Innovation in the structuring of Islamic sukuk securities

Rodney Wilson
School of Government and International Affairs,
Institute for Middle Eastern and Islamic Studies,
Durham University, Durham, UK

Abstract

Purpose – The purpose of this paper is to provide an analysis of different sukuk structures from a financial perspective. This examination includes murabahah and ijara-based sukuk, the former offering a fixed return, and the latter, the most popular form of sukuk, a variable return. The potential for other more novel sukuk structures based on musharakah partnership contracts is also examined, and sukuk pricing issues are explored using alternative benchmarks to London Inter-bank Offer Rate.

Design/methodology/approach – Flow charts are used to illustrate the financial transfers and the rights and obligations of sukuk investors as well as the beneficiaries of the funding. Historical data have used to assess whether the payments flows are more stable in the case of sovereign sukuk where the returns are based on gross domestic product (GDP) growth rather than interest.

Findings – The paper finds that special purpose vehicles are a prerequisite for the successful issuance and management of sukuk. The use of GDP-based pricing benchmarks would have resulted in greater payments stability for sovereign debt in Saudi Arabia, but not for Malaysia.

Research limitations/implications – The data analysis was restricted to two countries, but this could be extended. Alternative pricing benchmarks were suggested for sovereign sukuk but not for corporate sukuk.

Practical implications – Ministries of Finance and Central Banks of Muslim countries should review their debt financing policies and explore the potential of sovereign sukuk.

Originality/value – Little has been written previously on the use of musharakah partnership contracts for sukuk, and pricing issues have not hitherto been systematically investigated.

Keywords Islam, Securities markets, Liquidity, Malaysia, Saudi Arabia

Paper type Research paper

Introduction

Islamic securities have become increasingly popular in over the last five years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through the offer of corporate sukuk. In 2000 there were only three sukuk worth $336 million issued, but in 2004 there were 64 issues worth almost $7 billion, and in 2005 the figure will certainly exceed $10 billion with 54 issues already either fully subscribed or announced[1].

The advantage of sukuk is that they are compliant with shariah Islamic law (Wilson, 2004). Sukuk are therefore attractive investment instruments for Islamic banks, takaful Islamic insurance companies and shariah managed funds that cannot invest in conventional securities that involve payment of riba or interest. In addition there are an increasing number of Muslims of high net worth who want their asset holdings to comply with Islamic law.

Aims and objectives

The paper examines the market for, and usage of, sukuk, notably as tools for liquidity management. There is also an analysis of different sukuk structures from a financial perspective. This examination includes murabahah and ijara-based sukuk, the former offering a fixed return, and the latter, the most popular form of sukuk, a variable return.
The potential for other more novel *sukuk* structures based on *musharakah* partnership contracts is examined, which would offer different types of financial risk, and could be attractive for portfolio diversification.

The major criticism of *ijara sukuk* is that the return is usually benchmarked to the London Inter-bank Offer Rate (LIBOR) on $US dollar funds or the equivalent local rate in the case of issues in Malaysian ringgit. This is of course an interest rate, and although it is only used for pricing, and the payments associated with the *ijara* can be regarded as rents, the close link of the interest-based pricing with *riba* worries many *shariah* scholars (Usmani, 2002). In the paper alternative benchmarks based on real rather than monetary indicators are considered as a means of overcoming this problem. Macroeconomic indicators could be used for sovereign *sukuk*, and company performance indicators for corporate *sukuk*. Data on these variables is used for simulations of possible returns, so that these can be compared to the returns using interest-based benchmarks.

