

Islamic Bond Issuance - What Sovereign Debt Managers Need to Know



IMF Policy Discussion Paper

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and Amadou Sy*

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Monetary and Capital Markets Department

Islamic Bond Issuance—What Sovereign Debt Managers Need to Know

Prepared by Andreas Jobst¹, Peter Kunzel, Paul Mills, and Amadou Sy²

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Abstract

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Recent years have witnessed a surge in the issuance of Islamic capital market securities (*sukuk*) by corporates and public sector entities amid growing demand for alternative investments. As the *sukuk* market continues to develop, new challenges and opportunities for sovereign debt managers and capital market development arise. This paper reviews the key developments in the *sukuk* market and informs the debate about challenges and opportunities going forward.

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I. OVERVIEW

In the wake of a rapidly growing Islamic finance sector, recent years have witnessed a surge in the issuance of Islamic capital market securities (*sukuk*) by corporates and public sector entities amid greater demand for alternative investments. As the *sukuk* market continues to develop, new challenges and opportunities for debt managers arise as structured finance instruments are receiving increasing attention owing in large part to enabling capital market regulations and financial innovation aimed at establishing greater inclusiveness of *shari'ah* compliance. This paper reviews the current state of the *sukuk* market, examines pertinent legal and economic implications of *shari'ah* compliance on the configuration of *sukuk* issuance, and informs the debate about the prospects of *sukuk* issuance by sovereign issuers in both Muslim and non-Muslim countries going forward.

A. Definition of Islamic Finance

Islamic finance is driven by the general precept of extending the tenets of the religious beliefs in the *shari'ah* to financial agreements and transactions. *Shari'ah* law bans the sale and purchase of debt contracts, profit taking without real economic activity as well as activities that are not considered *halal* (*shari'ah*-compliant). Only interest-free forms of finance associated with investments that do not involve any association with pork, alcohol, fire arms, adult entertainment or gambling are considered permissible in Islamic finance.

Islamic finance principles ensure that contractual certainty and mutually beneficial balance are maintained between borrowers and lenders. Since Islamic law does not recognize the time due of money as in conventional finance, payment obligations are fixed ex ante and cannot be changed after a contract has been consummated. Contractual relationships between financiers and borrowers are not governed by capital-based investment gains but shared business risk (and returns) from entrepreneurial investment in lawful activities. Any financial transaction under *shari'ah* law implies direct participation in asset performance and assigns to financiers clearly identifiable rights and obligations for which they are entitled to receive commensurate return in the form of state-contingent payments. Profits are earned in line with *shari'ah* prescriptions and cannot be guaranteed ex ante but accrue only if the investment itself yields income.

B. The Current State of Islamic Capital Market Securities (*sukuk*)

Of all the rapidly growing Islamic capital market securities none are gaining in popularity as much as *sukuk*. The Islamic finance industry has grown by about 15 percent on average over the last three years in response to a profusion of investment products, which has been fueled by an increasing demand for investments that comply with Islamic law. Currently, more than US\$800 billion are lodged in Islamic banks, mutual funds, insurance schemes (*takaful*), and Islamic branches of conventional banks (Oakley et al., 2008). The most popular form of Islamic finance is commonly referred to as *sukuk*, which are wholesale, asset-based capital market

securities. Recent years have witnessed a surge in the issuance of *sukuk* by corporates and public sector entities amid growing demand for alternative investments.

***Sukuk* do not pay interest, but generate returns through actual transactions, such as profit-sharing or leasing.** While *sukuk* are structured in a similar way to conventional asset-backed securities (ABS) or covered bonds, they can have significantly different underlying structures and provisions. Most importantly, *sukuk*—like Islamic financial instruments in general—need to comply with *shari'ah*, which prohibits the receipt and payment of interest and stipulates that income must be derived from an underlying real business risk rather than as a guaranteed return from a loan. Thus, *sukuk* do not provide an explicit return guarantee or investment protection. As such, investors own the underlying asset(s) via a special purpose vehicle (SPV), which funds unsecured payments to investors from direct investment in real, religiously-sanctioned economic activity (Wilson, 2005).

***Sukuk* commoditize the proceeds from asset transfers between capital providers and users of different Islamic finance contracts.** Issuers of *sukuk* substitute capital market investors for traditional lenders as source of funding by converting the expected proceeds from bilateral risk sharing between borrowers and lenders in *shari'ah*-compliant finance contracts—such as lending transactions (installment sale) or trust-based investments in existing or future assets—into marketable securities. Hence, *sukuk* usually refinance the assets of one (or a combination) of three basic forms of Islamic finance³—synthetic loans (*murabaha*), sale-leasebacks (*ijara*), or profit-sharing arrangements (*musharaka* or *mudharabah*) (Iqbal and Mirakhor, 2006).

