SOVEREIGN *SUKUK*: ADAPTATION AND INNOVATION

A. ROGER WEDDERBURN-DAY*

I
INTRODUCTION

The history of the international bond markets is one of constant innovation and adaptation. One of the more-significant recent examples of this is the development of an international Islamic "bond" market and the position of sovereign borrowers at the forefront of that development of this market.

A. Islamic Bonds

Strictly speaking, Islamic bonds do not exist. The key aspects of Islamic doctrine that define what is and is not permissible in the finance field help explain why. Most people are familiar with the Islamic prohibition on the charging of interest (or *riba*). This prohibition is one of four major prohibitions that define the structuring of the Islamic equivalent of conventional bonds (referred to as *sukuk*), the others being a prohibition on uncertainty (*gharar*), a prohibition on gambling and speculation (*maisir*), and a prohibition on the use of or dealing in certain banned commodities (such as alcohol or pork). In contrast, Islamic doctrine encourages investors to share in the risks as well as in the rewards associated with particular investment activities. In conventional terms, equity-type investment is good (shares can go up as well as down) whereas debt investment (guaranteed return subject to credit risk, which Islamic doctrine does not regard as a real risk) is bad. Conventional bonds, of course, are the latter.

B. A Brief History of International *Sukuk*

In December 2001, Kumpulan Guthrie Berhad, a Malaysian company, completed the first international *sukuk* issue. This was a U.S.–dollar-

Copyright © 2010 by A. Roger Wedderburn-Day.

This article is also available at http://www.law.duke.edu/journals/lcp.

* Partner, Allen & Overy LLP (London). Mr. Wedderburn-Day specializes in debt and equity securities transactions, a field in which he has been actively involved since 1987. He has a wide-ranging sovereign securities practice having acted on issues by Abu Dhabi, Bahrain, China, Czechoslovakia, the Czech Republic, Dubai, Estonia, Hungary, Iceland, Latvia, Lithuania, Mexico, Ras Al Khaimah, the Slovak Republic, Spain, and the Ukraine, among others. Mr. Wedderburn-Day became involved in Islamic finance when he acted on the Bahrain *sukuk* and has been involved in many other *sukuk* transactions since then, including both the Pakistan and Ras Al Khaimah issues referred to in this paper.

denominated *sukuk*, targeted at investors in Asia and the Middle East. In July 2002, the Federation of Malaysia completed the second such issue. This was a U.S.–dollar-denominated *sukuk* sold internationally, including in the United States. This was also the first *sukuk* issue rated by international credit-rating agencies.

Since these first two transactions, the international *sukuk* market has grown significantly and has involved issuers located in Asia, the Middle East, and elsewhere. Although the market is dominated by borrowers in Malaysia and the Gulf Cooperation Council region (comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates), international *sukuk* have also been issued by borrowers located in Germany, Pakistan, Indonesia, and the United States.

C. The Importance of Sovereign Borrowers

In many cases, one of the early issuers of international *sukuk* in a particular country or territory has been a sovereign or quasi-sovereign borrower. Apart from the Malaysian sovereign *sukuk*, this has been true of Bahrain, Qatar, Pakistan, Indonesia, Ras Al Khaimah (one of the Emirates making up the United Arab Emirates), Germany (where the issuer was the State of Saxony-Anhalt), and Saudi Arabia (where the issuer was the Islamic Development Bank, a supranational located in the city of Jeddah).

A key driver of the sovereign involvement in many cases was the desire to establish a benchmark and to encourage the development of a *sukuk* market in the relevant country. Although less significant in countries where Islamic principles are already a part of national law, a secondary factor behind sovereign involvement was the need to facilitate the development of a legal framework that would support *sukuk* issuance. Indeed, the U.K. government, which has been considering a *sukuk* issue since mid-2007, has confirmed that these reasons are key factors in its desire to access the *sukuk* market.

