Sukūk structure for deficit financing during COVID-19 crisis

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Abstract

Purpose – This paper identified the sukūk structure suitable for deficit financing during the COVID-19 crisis. The study also explored the relevant Sharī‘ah contracts that could be utilized to issue sukūk that is suitable for various jurisdictions and corporations in handling deficit financing during the COVID-19 crisis.

Design/methodology/approach – The authors have adopted a qualitative research approach in which primary and secondary sources available on the subject were reviewed, especially a number of cases related to sukūk structures prior to and during the COVID-19 crisis and analyzed their performances and drawn their conclusions.

Findings – The outcome of this paper suggests that certain sukūk structures used during the COVID-19 crisis aimed primarily at financing deficit have been successful. Furthermore, these sukūk structures are relied very much on the obligator’s/issuer’s cash flow position. It has been revealed that if the sukūk is structured on equity-based contracts with lower repayment amount or no payment, it would not trigger default because the nature of this sukūk is the sharing of profit and loss, in accordance with a Sharī‘ah rule that there will be compensation for any loss only if deliberate and notable negligence is proven. However, if it is debt based or ijarah and wakalah contracts, then the payment to sukūk holders ought to be made as agreed and if not, it will trigger default. This payment is to be made from the cash flow of the issuer and if there is an issue in the cash flow of the issuer due to COVID-19, consent from the sukūk holders needs to be obtained to reschedule payment as found in the case of the Garuda Indonesia sukūk. However, as found in MASB’s IMTN sukūk case, if the cash flow of the company is good, then the chances of default are very slim. However, so far, three new sukūk in the middle of COVID-19 were issued, one by a corporation and two issued by a sovereign, one of which addresses the liquidity issues during the pandemic, and all these proved that sukūk is definitely a viable alternative mode for deficit financing and a reliable option during the COVID-19 pandemic.

Research limitations/implications – This paper looked into the sukūk structure, especially the sukūk which are yet to mature and the new sukūk issued during the crisis caused by the COVID-19 pandemic.

Practical implications – It is anticipated that the outcome of this research will assist the stakeholders in sukūk markets to understand the sukūk impact on COVID-19 related deficit financing and suggest various structures that could be utilized in the sukūk market in an unprecedented situation such as the COVID-19 economic distress.

Social implications – Looking at the social aspect of sukūk markets, this paper has endeavored to provide solutions to the financing of deficit for social well-being as a tool to provide relief and social stability in the lives of the people.

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Originality/value – The novel COVID-19 pandemic has caused unprecedented economic difficulties and market distress on a global scale; and this research sought to identify the relevant sukuk structures to be used for deficit financing during the pandemic crisis, especially the sukuk which are yet to mature and new sukuk issued during the pandemic period. The former includes HDFC Mudarabah sukuk (2019) Maldives and MAHB sukuk/MTN program (2010) Malaysia, while the latter includes IDB Trust Certificates, Phase 2 of the tranches (2020), the Federal Government of Nigeria Road sukuk (May, 2020) and Sharjah Government two billion Dirham sukuk (June, 2020).

Keywords Sukuk, COVID-19 crisis, Deficit financing

Paper type Research paper

1. Introduction

During the COVID-19 pandemic, many corporations and countries face difficulties in financing their projects, especially the short-term operations. This is because most businesses were closed and social activities were sanctioned in most countries to allow health workers to effectively contain the pandemic. With the closure of most economic activities, social interactions, sukuk and other Islamic banking and finance activities have also been affected and many investors and sukuk issuers are concerned particularly for the sukuk approaching maturity and also the newly-issued sukuk in the markets. This study aims to investigate the appropriate sukuk structure to be used during the pandemic for deficit financing purposes. This is to be done by analyzing the sukuk which are yet to mature particularly sukuk which are issued in Malaysia and Maldives. The paper also aims to investigate the new sukuk issuances that coincided with the period during which the pandemic was active and began proliferating globally. These types of sukuk to be investigated were issued in Saudi Arabia, Nigeria and the United Arab Emirates, respectively.

Sukuk is an Islamic alternative to the conventional bond. It can also be defined as “an Islamic financial instrument issued in the global capital markets”. Sukuk was defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI) as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity”. The performance of the sukuk market in 2019 alone proved the confidence and the success of sukuk as a reliable financial instrument. RAM Rating Services Bhd (2020a) reported that “the global sukuk market delivered a noteworthy performance in 2019, notching up USD130.2 billion of gross issuance, which is a 41.6% jump from USD91.9 billion the previous year and the top five countries by incremental value were, Turkey (+320.4%), Qatar (+62.2%), Malaysia (+57.7%), Bahrain (+45.1%) and Indonesia (+26.2%).

Even though issuance by non-core markets surged 138% to USD13.3 billion last year (2018: USD5.6 billion), the global sukuk market remained dominated by the Gulf Cooperation Council (GCC, 40%), Malaysia (34%) and Indonesia (15%)”.

As for sovereigns, Saudi Arabia retained its leading position in the global sovereign sukuk market with a 28.9% (USD21.4 billion) share. Indonesia was a close second (25.3% or USD18.7 billion), while Malaysia (18.5% or USD13.7 billion) was next, and then Turkey (USD7.0 billion or 9.5%). The main fund-raising objective was to complement the respective countries’ budget deficits (RAM Rating Services Bhd, 2020a). As for corporate sukuk issuances, Malaysia continued to lead with USD31.2 billion (or a 55.3% share), followed by the UAE with USD9.8 billion (17.3%). Saudi Arabia was next with USD9.1 billion or 16.2% ahead of Qatar (USD8.1 billion or 3.6%) (RAM Rating Services Bhd, 2020a). However, the structural dimension of sukuk issuances has changed during the dreaded COVID-19 pandemic.

