



SOVEREIGN ADVISORY SERVICES

# EMBRACING SOVEREIGN SUKUK

## DEMYSTIFYING SHARIA-COMPLIANT SOVEREIGN FINANCE

**ALVAREZ & MARSAL**  
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# CONTENTS

I. Introduction .....	3
II. The Structure of Sovereign Sukuk .....	4
A. Overview .....	4
B. Ownership Rights .....	6
C. Mechanisms for Generating Payments .....	6
III. The Market for Sovereign Sukuk .....	12
A. Sukuk Issuers .....	12
i. Overview .....	12
ii. Issuer Motivations .....	15
B. Sukuk Underwriters and Investors .....	17
C. Secondary Market Pricing .....	18
IV. Restructuring Sukuk .....	21
A. Restructuring Provisions in Sukuk Contracts .....	21
B. Complicating Factors .....	24
V. Conclusion .....	26
Appendix: Corporate Sukuk Defaults and Restructurings .....	27
East Cameron Partners .....	27
The Investment Dar .....	27
Dubai World .....	27
Dana Gas .....	27
Garuda Indonesia .....	27

# I. INTRODUCTION

Sovereign governments in Asia, Africa, the Middle East and elsewhere are increasingly turning to sukuk (Islamic or sharia-compliant bonds) to meet their financing needs. These issuers include several countries experiencing debt challenges, such as Pakistan, Egypt and Nigeria. However, many financial market stakeholders are less familiar with sukuk compared to traditional debt instruments. This research note seeks to demystify sovereign sukuk, from both market and legal perspectives.<sup>1</sup>

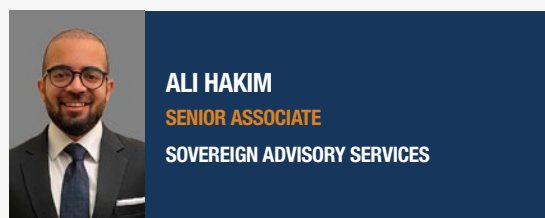
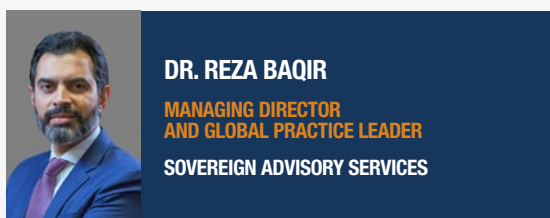
Part I of this paper delves into what sovereign sukuk are, examining the ways in which sukuk generate income for investors without relying on interest or contravening Islamic prohibitions. Part II provides an overview of the market for sovereign sukuk. It identifies and discusses the market participants (i.e., issuers, investors, and underwriters), their motivations and how sukuk yields compare with those on conventional bonds. Part III discusses how sukuk are likely to be treated if an issuing government defaults on or restructures its debt.

## A few of the key findings in this note are as follows.

- i. Sovereign sukuk are currently the most predominant form of sukuk finance, comprising approximately \$400 billion of the total sukuk market of \$730 billion at the end of 2021. If one includes sukuk issued by state-owned or state-controlled entities, the de facto share of sovereign sukuk in the total would be even greater.
- ii. The cost to sovereigns of financing from sukuk is often lower than that of financing from conventional international sovereign bonds. This is especially so for sovereigns with lower credit ratings and higher borrowing costs, suggesting that such countries may have particular opportunities to tap sovereign sukuk for their financing needs.
- iii. This “sukuk discount” does not stem from any de jure or de facto seniority to other obligations of the sovereign. Neither does it appear to stem from any sukuk-specific legal provisions that would pay out sukuk holders over holders of other bonds in the event of a default.

Taken together, these findings suggest that sovereigns, especially those that are facing higher borrowing costs, have a useful opportunity to tap sukuk finance for meeting their economic development and other financing needs. This paper’s analysis also suggests that potential investors in sukuk need not fear being subordinated to conventional bondholders of the sovereign. We hope that this work will help demystify sharia-compliant sovereign finance, especially at a time when a growing number of countries in the developing world have large financing needs.

## Authors



## SOURCE:

<sup>1</sup> The analysis in this paper relies on interviews with various experts in Islamic finance, prospectuses from publicly issued sovereign sukuk, sukuk yield data provided by Bloomberg and various secondary sources, including news articles and academic literature. We would like to thank colleagues at Rand Merchant Bank; the International Monetary Fund; White & Case; Freshfields Bruckhaus Deringer; DLA Piper; Tellmer; Clifford Chance; Curtis, Mallet-Prevost, Colt, & Mosle; and Linklaters for their input. With that said, this paper solely reflects the views of the authors. None of the opinions or information herein should be attributed to anyone else.

## II. THE STRUCTURE OF SOVEREIGN SUKUK

### A. Overview

Sovereign sukuk are financial instruments that replicate the economic effects of traditional sovereign bonds<sup>2</sup> while adhering to Islamic law (i.e., sharia). Sharia prohibits *riba* (interest), *gharar* (excessive uncertainty) and *maysir* (speculation). In addition, sharia disallows investments in certain prohibited industries (e.g., alcohol, pork, gambling). Accordingly, sukuk securities represent ownership shares in tangible assets and the rights to the profits from those assets, rather than receivables from debt obligations. Dollar-denominated sovereign sukuk are typically structured as trust certificates under English law.<sup>3</sup>

For investors, holding a sukuk is similar to holding a bond. Both instruments are contractual obligations whereby the government promises to both:

1. Periodically pay holders a certain amount (i.e. returns on assets), and
2. Repay the nominal value of the instrument at a certain future date (i.e. return of asset).

In the case of a bond, the periodic payment is called the “coupon,” and the nominal value is called the “par” or “face” value. In the case of a sukuk, the periodic payment is called the “periodic distribution amount,” and the nominal value is called the “dissolution distribution amount.” Sovereign bonds and sukuk can each be designed as either fixed- or floating-rate instruments, but both are usually fixed-rate.

Despite these similarities, the underlying structures of bonds and sukuk differ significantly. Bonds represent a bilateral relationship between an issuer and investors. Governments sell the bonds to investors in exchange for a promise to pay back interest and principal. These obligations are typically not secured against or otherwise tied primarily to state assets.

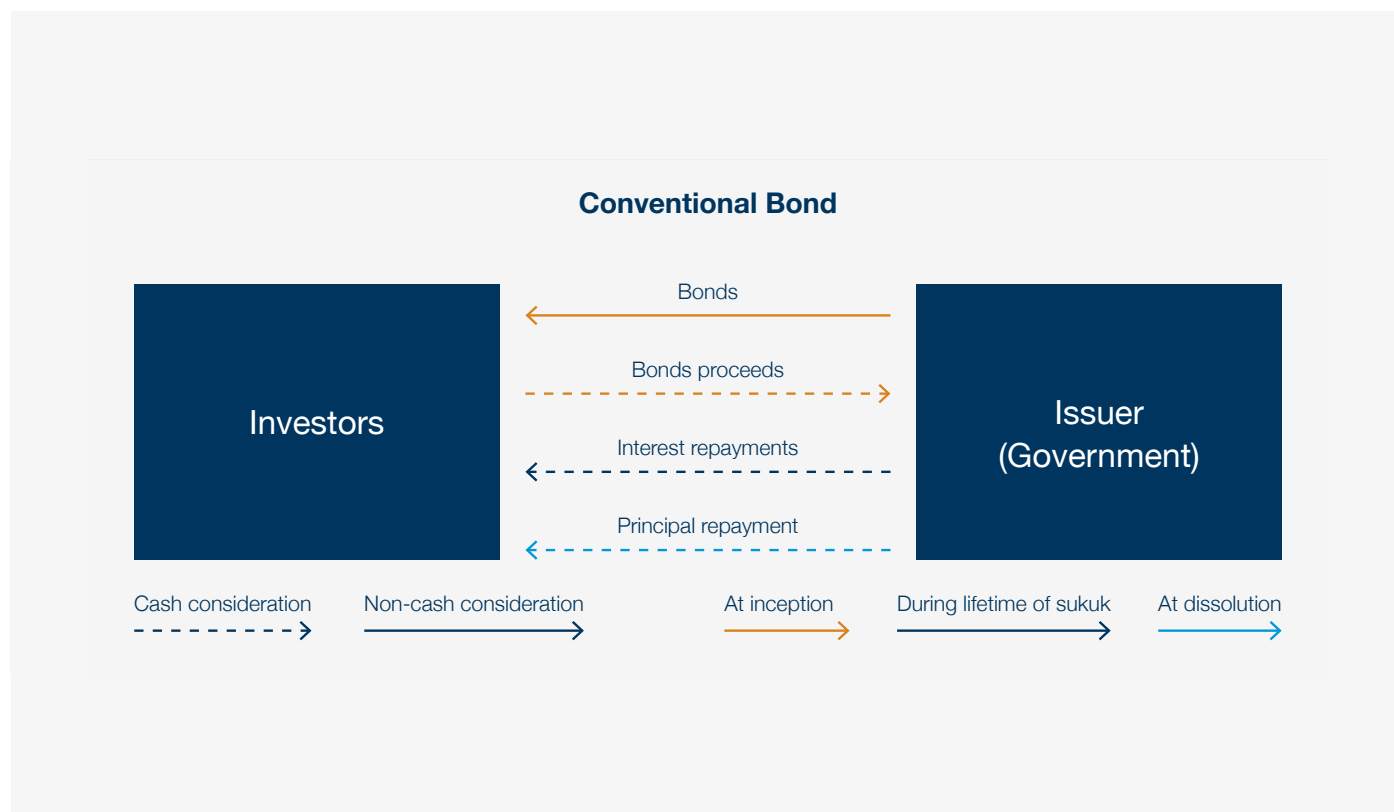


Figure 1: Basic bond structure

#### SOURCE:

<sup>2</sup> Note that sukuk originated by corporations or financial institutions are often designed with more equity-like features. However, publicly issued sovereign sukuk are all designed as fixed-income instruments at the time of writing.

<sup>3</sup> English law and New York law are commonly chosen as the governing law for international (non-local currency) bond issues. In the case of sukuk, English law has emerged as the convention.

Sukuk involve a more complex set of contractual relationships and derive their value—at least contractually—from specific assets. Under a sukuk arrangement,<sup>4</sup> the government creates an offshore special purpose vehicle (SPV), which issues sukuk certificates to investors in exchange for cash. The SPV then uses those proceeds to purchase one or more assets, often from the government but sometimes from a third party. The certificates held by investors represent equal and undivided shares in the ownership of those assets purchased by the SPV. Accordingly, the SPV periodically distributes the returns generated by (or contractually derived from) the assets to investors. At a pre-specified dissolution date, the government purchases the assets back from the SPV, and the SPV distributes the proceeds from this sale along with any remaining surplus in the SPV (net of costs) to investors.

International sovereign sukuk are almost always structured as trust certificates under English law, whereby the SPV serves as the trustee of the investors and manages the sukuk assets on their behalf. Typically, the trustee appoints a third-party

delegate to exercise its contractual rights, including taking enforcement action against the government in the event of default. Otherwise, an SPV wholly owned by the government would be unlikely to act against the government for the benefit of its investors.

Many civil law countries issuing local currency sukuk cannot rely on the concept of trusts, since their domestic legal regimes do not recognize them. Therefore, in certain countries alternative civil law structures have been developed to allow sukuk to be carried out under domestic laws. Some such jurisdictions have passed bespoke legislation to enable the issuance of sukuk under domestic law. For example, Turkey's sukuk regulation allows for the creation of "asset-lease companies," a specific type of SPV solely intended for the purpose of issuing sukuk.

Figure 2 depicts a stylized structure of a sovereign sukuk. Within this general structure, there is considerable variation both in the ownership rights transferred to investors and in the ways in which the underlying assets generate profits.

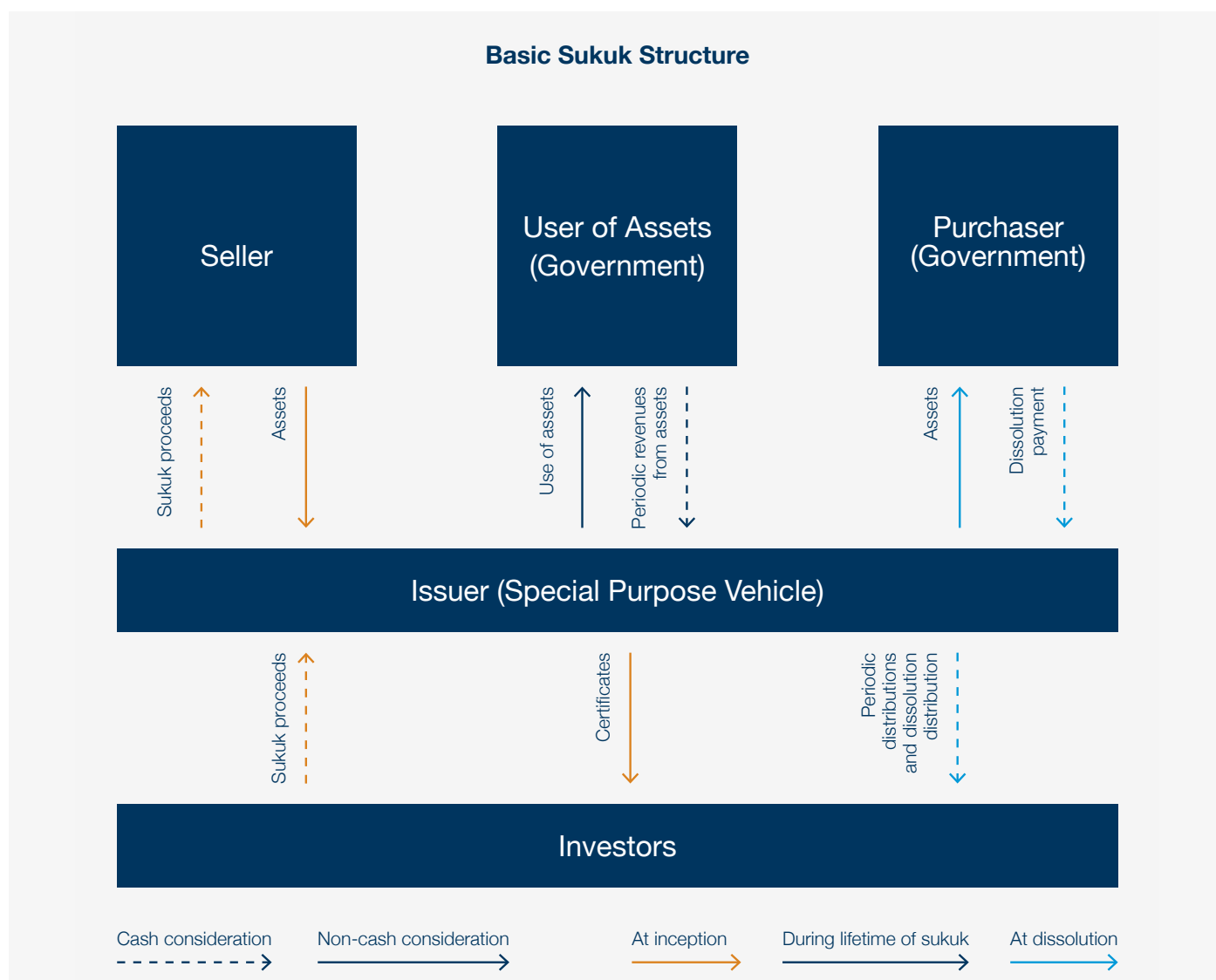


Figure 2: Basic sukuk structure

#### SOURCE:

<sup>4</sup> The description that follows is a generalization. Certain sukuk arrangements may diverge from this general outline.

