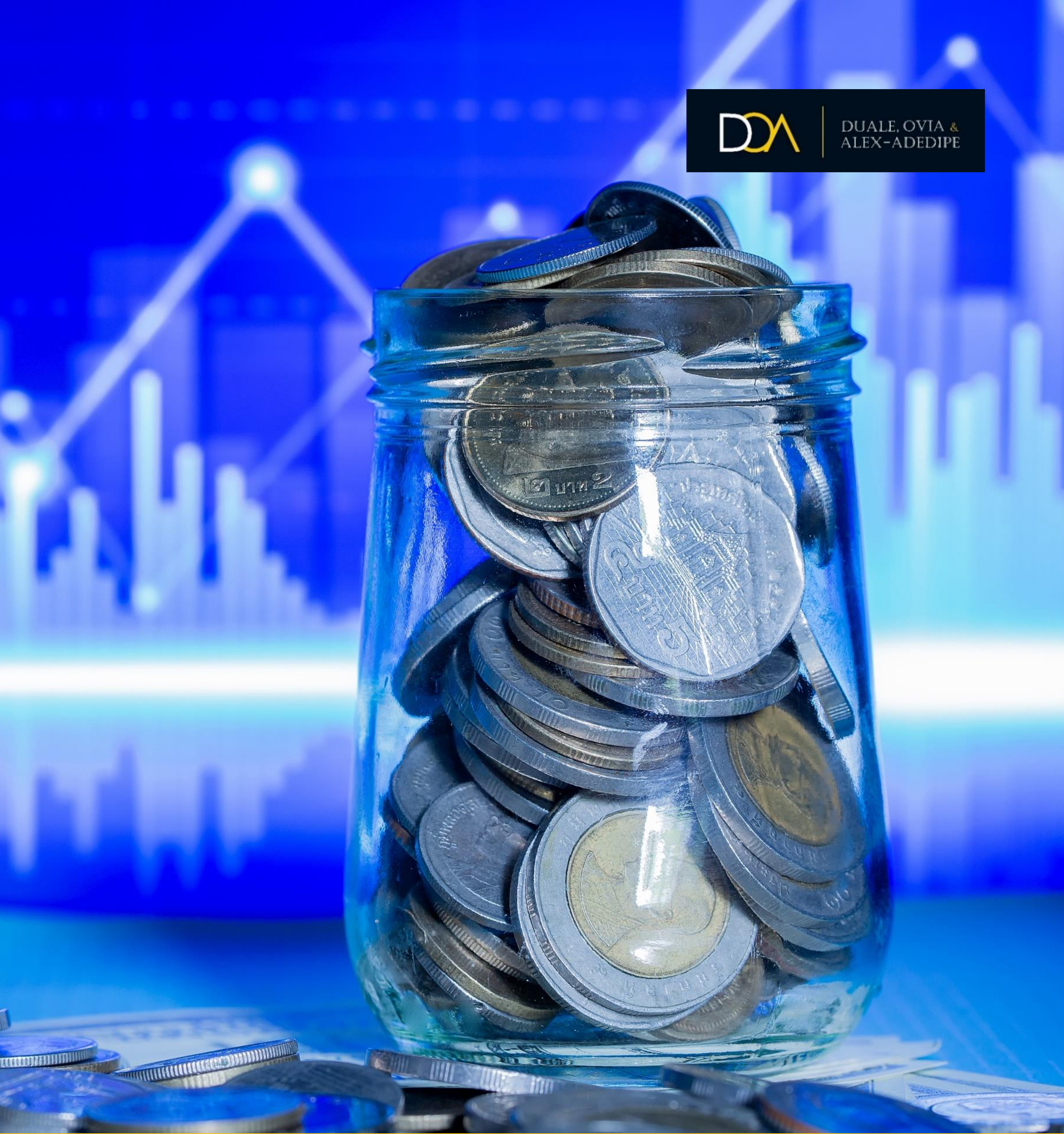

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Understanding the Issuance of Sukuk Bonds in Nigeria

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What is Sukuk?

A Sukuk is a sharia-compliant bond-like instrument used in Islamic finance. Sukuk refers to investment certificates or notes of equal value which represent the common, undivided interest/ownership title to shares and rights in any tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity in accordance with shariah principles and concepts approved by the regulatory authority[1].

Whilst conventional bonds are interest-bearing debt obligations; Sukuk provides non-interest-based investment/finance instruments that allow for direct asset ownership interest. Thus, Sukuk holders are entitled to share revenues generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of Sukuk assets. Furthermore, Sukuk unlike bonds, carry returns based on cash flow originating from the assets, based on which they are issued. Both Sukuk and bonds however, provide investors with payment streams. Worthy to note here is that, any income derived from a Sukuk Bond cannot be speculative which would make it no longer halal[2].

