



SECP

SECURITIES AND EXCHANGE
COMMISSION OF PAKISTAN

CONCEPT PAPER: LISTING OF SHORT-TERM SOVEREIGN SUKUK



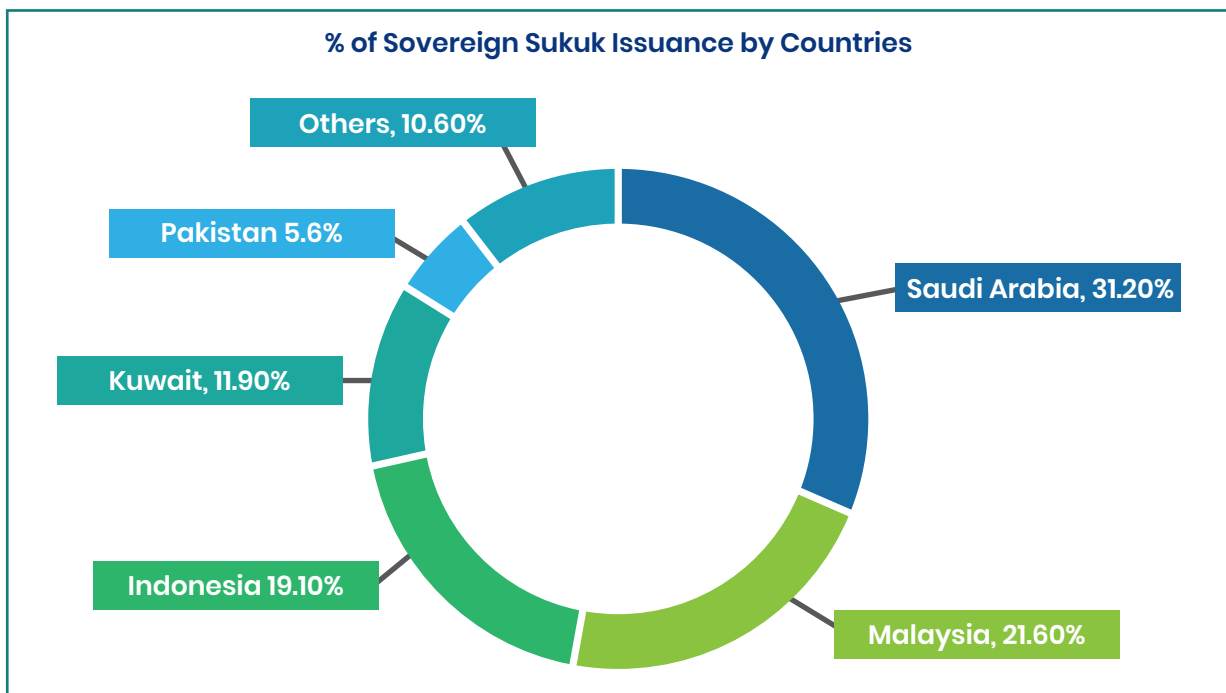
Preamble:

This document focuses on the roadmap for exploring possible structures of short term tradable sovereign sukuk for the development of Islamic capital markets. This is in line with SECP commitment for facilitating the smooth execution of FSC judgment for elimination of Riba from the country. SECP intends to seek feedback from stakeholders on the same.

1. BACKGROUND:

Sovereign Sukuk, commonly known as Islamic bonds issued by governments, represent a significant facet of modern finance with far-reaching implications. These financial instruments are structured in accordance with Islamic principles, ensuring compliance with Shariah laws. Governments issue sovereign sukuk to raise funds for various purposes, including infrastructure development, budgetary requirements, and financing public projects. Unlike conventional bonds, sovereign sukuk are generally asset-backed or asset-based, providing investors with a tangible stake in underlying assets or revenue streams. This approach ensures transparency, accountability, and risk-sharing among stakeholders.

According to Islamic Financial Stability Report- 2023¹, Sovereign sukuk contributes 12.7% of the total Islamic financial asset with \$415 billion amount. Sovereign Sukuk issuances have been particularly notable, with countries like Malaysia, Saudi Arabia, Turkey, Kuwait and Indonesia, followed by Pakistan, with 5.6% share of the total global outstanding sukuk, being major contributors. Saudi Arabia remained the largest sovereign sukuk issuer, followed by Malaysia, which overtook Indonesia as the second largest sovereign issuer.



