

Diploma in Islamic Banking (DIB), Part-I
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Code :101 (Alternative Financial System)

SESSION-III

Sukuk: Definition, Features, Classifications, Process
Takaful: Concept, Features, Historical Development

Presented by

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Session overview

The following important points will be covered as per [chapter 6](#) (Sukuk Market) and [chapter-7](#) (Takaful) of Code-101 of DIB Part-I:

1. Concept of Sukuk
2. How does Sukuk differ from Conventional Bond
3. Features of Sukuk
4. Securitization
5. Types of Sukuk
6. Prospect of Sukuk in Bangladesh
7. Recapping Sukuk

1. Risk concept in Shari'ah
2. Takaful
3. Why is Conventional insurance not acceptable by Shari'ah
4. Historical Development of Takaful as an alternative to conventional insurance
5. Types of Takaful business models
6. Differences between Islamic and conventional insurance
7. Recapping Takaful

1.1 Meaning and Definition of Sukuk

Sukuk is plural for Arabic word Sakk (صك). This word was used mostly in the Middle Ages to refer to “certificates” or papers denoting financial obligations from commercial activities.

AAOIFI Shari’ah Standard No. 17 “*Investment Sukuk*” defines Sukuk in the following manner:

“Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.”

[Ref.: AAOIFI Shari’ah Standard No. 17, Sec. 4/1/2/11]



2. How does Sukuk Differ from Conventional Bond?

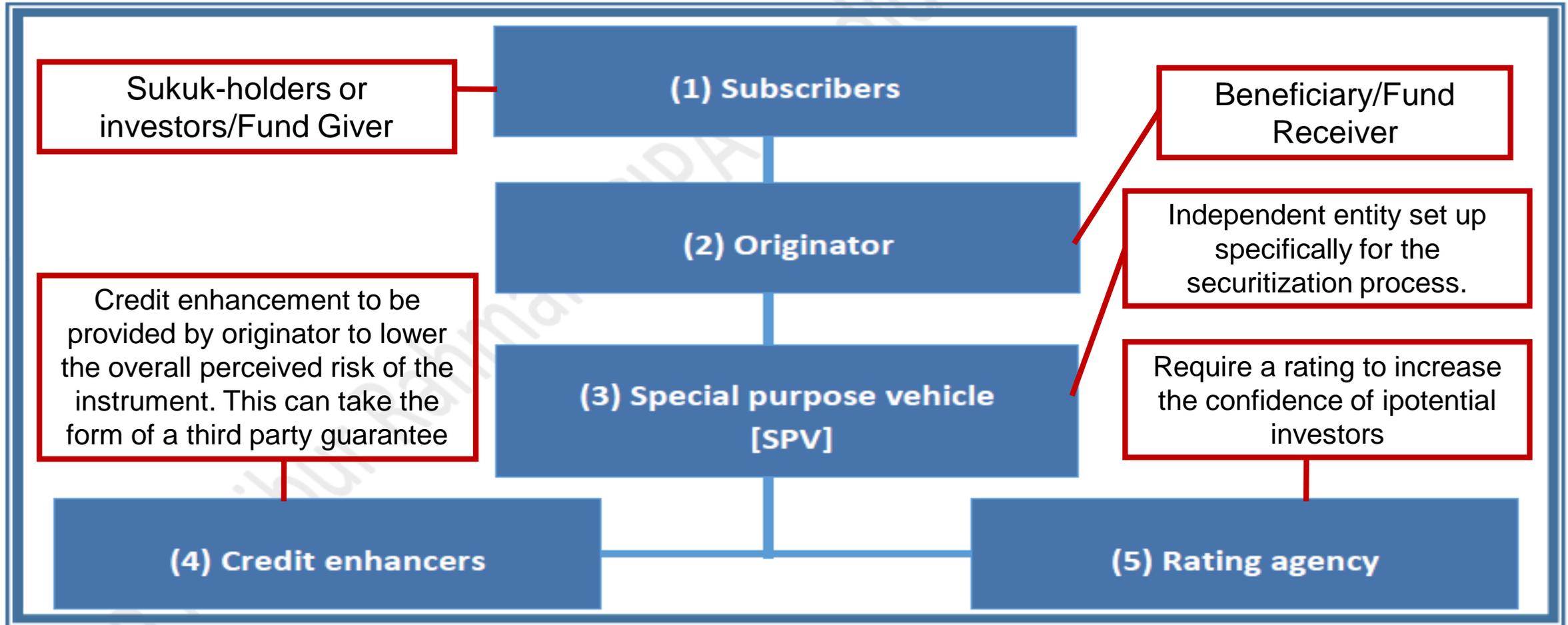
	Sukuk	Bonds
<i>Ownership</i>	Partial ownership of an asset.	Debt obligation.
<i>Compliance</i>	The assets that back sukuk should be compliant with Shariah.	Compliance with laws of country/locality they are issued in.
<i>Pricing</i>	The face value of a sukuk is priced according to the value of the assets backing them.	Bond pricing is based on credit rating, i.e. the issuer's credit worthiness.
<i>Rewards and risks</i>	<ul style="list-style-type: none"> ▪ Sukuk holder receives a share of profits from the underlying asset ▪ Sukuk holder accepts a share of any loss incurred 	<ul style="list-style-type: none"> ▪ Returns from bonds correspond to fixed interest (making them <i>riba</i>) ▪ Their principal is guaranteed to be returned at the bond's maturity date
<i>Effects of costs</i>	Sukuk holders are affected by costs related to the underlying asset. Higher costs may translate to lower investor profits and vice versa.	Bond holders generally aren't affected by costs related to the asset, project, business, or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.
<i>Sales</i>	Sale of ownership in the assets backing them.	Sale of debt.

4. Securitization

- Before understanding the mechanism of Sukuk, it is important to understand the concept of and need for securitization.
- **Securitization** is the process of **packaging a pool of assets into tradable securities** that can be sold to investors (through Sukuk) in the capital market.
- AAOIFI defines securitization as:
“... a process of **dividing ownership of tangible assets, usufructs or both into units of equal value** and issue securities as per their value. [AAOIFI Shari’ah standard no. 17: Investment Sukuk – Appendix (C)]
- Securitization allows an entity to **utilize non-marketable** assets on its balance sheet by packaging them into a pool of assets and transforming them into marketable assets.