## B. Ownership Rights

Sukuk can generally be divided into two categories based on the nature of the ownership rights transferred to investors: asset-backed sukuk and asset-based sukuk. **Virtually all international sovereign sukuk are asset-based, i.e. unsecured.**

Under asset-backed structures, the government transfers both legal and beneficial ownership over the assets to sukuk holders (via the SPV). In other words, the investors collectively enjoy full title to the underlying assets and can use and allocate the property as they wish. Because a “true sale” has occurred, investors assume the risk that the underlying assets will generate lower revenues than anticipated and do not have recourse to the government if there is a shortfall of payments. However, the sukuk certificates are secured claims against the underlying assets.

In contrast, under asset-based structures, which represent virtually all outstanding sovereign sukuk issuances, the government only transfers beneficial ownership over the assets to sukuk holders. In other words, the investors enjoy

the rights to the revenues or receivables generated by the assets, but do not have full title to those assets. As such, sukuk holders cannot seize or liquidate the underlying assets in the event of a default. Instead, they possess an unsecured claim against the government through the trustee, similar to a conventional bond.

There are several reasons that asset-based structures dominate the market. Modern asset-based sukuk were largely created to allow sharia-compliant investors to generate fixed income returns akin to conventional bonds. There has been limited investor demand for the economics of sukuk to deviate from those of unsecured bonds. Relatedly, there is limited appetite among governments to originate asset-backed sukuk, which would potentially jeopardize their control of state assets. Finally, asset-based sukuk are easier to structure under English common law.

Table 1 summarizes the differences between asset-backed sukuk and asset-based sukuk.

	Asset-backed sukuk	Asset-based sukuk
<b>Ownership rights transferred</b>	Legal and beneficial (economic) ownership	Beneficial (economic) ownership only
<b>Process</b>	Securitization of tangible assets	Securitization of receivables generated from assets
<b>Accounting for the asset</b>	Assets shifted to balance sheet of the SPV (“true sale”)	Assets remain on balance sheet of the government
<b>Recourse</b>	Recourse only to the underlying asset	Recourse only to government obligor
<b>Primary risk for investors</b>	Assets will not generate expected cash flows / returns	Government will default on payment obligations
<b>Valuation</b>	Based on liquidation value and/or cash flows of underlying asset	Based on credit status of government

Table 1: Asset-backed sukuk vs. asset-based sukuk

## C. Mechanisms for Generating Payments

Sukuk generate periodic payments for investors in a variety of ways that do not involve charging interest. Some of these structures adopt debt-like characteristics by paying investors a pre-determined rate of return. Others adopt equity-like characteristics by committing the parties to share in profits and losses according to pre-agreed terms. However, sovereign

sukuk that feature equity-like contracts are still typically designed as fixed-income instruments, which invest in assets with stable and predictable returns.

Table 2 lists four forms of sovereign sukuk. This list is not exhaustive but illustrates the variety of forms that sukuk can take.

	Conventional finance equivalent	Underlying asset	Characterization
<b>1. Al-Ijara</b>	Lease agreement	Real property	Debt-like
<b>2. Al-Murabaha</b>	Commodity trading agreement	Commodities	Debt-like
<b>3. Al-Mudaraba</b>	Profit sharing partnership	Public projects (e.g., infrastructure projects)	Equity-like
<b>4. Al-Wakala</b>	Agency agreement	Various investment assets	Equity-like

Table 2: Forms of sovereign sukuk



When choosing between these various structures, originating governments may consider several factors, including:

- **Contractual complexity:** More convoluted structures may worry investors who are accustomed to trading more straightforward fixed income instruments, like bonds.<sup>5</sup> Additionally, structuring convoluted sukuk may involve higher legal fees.
  - **Sharia-compliance risk:** The sharia requirements for certain types of sukuk (e.g., mudaraba) are more complex than for others (e.g., ijara).<sup>6</sup> An instrument that one or more Islamic scholars deem as a violation of sharia will be more difficult to sell on both the primary and secondary markets.
- Availability of required asset type:** To originate a particular form of sukuk, a government must own the appropriate type of underlying assets<sup>7</sup> or have access to those assets through a third party broker. The assets must be worth approximately the nominal value of the planned issuance.

The following sub sections describe four types of sovereign sukuk,<sup>8</sup> as well as hybrid forms that combine multiple

structures. The explanations and diagrams below illustrate the key features of each structure, although individual issuances may contain idiosyncrasies not reflected here.

### i. Sukuk al-Ijara

*Ijara* is a type of sharia-compliant lease contract. One party purchases property and then leases that property to another entity for an agreed duration and in exchange for an agreed rental fee. Under *ijara*, certain obligations — e.g., to maintain and insure the asset— cannot be shifted onto the lessee. As such, the parties often enter into a separate service agreement, under which the lessee assumes responsibility for maintaining and insuring the property.

In a sukuk al-ijara, the government transfers ownership rights to one or more properties to the SPV sukuk issuer. The SPV then leases that property back to the government and distributes the revenues generated from rental fees to the sukuk holders. At the end of the rental period, the government repurchases the property from the SPV. The SPV then dissolves and distributes the proceeds to its investors.

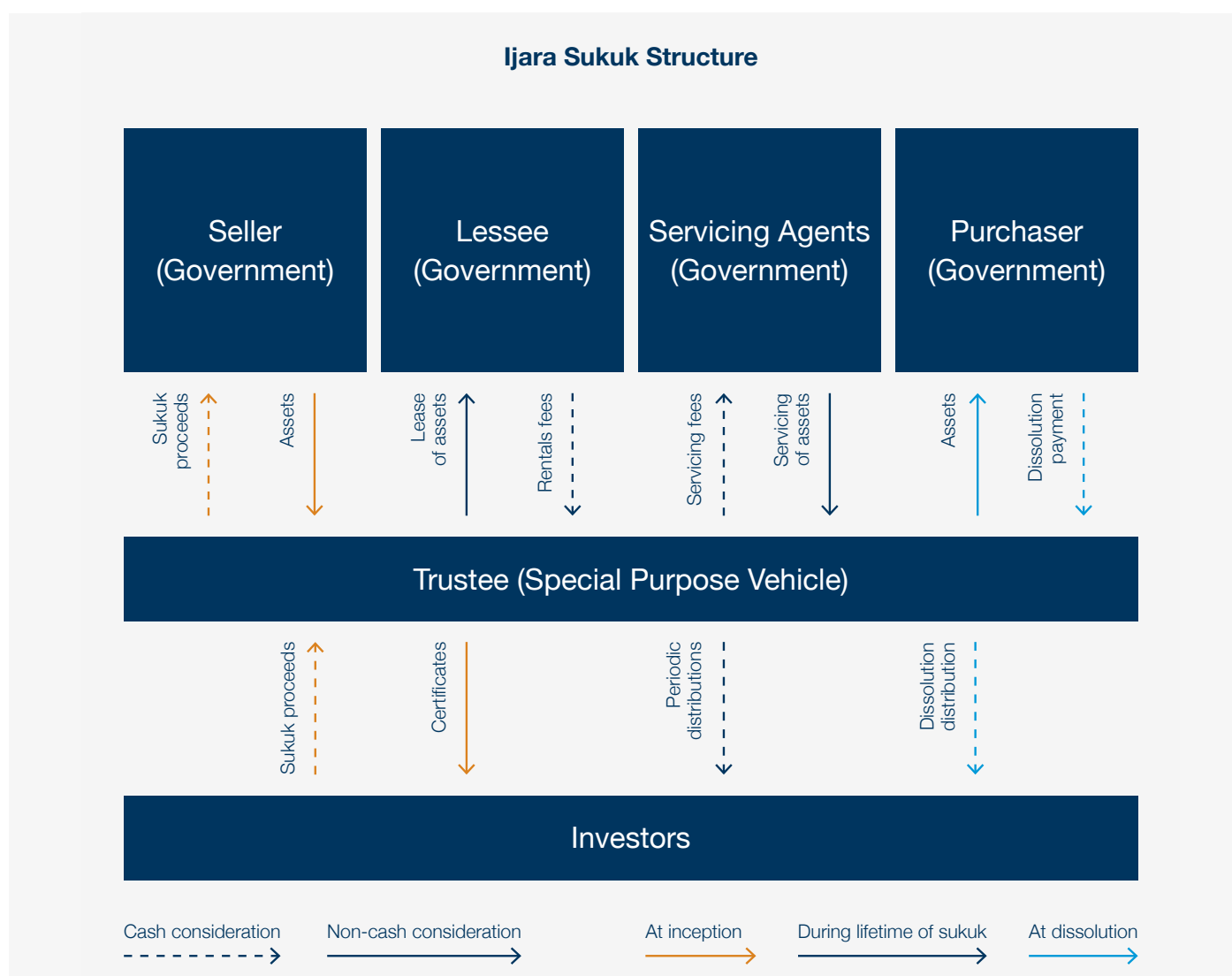


Figure 3: Sukuk al-ijara structure

#### SOURCE:

<sup>5</sup> Bennett, Michael. "Sukuk are just another capital markets instrument (and that is a good thing)". World Bank Blogs. (April 13, 2023).

<sup>6</sup> Godlewski, Christophe, Rima A Turk, and Laurent Weill. "Do the Type of Sukuk and Choice of Shari'a Scholar Matter?". IMF Working Papers 2014.147 (2014), A001. Web. 1 Aug. 2023; Utami, Datien Eriksa, Irawati, Zulfa. "Issuers' Insight for Identifying Choice of Sukuk Structuring." Jurnal Keuangan dan Perbankan 22(4). 680 (2018).

<sup>7</sup> Jobst, Andreas, Kunzel, Peter, Mills, Paul, Sy, Amadou. "Islamic Bond Issuance—What Sovereign Debt Managers Need to Know". IMF Policy Discussion Papers 2008. 9 (2008).

<sup>8</sup> It is worth noting that corporate sukuk utilize structures other than the four listed here (e.g., al-istisna, al-salam). However, these four types of sharia-compliant contracts constitute the vast majority—if not all—of the sovereign sukuk universe.

## ii. Sukuk al-Murabaha

Murabaha refers to an arrangement to purchase goods for a particular price and then resell them at a margin of profit agreed by the parties. Sukuk al-murabaha are certificates issued for the purpose of financing the purchase of goods through murabaha. Therefore, the assets underlying this form of sukuk are the goods that the sukuk proceeds are used to purchase. Typically, these goods are commodities.

Under sukuk al-murabaha, the SPV uses the sukuk proceeds to purchase commodities on a spot basis from a supplier. The SPV then sells those commodities to the government originator. The government pays the spot price plus a profit margin, which is payable in periodic instalments. The government then

resells the commodity to a separate commodity buyer on a spot basis. In summary, the government raises money through the spot sale of commodities purchased using sukuk proceeds and “repays” the sukuk holders in periodic instalments.

Sharia principles prohibit secondary market trading of sukuk al-murabaha after the commodities have been transferred to the government purchaser. At that point, the certificates represent a debt of the government to the sukuk holders. Trading these assets would therefore amount to trading in debt on a deferred basis and would contravene Islam’s prohibition of *riba*.<sup>9</sup>

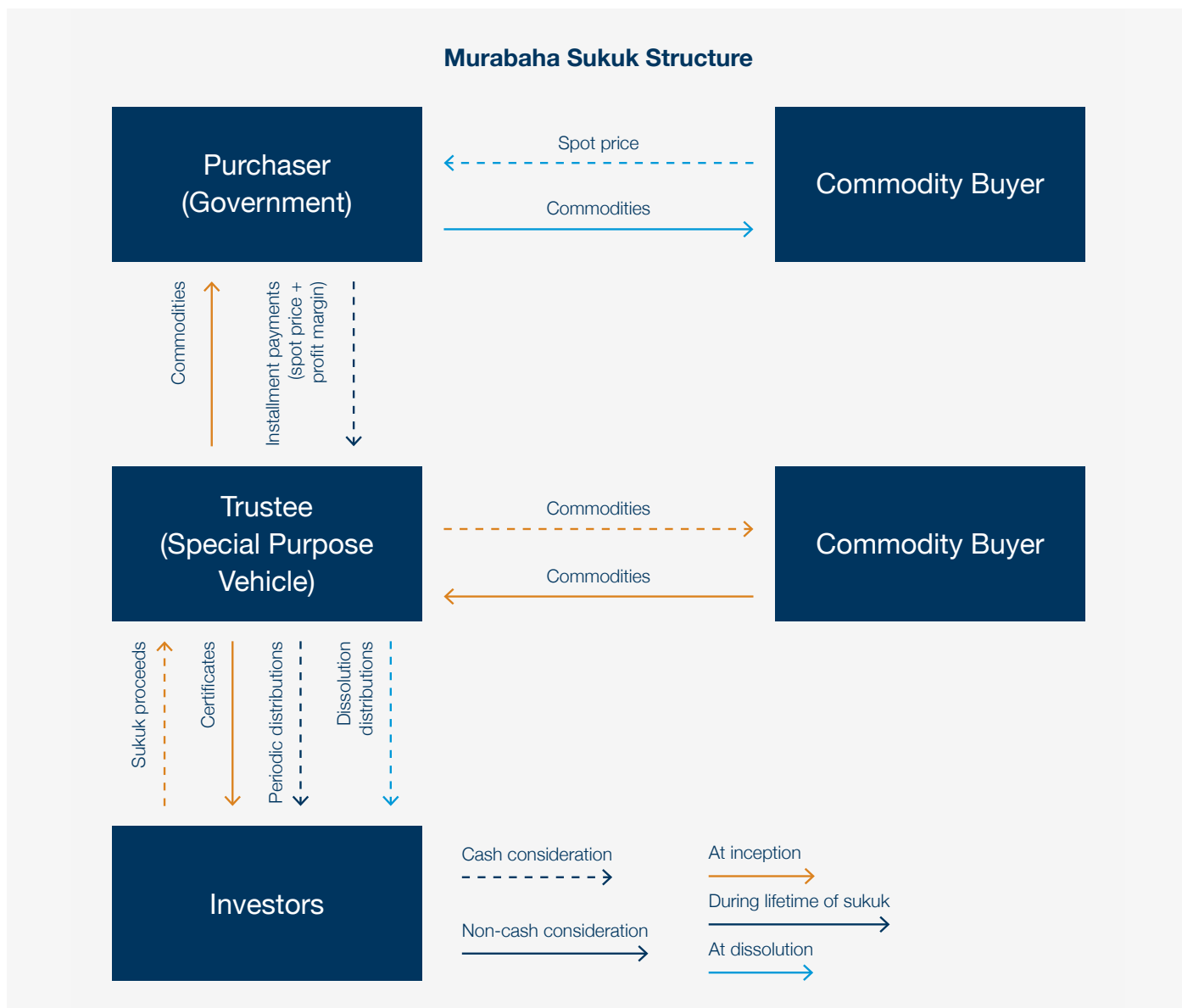


Figure 4: Sukuk al-murabaha structure

SOURCE:

<sup>9</sup> AAQIFI Sharia Standard No. 17, 5/2/15.



