Sukuk – An Alternative to Bonds
&
A Viable Liquidity Management Tool for Financial Institutions

by

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(1) Sukuk as a viable alternative to Conventional Bonds:

DEFINING SUKUK

- Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of a particular projects or special investment activity (AAOIFI).
- Sukuk are certificates that are backed by the underlying assets. These certificates are interest free and provide undivided beneficial ownership to the holder in the underlying assets which can be tangible as well as intangible.
  - Tangible: Sukuk Ijara with underlying real estate assets
  - Intangible: Sukuk Murabaha with receivables as underlying intangible assets
- Sukuk are the Islamic / Sharia Compliant alternative to conventional bonds

DIFFERENCES BETWEEN CONVENTIONAL BONDS & SUKUK

Subject	Conventional Bonds	Sukuk
Structure	Debt Contract	Any Sharia compliant structure contract such as ownership, ,partnership, lease, sales etc
Assets and utility of capital generated	No restrictions, profit maximisation is the main motive	Only halal assets are allowed. Capital can be invested only in permissible businesses
Returns	Fixed or floating rate of interest	Profits are generated through the underlying assets or projects
Guarantee of principal and Returns	Guaranteed by the issuer	Not guaranteed by the issuer
Trading	Based on sale of debt by discounting on the basis of time value of money	Based on the sale of the assets or the share owned in the project.

Sukuk VS Bonds: Comparison

- A bond is a debt financial instrument in which an investor loans money to an entity (typically corporates or governments) which borrows the funds for a defined period of time at a variable or fixed interested rate. The relationship between the bond issuer and the bond holders could be described as a borrower and a lender relationship.
- While a sukuk, the relationships between the parties are determined by the Sharia Contract used in their structure. The consequences are different from one structure to another.
- Sukuk are often refereed as Sharia – Complaint bonds.

SUKUK – MARKET GROWTH

- The sukuk market has been growing globally from both the issuers and investors aspect and has now become as integral component of the global capital market
- This Sharia-complaint bond structure used by both the government and corporates to raise funds.
- Investors who want to diversify their invest holdings are looking this fixed –income securities option to enjoy regular income.

DEMAND FOR SUKUK

- Sukuk is an investment financial instruments primarily used by Institutions, and High Net worth wealth individual investors because the maximum amount required is very high.
- Banks require Sukuk for:
  - Liquidity management – investment in case of excess liquidity and sell-off in case of shortage
  - Fund raising – cheap fund raising
- Insurance companies, pension funds asset managers, Sovereign wealth funds, etc. require Sukuk for long-term investments

PROFITS

- The return of sukuk may be similar to that of the conventional bonds.
- Profits in sukuk or interest in bonds is calculated annually.
- The differences lie in the generation of returns, that is, the process of profit generation.
- In the case of bonds the profit is interest either fixed or floating as agreed paid directly on cash. While in case of Sukuk profit comes the underlying assets or other business activities.
- In case of sukuk, the profit structure can be fixed or variable. For example if the under lying asset of a sukuk is a real estate, the rental proceeds can be variable. However, if the sukuk is based on buying and selling of goods, the selling price of the goods can be fixed thus making the sukuk profit fixed.

Repurchasing

- Both the bonds and sukuk are issued with an specific maturity dates.
- Upon maturity the issuers buys the bond back and the instrument is redeemed or retired.
- However, unlike the with conventional bonds, sukuk holders usually get their principal and profit in different ways depending on the underlying structure, for example.
  - In case of Sukuk Ijara, the obligor gives an undertaking to buy back the real estate assets from the investors and this constitutes the principal pay back while the rentals of the real estate assets are the profits;
  - In case of Sukuk Murabaha, the Sale Price of the Murabaha assets includes both the principal as well as profit

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Trading

- Secondary market trading of conventional bonds as well as Sukuk is on the basis of discounting
- However, the main difference between trading of bonds and trading of sukuk in the secondary market is that:
  - The conventional bonds are traded on the basis of discounting of debts,
  - While sukuk are traded on the basis of the sale of the underlying assets.
- Thus, in case of bonds, it is purely discounting of debt while in Sukuk the value of the underlying asset is discounted and not the debt. For example, discounting the value of real estate asset in case of Sukuk Ijara
- Hence, any Sukuk that represents debt cannot be traded in the secondary market, for example, Sukuk Murabaha.

