ISLAMIC CAPITAL MARKET PRODUCTS; THE INTRODUCTION OF REGULATIONS FOR SUKUK TO THE SRI LANKAN CAPITAL MARKET

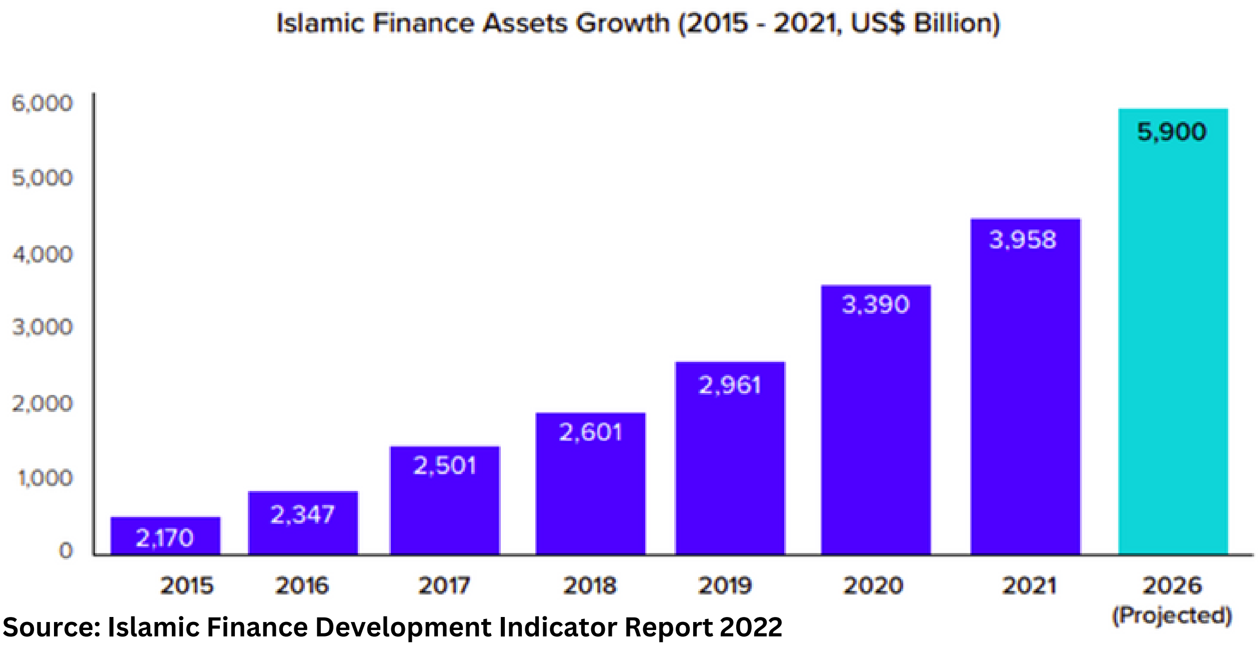
BY SECURITIES AND EXCHANGE COMMISSION OF SRI LANKA (SEC)

Islamic Capital Market Products (ICMP) are securities which are developed in compliance with Islamic Law, and ICMPs play an important role in the development of the Capital Market and the economy as it opens up opportunities for investment and fund raising. Many countries have introduced different types of ICMPs, such as Shariah-compliant equities, Islamic Collective Investment Schemes (ICIS) and Sukuk.

With the expansion of global private capital flows into high demand Capital Market product categories, Capital Markets have become important sources for tapping into domestic and foreign funds. Therefore, businesses willing to adhere to Shariah principles can raise funds by utilizing the growing demand and popularity enjoyed by ICMPs, especially Sukuk.

As per the Islamic Finance Development Indicator Report 2022 by Refinitiv, at present the global Islamic finance industry's assets amount to over USD 3 trillion, and according to Fitch Ratings, the value of Sukuk outstanding globally at the end of year 2022 was USD 765 billion; a 7.6% increase from the outstanding value in 2021. Further, there is an increasing trend in the issuance of sustainable Sukuk fueled by the emergence of green projects in need of funds and high demand driven by Environment, Social and Governance (ESG) centric investors. Accordingly, the total ESG Sukuk volume as at year 2022 stood at USD 24.5 billion, which is approximately 3% of the global Sukuk outstanding value.

Figure 01: Value of Global Finance Industry Assets



Source: Islamic Finance Development Indicator Report 2022

SHARIAH GOVERNANCE

The ICMPs require a product structure, screening methodology etc. to be approved by a Shariah board, the precise details vary from jurisdiction to jurisdiction. For example, some have a central Shariah authority, while others rely on Shariah boards at company level. Even where such approval is not a regulatory requirement, it is often a commercial requirement in the market.