4.1 Schematic presentation of Securitization



5. Types of Sukuk

**Sukuk Based on
Predictability of **Return****

**Sukuk Based on
Shari`ah **Contracts****

**Sukuk Based on
Underlying Asset**

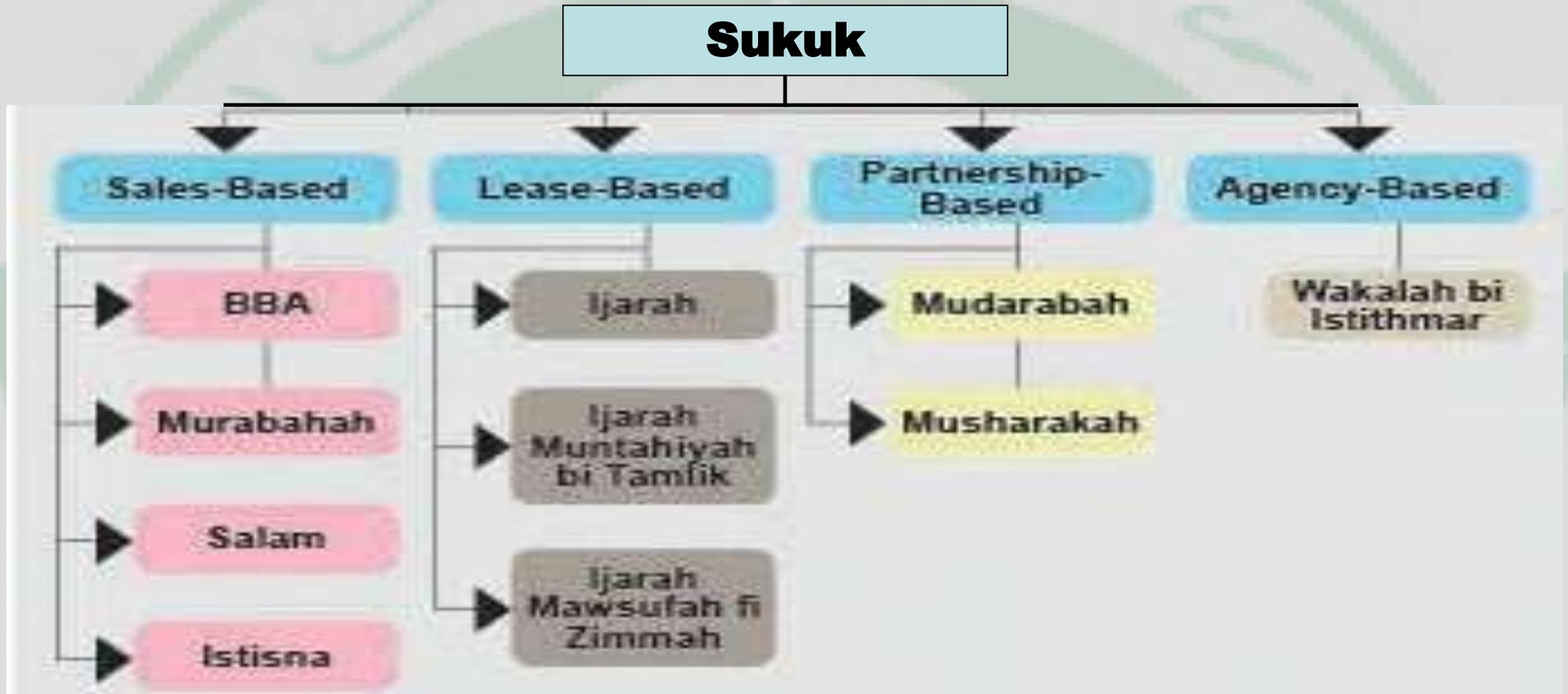
5.1 Types of Sukuk

(Based on Predictability of Return)

Debt type instruments	Debt-type instruments are investments that have terms providing fixed or determinable payments of profits and capital to the holder of instrument	Murabaha Sukuk <hr/> Salam Sukuk <hr/> Istisna'a Sukuk <hr/> Ijarah Sukuk
Equity type instruments	Equity type instruments are investments that do not exhibit features of debt-type instruments and include instruments that evidence a residual interest in the assets of an entity after deducting all its liabilities	Musharaka Sukuk <hr/> Mudaraba Sukuk

Source: AAOIFI Shari'ah Standard No. 17 "Investment Sukuk" & AAOIFI Financial Accounting Standard No. 25 "Investment in Sukuk, shares and similar instruments"

5.2 Types of Sukuk (Based on Shari`ah Contracts)

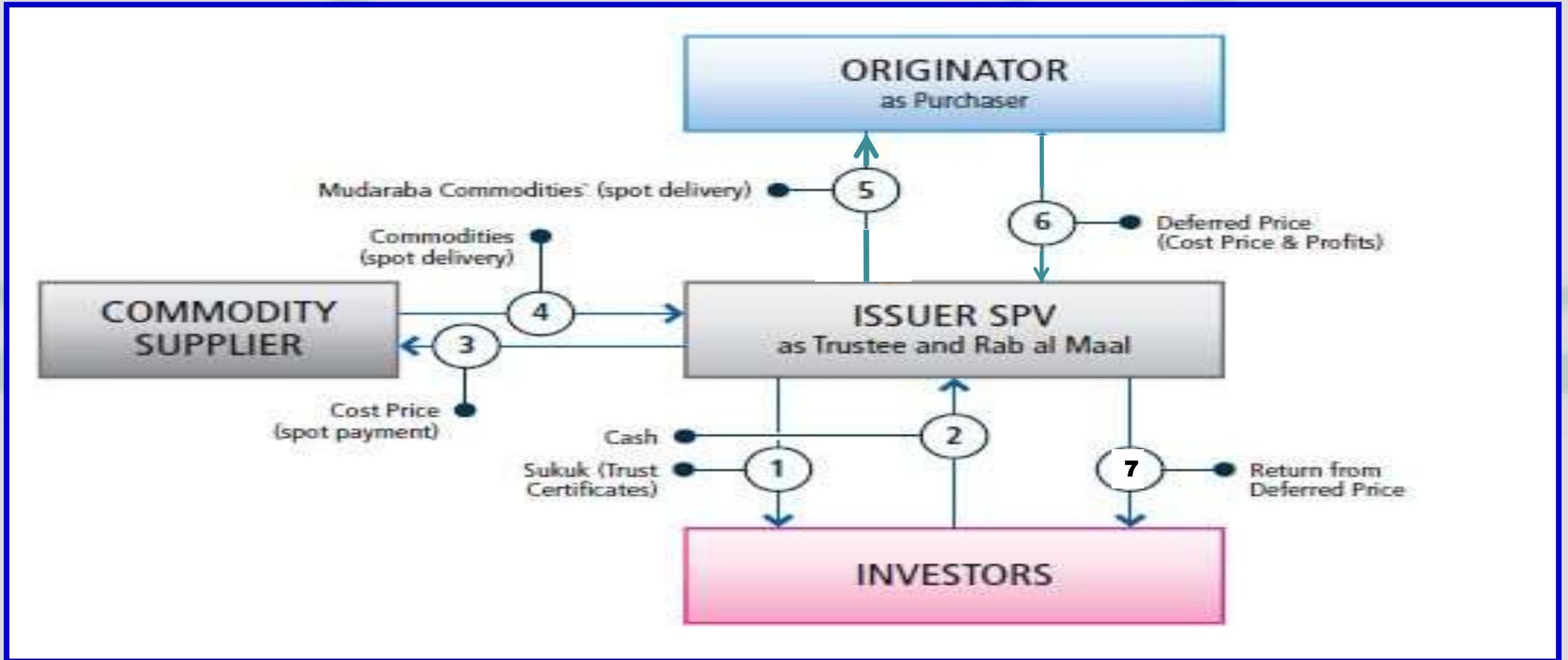


Source: Islamic Capital Market – Vol 5 , Securities Commission Malaysia (2009)

