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DISCOURSE ON THE CONCEPT AND VEHICLES OF BONDS IN ISLAMIC LAW

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Abstract

Sukuk, often referred to as Islamic bonds, represent a unique and innovative financial instrument within the realm of Islamic finance. Originating from the principles of Islamic law, *Sukuk* offers a distinct alternative to conventional bonds by adhering to Islamic principles that prohibits the payment or receipt of interest (*Riba*). Instead of interest-bearing debt, *Sukuk* are structured as investment certificates, granting investors a share in the ownership of tangible assets or services. This adherence to Islamic principles ensures that *Sukuk* are compatible with Islamic ethical and legal standards, attracting a diverse range of investors seeking financial instruments aligned with their religious beliefs. As *Sukuk* continue to gain prominence in global financial markets, they contribute to the development of more inclusive and diverse investment options, catering to both Islamic and non-Islamic investors alike. *Sukuk* provide an alternative means for raising capital that aligns with Islamic finance principles. *Sukuk* can resemble conventional bonds by some of its features, but it is technically neither debt nor equity. It is complex to understand the exact nature of *Sukuk* and differentiating them from bonds. This research Article made an extensive conceptual discourse on *Sukuk* and the vehicles of bonds under Islamic law, thereafter making findings that *Sukuk* is an instrument of the Islamic Capital Markets. Before investing in any *Sukuk*, Muslim investors should ensure that there is strict compliance with the sharia principles governing commercial transactions in Islamic Law

Keywords: Bonds, *Sukuk*, Islamic finance, vehicles of bonds.

1.1 Introduction

Islamic finance is a financial system comprising institutions, products (such as *Sukuk*) and services that operate according to Islamic law under the principle of

Islamic commercial laws. It involves the means by which corporations or governments raise capital and the forms of investments that are made in accordance with Islam. Just as conventional financial systems, Islamic financial system comprises of deposit taking banks, fund managers, investment firms, and insurance companies (*takaful*). These entities are governed both by Islamic law and the conventional finance industry's rules and regulations. Islamic Finance aims at ensuring or is based on the principle of 'justice and equity' for all parties involved in a transaction.¹

Islamic finance is based on the principle that the provider of capital and the user of the capital should equally share the risk of business ventures. It encourages sanctity of contracts, encouragement in business activities involving sharing of risks and prohibition of interest and prohibits speculative trading or any form of gambling. Islamic finance encourages profit-oriented business activities conforming to the strict ethical criteria of Islamic Law.² With the development of viable Islamic alternatives to conventional finance, Islamic-compliant solutions are now available to Muslims for their financial needs. Islamic finance has demonstrated that it can match the offerings of conventional banks.³

Capital market is a place or market where individuals, corporate entities or other forms of organisations in need of long-term capital, converge with those that provide the needed funds. The overwhelming purpose of traditional capital market is to connect surplus units and deficits in the financial system through structured products and services. The products exchanged through the market are the financial instruments/assets, through which the funds are challenged

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¹ 'Security and Exchange Commission Nigeria: *Sukuk* (Islamic Bond) At A Glance' [ND] <<https://sec.gov.ng/investor-education/sukuk-islamic-bond-at-a-glance/>> accessed 26 January 2025.

² S Ahmed, *Islamic Banking Finance and Insurance: A Global Overview* (Kuala Lumpur: A.S Noordeen 2006) 16.

³ Ibid 18-19.

from the investors/surplus to the deficit/users in order to make economic gains or to manage financial risks. On the one hand it becomes an asset to an entity, on the other hand, it becomes a liability to another entity. The financial assets include ordinary stock, shares, debentures and bonds.⁴ The conventional capital market operates as a network of parties with competing needs as to how to generate funds in order to satisfy or upgrade their developmental needs or economic growth. In contrast, the Islamic Capital Market mode of operation considers certain steps beyond conventional structural regulatory requirements. Islamic Capital Market, as a constituent of Islamic financial system, functions on a structured manner on a non-interest basis designed to provide ethical products and services on short-term, medium and long-term funding.⁵ In practice, Islamic Capital Market carefully follows the universal traditional inherited practices of conventional capital markets although with an addition that displays the unique Islamic value system. The Islamic value system prevents all harmful economic activities, it transcends to consider moral and ethical values for the society. It also complies with strict Islamic dictates and principles.⁶

One of the most popular Islamic Capital Market instrument is the *Sukuk*, and it is an alternative to bonds as long-term debt instruments. Islamic stocks and bonds (*Sukuk*) are the two key securities in the Islamic Capital Markets. However, the Islamic bonds (*Sukuk*) dominate the Islamic Capital Markets. *Sukuk* holders claim an undivided beneficial ownership in the underlying assets. There are two basic processes and structures of the Islamic bonds (*Sukuk*) involved in its issuance depending on whether the borrower needs the funding for a new venture or for an existing one.⁷ *Sukuk*, often referred to as Islamic

⁴ AB Dogarawa and others, *Introduction to Islamic Finance* (Zaria: ABU Press Limited 2024) 177-179.

