

# Economic Structural Reforms and Sovereign Assets-Backed Sukuk in Pakistan: A Systematic Literature Review

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## ABSTRACT

**Purpose:** The continuous increase in internal debts without the reciprocal implementation of economic reforms proportionately increase the cost of goods for the economic growth of Pakistan, which ultimately caused serious economic problems in an economy. The core purpose of conducting this study is to propose workable /attainable solutions by imposing economic structural reforms and sovereign asset-backed Sukuk to overcome the economic problems of Pakistan.

**Design/Methodology/Approach:** This study consist of an In-depth analysis consists of a detailed description of the theory and conceptual framework to support the research objective of this study through a systematic literature review.

**Findings:** The Study found that private-public partnerships to be financed through the issuance of sovereign Asset-Backed Sukuk which can ultimately protect investor's risk.

**Implications/Originality/Value:** This study also recommended that by using Assets- Backed Sukuk, an economy can increase in agriculture and industrial goods, increase in exportable goods that support the current account deficit, elimination of unfavorable balance of payments, removal of fiscal deficit and leads towards the sole objective of sustainable economic growth of Pakistan.

## 1. Introduction

Pakistan has been suffering from serious economic problems due to the non-implementation of economic structural reforms. These serious economic problems including but not limited to higher current account deficit, higher fiscal deficit, unfavorable balance of payments, high debts burden, inappropriate GDP growth, deeper poverty line, higher import bills versus lower exports proceeds, significant unemployment rate, higher inflation, poor health facilities and a higher ratio of children deprived of primary education (Economic Survey of Pakistan 2018-2019., 2019).

To remove economic problems being faced by Pakistan, there is dire need to immediately introduce and implement economic structural reforms to fix these economic problems. There have been two major hurdles in introducing and implementing desired economic reforms, non-availability of sufficient funds coupled with non-confidence of the private investors as regards the safety of their investments in the industrial and agriculture sectors of Pakistan economy. To immediately introduce desired economic reforms, under this research it is being modestly submitted a viable solution based on a road map to implement a doable proposal for introducing a new sovereign guaranteed form of financing enabling one-time injection of funds by the private investors including a fresh that yet to be declared under tax returns with a proposal to be taxed at three percent tax rate for the private-public partnership-based establishment of joint ventures between the private sector and provincial governments to create capital projects to get production of agriculture & industrial goods/assets, exploration of oil, gas, coal, gold, silver, raw diamonds, precious stones, construction of China Pakistan Economic Corridor (CPEC) related projects including roads/bridges/railways tracks, and to get alternative energy production.

The management stake for all these proposed private-public partnerships based joint ventures will be available to the private sector based on transparent bidding. The successful bidder will have to bring 10% seed capital of the relevant projects whereas up to 60% will be financed through the issuance of Asset-Backed Sukuk and the rest of 30% will be in the form of industrial/agriculture land or infrastructure to be provided by the relevant provincial government being remaining 30% capital requirements to initiate each said project.

To protect investors of Asset-Backed Sukuk against different risks their investment may face, foremostly losing of the principal amount of investment, it is proposed a federal sovereign guarantee for these Sukuk. Whereas other risks including but not limited to price risk/market risk, reinvestment risk, inflation risk, liquidity risk, foreign exchange risk has been covered under the structuring of Asset-Backed Sukuk and elaborated at the relevant portions of this research (Hameed, 2015).

As it has been proved in this research that an increase in internal debts results in an increase in inflation in Pakistan, therefore by the initiation of an aforementioned proposed new joint venture based fresh economic activities, it is hoped that by the gradual increase in the production of industrial/agriculture goods/assets, extraction & export of minerals, construction of CPEC related projects and increase in alternative energy production, will result in gradual decrease internal debts. Accordingly, time will come that only Asset-Backed Sukuk will be issued and for the sole purpose either to finance capital projects under each private-public partnership based joint venture or to finance their working capital requirements.