**The market for *sukuk***

So far *sukuk* issues have been largely confined to the Gulf countries and Malaysia, with the latter accounting for the overwhelming number of issues as Table I shows, although the amounts are significant in the Gulf where the average size of each issue tends to be larger (Wilson, 2005). The data for Table I relates to the period from January to September 2005, and since then there have been some very large issues in the Gulf, notably the $1 billion issues for the Civil Aviation authority of Dubai to fund the new terminal at the international airport, and the issuance of the largest ever Islamic *sukuk* security offering valued at $2.8 billion. This offer is by the Ports, Customs and Free Zone Corporation of Dubai, the holding company of Dubai Ports World and the Jebel Ali Duty Free Zone[2]. This interest-free financing, which complies with Islamic *shariah* law, is being handled by the Dubai Islamic Bank, the oldest Islamic commercial bank in the world and the third largest. The *sukuk* will pay 250-350 basis points over LIBOR, a very attractive rate providing a projected yield of 7.25-8.25 per cent, and is convertible after two years into shares, the first ever Islamic securities structure of this type.

The currency in which the *sukuk* are denominated reflects the country of issuance, with the Malaysian ringgit dominating, the ringgit being pegged to the US dollar until 2005 when a modest upward float occurred once the rates were freed (see Table II). Some capital controls on the Malaysian currency remain however, a legacy from the Asian economic crisis of 1997, and in practice the market for *sukuk* in Malaysia is

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount (US$)</th>
<th>Issues</th>
<th>Percent share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>4,205</td>
<td>255</td>
<td>65.7</td>
</tr>
<tr>
<td>UAE</td>
<td>750</td>
<td>2</td>
<td>11.7</td>
</tr>
<tr>
<td>Pakistan</td>
<td>600</td>
<td>1</td>
<td>9.4</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>500</td>
<td>1</td>
<td>7.8</td>
</tr>
<tr>
<td>USA</td>
<td>200</td>
<td>1</td>
<td>3.1</td>
</tr>
<tr>
<td>Bahrain</td>
<td>80</td>
<td>1</td>
<td>1.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>61</td>
<td>3</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>6,396</td>
<td>264</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: Islamic Finance News* (2005, p. 28)

Table I

Islamic securities by country: year to September 2005
mainly domestic, with the local banks, insurance and investment companies the major buyers and sellers. In the Gulf countries most issues are in US dollars, against which these currencies are pegged, although there is the possibility that with the introduction of a new unified currency for the Gulf Co-operation Council countries in 2010 the link with the US dollar may be replaced by a trade weighted basket. This could result in the new Gulf currency becoming the denominator of choice for sukuk issuance.

Although Citigroup was the leading sukuk manager in 2004 with five issues worth $854 million, it was overtaken by its international rival, HSBC in 2005, as Table III shows. The leading manager for most of 2005 was, however, the Malaysian investment bank, CIMB, although the full year figures are likely to see HSBC occupying the top slot. Standard Chartered and Deutsche Bank are the two other international banks with increasing experience of managing sukuk, a natural development given their major role in conventional bond, note and bill management. The other banks listed are Malaysian, apart from Dubai Islamic Bank, which as already indicated may become the leading manager as a result of the sukuk issued by the Ports, Customs and Free Zone Corporation of Dubai. Part of this sukuk funding is to finance the take-over of P&O Ports of the UK[3]. As other Dubai-based multinational companies expand worldwide the Dubai Islamic Bank should be well placed to manage further large sukuk issues. Emaar, the developer of some of the largest commercial real estate and residential projects in Dubai, is expanding its operations in Morocco and Saudi Arabia, notably in the latter Kingdom, where it is to be the co-developer of the $26 billion King Abdullah City north of Jeddah which is planned to be one of the world’s largest ports (Hassan and Al-Zahrani, 2005).