⁵ *Ibid*

⁶ *Ibid*.

⁷ *Ibid*.

bonds, represent a unique and innovative financial instrument within the realm of Islamic finance. Originating from the principles of Islamic law, *Sukuk* offer a distinct alternative to conventional bonds by adhering to Islamic principles that prohibit the payment or receipt of interest (*Riba*). Instead of interest-bearing debt, *Sukuk* are structured as investment certificates, granting investors a share in the ownership of tangible assets or services. This adherence to Islamic principles ensures that *Sukuk* are compatible with Islamic ethical and legal standards, attracting a diverse range of investors seeking financial instruments aligned with their religious beliefs. As *Sukuk* continue to gain prominence in global financial markets, they contribute to the development of more inclusive and diverse investment options, catering to both Islamic and non-Islamic investors alike. These financial instruments comply with Islamic law (*Shariah*) principles, which prohibit the payment or receipt of interest (*Riba*) and promote risk-sharing and asset backing. *Sukuk* provides an alternative means for raising capital that aligns with Islamic finance principles.⁸ The *Sukuk* comes in varying modes such as; *ijarah* (leasing), *musharakah* (Joint Venture), *mudarabah* (Profit sharing & Loss bearing Partnership) etc. The purpose of these unique products is to have positive, visible impact on the real economy where there is a shared prosperity among the *Ummah*. All these instruments can either be asset-based or asset-backed. In designing these instruments, a key requirement and Islamic noble goal is the attribute of *Ihsan* (goodness) in equitable distribution of the proceeds of the venture amongst the parties, avoidance of *ribawi* (interest-based) activities, and prohibition of speculative behaviour.⁹

Sukuk holders are entitled to share in the revenues generated by the *Sukuk* assets as well as being entitled to share in the proceeds of the realization of the *Sukuk*

⁸ ZA Khalid, 'Financial Sukuk: Concept, Legal Principles, and Types' [2024] (24) (2) *Asian Journal of Economics, Business and Accounting* 98-106.
<<https://journalajeba.com/index.php/AJEBA/article/view/1224/2443> > accessed 26 January 2025.

⁹ Dogarawa (n 4) 188-189.

assets. The claim embodied in *Sukuk* is not simply a claim to cash flow but an ownership claim and it confers a beneficial interest to the holder in terms of holding a proportional ownership of the underlying asset as well as the income that it generates. The relationship between the parties in *Sukuk* is governed by the relevant contracts selected by the obligor upon the issuance of *Sukuk*. Therefore the parties can have a partnership relationship or lessor or lessee relationship or other types of relationship, depending on the contract. The return in *Sukuk* is either fixed or floating depending on the selected structure by the issuer.¹⁰ The main features of *Sukuk* are that it must comply with the principles of Islamic commercial jurisprudence and the venture must be *halal*. Thus, an investment in a brewery or any business that is in conflict with the Islamic will not be tagged as *Sukuk*. *Sukuk* can resemble conventional bonds by some of its features, but it is technically neither debt nor equity. It is complex to understand the exact nature of *Sukuk* and differentiating them from bonds. In the case of *Sukuk*, income is generated from the assets. Whereas, in conventional bonds, income (scheduled and often fixed) is generated from a debt instrument. The return for *Sukuk* on invested capital is not guaranteed and may have fixed or variable rates of return. The return can be either derived from underlying asset attached to the venture or from sales, lease or partnership or business ventures. It is important to note that equity instruments can also take the form of *Sukuk*, depending on how they are structured.¹¹

This article primarily seeks to make a discourse on the concepts and vehicles of bonds in Islamic Law.

1.2 Bond in Finance

In finance, a bond is a fixed-income instrument and investment product where individuals lend money to a government or company at a certain interest rate for

¹⁰ Ibid 189.

¹¹ US Bebeji and BM Chalawa, 'Secularism, Islamisation and the Prospect of Sukuk under Nigerian Law' [2019] (39) *Ahmadu Bello University Law Journal* 121-122.

an amount of time. The entity repays individuals with interest in addition to the original face value of the bond. Bonds are used by companies, municipalities, states, and sovereign governments to finance projects and operations. Owners of bonds are debt-holders, or creditors, of the issuer. Bond details include the end date when the principal of the loan is due to be paid to the bond owner and usually include the terms for variable or fixed interest payments made by the borrower. Bonds are debt instruments and represent loans made to the issuer. Bonds allow individual investors to assume the role of the lender. Governments and corporations commonly use bonds to borrow money to fund roads, schools, dams, or other infrastructure. Corporations often borrow to grow their business, buy property and equipment, undertake profitable projects, for research and development, or to hire employees.¹²

