
DISCUSSION PAPER

MFM Global Practice

No. 18

June 2017

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Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective

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MFMDISCUSSION PAPER NO. 18

Abstract

A strong legal framework that forms the basis for the activities of debt managers is crucial for enabling an effective public debt management function. This paper aims to complement discussions on the legal foundations of debt management by detecting and discussing essential elements that allow the government to issue sukuk, the equivalent of bonds, in Islamic finance. Drawing on the cases of recent sovereign issuers, these discussions begin with outlining the clear provision of a mandate to issue and to employ certain public assets in the execution of underlying transactions, as well to establish, engage with, and administer Special Purpose Vehicles used in structuring these issuances. Additional aspects that need to be addressed are the treatment of proceeds and the assurance of investors with regards to debt service. The enabling environment should be complemented by changes in the taxation regime and financial market regulations that facilitate the issuances.

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JEL Classification: H63, G15, F65, G28

Keywords: Legal framework for public debt management, sovereign debt, sukuk

Establishing a Legal Framework for Sovereign Sukuk Issuance: A Public Debt Management Perspective

Emre Balibek¹

1. Introduction

Public debt management (PDM) essentially involves meeting the funding requirements of the government and managing its financial liabilities. More specifically, it can be defined as “the process of establishing and executing a strategy for managing the government’s debt in order to raise the required amount of funding at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk”.² Given the exposure of public sector balances to public debt, an efficient PDM structure, governed by a robust legal framework, is fundamentally important for a country’s macroeconomic stability. Debt management is a continuously evolving practice, driven by the need of debt managers to cope with changes in macroeconomic policies, financial market landscapes, and the actions of investors.

In recent years, several countries, both with and without majority Muslim populations, have issued sukuk, the equivalent of bonds in Islamic finance, with a view to diversifying the investor base. Although sovereign sukuk in essence has a similar financial effect as conventional sovereign bonds, in strict terms, it is actually different from a regular bond. While a traditional bond can be easily created, backed by the full faith and credit of the issuer, sukuk relies on the transfer of ownership or usage benefits on an underlying asset, and its structure should adhere to the Islamic Law (Sharia). Therefore, the differences between a traditional bond and sukuk require the adoption of a more comprehensive legal framework, especially in non-Islamic jurisdictions.

Sovereigns that envision issuing sukuk should design a careful legal framework, which not only complies with relevant Islamic principles, but also has to reflect the distinctive features of sukuk from an operational perspective. In many jurisdictions, the sovereign has to be given a specific mandate to create the underlying structure for using an asset, and to issue a certificate that offers investors the beneficiary rights from this asset. Consequently, the legal status of the underlying assets, and the certificate itself, have to be clearly defined. The framework for sukuk issuance should be a consistent part of the overall public financial management legal framework.

Challenges also include the establishment and administration of a Special Purpose Vehicle (SPV), which acts as the intermediary in the issuance process. In general, sovereign sukuk tends to not be issued directly by governments, but through subsidiary SPVs. For example, the sukuk ijara (lease)

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² See World Bank and International Monetary Fund Revised Guidelines for Public Debt Management, April 2014.

model, which has been used in some recent sovereign sukuk transactions, involves the sale or lease of tangible or non-tangible assets by a government to an SPV established by that government. The SPV then raises funding from the issuance of sukuk to investors, the proceeds of which are then made available to the government as payment for the sale or lease of assets to the SPV. The setting-up and management of the SPV is another consideration that has to be taken into account in establishing the legal framework. The multiple transfers of assets between the sovereign entity and the SPV might generate financial costs (such as title taxes and levies) and operational burdens, which in turn might lead to higher transaction and borrowing costs for the sovereign if not accounted for in the legal underpinning of the transaction.

The objective of this paper is two-fold: (i) to analyze recent cases where the authorities had to make amendments in the legal framework in order to proceed with sukuk issuance; and (ii) to ascertain the common features of a successful enabling legal environment to guide sovereigns that would like in the near future to issue sukuk. Some recent examples of such legal amendments include cases in the United Kingdom (UK), Luxembourg, Turkey, Indonesia, and the Hong Kong Special Administrative Region, China (HKSAR). In UK, the Finance Act of 2008 and the Government Alternative Finance Arrangements Regulations (GAFAR) of 2014 laid the basis for the first sukuk issuance in 2014. The Sukuk Law of 2014 in Luxembourg provided the mandate for the government to execute the 2014 sukuk issuance by selling three local buildings to an SPV under a sale, lease, and buy-back transaction. HKSAR's debut sukuk issuance came in the wake of a March 2013 law that allowed the government to issue sukuk under its existing bond program. In Turkey, the amendment of the Public Finance and Debt Management Law in 2012 enabled the Turkish Treasury to launch its first ever sukuk issuances in domestic and international markets. In 2008, Indonesia promulgated its own Sukuk Law, which was followed shortly thereafter by the issuance of the country's first sovereign sukuk.

This paper concentrates on these examples with a view to identifying the key considerations in the design of a legal framework for sukuk. The paper will focus on challenges from the public debt management perspective, particularly on issues of how countries have been amending debt management laws, setting up and running the SPVs, assuring that the funds raised by the SPVs end up in the debt office and that this debt is serviced back, and dealing with the operational costs of asset transfers in order to maintain debt service costs.

The paper is organized as follows: Section 2 describes the characteristics of sukuk; Section 3 discusses trends regarding activities of sovereign borrowers; Section 4 summarizes legal amendments that were adopted in some recent cases in different jurisdictions; Section 5 discusses the main considerations in designing a legal framework and common solutions; Section 6 discusses the requirements for a holistic framework, including the challenges in taxation and capital market regulations; and Section 7 summarizes the main conclusions of the paper.

2. Definition and Features of Sukuk

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)³ defines sukuk as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity” (AAOIFI, 2008). Hence, sukuk can be labeled more precisely as “Islamic investment trust certificates”. In sukuk, the investor is granted undivided, pro-rata ownership rights to the underlying assets and/or the income they generate, while in a conventional bond, the borrower offers to pay fixed or variable interest for a defined time period.

Sukuk securities must adhere to Islamic law, referred to as Sharia principles. In Islamic doctrine, money is considered to be a tool for measuring value and a medium of exchange, and has no inherent value itself. Accordingly, an investor should not gain profit simply for the provision of money. Therefore, generating money from money just for the use of money, that is, interest (riba), is prohibited. The return for an investor must be linked to the profits of the investment. Investors then have to obtain their share of the income actually generated by the business or the assets they invest in, which reflects their ownership rights and the commercial risk.

The assets or businesses underlying the sukuk must also be compliant with the practice of Islam (halal business). Prohibited (haram) business activities include production and sales of alcoholic beverages and pork products, gambling, and other activities considered dubious, immoral, or illicit. The holders of sukuk must be assured that the value of the certificate corresponds to assets that are not related to activities or products prohibited by Islam.

Islamic doctrine also forbids other activities, including: deliberately induced uncertainty or unnecessary risk in contracts (gharar); trades in which the outcome is entirely dependent on chance or speculation (maysir); and gains obtained by making use of the other party’s ignorance (jahl). The concept of uncertainty does not relate to the commercial risks, but mainly to the indispensable elements of the contract between two parties, such as a lack of clarity or opaqueness with regards to the price, time of delivery, subject matter, and so forth. Thus, the rights and obligations linked to the investment must be transparent and clear. On the other hand, Islamic doctrine encourages investors to share the risks as well as the rewards associated with investment activities. In line with this doctrine, a sukuk contract is a simply a funding arrangement between two parties: one providing the funds (the investor); and the other (a sovereign, corporation or an individual) borrowing the funds in return for ceding ownership or rights on permissible assets and/or economic activities that generate returns to be shared with the investor.

The AAOIFI has specified the categories of permissible sukuk types, and has listed a number of techniques to structure a transaction. Among those, some commonly-used types include the

³ AAOIFI is a not-for-profit organization that aims to promote and harmonize worldwide financial Sharia standards through its Sharia Board, which is made up of scholars representing various Muslim countries.

instruments described in Table 2.1. Detailed descriptions of sukuk structures are given in Kusuma and Anderson (2014)⁴ and Latham & Watkins (2015).

