

International sukuk: a need for more disclosure and better transparency

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Sukuk have developed to occupy a dynamic part of the Islamic financial system. A glance at the ratio of domestic versus international issues, however, reveals that there is some way to go before we can claim the sukuk market to be truly global. The value of global aggregate sukuk for the period January 1996 to September 2013 is \$488.17 billion, according to Thomson Reuters data. The sukuk market is dominated by domestic issues which represent 84% of the total market. International sukuk comprise only 16%. The issuance of international sukuk is a relatively new trend in Islamic debt markets. In 2002, the Malaysian government launched the first rated international sovereign sukuk. Since then, the value and volume of international sukuk have been on the rise. Cross-border sukuk is another consideration and a marker for the development of the global sukuk market. Cross-border issuances are few and far between although the number has been on the rise of late, with most activity coming from Gulf Cooperation Council (GCC) issuers tapping Malaysia's sukuk market.

According to Thomson Reuters Zawya's 2014 sukuk survey, 50.6% of investors prefer to invest in international sukuk, while 59.3% of lead arrangers believe that international sukuk will be the most expected type of issuance in coming years. This strong bias in favour of international sukuk is justifiable. Characteristics such as spread resilience, efficient distribution, tradability, and emerging market exposure have made them an attractive solution for Western institutional investors⁽¹⁾. Large conventional players with global market reach have helped distribution and have added depth to the market through increased participation. However despite the increasing trend toward international sukuk issuance there are various challenges in need of attention from the Islamic finance industry.

From the perspective of the global sukuk investor, there are two main issues impeding demand for international sukuk. First, there is the issue of enforceability from a common law and sharia perspective. The second issue relates to the underlying assets that make sukuk unique. As either asset-backed or asset-based securities, sukuk are said to represent ownership. However, opaque reporting of underlying assets and often undisclosed or ill-defined ownership structures create challenges for international investors performing their required due diligence. This issue is evident with even a cursory examination of the information outlined in sukuk prospectuses. Both these issues, which are somewhat interrelated, remain hotly debated among many stakeholders in the Islamic finance industry.



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Sharia enforceability

The distinction between sharia-incorporated jurisdictions and purely secular jurisdictions is important in addressing the issue of when, and under what circumstances, sharia is an enforceable element of a contract under the laws of a specific nation. Legal systems in many majority Muslim countries are still primarily secular.

Often, economic and legal structures are the product of legislation or royal decree, and some, if not most, of those structures remain unclear—or in conflict with, or contrary to sharia⁽²⁾.

Most legal systems have some provision incorporating sharia into the legal structure. However, the degree to which this incorporation occurs varies widely.⁽³⁾ So, there remains some question of whether, in what circumstances, and to what extent sharia will be enforced even in jurisdictions within the Islamic economic sphere.

To highlight the issues pertaining to enforceability of sharia in different jurisdictions, consider a typical sukuk issue from Saudi Electricity (SE) Company. The SE Sukuk issuance is a securitization of assets located in Saudi Arabia, a sharia-incorporated jurisdiction. In this case, the asset originator is located in the same jurisdiction, while the Special Purpose Vehicle (SPV) Sukuk issuer is located in the Cayman Islands, a secular jurisdiction that allows for the choice of applicable law for financial transactions.

¹ Although the Sukuk market has improved in terms of liquidity and spread resilience over the past 24 months compared to conventional bonds, Sukuk issues usually trade with bigger spreads and sometimes offer low liquidity.

² "Contractual Enforceability Issues: Sukuk and Capital Markets Development" by Michael J.T. McMillen

³ *Ibid*

SE Sukuk are sold to both Muslim and non-Muslim investors throughout the world. Applicable laws will include those of the sharia-incorporated jurisdiction (where the originator and the assets are located) and the Cayman Islands. In this case, sukuk certificates and the transaction documents are governed by English law. Furthermore, it is likely that securities laws in Saudi Arabia, as well as those of the various jurisdictions of the purchasers of the sukuk, will be applicable under certain circumstances.

Sukuk certificate holders share the added risk of courts not enforcing a foreign judgment in a country where sukuk assets are present. The legal system of the United Arab Emirates, for example, is unlikely to enforce a foreign judgment without re-examining the merits of the claim and may not recognize a foreign law as the governing law for a transaction. This is factored into sukuk prospectuses, for example in the Abu Dhabi Commercial Bank Islamic Finance (Cayman) Limited issue of 2011 due 2016, according to UAE commercial bank Abu Dhabi Commercial Bank (ADCB):

The UAE is a civil law jurisdiction, and judicial precedents in the UAE have no binding effect on subsequent decisions. In addition, court decisions in the UAE are generally not recorded. These factors create greater judicial uncertainty.⁽⁴⁾

Many of the countries where sukuk originators are domiciled allow arbitration under various international laws. However, investors are warned that there is no assurance that local courts will recognize and enforce any arbitral award. Moreover, the arbitration process can be costly and time consuming, as described in the SE Sukuk 2013 prospectus:

The Kingdom of Saudi Arabia is a signatory to the New York Convention on Recognition and Enforcement of Arbitral Awards (1958), and as such, any arbitral award could be enforceable in the Kingdom of Saudi Arabia but subject to filing a legal action for recognition and enforcement of foreign arbitral awards with the Board of Grievances, which can take considerable time.⁽⁵⁾

For sovereign sukuk, the country may unconditionally waive sovereign immunity, but it would still be difficult to enforce the waiver of immunity in a country's court against its own state. For instance, an Indonesian government November 21, 2012 sukuk prospectus explains that Indonesian law prohibits the seizure of property or assets owned by the republic:

The Republic is a sovereign nation. Consequently, it may be difficult for holders of the Certificates to obtain or enforce judgments against the Republic.⁽⁶⁾

4 Source: Sukuk Prospectus - ADCB Islamic Finance (Cayman) Limited due 2016 - Issue Date: November 22, 2011

5 Source: Sukuk Prospectus - Saudi Electricity Global Company 2 due 2023 & 2043- Issue Date: April 8, 2013

6 Source: Sukuk Prospectus - Republic of Indonesia Perusahaan Penerbit SBSN Indonesia II due 2018- Issue Date: November 21, 2012

7 "Contractual Enforceability Issues: Sukuk and Capital Markets Development" by Michael J.T. McMillen

8 Islamic Financial Services Industry Stability Report 2013

9 Ibid

In these examples, transactional and legal risks are significant, which can discourage global investors from entering the market. Transactional standardization is one of the methods of defining and reducing risk, reducing transaction costs, and preserving margins.⁽⁷⁾ Equivalent conventional securitization transactions are, for the most part, quite standardized. For example, with conventional transactions, the same forms of financing documents are used with minimal change from one transaction to the next. These documents have been used successfully over a period of years and have been the subject of considerable interpretive litigation. Sharia-compliant transactions of this type have not yet obtained an equivalent degree of standardization or concomitant certainty, consistency, predictability, or transparency, especially as to enforcement of sharia.

Moreover, the legal framework in majority Muslim countries may need amendments to current laws or the issuance of new statutes with respect to securities, capital markets, taxation, and contract law.⁽⁸⁾ It is a positive step that parliaments and supervisory authorities in a number of these jurisdictions have taken steps to issue or revise legislation and regulations for the issuance and trading of sukuk.

The Malaysian Securities Commission revised its Islamic Securities Guidelines, issued in July 2011, and issued its Guidelines on Sukuk in December 2012. The guidelines provide more comprehensive guidance on the subject, covering areas such as the approval process, applicable sharia rulings, and ratings and disclosure requirements. The Securities and Exchange Commission of Pakistan also issued draft rules for the issuance of sukuk in October 2012. Similarly, the Capital Market Authority of Oman issued its draft Sukuk Regulations in early 2013 to seek stakeholder feedback.⁽⁹⁾

Finally, the Turkish government passed legislation in February 2011 to facilitate the issuance of leasing certificates (Ijara Sukuk) that included tax neutrality measures consistent with equivalent conventional products.

Underlying Sukuk Assets, Ownership, and Prospectus Disclosures

According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), sukuk are defined as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services, or (in the ownership of) the assets of particular projects or special investment activity."

Investors, in general, and socially responsible investors, in particular, are interested in understanding as much as possible about the underlying assets to which they have an ownership claim. They would like to understand where these assets are located, their value, purpose, and income generation ability. Most sukuk prospectuses, however, provide little information about the sukuk or trust assets. Offering documents from GCC bank sukuk provide limited information regarding underlying assets; in fact, they discourage prospective investors from gathering information or performing due diligence on assets. One such document states:

No investigation or enquiry will be made and no due diligence will be conducted in respect of any Wakala Assets comprised within a Wakala Portfolio.⁽¹⁰⁾

A determination as to whether the transaction constitutes a “true sale” has not been fully disclosed in certain sukuk issuances, a clear legal risk. There is often no assurance in the prospectus that legal ownership has been transferred to the SPV from the original owner, as stated in this recent sukuk prospectus from Malaysia’s Sime Darby:

No steps will be taken to perfect the legal transfer of the ownership interest (including registration if required as a matter of law) in the Lease Assets of any Series with any relevant regulatory authority in Malaysia and, therefore, in relation to any Assets or Lease Assets which require perfection in order to legally transfer any ownership interest; Sukukholders shall not have legal ownership in any such Asset or Lease Assets.⁽¹¹⁾

There is, therefore, a need for more disclosure and better transparency to help investors make informed decisions. It is important to elaborate and more fully address sukuk assets and their legal ownership, while avoiding any conflicting clauses in order to comply with AAOIFI standard 5/1/8/3 on Investment Sukuk. That standard states:

The contract that forms the basis of the issue must be complete with respect to its elements and conditions and should not include conditions that conflict with its objectives and rules.

On the positive side, there has been noticeable progress with disclosure requirements in the industry. The Islamic Financial Services Board (IFSB) has proposed Guiding Principles on Investor Protection in Islamic Capital Markets as part of its Strategic Performance Plan 2012-2015. (12) On 18 September 2012, the IFSB, in collaboration with the International Organization of Securities Commissions (IOSCO) and the Malaysian Securities Commission, conducted a roundtable on disclosure requirements for Islamic capital market products. They discussed the importance of a strong disclosure regime in facilitating cross-border activity and the ways for collaboration between the IFSB and the IOSCO to address imminent issues concerning Islamic capital markets.

¹⁰ Source: Sukuk Prospectus – ADCB Islamic Finance (Cayman) Limited due 2016 - Issue Date: November 22, 2011

¹¹ Source: Sukuk Prospectus – Sime Darby Global Berhad due 2023

¹² Islamic Financial Services Industry Stability Report 2013

Conclusion

International and cross-border sukuk issuance is critical to strengthening the liquidity and price efficiency of Islamic financial markets. Global investors are looking for a more coherent understanding of contractual enforceability from both legal and sharia perspectives, and better disclosure with regard to a “true sale” and the underlying ownership of sukuk assets. There is a need for industry stakeholders, especially regulators and standard-setting institutions, to take more collaborative actions to standardize regulatory frameworks. This will provide the dual benefit of international confidence and strong legal backing to ensure investor protection.



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