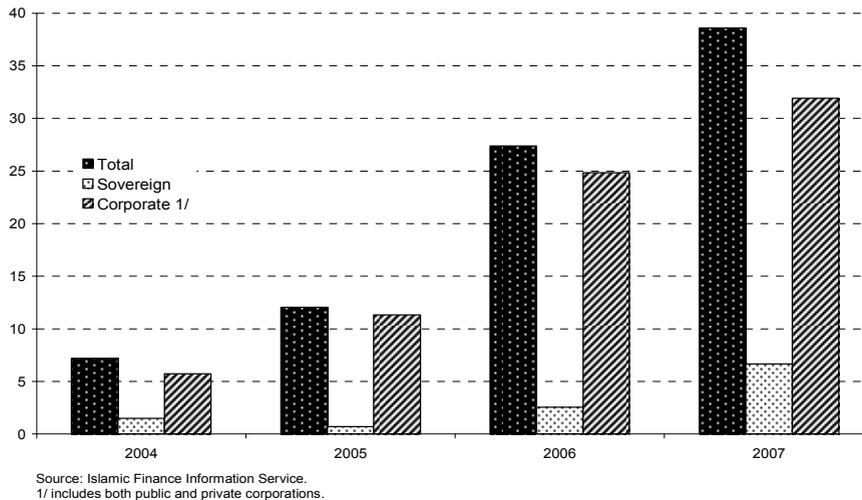
Although the current level of *sukuk* issuance remains a fraction of the global issuance of conventional bonds and ABS, the market for *sukuk* has been growing rapidly despite the global financial crisis triggered by the collapse of the U.S. subprime market. At the end of 2007, outstanding *sukuk* globally exceeded US\$90 billion (Moody's, 2007 and 2008). Gross issuance of Islamic structured securities has quadrupled over the past two years, rising from US\$7.2 billion in 2004 to close to US\$39 billion by the end of 2007 (Table 1 and Figure 1)—despite the financial market fallout of the U.S. subprime mortgage market crisis. The number of *sukuk* transactions rose to 119 (up from 109 in 2006), while the average transaction size increased to about US\$270 million from US\$175 million.

Based on current trends, the total amount of issued *sukuk* is likely to exceed US\$200 billion by 2010. Total issuance in 2007 was equivalent to roughly a quarter of conventional securitization in emerging markets but only two percent of conventional (local and foreign) bond issuance during the period. Although the issuance of *sukuk* has slowed to US\$2.3 billion in the first quarter of 2008 (down by almost half from the first quarter in 2007), the prevailing market

³ Some recent references on Islamic finance include Jobst et al. (2007), Sole (2007), Jobst (2007), Haque and Abbas (1998), and Sundararajan et al. (1998).

uncertainty and the retrenchment of real estate exposures worldwide has created a significant backlog of planned *sukuk* issues, which could see a restoration over the course of this year.

Figure 1. Global Issuance of Islamic Bonds (*sukuk*), 2004–07 (in US\$ billions).



Global issuance has historically been primarily in US dollars and concentrated in parts of Asia and countries of the Gulf Cooperation Council (GCC). About half of the issues in value terms originate in Asia (Malaysia and Brunei) and the other half in the GCC (Saudi Arabia, United Arab Emirates, Bahrain, Qatar, and Kuwait) and Pakistan. Although the US dollar has been the currency of choice since the beginning of the global *sukuk* market in 2002, there has been a marked shift towards non-dollar issuance with the share of US dollar-denominated *sukuk* dropping from 85 percent in 2002 to slightly more than 50 percent in 2007. This reflects both the dollar's declining value as well as growing demand for domestic currency issues. The other major currencies of issuance in 2007 were the Malaysian ringgit, the UAE dirham, and the Saudi-Arabian riyal. Individual Asian issues are denominated mostly in local currency and tend to be much larger (i.e., US\$750 million and above) than in the GCC (below US\$100 million).

While *sukuk* continue to evolve, a select few still dominate the market. *Musharaka* contracts⁴ continued to be the largest *sukuk* issued in 2007, accounting for more than US\$12 billion (or about one third) of issuance, although lease-based transactions are the most common. The issuance of *ijara sukuk* (which fund the gainful long-term transfer of an asset or service for a specified rent and term, frequently conditional on the future purchase of the assets for an agreed lawful consideration) amounted to about US\$10 billion, although the latter accounted for 54 deals compared to 22 *musharaka* structures. In terms of overall market share, the issuance of

⁴ In a *musharaka*, both the financier and borrowing enterprise (and possibly others) jointly contribute funds to an existing or future project, in form of capital or in kind, and ownership is shared according to each party's financial contribution.

trustee-type *mudarabah* structures (to fund a project or asset, which is then exclusively managed by the entrepreneur in accordance with agreed business objectives between financier and debtor) claimed third place, with close to US\$8 billion of issuance. Other Islamic finance contracts, such as *murabaha* (where the financier provides funds at a premium in return for the temporary transfer of a contractual asset for a specified period of time), *istisna* or *salam* only play a minor role. Growing demand for convertible *sukuk* also demonstrates strong demand for structures with an opportunity to benefit from the recent gains in local equity markets.