### iii. Sukuk al-Mudaraba

*Mudaraba* is a profit-sharing partnership to undertake a business or investment activity. One party (the rab-al-maal) provides capital, and the other party (the mudarib) provides the managerial or technical knowledge to deploy that capital in service of a profit seeking venture. The rab-al-maal and the mudarib share profits according to a pre-agreed ratio. The rab-al-maal bears all downside risk, since the mudarib does not contribute any capital.

Under *sukuk al-mudaraba*, the SPV transfers proceeds from the sukuk issuance to the government. The government then invests that cash in one or more public projects.

In other words, the SPV serves as the rab-al-maal, and the government serves as the mudarib. The SPV periodically receives a share of the profits generated from these projects, which it distributes to the sukuk holders. At the dissolution date, the government (mudarib) liquidates its investment portfolio and transfers a share of the proceeds to the SPV (rab-al-maal), which in turn distributes that money to investors as a dissolution payment.

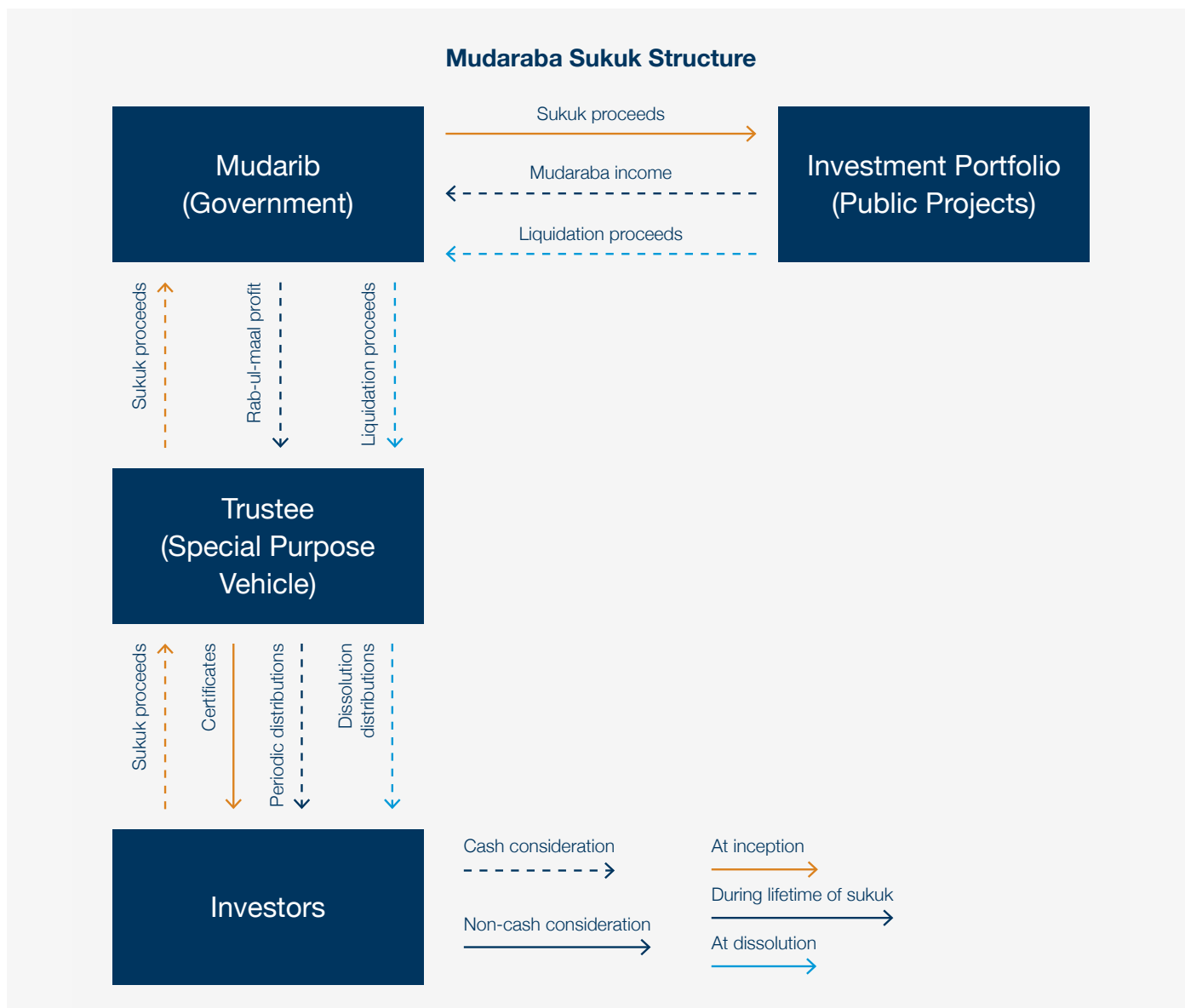


Figure 5: Sukuk al-mudaraba structure

#### iv. Sukuk al-Wakala

*Wakala* refers to an agency agreement whereby one party entrusts another party (the wakeel) to invest capital on its behalf. Sukuk al-wakala are certificates issued to raise capital that is subsequently invested, pursuant to a wakala agreement. The assets underlying this form of sukuk are those purchased by the wakeel using the sukuk proceeds.

Under sovereign sukuk al-wakala, the government obligor typically acts as the wakeel. It invests the sukuk proceeds in state owned assets<sup>10</sup> and can therefore set the amount of profits that the assets generate. The government pays the SPV a fixed periodic amount from these profits and keeps any remainder plus an investment fee. On the dissolution date, the SPV sells the wakala assets back to the government at a specified exercise price, allowing investors to recoup the initial amount that they paid for their certificates.

Although wakala and mudaraba both involve the SPV providing the government capital to engage in investment activities, sukuk al-wakala pay investors a fixed amount per period, whereas sukuk al-mudaraba pay investors a fixed share of the profits per period. In practice, this distinction makes little difference, since the government originator can structure a mudaraba such that investors' annual share of profits always equals the same gross amount.

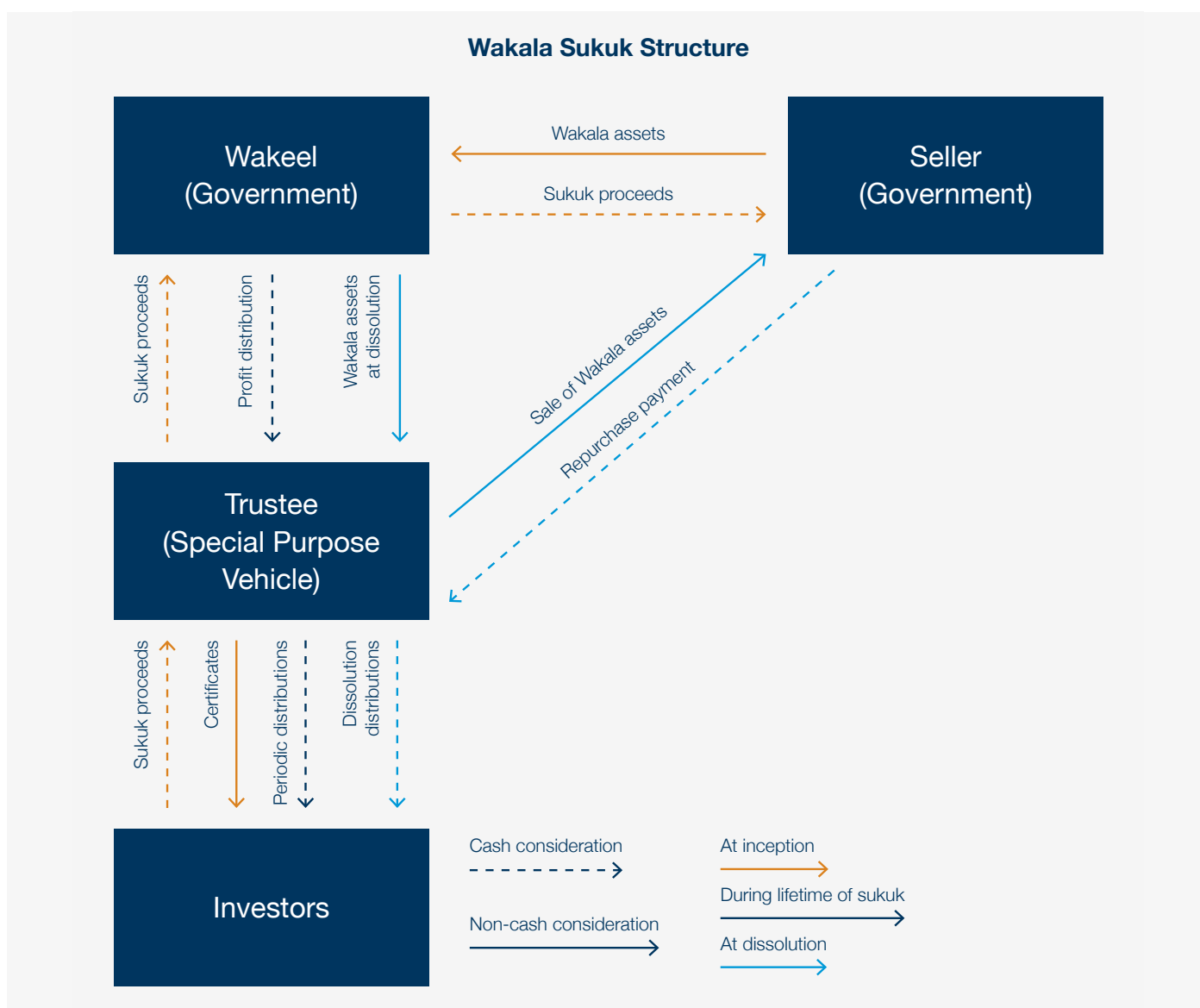


Figure 6: Sukuk al-wakala structure

SOURCE:

<sup>10</sup> Sovereign Indonesia Issues its Largest-ever Regular Annual International Sukuk Wakalah with a Two Tranche US\$3.25bn Offering Including a US\$1.5bn Green Sukuk". DDCAP Group. (August 15, 2022).

## v. Hybrid Sukuk

Sukuk often combine characteristics of multiple of the profit generation mechanisms described above. For example, some of the proceeds from a given sukuk may be used to finance an ijara transaction while the rest is used to finance a wakala transaction. Figure 7 depicts the structure of the Saudi Arabia sukuk maturing in 2029, which combines mudaraba and murabaha contracts.

Per **sharia standards** outlined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), hybrid sukuk are tradeable on the secondary market as long as more than 50 percent of the sukuk proceeds are invested within structures that are tradeable on the secondary market. This may explain why Saudi Arabia chose to allocate just over half of the proceeds of its 2029 sukuk to the mudaraba transaction. A lower ratio would have made the certificates non tradeable under AAOIFI standards.

