Journal of Islamic Finance Vol. 11 No. 2 (2022) 34-47
IIUM Institute of Islamic Banking and Finance
ISSN 2289-2117 (O) / 2289-2109 (P)

Hybrid Sukuk in Light of the Recent Implementation of AAOIFI Shariah Standard no. 59 Related to the Sale of Debt

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Abstract

Sukuk is among the primary fund-raising method for the sovereigns and corporates in a Shariah-compliant manner. Besides the Islamic investors, sukuk has been well received by conventional investors as an instrument that can provide similar risk and reward equal to the bond. However, as there are various sukuk structures in the market, hybrid sukuk is among the popular structure preferred by the issuers. One of the reasons is it requires a lower physical or tangible asset requirement i.e., 30% out of the total sukuk issuance amount ("tangibility ratio"). However, this changes with the implementation of Shariah Standard no. 59 on the Sale of Debt by Accounting and Auditing Organisation for Islamic Financial Institutions ("Standard 59") ("AAOIFI"). It mandates a higher tangibility ratio requirement and an additional requirement of maintaining the tangible asset value. Thus, via document analysis methodology, this paper aims to explore further the implication of these requirements toward the underlying asset condition and tradability of hybrid sukuk, as well as other potential impacts.

Keywords: *Islamic capital market, Sukuk structuring, Hybrid sukuk, AAOIFI Shariah standards, Sale of debt*

1. Introduction

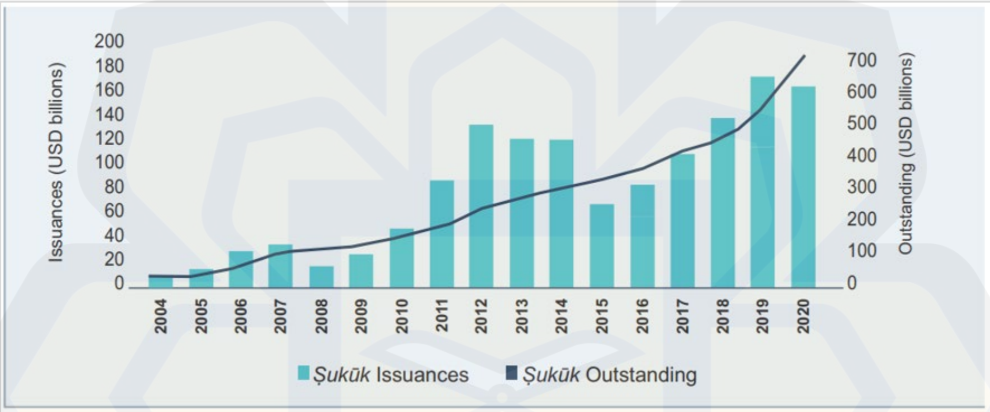
Sukuk is the key component of the Islamic financial system. It received a wider acceptance and participation from issuers, investors, corporate advisors, regulators, and other stakeholders in the international and local financial markets. The growth momentum of sukuk has been monumental since its inception in the market. The sukuk market is an attractive source of financing for issuers (especially governments, sovereign wealth funds and companies) to fund their initiatives and productive investment activities. The local and international capital markets favour sukuk because sukuk provides risk diversification options for the investors' portfolios. It satisfies their need for fixed-income financial assets as part of their diversification plan. Sukuk also enjoys an advantage where it can attract a broader investor base, i.e., both Islamic and conventional investors. The oversubscription of global sukuk issuances, especially those issued by sovereigns such as Malaysia and Indonesia, can be considered normal. Unlike its conventional bond counterpart, it can only attract conventional investors. Furthermore, because of the ability of sukuk to provide stable returns and a positive growth effect, it is also preferred by institutional investors as an avenue for their long-term investments (ISRA, 2017; Wan Mohamed Ali, 2014).

The increase in the sukuk demand has also been fuelled by the rise in the demand by the Islamic investors (especially Islamic fund managers) and from the Islamic financial institutions ("IFIs") as sukuk is a vital liquidity management tool for the IFIs (Dolgun and Mirakhor, 2021). Moreover, by utilising various Shariah principles to provide tailor-made solutions that meet the market's needs, sukuk has been established as a Shariah-compliant financial instrument that can offer the same features that the investors or issuers expect from a conventional bond.

Article history
Received: 26 August 2022
Accepted: 30 December 2022

Over the years, there have been a lot of developments in sukuk structuring, regulatory requirements, infrastructure, demand, and supply. Fast forward to 2020, International Islamic Financial Market ("IIFM") Sukuk Report 2021 reported that the sukuk industry posted the best year for sukuk issuances. It put sukuk as the main driving force of the Islamic finance industry, despite 2020 being a challenging year due to the unprecedented Covid-19. Sukuk issuances recorded an amount of USD174.60 billion, an increase of 19.84% year-on-year. Among the leading players contributing to the development of the industry are Malaysia, Saudi Arabia, UAE, Bahrain, Indonesia, Turkey, Pakistan, and Qatar (International Islamic Financial Market, 2021). There has been a burgeoning global interest in the sukuk market since its advent into the capital market. As a result, the global sukuk industry has experienced a compound annual growth rate of 26% (Islamic Financial Services Board, 2021). In the first half of 2021, the value of global sukuk outstanding was USD630 billion (Dinar Standard, 2022).

Table 1: Global sukuk issuances and sukuk outstanding trends 2004-2020



Source: (Islamic Financial Services Board, 2021)

2. The Dynamism of Sukuk Structures and Features

Sukuk structures and features have been evolving in line with the demand and development of the financial market (this will be discussed in detail in section 4). Sukuk started with only one Shariah contract i.e., Shell MDS Sukuk using *Bai Bithaman Ajil* contract. Over time, the market introduced various contracts, concepts and Shariah principles into sukuk based on the different needs and preferences of the issuers (ISRA, 2017). By using Shariah contracts such as sale, lease, agency, and partnership contracts, they create a financial obligation (principal and profit) between the issuers and the sukuk holders.