TYPES OF ICMPS

The ICMPs belong to three main categories; Shariah-compliant equities, Islamic Collective Investment Schemes (ICIS) and Sukuk.

SHARIAH COMPLIANT EQUITIES

Shariah-compliant equities are equities that are determined to be Shariah compliant, though the issuer may never have made a claim of compliance. The process for determining whether an equity is Shariah-compliant, and thus appropriate for investment by observant Muslims or by funds or institutions seeking Shariah compliance is known as Shariah screening. This applies a set of criteria approved by a board of Shariah scholars and includes both qualitative and quantitative factors.

QUALITATIVE SCREENING

Screens the main business of the company with the intention of determining that it is not engaged in activities forbidden by Shariah principles such as conventional insurance, manufacture or sale of tobacco-based products or related products, conventional banking, etc. Different Shariah boards have slightly different views on what is permissible. In the screening process, a small amount of non-compliant activity, typically up to 5%, may be permitted.

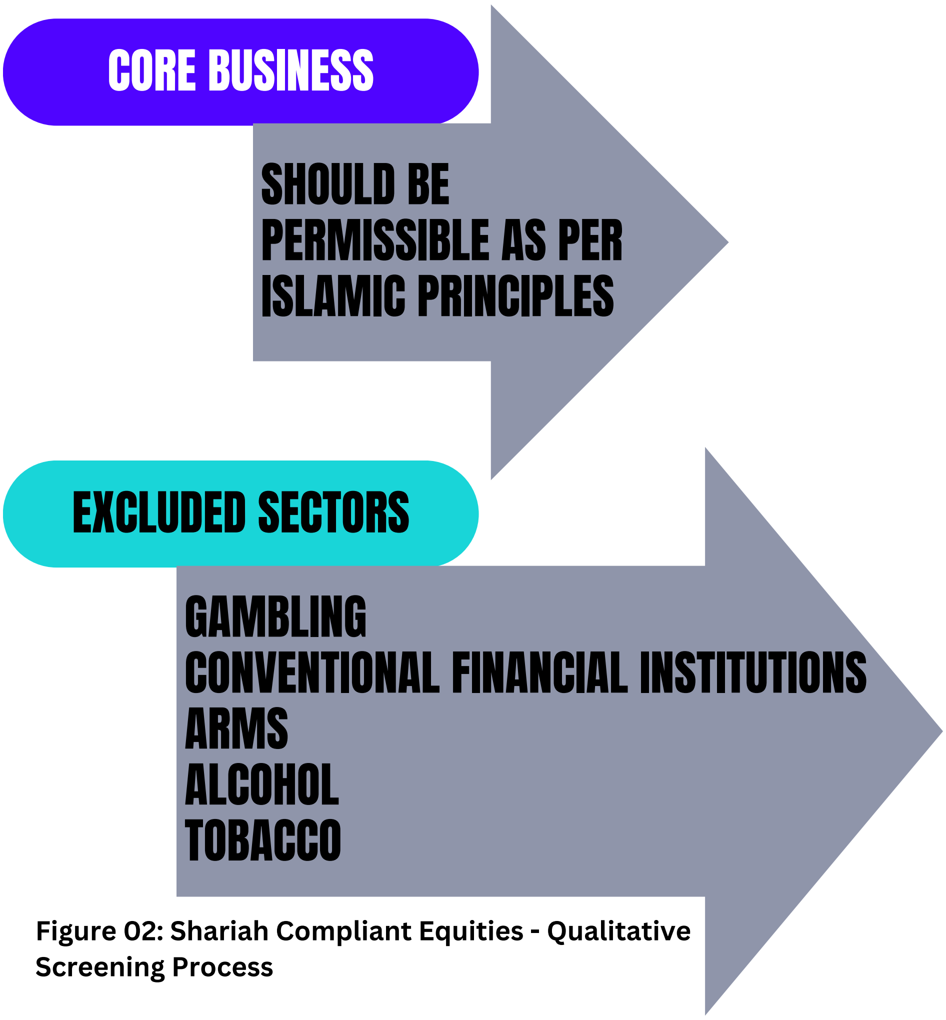


Figure 02: Shariah Compliant Equities - Qualitative Screening Process

QUANTITATIVE SCREENING

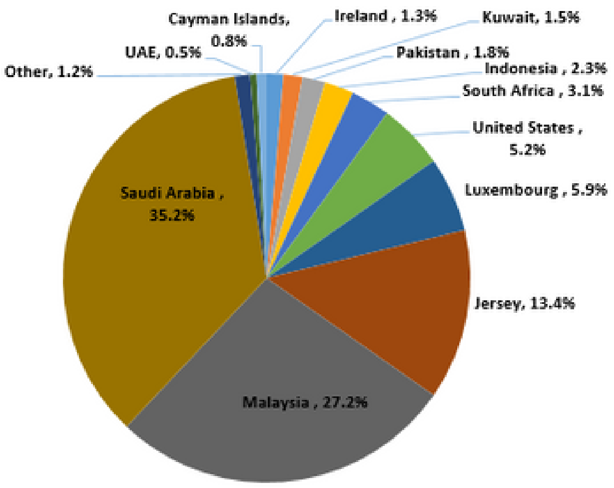
Screens the financial ratios of the company to ensure that it is not receiving or paying substantial amounts of interest. For example, a quantitative screen may require that the company's interest-bearing debt should not exceed 30% of its market capitalization.

Criteria	**Threshold**
Interest and income from impermissible sources / Total Income	**Less than 5%**