Table 2.1: Some Common Sukuk Structures

Underlying Structure Based on	Type	Short Description
Lease Agreement	Ijara (Lease)	Sukuk is issued to finance the purchase of certain assets which are leased out to a lessee, whose rent payments are used for the periodic payments to the investors (sukuk holders). At maturity, the assets are repurchased by an obligor, and the proceeds of this sale are transferred to the investors.
Sales Agreement	Murabaha (Mark-up Sale)	The proceeds of the sukuk are used to purchase commodities or other assets from a supplier. They are then on-sold at a deferred price, which includes a mark-up on the purchase price. The installments from the on-sale are then used to pay the periodic distribution amount due to investors under the sukuk.
	Istisna'a (Supply Agreement)	The proceeds from issuance are passed on to a contractor for future delivery of a manufactured or constructed asset, which is then to be on-sold after delivery to pay back the investors. This is often combined with a forward-lease agreement for the asset, and the fees received from this advance rental are used for periodic payments.
	Salam (Futures Contract)	The proceeds are used as spot payment for future delivery of a commodity, which is then sold to pay back the sukuk holders. The commodity must be a standardized one, and its quality, quantity, place, date, and time of delivery must be well defined in advance.
Agency Agreement	Wakala	An appointed agent (the wakeel) uses the sukuk proceeds to invest in a pool of permissible investments or assets. Periodic payments to investors are made from the profits derived from the investment.
Partnership Agreement	Mudaraba	Proceeds of the sukuk issuance are used by the issuer as capital to finance a business in partnership with an entrepreneur, who contributes his labor and expertise. Profit generated from the business is distributed in pre-defined proportions between the business entrepreneur and the issuer, who then uses them for periodic payments to the sukuk holders.
	Musharaka	Proceeds are utilized to finance a business, but on a joint-venture basis, where both parties contribute capital to the business. Periodic payments and payment at maturity are generated in a manner similar to those in a mudaraba structure.

⁴The authors also discuss the distinguishing characteristics of sukuk compared with conventional bonds.

While there might be several parties involved in a sukuk structure, in practice, all the transactions for issuance and the generation of returns are structured between two main parties, an originator and the issuer, which generally is an SPV. In particular, the originator assumes different roles in various stages of the process. Figure 2.1 illustrates the role of the originator, based on recent ijara type sukuk issuances of the Turkish Treasury. In this structure, the government, represented by the Treasury, undertakes the following multiple roles; (i) the original seller of the underlying asset(s); (ii) the party to whom those assets are leased back, (that is, the lessee); (iii) the servicing agent for the payments; and (iv) the obligor who commits to repurchase the assets.

The process starts by the issuance of the sukuk by the SPV, which is a subsidiary of the government. The proceeds are then passed on to the government as a payment for the sale of the underlying assets, which consist of government properties and/or land. The government in its role as the lessee leases back those assets and pays rent to the SPV for their use. The rent income is distributed to sukuk holders by the Treasury. At maturity, the government purchases the assets back from the SPV, and the proceeds of this repurchase are passed on to the investors. The roles of the parties involved in an ijara-type sukuk transaction are described in Table 2.2.

Figure 2.1: Sukuk Ijara Structure

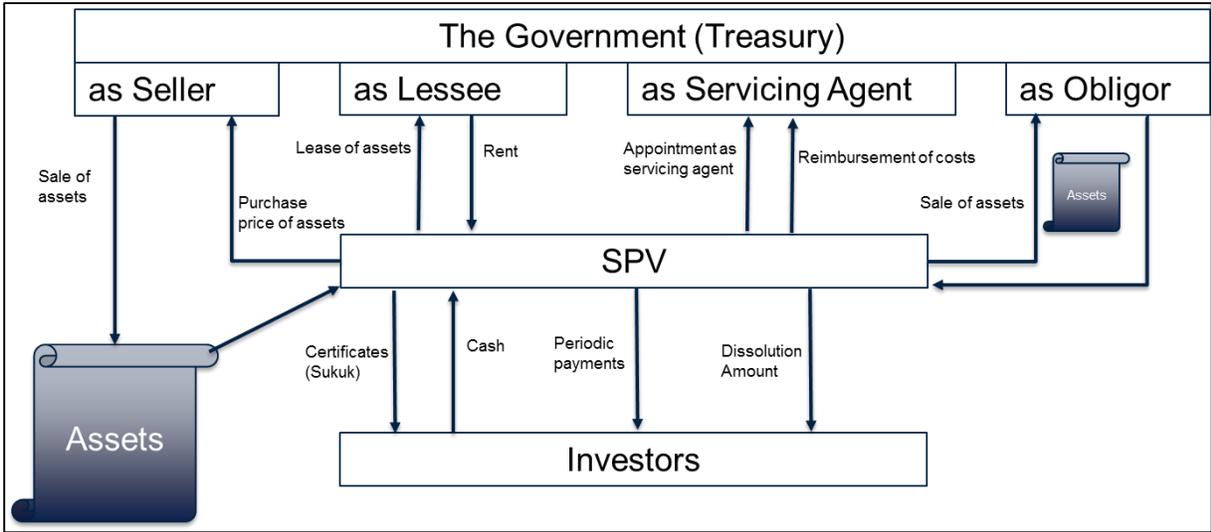


Table 2.2: Roles of the Government and the SPV in an Ijara-Sukuk

Role	Performer	Description
Issuer	SPV	Issues the certificate
Trustee/Lessor	SPV	Holds the trust assets in trust unequivocally for the sukuk holders as owners and beneficiaries pro-rata according to the face amount of certificates held by each investor; and distributes the income from the trust assets, in accordance with the Declaration of Trust.
Seller	The government	Sells to the trustee the underlying assets in line with a Purchase Agreement.
Lessee/Tenant	The government	Leases from the trustee, in accordance with a lease agreement, the underlying assets for a specified period, and pays rent on a periodic basis. The rent is intended to fund the periodic income payable by the issuer with respect to the certificates.
Servicing Agent	The government	Appointed by the trustee, pursuant to a Servicing Agency Agreement, and is delegated with the responsibility for: (i) the performance of all major maintenance and structural repairs; (ii) the payment of proprietorship taxes and levies (if any); (iii) dealing with the incident of a total loss.
Obligor	The government	Commits to repurchase the assets from the trustee, in accordance with the terms of a purchase undertaking, on a scheduled dissolution date at an (exercise price).

3. Trends in Sukuk Markets: Sovereign Borrowers

Over the last decade, there has been a notable growth of sukuk markets, and the instrument has emerged as a viable asset class, linking sovereign and corporate issuers with a wide pool of investors, not only in the Middle East and Southeast Asia, but all around the world, who are seeking to diversify their holdings beyond traditional assets. As of the end of 2017, the total outstanding volume of sukuk had reached a level of USD 320 billion (Islamic Financial Services Board (IFSB), 2017), compared to almost none at the start of the millennium. Increases in issuances were initially driven by Malaysia, concentrating on domestic markets, followed by the international issuances of the Gulf Cooperation Council (GCC) region. More recently, other countries with predominantly

Muslim populations, such as Indonesia, Turkey, and Pakistan, became regular issuers. Inaugural sovereign issuances from countries which do not have majority Muslim populations, including the UK, South Africa, and Luxembourg, demonstrated the significance of the sukuk market.

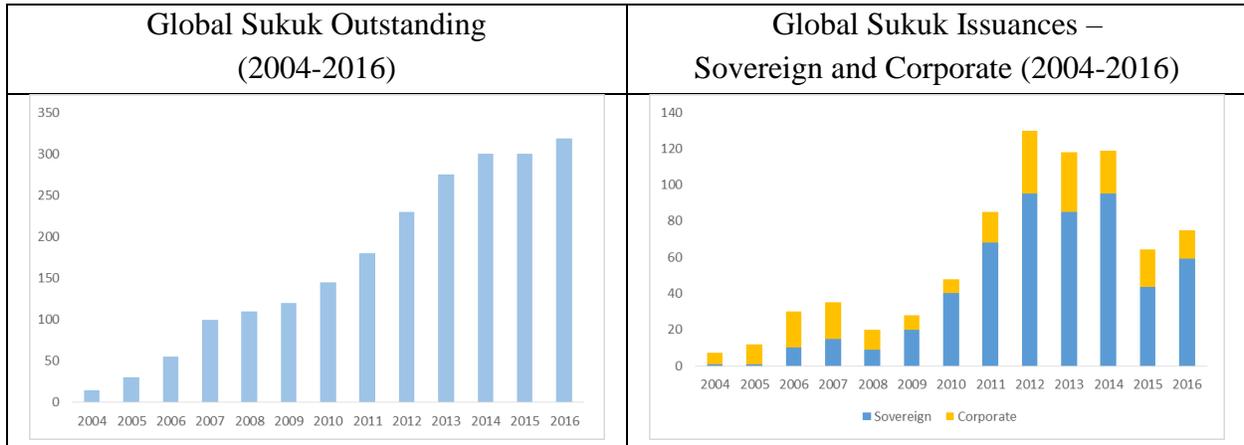
While the origins of sukuk can be traced back to the classical Islamic period (AD 700-1300), in modern times there was no activity until 1990, when an international company issued the first sukuk transaction in Malaysian Ringgit. After that transaction, it was another eleven years before the first sovereign issuance was made by the Bahrain Monetary Agency (now the Central Bank of Bahrain) based on the ijara structure, and an international sukuk issuance was made in United States dollars by a Malaysian company. In 2002, the Malaysian government made a second international issuance, which also became the first sukuk rated by international credit-rating agencies. Several sovereign issuances followed, including those by Qatar, Pakistan, and the Emirate of Dubai, which set the stage for unparalleled sukuk growth. In the GCC countries, for instance, sukuk issuances almost doubled between 2005 and 2007, increasing from USD 25.5 billion to USD 48.2 billion (Latham & Watkins, 2015). Indonesia and Pakistan entered the market in 2008, with Turkey following in 2012, and the countries became regular issuers, both in domestic and international markets.

