دار المراجعة الشرعيّة

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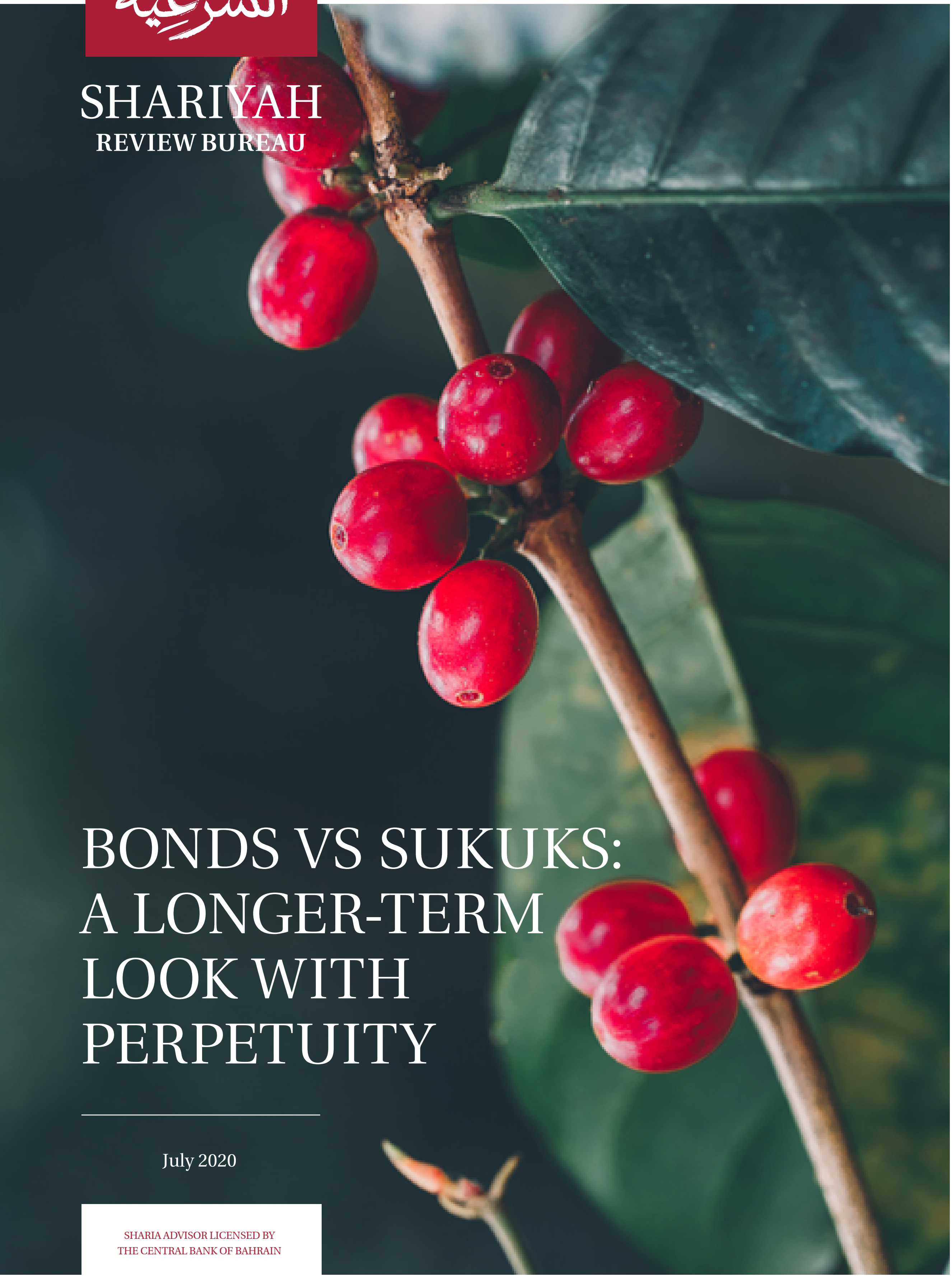

BONDS VS SUKUKS: A LONGER-TERM LOOK WITH PERPETUITY

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DIFFERENT TYPES OF SECURITIES

