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CONCEPTUAL AND STRUCTURAL DIFFERENCES BETWEEN CONVENTIONAL BONDS AND ISLAMIC *SUKUK*

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ABSTRACT

Often times, Sukuk securities are described similar to conventional bonds. The financial press and mass media name Sukuk as Islamic Bonds. Sukūk structures are designed based on the purpose and conditions of financing needs and are not (as in conventional borrowing) general purpose borrowing. Therefore, sukūk is a financial instrument with complex characteristics. Considering conceptual characteristics and structural procedure of Sukuk, this paper investigates differences between conventional bonds and Islamic Sukuk. Moreover, the three instruments of the Sukuk contract (mushārakah, murābahah and ijārah) are carefully examined. This paper clarifies that Sukuk and conventional bonds are legally distinct and have different structures.

Keywords: *Sukuk, Conventional Bonds, Islamic Capital market, Interest-Based Borrowing.*
JEL Classification: *G1, G12, R53, H74*

I. INTRODUCTION

Interest is prohibited in Islam and so is risk free investment. Islamic finance enjoys an exponential growth of 15-20 percent a year and there is little evidence to believe that this growth will slow down in the near future. Islamic finance is the fast growing segment of global finance in the world. *Sukuk*, for instance, has shown a tremendous growth since its global appearance in 2002. The first *Sukuk* instrument worth US$ 6oo million was issued by Malaysian government in 2002. This issuance of *sukuk* was followed by other countries such as Qatar in 2003 and Pakistan in 2005. After *sukuk* is being issued by several countries, it gained momentum with widespread acceptance and popularity in the global investment scene. Despite the ever increasing growth of Islamic finance industry, many practitioners and academicians are still unfamiliar with the process and structure of Islamic capital market (and hence *Sukuk* securities). This leads to a major strategic shortcoming especially in non-Muslim countries.

Sukuk and bonds are two kinds of financial instruments; despite their differences, they share similar responsibility of fund mobilizing from surplus (spending) units to shortage units. *Sukuk* can resemble conventional bonds by some of its features, but it is technically neither debt nor equity. It is complex to understand the exact nature of *Sukuk* and differentiating them from bonds (Jemal yousaf 2014). The purpose of this paper is indeed clarifying the difference between the concepts and structures of conventional bonds and Islamic *Sukuk*. It is necessary to present a conceptual framework of *Sukuk* first.

II. RESEARCH METHODOLOGY

This is an exploratory research. It is a research when a study is undertaken with the objective either to explore an area where little is known or to investigate the possibilities of undertaking a particular research study (Ranjit Kumar 2011). When used as a research methodology, a literature review identifies, analyzes and synthesizes available relevant research to a particular question or topic (Kitchenham 2004). Therefore, an extensive amount of existing literature is reviewed, summarized and synthesized and the results are reported at the end of the paper in the form of conclusion.

III. LITERATURE REVIEW

Conceptual Framework of Conventional Bonds and Islamic Bonds (Sukuk)

Over the last three years, Islamic finance industry had grown by more than 15 percent. This happened in response to a profusion of investment products fueled by an increasing demand for *Shariah* compliant investments (Andreas and others 2008). Islamic securities has become increasingly popular over the last three years as a mean of raising government finance (through sovereign issues) and as a way of companies obtaining funds by issuing corporate *Sukuk* (Wilson 2008). In place of debt, Islamic finance introduces securitized "asset-

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linked" securities. The key difference between conventional securitization and asset securitization in Islamic finance is the end investor's ownership rights, or access, to the securitized assets (Askari 2012). Following are the key conceptual differences between *Sukuk* and conventional bonds.

