

Q&A with Harj Rai & Lee Irvine

DEVELOPING SUKUK INTO A MODERN FINANCIAL INSTRUMENT

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Global sukuk issuances are expected to reach US\$175 billion in 2015, a 59 percent increase from 2014, and are projected to hit US\$250 billion by 2020 according to a study published by *Thomson Reuters*. The anticipated surge in issuances is attributed to the potential demand for sukuk surpassing supply.

With current constraints on liquidity in the banking sector likely to continue, we expect the sukuk market to be a key financing source for corporations over the next few years.

In this *lw.com* interview Latham & Watkins partner Harj Rai and associate Lee Irvine discuss the origins of sukuk and its evolution into a modern financial instrument.

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What is sukuk?

Rai: "Sukuk" commonly refers to Shari'ah-compliant financial products which seek to directly replicate conventional financial products while safeguarding principles of Islamic finance. Sukuk is often referred to as "Islamic bonds" owing to the fact that they are tradable securities that can be easily rated. Yet it is more accurate to equate sukuk with "Islamic investment trust certificates." Whereas bonds evidence a debt the issuer owes to the bondholders, sukuk certificates evidence the investors' ownership interest in the underlying sukuk asset, business, enterprise or project. This entitles the investors to receive a share of the income that the underlying asset generates.

When was sukuk first issued?

Irvine: Despite the fact that Islamic finance principles have existed since the founding of the religion itself, the first sukuk was not issued until 1990 — a 125 million Malaysian Ringgit sukuk issuance by Shell MDS Sdn Bhd. This issuance closely followed the statement from The Organisation of the Islamic Conference International Islamic Fiqh Academy (the Fiqh Academy), which approved sukuk trading and paved the way for the introduction of sukuk as a capital markets instrument.

Islamic Banks were established in the early 1970s but Shari'ah-compliant financial products were not a mainstream play until the 21st century, a time of unprecedented international growth in sovereign sukuk issuances by Malaysia, the State of Qatar, the Republic of Pakistan and the Emirate of Dubai.

What are the key Islamic Finance principles?

Rai: Sukuk must be structured in accordance with the principles of Islamic *Shari'ah*. These include: the prohibition of charging or receiving interest (*riba*); the assets or businesses underlying the sukuk must be Shari'ah-compliant (for example gambling and the sale or production of pork or alcohol are strictly prohibited); and the prohibition of intentionally induced uncertainty or unnecessary risk (*gharar*), whereby the transaction outcome is entirely dependent on speculation (*maysir*) and exploitation of ignorance (*jahf*). All rights and obligations relating to an investment certificate must be transparent and clear to be considered Shari-ah-compliant.

How has sukuk evolved to date?

Irvine: Shari'ah scholars and market participants have worked to develop structures that effectively replicate conventional financial products whilst remaining faithful to Islamic precepts. This development is still underway and continues to evolve as the management, arrangement or trading of sukuk becomes more global as the market expands.

Shari'ah scholars have arguably impacted investor confidence in the sukuk market. In late 2007 and early 2009, the sukuk market faltered slightly because of two distinct events: a debate which followed a divisive statement from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which questioned the Shari'ah-compliance of some sukuk structures; and the global credit crisis. The combination of these two events resulted in raising the cost of borrowing and a lack of investor commitment to, and confidence in, capital market securities.

These tough market conditions led many experts to revisit sukuk structures and realign them in accordance with the principles prescribed in the AAOIFI Statement, while at the same time ensuring that sukuk maintained equivalent economic characteristics of a conventional bond.

How will sukuk be structured in the future?

Rai: The events described above have resulted in an increasingly standardized sukuk market which favors three types of sukuk structure: *ijara*, *murabaha* and *mudaraba-wakala*. While greater standardization has been achieved, uncertainty with regard to Shari'ah-compliant structuring has not been eliminated. As more European and US institutional investors tap into the sukuk market, structures continue to be redesigned to better adhere to the AAOIFI principles whilst providing more flexibility with respect to the types of assets that can be used by adopting hybrid structures.

More Information

For more information and case studies on the development of sukuk and Shari'ah-compliant structures, [download the Sukuk Structuring Guide](#).

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