Assets have value and include real assets and financial assets. Real assets are physical assets such as land, buildings and gold. Financial assets are claims representing the right to some form of return or to ownership of physical assets. Tradeable financial assets are also known as securities. A security is a fungible, negotiable financial instrument that holds some type of monetary value. It represents an ownership position in a publicly-traded corporation (via stock), a creditor relationship with a governmental body or a corporation, or rights to ownership as represented by an option. Bonds are a common and popular low risk securities. However, bonds can be structured in a number of ways to attract different customers with specific risk-return requirements. This paper considers the Shariah compliance of perpetual bonds and looks at a proposed alternative in the form of perpetual sukuk.

INTRODUCTION TO BONDS

A bond is a type of investment that represents a loan between a borrower and a lender. Think of it as similar to getting a personal loan from a bank – except in this case you are the lender (known as the investor or creditor) and the borrower is generally a government or corporation (known as the issuer)[1]. With bonds, the issuer promises to make regular interest payments to the investor at a specified rate (the coupon rate) on the amount it has borrowed (the face amount) until a specified date (the maturity date). Once the bond matures, the interest payments stop, and the issuer is required to repay the face amount of the principal to the investor. Because the interest payments are made generally at set periods of time and are fairly predictable, bonds are often called fixed-income securities.

Example 1. Main features of a bond

A bond has a par value of £100, a coupon rate of 6% (paid annually), and a maturity date of three years. These characteristics mean the investor receives a coupon payment of £6 for each of the three years it is held. At the end of the three years, the investor receives back the £100 par value of the bond.

Par value = £100
Coupon Rate = 6%
Maturity = 3 years
Coupon Payment = £6.00

1 IIAC (2008), Bonds: An introduction to bond basic, Available from: http://iiac.ca/wp-content/themes/IIAC/resources/146/original/BondsEN.pdf

Difference between equity and debt investments

Bonds are considered debt investments. On the other hand, a stock purchase is considered an equity investment because the investor (also known as the stockholder) acquires a beneficial interest and equitable ownership in the corporation. The issuers of stock or equity are typically companies; issuers of debt can be either companies or governments. While bonds generally don't provide an opportunity to share in the profits of the corporation, the stockholder is entitled to receive a portion of the profits and may also be given voting rights. Bondholders earn interest while stockholders typically receive dividends. Both may experience capital gains or capital losses if the price at which they sell their holdings is, respectively, higher or lower than the price at which they bought them. Coupon rates are most often fixed – the rate of interest stays constant throughout the life of the bond. However, some bonds have variable or floating coupon rates (interest payments change from period to period based on a predetermined schedule or formula). Some bonds pay no interest at all until maturity. Because bondholders are creditors rather than part owners, if a corporation goes bankrupt, bondholders have a higher claim on assets than stockholders. This provides added security to the bond investor – but does not completely eliminate risk. Finally, bonds also trade differently from stocks. Bonds typically trade in the over-the-counter (OTC) market – for example, from a broker to a broker at another firm directly – instead of on a stock exchange.

Different types of bonds

Bonds include a very broad array of different products that have markedly different terms and conditions. They range from so-called 'simple bonds' to some very complex debt securities.
A bond is regarded as a 'simple bond' if:

- it has a fixed or floating coupon rate that does not change for the life of the security;
- interest payments under the security are paid periodically and cannot be deferred or
- capitalised by the issuer;
- it has a fixed maturity date which is not more than 15 years after its date of issue;
- it is not subordinated to other debts owed to unsecured creditors generally; and
- it does not attach any options to convert it to equity or to extinguish it (so-called 'knock-out' options).

Examples of more complex bonds include:

- bonds that allow the issuer to defer or capitalise interest payments under certain conditions;
- bonds that provide for the coupon rate to be re-set at certain times (often called 're-set' or 're-settable' bonds);
- bonds that give the issuer the option to extend them but at the price of paying a higher coupon rate (typically called 'step-up bonds'); and
- bonds that are more properly characterised as 'hybrid securities', in that they combine features of debt securities and equity securities. Examples include convertible or converting bonds (bonds that convert into shares or other securities under certain conditions), perpetual bonds (bonds which don't have a maturity date), subordinated bonds (bonds that are subordinated to the claims of other creditors) and knock-out bonds (bonds that give the issuer or a third party a right to extinguish them under certain conditions).