COVID-19 is a pandemic that was first discovered in December 2019 in Wuhan, China, that went on to affect the whole world. Initially, it was anticipated that COVID-19 was merely a health crisis that would have no economic or financial implications. However, within less than
five months of its discovery and the acknowledgment of its spread, worldwide economies and financial activities have come to a standstill. Today, the world is witnessing a situation it never ever anticipated and could prepare for. In light of this, like any other financial instrument, *ṣūkūk* has also been significantly affected by this pandemic. As such, this qualitative research aimed to determine the effect of the COVID-19 pandemic on *ṣūkūk* markets by specifically identifying its impact on *ṣūkūk* yet to mature as well as new *ṣūkūk* issuances. The method adopted for this research is a qualitative research method where a number of cases related to *ṣūkūk* issuance prior to and during the COVID-19 crisis were analyzed to understand the relevant structure suitable for deficit financing during the pandemic.

This paper is organized in five different sections. Following the Introduction, section two discusses the literature review, focusing on the *modus operandi* of *ṣūkūk*, while section three provides details of the impact of COVID-19 on the *ṣūkūk* market. Section four offers recommendations for further research, and finally section five concludes the paper.

2. Literature review

*Ṣūkūk* markets have been one of the most sustainable channels of financing in many economies today, with many corporate and government agencies worldwide turning to *ṣūkūk* issuances to address their financing needs. The concept of *ṣūkūk* was approved by the Council of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC) in its fourth session held in Jeddah, Kingdom of Saudi Arabia from 18–23 Jumada Al-Thani 1408H (6–11 February, 1988) (IIFM, 2011). The literature addresses the economic influence of COVID-19 during the global economic distress resulting from the pandemic. It also looks at the literature which has targeted the impact of Islamic finance and the general performance of Islamic financial institutions during the COVID-19 pandemic as well as the nature of *ṣūkūk* and its *modus operandi* by highlighting the key differences between the *ṣūkūk* and conventional bond.

Deficit financing is one of the reasons many Governments across the globe are having the interest in the issuance of *ṣūkūk* for many reasons, one such reasons is the *ṣūkūk* capability to support budget deficit financing. Salman *et al.* compares *ṣūkūk* and bond absorption in deficit budge financing in Indonesia, and the research finding was very clear that *ṣūkūk* has a very significant and positive effect on deficit financing budget in the country (Parisi and Rusyidiana, 2016). *Ṣūkūk* was also used to support the Nigeria’s budget deficit to strengthen the country’s economy. Baita, argued that *Ṣūkūk* have been proven to be the alternative to other interest bearing financial instruments, and it is so efficient to effectively finance the budgetary and infrastructural deficit of the Nigeria’s development projects (Baita, 2019).

Khanawaz and Rabbani (2020) in their book chapter highlighted that the effect of COVID-19 pandemic on the world economy is even greater than that of the Second World War, and the “Great Depression” of the 1930s, and even the financial crisis of 2008/2009. The COVID-19 pandemic has left a lot of businesses on the brink of collapse. Following this, there is a need to find some alternative ways to bail out the affected businesses in this dire economic situation. The chapter found that the Islamic financial system combined with the financial technology (FinTech) together could be the solution to help these small businesses and individuals impacted by the current pandemic-related economic distress. The study suggested the use of a FinTech model based on Artificial Intelligence of the *Qardh Al-Hasan* (Benevolent loan). The study proposed that *Qardh Al-Hasan* could be the landscape for the social and sustainable finance in fighting the persistent effect of COVID-19 on the Small and Medium Enterprises (SMEs) (Khanawaz and Rabbani, 2020).
In studying the empirical evidence the authors show that sukūk differs from the conventional bonds from the risk perspective. Some studies have also been done to highlight such reality through empirical study. Nasir and Farooq (2017) conducted a comparative risk analysis of sukūk and conventional bonds in Pakistan, and indicated that sukūk faced less risk and offered greater stability as a financial instrument in comparison with the conventional bonds. Risk and stability of sukūk can be clarified with the diversification theory and the liquidity perspective. They also reported that; “correlation among most of sukūk securities is less or negative, which helps in diversifying their risk. However, the attribute of stability can be due to the comparatively fewer days of trading in the case of sukūk.”

It is important to highlight that the COVID-19 outbreak was not caused by the bad policies of the financial institutions or the weakness of the financial system; and the impact of the COVID-19 could be representing a temporary shock to the world economy. Therefore, when assigning the weightage on the good, bad and base case scenarios, financial institutions may be advised to evaluate if the economic slowdown may be expected to continue in future years, then, the highly affected industry borrowers could be more heavily weighted on the bad scenario for the longer term (e.g. 2-3 years for the tourism industry). The industrial sector that is expected to recover more rapidly could be more heavily weighted on the bad scenario in the short-term (e.g. a year for hypermarkets). On the other hand, in the long-term the base case scenario may continue to be more heavily weighted with the expectations of an economic recovery (Deloitte Financial Report, 2020).

In another study, Hamzah et al. (2018) examined the incentives for risk shifting in debt-based and equity-based contracts according to the critiques of the similarities between sukūk and bonds; this indicates that “there is a need for greater global awareness of the hazards related to debt, that should be increased as a means of minimizing the quantum debt outstanding globally.” They also highlighted that many researchers and financial regulators state that “sukūk are designed to be a substitute for debt” and due to the global financial crisis, amid the desperate search for approaches to pre-empt future financial shocks, their study seeks to facilitate the creation of future stability by motivating market players to circumvent debt-based activities to promote equity-based instruments.

2.1 The nature of sukūk
Sukūk is an instrument of the Islamic debt market. However, some perceive it as a hybrid form of security, which has similar features of bonds and stocks (Zolfaghari, 2017). This view is expressed because, unlike in conventional bond, sukūk uses the Islamic commercial contracts of sale, lease, service or partnership, where the relationship between the sukūk issuer and the sukūk holders is derived from these contracts. Furthermore, these underlying contracts also determine the Shari‘ah rules applicable to the transaction, including the economic activity the party engages in or the underlying asset that is used in the transaction. The most well-known definition used to define sukūk is the definition of sukūk by the AAOFI in their Shari‘ah Standard (17) on investment sukūk, where it is defined as “certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or in the ownership of the assets of particular projects or special investment activities” (AAOFI Standard No. 17, 2017).

