

Standardization and Authenticity in the Global *Sukuk* Market

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INTRODUCTION

While the *sukuk* market was not spared by the recent global financial crisis, its track record in preceding years has been unique. Indeed, between 2001 and 2007, the growth rates experienced in the Islamic finance industry and the *sukuk* industry in particular have been impressive. From 2005 to 2007, the growth in issuance value was 204 percent. As an Islamic alternative to the conventional bond, *sukuk* provide a unique tool of financing for Islamic as well as non-Islamic entities.

With high growth rates in the recent past and a solid potential for further growth, the *sukuk* industry has many challenges to overcome. Lack of standardization, higher costs, and structuring complexities are some of the key issues addressed in this paper. The immediate implication of these challenges is the relative absence of small and medium sized enterprises (SMEs) in the growing list of players within the industry. This is true both on the issuance side as well as the investment side. Indeed, if the *sukuk* market could somehow embrace SMEs, it could make a leap into becoming a mass market. *Sukuk* could then become an instrument accessible to retail investors and a popular and widely used financing instrument for the wide range of family businesses that dominate the business scene in the Islamic world.

¹ This paper was completed while the author was a Senior Vice President responsible for Innovation and Development at the Dubai International Financial Exchange (Nasdaq Dubai), UAE. An acknowledgment of feedback and support is due to Dr. Nazim Ali, Sheikh Hussein Hamad Hassan, and Sohail Zubairi.

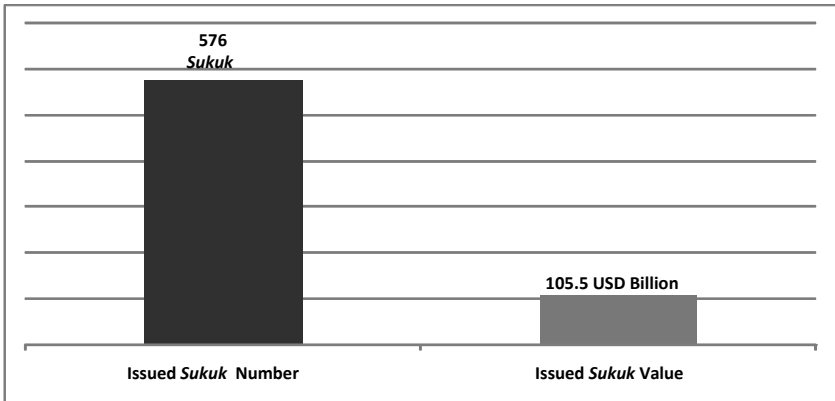
This paper proposes a model for standardization in the *sukuk* market that also addresses authenticity issues in *sukuk* structures. More specifically, it addresses the common practice of using orphan special purpose vehicles (SPVs) as third parties to facilitate *shari'a* compliance. Indeed, the standardization model presented here is based on the creation of an authentic third party that acts as an Islamic clearing agent of sorts and fulfills the role of an independent central Islamic trustee that could be used by many issuers.

The paper is divided into four sections. Section one provides a snapshot of the global *sukuk* market. The database uses data providers such as Islamic Financial Information Service (IFIS) and Zawya and complements the information through direct reference to stock exchanges, securities commissions, and other relevant sources such as lead managers and when necessary issuers. The period covered extends from 2001 to 2007. Section two describes and develops a theoretical framework, which I believe is important in justifying the focus on standardization and the necessity of innovation to achieve it. Section three explores in detail the proposed standardization solution for *sukuk*. Section four concludes the paper.

THE GLOBAL *SUKUK* MARKET: A SNAPSHOT

During the last couple of years, *sukuk* have emerged as a unique asset class. The market has been growing steadily over the past seven years and has witnessed phenomenal growth, particularly in 2006 and 2007. Charts 1 to 7 describe this market as it stands by the end of 2007. As of 2007, a total of 576 *sukuk* had been issued globally, representing an issuance value of US\$105.524 billion.

Chart 1: Global *Sukuk* Issuances, Number and Value, 2001- 2007



The number of *sukuk* issuances has been rising steadily over the past seven years. As shown below in Chart 2, 140 *sukuk* were issued in 2007 as compared to 31 in 2001. The number of *sukuk* issuances has grown at a compounded annual growth rate (CAGR) of 52 percent. The rise in the values of *sukuk* issued has been even more significant. Chart-3 reveals the yearly *sukuk* issuance in terms of values. In 2007, the total value of *sukuk* issued was US\$41.24 billion compared to US\$4.7 billion in 2001. The value of *sukuk* issuances has been growing at a CAGR of 56 percent.