A bond under the Western banking system is an interest-bearing certificate of debt by which the issuer, government or corporation obliges itself to pay the interest and principal amount at a specified time, usually five years or more after date of issue.¹³

1.2.1 Bond in Islamic Finance

Sukuk (Islamic bond or “Sharia-compliant” bond) is an Islamic financial certificate that represents a portion of ownership in a portfolio of eligible existing or future assets. They can be considered as an Islamic version of conventional bonds. Sharia (Islamic law) prohibits lending with interest payments (*riba*), which is considered usurious and exploitative in nature. Thus, bonds are forbidden in Islamic finance.¹⁴

Sukuk is an Arabic word, refers to investment certificates or notes which evidence proportionate interest in ownership of tangible assets, usufructs and services or investment in the assets of particular projects or special investment

¹² F Jason, ‘Bonds: How They Work and How to Invest’ [2024] <<https://www.investopedia.com/terms/b/bond.asp>> Accessed 8 April 2025

¹³ Ahmed (n 2) 337

¹⁴ ‘Capital Markets: Sukuk’ [ND] <<https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/sukuk/#:~:text=Sukuk%20>> accessed 26 January 2025.

activity that adhere to the principles of Islamic.¹⁵ The basic principle behind *Sukuk*, popularly known as an Islamic or Islamic-compliant “Bond”, is that the holder has an undivided ownership right in a particular asset and is therefore entitled to the return generated by that asset. As a component of Islamic finance, *Sukuk* is a non interest based investment and financing instrument but its application is not restricted to Muslims as it conforms to ethical standards and justice.¹⁶

According to the Securities and Exchange Commission (SEC), *Sukuk* refers to investment certificates or notes of equal value which evidences undivided interest or ownership of tangible assets, usufructs and services or investment in the assets of particular projects or special investment in the assets of particular projects or special investment activity using Islamic principles and concepts approved by the SEC¹⁷

Islamic Bonds (*Sukuk*) is a relatively new financial instrument developed in the 1990s. A *Sukuk* is an innovative concept in Islamic Finance because it is an Islamic Compliant Product, reverse engineered from a standard global capital market product. Islamic Bond does not pay interest and instead make regular payment based on profits from approved investment or rent on a property. Islamic Bonds generally has a shorter term with a maturity of three to five years.¹⁸ Islamic Bonds are now gaining international acceptability, which would help the Muslim Countries with their needs for building and renovating infrastructure.¹⁹

1.3 The Origin and Legal Status of *Sukuk*

The application of *Sukuk* is not a recent phenomenon, it is as old as Islam. Prior to the modern period, Islamic communities used *Sukuk* as ‘papers’ to represent

¹⁵ ‘Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance’ (n 1)

¹⁶ Ibid

¹⁷ Bebeji and Chalawa (n 11) 120

¹⁸ Ahmed (n 2) 289-290

¹⁹ Ibid 292

financial commitments that originate from trade and other economic transactions. The first *Sukuk* transaction took place in Damascus, Syria in the 7th Century AD. Modern resurgence of *Sukuk* has been propelled by renewed recognition of the concept by the Islamic FIQH Academy of the Organization of Islamic Countries (OIC) and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). These institutions are standard setting organizations in the Islamic finance industry and have enabled *Sukuk* structures to be developed leading to the first successful issuance of *Sukuk* by the Malaysian Government in 1983. The rationale behind the creation of *Sukuk* is to provide an alternative to conventional bond in a Islamic compliant manner.²⁰

A bond is a certificate which, according to its terms, obliges the issuer to pay the bearer the face value plus the agreed amount of interest when it reaches maturity, or to pay other benefits, such as prizes awarded by drawing lots, or payment of a fixed amount, or any discount.²¹ The Islamic Fiqh Council has researched the matter of dealing in bonds and issued the following statement:

- a. Bonds which represent a commitment to pay the face value plus interest, or conditional benefits, are *Haram* (Prohibited) according to Islamic Law, whether one is buying, selling or handling them, because they are considered to be interest-based loans.
- b. This applies whether they are issued by private companies or by public bodies run by the state. The fact that they are forbidden is not affected by giving them other names such as “certificates”, “investment documents” or “savings”, or calling the interest “profit”, “commission” or “returns”.
- c. Also forbidden are bonds that offer prizes, because these are loans made on the condition that the benefits or increase will go to the group loaning the money, or to one of them, who is not specified at the time of

²⁰ ‘Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance’ (n 1)

²¹ I Saujan, 'Legal States of Bond in Islam and Shari'ah Compliance Bond (Sukuk)' [10 June 2010] <<https://www.slideshare.net/slideshow/legal-states-of-bond-in-islam-and-shariahpdf/258353013> > accessed 26 January 2025.

investment, in addition to the fact that this is based on the idea of gambling.