The EUR100 million ijara-type sukuk issued in 2004 by the German Federal State of Saxony-Anhalt was one of first sukuk issued by a non-Islamic sub-sovereign,⁵ but until recently, sukuk markets were mostly dominated by countries with predominantly Muslim populations. Starting in 2014, the UK, South Africa, HKSAR and Luxembourg, which do not have majority Muslim populations, joined the list of sukuk issuers. In Africa, Sudan and Gambia became the first regular sukuk issuers, followed between 2013 and 2016 by the initial issuances of Nigeria, the Ivory Coast, Senegal, and Togo. In the Middle East, Jordan entered the market in 2016 with two sukuk issuances.

Sovereigns have generally pioneered the sukuk issuances in their respective jurisdictions, and these issuances have been a catalyst for the market. In 2016, 80 percent of the global sukuk issuances came from sovereigns, including quasi-sovereigns, and multilateral issuers (Figure 3.1). Since 2009, this ratio has stood at a level between 70 percent and 80 percent. (IFSB, 2017). The drop in total sovereign sukuk issuances in 2015 and 2016 was mostly attributable to the decision of the Central Bank of Malaysia to discontinue its short-term sukuk program. Issuance by sovereign and quasi-sovereign institutions in Malaysia and Indonesia continue to dominate the market, with two of them accounting for about 65 percent of sovereign issuances in 2016. They are followed by issuances from jurisdictions in the GCC region, Turkey and Pakistan (Figure 3.2).

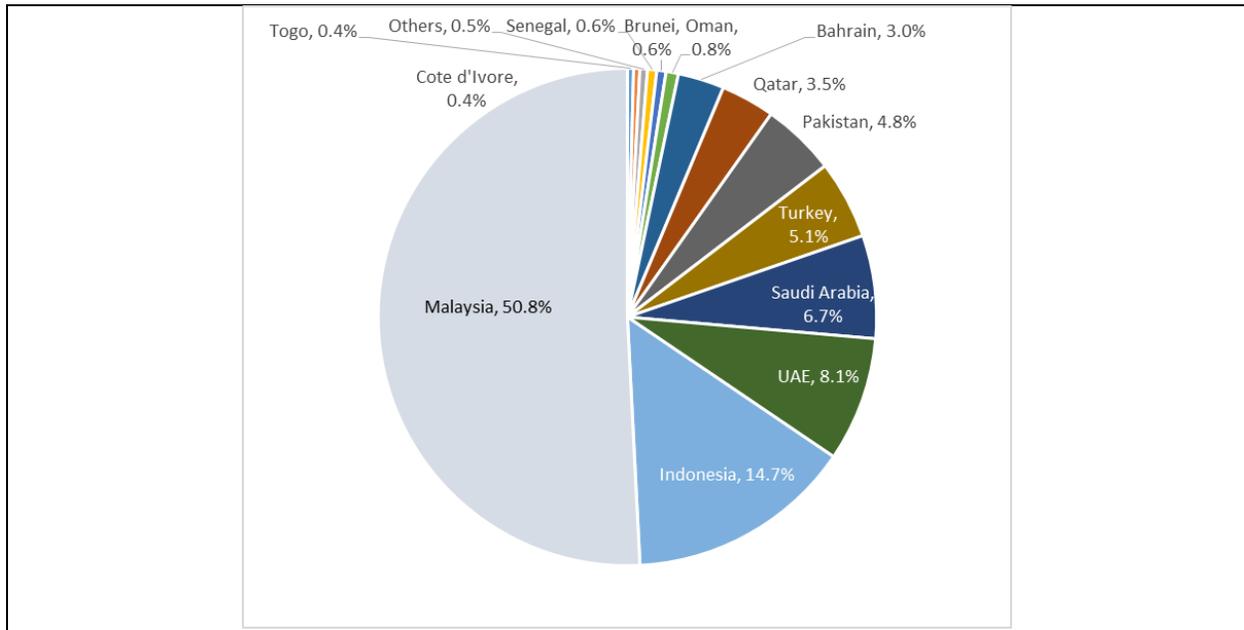
⁵ IIFM (2009).

Figure 3.1: Global Trends in Sukuk



Source: IFSB (2017)

Figure 3.2: Sovereign Issuance by Jurisdiction in 2016⁶



Source: IFSB (2017)

Sovereigns have several objectives in issuing sukuk. One main objective is to diversify the investor base and reach new investors, who are reluctant to invest in conventional securities. From a debt-management perspective, especially for local investors who have a tendency to abstain from interest-bearing securities, the availability of sukuk might provide a stable alternative for investment in government debt, and increase opportunities to invest. Sovereigns can also reach a new global demand base by making their sukuk available to international investors who are in

⁶ Includes sub-sovereigns and multilateral organizations

search of instruments that are compliant with Islamic doctrine, or who are merely trying to diversify their holdings beyond traditional assets.

In Malaysia, where there is an established Islamic finance industry, one of the objectives of the government's economic program is to "reinforce Malaysia's position as a global Islamic finance marketplace through innovative Islamic financial products and services" (Malaysia Office of the Prime Minister, 2015). The issuance of sukuk by the Ministry of Finance, the central bank, and the sovereign wealth fund provides assets for the Islamic finance industry and serves strategic objectives of the government. In Indonesia, where the Islamic finance industry lags behind its peers despite having one of the largest Muslim populations in the world, the issuance of sukuk by the Ministry of Finance also helps the development of the industry in line with an announced roadmap (Indonesia Financial Services Authority (OJK), 2015).

In other settings, sukuk issuance also serves financial inclusion objectives by providing an investment opportunity to investors who are otherwise underserved by the government. In Turkey, where the Islamic financial industry constitutes about 5 percent of the banking sector, regular domestic sukuk issuance by the government provides this segment of the sector with access to non-interest bearing investment options, which can also be used as collateral in accessing the central bank's liquidity facilities.

Sovereign sukuk issuances are also vital for setting precedent, deepening the market, establishing pricing benchmarks, and encouraging private issuances, as well as for bringing in other issuers from abroad. Luxembourg launched its sovereign sukuk in 2014 to promote the country's position in the Islamic finance industry (Luxembourg Agency for the Development of the Financial Center, 2015). Previously, the country's stock exchange had been the first European stock exchange to list a sukuk, and its central bank joined the Islamic Finance Services Board (IFSB). The first sukuk issued by the Republic of South Africa was also listed in Luxembourg. A UK issuance in 2014 also served similar objectives, aiming to promote London's position as a leading center for Islamic finance (UK Trade & Investment (UKTI), 2014). HKSAR and South Africa also had similar objectives in their own regions. These issuances also served the objective of investor diversification. In HKSAR's first issuance, about 83 percent was allocated to investors in the Middle East and Asia, while this ratio was 80 percent in the case of Luxembourg, 61 percent in the UK, and 59 percent in South Africa (International Islamic Financial Market (IIFM), 2016). Similarly, for Turkey's first international sovereign sukuk issuance in 2012, about 70 percent of the allocations were to investors based in the Middle East and Asia (Turkish Treasury, 2012).

The issuances by newcomers mostly adhered to the ijara structure (Table 3.1). Other regular issuers such as Turkey and Pakistan also used the ijara structure. The Ministry of Finance of Malaysia has adopted the wakala structure since 2011, followed by Indonesia in 2014. Bahrain uses salam and ijara structures. The ijara and wakala structures have been gaining prominence over recent years,

replacing musharaka and mudaraba contracts, which in 2007 constituted about 40 percent of the issuance volume.

Table 3.1: Recent Issues in Select New Jurisdictions

Sovereign Issuer	Issue Date	Amount (USD Million)	Tenor	Currency	Structure
UK	Jun-2014	340	5 years	GBP	ijara
HKSAR	Sep-2014	1,000	5 years	USD	ijara
South Africa	Sep-2014	500	5.75 years	USD	ijara
Senegal	Jun-2014	200	4 years	CFA-Franc	ijara
Luxembourg	Oct-2014	220	5 years	EUR	ijara
HKSAR	May-2015	1,000	5 years	USD	wakala
Ivory Coast	Dec-2015	244	5 years	CFA-Franc	ijara
Senegal	July-2016	341	10 years	CFA-Franc	ijara
Togo	Aug-2016	263	10 years	CFA-Franc	ijara
Ivory Coast	Sep-2016	263	7 years	CFA-Franc	ijara
HKSAR	Feb-2017	1,000	10 years	USD	wakala

Source: IIFM (2016), IFSB (2017)

While new issuers are entering the market, regular issuers such as Malaysia, Indonesia, and Turkey contribute to the development of Sukuk markets with innovative approaches. Malaysia’s global Sukuk offerings issued in April 2016, and maturing in 2016 and 2046, using the wakala structure, marked a major breakthrough in sovereign issuance. This was the first sovereign sukuk issued without utilizing physical assets (such as land and buildings) or commodities. The underlying assets for the offering consisted of 100 percent non-physical assets, namely, vouchers representing entitlement to a specified number of travels and shares. In August 2016, Indonesia launched a retail-oriented “Saving Sukuk” with an effort to diversify the investor base. In September 2016, Turkey issued an inflation-linked sukuk (lease certificate) in the domestic market.