II
KEY DEVELOPMENTS IN SOVEREIGN *SUKUK* ISSUES

The innovation and adaptation that first enabled the issuance of Islamic "bonds" and thereafter improved the structures initially used are particularly notable in a number of specific *sukuk* issues. The Malaysian issue used structuring that enabled an Islamic security to substantially replicate a conventional debt security. Three other Islamic issues of note are the Bahrain *sukuk*, the fourth sovereign *sukuk* (and fifth international *sukuk*), which significantly refined the structure of international *sukuk* issues; the Pakistan *sukuk*, which was one of the last international *sukuk* to use a true-sale structure; and the Ras Al Khaimah *sukuk*, which was the first sovereign *sukuk* to be issued under a *sukuk*-issuance program.

A. The Malaysian *Sukuk*

In the Malaysian *sukuk*, the Federal Lands Commissioner of Malaysia (a statutory entity set up to hold government land) sold beneficial title to certain parcels of land to a newly formed Malaysian special-purpose company owned by the government. The special-purpose company (the issuer) funded the purchase price by issuing trust certificates (or *sukuk*) to international investors. The Federal Lands Commissioner continued to hold the registered, legal title to the land, but as bare trustee for the benefit of the issuer. This avoided the need to register title and also avoided stamp and transfer duties.

Having issued the *sukuk*, the issuer and the government then entered into a master *ijara* (or lease) contract (governed by Malaysian law) under which the parties agreed to enter into successive semiannual leases of the land up to the maturity date of the *sukuk*. Under each lease, the rent was set by reference to the then-current, six-month London Interbank Offered Rate (LIBOR)[1] and was paid by the government (as lessee) to the issuer (as lessor) at the end of the relevant lease period. The government also entered into a unilateral purchase undertaking, in which it undertook in favor of the issuer to repurchase the land for the same price at which it was sold at the maturity date of the *sukuk*.

The conditions of the *sukuk* in turn provided that the holders were entitled to receive periodic distributions on their *sukuk* in amounts and on dates matching the rental payments due under the lease agreements.[2] In addition, the conditions of the *sukuk* provided that, at its maturity, the holders were entitled to be repaid the amount invested by them. Essentially, therefore, the issuer simply passed through to the holders of the *sukuk* on each periodic distribution date the payments received by it from the government under the lease and, on the maturity date, the payment received by it from the government under the purchase undertaking. The conditions further provided that recourse against the issuer be limited to the amounts actually received by the issuer from the government, thereby making it clear that the credit risk the investors were assuming was that of the government. The issuer was thus established in a manner designed to make bankruptcy as remote as possible.

Unlike conventional debt securities, which record a debt owed by the issuer to the investor, *sukuk* are trust certificates that record a trust declared by the issuer over certain assets. Thus, *sukuk* are not debt instruments at all; instead, they are designed to convey an ownership interest in one or more tangible underlying assets. This is an important feature, for it is the ownership interest conveyed by a *sukuk* that makes it a tradable instrument for Sharia purposes.[3]

---

1. Islamic scholars generally accept the use of interest-based reference rates on international *sukuk* transactions.

2. Malaysia Global Sukuk, Inc. 22 (July 3, 2002) (prospectus, on file with *Law & Contemporary Problems*).

3. Changing Sharia interpretations and the global financial crisis have affected the *sukuk* market and sovereign issuance in particular. *See infra* Part III.

As with a conventional debt security issued by Malaysia, a number of risks inherent in the Malaysian *sukuk* required investor protection. A conventional, unsecured sovereign debt security includes events of default in the conditions (which provide the investors with an acceleration right in the event of nonpayment or of certain other events) and may also include a negative pledge. The Malaysian *sukuk* included similar provisions, although many of these provisions could be found in the lease agreement rather than in the conditions of the *sukuk* (reflecting that the *sukuk* were issued by a special-purpose vehicle). To ensure that the issuer would have recourse to funds if an event of default occurred, the purchase undertaking by the government included a promise to buy the land back following an event of default at the original sale price.