- d. Another kind of forbidden bonds, which it is haraam to buy, sell or handle, is bonds or documents based on bidding for a specific project or activity from which the owners will not benefit in any definite way, but will only receive a share of the profits according to the number of bonds or documents that they own, and they will only receive this profit if the project is actually carried out.²²

Mufti Billal Omarjee view;

- i. The bondholder lends money to a company, government or some other organization. In return typically, the company or government promises to pay a predetermined regular interest and a capital sum at the end of the bond's life. There are different types of bonds and they are all interest bearing instruments. Hence it is not permissible to invest in them.
- ii. The Islamic compliant alternative to bonds is the *Sukuk* in which we can invest.²³

1.4 Principles Guiding the Use of *Sukuk*

Financing and investment in *Sukuk* must comply with Islamic law and ethical standards referred to as Islamic principles as follows:

- i. Projects to be funded from *Sukuk* must be beneficial and not be harmful to the society such as dealings on alcohol.
- ii. Any transfer of asset/property should be through a valid contract
- iii. The activity for which the transaction is based must be permissible in Islamic and based on mutual consent.
- iv. Transaction must be free of unlawful conditions in the form of deceit, fraud, uncertainty/ambiguity that might lead to destruction or loss
- v. Transaction should be free of speculation and gambling
- vi. Interest is forbidden/prohibited

²² Ibid.

²³ Ibid.

- vii. *Sukuk* must be backed by or be based on some underlying assets.
- viii. The *Sukuk* assets must be a well-defined (specifications), physical existing (location) and known property with commercial value (revenue generating) (e.g. land, building, machinery) and owned by the seller
- ix. Returns to *Sukuk* holders are, as much as possible, generated from the revenue or cash flows of the underlying assets such as rent , profit or disposal
- x. Asset can be tangible or intangible e.g. marketing rights, concession agreement e.t.c.
- xi. For any *Sukuk* to be tradable, there must be 1/3 of its assets in tangible form²⁴

1.5 Similarities and Differences between *Sukuk* and Conventional Bond

Islamic and conventional bonds share the following characteristics:

- a) Investors receive a stream of payments: Conventional bonds provide investors with interest payments, while *Sukuk* allows investors to receive profit generated by the underlying asset.
- b) Less risky investments than equity: *Sukuk* and bonds are considered less risky investments relative to equities.
- c) Initially sold by the issuers: Both are initially sold by the issuers to the investors. Afterward, both securities are traded over the counter.²⁵
- d) As with conventional bonds, *Sukuk* are issued with specific maturity dates.
- e) They are both tradable securities i.e. they can be sold to a willing buyer.
- f) Both securities can be rated for purposes of issuance²⁶

There are few important differences between Islamic and conventional bonds, as summarized in the table below:

²⁴ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

²⁵ 'Capital Markets: Sukuk' (n 14)

²⁶ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

	<i>Sukuk</i>	Bonds
Ownership:	Partial ownership of the asset	Debt obligation
Compliance:	Complies with Sharia	Complies with country/region of issuance
Pricing:	Based on the value of the underlying asset	Based on issuer's creditworthiness ²⁷

1.6 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”)
- f. Sharia Principles and Law
- g. Guidelines of reputable local and international institutions including Central Bank of Nigeria, Islamic Financial Services Board and AAOIFI.²⁸

In Nigeria, *Sukuk* transaction is regulated through the framework provided under the Investment and Securities Act 2007 and SEC’s guidelines on *Sukuk*. Others are guidelines of reputable local and international institutions including CBN, Islamic Financial Services Board (IFSB) and AAOIFI.²⁹

1.7 Categories and Vehicles Of *Sukuk*

Sukuk can be categorized as follows:

²⁷ 'Capital Markets: Sukuk' (n 14)

²⁸ Duale, Ovia and Alex-Adedipe, 'Understanding the Issuance of Sukuk in Nigeria' [ND] <<https://www.doa-law.com/wp-content/uploads/2024/03/Understanding-the-Issuance-of-Sukuk-Bonds-in-Nigeria.pdf>> accessed 26 January 2025.

²⁹ ‘Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance’ (n 1)

- i. Product-based: The AAOIFI which issues standards on accounting, auditing, governance, ethical, and Islamic standards has laid down 14 different types of *Sukuk*. The common ones include *Ijara* (Lease) *Sukuk*, *Murabaha* (Cost-plus-profit margin sale) *Sukuk*, *Musharaka* (Profit & Loss Sharing Partnership) *Sukuk*, *Mudaraba* (Profit sharing & Loss bearing Partnership) *Sukuk*, *Istisna* (Construction/Manufacturing Financing) *Sukuk* and *Salam* (Sale with spot payment but deferred delivery) *Sukuk*.³⁰
- ii. Issuer-based: Issuers including Sovereign, company and financial institution can raise funds through issuance of Sovereign, Sub-national or corporate *Sukuk* respectively.³¹

