ESTABLISHING SINGAPORE AS AN ISLAMIC FINANCIAL HUB
SUKUK MASTERCLASS
23RD February 2006

THE EVOLUTION OF SUKUK

Instructor:
NATHIF J. ADAM (ACIB)
HEAD OF INVESTMENTS AND INTERNATIONAL BANKING
SHARJAH ISLAMIC BANK
IMPORTANT NOTE

THE VIEWS AND INFORMATION HEREIN ARE PERSONAL TO THE PRESENTER AND DO NOT NECESSARILY PRESENT THOSE OF SHARJAH ISLAMIC BANK OR ANY OTHER PERSON OR ENTITY FOR THAT MATTER. WHILE EVERY EFFORT HAS BEEN MADE TO ENSURE ACCURACY, THE PRESENTER ACCEPTS NO LIABILITY FOR ANY ERRORS OR OMISSIONS OF FACT OR SUBSTANCE IN THE INFORMATION CONTAINED HEREIN.

THIS PRESENTATION DOES NOT REPRESENT BUSINESS SOLICITATION FROM ANY PERSON WITHIN THE CONTEXT OF ANY APPLICABLE LAWS.
INTRODUCTION TO ISLAMIC LAW (SHARIA)

• The Sharia (Islamic Law) is the code of conduct ordained by Islam for its followers.

• It is much wider in scope than the concept of law as understood in a western context.

• Every aspect of a Muslim’s life is subject to the lens of Sharia scrutiny.

• The Sharia regards commercial activities as part of one’s religious life.
IN ISLAM DOING LEGITIMATE BUSINESS AND EARNING A DECENT RETURN NOT ONLY HIGHLY ENCOURAGED BUT REGARDED AN ACT OF WORSHIP
However, the Sharia requires that the creation of wealth should not be at the expense of morals, values and public interest.
CONTRACTS AS THE ESSENCE OF BUSINESS
In Islam proper governance of financial activities is a priority issue. The longest verse in the Quran V. 2:282 discusses in detail matters of debt documentation, witnessing and many other matters.

Hence, all contracts have to be conducted in methods compliant with the principles and rules of Islamic Sharia.

Financial governance is done through a division of the Sharia known as *Fiqh Muamalat* - Islamic commercial jurisprudence. *Fiqh Muamalat* lays down what types of contracts are permissible or valid and what types are impermissible or invalid.
## COMPARATIVE ANALYSIS OF MAIN ISLAMIC FINANCE CONTRACTS

<table>
<thead>
<tr>
<th>Uses of contract</th>
<th>Type of financing</th>
<th>Main Risk(s)</th>
<th>Can financier(s) take Collateral?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Murabaha</td>
<td>Trade Finance</td>
<td>Deferred sale “dayn”</td>
<td>Default</td>
</tr>
<tr>
<td>Ijara</td>
<td>Leasing</td>
<td>Lease finance “Dayn”</td>
<td>Default and destruction</td>
</tr>
<tr>
<td>Bei’- salam</td>
<td>Pre-production finance</td>
<td>Foward sale “Dayn”</td>
<td>Default</td>
</tr>
<tr>
<td>Istisn’a</td>
<td>Construction finance</td>
<td>Installement sale “Dayn”</td>
<td>Default</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>Equity financing</td>
<td>Business (Entrepreneurship) financing</td>
<td>Fraud, negligence, Moral hazard, etc</td>
</tr>
<tr>
<td>Musharaka</td>
<td>Equity financing</td>
<td>Joint venture</td>
<td>Fraud, negligence, Moral hazard, etc</td>
</tr>
</tbody>
</table>
INTRODUCTION TO SUKUK AND CURRENT MARKET OVERVIEW
ASSET MONETIZATION

* ASSET MONETIZATION IS A WELCOME VALUABLE FINANCIAL PROCESS REQUIRED IN ALL CIVILIZED MARKETS

* CONVENTIONALLY THIS IS ACHIEVED THROUGH THE PROCESS OF SECURITIZATION

* IN THE ISLAMIC PERSPECTIVE THIS IS ACHIEVED THROUGH THE PROCESS OF TASKEEK (SUUKUK ISSUANCE)
SUKUK - A GLOBAL PRODUCT

USA
Europe
The GCC
Pakistan
South East Asia
Australia
### SAMPLE OF GLOBAL SOVEREIGN ISSUES

