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Sukuk tough to issue

The problem is, you have to convince someone that sukuk are normal bonds

Market participants in Korea are turning their attention to Islamic finance. In an effort to keep pace with global trends and take advantage of the potential for growth, the Korean Financial Supervisory Commission (FSC) has announced plans to make legislative changes to enable Korean banks to enter into Islamic financial markets abroad. It is reviewing various ways to support such entry by streamlining its accounting principles to bring them into line with *shariah* (among other things). However, the lack of in-depth study of its intricacies and dynamics is an indication that it is still in its infancy in Korea.

Given the unique challenges presented by the unconventional structures and instruments used in the Islamic market, a study into their feasibility in Korea must be undertaken from financial, accounting, legal and tax perspectives.

Compare and clarify

One of the key issues is whether *sukuk* can be issued by a Korean company under Korean law. In Korea, a joint stock company (*chusik hoesa*) can raise funds in the market through the issue of shares or debt securities including conventional bonds and special bonds which, under the Korean Commercial Code (KCC), cannot exceed four times the net asset value of a joint stock company. In addition, a listed company can raise funds through the issue of special bonds under the Securities Exchange Act (SEA).

If *sukuk* were to be issued in Korea, it is unlikely that the SPV issuing the *sukuk* would be listed on either the Korea Stock Exchange (KSE) or Kosdaq. For the SPV to be able to issue *sukuk* under Korean law (regardless of whether such issue takes place onshore or offshore), the *sukuk* would necessarily have to fall into one of the types of debt securities that can be issued by Korean companies under the KCC. Since *sukuk* are viewed as similar to conventional bonds under the KCC, it would be necessary to compare the two to determine whether the *sukuk* are similar enough to conventional bonds to be regarded as one of the debt securities that can be issued under Korean law.

On one hand, *sukuk* have certain attributes that make them comparable to a conventional bond. First, from an economic perspective, the substance of a *sukuk* is similar as its issuance permits a party in need of funds to finance them from another party. Second, an arrangement involving periodic distributions by the SPV to the certificate-holders is comparable to an arrangement involving the distribution of the regular coupon payments by the issuer to the investors in a conventional bond. Third, like a conventional bond, a *sukuk* is a standardised and marketable security, with its face value representing par value. Fourth, in the event of default, the certificate-holders would not be able to exit their investments by way of disposal of the underlying assets but rather must rely on the originator's ability to honour its undertaking to purchase the assets back from the SPV in certain cases (including a case of default), which indicates that the certificate-holders would ultimately depend on the originator's credit to recoup their original investments. For this reason, as in the case of the conventional bond where the credit rating of the bond mirrors that of the issuer, the credit rating of the *sukuk* mirrors that of the originator.

Despite many similarities, *sukuk* are distinguishable from conventional bonds as they are asset-based. Unlike conventional bonds, which merely represent a contractual claim, *sukuk* represent an undivided *pro rata* ownership of the underlying assets. This fundamental difference makes it difficult to reach a conclusion about whether *sukuk* are comparable to conventional bonds.

Since it is not certain whether *sukuk* would fall under one of the types of securities issuable under Korean law, whether *sukuk* can be issued by a Korean company remains unclear.

Securitise and classify

Another key issue raised in the context of Korean law is whether *sukuk* can be purchased by a Korean financial institution (Korean bank or Korean securities company). According to Korean law (specifically the Banking Act and the SEA), the securities that can be purchased by a Korean financial institution are limited to transferable securities as defined under the SEA (including, but not limited to, national bonds, local government bonds, debt securities, stock, capital contribution certificates, beneficiary certificates and equity-linked securities). Would *sukuk* be treated as conventional bonds here?

The issue must be looked at in the context of legislative changes that are scheduled to take place in Korea. The enactment of the Capital Market and Financial Investment Services Act (Consolidated Act) on February 4 2009 will either amend or replace existing laws. One law to

be replaced is the SEA. The Consolidated Act will take an inclusive rather than an exclusive approach to defining financial investment products to embrace more potential products.

All financial investment products will be classified as either securities or financial derivatives, with securities further classified into one of the following: debt securities, equity securities, beneficiary certificates, investment contract securities, securitised derivatives and depositary receipts. Debt securities will encompass national bonds, local government bonds, special bonds, conventional bonds, commercial paper, and any similar securities that represent debt claims.

Although the practical implications of the Consolidated Act will become apparent once it is implemented next year, there is no doubt that the range of investable securities will be substantially expanded.

Asset ownership decides

Sukuk are often compared to conventional asset-backed securities as they are backed by assets and have a similar transaction structure. This similarity makes it necessary to determine the feasibility of issuing *sukuk* through asset-backed securities under Korean law.

