

## The future of *sukuk*

*Sukuk* in general market parlance refers to negotiable financial instruments that do not have elements that are prohibited in Islam. Formal definitions can be found in international standards such as in the *shariah* standard of the Accounting and Auditing Organisation for Islamic Financial Institutions (Aaoifi) as well as in local regulatory guidelines such as in the case of Malaysia issued by the Securities Commission of Malaysia. In the former, investment *sukuk* are described 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 whilst in the latter *sukuk* are simply defined as a document or certificate which represents the value of an asset.

Although often referred to as Islamic bonds, *sukuk* do not evince borrowing. One of the fundamental differences between a *sukuk* and a conventional bond lie in the underlying contract that gives use to the issuance of *sukuk*. Bonds are creatures of lending but *sukuk* is not premised on lending.

Arguably the most recent innovation in financial instruments *sukuk*, notwithstanding its religious roots, is not unlike any other financial instrument in that it is a produce created by market demand. Hence it is no surprise that *sukuk* too have evolved into many variant structures and continues to do so as dictated by market forces

These structures employ various Islamic contracts that are suitable for the financing required. Presently the choice of Islamic contracts is largely driven by the views on *shariah* on the acceptability of the structures employed and the ability of secondary trading of *sukuk*.

In Malaysia, the formal legal and regulatory framework for the issue of *sukuk* as well tax neutrality policies and incentives facilitate the issuance of *sukuk*. In addition, specific government policies relating to the promotion of Islamic finance, both domestic and internationally provides impetus in Malaysia. The Malaysia International Islamic Financial Centre is testament to this.

Since the first *sukuk* was issued in Malaysia in 1990, the variants of *sukuk* structures that had been issued have seen a broad spectrum of innovative structures such as *sukuk bai' bi'haman aji'* in 1990, *sukuk mudharabah* in 1994, *sukuk ijarah* in 2001, sovereign *sukuk* in 2002, *sukuk musyarakah* in 2005 and exchangeable *sukuk* in 2006. The *sukuk* structures themselves range from those that simply represent the payment obligations of deferred payment sales to more complicated

trust certificates with exchangeable features. For example the exchangeable *sukuk* breaks new ground in using intangibles in its structure. These Malaysia-originated *sukuk* have been successfully marketed globally and listed on international exchanges such as Luxemburg and Dubai.

With the increasing global demand for *sukuk*, it is no surprise that market demands have pushed certain variants of *sukuk* to have modified features that mirror conventional bonds. This has highlighted the risk of contradicting views on *shariah* compliance for certain *sukuk* structures.

For example, attempts to create *sukuk* with debt obligation features in spite of being premised on profit and loss parity have led to structures that embed additional purchase undertakings by the issuer or lending obligations to the issuer by an obligor in a particular manner which for certain contracts under the *shariah*, such as *musharakah* and *mudharabah*, could render these contracts questionable for *shariah*. The concerns raised to the *Shariah* Board of Aaoifi on these types of practices led it to issue a statement in 2008 with more detailed guidance on the *shariah* standards it had issued on *sukuk*. That statement issued may appear awkward since almost all *sukuk* issued had already been endorsed by *shariah* advisers. The statement emphasizes the need, in addition to the requirement of *shariah* advisers, for other advisers that are not only competent in their respective disciplines but also have a certain degree of understanding of the requirements of the *shariah*. In particular legal advisers play a key role to mitigate the inherent legal risks, including risks of *shariah* non-compliance in the structuring and documenting of *sukuk*, where a basic understanding of Islamic contracts may be insufficient to efficiently structure and document the *sukuk* as structures become more innovative.

*Sukuk* structures, being relatively new, hold great potential both in enhancing the efficiency of present structures as well as in the introduction of new ones. The new economic landscape makes *sukuk* even more relevant, with financial instruments that link relationships directly to real economic activities rather than just lending. With *sukuk* documentation just beginning to be tested in financial stresses, pushing innovation on *sukuk* provides the legal practitioner with new challenges in exciting times.

Andri Aidham

Kadir, Andri & Partners,  
8<sup>th</sup> Floor, Menara Safuan,  
80, Jalan Ampang,  
50450 Kuala Lumpur,  
Malaysia.

T : +6 03 2078 2888  
F : +6 03 2078 8431  
E : [partner@kaaplav.com](mailto:partner@kaaplav.com)  
W : [www.kaaplav.com](http://www.kaaplav.com)