Interest bearing borrowings / Market Capitalization	**Less than 30%**
Cash plus Cash equivalents plus Short Term Investments / Market Capitalization	**Less than 30%**
Cash plus Cash equivalents and Receivables / Total Assets	**Less than 30%**

Figure 03: Example of Factors Considered in a Quantitative Screening

The Shariah-compliance status of an equity may change from time to time. Conversely, a company may sell off a business that was making it non-compliant or pay down existing debts. Therefore, the list of compliant equities is to be reviewed from time to time.

Figure 04: Islamic Fund Assets by Domicile (%) 2021



Source: Islamic Financial Services Industry Stability Report 2022

SUKUK

A Sukuk is a financial instrument similar to conventional debt securities and is linked to an underlying asset (normally tangible). From the perspective of investors, holding a Sukuk represents partial ownership of the relevant asset. Sukuk exist because in Islamic finance, the charging or receiving of interest is prohibited; under Shariah, an investor should realize no profit or gain merely for the employment of money.

ISLAMIC COLLECTIVE INVESTMENT SCHEMES

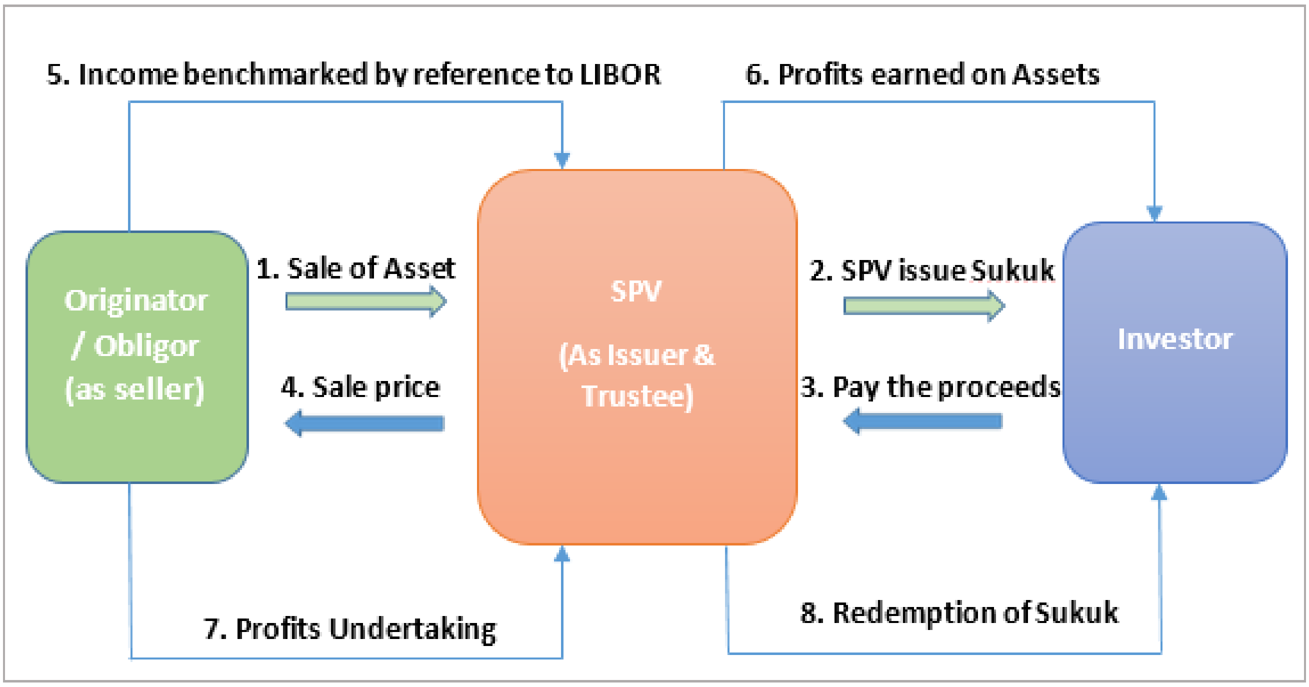
Islamic Collective Investment Schemes (ICISs) in general use the same legal structures as conventional funds but is required to invest in Shariah-compliant assets. Equities will be screened in a similar way as described above with appropriate variations for non-equity assets. In addition to funds investing in equities and other tradable securities, there are money market funds, real estate funds, commodities funds, venture capital funds, etc.

