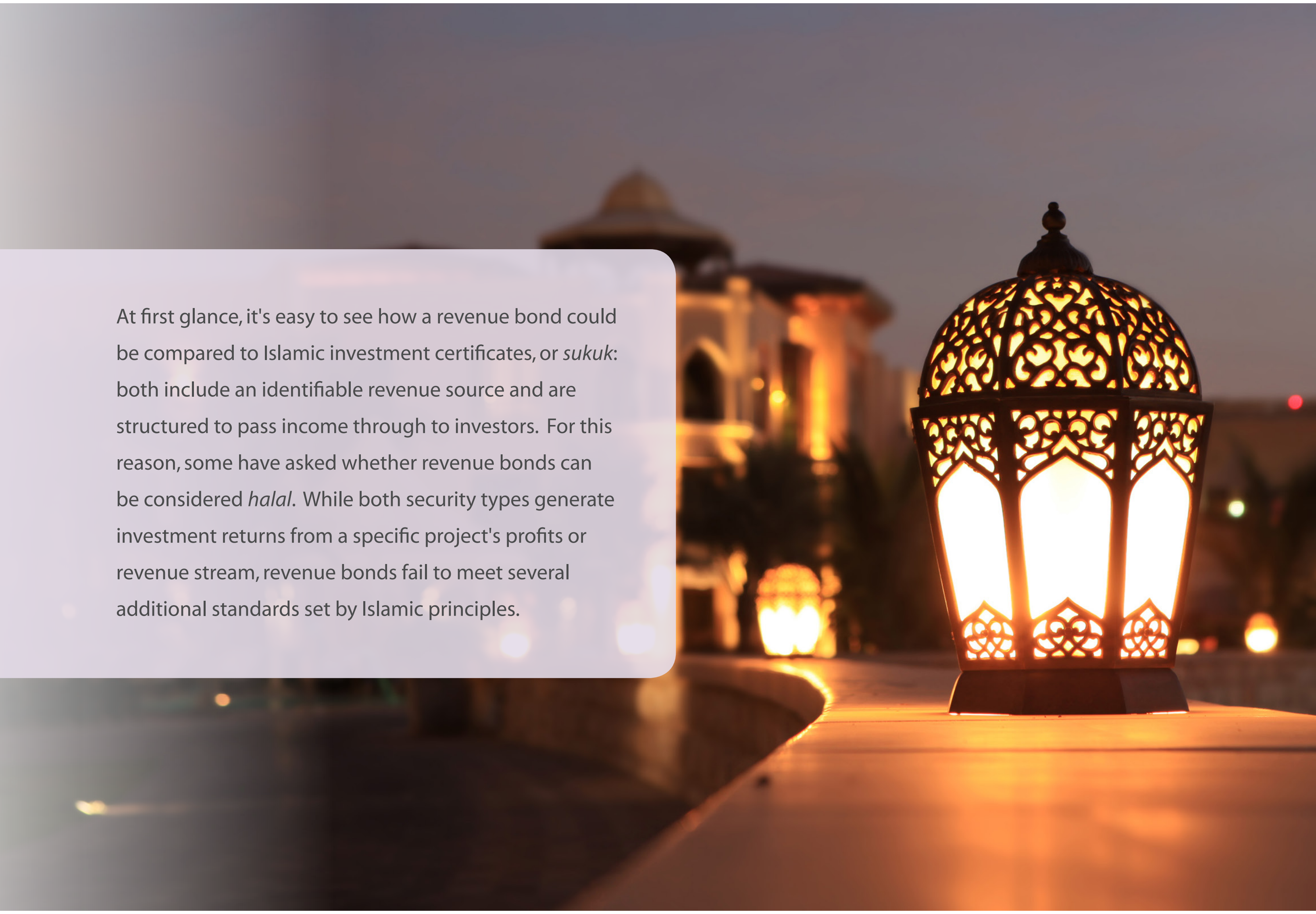
Saturna White Paper: Educational Series

Can Revenue Bonds Be *Halal*?



At first glance, it's easy to see how a revenue bond could be compared to Islamic investment certificates, or *sukuk*: both include an identifiable revenue source and are structured to pass income through to investors. For this reason, some have asked whether revenue bonds can be considered *halal*. While both security types generate investment returns from a specific project's profits or revenue stream, revenue bonds fail to meet several additional standards set by Islamic principles.

Amana Mutual Funds Trust

For an investment certificate to be considered halal, it must meet several "CORE" criteria: Compliance with Islamic principles, Ownership of the security's underlying assets, Risk-sharing among contractual parties, and Exposure to losses if the assets lose value. Municipal bonds – and any other type of traditional bonds that pay interest – fail to meet these requirements.

SURFACE SIMILARITIES BETWEEN *SUKUK* AND REVENUE BONDS:

✓ Both have a stated maturity and scheduled income distributions.

✓ Both finance assets and improvements that generate revenue passed through to investors.

✓ Both generate investment returns from the assets' revenue stream and profit.

✓ Both use tangible assets as collateral for the underlying security's cash flow.

✓ Both may be rated by a major credit rating agency, such as Moody's, S&P, and Fitch.