Chart 2: Yearly *Sukuk* Issuance, Number, 2001–2007

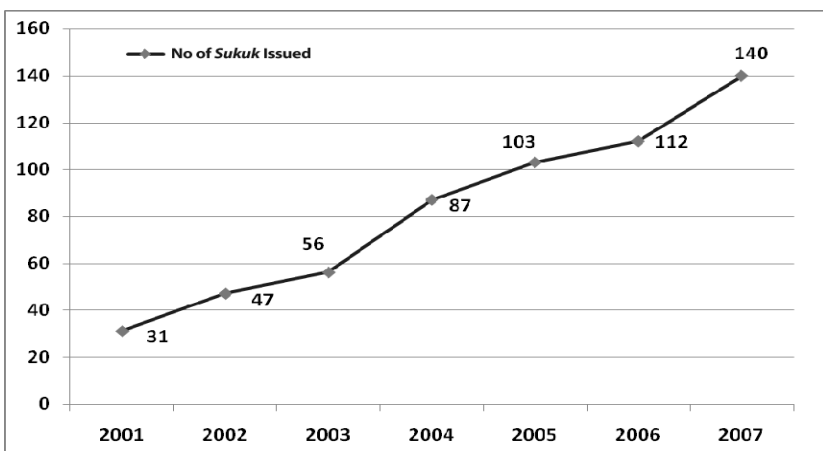


Chart 3: Yearly *Sukuk* Issuance, Value in USD Millions, 2001–2007

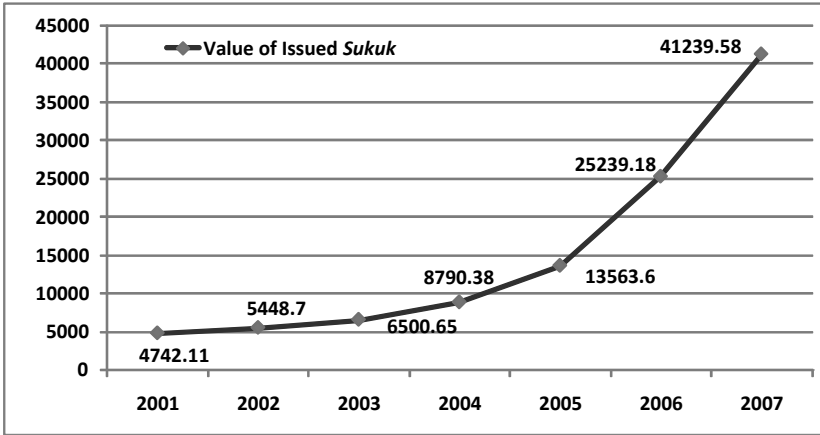
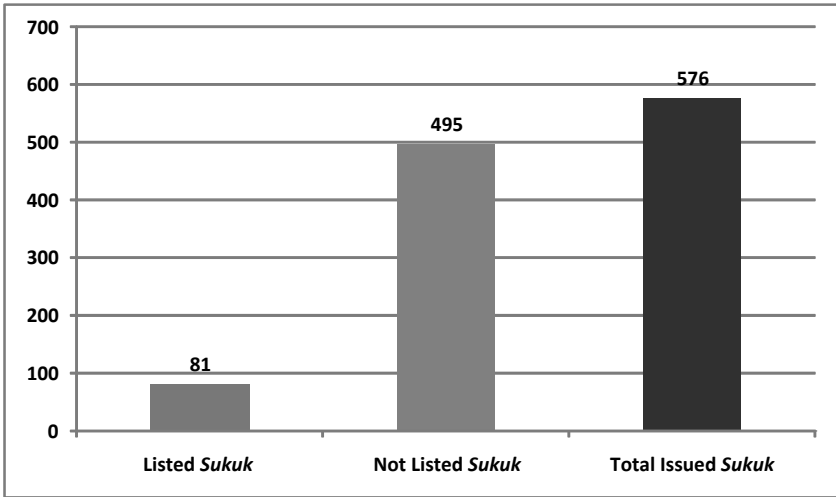