Other risk concerns that were identified as being specific to the Malaysian *sukuk* (as opposed to a conventional debt security issued by Malaysia) included the following:

> 1. Who bears the maintenance costs for the land (in particular any buildings or equipment on the land)? Under Sharia principles, the lessee is responsible for the day-to-day (or ordinary) maintenance of the assets being leased while the lessor is responsible for all other maintenance and repair (major maintenance). Reflecting that the lessor was a special-purpose company and therefore not in a position to undertake major maintenance, the issuer and the government entered into a service-agency agreement under which the government, acting as the issuer's agent, agreed to perform any major maintenance necessary against reimbursement by the issuer at maturity. Recognizing that this could involve the issuer's expending funds which it would not have, the purchase price of the land at maturity was amended to comprise the original price paid plus any amount owed by the issuer for major maintenance, with the two maintenance amounts being set off against each other.
>
> 2. What happens if the property is destroyed? Under Sharia principles, a lessee cannot be required to pay rental for a property that has been destroyed because that would place an important incidence of ownership on the lessee (rather than on the owner). Thus the leases in the Malaysian *sukuk* provided that they would terminate on a total-loss event occurring in relation to the land. Total-loss events include expropriation or destruction beyond economic repair of the land. This would mean, however, that if a total-loss event occurred, investors would suffer not only the loss of the periodic distribution amounts due after the date of the loss but would also not receive the return of their principal, for there would be no asset to sell at maturity. This is a risk they were not prepared to take, so the service-agency agreement imposed an obligation on the government (as agent of the issuer) to insure against a total loss, with the costs of that insurance to be

reimbursed by the issuer (in the same manner that the costs of major maintenance are reimbursed). Accordingly, in the event that a total-loss event occurred, investors would have rights to the insurance monies payable for that loss.

3. What happens to the land on a default? Under the Malaysian *sukuk* structure, the issuer is the beneficial owner of the land. The trust certificates issued by the issuer represent an undivided beneficial ownership interest in the trust assets (being the issuer's rights to the land as well as its rights respecting the underlying contractual documentation such as the leases and the purchase undertaking). Given this ownership structure, an investor might reasonably conclude that on a default by the government, he would have recourse to the land and could sell it to fund repayment of his *sukuk*. The conditions of the *sukuk*, however, specifically provide that under no circumstances shall the issuer or any investor have the right to sell the land other than to the government in accordance with the purchase undertaking. This limited-recourse provision reflects the commercial intention (seeking to replicate in a Sharia-compliant manner, and as far as possible, an unsecured conventional debt security). As a result of this provision, should the government default, the only rights the investors would have respecting that default would be to sue the government for failure to perform its obligation under the purchase undertaking to buy the land back on an event of default occurring. This right is the equivalent of the right of an investor in a conventional debt instrument to sue for unpaid principal.

B. The Bahrain *Sukuk*

In the Bahrain *sukuk*, the original intention was to have a similar sale and leaseback structure as Malaysia did. For various Bahrain-specific reasons, though, it was not possible for the government to sell the land, so a head-lease–sublease structure was devised. The head-lease–sublease allowed the Bahraini government to lease certain vacant land located at Bahrain's airport to the issuer, a special-purpose Bahraini company established by the central bank for the purposes of the transaction, for a term of 100 years.[4] A single, advance rental payment was made by the issuer for this lease and funded by the issuer issuing the *sukuk*. The issuer then sublet the land back to the Bahraini Government for the term of the *sukuk*. At maturity, a termination payment was made by the Bahraini Government to the issuer for the head lease, and this payment funded the redemption of the *sukuk* by the issuer.

One other area in which the Bahrain *sukuk* was innovative involved the position on enforcement. In a conventional debt security for which a trustee is

4. BMA International Sukuk Company 20 (June 30, 2004) (prospectus, on file with *Law & Contemporary Problems*).

appointed, the duties of the trustee are minimal, so long as the issuer is performing its obligations. However, should the issuer default, the trustee assumes significant responsibilities in terms of enforcement against the issuer. One issue that concerned the managers and investors in the Bahrain *sukuk* was that, as a government-owned company, the issuer would be susceptible to direction by the government and might not therefore take the necessary action to enforce against the government in the event of a default. In addition, as a special-purpose company, the issuer (even if it wanted to) might not have the ability to take enforcement action either through lack of funds or through lack of personnel.