2.2 Modus operandi of sukūk
The modus operandi of sukūk depends on the underlying Shari‘ah contract(s) used to structure such sukūk. Unlike conventional bond, sukūk does not have a uniform structure. Therefore, the sukūk structuring process becomes more complex than that of the
conventional bond and the transaction cost also becomes more expensive than that of the conventional bond as the number of processes and the parties involved in the transaction depends on the sukuk structure. Due to the Shari‘ah-compliance feature embedded in sukuk, in all sukuk structures, the involvement of competent Shari‘ah advisers, whether a person or a firm, depending on the regulatory requirements of the jurisdiction in which the sukuk is issued, becomes a uniform and integral part of the sukuk structuring process.

There are two main types of sukuk: that are asset-based and, asset-backed sukuk. In asset-based sukuk, the principal is covered by the capital value of the asset but the returns and repayments to sukuk holders are not directly financed by these assets while in asset-backed sukuk, the principal is covered by the capital value of the asset but the returns and repayments to sukuk holders are directly financed by these assets (Zolfaghari, 2017, p. 8). The main differences between these two types of sukuk are summarized in Table 1.

To understand the modus operandi of sukuk, four different sukuk structures are discussed in this part; sukuk structured using debt contracts, lease contract, partnership contract and service-based contract.

2.2.1 Sukuk structured using debt-based contracts. Debt-based contracts utilized in Islamic finance are created using sales contracts where the contract obligation is paid on a deferred basis. Looking into the Shari‘ah rules, though it is a sales contract, the deferred obligation to pay becomes a debt liability from the side of the buyer. As a result, even if one installment is unpaid as per agreement made between the seller and buyer, default will be triggered. Likewise, since it is a debt obligation, which is created not by way of a loan, any extra amount charged due to late payment would be tantamount to riba (interest) and as such, except as ta‘lidh (compensation) or gharamah (penalty over penalty), rules laid down by the Shari‘ah scholars and jualuwas issued, no extra amount can be charged above and beyond the price agreed at the time of the agreement in these types of Islamic finance contracts. The major debt contracts used in the Islamic finance include murabahah, which is a trust sale, where it is mandatory to disclose the cost price plus the profit charged when selling it to the buyer; tawarruq, where the buyer first acquires a property from a seller on a deferred basis and then goes to market and sells it on spot and acquires cash to use for any purpose he needs; salam, where a forward sale is agreed of some defined homogenous goods (quantity and quality) that would be produced in future and the price for which will be paid on spot, but the goods will be delivered at a fixed future date; istisna’, where it is used to produce manufactured goods, where the specification of goods to be manufactured is clearly given by the person who orders and the price payment mode and frequency have been agreed by the parties in specific terms.

<table>
<thead>
<tr>
<th>Categories</th>
<th>Asset-based sukuk</th>
<th>Asset-backed sukuk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source of Payment</td>
<td>Payment is from originator/obligor’s cash flows</td>
<td>Payment is from the revenue generated by underlying asset</td>
</tr>
<tr>
<td>Presentation/</td>
<td>The asset stays on the balance sheet of originator/obligor</td>
<td>The asset is separated from the originator’s book</td>
</tr>
<tr>
<td>disclosure of the asset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Types of sukuk</td>
<td>Beneficial ownership but with no right to dispose of the asset</td>
<td>Legal ownership with the right to dispose-off the asset</td>
</tr>
<tr>
<td>holder’s ownership</td>
<td>Purchase undertaking at par from obligor is the ultimate recourse, which is only to obligor and not the asset</td>
<td>Sukuk holders only have recourse to asset, hence asset plays genuine role in defaults</td>
</tr>
<tr>
<td>Recourse</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source(s): Zolfaghari (2017)
In structuring sukiik using the above stated Shari‘ah contracts, the specific obligations between the parties are derived from the Shari‘ah contracts used. Furthermore, in selling of sukiik in the secondary market, the type of contract(s) used in sukiik structuring plays a vital role. Except for salam and istisna ‘based sukiik, in all the other types of sukiik, default will occur upon default in the payment obligation as agreed in the contract which is supposed to be made periodically in future. In the case of salam, default will occur due to failure of delivery of goods agreed as per the description to the forward buyer and in istisna’, default will occur upon either failure of construction of the ordered goods as agreed or within the time frame by the manufacturer or if the person who orders to manufacture the goods fails to make payment as agreed, depending on how it is structured.

Chapter two, paragraph 2.01 of “Guidelines on Issuance of Corporate Bonds and Sukiik to Retail Investors” of the Securities Commission (SC) Malaysia defines sukiik murabahah as “certificates of equal value evidencing the certificate holder’s undivided ownership of the asset, including the rights to the receivables arising from the underlying contract”; sukiik istisna as “certificates of equal value evidencing the certificate holder’s undivided ownership of the asset, including the rights to the receivables arising from the underlying contract.” In this “Guidelines”, it does not provide a definition of sukiik tawarruq and sukiik salam. The Shari‘ah Advisory Council (SAC) of Bank Negara Malaysia (BNM) in its 67th meeting held on 3rd May 2007 had resolved that “there is no objection in Shari‘ah for the issuance of sukiik commodity murabahah based on tawarruq as long as the sale transactions involve three or more contracting parties and the modus operandi of such sukiik is that sukiik involves commodity murabahah transaction through tawarruq contract to create indebtedness between the sukiik issuer and investors where the debt will be settled by the sukiik issuer on maturity date (Bank Negara Malaysia, 2010, p. 98). In sukiik salam, the issuer sells the salam asset and the subscribers or sukiik holders are the buyers of that asset where the price of salam is paid on spot by the sukiik holders and the sukiik issuer is obliged to deliver the salam asset on a future date. Parallel salam contracts are executed to ensure that the salam sukiik holders’ benefit.