Sukuk came into the market to provide the issuers and investors with the same commercial features and benefits of a bond. As an essential type of asset, sukuk could be just as crucial for Islamic investors as traditional bonds are for conventional investors (Wan Mohamed Ali, 2014). The sukuk market is categorised under the debt capital market because the objective behind structuring a contemporary sukuk is to produce a fixed income return (Wilson, 2004; ISRA, 2017). The appetite for fixed-income instruments resulted in the vast majority of 90% sukuk in the market being structured to replicate the conventional unsecured bond. It simply shows that the investors want an Islamic version of a bond (Hanefah et al., 2013). In other words, despite the difference in the operationalisation of both instruments (bond is a simple loan while sukuk is based on various Shariah contracts and principles), the use case for both as funding vehicles are the same. Of course, except for the utilisation of sukuk proceeds, which must be for Shariah-compliant purposes only. Besides replicating the bond's fixed income nature, sukuk also must keep in line with the innovation in the bond's space, such as tier 1 bonds and perpetual bonds.

As a result, sukuk has gone through a high degree of Shariah dynamism and innovation since the inception of the Islamic finance industry. There has been a lot of development and innovation in sukuk structuring using the approved Shariah contracts and principles, which stems from the substantial and continuous investments in research and development by the regulators and industry players. These development and innovations align with the issuers' greater sophistication and complexity of requirements and needs.

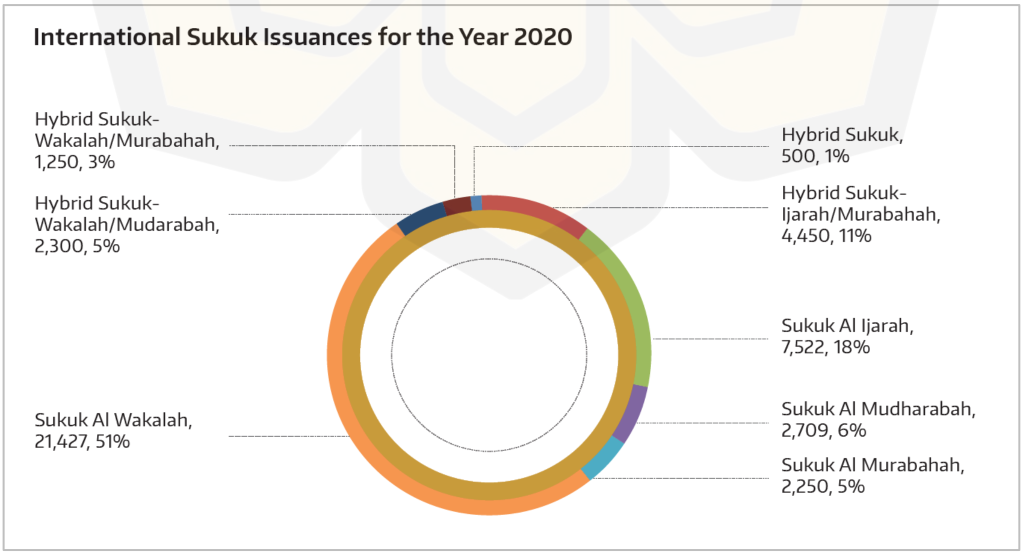
The innovation of sukuk takes place in different parts of the sukuk operationalisation. For example, it can be in the underlying assets, sukuk tenor, security and credit enhancement, payment mode, financial behaviour, etc. (Bakar, 2017). Among the common sukuk structures that can be found in literatures and textbooks are sukuk that are based on *Mudarabah, Musharakah, Wakalah, Ijarah, Murabahah, Salam, Istisna', Salam* and *Bai' Bithaman Ajil*. The underlying Shariah contracts are then applied to structure various commercial-based innovations in the market, such as senior unsecured sukuk, perpetual sukuk, convertible sukuk, exchangeable sukuk, and subordinated sukuk.

Besides the recently implemented Standard no. 59 (Standard 59), among existing AAOIFI Shariah Standards applicable to sukuk structuring are Shariah Standard No. 17 on Investment Sukuk and Shariah Standard No. 21 on Financial Paper. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standard no. 17 on Investment Sukuk also provides numerous types of sukuk structures which are (AAOIFI, 2003):

1. Certificates of ownership in leased assets
2. Certificates of ownership of usufructs
   a. Certificates of ownership of usufructs of existing assets
   b. Certificates of ownership of usufructs of described future assets
   c. Certificates of ownership of services of a specified party
   d. Certificates of ownership of described future services
3. *Salam* Sukuk
4. *Istisna'* Sukuk
5. *Murabahah* Sukuk
6. *Musharakah* Sukuk
7. *Mudarabah* Sukuk
8. Investment Agency Sukuk
9. Sharecropping certificates (*Muzara'ah* Sukuk)
10. Irrigation certificates (*Musaqat* Sukuk)
11. Agricultural certificates (*Mugharasah* Sukuk)