Sukuk

Sukuk is the plural form of *Sukk* which in Arabic means legal instrument, deed or check (Safari 2013). *Sukuk* are entitlement scrips with each *sukk* (scrip) representing a fractional ownership in an underlying asset or project (Jabeen and Jawed 2007). In may 2003, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) officially defined *Sukuk* in the standard for investment *Sukuk* as certificates of equal value representing undivided shares in ownership of tangible assets (J.Godlewski and others 2011). Although *Sukuk* are sometimes called Islamic bonds, but the correct translation of the Arabic word "*Sukuk*" is Islamic Investment Certificate (Tahmoures and others 2013). *Sukuk* is a standard Arabic term used for securities or bonds structured according to the principles of Shari'ah and are referred to as Islamic trust certificate, Islamic bonds or Islamic debt security (Ahmed and others 2014). Modern *Sukuk* are better described as Islamic Investment certificates and should not necessarily be regarded as a substitute for conventional interest-based securities. The reason is not to engineer financial products that mimic fixed rate bills and bonds as understood in the west, but to develop innovative types of assets complying with Islamic law (2008 Wilson). Sukuk are backed by an ownership share in an asset or business project, and the earnings generated by that project are paid to the Sukuk holder (investor) in the form of a periodic profit distribution (Lackmann 2015).

Shariah Compliance

The emergence of a unique capital market, where compliancy to *Shariah* principles is given priority, is the product of a natural progression in the growth of Islamic financial services industry (Arshad and Rizvi 2013). Islamic finance is driven by the general precept of extending the tenets of the religious beliefs in *Shariah* to financial agreements and transactions.

Shariah law strictly prohibits the sale and purchase of debt contracts, taking profit without any economic activity as well as activities that are not considered *halal* (*Shariah'*-compliant) (Jobst and others 2008). The principle of *Shariah* compliance does not apply to the conventional bonds. Furthermore, with the issuance of *Sukuk*, an item is bought or financed in such a manner that each investor contribute a certain amount to its price and operations, and in turn becomes owner of the proportion contributed, by holding the *Sukuk* scrips of that value (Jabeen and Javed 2007). The underlying assets have to be real assets (*Shariah* standard 1424-5H/2003-4). *Sukuk* or often referred to as Islamic bonds or Islamic investment certificates similar to conventional allowing sovereign and corporate entities to raise funds in capital markets but following the principles of *Shariah* which is the Islamic legal code (Haron and Ibrahim 2012).

Liquidity Management

In the past, the funds were placing through the inter-bank market on a *murabaha* basis with firms that could sell and buy goods on their behalf, usually by the London metal exchange (Essia Ries Ahmed and others 2014). Prior to *Sukuk* availability, placing funds through inter-bank market on a *murabaha* basis were the only means for Islamic banks to obtain a return on liquid reserves (Rodney Wilson 2008). *Murabaha* is a mark-up payment viewed legitimate by *Shariah* scholars because it is based on real trading transaction rather than being simply a return on a monetary deposit. Consequently; with the advent of *Sukuk*, although Malaysian market can be regarded liquid as the volume of secondary trading in Gulf countries is minimal, there are more diversified possibilities for liquidity management. The reason for this possibility is that the demand exceeds supply and Islamic banks that acquire *Sukuk* usually hold them till maturity and it turns to be reluctant to sell them (Abbas 2005).

Prevention of Speculation

Islamic law generally encourages commercial activities based on honesty. Meanwhile, it forbids certain types of commercial behaviours that are commonplace in other parts of the world. Most importantly, *Shariah* forbids the exchange of interest or *riba*. Additionally, Islamic law does not allow the Muslim faithful to undertake a speculative level of risk known as *Gharar* (Abdel-Khaleq 2007). Speculation is facing high degree of uncertainty which cannot be calculated. However; investors always calculate risk with return receipt. In Islam, speculation is prohibited not only because of uncertainties that exist for investors, but also the intentions and the way people use these uncertainties (Pasaribu 2015).

To summarize, conventional bonds are financial obligations, in the form of certificates, issued by borrowers to creditors. They have guarantee feature in which creditors guarantee capital payment with capital charge to the borrowers. The primary objective of conventional bond is to gear up the issuer's leverage through a loan