Whereas conventional bonds evidence a debt owed by the issuer to the bondholders, sukuk certificates evidence the investors' ownership interest in the underlying sukuk asset, which entitles them to a share of the income generated by that asset. However, in practice, the contractual structure is such that the return is predetermined and the dominant risk is the credit risk of an ultimate obligor. They are thus very similar to conventional debt securities in economic terms.

The underlying Sukuk assets must be Shariah-compliant, as must the use of the Sukuk proceeds. The assets or businesses underlying the Sukuk cannot be related to gambling, manufacture or sale of tobacco-based products or related products, conventional banking amongst other things.

The nature of Sukuk structures vary. A few examples of Sukuk structures include, Ijarah, Murabaha, Salem, Wakala and Mudaraba. However, typically, a company that requires capital (referred to as the "originator") establishes a Special Purpose Vehicle (SPV) and sells assets to the SPV. This SPV issues Sukuk certificates that are sold to the investors. The originator then contracts to use the assets in its business, for example, by leasing them back; the payments received for this provide the return to the investors. It also contracts to buy back the assets at the end of the period. A well-known variation on this structure involves transferring the beneficial but not the legal ownership of the underlying assets. One way of doing this is for the originator to grant the SPV a long lease over the assets (e.g. 15 years) and to lease them back for a shorter period (e.g. 5 years).

Figure 05: Typical Structure of a Sukuk



Source: Islamic Financial Services Industry Stability Report 2022

Sukuk may be issued in a domestic or foreign currency (usually USD). Where they are aimed at an international market it is common for them to be listed on more than one exchange; Kuala Lumpur, Dublin and Dubai are popular listing venues for non-local issuers.

Sukuk vary in tenor; short-term and with durations in excess of 10 years. However, the majority of Sukuk issued up until now have a maturity of three or five years.

SIMILARITIES AND DIFFERENCES BETWEEN CONVENTIONAL BONDS AND SUKUK

SIMILARITIES

Both provide investors with payment streams; Sukuk investors receive profit generated by the underlying asset on a periodic basis while bond investors receive periodic interest payments

Bonds and Sukuk are issued to investors and may be used to raise capital for a firm

Both are considered to be safer investments than equities

DIFFERENCES

Bonds are debt obligations and hence there is no ownership or share in the project or business

In contrast, Sukuk holders enjoy ownership of the asset

Bonds can be used to finance any asset, project, business or joint venture that complies with local laws

The asset on which Sukuk are based needs to be compliant with Sharia law

Face value of the bond is based on credit worthiness of the issuer

The Fair Value of Sukuk is based on the market value of the underlying asset

Bondholders receive interest for the life of the bond. The principal is also guaranteed and will be returned on the maturity date of the bond

Sukuk holders receive a predetermined share of profits/rental from the asset. They also accept a share of the loss

Bondholders are not exposed to asset fluctuation or the cost of the asset or business

Sukuk holders on the other hand are affected by the performance of the asset in the market. Higher costs lead to lower profits and vice versa

BENEFITS AND RISKS ATTRIBUTED TO SUKUK

BENEFITS

Sukuk could be used to finance large Infrastructure projects

Provides a mechanism to finance large commercial and industrial ventures promoting corporate and SME businesses in the island

Offers investment opportunities to groups who are interested in investing in Sri Lanka through a Sharia compliant model, especially from the Middle East