The primary *sukuk* market is dominated by corporates, which have accounted for over 86 percent of total historic issuance through end-2007. Corporate issuance—both public and private—has expanded rapidly, doubling both between 2004–05 (from US\$5.7 billion to US\$11.3 billion) and 2005-06 (from US\$11.3 billion to US\$24.8 billion) to reach almost US\$32 billion in 2007. The largest proportion of corporate *sukuk* was issued in the financial services sector, accounting for 31 percent of total volume, followed by real estate with 25 percent and utilities with 12 percent. While Asia (specifically Malaysia) accounted for the bulk of all issues in 2004 (close to 90 percent), issuance activity in the GCC has picked up rapidly and now accounts for more than 43 percent of all issues (by number). Despite limited funding needs of many sovereigns in the GCC, sovereign issues have also been growing strongly (more than quadrupling to about US\$4.8 billion in 2007), motivated by the objective of developing local capital markets. Yet despite growing market maturity, supply remains concentrated, with the top five lead managers accounting for almost 40 percent of global *sukuk* issuance in 2007.

Many corporate issues are quasi-sovereign and as such are seen to benefit from implicit sovereign guarantees. This has facilitated the placement of larger issue sizes. Thus, although *sukuk* are linked to an underlying asset, investor appetite is probably driven primarily by the sovereign nature of the risk as the underlying asset risk is seen as incidental to the overall exposure. This factor also helps to explain the ability of corporates to make successful large scale placements in recent years, including two UAE-based issues of US\$3.5 billion in 2006.

Table 1. Global Issuance of Islamic Bonds (*sukuk*) (in US\$ million), 2004–07.

Sukuk Issuance, 2004-2007 (US\$ millions)				
	2004	2005	2006	2007
Total	7,210.5	12,033.8	27,392.5	38,596.6
Sovereign	1,479.4	706.5	2,560.0	6,679.9
<i>of which:</i>				
local currency	356.4	106.5	1,210.0	2,507.4
FX	1,123.0	600.0	1,350.0	4,172.5
Corporate	5,731.2	11,327.3	24,832.5	31,916.7
<i>of which:</i>				
local currency	4,692.8	8,745.4	14,743.8	18,411.6
FX	1,038.4	2,294.9	9,923.0	13,405.1
Asia and Pacific	5,050.5	8,806.0	15,901.8	20,016.1
Sovereign	0.0	0.0	1,628.0	1,961.0
<i>of which:</i>				
local currency	0.0	0.0	758.0	1,961.0
FX	0.0	0.0	870.0	0.0
Corporate	5,050.5	8,806.0	14,273.8	18,055.1
<i>of which:</i>				
local currency	4,666.7	8,745.4	13,943.8	13,401.5
FX	383.8	60.6	330.0	4,653.6
Middle East and Central Asia	2,037.1	2,940.8	11,325.0	18,480.6
Sovereign	1,356.4	706.5	932.0	4,718.9
<i>of which:</i>				
local currency	356.4	106.5	452.0	546.4
FX	1,000.0	600.0	480.0	4,172.5
Corporate	680.7	2,234.3	10,393.0	13,761.7
<i>of which:</i>				
local currency	26.1	0.0	800.0	5,010.2
FX	654.6	2,234.3	9,593.0	8,751.5
Other	123.0	287.0	165.7	100.0
Germany Sovereign (EUR)	123.0	0.0	0.0	0.0
US Corporate (USD)	0.0	0.0	165.7	0.0
UK Corporate (GBP)	0.0	287.0	0.0	0.0
Other	0.0	0.0	0.0	100.0

Source: Islamic Finance Information Service (IFSI).

The thriving market of *shari'ah*-compliant securities reflects the growing need for long-term funding instruments in Islamic finance. While there may be a cyclical element of current demand resulting from high oil revenues in the GCC, this supplements an upswing in the supply of *sukuk* as a source of long-term funding (Boustany et al., 2005). Many Islamic financial institutions seek long-term funding to resolve the characteristic mismatch between their long-term maturities of originated loans and the shorter-term financing (through retail deposits) that backs them. The issuance of *sukuk* with longer tenors would allow banks to finance loan origination with stable sources of long-term funding, so limiting the maturity mismatch that the recent surge in real estate lending would otherwise produce.⁵ More specifically, *sukuk* can help issuers resolve short-term liquidity constraints and satisfy the huge demand for infrastructure funding and real estate lending in the GCC and many emerging economies in Asia in tandem with favorable local regulations supporting the development of Islamic finance.⁶ Moreover, the *takaful* insurance market is growing rapidly but, as yet, has few suitable longer-maturity assets to invest in and so provides a ready investor base for *sukuk* issues.

The growth in the *sukuk* market is generating interest among issuers in other regions. Although *sukuk* have been rarely issued outside Asia and the GCC, they are beginning to gain popularity in countries with conventional financial systems. Following the precedent of the German State of Saxony-Anhalt, which launched the first sovereign *sukuk* in a non-Islamic jurisdiction⁷, the U.K. Treasury established an Islamic Finance Expert Group with the objective to advise the national government on promoting Islamic finance in the U.K. in April 2007. More specifically, this group is currently conducting a feasibility study to examine the practical, legal, and tax implications of the U.K. government issuing sovereign *sukuk* in the wholesale market. Also several corporates in non-Muslim countries have raised external finance via *sukuk* recently. The World Bank also issued its first local currency-denominated *sukuk* totaling 760 million Malaysian ringgit (US\$200 million) in 2005 (Iqbal and Tsubota, 2006).