During 2022–23, the government raised Rs. 847.6 billion through Sukuk issuance from the domestic market (total issuance of Rs. 3,150.6 billion as of June 30, 2023). In December 2023, the government proceeded with issuance and listing of GoP Ijarah Sukuk (short and long-term) at the Pakistan Stock Exchange Limited (PSX), which is a major breakthrough in the domestic Sukuk market. The Government of Pakistan decided to issue GoP Ijarah Sukuk through the capital market infrastructure institutions with issuance, auction, trading, transfer and settlement of the sukuk through PSX, National Clearing Company of Pakistan Limited and Central Depository Company of Pakistan Limited. Previously, government securities were auctioned only through mechanism provided by the State Bank of Pakistan.

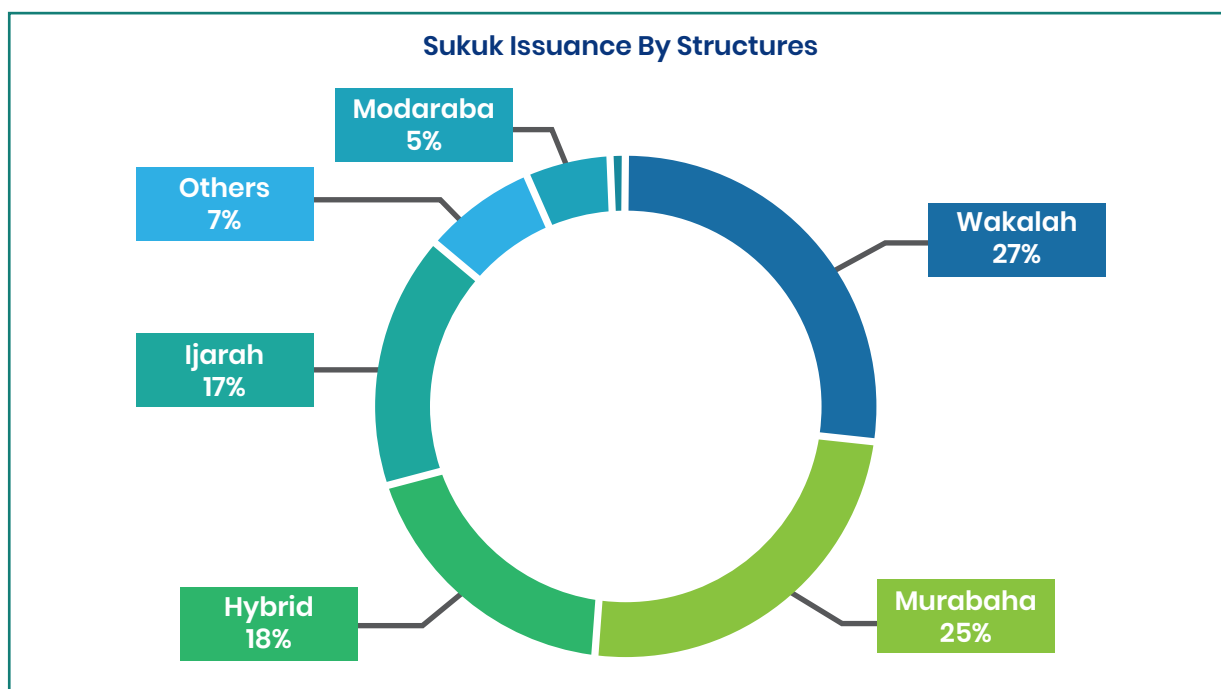
¹ https://www.ifs.org/wp-content/uploads/2023/10/Islamic-Financial-Services-Industry-Stability-Report-2023_En.pdf

As of now, different types of sovereign Sukuk instruments including discounted, fixed rate and variable rate sukuk of different maturities have been issued and are available for trading at PSX. The model for reopening of already issued sovereign sukuk instrument has also been tested successfully. As a result, the Government has increased the frequency of auctions through CMLs from monthly to fortnightly basis. Till date, the Government has raised c. PKR 713 billion in Eleven auctions through PSX.

Most sovereign sukuk issued are tradable in secondary markets due to their structuring in a way that makes trading permissible for this type of security, but they are long-term instruments. There is a need for short-term tradable sovereign sukuk for the development of the Islamic capital market and also to facilitate Islamic financial institutions and individual investors looking for short-term liquidity arrangements and investment avenues. This would also help in development of Shariah compliant sovereign yield curve for varying maturities. This concept paper is intended to explore the possible structure that can be used for the issuance of short-term sovereign sukuk.