5.3 Types of Sukuk (Based on Underlying Asset)

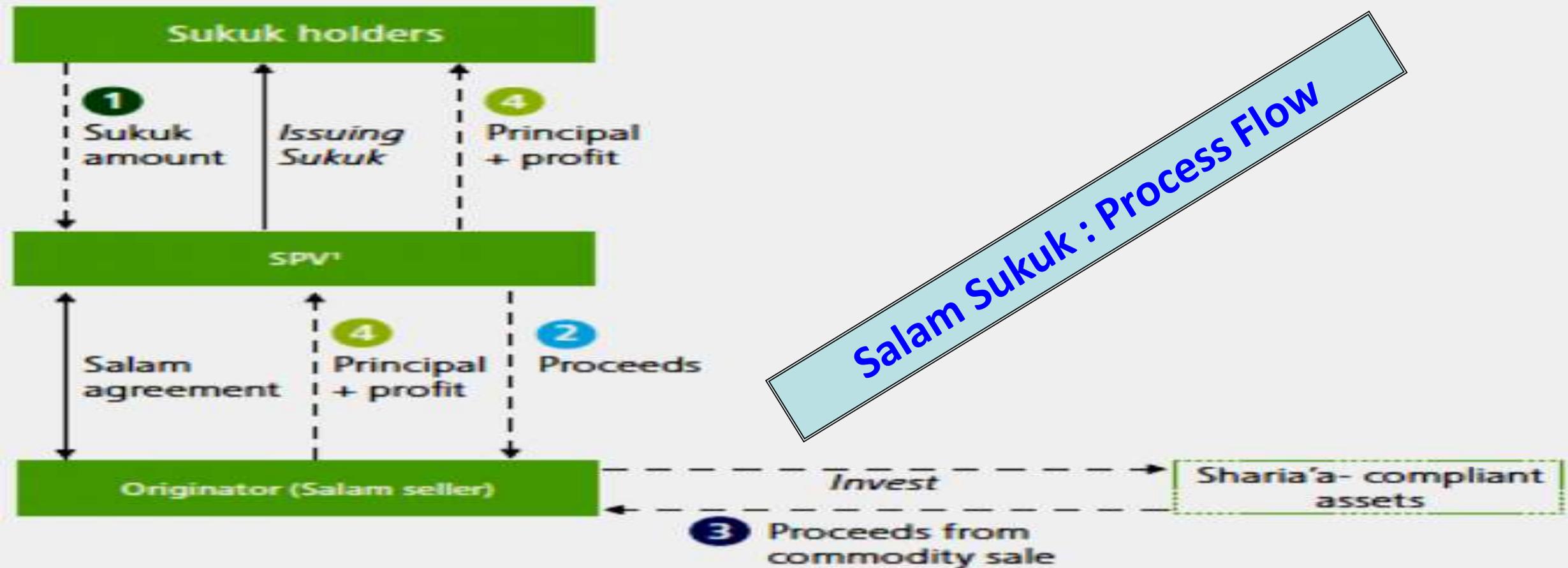
	Asset-backed Sukuk	Asset-based Sukuk
Issuer	SPV	SPV
Process	Securitization of tangible assets	Securitization of receivables
Characterization	Equity-like	Debt-like
Sources of payment	The revenues generated by the underlying asset	The originator's/obligor's cash flows
Sukuk holder's ownership	Legal ownership with right to dispose of underlying assets	Beneficial ownership with no right to dispose of underlying assets
Recourse	Sukuk holders have recourse only to underlying assets but cannot recourse to the originator	Sukuk holders can recourse to the originator if there is a shortfall in payments

5.1 Murabaha Sukuk



This **cannot be traded** in the secondary market since it is a debt obligation and Shari'ah prohibits the buying and selling of debt instruments.

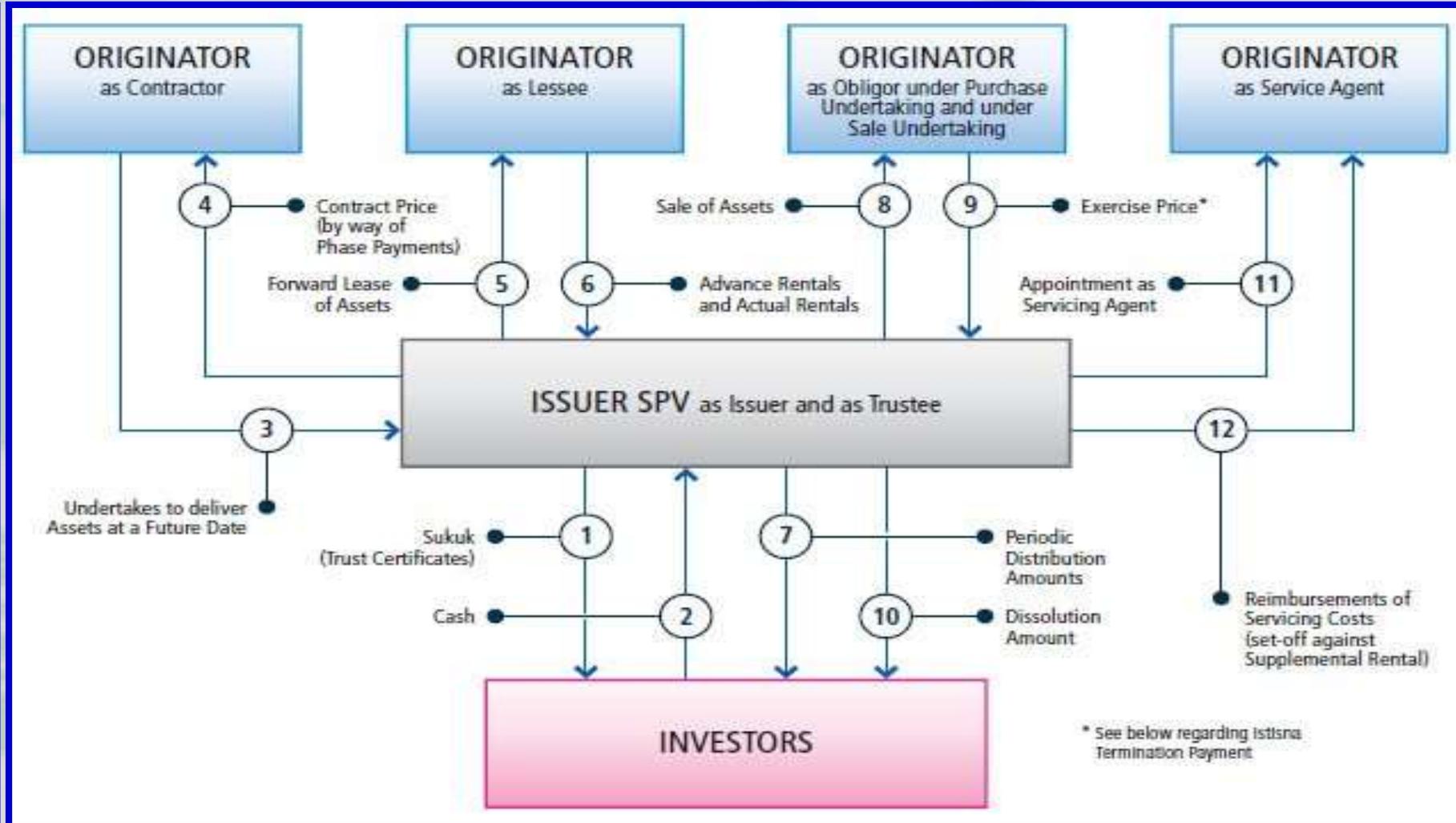
5.2 Salam Sukuk



- Salam Sukuk certificates **cannot be traded** until the asset is in a tangible form and delivered at maturity.