The development of a liquid secondary *sukuk* market, however, will depend on that of *sukuk* as interbank money market instruments and *shari'ah*-compliant short-term liquidity facilities. Given the current short-term nature of bank liabilities, the creation of money market instruments and asset securitization with shorter maturities should help to encourage a secondary market for *sukuk*. Although Islamic banks are currently one of the largest buyers of *shari'ah*-compliant products (at long maturities), they would benefit most from issues at shorter tenors. Short-term *sukuk* could serve as money market instruments for liquidity management purposes. Malaysia and Bahrain are the only Muslim countries that have developed an active interbank market. Since 2001, the Central Bank of Bahrain (CBB) has issued short-term *sukuk* (with a

⁵ At the moment, several large banks in the GCC package their revenues from mortgage and commercial lending into *sukuk* structures, which represent the majority of outstanding *murabahah sukuk* globally.

⁶ In addition, hedge funds and conventional investment institutions are beginning to hold *sukuk* for purposes of either yield pick-up or portfolio diversification.

⁷ The five-year €100 million (US\$147 million) *ijara sukuk* was based on a sale (to an SPV) and leaseback (to Saxony-Anhalt) of certain previously state-owned real estate assets.

cumulative value of US\$287 million) of either three- or six-month maturities (in addition to medium- and long-term notes). In the GCC, 20 percent over-subscription for these *sukuk* indicates the substantial demand for a *shari'ah*-compliant interbank market. In Malaysia, similar considerations apply to Government Investment Issues (GII) and Bank Negara Malaysia Negotiable Notes (BNNN). Alternatively, banks can resort to asset securitization in order to transform the proceeds from Islamic contracts into customized capital market securities with variable maturities. One such transaction was completed in July 2005 by *Cagamas Berhad*, the National Mortgage Corporation of Malaysia, when it issued the first Islamic mortgage-based securities as *mudharabah* bonds with varying returns and maturities, ranging from three to 20 years (having issued the first Malaysian conventional mortgage-backed security (MBS) in October 2004).

II. CURRENT ISSUES IN THE SUKUK MARKET

Despite the strong potential for the *sukuk* market, a number of hurdles remain:

Economic and financial challenges:

- i. the identification of underlying reference assets and security designs that meet *shari'ah* requirements⁸ and, at the same time, offer attractive returns to both the users and suppliers of capital;
- ii. the absence of structural features that are standard in conventional securities but which are not normally contractually permissible in an Islamic context (e.g., repayment guarantees, credit enhancements, and liquidity support mechanisms), including asset management practices (e.g., the trading of debt securities) and payment structures (e.g., no discounted issues and pay-through mechanisms);
- iii. many commonly-used risk management instruments for currency, interest rate or credit risk under *shari'ah* law are not acceptable to most *shari'ah* scholars, while *shari'ah*-compliant substitutes have been slow to develop;
- iv. limited historical performance data on *shari'ah*-compliant assets and untested stress scenarios limit confidence when estimating likely recovery rates used in pricing and rating of such securities;
- v. the typical “buy-and-hold” investment strategies and limited diversity of *sukuk* investors produce illiquid secondary markets and inhibit efficient price discovery; and;

⁸ It is important to recognize that *shari'ah* compliance is a continuous process that ends at the legal maturity date of the transaction.

- vi. tax disincentives to issue *sukuk* (in lieu of conventional debt), since Islamic finance transactions—due to their asset-backed structure—often incur double taxation (of dividends in equity-based contracts) without tax deductions on interest expenses (i.e., “tax shield”) as is the case with conventional debt funding (Jobst, 2007).

Legal and regulatory challenges:

- i. In *sukuk*, the underlying reference assets and the transaction structure need to satisfy both commercial and *shari’ah* law, which can generate inconsistencies concerning asset control and bankruptcy resolution for investors in non-Islamic countries. For instance, insolvency procedures subject to *shari’ah* law could displace investor protection (such as bankruptcy remoteness and repayment guarantees),⁹ leading to a reclassification of collateral assets as part of the bankruptcy estate of the originator.¹⁰ There can also be issues regarding the enforceability of asset claims, including unclear creditor rights;¹¹
- ii. Islamic jurisprudence is neither definite nor bound by precedent and rulings in one jurisdiction may not be uniformly enforced in others.¹² As a result, the absence of widely recognized standards for *shari’ah* compliance may challenge the legal status and restitution interest of investors;¹³
- iii. Similarly, regulatory standards pertaining to *shari’ah* compliance vary considerably. Nonetheless, various Islamic organizations (notably the International Islamic

⁹ The requirement of a direct linkage between identifiable assets and investors under Islamic law belies the commercial principle of perfected security interest in asset-backed transactions, i.e., establishing a legal separation of assets from the bankruptcy estate of the asset originator.

¹⁰ Note, however, that the principle of contractual certainty is at the heart of Islamic law. In fact, uncertainties or ambiguities can lead to disputes that may render a contract void under *shari’ah*. Thus, issues of bankruptcy resolution, in the case of *sukuk* issuance, do not arise so much from contractual uncertainty as from instances when contractual rights and agreements under commercial law encroach upon the inseparability of investor returns and asset performance as required by *shari’ah*.