1.7.1 *Ijara* (Lease) *Sukuk*

Ijara is a contract where a party purchases and leases out a specific asset (e.g. equipment, parcels of land, buildings) required by a client for a rental fee. The duration of the rental and the fee are agreed in advance in the contract entered into between the Lessor (Asset Owner) and Lessee (Beneficiary) and ownership of the asset remains with the lessor.³²

Sukuk Ijara are asset-backed securities, which are sold to a special purpose company by the issuer, which then rent them back. The rental payments go to investors in the debt instead of interest. The borrower buys back the assets at an agreed price at maturity and the investors are repaid the principal.³³

Ijarah Sukuk pertains to leased assets and carries equal values. They are issued by the owner of the leased property or their agent. The transaction involves selling the leased asset through *Sukuk*, making the holders both owners of the asset and beneficiaries of the rental income, proportional to the *Sukuk* portions each holds. For example, a leased building generates monthly or yearly income,

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

³³ Ahmed (n 2) 290

constituting the return for *Sukuk* holders who are considered partners in the ownership of the building. Additionally, *Sukuk* holders have the flexibility to sell their *Sukuk*. The value of the *Sukuk* depends on market factors such as supply and demand dynamics.³⁴

Bahrain is the first sovereign to issue *Ijarah Sukuk* in the world for the domestic market offering numerous opportunities to investors worldwide.³⁵ *Ijara* Bonds can be issued in the capital market to mobilize deposit for the development of long term infrastructure project they are completely negotiable and can be traded in secondary market.³⁶

1.7.2 Murabaha (Cost-plus-profit margin sale) Sukuk

Murabaha is basically a sales contract whereby goods are sold at a price which includes the purchase price plus a margin of profit agreed upon by both parties concerned. The price is paid in cash or in installments. *Murabaha Sukuk* are certificates of equal value issued for the purpose of financing the purchase of goods through *murabaha* so that the certificate holders become owners of the *murabaha* commodity. The proceeds from the *Sukuk* are used to purchase and take title of the commodities from a Supplier/Vendor and sell to the *Sukuk* Originating Entity at cost plus a reasonable profit payable in future. This true sale transaction entails the seller disclosing in advance to the buyer profit to be made in the transaction. The *Murabaha* contract is widely used as a short-term financing instrument.³⁷ *Murabaha Sukuk* carry equal values issued by a trader or their agent for the purpose of purchasing a certain commodity, then selling it with a known markup, such as equipment needed within a manufacturing contract. For example, machinery is purchased through *Murabaha*, and the

³⁴ Khalid (n 8)

³⁵ Ahmed (n 2) 296

³⁶ Ibid 337

³⁷ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

Sukuk holders become the owners of the equipment. The selling price is determined with a *Murabaha* markup.³⁸

1.7.3 *Musharaka* (Profit & Loss Sharing Partnership) *Sukuk*

Musharaka means a partnership arrangement between two or more parties to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the venture. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of capital contribution. *Musharaka Sukuk* is a project/business equity financing where the certificate holders, via an SPV become part owner of the project while the Originating Entity is the other partner. The structure of *Musharaka* requires both parties to provide financing in cash or in kind to the project, share the profit/return based on the agreed sharing ratio and loss based on the proportionate capital contribution to the project. The Certificates are tradable in the secondary market.³⁹

1.7.4 *Mudaraba* (Profit sharing & Loss bearing Partnership) *Sukuk*

Mudaraba is partnership contract between the capital provider (*Rabb al-Māl*) and an entrepreneur (*Muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.⁴⁰ *Mudaraba Sukuk* are trust certificates issued to finance projects or business activities funded with *Sukuk* proceeds but managed by the Originating Entity on behalf of the *Sukuk* holders. The profit generated from the project/business activities is shared between the SPV (for *Sukuk* holders) and

³⁸ Khalid (n 8)

³⁹ 'Security and Exchange Commission Nigeria: *Sukuk* (Islamic Bond) At A Glance' (n 1)

⁴⁰ *Ibid*

Originating Entity acting as an entrepreneur based on the pre-agreed ratio while in the case of loss, it is borne completely by the *Sukuk* holders as providers of the funds.⁴¹ Mudaraba *Sukuk* carry equal values issued by the organizer for the purpose of organizing and managing a proposed project for funding. *Sukuk* holders become capital owners in the project, and the project remains a partnership between them and the organizer. Profit and losses are shared based on agreed-upon percentages.⁴²

1.7.5 *Istisna*' (Construction/Manufacturing Financing) *Sukuk*

Istisna' is defined as a contract with a manufacturer to make something or a contract on a commodity on liability with the provision of work or to order a manufacturer to produce a specific commodity in a specific way.⁴³

