ISTISNA’ SUKUK – A PRELIMINARY GLIMPSE

INTRODUCTION
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Istisna’ contract is unique in that it is exempted from the basic ruling of sale that requires the existence of a transacted asset. Generally speaking, istisna’ can be briefly defined as a sale contract where the purchaser orders the seller to manufacture an asset according to particular specifications at request. The purchaser will make a request to purchase from the seller an asset, which is yet to exist, that will be manufactured and delivered upon completion according to the agreed stipulated future time. The buyer has the option to make the purchasing payment either on spot or on deferred basis through a staged payment method based on the phases of completion.

The ruling in istisna’ transaction requires that the price and the specification of the transacted asset must be precisely described at the outset to avoid uncertainty (gharar). The ruling also states that the asset must be of manufacturing and constructing in kind. Istisna’ contract is only binding once the project commences. Thus, one party may revoke the contract if the manufacturing or constructing process is yet to commence. Once manufacturing and constructing process has been commenced, no unilateral termination of contract is allowed unless there is a mutual agreement between both parties.

There are varieties of methods that can be adopted in structuring sukuk (Islamic financial certificates) using istisna’ contract. This article will give a brief explanation to readers on how istisna’ contract is employed in sukuk structure by illustrating two samples of istisna’ sukuk models. It is also worth noting that there could be a combination of two istisna’ transactions, known as istisna’ mawazi (parallel istisna’), used for issuance of sukuk.

ISTISNA’ SUKUK

Besides financing projects, mainly in infrastructure, istisna’ sukuk are usually issued for funding large construction and manufacturing projects such as airports, commercial buildings, bridges, power plants, etc. Since the issuance of istisna’ sukuk is based on sale contract where the price is paid on a future date, the sukuk are issued to represent investors’ right to the debt owed by the sukuk issuer. In other word, the sukuk evidence financial obligation of the sukuk issuer to make payment to the investors at an agreed future date. It is also common that istisna’ sukuk are issued by issuers to represent the undivided right and ownership of the investors over the underlying asset in the istisna’ transaction.

ISTISNA’ SUKUK TO REPRESENT ISTISNA’ SELLING PRICE

As mentioned above, the issuance of istisna’ sukuk indicates the right of investors, i.e. sukuk holders, over the selling price due to deferment of price settlement. This can always be seen in a parallel istisna’, which involves two contracting parties in both transactions. In the first istisna’ contract, the originator (issuer) agrees to construct istisna’ asset and delivers it to the investors on a future date. In return, the price settlement by the investors is payable by lump sum or in phases, according to the stages of completion of the asset. Subsequently, both parties sign separate istisna’ agreement, in which the investors agree to construct the asset and deliver it to the originator. In the second istisna’ contract, the istisna’ sale price, which comprises of purchasing price plus profit, will be paid by the originator on a future date. The deferment of price settlement renders the originator indebted to the investors. Pursuant to this, the originator-cum-issuer will issue sukuk as to evidence the originator’s responsibility to fulfill its financial obligation to the investors. The issuance is also to represent the investors’ ownership over the receivables owed by the originators. The basic structure is illustrated in the following Table.

Table 1 – Istisna’ Sukuk Transaction Structure (Model 1)

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1. Under *istik*ā’ purchase agreement, the originator (issuer) agree to construct an identified *istik*ā’ asset and deliver it to the investors in consideration of an agreed *istik*ā’ purchase price.

2. The *istik*ā’ purchase will be paid by the investor in one lump sum or by stages at a specified time. The proceeds will be used to finance the project.

3. Subsequently, the investors enter into second *istik*ā’ transaction (*istik*ā’ sale agreement) and agree to construct the identified *istik*ā’ asset for the originator. The selling price which is made up of the original asset purchase price and the profit margin is payable according to an agreed payment schedule.

4. The originator (issuer) will issue *sukūk* to the investors as evidence for issuer’s financial obligation on the settlement of the price.

5. The payment will be settled in periodical basis e.g. semi annual. The *sukūk* shall be redeemable upon maturity.

**istik*ā’ sukūk to represent istik*ā’ asset**

Some *sukūk* issuances represent a proportionate right and ownership interest towards the *istik*ā’ asset instead of evidencing deferred selling price. In that method, it is common that Special Vehicle Purpose (SPV) is initially established to act as a trustee to the investors (*sukūk* holders). Firstly, the SPV raises fund by inviting interested investors to finance a specific project. Upon receiving the proceeds from the investors, the SPV will issue *sukūk* to the investors. The flow of *istik*ā’ transaction begins with the SPV executing an *istik*ā’ contract with a contractor requesting it to manufacture the identified *istik*ā’ asset. Therefore, at this stage the *sukūk* holders possess a proportionate right and ownership interest over the *istik*ā’ asset. Hence, in this *sukūk* transaction, the certificates issued by SPV to the investors serves as right of ownership over the underlying asset of the *istik*ā’ transaction. Once the project is completed, the asset is sold to a third party, and the payment (principal plus profit) will be distributed to investors.