The Act Concerning Asset-Backed Securitisation (ABS Act) was enacted in 1998 after the onset of the Asian financial crisis to aid asset-backed securitisation. The ABS Act confers certain privileges and benefits, including the reduction of or exemption from taxes (such as acquisition tax and registration tax) and simplified procedures for the transfer of ownership or security interests that accompany the transfer of the underlying assets. Although it is still possible to complete an asset-backed securitisation outside the ABS Act, it would lose its privileges and benefits. For this reason, most asset-backed securitisations in Korea are issued under the ABS Act.

Is *sukuk* one of the types of securities that can be issued by an SPV under the ABS Act? Since it is hard to characterise a *sukuk* as an equity security, the question is whether it can be characterised as a debt security (conventional bond) instead. As detailed above, it is difficult to conclude whether a *sukuk* can be characterised as a conventional bond. The ABS Act also requires a securitisation plan to be registered with the Financial Supervisory Comission (FSC) in order to undertake an asset-backed securitisation. The lack of clarity surrounding the legal nature of *sukuk* makes it unlikely that the FSC would approve the registration by classifying a *sukuk* as the type of security that can be securitised under the ABS Act.

Another issue is the true sale requirement imposed by the Act. At the heart of what constitutes a true sale under the ABS Act lies the need to make a distinction between a complete transfer of ownership (true outright sale), and a transaction that merely creates a security interest for the purpose of financing the necessary funds (a secured loan).

If the transfer of the underlying assets from the originator to the SPV under a *sukuk-al-ijara* is characterised as a true sale, then such assets would not be included in the bankruptcy estate of the originator, isolating the assets from bankruptcy risk. If it is merely a secured loan, the assets would be included in the bankruptcy estate and the SPV's only recourse would be in its capacity as a secured party in respect of such securitised assets, exposing the certificate-holders to the originator's bankruptcy risk.

The true sale requirement imposed by the ABS Act may be difficult to achieve under a *sukuk-al-ijara* structure because the objective is not necessarily to effect a true sale but to finance the necessary funds through the use of the assets. The sale under a *sukuk-al-ijara* may not entail transfer of ownership. The interest in the underlying assets represented by the *sukuk* need not be perfected: it does not need to be registered to the extent that such registration is required for perfection of the interest in the underlying assets.

So the transfer of assets under a *sukuk-al-ijara* may only accompany the transfer of beneficial ownership from the originator to the SPV. This transfer is problematic as the distinction between legal ownership and beneficial ownership is not readily recognised in Korea (except, for instance, in the limited context of a trust), and because it will not satisfy the true sale requirement. So for *sukuk* to be issued under a *sukuk-al-ijara* structure pursuant to the ABS Act, the complete transfer of ownership (in the sense of being perfected) of the underlying assets from the originator to the SPV is a prerequisite.

Taxation issues

Since *sukuk* issued under a *sukuk-al-ijara* structure predicates transfer of the underlying assets, there may be tax burdens.

Acquisition tax may be imposed. It is payable upon acquisition of certain types of assets (including immovable property). The amount payable is up to 2% of the purchase price at the time of acquisition. The tax will be not necessarily be imposed when the registration of title or change of registered titleholder is consummated, but rather when acquisition is deemed to have occurred. Although the issue of what constitutes acquisition for acquisition tax purposes would depend on the circumstances of each individual case, the transaction

between the originator and the SPV would likely be construed as the taxable acquisition. Also, to the extent that the *sukuk* represents an ownership interest in the underlying assets, the certificate-holders (in addition to the SPV) may also be subject to acquisition tax.

There may be other potential tax burdens in the form of capital gains, registration and acquisition taxation when the originator buys the underlying assets back from the SPV at a later date. First, the SPV would be subject to capital gains tax if and to the extent that the sale price exceeds the original purchase price. As in the case of acquisition tax, capital gains tax does not depend on the registration of title or change of registered title-holder. Second, if the registration of title or change of registered title-holder is required to transfer the ownership of the underlying assets, registration tax (of an amount equal to the acquisition tax) may also be imposed. Third, acquisition tax would be imposed when the originator purchases the assets back from the SPV at a later date. Without special privileges (reduction of or exemption from certain taxes), the potential tax burdens associated with a *sukuk-al-ijara* are likely to reduce its attractiveness to Korean financial institutions.

Rental payments and cashflow possibilities

In a *sukuk-al-ijara*, corporate tax would be imposed on the SPV in respect of the periodic lease rental payments it receives from the originator. However, given that the SPV would also pay the certificate-holders, it would not incur corporate tax as long as the periodic distributions it makes to investors are treated as tax-deductible expenses for accounting purposes.

As opposed to an asset-backed securitisation, where the payments made by the SPV to the investors are characterised as interest (tax-deductible expenses for accounting purposes), the payments made by the SPV to the certificate-holders in the context of *sukuk* cannot be classified as interest. The payments cannot be classified as dividends either, as the certificate-holders do not have an equity interest in the SPV. Therefore, the periodic distributions would not constitute tax-deductible expenses for accounting purposes. Consequently, the SPV would not be able to avoid paying corporate tax on the periodic lease rental payments. This could have adverse cashflow implications.