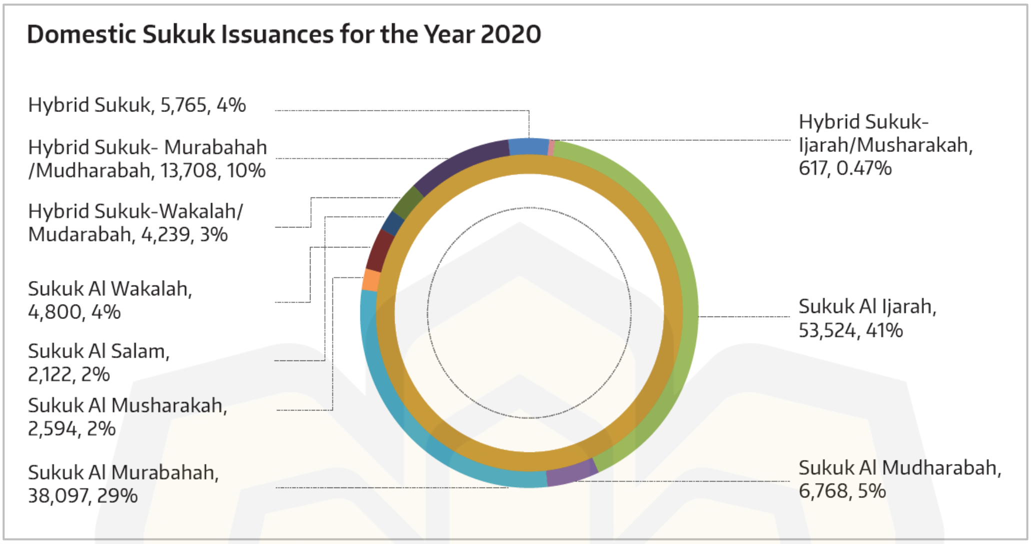
However, not all of them are widely used in the market. Agriculturally based *sukuk* (*muzara'ah*, *musaqat* and *mugharasah sukuk*) are among them, but they may be beneficial to jurisdictions that have potential agricultural projects. In recent years, the most popular structure remains hybrid sukuk (the focus of this paper), as reported in the Sukuk Report 2021 by IIFM. The following diagrams depict the breakdown of the Shariah structures used for sukuk issuances at various levels.

Table 2: International sukuk issuance for the year 2020



Source: International Islamic Financial Market (2021)

Table 3: Domestic sukuk issuance for the year 2020



Note: Sukuk *Wakalah* is defined by the report as a combination of *Ijarah* with *Murabahah*. It is also falls under hybrid sukuk

Source: International Islamic Financial Market (2021)

Despite the innovation and various usage of Shariah contracts, it is essential to note that the development of sukuk came from the need for an alternative to the conventional bond. A conventional bond represents a debt instrument rather than an equity instrument. Thus, sukuk has been structured to have a similar risk-reward structure and other features of a traditional bond (ISRA, 2017).

3. The implementation of Standard 59 on the Sale of Debt by AAOIFI

As far as this research is concerned, there are four regulatory or standard setting bodies that provide standards, guidelines, references, or provisions relevant to Shariah to be applied in sukuk structuring ("Shariah standards"). They are AAOIFI, the Securities Commission Malaysia ("the SC"), Islamic Financial Services Board and IIFM. In the context of the global sukuk market, AAOIFI Shariah standards are among the primary references in structuring a suku*k*. Though not a mandatory requirement, AAOIFI stated that 19 jurisdictions or countries fully adopt their Shariah standards, such as UAE, Bahrain, and Yamen, to name a few (AAOIFI, 2020). Therefore, any issuer that targets liquidity from these jurisdictions or countries will most likely structure their sukuk to comply with AAOIFI Shariah standards. As for Shariah-related rules and regulations for sukuk by the SC, it is mandatory to be complied with for the local sukuk issuances in Malaysia (Securities Commission Malaysia, 2021a).

Among existing AAOIFI Shariah standards relevant to sukuk structuring are Shariah Standard No. 17 on Investment Sukuk and Shariah Standard No. 21 on Financial Paper. Recently, the sukuk industry welcomed another Shariah standard by AAOIFI in the form of Standard 59 on the sale of debt ("Standard 59"). The compliance deadline was 1st January 2021 for the country that adopts AAOIFI on a mandatory basis, such as UAE. Standard 59 provides relevant requirements for the sale of debt. It discusses, among others, the definition of debt, types of sale of debt, rules on the sale of debt, and the contemporary application of the sale of debt (AAOIFI, 2018).

Two notable areas where the adoption of Standard 59 will affect the Islamic finance industry's existing practices are the rollover of debt-based financing and the trading of sukuk, which contains the element of debt. While the latter would be the focus of this paper, the former is a situation where a *Murabahah* financing cannot directly refinance another *Murabahah* financing. The previous practice in which such direct refinancing was a central feature is not acceptable under Standard 59 (Armstrong et al., 2021).

Sukuk structuring pre-implementation of Standard 59 by AAOIFI

Before we discuss the implementation of Standard 59 and its implication for the sukuk market, it is crucial to understand the historical development of sukuk structuring. Following this historical development, we will realise that the innovation in shariah contracts, structures, underlying assets, and their composition is directly related to the capability of the sukuk issuer, i.e., whether they can provide sufficient underlying assets or not. Providing sufficient assets is the key requirement in structuring a sukuk (Radzi, 2018). The requirement by Standard 59, specifically paragraph 8 on the sale and negotiability of the debt when combined with other assets, is directly related to this requirement. The following also provides the historical background of hybrid sukuk, which shall be affected by the implementation of Standard 59.

a. Debt based structure: 1990

Early 1990 was when the market familiarised itself with the sukuk concepts, mechanisms, and structures. Thus, the sukuk growth during this period was limited and focused on Islamic finance-friendly jurisdictions like Malaysia. In 1990, a non-Islamic company named Shell MDS Sdn Bhd issued a debt-based sukuk structure i.e., *Bai' Bithaman Ajil* (BBA) or sale with deferred price. It was the first ringgit-denominated corporate sukuk issued in Malaysia (ISRA, 2017).

b. Ijarah sukuk: 2001

In 2000, the prototype of the modern sukuk i.e. Ijarah Sukuk was introduced during the 11th Islamic Development Bank Symposium (Haneef, 2009). It is the well-known structure where the obligor sells certain physical assets to the Special Purpose Vehicle or SPV (issuer). Afterwards, the SPV leases the assets back to the obligor, and the rental becomes the sukuk return for the sukuk investors (Nasir et al., 2022).

The Government of Bahrain adopted this structure in September 2001, but it was mainly subscribed by the local investors as it did not meet the international bond standards. The sukuk was not rated, listed, or cleared through any clearing house. In December 2001, Kumpulan Guthrie Berhad, a Malaysian public listed company, also issued *Ijarah* sukuk. The sukuk documentation was in line with the internationally recognised U.S. Regulation S format (formats used for conventional global bonds) and was listed on the Labuan International Financial Exchange. However, the sukuk was neither rated by the leading international agencies nor cleared by any clearing house. As a result, it was not widely distributed in the global capital markets (Haneef, 2009).