It is also a common practice that *ijara* (leasing) arrangement is combined with *istik*ā’ arrangement. During the construction period, the third party will rent the *istik*ā’ asset under the principle of *ijara mawsūfah fi dhimmah* (forward lease). This combination enables the investors to enjoy periodical return in the form of rental fee during the construction of the asset. The flow of transactions is depicted in the diagram below (Table 2).

![Diagram of *istik*ā’ sukūk transaction structure](Image)

**Table 2 – *istik*ā’ Sukūk Transaction Structure (Model 2)**

*Source – Authors’ Own*

1. The issuance proceeds received by SPV (as trustee of *sukūk* investors) are used to finance construction projects.

2. *Sukūk* are issued to investors by SPV.

3. SPV executes an *istik*ā’ contract with a contractor to build an identified asset which is to be delivered on a specified future date.

4. The *istik*ā’ purchase price is settled on staged basis and at specified times.

5. During the construction, the SPV leases the *istik*ā’ asset under the principle of *ijara mawsūfah fi dhimmah* (forward lease).

6. The end user will pay the rental to SPV at an agreed formula. Proceeds received from the end user is distributed to investors periodically e.g. semi annual basis until maturity.

7. Upon completion of the project, the asset is sold and delivered to the end user.
CONCLUSION
In summary, *istisna’* contract is commonly used in structuring *sukuk* for financing manufacturing and construction projects. Depending on how the *istisna’ sukuk* are structured, the issuance may represent monetary receivables due to indebtedness of the issuer to the investors, which also simultaneously evidence the financial obligation of the issuer. On the other hand, in some structures, the *sukuk* are issued to evidence the undivided right and ownership over the *istisna’* asset under construction. Similar to other sale based *sukuk*, the disadvantage of *istisna’ sukuk*—which are treated as debt instruments—is the restriction on the tradability of the *sukuk*, which is not allowed except in Malaysia. The Middle East jurisdiction ruled that *istisna’ sukuk* cannot be traded on secondary market unless at par value, otherwise it will trigger the issue of bay’ dayn (sale of debt). Despite such restriction, it is interesting to note that, for *istisna’ sukuk* that represent asset, if the *sukuk* assets consist of a minimum of one-third tangible assets as opposed to monetary assets, it meets Shari’ah requirement for the tradability of the *sukuk*—even at discount—as what has been seen in Tabreed Sukuk (Sukuk issued by Tabreed Inc. in 2006).

APPENDIX

**AAOIFI Shari’ah Standards on Parallel *Istisna’***

7.1 It is permissible for the institution to buy items on the basis of a clear and unambiguous specification and to pay, with the aim of providing liquidity to the manufacturer, the price in cash when the contract in concluded. Subsequently, the institution may enter into a contract with another party in order to sell, in the capacity of manufacturer or supplier, items whose specification conforms to the wishes of that other party, on the basis of parallel *Istisna’*, and fulfill its contractual obligation accordingly. This is permissible on condition that the delivery date stipulated in the parallel (sale) contract must not precede that stipulated in the original purchase contract, and, moreover, the two contracts should remain separate from each other (see, item 3/1/4).

7.2 It is permissible for the institution, acting in the capacity of the producer or supplier, to conclude an *Istisna’* contract with the aim of selling such items to the customer on a deferred basis, and to enter into a parallel *Istisna’* contract on an immediate payment basis with a manufacturer or builder to acquire such items as per the specifications in the first contract and sell them to the customer. This is permissible on condition that the two contracts should remain separate and, moreover, be subject to the matters set out in item 3/1/4.

7.3 As a result of concluding an *Istisna’* contract in the capacity of a producer or supplier, the institution must assume liability for ownership risk and maintenance and insurance expenses prior to delivering the subject-matter to the ultimate purchaser (the customer). Moreover, the institution is not permitted in the parallel *Istisna’* contract concluded with the manufacturer, to transfer to the latter the risk arising from its obligations toward the customer.

7.4 It is not permitted to make any contractual link between the obligations under two contract (the contract of *Istisna’* and the contract of parallel *Istisna’*) when they are concluded. Therefore, it is also not permissible for a party to an ordinary *Istisna’* contract i) to withdraw his contractual obligations or delay delivering the subject-matter of the contract because the obligation under parallel *Istisna’* did not take place or ii) to increase the price of the goods to be delivered because of an increase in the cost of goods in the parallel *Istisna’*. However, there is no restriction on the right of the institution to stipulate conditions and requirements when concluding a parallel *Istisna’* contract as a purchaser, including a penalty clause similar to, or different from, that which the customer has stipulated in the first *Istisna’* contract in which the institutions is the supplier.

*Source* – AAOIFI Shari’ah Standards (2010).

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