2.2.2 Sukiik structured using lease-based contract. Lease-based sukiik can be structured using the Shari‘ah commercial contract of ijara where a Shari‘ah compliant defined object which is not perishable or gets exhausted when used could be given for a defined lease period for a defined rent. This is a famous contract used to structure sukiik. Like debt contracts, in ijara, the rent is an obligation that shall be paid by the lessee and non-payment of it as agreed will trigger default. Therefore, these types of contract very much depend on the cash flow of the lessee.

Chapter two, paragraph 2.01 of “Guidelines on Issuance of Corporate Bonds and Sukiik to Retail Investors” of the SC Malaysia defines sukiik ijara as “certificates of equal value evidencing the certificate holder’s undivided ownership of the leased asset and/or usufruct and/or services and rights to the rental receivables from the said leased asset and/or usufruct and/or services.”

2.2.3 Sukiik structured using partnership-based contract. Sukiik can be structured using two types of Shari‘ah commercial contracts. They are mudarabah, which is a fund management partnership where one party gives funds and the other party manages it to invest in a Shari‘ah-compliant real economic activity where the parties agree to share profit as per a pre-agreed profit-sharing ratio and in case of loss except in case of negligence all financial losses will be borne by the person who invested the money; and musharakah is when both parties agree to do a Shari‘ah-compliant activity on terms they agree, where a profit sharing ratio is agreed and loss depends on capital contribution. In these two types of partnership, or equity-based contracts, the profit cannot be guaranteed in any way. This means that profit generation shall depend on the real economic activity which they conduct
and it shall be tied to the return generated from such activity. Therefore, in this type of contract, even if there is no payment due to loss, it does not trigger default. This is an inherent risk that ought to be noted by those participating in such a contract.

Chapter two, paragraph 2.01 of “Guidelines on Issuance of Corporate Bonds and 什鲁克 to Retail Investors” of the SC Malaysia defines 什鲁克 mudاربah as “certificates of equal value evidencing the certificate holder’s undivided ownership in the mudاربah venture” and 什鲁克 mushارakah as “certificates of equal value evidencing the certificate holder’s undivided ownership in the mushارakah venture.”

2.2.4 什鲁克 structured using service-based contract. Wakalah or agency for a fee is a service-based contract approved by Shari‘ah, which is used to structure 什鲁克. In a Wakalah contract, the principal appoints an agent to perform an act which is Shari‘ah-compliant on behalf of the agent creating a fiduciary duty between them. The breach of fiduciary duty of the agent will trigger default in this case. 什鲁克 wakalah for investment (istihamar) is a 什鲁克 structure used in the market.

Chapter two, paragraph 2.01 of “Guidelines on Issuance of Corporate Bonds and 什鲁克 to Retail Investors of Securities” of the SC Malaysia defines 什鲁克 wakalah bi al istihmar as “certificates of equal value evidencing the certificate holder’s undivided ownership in the investment assets pursuant to his investment through the investment agent.”

2.3 Differences between 什鲁克 and bond
As evident from the earlier discussion, there are differences between 什鲁克 and bond even though both are considered as debt instruments with maturity period in capital markets. The fundamental difference between 什鲁克 and bond is that 什鲁克 is a Shari‘ah-compliant instrument whereas bond is not. The modus operandi of bond is based on a loan relationship with maturity where the bond issuer promises the bond holder that the principal they pay to buy the bond will be returned upon maturity or as agreed with the interest of which from the Shari‘ah perspective is considered riba, prohibited in Shari‘ah, which is the lex loci applicable to all Islamic finance transactions including 什鲁克. The main differences between 什鲁克 and bond are illustrated in Table 2.

<table>
<thead>
<tr>
<th>Šukūk</th>
<th>Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>Partial ownership of an asset</td>
</tr>
<tr>
<td>Compliance</td>
<td>The assets that back 什鲁克 should be compliant with Shari‘ah</td>
</tr>
<tr>
<td>Pricing</td>
<td>The face value of a 什鲁克 is priced according to the value of the assets backing them</td>
</tr>
<tr>
<td>Rewards and risks</td>
<td>什鲁克 holder receives a share of profit from the underlying asset. 什鲁克 holder accepts a share of any loss incurred</td>
</tr>
<tr>
<td>Effect of costs</td>
<td>什鲁克 holders are affected by costs related to the underlying assets. High costs and translate to investor profits and vice versa</td>
</tr>
<tr>
<td>Sales</td>
<td>Sale of ownership in the assets backing them</td>
</tr>
</tbody>
</table>

Source(s): Bond+Šukūk Information Exchange (bix) (2019)
3. Impact of COVID-19 on sukūk market

Hidayat et al. (2020) observes that COVID-19 has had an adverse impact on the sukūk market using returns from five sukūk and bond indexes between December 2019 and April 2020 as shown in Figure 1, which clearly shows a sharp drop in sukūk returns in March 2020.

Due to COVID-19, new policies have been implemented by countries as part of fiscal stimulus and monetary policy to buy back the sukūk issued by the government. In this regard, for example, Sukmana et al. (2020) reported: “Now, Bank Indonesia, the central bank, is authorized to purchase sovereign bonds and sukūk directly in the primary market whereas previously, purchases were only possible in the secondary market to conduct monetary policy” (p. 34).

It is imperative to analyze the sukūk role in financing financial deficit resulted from the COVID-19 pandemic and to also understand the maximum protection and the rights the existing and potential sukūk holders might realize.