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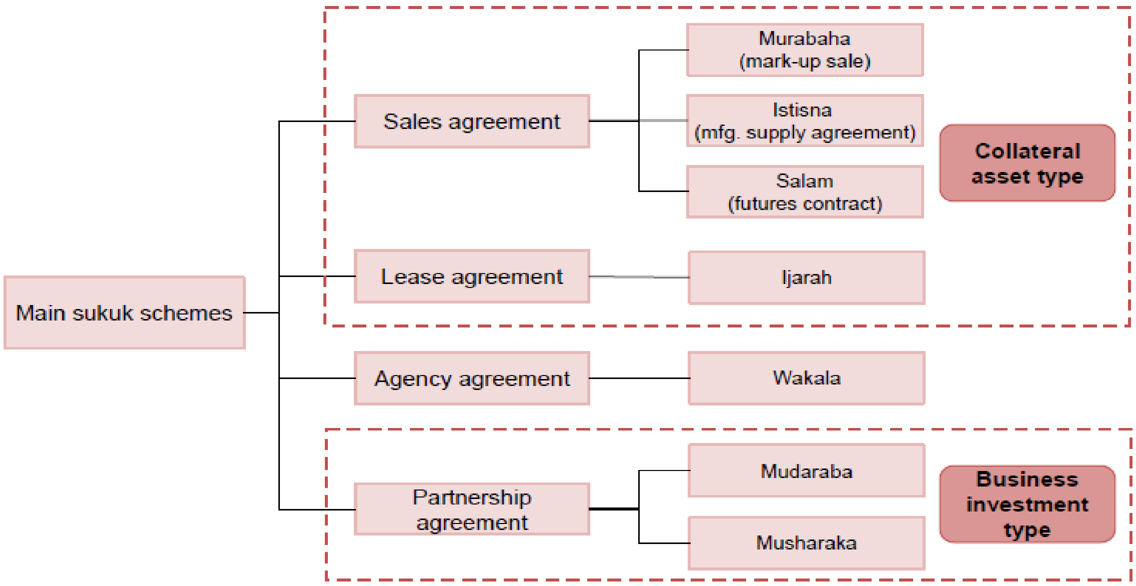
relationship; this loan relationship implies a contract with the characteristic of earning money on money. This practice is known as *riba* and is prohibited in Islam (Adam and Thomas 2004).

In contrast, *Sukuk* represents asset ownership passed from the issuer to *Sukuk* holders in the form of *Shariah* compliant contract such as lease, partnership or sale contract which originates from business and trade activities. The return can be either derived from underlying asset attached to *Sukuk* or from sales, lease or partnership or business ventures, which characterizes *Sukuk* as an asset based financing instrument. It is important to note that *Sukuk* are not always debt instruments, but sometimes equity instruments depending on how they are structured (Nazar 2015). The risks associated with *Sukuk* are broader than conventional fixed income instruments that they involve not only credit risk, but also market risk, asset quality risk, regulatory risk and so forth (Zaidi 2009). While *Sukuk* represents a share in the project, business or joint venture, the conventional bonds merely represent a share in the total debt (Jamaldeen 2012). Moreover; instead of paying a fixed annual interest, the payouts to investors over the life of *Sukuk* come in the form of lease payment, profit from the sales of tangible assets, or profit from a joint venture business, depending on the type of *Sukuk* (Yasnida and Minai 2009). Maysam Safari, while measuring yields on *Sukuk* and conventional bonds, used Granger causality tests to confirm whether *Sukuk* and conventional bonds are equivalent. According to him, if the yields of *Sukūk* are the same as those of conventional bonds, Granger causality tests could confirm their equivalence. Practically the tests showed otherwise. The yields of *Sukūk* instruments were significantly higher than yields of conventional bonds even after controlling issuers, rating quality and tenure in matched samples tests (Safari and others 2013).

Structural Differences Between *Sukuk* and Conventional Bonds
Unlike conventional bonds with fixed coupon payments, s*ukuk* are structured as participation certificates that provide investors with a share of asset returns making them compatible with the Islamic prohibition of interest payments (Haron and Ibrahim 2012). Although many *Sukuk* structures are designed to replicate the economic function of conventional bonds, their legal structures are different (Hassan and Kholid 2009). The specific contract of exchange of *Shariah*-compliant asset will determine the *sukuk* structure. Such contracts can be made through the sale and purchase of an asset based on deferred payment, leasing of specific assets, and participation in joint-venture businesses or agency-based (Shahida and Sapiyi 2013) .The following part therefore explains three *Sukuk* Structures. Although the explanation of the types of *Sukuk* is beyond the scope of this paper, a diagrammatic representation of the types of *Sukuk* is presented in figure 1.