4. Cases from Different Jurisdictions in Designing Legal Frameworks for Sovereign Sukuk Issuance

Because sukuk serves various objectives, it is becoming a standard component of the range of instruments used by public debt managers. In the following sections, some recent examples of changes in debt management legislation are summarized as background for the discussion of key issues that should be identified and resolved relating to inclusion of sukuk in the government’s financing mix.

4.1 Indonesia

The Indonesian government issued its first sovereign sukuk using the ijara principle in August 2008 in conformity with the “Law on Sovereign Sharia Securities,” also known as the “Sukuk Law,” enacted in the same year.⁷ This stand-alone Sukuk Law authorized the government to issue sukuk, which is referred to as SBSN, and defined the forms, types, and definitions of securities that can be issued by the government, and described the purposes of issuance of sukuk. This law regulates the employment of assets for the purposes of issuance, as well as the foundation of the SPV, and the repayment of funds. Accountability and transparency principles are also referred to in the law.

The Sukuk Law presented the concept of separation of legal title and beneficial rights, so that the government could transfer the beneficial rights of state-owned assets while retaining the legal title. This law requires compliance with Law No. 1 of 2004, which regulates the sale or transfer of state-owned assets, allowing for such assets to underlie financial obligations as long as legal title remains with the government. The government is allowed to transfer to a financing party the beneficial rights of use of state property, provided such property is not compromised. This practice is generally known as the right of usufruct.

The framework drawn by the sukuk law was complemented with several secondary pieces of legislation, including government and ministerial regulations, regarding the foundation and functioning of the intermediary SPV, and the methods of issuance in domestic and international markets⁸ (Asian Development Bank (ADB), 2012). The legislative framework also includes opinions (fatwa) from the Ulema Council of Indonesia (Majelis Ulama Indonesia) on compliance with Sharia principles.

Since its first sovereign issuance in 2008, Indonesia has been very active in introducing new types of instruments and employing different issuance methods. Its first global issuance came in 2009, together with the retail and “hajj” (pilgrimage) fund sukuk programs. The auction method, introduced for domestic sukuk in that year, became a regular mechanism beginning in 2010. In 2011, Islamic T-Bills and project-based sukuk were introduced. The wakala structure was adopted

⁷ Law Number 19 of 2008.

⁸1. Domestic Issuance:

a. Book building for Sovereign Sukuk (Finance Minister Regulation No. 118/PMK.08/2008 on Issuance and Sale of SBSN in Domestic Primary Market through Book building);

b. Book Building for Sovereign Retail Sukuk (Finance Minister Regulation No. 218/PMK.08/2008 on Issuance and Sale of Retail SBSN in Domestic Primary Market);

c. Auction (Finance Minister Regulation No. 11/PMK.08/2009 on Issuance and Sale of SBSN in Domestic Primary Market through Auction); and

d. Private Placement (Finance Minister Regulation No. 75/PMK.08/2009 concerning Issuance and Sale of SBSN through Private Placement)

2. International Issuance:

a. Book Building (Finance Minister Regulation No. 152/PMK.08/2008 concerning SBSN Issuance in Foreign-Currency Denomination in the International Primary Market with changes reflected in Finance Minister Regulation No. 129/PMK.08/2009);

b. Private Placement (Finance Minister Regulation No. 75/PMK.08/2009 concerning Issuance and Sale of SBSN through Private Placement)

in the global issuance of 2014, and a “saving sukuk” program was launched in 2016. As of 2015, Indonesia stood as the largest issuer of sukuk after Malaysia.

4.2 Turkey

Turkey executed its first sovereign sukuk issuances in international and domestic markets in September and October 2012, respectively, following the enactment of amendments to the Law on Regulating Public Finance and Debt Management (Law No: 4749) in 2012. Article 7/A, which was added to the law, explicitly authorized the minister in charge of the Turkish Treasury to establish “Asset Leasing Companies” (that is, the SPVs in the Turkish case) which are mandated to issue so-called “lease certificates,” replicating the ijara structure, based on movable, immovable, and intangible assets in local and foreign markets. The article was further amended in 2013, clarifying operational issues regarding the management and auditing of the SPVs, and the administration of assets related to the SPV. Changes to Article 14 of the law aimed at accounting principles, while changes in Article 15 ensured the mitigation of operational costs that would arise from multiple-asset transfers and related paperwork in preparation of sukuk issuance. The amendments to the debt management law do not make an explicit reference to Sharia compliance or a requirement for “fatwa”.

In the Turkish case, sovereign issuance followed the initial debut issuances in the private sector in 2010 and 2011. A series of changes between 2010 and 2013 in the capital market regulations and conventions, including amendments in the Capital Markets Law itself, paved the way for the incorporation of sukuk in financial markets as a standard instrument. In 2011, the taxation regime for sukuk was clarified to facilitate transactions.

Following the first amendments in the public debt management framework, the Turkish Treasury made its inaugural issuance in international markets in September 2012 with a five-year USD 1.5 billion bond, followed by the local issuance of a two-year TRY-denominated bond. Since that time, the Treasury became a regular issuer by launching, on average, one international and two domestic certificates annually between 2013 and 2016. In 2016, Turkey introduced a five-year local currency sukuk with the intention of extending maturities, as well as an inflation-linked sukuk in local currency.

4.3 United Kingdom

In June 2014, the UK became the first western central government to issue a sovereign sukuk. While the primary debt management legislation in the UK is the National Loans Act of 1968, the issuance was enabled by the inclusion of the so-called “alternative finance arrangements” in the Finance Act of 2008, enacted to grant and alter certain duties, taxes, and charges, and to make provisions in connection with finance. The general framework was later complemented by the

promulgation of the “Government Alternative Finance Arrangements Regulations” (GAFAR) in 2014.⁹

Section 157/1 of the Finance Act provided a broad mandate to the UK Treasury to issue regulations for raising money through alternative finance arrangements. The provisions regarding the regulations were further specified in Schedule 46 of the Act. The Treasury then used its mandate to issue the GAFAR, which identifies alternative finance arrangements which are available to the Treasury, lists the purposes for which money may be raised through these arrangements, and describes other measures which enable or facilitate those arrangements, such as the running of the intermediary “company,” that is, the SPV, through which the issuances will be made.

Origins of Islamic finance in the UK date back to the 1980s when the first commodity murabaha transactions were made and the first UK Islamic bank was launched in 1982. During the 1980s, a number of investment banks offered customized products to their Middle Eastern clients, mostly in the areas of trade finance, leasing, and project finance. The industry began the new millennium with the government’s regulatory and political support, exemplified by the establishment of a working group by the Bank of England in 2001 which included representatives from the Treasury, the Financial Services Authority, financial institutions, and members of the Muslim community. Since that time, the UK government and regulators have attempted to facilitate market development through the addition of “alternative finance” clauses to various taxation Acts (UKTI, 2014). While the 2014 ijara remains the only sukuk issued by the government as of that date, the UK has established herself as a major center for the issuance and trading of international certificates. Total volume of sukuk issued at the London Stock Exchange (LSE) reached a level of USD 48 billion as of January 2017 (LSE, 2017).

4.4 Luxembourg

Luxembourg’s initial sovereign sukuk was issued in October 2014, following the enactment of a dedicated law in July of the same year. The Law No: 6631, dated July 12, 2014, on the “Authorization for Transfer of Three Buildings for their Rental and Repurchase,” enabled the government to use three buildings as the underlying assets for Sukuk transactions. The enabling environment in Luxembourg also included amendments in taxation legislation. In 2010, Luxembourg tax authorities disseminated regulations relating to the direct and indirect tax treatment of certain Islamic finance techniques, defining the tax treatment of various Islamic modes of finance under Luxembourg tax law, and testifying to the willingness of the Luxembourg tax authorities to grant beneficial tax treatments to Sharia-compliant structures in order to put conventional and Islamic finance on the same footing.

The country’s experience with Islamic finance dates back to 1978, when Luxembourg hosted the first Islamic finance institution established in a Western Country. In 1983, the first Sharia-

⁹ Statutory Instrument 2014/1327.

compliant insurance (takaful) company in Europe was established in Luxembourg (Luxembourg Agency for the Development of the Financial Center, 2015). In 2010, the Luxembourg Central Bank became one of the founding members of the International Islamic Liquidity Management Corporation, an international institution established by central banks, monetary authorities, and multilateral organizations with the objective to create and issue short-term Sharia-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

Over the last decade, investors, including sovereign wealth funds from Middle East countries, Islamic investment banks, and individual investors, have been quite active in structuring their investments through Luxembourg. While the government's 2014 issuance remains its only one, the country is recognized as one of the leading European centers for Islamic finance.