Istisna' involves the sale of a specified asset, with an obligation on the part of the seller to manufacture/construct it using his own materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or installments. *Istisna*' *Sukuk* are certificates issued with the aim of mobilizing funds for the advance funding of real estate construction and manufacturing large assets such as power plants. The *Sukuk* proceeds are used to fund the contractor or manufacturer during the construction of the asset. The investors via SPV acquire title to that asset and upon completion either immediately pass title to the Obligor on agreed deferred payment terms or lease the asset to the developer under a hybrid contract of *Istisna-Ijara Sukuk*. This *Sukuk* is tradable only after delivery.⁴⁴

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

⁴¹ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

⁴² Khalid (n 8)

⁴³ MMA Al-Bashir, *Istisna (manufacturing contract) in Islamic banking and finance: Law & Practice* (Kuala Lumpur: A.S Noordeen 2006) 7

⁴⁴ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

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 market⁴⁵

1.7.6 Salam (Sale with spot payment but deferred delivery) Sukuk

Salam is the sale of a specific commodity with defined quality and quantity which will be delivered to the purchaser on a fixed date in the future against an immediate advanced full payment of price. *Salam Sukuk* are certificates of equal value issued for the purpose of mobilizing *salam* capital so that the goods to be delivered on the basis of *salam* come to the ownership of the certificate holders. It is most commonly used in the agricultural sector.⁴⁶ 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*.⁴⁷

1.8 Structures of Sukuk

Sukuk structuring typically involves the packaging of pools of Islamic-compliant asset/projects which has to be reviewed and approved by Islamic advisers to ensure compliance with Islamic. *Sukuk* are structured based on the specific contract of exchange of the Islamic-compliant assets. Such contracts can be

⁴⁵ Duale, Ovia and Alex-Adedipe (n 28)

⁴⁶ 'Security and Exchange Commission Nigeria: Sukuk (Islamic Bond) At A Glance' (n 1)

⁴⁷ Duale, Ovia and Alex-Adedipe (n 28)

made through the sale and purchase of an asset based on immediate, installmental or deferred payment, leasing of specific assets or participation in joint-venture businesses. The issuer funding objectives dictates which structure to adopt. Each structure may be used singly or combined with another in line with the underlying commercial and contractual basis for the *Sukuk*.⁴⁸

1.9 Special Purpose Vehicle (SPV) in *Sukuk* Transaction and Other Issuing Agencies

An SPV is a company incorporated for the purpose of financing a *Sukuk* based project originated by an obligor i.e company or government seeking to raise fund. *Sukuk* Issuing Agencies in Nigeria include the following;

- a) Public companies (including SPVs);
- b) State Governments;
- c) Local Government;
- d) Government Agencies; and
- e) Multilateral Agencies.⁴⁹

1.10 Asset-Backed *Sukuk* And Asset-Based *Sukuk*

Asset-backed *Sukuk* involve granting the investor (*Sukuk* holder) a share of a tangible asset or business venture along with a corresponding share of the total risk in line with his level of investment. In this structure, there is a true sale transaction, where the originator sells the underlying assets to an SPV as Trustees that holds these assets and issues the *Sukuk* backed by them. The buyers of *Sukuk* don't have recourse to the originator if there are payment defaults. All of the risks and rewards of ownership passes to the SPV. The *Sukuk* holders must assume any losses in case of impairment of *Sukuk* assets. Assets remain under the ownership of investors throughout the maturity period and

⁴⁸ 'Security and Exchange Commission Nigeria: *Sukuk* (Islamic Bond) At A Glance' (n 1)

⁴⁹ Duale, Ovia and Alex-Adedipe (n 28)

See also SEC Rules 572

returns are linked to performance of the assets. In the event of default, *Sukuk* holders have recourse to assets. If the returns fail to arise, the *Sukuk* holders suffer the losses. Examples of Asset Backed *Sukuk* include *Musharaka* and *Mudaraba*.⁵⁰

Asset-based *Sukuk* entails the issuer purchasing the underlying assets and then investing, trading or leasing them on behalf the investors (*Sukuk* holders), using the funds raised through the issued certificates (*Sukuk*). This structure, most often, takes the form of a sale-lease to the originator and is embedded with a binding promise from the originator to repurchase the underlying assets at maturity.⁵¹ In this structure, the *Sukuk* holders can only require the originator to purchase the underlying assets. As such, the *Sukuk* holders have an unsecured debt claim against the originator embodied in the payment of the purchase price following an execution of the binding purchase promise. This implies that *Sukuk* holders don't have full recourse to the underlying assets and the underlying assets are not used as collateral. Asset-based *Sukuk* grant only beneficial ownership to the *Sukuk* holders, so that in case of default, the investor would be left without any claim on these assets. This makes this type of *Sukuk* more akin to debt or bonds. Examples of asset based *Sukuk* include *Murabaha*, *Salam* and *Istisna*.⁵²

1.11 Benefits Of *Sukuk*

- a. Domestic issuer (sovereigns and corporations) can use *Sukuk* instrument to tap funding from international market with huge investor base and thereby attracting direct foreign investment (DFI).
- b. Issuance of *Sukuk* can attract domestic investment capital which is invested according to Islamic principles.

