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Equity-based sukuk: square peg, round hole

There is a tension within Islamic finance between what is viewed as ideal—Islamic finance being different from conventional finance—and what is possible with the real-world constraints of investor preference and regulations (e.g. Basel capital requirements for banks). A paper by Omar Salah about the effect of the AAOIFI ruling on equity-based sukuk shows how structures can change to move practice closer towards ideal by looking at pre- and post-ruling examples of mudaraba sukuk.

Salah describes the theoretical structure of mudaraba sukuk with the important feature that "*sukuk* holders do not receive a fixed return and [bear the] risk that [they] will not receive the expected return in case the underlying projects do not perform". He then describes several pre-AAOIFI ruling sukuk that mitigate these risks through interest-free loans from the originator and purchase undertakings to redeem the sukuk at par upon maturity, two features which AAOIFI's Shari'ah board said were not allowable.

The solution—illustrated using the post-ruling Saudi Hollandi sukuk—replaces the purchase undertaking with a call option for the originator if the assets are valued in excess of par and subjects the periodic profit payments to final settlement upon maturity, forcing investors to realize a loss if the mudaraba loses value in excess of the value of the reserve account.

The underlying problem facing mudaraba issuers (which explains why so few have been issued post-ruling) is that it attempts to fit a square peg into a round hole. Investors want a fixed income-like instrument while the equity-based structure demands loss sharing. The creative solution from the Saudi Hollandi Bank sukuk accommodates this requirement to a degree, but there remains the problem of valuing the underlying assets, which is more art than science.

Valuation problems are common in banking and finance (e.g. the discrepancy between the trading price of Arcapita murabaha pre-bankruptcy with the values of assets on its balance sheet). This makes fixed duration mudaraba and musharaka sukuk difficult because redemption on maturity has to occur at a valuation determined *ex post*, without reference to the par value.

This will always be difficult unless the sukuk assets can be valued with reference to market prices so perhaps mudaraba and musharaka structures are more useful in equity markets, rather than sukuk, since by their nature it is difficult to replicate the risks and returns of fixed income.

Until next week,
Blake Goud

My Reading List

Islamic Finance- The Impact of the AAOIFI Resolution on Equity-Based Sukuk Structures (pdf)

Form vs. substance or pragmatism vs. idealism? (Sharing Risk)

Summary of the AAOIFI ruling and the Saudi Hollandi Bank sukuk (Sharing Risk)

Blog Posts This Week

Why does Islamic finance ignore agriculture and SMEs?

Highly leveraged Islamic private equity will not perform differently than conventional private equity!

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