After the 18<sup>th</sup> constitutional amendment, provinces have been more empowered to initiate capital investment to increase their revenues. Accordingly, each province can offer attractive private-public partnerships to the private sector to establish joint ventures with the private sector to initiate industrial projects for the production of value-added goods/assets including value-added goods for exports, agricultural projects for the production of agriculture

produces, to initiate exploration & extraction of oil, gas, coal, gold, silver, raw diamonds, precious stones, to initiate construction of China Pakistan Economic Corridor (CPEC) related projects including roads/bridges/railways tracks development, and to initiate alternative energy production units (World Bank, 2019). All these joint ventures will be financed up to 60% of the capital project outlay through the issuance of asset-backed Sukuk to private investors with a proposal to be sovereign guaranteed by the federal government.

## 2. Literature Review

### 2.1. Sukuk: Islamic Bonds

Sukuk is derived from the word Suk, that demonstrate as an instrument of equal value on behalf of investors of the Sukuk holders in the investment of the issuer to the extent of the entire share in the ownership of the recognized tangible assets. The possession over the assets of specific projects or distinctive investment activity based on features and structures including sharing mode approved by the Shari'ah Advisors/Scholars. The Sukuk is the Islamic certificate which is underlined the ownership right to its holder. It can also be called Islamic bonds. The AAOIFI standard indicates that the underlying contract or arrangement for Sukuk must be under Shari'ah (AAOIFI, 2017).

Based on this definition, theoretically, Sukuk holders should share profit and loss resulted from an underlying asset(s)/project/usufruct/services/special investment activity, however during the infancy stage of Islamic Finance, applications of Sukuk in a competitive market usually followed structures providing assets tagging with Sukuk subscription money to make Shari'ah compliance for profit taking by Sukuk holders, followed by a maturity date like conventional bonds, and their yield based on a money market benchmark, like LIBOR. Consequently, the risk of loss by Sukuk holders was restricted to loss of assets instead of loss of business venture, as against shareholders of a common stock company who bear losses of business ventures. Similarly, at the time of insolvency and opposing the shareholders, Sukuk holders can take benefit from the significance right over underlying assets investment activities, in comparison to unsecured creditors. Conditionally and opposing to the early theory in the reflection of Sukuk (sharing in profit and loss), currently the majority of Sukuk so far issued are of fixed income nature and any decrease in the value of an underlying asset(s)/project/usufruct/services/special investment activity is covered by the issuer or originator, by in-time making profit payments to Sukuk holders through any other means even taking loans and by arranging Takaful/insurance to make good the loss to underlying assets. On the other hand, new forms of Sukuk issuance such as asset-backed, convertible, subordinated, and perpetual are today's needs to get rid of serious economic problems being faced by Pakistan. Features of such Sukuk are very similar to a hybrid of conventional bonds and stocks (Richardson, 2007). In the light of special feature of Sukuk that signifying partial ownership of its holder over the related underlying asset (s)/project/usufruct/services/special investment activity or project, somehow this study may practice these new hybrid tools to prevent prevailing risk associated to further securities and hybrids, such as credit and bankruptcy risks along with the practice them more in financing to a private-public partnership based new capital projects (zolfaghari, 2017). Nonetheless, if Shari'ah rulings related to Shirkah and Mudarabah modes which are equity-based/participatory modes of Islamic Finance be used for Sukuk issuance, instead of currently practiced modes of Ijarah and Diminishing Musharakah, then such Sukuk will result in the issuance of Asset-Backed Sukuk (ISRA, 2013).

### 2.2. Conventional Versus Islamic Money and Capital Markets

From conventional perspectives, one way to classify financial markets may be based on the original term to maturity of the financial claims that are traded. Normally, the market in which financial instruments with one year or less to maturity are traded is called the money market,

though one can argue that there are exceptions and we observe financial instruments being traded in the money market having more than one-year maturity. Whereas the market in which medium- to long-term instruments like fixed income securities are traded is classified capital market though one can argue that we observe no maturity equity instruments like equity shares traded in the capital market.(Salah, 2010). Accordingly, one more classification from the investors' perspective can be observed which is based on a risk-averse characteristic(Sulaiman, 2012).