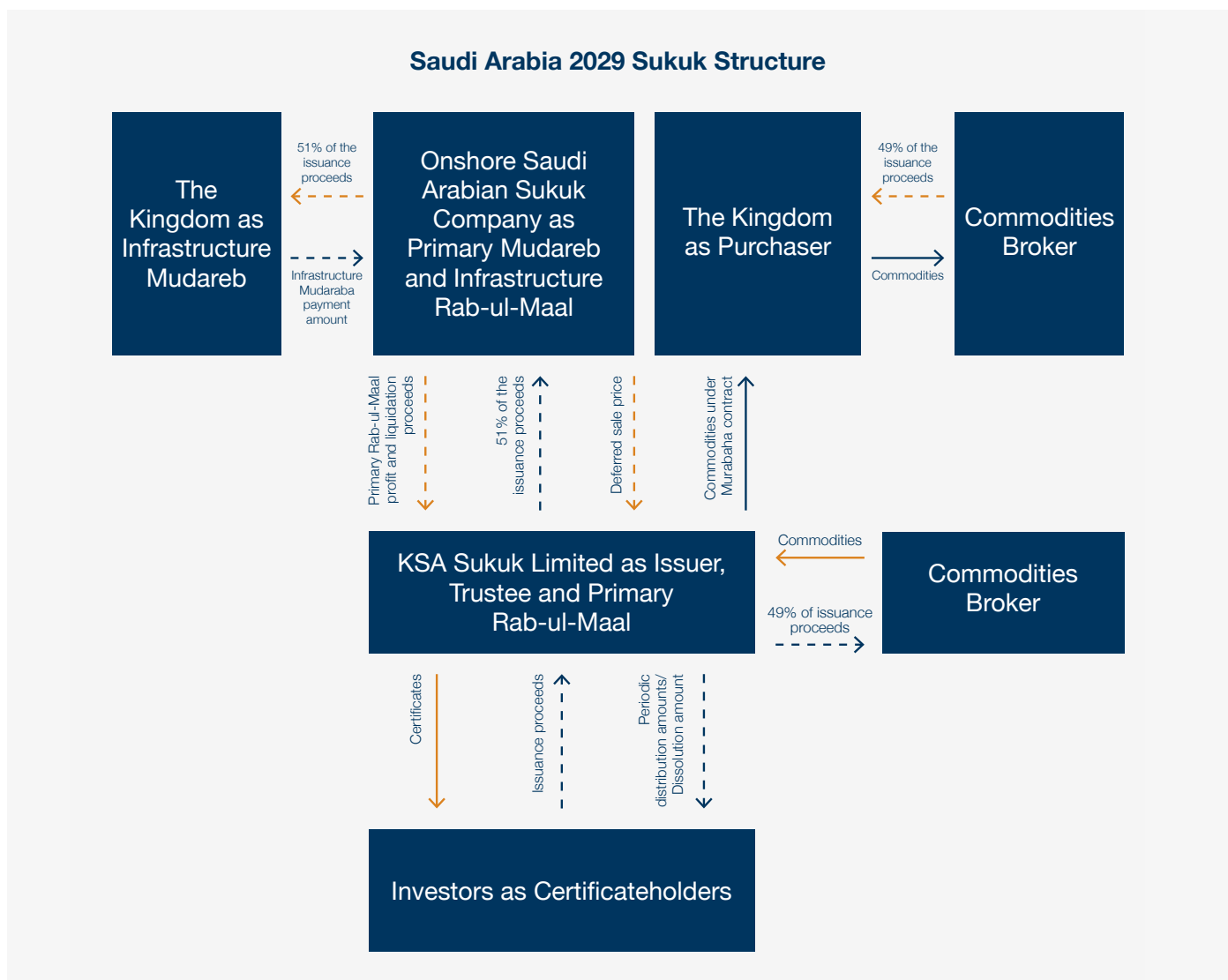


Figure 7: Saudi Arabia 2029 sukuk structure

### III. THE MARKET FOR SOVEREIGN SUKUK

This section provides an overview of the market for sovereign sukuk. It discusses the size of the market and the major market participants, including issuers, underwriters and investors. Additionally, the section examines the pricing of sukuk within the secondary market and draws inferences from this data about investors' perceptions of sukuk compared to traditional bonds.

One of the messages from the analysis below is that for many sovereigns the cost from sukuk financing is often less than from financing from conventional international instruments. This is especially so for sovereigns that have lower ratings and face higher costs of borrowing in international capital markets.

#### A. Sukuk Issuers

##### i. Overview

As of July 2023, there are more than \$53 billion of outstanding dollar-denominated sukuk issued by sovereigns.<sup>11</sup> At least 10 national governments have outstanding sukuk in USD. These include Bahrain, Egypt, Hong Kong SAR, China, Indonesia, Malaysia, Maldives, Oman, Pakistan, Saudi Arabia, and Turkey. In addition to these sovereign dollar sukuk, some sub sovereign entities—such as Dubai, Ras Al-Khaimah, and Sharjah—have also issued sukuk.

Table 3 provides a list of outstanding dollar-denominated sovereign sukuk as of July 2023.

Originator Government <sup>12</sup>	Maturity (DD/MM/YYYY)	Nominal Value (USD millions)	Fixed Coupon Rate (%)
Bahrain	12/02/2024	1,000	5.62
	14/11/2024	1,000	6.25
	20/03/2025	850	5.25
	05/10/2025	1,000	6.88
	30/03/2027	1,000	4.50
	16/09/2027	1,000	3.95
	18/05/2029	1,000	3.88
	18/10/2030	1,000	6.25
Egypt	28/02/2026	1,500	10.88
Hong Kong SAR, China	28/02/2027	1,000	3.13
Indonesia	10/09/2024	1,500	4.35
	28/05/2025	2,000	4.33
	29/03/2026	1,750	4.55
	09/06/2026	1,250	1.50
	29/03/2027	2,000	4.15
	06/06/2027	1,750	4.50
	01/03/2028	1,750	4.40
	09/06/2031	1,000	2.55
	06/06/2032	1,500	4.70
Malaysia	22/04/2025	1,000	3.04
	27/04/2026	1,000	3.18
	28/04/2031	800	2.07

#### SOURCE:

<sup>11</sup> According to International Islamic Financial Market's 2022 sukuk report, there were \$83 billion in outstanding dollar-denominated sovereign sukuk at the end of 2021. The IIF's higher figure is partially due to the fact that it includes issuances by sub-national governments (e.g., Dubai, Abu Dhabi, and Ras Al-Khaimah). However, it is still possible that the current figure for outstanding sukuk is larger than the \$53 billion reported here. Nevertheless, for the sake of integrity we have only included issuances we are aware of in our dataset.

<sup>12</sup> Because sukuk certificates are technically issued by a special purpose vehicle rather than by the government itself, governments are referred to as the "originators" rather than issuers.



Originator Government <sup>12</sup>	Maturity (DD/MM/YYYY)	Nominal Value (USD millions)	Fixed Coupon Rate (%)
<b>Maldives</b>	04/08/2026	300	9.88
<b>Oman</b>	01/06/2024	2,000	4.40
	31/10/2025	800	2.07
	15/06/2030	1,750	4.88
<b>Pakistan</b>	31/01/2029	1,000	7.95
<b>Saudi Arabia</b>	25/10/2028	2,500	5.27
	22/05/2029	3,000	4.27
	29/10/2029	2,500	2.97
	22/05/2033	3,000	4.51
<b>Turkey</b>	25/11/2024	1,000	4.49
	13/11/2025	2,500	9.76
	22/06/2026	2,500	5.13
	24/02/2027	3,000	7.25
<b>Total</b>		53,500	

Source: Bloomberg \* Data as of 11th July 2023

Among these countries, Indonesia has the most dollar-denominated sukuk obligations, with \$14.5 billion in outstanding certificates. Saudi Arabia is next with \$11 billion, and Turkey has \$9 billion. Indonesia is also the most frequent

originator (nine outstanding issuances), and Bahrain is a close second (eight outstanding issuances). Figure 8 displays the total value of outstanding issuances by country.

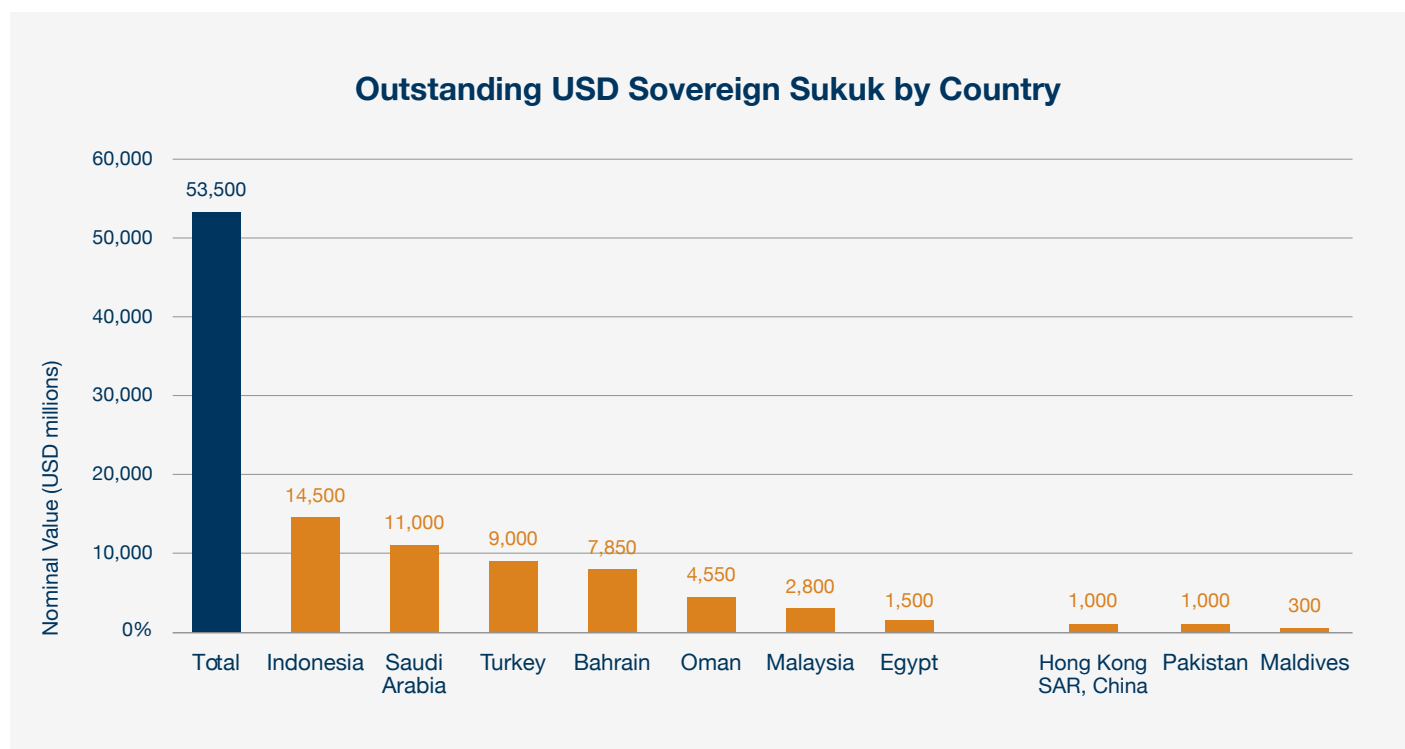


Figure 8: Outstanding Dollar-denominated Sukuk. Source: Bloomberg

Of course, dollar-denominated sukuk are only one part of the sovereign landscape. Several governments listed above also **originate** sukuk in their own local currencies. For example, in 2021 the Indonesian government originated more than \$3 billion worth of sukuk in rupiahs, which was more than three times the value of dollar-denominated sukuk that it issued in the same year. Saudi Arabia, Turkey, Malaysia and Pakistan also issued domestic currency sukuk in 2021.

Additionally, many countries without any outstanding USD sukuk have conducted issuances in domestic currencies. For example, **Senegal**, Togo and Cote D'Ivoire have all raised money through sukuk denominated in CFA francs; the United Arab Emirates has **originated** sukuk in dirhams; and the United Kingdom has **originated** sukuk in pounds. Other

recent domestic currency originators **include** Bangladesh, Nigeria and Qatar.

In total, the domestic currency sovereign sukuk market **amounted** to \$313 billion equivalent at the end of 2021. This was between three and six times the size of the dollar-denominated market at that time.

Table 4 lists countries that have originated sukuk in dollars or in their domestic currencies. Note that the domestic currency list contains countries with outstanding sukuk as well as those with sukuk that have recently matured. Because information about local currency sukuk is less readily available than for international sukuk, we do not provide details about specific local issuances.

	Outstanding USD Sukuk <sup>13</sup> (# issuances)	Local Currency Sukuk in Last 5 Years	Credit Rating (S&P)
<b>Bahrain</b>	\$7.9 billion (4)		B+/B
<b>Bangladesh</b>			BB-
<b>Cote D'Ivoire</b>			BB-
<b>Egypt</b>	\$1.5 billion (1)		B-
<b>Hong Kong SAR, China</b>	\$1 billion (1)		AAA
<b>Indonesia</b>	\$14.5 billion (9)		BBB
<b>Luxembourg</b>			AAA
<b>Malaysia</b>	\$2.8 billion (3)		A-
<b>Maldives</b>	\$0.5 billion (1)		B*
<b>Nigeria</b>			B-
<b>Oman</b>	\$4.5 billion (3)		BB+
<b>Pakistan</b>	\$1 billion (1)		CCC+
<b>Qatar</b>			AA
<b>Saudi Arabia</b>	\$11 billion (4)		A-
<b>Senegal</b>			B+
<b>Togo</b>			B
<b>Turkey</b>	\$9 billion (4)		B
<b>United Arab Emirates</b>			AA
<b>United Kingdom</b>			AA
<b>Total</b>	\$53.7 billion		

Table 4: International and Domestic Sukuk Originators

Standard & Poor's assigns the country a long-term issuer default rating of B+ or lower as of October 1, 2023.

Sukuk issued

\* Standard and Poor's rating not available. Fitch rating used instead.

#### SOURCE:

<sup>13</sup> Nominal values are only available for sukuk issued in USD. Data for local currency sukuk is sparser.

There may be more countries that have originated sukuk that we are unaware of, e.g., because those sukuk were privately placed and not reported publicly.

Sovereign governments are by far the largest originators of sukuk. According to the International Islamic Financial Markets **2022 Annual Report**, sovereigns accounted for 46 percent of all international sukuk outstanding at the end of 2021, and state owned or state affiliated entities accounted for another 22 percent. Meanwhile, the corporate and financial sectors only originated 15 percent and 17 percent of all outstanding international sukuk respectively. For domestic sukuk, sovereigns and quasi sovereigns made up 57 percent and 16 percent of the market respectively. In 2021, sovereigns alone **originated** more than \$110 billion worth of sukuk in

dollars and local currencies. This split is roughly similar to that of the global bond market, wherein approximately **50 percent** of the \$128 trillion market is composed of sovereign bonds.

Sukuk are an increasingly important means of raising capital for many governments. The value of public sector sukuk issuances has **been rising** since 2015. During this period, sukuk issuances grew more rapidly than governments' overall borrowing requirements. While sukuk issuances more than tripled from approximately \$33 billion to \$110 billion between 2015 and 2021 (see Figure 9), gross borrowing requirements less than doubled—from roughly \$8 trillion to \$14 trillion. Therefore, sukuk constitute a growing—albeit still modest—proportion of overall government borrowing.