¹¹ The development of synthetic *sukuk* structures could establish direct ownership in the underlying asset (according to *shari’ah* requirements while maintaining perfected security interest and bankruptcy remoteness under the precepts of commercial law.

¹² Presently, the *shari’ah* approval process is ad hoc and beset by legal uncertainty from the heterogeneous assessment of *shari’ah* compliance across different jurisdictions and Islamic schools of thought.

¹³ Since Islamic law itself is divided in different juristic schools of thought (*madhahib*), there is no consistent ruling of Islamic courts on the religious compliance of the eligibility of certain assets and transaction structures. That said, some progress has been made to establish general applicability of *shari’ah* standards. Malaysia was the first country to institute a registered and regulated *shari’ah* advisory market. The creation of a *National Shari’ah Council* at the central bank soon prompted similar efforts in Pakistan, and more recently, the UAE.

Financial Market (IIFM), the Islamic Financial Services Board (IFSB), and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), have been working towards regulatory consolidation and harmonization. A Task Force of the IFSB is due to publish recommendations for more standardized *sukuk* structures in 2008 (Jobst et al., 2007). AAOIFI has identified at least 14 possible *sukuk* structures, which underscores the how many types of *sukuk* structure there can be (Ainley et al., 2007).¹⁴ In March 2008, AAOIFI finally introduced new rules on the sale of *sukuk*.¹⁵ Greater standardization would enhance the valuation and efficient pricing of *sukuk* and improve secondary market liquidity within regulatory frameworks that are cast in a way to be flexible enough to adapt to the characteristics of new Islamic capital market securities while preserving universal standards of market supervision and financial surveillance.

¹⁴ AAOIFI recognizes 14 types of *sukuk*. The most prominent structures are *sukuk al-salam*, *sukuk al-ijara*, *sukuk al-musharaka*, *sukuk al-mudharaba*, *sukuk al-intifa'a*, *sukuk al-istisna*, and *sukuk al-musharaka*.

¹⁵ The *Malaysian Financial Market Association* (Persatuan Kewangan Malaysia) taking efforts to create more liquidity and enhance transparency of the domestic *sukuk* market by sponsoring the standardization of contract and documentation standards with a view to elevate Malaysia's aspirations of consolidate its position as a leading center of Islamic finance.

Box 1. Malaysia as a Front-runner of Islamic Capital Markets

Malaysia has become the frontrunner for the development of Islamic capital markets since the 1980s. The country now accounts for about two-thirds of the global Islamic securities outstanding and represents the largest *sukuk* market in terms of outstanding size and number of issues, estimated at US\$47 billion at end-2006. While *sukuk* account for 14 percent of Malaysian public sector bonds outstanding, they represent about half of the total stock of Malaysian corporate bonds (US\$32 billion). Corporate *sukuk* are issued mainly by the infrastructure/utilities and property/real estate sectors (70 percent).

The authorities have played a key role in the development of *sukuk*, including the issuance of local and global benchmark Islamic instruments. After the first *sukuk* issue in 2002, Islamic finance came into its own in October 2004, after *Cagamas Berhad*,¹ the National Mortgage Corporation of Malaysia, issued a RM1.6 billion (US\$432 million) conventional *mortgage-backed security* (MBS) to create a (liquid) yield curve for securitized debt with longer maturities. Although the transaction was conventional, it established a pricing benchmark for subsequent offerings in Malaysia, which were predominantly *sukuk*. In July 2005, Cagamas also raised funding with its first Islamic mortgage-backed issue of *mudharabah* bonds amounting to RM2.05 billion (US\$532 million), which added a new asset class to the local debt market. In 2005, Malaysia's central bank launched the first regular issue of *ijara* leasing securities, and, having successfully placed US\$750 million worth of local currency-denominated Islamic bonds (as exchangeable trust certificates) in 2006, Malaysia's state-investment agency *Khazanah Nasional Berhad* has placed its first U.S. dollar-denominated Islamic security issue of US\$647 million in March 2008.

The growth in size and scope of Malaysia's *sukuk* market was accompanied by changes in the institutional and regulatory framework as well as market infrastructure. In 2000, the government's ten-year *Capital Market Master Plan* provided the broad strategic position and future direction for Malaysia's Islamic capital market. Over the last two years, Malaysia has stepped up efforts to deepen its domestic capital market and broaden its investor base, announcing a number of measures to foster greater asset diversity in the *sukuk* market with the release of revised guidelines for Islamic securities. More broadly, the authorities are aiming to increase the role of Islamic finance in the domestic intermediation process. Malaysia is also intending to ease rules to allow banks to conduct Islamic banking business in foreign currencies.

Recent policy initiatives now aim to leverage existing achievements in the domestic capital markets to strengthen Malaysia's position as an international hub for Islamic finance. The Ninth Malaysia Plan (9MP) for the 2006-2010 period aims to position Malaysia as a center for origination, distribution, trading, funds and wealth management of Islamic finance products. The Malaysia International Islamic Financial Centre (MIFC) was established in 2006 as a one-stop contact point to facilitate the issuance of *sukuk* against the background of growing competition with other centers of Islamic finance. Although the Malaysian market has been the beneficiary of most innovation in *sukuk*, the degree of religious approval of *sukuk* by *shari'ah* boards varies throughout the rest of the Islamic world. For instance, in Saudi Arabia, the trading of *sukuk* is prohibited. Malaysian *sukuk* structures are regarded as relatively liberal by most other Islamic jurists.