⁵⁰ 'Security and Exchange Commission Nigeria: *Sukuk* (Islamic Bond) At A Glance' (n 1)

⁵¹ Ibid.

⁵² Ibid.

- c. *Sukuk*, as an investment product, appeal to faith-based investors as well as conventional investors who are seeking liquid, diversified and attractively priced instruments with stable returns
- d. *Sukuk* ensures that every financial activity is backed by real economic activity and thus promotes financial stability and real economic development.
- e. *Sukuk* as investible product serves as liquidity management tool for banks and other Islamic financial institution.
- f. The tradable nature of *Sukuk* enables investors to liquidate their investments with ease whenever the need arises and as a result, enhances market liquidity
- g. *Sukuk* investment is relatively free from default risk
- h. Income from *Sukuk* investment is tax-free in advance markets
- i. *Sukuk* certificate qualify as collateral for interest-free borrowing
- j. *Sukuk* pricing is competitive in relation to other financing mode
- k. Low cost financing because it carries no burden of debt
- l. *Sukuk*, as an asset class, provides an alternative investment opportunity for the ethically conscious populace and otherwise
- m. *Sukuk* provides an alternative source of funding developmental and expansion projects
- n. When project-based, *Sukuk* can generate jobs.
- o. Issuance of *Sukuk* deepens the domestic bond market in order to promote economic growth
- p. *Sukuk* structures mandate accountability to finance providers, thus it will promote better governance on corporate and institutional levels
- q. Investment in *Sukuk* has a social and an ethical benefit to the wider society beyond “pure return”⁵³

⁵³ Ibid.

1.12 Risks of Issuing or Investing in *Sukuk*

Some of the varied risks that can affect *Sukuk* include:

- a. **Interest rate risk** – *Sukuk* certificates are exposed indirectly to interest rate fluctuations. Investment profit is tied to benchmarked interest rate and most *Sukuk* issue have fixed payment. Thus, when the market interest rate rises, *Sukuk* value drops.
- b. **Liquidity risk** – *Sukuk* certificates tend to be held until maturity due to the absence of well structured and sufficiently liquid secondary market.
- c. **Islamic negligence risk** – a risk of loss of asset value resulting from failure/negligence of issuer to adhere with the rules and principles of Shari‘ah throughout the duration of *Sukuk* issuance.
- d. **Credit risk** – adverse changes in market rates will unfavorably affect the credit worthiness of the issues.
- e. **Foreign exchange risk** – unfavorable exchange rate fluctuations will invariably have an effect on the assets in the *Sukuk* pool and in the currency of denomination in which the *Sukuk* funds are accumulated.
- f. **Market risk** – risk of fall in asset value.
- g. **Assets risk** – loss/damage of the underlying asset.
- h. **Default risk** – this is risk related to the ability and desirability of the buyer/debtor to pay the debt as at when due. It involves the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements. It is also related to delivery of sub-standard goods/projects or delay by the Supplier as against the contract’s specifications.
- i. **SPV specific risks** – possible failure/negligence of SPV to reimburse the *Sukuk* holders
- j. **Exit risk** – the inability of the SPV to dispose the asset/business at the end of the contract.⁵⁴

⁵⁴ Ibid.

1.13 Potential Projects To Be Financed From *Sukuk*

Prospective issuers of *Sukuk* may invest the *Sukuk* proceeds in the following projects areas: Agriculture, Roads, Air Transport, Rail Transport, Power, Petroleum Refining, Mass Housing, Education, Health facilities, Water and sanitation etc. Interested persons can buy *Sukuk* during public offer through Capital Market Operators registered by the Securities and Exchange Commission or on recognised and registered Exchanges through a stockbroker. Today, over 20 countries in Europe, Asia, Middle East and Africa have issued either corporate or sovereign *Sukuk* with Malaysia and United Arab Emirates at the forefront. Other countries include Bahrain, Indonesia, Iran, Qatar, Kuwait, Pakistan, Saudi Arabia, Singapore, Somalia, Turkey, Brunei, UK, Hong kong, Egypt, Ivory Coast, Senegal, Gambia, South Africa and Nigeria. The global *Sukuk* market continues to witness remarkable growth since after the 2008 global financial crisis. Annual issuances have grown from \$15 billion in 2008 to almost \$120 billion in 2014. Most of the *Sukuk* issuances recorded oversubscription. For instance, UK's £200m Sovereign *Sukuk* sale in 2014 attracted effective demand worth £2.3bn, an increase by 11.5 times. Outstanding volume of *Sukuk* hit \$290 billion in 2015 from 587 instruments. The growth of the *Sukuk* market has been largely driven by liquidity in gulf countries, its focus on socially responsible investment, its innovative asset backed funding structures, and government's support through regulation and issuances.⁵⁵

1.14 Conclusion

Sukuk is one of the most popular Islamic Capital Market instrument. *Sukuk*, often referred to as Islamic bonds, represent a unique and innovative financial instrument within the realm of Islamic finance. Originating from the principles of Islamic law, *Sukuk* offer a distinct alternative to conventional bonds by adhering to Islamic principles that prohibit the payment or receipt of interest

⁵⁵ 'Security and Exchange Commission Nigeria: *Sukuk* (Islamic Bond) At A Glance' (n 1) See also, Bebeji and Chalawa, (n 11) 122-126.