DEMAND DRIVERS

- Prosperous and dramatically growth for the Islamic funds industry.
- An alternative source of funding since it is Sharia complaint and used as alternative conventional bonds.
- Drying up the syndication loans market. After the 2008 economy crises the syndication loans portfolio dried up and since the maintenance of the syndication loan is expensive than bonds, the sukuk issuance was alternative.
- Eurozone financial crises pushing investors and borrowers to other regions market.
- Asset based ownership and hence secured. These attract risk averse (strong dislike) investors.

(2) Sukuk – A liquidity Management tools for Islamic Financial Institutions in Africa of the Industry.

IMPORTANCE OF LIQUIDITY MANAGEMENT

- Liquidity is a financial institution’s capacity to readily meet its cash and collateral obligations at a reasonable cost. When it comes to managing their liquidity, conventional credit institutions have at their disposal well-developed interbank markets that can be tapped for short-term funding, as well as a plethora of instruments.
- Islamic financial institutions (IFIs) face great difficulties in managing their liquidity.
- The dearth of financial instruments at the disposal of IFIs makes for less efficient liquidity management, as more than necessary cash is held, thereby reducing their profitability.

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SUKUK FOR MEETING REGULATORY CAPITAL REQUIREMENTS

- Basel III is a regulatory framework on financial institutions capital adequacy, stress testing and market liquidity risk management.
- Basel III introduces two new ratios (liquidity coverage ratio and net stable funding ratio) that banks must maintain as a minimum at virtually all times to help ensure they maintain sufficient liquidity to withstand cash obligations even under stress.
- As Basel III requirements start to roll in from 2015, the deficiency of alternative Shariah compliant liquidity management tools and the absence of a developed Islamic money market, could adversely affect the operations of Islamic banks.
- The idea that Islamic financial institutions are immune to liquidity risk has proven to be wrong with the default of many Sukuk-oriented Islamic funds.
- Organizations such as IFSB are already revising their regulatory and supervisory rules in line with the Basel III framework.
- The magnitude of the impact will basically depend on other factors, such as the jurisdiction where the IFI operates and the nature of banking activities within each institution.

THE WAY FORWARD: RECOMMENDATIONS

The way forward

- To promote liquidity management, regulators and other Islamic finance market stakeholders need to work on:
  - ➢ Building a global robust, integrated cross-border liquidity infrastructure which includes a money market and secondary market – the International Islamic Liquidity Management Corporation headquartered in Malaysia and the Bahrain Liquidity Management Centre are a step in the right direction
  - ➢ A globally accepted legal and Shariah regulatory framework in order to standardize Sukuk rules and regulations.

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SUKUK EXAMPLES AFRICA CAN FOLLOW

- In order to address liquidity management issues, some central banks and government organizations have taken some initiatives. For example, Central Bank of Bahrain (CBB), Central Bank of Gambia (CBG), Bank Negara Malaysia (BNM), etc. have issued short-term Sukuk with small tenors.
- In this regard, CBB issues two types of short-term Sukuk, namely, Sukuk Ijarah and Sukuk Salam. While Sukuk Salam is issued at regular intervals
- CBB Sukuk, although issues in domestic market, has always witnessed full subscription, in fact, at times over-subscription.
- Central banks in Africa can also follow these examples. Gambia is already following by issuing Sukuk Salam in the domestic market at regular intervals
- The Republic of Djibouti has the potential to become the hub for Islamic banking, especially, in the sector of Sukuk.

THANK YOU!

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