INTRODUCTION TO PERPETUAL BONDS

Perpetual bonds are fixed income securities without any maturity dates tied to it. Perpetual bonds are ranked higher than normal equities and classified to be junior to bonds with a defined maturity. Perpetual bonds are also commonly known as “*Perps*” or “*Consol*”. The interest on the principal amount is paid out in perpetuity. In essence, the notion of perpetual bond is quite similar to a dividend-paying share in the sense where as long as investors are in possession of the bond, they will be getting a recurring interest pay-out for as long as the bond is with them[2].

A perpetual bond differs from an ordinary bond in the following ways[3]:

- Perpetual bonds have no maturity date.
- Perpetual bonds usually have a callable feature. This entitles the issuer to pay back the bond early under certain conditions.
- If the issuer gets into financial difficulties, it may decide to reduce the coupons or not to pay them at all. The coupon is therefore not guaranteed.
- A perpetual bond also has a number of features of an equity investment. The risk inherent in such an investment is therefore considerably greater than that in a classic bond.

A company may issue a perpetual bond which offers a coupon payment forever, at least theoretically. The issuer does not have to redeem perpetual bonds but is responsible for coupon payments.

Perpetual bonds are used as a source of subordinated debt. Since it does not have to be repaid, it is considered a source of Tier 1 capital (i.e. equity capital and disclosed reserves) for banks. When issued by a bank, perpetual bonds help to fulfill the bank’s capital reserve requirements. Even though they are technically a form of debt, they qualify as “equity” on the bank balance sheet. Although there is usually no set maturity date, perpetual bonds may be structured to allow the bonds to be callable after a set period of time, usually between 5 and 10 years. This is especially important if the interest rates fall sharply and the issuer needs to reduce the interest cost[4].

2 Lau,L. (2018), This is what you should know about perpetual bonds, Zuuonline. Retrieved from: https://zuuonline.sg/investment/bonds/this-is-what-you-should-know-about-perpetual-bonds/

3 BNP Paribad, What are perpetual bonds? Retrieved from: https://www.bnpparibasfortis.be/rsc/contrib/document/1-Website/5-Docserver/BNP/F04824E.pdf

4 Investing Answers, Perpetual Bond, Retrieved from: https://investinganswers.com/financial-dictionary/bonds/perpetual-bond-1597

Advantages and Disadvantages of Perpetual Bonds

From a conventional financial perspective, some of the said advantages of perpetual bonds are as follows:

1. Perpetual bond holders will be able to receive fixed interest repayments on a fixed schedule for an indefinite amount of time till a specific date is given from the issuer to redeem the bond.

2. Some perpetual bonds come with a “step up” feature that increases the interest payment at a predetermined point in the future. In technical terms, this is referred to as a “growing perpetuity.” The step-up feature may include conditions such as holding onto bonds for above X number of years would trigger an increase in interest for higher pay-outs.

3. Perpetual bonds have a higher yield than normal bonds.

4. Perpetual bonds can be traded in the secondary market.

Some of the said disadvantages of perpetual bonds are as follows:

1. Perpetual bond holders do not have any control over when the bond will be redeemed nor do they have any rights to affect or request the call dates as this decision can only be made by the issuer.

2. Issuers are not obliged to redeem perpetual bonds as it is non-redemptional in and of itself.

3. Investors have to bear with the credit rating of the issuer for a very long period of time, this can be a matter of concern if financials deteriorate. This is the reason that perpetual bonds are considered to be equity-like securities. In some issuances, there are clauses which allow the bonds to be converted into equity on pre-set conditions.

4. Perpetual bonds do not come with voting rights, unlike ordinary shares, so holders do not get a say on any aspect of the issuing firm.

Risks in Perpetual bonds

Perpetual bonds are exposed to a number of risks such as:

Currency risk
If perpetual bonds are invested via foreign currency, there is a currency risk. The amount that can be received in a foreign currency in the event of sale or on the expiry date can be more or less than the amount that originally invested owing to the exchange rate.