4.5 HKSAR

On March 26, 2014, the Legislative Council of HKSAR passed the Loans (Amendment) Bill 2014¹⁰ to put in place a legal framework for alternative bond issuances under the government's bond issuance program. The Bill included revisions not only to the "Loans Ordinance" (Chapter 61 of the Laws of HKSAR) to expand the mandate of the government of the HKSAR to include sukuk in the government's instrument set, but also to the "Inland Revenue Ordinance" (Chapter 112) to regulate taxation issues in the transfer of assets and profits in the issuance of sukuk. The "Bond Fund Resolution" was also amended to manage the sums raised and to enable redemptions.

The changes in the debt management legislation followed those made in the general taxation scheme in July 2013. The so-called "Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013"¹¹ provided a comparable taxation framework for some common types of sukuk, equivalent to conventional bonds, without providing incentives. The specified alternative bond schemes covered under the legislation included ijara, musharaka, mudaraba, murabaha, and wakala structures. The amendment ensured that the specified schemes would be treated as "debt arrangements" upon satisfying certain conditions.

These amendments enabled HKSAR to issue its inaugural sukuk in September 2014 in the form of a USD 1 billion, five-year ijara, underpinned by selected units in two commercial properties in Hong Kong. Given the high demand for the first issuance, marked by a subscription rate of 4.7 times, the government launched its second sukuk in May 2015, and third in February 2017, this time using the wakala structure, with underlying assets that included commodities as well as select units in commercial properties.

¹⁰ Ordinance Number 7 of 2014.

¹¹ Ordinance Number 10 of 2013.

5. Considerations for the Legal Framework for Sukuk from a Debt Management Perspective

A strong governance structure that shapes and administers the activities of debt managers is crucial for enabling an effective public debt management function. A sound legislative framework that defines and clarifies the powers and responsibilities of debt management units, and supports competence and operational focus, is a key component of this governance framework. Over the last two decades, a growing number of countries have initiated reforms to strengthen government debt-management capacity, which in many cases required revising or redesigning the legal framework.

The Guidelines for Public Debt Management (World Bank (WB) and International Monetary Fund (IMF), 2014) underlines the importance of sound governance for improving debt-management architecture. Roy and Williams (2010) discuss some general issues that arise in relation to debt-management legislation and how they interact with other provisions, highlighting the provisions that might be included in an integrated debt-management law. The Debt Management Performance Assessment (DeMPPA) tool of the World Bank recognizes legal framework as one of fourteen indicators for judging a country's performance against internationally recognized standards. Adawzi (2015) analyzes a set of issues in the design of PDM legal frameworks and identifies key elements that would make up a sound legal basis.

The essential elements of a PDM legal framework include: the definition of the scope of public debt, (that is, what constitutes public debt in terms of coverage of institutions and instruments); provision of the authority of the relevant executive branch of the government to borrow; assurance for debt service; specification of borrowing purposes; clear debt management objectives; and the specification of audit, reporting, and accountability processes. Other elements, such as borrowing limits, institutional arrangements, including the establishment of a debt management entity, regulations regarding borrowing by other public entities, and management of contingent liabilities, are also generally included.

As observed in the cases of new sovereign issuers, the distinctive features of sukuk, such as the underlying assets and the mechanisms to generate the cash-flows, necessitates a careful consideration and amendment of the legal framework for public debt management, as well as other related legislation. Debt managers do not necessarily have access to the assets owned by the government, other than financial assets, and in many jurisdictions, they have to be provided with a specific mandate to use a set of eligible assets in the creation of sukuk structures. The legal framework should also provide assurances that sukuk issuance is consistent and compatible with the structure that defines the rules for conventional borrowing. The following sections will identify and discuss the key issues for development of a legal framework that empowers the government to embrace sukuk as part of the government's available financial instruments.

5.1 Legal Mandate to Issue Sukuk and to Use Public Assets

A “sine qua non component” of the legal framework for PDM is the clear provision of the authority to borrow. The authority to borrow and to issue new debt and guarantees, and if applicable, to undertake other financial transactions on the government’s behalf, such as debt exchanges, buy-backs, and use of derivatives, should be clearly defined in legislation. In different cases, this mandate is provided for in the Constitution and/or in primary legislation, such as debt-management or public financial-management laws.

In many jurisdictions, in order for the debt-management unit to be able to issue sukuk, the mandate of the debt manager should be extended to cover those instruments. This is especially relevant in cases where borrowing instruments that are allowed are explicitly specified in legislation. Another consideration is recourse to assets that are to be used to underpin the issuance of sukuk. The types of assets that fall within the mandate of debt managers are generally limited to financial claims or assets of the government, including cash balances. Cash balances or other financial assets that are remunerated to generate interest revenue, however, cannot be used to back the sukuk issuance, since this would be contrary to Islamic doctrine. Therefore, other types of assets that are eligible should be designated. Limitations of assets that comply with the requirements and are usable impose restrictions on the amount of sukuk that can issued. Therefore, debt managers should carefully consider the availability of assets in planning the issuances.

Indonesia’s sukuk law extends a clear mandate to the government to issue “Sovereign Sharia Securities” (Article 5/1) for the “purpose of financing the State Budget and projects” (Article 4). This mandate must be executed by the Minister of Finance (Article 5/2). The law also provides an unequivocal mandate to use state owned assets, including lands, buildings, and others, as the basis for issuance (Article 10). The minister has the authority to sell or lease only beneficial rights for a period of maximum sixty years (Article 11). At the maturity of sukuk, the underlying rights have to be repurchased (Article 12)

The amendments in the Public Debt Management Law in Turkey authorize the minister in charge of the Treasury to issue “lease certificates” through asset-leasing companies, and to use tangible and intangible assets owned by public entities as underlying assets (Article 7/A). The eligible assets must not involve any private ownership. The asset-leasing companies are entitled to issue certificates in domestic and external markets.

In the UK, Section 157/1 of the Finance Act stipulates that “the Treasury may by regulations make provision for raising money through alternative finance arrangements” which are further defined in the Act as “arrangements which in the Treasury's opinion— (a) equate in substance to a loan, deposit or other transaction of a kind that generally involves the payment of interest (including the issuance of government securities), but (b) achieve a similar effect to such a transaction without including provision for the payment of interest” (Article 157/8). According to the GAFAR, the

Treasury or the state secretary is authorized to transfer to a company a qualifying interest in land and to enter into a leaseback agreement for the purpose of generating income or gains, on the condition that the interest is transferred back to the government.

Luxembourg's stand-alone sukuk law differs from others by designating direct ownership or rights to ownership of three specific government-owned properties, with full addresses given in the law, as underlying assets (Article 1), instead of defining general rules for eligible assets. The law authorizes the government to sell these assets to public limited companies, and lease them back, on the condition that ownership is returned back to the government after a five -year period.

In HKSAR, the mandate to issue sukuk has been granted by an amendment to the primary legislation that extends the definition of borrowing in a way to include so-called "alternative bond schemes," the structure of which are described in detail (Article 3 and 4 of the Loans (Amendment) Ordinance of 2014). The described structure includes the interaction between the government and an SPV to generate the borrowing and cash-flows in a sukuk structure. A succeeding clause (Article 5) extends the "power to borrow" to cover the newly-defined borrowing scheme.

In all the cases discussed, the legal framework was amended in order to provide explicit authority for the issuance of sovereign sukuk, even though the definition of sukuk itself is not always direct. While the legislation enacted in Indonesia makes an explicit reference to sukuk and Sharia compliance, in other examples sukuk is indirectly defined, and there is no reference to Islamic doctrine. Turkish debt management legislation defines "lease certificates," the Turkish equivalent to ijara structure. In the UK and HKSAR, legislation instead refers to generic "alternative finance arrangements" or "alternative bond schemes," and describes mechanics that replicate some sukuk structures. Luxembourg has a similar approach. The power to employ state-owned assets is always explicitly defined, with conditions that guarantee the preservation of state ownership in the long run (after maturity).

5.2 Types of Instruments

Countries that are considering including sukuk in the government's set of financial instruments should carefully analyze different types of structures they might consider to issue in the medium and long term. Amendments of high-level debt-management legislation would require involvement of the parliament and various time-consuming statutory stages, and therefore frequent changes might not be possible. Consequently, countries may adopt different approaches in drawing up the legislation depending on the perceived need for future flexibility to incorporate different types of instruments.

In Indonesia, the main types of sukuk that are allowed are explicitly defined with reference to their specific and internationally accepted names. Those include the ijara, mudaraba, musharaka, and istisna'a. However, the executive is also granted an important degree of flexibility under the Sukuk

Law to make “contracts (akads) that are not in conflict with Sharia principles”. On the other hand, public debt legislation in Turkey only allows for “lease certificates”.