Figure 1 : Types of *Sukuk*



Source: Nomura Institute of Capital Markets Research

Meysam Safari (2013) classifies types of *Sukuk* based on their underlying contractual structures into three categories namely pure debt-based *Sukuk*, Equity-based *Sukuk* and Asset-backed *Sukuk.* This classification is shown in figure 2 below.

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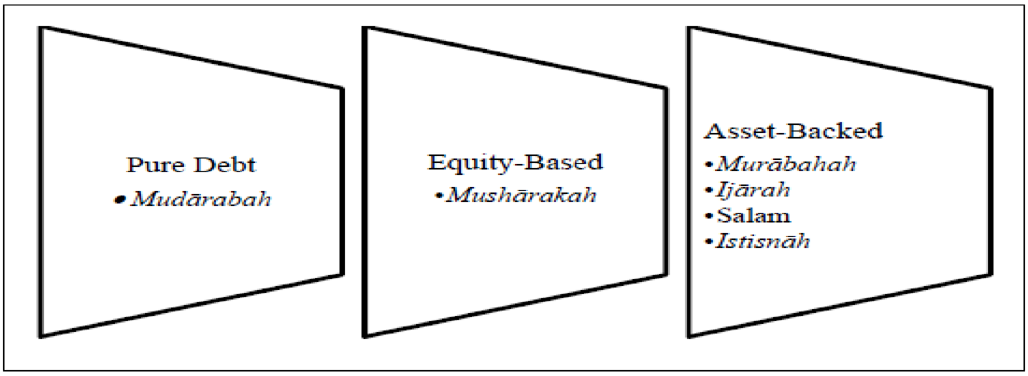
Figure 2: Types of Sukuk based on their underlying contractual structure

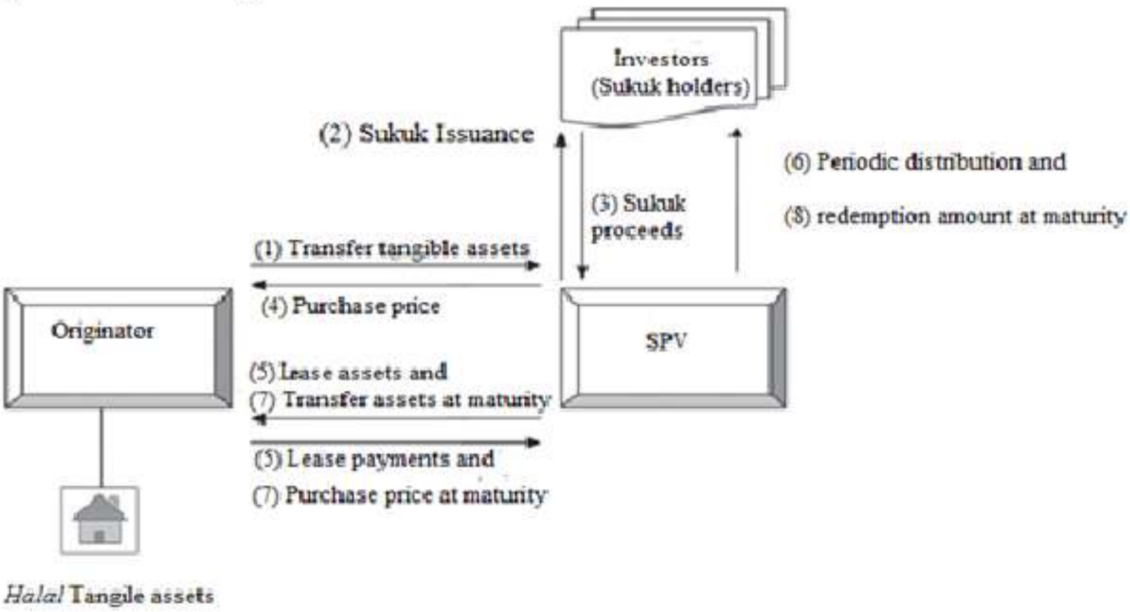


Source: Meysam Safari (2013)

