

## In The Know

### Leveraged Finance Newsletter

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## The Rise of Sukuk in Global Finance

Global sukuk issuance is projected by S&P Global to reach \$160 billion-\$170 billion in 2024, driving the total global outstanding sukuk market to an estimated \$875 billion.

The popularity of sukuk arises from consensus among Islamic scholars and standardised documents, with favourable tax treatment in many jurisdictions fuelling market growth. In this edition of In the Know, we look into sukuk structures, their types, and delve into the key documents and risks associated with two typical structures and scenarios. Additionally, we discuss the future of Islamic finance and its growth drivers.

Islamic finance refers to Shariah-compliant structured finance based on the core belief that money itself does not have any intrinsic value, and so making money from money should be avoided. In practice, this means refraining from engaging in either paying or receiving interest (*Riba*) in its conventional conceptualisation.

Islamic finance comprises various structures that are largely either asset-based in nature, i.e., structures involving an asset transfer, or based on the concept of risk-sharing, i.e., structures assuming commercial risk via an alternative route.



## Sukuk

Sukuk are Shariah-compliant bond-like structures, which represent an undivided ownership share in an underlying asset or interest held by the issuer. With the economic effect of sukuk being similar to a conventional bond, the gist of the instrument is that having an undivided ownership share in the underlying asset entitles the sukuk holder to a proportional share of the returns generated by the asset.

To ensure Shariah-compliant returns, sukuk are often used in combination with other compliant financing techniques, such as leasing the underlying asset to generate income.

## Typical structure

A typical sukuk structure will involve the entity that wishes to raise funds establishing a special purpose vehicle (SPV) in a tax-efficient jurisdiction and selling the underlying assets to this SPV. The SPV holds these assets under trust in favour of the sukuk holders, who are issued sukuk certificates in exchange for a fee. The issuer funds the purchase of the assets with the issue proceeds.

The structure underlying the sukuk varies across jurisdictions, based primarily on tried and tested approaches that are acceptable to investors from both Shariah and market standard perspectives.

## Governing law

The terms and conditions of sukuk are generally governed by English law. However, in some cases, underlying documents such as sale and purchase agreements will typically be governed by local law. In jurisdictions such as Saudi Arabia, the documentation will typically be governed entirely by local law as the sukuk market has developed domestically.

## Negotiable instruments

While investors generally tend to hold their sukuk to maturity rather than trade them, there has recently been an uptick in the growth of the secondary market for sukuk due to document standardisation (including standardisation of covenant packages), better understanding of sukuk offerings and scholarly consensus on Shariah compliance.

## Credit ratings

Credit rating agencies do not verify Shariah compliance of rated sukuk and only take non-compliance into account if this constitutes an event of default. Credit ratings of sukuk generally mirror the issuer's rating.

Although these features are common, there are a number of different structures used for different purposes.

## An overview of Islamic finance structures used in Sukuk transactions

### Ijara

Central contract is a lease agreement - commonly used for real estate or equipment financing - where the financier (lessor) has notional ownership of the leased asset for the entire lease period and leases it to the borrower (lessee) who pays rent to the lessor for the use of the asset.

### Mudaraba

An investment partnership where the investor contributes capital towards an underlying business, managed by the mudarib, and on agreed dates and in agreed percentages, the mudarib and investor share profits.

## Istisna

Based on a manufacturing or construction contract, where the issuer agrees to deliver a project or asset at a future date and at an agreed price. The investors then pay the agreed amount either in instalments, upon delivery or after the project is completed.

## Salam

Based on a forward-sale contract where the issuer receives payment upfront for assets but delivers the assets back at periodically spaced future dates and at a lower price than the sale price the asset was sold at, with the difference in price representing profit for the issuer.

## Wakala

Agency contract-based model in which a wakeel acts as agent of the issuer and invests in a portfolio of assets in exchange for an incentive fee.

## Murabaha

Based on a cost-plus financing model for synthetic trading of commodities, where the originator agrees to sell commodities for the issuer and pays the issuer the sale price in instalments.

## Musharaka

A joint venture or partnership-based model where all parties contribute capital and share all profits and losses – no longer common following an Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) statement in 2008.

## Sukuk al-Istithmar

Employed to finance a specific economic project or investment – all the underlying contracts discussed can be pooled together under this structure to diversify asset classes and create a larger fund.

## Two typical sukuk structures and scenarios

### Where the proceeds of an issuance are used to purchase an asset

#### Example:

**Sukuk al Ijara** – A leaseback structure where an issuing entity issues sukuk into capital markets. → The issuing entity then uses proceeds from the issue to purchase an asset from the originator. → The issuing entity leases the asset back to the originator. → Each sukuk holder is then entitled to receive the rental income generated under the lease pro rata to its ownership in the underlying real estate asset based on the sukuk held by it.