<table>
<thead>
<tr>
<th>SUKUK BENEFICIARY</th>
<th>ISSUE AMOUNT</th>
<th>ISSUE DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>$ 600 M</td>
<td>June, 2002</td>
</tr>
<tr>
<td>IDB</td>
<td>$ 400 M</td>
<td>August, 2003</td>
</tr>
<tr>
<td>Qatar</td>
<td>$ 700 M</td>
<td>September, 2003</td>
</tr>
<tr>
<td>Bahrain</td>
<td>$ 250 M</td>
<td>February, 2004</td>
</tr>
<tr>
<td>Saxony-Anhalt</td>
<td>Euro 100 M</td>
<td>July, 2004</td>
</tr>
<tr>
<td>State of Sarawak, Malaysia</td>
<td>$ 350 M</td>
<td>November, 2004</td>
</tr>
<tr>
<td>Pakistan</td>
<td>$ 600 M</td>
<td>December, 2004</td>
</tr>
<tr>
<td>Dubai Civil Aviation (DCA)</td>
<td>$1 BN</td>
<td>December, 2004</td>
</tr>
</tbody>
</table>
BMA’S IJARA SUKUK PROGRAMME
MEDIUM TO LONG TERM ISSUANCE

Millions

$250
$200
$150
$100
$50
$0

1st Issue 2nd Issue 3rd Issue 4th Issue 5th Issue 6th Issue 7th Issue 8th Issue 9th Issue 10th Issue
The singular “Sakk” derived from classical Arabic meaning a document or tablet representing a contract or conveyance of rights, obligations and/or monies.

Was extensively used during Medieval Islam and related to the transfer of financial obligations.

Western historians, Abraham Udovitch and Walter Fischel confirm the word “Sakk” worked its way into western Europe to become the modern day Latin word of “Cheque”.

SUKUK – A HISTORICAL PERSPECTIVE
**SUKUK**

- Financial securities of equal denominations represented by a portfolio of eligible tangible assets and/or services.

- The Sukuks would be tied to an eligible Sharia contract and would represent undivided ownership rights to the underlying assets and/or services.

- Due consideration should be given to the specific Sharia requirements of each contract.
SAMPLE OF ISSUES POSSIBLE UNDER AAOIFI SUKUK STANDARD

AAOIFI SUKUK STANDARD

SUKUK OF EXISTING OWNED ASSETS

Sukuk of Existing Services

Sukuk of Future Services

Mugharasa Sukuk

Musaqa Sukuk

Muzara’a Sukuk

Istisn’a Sukuk

Murabaha Sukuk

Musharaka Sukuk

Mudaraba Sukuk

Wakala Sukuk
SUKUK: STRUCTURAL PERSPECTIVES
USES OF FUNDS BY ISLAMIC BANKS

CONTRACTS USED IN FINANCING ACTIVITIES

DEBT BASED CONTRACTS
- Murabaha
- Istisna’a
- Ijara
- Bei’ Salam

EQUITY BASED CONTRACTS
- Musharaka
- Mudarabah
- WAKALA
- Muzara’a
UNDERSTANDING ASSET SALE & LEASE-BACK STRUCTURES AS THE BASIS FOR MOST SUKUK TRANSACTIONS
IJARA SUKUK

- The dominant type of Sukuk so far issued.
- Enables easy tradability of Sukuk (subject to terms of underlying contract).
- Is a fixed income asset class type - enables distribution of pre-determined dividends (coupon-paying bonds)
- Are asset or service backed
IJARA SUKUK

• Can be issued by the owners of:
  - Existing Leased assets
  - Existing assets to be leased on contract
  - Assets to be constructed/manufactured subject to lease.
  - Assets held on the basis of a Head Lease.
  - Services acquired
  - Services to be acquired.
SALE & LEASE-BACK SUKUK

- The leased assets are the responsibility of the Lessor (Issuer) throughout the duration of the Ijara.