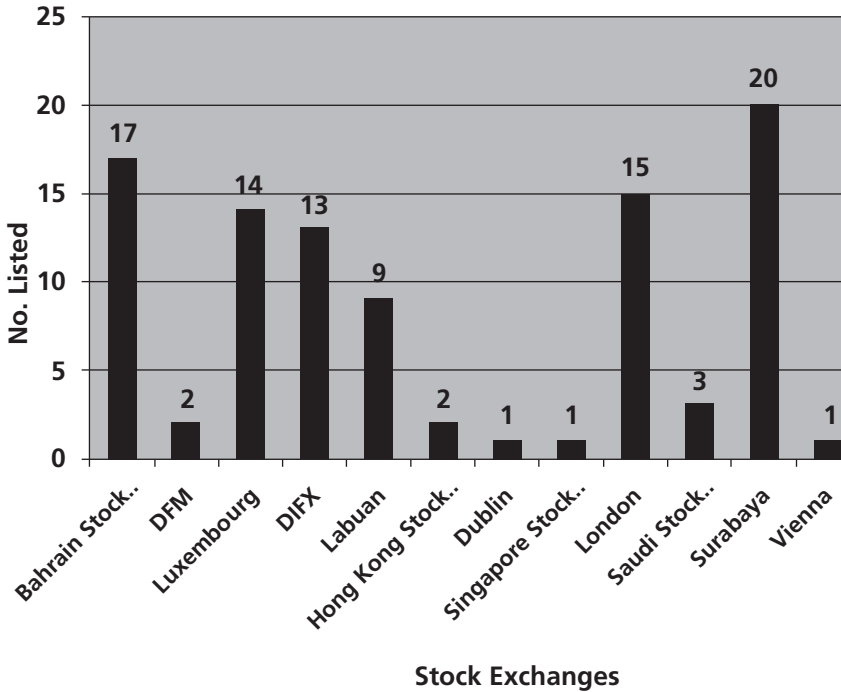
Chart 4: Number of *Sukuk* Issued and Listed on Exchanges, 2001–2007



Several *sukuk* have been listed on stock exchanges across the world to generate investor demand and facilitate further liquidity and trading. Chart 4 reveals that 14 percent of the 576 *sukuk* issued between 2001 and 2007, i.e., 81 *sukuk*, have been listed on stock exchanges. Chart 5 reveals the exchanges where *sukuk* have been listed and their

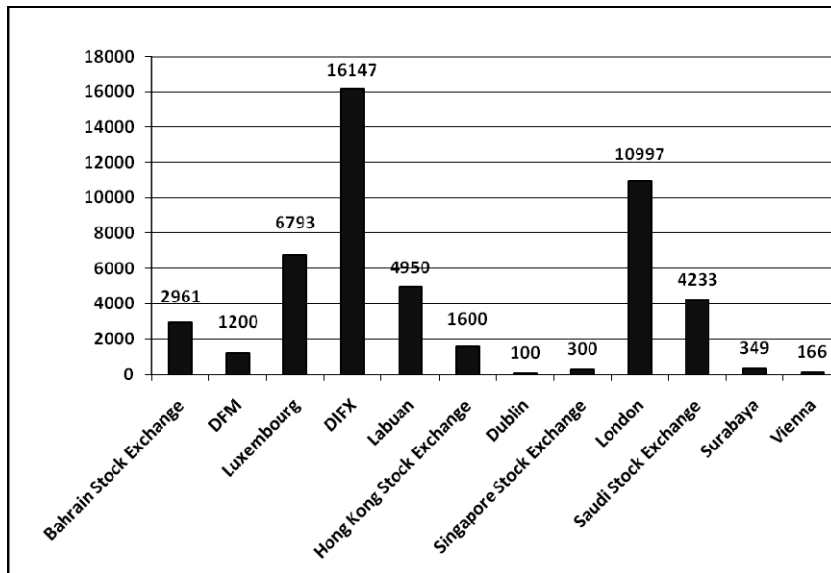
numbers. It should be noted that due to cross-listings the total exceeds 81.