Malaysia is also actively engaged in the standard setting and international harmonization of Islamic capital markets. Malaysia's only fully-fledged Islamic banks, *Bank Islam Berhad* and *Bank Muamalat Malaysia Berhad*, agreed to execute a derivative master agreement for the documentation of Islamic derivatives in November 2006. This standardization initiative was sponsored by the *Malaysian Financial Market Association* (Persatuan Kewangan Malaysia) with participation from both Islamic and conventional Malaysian banks in a bid to create more liquidity and enhance transparency (Jobst, 2006).

¹ *Cagamas Berhad* is a government-controlled secondary mortgage facility, which provides short- and medium-term finance and capital market access to mortgage lenders. The indirect government sponsorship of mortgage credit implies direct participation of Cagamas in the performance of the acquired mortgage pool. It refinances itself through the issuance of unsecured conventional debt securities (fixed or floating rate bonds or short-term notes) or, more recently, through Islamic bonds without a pre-specified investment return.

The process of regulatory harmonization and standard setting coincides with institutional competition for leadership in the development of Islamic capital markets. Several Islamic countries—such as Bahrain, UAE, and, in particular, Malaysia (see Box 1)—have taken policy initiatives to encourage *shari'ah*-compliant securities issuance in a bid to promote Islamic finance and anchor the origination of *sukuk* in their home jurisdiction. Whereas Malaysia and Bahrain pioneered the *sukuk* industry, UAE has been particularly active in consolidating secondary market trading on the Dubai International Financial Exchange, which boasts the highest market value of *sukuk* listed across the globe.

III. THE CASE FOR (AND AGAINST) SOVEREIGN SUKUK ISSUANCE—THE ISSUER'S PERSPECTIVE

A. Current Considerations

The sovereign *sukuk* market has witnessed considerable institutional and geographical diversity since the first sovereign issue (Malaysian Global Sukuk) in 2002. Malaysia, Qatar, Bahrain, and Pakistan are the most prolific national issuers. Also quasi-sovereign entities, international financial institutions (IFIs), such as the Islamic Development Bank, the World Bank, and its private sector arm, the International Finance Corporation, publicly-listed corporates, privately-owned companies, and religious councils, such as the Singapore Islamic Religious Council (MUIS), have issued *sukuk*.

***Sukuk* issuance can offer a straightforward capital cost advantage for sovereign borrowers due to a potentially broader investor base and its asset-backed structure.** *Sukuk* tend to be bought at a premium over conventional bonds of similar maturity. This can be the result of current valuation techniques, which do not take into account different investment risks from *shari'ah*-compliant securities investment, or specific investment interests, such as *shari'ah* compliance of the transaction or hedge funds seeking asset returns uncorrelated to conventional fixed income assets. In addition, the asset-backed nature of *sukuk* implies that, for some sovereign or public sector issuers, a higher credit rating can be achieved for a *sukuk* structure than from standard unsecured bond finance, potentially lowering the cost of capital.¹⁶

At the same time, however, administrative considerations can lead to additional costs while limiting fiscal flexibility. The initial structuring and issuance costs of *sukuk* are likely to be higher than a standard security. Since Islamic finance principles require direct asset ownership

¹⁶ The *ijara sukuk* by the German State of Saxony-Anhalt underscores the apparent price benefits from *shari'ah*-compliant issuance. While Saxony-Anhalt raised a total of US\$1.2 billion through conventional covered bonds at an average spread of 17 basis points over EURIBOR in 2004, its premier *sukuk* issuance priced at a spread of merely one basis point, which resulted in non-cumulative net interest savings of US\$192,000 per year for the State's Treasury.

by creditors, specific cash flows from real assets need to be identified to support the structure. Such deals are more likely to be related to particular projects and programs, thereby increasing the lead time needed to prepare and issue the security. In addition, for sovereign issuers revenues may need to be ring-fenced, effectively limiting fiscal flexibility. Non-Islamic sovereigns, in particular, would need to consider the necessary organizational changes needed to administer the *shari'ah*-compliant structure.

Also limited secondary market trading could reflect negatively on issuance cost. The likely bespoke nature and limited tradability of *sukuk* is likely to constrain secondary market liquidity, resulting in a higher yield at issue.

Box 2. Islamic Central Bank and Government Securities in Sudan

Both the Central Bank of Sudan (CBS) and the Government of Sudan (GoS) have raised funds through the domestic issuance of *shari'ah*-compliant securities via the Sudan Financial Services Company (SFSC), which was created in 1998. The three types of securities that have been issued so far are: (i) *Central Bank Musharaka Certificates* (CMCs), (ii) *Government Musharaka Certificates* (GMCs), and (iii) *Government Investment Certificates* (GICs) (Ali, 2005).

CMCs were issued primarily for the implementation of monetary policy but proved to be too costly. CMCs were akin to trust certificates in a closed-end fund managed by the SFSC, which assigned investors a stake in commercial banks in which the central bank was a shareholder. Despite strong investor demand, the security design of CMCs was severely flawed. Issuance of CMCs was soon discontinued due to their high cost, limited volume, and lack of tradability.