Table II.
Islamic securities by currency: year to September 2005

<table>
<thead>
<tr>
<th>Currency</th>
<th>Amount (US$)</th>
<th>Issues</th>
<th>Percent share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ringgit</td>
<td>4,405</td>
<td>256</td>
<td>68.9</td>
</tr>
<tr>
<td>US dollar</td>
<td>1,850</td>
<td>4</td>
<td>28.9</td>
</tr>
<tr>
<td>Bahrain dinar</td>
<td>80</td>
<td>1</td>
<td>1.2</td>
</tr>
<tr>
<td>Indonesia rupiah</td>
<td>61</td>
<td>3</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td>6,396</td>
<td>264</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Islamic Finance News (2005, p. 28)

Table III.
Major managers of sukuk securities: year to September 2005

<table>
<thead>
<tr>
<th>Manager</th>
<th>Amount (US$)</th>
<th>Issues</th>
<th>Percent share</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIMB</td>
<td>1,323</td>
<td>47</td>
<td>20.7</td>
</tr>
<tr>
<td>HSBC</td>
<td>1,224</td>
<td>18</td>
<td>19.1</td>
</tr>
<tr>
<td>Aseambankers</td>
<td>531</td>
<td>39</td>
<td>8.3</td>
</tr>
<tr>
<td>AmMerchant Bank</td>
<td>506</td>
<td>50</td>
<td>7.9</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>316</td>
<td>28</td>
<td>4.9</td>
</tr>
<tr>
<td>Citigroup</td>
<td>300</td>
<td>1</td>
<td>4.7</td>
</tr>
<tr>
<td>Dubai Islamic Bank</td>
<td>283</td>
<td>2</td>
<td>4.4</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>275</td>
<td>3</td>
<td>4.3</td>
</tr>
<tr>
<td>EON Bank</td>
<td>246</td>
<td>47</td>
<td>3.8</td>
</tr>
<tr>
<td>RHB Bank</td>
<td>201</td>
<td>45</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: Islamic Finance News (2005, p. 28)
Sukuk securities as a tool for liquidity management

Before sukuk became available the only means for Islamic banks to obtain a return on liquid reserves was to place funds through the inter-bank market on a murabahah basis with institutions that would buy and sell commodities on their behalf, often through the London metal exchange. This resulted in a mark-up payment that was viewed as legitimate by shariah scholars as it was based on a real trading transaction rather than being simply a return on a monetary deposit. The problem for Islamic banks was that there were only a small number of institutions capable of managing funds in this way and hence charges were relatively high and returns were low.

With the advent of sukuk there are more diversified possibilities for liquidity management, although only the market in Malaysia can be considered liquid, as the volume of secondary trading in the Gulf is minimal to date, largely because demand exceeds supply, and Islamic banks that acquire sukuk usually hold them to maturity, and are reluctant to sell (Abbas, 2005).

Sukuk structures

As with conventional debt securities sukuk are issued for a fixed time period rather than in perpetuity as in the case of equity. The time period can vary from three months in the case of sukuk that are similar to treasury bills, to five or even ten years for those that resemble conventional notes. Most sukuk to date have either been murabahah or ijara based, with the former offering a fixed return like a bond, while the latter provides a variable return similar to a floating rate note (Aquil, 2005).

What makes a sukuk acceptable under shariah law is that it must be backed by a real asset such as a piece of land, a building or an item of equipment, and therefore when sukuk are bought and sold the purchaser and seller are dealing indirectly in a real asset, and not simply trading paper. With a murabahah sukuk an Islamic bank securitises its trading transactions with a proportion of the fixed mark-up providing the return to the sukuk investor, and the bank using the repayment from its trading client to repay the sukuk holder on termination of the contract.

In practice salam (or bay’ al salam) structures have proved more popular for short run financing sukuk than murabahah as the latter usually involves commodity trading, the finance of which is not the aim of most sukuk issues. Salam simply refers to a sale in which payment is made in advance by the buyer, and the delivery of the asset is deferred by the seller. The period involved is usually short, as with murabahah, three month being typical. In practice a salam sukuk can be considered as a shariah compliant substitute for a conventional treasury bill issued for three months short-term financing by governments, as the return and the period to maturity are fixed when the offer is made. Such salam sukuk have been issued by the Bahrain Monetary Agency at three monthly intervals since 2002 as part of the short-term financing facilities arranged on behalf of the Government of Bahrain (Bahrain Monetary Agency, 2002).