Chart 5: Number of Listed *Sukuk* per Exchange, 2001–2007



Eighty-one *sukuk* have been listed on twelve stock exchanges throughout the world, including major global hubs such as the DIFX (Nasdaq Dubai) and the LSE. The Indonesian Surabaya Stock Exchange has had 20 *sukuk* listed and is host to 20.4 percent, the highest number of listed *sukuk*. The Bahrain Stock Exchange and London Stock Exchange have 17 and 15 *sukuk* listed, respectively. Other stock exchanges with a high number of listed *sukuk* include the Luxembourg Stock Exchange with 14, the DIFX with 13, and Labuan Malaysian Stock Exchange with 9 *sukuk*. GCC stock exchanges including DIFX, DFM, Bahrain, and Saudi Tadawul account for 35 *sukuk* or 35.7 percent of the total number of listed *sukuk* between 2001 and 2007.

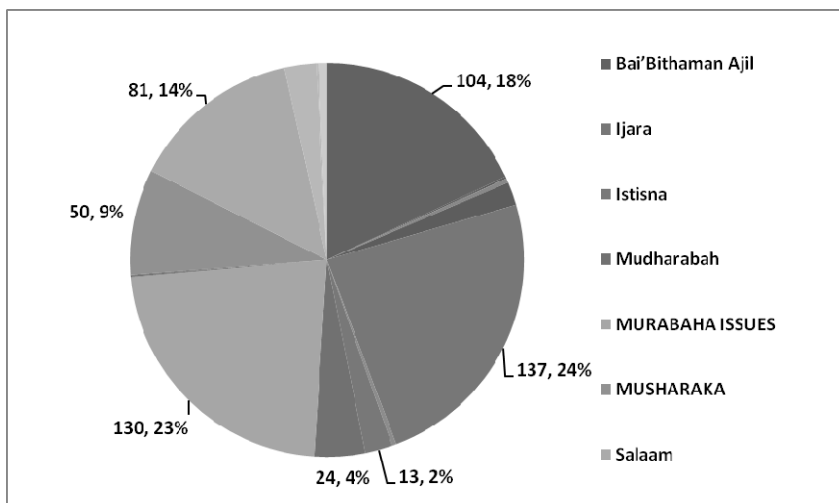
Chart 6: Value of Listed *Sukuk* per Exchange, in USD Millions, 2001–2007



By 2007, the total value of listed *sukuk* across all exchanges amounts to US\$49.7 billion. DIFX had the highest value of *sukuk* listed at US\$16.14 billion. This represented 32 percent of the total value of *sukuk* listings. The London Stock Exchange had approximately US\$ 10.9 billion worth of *sukuk* listed, which represents 21 percent of the total. It should be noted that the value figures should only be used as indicative descriptions due to double-counting given cross listings across exchanges.

Looking at the major types of *sukuk* structures used, Chart-7 below reveals that 137 *Ijara sukuk* have been issued between 2001 and 2007. These account for 24 percent and the largest of all *sukuk* instruments issued. *Murabaha* issues account for 23 percent of all global *sukuk* issuances. One hundred four *Bai' Bithaman Ajil sukuk* have been issued, particularly in the early years in Malaysia, representing 18 percent of total *sukuk* issued. *Salam sukuk*, most commonly issued as short-term *sukuk* by the Central Bank of Bahrain, rank fourth and account for 14 percent of all *sukuk*. Other relatively sizeable *sukuk* instruments include *musharaka* and *mudaraba*, which account for 9 percent and 4 percent of all *sukuk* respectively.

Chart 7: Global *Sukuk* Instrument Breakdown, 2001–2007



The above discussion is a snapshot of the global *sukuk* market as it stood by the end of 2007. The figures reveal a fast growing industry that is still in its early stages of evolution, with tremendous potential for innovation and further development. Indeed, the *sukuk* industry has not been spared by the credit freeze across conventional markets. Based on a recent Standard and Poor's report, global *sukuk* issuance dropped to US\$15 billion in 2008.² While the slowdown has been significant, the potential of *sukuk* as a unique asset class remains unchallenged.

The next section discusses a framework for the future, addressing strategic and tactical issues relevant to the ongoing process of self-definition experienced by this young and growing industry.

A FRAMEWORK FOR THE FUTURE

The rapid growth of Islamic finance and the *sukuk* market have spread excitement and anticipation among all players. Whether governments,³ exchanges, banks, law firms, or other institutions, the benefits of taking

² Standard and Poor's, "Sukuk Market Declined Sharply in 2008, But Long-Term Prospects Remain Strong," 2009.