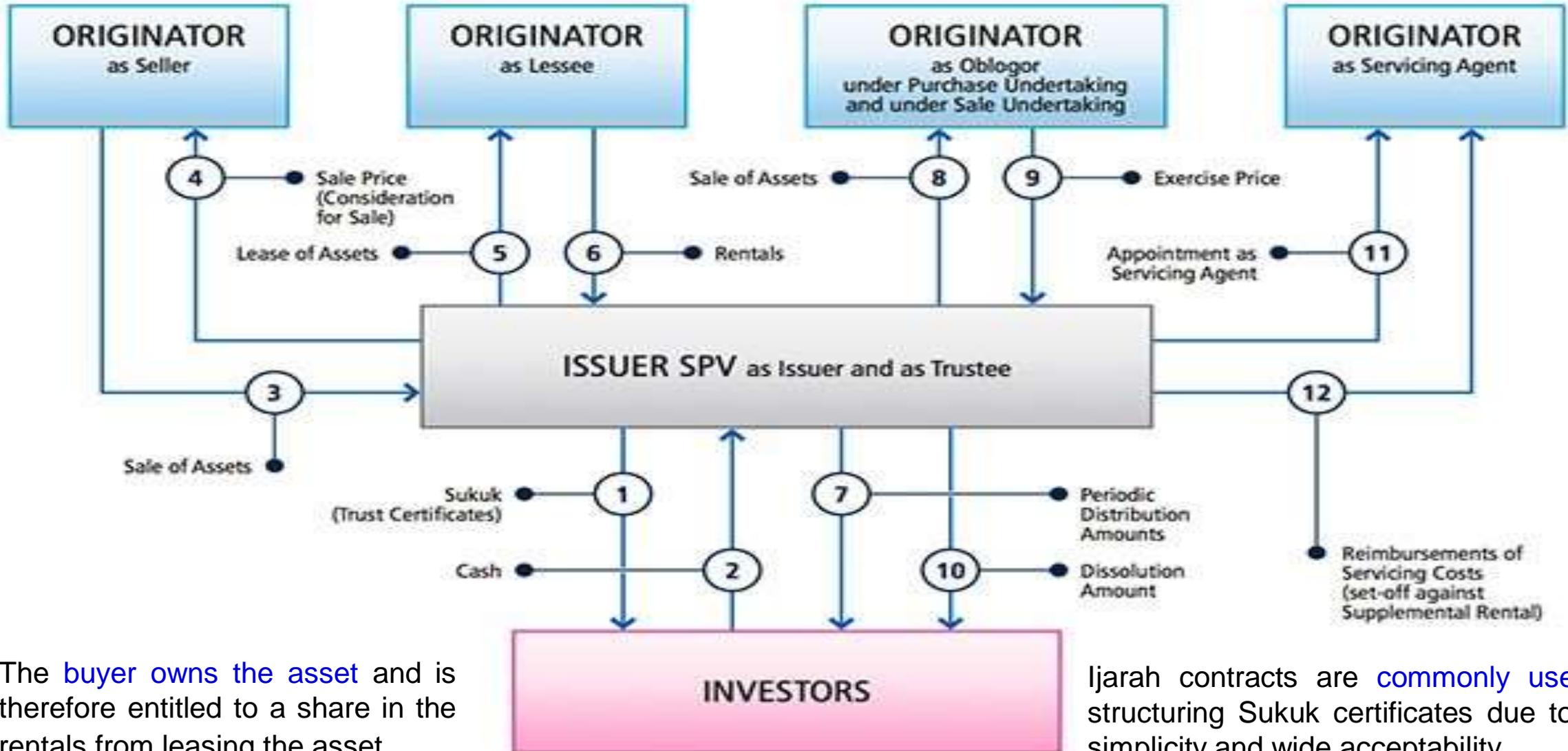
5.3 Istisna'a Sukuk

➤ Trading of these debt certificates in the secondary market other than on face value is prohibited in Shari'ah. Istisna'a is therefore a less popular structure for Sukuk.



Istisna'a Sukuk : Process Flow

5.4 Ijarah Sukuk: Process Flow

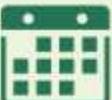


The buyer owns the asset and is therefore entitled to a share in the rentals from leasing the asset.

Ijarah contracts are commonly used for structuring Sukuk certificates due to their simplicity and wide acceptability.

5.4.1 Example: Govt. Ijara Sukuk

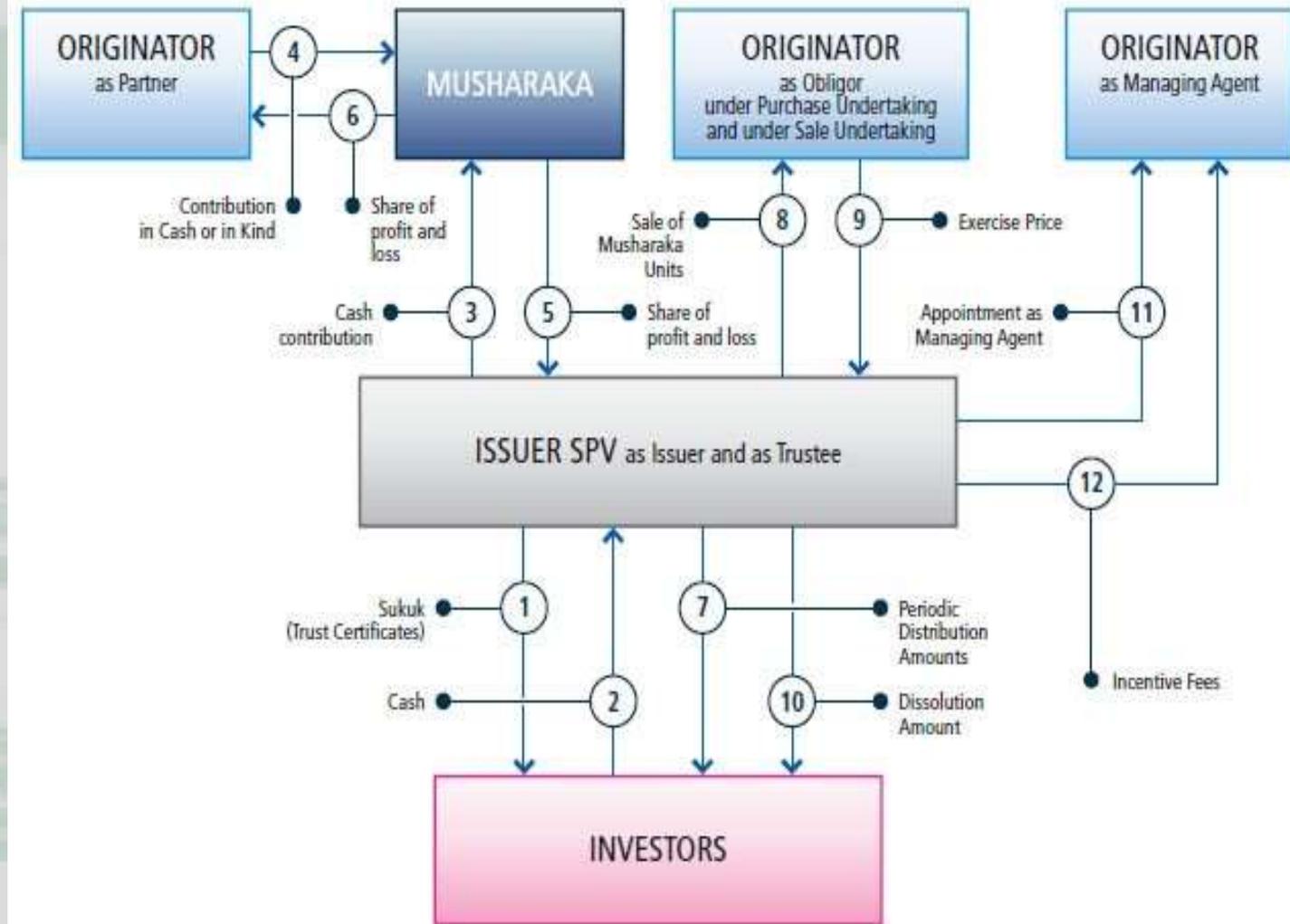
ISLAMIC BOND TO FUND SAFE WATER (B)

 Tk8,000 crore to be raised by the Shariah-compliant bond	 Tk10,000 denomination of each Sukuk
5 years maturity period of bonds 	4.69% profit on aggregate investment; paid on half-yearly basis 
Investment open to both corporate institutions and individuals 	

- The **first Govt. Sukuk** in the country was issued by the Bangladesh Bank on December 28, 2020
- Total tk **4,000** crore collected for the projects through an auction. Investors submitted bids worth Tk 15,153 crore during the auction (about 4 times over)
- In June 9, 2021, a **second auction** was held to generate the remaining BDT 40.00 billion for the fund, which was again over 8 times oversubscribed.
- **Purpose:** for financing safe water supply projects across the nation
- **Tenure** : 5 Years
- **Rent** : 4.69%
- On December 29, 2021, the **third auction** was performed in order to raise BDT 50.00 billion for a government elementary school project. It was five times oversubscribed.