2. SUKUK STRUCTURES:

There are four major categories of Sukuk; (1) Sale-based (2) Lease-based (3) Partnership-based (4) Agency-based. All Shariah compliant instruments issued, use these four categories singly or jointly to make hybrid sukuk structure. As per the IFSB report, Wakala is the most widely used Shariah structure for sukuk mainly due to the fact that this structure has trading feature. Though Sukuk are mainly used to generate liquidity but this instrument is also beneficial for secondary market players as investors can earn Shariah compliant profit through such instruments.



Sukuk structures vary in complexity and are tailored to meet specific financing needs while adhering to Islamic principles. Some of the widely used sukuk structures include:

- **Ijarah Sukuk (Lease-Based Sukuk):** In this structure, the issuer leases an underlying asset (such as real estate, equipment, or infrastructure) to the sukuk holders for a predetermined period. Sukuk holders receive periodic rental payments, which represent their returns on investment. At the end of the lease term, the ownership of the asset may transfer to the sukuk holders or a third party. Sukuk instruments based on Ijarah structures are normally tradable instruments.
- **Modaraba Sukuk (Partnership Based Sukuk):** Modaraba sukuk involve a partnership between the issuer (as the capital provider) and the sukuk holders (as the investors). The issuer acts as the mudarib (entrepreneur) who manages the investment on behalf of the sukuk holders. Profits generated from the investment are shared between the issuer and the sukuk holders based on a pre-agreed profit-sharing ratio, while losses, if any, are borne solely by the sukuk holders. This is also a tradable instrument and can be used for short term and long-term requirement of financing.
- **Musharakah Sukuk (Partnership Based Sukuk):** Musharakah sukuk represent an equity-based partnership between the issuer and the sukuk holders. Both parties contribute capital to a joint investment venture, and profits/losses generated from the venture are shared based on a pre-agreed profit-sharing ratio. Sukuk holders have ownership rights in the underlying assets of the venture. This is also a tradable instrument and can be used for short term and long-term financing requirements.
- **Murabaha Sukuk (Sale based Sukuk):** Murabaha sukuk are based on the Murabaha financing structure, where the issuer purchases an asset and sells it to the sukuk holders at a markup price. The sukuk holders make deferred payments to the issuer, representing the purchase price plus profit margin. This structure is commonly used for short-term financing needs and is not tradable.
- **Wakala Sukuk (Agency based Sukuk):** Wakala Sukuk is a type of Islamic financial instrument structured based on the concept of wakala, which is an agency contract. In this arrangement, the issuer acts as the principal and appoints a wakil (agent) to manage specified assets or investments on behalf of the Sukuk holders (investors). This structure is commonly used for short-term financing needs and is generally tradable.
- **Istisna Sukuk (Sale based Sukuk):** In an Istisna Sukuk, the issuer (often a government or a corporation) sells certificates to investors, representing ownership in an underlying asset that is yet to be constructed or developed. The proceeds from the sale of these certificates are used to finance the construction or development of the asset. This structure is commonly used for short-term financing needs and is not tradable.
- **Salam Sukuk (Sale based Sukuk):** Salam sukuk involve the sale of commodities or goods with deferred delivery against advance payment. The issuer sells a commodity to the sukuk holders at a predetermined price payable upfront. The delivery of the commodity occurs at a future date. The proceeds from the sale are used by the issuer for financing purposes. This structure is commonly used for short-term financing needs and is not tradable.

- **Hybrid Structures:** Some sukuk structures combine elements of different Islamic contracts to create hybrid structures that cater to specific financing needs. For example, a sukuk may combine Ijarah and Musharakah structures to finance a large infrastructure project, providing investors with a combination of rental income and profit-sharing returns. Such instruments are tradable.

In 2021, the Government of Pakistan also issued the Asset Light Sukuk Framework² aiming to enable the issuance of sovereign Sukuk on hybrid structures and do not require property or land as 100% of the underlying asset. The said framework was developed by a consultant firm of Asian Development Bank (ADB) providing an indicative list of generic Sukuk structures using a variety of Islamic financial arrangements that could be applied to future Sukuk issuances whether in the form of single Sukuk issuance or a Sukuk programme. The document also provides high-level process flows, and potential applications and sample use cases for each structure.

This framework has enabled the government of Pakistan to initiate reforms to adopt asset light Sukuk structures for issuance of sovereign and quasi-sovereign sukuk.