The CORE Criteria of *Halal* Investment Certificates

Compliance with Islamic Principles

One critical distinction between revenue bonds and Islamic investment certificates is the *halal* certification process. In order to be considered *halal*, an investment certificate must undergo and pass a religious review by a board of Islamic scholars prior to issuance. The board then issues a *fatwa* certifying compliance with Islamic investing standards.[1] The examination includes the security's structure and purpose as well as the business operations of the underlying assets. Not only must the security be structured to avoid paying interest, the assets financed must avoid involvement in businesses such as alcohol, tobacco, pork processing, and other activities prohibited by the Islamic faith.

FATWA "FAHT-WAH": A LEGAL OPINION OR DECREE HANDED DOWN BY AN ISLAMIC RELIGIOUS LEADER [2]

Guidelines issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a Bahrain-based Islamic financial standards organization, state that securities given a *fatwa* must also be subject to ongoing monitoring by an Islamic board. AAOIFI specifies that each security's prospectus "must explicitly mention the obligation to abide by the [Islamic] rules and principles" and that an Islamic board must approve the issuance and monitor its implementation throughout its duration.[3]

While AAOIFI establishes rules and guidelines for market participants, it does not ascertain or opine as to whether any particular issuer's security meets or exceeds them. Other Islamic financial standard-setting organizations, such as the Islamic Financial Services Board (IFSB) and the Islamic Fiqh Academy, aim to establish best practices. Despite their differences in approach, standard-setting organizations collectively agree on what constitutes an Islamic-compliant security. Conventional revenue bonds do not conform to these established parameters. The process of obtaining a *fatwa* is an important, distinguishing characteristic of what makes *sukuk* compliant with Islamic principles.

Ownership of Assets

Halal investing principles require that investment certificates, such as *sukuk*, be structured to ensure sharing of profits and when appropriate, losses. To accommodate the need for shared risk, *halal* non-equity income investment certificates must represent ownership or beneficial ownership interests (usufruct) in assets or a commercial enterprise. In the case of an asset-backed *sukuk*, for example, this requires a legal transfer of the assets from the originator to the investors.[4]

PAYMENTS TO THE CERTIFICATE HOLDERS ARE BASED ON THE NET PROFITS GENERATED BY THE UNDERLYING ASSETS

Payments to the certificate holders are based on the net profits generated by the underlying assets, and holders accept a share of any losses incurred. The issuer cannot guarantee the security's investment return or establish a predetermined price (principal repayment) at the end of investment certificate's tenure; hence establishing a true risk and profit-sharing relationship that results from ownership. Because revenue bonds are structured as debt repayment contracts, they do not fulfill the ownership component required of *halal* investment certificates.

Risk-sharing

Islamic economic thought prefers profit-sharing modes of financing in which the financier assumes some business risk. As a result, both the investor and the issuer of the investment certificate must share in the enterprise's risks and returns. This is, in part, a primary reason why *halal* investing prohibits instruments that derive returns from interest payments on loans or debt – they fail to satisfy an important risk-sharing tenet of Islamic principles.

The distinction between interest and profit arises from the fact that they are earned in different ways. Profit is earned through business operations or assets subject to risk, while interest is obtained in a risk-reduced manner because the interest payments received have no direct relationship to the performance of the underlying assets. In effect, an interest-based loan is the sale of a given amount of money for more money. Islamic principles consider money to be an intermediary between goods, therefore charging interest on loans is considered unjust. The unbalanced risk allocation between revenue bond issuers and investors disqualifies revenue bonds as *halal* investments.

Exposure to Enterprise Risk

Conventional bondholders receive cash flows that are independent of profit or loss earned from the funds raised through issuing bonds. Unlike shareholders, bondholders receive rewards that have been determined and agreed upon in advance through a contractual agreement and covenants that obligate financial performance of the issuer regardless of how the underlying assets perform.

As a result, creditors are not exposed to the uncertainties, or risks, of the underlying assets or business enterprise but rather the creditworthiness of the issuer itself. In other words, creditors do not share the risks faced by the enterprise they finance. It is for this reason that interest-based bonds are risk-transferring rather than risk-sharing contracts. The ownership and risk-sharing structure of *halal* investment certificates exposes them to a risk of loss if the underlying assets lose value or the enterprise fails to produce a profit. Because revenue bond investors do not assume the risk of the underlying enterprise they finance, revenue bonds are not considered *halal*.

	Sukuk **/ Islamic Investment Certificates**	**Revenue Bonds**
Compliance	• Security obtains a *fatwa*: Initial and ongoing review by Islamic board; • Underlying assets must be *halal* (NO alcohol, tobacco, pork-processing, interest-based finance, etc.); • Investor receives pass-through income.	• No Islamic review or *fatwa* certifying that security meets *halal* compliance criteria; • Investor receives interest payments.
Ownership	• Ownership interests, not debt; • Profit from assets is passed through to investors; • Principal repayment not guaranteed if value of assets declines.	• Investor is lender, not owner; • Revenue from assets is used to repay debt; • Bond certificate guarantees interest and principal payments.
Risk-sharing	• Issuer and investor share the risks and rewards of underlying enterprise; • Investor returns linked to issuer returns.	• Imbalanced allocation of risk: issuer contractually obligated to pay interest and repay principal; • Investor returns linked to scheduled payments.
Exposure	• Investor exposed to business risk; • Investors receive a share of profits from the underlying assets and accept a share of any loss incurred.	• Investor exposed to credit risk; • Due to the issuer's contractual obligations, investors retain greater legal recourse in the event of default.