Liquidity risk
A bond's liquidity reflects whether it is easy or difficult to sell the bond on the market. Liquid bonds are easy to buy and sell. Illiquid bonds are more difficult to buy and sell. Perpetual bonds can only be traded on a limited market.

Interest rate risk
The value of a bond is considerably dependent on the evolution of the market interest rate: if the interest rate rises, a bond's value falls; and if the interest rate falls, the bond's value rises. The longer the term of the bond, the more the value will rise or fall if there is a change in the market interest rate. The interest rate risk inherent in perpetuals is therefore greater than in classic bonds.

Insolvency risk
The lengthy term in perpetual bonds means that investors are inevitably exposed for a long period to the issuer's credit risk, which can increase in regard to the time of issue or of purchase at a later date. Perpetual bonds are often very strongly subordinated bonds. This means that, in the event of bankruptcy, an investor will only be paid back after all creditors and after the holders of classic subordinated bonds. It is therefore highly unlikely that in such a case one will recoup any of their outlay[5].

Credit Risk[6]
The tenure of perps is uncertain, so it is possible that the fundamentals of the issuer will eventually change, sometimes for the worse. If so, it could have an adverse impact on the issuer's ability to meet payments to the perp holders.

Call Risk
Perpetual bonds may have a call provision, which allows the issuer to redeem the securities at a certain redemption value. This is an option, not an obligation. Generally, issuers exercise the call provision when it best suits them, but not necessarily the holders.

Reinvestment Risk
Issuers can call back high-coupon-rate perpetual bonds when interest rates are low, but this subjects investors to reinvestment risks.

Cash Flow Risk
With some bonds, the issuer may be able to defer all or part of the distribution payments without triggering a default.

5 BNP Paribad, What are perpetual bonds? Retrieved from: https://www.bnpparibasfortis.be/rsc/contrib/document/1-Website/5-Docserver/BNP/F04824E.pdf

6 Shareinvestor. Ups and downs when investing in perpetual securities. Retrieved from: https://blog.shareinvestor.com/ups-and-downs-when-investing-in-perpetual-securities/

SHARIAH REVIEW OF PERPETUAL BOND

A bond is a debt obligation for which the issuer pays a pre-determined rate of return to the bond holder. There is no investment in any underlying asset; rather, the issuer has a personal right and a liability on his legal personality. A repayment of debt with interest is due to the bond holder. The payment for the bond is effectively a loan (*Qard*) from a Shariah perspective.

In Islam, a loan (*Qard*) is considered a gratuitous contract, and it is commendable for a lender to provide a loan to a borrower who needs money. Both the Qur'an and Sunnah promise reward to a lender who provides a loan to a person in need. The fact that the Shariah prohibits the lender to derive any conditional benefit from the loan further emphasises its gratuitous nature. It also implies that the loan contract should not be used for profiteering purposes. Thus, any profit or additional return in lieu of the loan is impermissible and non-Shariah compliant. Both the Qur'an and Sunnah have prohibited the lender from charging the borrower any additional amount. The Qur'an emphasises that the lender is entitled to receive the principal amount. It states:

> 'O you who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from Allah and His Messenger. But if you turn back, you shall have your capital sums: Deal not unjustly, and you shall not be dealt with unjustly'
>
> (al-Qur'an, 2:278-279).

A famous juristic maxim also states: "Any loan which draws an increment is Riba" (Ibn Abi Shaybah). *Riba* is more than just simple interest and compound interest; *Riba* is an unjustified excess in a bilateral contract which is stipulated for one of the two transacting parties and is without consideration.

To elaborate, there are two types of *Riba*:

1. *Riba al-Nasi'ah* is the advantage and excess gained without consideration by deferring delivery of any homogenous counter exchanges. This excess manifests upon default or delay in payment where time is factored as a consideration.
2. *Riba al-Fadhl* is a contractually agreed excess in units without any consideration in an exchange of homogeneous goods.