3.1 Sukūk yet to mature

Knowing the nature of the modus operandi of sukūk, it is prima facie clear that the sukūk which has been issued and has not yet matured will definitely be adversely affected. The rating of sukūk will be affected, at the same time there could be a possibility of those sukūk being defaulted due to poor performance of sukūk assets. The impact of COVID-19 on different sukūk will differ according to the type of the sukūk. The Shari‘ah contracts used and the underlying sukūk asset would be the contributory determinants. It is also said that there is a possibility of experiencing a number of defaults among sukūk issuers this year, especially for those with weak creditworthiness (Haroon, 2020). For illustration purposes and to explain the practical aspect of this type of sukūk, some examples of sukūk which are yet to mature will be analyzed in the following paragraphs.

3.1.1 Sukūk mudārabah issued by the housing development corporation (HDFC) PLC, Maldives. There are three sukūk mudārabah issued by HDFC Maldives and these three sukūk have no involvement of a special purpose vehicle (SPV) as illustrated in Figure 1. HDFC Maldives is owned by the government of Maldives (49%), International Finance Corporation...
Since the government of Maldives has requested to provide a six-month moratorium to customers of financial institutions affected by COVID-19, HDFC Amna, the Islamic window of HDFC via announcement number (IUL)/HDFC/2020/04 dated 26th March 2020 has also provided a moratorium from 1st March 2020 to 31st August 2020 to the customers. To finance the operations of HDFC Amna there are three sukuk issued by HDFC, which are based on the Shar’ia concept of mudarabah. Figure 2 illustrates the sukuk structure.

Due to the moratorium, the sukuk holders will be adversely impacted as the sukuk holders are supposed to receive the money paid by the customers of HDFC Amna. Since the pandemic in this case can be considered as a force majeure, there is no case of negligence, that could be established on the part of muḍārib which is HDFC, and then there will be no compensation awarded to the sukuk holders. Therefore, in this case, the actual loss will be suffered by the sukuk holders if there is no payment or less periodic payment made to the sukuk holders, but there will be no default as the nature of this sukuk is muḍarabah that would last for the tenure of the sukuk.

3.1.1.1 Implications. First, HDFC has issued a sukuk based on muḍarabah, where the sukuk holders are supposed to be paid from the money received from the payment of HDFC Amna’s customers who have obtained financing facilities. However, since the government has requested all financial institutions to give a six-month moratorium on financing facilities given, thus, the sukuk holders will not be able to get a return during the moratorium period. Therefore, there will be a question on how will the loss for sukuk holders which is the rabb al maal (capital provider) in this case be recovered.

Second, however, since HDFC sukuk is based on the muḍarabah concept, the inability to make the payment due to loss in a quarter, will not be tantamount to a default as the nature of the muḍarabah contract is that even loss can be suffered by the sukuk holders, if the business does not perform well. The actual profit and loss sharing ought to be evident in this type of a contract.

3.1.2 Malaysia airports holdings Berhad’s (MAHB or the group) sukuk/IMTN program, Malaysia. On 30th August 2010, MAHB via its wholly-owned subsidiary, Malaysia Airports Capital Berhad, successfully completed its inaugural first tranche issuance of a 10-year RM

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**Figure 2.** HDFC muḍarabah sukuk structure
IES

1.0 billion Islamic Medium-Term Notes (Islamic MTN) at a yield of 4.55%, pursuant to its Islamic Commercial Paper Program and Islamic MTN Program with a combined aggregate nominal value of up to RM 3.1 billion (collectively known as the “Sukūk” program) (Malaysia Airports, 2010, p. 26). Since the maturity date of the sukūk is in August 2020 and due to the adverse effects of the pandemic which have substantially paralyzed the airline industry, it is perceived that there could be a default of the sukūk Islamic MTN by MAHB as they might face a cash flow issues. On 22nd April 2020, the RAM Rating Services Bhd issued a press release stating that “strong liquidity of MAHB allows it to manage negative impact of Covid-19” (RAM Rating Services Bhd, 2020b) where it is stated that:

In the interim, MAHB’s liquidity position is strong, with about RM2.7 billion of cash and liquid instruments (as of 2nd April 2020) against RM1.3 billion of short-term debts as at end-December 2019 (including RM1 billion of Islamic MTN maturing in August 2020). We understand that MAHB is in advanced stages of refinancing the maturing Islamic MTN through facilities from several financial institutions.

As per MAHB term sheet, the Sharī’ah structure used for Islamic MTN of MASB used is the Sharī’ah ījārah and murābāhah utilizing commodities (“Commodity murābāhah”). The facility description provided for this issuance is Islamic Commercial Papers (“ICPs”) Program (“ICP Program”) and an Islamic Medium-Term Notes (“IMTNs”) Program (“IMTN Program”) where collectively both ICPs and IMTNs are referred to as sukūk. The sukūk ījārah is described in Figure 3 while sukūk commodity murābāhah involved in this sukūk is described in Figure 4.

3.1.2.1 Implications. First, since the Islamic MTN program is based on debt and ījārah-based Sharī’ah contracts, the return needs to be paid from the cash flow of the issuer and fortunately for MAHB, their liquidity position was not affected by COVID-19 and the sukūk holders were paid.

Second, the lesson learned in this regard is that in Islamic debt contract sukūk papers, the payment is to be made by the issuer and as such, the behavior in this case has some similarities with that of a conventional bond.

3.1.3 Garuda Indonesia Sukūk. Garuda Indonesia issued a five-year tenure US$496.8 million global sukūk with a return of 5.95% per annum (Mufti, 2020). This sukūk was to mature on 3rd June 2020. It is reported that Garuda Indonesia is drowning in debt (IFN, 2020) and in May 2020, it was reported that Garuda Indonesia was reaching out to its sukūk holders to “hold a discussion on repayments due in June as the airline struggles to maintain cash flow amid the turbulence caused by the Covid-19 outbreak” (Mufti, 2020). The sukūk is based on the concept of wakālah where the issuer is Garuda Indonesia Global Sukūk Limited and the purpose of the issuance was for Sharī’ah-compliant general corporate purposes, inclusive of the repayment of certain existing Islamic financing arrangements (COMCEC, 2018). This means that the sukūk repayment depends on the cash flow of the company. It is imperative to note that this is the first unrated US dollar sukūk from an Asia Pacific issuer (IFN, 2016). The sukūk structure is provided in the following Figure 5.