Regulatory Framework for Sukuk in Nigeria

a) The Investment and Securities Act
b) Securities and Exchange Commission Rules, 2013 As Amended ("**SEC Rules**")
c) NGX Rules for Listing of Sukuk and Similar Debt Securities
d) FMDQ Exchange Sukuk Listing Rules
e) Approved Principles and Concepts of the Accounting and Auditing Organization for Islamic Financial Institution ("**AAOIFI**")[3]
f) Sharia Principles and Law
g) Guidelines of reputable local and international institutions including Central Bank of Nigeria[4], Islamic Financial Services Board and AAOIFI.

Who Can Issue Sukuk[5]

a) Public companies (including SPVs);
b) State Governments;
c) Local Government;
d) Government Agencies; and
e) Multilateral Agencies.

[1] AAOIFI, 2008; 569 SEC Rules
[2] Arabic word for "permissible"
[3] 570 SEC Rules
[4] Framework for the Operationalization of the CBN Non-Interest Asset Backed Securities, 2022; Guidelines for Granting Liquid Asset Status to Sukuk Instruments Issued by State Governments, 2016
[5] 572 SEC Rules

BASIC FEATURES OF SUKUK

Sukuk structures must comply with Islamic principles, such as the prohibition of interest (*riba*), excessive uncertainty (*gharar*), and speculation (*maysir*).

Sukuk are based on the principle of risk-sharing between the issuer and investors. Sukuk structures entitle investors to share in the profits or revenues generated by the underlying asset or project. They also share in the risks and potential losses.

Sukuk can be either asset-based or asset-backed. Asset-based sukuk are backed by a pool of assets or projects, while asset-backed sukuk are directly backed by specific tangible assets or usufruct (right to use an asset). This ensures that the transaction is based on real economic activities and assets, rather than pure debt.

Sukuk-holders have ownership rights or undivided interests in the underlying asset or project. The legal title of the asset may be transferred to a special purpose vehicle (SPV) that acts as a trustee on behalf of the

General Shariah Principles as Applicable To Sukuk Issuance

The SEC Rules provides the following principles[6]:

Requirement of underlying asset

Under contracts of exchange (such as murabahah, istisna` and ijarah), an asset, whether tangible or intangible, shall be made available for sukuk to be issued subject to the following:

a) The underlying asset and its use shall comply with the requirements of Shariah;
b) An encumbered asset, such as an asset charged to a financial institution, or an asset that is jointly-owned with another party, can only be used as underlying asset provided the issuer has obtained the consent of the chargee or joint-owner; and
c) Where receivables are used as the underlying asset, they shall be established, certain (mustaqir) and transacted on cash basis (on spot).

Asset pricing

Sukuk contract that involves the sale and purchase of underlying assets. When the (Issuer/originator) purchase the underlying assets, the purchase price shall comply with the following pricing guidelines:

a) The purchase price shall not exceed 1.51 times of the market value of the asset; and
b) This shall also be applicable to murabaha, ijarah and istisna contracts.

Sukuk Types and Structures

One of the primary requirements for making an investment certificate Shariah compliant is that it should not represent any interest-bearing debt as the dominant part of the underlying assets. Sukuk can be of many types depending on the type of Islamic modes of financing and the trade structure undertaken. The most common among those are ijarah, musharakah, mudarabah, hybrid, salam and istisna. It is however important to note that the Securities and Exchange Commission of Nigeria ("**SEC**") only identifies 4 (Four) Sukuk structures under the SEC Rules (Sukuk Ijarah, Sukuk Musharakah, Sukuk Istisnah and Sukuk Murabaha) and any other form of contract approved by SEC.

A) Sukuk Ijarah (Lease)

This is likened to a finance lease – it involves the transfer of ownership or benefit/usufruct of tangible assets such as real estate, aircraft or ships from an originator to an SPV, which then issues to investors Sukuk certificates representing undivided ownership interests in such assets. Under the Sukuk Ijara:

[6] 575, SEC Rules

i. The parties to this structure are (a) the Sponsor of ijarah-Sukuk; (b) the Special Purpose Vehicle (**SPV**) i.e the issuer of ijarah-Sukuk; and (c) the investors (Sukuk holders).

ii. A single or group of assets that are admissible for ijarah contract are selected. The Sponsor establishes an SPV with separate, independent, legal personality to whom it sells the asset(s) with the understanding that the Sponsor will lease back the asset from the SPV.

iii. The SPV then securitizes its assets by issuing Sukuk Ijarah (i.e certificates of equal value representing undivided shares in ownership of the tangible assets) for sale to investors. The Sukuk sale proceeds provide funds to SPV to pay for the asset(s) purchased from the Sponsor.

