Understanding SUKUK – Series 1

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Introduction

The international and domestic capital markets, in exploring various forms of funding options, over the years have facilitated the prominence of ethical-based debt financing. In recent times, the government and corporate entities within Nigeria are increasingly accessing the capital markets to attract funding from investors inclined to a peculiar form of ethical-based debt instruments known as Sukuk. Sukuk refers to sharia-compliant financial instruments representing undivided interests in the ownership of defined assets. Sukuk are based on prescribed principles of Islamic Law, and as an Arabic term, it relates to investment certificates or notes which indicate proportionate interest of the holders in the ownership of tangible assets, usufructs and services or investment in the assets of particular projects or investment activities that adhere to the principles of Shariah.

A typical Sukuk transaction is similar to a conventional bond issuance wherein the investor, (in this case, the Sukukholder), is entitled to receive income from the assets or projects the funds invested was used to finance. In a Sukuk, the issuer of the Sukuk, (for example, the Federal Government of Nigeria ("**FGN**"), or a sponsored special purpose vehicle), sells an investment certificate to Sukukholders at a pre-determined price. The issuer, or where applicable FGN then uses the proceeds from the sale of the investment certificate or note to finance an asset or a project, for instance a road construction. In return, each Sukukholder holds partial ownership of this asset and is paid an income according to the terms of the parties' agreement. However, unlike conventional bonds, the structuring of Sukuk requires Shariah-compliant underlying asset and adherence of the structure to Islamic law.

Islamic law principle prohibits the lending of money with interest payments, thereby forbidding the use of conventional bonds for financial transactions. Sukuk is therefore used as an alternative to conventional bonds, and it does not indicate the existence of any debt obligation as the issuer uses the proceeds from the certificate to purchase an asset, of which the investor also receives partial ownership.

As a financing mechanism, the aim of a Sukuk is to connect liquid entities with persons who require capital to finance the purchase of an asset or the execution of a project. This ensures that persons who have capital are provided with an avenue to invest in certificates or notes, subject to an agreement to receive returns over a period of time.

Regulation of Sukuk in Nigeria

The concept of Sukuk is as old as Islam. Islamic communities had used Sukuk as 'papers' to represent financial commitments that originate from trade and other economic transactions[1]. Historically, the first Sukuk transaction is stated to have taken place in Damascus, Syria in the 7th Century AD.

The modern resurgence of Sukuk has been propelled by the renewed recognition of the concept by the Islamic FIQH Academy of the Organization of Islamic Countries, and the Accounting and Auditing Organisation of Islamic Financial Institutions ("**AAOIFI**"). These institutions are standard-establishing organisations in the Islamic finance industry and have enabled Sukuk structures to be developed leading to the first successful modern issuance of Sukuk by the Malaysian Government in 1983.[2]

[1] https://sec.gov.ng/investor-education/sukuk-islamic-bond-at-a-glance/
[2] ibid

Under Nigerian law, Sukuk is regulated by the provisions of the Securities and Exchange Commission Rules 2013 (as amended) (the **"SEC Rules")** and the Investments and Securities Act, while the primary regulator is the Securities and Exchange Commission (the "**SEC**"). In addition, the Nigerian Exchange Limited, FMDQ Exchange Limited and FMDQ Private Markets Limited have also prescribed rules and regulations governing the listing of Sukuk on their respective platforms.

Pursuant to the SEC Rules, public companies, special purpose vehicles, Federal Government of Nigeria, state governments, local governments, and government agencies as well as multilateral agencies are eligible to issue, offer or make an invitation of Sukuk upon seeking the SEC's approval.[3]

Specifically, the SEC Rules provide that the issuer of a sukuk shall appoint a SEC registered shariah adviser of good repute and character, adjudged to be sound and with necessary qualification in Islamic FIQH/jurisprudence, Islamic finance and capital market. The shariah adviser shall deliver to the SEC, a documentary pronouncement on the Sukuk's compliance with Shariah law. Also, the SEC Rules prescribes that an underlying asset, whether tangible or intangible shall be made available by the issuers as a condition precedent to the issuance of the Sukuk. It is important to note that the purchase price of the underlying asset must not be more than 1.5 times its market value. In the same vein, the issuer is to ensure that the certificate or notes in connection with a Sukuk issuance is rated and the rating must be made available throughout the tenure of the Sukuk issue.

Structuring Sukuk Transactions in Nigeria

In structuring Sukuk transactions, the factors to consider include whether or not there will be a transfer of title, the nature of assets, applicable tax and Zakat, tradability of the Sukuk, and the applicable laws.

There are forms which Sukuk transactions may be structured in, as approved by the AAOIFI. However, only 4 (four) Sukuk structures are recognized by the SEC which may be adopted individually or combined based on the issuer's need.

Sukuk Al-Ijarah (Lease Contract): Some schools of thoughts consider the ijarah Sukuk as the classical Sukuk structure and some analysts consider that it is the most used structure. This structure involves the sale and lease-back of assets in existence (e.g., real estate, plant and machinery, aircraft and ships as well as other tangible assets), which can also be structured as a master lease or sub lease arrangement. The rental rates of return on Sukuk Ijarah can be fixed or floating. The cash flows from the lease which comprise of rental and principal repayments are passed through to Sukukholders in the form of coupon and principal payments. This structure was adopted for Nigeria's novel Sukuk issuance by the Osun State Government.

Sukuk Al-Istisnah (Exchange Contract): This is also referred to as an exchange contract. This structure involves the sale of an identified asset, with an obligation on the part of the seller to manufacture or construct, using his own materials and to deliver the constructed goods or project on a pre-determined date in return for an agreed price to be paid as a lump sum or instalmentally. It is typically curated for the sale of goods or commodities to be produced in the future. The structure is especially suitable for financing large infrastructure projects.