³ For growing Islamic and non-Islamic interest in this developing industry, see HM Treasury, *Government Sterling Sukuk Issuance: A Consultation*, 2007.

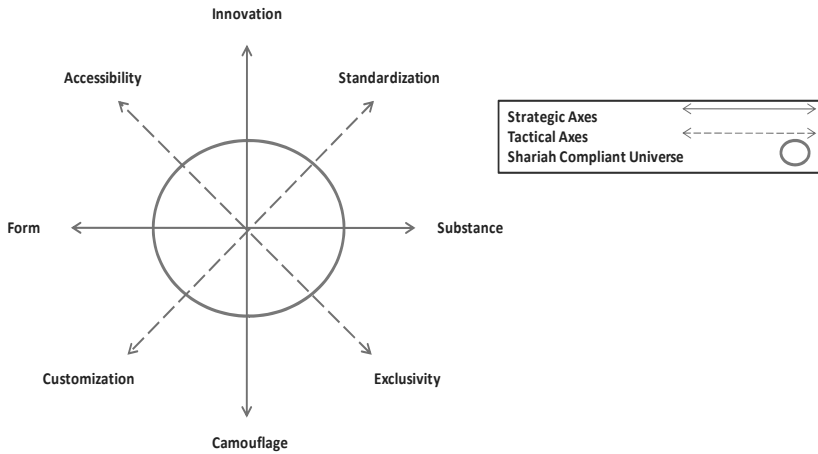
part and contributing to this infant and fast growing industry have been obvious.⁴ In parallel, many conferences and seminars have been organized to address the many pressing issues. Indeed, this young industry is seeking to find itself, to invent itself according to the principles of the *shari'a*. This self exploration and invention is a powerful process that without any doubt will determine the future course of development of the *sukuk* market.

The framework proposed here suggests that all players in the Islamic finance field are faced with a number of key strategic decisions (figure 1). The first and most important strategic decision concerns an entity's position vis-à-vis form and substance. In other words, to what extent does an entity seek to achieve authentic Islamic solutions? Naturally, given the pluralistic nature of Islam, and the nature of *ijtihad*,⁵ there could be many interpretations of what is truly and authentically Islamic finance and what is not. All in all, the first strategic decision concerns the pursuit of form or substance, or both in balance. Do we dedicate resources to “appear” Islamic, or do we dedicate resources to “be” Islamic (always allowing for multiple interpretations)?

⁴ For additional material on the recent momentum and future prospects of Islamic finance and the *sukuk* market see: Zamir Iqbal, “Islamic Financial Systems,” *Finance and Development*, IMF, 2007, Volume 34, No. 9, 42–45; Zamir Iqbal and Hiroshi Tsubota, *Emerging Islamic Capital Markets: A Quickening Pace and Potential*, Euromoney Handbook DCM, 2006, The World Bank, 5–11; Ahmed A. El Waleed, “Sukuk—A Sharia Advisory Perspective,” *Islamic Finance News*, 2007, Vol. 4, Issue 29, 1–4; Global Investment House, *Sukuk—A New Dawn of Islamic Finance Era*, 2008.

⁵ *Ijtihad* refers to the process of independent effort and interpretation that is applied by Islamic scholars.

Figure 1: Framework for the Future



The second strategic decision, which is a direct result of the first, concerns the position of an entity vis-à-vis innovation and/or camouflage. In other words, depending on what an entity's purpose is, it will dedicate resources to innovation, which is far more costly and much riskier, or to camouflage, which consists of transforming the appearance of what is already available in order to blend in with the environment and meet the general requirements of the principles.

Depending on where we position ourselves on these two strategic axes, we also determine what type and how much resources we dedicate to our Islamic finance initiatives and thus we determine the impact and extent of our contribution to this unique and promising industry.