Shariah has not considered money to be a commodity but a medium of exchange. When money of the same genus is exchanged, it must be on spot and in equal quantity. Exchanging different amounts at different times brings into effect both forms of *Riba: Riba al-Nasi`ah* and *Riba al-Fadhl*.

SHARIAH COMPLIANT ALTERNATIVE TO BONDS

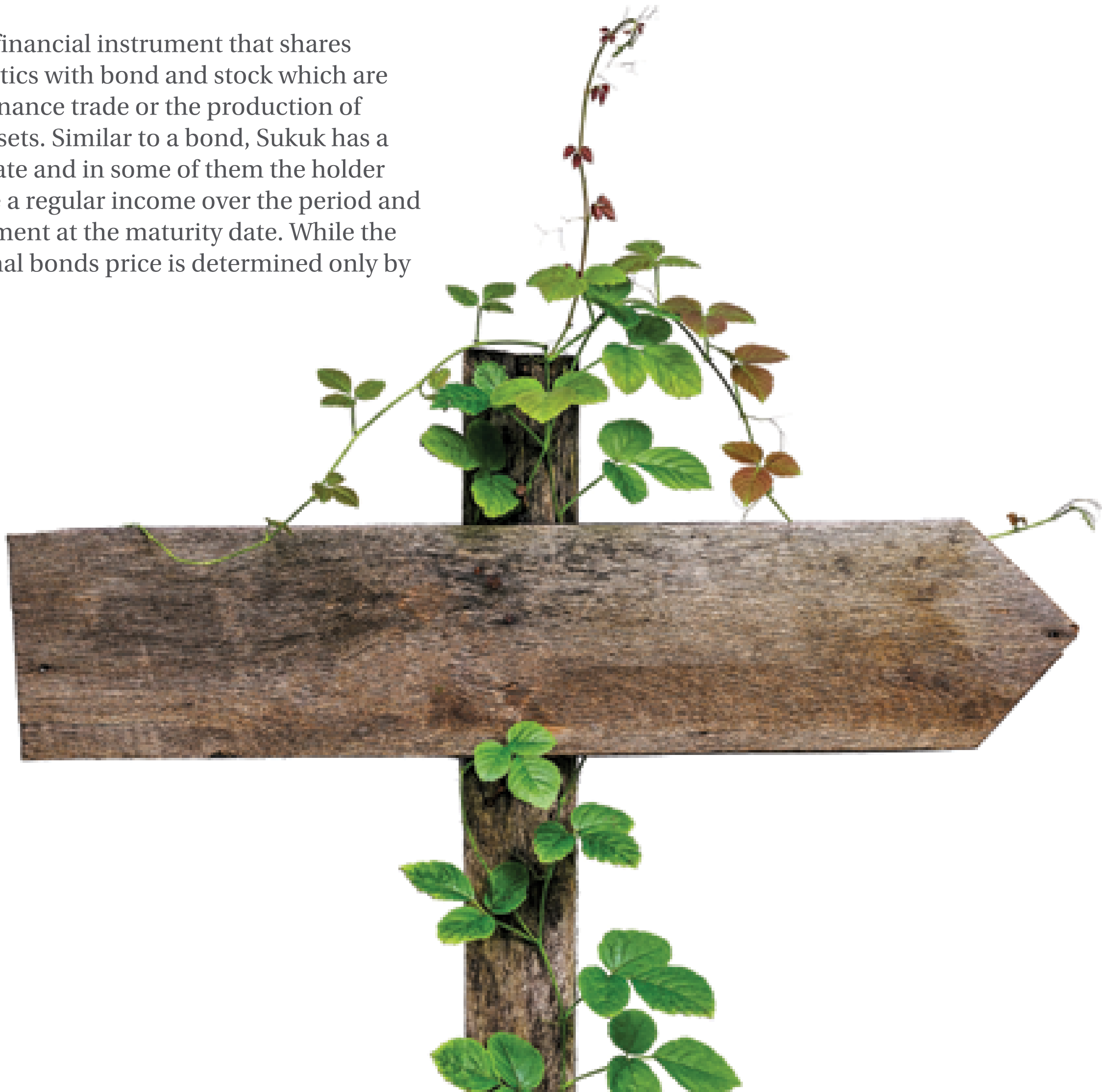
An alternative to a perpetual bond can be perpetual Sukuk. The AAOIFI Shariah Standard No.21 proposes an alternative to bonds by stating: “The Shari’ah substitute for bonds is investment Sukuk.”