From 2001 to early 2007 the government used short-term GMCs to finance the government budget deficit. Investment in GMCs was restricted to Sudanese nationals. Investors received ownership interest in a portfolio of specific state-owned enterprises, whose profits were distributed as pro-rated bullet payments at maturity. GMCs were tradable in the secondary market immediately after issuance. Amid an improved fiscal position, the government discontinued GMCs in early 2007 following reduced short-term financing needs. In 2003, the government also introduced GICs to fund its trade, procurement, and development projects. Unlike GMCs, investors (which can include foreigners) are shareholders of an investment company managed by SFSC and do not hold a title to government assets. GICs can also be traded in the secondary market.

***Shari'ah* compliance may also raise legal and accounting challenges, particularly for first-time issuers.** Commercial enforceability of investor claims in *sukuk* requires that the legal issuer needs to be a separate entity that is bankruptcy remote from the sovereign. Such legal separation from the sponsoring government ministry may require primary legislation, as well as difficult policy decisions over government accounting rules and accountability to ministers and parliament. Moreover, as noted above, issuing in line with existing legal and regulatory frameworks may prove challenging, particularly for new *sukuk* issuers. Also the question

surrounding the enforceability of investor interest under Islamic jurisprudence still entails considerable legal uncertainty, given the potential of Islamic jurisprudence to invalidate perfected security interest (under commercial law) on the grounds of full recourse to the originator.

Some sovereign *sukuk* serve as financing instruments for liquidity management and monetary policy. Most countries with an Islamic finance presence maintain dual systems where conventional instruments coexist with *shari'ah*-compliant ones. In these countries, Islamic banks rely on short-term *sukuk*, mostly commodity *murabaha*, which are structured to assist with liquidity management, similar to conventional interbank lending. For instance, in Malaysia, Government Investment Issues (GII) and Malaysia Islamic Treasury Bills (MITB) were issued to allow Islamic banks to hold liquid paper that meet their statutory liquidity requirements, because they are unable to purchase or trade in interest-bearing Malaysian Government Securities (MGS) and Malaysian Treasury Bills (MTB). In addition, the availability of short-term *sharia'ah* compliant investment instruments improved the profitability of holding liquid funds. Similarly, in Sudan (see Box 2), a variety of *sukuk* have been used for monetary policy operations. However, the government has had to discontinue a number of them given their high issuance cost, limited volume, and lack of tradability. Innovation is continuing to design *sukuk* more suitable to monetary operations.

From the perspective of a sovereign issuer, the assessment of costs and benefits may be decided by broader policy considerations. A public sector issuer may decide whether to issue a *sukuk* purely on the grounds of weighing the expected cost of issuance against alternative financing means. However, broader considerations may be relevant. First, sovereign issuers may wish to issue benchmark *sukuk* for market development purposes, though this objective might conflict with existing conventional debt issuance and complicate market valuation. Although the nature of *sukuk* makes straightforward comparability across issues difficult, sovereign issues can still provide helpful benchmarks and hedging tools for lead managers and market-makers. Second, as noted above, domestic *sukuk* issuance can facilitate the diversification of domestic capital markets and attract Islamic investors in countries with conventional financial systems.

Also political externalities need to be taken into account. *Sukuk* issuance entails obtaining a legal opinion from a panel of *shari'ah* jurists or scholars (a “*shari'ah* board”)—a feature that may breach the religious neutrality of government and require more nuanced regulatory oversight in some countries. While it would not be appropriate for financial market supervisors in non-Muslim countries to judge between different interpretations of *shari'ah*, consistent application of regulatory standards would warrant the assessment of the role of non-regulated *shari'ah* boards and how they affect the financial and operational viability of an authorized financial institution or SPV. In addition, institutional competition might become fiercer in the future with several countries competing to become centers of Islamic finance.

At the same time, Islamic bond issuance from new sovereign issuers could provide much needed diversification benefits to Islamic investors. Past *sukuk* have been limited in structural diversity (e.g., *murabaha sukuk* in Malaysia as opposed to *musharaka sukuk* in GCC), and the expansion of *sukuk* issuance beyond these regional boundaries could improve the asset risk exposure of investors. Moreover, *sukuk* denominated in currencies other than U.S. dollars (in GCC) or local EM currencies (in Malaysia, Brunei, and Indonesia) would augment the existing currency spectrum available to investors and provide the opportunity for implicit foreign exchange hedges through opposite positions in *sukuk* issued in different currencies.

Recent issuance activity and the experience of seasoned issuers might provide valuable insights for *sukuk* issuance by sovereigns outside the Islamic world. The lessons from recent non-Islamic issues—both sovereign and corporate—as well as that the experience of countries with a dual financial system (conventional and Islamic)—such as Malaysia and Sudan—can help new issuers innovate and adapt their infrastructure and regulation to ensure *shari'ah* compliance (see Box 1).

