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LOCAL News

Issuance of Sukuk landmark towards Islamic Capital Market in Brunei

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His Majesty delivers the titah on the eve of Hari Raya. Sultan announced Brunei will issue short term Islamic bonds early next year.

The successful development of a robust and resilient Islamic financial system depends on the ability to integrate the various components of the Islamic financial system that includes the Islamic banking industry, takaful and the money and capital markets. Of equal importance is also to integrate the domestic Islamic financial system with the international financial system. Islamic banks and takaful in Brunei Darussalam are quite successful in controlling a substantial percentage of the total deposits in the country. Since early 1990s, we have witnessed the success of the development of Tabung Amanah Islam (TAIB), Islamic Bank Brunei (IBB), Islamic Development Bank Brunei (IDBB) and Takaful companies such as Takaful Bank Pembagunnan Islam, Insurance Islam TAIB, Takaful IBB; have contributed to the rapid expansion in the Negara Brunei Darussalam's a comprehensive Islamic financial system.

On the occasion of Aidilfitri, His Majesty the Sultan and Yang Di-Perutan of Brunei Darussalam in a titah disclosed the government plan to establish an Islamic capital market in the country. *Sukuks* are a valuable part of this vision and Islamic capital market will be initiated through the issuance of the *"sukuk al -Ijarah"* early next year in order to build stability into the Islamic financial system.

Indeed, what is a sukuk? An Islamic bond which is structured by bundling leasing transactions but behaves in practice like any highly-rated bond. The reason for the excitement is rather longer. Firstly, *sukuk* brings a new source of funds, generally at attractive rates. And secondly, it is vital to developing deeper and more liquid Islamic capital market. There is a great deal of surplus cash sitting in Islamic financial institutions waiting to be tapped by new financial instruments. *Sukuks* can allow this pot of gold to be unlocked. If the *Sukuk* can be competitively structured according to the *Syariah law* and a market for these is developed in Brunei, the economy will largely be benefitted. In this regard, we will discuss the Islamic *Sukuk* structures and its Islamic features, which differ from a conventional bond or securities.

Structures of Sukuk

The *Sukuk* products are asset-backed, stable income, tradable and *Syariah* compatible trust certificates. The primary condition of issuance of *Sukuk* is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institutions or any entity which wants to mobilise the financial resources. The identification of suitable assets is the first, and arguably most integral step in the process of issuing *Sukuk* certificates. The Syariah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts (e.g. *Murabaha*, *Istisna*).

Types of Sukuk

The proper classification of the asset classes will also determine the type of certificates to be issued. It is imperative to note that these assets can be prepared for the issuance of trust certificates in a number of ways conditional to the need of the issuing entity.

(1) Pure Ijarah Sukuk

This certificate is issued on stand-alone assets identified on the balance sheet. The assets can be parcels of land to be leased or leased equipment such as aircrafts and ships. The rental rates of returns on these *sukuk* can be both fixed and floating depending on the particular originator.

(2) Hybrid/Pooled Sukuk

The underlying pool of assets can comprise of *Istisna*', *Murabahah* as well as *Ijarah*. Indeed, having a portfolio of assets comprising of different classes allow for a greater mobilisation of funds. *Murabaha* and *Istisna* assets can comprise a portfolio of funds. However, still at least 51 per cent of the pool must comprise of *Ijarah* assets. Due to the fact the *Murabahah* and *Istisna'* receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

(3) Variable Rate Redeemable Sukuk

The above-mentioned two types of *sukuk* would partially represent the strength of the issuer's balance sheet. Under some conditions, implementing *sukuk* by representing the full strength of an issuer's balance sheet can prove to be beneficial. Several corporate entities refer to these *sukuks* as Musharakah Term Finance Certificates (MTFCs). This can be considered as an alternative to *sukuk* because of its seniority to the issuer's equity, its redeeming nature and its relatively stable rate as compared to dividend payouts. MTFCs have a few advantages. First, employing Musharakah returns is preferred from the viewpoint of jurists as such an arrangement would strengthen the paradigm of Islamic banking that considers partnership contracts as the embodiment of core ideals. Secondly, the floating rate of return on these certificates would not depend on benchmarking with market references such as LIBOR but would instead be contingent on the firm's balance sheet actualities.

(4) Zero-coupon non-tradable Sukuk

Another possible classification of *sukuk* structures can be created where the assets to be mobilised do not exist yet. Consequently, the objective of the fund mobilisation would be to create more assets on the balance sheet of company through *Istisna'*. However, certificates of this nature would not readily be tradable because of Syariah restrictions. The primary asset pools to be generated would be of the nature warranted by *Istisna* and installment purchase/sale contracts that would create debt obligations. The certificate on these debt arrangements can be termed as fixed rate zero coupon *sukuk*.

(5) Embedded Sukuk

These could be sukuk whether zero-coupon, pure-Ijara or hybrid, with the embedded option to convert into other asset forms depending on specified conditions.