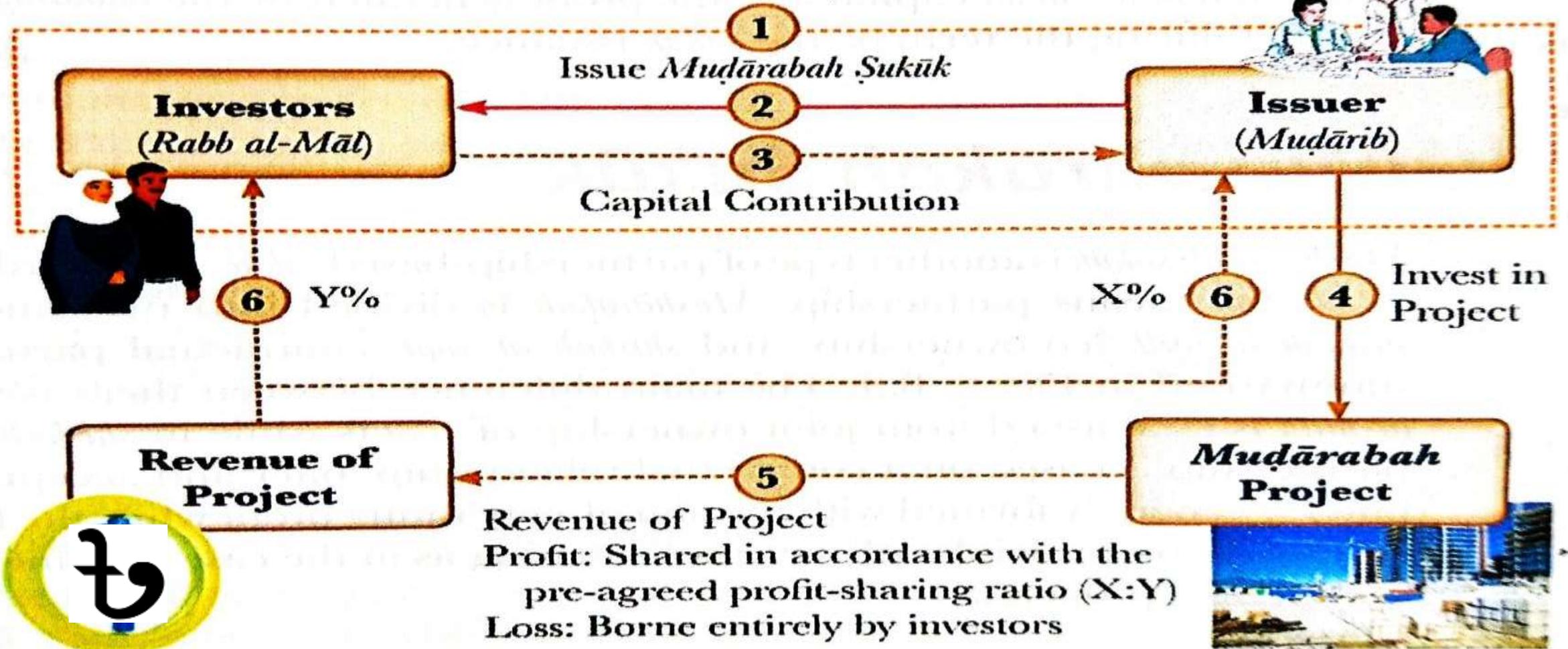
5.5 Musharaka Sukuk (Contd.)

- Musharaka Sukuk represent **ownership** of the investors in the underlying asset to be purchased for a Shari'ah compliant activity.
- Sukuk holders (investors) have a right to the **periodic distribution** amount and the dissolution amount.
- Musharaka Sukuk **can be traded** in the secondary market. However, trading these certificates is not allowed if the Musharaka venture is still in the shape of cash or receivables.
- The general principles of the Musharaka contract are applicable on Musharaka Sukuk.



5.6 Mudaraba Sukuk

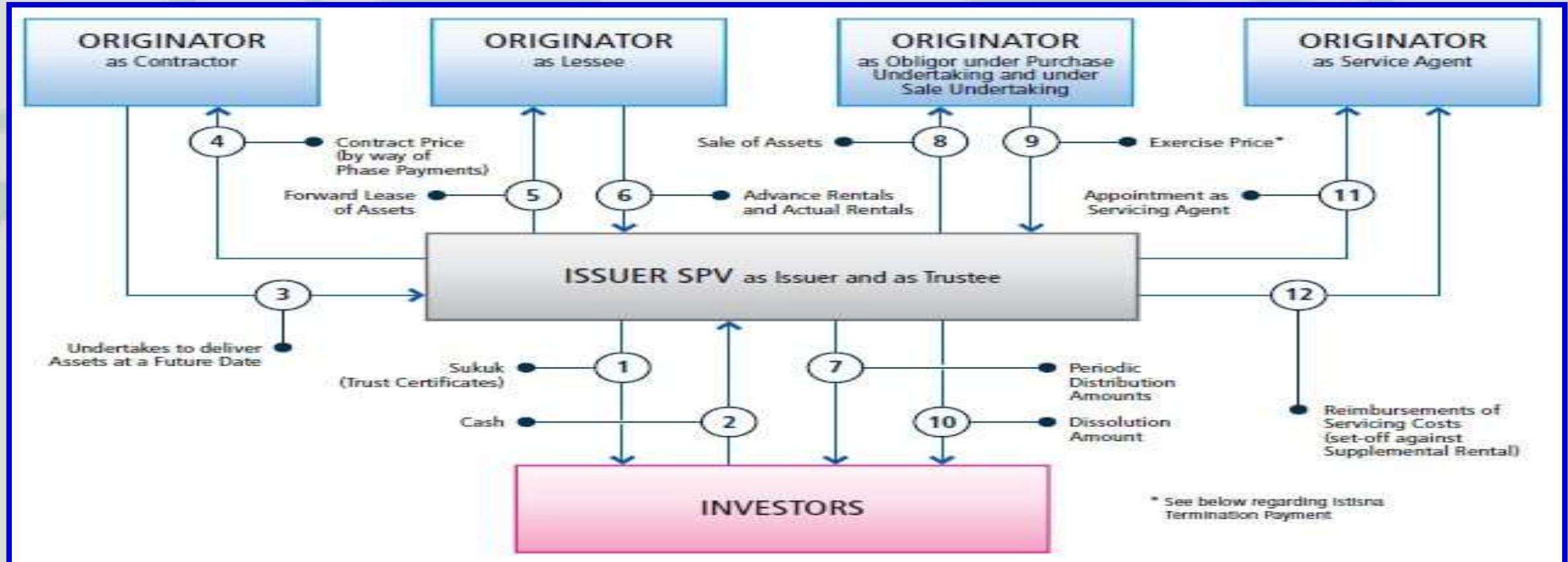
Contract of *Mudārabah*



Ref.: Sukuk: Principles & Practice, ISRA, 2017, P-347

5.7 Hybrid Sukuk

This is a type of Sukuk in which two or more Islamic finance contracts are used. The above mentioned Istisna structure may also be an example of hybrid sukuk. Because, the *Istisna*, *Ijara* and *wakala* contract are used in that structure:



6. Prospect of Sukuk in Bangladesh

- Now, Many mega projects are developing in Bangladesh. Such as Metro Rail, mass rapid transit (MRT), Extension Project of Hazrat Shahjalal International Airport etc. There is a need for more investment. The demand for this investment can be met through Sukuk bonds.”
- Long-term finance for the development of the private sector is necessary. We are mostly dependent on commercial banks for any financing but banks are not supposed to provide funds for the long term,
- Besides the above, There are many opportunities to launch Sukuk in Bangladesh. It is possible to get good returns from this Shari`ah compliant instrument.
- The massive oversubscription implies that the Sukuk market in Bangladesh has a bright future.