[3] Rule 572, SEC Rules and Regulations (as amended).

Sukuk Al-Musharakah (Sharing Contract): The Musharakah Sukuk structure involves a sharing contract. It is a partnership between an entity, usually a special purpose vehicle and an obligor, wherein they contribute funds and jointly own the assets purchased with proceeds of the issuance. The Musharakah structure is the most suitable structure if the originator does not own an actual tangible asset or does not have sufficient funds to purchase such an asset to permit an Ijarah structured on a sale and leaseback arrangement.

Sukuk Al-Murabaha (Financing Contract): This Sukuk structure essentially involves a financing contract, and it is typically used where no tangible underlying assets can be identified in the issuer or originator's business or operation. Sukuk Murabaha takes the form of a sales contract whereby commodities are sold at a price which includes the purchase price plus a margin of profit agreed upon by both parties concerned. Typically, proceeds from the issuance of Sukuk are used to purchase and take title of the commodities from a supplier or vendor and sell to the Sukuk originating entity at cost plus a reasonable profit payable in future. This structure entails the seller disclosing in advance to the buyer the profit to be made in the transaction.

Apart from the structures stated above, the SEC may also approve innovative Sukuk structures from time to time.

Since Nigeria’s first Sukuk issuance in 2013 by the Osun State Government, which was utilised for the construction of 26 (twenty-six) schools by the state government using Ijarah Sukuk of ₦11.4 Billion, Sukuk issuances in the Nigerian financial markets have been infrequent. Some of the major issuances are:

- Construction of luxurious apartments in Ikoyi – Lagos by Lotus Capital Limited, using ₦1 Billion private Sukuk of Al-Istisna.
- Construction of roads by the Federal Government using Ijarah Sukuk of ₦100 Billion.

The professional parties and transaction documents required in a Sukuk largely depends on the structure adopted by the parties. In practice, the parties to a Sukuk issuance include the issuer, financial adviser or issuing house, trustees, solicitors, receiving bank, shariah adviser, amongst others.

Key Features of Sukuk

1. Sukuk represent the proportionate ownership of the underlying assets.
2. Sukuk are structured using shariah compliant contracts.
3. The Sukuk proceeds must be used only on Shariah-compliant activities.
4. The trading of Sukuk in the secondary market needs to comply with shariah requirements.
5. Sukuk can be rated, listed and cleared by clearing houses.

Benefits of Sukuk

Sukuk complies with Sharia principles while boosting the standard of living in the society and assisting to develop the economy. However, Sukuk also bring several other important benefits.

- It affords domestic issuers an opportunity to gain access to funding from international markets.

- It ensures that every financial activity is backed by real economic activity, thus, promoting financial stability and real economic development.

- It provides an alternative investment opportunity for the ethically conscious populace as well as the conventional investors who are seeking liquid, diversified and attractively priced instruments with stable returns.

- Due to its shariah compliant nature, Sukuk structures mandate accountability and transparency to investors, thereby, promoting better corporate and institutional governance.

The Future of Sukuk in Nigeria

The Sukuk market is currently attracting attention globally. It is expected that it will continue to attract more attention especially from some of the world's largest institutional investors who may consider Sukuk as the most effective way of investing in emerging markets and diversifying their investment portfolios.

In coming years, we expect to see more Sukuk issuances from multi-national corporations, especially those with significant operations in the Muslim societies. In November 2009, General Electric, a company ranked in the Fortune 500, in an attempt to diversify its source of financing became the first global multinational corporation entrant into the Sukuk market, with a US$500 million issuance to investors in the Middle East, Asia and Europe. We have since then seen more multi-national follow suit.

According to the Global Sukuk Market Dashboard issued by Fitch Ratings, the global outstanding Sukuk as at the 3rd quarter of 2021 is approximately US$775.4 Billion. Sukuk supply is expected to rise in the first quarter of 2022 after it showed strong growth during 2021, supported by strong investor appetite and issuers' refinancing and funding diversification needs.[4]

In Nigeria, Sukuk bonds are a viable investment option and are beginning to gain more investors' attention/confidence. The Debt Management Office (DMO) recently listed the ₦162.557billion, 7-year, FGN Ijarah Sukuk with a rental rate of 11.20% on the floor of the Nigerian Exchange Limited and FMDQ Securities Exchange Limited which further confirms the viability of Sukuk as a financing option. There are approximately 90 million Muslims residing in Nigeria[5] and this population creates a reasonable mass for Islamic Finance in areas of retail, corporate and the SME landscape, all of which could help grow both corporate and sovereign Sukuk issues in Nigeria.

Also, on 28 October 2021, the National Pension Commission (the "**Commission**") announced the introduction of the Non-Interest Fund and issuance of its Operational Framework for the Non-Interest Fund. The introduction of the Non-Interest Fund is in furtherance of the Commission's objective to provide diverse investment portfolio options, and to meet the increasing demand by pension contributors and retirees to invest in non-interest ethical instruments. Based on the Regulation on Investment of Pension Fund Assets issued by the

[4] https://www.fitchratings.com/research/islamic-finance/global-sukuk-market-dashboard-3q21-13-10-2021
[5] Which countries have the 10 largest Christian and Muslim populations? | Pew Research Center

Commission in 2019, Pension Fund Administrators are permitted to invest pension fund assets under their management in Sukuk and other Shariah non-interest compliant instruments registered with the Securities and Exchange Commission.

At Aluko & Oyebode, we are versed in the legal and practical nuances of Sukuk and are willing to advise clients desirous of exploring this financing option.

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