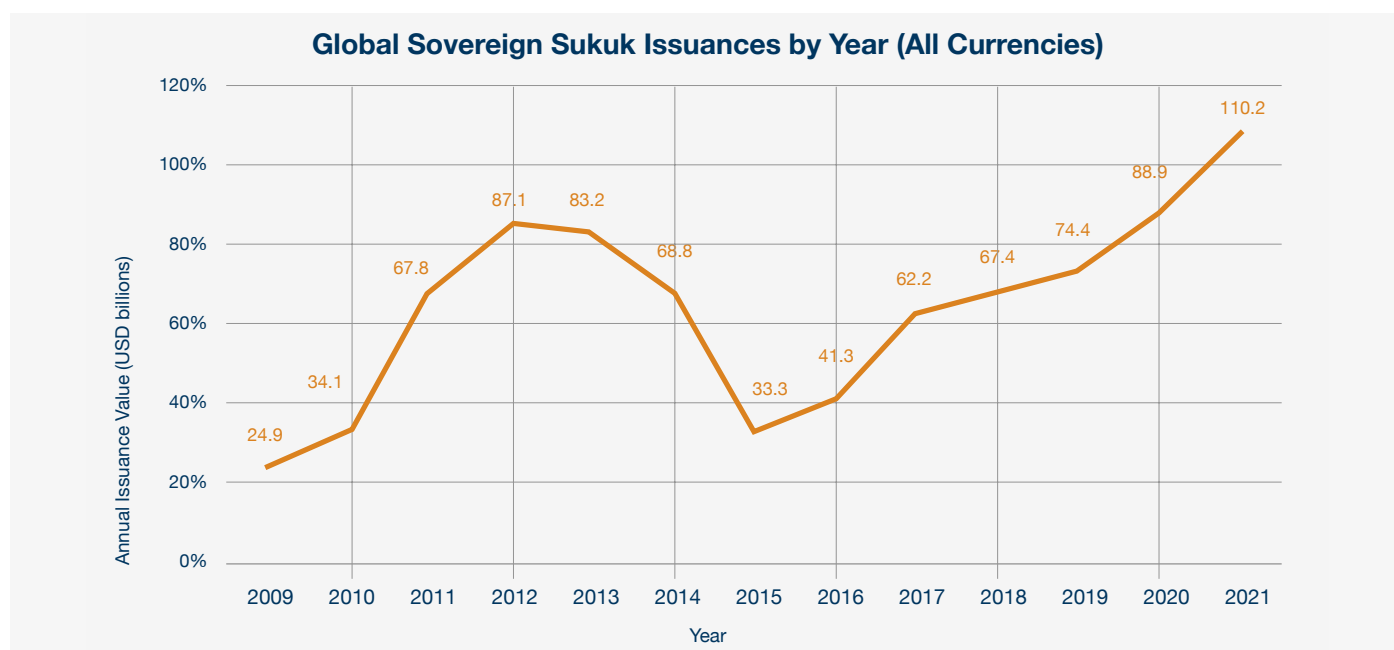


Figure 9: Annual sukuk issuances (all currencies). Source: International Islamic Financial Market.

According to **Refinitiv**, overall sukuk borrowing will continue to grow until at least 2027.<sup>14</sup> This growth is unlikely to come exclusively from the corporate and financial sectors, given sovereign issuers' historical dominance of the market, meaning that governments will likely continue to increase borrowing through sukuk schemes.

It is worth noting that because of the outsized role of sukuk issuers and investors from the Persian Gulf, the market is sensitive to oil prices. For example, volumes of sukuk issuances declined dramatically between 2012 and 2015 as crude oil prices collapsed and **reduced liquidity** among Gulf-based investors.

## ii. Issuer Motivations

Sukuk offer several potential advantages over other means of financing for governments:

- **Stronger demand.** In a survey conducted by Refinitiv last year, government representatives often cited stronger demand for sukuk compared to conventional bonds as a motivation for issuing sukuk. Sovereign sukuk issuances—even those by heavily indebted countries—are often heavily oversubscribed. Egypt's debut \$1.5 billion sukuk **attracted bids** of more than \$6 billion in 2023. Pakistan's 2022 sukuk was oversubscribed more than **two times**. There is also strong investor appetite for domestic currency sukuk. The United Arab Emirates' first domestic auction last year was oversubscribed more than **seven times**. Nigeria's 250 billion naira offering in 2021 received bids amounting to more than **three times** that value.

### SOURCE:

<sup>14</sup> Some forecasters have **predicted** that sukuk issuances in 2023 will be lower than in 2022. However, this would be due to sustained economic growth in the Middle East and Southeast Asia, reducing overall government borrowing needs, rather than governments turning away from sukuk specifically.

- **Lower borrowing costs.** Because of this strong demand, some sovereigns have achieved lower borrowing costs for sukuk compared to conventional unsecured bonds. Indeed, 30 percent of sovereigns mentioned lower borrowing costs as a reason for considering sukuk over conventional bonds in the Refinitiv survey. Egypt **priced** its three year sukuk maturing in 2026 to yield 11 percent, while the country's 2026 conventional bonds were yielding 11.5 percent. Similarly, Pakistan was able to **negotiate**

annual payments on its 2022 sukuk down to 7.95 percent despite a benchmark rate of 8.25 to 8.375 percent. Turkey **sold** \$3 billion in sukuk in 2022 at 7.25 percent, despite initial guidance between 7.5 percent and 7.625 percent, after receiving initial orders of more than \$10 billion. Table 5 calculates the cost savings associated with various dollar-denominated sukuk maturing within the next 10 years.

Originator Government <sup>15</sup>	Year of Maturity	Nominal Value (USD millions)	Average difference in yield to maturity from comparable eurobond <sup>16</sup> (basis points)	Implied yearly theoretical government savings <sup>17</sup> (USD millions)
Bahrain	2029	1,000	-110	11.0
	2030	1,000	-86	8.6
Egypt	2026	1,500	-339	50.9
Indonesia	2024	1,500	-13	1.9
	2025	2,000	-15	3.0
	2026	1,750	-7	1.2
	2027	1,750	-2	0.3
Pakistan	2029	1,000	-990	99.0
Saudi Arabia	2028	2,500	-8	1.9
	2029	3,000	2	-0.6
	2033	3,000	5	-1.4
Turkey	2026	2,500	-77	19.3
	2027	3,000	-84	25.2
<b>Total</b>		<b>25,500</b>		<b>220</b>

Table 5: Implied savings from sukuk issuances. Source: Bloomberg (A&M analysis)

Based on this sample, cost savings associated with sukuk vary with the creditworthiness of the originating government. As of August 2023, the two governments with “investment grade” ratings (Indonesia and Saudi Arabia) had realized negligible savings from issuing sukuk as opposed to conventional bonds. Among countries rated at “sub-investment grade” levels, the two countries with at least one credit rating in the “CCC” range or below (Egypt and Pakistan) have the highest implied savings from issuing sukuk (339 basis points and 990 basis points respectively); the two countries with credit ratings in the slightly higher “B” range also save significantly by issuing sukuk, although not by as much as Egypt and Pakistan.

Sukuk may command lower yields than comparable Eurobonds if investors believe that sukuk would fare better than bonds in a default or restructuring scenario. We discuss this hypothesis further in Section III(C) and Section IV below, where we show

that this is likely not the reason behind such a sukuk discount. There is also a negative correlation between the volume of sukuk issuances by a particular government and the cost savings that government realizes from issuing each sukuk.

This pattern is consistent with the hypothesis that governments can sell sukuk at lower yields than conventional bonds because of unmet demand for sharia-compliant assets. If governments sell a sizeable fraction of certificates to local Islamic banks and other domestic investors, the market for these instruments may be more saturated in Saudi Arabia and Indonesia than in Egypt and Pakistan. Section III(C) discusses these pricing dynamics further.

#### SOURCE:

<sup>15</sup> This table contains a limited sample of sukuk for which yield data for the sukuk and yield data for one or more bonds maturing within a year of the sukuk were available. The one exception is Pakistan, for which the comparison bond matures 14 months before the sukuk. The sample is not necessarily representative of all dollar-denominated sovereign sukuk.

<sup>16</sup> We examine the average difference in yields to maturity between each sukuk and a dollar-denominated bond maturing in the same year during the period spanning 15 July, 2022, and 7 July, 2023.

<sup>17</sup> These figures do not represent actual savings, which would be a function of difference in the yields to maturity of a sukuk and a comparable bond at the time of issuance. Instead, we average the difference in yields over the span of a year, in order to estimate the expected savings governments might achieve from issuing sukuk and to smooth out any coincidentally large or small spreads in sukuk and bond yields at the time of issuance.



- **Wider investor base.** Another benefit of sukuk for issuers is that it allows them to diversify their investor base. **More than half** of sovereigns mentioned this wider appeal as an important reason for considering sukuk. In particular, sukuk attract interest from individuals and funds that prefer or exclusively pursue sharia-compliant investments. The fact that sharia-compliant investors have fewer investment opportunities than other investors may partially explain the relatively high demand within the market. That being said, many of the highest-volume sukuk buyers also buy Eurobonds and do not specifically invest based only on sharia principles.
- **Market stimulation.** A potential benefit of domestic sukuk is that they can provide a risk free or low risk benchmark against which a local currency yield curve can be established. According to some **sovereign originators**, establishing such a benchmark can help stimulate the domestic private sector sukuk market. Domestic sovereign bond issuers also commonly tout the potential for domestic market development, but **evidence** is inconclusive as to whether sovereign issuances help the corporate sector issue more bonds in local currency.
- **Providing investment opportunities for local investors.** Another reason that governments issue domestic sukuk

is to provide instruments that domestic sharia-compliant investors can use to manage liquidity. In **announcing** its dirham sukuk program, the United Arab Emirates highlighted the goal of “[supporting] investment options and alternatives that are compatible with the provisions of Islamic Sharia.” The press release for a Nigerian naira sukuk in 2022 emphasized “the government’s objective of promoting financial inclusion” through the creation of sharia-compliant assets.

In summary, the primary benefits of sukuk are interrelated. Because of their distinct features, sukuk typically appeal to a wider group of investors than conventional bonds, and thus demand for sukuk is generally relatively high. This historic high demand for sukuk in turn allows governments to borrow at cheaper rates. A secondary benefit of issuing domestic sukuk is that doing so can stimulate both supply of and demand for local private sukuk.

## B. Sukuk Underwriters and Investors

Standard Chartered, Citigroup, and JPMorgan were the top underwriters of international sukuk by deal value during the first half of 2023. The top underwriters by number of issuances were Standard Chartered, HSBC, and First Abu Dhabi Bank. Table 6 provides a ranking of the top 10 underwriters within the market.

#	Investment Bank	Amount (USD millions)	Number of issuers	Number of issues	Share of total issuance amount (%)
1	Standard Chartered Bank	2,135	12	14	10
2	Citigroup	2,102	9	10	10
3	JPMorgan	1,865	9	11	9
4	HSBC	1,503	11	12	7
5	Goldman Sachs	1,323	3	4	6
6	BNP Paribas	1,295	3	4	6
7	First Abu Dhabi Bank	1,277	11	12	6
8	AlJazira Capital Co.	1,073	2	3	5
9	Emirates NBD	841	7	7	4
10 (tie)	Dubai Islamic Bank / Bank ABC	515	7	7	2
<b>Total</b>		<b>21,615</b>	<b>74</b>	<b>84</b>	<b>67</b>

Table 6: Top sukuk underwriters by value (Jan-Jun 2023). Source: Cbonds

Note that Table 6 indicates new issuances of international sukuk (including sovereign, quasi-sovereign, and corporate sukuk) in the first half of 2023, whereas Table 3 and Table 4 indicate total outstanding nominal volumes of international sovereign sukuk, which is why the totals do not match.

Of course, because the market is relatively small, the top issuers vary significantly by year. For example, in 2020, Citibank and JPMorgan were **positioned** sixth and eighth respectively by deal value, with Standard Chartered, HSBC, and Natixis occupying the top three positions. In 2019, HSBC was third and Kuwait Finance House was second. Despite this fluctuation, Standard Chartered has consistently been the top issuer.

Very little information is publicly available about the holders of sovereign sukuk. Lawyers and bankers who have worked on sukuk issuances report anecdotally that primary market buyers consist largely of both traditional sovereign debt investors (e.g., Blackrock, PIMCO) and Islamic banks. However, secondary market transactions tend to transfer sukuk away from conventional investors and toward sharia-compliant investors. While traditional bondholders are often open to selling the securities when their market price exceeds their face value, sharia-compliant investors tend to buy and hold because of the dearth of other sharia-compliant assets in the market.

### C. Secondary Market Pricing

In general, dollar-denominated sovereign sukuk tend to be priced similarly to Eurobonds with similar maturities. According to an **analysis** by Fitch Ratings of 38 sukuk and comparable bonds, over 60 percent of which were sovereign issuances, sukuk and bonds have a pricing correlation of 95 percent.

However, there are several cases in which sovereign sukuk have lower yields than bonds with similar maturities issued by the same government. Such patterns are illustrated in Figure 10 below for Bahrain, Turkey, Egypt, and Pakistan respectively.