7. Recapping Sukuk

This Session gave an overview of the following:

- Investment Sukuk are **certificates of equal value** representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or a special investment activity.
- Securitization is the process of packaging a **pool of assets** that are on an entity's balance sheet into tradable securities that can be sold to investors (through Sukuk) in the capital market.
- The **main parties** involved in Sukuk arrangements include: investors, special purpose vehicles (SPVs) and originators.
- Sukuk are typically of **two types** – asset backed and asset based. The former involves true sale of assets while the latter involves securitization of the receivables only.
- Asset based Sukuk are more **popular**.



Takaful

**Concept, Features,
Historical Development**

Introduction to Takaful

- Risk is inherent in every human act.
- Individuals and companies are invariably exposed to unexpected tragedies such as loss of a bread earner, disabilities, accidents and destruction to business and wealth.
- Planning to protect oneself against unforeseen events is not only natural but also encouraged in Shari'ah.
- To satisfy this intrinsic need for self-preservation via Shari'ah compliant means, Takaful has emerged as an alternative to conventional insurance.
- Takaful, through its base model of promoting cooperation and mutual indemnification of losses amongst members, expunges all Shari'ah repugnant elements such as speculation, gambling and interest from prevailing practices in conventional insurance..

1. Risk concept in Shari'ah

- The Islamic concept of risk is often explained using **two Arabic words**: *Khatar* (خطر) and *Gharar* (غَرَر).
- *Khatar* is the modern translation of risk, its origins refer to respect and also **recklessness** or **danger**.
- *Gharar* on the other hand, refers to any uncertainty, ignorance, deception or speculation that may exist in a transaction.
- Islamic principles advocate the reduction of *Gharar* and *Khatar* to an acceptable level, or else the transaction would be considered impermissible.
- Therefore, risk management becomes **vital** for the legitimacy of transactions with the broad objective being the promotion of social and economic wellbeing.
- **Takaful provides essential support** within this Shari'ah compliant risk management model. As a mutual assistance solution, Takaful accepts a group of risks from participants that contribute to a Takaful risk fund.

2. Takaful

Allah SWT says

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ ۖ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

“And cooperate in righteousness and piety, but do not cooperate in sin and aggression”

(Sura Mayedah: 2)

Islamic insurance is commonly referred to as '**Takaful**' (التكافل), an Arabic word derived from the word '**Kafalah**' (الكفالة) which means 'guaranteeing each other'.

Islamic insurance is essentially based on the concept of mutual help, brotherhood, solidarity and mutual assistance with respect to any calamity that a beneficiary may experience, e.g. loss of property, life, etc.

Islamic insurance or Takaful is a form of risk management

AAOIFI defines Islamic insurance as: ... a kind of cooperative insurance, which covers all types of risks, under the management of a specialized company that adheres to the rules and principles of Islamic Shari'ah. The contract of Islamic insurance is based on mutual assistance and donations, whereas the compensation received in case of loss or damage associated with risk faced, is shared voluntarily among the participants.

(AAOIFI Shari'ah Standard No. 26 “Islamic Insurance”)

3. Why is Conventional insurance not acceptable by Shari'ah

Prohibited elements in conventional insurance

i. Riba

Both direct and indirect Riba can be found in insurance transactions

❑ Direct Riba

Direct Riba is evidenced in the sale of a right for a premium paid. Essentially it is sale of **some money (premium)** by the insurer for **more money (payment by insurance company in case of a loss event)**. This exchange of money for money of unequal amounts is direct Riba.



❑ Indirect Riba

Indirect Riba exists when premiums are **invested** by insurance companies in **interest-bearing securities** such as fixed-term interest deposits, bonds and derivatives. Interest from these investments is often used in claim payouts to the policyholders.

3. Why is Conventional insurance not acceptable by Shari'ah (Contd.)

ii. Gharar

In conventional insurance, neither the insured nor the insurer knows when the loss will occur, what the amount of loss will be or whether it will ever occur at all. The level of uncertainty is therefore significantly high.

The prohibition of *Gharar* in Shari'ah implies that any commutative or sale contract involving significant uncertainty and/or lacking transparency would be invalid.

iii) Qimar

Qimar is defined as an arrangement in which the acquisition of property is contingent upon the occurrence of an uncertain event, as is the case in gambling. In conventional insurance, the policyholder stands to lose all the premiums paid if the risk does not materialize. On the other hand, he/she stands to receive more should a misfortune occur whilst paying a small premium.

4. Historical Development of Takaful as an alternative to conventional insurance

Takaful is **not a new concept**. Islamic society has been practicing similar methods of risk protection for centuries. However, in its modern form the introduction of Takaful is a **recent phenomenon**.

In fact, it was **practiced by the Arabs of pre-Islamic** Arabia and continued after the advent of Islam.

The **formal practice** of Takaful can be traced to the second century of the Islamic era when Muslim Arabs, while expanding their trade into Asia, mutually agreed to contribute to a fund to protect themselves in the event of a **mishap or piracy along their numerous sea voyages (marine insurance)**.

The modern Takaful industry is only a few decades old. The first Takaful company was established in **1979 in Sudan** and the **second in 1984 in Malaysia**.

The **Grand Council** of Islamic Scholars in Makkah and the Majma Al Fiqh al Islami played a major role in the development of Takaful when, **in 1985, they declared that conventional commercial insurance was Haram** (forbidden) and only insurance based on the application of Shari'ah compliant cooperative principles and charitable donations was Halal (permissible).

4.1 Historical Development of Takaful : Perspective Bangladesh

Islamic insurance was introduced in Bangladesh on December 12, 1999. Islami Insurance Bangladesh Ltd. is the first full fledged Islamic insurance in Bangladesh.

Presently, there are eight full-fledged Islamic insurance companies and 13 Islamic insurance windows operating takaful in Bangladesh. Each takaful company and its windows have *Shari'ah* boards to monitor takaful activities. All directors and *Shari'ah* boards of each takaful company and its windows gathered in June 20, 2002, in order to regulate and standardize the system across all operators. They met again in August 13, 2002 to establish the Central *Shariah* Council for Islamic insurance of Bangladesh.

Bangladesh is the third biggest Muslim country in the world. It can be hoped that there are ample opportunities for Islamic insurance companies and grow in Bangladesh.

4.2 Contemporary practice of Takaful (Islamic Insurance)

The practice of Takaful differs from one jurisdiction to another in terms of which business model is deployed. However, the fundamental operational nuances remain the same. The following basic practices form the foundation of Takaful:

- 1. Takaful fund:** Contributions (donations or **Tabarru**) from members who wish to participate in the Takaful protection (policy holders) are used to create a fund which will be used to provide financial help at the occurrence of specified losses. All participants contributing funds are partners in indemnifying each other under specified risks.
- 2. Takaful operator:** The Takaful fund requires **management**. Contributions need to be collected and accounted for, whilst claims made by participants need to be verified and subsequently paid out. The management of the Takaful enterprise is handed over to a Takaful operator.
- 3. Management contract:** The Takaful operator has no claim over the profit or loss incurred by the fund and is in fact a separate entity to the Takaful fund. The **Takaful operator is mandated by the participants of the Takaful fund to manage the fund through a management contract**. The Takaful operator is remunerated for its efforts through fees against services.