A typical salam sukuk structure is shown in Figure 1, with a special purpose vehicle (SPV) created as a legal entity for the duration of the sukuk with the sole purpose of administrating the payments made to the investors and holding the title to the assets on which the sukuk is based (Dommisse and Kazi, 2005). The SPV can be regarded as a non-profit making trust, indeed the trust structures for which there is special provision for in English law are widely used for cross-border sukuk issues. As Malaysian law is very similar to English law, with comparable provision for trusts, this has facilitated the development of a market in sukuk in Kuala Lumpur.
The first stage in the operation of a sukuk is when the issuer (for example, the government of Bahrain) transfers a title to the assets to the SPV, which in turn issues certificates of participation to the investors, who may be Islamic banks, takaful Islamic insurance companies or investment companies that want to hold their liquid assets in a shariah compliant form. The certificates of participation represent an undivided right to an interest in the assets, which means that the assets cannot be sold to another party for the duration of the sukuk. In return for the certificates of participation the investors make an up-front payment which entitles the investor to a future refund of the investment plus a fixed mark-up agreed in advance. It is because the initial payment is in advance, or up-front, that designates the structure as salam.

As Figure 2 shows, the initial cash provided by the investors and collected by the SPV is used to make a payment to the issuer in return for an undertaking to deliver the asset at maturity. At that stage, typically after three months, the SPV takes delivery of the asset, but sells it back to the issuer. The proceeds from this sale are then used to reimburse the cash provided by the Islamic investors, and provide them with the preagreed mark-up return in relation to their investment. Before obtaining the return of their cash and the mark-up the investors have to surrender their
certificates of participation to the SPV, implying they have no further right to an interest in the assets.

With an *ijara sukuk* the prime function of the SPV throughout its life is the management of the *sukuk*, in particular the receipt of rent from the client for the leased asset and the payment to sukuk investors (Aseambankers, 2005). When the *sukuk* matures the SPV no longer has a role, and consequently it is wound up and ceases to exist as a legal entity. With this arrangement the SPV has no other obligations apart from those involved with the specific *sukuk*, and therefore it has none of the risks associated with a bank, nor is it subject to bank regulation. In other words the SPV is bankruptcy remote, and hence is attractive to both the issuers and the investors. This is seen as a major advantage, justifying the relatively high legal costs of establishing the SPV. The risk assessment of the *sukuk* will simply depend on the client’s perceived ability to make the payments to the SPV, which in the case of a government is the sovereign risk, and in the case of a company is the corporate risk. Not surprisingly this simple *ijara* SPV structure accounts for the overwhelming majority of *sukuk* issued to date.

Figure 2 illustrating an *ijara sukuk* structure, is similar to that for a *salam sukuk*, but variable rental payments are made rather than the mark-up being fixed. As with the *salam sukuk* the Islamic investors put in cash in return for certificates of participation which give them an undivided interest in the underlying asset. As the duration of the financing is much longer, usually at least five years, the title to the asset is held by the SPV, not the issuer, as the cash provided by the investors is used by the SPV to acquire the title from the issuer. It is the sale of the title that provides the issuer with the financing. As the issuer will continue to use the asset after it is sold there is a leaseback arrangement where the issuer pays rent to the SPV for the usufruct rights. It is these payments that enable the SPV to pay the investors a stream of rental payments representing the coupon on the *sukuk* security.

As *ijara sukuk* are typically issued for periods of at least five years it is usual for the investors to receive a direct guarantee from the issuer of the SPV obligations, as this provides assurance given that the ability of the SPV to fulfil its commitments ultimately depends on the rental payments made by the issuer. This guarantee also includes the obligation by the issuer to buy-back the asset at the end of the period of the lease for an amount that is equivalent to the original price at which the asset was sold. There can in other words be no capital gain or loss for the SPV or the issuer. It is the buy-back by the issuer that provides the funds for the reimbursement of the investors of the sum they originally invested, also without capital gains or losses. The rating of the *ijara sukuk* will depend on the rating agency’s evaluation of the ability of the issuer to honour these commitments, and if the financial circumstances of the issuer change during the leasing period this may result in a downward or upward adjustment in the rating (Richard, 2005).