Later in 2002, the Government of Malaysia issued the first Islamic global *Ijarah* Sukuk backed by sovereign assets such as administrative buildings, hospitals, and academic institutions. The sukuk complied with the U.S. Regulation S and Rule 144A formats used for conventional global bonds. It was the first sukuk listed on the Luxembourg Stock Exchange and rated by Standard & Poor and Moody. It was offered globally to Islamic and conventional investors. The issue was a massive success that it was twice oversubscribed (Haneef, 2009). It was an important achievement because the sukuk integrated *Ijarah* Sukuk with the conventional bond practices such as listing, ratings, dematerialised scripts and centralised clearance (Radzi, 2018). After this sukuk, there were other successful *Ijarah* sukuk issuances, such as by the State of Qatar (USD700 million) and the Kingdom of Bahrain (USD250 million) in 2004.

c. Asset-backed sukuk vs asset-based sukuk: 2002

Ijarah sukuk was initially structured to be an asset-backed sukuk. But later, it was structured to be an asset-based sukuk which is also the prevalent structure in the present sukuk market. In principle, asset-backed sukuk is like the securitisation process, where the financing is raised on an off-balance sheet basis. Hence, issuing an asset-backed sukuk will not further increase the issuer's existing debt level under the balance sheet. The investors also have recourse to the underlying assets in the event of default and face assets risk throughout the sukuk period rather than the issuer's credit risk (as in the case of asset-based sukuk). It also renders the sukuk a secured instrument (ISRA, 2017).

In 2002, the Malaysian Global Ijarah Sukuk was initially structured to be an asset-backed sukuk as it was backed by sovereign assets. But, the Government of Malaysia then had unredeemed unsecured international bonds, which contained standard negative pledges that restrain the bond issuer (Government of Malaysia) from issuing a bond that is not in *pari passu* with the existing unsecured bond. Thus, issuing an asset-backed sukuk would directly breach this clause (Haneef, 2009). As an explanation, when there is an event of default in asset-backed sukuk, the sukuk holders have the priority claim over other creditors (in this case, the existing bondholders) towards the underlying assets.

As a solution, the structure was revised by giving beneficial ownership (but not legal ownership) to the sukuk holders during the sukuk's tenure, which satisfied the transfer of asset ownership requirement under the *Ijarah* principles. But, in the event of default, the sukuk trustees cannot retain or sell the assets to any third party. The sole recourse by the sukuk holders to the assets would be to dispose of the assets to the Government of Malaysia only and to seek payment. As a result, disposing of the assets to the Government of Malaysia renders the sukuk holders as the unsecured creditors. It thus renders the sukuk as an asset-based sukuk, although the sukuk had underlying assets (Haneef, 2009; Radzi, 2018). Consequently, the sukuk holders would only have recourse to the issuer (Government of Malaysia), not the underlying assets. In the current sukuk market, almost all sukuk are asset-based.

d. Short-term Salam sukuk and Ijarah sukuk by the Kingdom of Bahrain: 2001-2005

The Central Bank of Bahrain launched the monthly programme of short-term Bahraini dinars *Salam* sukuk issuances in 2001 to broaden the depth and liquidity of the Islamic financial markets in Bahrain. Though oversubscribed, the sukuk represents sale of debt. Thus, it cannot be traded in the secondary market. Therefore, the Central Bank of Bahrain launched a separate programme using the *Ijarah* principle in 2005 (ISRA, 2017). This development is worth to be mentioned because the *Salam* structure is seldom used in the market. It shows that not all sukuk structures proposed by various proponents (such as profit loss sharing, *Salam* and others) can be implemented easily in the market. In this case, the feature of tradability is significant that they had to launch a separate program using the *Ijarah* principle.

e. Blended asset sukuk or hybrid sukuk: 2003

Blended asset sukuk, or also known as hybrid sukuk ("hybrid sukuk"), consists of two or more components where the first component represents physical or tangible assets and the second component, in most cases, represents Shariah-compliant receivables. The primary condition that must be met is that the first component has to form 51% or 30% of the whole sukuk portfolio (the differences between these ratios to be explained below). This structure relieves potential issuers who cannot provide 100% physical or tangible assets based on the value of the sukuk issuance, as per the case in *Ijarah* sukuk.

The Islamic Development Bank ("IDB") introduced the structure to the market in 2003 with a USD400 million sukuk as IDB lacked sufficient physical assets to be made as the underlying assets and had more Shariah-compliant receivables on its book. The sukuk consisted of 65.8% *Ijarah* assets (complied with the minimum 51% physical or tangible assets portion as decided by the Shariah scholars at that time), and the rest consisted of *Murabahah* and *Istisna'* assets (receivables). Also named *Istithmar* sukuk at that time, the structure was well received by the Islamic and conventional investors. A few years later, IDB even came back with a lower physical or tangible assets portion, where the *Ijarah* asset portion consisted of 30% only (Haneef, 2009).

In the middle east, trading debt or receivables is not allowed except at par, following the rule of *Bay' al-Dayn*. However, with the hybrid sukuk structure, debt or receivable is allowed to be part of the total underlying assets as long as the physical or tangible assets ("tangible assets") forms 51% or 30% of the total sukuk issuance amount based on the concept of *Khultah* (mixture of assets) (Haneef, 2009). Hybrid sukuk is an alternative to debt-based sukuk (Noor and Shahimi, 2013).

