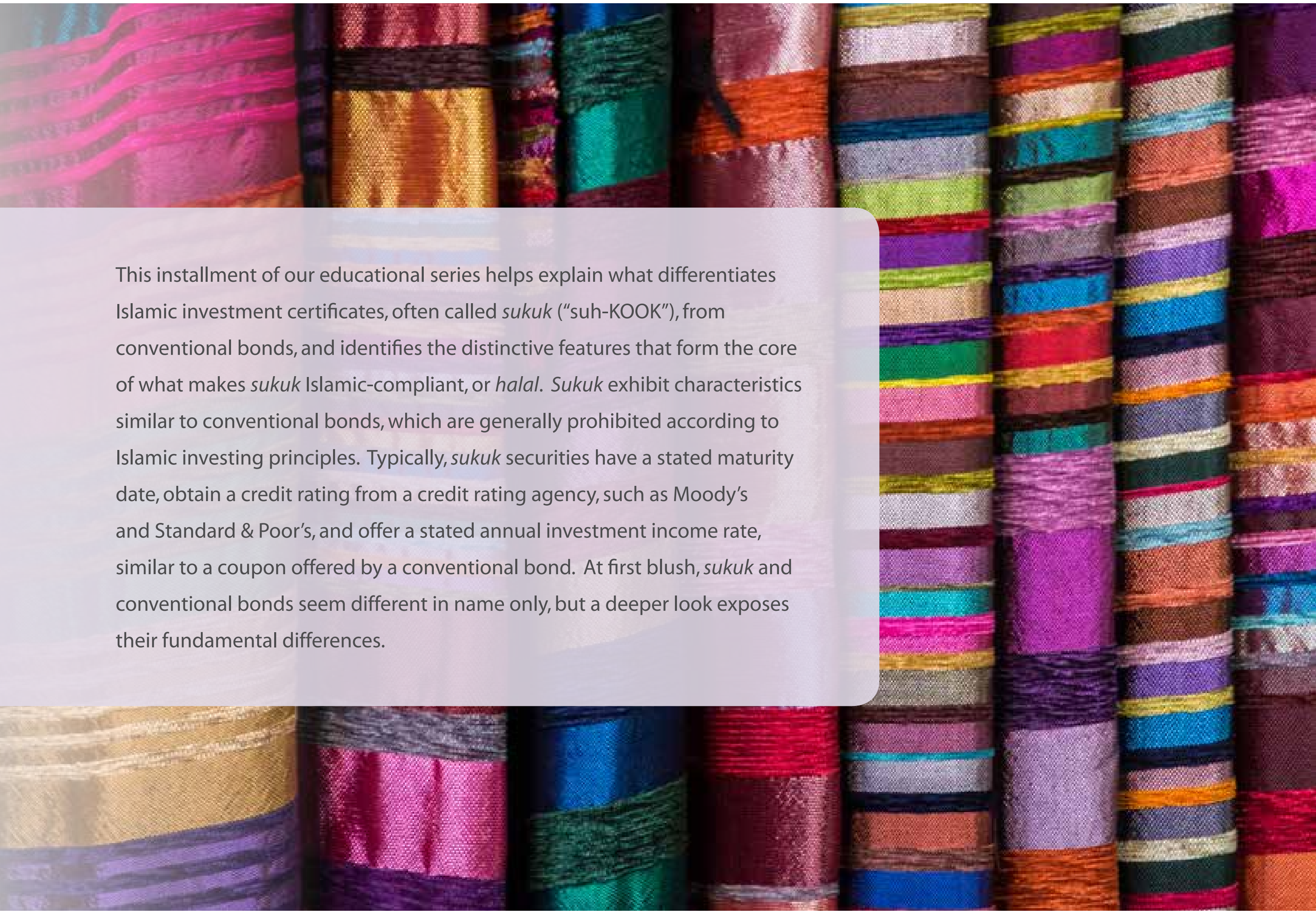
Saturna White Paper: Educational Series

What Makes *Sukuk Halal*?



This installment of our educational series helps explain what differentiates Islamic investment certificates, often called *sukuk* ("suh-KOOK"), from conventional bonds, and identifies the distinctive features that form the core of what makes *sukuk* Islamic-compliant, or *halal*. *Sukuk* exhibit characteristics similar to conventional bonds, which are generally prohibited according to Islamic investing principles. Typically, *sukuk* securities have a stated maturity date, obtain a credit rating from a credit rating agency, such as Moody's and Standard & Poor's, and offer a stated annual investment income rate, similar to a coupon offered by a conventional bond. At first blush, *sukuk* and conventional bonds seem different in name only, but a deeper look exposes their fundamental differences.