In parallel, firms and players in the Islamic finance arena are faced with broad tactical decisions: (1) the decision to pursue exclusivity vs. accessibility, and (2) the decision to seek standardization vs. customization.⁶ These decisions, which are highly dependent on the nature of the institution concerned, determine the nature, extent, and focus of the Islamic finance initiatives that companies undertake. For example, a law firm, a bank, and an exchange would most definitely be inclined to adopt very different positions when it comes to standardization and accessibility. Indeed, the nature and size of the companies in question could be a crucial variable. All in all, depending

⁶ A. Papazian, *The Global Sukuk Market: Developments and Prospects*, 2007.

on a firm's position vis-à-vis these two axes, an entity determines the type of projects and objectives it seeks to implement.

While the future of the industry and Islamic finance in general will be determined through the ongoing and future projects and negotiations of all the players, the development of a mass market in *sukuk* will depend on more standardization and more accessibility.

The next section proposes a model for standardization in the *sukuk* market.

CENTRAL ISLAMIC TRUSTEE (CIT): A STANDARDIZATION SOLUTION FOR *SUKUK*

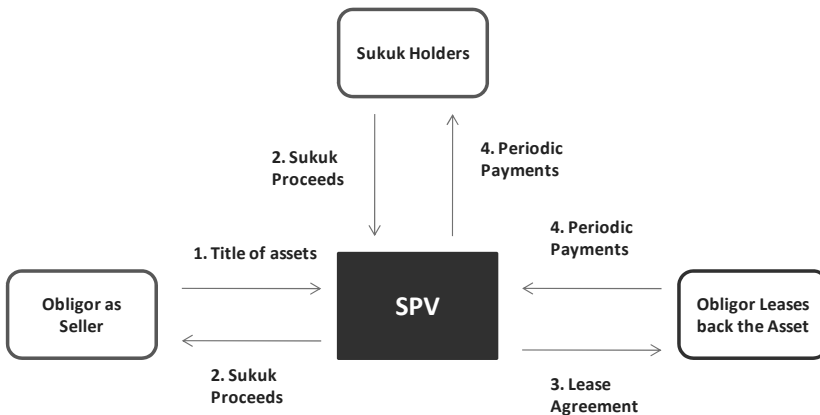
At the heart of all the *sukuk* structures is a Special Purpose Vehicle (SPV).⁷ The very objective of such a company is to have an entity that will hold the *sukuk* assets on trust or as agent for and on behalf of *sukuk* holders. SPVs are usually owned by a charitable trust. The share capital of such SPVs is set at the minimum possible depending on the jurisdiction of incorporation. An SPV's board of directors generally consists of nominee directors who represent *sukuk* holders or initial investors. The board operates in accordance with the instructions of *sukuk* holders. All relevant details are set out in clear terms in the declaration of trust and offering circulars or terms and conditions of the *sukuk*.

The SPV enters into various transaction documents (almost all transaction documents and capital market documents necessary for the issuance, listing, and redemption of *sukuk*) for and on behalf of *sukuk* holders, issues the *sukuk*, and holds the *sukuk* assets in trust for the benefit of the *sukuk* holders. An SPV, in its capacity as issuer and trustee, invests the proceeds of the *sukuk* in the project identified in the business plan of the underlying *sukuk* structure.

⁷ For additional and background discussion on *sukuk* please see Muhammad al-Bashir Muhammad Al-Amine, "The Islamic Bonds Market: Possibilities and Challenges," *International Journal of Islamic Financial Services*, 2001, Vol. 3, p. 1; Dar Al Istithmar, *Sukuk: An Introduction to the Underlying Principles and Structure*, 2006; Abdulkader Thomas, *Structural Challenges Impeding Growth of the Sukuk Market*, August 2006; Abdulkader Thomas and Sh. Muhamed Becic, *Debt or Equity in the Sukuk Market*, June 2007; Thomas and Becic, *Are Sukuk Islamic? The Sukuk Market*, December 2007; Rodney Wilson, *Innovation in the Structuring of Islamic Sukuk Securities*, 2006.

To visualize the role of SPVs, figure 2 provides an example of a *sukuk* structure where the central role played by the SPV is revealed.

Figure 2: *Ijara Sukuk* Structure



In the case of a simple *ijara sukuk* (lease *sukuk*), for example, the role of the SPV (acting as agent and/or trustee) is to purchase the underlying asset from the primary obligor (by utilizing the *sukuk* proceeds) and then to lease the asset back to the obligor (receiving rentals that become the payments to *sukuk* holders). However, as an entity, it is neither responsible for the payments, nor guarantees the payments. The SPV is a trustee that acts as a legal conduit to a *shari'a* compliant *sukuk* structure.