The structure also satisfied the requirement provided by AAOIFI Shariah Standard no. 21 on Financial Paper (2003, before the implementation of Standard 59 in 2021). The standard requires the tangible assets to be 30% for it to be tradeable at premium, discount, or par. This clause, however, was for shares trading. As there was no specific requirement for sukuk trading, it was adopted by the market in structuring hybrid sukuk (ISRA, 2017). This requirement later changed with the implementation of Standard 59.

f. Partnership-based sukuk or asset light sukuk:2001-2008

Despite the lower asset requirement under hybrid sukuk, there were still corporates that could not meet the 30% physical assets requirement due to their lack of tangible assets that can be set aside to be made as the underlying assets for the sukuk. Nonetheless they were still interested in tapping the liquidity available in the Islamic capital market. Therefore, asset light sukuk came into the market, which refers to *Musharakah* sukuk and

Mudarabah sukuk. Therefore, under these structures, it is not a requirement to provide any physical assets at the time of sukuk issuance (Radzi, 2018).

These partnership-based sukuk were tested in small issuances from 2001 until 2005. The volume and size started to increase in 2005 with the issuance of Islamic Residential Mortgage-Backed Securities by Cagamas (*Musharakah*), *Mudarabah* sukuk by PG Municipal Assets Bhd, and exchangeable *Istithmar* sukuk by Khazanah (Haneef, 2009). However, partnership-based sukuk experienced a slump due to the infamous remarks by Sheikh Taqi Usmani in 2007 (Usmani, 2007). He stated that 85 per cent of sukuk in the market that time were not Shariah compliant due to the application of purchase undertaking in *Musharakah* and *Mudarabah* contract.

The name 'asset-light' was given because the issuer may not have any revenue-generating asset to issue the sukuk at the outset, though the assets will be acquired or developed later to provide the return and cash flow to the investors (ISRA, 2017). An example of such sukuk was the USD 300 million Dubai Metals and Commodities Exchange (DMCE) sukuk issued in 2005. However, this structure raised a few critical Shariah issues, that it was banned with the issuance of AAOIFI rulings in February 2008. Among the critical issue related to this research was the tangibility ratio issue. The land contributed by the DMCE was only worth USD48 million, while the capital contribution from the sukuk was USD300 million. While the sukuk holders own *Musharakah* units, the sukuk represents 86% cash and 14% tangible or physical assets. Therefore, it did not meet the tangibility ratio requirement by AAOIFI, where it should not be less than 30% (AAOIFI Shariah Standard no. 21 on Financial Paper). Thus, the sukuk holders could not trade the sukuk as it was equivalent to cash trading (Haneef, 2009; Radzi, 2018).

g. Criticism towards the sukuk industry: The infamous Sheikh Taqi Usmani remarks in 2008

The sukuk market went through constant market expansion from 2001 until 2007 (ISRA, 2017). However, the growth went south in 2008 due to two main events. The first is the historical global financial crisis. Secondly, the criticism by Sheikh Taqi Usmani towards certain partnership-based sukuk, which were primarily issued in the Emirates of Dubai. He stated that 80% of the sukuk *Musharakah* in the market at that time were non-Shariah compliant. He specifically mentioned the non-Shariah compliant practice of undertaking by the issuer/obligor to purchase the assets at a fixed price from the sukuk holders upon maturity or event of default (Usmani, 2007).

Following the remarks by Sheikh Taqi Usmani, AAOIFI issued a resolution in 2008 which provided requirements that rendered the asset-light sukuk structures at that time to be non-compliant with the resolution (Radzi, 2018). As a result, partnership-based sukuk or asset-light sukuk offering such as *Musharakah* sukuk and Mudarabah sukuk were not seen in the market since the resolution was issued in 2008 (Haneef, 2009).

h. Post-2008

As the AAOIFI resolution effectively wiped-out asset light sukuk from the market post-2008, the market returned to the basic sukuk structures. The Republic of Indonesia successfully issued its inaugural USD500 million *Ijarah* sukuk. The sukuk was oversubscribed up to USD3 billion. The Kingdom of Bahrain also returned with a USD650 million *Ijarah* sukuk. Petronas also debuted its *Ijarah* sukuk in August 2009, which was remarkably oversubscribed by five times. All of these were asset-based *Ijarah* sukuk (Haneef, 2009).

i. The return of hybrid sukuk or asset-blended sukuk: 2012

Just when the market returned to the traditional *Ijarah* sukuk, it faced another stumbling block as the Repurchase Undertaking in *Ijarah* structures was questioned in the IFA-OIC in its 20th session (2012). They prohibited the structure due to the similarity of the asset-based *Ijarah* sukuk with the *bay' al-inah* (ISRA, 2017), nonetheless it was a resolution and not a regulation. So, there were still *Ijarah* sukuk issued after 2012 but were mainly by sovereigns issuers due to their ability to provide the underlying assets, such as Turkey (2012), the Hong Kong Government (2014), the Government of Luxembourg (2014), the State of Senegal (2014), the United Kingdom (2014) and the Government of Jordan (2016) (ISRA, 2017).

During this period, the market was also slowly returning to asset blended sukuk. It started with the issuance of *Wakalah* sukuk (a form of asset blended sukuk) by the Government of Malaysia in 2011. The sukuk was a global USD 2 billion dual-tranche *Wakalah* sukuk, which consisted of 52% Shariah compliant shares and 48% *Murabahah* receivables. It received tremendous participation from local and global investors, especially from the Middle East. The Hong Kong Government also issued a sukuk with the same structure in 2015; one-third of the underlying assets consisted of office buildings in Hong Kong, while the rest were Shariah-compliant commodities (*Murabahah* receivables) (ISRA, 2017).

Based on the above discussion, we can conclude that structuring a sukuk is not about the Shariah structure only. It is also about providing the best structure that complies with the relevant regulations and ultimately suits the capability and appetite of the issuers. Furthermore, the issuers' capability to provide the underlying assets for a sukuk issuance has been the main driver of the innovation in sukuk structuring. Lastly, hybrid sukuk is the recent and more accepted solution at the global sukuk market as it aligns with the relevant AAOIFI Shariah standards (before the implementation of Standard 59). It also provided the issuer with limited capability in providing the underlying assets, with the least tangible asset requirement of 30% only.