iv. Under the lease back between the Sponsor (as Lessee) and the SPV (as Lessor), rent is negotiated, and a term-specific lease contract is signed. The rental rates of return on the Sukuk Ijarah can be fixed or floating. The cash flows from the lease which comprise of rental and principal repayments are passed through to Sukuk holders in the form of coupon and principal payments[7].

v. The rent-pass-through structure is adopted by the SPV to pass on the rents collected from the Sponsor-cum-lessee to the Sukuk holders[8].

vi. At the expiry (or termination) of the lease deed the flow of rents will stop and ownership of the asset pool would be with the Sukuk-holders as a group. If the underlying asset has a market value the Sukuk-holders can realize capital gain (or loss).

    a. Therefore, to close the ijarah-Sukuk structure with features attractive for both supply and demand the Sukuk contract may include a put option to the Sukuk-holders that the Sponsor is ready to buy the Sukuk at their face value on maturity or dissolution date.

    b. These returns along with low risk and exit possibility through secondary market (liquidity) constitute the incentives for investors to buy the Sukuk.

B) Sukuk Murabaha (Cost-Plus-Profit Margin Sale)

Murabaha is a contract that refers to the sale and purchase of assets whereby the cost and profit margin (mark-up) are made known and agreed upon by the parties. The Murabaha contract is widely used as a short-term financing instrument or where no tangible underlying assets can be identified in the Issuer or originator's business or operation.

[7] This structure was adopted for Nigeria's novel Sukuk issuance by the Osun State Government
[8] Introduction to Ijarah Sukuk: Current Structures and Future Prospects, Salman Syed Ali

Sukuk Murabaha are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that holders of the certificate become owners of the Murabaha commodity. Under the Sukuk Murabaha:

i. A master agreement is signed between the SPV and the Sponsor.

ii. SPV issues Sukuk to the investors and receive Sukuk proceeds. The proceeds from the Sukuk are used to purchase and take title of the goods.

iii. The SPV buys commodity on spot basis from the goods supplier

iv. The SPV sells the goods to the Sponsor at the spot price plus a profit margin, payable on instalments over an agreed period.

v. The Sponsor sells the goods to the buyer on spot basis.

vi. The investors receive the final sale price and profits.

The negotiability of these type of Sukuk or their trading at the secondary market is not permitted by Sharia (Islamic Law), as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading will amount to trading in debt or on a deferred basis, which will result in Riba (Usury)[9].

C) Sukuk Musharaka (Profit & Loss Sharing Partnership)

Musharaka means a relationship established under a contract by the mutual consent of the parties to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the venture. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Sukuk Musharaka are documents of equal value which evidence undivided ownership of the certificate holders in the Musharaka venture (partnership). They are issued with the aim of using the mobilised funds for establishing a new project or developing an existing one or financing a business activity on the basis of the partnership contracts. The certificate holders via an SPV become part owner of the project while the sponsor is the other partner. These Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. The typical Sukuk Musharaka structure requires that:

i. The Sponsor and the SPV enter into a Musharaka arrangement for a fixed period and an agreed profit-sharing ratio. The Sponsor undertakes to buy Musharaka shares of the SPV on a periodic basis.

[9] Sukuk: An Introduction to the Underlying Principles and Structure, June 2006, Dar Al Istithmar

ii. The Sponsor may contribute land or other physical assets to the Musharaka and the SPV contributes cash (i.e., the issue proceeds received from the investors/certificate holders) to the Musharaka.

iii. The Musharaka appoints the Sponsor as an agent to develop the land (or other physical assets) with the cash injected into the Musharaka and sell/lease the developed assets on behalf of the Musharaka

iv. In return, the agent (i.e. the Sponsor) will get a fixed agency fee plus a variable incentive fee payable.

v. The profits are distributed to the Sukuk holders.

vi. The Sponsor irrevocably undertakes to buy at a pre-agreed price the Musharaka shares of the SPV on say semi-annual basis and at the end of the fixed period the SPV would no longer have any shares in the Musharaka.

D) Sukuk Mudaraba (Profit Sharing & Loss Bearing Partnership)

Mudaraba is a contract made between two parties to enter into a business venture. The parties consist of the rabb al-mal (the party providing the capital who only contributes capital to finance the venture i.e sleeping partner) and the mudarib (entrepreneur) who will manage the venture. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital. The difference between this structure and Sukuk Mushrakah is the absence of a sleeping partner (Partner who only provides capital) in Sukuk Mushrakah.