Sukuk Al-Ijara Strucure

Sukuk Al-ijara structure is based on the contract of *Ijara* (Iqbal amd Mirakhor 2006). *Ijara* is a contract which allows the transfer of usufruct of an asset in return for rental payment) which is similar to the lease contract. *Sukuk* are based on the underlying tangible assets that the special purpose vehicle (SPV) has acquired rather than being debt securities (HM revenues and customs 2008). Instead, *Sukuk al ijara* structure uses the leasing contract as the basis for the returns paid to investors, who are the beneficial owners of the underlying asset and as such benefit from the lease rentals as well as sharing in the risk (Saaed and Salah 2014). Figure 3 explains *Sukuk Al-ijara* structure.

Figure 3 : ***Sukuk Al-Ijara***



Source: Saeed and Salah 2014

Sukuk Al ijara contract starts with a party who needs financing; this party is referred as originator in this case. The originator establishes a special purpose vehicle SPV, a separate legal entity with the sole purpose of facilitating this transaction. The SPV then purchases certain tangible assets from the originator at an agreed predetermined purchase price; this price will be equal to the principal amount of the *Sukuk*. In order to finance the purchase of the assets, the SPV issues *Sukuk* to *Sukuk* holders. These *Sukuk* holders are investors who are looking for *Shari'ah*-compliant securities. The SPV uses the *Sukuk* proceeds to pay the originator the purchase price of the tangible assets. The SPV will also declare a trust over the tangible assets and hold the assets as a trustee for the *Sukuk* holders being the beneficiaries. Then the originator and the SPV will enter into a lease agreement for a fixed period of time, which is the *ijara* agreement (Saeed and Salah 2014).

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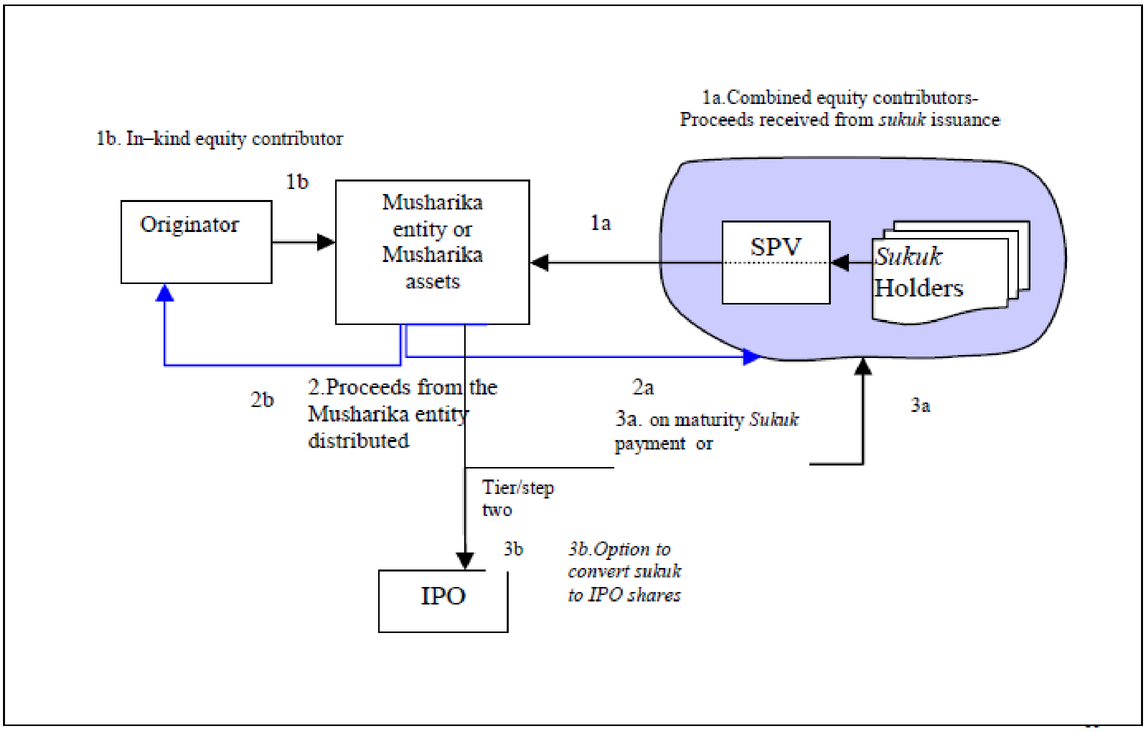
Under this lease agreement, the SPV (lessor) leases the assets back to the originator (lessee). Consequently, the SPV receives periodic rentals from the originator for the use of the underlying tangible assets. The SPV uses these amounts to pay the periodic return to the *Sukuk* holders, since they are entitled to these payments as the beneficial owners of the tangible assets. The lease payments from the originator to the SPV and the periodic payments from the SPV to the *Sukuk* holders will continue until maturity date. At maturity date, the originator purchases the assets back from the SPV at a predetermined value pursuant to a purchase undertaking. The originator becomes the legal owner of the assets and pays a purchase price equal to the initial purchase price of the assets and, thus, also equal to the principal amount of the *Sukuk*. Hence, the SPV can pay the *Sukuk* holders their principal amount back, which allows the *Sukuk* certificates to be redeemed.