The investors who have risk-averse characteristic mere content to have a low fixed income but without bearing the risk of losing their capital or principal amount of investment, invest their capital in the money market which has no equity instrument being traded (Zaheer, 2013). Whereas, the investors who have the risk appetite to earn more with bearing the risk of losing their capital or principal amount of investment, invest their capital in the capital market. Thus, there are short and long gainers both enter and exit from the capital market based on short and long gain objectives. One more classification which may lead to deciding whether an instrument be offered for subscription and then to be traded is the volume of finance involved in the relevant instrument wise per party exposure/risk appetite of the subscriber/trader interested in the subscription or trading in the relevant instrument.

On the other hand, one of the basic fundamental principles of Islamic Finance is risk-taking which is derived from the Hadith MubarakahAlKhirajBiddaman (AlTirmidi:1206:RaqaMAl-Hadith, Ibn-e-Majah:2234:RaqaMAl-Hadith,) which plain meaning for understanding purpose is profit is linked with taking risk of loss of principal investment (RasulMaal). Accordingly, unless an investor undertakes his willingness to bear the loss of capital or principal amount of investment (RasulMaal) can neither subscribe for nor trade any instrument whether it is conventionally classified as a money market instrument or capital market instrument. Consequently, without going into very deep to understand the basis of Islamic Finance and their applications, just one principle i.e. risk-taking as defined in the aforesaid Hadith Mubarakah clearly distinguishes Islamic money and capital market with conventional money and capital market, though there are other five principles which are equally applied to classify an instrument of Islamic money or capital market. These other five principles are no Riba (interest) earning, no investment activity prohibited by Shari'ah rulings, the sanctity of contracts, fairness, and materiality/economic purpose.

The law of the land permits issuance of Term Finance Certificates having the characteristics of equity capital under section 120 of Companies Ordinance 1984. Accordingly, it is legitimate to structure and issue instruments having the nature of equity capital which can fulfill Shirkah/Mudarabah requirements of instruments issued, subscribed for, and then traded based on Shari'ah principle of profit and loss sharing.

### **3. Methodology**

Based on the above literature,this study consist of an in-depth analysis of a detailed description of the theory and conceptual framework to support the research objective of this study through a systematic literature review.The authors further apply the principle defined in aforesaid Hadith Mubarakah along with applying five other basic principles as defined above, while structuring and issuance of instruments in the Islamic money market or Islamic capital market. Moreover, to explore the effect on economic reforms through asset-backed Sukuk, the researchers applied Shari'ah rulings related to Shirkah and Mudarabah, guiding to earn a return on investments based on taking risk of losing capital or the principal amount of investment (RasulMaal).

## 4. Results&Discssions

### 4.1. Asset-Based and Asset-Backed Sukuk – A Comparison

Since the issuance of Asset-Backed sovereign Sukuk has built-in opportunities to overcome the economic problems of Pakistan, thus literature was reviewed for this purpose. It is found that research for this purpose needs to be advanced as researches so far limited to explore the opportunities of unlocking a new avenue being Sukuk issuance just to highlight how formal sectors can practice Sukuk issuance being a mere substitute for conventional bonds (Araar, 2014), rather exploring potential benefits at the macro level by the issuance of assets backed Sukuk. Literature was also reviewed believing that great prospects are waiting for the betterment of economic conditions of Pakistan by the issuance of sovereign Asset-Backed Sukuk issuance. It is found that research for this purpose needs to be advanced as researches so far limited to explore the prospects of Sukuk issuance in the financial market (Mohamad Zaid Mohd Zain, 2011) Being a Shari'ah-compliant instrument to substitute bonds issuance, rather highlighting potential benefits of sovereign assets backed Sukuk issuance to resolve economic problems of underdeveloped economies. Believing that economic problems can be overcome by the issuance of sovereign Asset-Backed Sukuk, thus literature was reviewed for this purpose. It is found that research for this purpose needs to be advanced as researches so far limited to explore the need for the formation of new regulations for the applications of Islamic Finance as an alternative to capitalism to overcome the economic crisis (Karim, 2010). Consequently, there seems a dire need to present how economic problems being faced by Pakistan can be overcome by the issuance of sovereign Asset-Backed Sukuk.

