and the Originator as service agent (see Section 6.1 (Sukuk al Ijara)), which applies following completion of the relevant assets under the Istisna Agreement.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the relevant Istisna Assets from the Issuer upon the occurrence of an event of default and which applies following completion of the relevant assets under the Istisna Agreement.
- A Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell the relevant Istisna Assets to the Originator at or prior to the relevant maturity date and which applies following completion of the relevant assets under the Istisna Agreement.



## 6.7 Sukuk al Wakala

The returns for Sukukholders from a Sukuk al Wakala are generated from a specified pool of assets or investments that is managed by a Wakil. A Sukuk al Wakala is similar to Sukuk al Mudaraba, with the key distinguishing factor being the way in which the Wakil is remunerated.

### Essential steps

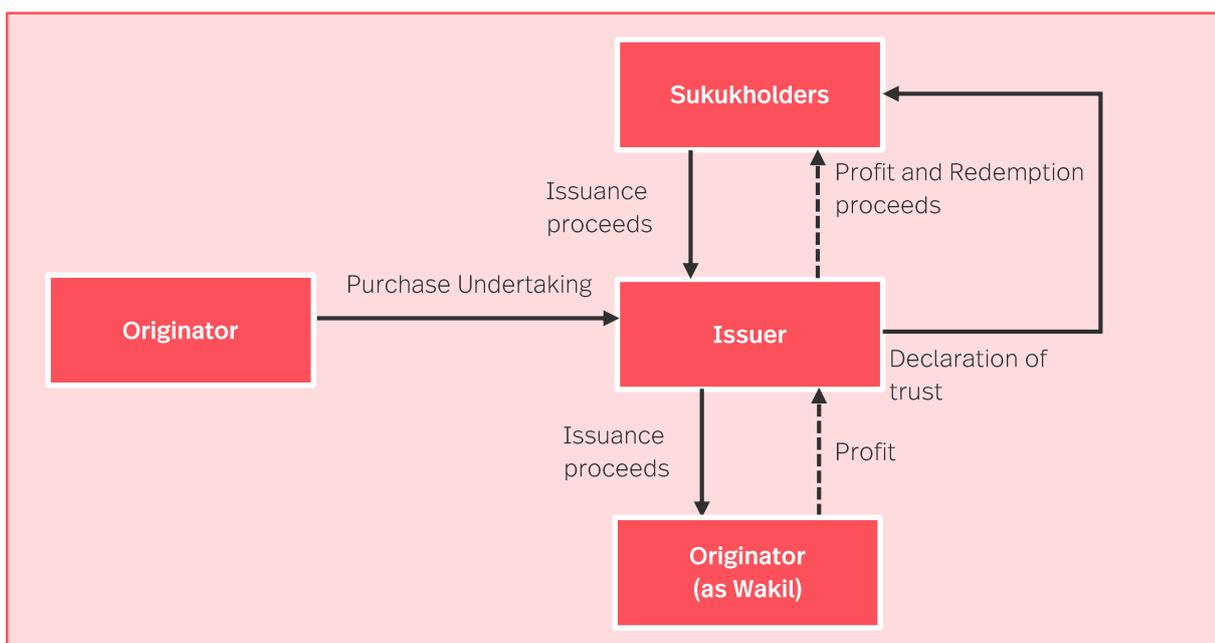
The principal steps for the issuance of a Sukuk al Wakala are as follows:

- The Issuer issues Sukuk certificates to Sukukholders.
- The Issuer (as Muwakkil) appoints the Originator as the Wakil to invest the issuance proceeds on behalf of the Issuer in a pool of assets or investments within specified parameters.
- The assets of the Wakala would typically comprise a mixture of equity and debt instruments.
- The Issuer declares a trust over its interest in the assets of the Wakala in favour of the Sukukholders.

- The Issuer will have agreed with the Wakil that, on each agreed distribution date, any profits up to an agreed rate will be paid to the Issuer (for distribution to the Sukukholders). Any profits in excess of the agreed rate will be retained by the Wakil as an incentive.
- At maturity, the cash value of the investments/assets of the Wakala are returned to the Issuer (for distribution to the Sukukholders as redemption proceeds). In respect of some Sukuk al Wakala instruments, the Originator would grant a Purchase Undertaking in favour of the Issuer.

The principal documents used in a Sukuk al Wakala are as follows:

- A Wakala Agreement between the Originator and the Issuer, pursuant to which the Issuer as Muwakkil appoints the Originator to act as Wakil and pays the issuance proceeds to the Wakil.
- A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer's interest in certain assets of the Wakala.