Provides an alternative to conventional methods of raising capital

Sukuk provide project-specific models to be used depending on the objective of the issue

Return on Sukuk is expected from the principal asset, which differs from the conventional bond, where the return is based on a fixed rate of interest

Investment available to institutional and retail investors

RISKS

Sukuk have a fixed return. Therefore, if market interest rates rise above the fixed rate, the value of the Sukuk value could decline. This is similar to conventional debt instruments

Lack of specialist knowledge in Islamic finance. Since Sukuk circulate in conventional markets, a sound knowledge of both conventional bond markets as well as basic Shariah principles is essential for a successful Sukuk market

If the underlying asset is denominated in one currency and the Sukuk certificate is offered in another currency, fluctuations in exchange rates could lead to exchange losses

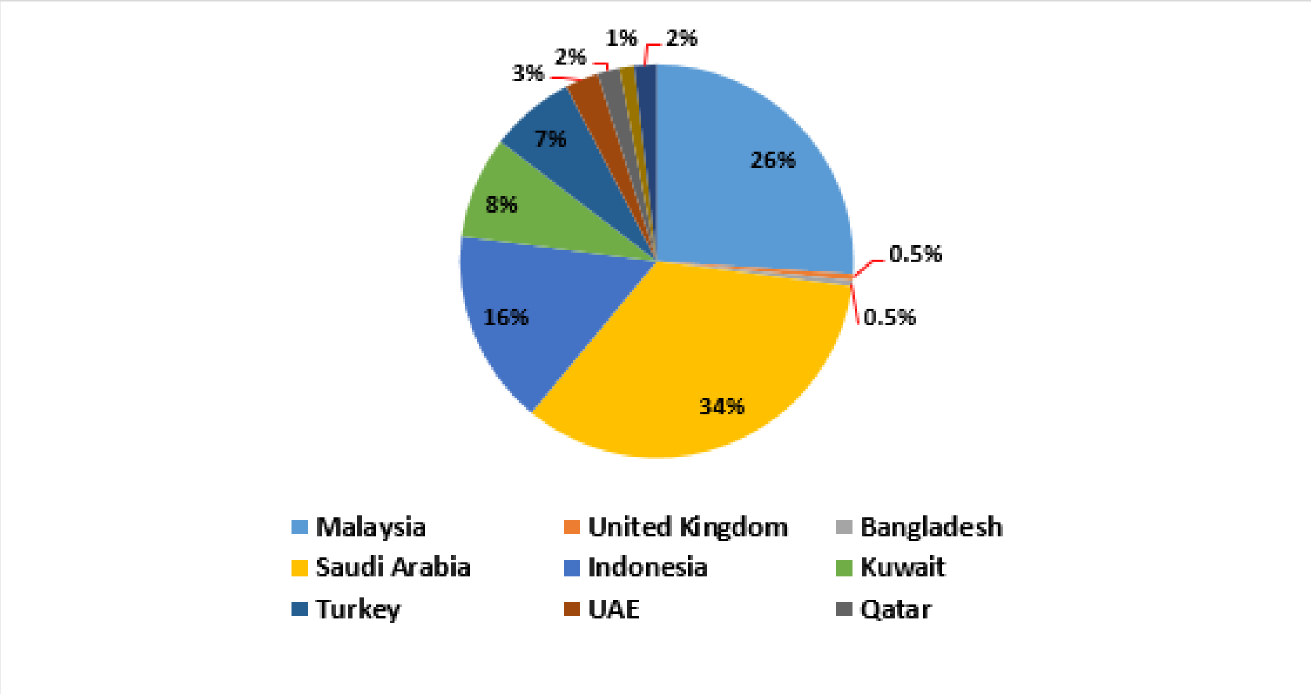
Loss of asset value due to non-compliance with Shariah standards and principles