In the UK, the approach in the primary legislation is more flexible by referring to a generic definition which leaves it up to the Treasury to decide which instruments are eligible because they can be considered to replicate characteristics of regular instruments without involving interest payments. Nevertheless, the GAFAR issued by the Treasury has taken a more concrete approach as it mentions the requirement for a leaseback agreement “for the purpose of generating income or gains for the bond” (Regulation 3). This effectively restricts eligible instruments to ijara-type certificates. Luxembourg’s stand-alone sukuk also only allows for the ijara structure.

HKSAR’s definition of an “alternative bond scheme” generally describes the processes for generating borrowing via an SPV, and seems to provide a high degree of flexibility to debt managers to employ different sukuk types, but there is no explicit mention of any specific structure. As of March 2017, HKSAR had issued two different types of sukuk in three transactions.

The decision in regards to which types of sukuk schemes are allowed and how to refer to them in the legislation is country specific and depends on the need for flexibility to be granted to sovereign debt managers. Indonesia, the largest Muslim country with the goal of promoting Islamic finance infrastructure, has been issuing several different types of certificates catering to various investor groups. The UK and Luxembourg, where conventional bonds are expected to remain as the major borrowing instruments, have so far issued only one security each, and probably do not need to make set-ups for other types of instruments.

5.3 Establishment and Management of SPVs

In the process of sukuk issuance, the SPV serves as a counterparty to the government and enables the government to play its different roles in the scheme. The existence of an SPV not only facilitates the employment of state-owned assets to generate the necessary cash flows, but also assists in ensuring compliance with Islamic doctrine, which requires abstinence from the concept of interest. The legal framework in some countries may prevent the sale of sovereign assets to the private sector, especially to foreigners. There might be other restrictions regarding engagements with private parties for the purposes of making financial transactions. However, by involving the SPV, the government ensures that the asset remains in public hands, and that the contractual processes are facilitated.

SPVs are established with the sole purpose of issuing sukuk and do not engage in any other business that might be contradictory to the worldview of potential investors. Governments that issue sukuk are also issuers of conventional bonds which pay interest. Therefore, by establishing an SPV as a separate legal entity, sovereigns are able to isolate their sukuk programs from other conventional issuances that involve payment of interest to lenders. Table 5.1 shows the SPVs set up recently by some countries.

Table 5.1: SPVs in New Jurisdictions of Sukuk Issuance

Jurisdiction	SPV	Government Ownership
Indonesia	Perusahaan Penerbit SBSN (I, II and III)	100%
Turkey	Undersecretariat of Treasury Asset Leasing Company (Hazine Mustesarligi Varlik Kiralama Sirketi- HMKVK)	100%
UK	HM Treasury Sovereign Sukuk PLC	100%
Luxembourg	Luxembourg Treasury Securities SA	100%
HKSAR	Hong Kong Sukuk (2014 Limited, 2015 Limited, and 2017 Limited)	100%

Indonesia’s domestic sukuk program is executed through “Perusahaan Penerbit SBSN” (PP SBSN), a 100 percent government-owned company, established in line with the mandate granted by the Sukuk Law (Article 13). For international sukuk, the government used PP SBSN I and II for the stand-alone issuances in 2009 and 2011, respectively, and has made issuances through PP SBSN III since 2012. The SPVs were established in line with a government regulation which defines their functions, responsibilities, reporting requirements, organizational structure, and capital.¹² PP SBSN acts as the issuer at the issuance stage, and as a trustee representing investors for the generation of revenue on the underlying asset. In the latter capacity, it leases the trust assets to the government and receives the periodic returns generated. The SPV is run by staff who are also the employees of the Directorate of Islamic Financing at the Ministry of Finance. They do not receive any extra salary or compensation for their work at the SPV.

Turkey’s “Asset Leasing Company” (HMKVK) has been established by a ministerial decree as a subsidiary of the Turkish Treasury within the mandate given to the minister in charge of the Treasury by an amendment in public debt management legislation.¹³ The company is only authorized to engage in sukuk transactions by taking over government-owned assets and employing them for the generation of returns. The company has been exempted from most requirements of the Turkish Commercial Code that governs establishment and management of commercial businesses. HMKVK executes a regular issuance program in domestic and external markets, and is administered and represented by the staff of two distinct departments within the Treasury, depending on the venue of issuance of the sukuk. These staff do not receive any extra compensation (other than their treasury salaries) for their roles in running the SPV. The company is exempt from taxation and does not pay corporate or any other form of tax.

¹² Government Regulation 57/2008 has been amended several times, most recently in 2015.

¹³ Decree of the Office of the Deputy Prime Minister, August 17, 2012, No: 2015/805.

In the UK, the single sovereign sukuk was issued by HM Treasury Sovereign Sukuk PLC, whose sole activity was to issue and service this security. Regulation 3 of GAFAR stipulates the establishment of the company under the “Companies Act”. Even though GAFAR allows for the company to be established by the Treasury or independently, in practice it was established as a subsidiary of the Treasury. The company draws its staff resources from the Treasury and the government legal department. The staff is provided free of charge and the company is reimbursed for minor administrative costs, including operating and audit costs (HM Treasury Sovereign Sukuk PLC, 2015). GAFAR provides the mandate for the Treasury to provide financial assistance to the SPV. The only cost for the company, other than periodic payments to investors, is corporate tax.

Luxembourg Treasury Securities SA, a company incorporated in Luxembourg as a public limited liability company and registered with the Luxembourg Trade and Companies Register, has also been incorporated solely for the purpose of making sukuk issuance transactions. The company is primarily managed by civil servants, and receives domiciliation services from a private agent for administrative, accounting, and related services.¹⁴

HKSAR has chosen to set-up two separate SPVs for its two sukuk issuances: Hong Kong Sukuk 2014 Limited, and Hong Kong Sukuk 2015 Limited. Both SPVs were established by the mandate granted by the Loans (Amendment) Ordinance 2014, and subject to the Companies Ordinance, which regulates the constitution of companies, directors’ liabilities and powers, creditors’ rights, and liquidation in HKSAR. The SPVs are wholly owned by the HKSAR government and are directed by executives appointed from the Hong Kong Monetary Authority.

All SPVs in the discussed examples were established based on a clear, legal mandate under the provisions of the legal framework. While the establishment of SPVs in the UK, Luxembourg, and HKSAR all followed regular methods for the establishment of a company in their own jurisdictions, Turkey has made its own SPV exempt from several requirements of the commercial code. A common tendency is to employ civil servants in the administration of the SPV to minimize operational expenses. Therefore, as a practical matter, the government executes transactions and payments for the sukuk through its staff who are appointed to the SPV.

5.4 Treatment of Proceeds and Debt Service

Sound practice suggests that government borrowing is executed either by a principal debt management unit, or by units that closely coordinate. Centralization of government cash balances is also essential for efficient cash management. In strict technical terms, sovereign sukuk is issued by SPVs, which are subsidiaries of the government, and they initially receive the proceeds from issuance. Therefore, a sound legal framework should confirm oversight by the debt-management unit in the sukuk issuance process to ensure the transfer to the government accounts of the funds

¹⁴ The Government of the Grand-Duchy of Luxembourg, Information Memorandum, October 2, 2014.

raised. Sukuk issuance should be part of the overall debt management strategy; and the establishment of the SPV should not result in a fragmented debt and cash management structure.

Another concern that needs to be considered in the design of a legal framework is the reassurance of investors as regards the repayment of debt. Sound public-debt legislation should not only provide for the mandate to borrow, but also the authority and pledge to repay debt and related costs and expenses. In the case of sukuk, the existence of the SPV in the process would generally require a clear statement in the legislation about how debt will be serviced.

For sukuk markets in general, one area of particular emphasis is resolution of cases of distress. The adequacy of dispute-resolution regimes is more crucial for corporate issuers since in cases of sovereign issuers, the investors anticipate that the government will back the SPV in a distress situation. Especially in cases, where investors do not have recourse to the assets due to restrictions relating to the transfer of title in the event of default, markets expect that the government will eventually service the liability due from sukuk.

Indonesian sukuk law clearly stipulates that execution of the sukuk program should be treated as part of the overall debt-management function (Article 18). It also requires transfer of funds to the State General Treasury Account (Article 19). The law imposes the obligation for the government to pay the returns and principal on securities issued directly by the government itself or through the SPV, and requires the provision of funds in the state budget in every fiscal year until expiration of the security (Article 9). The government is obliged to repurchase the underlying asset when the certificate becomes due (Article 12). Therefore, creditors realistically bear the credit risk of the government itself.

Turkish debt management law allows the issuance of “lease certificates” only on the condition that proceeds are transferred to the Treasury. Repayment assurance is not explicitly given, although the definition of “public debt” implicitly covers those securities and makes them subject to the same treatment as conventional bonds in debt service.

In the UK, GAFAR requires the transfer of any money raised through a sukuk-type arrangement into the National Loans Fund, which accounts for government borrowing and lending (Regulation 8). It also stipulates that payment of expenses incurred in connection with sukuk and its redemption is to be charged on and paid out of the National Loans Fund with recourse to the Consolidated Fund, that is, the government’s main bank account at the Bank of England.