**Musharakah sukuk**

As the majority of *sukuk* are *ijara* based this structure is well tried and tested, which reduces the legal costs and structuring fees involved with new issues. There is nevertheless an interest in innovation in *sukuk* by both issuers and law firms, partly because of the prestige involved in being first in the field with a new innovative product, but also more fundamentally because partnership structures based on *musharakah* are much closer to the traditional forms of business organisation and financing long practiced informally in the Muslim World (Siddiqi, 1985). In the case of *istisna* structures, another possible innovative *sukuk*, their credibility comes from the
practical consideration of them being well suited for project finance, which is increasingly important in Muslim states where governments are more and more reluctant to simply fund new infrastructure schemes from their own budgets, and there is a greater stress on private–public partnerships.

It is the diminishing musharakah structure (see Figure 3) that has the most potential for sukuk as this involves an Islamic bank or shariah compliant investment company providing up-front investment funding to the issuer, with both parties establishing an SPV to administer the sukuk. The financial structure is similar to an ijara sukuk, but the payments flows are quite distinct, both legally and operationally. The issuer sells an asset to the SPV while entering a partnership rather than a leasing agreement. The Islamic investors pay out cash as before, but receive certificates of partnership rather than simply certificates of participation. The legal implication is that both the investors and the issuer are partners in the SPV but that the share of the investors in the SPV will diminish over time as instalment payments are made by the issuer to repurchase the asset. It is these repayments, plus the rental paid by the issuer for the use of the asset, that provides the income stream for the investors. Whereas with a salam, ijara or musharakah sukuk the investors receive the return of their capital at the end of the period, with a diminishing musharakah structure they receive the return of their capital in instalments, with the final instalment terminating the partnership.

There is considerable flexibility with diminishing musharakah sukuk with respect to the payments schedule and amounts, as long as the parties agree on the terms when the partnership involving the SPV is established. The repayments will usually be monthly or quarterly, but they do not have to be in equal instalments. Smaller instalments could be made during the initial period of the sukuk, with most of the asset value or SPV capital remaining with the investors, but the amount of the instalment payments could increase in a linear fashion, or according to some predetermined formula. As the issuer increases their share of the asset through the buy-back they might be expected to pay less rent for the remaining share, but this does not necessarily have to be the case, especially if there is capital appreciation in the value of the asset. In other words when instalment and rental payments are aggregated, they

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**Figure 3.** Diminishing musharakah sukuk structure
might be constant, diminishing or increasing over time, provided both parties agree to
the formula used and the documentation is transparent.

Musharakah sukuk appear to be gaining in popularity and there have been several
recent issues in both Malaysia and the Gulf. In December 2005 it was announced that
Vastalux, an oil and gas servicing company, would issue a musharakah sukuk valued at
RM 100 million with a five year maturity to finance the company’s existing offshore
operations off Peninsula Malaysia and in Sarawak (Newswire, 2005). Another
Malaysian company announced in October 2005 that it would be raising US$ 120
million through a musharakah sukuk to part finance the development of the
international feeder port of Tanjung Api-Api in southern Sumatra, Indonesia (Eastern
Oracle, 2005). The largest musharakah sukuk to date, valued at $550 million, was for
Emirates Airlines to finance a new engineering centre in Dubai to service its aircraft.
The SPV, designated “Wings”, entered into a musharakah partnership arrangement
with Emirates for the development of the engineering facility, with the sukuk maturity
being five years (New Millennium Publishing, 2005).

Sukuk pricing and risk assessment
The major criticism of ijara sukuk, as already indicated, is that the return is usually
benchmarked to the LIBOR on $US dollar funds or the equivalent local rate in the case
of issues in Malaysian ringgit. This is of course an interest rate, and although it is only
used for pricing, and the payments associated with the ijara can be regarded as rents,
the close link of the interest-based pricing with riba worries many shariah scholars.

