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**SUKUK FINANCING FOR DEVELOPMENT
AND INFRASTRUCTURAL PROJECTS:
PROPOSED SEVERAL SUKUK STRUCTURES**

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CURRENT ISSUES

- ❖ The world is facing **excessive levels of debt**, not much room for more debt funding
- ❖ **Rising interest rate** environment poses serious cause for concern given the build-up in debt
- ❖ **Equity financing** is not an option for governments. Very expensive
- ❖ **There is a need to explore solutions without leverage and to move away from over-reliance on debt**

SUKUK ALTERNATIVES

Ismath Bacha & Mirakhor (2018) – in order to fund the development infrastructures, **most of Muslim countries suffer from external debt.**

Even though those countries **need substantial development infrastructure**, however, they cannot fund them domestically due to **inadequate resources.**

Therefore, these governments **often borrow from foreign countries** or **international financial institutions.** The borrowing country faces numerous challenges such as

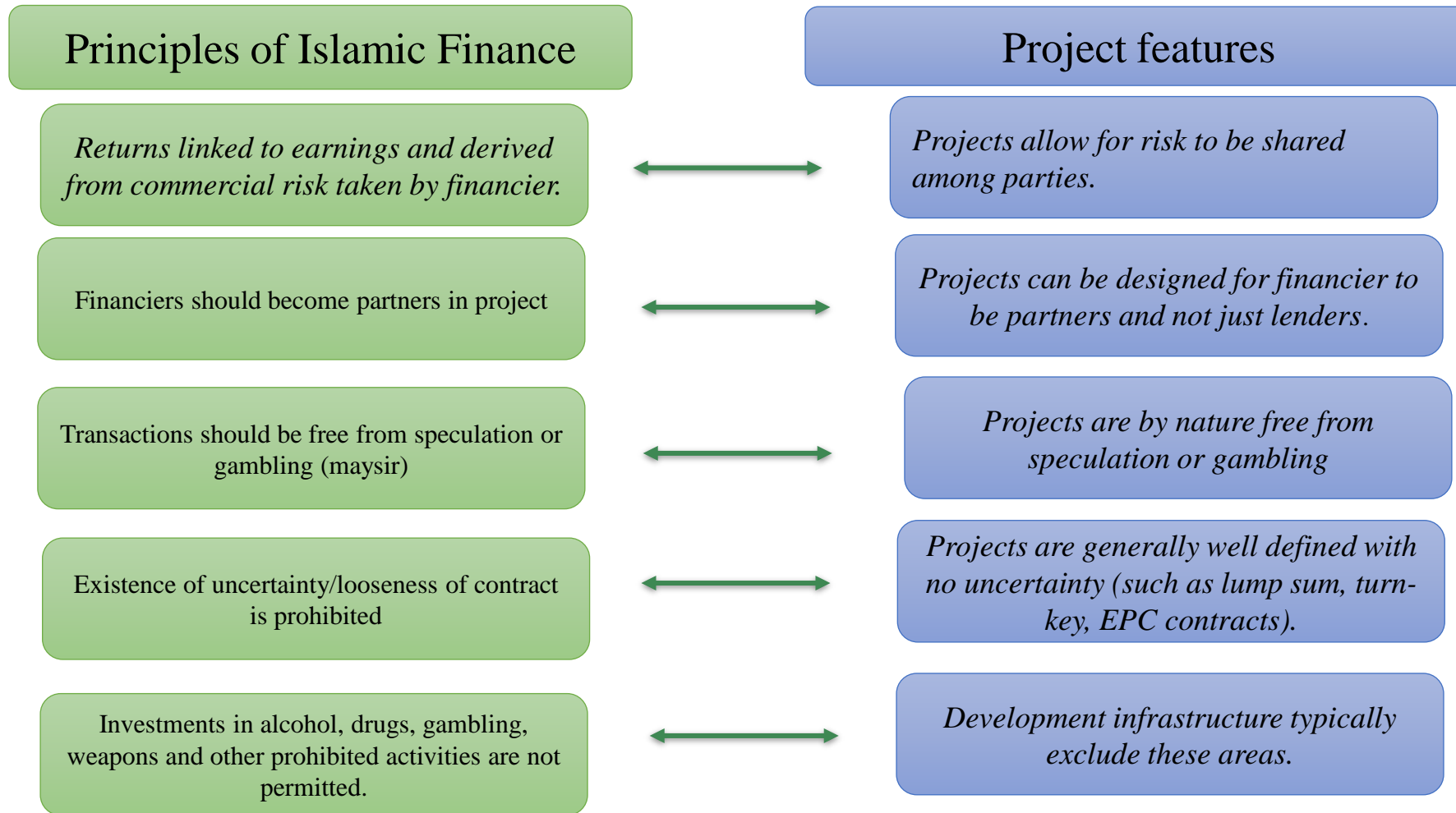
i) **the fluctuation of home currency** while the borrowing denominated in foreign currency;

ii) **leverage and economic fluctuation of a country** increased due to such borrowing;

iii) also **those countries face commodity price vulnerability** due to heavily reliance on commodity exports.

They argue that the recent **innovation of Islamic Bond** (sukuk) can be **reduce such external borrowing, leverage and vulnerability.**

SUKUK IN PROJECT FINANCING



Source: Mobilizing Islamic Finance for Infrastructure, PPP – Report 2017. World Bank, PPIAF, IDB

Obiyathulla Ismath Bacha, *Development without Debt: Thoughts from Islamic Finance*, International Conference on Infrastructure, Growth and Development, 6th – 7th Sept. 2018, EBRD & UCL, London.