3.1.4.1 Implications. First, due to COVID-19, the transport industry has come to a complete halt and it has hit the airline industry badly. Therefore, any sukūk issued by any member of the airline industry is affected due to this, as cash flow management has become a daunting challenge.

Second, the sukūk shows that there is no much difference in case of default between a sukūk and conventional bond issued based on wakālah contract.

3.2 Islamic development band (IsDB) trust certificates sukūk

The IsDB’s trust certificate was rated AAA and listed by three designated agencies, Moody, Bursa Malaysia and Nasdaq Dubai. A total of 61% of the issue size was allocated to investors
in MENA (Middle Eastern and North African) countries, 18% to investors in Europe, while Asian investors were allocated 21%. Orderbook was opened with the release of the initial price thoughts on Wednesday, March 07, 2018. The sukuk was priced on Thursday, March 08, 2018 at Mid Swap (MS) plus 33 basis points (bps), 4 bps below the IDB’s September 2017 issuance, which was priced at MS + 37 bps with profit rate of 3.10%; the sukuk will mature in 2023. Below is the structure overview of the IsDB’s Trust Certificate (sukuk) structure (Figure 6).

1. A special purpose vehicle, SPV (“issuer”) shall be set-up. MAHB and the Issuer (acting on behalf of the sukuk holders) shall from time to time execute asset purchase agreement(s), under which MAHB shall sell certain leasable Shari‘ah-compliant assets (the Assets), by way of transfer of beneficial ownership, to the issuer for a mutually agreed asset purchase price which shall be at all times comply with the SC’s Shari‘ah Advisory Council Pricing Guidelines, pursuant to the trust deed and Asset Declaration of Trust, the SPV shall hold the Assets on trust for the sukuk holders.

2. The Issuer shall issue the sukuk holders to evidence the sukuk holders’ proportionate undivided beneficial ownership and/or interest in the Trust Assets (entitling the sukuk holders to, amongst others, receive the ijarah rentals and all other payments in relation to the Trust Assets). The proceeds from the sukuk will be used by the issuer to purchase Assets from MAHB.

3. The issuer shall lease the Asset to MAHB under an ijarah agreement for a specific lease term in return for periodic one-off ijarah payments. There shall be purchase undertaking executed by MAHB for the benefit of the issuer (acting on behalf of the sukuk holder).

4. MAHB shall pay periodic/one-off ijarah rentals due to under the ijarah Agreement to the Issuer, and

5. The issuer shall make periodic/one-off distributions to sukuk holders equivalent to the periodic/one-off ijarah rentals received from MAHB. On maturity date, Event of Default (“EOD”) Dissolution Event or Mandatory Redemption Event, MAHB, as the Obligor, shall purchase the Asset and the issuer shall sell the Assets at the exercise price, pursuant to the purchase undertaking executed by MAHB for the benefit of the issuer (acting on behalf of the sukuk holders).

Source(s): MAHB Term sheet (2010)
Note(s):

1. Issuer will be appointed as agent (wakeel) of the sukūk holders to buy Sharī‘ah-compliant (the Commodity) (in such capacity, the Purchase Agent).

2. MAHB will issue a purchase order (The Purchase order) to the Purchase Agent (acting on behalf of sukūk holders) at a deferred sale price (the Sale Price)

3. Based on the Purchase Order, the Purchase Agent, on behalf of the sukūk holders shall purchase, on a spot basis, the commodity from commodity vendor(s) in the Bursa Suq Al-Sila’ to the sukūk proceeds.

4. The Issuer shall then issue the sukūk to evidence the sukūk holders’ ownership of the commodity and the rights of the sukūk holders via the issuer (acting in its capacity as the Purchase agent) under the contract for the purchase of the commodity from the CTP and, upon onward sale of the commodity to MAHB, the Sale Price and the rights of the sukūk holders via the issuer (acting in its capacity as the Purchase Agent) under the contract for the sale of the commodity to MAHB (the murābahah Sale Agreement). The proceeds received from the sukūk holders shall be used by the issuer to pay the Purchase Price.

5. Pursuant to the undertaking to Purchase, MAHB shall buy the commodity from the Purchase Agent at a sale price (which shall be the Purchase Price plus a profit margin) payable on an instalment payment basis.

6. MAHB shall then sell the commodity to commodity buyer(s) in the Bursa Suq Al-Sila’ commodity market (through the CTP) on a spot basis for an amount equal to the purchase price.

On-going cash flows and maturity

7. At maturity, Event of Default/Dissolution Event or Mandatory Redemption Event, MAHB (as part of its obligation to pay the sale price) will pay the Purchase Agent who in turn will pay the sukūk holders all amounts outstanding on the sale price as final settlement (subject to the redemption rebate where applicable) upon which the sukūk will be cancelled.

Source(s): MAHB Term sheet (2010)


**Garuda Indonesia Sukuk (Sukuk) structure**

**Figure 5.** Garuda Indonesia Sukuk structure for deficit financing

**Source(s):** Garuda Indonesia (2015)

**Figure 6.** IDB trust certificate (Sukuk) structure

**Source(s):** IDB Trust Certificates (www.isdb.org)
3.2.1 Implications. First, despite using wakālah structure for this sukūk in particular, the financial stability of the issuer proves the sukūk as highly rated even during the pandemic. Another tranche of the IsDB trust certificate rated AAA/AAA/AAA by Moody’s, S&P and Fitch shows all stable outlooks. The bank has successfully priced a US$1.5 billion, five-year trust certificates (Sukūk) under its US$25 billion trust certificate issuance program. The sukūk was priced at par at 2.843%, to be payable on semi-annual basis, marking IsDB’s first public issuance in 2019.