The problem for the financiers is that they want the investors to regard the sukuk as
identical to their equivalent conventional asset classes rather than being distinctive
from a financial perspective, as this simplifies risk assessment. Investors are more
relaxed if a security has a familiar structure rather than being unknown and untried.
Hence the innovation with sukuk is solely legal; their distinctive characteristic being
shariah compliance, but there has been no financial innovation.

Risk rating agencies are willing to rate sukuk because of their familiar structures,
with assurance for investors provided by Standard & Poor's, the global leader, or
Capital Intelligence, the agency that specialises in rating Middle Eastern banks. A
dedicated Islamic sukuk rating agency has been established by the Islamic
Development Bank, and the Rating Agency of Malaysia has acquired much experience
of sukuk evaluation, but these use similar criteria to other rating institutions.

Financial innovation with sukuk
For sukuk to be distinctive from conventional securities financial engineering will be
necessary to bring about new types of products. These may be initially more costly for
the clients in terms of the rates that are offered to attract investors, and the latter may
be uncertain and cautious about committing their funds to the unfamiliar. Conventional
and Islamic banks involved with new types of sukuk will incur product development
costs, often without the certainty that they can be recouped. Yet for those who do
launch successful products the rewards could ultimately be high, as even if other
institutions copy the same formula, the recognition that comes from being first in the
field can be very helpful for longer term business generation.

The key to innovation is to focus on pricing and risk characteristics. For sovereign
sukuk pricing could be based on real macroeconomic variables such as gross domestic
product (GDP) growth rather than interest benchmarks. When GDP growth was high
government tax revenue would usually increase more rapidly, especially for countries
with income or sales taxes. This would enable governments to pay a higher return to investors in their sovereign *sukuk*. Conversely when gross domestic product (GDP) growth was lower, government revenue would be lower, implying a reduced capacity to service debt and pay *sukuk* holders. In other words *sukuk* holders would be taking on some of the sovereign risk (Tariq, 2004). By sharing risk with governments and reducing their obligations in times of difficulty, the risk of default would be reduced. This might enable sovereign *sukuk* based on GDP benchmarks to be more favourably rated than the present “conventional” *sukuk*.

Interest rate and GDP growth figures are shown in Table IV for Saudi Arabia and Malaysia, with non-oil GDP growth taken as a more stable indicator for Saudi Arabia given the volatility of international oil markets, and hence the Kingdom’s oil sector and overall GDP growth. As *ijara sukuk* typically pay at least 200 basis points over base interest rates, such as those on inter-bank deposits cited in the table, the average return over the period from 1999 to 2005 for investors would have been 5.69 per cent on Saudi riyal denominated *sukuk* and 5.05 per cent on Malaysian ringgit denominated *sukuk*. The riyal return including the premium is substantially higher than what might have been obtained on *sukuk* whose yield was based on Saudi Arabian non-oil GDP growth without any premium. In the case of ringgit denominated *sukuk* the return of an offering based on GDP growth would have been marginally greater than that on ringgit inter-bank rates with the premium added.

Investors in *ijara sukuk* are not only concerned with average returns however, but also with the volatility of the returns as a lower volatility will generally be preferred to a higher volatility by the risk adverse[4]. The SDs from the means are shown in Table IV, with significantly lower volatility for returns based on non-oil GDP growth than for returns based on inter-bank rates in Saudi Arabia. With this lower volatility investors might be willing to purchase riyal denominated *sukuk* without any premium on non-oil GDP returns even if there is a 200 basis points mark-up on Saudi inter-bank returns. In Malaysia the reverse is the case, as with the much higher volatility of GDP growth, a return based on this that is only marginally greater than the ringgit inter-bank rate would be unlikely to attract investors motivated only by financial returns[5]. In this case a premium would have to be paid by the *sukuk* issuer above GDP growth rates to ensure that the offer was fully subscribed.

