

# SHARIAH REQUIREMENTS IN SUKUK STRUCTURING

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The *sukuk* market has taken an interesting turn across many aspects in recent years. *Sukuk* structures have advanced from a plain vanilla fixed income instrument to a hybrid structure having both debt and equity features. Similarly, the language used in drafting present *sukuk* offering circulars has changed. The underlying assets have also evolved from pure debt as in the case of *bai bithaman ajil* (BBA) *sukuk*, to lease-based assets as in *ijarah sukuk*, to a mixture of debt and tangible assets as in *istithmar sukuk*. Perhaps the most notable progression has been on the structuring side and obtaining of the *fatwa* for *sukuk* transactions. This article will therefore articulate some of the requirements and processes involved in current *sukuk* structuring.

## SHARIAH APPROVAL

This is typically a two-step process. Once the commercial terms have been agreed upon and assets for a transaction have been identified, the Shariah advisors together with their legal counsel prepare a structure paper with summary details of the transaction including specifics on the assets, Islamic contracts to be used, as well as use of proceeds.

Once the scholars approve the structure paper in principle, the legal documentation is prepared accordingly. Subsequently, when the documentation is in its near final form, the Shariah scholars review and provide comments before the signing of the *fatwa* allowing the transaction to proceed from an Islamic acceptability perspective. There may be times in between these two

stages where Shariah advisors' input is sought to clarify concerns, which may not have been previously discussed.

Recent dealings with scholars and feedback from lawyers and bankers have revealed that it is now taking longer to obtain Shariah approval in principle, even on well-known structures, such as the *ijarah*. It is refreshing to see that scholars are now taking a very keen interest to ensure that not only the assets, structure and contracts are sound but also that its application is suitable to the use for the issuer/beneficiary.

Whilst one can point to previous outstanding or approved *sukuk* structures, the scholars insist on working through each transaction on its own merit without being influenced by precedence. This new level of governance is inspiring for the market and provides more confidence to those who blame scholars and lawyers who drafted *sukuk* contracts without effective communication in place. Of concern now remains the time frame for issuance of a transaction, which points to the benefit of obtaining approval on a *sukuk* programme versus one-time standalone transactions, where the issuance time frame is of grave concern to the issuers and the financial advisors alike especially during volatile economic conditions such as those observed for the best part of this year.

## UNDERLYING ASSETS

Sharia committees have been looking into reviewing the *ijarah sukuk* structure for a real estate asset which is still under construction and required *sukuk* proceeds for completion. In the past, we had seen that as long as the value of the



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assets was at least equal to the *sukuk* issuance amount, then for structuring purposes and for Shariah approval, this was sufficient to proceed. In this case, however, the scholars spent time to ensure that the documentation explicitly stated that only the percentage of the asset already constructed together with the land is subject to the *ijarah* contract and the rental payments determination, and that it should be made clear that those floors which are to be built post-*sukuk* issuance are owned outright by the Issuer/Beneficiary and should not form part of the initial *ijarah* contract.

In essence what the scholars have rightfully indicated is that the completed asset on that land will be jointly owned by the *sukuk* holders and the issuer, with the *sukuk* holders owning the land and the asset up to the percentage as stated at the time of the *sukuk* issuance and the balance by the issuer as and when construction of the asset is completed.

Whilst precedence showed that no such conditions were placed on previously issued *sukuk*, it became apparent that the level of scrutiny by Shariah scholars of language used and technical parameters such as the level of completion of an asset or continued use of proceeds is increasing. If one looks at this from a legal lens, since the

structure is, in any case, asset-based and not asset-backed, the *sukuk* holders are in no worse a position than under the scenario where the completed floors of the building would also be under *sukuk* holders' ownership, because in case of bankruptcy or wind up the assets would revert back to the beneficiary.

## SUKUK YIELD

Further, where previously *sukuk* documentation stated that rental yield will be equal to the *ijarah sukuk* distribution payments, the new norm is to state that the rental yield will be in an amount "as agreed" and that to the extent the rental yield is higher than *sukuk* distribution amounts, then it is to be given to the issuer/beneficiary as a performance incentive. *Ijarah sukuk* in the past have neglected to include this explicitly stated feature; we have, however, previously seen such drafting in the case of *wakalah* and *musharakah sukuk* structures where in any case the profit distribution amounts are not guaranteed explicitly. Whilst this is not a significant departure from a risk or return perspective for *sukuk* holders, it is important to note that is a refinement to language used in earlier *ijarah sukuk*.

## THE USE OF SUKUK PROCEEDS

In all circumstances we are seeing an increasing insistence of scholars to have a Shariah advisor/supervisor appointed to the issuer, in order to ensure that proceeds are indeed used as prescribed initially and that no breach of Shariah is seen during the life of the *sukuk*. An example of this is the Dubai-based GEMS Schools *Sukuk* 2013 where scholars insisted that proceeds may only be used in business of the primary school business of GEMS within the GCC. At first glance one may wonder why this condition would be imposed since education is fundamentally a core Shariah-compliant business. The scholars rationalized that within the GCC, the syllabus is known and understood but outside the GCC this is not always the case. Even in the Western education system there are parental concerns on content which is being debated. This new element of governance is a positive change in the market but it does raise the overall cost of issuance of *sukuk* versus conventional bonds.

My view is that this marginal increase in costs should not deter any potential issuers, as the potential investor base which becomes available is far larger than the conventional investor pool. The latter is open to investing in *sukuk* as long as the credit profile fits its criteria. Moreover, the cost mitigates governance risks for the life of the *sukuk*. Only time will tell how successful these new changes will be, but for now the news for lawyers and other advisors is to come prepared with more detailed structure papers in front of their Shariah committees.

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## THE WAY FORWARD

In the longer term, one could argue that the increased scrutiny of *sukuk* and continued periodic review is a positive step to mitigate Shariah non-compliance risk. The question then arises of the increased cost and the fact that this may be a deterrent to some potential issuers who are agnostic and will only issue in Islamic format if there is no difference in price or issuance costs as against conventional bonds.



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