Legislative and Regulatory implications

STATISTICS ON SUKUK ISSUANCES

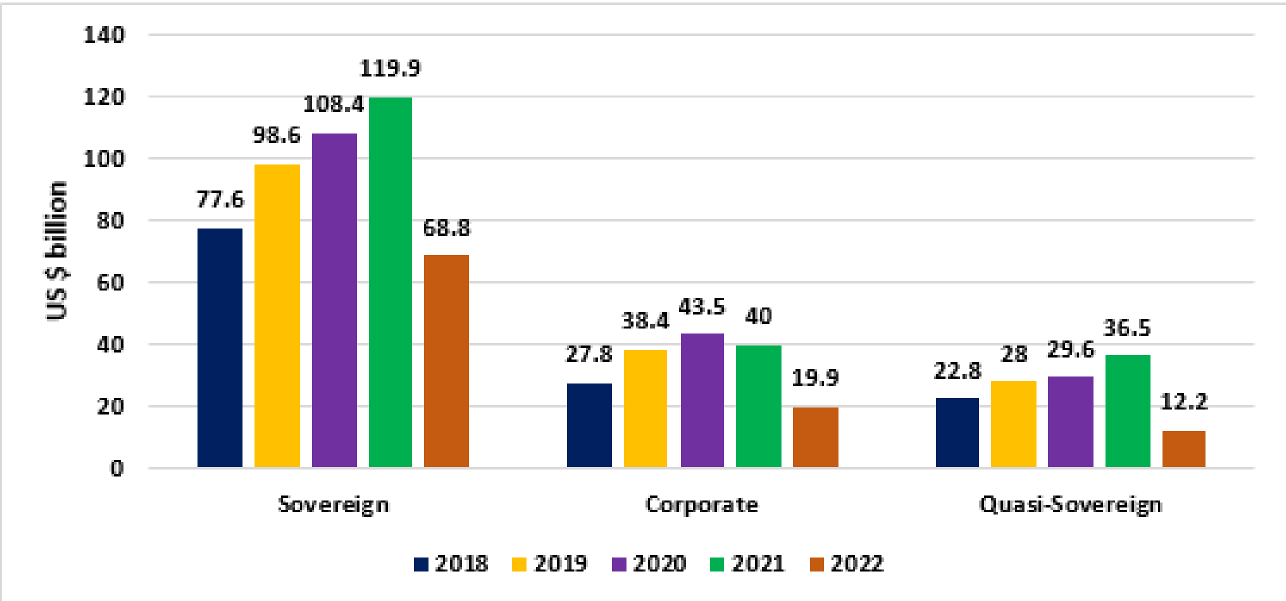
Malaysia, Saudi Arabia and Indonesia remain as the largest issuers of Sukuk and, together made up approximately 75 percent of Sukuk issued in the year 2021 and the first half of year 2022. Sovereigns continue to drive Sukuk issuance, claiming to about 60 percent of global issuances.

Figure 06: Total Sukuk Issuances by Domicile (%) (2021)



Source: Refinitiv

Figure 07: Sukuk Issuances by Issuer Type from 2018 to 2Q 2022



Source: Refinitiv

PROPOSED INTRODUCTION OF SUKUK PRODUCTS AT THE COLOMBO STOCK EXCHANGE (CSE)

At a time when there is a growing appetite and demand for ICMPs from investors and, with the success of other jurisdictions entwining the product into the Capital Market framework, by introducing a product such as Sukuk at the CSE, Sri Lanka would be able to tap into the much needed foreign funds and source it for development goals through the Capital Market framework.

The SEC approved in principle the introduction of ICMPs to the Sri Lankan Capital Market in June 2021. Thereafter, under the Capital Market Development Program of the Asian Development Bank (ADB), the SEC received technical assistance for conducting a needs assessment for Shariah-compliant securities in Sri Lanka, and identify potential Shariah-compliant Capital Market instruments to be introduced to the local market, and to formulate a policy and regulatory framework for the identified products in consultation with the SEC and the CSE.

Subsequent to the assessment done by the ADB experts, it was highlighted that there is a keen interest by the issuers and investors both for introducing Sukuk products and it was recommended to introduce Sukuk products to the Capital Market by making amendments to the existing listing rules applicable to debt securities at the CSE.

Subsequent to a stakeholder consultation process, the ADB consultants together with the SEC and the CSE developed the Regulatory Framework for introducing Sukuk products which was approved by the SEC Commission. According to the Regulatory Framework, an entity planning to list Sukuk products at the CSE is required to provide details such as a description of the underlying Sukuk structure, the relationships between the parties, and the flow of funds including a structure diagram in the Prospectus or Introductory Document. The rules for introducing Sukuk products were developed by the CSE in accordance with the approved Regulatory Framework by the SEC Commission in June 2023.

The issue of Sukuk products in various jurisdictions over the world has grown rapidly during the past few years giving proof of the popularity of the product. The introduction of Sukuk products at the CSE would broaden the product offering and open up new avenues for attracting much needed foreign funds to the Sri Lankan Capital Market and, be a catalyst towards the growth of Sri Lanka's economy.

SEC SECURITIES AND EXCHANGE COMMISSION OF SRI LANKA