Based on the historical development of sukuk as discussed above, a few conclusions can be made. Firstly, structuring a sukuk is not about the Shariah structure only. It is also about providing the best structure that complies with the relevant regulations and ultimately suits the capability and appetite of the issuers. Secondly, the issuers' capability to provide the underlying assets for a sukuk issuance has been the main driver of the innovation in sukuk structuring. Lastly, hybrid sukuk is the recent and more accepted solution at the global sukuk market as it aligns with the relevant AAOIFI Shariah standards (before the implementation of Standard 59). It also provided the issuer with limited capability in providing the underlying assets, with the least tangible asset requirement of 30% only.

Herein, we will investigate how the implementation of Standard 59 will shape the sukuk industry moving forward especially towards structuring a hybrid sukuk.

4. The Innovation in Hybrid Sukuk

There have been a lot of innovations in structuring hybrid sukuk in the global sukuk market, especially on the tangible asset portion, as per the following table 4:

Table 4: Innovations in hybrid sukuk

Sukuk	Issuance Year	1st Sukuk Component	2nd Sukuk Component
Malaysia sukuk Global Berhad	2016	Vouchers representing travel entitlements	Shariah-compliant shares
Dar Al Arkan	2017	*Ijarah* assets	*Murabahah* receivables
Sharjah sukuk Programme Limited	2017	*Ijarah* assets	*Murabahah* receivables
KSA sukuk Limited	2017	*Mudarabah* agreement, a form of Islamic investment management partnership	*Murabahah* receivables
Apicorp sukuk Limited	2017	*Wakalah* Assets that are *Ijarah* Assets and/or tangible sukuk	*Murabahah* receivables

Source: Respective sukuk's information memorandum or offering circular

IIFM Sukuk Report 2021 stated that sukuk *Wakalah* (defined by the report as a combination of *Ijarah* with *Murabahah* and is considered as hybrid sukuk) represented 51% of the total international sukuk issuances for the year 2020, while other hybrid sukuk structures represented 13.17% of the 2020 international sukuk issuances. Among the combinations of contracts for hybrid sukuk as provided by the report are (International Islamic Financial Market, 2021):

1. *Murabahah* and *Ijarah*
2. *Murabahah* and *Mudarabah*
3. *Murabahah* and *Wakalah*
4. *Ijarah* and *Musharakah*

In most cases, hybrid sukuk comprises two components of underlying assets. But there were hybrid sukuk that consisted of more than two components. For example, Projek Lintasan Shah Alam Bhd (domestic sukuk issued in 2008) consisted of *Ijarah*, *Mudarabah* and *Ijarah mawsufah al-dhimmah* components. The second example would be the sukuk issued by the Government of Malaysia in 2011 which consisted of *Ijarah* assets, *Murabahah* receivables, and Shariah-compliant shares. RAM Rating stated that the trend towards hybrid sukuk had been driven by conformity to the AAOIFI Shariah Standards. In addition, the landmark USD6 billion sukuk by Saudi Aramco in 2021 also used the hybrid sukuk structure (Islamic Markets, 2021).

Why hybrid sukuk is preferred over other sukuk structures?

As mentioned before, the issuer must fulfil the essential requirement to provide sufficient underlying assets. However, this is not an easy feat for the potential issuers due to the following factors (ISRA, 2017):

1. They might not be able to provide adequate unencumbered assets that match the sukuk issuance amount
2. The assets they have might be complex or otherwise not suitable for a sukuk issuance, or
3. The issuers might have any constrain in selling the assets to the sukuk holders, given standard negative pledge provisions provided to earlier creditors.

Between asset-backed sukuk and asset-based sukuk, the latter is preferable by the issuers due to the constraints and requirements in the asset-backed sukuk structure as per our discussion above. But, even with some asset-based sukuk such as *Ijarah* sukuk, it still requires the issuers to provide Shariah-compliant assets with a value similar to the total issuance amount, to exist during the issuance and throughout the sukuk tenure (ISRA, 2017).

Thus, it gave birth to the popularity of hybrid sukuk. Hybrid sukuk is the preferred sukuk structure, especially in recent years, because of its flexibility in structuring the sukuk (multiple combinations of Shariah contracts based on the issuer's preference). It also addresses the issuer's limitation in providing sufficient tangible assets as the underlying assets as they have to provide assets with the value equivalent to 51% or 30% of the total sukuk issuance amount only (Haneef, 2009; ISRA, 2017). The rest of the percentage would be covered by the receivables from the sale of commodities. In other words, it resolves the issuer's dilemma of providing 100% value of tangible assets as the underlying asset for the sukuk issuance (ISRA, 2017).

As an illustration, if the nominal value of a hybrid sukuk is USD1 billion, the issuer must provide tangible assets, e.g., a commercial building (for *Ijarah*) with a value of USD300 million only (applying the 30% requirement). As a comparison, for sukuk *Ijarah* with the same nominal value of USD1 billion, the issuer must provide tangible assets, e.g., a commercial building with a value of USD1 billion.

Furthermore, the issuers can choose any types of tangible assets that they prefer, or more accurately, what kind of tangible assets they have at the point of issuance. As mentioned in Table 4, the tangible asset component can be in the form of *Ijarah* assets, *Mudarabah* assets, *Istisna'* assets or even rights such as vouchers and shares. This flexibility is crucial for the issuers, as the availability of the underlying assets is critical in enabling the issuer to issue a sukuk.

Besides that, the issuer must also be willing to set the assets aside during the sukuk tenor. It means their assets cannot be sold, leased, or used as securities for any financial or administrative requirements because the ownership of the assets has been transferred to the sukuk holders, whether legally or beneficially. Though in most structures, the assets will return to the issuer by repurchasing them, from the management perspective, it is not a good practice. Because the company's assets are tied by negative pledge or limitation which restricts their freedom and flexibility of any commercial conduct and corporate exercise towards their assets (Bakar, 2017).