In reality matters are more complicated, as an *ijara sukuk* with inter-bank rates used as the benchmark is like a floating rate note, where the market value of the note seldom...
Structuring of Islamic sukuk securities

varies from the maturity value, unlike a fixed rate bond. However, once a benchmark that was not based on inter-bank rates is used, short- and even medium-term capital gains and losses would be possible, the extent of these depending on the time to maturity. If GDP growth rose relative to inter-bank rates, demand for the sukuk would increase given its higher return, and hence the price would rise. Conversely if GDP growth fell relative to inter-bank rates, investors who sold their sukuk in the secondary market would suffer capital losses. Therefore, as with fixed rate securities, prices would depend on interest rate expectations, but in the case of sukuk benchmarked against GDP growth, expectations about growth performance would also influence pricing.

Corporate sukuk could be benchmarked against indicators relating to the performance of the companies being financed. Share prices would be an inappropriate indicator, as this would blur the distinction between sukuk securities and equity investment. However, the use of dividend or profit indicators would be entirely appropriate, which could be the basis for a new type of sukuk based on a musharakah partnership structure. Musharakah contracts are for fixed time periods, like sukuk, and involve profit and loss sharing. These sukuk would therefore have a downside risk, as capital cannot be guaranteed, but the returns offered by the companies being financed could compensate for these risks.

The profit shares would clearly have to be attractive, but under musharakah contracts investors are permitted to be remunerated for amounts in excess of their actual investment contribution, as long as losses are shared in direct proportion to the profit shares. The attraction for investors in musharakah sukuk would be that there was a predefined exit, and in addition early exit would be possible as the musharakah would be securitised. The illiquidity of traditional musharakah contracts, and uncertainty regarding the exit route, largely explains why this form of shariah compliant financial contract has failed to become popular.

Another possibility would be mudarabah based corporate sukuk, with investors sharing in the profits or dividends, but not in the losses, although as with mudarabah investment deposits with Islamic banks, there could be no absolute guarantee of capital values. With mudarabah sukuk the return would be lower than with musharakah sukuk, but companies would be expected to make some provisions in highly profitable years so that payouts could be maintained in less profitable or loss making years. Shariah boards have authorised this practice for investment mudarabah deposits with Islamic banks. For investors the returns profile would be smoother for mudarabah sukuk than for their musharakah equivalent, but the expectation would be for higher returns on average to compensate for the greater risk involved.

Conclusions

Although sukuk issues are taking off, with governments such as that of Indonesia planning substantial issues worth over $500 million for 2006, there is the same financial risk of default with sovereign sukuk as with conventional debt instruments. Some of the countries issuing sukuk have experienced major debt servicing problems in the recent past, and there is the danger that history might repeat itself. Corporate issues by large and medium sized companies, especially those involved in real estate developments, also carry substantial risks if property prices start to decline, or if the high oil prices currently being enjoyed by the Gulf countries prove unsustainable.

Sukuk based on participatory structures, with risk sharing by investors, may be a way forward. The risk with these proposed structures is of variable returns rather than
of default, which may well be more acceptable to informed investors in any case. Sukuk have taken off in terms of quantity, but the emphasis now needs to shift to quality. The Islamic scholars have shown their willingness to apply the principles of ijtihad or legal adaptation to the sukuk now being traded, but the finance specialists have arguably failed the industry to date. In financial terms the current sukuk offerings simply mirror their conventional equivalents. More financial engineering and imagination are clearly needed if new products are to be developed, with distinctive risk characteristics that will appeal to Muslims, and indeed non-Muslims seeking to diversify their risk portfolios.

Notes
4. Road shows may be needed to explain the issues to investors. See McNamara (2005).
5. Empirical evidence from Malaysia indicates that financial factors are more important than religious factors in determining the choices between Islamic and conventional securities, even for Muslim dealers. See Gadar (2004).

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**Corresponding author**
Rodney Wilson can be contacted at: R.J.A.Wilson@durham.ac.uk