# Sukuk structuring issues

## 7 Sukuk structuring issues

### 7.1 Asset-backed and Asset-based Sukuk

There continues to be a debate in the Islamic finance industry as to whether Sukuk are asset-based or asset-backed instruments. There is a belief that Sukuk that are asset-backed are closer to Shariah principles than Sukuk that are asset-based.

The rating provider Moody's Investors Service has described<sup>(11)</sup> a clear distinction:

- **'Asset-backed Sukuk'** are Sukuk where their ratings are "primarily dependent on a risk analysis of the assets" and that "the key securitisation elements are in place to ensure that Sukukholders have beneficial title and realisable security over the assets".
- **'Asset-based Sukuk'** are Sukuk where their ratings are "primarily dependent on the riskiness of the borrower/sponsor/originator/lessee" i.e. the source of the profit and principal payments is the originator.

It is therefore possible for Sukuk to be either asset-backed or asset-based depending on how they are structured. Most international Sukuk are structured on an asset-based basis.

The use of assets to generate cash flows can, however, create problems for Issuers. The first issue is to identify unencumbered, Shariah compliant assets that can be used to support the Sukuk issuance. Some international Sukuk al Ijara issuances have a Substitution Undertaking granted by the Issuer in favour of the Originator which allows the Originator to substitute the assets underlying the Sukuk for similar assets in scenarios such as where the original assets are no longer Shariah compliant or are subsequently encumbered.

There may be instances where an Issuer has appropriate assets but they are restricted (perhaps for legal or policy reasons) from transferring title to those assets to third parties or to companies incorporated outside of the local jurisdiction. In these circumstances, a Sukuk al Intifa may be

more appropriate (similar to a Sukuk al Ijara, but the underlying assets of the Sukuk are in the usufruct of an asset, such as a sub-lease).

Depending on the structure of the Sukuk issuance, such as in a Sukuk al Salam or Sukuk al Istisna, the assets delivered at maturity must conform to the agreed specification, which may be difficult to ensure in practice.

In the context of many developing economies, there may be uncertainty as to what rights the Sukukholders have in respect of assets that are provided as security for the Sukuk issuance. For example, can mortgaged properties be liquidated in practice by the relevant security trustee?

### 7.2 AAOIFI Statement on Sukuk, February 2008

In November 2007, the prominent Shariah scholar and president of the AAOIFI Shariah council, Mufti Muhammad Taqi Usmani, was quoted in the media to have stated that 85% of Sukuk did not comply with Shariah.<sup>(12)</sup> The quotation was not quite accurate, as he was referring to 85% of Sukuk al Musharakah (see Section 6.2 (Sukuk al Musharakah)). He was concerned with the undertakings being issued by the Originators in order to fix the principal amount payable under such Sukuk. He believed that this practice was contrary to the core principles of Musharakah and Mudaraba, which were intended to be equity instruments.

The reporting of Mufti Usmani's comment led to an almost standstill of issuances of Sukuk al Musharakah and Sukuk al Mudaraba. The value of Sukuk issued in 2008 fell, although this may be partly attributable to the onset of the global financial crisis as well as the reported comments of Mufti Usmani. Much commentary and discussion followed within the Islamic finance industry, resulting in the publication of a statement by AAOIFI in February 2008 intending to clarify its rules on Sukuk.

<sup>(11)</sup> Shari'ah and Sukuk: A Moody's Primer, Moody's Investors Service, 31 May 2006

<sup>(12)</sup> Reuters, Most sukuk 'not Islamic', body claims, 22 November 2007



As a consequence of AAOIFI's statement in February 2008, the number of Sukuk al Musharakah and Sukuk al Mudaraba issuances has receded and investors in the Middle East have since tended to favour Sukuk al Ijara issuances.

The comments of Mufti Usmani and the subsequent statement by AAOIFI were triggered by several Shariah scholars and financial advisors interpreting Shariah principles differently to the rest of the industry. Although the AAOIFI Shariah Standards are not mandatory, they are increasingly influential. The events illustrated the importance of aligning international Sukuk issuances with industry best practices, even if they are certified as compliant by qualified Shariah scholars.

### 7.3 Trading Sukuk and secondary markets

Research undertaken by Thomson Reuters and Zawya identified that the majority of participants in a survey strongly agreed that the listing and rating of Sukuk were important for investors.<sup>(13)</sup> The listing of Sukuk greatly enhances their tradability.