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What Makes *Sukuk Halal*?

Sukuk's bond-like attributes lend familiarity and promote greater acceptance and adoption by investors globally. Yet, below the surface *sukuk* are distinct in form and substance to abide by the Islamic faith's strict prohibition on the payment of interest (*riba*).[1] Whereas bonds represent a legal debt obligation, *sukuk* reflect an undivided beneficial ownership interest in an asset. Therefore, to understand what makes *sukuk* investment certificates *halal*, it is important to examine the process by which they are formed and structured.

Context & Background

The application and interpretation of religious scripts can vary within the same religious community while still adhering to the core tenets of a particular faith. Similarly, within the Muslim community diverse interpretations emerge across different religious sects and are subject to cultural and geographic influences within a broad range of Islamic schools of thought. For example, differing interpretations exist among Islamic fundamentalists and modernists yet they each adhere to core Muslim tenets.

Recognizing the Muslim community is diverse, Islamic investment certificates do not simply embody the primary tenets of the Muslim faith, but also the spirit of Islamic investing principles through the process of the securities' formation. The certificates must not only avoid investment in business activities prohibited by Islamic principles, such as alcohol, gambling, and pork processing, but also be structured to avoid indebtedness and interest payments associated with bonds.

THE GLOBAL MUSLIM COMMUNITY REPRESENTS ROUGHLY 23% OF THE WORLD'S POPULATION, MAKING ISLAM THE SECOND-LARGEST RELIGION

While beyond the scope of this educational piece, there are several authors who offer thoughtful guidance on the integration of Islamic finance. For example, Usman Hayat, CFA, and Adeel Malik, PhD, state in their circulation *Islamic Finance: Ethics, Concepts, Practice,* "At its heart, the Islamic approach to economics emphasizes a balance between competing considerations: wealth accumulation versus wealth distribution, private incentives versus public interest, the spiritual versus the material, the needs of the present generation versus the needs of future generations, and the 'here' versus the 'hereafter.'"[2] The authors later add, "What is different about Islamic economic thought, however, is the reliance on divine revelation as a source of knowledge and on its moral articulation."

***Sukuk*:** Financial & Religious Integration

Two primary features distinguish Islamic-compliant securities from conventional fixed income securities. The first is the security's structure, and the second is the requirement that the financial instrument be reviewed by an Islamic religious body to ascertain its *halal* status prior to issuance.

Sukuk Structure

Islamic economic thought favors profit-sharing modes of financing in which the financier assumes some business risk. As a result, both the investors and the issuers of the investment certificates share in the enterprise's risks as well as returns. Investors tend to share profits and losses proportional to their ownership interests (akin to shares) in the certificates.

To be considered *halal*, *sukuk* must conform to Islamic investing principles. The investment certificate itself must represent an ownership or beneficial ownership interest in assets of a commercial enterprise. This requires the certificate's structure to reflect a legal transfer of ownership of the underlying assets from the issuer to the investor. Payments to the certificate holders are based on the net profits of the underlying assets. The issuer cannot guarantee the security's investment return, such as a coupon rate, or establish a predetermined price, such as a principal value, at the end of the investment certificate's tenure; hence establishing a true risk-return relationship.

In contrast, conventional bondholders receive cash flows that are independent of the amount of profit or loss earned from the funds raised through issuing bonds. Unlike shareholders, bondholders receive income that has been determined and agreed upon in advance. As a result, creditors avoid direct exposure to the uncertainties, or risks, of the underlying assets or business enterprise. Rather, their risk is tied to the creditworthiness of the issuer. In other words, creditors do not directly 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.[6] Furthermore, *sukuk* investors may obtain a higher value at the end of the investment certificate's tenure if the market value of the security's underlying asset or business enterprise appreciates. Bondholders receive only the return of their original principal, or par value, upon the security's maturity.

What makes *sukuk halal*?