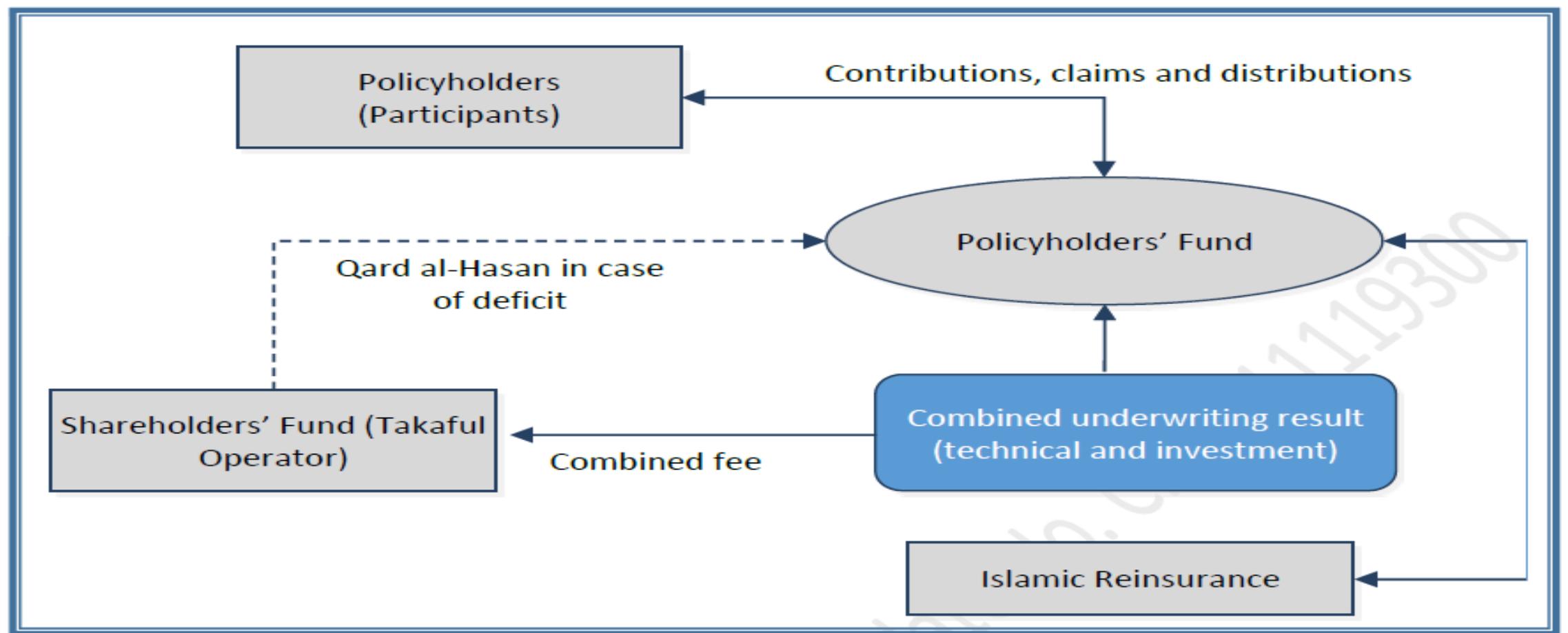
5. Types of Takaful business models

5.1 : Mudaraba

Under the *Mudaraba* model, the operator and policyholders enter into a contract of *Mudaraba*. The **policyholders** are considered *Rab al-maal*, and the **operator** is considered the *Mudarib*. The basic features of the *Mudaraba* model are as follows:

- The *Takaful operator* manages the *Takaful* fund and makes investments in Shari'ah compliant avenues;
- Profit from the investments is divided according to a mutually agreed ratio between the fund and the Takaful operator;
- Losses are borne by the fund. In case of deficit, the Takaful operator provides funds to the policyholder fund on the basis of *Qard al-Hasan* to tackle temporary deficits that can be covered out of future surplus; and
- Note that the *Takaful operator's remuneration* does not directly depend on the underwriting surplus or shortfall of the fund.

5.1 Mudaraba model: Process Flow



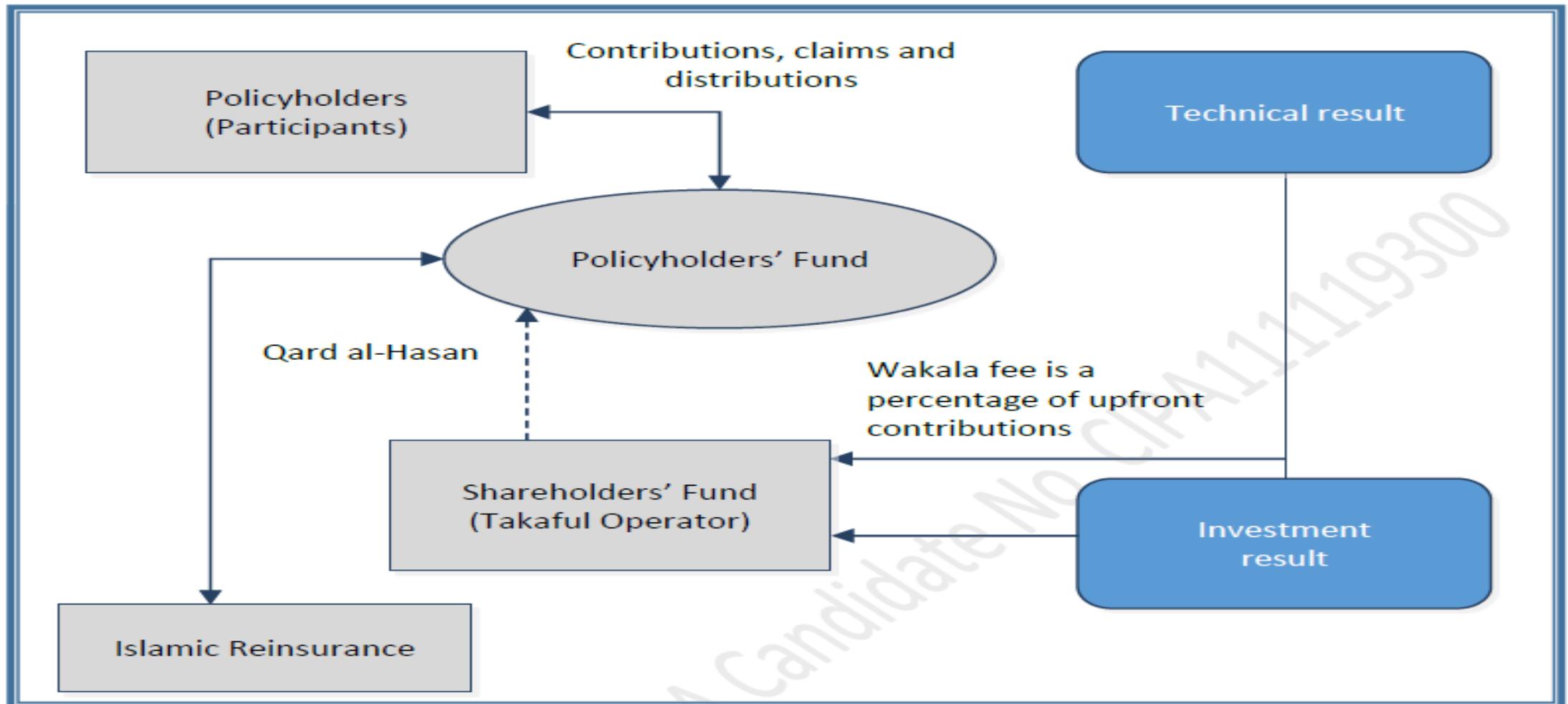
The Mudaraba model is the most popular model in different countries.