Whilst Malaysia has the most active secondary market in Sukuk, trading remains limited in the MENA region. Significant steps have been taken recently to drive growth in the secondary market for Sukuk. For example, the International Islamic Liquidity Management Corporation (the 'IILM') has been established to facilitate more efficient global liquidity management solutions for Islamic financial institutions. On 26 August 2013, the IILM issued the first US Dollar-denominated, highly rated, short-term, tradable, Shariah-compliant Sukuk. Furthermore, the Central Bank of Bahrain has since 2001 issued short-term Sukuk of either three or six-month maturities, in addition to medium and long-term notes. The over-subscription for these issuances indicates a substantial demand for a Shariah-compliant interbank market.

The main factors that have hindered the growth of Sukuk secondary market have included the following:

- **Buy and Hold to maturity culture** – many Sukukholders maintain their holdings until maturity due to a lack of alternative instruments. However, liquidity in the MENA region has notably improved in recent years due to the considerable growth and diversity in issuances.

- **Limited quality of assets available for issuances** – Sukuk in the MENA region are still largely Ijara-focused. The ability to make such issuances is therefore limited by the availability of assets such as land and buildings that can be used to support such issuances. More diversity in the asset classes that are used to support Sukuk issuances will increase issuance.
- **Lack of harmonisation** – a key challenge to achieving a global Sukuk market is the difference of opinions among various Shariah scholars, especially differing views on the tradability of Sukuk. Furthermore, differences in the acceptability of certain Sukuk structures are also limiting the marketability of such Sukuk internationally. In order to overcome this challenge, Sukuk issuers that seek to maximise their investor base are now opting for structures that are more broadly accepted by most jurisdictions.

### 7.4 Sukuk and taxation

In the United Kingdom, land transactions attract Stamp Duty Land Tax ('SDLT'). In recognition of the double-levy of SDLT on Ijara transactions and Murabaha transactions involving land, the UK government passed a law in 2003 providing relief from SDLT on property sold to a financial institution that was then transferred onto an individual.<sup>(14)</sup> The relief was extended to institutions in 2006, and in relation to Sukuk issuances in 2009. Removing the tax disadvantages to Islamic financings in this manner can help the Islamic finance and Sukuk markets grow in different countries.

Certain jurisdictions, such as Malaysia, have attempted to incentivise Islamic finance over conventional finance (from a taxation perspective). These incentives would be controversial in a country like the United Kingdom where Muslims are only a small minority of the population and the government has pursued the creation of a 'level playing field' strategy for the taxation of Islamic financial products. However, such incentives may for governments be more attractive in countries with a majority Muslim population and we are seeing evidence of this in the introduction of Islamic finance related laws, regulations and tax incentives in various MENA jurisdictions.