The new tangibility ratio requirement and its implication for structuring hybrid sukuk

Table 3 summarises the new requirements by Standard 59 relevant to structuring hybrid sukuk and the comparison with the previous practices in the sukuk industry:

Table 3: Comparison between the requirements by Standard 59 and the practice before the implementation of Standard 59

New Requirement by Standard 59	The Practice Before the Implementation of Standard 59
The tangibility asset ratio shall exceed 50%* and must be maintained throughout the sukuk period ("tangibility ratio"). *For ease of reference, herein will be referred as 51%. Because 50.00000001% or similar numbers also satisfied the requirement but very hard to be used as reference in this paper.	51% or 30% ratio of tangible assets No provision that requires maintaining any tangibility ratio throughout the sukuk period
If the tangibility ratio falls below 51%, it must be brought up to the allowable ratio (51%) within the period as prescribed by the Shariah advisor.	No provision that requires maintaining the tangibility ratio throughout the sukuk period
If the tangible asset ratio falls below 33%, the issuer must advertise/inform the sukuk holders that the sukuk cannot be traded, except by following the Shariah rules on debt trading (at par only). If the sukuk is listed on any exchange, it must be delisted.	No provision that requires maintaining the tangibility ratio throughout the sukuk period No provision that requires the sukuk must be delisted

Source: AAOIFI (2018)

This paper will refer to the above requirements as the tangibility ratio requirement by Standard 59. According to ISRA, the key Shariah requirements in structuring sukuk are (ISRA, 2017):

1. Shariah-compliant contracts
2. Shariah-compliant underlying assets
3. Shariah-compliant utilisation of proceeds
4. Redemption and trading of sukuk in line with Shariah

Based on the above key Shariah requirements, the implication of Standard 59 for structuring hybrid sukuk are related to the underlying assets and tradability of sukuk, which will be discussed in detail in the following sections.

The implication of Standard 59 towards the underlying assets requirements for hybrid sukuk

Among the apparent impact on the sukuk issuers is the higher asset tangibility ratio of 51%. Before the implementation of Standard 59, among the popular the tangibility ratio adopted in the industry was 30%, adopting the requirement by Paragraph 3/19 of Standard 21 on financial paper (AAOIFI, 2015). The provision is for shares trading, not specifically for sukuk. But it was also applied in the context of sukuk before the implementation of Standard 59 (ISRA, 2017).

The difference between 30% and 51%, in the context of USD1 billion sukuk issuance, an average issuance amount for a global senior sukuk issuance, the difference between providing USD300 million or USD510 million underlying assets is enormous for the issuers, especially for the corporate issuers. The higher tangibility ratio requirement of 51% also limits the issuer's ability to leverage up, which results in the most likely event that they will opt for conventional bond issuance instead of sukuk, which will further hurt the sukuk supply (Saba and Barbuscia, 2021).

Furthermore, the 51% asset tangibility ratio must be maintained throughout the whole sukuk period. This condition was not a condition in the previous global senior sukuk issuances. To illustrate the extent of this condition, we must remember that the underlying tangible assets are open to some risks that may affect their value. Take commercial buildings for example, their value may depreciate due to various events such as fire accidents, damage to the building, and market sentiment towards the building area. As a result, the value of the commercial building may depreciate below RM510 million (applying the 51% requirement over USD1 billion issuance). The same situation could also be applied on shares, where the assets price volatility is relatively higher than physical assets such as a commercial building.

Before Standard 59, this was not an issue (depreciated below RM510 million) as the issuer only needs to bring the value up to 51% on a best effort basis only (Islamic Finance News, 2021a). There was also no strict requirement when the value depreciated below RM510 million (such as the delisting requirement). However, by virtue of Standard 59, when the value depreciates below RM510 million, the issuer needs to bring the value up to 51% within a specified period as their Shariah advisor advised.

The additional requirement of maintaining the value does not stop here. Suppose the value of the tangible assets further falls below 33%. In that case, it mandates the worst ultimatum towards the sukuk, which shall be further discussed in the next section as it relates to the tradability of the sukuk.

The implication of Standard 59 towards the tradability of hybrid sukuk

One of the main features of sukuk (and bond) is its ability to be traded in the secondary market. The investors buy a sukuk knowing that they can liquidate their position in the secondary market before the maturity of the sukuk when they need cash or for any other relevant purposes. This feature is important because sukuk is also an essential tool in liquidity management, especially for Islamic banks (Dolgun and Mirakhor, 2021). Thus, the tradability of sukuk is the primary consideration when the investment bankers structure a sukuk. As trading conventional bond is without any limitation in trading the bond as it does not have to comply with any rules, the tradability of sukuk is guided by the relevant Shariah principles. In other words, each sukuk structure such as *Ijarah* sukuk, *Mudarabah* sukuk or hybrid sukuk are subject to the applicable rules concerning sukuk tradability. Most of them are related to the impermissibility to sell something that one does not own (ISRA, 2017) and, relevant to this research, the rules on *Bay' al-Dayn* or the sales of debt as provided by Standard 59.

Murabahah sukuk, which represents 100% commodity *Murabahah* receivables, is among the preferred structure in Malaysia. It represents 54.03% of the total sukuk issued in the fourth quarter of 2021 (Securities Commission Malaysia, 2021b). *Bay' al-Dayn* is allowed to be traded at any price by the Shariah Advisory Council of the Securities Commission Malaysia ("SAC of the SC") and to be applied in the Malaysian Islamic capital market (Securities Commission Malaysia, 2006). Therefore, *Murabahah* sukuk (which represents the *Murabahah* receivables) in the Malaysian secondary market can be traded at any price based on the agreement between the parties involved, not necessarily at par.

However, under Paragraph 5/2/15 of AAOIFI Shariah Standard no. 17 on Investment Sukuk ("Standard 17"), *Murabahah* certificate is not allowed to be traded after the delivery of the *Murabahah* commodity to the sukuk investors. Because at this point, the sukuk represents receivables, which is not permitted by the standard because it allows the sales of debt at par price only. Trading a sukuk at the secondary market at par price is impossible as the market steers the price of an asset toward its actual value through the natural workings of supply and demand. Under the standard, the *Murabahah* sukuk can only be traded at any price before the delivery of the commodity because the certificate (sukuk) at that point in time represents the commodity, not the receivables (AAOIFI, 2003).