This issue had also been considered on the Malaysia *sukuk*; the solution there was for the issuer to appoint an independent third party to act as a cotrustee with the same rights and obligations as the issuer in its capacity as trustee. In the event of any disagreement or conflict between the two trustees, the views of the cotrustee would prevail.

In the Bahrain *sukuk*, a slightly different solution was adopted: the issuer (in its capacity as trustee) at the outset of the transaction delegated its rights and obligations as trustee to an independent trust company contingent on a default occurring. The effect of the provision was that if a default did occur, the issuer would cease to have any duties as trustee, and these duties would pass to the independent trust company, putting the *sukuk* holders in much the same position as holders of conventional debt securities for which a trustee is appointed. This delegation feature is now standard on almost all international *sukuk*.

C. The Pakistan *Sukuk*

Like the Malaysia *sukuk*, the Pakistan *sukuk* involved a sale and leaseback structure. An interesting feature of the Pakistan *sukuk* (and of the Bahrain *sukuk* before it) was that the *sukuk* assets were sold in a true sale (where legal title to the assets concerned passed to the issuer) as opposed to the kind of beneficial ownership distinguishing the Malaysian *sukuk*. The asset was a part of a motorway. Because the sections of the motorway being sold ran through a large number of different administrative districts, the transaction involved the registration of the sale of approximately 125 separate land parcels in nine separate administrative districts. All parcels were required to be registered at closing, involving a significant administrative burden. This appears to have been one of the last of the true-sale, unsecured *sukuk* transactions, with subsequent issues reverting to the Malaysian formula and typically conveying only a beneficial, unregistered ownership interest in the underlying assets.

D. The Ras Al Khaimah *Sukuk*

Like Pakistan's, the Ras Al Khaimah *sukuk* involved the sale and leaseback of a road owned by the government. Unlike the previous sovereign *sukuk* transactions, though, the issuer in the Ras Al Khaimah *sukuk* was a Cayman

Islands–incorporated, orphan special-purpose company rather than a locally incorporated, government-controlled company.[5] This reflected the position adopted by a number of influential Islamic scholars that there should be no ownership relationship between the issuer and the underlying obligor absent a good reason an independent entity could not be established.

As there was no such good reason regarding the Ras Al Khaimah transaction, the parties agreed that a Cayman Islands orphan company would be used. But during the process of the transaction, the Ras Al Khaimah government became concerned that it might lose control over its assets, given its lack of control over the issuer. The parties debated a number of possible solutions, including, among others, amending the articles of association of the issuer, giving additional contractual comfort to the government, and relying on the reputation and good faith of the issuer–administrator and its directors. Ultimately, specific additional contractual provisions were included, which gave sufficient comfort to the government to enable it to proceed with the transaction.

The Ras Al Khaimah *sukuk* was issued under a *sukuk* program, the first such program to be established by a sovereign. Subsequently, the government of Dubai has also established a *sukuk* program.

III

THE IMPACT OF THE 2008 GLOBAL FINANCIAL CRISIS ON SOVEREIGN *SUKUK* ISSUANCE

Since late 2007, the *sukuk* market has been adversely affected by two separate factors—a change in the position of most major Islamic scholars on the acceptable types of structure[6] and the impact of the global financial crisis that started towards the end of 2007. An International Monetary Fund paper published in July 2008 showed total *sukuk* issuance in the years 2004 to 2007 growing from approximately $7.2 billion[7] in 2004 to $12.0 billion in 2005, $27.4 billion in 2006, and $38.6 billion in 2007.[8] At the end of 2007, outstanding *sukuk* globally exceeded $90 billion. The paper suggested that, based on current trends, the total amount of issued *sukuk* was likely to exceed $200 billion by the end of 2010.[9]

In September 2009, Standard and Poor's published a report showing that *sukuk* issuance in 2008 was approximately only $15 billion, reflecting both the

5. RAK Capital 51–52 (May 2, 2008) (prospectus, on file with *Law & Contemporary Problems*).

6. In March 2008, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) published new guidance on the permitted structures for *sukuk*, which significantly restricted the future use of previously available structures. ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, SHARI'AH BOARD RESOLUTIONS ON SUKUK 2–3 (2008).

