

Public Consultation on

Proposal for Introducing Sukuk Products at the Colombo Stock Exchange

6th July 2022



Foreword

This paper discusses the concept of introducing Sukuk products to the Sri Lankan Capital market, and seek public comment on the proposed policy and regulatory framework developed under the technical assistance provided by the Asian Development Bank (ADB). The Securities and Exchange Commission of Sri Lanka (SEC) would like to invite the submission of written comments on the questions posed in this consultation paper, **on or before 1st August 2022**, under the title **“Public Consultation on Proposal for Introducing Sukuk Products at the Colombo Stock Exchange”**. Comments received may be publicly available and will not be treated as confidential unless a special request is made in that respect.

1. Islamic Capital Market Products

- 1.1. Islamic Capital Market Products (ICMP) are securities which are developed in compliance with Islamic Law and ICMPs play an important role in the development of the capital market and the economy as it opens up opportunities for investment and fund raising. Many countries have introduced different types of ICMPs.
- 1.2. According to S&P Global Ratings, the global Islamic finance industry will expand 10%-12% in 2021-2022. It is observed that there was a 10.6% growth in global Islamic financial assets during the year 2020 despite the Covid-19 pandemic.

2. Sukuk

2.1. An Overview

- 2.1.1. A Sukuk is a financial instrument similar to conventional debt securities and is linked to an underlying asset (normally tangible). From the perspective of the investors, holding of a Sukuk represents a partial ownership in the relevant asset. Sukuk exist because in Islamic finance the charging or receiving of interest is prohibited; under Shariah, an investor should realize no profit or gain merely for the employment of money.
- 2.1.2. Whereas conventional bonds evidence a debt owed by the issuer to the bondholders, sukuk certificates evidence the investors' ownership interest in the underlying sukuk asset, which entitles them to a share of the income generated by that asset. However, in practice the contractual structure is such that the return is predetermined and the dominant risk is the credit risk of an ultimate obligor. They are thus very similar to conventional debt securities in economic terms.
- 2.1.3. The underlying sukuk assets must be Shariah-compliant, as must the use of the sukuk proceeds. The assets or businesses underlying the sukuk cannot be related to gambling, or the production or sale of alcohol or pork, amongst other things.
- 2.1.4. The details of sukuk structures vary. However, typically a company that requires capital (referred to as the “originator”) establishes a special purpose vehicle (SPV) and sells assets to the SPV. This special purpose vehicle (SPV) issues Sukuk certificates that are sold to the investors. The originator then contracts to use the assets in its business, for example by

leasing them back; the payments received for this provide the return to the investors. It also contracts to buy back the assets at the end of the period.

- 2.1.5. The total value of Sukuk issuances in year 2020 was USD 163 billion where 53% of issuances were by sovereigns, 10% by multilaterals, and 37% by 3corporates, most of them financials. The total value of Sukuk outstanding at the end of the year was USD 703 billion. The largest country of origin for Sukuk was Malaysia, followed by Saudi Arabia and Indonesia.
- 2.1.6. Sukuk may be issued in domestic or foreign currency (usually USD). Where they are aimed at an international market it is common for them to be listed on more than one exchange; Kuala Lumpur, Dublin and Dubai are popular listing venues for non-local issuers.
- 2.1.7. Sukuk vary in tenor. Some Central Banks issue short-term (for example 90-day) Sukuk. Some Sukuk have durations in excess of 10 years. However, the majority of Sukuk issued up until now have a maturity of three or five years.

2.2. Challenges to the Development of the Sukuk Market

- 2.2.1. **Legal Regime:** The transfer by the originator of assets underlying the sukuk to the SPV may give rise to additional taxes and stamp duties, putting sukuk at a disadvantage when compared with conventional bonds. One of the primary reasons that Malaysia accounts for a high percentage of global sukuk issuances is because its government has enacted tax, land transfer and registration laws that do not penalize sukuk issuances in comparison with conventional bond issuances. However, we believe there are some structures which may be usable in Sri Lanka without incurring substantial tax disadvantages.
- 2.2.2. **Standardization:** As part of a sukuk transaction, a legal pronouncement is conventionally procured from Shariah scholars to provide issuers and investors with comfort that a sukuk instrument is Shariah-compliant. However, there are some points on which scholars differ and such differences in opinion can create uncertainty in international markets particularly.
- 2.2.3. **Mechanics for Default:** It is essential for the development of a mature market that sukuk investors understand their rights and remedies in default scenarios.
- 2.2.4. **Costs of Issuance:** Sukuk generally have higher costs of issuance than bonds, partly because of more complex legal documentation and partly because of the need for a Shariah pronouncement.