<sup>(13)</sup> Thomson Reuters Zawya Sukuk Perceptions and Forecast Study 2013

<sup>(14)</sup> Finance Act 2003



# What lies ahead?

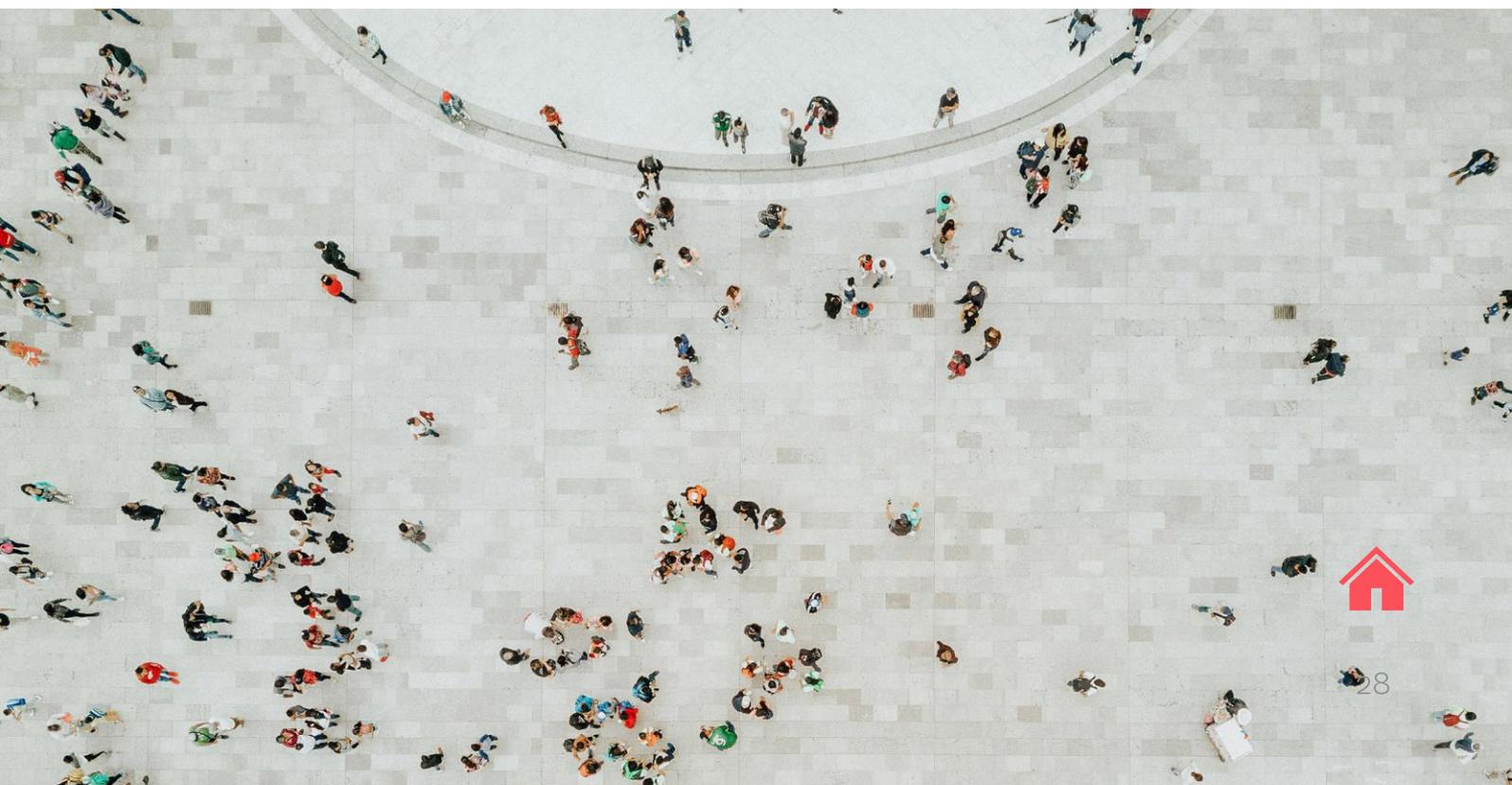
## 8 What lies ahead?

Prior to the economic downturn caused by the coronavirus outbreak, the broad expectation was that the global Sukuk market's strong performance would continue through 2020. Sukuk issuance had increased globally between 2018 and 2019 thanks in part to high levels of liquidity in Indonesia, the return of some GCC sovereign issuers to the global market and good performance in Malaysia. While it is difficult to predict whether such strong market performance will continue once the global and Middle Eastern economies recover, it is fair to say that Sukuk have become a cornerstone of the Islamic finance market.

Sukuk remain very much in demand amongst investors (especially Shariah-sensitive investors) looking for relatively secure income-generating instruments compared to risky equity investments. Islamic financial institutions find them particularly useful for liquidity management purposes. Non-Muslim countries have also taken notice of the potential of the Sukuk as an instrument. In 2019, the United Kingdom announced that it would follow up its 2014 Sukuk with a second issuance. As the Sukuk moves ever closer to the mainstream, the appeal of Sukuk markets an attractive alternative way for issuers to raise finance becomes more apparent. They are therefore an important part of the overall Islamic financial market.

In 2017, Tadau Energy of Malaysia issued the world's first ever green Sukuk amounting to USD 58.4m. Since then, demand for and interest in environmental, social and green ('ESG') finance have grown exponentially, alongside an equivalent interest in Sukuk. In 2019, the Government of Indonesia issued two green Sukuk with a total value of USD 2bn and is using the capital raised by the Sukuk for a variety of projects with an emphasis on sustainable development.

In terms of current and future trends, both issuers and investors are increasingly interested in socially responsible/green Sukuk which has certainly been, and should continue to be, a growth area as ESG financing rapidly infiltrates the capital markets and as regulators and the International Capital Market Authority continue to promote its use. Simmons & Simmons is a global market leader in advising on ESG debt generally, having most recently advised Swisscom on a €500 million green bond and FTSE 100 educational publisher Pearson plc on a £350 million education-linked social bond, among many other landmark ESG transactions.



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