SUKUK STRUCTURES

- Theoretically, a sukuk can be based on any Shariah based contract. Most sukuk are based on the following contracts:
 - ❑ *Ijarah* (lease based transaction)
 - ❑ *Murabahah* (profit mark-up sale)
 - ❑ *Wakalah* (agency contract)
 - ❑ *Istisna* (progress based arrangement – manufacturing)
 - ❑ *Bay Salam* (forward sale)
 - ❑ *Musharakah* (partnership, with both partners providing labour and capital)
 - ❑ *Mudarabah* (profit & loss sharing arrangement)

SUKUK STRUCTURES

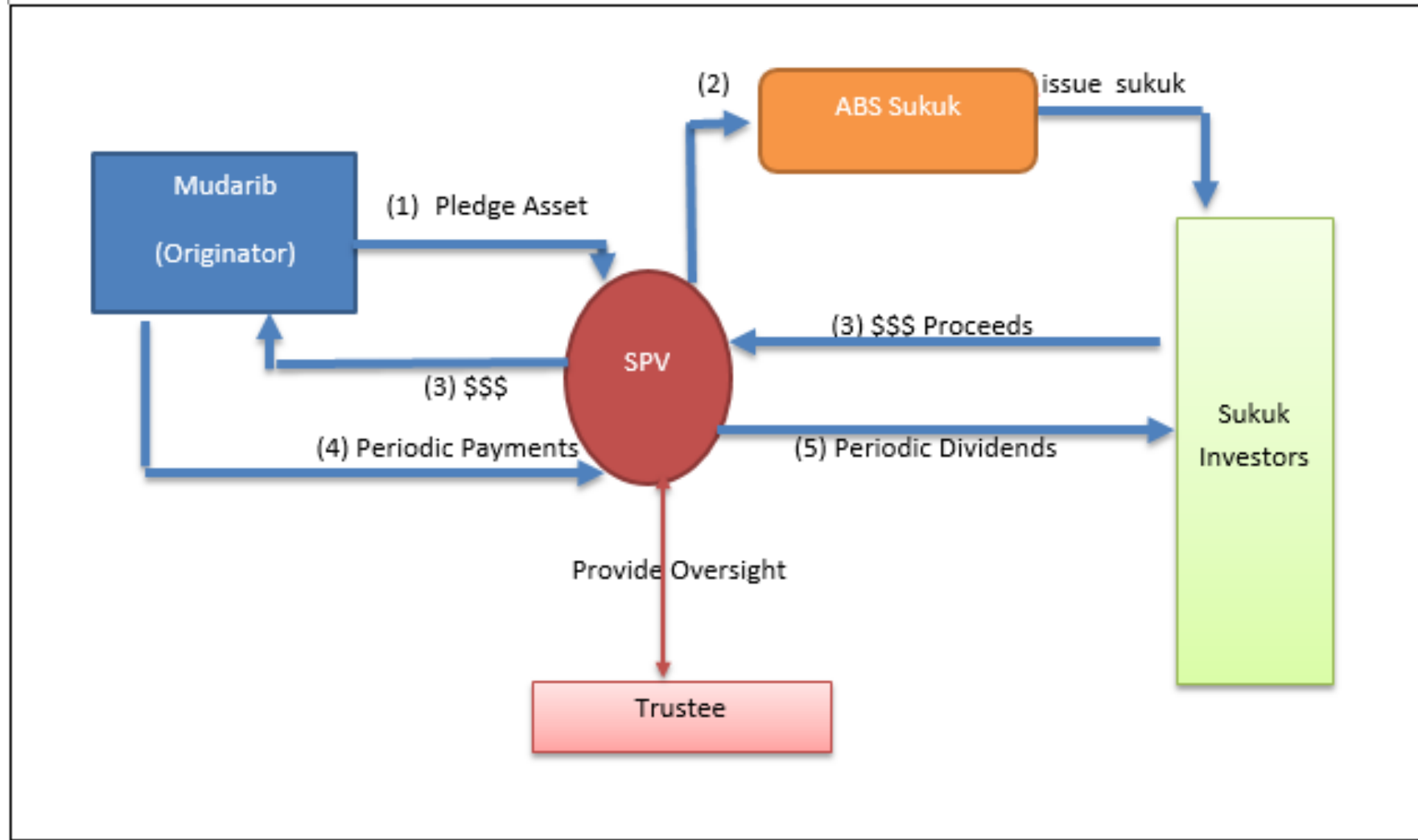
Being a structured product, a *sukuk*'s design would depend on several factors. Key among these would be:

- I. compliance with underlying *Shariah* contract(s),**
- II. the needed risk profile,**
- III. the desired cash flow profile (for both the originator and investor) and**
- IV. potential market acceptance of the *sukuk*.**

AN ASSET-BASED SUKUK STRUCTURE (PROBLEMATIC STRUCTURE)

- ❑ In the generic asset-backed structure above, the *mudarib*, who is the originator (borrower), **first establishes a *special purpose vehicle*** (SPV) which a legal entity.
- ❑ The originator then injects **or transfers the asset** which will become the underlying asset of the *sukuk*, to the newly established SPV.
- ❑ Since the “collateral” for the *sukuk* is the SPV’s asset, the *sukuk* is an Asset-Backed Security (ABS). The servicing of the needed *sukuk* payments to the investors is made by the SPV from payments it receives from the *mudarib* (originator) for use of the asset (usufruct).