Sukuk Mudaraba are certificates of equal value which evince undivided ownership of the certificate holders in the mudaraba venture. The issuer of these certificates is the Mudarib, the investors/certificate holders are the capital providers, and the realised funds are the Mudaraba capital. Mudaraba Sukuk give its owner the right to receive his capital at the time the Sukuk are surrendered, and an annual proportion of the realised profits as agreed.

Sukuk Mudaraba’s are important in development financing, because it is related to the profitability of the projects. They neither yield interest nor entitle owners to make claims for any definite annual interest, and are like shares with regard to varying returns, which are accrued according to the profits made by the project. On the expiry of the specified time of the subscription, the Sukuk holder is given the right to transfer the ownership by sale or trade in the securities market at his discretion. Under the structure:

i. The Mudarib enters into an agreement with the project owner for construction/commissioning of the project.

ii. The SPV issues Sukuk to raise funds.

iii. The Mudarib collects regular profit payments and final capital proceeds from project activity for onward distribution to investors.

iv. Upon completion, the Mudarib hands over the finished project to the owner

E) Sukuk Istisna (Construction/ Manufacturing Financing)

Istisna is a purchase order contract where a buyer requires a seller or a contractor to deliver or construct the asset to be completed in the future according to the specifications given in the sale and purchase contract. The payment term can be as agreed by both parties in the contract. In other words, a manufacturer or builder agrees to produce or construct a building at a given price on a given date in the future. Price can be paid in instalments, step by step as agreed between the parties.

Sukuk Istisna, are certificates that carry equal value and are issued with the aim of mobilizing the funds required for construction/ goods production that are owned by the certificate holders. The issuer of these certificates is the manufacturer, the subscribers are the buyers of the intended goods, while the funds realized from subscription are the cost of the goods. The certificate holders own the goods and are entitled to the sale price of the certificates or the sale price of the good sold based on a parallel Istisna, if any. The certificates may be cashed only on maturity, as Sukuk Istisna cannot have a secondary market. Under the Sukuk Istisna:

i. SPV issues Sukuk certificates to raise funds for the project.

ii. Proceeds of the Sukuk issued are used to pay the contractor/producer to deliver the future project.

iii. Title to assets is transferred to the SPV.

iv. The property/project is leased or sold to the end buyer. The end buyer pays monthly instalments to the SPV.

v. The returns are distributed among the Sukuk holders.

F) Sukuk Salam (Sale with Spot Payment but Deferred Delivery)

Sukuk Salam[10] involves the purchase of assets by one party from another party on an immediate payment or on the spot payment but with a deferred or delayed delivery period. The Sukuk Salam are certificates of equal value issued for the purpose of mobilizing an SPV, The issuer of the certificates is a seller of the goods of Salam, the subscribers are the buyers of the goods, while the funds realized from subscription are the purchase price (Salam capital)

[10] Salam is the sale of a specific commodity, well defined in its quality and quantity which will be delivered to the purchaser on a fixed date in the future against an advanced full payment of price at spot.

of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any.

Salam-based securities may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. The SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the Sukuk. The structure requires that:

i. The SPV signs an undertaking with Sponsor to source both commodities and buyers.

ii. The Sponsor contracts to buy, on behalf of the end-Sukuk holders, the commodity and then to sell it for the profit of the Sukuk holders.

iii. Salam certificates are issued to investors and the SPV receives Sukuk proceeds. The Salam proceeds are also passed onto the Sponsor who sells commodity on forward basis (sale of asset at a specified price and at a fixed date in the future).

iv. The SPV receives the commodities from the Sponsor and the Sponsor, on behalf of Sukuk holders, sells the commodities for a profit.

v. Sukuk holders receive the commodity sale proceeds.

G) Hybrid Sukuk

Under a hybrid Sukuk, the underlying pool of assets can comprise of Istisna, Murabaha receivables as well as Ijara. A portfolio of different classes of assets allows for a greater mobilization of funds. However, as Murabaha and Istisna contracts cannot be traded on secondary markets as securitized instruments at least 51 percent of the pool in a hybrid Sukuk must comprise of Sukuk tradable in the market. Where the Murabaha and Istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return. While the hybrid Sukuk is not popular, it provides the potential of new structures and benefits to the investors.

Since the issuance of the first Sukuk Bonds in Nigeria by the Osun state government in 2013, Sukuk Bonds have been a primary source of funding major road projects in Nigeria between 2017 - 2023. Since 2013, the capital market has however witnessed several sovereign and corporate Sukuk issuances, which offer more competitive terms in comparison with the increased rates of interest-based finance. To deepen the market, the SEC is collaborating with the Islamic Financial Services Board on harmonizing regulatory and supervisory standards, as well as the integration of the Islamic capital market with the conventional financial system.

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