(*Riba*). Instead of interest-bearing debt, *Sukuk* are structured as investment certificates, granting investors a share in the ownership of tangible assets or services. This adherence to Islamic principles ensures that *Sukuk* are compatible with Islamic ethical and legal standards, attracting a diverse range of investors seeking financial instruments aligned with their religious beliefs. *Sukuk* provide an alternative means for raising capital that aligns with Islamic finance principles. The *Sukuk* comes in varying modes such as; *ijarah* (leasing), *musharakah* (Joint Venture), *mudarabah* (Profit sharing & Loss bearing Partnership) etc. The purpose of these unique products is to have positive, visible impact on the real economy where there is a shared prosperity among the *Ummah*. All these instruments can either be asset-based or asset-backed. In designing these instruments, a key requirement and Islamic noble goal is the attribute of *Ihsan* (goodness) in equitable distribution of the proceeds of the venture amongst the parties, avoidance of *ribawi* activities, and prohibition of speculative behaviour. The main features of *Sukuk* are that it must comply with the principles of Islamic commercial jurisprudence and the venture must be *halal*. Thus, an investment in a brewery or any business that is in conflict with the Islamic will not be tagged as *Sukuk*. *Sukuk* can resemble conventional bonds by some of its features, but it is technically neither debt nor equity. It is complex to understand the exact nature of *Sukuk* and differentiating them from bonds. In the case of *Sukuk*, income is generated from the assets. Whereas, in conventional bonds, income (scheduled and often fixed) is generated from a debt instrument. The return for *Sukuk* on invested capital is not guaranteed and may have fixed or variable rates of return. The return can be either derived from underlying asset attached to the venture or from sales, lease or partnership or business ventures. It is important to note that equity instruments can also take the form of *Sukuk*, depending on how they are structured.

1.15 Findings

Based on the research conducted, the following findings are proffered;

- a. **Sukuk is an instrument of the Islamic Capital Market:** *Sukuk* is a key security in the Islamic Capital Market and are an alternative to conventional bonds as long-term debt instruments. *Sukuk* offer a distinct alternative to conventional bonds by adhering to Islamic principles that prohibit the payment or receipt of interest (*Riba*). Instead of interest-bearing debt, *Sukuk* are structured as investment certificates, granting investors a share in the ownership of tangible assets or services.
- b. **Compliance with Sharia Principles:** Financing and investment in *Sukuk* must comply with Islamic law and ethical standards referred to as Islamic principles. Projects to be funded from *Sukuk* must be on transactions that are permissible, free from *riba or gharar*.
- c. **Similar to Conventional Bonds:** *Sukuk* can resemble conventional bonds by some of its features, but it is technically neither debt nor equity. It is complex to understand the exact nature of *Sukuk* and differentiating them from bonds.
- d. **Vehicles of Sukuk:** The *Sukuk* comes in varying modes and the common ones include *Ijara* (Lease) *Sukuk*, *Murabaha* (Cost-plus-profit margin sale) *Sukuk*, *Musharaka* (Profit & Loss Sharing Partnership) *Sukuk*, *Mudaraba* (Profit sharing & Loss bearing Partnership) *Sukuk*, *Istisna* (Construction/Manufacturing Financing) *Sukuk* and *Salam* (Sale with spot payment but deferred delivery) *Sukuk*.

1.16 Recommendations

The research is concluded with the following recommendations based on the above findings;

- a. Muslim Investors in capital market should invest in Islamic bonds (*Sukuk*) as an alternative to the conventional bonds. Islam regulates the

total way of life of a Muslim inclusive of the financial/commercial activities of a Muslim and *Sukuk* are in compliance with the Sharia principles.

- b. Before investing in *Sukuk*, ensure that there is strict compliance with the sharia principles governing the commercial transactions to invest in.
- c. Differentiate Islamic bonds (*Sukuk*) from conventional bonds before investing in *Sukuk*: *Sukuk* can resemble conventional bonds by some of its features, however, strictly speaking, *Sukuk* is different from conventional bonds. *Sukuk* represent a unique and innovative financial instrument within the realm of Islamic finance and it offers a distinct alternative to conventional bonds by adhering to Islamic principles that prohibit the payment or receipt of interest (*Riba*).