Although all of the Sukuk traded in the international markets are asset-based, and thus by their commonly used similar structure, making them dependent on the creditworthiness of the sponsor, rather than the performance of the assets. Asset-Backed-Sukuk usually comprises permitting the investor (Sukuk holder) a share of a tangible asset(s) or business venture or business/investment activity corresponding to the pro-rata share of the total risks and rewards, associated with the underlying tangible asset(s) or business venture or investment activity (Medeossi, 2017).

This study moreover clarified some misconceptions often found among the investors and the relevant stakeholders that Asset-Backed Sukuk is just a replica of Asset-Backed securitization. This is not the case, the reason being Asset-Backed securitization just deals with sale transaction, where the originator sells the beneficial ownership of the underlying assets to a special purpose vehicle (SPV) that holds the beneficial ownership of these assets on behalf of investors who enjoy the returns by having assigned the receivables of these assets. On the other hand, Asset-Backed Sukuk is an equity stakeholding investment that requires owing all risks and rewards associated with the underlying tangible asset(s) or business venture or business/investment activity by the Asset-Backed Sukuk holders. Accordingly, for asset-backed Sukuk, the investors have a dependency upon the actual cash flow generated from the underlying asset(s) thus exposure to asset values/performance of the business venture/business activity/investment activity. In other words, in the true sense, profit & loss sharing is the basis for Asset-Backed Sukuk issuance. Thus, more sophisticated analytical modeling and instruments are needed to assess the value of assets/business venture or business/investment activity and their cash flows.

For asset-backed Sukuk, we need to consider how cash flow arising from the assets/business venture or business/investment activity can be monitored and reported. In contrast, under the commonly known existing asset-based Sukuk methodology, we analyze the balance sheet of the sponsor and largely ignore asset(s) performance/performance of the business venture/business/investment activity.

## 4.2. Securitization Model-Based Comparison

Asset-based Sukuk structures based on the securitization model. It is some sort of acquiring beneficial ownership of assets/title of assets or intensifying investment through the sale and leaseback of assets wherein;

1. Beneficial owners/title holders contribute by disbursing an issue price to a special purpose vehicle (SPV).
2. On the Contrary, the SPV issues Sukuk signifying the proportion of each beneficial owner/titleholder owns in the SPV.
3. The SPV practices the funds raised and the acquisition of the beneficial ownership of the asset/title of the assets from the originator/obligor/seller.
4. In return, beneficial ownership/title of assets is granted to the SPV by the originator/obligor/seller.
5. The SPV then, substitute as a lessor on behalf of Sukuk holders, leases the assets back to the originator/obligor/seller under a sale & lease Back arrangement.
6. The originator/obligor/seller becomes lessee and pays agreed payments to the SPV, as the SPV holds the beneficial ownership/title of the assets.
7. The SPV then periodically distributes lease rentals and at the expiry period of Sukuk, capital to the Sukuk holders by selling back the beneficial ownership/title of the assets to the originator/obligor/seller. Thus, the Sukuk holders have recourse to the originator/obligor/seller if a default occurs.

SECP has issued regulations for the issuance of Sukuk. Accordingly, every issue of Sukuk is a legitimate activity to attract investors by subscribing for any issuance of Sukuk not only under section 120 of Companies Ordinance 1984 but under SCEP Regulations for issuance of Sukuk.