3. GLOBAL TRENDS AND PRACTICES:

Sukuk structures vary, and they can be based on different Islamic finance principles such as Musharakah (partnership), Mudarabah (fund management), Ijarah (leasing), Murabaha (sale), Istisna (sale), Salam (sale) or Wakala (agency). This diversity allows issuers to tailor Sukuk to specific economic needs. 52% of global short-term Sukuk issuances until December 2022 were based on the Murabaha (cost plus sale) structure, which is non-tradeable. Sukuk Al Murabaha has historically been the most dominant structure for Sukuk issuances. Even in 2022, around USD 42 billion, or 29% of total domestic issuances, were based on the Murabaha structure. As is the case in international Sukuk issuance, a new hybrid Sukuk, Murabaha and Mudarabah, was added by Saudi Arabia, and due to large issuances, the share in 2022 works out to be USD 30.470 billion, or 21%. Some notable global examples of hybrid Sukuk structures are listed below.

- **Mudarabah and Commodity Murabaha:** This structure has been used by KSA as part of its program, for domestic and international Sukuk, which are long-term tradable securities (up to 30 years of maturities). A major portion of the proceeds was invested by Issuer SPV under Mudarabahas, while the remaining was deferred to Murabaha.
- **Wakala Sukuk (Ijarah and Commodity Murabaha):** This structure is prevalent in the UAE, wherein the majority of proceeds are used to purchase 50-year-old infrastructure rights relating to certain roads, highways, bridges, dams, etc., whereas the remaining proceeds are used for commodity Murabaha. These are long-term tradable securities.
- **Salam and Ijarah Sukuk:** The Central Bank of Bahrain (CBB) has established a Liquidity Management Centre (LMC) to promote trading of Sukuk and undertaken two initiatives. a) Salam Sukuk as Islamic non-tradeable short-term securities with a maximum tenor of up to 3 months. Under this structure, the government sells commodities (typically LME commodities) to buyers (Sukuk holders) against advance payment with delivery at a future date. On maturity, the government sells commodities as agents of Sukuk holder; b) Ijarahh Sukuk for both short-term, i.e., 6 months, and long-term, i.e., 3–10 years. An SPV uses the majority of its proceeds to purchase tangible assets from the government, whereas the remaining proceeds are used to enter into commodity Murabaha through a trustee.

² https://www.finance.gov.pk/dpco/GoP_Asset_Light_Structure_Framework.pdf

- **Wakala Sukuk (based on Ijarah, Government Services, and Commodity Murabaha):** In Malaysia, through the Bursa Suq Alsila platform, to purchase Shariah-compliant commodities with 100% proceeds and their sale to the government on a deferred cost-plus basis payable at maturity. These are non-tradable domestic sukuk. For international issuance, a combination of Ijarah, government services like the issuing of licences, permits, etc., and commodity Murabaha.

4. POSSIBLE SHORT-TERM STRUCTURES

Structuring short-term sovereign sukuk in hybrid mode appears to be the most ideal way for the issuance of short-term sovereign sukuk and its listing on PSX. These structures will be complicated and difficult to execute, therefore requiring capacity building at different levels. A single-structure or a combination of structures can be used to structure short-term tradeable sovereign Sukuk.

Few possible alternatives that can be explored are as follows:

- Musharakah Sukuk** (this structure is being widely used by corporates for working capital requirements for a period of 6 months)
 - MoF can offer partnerships to sukuk holders on any profitable venture (e.g., activities of Pakistan petroleum, power generation, any specific profitable route of PIA, railway, services of universities, hospitals, or other agencies, etc.)
 - A Shirkat ul Milk (joint-ownership) agreement may be executed between MoF acting on behalf of GoP and Sukuk holders.
 - The revenue and profit generated from the operations of these entities for any specific period (quarterly or semi-annually) may be distributed between the parties as per the pre-agreed profit-sharing ratio.
 - Upon maturity, MoF will purchase the shares of sukuk holders to redeem the sukuk.
 - Or, upon maturity, another sukuk on the same asset may be issued so that new sukuk holders can purchase the share of the existing sukuk holder to redeem their investment.
 - This structure could be used for short-term Sukuk (3 to 6 months) and is generally tradeable.
- Murabaha Sukuk** (Generally non-tradeable sukuk structure with maturity of 3-6 months)
 - MoF requests the purchase of a specified commodity, and SPV will issue the sukuk to collect proceeds.
 - SPV to purchase the required goods using the proceeds and will sell the same to MoF on deferred sale. The MoF can fulfil its needs for importing commodities or sell commodities to generate liquidity.
 - Upon maturity, the remaining inventory may be sold to MoF, and the complete cost-plus profit may be repaid to sukuk holders for redemption.
 - This is generally a non-tradable structure, but to make it tradable, 20% of inventory should be kept by SPV so that sukuk holders can sell their sukuk in the secondary market.