B. Present Challenges and Policy Implications

There are several issues related to sovereign debt managers' decision to consider in the context of *sukuk* issuance:

- i. To what extent is the surge in *sukuk* issuance related to cyclical developments, stemming, for instance, from high oil revenues in GCC countries?
- ii. How sustainable is market growth and what factors may hold back further market development? In particular, what are the main economic, legal, and regulatory challenges that need to be overcome?
- iii. What aspects of *sukuk* market reform will be most difficult to implement? What lessons can be learned from seasoned and new issuers and regulatory and standard-setting bodies?
- iv. How to integrate *sukuk* issuance into the overall debt strategy, and what are the implications, if any, for debt sustainability and debt management?
- v. What are the operational implications of using *sukuk* for monetary management, and how does it affect the relation between the *sukuk* market and liquidity in the money and conventional debt markets?

In addition, recent regulatory changes concerning the structure of *sukuk* warrant careful consideration. In February 2008, the *shari'ah* committee of AAOIFI issued new recommendations regarding *sukuk* structures and their issuance. These proposed rules attracted significant attention prior to their release, following a statement by the chairman of the *shari'ah*

committee in November last year indicating that 85 percent of *sukuk* issues in the GCC do not concur with *shari'ah* principles. The new rules, if adopted, are expected to increase the issuance cost of *sukuk*.¹⁷ The debate about the general applicability of these recommendations with regard to the approval process of *sukuk* has raised general concerns about the *shari'ah* governance of Islamic capital markets.

The key recommendations of AAOIFI relate to the role of asset ownership, investment guarantees, and the *shari'ah* advisory and approval process in *sukuk* origination and trading.¹⁸ Under the new guidelines for *sukuk*:

- i. Investors will be required to become legal owners (with all of the rights and obligations that accompany actual ownership) of the assets underlying the *sukuk* transaction, rather than nominal holders of the securities, which had previously effectively transformed asset-based *sukuk* into asset-backed securities (ABS);
- ii. Contrary to current practice, issuers or managers of *sukuk* cannot guarantee principal investment to *sukuk* certificate holders by agreeing to purchase the underlying assets for a fixed nominal value of those assets at maturity or in the event of default regardless of potential profits or losses.¹⁹ It is permissible, however, that issuers agree to acquire the assets for their net value or fair market value in accordance with existing *shari'ah* rules governing Islamic lending contracts;
- iii. Issuers and managers of *sukuk* must not offer loans to investors when actual earnings from the underlying assets fall short of expected earnings. However, it is permissible to establish a reserve account for the purpose of covering such a shortfall;
- iv. *Sukuk* cannot represent either revenue streams or debt with the exception of either (i) a trading or financial entity that sells all its assets or (ii) a portfolio that includes a standing financial obligation, which is deemed incidental to a physical asset underlying the transaction;

¹⁷ However, the emerging controversy about the *shari'ah* compliance of outstanding *sukuk* quickly dissipated once AAOIFI proposed to “grandfather” all outstanding issues. Note, however, that AAOIFI standards would need to be first approved by national regulators to take effect.

¹⁸ Most of these *sukuk* have been sold with a borrower/creditor guarantee to repay the full notional amount at maturity, or, in the event of default or early redemption, mirror the structure and payout of a conventional bond. Such a promise (and not the option) to repay capital violates the principle of risk- and profit-sharing under Islamic law.

¹⁹ Recall that under *shari'ah* rules, issuers and investors are required to equitably share transactions-related profits or losses.

- v. In lease-based *ijara sukuk*, it is permissible for the lessee to agree to repurchase the contractual assets for their nominal value as long as the lessee is not also an investor or agent;
- vi. In addition to the issuance of a *fatwa* (religious approval) on the structure of *sukuk*, a *shari'ah* supervisory board is also required to review all contracts and documentation related to the actual transaction, which involves verifying that the manner of implementation accords with *shari'ah* principles.

IV. CONCLUSION

The *sukuk* market has expanded dramatically over the recent past and continues to generate strong interest by new issuers in Muslim and non-Muslim countries alike. Given the existing intensity of investor interest in *shari'ah*-compliant assets, the potential of *sukuk* is likely to strengthen, especially given increasing opportunities from financial innovation. While the continuous growth of overall *sukuk* issuance is expected to be somewhat depressed in response to the fallout of the U.S. sub-prime markets crisis and the legal uncertainty surrounding the recent AAOIFI ruling on *sukuk*, especially sovereign *sukuk* are likely to gain popularity as more governments in both Muslim and non-Muslim countries explore options to diversify their traditional debt portfolios. The latest examples of this trend are efforts in the U.K., Japan and Thailand to establish a *sukuk* issuance program and Indonesia's bill on Islamic debt financing (April 2008), which will enable the government to fund large parts of its budget deficit by issuing *sukuk*.

That said, some critical constraints arising from continued legal uncertainty and regulatory divergences that still need to be overcome. As issuers weigh the costs and benefits of *sukuk* issuance in a broad policy context, continued efforts will be required to overcome a series of economic, legal and regulatory issues. In this regard, the lessons learned of both seasoned and newer issuers provide valuable guidance going forward. The positive market response to current standard setting aimed at curbing concerns about contract enforceability caused by diverse interpretations of *shari'ah* principles is encouraging but future growth of global *sukuk* issuance will depend on how easily these new structures are accepted and understood.

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