## 4.3. Economic Reforms through Asset-Backed Sukuk

Asset-backed Sukuk undoubtedly obligate the traits of equity stake, means the asset(s) or business venture/business/investment activity is either owned directly by the Sukuk holders or through SPV on behalf of Sukuk holders corresponding to the percentage of risks and rewards owned by each Sukuk holder (Christophe J. Godlewski, 2013). Hence, should the returns fail to arise, the Sukuk holders suffer the losses. Besides, since there is no maturity date, therefore revitalization for the Sukuk holders is an open market value at the secondary market, which could be greater than or less than the value at which Asset-Backed Sukuk subscribed in the primary market, as the Asset-Backed Sukuk holders have no recourse to originator/obligor/seller if a default occurs (D. Covitz, 2013).

This study can review the dissimilarities of these two categories of Sukuk under the below table;

**Table.1. Differences between the Two Types of Sukuk**

<b>Categories</b>	<b>Asset-Backed</b>	<b>A New Horizon of Asset-Backed</b>
Source of Payment	The source of payment comes from the originator/obligor's/seller's cash flows.	The source of payment comes from the revenue generated by the underlying asset (s)/business venture/business/investment activity.
Presentation/disclosure of the asset	The assets are shown under leased assets on the balance sheet of the originator/obligor/seller.	The asset(s) are separated from the originator's book by raising capital or the equity raised by the business venture for business or investment activity through Asset-Backed Sukuk issuance, proceed of assets backed Sukuk is shown under redeemable capital. Though Asset-Backed Sukuk holders do not enjoy voting rights in the Company/Corporation the Company/Corporation has an option to purchase the Sukuk from the holders at an agreeable value at the time of such purchase and to show them under Treasury Stocks after converting them into equity stocks having voting rights.
Status of Sukuk holders	Similar to secured creditors, because the originator has to redeem them at maturity date and that Sukuk holders have recourse upon originator/obligor/seller	Similar to equity holders as the Asset-Backed Sukuk holders have the ownership rights over the business venture/business activity and to have a residual claim of residual assets' proceeds in case of liquidation of the Company/Corporation proportionate to the subscription amount along with the right to dispose of the Asset-Backed Sukuk in the secondary market
Recourse	Purchase undertaking at par from the obligor is the ultimate recourse. The recourse is only to the obligor and not the asset.	No recourse to the issuer but to have a residual claim of residual assets' proceeds in case of liquidation of the Company/Corporation proportionate to subscription amount.

**Source: International Shari'ah Research Academy for Islamic Finance (ISRA)**

## 5. Conclusion

Economic problems being faced by Pakistan demand dire need to initiate structural reforms to overcome these economic problems. None of the required structural reforms can be successful unless there is an arrangement of sufficient funds to finance economic activities required by the structural reforms. Accordingly, creating private-public partnerships to establish joint ventures between each respective provincial government and the private investors has been proposed in this research. It has been proposed that all such joint ventures be financed up to 60% of their long-term financing requirements by the issuance of sovereign Asset-Backed Sukuk to overcome economic problems being faced by Pakistan. It is expected that if proposed financing is arranged for the desired creation of joint venture based on private-public partnerships will create desired economic activities in Pakistan to increase in agriculture and industrial goods, increase in exportable goods, increase in cheaper energy production, which will ultimately result in a decrease in inflation, reduction in the poverty line, removal of current account deficit, removal of an unfavorable balance of payments and removal of fiscal deficit to finally achieve the sole objective of sustainable economic growth of Pakistan.

It has been proposed that said private-public partnerships to be financed through the issuance of sovereign Asset-Backed Sukuk, structured to mitigate different risks investors of such Sukuk may face. With this effort, it is expected that increase in agriculture and industrial goods, increase in exportable goods, increase in cheaper energy production, will ultimately result in a reduction in inflation, reduction in the poverty line, removal of current account deficit, removal of an unfavorable balance of payments, removal of fiscal deficit to finally achieve the sole objective of sustainable economic growth of Pakistan.

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