When a *sukuk* is brought to listing on an exchange, the legal issuer is the SPV. However, regulators look through the SPV and consider the primary obligor as the reporting entity. Indeed, this is common practice across many jurisdictions and regulators. The SPVs have no financial or reporting responsibilities. Their function is to be a legal entity that buys/rents the underlying asset from the primary obligor, legally acts as the issuer of the *sukuk*, and appoints (legally) the relevant entities to manage and administer the transaction. It does not itself manage cash or responsibilities.

Acting as an issuer/trustee/agent in a *sukuk* structure, the specific functions of an SPV are:

1. *Core Transaction Documents:* Enters into and executes all Core Transaction Documents in relation to the underlying

sukuk structure (for example, *musharaka* agreement, asset purchase agreement, lease, undertakings, *mudaraba* investment agency agreement, *istisna'*, management agreement, etc.).

2. *Capital Market Documents*: Appoints (legally) the mandated lead arrangers, arrangers, underwriters (subscribers), paying agent, collection agent, security agent, transaction administrator, book runners and publisher for the printing of offering circular, etc.

At the core of the standardization model proposed in this paper is an entity that I call the Central Islamic Trustee (CIT). The mission of the Central Islamic Trustee is envisaged to be that of a facilitator and a source of standardized *sukuk* contracts. Moreover, the CIT is expected to provide the market with a genuine third party that would be in a better position to safeguard and pursue the interests and rights of *sukuk* holders. The existence of such an entity will give more meaning and authenticity to the SPVs and their role in *sukuk* structures.

The Central Islamic Trustee must be organized as a charitable trust that will serve the industry through the provision of standardized *sukuk* blueprints. It will create SPVs (Figure 3) and provide administrative services to them, thus standardizing incorporation documents and other related transaction documents. The Central Islamic Trustee will establish an SPV (on the request of an originator/arranger of a *sukuk* issue), monitor it, and facilitate the appointment of or enter into different relationships by the trustee/issuer with other concerned parties for the purpose of the issuance of a *sukuk* (Figure 4).

Figure 3: CIT Structure

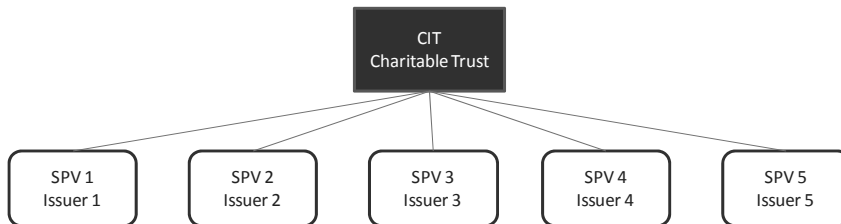
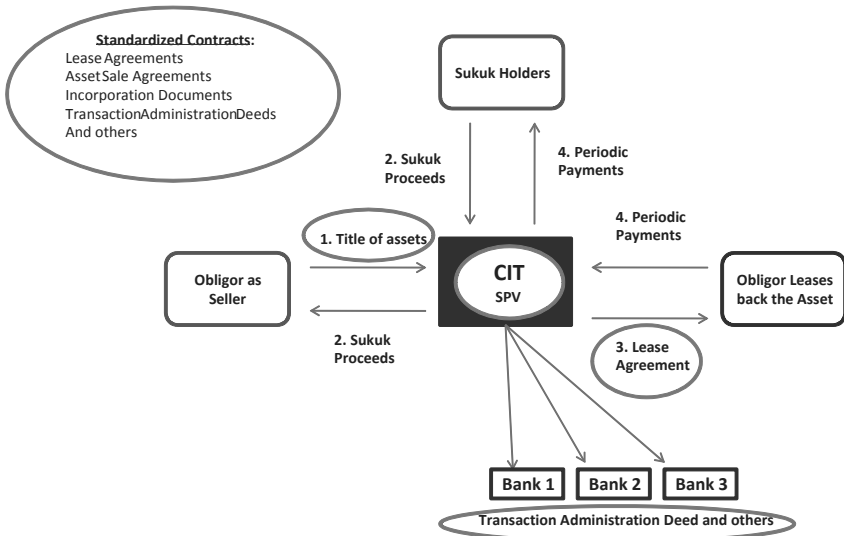


Figure 4: CIT in an *Ijara Sukuk* Structure



In order to achieve its purpose and engage all the existing players in the *sukuk* market, the CIT will need to have a set of strictly defined functions or services. The list below is not exhaustive, but clearly defines the role of *sukuk* facilitator in the market alongside other players.