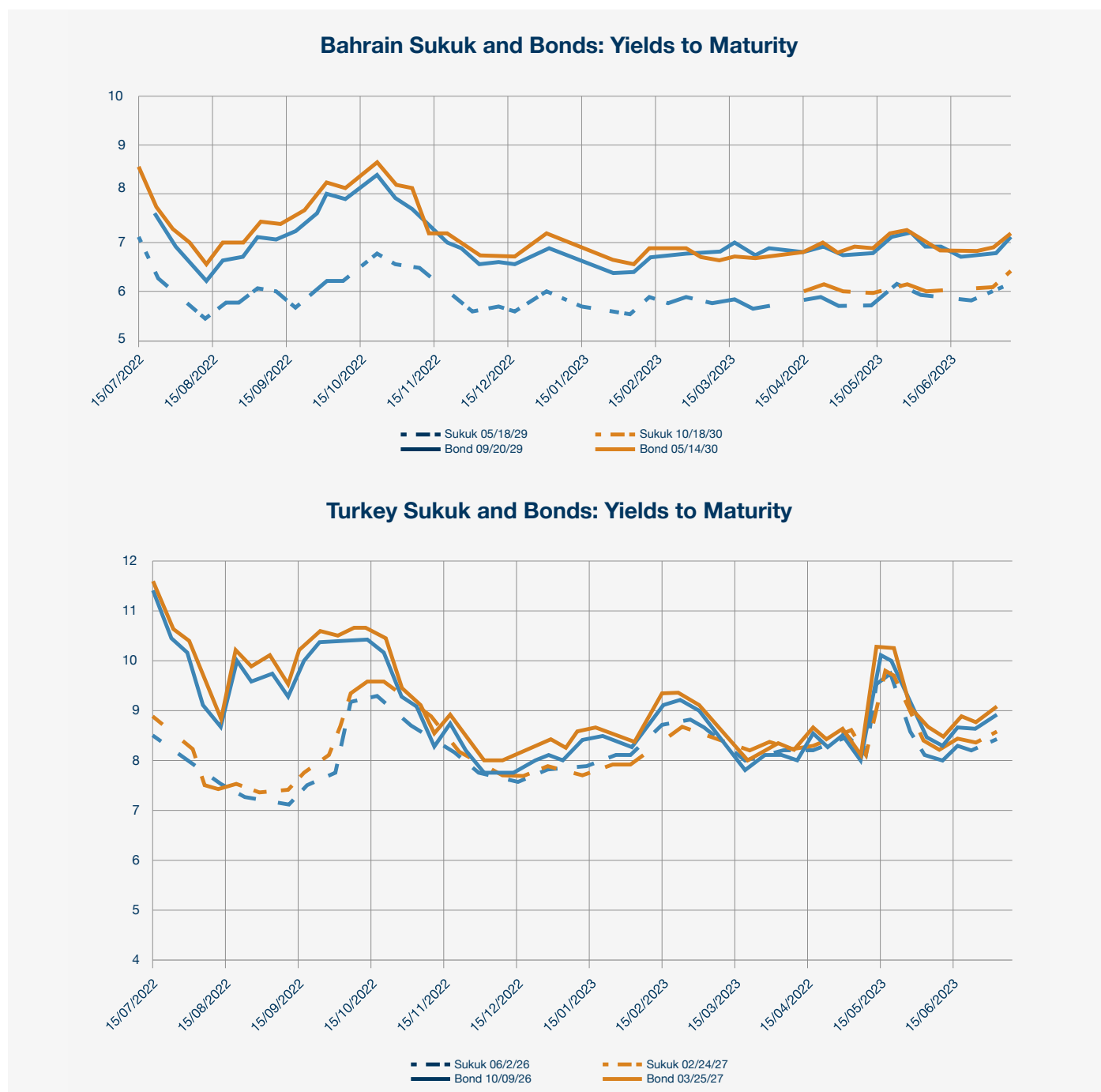
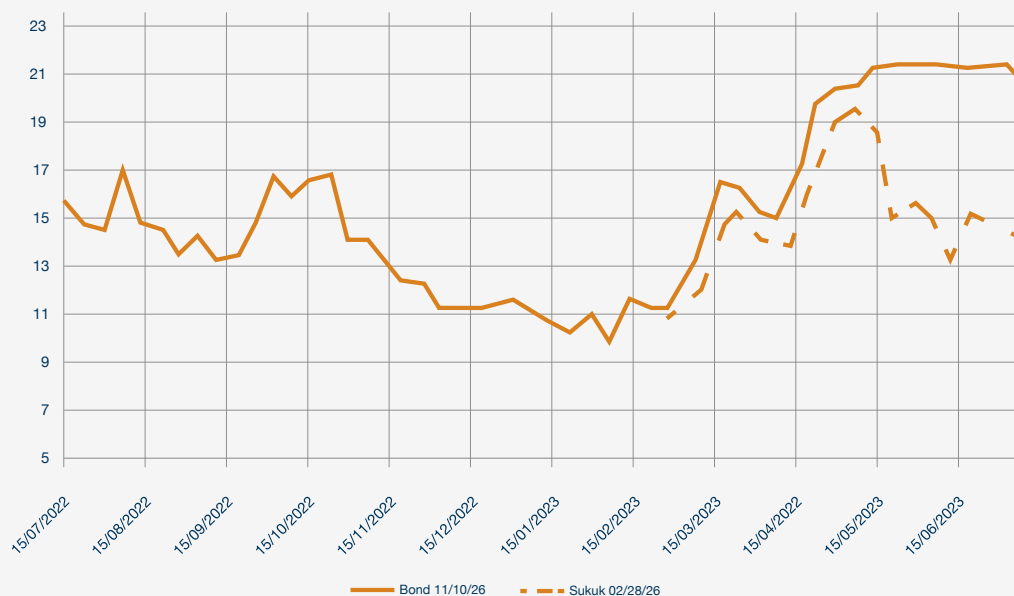


Figure 10: Sovereign sukuk trading at lower yields than comparable bonds. Source: Bloomberg (A&M analysis)<sup>18</sup>

#### SOURCE:

<sup>18</sup> The Pakistan sukuk matures 14 months after the comparison conventional bond. All else equal, instruments with later maturities tend to trade at higher yields than those with earlier maturities. Therefore, the gap in yields between a Pakistani sukuk and conventional bond maturing at the same time might actually be larger in magnitude than the one depicted here.

### Egypt Sukuk and Bonds: Yields to Maturity



### Pakistan Sukuk and Bonds: Yields to Maturity

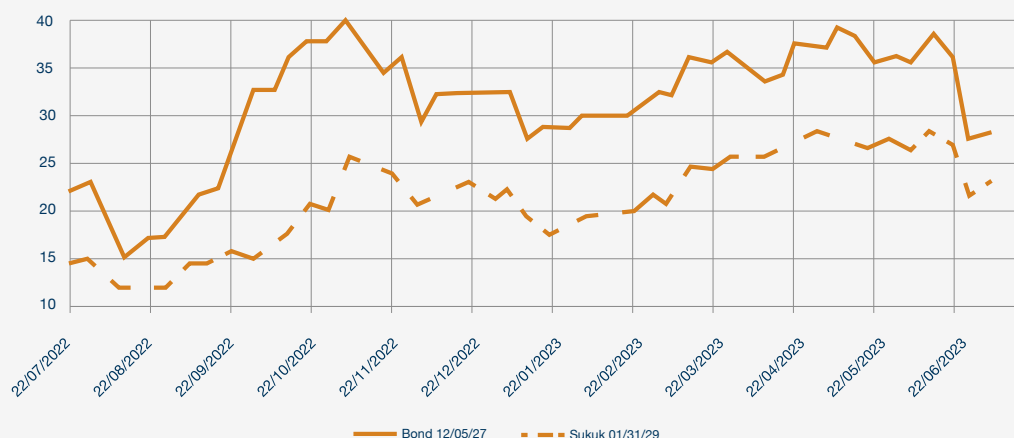


Figure 10: Sovereign sukuk trading at lower yields than comparable bonds. Source: Bloomberg (A&M analysis)

There are several potential explanations for the lower average yields for sukuk. One possibility is that the market considers sukuk to have a lower probability of default than bonds. For example, if investors believe that sukuk payments are made from the cash flows of particular assets rather than from a government's general budget, they might view the likelihood of a missed sukuk payment as lower. Payments on sukuk are not necessarily made from a ringfenced pool of cash. In fact, the rating agency Fitch treats sukuk as senior unsecured obligations which provide full recourse to the government. Nevertheless, investors may view "asset-based" instruments as safer than conventional bonds.

Another hypothesis—considered by Mitu Gulati and Mark Weidemaier—is that investors believe sukuk would fare better in a restructuring scenario. This might be the case if sukuk holders believed that their certificates were secured by the assets underlying the sukuk (i.e., that the sukuk were asset-backed rather than asset-based). Alternatively, investors might believe that sukuk holders could hold out from a Eurobond restructuring

to negotiate better terms as part of a wider sovereign debt restructuring. This might be the case if sukuk holders were not bound by the crossseries collective action clauses included in conventional debt instruments or represented a sufficiently large and wellcoordinated share of a government's obligations that they could block a restructuring vote. As we discuss in Section IV, there is good reason to believe that sukuk would be restructured similarly to conventional bonds based on the instruments' documentation, which closely mimics the terms of unsecured sovereign bonds. Even so, investors may not examine the offer documents closely and thus incorrectly expect to receive a higher payout on distressed sukuk than on distressed bonds.

If different expected restructuring outcomes were driving the difference in yields, one would expect the gap to expand as the perceived risk of default increased. The charts above provide some evidence to support that expectation. Figure 10 show that Egypt's sukuk began trading at higher prices after the announcement of the 2023/2024 draft budget, which **raised**

**concerns** about debt sustainability, on May 9th, 2023. Figure 10 also shows that the yield gap between Pakistan’s sukuk and its 2027 Eurobond narrowed significantly after it agreed to a new **bailout deal** with the IMF at the end of July 2023.

Another possible reason for the lower yields among sukuk is that there is greater demand for sukuk, at least among some investors. For example, sharia-compliant investors with relatively few investment opportunities may be eager to buy sukuk even at a relative premium to otherwise similar bonds. In that case, fluctuations in the size of the yield gap would be positively correlated with the liquidity of sharia-compliant investors. Unfortunately, this hypothesis is difficult to verify without information about specific investors. Nevertheless, greater

demand for sukuk affecting secondary market prices seems likely, especially given the evidence presented in Section II(A)(ii) that greater demand affects the coupon rate at issuance.

Another notable difference in the yields between sukuk and bonds is their volatilities. Bond yields have significantly higher standard deviations than sukuk yields, as shown in Figure 11. Although variances differ widely between countries, we nevertheless see that bond yields fluctuate more than sukuk yields within a given country. The smallest relative difference in standard deviations among the four countries is in Pakistan, where bond yields have 22 percent higher standard deviation than sukuk yields. The largest difference is in Bahrain, where the bond yield’s standard deviation is 146 percent greater than the sukuk yield’s standard deviation.

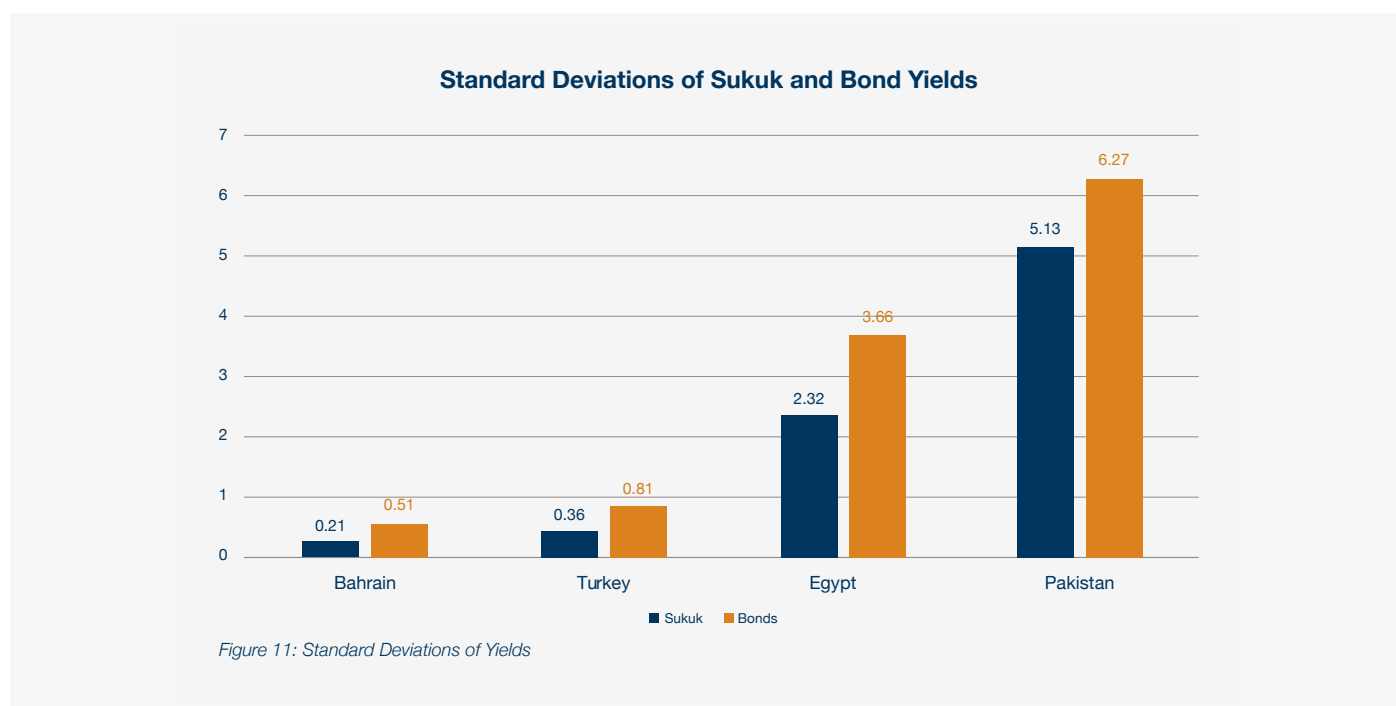


Figure 11: Standard Deviations of Yields. Source: Bloomberg (A&M analysis)

Less volatile sukuk yields are consistent with the notion that sukuk holders are on average less sensitive to market information than bondholders. One possible reason is that sukuk tend to attract buy-and-hold investors. Sharia standards impose limitations on secondary market trading of securities. Additionally, many Islamic banks prefer to hold sukuk until maturity, since the relative lack of supply of sukuk makes finding replacement investments difficult. They also often purchase and hold sukuk securities for regulatory reasons, e.g., to meet their high-quality liquid asset ratio requirements. As a result, sukuk markets are generally understood to be less liquid than conventional bond markets.

One would expect sukuk’s lower liquidity to raise their yields compared to conventional bonds to compensate investors for greater liquidity risk. If there was such a liquidity premium for sukuk, then the yield differences in Figure 10 and Table 5 would actually underestimate the degree to which the market expected sukuk to outperform conventional bonds.

The fact that the sukuk in our sample were largely issued after their comparison bonds may partially offset this liquidity effect. Although we compare sukuk to conventional bonds with similar maturity dates to generate Figure 10 and Table 5, the sukuk were issued later than their comparison bonds in each case except

one.<sup>19</sup> More recently issued securities tend to have slightly more liquid markets and thus lower yields, so this characteristic of our sample potentially introduces some negative bias into our estimates of sukuk yields compared to those of conventional bonds. Anecdotal, however, it does not seem that the bonds’ earlier dates of issuance have a large impact on pricing. For example, Pakistan’s Eurobond maturing in 2031 was issued within a year of its sukuk maturing in 2029 and yet has similar yields to the country’s 2027 bond and much higher yields than the 2029 sukuk. A more robust investigation into how secondary market liquidity affects sukuk yields could be a fruitful area of future research.

There is little reason to worry that relatively low sukuk transaction volumes significantly affect the accuracy or precision of our yield data. It seems unlikely that low transactions volumes would introduce systematic bias and therefore reduce the accuracy of yield estimates over time. Indeed, in Figure 10 sukuk yields typically increase or decrease simultaneously with those of similar bonds (even though their levels may differ), suggesting that the sukuk data correctly reflects changes in market pricing. And the fact that sukuk yields are less volatile than yields for conventional bonds suggests that sukuk yield estimates do not experience more random day-to-day variation than bond yields.