Second, the financial stability of IsDB appeared during the COVID-19 pandemic. The rating exercise of the bank which was rated AAA by three renowned rating agencies. Pitch rating agency affirms that the firm’s rating indicates IsDB stable and assured support for all the member countries during the pandemic. Assessment by Fitch rating indicates that the AAA rating of the IsDB is an affirmation that the bank will not be affected by the global distress related to the COVID-19 pandemic, likewise the sukūk issued by the bank.

Third, besides, the ‘AAA’ rating is an assurance of the bank’s general strength, sustainable financial capability and competitiveness. Apart from IsDB current rating by the three renowned international rating agencies; Standard and Poor’s Global Ratings, Fitch Ratings and Moody’s Ratings, IsDB is further rated by the Malaysia Rating Corporation (MARC). All four international agencies have rated the Bank at ‘AAA’ with a “stable outlook”, recognizing the very strong financial and business profile, underpinned by robust financial and non-financial metrics (Fitch Ratings London, 2020).

3.3 The new sukūk issuances during COVID-19 pandemic

The pandemic has created turmoil in corporations as well as many governments corporations and governments are struggling to manage their cash flows. Many corporations and government agencies have lain off many of their employees as they could not find an immediate suitable source of funding to deal with the financial crisis caused by the pandemic. In this complex and worrying situation, some have forecasted that; the coronavirus crisis will also provide a window of opportunity for sovereigns to raise funds to finance aid packages, and for corporates to lock in more attractive funding rates while taking stock of their financing maturity profiles; and in such highly uncertain times, investors will seek safer havens by moving into bonds and sukūk, thereby benefiting some key economies in the sukūk market (RAM Rating Services Bhd, 2020a, b).

The reality which COVID-19 has forced on the whole world is to find alternative financing mechanisms apart from the financing facilities or loans provided by the banks. The failure of having a debtor-creditor based relationship without linking the return payment to a performance of a real asset or a real economic activity has been evident due to this pandemic proving the risk sharing nature of sukūk. As such, the corporations and governments may consider going for the sukūk option more than the conventional bond option.

Furthermore, multilateral financial institutions, such as IsDB is working with governments of different countries to provide financing options including grants and raising funds through sukūk structuring. As such, there is a possibility that the number of sukūk issuances by sovereigns might increase exponentially in the upcoming months. The objective of such issuances would be to assist governments to come out of the financial crisis caused by the pandemic by having enough liquidity to pump money into the private sector to ease the lack of liquidity issues they face. This way unemployment rate could go down and the social harmony with economic stimulation could be achieved.

What is predicted from the reactions of the corporations and governments is that there is definitely a need for an alternative source of financing. Since sukūk has the potential to meet this need and since IsDB is also closely working with different governments towards it; there is a hope that the prospects for sukūk market are bright. In this regard, the rating agency Moody’s anticipates worldwide sovereign long-term sukūk issuance to grow at a modest rate...
in 2020, continuing the expansionary trend of the past few years and it is projected that the global long-term gross sovereign sukuk issuance will attain approximately US$75 billion, from US$71 billion in 2019, which takes into account wider fiscal deficits and a drive-in market development by major sovereign issuers (Gulf News, 2020).

However, some researchers predicted that there would be a decline in sukuk issuances in 2020 due to the COVID-19 pandemic. Haroon (2020) observed that as per S&P Global Rating, there would be a 40% slump in global sukuk issuances volume due to liquidity issues resulting from the pandemic faced by the banks and the complex process involved in sukuk structuring compared to that of conventional bonds. It was projected that sukuk issuance will drop to US$100 billion in 2020 from US$162 billion in 2019 (Haroon, 2020).

Despite the forecasts of the sukuk market slowing down in 2020 as a result of the pandemic, the world has witnessed issuances of some new sukuk in the middle of the pandemic; one by a company and other two by sovereigns. It was reported that Top Glove of Malaysia, ranked the world’s leading glove manufacturer with a 26% global market share has issued a perpetual sukuk of MYR1.3 billion (approximately US$300 million) based on the concept of wakalah in February 2020 from its MYR3.0 billion (approximately US$720 million) via its wholly-owned SPV, TG Excellence Berhad and it is callable on 27 February 2025 with a profit rate of 3.95% and rated AA-(IS) by MARC where the proceeds were utilized to refinance existing obligations and to partly finance their capex requirements (Ghazali, 2020). It is expected that the demand for medical gloves will increase very substantially due to pandemic and this opportunity has been taken advantage of by the company to issue sukuk to raise financing.

In the middle of COVID-19, the Federal Government of Nigeria (FGN) Road Sukuk was issued whereby the sukuk proceeds were used to construct roads mentioned in the prospectus and ownership of the roads was given to the various investors based on amount they have put in the sukuk. Upon completion of the roads, FGN would pay a levy to the investors twice a year at the rate of 11.2% p.a. and at the end of seven years FGN would buy back the project from the investors at the actual money invested (Jaiz Bank Plc, 2020). This is a sukuk ijarah, whereby the intended amount to raise was NI 50 billion (approximately US$ 129,350,400) and it is to be due in 2027 (Jaiz Bank Plc, 2020). The opening date for subscription was on 21st May 2020 and as per the offer for subscription, the sukuk proceeds would be solely utilized to construct rehabilitate key roads across the six geopolitical zones of the country. It is an ijarah sukuk issued by FGN Roads Sukuk Company Plc. on behalf of the FGN; and redemption will be made via a bullet payment on the date of maturity while the levy is payable half yearly (Debt Management Office Nigeria, 2020).

