Sukuk innovation needs to go further

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Sukuk needs to move towards enhanced risk sharing to have real value added and a competitive edge over conventional bonds

By DR OBIYATHULLA ISMATH BACHA

Sukuk, which is probably Islamic finance's most popular product, has of late gone through a fair bit of innovation. As opposed to their earlier structures which were nothing but Shariah-compliant straight debt, some of today's sukuk come with a variety of features.

Broadly speaking, there are two broad thrusts in the innovation that have taken place. First, the use of embedded options for better risk management/profiling. Second, innovation seeking to overcome limitations like the need for physical underlying assets.

Though options — especially the exchange-traded variety — are still anathema to a majority of the fuqaha (Shariah scholars) fraternity, their use within sukuk structures appears to be booming. A wide range of sukuk, originating from diverse geographic jurisdictions, come with embedded options.

While many come embedded with either calls or puts, several come with both. A call option which provides the right to purchase an under-lying asset at a predetermined price, is typically embedded to minimise the risk to the obligor in acquiring the asset at maturity. In addition to ensuring possession, he knows the maximum price he would have to pay.

An embedded put option, on the other hand, favours the sukukholder. The put enables the holder to sell the under-lying asset to the obligor at a predetermined price. With the put, the ability to enforce sale of the asset to the obligor not only reduces the risk of repayment at maturity, but also sets a minimum price he would receive for it.

Embedded puts are also used within sukuk structures to protect the sukukholder from changes in the ownership of the obligor. In the event of a change in ownership of the sukuk-issuing firm, the embedded put would enable the sukukholder to redeem the sukuk outright at a predetermined face value. This effectively eliminates risks to sukukholders arising from ownership changes.

Embedded Call Options

A number of Islamic banks have also issued perpetual sukuk with embedded call options for the purpose of meeting their Basel III capital adequacy requirements.

The embedded call options enable the issuing banks to recall portions of the outstanding sukuk for redemption at predetermined future dates and prices, thereby enabling the banks to manage their outstanding obligations.

At least one sovereign wealth fund, Malaysia's Khazanah Nasional Bhd, has issued "exchangeable sukuk" which allow the holders to either convert the sukuk to the under-lying asset, which in this case are public listed shares, or redeem the sukuk at face value.

This convertibility provides the sukukholder with a potential for additional profit. If the underlying shares have a market value higher than the conversion price, converting would be profitable, else they receive the face value. The exchangeable sukuk is akin to the convertible bond.

It is obvious that the use of embedded options brings many benefits. By enabling the management of risk, the sukuk's risk profile is changed. This has an impact on the required yields of investors and, therefore, the cost of funds to the issuer.

For example, when embedded put options reduce the risk to sukuk investors, it should lead to a lower required yield than otherwise. The lower required return by investors, translates into lower cost of funds to issuers. Similarly, the ability to convert a sukuk to stock, and potentially profit, has the same impact on required yield and cost reduction.

Readers familiar with option- based investment strategies should be able to see that the exchangeable sukuk is similar to a "covered call write", a strategy by which one sells a call on a stock currently owned. The objective being to earn extra (from call premiums received) from the low beta stocks held within a portfolio. The ability to do the same within a Shariah-compliant framework means that innovation can be a way to overcome the higher transaction cost disadvantage of Islamic finance.

Unencumbered Assets

Aside from clever use of options to minimise risks and costs, sukuk innovation has also been aimed at overcoming the limitations imposed by the need for unencumbered assets to be pledged as the underlying asset for sukuk issuance.

Telcos such as Axiata have also issued sukuk with airtime vouchers as the underlying asset *(Pic by Ismail Che Rus/TMR)*

Though not the first of its kind, the Emirates airline sukuk which had "airline passenger miles" as the underlying asset became a trendsetter. The Emirates sukuk was, in effect, securitising future revenue and using it as the pledged underlying asset.

Telecommunications companies (Telcos) like Emirates Telecommunication Group Co PJSC of the United Arab Emirates, Ooredoo QSC of Qatar, Malaysia's Axiata Group Bhd and the Pakistan Mobile Communications Ltd have all issued sukuk with airtime vouchers as the underlying asset.

While a structure that uses securitised future revenue as the underlying asset overcomes a key limitation to sukuk issuance, the repayments of the sukuk are not linked to the revenue earned from the underlying asset. The structures provide for fixed returns to sukukholders regardless of actual revenue.

Thus, despite the innovation, such sukuk are nothing but debt. This is unfortunate as the securitised future revenue could have been the basis for sukuk returns. The sukuk would then be risk sharing, quasi-equity like instruments. A risk-sharing sukuk would avoid the leverage and increased risk to the issuer that is inevitable from debt financing.

While sukuk design has indeed come a long way by clever use of leading edge finance techniques, they need to move towards enhanced risk sharing if sukuk is to have real value added and a competitive edge over conventional bonds.

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