In response to the emergence of interest in issuances of Islamic asset-backed financial instruments, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) released an exposure draft of its Syariah standards concerning *sukuk* in November 2002. According to the exposure draft: "Investment sukuk are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs, and services, or equity of a given project or equity of a special investment activity."

Recent Developments of Sukuk Markets in the Islamic Countries

The *sukuk* market has emerged during the previous four years. First of all Bahrain issued domestic sovereign fixed-rate *Ijarah* and *Salam sukuk*. It was followed by the issuance of floating rate *Ijarah sukuk* as well as *pooled sukuk* by both corporate bodies and sovereigns in several countries. These *sukuk* are based on *Salam, Ijarah, Istisna, Istisna-cum-Ijarah* and on the basis of pooled portfolios.

The present size of the market of the *sukuk* is estimated to be over US$4.5 billion growing at a rate of more than 90 per cent. This estimate does not include the amount of the Malaysian domestic Islamic debt issues and the Bahraini *Salam sukuk* issues. The *Salam sukuk* of Bahrain are monthly issues and are non-tradable. So far more than 45 issues of these *Salam sukuk* have been made, each one of them oversubscribed. Indeed, the largest issuance as of this writing is the $750 million mandate awarded to Dubai Islamic Bank in June 2004 by the Department of Civil Aviation (DCA), UAE, to raise funds for the expansion of the Dubai International Airport. The relatively low number of issues had inhibited overall liquidity in the markets as investors were inclined to hold on to their investments. With the growing number of larger corporate issues being listed, however, *sukuk* secondary markets can look forward to increased trading and activity.

Market of Sukuk in the Global Aspects

The market for *sukuk* has injected a much-needed scope for liquidity management in Islamic banks. Previously, such liquidity could only be secured through continuous *Murabahah* transactions. In a global market where conventional finance dominates, liquidity could only be acquired by transactions limited to specific Syariah acceptable commodities such as industrial goods, metals and oils. The process of issuing *sukuk* certificates allows Islamic financial institutions to garner a much wider asset pool that were previously either inaccessible or inefficient.

However, some of the corporate and sovereign *Sukuk* prospectuses have come under increased scrutiny for their *Shari'ah* suitability. The predominant feature of several of the prospectuses is the floating rate return distributed to the certificate holders. The market reference used is the London Inter-bank Offer Rate (LIBOR) over which a competitive premium is added. However, it should be observed that in the case of the *Ijarah sukuk* arrangements, LIBOR serves as a market reference for the returns and the intrinsic distributions arise from the rentals pertaining to the leasing arrangements with the originator and special purpose vehicle (SPV).

The *sukuk* issuance by the Islamic Development Bank, Jeddah serves as an excellent and promising example for future arrangements. The prospectus of the IDB, Jeddah contained clear and precise *Syariah* considerations outlined by numerous leading scholars and it involved an innovative portfolio combination of *Ijarah*, *Murabaha* and *Istisna* projects. Also, returns were not ambiguously related to market benchmarks but were agreed upon a fixed rate of return on the relevant contracts and assets. One dimension of the paradigm of Islamic finance that should not be lost upon compromises for increased profitability is altruism. In this regard, the *sukuk* prospectuses have not only mobilised previously untapped public sector funds but have also introduced long sought funding for development projects. The Qatar Government issued *sukuk* to fund a large medical complex (Hamad Medical City) in Doha and the Malaysia *sukuk* certificates raised funds for several government owned hospitals as well as offices.

Incidentally it may be mentioned here that most significantly, the Islamic Development Bank (IDB) *sukuk* prospectuses raised funds for projects in 21 developing nations in a wide range of schemes that included power transmissions, hospitals, steel manufacturing, mineral water networks, livestock breeding, sea port development, pharmacology research, agricultural irrigation, telecommunications projects, rural development and colleges.

Islamic Features at the Sukuk Structures

The *Sukuk* certificates serve to replicate the functions of tradable securities in resources mobilisation from markets and injecting liquidity into the enterprise or government and in providing stable resource of income for investors. The s*ukuk* bears the financial risk and it distinguishes from conventional bonds and asset securitisations in several ways:

Conventional investors in corporate and government bonds hope to capitalise on favourable developments in interest rates. Capital gains are accumulated when fixed-rate bond prices rise as variable market indices fall. The legitimacy of s*ukuk* structures in the Syariah lie in the fact that they do not take advantage of interest rate movements.

Investing in *sukuk* issuances involve the funding of trade or production of tangible assets. *Sukuk* are directly linked with real sector activities. Hence these will not create short-term speculative movement of funds and potential financial crises.

Sukuk investors have an inherent right to information on the use of their investments, nature of the under-lying assets, and other particulars that would otherwise be considered redundant in conventional investments. This will help to introduce discipline in the market.

The establishment of an Islamic capital market in Brunei, where investment and financing activities and products are structured in accordance with *Syariah* principles, will be the outcome of a natural progression in the growth of the Islamic financial services industry. It is expected that the Islamic form of product structuring, project financing, stock brokering, asset management and venture capital services will be increasingly made available in the coming years in Brunei Darussalam.

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