Offshore issues

If the SPV is established offshore, the *sukuk* would be issued in accordance with the laws of the jurisdiction of the establishment of the SPV. But the transfer of the assets would be effected under Korean law, since that is where the assets would be located.

Assuming that the assets are immovable property, the *sukuk-al-ijara* through which the offshore SPV purchases the assets from the onshore originator to issue the *sukuk* would be subject to two requirements under Korean law. First, for the offshore SPV to acquire immovable property located in Korea, it must file a report to the designated foreign exchange bank under the Foreign Exchange Transactions Act. If the immovable property is land, a report under the Foreign Land Acquisition Act must also be filed. Second, since the offshore SPV will need to lease the immovable property to the originator after acquisition, the SPV must have a permanent establishment in Korea, the procedures for the establishment of a place of business and its registration with the Korean tax authority must also be complied with.

Step this way

There are also many other obstacles to be overcome before Korea can enjoy the fruits of the Islamic finance market. While this is expected to be challenging and time-consuming to say the least, the time is right for Korean market participants to start making efforts to understand the theoretical and practical implications of Islamic finance techniques. Such efforts, together with recent initiatives by the FSC, would be a step in the right direction.

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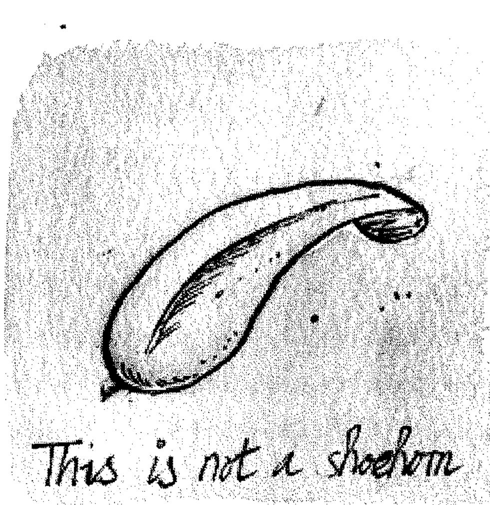

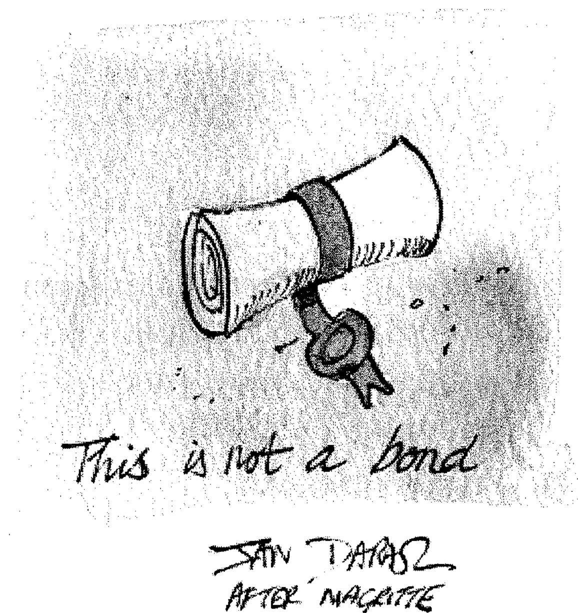

How an *ijara* works

A *sukuk-al-ijara* is one of the most common structures used in the issuing of *sukuk*, an Islamic financing instrument. It is typically structured as follows: (i) a special purpose vehicle (SPV) is established as the issuing entity for the *sukuk* and issues *sukuk* certificates to investors for raising funds to finance the purchase of certain assets; (ii) the originator sells assets to the SPV for a pre-determined purchase price in accordance with an asset sale and purchase agreement; (ii) the SPV then leases those assets, pursuant to an *ijara* (Islamic lease) agreement, to a third party, often the originator itself or a third party connected to the originator, for a fixed period of time in exchange for periodic lease rental payments; (iii) the payment obligations of the originator to the SPV under the *ijara* agreement will mirror the payment obligations of the SPV to the investors who hold the *sukuk* certificates (certificate-holders).

When entering into the *ijara* agreement, the originator will grant a purchase undertaking in favour of the SPV undertaking to buy those assets from the SPV at a pre-determined price on a future date. The SPV will use the lease rental payments received from the originator to make periodic distributions to the certificate-holders.

Upon maturity of the lease or the event of default, the SPV will oblige the originator to purchase the assets for the outstanding amounts still owed under the *sukuk*.

The *sukuk* represents undivided *pro rata* ownership of the underlying leased assets and the *sukuk* certificate shows this, as well as an interest in the assets themselves. In jurisdictions where legal ownership and equitable ownership are recognised, such interest may not necessarily represent the registered title of an asset in the context of *sukuk*: the legal ownership may still lie with the originator and the beneficial ownership represented by the *sukuk* would correspond to the right to proceeds flowing from the assets, including periodic lease rental payments.

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