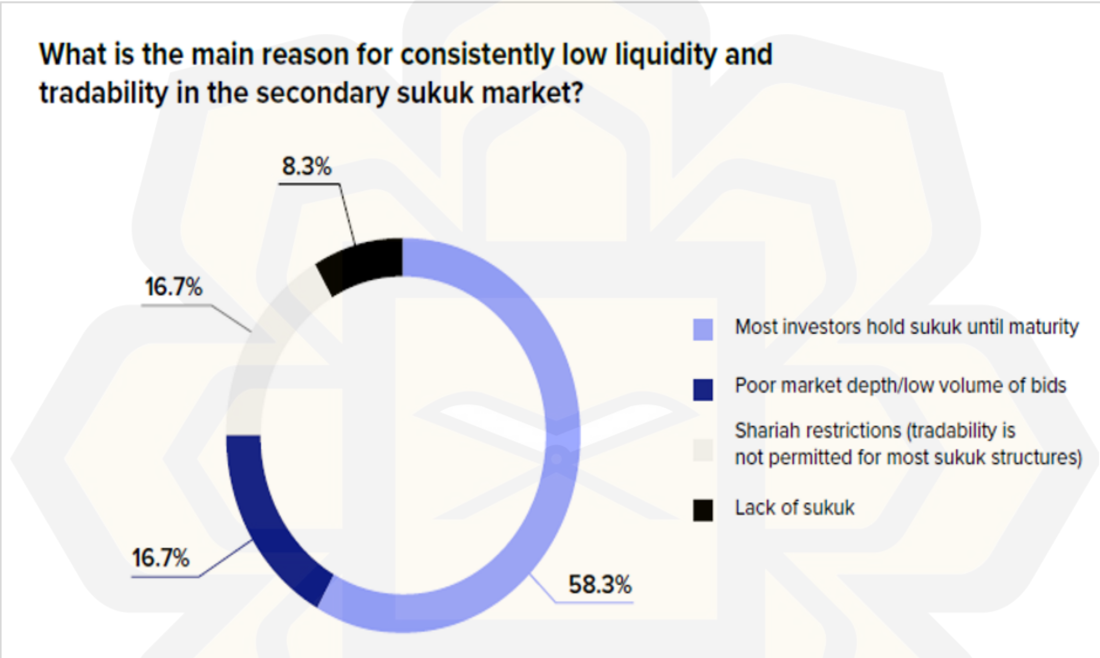
As *Murabahah sukuk* is easier to illustrate the application of *Bay' al-Dayn* rules in sukuk trading, Standard 17 paragraph 5/2 also provides the tradability rules for all types of sukuk structures mentioned under the same standard as mentioned in section 2. As for hybrid sukuk, similar tradability rule by AAOIFI Shariah standards was not clear before the implementation of Standard 59, and AAOIFI themselves admitted it (Islamic Finance News, 2021b). The only reference adopted by the market was the 30% tangibility ratio on Paragraph 3/19 of Standard 21 on financial paper. But, this paragraph was specifically for shares trading, not sukuk trading (AAOIFI, 2015). In addition, there is no requirement by the same paragraph to follow the *Bay' al-Dayn* rules (at par only) or delisted if it breached the 30% tangibility ratio.

Thus, Standard 59 imposed a conclusive ratio (51% at inception, 33% minimum) that must be maintained because only then the sukuk can be traded at any price in the secondary market. In this case, the *sukuk* will not be considered as debt because the tangible asset portion is significant i.e., more than 33%, following the rule of less than a third is considered as little. In this situation, trading the hybrid sukuk represents trading the tangible assets, not debt (as in the case in *Murabahah* sukuk). Therefore, it can be traded in the secondary market at any price. While this paper will not discuss the shariah justification in details, refer to Standard 59 for the detailed Shariah justifications.

Operationally, suppose the value goes below RM330 million (33%). In that case, the sukuk holders need to be informed by the issuer that the sukuk must be traded according to the sale of debt rule (must be traded at par only) and must be delisted if listed on any exchange. The delisting must be made because logically it is hard to observe the *Bay' al-Dayn* rules in the secondary market. The impact of delisting is huge because it provides additional risk for the sukuk holders. Such risk is not present in the conventional bond. According to a survey by Refinitiv, 58.7% of the sukuk holders hold the sukuk to maturity (Refinitiv, 2021). The investors (especially the Islamic financial institutions) are also cautious of the delisting event as most want to hold the sukuk to maturity. As a result, the lack of investors' participation in the sukuk that complies with Standard 59 may result in the lack of interest in the book-building exercise, ultimately leading to a higher funding cost for the issuer (Gulf Bond and Sukuk Association, 2021).

Thus, the tradability of sukuk is a vital consideration when structuring a sukuk (ISRA, 2017). In the same survey by Refinitiv (2021) as per Table 4, the issue of tradability was among the main reason liquidity and tradability have been low in the secondary market. It shows that, even before the implementation of Standard 59, the tradability of sukuk is already a concern among the industry players. Further complexity with the implementation of Standard 59 by AAOIFI may further aggravate the situation.

Table 4: Survey on sukuk



Source: (Refinitiv, 2021)

5. Conclusion

Based on the above, it can be concluded that the requirements under Standard 59 significantly impact the structuring of hybrid sukuk. The new requirements are stricter by requiring a higher tangibility ratio and additional requirement to maintain the tangible asset value. Furthermore, the requirement of delisting the sukuk if it falls below 33% is a big red flag for the sukuk holders if they intend to hold the sukuk until yield to maturity. While research on the Shariah justification behind these requirements and their impacts on the offering of hybrid sukuk will be conducted separately, the author believes that the implementation of Standard 59 shall be another historical checkpoint in sukuk structuring. Like other historical checkpoints of sukuk structuring as discussed in the early part of this paper, it requires the industry players to pivot and come out with solutions to maintain the positive growth of the sukuk industry. Hence, further research on this area is crucial.

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