**Pros** – This is a relatively streamlined and precedented approach, which makes it the most common structure used for sukuk issuances.



**Cons** – Originators don't always own a Shariah-compliant asset, and if they do, it is not always available to lease during the term of the sukuk. There are also many jurisdictions with significant tax consequences for introducing assets into a sukuk structure because they could attract stamp duty upon transfer (for land assets) if perceived as a conventional transfer. It is also worth noting a proposed amendment to the AAOIFI Shariah Standard 62, currently going through an extended consultation period, is likely to have a significant impact on Ijara based sukuk if implemented.

**Key underlying documents needed**

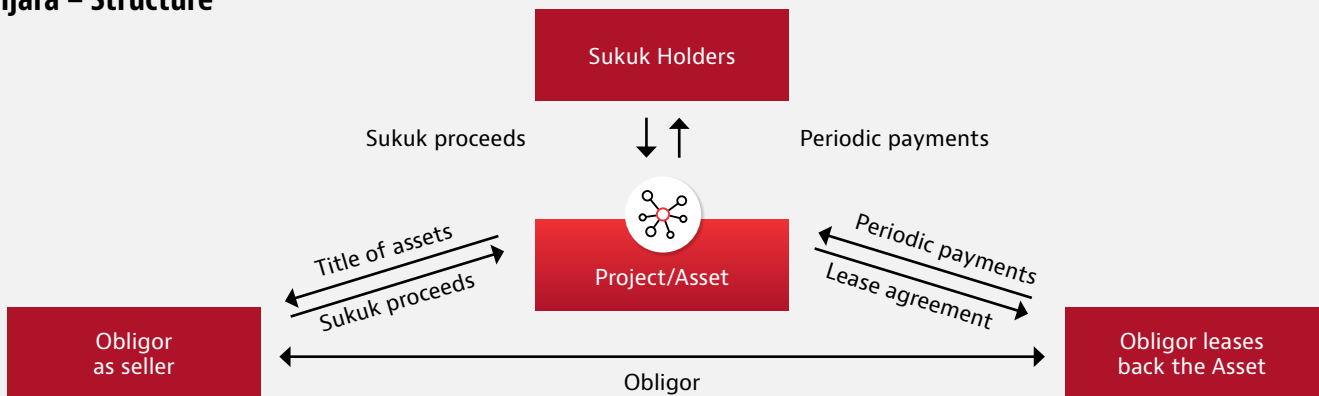
- Sale and Purchase Agreement between the originator and the issuer (documenting the asset sale from the originator to the issuer in return for the issuance proceeds)

- Lease Agreement governing the lease arrangements
- Service Agency Agreement placing the ongoing maintenance obligations relating to the asset on the originator, which would otherwise be the issuer's responsibility
- Purchase Undertaking documenting the obligation of the originator to purchase and the issuer to sell the asset at the end of the agreed time frame for the financing (i.e., the maturity date)

**Risk in Ijara**

The lessor (i.e., the issuer) bears the risk on the asset during the lease period unless (under the terms of the Service Agency Agreement) the asset is damaged as a result of the lessee's negligence.

**Ijara – Structure**



**Where the proceeds of an issuance are invested**

**Example:**

Sukuk al Wakala: The issuing entity appoints a 'wakeel', i.e., an agent to invest the proceeds per the terms contained in a 'wakala', i.e., an agency contract. → The wakeel invests the

funds in a portfolio of Shariah-compliant assets, some of which may already be owned by the wakeel. → Parties to a wakala will agree at the outset that the profit generated will return to the wakeel and then to the wakala investor, and so profits will be returned periodically with the wakeel retaining a certain amount as an incentive fee.

**Pros** – Since the originator is also the wakeel, the wakeel will be responsible for managing the wakala assets, which creates operational efficiency as they are familiar with the assets. This also may boost confidence among the sukuk holders as the wakeel have the requisite expertise to manage the assets under them.

**Cons** – A fixed rate of profit is unacceptable in a wakala structure in the view of most Islamic scholars. As such, the guaranteed profit structures which made wakala so popular are no longer possible to achieve, giving rise to the possibility that the return generated on assets may not be sufficient to pay a profit, and sukuk holders may suffer a loss.