AN ASSET-BASED SUKUK STRUCTURE



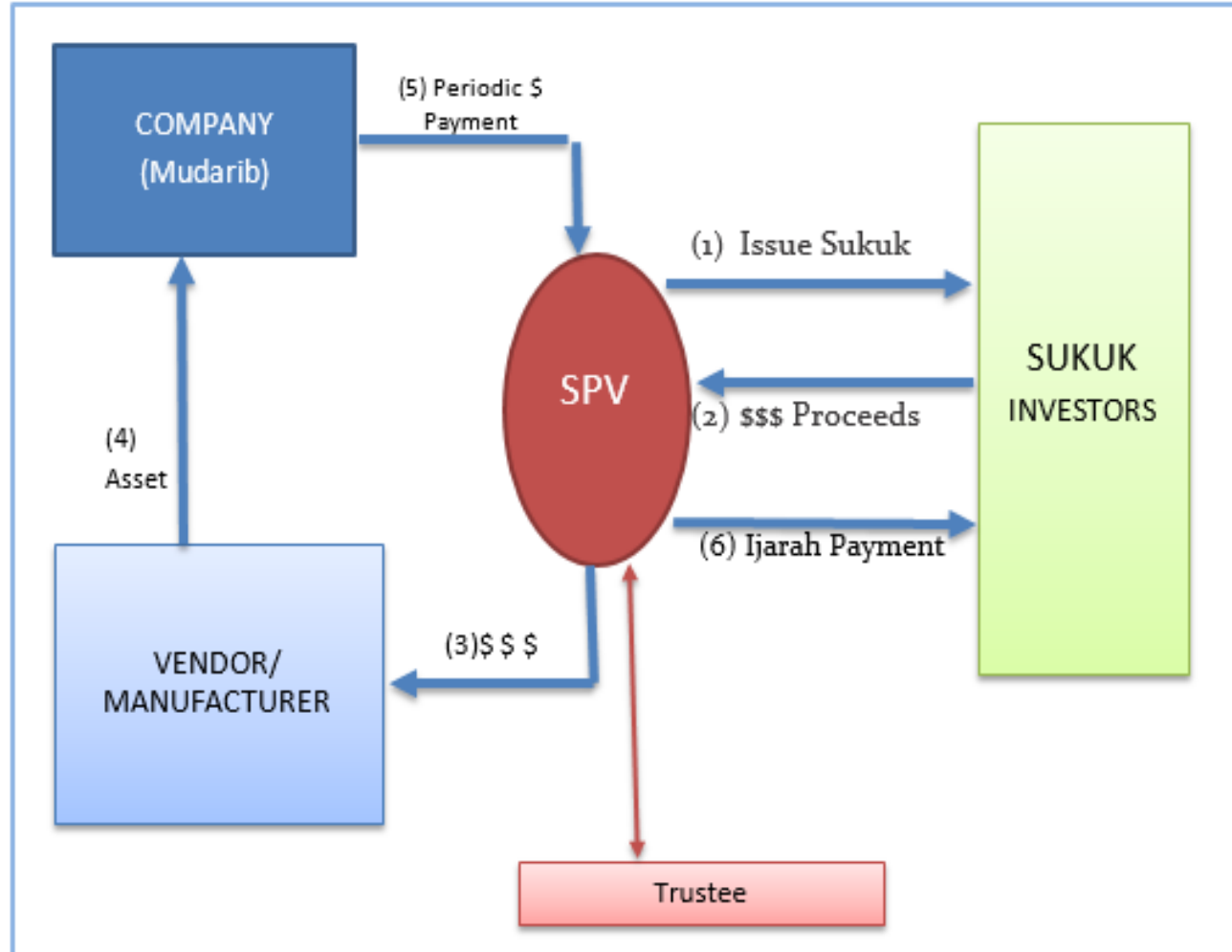
SUKUK AL IJARA

In the ***ijarah structure***, the *mudarib* begins with the establishment of the SPV. The SPV issues the *sukuk* to investors and uses the proceeds to **buy the asset from the vendor/manufacturer.**

The SPV which is now the owner of the asset, “leases” the asset to the *mudarib*'s company in return for periodic lease payments. The lease payments received from the company are passed through to investors as their returns on the *sukuk*.

The *ijarah* structure typically has an embedded sale contract enabling the *mudarib* to purchase the asset from the SPV at the end of the lease period. ***From a Shariah viewpoint, the sale price should not be predetermined/fixed up front, but determined at the end of the lease period and dependent on market conditions then.***

TYPICAL IJARAH BASED SUKUK STRUCTURE



MURABAHAH OR BBA SUKUK

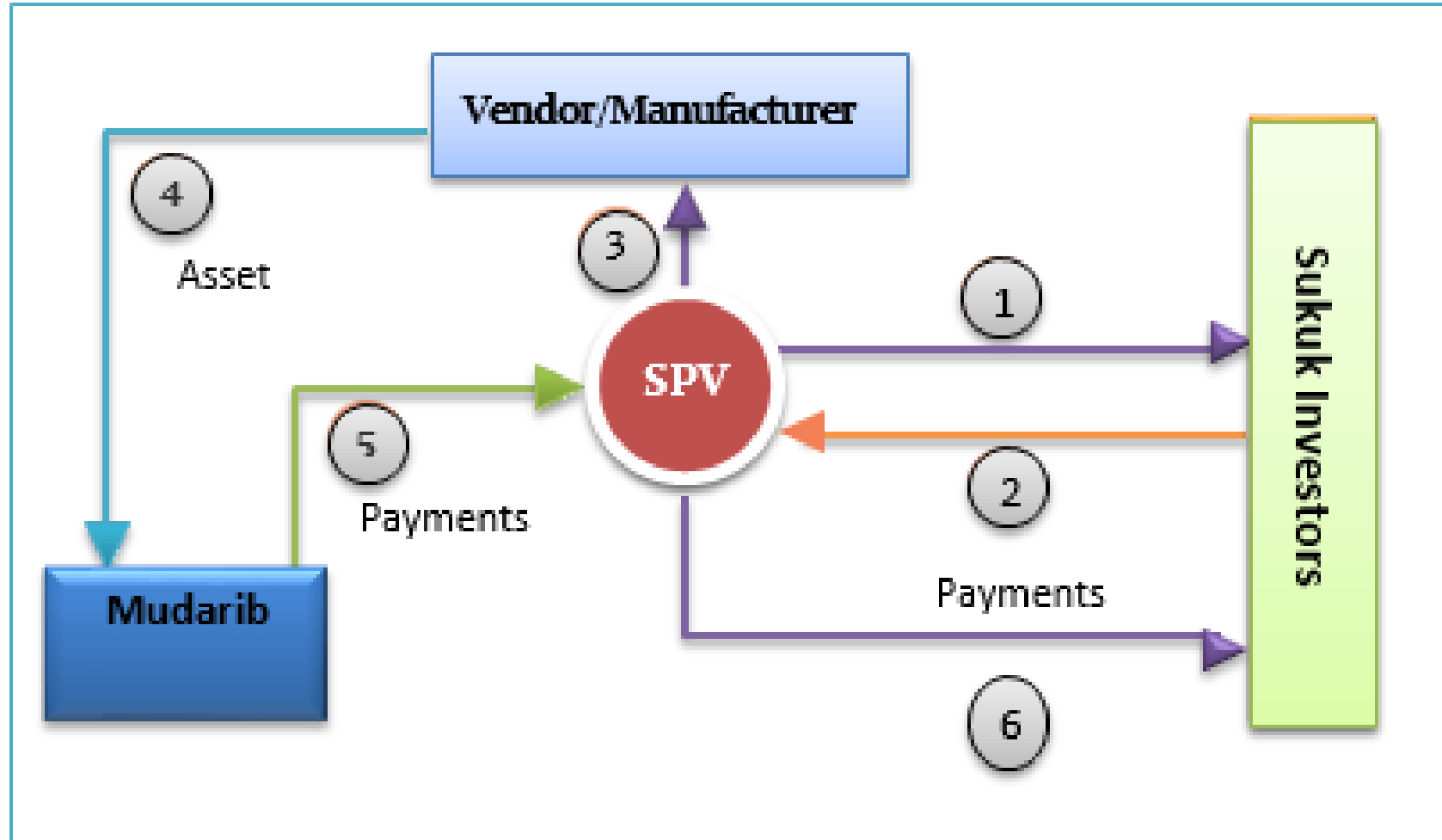
- ❑ In a BBA based *sukuk*, a *mudarib*, who is the originator, seeks funding for the **purchase of a needed asset** through the issuance of a *sukuk*. Again the issuer will be the SPV which will be the legal owner of the asset.
- ❑ The SPV uses the proceeds from *sukuk* issuance to **pay the vendor/manufacturer** for the asset needed by the *mudarib*. On receiving payment from the SPV, the vendor/manufacturer delivers the asset to the *mudarib*.
- ❑ The *mudarib* will be obliged to pay the SPV the **purchase price plus a profit mark up**. The sum will be paid as an annuity of installments.