Musharaka Sukuk (Sukuk based on equity participation)

In *Musharaka Sukuk*, the *Sukuk* have an element of *Sharikat-ul-Aqd* or *Sharikat-ul-Milk* at the initial stage and yet others have a conversion into equity (Jabeen and Tariq 2007). According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shariah* standard No.12, *Musharaka* or *Sharikat-ul-Aqd* means contractual ownership. *Sukuk* based on the concept of *Musharaka* are called "*Musharaka Sukuk*".

Figure 4: *Musharaka Sukuk*



Source: Jabeen and Tariq 2007

In a *Musharaka Sukuk* structure, the originator forms an independent Special Purpose Vehicle (SPV) for the purpose of floating the *sukuk* and for managing a project, a *Musharaka* entity or *Musharaka* assets. The SPV issues *sukuk* certificates for the purpose of *Musharaka*-based participation in the project. The proceeds of the *sukuk* are used as the equity contribution of the SPV (and *sukuk* holders), along with the (usually) in-kind contribution of the originator in the *Musharaka* project or entity. The *Musharaka* entity is managed separately from the main business of the originator. However, if the expertise of the originator is required, the originator serves as manager and agent of the partners too.

The proceeds (profit and loss) from the business are shared among the originator and the SPV on the basis of a pre-agreed ratio and terms of the contract. The SPV further distributes the proceeds among the *Sukuk* holders on the basis of the terms of the contract. At the end of the *Sukuk* term (maturity) which usually coincides with the maturity /or completion of the *Musharaka* business/project, the project is wound up and the proceeds distributed and sold according to the terms of the contract. If it is a two tiered *Sukuk*, the option to redeem or convert *Sukuk* into IPO shares according to the terms given, is available to the *Sukuk* holders.