Another sukuk issuance has also been announced by the government of United Arab Emirates (UAE) which raised two billion Dirham via sukuk. However, this sukuk was issued purposely to support the Shari’ah banking system during the pandemic. It was also issued to rescue the economy, with the government using the sukuk to support its corporates, SMEs, the banking sector and even individuals affected by the pandemic. The sukuk issued was based on the targeted economic support program initiated by the Central Bank of the UAE, which issued it under liquidity support mechanism which appointed the Sharjah Islamic Bank as the sole arranger for the sukuk, and the certificates would be paying a profit rate of 1.5% to mature in May, 2021. Furthermore, the Government of UAE has also in March 2020, listed its US$200 million sukuk on Nasdaq Dubai, a brave step that showcased a broad potentiality of sukuk markets evolution during the COVID-19 crisis and amidst this unprecedented global financial distress.

It was not a surprise to many stakeholders and researchers when the Moody’s investment services issued a projection on March 25, that sovereign sukuk issuances would reach USD75 billion in the year 2020 despite the COVID-19 pandemic. This projection was actually in the anticipation of a 6% increment compared to USD71 billion of the 2019 market share of the sovereign sukuk issuances. The projection indicates that the sovereigns will be in need of more
IES funds via sukūk markets due to oil prices decline and the fall of government revenues due to the COVID-19 pandemic and the economic sanctions involved. Christian de Guzman, the Moody's Senior Vice President indicated that Moody anticipated larger fiscal deficits, greater schedule repayments and local Islamic financial markets could lead to bigger sukūk issuances in the coming few years. Furthermore, the impact of the pandemic may trigger higher deficits and heavy financing needs for hydrocarbon exporting issuers, this involving the players in South Asia and those in the GCC. Another good opportunity for the sukūk market is the integration of environmental social and governance interests which indicates the move to project a massive green sukūk offerings with the sukūk market players and beyond.

4. Recommendations
This paper suggests that there is definitely an opportunity for the sukūk market during the COVID-19 financial distress. While the existing sukūk issued might face some challenges in fulfilling their obligations, this pandemic will create a “new normal” for the sukūk market to grow. The traditional way of sukūk issuing might experience some changes to facilitate deficit financing models for many jurisdictions and cooperation and even financial institutions. Below are some recommendations in light of the discussions in this paper.

First, there is a need to incorporate some clauses in sukūk documentation to allow a sukūk return payment moratorium clause instead of declaring it to be an outright default if there is an unprecedented pandemic situation like the COVID-19. This could be implemented in specifically sukūk structures that are structured on debt-based instruments, contracts where non-payment to sukūk holders may be tantamount to a default situation. The experience of Garuda Indonesia sukūk in this pandemic shows that sukūk holders’ meeting needs to be conducted using modern technology since physical meetings are almost impossible or inadvisable to be held. Instead of sending notices to sukūk holders as done in this case, it is best to have a sukūk holders’ virtual meeting to sort out the issue of postponing payment.

Second, when a default does occur, the sukūk moratorium clause shall also be Sharī‘ah-compliant and it should be arranged according to the Sharī‘ah contracts used to structure the sukūk. In the sukūk structuring process, using equity-based sukūk shall be favored rather than debt-based arrangements. This is because the risk-sharing nature of equity-based contracts considers the circumstances and the situation the sukūk holders are in that is tied to the performance of the underlying sukūk assets. Therefore, facing any unprecedented situation will not immediately trigger default.

Third, ijārah sukūk could also be a favorable option in the sukūk market during the pandemic, especially when it is used by sovereign governments, since most governments can be seen as issuers with strong liquidity capabilities to pay the ijārah during the pandemic, as in the case of the Federal Government of Nigeria’s Road Šukūk. However, the similar ijārah sukūk option might not be favorable in other countries such as Malaysia, especially in road financing, where the ijārah receivables are actually paid via toll-gates receivables which is technically stopped during the pandemic and because of the imposed movements control and travels restrictions laws during the pandemic.

Fourth, wakālah sukūk could also be favorable during the pandemic situation, as the wakeel has the right to invest the funds generated in various businesses which could be channeled to the food industry and health care industry as they offer higher profitability potential than many other industries badly affected by the pandemic.

5. Conclusion
There is no doubt that every crisis has a way out and offers possible opportunities. As such, COVID-19 has also created a “new normal” for sukūk markets. The market players need to embrace this new normal to strengthen the sukūk market capabilities in financing deficit in this
time of crisis. The lessons taught by the pandemic need to be understood and one should know that such situation should be seen as merely a hiccup to the existing sukūk issued in the market. There is also an opportunity for the sukūk market to grow new structures that are relevant to any difficult situation. This is especially true for sukūk structured on debt-based contracts where non-payment of a fixed amount may be tantamount to a default. It is understood from this research that non-performance of all types of sukūk would not automatically trigger default in all types of sukūk. It is only the sukūk which is based purely on debt contracts that is most likely to face this issue. This simply indicates that having a non-debt-based structure to issue sukūk reflects the true risk-sharing nature of Islamic finance and COVID-19 has provided an opportunity to truly take the advantage of integrating such contracts in the sukūk structure. It is anticipated in future sukūk structuring processes that the issuer may consider using equity-based contracts for the betterment of the sukūk market, and there will be practical differences between the new sukūk issued and the conventional bonds in this respect. It is anticipated that during this pandemic, the stakeholders in the sukūk market would have learned beneficial lessons and now understand that many opportunities can be created to adapt to and exploit unprecedented situations and the opportunities are truly reflected in the sukūk market today and will be more visible in future sukūk issuances especially in the year 2021 and beyond.

Further research in the sukūk and COVID-19 should evaluate the sukūk market trend as well as subscriptions and secondary market responses to the current financial distress caused by the pandemic crisis. It is obvious that the pandemic has caused a lot of economic difficulties to many individuals and corporations, hence investing in sukūk could be a favorable or not favorable to investors, this should be further explored.

References


Further reading


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