#### SOURCE:

<sup>19</sup> The Saudi Arabia 2028 sukuk was issued in January 2023, while the bond to which we compare it was issued in October 2022.



## IV. RESTRUCTURING SUKUK

The restructuring process for sovereign sukuk is an opaque and poorly understood area of law, given the small number of precedent cases (all in the corporate context), the relative newness of the market and the underdevelopment of statutory and regulatory regimes dealing with default in many issuing countries (e.g., in the Middle East). However, it is a topic that is likely to become increasingly relevant given the **precarious** debt positions of several sovereign issuers, including Pakistan, Egypt and Turkey.

There has been little work to address the question of how sukuk would be restructured. To date, there has never been a sovereign sukuk restructuring, and restructurings of corporate sukuk have been rare (see some examples in Appendix A). This note aims to fill this gap in our understanding of sukuk by examining the ways in which restructuring a sovereign sukuk would compare to the restructuring of a conventional bond. These insights rely on the analysis of the recent international sukuk prospectuses of Bahrain, Egypt, Hong Kong SAR, China, Indonesia, Malaysia, Oman, Pakistan, Saudi Arabia and Turkey. They also draw on conversations between the Alvarez & Marsal team and representatives of law firms, banks and other institutions involved in the issuance of international sukuk.

We conclude that the restructuring of international sukuk would be largely similar to the restructuring of a conventional international sovereign bond. The restructuring-related provisions typically included within sovereign bond contracts

are all found consistently and in substantially similar form within sovereign sukuk contracts. However, there are open questions regarding the operation of collective action clauses (CACs) within sovereign sukuk. Additionally, the requirement that sharia scholars approve any restructuring deal adds a layer of complexity to sukuk restructuring that does not exist in sovereign bond restructurings.

### A. Restructuring Provisions in Sukuk Contracts

Sovereign bond contracts contain a variety of boilerplate clauses to protect creditors during a default scenario and to facilitate orderly and equitable restructurings. These protections include pari passu clauses, negative pledge clauses, cross-default clauses, collective action clauses, foreign law clauses and waivers of immunity. Each of these mechanisms appear in all of the sovereign sukuk base prospectuses that we have reviewed, as shown in Table 7. We reference the most recent base prospectus we were able to locate for each country.

Inclusion of these standard credit boilerplate clauses helps ensure that a potential sovereign sukuk restructuring unfolds on terms that are familiar from previous bond restructurings. Below, we explain the relevance of each of these provisions to the restructuring process. These explanations use the text from the 2029 Pakistan sovereign sukuk for illustration, but the language in the other sukuk prospectuses identified within Table 7 is substantially similar.

Originator, prospectus year	Pari passu clause	Negative pledge clause	Cross-default clause	Single-limb CAC	Two limb CAC	English law	Non-local dispute resolution <sup>20</sup>	Waiver of immunity	Designated sukuk holder representative
Bahrain, 2019									
Egypt, 2023									
Indonesia, 2018									
Malaysia, 2015									
Oman, 2018									
Pakistan, 2022									
Saudi Arabia, 2019									
Turkey, 2022									

Table 7: Creditor protection clauses within sovereign sukuk

Clause included

SOURCE:

<sup>20</sup> Jurisdiction over disputes given to an arbitral tribunal, English courts and/or some other body outside of the jurisdiction of the originating country.

## i. Pari Passu Clauses

*The payment obligations of the Government (in any capacity) to the Trustee under the Transaction Documents to which it is a party in respect of each Series of Certificates are direct, unconditional and (subject to Condition 5) unsecured obligations of the Government and shall at all times rank pari passu with all other present and future unsecured and unsubordinated External Indebtedness of the Government.*<sup>21</sup>

The language above mimics the International Capital Markets Association's standard pari passu provision for sovereign notes issued under English law.<sup>22</sup>

The clause confirms that sovereign sukuk, like sovereign bonds, represent senior unsecured obligations of the government. As discussed in Section II of this paper, sovereign sukuk are typically designed as asset based rather than asset backed obligations. In other words, although sukuk payments are technically derived from specific assets, the certificate holders do not legally own those assets. As such, the sukuk holders do not have recourse to the assets if the government obligor ceases payment prematurely.

Indeed, the sukuk terms later note that, "the proceeds of the trust assets are the sole source of payment on the trust certificates."<sup>23</sup> They also state that if a "dissolution event" (i.e., a default) takes place, holders may elect to redeem their certificates at its par value.<sup>24</sup> However, they do not specify an option for investors to collect and liquidate the sukuk assets.

The exact meaning of the phrase pari passu in sovereign debt instruments is still unsettled. A New York judge in *NML Capital Ltd v. Argentina* determined that the clause requires debtors to refrain from making payments toward some obligations without making ratable payments toward all other pari passu obligations. In other words, debtors cannot pay some senior unsecured creditors while ignoring others. This interpretation would assure sukuk holders that their claims would remain on equal footing to those of other claimants if the government entered financial distress or undertook a restructuring.

Irrespective of the proper interpretation of the pari passu provision, substantially similar language appears in sovereign bonds issued under English law. Therefore, the pari passu clause within sukuk are unlikely to create issues that would not otherwise arise within a bond restructuring.

## ii. Negative Pledge Clauses

*The Government undertakes that, so long as any Certificate remains outstanding, the Government will not, save for the exceptions set out below in Condition 5(b), create, incur, assume or permit to subsist any Security upon the whole or any part of its assets or revenues to secure (i) any of its Public External Indebtedness; (ii) any of its Guarantees in respect of Public External Indebtedness; or (iii) the Public External Indebtedness of any other person without at the same time or prior thereto securing the Government's obligations under the Transaction Documents to which it is a party equally and rateably therewith or providing such other arrangement (whether or not comprising Security) as shall be approved by an Extraordinary Resolution of Certificate holders.*<sup>25</sup>

A negative pledge clause prohibits the obligor from pledging any of its present or future assets in order to secure its obligations to other creditors unless it also similarly secures its obligation to the certificate holders against the same assets. This commitment contains exceptions allowing the government to borrow on a secured basis to acquire property or finance projects.<sup>26</sup>

Negative pledge clauses help prevent the emergence of new senior secured claims on the obligor's assets. These assets would otherwise be unavailable to satisfy sukuk holders claims against the government in the event that it becomes distressed or defaults on its obligations.

## iii. Cross-Default Clauses

Sukuk certificates may be redeemed at the "Dissolution Distribution Amount" (i.e., face value)<sup>27</sup> if a "Dissolution Event" (i.e., an event of default) occurs.<sup>28</sup> Dissolution events not only include the government's failure to make scheduled payments to sukuk holders but also any default by the government on its other sukuk, external indebtedness, or guarantees of other entities' debts.<sup>29</sup>

These so called "cross-default" provisions prevent the government from selectively defaulting on its external obligations. They effectively trigger the default rights of all creditors and sukuk holders simultaneously. This provision avoids a piecemeal, inequitable, and potentially contentious restructuring process wherein some creditors are forced to accept less favorable payment terms while others enjoy full repayment.

### SOURCE:

<sup>21</sup> See Pakistan International Sukuk Terms and Conditions, art. 4(a).

<sup>22</sup> International Capital Markets Association, STANDARD PARI PASSU PROVISION FOR THE TERMS AND CONDITIONS OF SOVEREIGN NOTES, available at: <https://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf>.

<sup>23</sup> See Pakistan International Sukuk Terms and Conditions, art. 4(b); Saudi International Sukuk Terms and Conditions, art. 5.2.

<sup>24</sup> See Pakistan International Sukuk Terms and Conditions, art. 9(d); Saudi International Sukuk Terms and Conditions, art. 11.5.

<sup>25</sup> Id. at art. 5(a).

<sup>26</sup> Id. at 5(b).

<sup>27</sup> Redemption of sukuk certificates at the dissolution distribution amount is the equivalent of acceleration of principal repayment on a bond.

<sup>28</sup> Id. at 9(d).

<sup>29</sup> Id. at 1.

#### iv. Collective Action Clauses

The collective action clauses featured in the terms and conditions of sovereign sukuk notes are based on the International Capital Markets Association's "Standard Aggregated Collective Action Clause" from 2014.<sup>30</sup> This "enhanced CAC" design, which the IMF Executive Board endorsed in 2014, has become the gold standard for sovereign notes issued since the European debt crisis that began in 2009.

Collective action clauses facilitate widespread investor participation in the restructuring process. They bind all holders of a particular sukuk to any restructuring proposal approved by holders representing a supermajority (usually 75 percent) of the face value of that series.<sup>31</sup> This contractual tool prevents a small group of sukuk holders from strategically holding out from the restructuring process in the hope of receiving a better deal. It also reduces the level of coordination required of both sukuk holders and the government to amend the payment terms of the instrument.

In addition to allowing for easier restructurings of individual series of sukuk, CACs enable multiple sukuk to be restructured simultaneously as part of an aggregated vote across all affected series. International sovereign sukuk allow both "single limb" and "two limb" aggregated voting. The single limb process requires that holders "representing at least 75 percent of the aggregated face value of outstanding certificates" approve the proposal.<sup>32</sup> An additional requirement of a single limb restructuring is the "Uniformly Applicable" condition, which requires that the holders of all affected series are invited to exchange their instruments for the same new instrument or are allowed to select from the same menu of new instruments.<sup>33</sup> In short, each group of investors must receive the same deal from the government.

The two-limb process requires approval by holders of at least two-thirds of the aggregated face value across all affected series, as well as approval by holders of at least half of the aggregated face value of each affected series.<sup>34</sup>

The CACs included within sukuk also potentially enable aggregated voting across both sukuk and traditional bonds. We discuss this possibility at more length in the subsequent section.

#### v. Governing Law and Dispute Resolution

Finally, international sovereign sukuk certificates—including the terms and conditions described here—are issued under English law. The governments that have outstanding international sovereign sukuk also issue their sovereign bonds under English law. As such, a court's interpretation with the terms of the sukuk should align with a court's interpretation of any substantially similar language within sovereign bond.

It is worth mentioning that a sukuk arrangement consists of multiple contracts, some of which may be governed by local law. For example, the Pakistan 2029 sukuk consists of a Master Purchase Agreement, Master Lease Agreement, a Purchase Undertaking, a Service Agency Agreement, and a Master Trust Deed. The mixture of English and Pakistani law may potentially create loopholes or opportunities for strategic litigation that do not exist for a sovereign bond. However, the Trust Deed—which establishes the relationship between the Trustee and the certificate holders—and Payment Undertaking—which allows recourse against the sovereign in the event of default—are both governed by English law.

In addition to issuing key sukuk contracts under English law, sovereign originators grant jurisdiction over disputes related to the terms of the sukuk to non local bodies. Many sukuk agreements contain arbitration clauses, which state that any disputes arising in connection with the certificates shall be resolved through out of court arbitration.<sup>35</sup> Other sukuk assign jurisdiction to the courts of England.<sup>36</sup> Some sukuk allow for adjudication by local courts, but only at the election of certificate holders. These arrangements increase the likelihood that any conflicts during the default or restructuring process are resolved in an impartial manner. Granting exclusive jurisdiction to domestic courts, by contrast, would increase the risk of biased judgements in favor of the government.

Finally, as is typical in sovereign bond agreements, government originators waive their sovereign immunity privileges or the purposes of disputes regarding the sukuk arrangement.<sup>37</sup> As such, foreign court judgements and the decisions of arbitral tribunals can be enforced against state assets. Of course, as a practical matter, successful attachment of government property in sovereign debt litigation has been rare,<sup>38</sup> and the same is likely to be true in any litigation related to sovereign sukuk.

#### vi. Trustee/Delegate

The terms of sovereign sukuk certificates require the Trustee SPV to appoint a delegate to exercise its rights and responsibilities under the Trust Deed in the interest of the sukuk holders.<sup>39</sup> The role of the delegate is essentially the same as the role of a trustee in a conventional bond structure. The duties of the delegate may include monitoring the government's compliance with the sukuk arrangement, facilitating amendments or waivers to any terms of the sukuk, and calling and coordinating meetings of certificate holders.

The role of the delegate is important for at least two reasons. First, the investors themselves are not well equipped to serve as day to-day custodians and administrators of the sukuk. Second, the Trustee SPV, which is wholly owned by the government, is unlikely to attempt to enforce the sukuk against the government even if doing so would be in the best interest of its investors.

#### SOURCE:

<sup>30</sup> International Capital Markets Association, STANDARD AGGREGATED COLLECTIVE ACTION CLAUSES ("CACs") FOR THE TERMS AND CONDITIONS OF SOVEREIGN NOTES.

<sup>31</sup> Pakistan International Sukuk Terms and Conditions, art. 15(b)(iii)(A).

<sup>32</sup> *Id.* at 15(c)(iii).

<sup>33</sup> *Id.* at 15(c)(v).

<sup>34</sup> *Id.* at 15(d)(iii).

<sup>35</sup> See e.g., Terms and Conditions of the Trust Certificates, Saudi Arabia 2029 sukuk, art. 25.2.

<sup>36</sup> See e.g., Pakistan International Sukuk Terms and Conditions, art. 22(a).

<sup>37</sup> *Id.* at art. 22(c).

<sup>38</sup> Julian Schumacher, Christoph Trebesch, and Henrik Enderlein, What Explains Sovereign Debt Litigation?, 28 J. OF LAW & ECON. 585 (2015).

<sup>39</sup> *Id.* at art. 17.





## B. Complicating Factors

The contractual composition of sovereign sukuk suggests that restructuring these instruments is likely to be broadly similar to restructuring sovereign bonds. Nevertheless, there are at least two issues that make a restructuring involving sukuk potentially, more complicated than one that does not involve sukuk. The first is the use of enhanced CACs to aggregate voting across sukuk and conventional bonds. The second is the role of Islamic scholars as arbiters of the restructuring's compliance with sharia principles.

### i. Aggregation Across Sukuk and Bond Series

As discussed above, international sovereign sukuk typically include collective action clauses that allow for single limb and two limb voting. These clauses would allow multiple sukuk originated by the same sovereign to be aggregated into a single restructuring vote. However, the issue of whether and how sukuk could be aggregated with conventional bonds using CACs is more complicated.