MURABAHAH OR BBA SUKUK

These periodic payments are passed thru the SPV to the *sukuk* investors as *sukuk* cash flows.

In Malaysia, many *fuqaha* have been uneasy with the BBA structure. ***The fixity of payments and the predetermined cash flows are a concern from a Shariah viewpoint.*** Following much criticism from Middle Eastern scholars and investors, the BBA structure is not as popular as it once was.

TYPICAL BBA BASED SUKUK STRUCTURE



GOVERNMENT OF MALAYSIA SUKUK (2001)

- ❑ This was the first sovereign *sukuk* by the Malaysian government. Known as the Malaysian Global *Sukuk* was issued for a sum of US\$600 million with maturity in 2007.
- ❑ Based on the *Ijarah* contract, the *sukuk* provided undivided beneficial ownership of four land parcels that had been placed in a trust. The land parcels were sold by the government to an SPV, which then leases it back to the government in return for semi-annual lease payments.

GOVERNMENT OF MALAYSIA SUKUK (2001)

- The lease payments were determined based on LIBOR as the reference rate. The payments were 6 month LIBOR + 0.95%. This implies that if the 6 month LIBOR is 5% at the time a lease payment is due, the *sukuk* will pay;

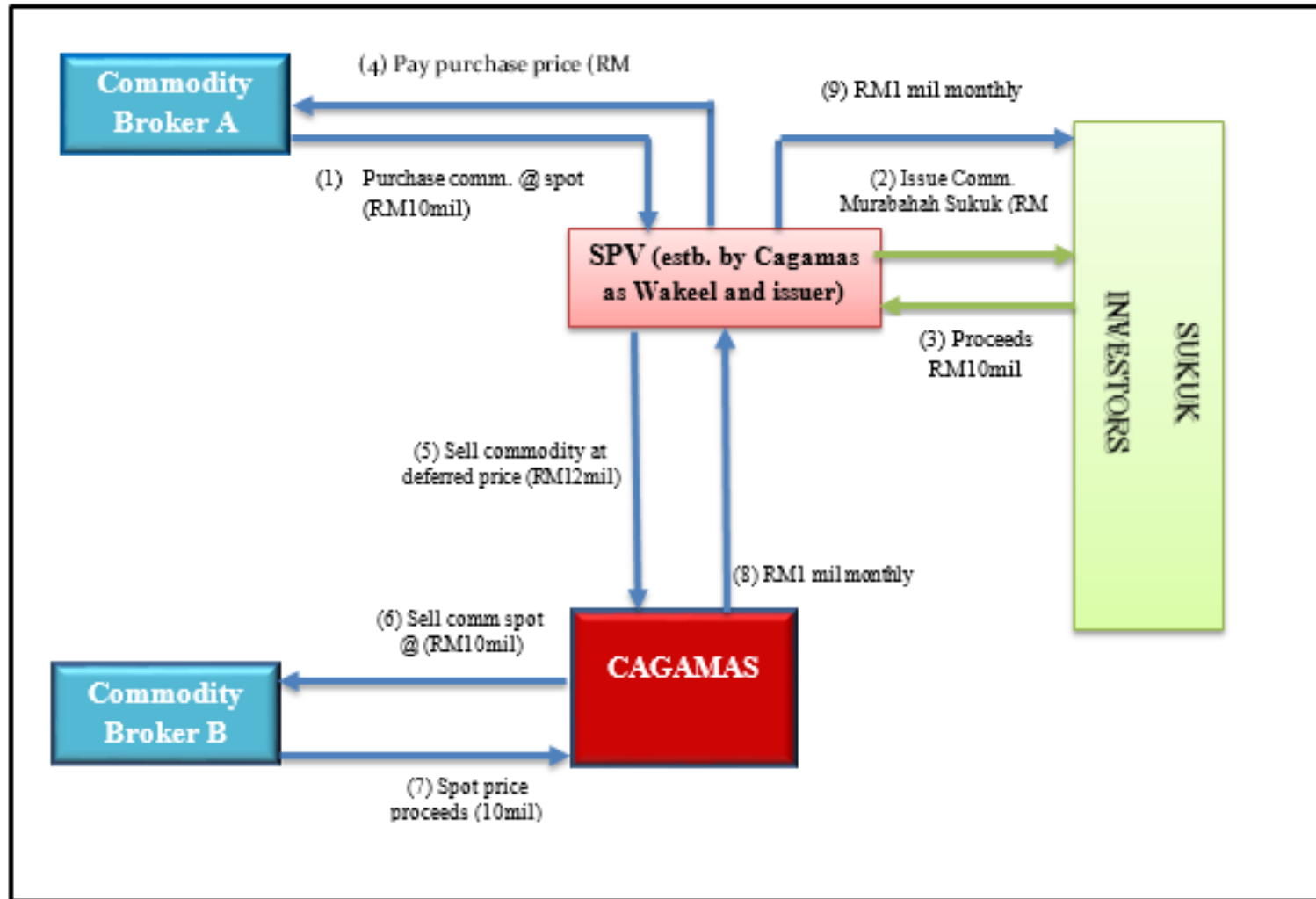
$$[(5\% + 0.95\%)/2] \$600 \text{ million} = \$17.85 \text{ million}$$