The overall risk profile and economic return for a Sukuk investor has some similarities albeit differences to a conventional bond where the bondholder is a debtor of the issuer.

AAOIFI defines Sukuk as being: “Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activities.” Unlike a conventional bond (secured or unsecured), which represents the debt obligation of the issuer, a Sukuk technically represents an interest in an underlying funding arrangement structured according to Shariah, entitling the holder to a proportionate share of the returns and at a defined future date the return of capital.

Sukuk is a financial instrument that shares characteristics with bond and stock which are issued to finance trade or the production of tangible assets. Similar to a bond, Sukuk has a maturity date and in some of them the holder will receive a regular income over the period and a final payment at the maturity date. While the conventional bonds price is determined only by the creditworthiness of the issuer, Sukuk price is determined by the creditworthiness of the issuer and the value of the asset. Although Sukuk is also similar to stocks in the sense that it represents ownership and no guarantee of a fixed return (at least theoretically and in the standard model of Sukuk) but stocks have no maturity date. Sukuk also have to relate to a specific asset, project or service.

Among the benefits of Sukuk are that most Sukuk are a tradable capital market product providing medium to long-term fixed or variable rates of return. It is assessed and rated by international rating agencies, which investors use as a guideline to assess risk/return parameters of a Sukuk issuance. It has regular periodic income streams during the investment period with easy and efficient settlement and a possibility of capital appreciation of the Sukuk. Finally, most Sukuk are liquid instruments and tradable in secondary market.



PERPETUAL SUKUK

Perpetual sukuk are issued by corporates and Islamic banks. Perpetual sukuk are debt securities with no fixed maturity date. They are regarded as hybrid securities because they are a debt security with equity-like features due to the absence of maturity, hence such Sukuk are treated as equity rather than debt. Perpetual Sukuk are viewed as part of capital due to the absence of a redemption date. Sukuk holders cannot redeem their certificates (Sukuk) unless a redemption trigger event occurs. In case of redemption, Sukuk may be redeemed in whole but not in part. Perpetual Sukuk have the features of "permanence" and "loss absorption" which means the Sukuk carry a perpetual legal tenure and subordinated to debt and other liabilities of the Sukuk issuer. Perpetual Sukuk are innovative form of debt instruments (from a legal standpoint) with equity-like features that typically ranks senior only to common equity[7].

In the last decade, a number of Islamic banks have issued perpetual Sukuk to strengthen their Tier-1 capital requirements to comply with the Basel III regulations. Abu Dhabi Islamic Bank recently issued a $750 million perpetual Sukuk[8] which was based on Sukuk al-Mudharabah. Corporate institutions have also issued perpetual sukuk to raise capital. Malaysia Airline System Berhad issued a perpetual junior sukuk whilst Malaysia Airports Holdings Berhad issued a perpetual subordinated Sukuk both based on Sukuk al-Musharakah.

Features of perpetual Sukuk issued by corporate issuers[9]:

- Perpetual sukuk are contractually subordinate to the claims of external creditors. If the issuer faces liquidation, the outstanding claim from the perpetual sukuk will rank junior to a straight debt obligation but senior to the issuer's ordinary shares and typically to preference shares as well.
- Perpetual tenure is required for accounting equity treatment.
- Perpetual sukuk generally carry the right or option of the issuer to redeem the perpetual sukuk. This is done to preserve the equity-like characteristics.
- Perpetual sukuk initially pay a fixed profit rate; however, after the first call date they commonly include a step-up profit feature where the prevailing profit rate will be revised. The step-up profit feature is also used as an incentive.
- In order to be recognised as equity under accounting standards, the issuer must have the ability to defer profit without being in default. This feature gives perpetual sukuk characteristics similar to equity in that the instrument absorbs losses before other senior creditors when the issuer's financial conditions deteriorate.
- Perpetual sukuk provide protection to senior and other creditors. Such sukuk provide a capital cushion to absorb any unexpected losses.