3. Introduction of Sukuk to the Sri Lankan Capital Market Landscape

- 3.1. It is noteworthy to highlight that majority of global Sukuk issuances are dominated by Sovereigns and, it is an internationally accepted view that sovereign issues in domestic currency are enormously helpful to establish a yield curve. The lack of any Sovereign issues though not an absolute barrier poses an impediment for corporate issuances. However, Sovereign Sukuk issuances are not under the purview of the SEC but under the Central Bank of Sri Lanka/ Treasury. Accordingly, this paper only discusses the potential for Sukuk issuance within the capital market framework.

- 3.2.** It is proposed to introduce corporate sukuk in local currency by introduction of requisite clauses to the existing listing framework of the Colombo Stock Exchange (CSE). Corporate issuances in foreign currency would adhere to the framework enabled for local (LKR) Sukuk issuances once the enabling legislation is in place.
- 3.3.** The SEC and CSE are in the process of enabling a platform for listing, trading and settlement of foreign currency denominated securities issued by entities established/incorporated in Sri Lanka at the CSE. Once enabled, this framework could be extended for other classes of securities including Sukuk. Additionally, corporates that wish to issue foreign currency denominated Sukuk may do so by listing at an international venue popular for Sukuk listings. The listed value of Sukuk in Dubai, one of the largest centres for Sukuk listings globally recently reached \$77.56 billion. However, the country's credit rating will have an impact on the issuance of foreign currency sukuk.

4. Amendments proposed to the existing listing framework at the CSE for issuing Sukuk products

- 4.1.** The following information should be included in the Prospectus or Introductory Document,
- A description of the underlying Sukuk structure, the relationships between the parties and the flow of funds, including a structure diagram;
 - A statement by the Shariah Supervisory Board (SSB) signed for or on behalf of all its members that the proposed sukuk are compliant with Shariah rules and principles, and of the basis on which this conclusion is reached.
- 4.2.** The composition of the SSB:
- The SSB must comprise a minimum of three (3) members;
 - A majority of the members of the SSB, and at least three (3) members in total, should have the requisite educational and professional experience and have already served on the SSB of a regulated Islamic financial services institution or on a national Shariah authority.
- 4.3.** In the case of Shariah compliant debt securities (Sukuk), reference to "interest" in the rules should be treated as references to the "expected return" on the instrument.
- 4.4.** Where the Sukuk are issued by a SPV, references to disclosures in respect of the issuer should be treated as disclosures to be made in respect of the Originator.

5. Requirements/ Restrictions on Investors

- 5.1.** Globally there are limited retail issuances and, sukuk are often structured with large unit sizes with the aim that they should not reach retail investors.
- 5.2.** In order to ensure a phased introduction and familiarization for the Sukuk product, at the introductory stage, investment in the product can be limited to institutional and qualified retail investor categories. Since most Sukuk trading elsewhere, takes place over-the-counter rather than on exchange, if there is support for such a limitation an additional amendment to the listing framework will be made to require a minimum unit size.

6. How to Submit Comments

The SEC would like to invite the submission of written comments for the following:

- (A) What are your views on the proposed framework for the issuance of Sukuk products
- (B) What are your views on imposing a limitation on allowed investor categories and issue size at the product introductory stage?
- (C) Any additional suggestions or views with regard to making the product launch a success?

Please submit your written comments **on or before 1st August 2022**, under the title "**Public Consultation on Proposal for Introducing Sukuk Products at the Colombo Stock Exchange**"

Written comments may be sent by any one of the following methods:

- 1. By Registered post:** Acting Director Capital Market Development Division,
The Securities and Exchange Commission of Sri Lanka
Level 28- 29 East Tower
World Trade Centre
Echelon Square,
Colombo 01.

Your comments should be submitted in an envelope marked "**Public Consultation on Proposal for Introducing Sukuk Products at the Colombo Stock Exchange**" on the top left hand corner of the envelope.

- 2. By Email:** prabash@sec.gov.lk

If you wish to provide comments in the capacity of a representative of an organisation, you should provide details of the organisation whose views you represent.

Participants submitting comments should include their personal/company particulars as well as their correspondence address, contact phone number and email address on the cover page of their submissions.

The comments received would be subject to consideration by the SEC. Comments received may be publicly available and will not be treated as confidential unless a special request is made in that respect.