	Sukuk	**Conventional Bonds**
Underlying Asset	Proof of ownership in an asset	Debt obligation
Legal Structure	Holders each hold an undivided beneficial ownership in underlying assets	Issuer has a contractual obligation to pay bond holders interest and principal on certain specified dates
***Halal* considerations**	The underlying assets are *halal*	n/a
Pricing	Pricing based upon value of underlying assets	Pricing based on credit rating of issue and issuer
Valuation	Buyers purchase assets that have value	Buyers act as creditors in implicit loan agreement
Investment rewards and risks	Holders receive a share of profits from the underlying assets (and accept a share of any loss incurred)	Holders receive regularly scheduled interest payment for the life of the bond, and the principal is returned at the bond's maturity date

Integration of Islamic Principles: Review & Oversight

To be sanctioned as *halal*, issuers of *sukuk* must obtain a *fatwa* and undergo the process of religious review and approval by Islamic scholars, prior to issuance of the certificates. [7]

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a Bahrain-based Islamic financial standards organization, furnishes guidelines mandating ongoing security monitoring by a board of Islamic scholars. Each security's prospectus must explicitly mention the obligation to abide by Islamic rules and principles, and an Islamic board must approve the procedures of the issue and monitor the project's implementation throughout its duration. [8]

FATWA "FAHT-WAH"
A legal opinion or decree handed down by an Islamic religious leader [9]

It is important to note that AAOIFI only establishes rules and guidelines for market participants regarding a security's compliance with Islamic principles. AAOIFI does not ascertain or opine as to whether any particular issuer's security meets or exceeds the guidelines. A host of other Islamic financial standard-setting organizations aim to establish best practices, such as the Malaysia-based Islamic Financial Services Board (IFSB) that promotes and enhances Islamic financial services, as well as the Saudi Arabia-based Islamic Fiqh Academy, among others. As a result of the multitude of influential standard-setting organizations, differences among competing sets of guidelines can and do exist. Despite this, there is general collective agreement of what makes *sukuk halal*.

Conclusion

While Islamic certificates may superficially exhibit characteristics common to conventional bonds, the extent of these similarities is limited to features that promote broader acceptance among investors. The tenet of risk-sharing in conjunction with returns tied specifically to the security's underlying asset performance, untethered to any promissory assertion of investment outcome, clearly set these investment certificates apart from conventional bonds. *Sukuk* certificates constitute evidence of ownership of the underlying assets or the right to their use or services. *Sukuk*, therefore, facilitate investment, not lending. Furthermore, these securities incorporate a systematic review by a reputable advisory board to ascertain that the investment activity conforms to Islamic principles.

SUKUK CERTIFICATES CONSTITUTE EVIDENCE OF OWNERSHIP OF THE UNDERLYING ASSETS OR THE RIGHT TO THEIR USE OR SERVICES

Having served American Muslim investors for over 25 years, Saturna Capital recognizes that *halal* investment allocation choices customarily have been limited to equities and cash. The Amana Participation Fund aims to offer a third asset class to serve the financial planning needs of Muslim investors: a *halal* option that parallels the income-producing, historically lower-volatility, and principal-preserving characteristics traditionally available to conventional bondholders. With its stated objectives of capital preservation and current income, the Participation Fund expands opportunities for investors who abide by Islamic principles and for others who seek less traditional alternatives.

Additionally, mutual funds in particular offer these benefits:

- Diversification
- Liquidity
- Professional management
- Regulatory oversight

It is important to note that the Participation Fund is not a cash alternative or deposit account, but rather is best suited for investors with an investment time horizon of at least two or more years. The *sukuk* market has experienced favorable growth and broader acceptance within the investment community, however it is still viewed as a newly-developing and nascent market. Please carefully review the Fund's prospectus regarding risks and disclosures or seek the advice of a professional advisor before investing.

About The Author

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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] *Yousri Ahmad, Dr. Abdel-Rahman. Riba, Its Economic Rationale and Implications. Institute of Islamic Banking and Insurance. http://www.islamic-banking.com/iarticles_8.aspx*

[2] *Hayat, U., Malik, A. Islamic Finance: Ethics, Concepts, Practice, CFA Institute Research Foundation, 2014. http://www.cfapubs.org/doi/pdf/10.2470/rflr.v9.n3.1*

[3] *Center for Islamic Wealth Management. Bank Negara Malaysia. SRIs & The Case For Islamic Investment Funds, 2015. https://www.islamicfinance.com/wp-content/uploads/2016/01/Islamic-Investment-Funds.pdf*

[4] *Desilver, Drew. World's Muslim population more widespread than you might think, Pew Research Center, June 7, 2013. http://www.pewresearch.org/fact-tank/2013/06/07/worlds-muslim-population-more-widespread-than-you-might-think/*

[5] *The Future of World Religions: Population Growth Projections, 2010-2050, Pew Research Center Demographic Study, April 2, 2015. http://www.pewforum.org/2015/04/02/religious-projections-2010-2050/*

[6] *Kamali, M.H., Abdullah, A.K., editors. Islamic Finance: Issues in Sukuk and Proposals for Reform, Chapter 4, Sukuk and Bonds: A Comparison, 2014.*

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

[8] *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*

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

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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.

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