- Listed for trading on the Luxembourg Stock Exchange, this *sukuk* was the first to comply with all the needed regulations to be tradable internationally. In essence, it complied with the needed regulation for a conventional bond to be listed and traded internationally. **This *sukuk* was also the first “asset-based” rather than asset backed *sukuk*.**

A WAKALAH BI AL ISTHIMAR SUKUK

- In the typical sukuk wakalah structure, the obligor or issuer is a *wakil* or **agent of the sukuk holders**. The agent is tasked with using the sukuk proceeds to invest in a specific project or business, manage it and provide a return to sukuk holders based on the returns of the investment. The wakalah or agency agreement specifies the arrangement.
- The obligor would be entitled to either a fixed or variable fee from the profits of the investment. The obligor is entitled to enter into other contracts like *mudarabah* or *ijarah* etc, with other parties in the course of undertaking and managing the investment.
- The wakalah contract has of late become very popular given its flexibility

A COMMODITY MURABAHA SUKUK - CAGAMAS



UNIQUE SUKUK STRUCTURES

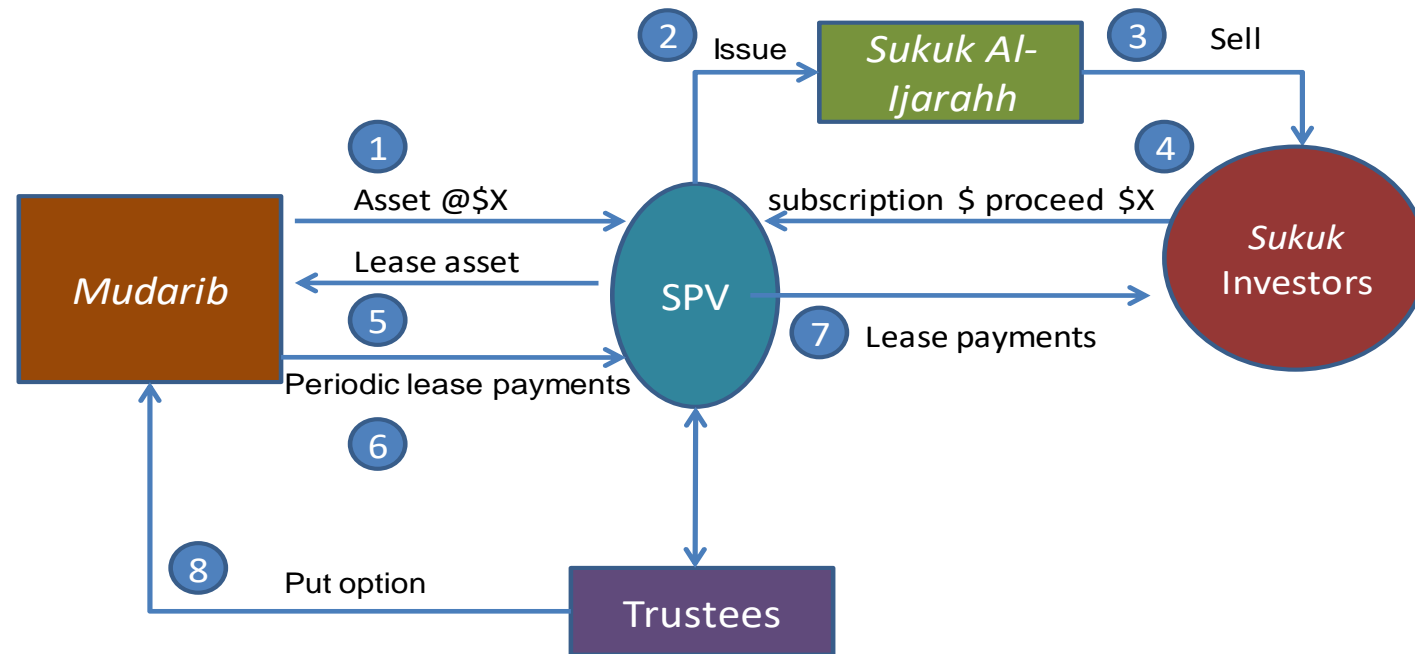
- There has been a trend towards more complex structures due to altered risk profiles, different cash flows profiles, or cash flow profiles dependent on outcomes (contingent payoffs) .
- The need for such cash flows are often the result of wanting to avoid fixed returns/cash flows. Thus, we have seen of late, *sukuk* that would have payoffs attached to commodity prices, *sukuk* that are exchangeable at maturity to equity of the *mudarib* (KFC, Malaysia) or groups of stock of other companies, held by the *mudarib* (Khazanah, Malaysia).

UNIQUE SUKUK STRUCTURES

- There has also been *sukuk* with embedded options. The options could be Call options on the underlying asset made available to the *mudarib* or Put options on the asset made available to the SPV (trustees).