Central Islamic Trustee (CIT) Services and Delivery

- Facilitating *sukuk* issuance for interested parties;
- Establishment of SPVs for *sukuk* issuance;
- SPV administration for *sukuk*;
- Administrative and secretarial support to SPVs for *sukuk*;
- Provision of full set of incorporation documentation for SPVs;
- Provision of directors and statutory officers (including company secretary) for SPVs, and provide registered office service and address for SPVs;
- Provision of legal documentation to create the *sukuk* structure;

Islamic Finance

- Audit coordination;
- Transaction accounting;
- Security issuance and accounting.

The SPVs created and owned by the CIT must be segregated from each other. This is critical in order to avoid the potential systemic risks that could arise from such a central institution acting as a party to so many transactions. Although, as discussed earlier, given the nature of *sukuk*, CIT SPVs will not be the actual obligors in these transactions, and thus will not have any ongoing reporting responsibilities. However, they will play an active role in representing *sukuk* holders, safeguarding their rights, monitoring the issuance process, coordinating the different functions of the issuer SPV, and will be an actively managed independent institution from the obligor or the originator.

Indeed, in many ways, given the functions and services of the CIT as described here, the idea is quite close to other conventional SPV providers in the securitization and structured finance industries. The fundamental differences are three key features of the CIT: (1) the CIT will have to be an Islamic entity organized as a charitable trust that aims at promoting the growth and development of the *sukuk* industry; (2) the CIT will be acting as a genuine third party in the *sukuk* transactions thus ensuring that the link between the Sukuk holders and the obligor is not just a legal entity, and finally (3) the CIT will not just be in the business of bankruptcy remoteness, but in the business of *sukuk* investor representation, protection, and monitoring.

CONCLUSION

Like every young and developing industry, market size and reach are crucial issues for the *sukuk* market. This paper reveals an exciting and promising picture for these new and unique instruments. As of 2007, a total of 576 *sukuk* had been issued globally, with an issuance value of US\$105.524 billion. Between 2001 and 2007, the number of *sukuk* issuances per year has been rising at a CAGR of 52 percent. In terms of value growth, the CAGR is 56 percent. Between 2005 and 2006 the increase in value is 86 percent, while between 2006 and 2007 the increase is 63 percent. In total, 81 *sukuk* (14 percent of a total of 576) have been listed on exchanges around the world, representing a value of US\$37.4 billion.

While providing a snapshot of numbers and values in the *sukuk* market, this paper's main contribution is to identify standardization as a key strategic target for this industry and to suggest an institutional solution that could potentially become a crucial catalyst for lower fees and a wider mass market that encompasses small and medium sized players.

The paper proposes that standardization could be achieved through a trust entity that provides support to investors, issuers, and investment banks through SPV provision and pre-approved contracts. Indeed, the Central Islamic Trustee (CIT) does not provide a product-specific solution, but an infrastructural contribution.

The Central Islamic Trustee is conceived as a centralized institution of trust, providing the current *sukuk* structures with SPVs that are more than just mere legal formalities, but entities that are managed and centralized through a trustworthy and credible institution, truly managed as a third party. The CIT will have to act as a genuine third party in *sukuk* transactions, thus ensuring that the link between the *sukuk* holders and the obligor is not just a legal entity. It should be emphasized that the CIT will not be in the business of bankruptcy remoteness, but in the business of *sukuk* investor representation, protection, and monitoring.

The CIT will achieve lower legal and *shari'a* compliance costs through the development of standardized contracts and economies of scale. It would facilitate the supply of *sukuk* and provide necessary infrastructure for the entry of small and medium sized enterprises into the *sukuk* market. After all, the CIT will be acting as a trustee for investors and a variety of originators, providing them with issuer SPVs, making it a genuine third party in *shari'a* compliant transactions.

The *sukuk* market needs an institution like the Central Islamic Trustee in order to take a leap into a greater, wider, broader, and more credible future.