Sukuk contracts typically allow the instruments to be restructured in an aggregated fashion alongside other “securities capable of aggregation.” The Pakistani prospectus defines this term as follows:

*those securities which include or incorporate by reference this Condition 15 and Condition 16 or provisions substantially in these terms which provide for the securities which include such provisions to be capable of being aggregated for voting purposes with other series of securities.*

In other words, the sukuk can be aggregated with other securities that contain substantially similar CACs. By contrast, the enhanced CACs in Pakistani sovereign Eurobonds identifies “*debt securities* capable of aggregation” (emphasis

added), which include “those debt securities” which include substantially similar CACs.<sup>40</sup> By design, sukuk are not debt securities but rather represent an ownership stake in tangible assets. The explicit reference to “debt” in the Eurobond CACs may create an opportunity for sukuk investors to object to aggregation with conventional bonds. However, the fact that the CACs included in the sukuk and bond contracts are otherwise virtually identical<sup>41</sup> suggests that the drafters of sukuk contracts intended for the possibility of aggregation with conventional bonds. Indeed, the lawyers with whom we have spoken generally believe that a cross-series aggregation involving sukuk and bonds would be possible.

Assuming sukuk-bond aggregation is possible, such aggregation would likely rely on two-limb voting. The single-limb process’s “Uniformly Applicable” condition would be difficult to meet, assuming that sharia-compliant investors would want to replace their sukuk with new sukuk and that bondholders would want to replace their bonds with new bonds. Theoretically, the government obligor could offer both groups a choice of whether to exchange their current notes for sukuk or bonds, but arranging sukuk to potentially cover all of a country’s outstanding bond obligations would be impractical.

Sukuk holders would directly participate in a cross-series aggregated vote, rather than having the trustee SPV—operating through the delegate—vote on their behalf. The sukuk terms specify that modification of one or more series of certificates requires approval by holders representing a specified percentage of the “aggregate face amount of the outstanding securities of the affected series.”<sup>42</sup> Any reference to “securities” means “trust certificates, bonds, debentures or other securities...issued directly or indirectly by the Trustee or Government.”<sup>43</sup> Given that individual investors, rather than the trustee SPV, own the trust certificates, those investors are the relevant voters on any restructuring proposal.



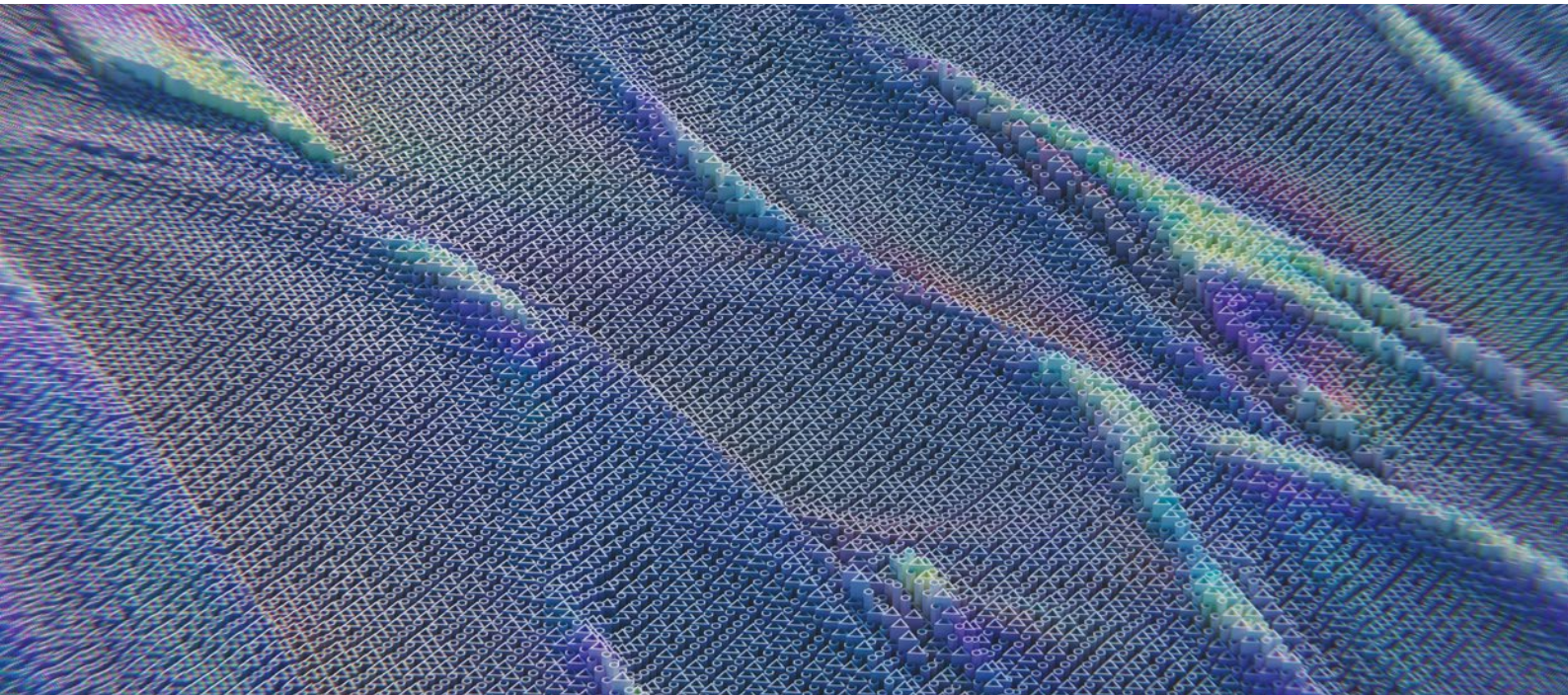
## ii. Approval by Sharia Scholars

Sukuk structures are typically approved by one or more groups of Islamic scholars to confirm their sharia-compliance prior to the issuance of certificates. For example, the Pakistan 2029 sukuk was approved by the Internal Sharia Supervisory Committee of Dubai Islamic Bank and the Standard Chartered Bank Global Shariah Supervisory Committee. The Saudi Arabia 2029 sukuk was approved by the Shari'a Supervisory Board of Citi Islamic Investment Bank, the Executive Sharia Committee of HSBC Saudi Arabia and several other bodies. These scholars may assess sharia-compliance based on standards published by Islamic finance organizations, such as the Accounting and Auditing Organization for Islamic Financial Institutions. Confirmation of sharia-compliance is a requirement for certain sharia-compliant investors to purchase the securities.

Similarly, sharia scholars would need to approve any restructuring proposal for that proposal to be palatable to Islamic investors.<sup>44</sup> For example, the scholars may want to confirm whether the asset base used for the original sukuk is suitable as a basis for the new notes issued to investors.<sup>45</sup> The sharia advisors would also need to approve any documentary amendments to be made to the instruments. A restructured instrument may remain valid under English law even without receiving sharia approval, but even non-sharia-compliant holders are unlikely to support a restructuring proposal that would close off the certificates to the sharia-compliant market.

The exact constraints that sharia law may put on the form of a future sovereign restructuring are not known, given the dearth of relevant precedent. Classic sharia scholarship also provides limited guidance, as it deals primarily with the obligations of natural legal persons, rather than businesses or states.<sup>46</sup> However, the sharia preference for parties to amicably resolve disputes through equitable means (al-sulh) suggests that they should have flexibility to decide on a resolution that is appropriate under the circumstances assuming that it avoids other sharia prohibitions (e.g., on interest, excessive risk-taking, etc.).<sup>47</sup> The underlying structure of a sukuk may play some role in the restructuring options available. For example, in Malaysia, a fixed-rate murabaha transaction must be restructured through the creation of a fresh sukuk facility and offering a coupon exchange.<sup>48</sup> By contrast, the terms of payment in an ijara contract could be amended directly through mutual agreement without conducting an exchange.

Lawyers with whom we spoke indicated that the involvement of sharia scholars would probably not prevent a deal that was otherwise agreeable to investors and the originating government. And although we do not know exactly how the first sovereign sukuk restructuring will unfold, sharia-compliance was not a binding impediment to the corporate sukuk restructurings described in the Appendix. Nevertheless, this additional layer of approval may add time and complexity to the sovereign restructuring process.



### SOURCE:

<sup>40</sup> Terms and Conditions of Pakistan Global Medium Term Note Programme, art. 15.1(i).

<sup>41</sup> *Id.* at art. 15.

<sup>42</sup> See Pakistan International Sukuk Terms and Conditions, art. 4(d)(ii).

<sup>43</sup> *Id.* at art. 15(a)(ix). <sup>44</sup> M.K. Hassan & M. Rashid, Post-Default Sukuk Restructuring: An Appraisal of Shari'ah Issues, 19 ISLAMIC FIN. REV. 133 (2019).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Peter Godwin & Azlin Ahmad, Issues to consider in Islamic financing enforcement or restructuring, HERBERT SMITH FREEHILLS (June 4, 2020).



## V. CONCLUSION

Governments are increasingly turning to sukuk meet their financing needs. This paper has shown that sukuk can often allow sovereigns to raise capital more cheaply than is possible using conventional international sovereign bonds. This is especially so for countries facing higher borrowing costs and lower creditor ratings. The analysis has also shown that this “sukuk discount” does not stem from any *de jure* or *de facto* seniority to other obligations of the sovereign. Neither does it appear to stem from any sukuk-specific legal provisions that would pay out sukuk holders over holders of other bonds in the event of a default.

Our overall goal in this paper was to demystify sovereign sukuk finance. Potentially fruitful areas for future research include: more detailed explorations of the factors that affect sukuk pricing; domestic regulatory regimes surrounding sukuk (e.g., in Turkey, Indonesia, and Malaysia); and whether particular sukuk structures are well suited to particular types of debtors.

We hope that this paper will open the door for more countries to consider sukuk as part of their broader public finance strategies and for researchers and practitioners to devote greater attention to this potentially important area of sovereign finance.



# APPENDIX: CORPORATE SUKUK DEFAULTS AND RESTRUCTURINGS

This appendix summarizes several high profile defaults of corporate sukuk, some of which were restructured.

## East Cameron Partners

**Facts:** East Cameron Partners (ECP) was an oil and gas company with gas properties in the United States. ECP issued a \$166 million sukuk al musharaka in 2006 with a maturity period of 13 years. The sukuk investors owned the right to receive a fraction of the proceeds from the two gas properties (an Overriding Royalty Interest). The issuing SPV was advertised as being “bankruptcy remote,” meaning that its assets would not be consolidated with ECP’s in a bankruptcy scenario. In 2008, the company defaulted on its periodic payments from sukuk holders.

ECP filed for Chapter 11 bankruptcy protection in the United States. It asked the court to consider the sukuk transaction as a loan to ECP secured by the Overriding Royalty Interest. This characterization would classify the sukuk holders as creditors who were required to share the assets of the corporation (including royalty interest) with other creditors.

**Outcome:** The bankruptcy court rejected ECP’s request, determining that the holders “invested in the sukuk certificates in reliance on the characterization of the transfer...as a true sale.” Therefore, the SPV legally owned the Overriding Royalty Interest and had an exclusive claim to that property. In other words, the court determined that ECP had originated an asset backed sukuk, rather than an asset-based sukuk.

## The Investment Dar

**Facts:** The Investment Dar (TID) is a sharia-compliant Kuwaiti holding company that engages in consumer and commercial financing, investment and asset management, and real estate development. In 2009, TID defaulted on a \$100 million sukuk and subsequently entered negotiations with creditors to restructure approximately \$3.5 billion in debts. The companies’ other obligations were also structured as sukuk, rather than as conventional debt instruments. TID was one of several Kuwaiti investment companies that defaulted during the global financial crisis after a loan financed buying spree in the prior years.

**Outcome:** TID agreed to a restructuring deal with creditors in 2011 that involved a liquidity injection by the group’s existing shareholders, an exchange of certain sukuk obligations for company equity, and full repayment of other obligations. However, even after that deal, TID continued to pursue restructurings of its other obligations. In 2016, Al Rajhi Bank, one of TID’s largest creditors, formed a creditors committee to negotiate a wider restructuring. Previous restructuring efforts had failed in part due to some creditors choosing to remain inactive.

Beginning in 2016, TID was also the subject of several litigation efforts by creditors seeking to enforce the company’s unfulfilled obligations. Because TID’s sukuk were issued domestically, these disputes were located in Kuwaiti courts.

## Dubai World

**Facts:** Nakheel World was a Dubai based real estate developer. In 2006, Nakheel originated a \$3.5 billion USD denominated sukuk that would mature in 2009. Dubai World, Nakheel’s parent company and an investment firm owned by the Government of Dubai, guaranteed the sukuk. The sukuk was structured as an ijara transaction, whereby certificate holders owned the leasehold interests on land, buildings, and other property on the Dubai waterfront. Following the 2008 global financial crisis, the Dubai government sought a standstill for \$59 billion owed by Dubai World, including the \$3.5 billion Nakheel sukuk.

**Outcome:** In December 2009, the Government of Abu Dhabi extended a \$10 billion loan to Dubai to help it pay off its debts. As a result, Dubai World was able to pay sukuk holders the full contractually mandated dissolution amount at maturity.

## Dana Gas

**Facts:** In 2017, the UAE energy company Dana Gas refused to redeem \$700 million in maturing dollar-denominated sukuk. The company argued that changes to Islamic finance standards in the years since the certificates were issued meant that they were no longer sharia-compliant and therefore unlawful in the UAE. Sukuk holders were unable to declare a default because of injunctions granted by English and UAE courts that were adjudicating the lawfulness of the instruments.

**Outcome:** A London High Court judge determined that the Dana Gas certificates, which were issued under English law, were “valid and enforceable.” The UAE court never reached a decision in the matter. In 2020, Dana Gas announced that it would fully repay sukuk holders using a combination of cash reserves and liquidity provided by a third party loan. The sukuk was never restructured.

## Garuda Indonesia

**Facts:** Garuda is the flag carrying airline of Indonesia. In June 2021, it **announced** that it would be unable to make payments on its \$500 million USD denominated sukuk because of reduced revenues during the COVID 19 pandemic. Around the same time, the company agreed to a temporary suspension of payments to other creditors and lessors while they negotiated a wider debt restructuring. Garuda had already restructured the sukuk once in 2020 by extending its maturity by three years.

**Outcome:** Garuda succeeded in restructuring the sukuk as part of a deal that covered \$9.58 billion of bank, bond, lease and other indebtedness. The plan was approved by 95% of the company’s creditors and subsequently ratified by an Indonesian court.





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