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Sukuk Securities

New Ways of Debt Contracting

MOHAMED ARIFF

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As often happens with new topics of investigation, writers benefit from ideas that come from many unexpected sources. So we want to acknowledge the many who, through their discourses with the authors of this book, have provided seminal ideas that are part of the growing literature on Islamic debt instruments. We dedicate this book to all those people first because we owe them all a collective debt. Next, we dedicate this book to the researchers and practitioners who are day by day expanding our understanding of what constitutes Islamic finance.

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Preface

This book is about an emerging financial market that promises to provide effective funding for *production activities* under a set of safe risk-sharing and profit-sharing finance principles built into the design, and trading of a wholly new form of fixed-income securities called *sukuk*. In a speech on October 13, 2013, announcing new laws to get London to join *sukuk* trading, British prime minister David Cameron said that the new investments are possible "because of the unique openness of the city of London and because of our commitment to help London lead the way in Islamic finance across the world, just as it has led the way in global finance across the ages."

Sukuk contracts are based on an entrepreneur and a financier taking a business risk together and sharing the profits while being prepared to incur losses together if the venture goes bust. The *sukuk* securities market is found in 12 countries, as of 2014. *Sukuk* trading started in 1998 on a small scale and has grown to its present size of close to US$1.2 trillion. When fully developed, it offers an alternative mode of fund-raising for all users of funds as long as the specific needs are taken into account and a *sukuk* contract is provided that meets those needs.

There is no literature dedicated solely to introducing these revolutionary securities markets to the readers in a comprehensive manner or, equally important, to providing a technical introduction to market players to what is described by the financial press as the Islamic (participation) debt market.

Given the endorsement of the World Bank for this new form of financing for developing countries, the value of new issues has grown 45 percent per year from 2011 to 2013, compared with a 17 percent growth per year from 1998 to 2010. The markets for this new form of debt are becoming more attractive to corporations, which are increasing players in all 12 markets. Governments are substantial players in sourcing infrastructural development funding. Agencies such as central banks and public works and energy firms are also seeking to raise funds in this new form.

This book attempts to answer a number of questions for both novices and experts in these marketplaces: What is a *sukuk* security? How should it be classified vis-à-vis bond markets? How is it designed? What are the different types of *sukuk* contracts that uniquely match the needs of farmers, on the one hand, and the working capital of a manufacturer, on the other hand? How big is the market? Why is its targeted funding mode superior to the general-purpose borrowing through conventional bond funding? How is this market different from the common bond market?

Commentators have hailed this form of financing with full asset backing as having the potential to reduce the appetite for debt. By design, borrowers could not borrow more than 100 percent of the value of their assets. We look at this new debt instrument in the context of debt overload in both the public and private sectors in the first two decades of the current century. Since 2008, debt has been decreased by governments, corporations, and individuals because the world has taken on too much debt per capita in the last quarter century. According to the World Bank criterion, debt should not be more than 80 percent of the gross domestic product (GDP) for the economy to be sustainable.

Since the onset of the global financial crisis as well as the Eurozone debt crisis, economic agents are quickly limiting debt across the world to make their economies crisis-resistant. The design features explained in this book on *sukuk* offer a better choice than the radical idea of fully backed banks or the idea of returning banks to the same mode as corporations in backing equity at about 30 percent of total assets. These calls are being made by analysts to stabilize the financial system without examining the merits of *sukuk* as an alternative to the same malady.

This new debt instrument locks the producer and the financier to the profit-and-loss outcomes of a project before asking for rewards from a venture. Such a mode of finance, along with the limiting of loans to no more than 100 percent of the asset value of a borrower, is extolled by many scholars and international institutions as a solution to the debt overload at current period. It appears that this debt overload is the servitude of humanity to modern financial corporations predicted by Thomas Jefferson in the 19th century at the birth of fractional banking. Under fractional banking, banks create money with very little asset backing compared to the 100 percent asset backing by the borrower when a *sukuk* contract is made.

In a sermon in August 2013, Pope Benedict XVI commented that modern lending practices are basically faulty in logic and harmful to the world order and natural justice. Could the new form of debt described in this book be a long-term solution to the ills of modern debt practices based on one-sided contracts in which risk is not shared?

Acknowledgments

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Several industry people extended their helping hands. Two we would like to name are Meor Amri Meor Ayob of Bond Pricing Agency Malaysia and Dr. Yeah Kim Leng of Bond Rating Agency Malaysia, both of whom made it possible for us to access data and expertise at their respective firms. Mervyn Lewis, in Adelaide, Australia, and Michael Skully and Abdullah Saeed, both in Melbourne, Australia, deserve a special mention for their continued joint work on Islamic finance research that has added a fair amount of new knowledge to this fledgling field of study.

To the numerous others who participated in the making of this book, we owe an intellectual debt for sharing their ideas, time, and expertise.

We owe an intellectual debt to Peter Casey for his permission to reproduce a chapter on regulatory lessons (Chapter 11). He is an experienced regulator of *sukuk* markets with experience in the United Kingdom and United Arab Emirates. Equally important, we thank Abdullah Saeed and Omar Salah for their elucidation in Chapter 3 on the theoretical aspects of *sukuk* structures. They have all added great insights on the regulatory framework.

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PART One

The Foundation of *Sukuk* Securities