According to Luxembourg’s sukuk law, the government guarantees all civil liability claims against the SPV, including costs and expenses of any kind which are directly or indirectly related to the ownership, leasing, sub-leasing, assignment, redemption, and management of the properties sold (Article 3). There is no explicit requirement for the transfer of funds to government accounts.

As discussed previously, HKSAR's Loans (Amendment) Bill of 2014 extends the definition of borrowing in a way to include the so-called "alternative bond schemes," and by doing so, it requires debt raised through these schemes to be treated as regular government debt. This effectively covers the employment of proceeds and exposes the lenders to the sovereign's credit risk rather than that of the SPV.

One particular risk that investors are exposed to is the risk of destruction of assets during the life of the certificate before redemption. In international sukuk offerings, this risk is referred to as the occurrence of a "total loss event", which covers the total loss of, or destruction of, or damage to the whole of the assets, or of any event or occurrence that renders the assets permanently unfit for any economic use, and the repair or remedial work is wholly uneconomical. In the examples of the UK, Luxembourg, and HKSAR, the government in its role as the "servicing agent" assumes the responsibility to insure the lease assets in the name of the trustee against the occurrence of a "total loss event" through the "servicing agency contract". In general, the government reserves the option to replace the assets.

5.5 Management of Assets and Costs

The transactions required to generate the cash-flows for a sukuk structure raises several considerations from an operational perspective. These include the transfer of assets between the government and the SPV, the management of the assets, and in case they are physical, the maintenance of the assets. Unless carefully foreseen and planned, these transactions may create an additional burden on the debt-management unit and/or the SPV and add to the overall borrowing cost.

In Turkey, the amended debt management legislation clearly stipulates that all processes regarding the maintenance, renovation, and administration of underlying assets are the responsibility of the institutions to which those assets belonged before they were designated for the sukuk transaction (7/A). As those institutions continue to use those assets as lessees, the costs related to those processes are to be met not from the budget of the Treasury or its SPV, but from budgetary allocations of the original owner institutions. The law also specifies that the assets transferred to the SPV are subject to the same legislative requirements covering other government properties. For example, the SPV's assets are exempt from compulsory insurance requirements that apply to private properties. The rent contracts that support sukuk transactions are also exempt from articles of other legislation that governs rent contracts. With these clauses, the law specifies that the transfer of assets and their rental are just for the purposes of generating the "lease certificate," and minimize the operational burden on the debt-management unit or the SPV concerning the management of the assets and the contracts. From the point of view of the institutions whose assets are made subject to the sukuk contract, there is no additional burden, because they would be carrying out the same maintenance and repair processes and incurring the same costs regardless of their status as owner or tenant.

In the UK, the maintenance and management of underlying assets are not covered in the legislation, while the sublease contract signed between the SPV (as trustee) and the government (as tenant or lessee) as part of the sukuk issuance process stipulates that the tenant is responsible for all ordinary maintenance and repair required for the premises at its own cost. Then with an accompanying “Servicing Agency Agreement”, the SPV designates the government also as its “servicing agent” and delegates to it the responsibility for the performance of all major maintenance and structural repairs, as well as the payment of proprietorship taxes arising with respect to the premises. The servicing agent is reimbursed for any payments made or incurred by it in respect to the services performed during any rent period. However, the transaction is structured in such a way as to raise the periodic rent payment by a supplementary rent amount that would cover the servicing charges. The servicing charges are then offset against the supplementary rent. In economic effect, the maintenance and repairs expenses are covered by the government.

Luxembourg and HKSAR also do not account for the operational issues in the legislation and account for them in the underlying contracts that support the sukuk. In the recent wakala-type sukuk issued by HKSAR, the government as the “wakeel” (the agent) of the SPV is responsible for maintenance of the assets and payment of taxes and levies.

5.6 Sharia Compliance

Compliance with Islamic principles is a must for a successful sukuk transaction. However, assurance that investors adhere to Sharia is a challenge in countries governed by a legal system that is independent of Sharia. Not only Muslim-minority countries, but also many Muslim-majority countries are governed by secular laws which cannot make an explicit reference to religion.

In the cases of Turkey, the UK, Luxembourg and HKSAR, the legislative framework does not mention Sharia principles, nor provide any guarantee to investors on the compliance with Islamic doctrine of the instruments and the methods of issuance. The instruments are indirectly defined in the legislation, with the aim of satisfying the required principles without openly naming them.

The circulars describing the instruments issued also emphasize the nonexistence of assurance that the sukuk certificates are Sharia compliant. The role of getting opinion from Islamic scholars on compliance with Sharia is left to lead managers and/or other financial institutions who act as intermediaries in the issuance process on a per-transaction basis. Even though these institutions obtain opinions from their own selections of boards of scholars, potential investors are advised not to rely on such approvals but to consult with their own Sharia advisers as to whether the proposed transaction is in compliance with their individual standards of compliance with Sharia principles. In the offering circular of the UK’s single sukuk, the investors are also reminded that any disputes will be subject to the laws of England and Wales, and that the courts will interpret the respective terms of the transaction documents or the certificates under those laws in determining the

obligation of the parties involved.¹⁵ A similar reminder is also contained in the offering memorandum issued by Luxembourg Treasury Securities SA, emphasizing that enforcement of any obligations of any of the parties may, if in dispute, be the subject of court proceedings under the laws of (i) Luxembourg or (ii) England and Wales.¹⁶

While Indonesia is also a secular country with a constitution, it differs from the above cases because the sukuk law explicitly requires the minister to request an opinion (fatwa) on Sharia compliance from the Ulema Council of Indonesia (Majelis Ulama Indonesia) in order to give assurances to investors that investment in the sovereign sukuk does not violate Sharia principles. In this context, several “fatwa” were issued to regulate the securities and their methods of issuance.¹⁷ These “fatwa” reflect the opinion of scholars on the compliance with Islamic doctrine of sukuk structures, issuance methods, and transactions.

To what extent a certain legal document can refer to Islamic principles differs by jurisdictions. In countries where Sharia principles are not allowed, or are not encouraged, to be mentioned in legal documents, extra attention must be given to the drafting of the primary and secondary legislation that implicitly and/or indirectly describes the instruments and the standards that they must adhere to. The clauses in the legislation that do not satisfy the investors’ needs are likely to lead to deferrals or failures in the launch of sovereign sukuks.

6. Other Areas of Consideration

The taxation of government securities, and the regulations regarding securities being traded in secondary markets, fall beyond the scope of debt-management legislation and are generally governed by the general laws and regulations regarding taxation and capital-market regimes in a country. Nevertheless, an enabling environment for the launch of sovereign sukuk would require supportive approaches in those areas to provide an equal footing to them with regard to conventional bonds.

6.1 Taxation

Taxation discussion in the context of sukuk primarily involves two components: (i) the taxation of returns of certificate holders; and (ii) potential taxes and levies generated by the underlying transactions and contracts. Countries tend to require tax treatment for investment gains from sukuk on an equal footing with conventional securities. Provision of “tax neutrality” is essential for

¹⁵ UK Sovereign Sukuk PLC’s Offering Circular, August 2014, available at <https://www.gov.uk/government/publications/uk-sovereign-sukuk-plcs-offering-circular>.

¹⁶ Information Memorandum, Luxembourg Treasury Securities SA, October 2014.

¹⁷ Number 69/DSN-MUI/VI/2008 on Sovereign Sharia Securities.

Number 70/DSN-MUI/VI/2008 on Issuing Methods of Sovereign Sharia Securities.

Number 71/DSN-MUI/VI/2008 on Sale and Lease Back.

Number 72/DSN-MUI/VI/2008 on Sovereign Sharia Securities Ijara Sale and Lease Back.

Number 76/DSN-MUI/VI/2010 on Sovereign Sharia Securities Ijara Asset to be Leased.

Number 95/DSN-MUI/VIII/2014 on Sovereign Sharia Securities Wakala.

supporting a level playing field for potential investors, and sovereigns tend to amend and/or reinterpret their existing income taxation schemes to accommodate sukuk.

In the UK, the Her Majesty's Revenues and Customs (HMRC) publication, "Guidance Note on the Tax Treatment of Islamic Financial Transactions" issued in 2010, clearly defines the concept of "investment return" for sukuk transactions. Accordingly, "investment return" includes "the excess of the amount paid by the certificate issuer on redemption of the certificate over the amount paid in respect of the certificate by the original beneficial owner of the certificate and the amount of any other periodic payments made by the sukuk issuer to the certificate owner from profits or gains derived from the asset". In effect, the investment return matches "the amount which would be equivalent to interest on a conventional bond and includes any premium payable on redemption whether that amount is payable to the original purchaser or to an investor who purchased the certificate on the secondary market together with any other periodic payments made by the issuing company from profits or gains derived from the underlying asset". The guidance also specifies that "investment return will be treated for the purposes of the Taxes Acts as interest on a security and the return will be chargeable to tax accordingly".