7. All references to currency are in U.S. dollars.

8. Andreas Jobst et al., *Islamic Bond Issuance—What Sovereign Debt Managers Need to Know*, INTERNATIONAL MONETARY FUND (July 2008), http://www.imf.org/external/pubind.htm.

9. *Id.*

adverse effects of the scholars' acceptance of the *sukuk* and the 2008 financial crisis.[10] The same report noted that issuance in the first seven months of 2009 was approximately $9.3 billion compared to $11.1 billion in the same period of 2008, suggesting a continued slowdown in 2009. But in November 2009, Moody's issued a report noting that global *sukuk* issuance had surged by forty percent in the first ten months of 2009 compared with the corresponding period of 2008,[11] reflecting both continued recovery in the later part of 2009 and the significant slowdown experienced at the end of 2008. The Moody's report noted that "sovereigns and government-related issuers (GRIs) have now become the most common *sukuk* issuers as they face a need to launch a variety of funding programmes amid declining economic activity, fiscal deficits and lower commodity prices."[12]

Although the changing views of Islamic scholars, formalized and published in March 2008,[13] significantly reduced the number of structures acceptable for use in *sukuk* and therefore contributed to the fall in *sukuk* issuance in 2008, this guidance did not significantly adversely affect sovereign issuance. The reason was that the guidance did not affect the use of the *ijara* (sale and leaseback) structure, and it is this structure that has been most used by sovereign issuers of *sukuk*.

One notable significant effect of the global financial crisis on sovereign *sukuk* issuance was the delay in issuance by the U.K. government of its debut *sukuk*. The U.K. government conducted public consultations in May and November 2007 on its plans to issue a *sukuk*. A number of responses were received to both consultations and, in June 2008, the government published its response.[14] In the response, the then-Economic Secretary to the Treasury confirmed that the government was committed to continuing support of the long-term development of Islamic finance in the United Kingdom. The response stated that the government favored establishing a program for the issuance of short-term *sukuk* instruments using an *ijara*-based structure. But the government recognized that a number of issues relating to the structuring, regulation, and taxation of *sukuk* remained, which it intended to continue to address.

In the autumn of 2008 and reflecting the effects of the global financial crisis, the U.K. government announced that its plans to issue *sukuk* had been placed on hold. But the government has continued to work on resolving the obstacles

10. Press Release, Standard & Poor's, Sukuk Market Has Continued to Progress in 2009, Despite Some Roadblocks (Sept. 2, 2009) (on file with *Law & Contemporary Problems*).

11. Press Release, Moody's Investors Service, Sukuk Issuance Surges, Dominated by Government-Related Issuers (Nov. 10, 2009) (on file with *Law & Contemporary Problems*).

12. *Id.*

13. *See* ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 6.

14. DEBT MANAGEMENT OFFICE OF HER MAJESTY'S TREASURY, GOVERNMENT STERLING SUKUK ISSUANCE: A RESPONSE TO CONSULTATION X (June 2008).

identified in the response and most recently has enacted legislation[15] designed to address the unequal regulatory treatment in the United Kingdom of *sukuk* and conventional bonds.

It is likely that, as markets around the world emerge from the global economic downturn experienced since late 2007, activity in the *sukuk* market will increase and adaptation and innovation in the market will continue. One anticipated trend in particular is the use of the market by non-Islamic borrowers based in non-Islamic countries. The governments of a number of European and Asian non-Muslim countries have expressed interest in the possibility of *sukuk* issuance and a recent high profile example of a *sukuk* from a non-Muslim international borrower was the issue by GE Capital Sukuk Ltd. in November 2009 of a $500 million *sukuk*.

15. The Financial Services and Markets Act, 2000, c. 8 (Eng.), *amended by* (Regulated Activities) (Amendment) Order 2010 No. 905.