7 Zofaghari, P. (2017). An Introduction to Islamic Securities. Uppsala: Faculty of Law Working paper. Retrieved from: http://www.jur.uu.se/digitalAssets/563/c_563862-l_3-k_wps2017-2.pdf

8 Thomson Reuters (2018). Abu Dhabi Islamic raises $750 million in Tier 1 perpetual sukuk.

9 Fitri Ellias et al. (2015). Perpetual Sukuk: A Preliminary Shariah assessment. Kuala Lumpar: Shariah Forum KLIFF. Retrieved online:

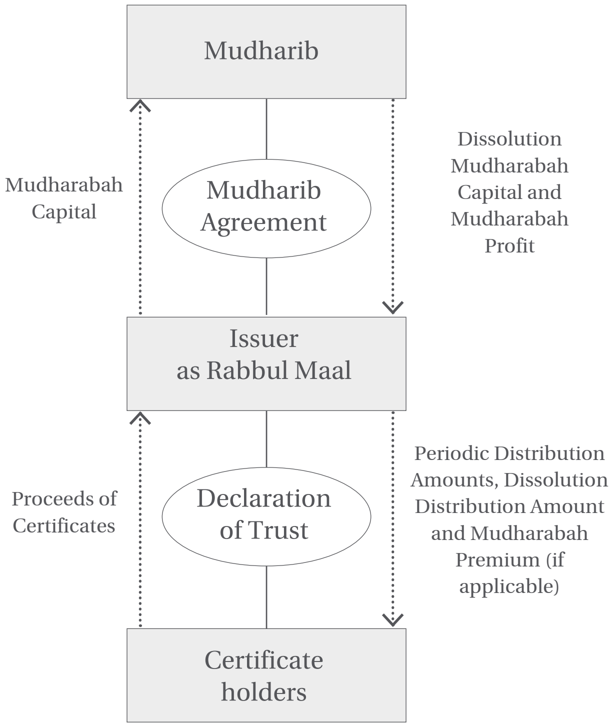
Since perpetual sukuk issued by Islamic banks are used to strengthen Tier 1 (T1) capital they need to meet Basel III requirements as well as any additional regulatory requirements by the central bank of their respective jurisdiction. Some of the Basel III requirements are as follows:

- AT1 instruments must not have step-up features or other incentives to redeem, including a call option.
- Distributions/payments shall always be at the full discretion of the financial institution, and as such any waived distributions/payments are non-cumulative.
- Write-off or conversion mechanisms for achieving principal loss absorption.

A perpetual sukuk has some of the following benefits:

- Represent a unique balance sheet management tool which is potentially cost effective;
- Denote a non-dilutive way of shoring up capital, i.e. they entail no adverse effect of shareholder dilution;
- Represent a longer-term mode of funding compared to straight or plain vanilla Sukuk
- Enhance the issuer's credit profile due to increased financial flexibility and efficient capital management, in particular where perpetual Sukuk are treated as equity from the accounting standpoint; and
- Offer investors a potentially attractive risk and return profile compared to senior Sukuk[10]

The Abu Dhabi Islamic Bank's perpetual sukuk has been processed in the following manner:



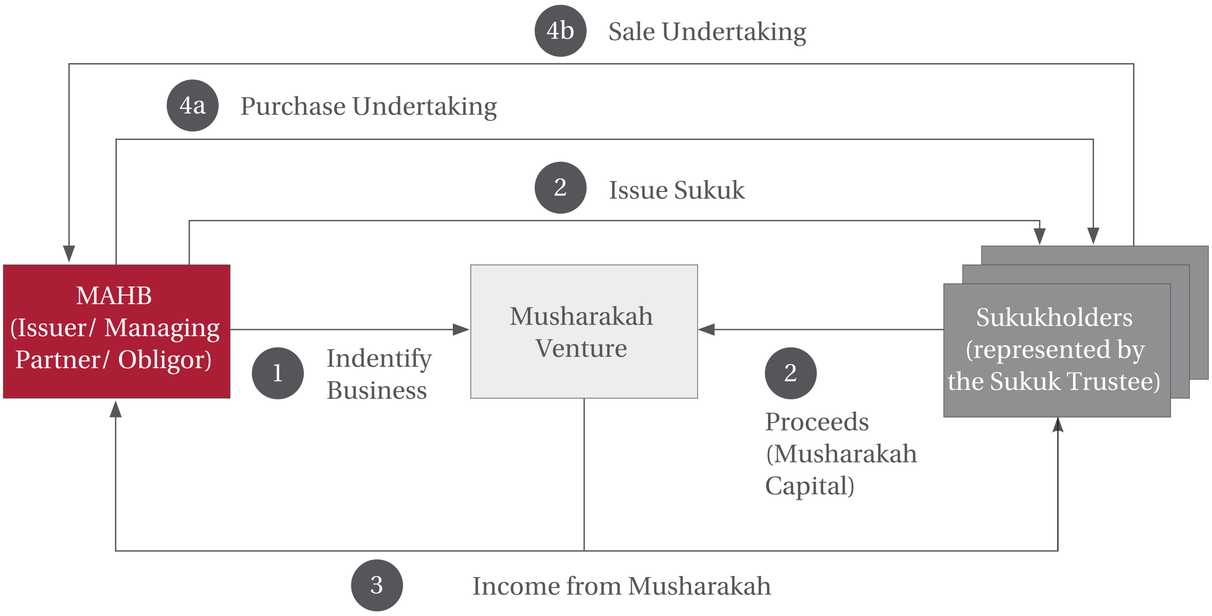
The prospectus describes the steps of the Sukuk structure in the following manner:

1. The certificate holders will pay the issue price for the certificates after which a trust is formed.
2. The trustee applies the proceeds as the capital of Mudharabah. Abu Dhabi Islamic bank as the Mudharib will invest the capital in the business activities of the bank.
3. The profit is distributed periodically between the certificate holders (Rabbul Maal) and the bank (Mudharib)



10 Fitri Ellias et al. (2015). Perpetual Sukuk: A Preliminary Shariah assessment. Kuala Lumpar: Shariah Forum KLIFF.

Malaysia Airports Holdings Berhad's perpetual subordinated Sukuk was structured in the following manner:



The Principle Terms and Conditions describes the steps in the following manner:

1. The Sukuk trustee (on behalf of all the Sukuk holders) and MAHB will enter into a master Musharakah agreement under which, the parties as Musharakah partners may, from time to time, enter into Musharakah agreements

2. The Sukuk holders shall provide capital contribution to the Musharakah venture through subscription of the Sukuk Musharakah which will be issued by the issuer.

3. Income from the Musharakah venture shall be distributed to each partner based on a profit-sharing ratio which will be determined prior to the issuance of the Sukuk Musharakah. Any losses incurred in the Musharakah venture shall be borne by each partner in proportion to each partner's respective capital contribution in the Musharakah venture.

Conclusion

A bond is a type of investment that represents a loan between a borrower and a lender. There are various types of bonds. Perpetual bonds have features similar to an equity investment as they do not have a maturity date and they usually have a callable feature too. Since it does not have to be repaid, it is considered a source of Tier 1 capital (i.e. equity capital and disclosed reserves) for banks. From a Shariah perspective, a bond is a interest-based (*riba*) debt obligation for which the issuer pays a pre-determined rate of return to the bond holder. An alternative to perpetual bonds is perpetual Sukuk. Perpetual sukuk are issued by corporates and Islamic banks. Perpetual sukuk are regarded as hybrid securities because they are a debt security with equity-like features due to the absence of maturity, hence such Sukuk are treated as equity rather than debt.

ABOUT SRB

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We've been preparing our clients for a new world in which Sharia Advisory rapidly becomes the currency of choice. From faster Certification programs, to direct Sharia Supervisory access, and perhaps most critically, navigating through the economic structures of clients offerings within a matter of days. We've have been working hard to help clients like you capitalize on opportunities in global Islamic financial markets.

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The future of Sharia Advisory and Audit is exciting and we are very lucky to be a part of this business!

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