In Indonesia, in line with a government regulation issued in 2009, income from coupons and capital gains from selling sukuk are subject to the same level of withholding tax as government bonds.¹⁸ In Turkey, after amendments were made in 2011 to the Income Tax Law, gains on "lease certificates" are treated similar to conventional bonds.¹⁹ A circular issued by Luxembourg tax authorities in 2010 stipulates that sukuk is considered as debt for tax purposes.²⁰ The same approach was also adopted in HKSAR, where through an amendment in the tax legislation, "alternative bond schemes" are regarded as having the same status as regular debt arrangements.²¹

Since sukuk issuance is enabled through the SPV, to which assets are transferred and through which payments are made, tax codes should also be amended in such a way that these underlying transactions do not create additional taxation burdens. Possible tax liabilities that might arise during the preparations and operation of the sukuk include taxes or levies on title transfers, rent income, and corporate profits.

In the UK, amendments to the Stamp Duty Land Tax in 2003 enabled the removal of the double charge that would otherwise arise when an institution purchases property and later resells it. A second circular in Luxembourg, this time by the Indirect Tax Authority, clarifies the tax treatment of murabaha and ijara agreements in regard to registration duties and value-added tax.²² The transfer tax levied on the acquisition of property is significantly reduced provided that the purpose

¹⁸ Government Regulation No. 25 of 2009 on Income Tax for Sharia-Based Activities and Government Regulation No. 16 of 2009 on Income Tax for Bond Interest Income.

¹⁹ Law No 6111, Dated February 13, 2011.

²⁰ Circular No LG-A No. 55, 2009.

²¹ The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013, Ordinance No. 10 of 2013.

²² Circular No. 749, 2010.

of the transaction is to purchase the property to resell it under such structures. The tax amendments of 2013 in HKSAR also exempted from tax liabilities any asset transfers between the originator and the issuer that were made for qualified investment arrangements. In addition, the income, expenditures, profits, gains, or losses arising from the underlying assets are regarded as those of the originator. In Turkey, amendments to several tax laws in 2011 through an omnibus law²³ clarified the issues with the stamp duty, corporate tax, and value-added tax related to sukuk and the transfer of assets to asset leasing companies.

6.2 Market Development Considerations

In a holistic approach, an effective framework for sovereign sukuk, as well as for private issuances, should be complemented by accommodative amendments in the capital markets legislation. To be able to attract investors, sukuk should be able to receive the same treatment as other debt securities regarding regulations concerning the market activities listing in exchanges, custody, clearance, and so forth.

In Turkey, a Capital Markets Board (CMB) Communique in 2010 paved the way for the sukuk market by regulating the principles and rules regarding board registration, issuance, and sale of ijara certificates, and the establishment and activities of asset lease companies.²⁴ In 2012 and 2013, through a series of regulations issued by the Istanbul Stock Exchange (Borsa Istanbul), public and private lease certificates were accepted among eligible instruments that could be traded in the Debt Securities Market, and market conventions were regulated.²⁵ In 2013, following the enactment of a new Capital Markets Law,²⁶ the Capital Markets Authority widened the definition of lease certificates, allowing contracts to be based on ownership, management, trade, and partnership.²⁷ The debt-management law was also amended to clarify that sovereign lease certificates are subject to the same treatment as other government securities regarding the Capital Markets and Central Bank Laws (Article 7/A).

In the UK, the amendments made in 2010 in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) allowed for alternative finance investment bonds that satisfy the conditions of the new Article 77A to receive equivalent treatment to conventional bonds.²⁸ The schedule to the amendment order contains consequential amendments to primary and secondary legislation with the same goal. In Luxembourg, the capital market regulator (Commission de Surveillance du Secteur Financier - CSSF) issued a communique in 2011 to

²³ Law No: 6111, dated February 2011.

²⁴ Capital Markets Board Communiqué, April 1, 2010 (Series: III, No: 43).

²⁵ Borsa Istanbul Circulars 401, 403, 422, 427.

²⁶ Law No: 6332, dated December 30, 2012.

²⁷ Capital Markets Board Communiqué, June 7, 2013 (Series: III, No: 61/1).

²⁸ The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010.

specify how sukuk should be treated.²⁹ Accordingly, sukuk are either treated as asset-backed securities or as guaranteed-debt securities depending on certain conditions.

In Indonesia, the capital markets law also adopts a holistic approach and covers conventional and Sharia-based financial markets.³⁰ In line with the objective of further development of Islamic finance, the capital markets authority issued a package of rules in 2006 governing the underlying contracts, issuance, and listing of Sharia-based securities, leveling the playing field.³¹

The requirements to promote sukuk as a sustainable financing instrument for the government, and as an attractive investment alternative for creditors, go beyond amendments to define their legal status. Jobst et al. (2008) discusses the economic, financial, and legal challenges in sukuk markets from a debt-management perspective. Wedderburn-Day (2010) elaborates on legal complexities compared to conventional debt. Kusuma and Anderson (2014) identify the key issues impeding further development of sukuk markets as standardization of structures and practices, investor protection concerns relating to insolvency and governance regimes, and market liquidity. Their proposals for areas of development include: well-functioning money markets; a market infrastructure that facilitates trading, price transparency, and efficient clearing and settlement of transactions; a derivatives market with hedging tools to support risk management by issuers and investors; and a credible legal and regulatory framework.

A few cases of defaults of sukuk highlight the need for backing-up insolvency regimes with sound legislation. Default resolution may be very complex because of insufficient supporting laws in a given country as demonstrated by the “Nakheel Sukuk” case in Dubai, where in a distress situation, legal problems were revealed about investors’ rights on the underlying assets, complicated by their misperceptions about the existence of a government guarantee for the originator, which was a public sector company (van Wijnbergen and Zaheer, 2013).

The extent to which the legislation has to be modified is also dependent on the type of law system employed in a country, that is, civil or common law. Tariqullah et al. (2014) discuss the regulatory and legal challenges for an enabling environment for sukuk and argue that the characteristics of common law regimes, where case law in the form of published judicial opinions is of primary importance, allow for favorable circumstances, as compared to civil law systems with codified statutes. The argument is based on the fact that a common law regime is more inclined to focus on the case and the contract themselves with a perspective based on economic substance, which facilitates the use of SPVs and transfer of assets, as opposed to focusing instead with a legal perspective based on form.

²⁹ Communique, January 26, 2011.

³⁰ Law No. 8/1995.

³¹ Rule No. II.K.1 on Criteria and Publishing List of Sharia Securities.

Rule No. IX.A.13 on Shari’a Securities Issuance.

Rule No. IX.A.14 on contracts (akad) used in the issuance of Shari’a securities in the capital markets.

7. Conclusion

Governments are increasingly using sukuk to meet their financing needs, to diversify the investor base, to promote financial inclusion objectives, and to endorse their countries' status as financial hubs. Traditional public debt-management laws, which include the mandate, objectives, and purposes of borrowing; and govern operations of debt managers, generally cover conventional debt securities and loans. While resulting cash flows from a sukuk issuance are similar to those of a conventional bond, the differences in the underlying structure require a careful reconsideration of the existing legislation. Therefore, in recent years several sovereigns amended their debt management legislation to enable the issuance of sukuk.

In Indonesia and Luxembourg, the legislators preferred stand-alone sukuk laws, as opposed to other countries that amended their existing debt-management or related laws. Although the format of legislation differs by jurisdictions, there are several key elements that a country should include in the design or enhancement of the legal framework for sukuk. These start with a clear provision of a mandate to the executive to issue sukuk, together with the authority to employ certain public assets in the execution of underlying transactions and to establish and/or engage with SPVs. Another essential element that needs to be addressed is the assurance of investors with regards to debt service. The legal framework should clarify the treatment of debt proceeds and the government's ability and pledge to pay back debt. While country cases also differ in the degree of detail in terms of management of the underlying assets and the SPV itself, these issues also need to be carefully designed and incorporated in the law with a view to avoiding operational costs that might eventually increase the cost of borrowing.

Referral to Islamic principles also differs by jurisdictions. In cases where these are not explicitly mentioned, a common solution is to describe the processes that support the instrument and generate the cash flows. These clauses of the law should be prudently drafted with a view to satisfying the requirements of investors who are active in the Islamic finance segment of the market. These descriptions also determine the types of securities that are permitted to be used by the debt managers. Therefore, legislation should adopt a longer-term perspective regarding the preferred boundaries of the set of instruments employed. These boundaries should be drawn broader for countries that expect to be regular issuers of sukuk.

For a complete enabling environment, the changes in debt management legislation should be complemented by revisions in the taxation and capital market frameworks to allow for the treatment of sukuk on the same footing as conventional bonds. Tax regime and capital market legislation, although beyond the mandate of public debt managers, are important determinants of the level of market development for government securities. Therefore, a close coordination between relevant authorities is required in the review of the existing legislation, with a view to identify deficiencies and to devise remedies.

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