5.2 Wakalah Model

Under the Wakala model,

- The Takaful **operator acts as an agent** (of the participants) who manages the fund for a fixed fee.
- As an agent, the operator is entitled to an **agency fee** (remuneration) and a **performance fee** (as commission).
- The **surplus** of the participants' investment funds **goes to the participants**. The **agency fee rate is fixed annually** in advance in consultation with the Shari'ah board of the Takaful operator.
- The **performance** fee, which is related to the level of performance, is given as an **incentive** for good administration and governance of the participants' fund.

5.2.1 Wakalah Model: Process Flow

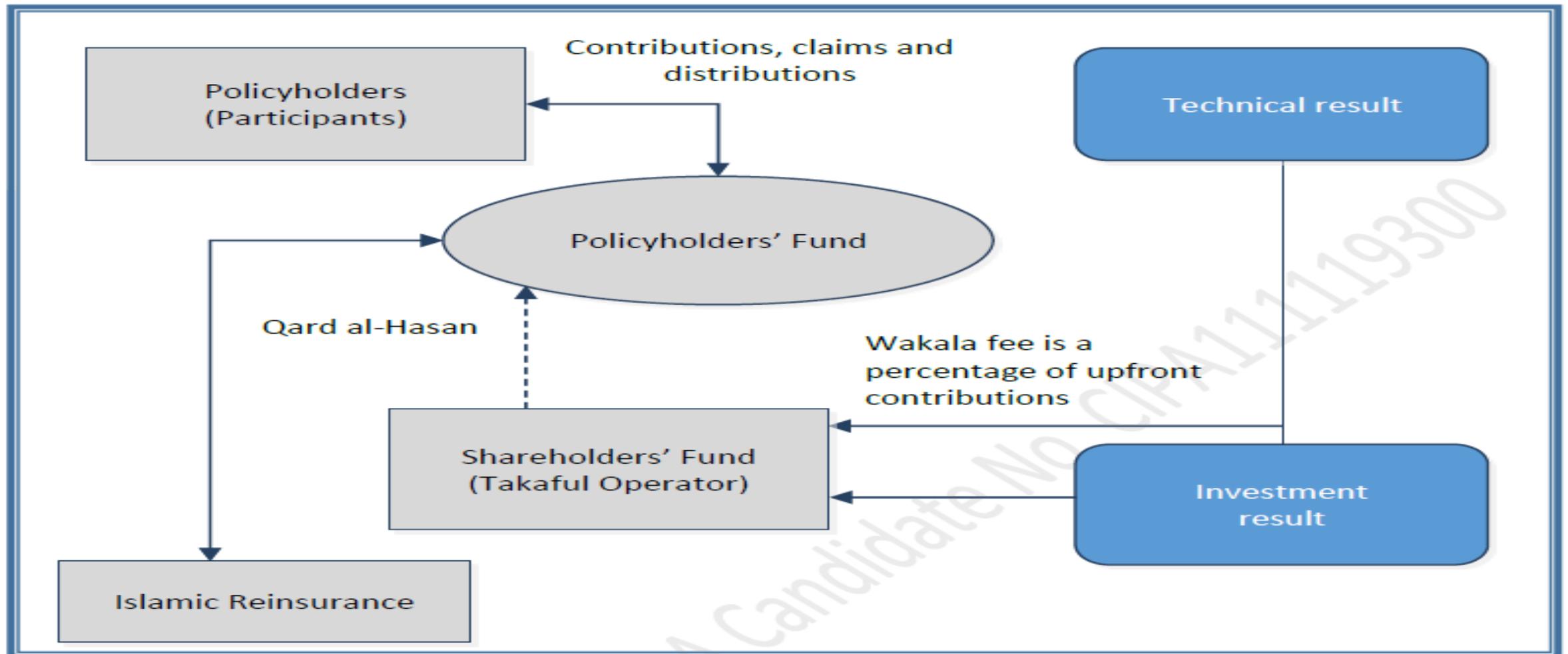


5.3 Hybrid Wakala-Mudaraba

Under the Hybrid Wakala-Mudaraba model,

- The **Wakala** principle is applied **in the underwriting** activities while a **Mudaraba contract is used in the investment** of the Takaful funds.
- The Takaful operator is entitled to both an **agency fee** for managing the fund as the Wakeel (agent) and a share of the **profit** for managing the investment of the fund as Mudarib.
- This approach is widely adopted in **United Arab Emirates**.

5.3.1 Process Flow of Hybrid Wakala-Mudaraba



6. Differences between Islamic and conventional insurance

	Islamic insurance	Conventional insurance
Type of contractual obligations	Based on non-commutative (non-commercial) contract. Premium belongs to Takaful fund and the risk is shared in proportion to the premium contributed by each participant.	Based on commutative or commercial contract. Premium belongs to the insurance company and the risk is sold in exchange for premium paid by the participants.
Concept	Islamic insurance is based on mutual co-operation.	Conventional insurance is based solely on commercial terms.
Shari'ah non-compliant elements	Islamic insurance is free from interest (Riba), excessive uncertainty (Gharar) and gambling (Qimar). (Gharar is allowed in a non-commercial contract)	Conventional insurance includes elements of interest, excessive uncertainty (in a commercial contract) and gambling.
Risk sharing or transfer	Risk is shared among policyholders.	Risk is transferred from policyholders to the insurance company.

6. Differences between Islamic and conventional insurance (contd.)

Investment	Investments made by Islamic insurance companies are based on Shari'ah principles.	Investments made by conventional insurance companies do not conform to Shari'ah requirements and may generate Shari'ah prohibited returns.
Ownership	The ownership of premium remains with the fund.	The insurance company owns the premiums paid by policyholders.
Surplus	Any surplus can be distributed among policyholders, retained in the fund as reserves or paid in charity.	Any surplus or deficit in conventional insurance pertains to the company's shareholders.
Compliance	Islamic insurance companies are required to remain compliant with governing laws as well as Shari'ah principles.	Conventional insurance companies are only subject to the governing laws of the land.
Fund	There is a segregation between the accounts of the participants of the Takaful fund and those of the shareholders.	No such segregation is in place in conventional insurance.

7. Recapping Takaful

- The concept of insurance is legitimate in Shari'ah; however, the way it is practiced in conventional insurance is not in line with Shari'ah.
- Elements which render conventional insurance void under Shari'ah are:
 - ❖ Riba (interest);
 - ❖ Gharar (excessive uncertainty); and
 - ❖ Qimar (gambling).
- The basic concept of Takaful (Islamic insurance) is based on the principles of joint guarantee and mutual cooperation. Takaful is a non-commutative contract in which the Shari'ah ruling is different for elements such as Gharar vs. a commutative contract.

7. Recapping Takaful (Contd.)

- Different markets have preferences for different Takaful models; the commonly used models are:
 - ❖ Mudaraba model;
 - ❖ Wakala model; and
 - ❖ Hybrid Wakala-Mudaraba model;
- The Islamic insurance company (also known as a Takaful operator) acts as a fund manager and not as a fund owner. Risk is shared through mutual agreement of the participants



**BREAK
TIME !!**