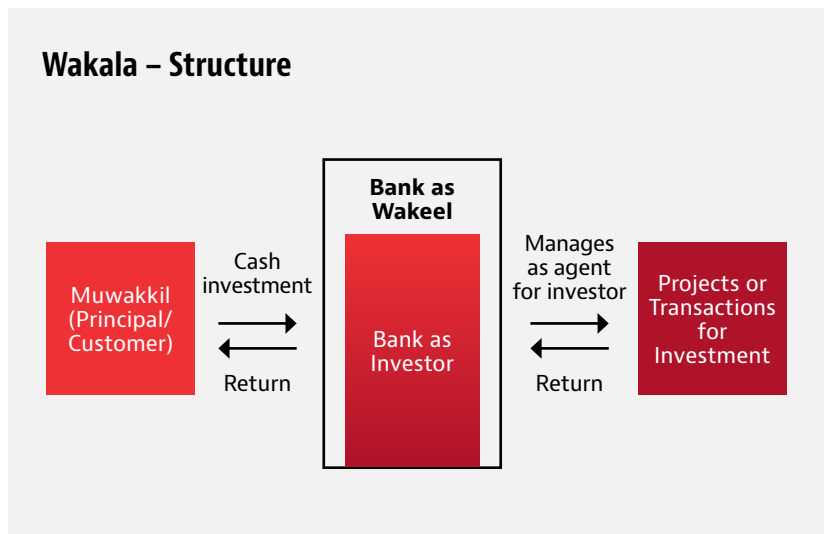
### Key documents needed

- Sale and purchase agreement to transfer the originator's assets into an SPV
- Wakala agreement between the wakeel and SPV
- Purchase undertaking in favour of the SPV executed by the originator

### Risk in Wakala

Wakala is a profit and loss sharing arrangement. At the end of the wakala agreement, the expectation is that the principal will receive its return. If the initial investment is lost, there is no recourse to the principal in a pure wakala arrangement unless the agent has been negligent or fraudulent.

To protect itself, a principal will often insert a clause into the wakala agreement specifying that unless a certain percentage return is generated, the agent will be deemed negligent and must make up the shortfall.



## Why are sukuk popular?

S&P Global expect that global sukuk issuance will reach about \$160 billion-\$170 billion in 2024, with the total global outstanding sukuk growing to an estimated \$875 billion according to Franklin Templeton. The popularity of sukuk has been partially attributed to a growing consensus between Islamic scholars and a greater standardisation of sukuk documents.

This, coupled with favourable tax treatment in many jurisdictions (including in the EU and the UK) has allowed the market to develop considerably.

High demand for and low supply of sukuk created a favourable market for issuers in 2023, with Egypt having debuted a three-year \$1.5 billion sukuk with a yield of 11% in February 2023.

## The future of Islamic finance

The extent to which Islamic finance generally, and global sukuk issuance in turn, grows in value will depend on a number of factors.

## Continued harmonisation of Shariah rulings

There are a number of institutions, such as AAOIFI, making efforts to harmonise Shariah rulings, as

well as various centralised Shariah boards. For example, the United Arab Emirates Ministry of Finance, the Islamic Development Bank and the Dubai Islamic Economy Development Centre established a partnership to develop an international legislative framework for Islamic Finance with the aim of reducing discrepancies around the globe.

### Digitalisation/fintech

Digitalisation may become a core part of Islamic finance's future, helping to reduce operating expenses, boost revenue and automate internal processes. For example, Islamic Finance structures like murabaha and Ijara are now being streamlined through automation and simplification.

Islamic fintech is also experiencing substantial growth, with Islamic fintech transactions totalling \$79 billion in 2021, while projections indicate an annual growth rate of 18%, potentially reaching \$179 billion by 2026.

### Ethical investments

Environmental, social and governance factors may become increasingly important in Islamic finance, for example, through the development of green sukuk; there have recently been projects such as the Republic of Indonesia's Sovereign Green Sukuk issuances, Al Rajhi

Bank's Sustainable Sukuk and DPWorld's Green Sukuk. Ethical considerations may also lead to the appeal of Islamic finance beyond the Middle East.

The Islamic Finance Council UK (UKIFC) estimates that sustainability and green sukuk could generate between \$30 billion-\$50 billion of capital towards Sustainable Development Goals by 2025.

### Untapped markets

The five most populous Muslim countries (Pakistan, Indonesia, Bangladesh, Türkiye and Egypt) are at the early stages of developing an Islamic finance industry. Africa is attracting interest from Islamic banks, with Nigeria having a sukuk market of \$1.6 billion in 2023, and predicted to grow further.

### Conclusion

In summary, the sukuk market has demonstrated adaptability, innovation, and ability to alignment with global trends in "traditional" debt capital markets. Issuers and investors should engage with their advisors to ensure that the form of sukuk finance they will issue or invest in meets their needs; with the many options available, there is likely to be a solution that can be tailored to them.

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