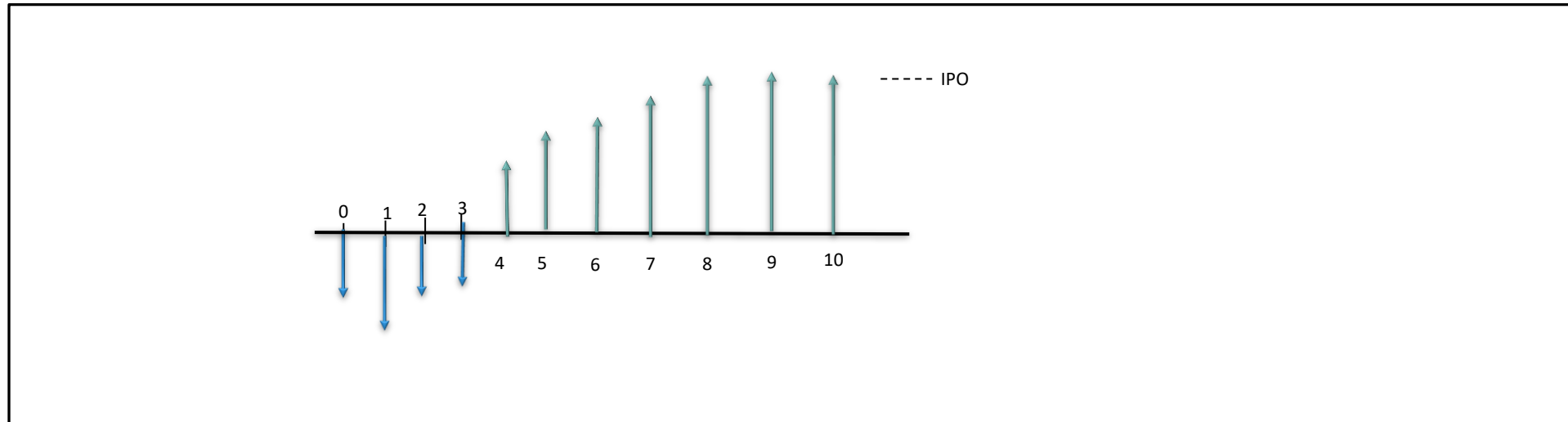
SUKUK STRUCTURE WITH AN EMBEDDED PUT OPTION

A Sukuk Ijarah to Finance a Sale – Lease Arrangement – with an Embedded Put Option



Proposed Sukuk Structures

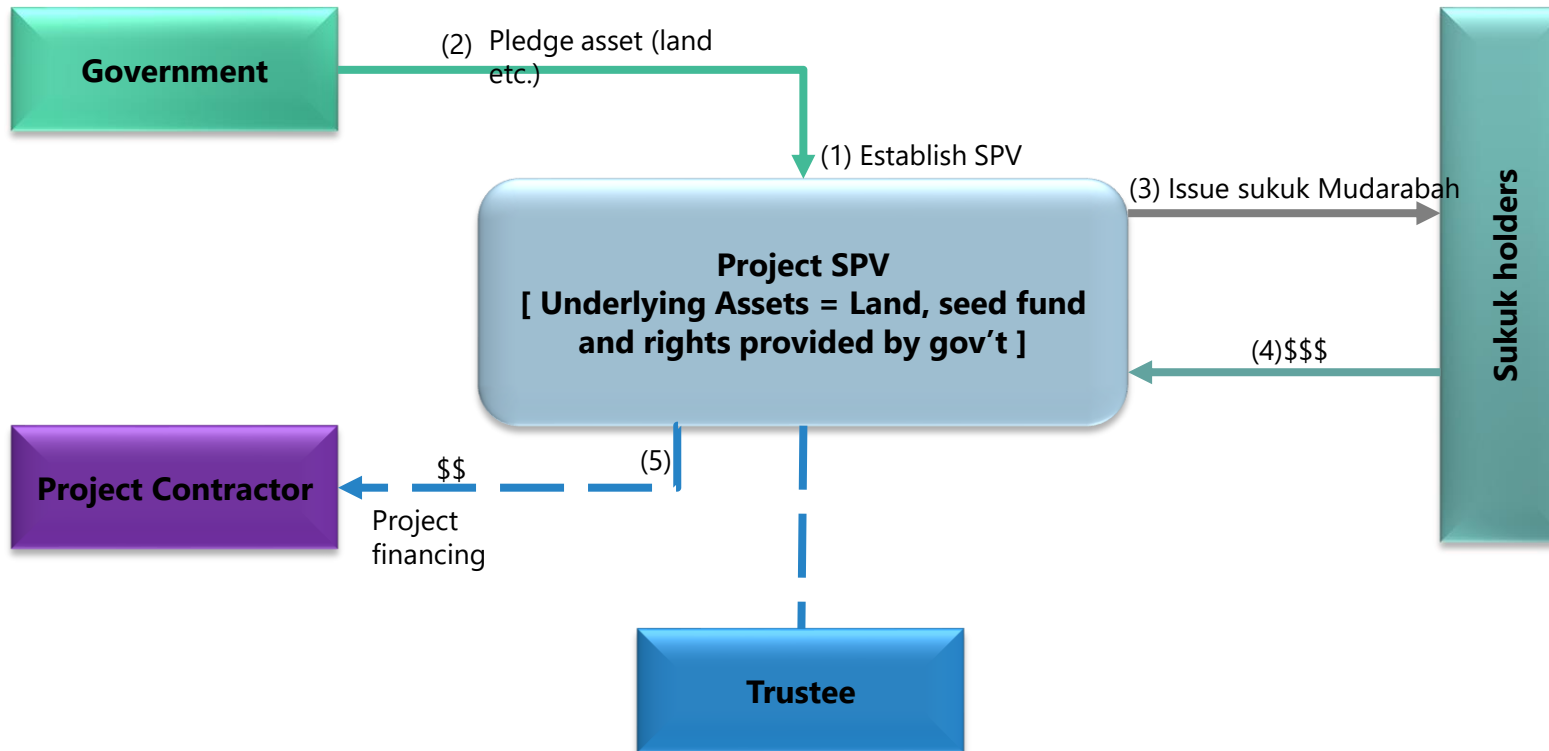
EXPECTED CASH FLOWS/NET PROFIT OF PROJECT



The government now needs to determine how to fund the needed **FUND**.
could issue 10 year convertible **Istisna-Mudarabah sukuk**
a convertible "Islamic instrument" with a construction and **profit/loss sharing contract**.