iii. Wakala & Commodity Murabaha

- An SPV is created to purchase certain pre-identified real assets of any service providing entity from GoP using at least 26% of Sukuk proceeds.
- Remaining proceeds can be used to execute commodity Murabaha transaction to make it asset light.
- Sukuk holders through SPV may appoint GoP as their agent to collect fees from the general public, which may be treated as income for the Sukuk holders.
- NADRA, passport offices, or university assets may be used for this purpose.
- Upon maturity, the MoF can buy the asset from the sukuk holders.
 - A separate undertaking may be obtained from sukuk holders to sell it back to the MoF upon maturity, similar to the current practice of Ijarah sukuk.
 - The subject matter of the agency arrangement should be Shariah-compliant.
 - Sukuk proceeds may be used by the MoF to manage liquidity requirements.
 - This structure is generally tradeable and can be issued for short and medium-term Sukuk
 - This structure may further be explored to use in combination of different contracts in light of the international practices.

iv. Salam cum Wakala Sukuk

- Salam is a sale contract involving spot payment of the full sale price and deferred delivery of the subject matter (Salam assets).
- The MoF will sell specified assets to be delivered in a future date to the sukuk holders for arranging short-term liquidity.
- Sukuk holders will pay 100% of the sale proceeds in advance to MoF.
- Upon maturity, MoF will deliver the asset to SPV, and subsequently, the Sukuk holder will appoint MoF as an agent to sell the Salam subject matter.
- MoF will share the sale proceeds with sukuk holders to redeem the sukuk.
- This structure is non-tradable.

v. Istisna cum Ijarah Sukuk

- The government may require an infrastructure project to be constructed (a road, bridge, building, dam, and construction).
- The Sukuk proceeds can be used to manufacture or construct a specific subject matter (Istisna's assets) to be delivered on an agreed-upon future date.
- Upon construction, the project will be handed over to the government. The government may redeem the sukuk by making payments out of the development budget or lease the asset to the investors by issuing another Ijarah sukuk.
- This Istisna Sukuk is non-tradeable, whereas the Ijarah Sukuk may be tradable.
- To make it tradable, forward Ijarah contract option may be explored.

5. PROPOSED INTERVENTIONS:

It transpires from the above that both international and domestic Sukuk issuances are now moving to hybrid/asset-light structures to address the availability of asset issues while retaining the tradability features. In Pakistan, the structural limitation (only Ijarah Sukuk) is creating difficulty in expanding sovereign sukuk to include short-term (3-6 month) sovereign sukuk. Further, from global practices, it has been observed that mostly short-term sovereign sukuk are based on structures that are not tradeable (Murabaha, Salam, Istisna). For the introduction of sovereign short-term tradeable sukuk, structural innovation is required. Considering trends in the Pakistani sukuk market, structuring short-term sovereign sukuk in hybrid mode appears to be the most ideal way for the issuance of short-term sovereign sukuk and its listing on PSX.

To take the matter forward, the Debt Management Office (DMO) of the Government of Pakistan, the Joint Financial Advisors of the DMO, the representatives of SECP, and selected market participants can devise a road map for structuring short-term sovereign sukuk. This may include identifying propositions available for the issuance of short term tradeable and non-tradeable sukuk and documenting process flows with indicative timelines for the issuance of sovereign sukuk. In the first phase, the Government of Pakistan may consider issuing non-tradeable short term sukuk, with auction of such sukuk taking place through PSX, CDC and NCCPL. Infrastructure for auction of GOP sukuk instruments is already available. It can be clearly indicated prior to the auction that such Sukuk will not be tradeable and can only be redeemed on maturity.

Further, it is also imperative to develop an offering document or information memorandum for regular issuance of sovereign sukuk with defined procedures and steps and indicative timelines. Particularly in the case of the issuance of listed short, medium, and long-term Sukuk, the offering document serves as a base for information disclosure to the general public, including ordinary retail investors.

6. WAY FORWARD:

SECP, in light of its mandate and commitment to develop a Shariah-compliant capital market, is exploring possibilities to move forward in this way. This concept paper has been prepared to seek feedback from all stakeholders. Stakeholders are requested to submit their feedback and suggestions to the Commission at Sukuk.Feedback@secp.gov.pk latest by **August 22, 2024** on this concept paper or any other possible structure to enable and promote further issuance of sovereign sukuk in the Pakistani market.



SECP

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