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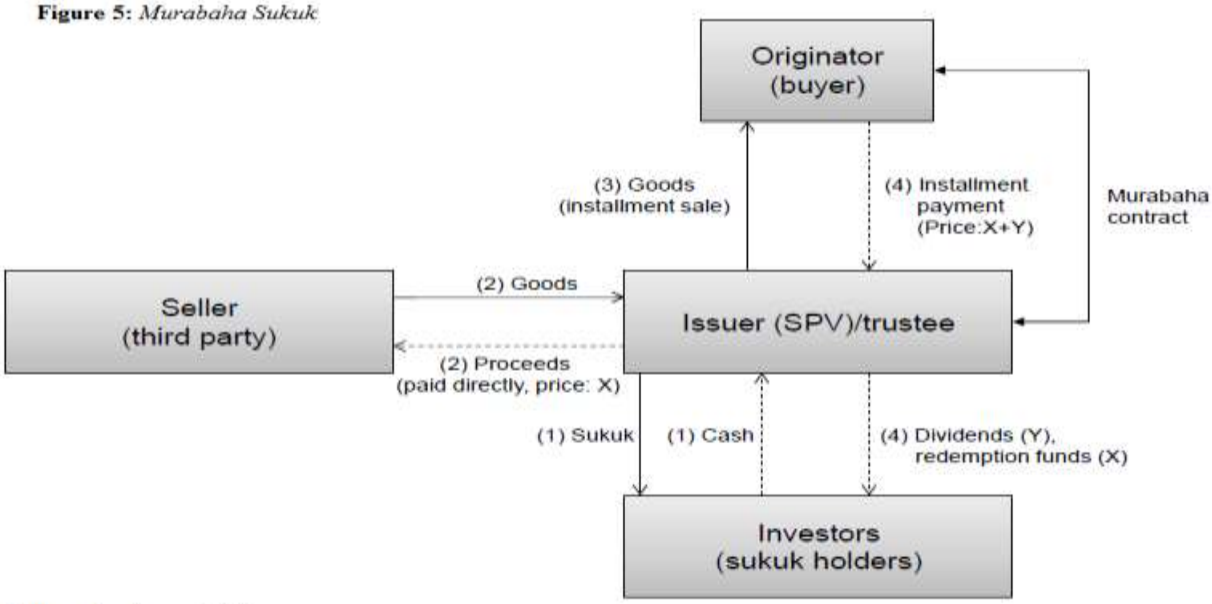
This provides a further opportunity to the *Sukuk* holders to avail an equity conversion facility, usually at rates, that are better than the market rates at that time. To re-iterate, if the *Musharaka* business is such that it cannot be wound up, or the originator wants to continue running it, it is only feasible to launch an IPO or ascertain its value at which the originator can purchase the contribution made by the *Sukuk* holders. Example of the above-mentioned *Musharaka* based *Sukuk* include the PCFC (Dubai Ports) *Sukuk* (i.e. The PCFC Development FZCO *Sukuk* of Dubai**,** issued on 23rd January 2006), a combination of pre- IPO (Initial Public offering) along with the *Musharaka sukuk* structure; Caravan 1 Limited (2004) a two- tier structure with *Sukuk* and redeemable participatory shares issued involved securitization of Automobiles (Inventory), as well as two SPVs in two different jurisdictions (Jabeen and Iqbal 2007).

Murabaha Sukuk

Figure 5: *Murabaha Sukuk*



Source: Lackmann 2015

As shown above, in case of *Murabaha Sukuk*, a special purpose vehicle (SPV) is established and at the same time a *Murabaha* contract is signed with the originator who wants to buy the product. All the essential terms and conditions are determined ahead of time. The *Sukuk* is issued afterward. The SPV acts as a trustee for investors and uses the funds obtained for purchasing (in cash) the product demanded by the originator. SPV then resells the product to the originator at the predetermined mark up price (Bedi Gunter 2015). This in turn funds the dividends paid to investors. In fact, this dividend is not interest generated by debt but profit generated from the sale of the product and is thus considered *Shariah* compliant.

IV. CONCLUSION

The differences between *Sukuk* and conventional bonds lie in the very nature or purpose of funding as well as the way *Sukuk* is structured. In case of *Sukuk,* income is generated from the assets. Whereas; in conventional bonds, income (scheduled and often fixed) is generated from debt instrument. Dislike conventional bonds in which the issuer is a borrower, in *Sukuk,* the issuer is a seller of assets. Moreover; in case of *Sukuk,* there is a seller-buyer relationship but in case of conventional bonds there is a lender-borrower relationship. The return in case of *Sukuk* is "expected return" but in case of Bonds, it is pre-determined. In addition, in case of *Sukuk*, *Sukuk* holder is considered the owner of assets whereas, in case of conventional bond, the bond holder is a lender. As for as the risk management is concerned, the major risk in case of Sukuk lies with underlying assets but in case of conventional bonds, the major risk (credit risk) lies with the issuer of the bond. The face value of a conventional bond is based on the credit worthiness (including its rating) of the issuer. But the face value of *Sukuk* is based on the market value of the underlying asset. Bonds can be used to finance any project, business, asset or joint venture that complies with the local legislation. But the assets on which *Sukuk* are based (underlying asset) must be *Shariah*-compliant. In fact, Sukuk holders can be affected by the costs related to the underlying asset and so higher costs will lead to lower investor profits. But conventional bond holders are generally not affected by the cost related to the business, project, asset or joint venture.

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