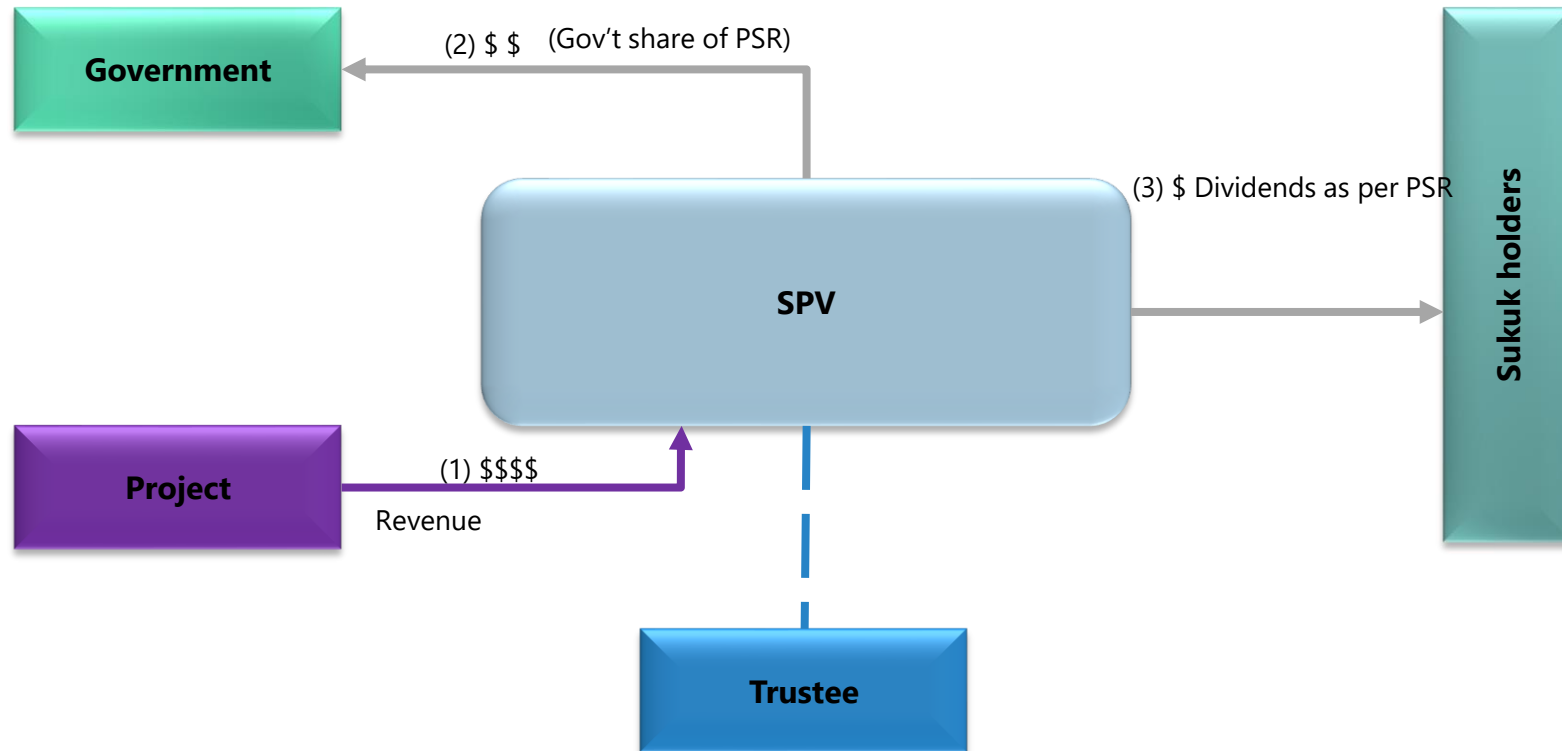
The Sukuk Issuance Process

Stage 1: Year 1 - 3



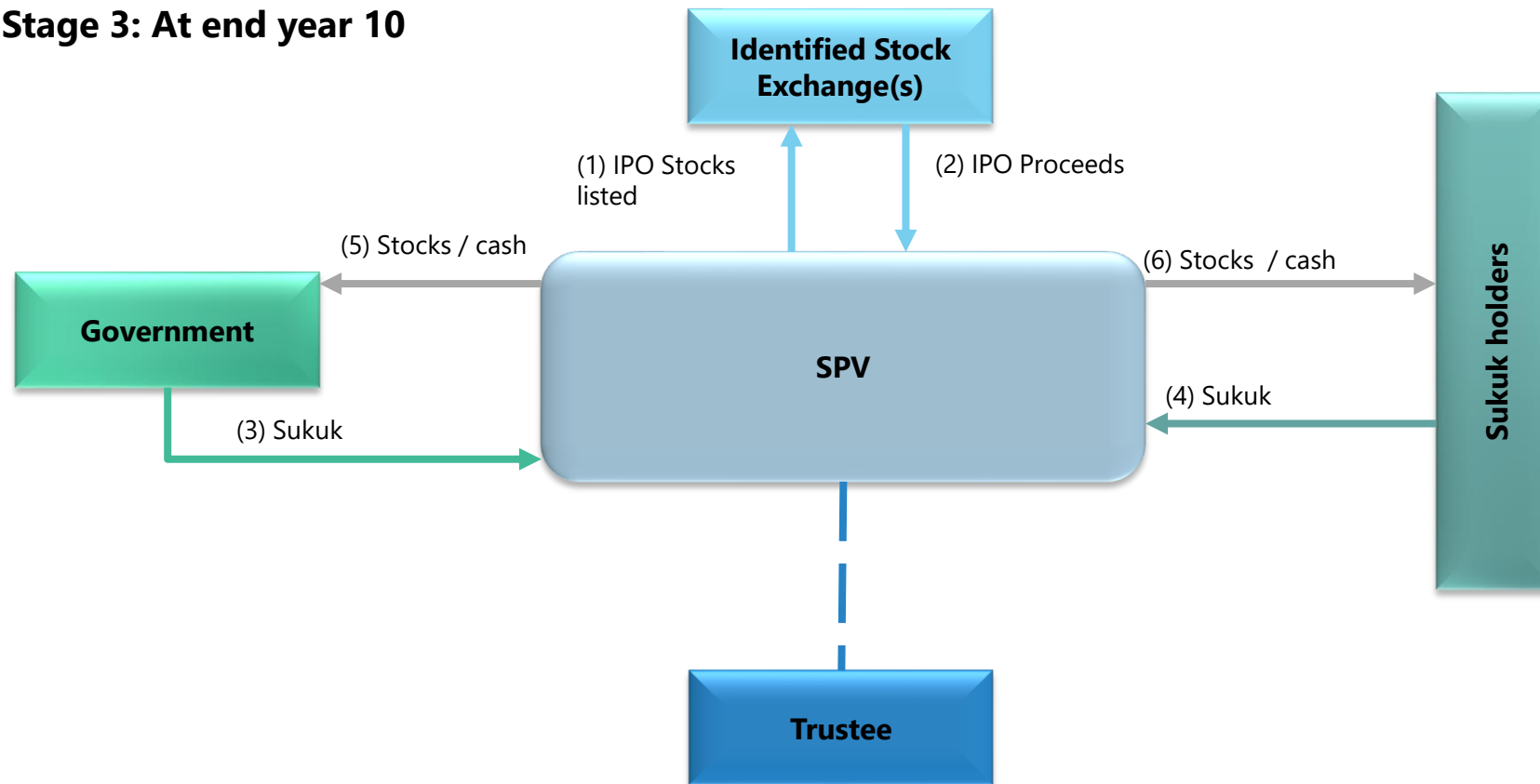
Revenue Generation & Distribution

Stage 2: Year 4 - 10



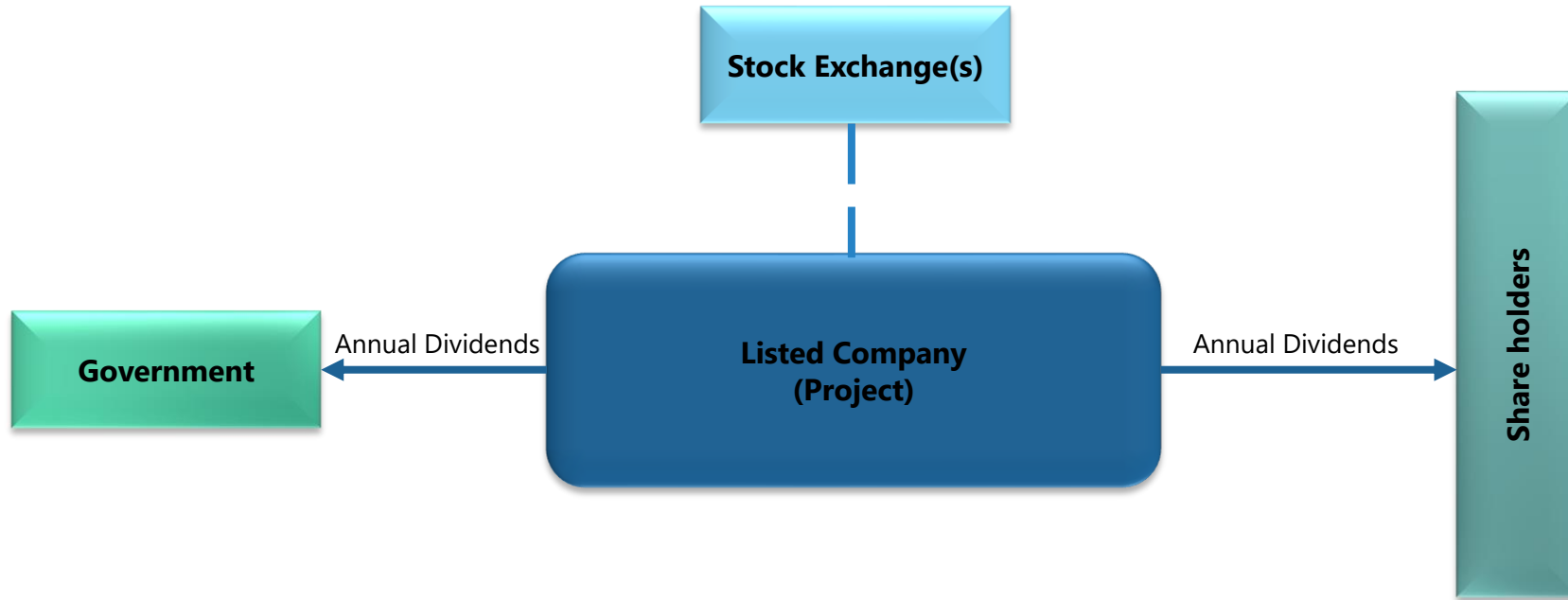
The IPO Process

Stage 3: At end year 10



Post IPO – Listed Company

Stage 4: Post IPO



THE ISSUES AND CHALLENGES OF THE SUKUK

The issuances of partnership *sukuk* is getting less popular in the capital market in the past years.

Mudharabah sukuk, it is an equity-based *sukuk* structure where profits and losses are shared between the partners.

However, there were several instruments that **fixed the periodic returns** over the *sukuk* and **guarantee the principal amount** of the *sukuk* holders.

THE ISSUES AND CHALLENGES OF THE SUKUK

Islamic scholars who **oppose bay al-inah** believe the contract is a planned agreement which created by the parties themselves.

At the end of the agreement, one of the parties will obtain immediate cash against a future obligation settling a higher amount. It seems that **both parties have no intention to commit to the sale contracts** and to use the asset as any consumer does.

The **repurchase obligations** make the sukuk is unacceptable from Islamic perspective.

Murabahah Sukuk – Is it **really asset based** or “**merely**” **asset backed**?

RECOMMENDATIONS

Issuing sukuk for **real needs**;

Not just for merely fund raising by application of **controversial contracts** such as Bay Al-Inah, Bay Al-Dayn, etc.

Increase the **partnership based sukuk** such as *Mudarabah* and *Musharakah* sukuk;

Sukuk projects can be design a way that **financier to be partners and not just lenders** and allow for risk to be shared among parties.

Sukuk must issued based on **real needs such as for developmental and infrastructural projects**, not for just fund-raising activities by using manipulated assets.

It is issued **not only for Institutional investors**, it should encourage the **public participation** as well by offering smaller denominations.



Thank you

Q&A

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