Conclusion

The best way to think about whether any security may be labeled *halal* is to determine whether the investment spreads risk and affords beneficial ownership to the parties involved. Does it include a risk-sharing component ensuring that investors' and issuers' interests are aligned? Does the investor have an ownership or beneficial ownership interest in assets or a commercial enterprise? Is the investment contract free of obligations or guarantees of investment results? Has the security undergone an Islamic review and obtained a *fatwa* ascertaining whether the security and issuer meet Islamic standards? The answer to these questions with regard to revenue bonds is a resounding "no." At their core, revenue bonds are not *halal*.

About The Author

Patrick Drum MBA, CFA®, CFP®
Amana Participation Fund Portfolio Manager

Patrick T. Drum, Research Analyst and Portfolio Manager, joined Saturna Capital in October 2014.

He is a select member of the United Nations Principles for Responsible Investment (UNPRI) Fixed Income Outreach Subcommittee and an adjunct professor of finance at Pinchot University, formerly known as Bainbridge Graduate Institute (BGI). Mr. Drum has nearly 10 years of experience integrating ESG considerations into fixed income portfolio management.

He holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder (CFA) and a Certified Financial Planner®. Mr. Drum has more than 20 years of investment experience in serving institutions and private clients.

Footnotes

1 *Rahail, A., Hogan, L. Sukuk and Islamic Capital Markets: A Practical Guide, Globe Law and Business, 2011.*

2 *Fatwa. Merriam-Webster.com. September 19, 2016 http://www.merriam-webster.com/dictionary/fatwa*

3 *Shari'a Standards for Islamic Financial Institutions, 1432 H, 2010. Accounting and Auditing Organisation for Islamic Financial Institutions, Standard 17, Investment Sukuk, p. 313. http://www.iefpedia.com/english/wp-content/uploads/2012/11/utoew.pdf*

4 *Hegazy, H. A Legal and Geopolitical Perspective on Sukuk in the GCC, Middle East Insights, Islamic Finance Special, Middle East Institute, National University of Singapore, August 4, 2016. https://mei.nus.edu.sg/themes/site_themes/agile_records/images/uploads/Download_Insight_IFS_6_Hegazy.pdf*

Amana Mutual Funds Trust

www.amanafunds.com

This publication should not be considered investment, legal, accounting, or tax advice or a representation that any investment or strategy is suitable or appropriate to a particular investor's circumstances or otherwise constitutes a personal recommendation to any investor. This material does not form an adequate basis for any investment decision by any reader and Saturna may not have taken any steps to ensure that the securities referred to in this publication are suitable for any particular investor. Saturna will not treat recipients as its customers by virtue of their reading or receiving the publication.

The information in this publication was obtained from sources Saturna believes to be reliable and accurate at the time of publication.

All material presented in this publication, unless specifically indicated otherwise, is under copyright to Saturna. No part of this publication may be altered in any way, copied, or distributed without the prior express written permission of Saturna.

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Amana Participation Fund in a current prospectus or summary prospectus, please visit www.amanafunds.com or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

Investing involves risk, including possible loss of principal. Generally, an investment that offers a higher potential return will have a higher risk of loss. Stock prices fluctuate, sometimes quickly and significantly, for a broad range of reasons that may affect individual companies, industries, or sectors. When interest rates rise, bond prices fall. When interest rates fall, bond prices go up. A bond fund's price will typically follow the same pattern. Investments in high-yield securities can be speculative in nature. High-yield bonds may have low or no ratings, and may be considered "junk bonds." Investing in foreign securities involves risks not typically associated directly with investing in US securities. These risks include currency and market fluctuations, and political or social instability. The risks of foreign investing are generally magnified in the smaller and more volatile securities markets of the developing world.

In addition to the fixed-income market risks above, the Amana Participation Fund entails risks specific to investing in sukuk. Sukuk structures may be significantly more complicated than conventional bonds and often include a series of entities created specifically to support the sukuk structure. In addition, sukuk are largely created in or otherwise subject to the risks of developing economies, many of which have weak or inconsistent accounting, legal, and financial infrastructure. The structural complexity of sukuk, along with the weak infrastructure of the sukuk market, increases risks of investing in sukuk, including operational, legal, and investment risks.

Performance data quoted represents past performance which is no guarantee of future results.

Distributed by Saturna Brokerage Services, member FINRA / SIPC. Saturna Brokerage Services is a wholly-owned subsidiary of Saturna Capital Corporation, adviser to the Amana Mutual Funds Trust.

SATURNA CAPITAL

1300 N. State Street
Bellingham, WA 98225-4730
www.saturna.com