- Services such as major maintenances may be maintained by the lessee on behalf of the Lessor. This may be done through a service agency agreement.

- Where a variable rate Sukuk is envisaged, a Master Lease Agreement will be ideal.
Primary Sukuk Holders

Secondary Sukuk Holders

Issue Arranger

Memo of Understanding

Periodic Rentals

Sukuk Issuance To Investors (PPM)

Sukuk Proceeds

Periodic Rentals

Special Purpose Company (SPC) (Issuer)

Originator takes Sukuk proceeds

Asset sale contract

Periodic Rentals

ORIGINATOR

ORIGINATOR

1

2

3

4

5

6

7

8

9

10
SIMILARITIES AND DIFFERENCES OF SUKUK WITH OTHER CONVENTIONAL SECURITIES
THE SIMILARITIES

• **Marketability:**
  Sukuk are monetised real assets that are liquid, easily transferred and traded in the financial market.

• **Ratability:**
  Sukuk are easily analysed by international and regional rating agencies which facilitates their marketability.

• **Enhancement:**
  Different Sukuk structures may allow for credit enhancements or wraps that broaden their appeal to risk-averse investors in the Islamic investor sphere as well as conventional investors outside the Islamic market.

• **Versatility:**
  The versatility of Sukuk structures defined in the AAOIFI standards allow: structuring across legal and tax domains of products that meet diverse financing needs; may offer fixed or variable income options; may achieve cross listing capabilities and are compatible with global bond regulations such as regulations S and 144A.
CONVENTIONAL BONDS

DEBENTURE BONDS
(General obligations of the issuer)

SECURED BONDS
(Collateralized by specific assets of the corporation)
## COMPARISON WITH CONVENTIONAL DEBENTURE BONDS

<table>
<thead>
<tr>
<th>SUKUK</th>
<th>BONDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sukuk represent ownership stakes in existing and/or well defined assets.</td>
<td>Bonds represent pure debt on the issuer.</td>
</tr>
<tr>
<td>The subject of the contract in Sukuk is a contract based on lease or a defined business undertaking between the Sukukholders and the originator.</td>
<td>Bonds basically create a Lender/Borrower relationship - i.e. a contract whose subject is purely earning money on money (Riba-Usury).</td>
</tr>
</tbody>
</table>
## COMPARISON WITH DEBENTURE BONDS --- CONT.

<table>
<thead>
<tr>
<th>SUKUK</th>
<th>BONDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>The underlying Sukuk assets, business or project must be of a nature that their halal (permissible) use is possible.</td>
<td>Such a condition does not apply under bonds which can be issued for illegitimate purposes</td>
</tr>
<tr>
<td>Sale of a Sukuk represents a sale of a share of assets, business activity or project.</td>
<td>Sale of a bond basically represents sale of a debt.</td>
</tr>
<tr>
<td>COMPARISONS WITH SHARES</td>
<td>SUKUK</td>
</tr>
<tr>
<td>-------------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td><strong>Duration of investment</strong></td>
<td>Limited investment period</td>
</tr>
<tr>
<td><strong>Rights to company capital gains</strong></td>
<td>Not in Ijara contracts but increased returns may be earned in Mudaraba and Musharaka notes</td>
</tr>
<tr>
<td><strong>Frequency of flow of income from investment</strong></td>
<td>Regular/variable</td>
</tr>
</tbody>
</table>
SUKUK COMPARED TO CONVENTIONAL DERIVATIVES PRODUCTS
DERIVATIVES

• A derivative is a financial instrument which derives its value from the value of other financial instruments (underliers). Example – a stock option is a derivative because it derives its value from the value of a stock.

• A unique characteristic of derivatives is the further unbundling of the derived product into further exotic instruments.

• For instance, a typical bond could be unbundled into credit tranches, principal strips, interest-only strips, interest differential strips, with the possibility of swapping the interest strip against another interest index.
DERIVATIVES

• Thus, the various derived products move far and far away from the primary product (underlier).

• Both the primary instrument and its derived off-shoots are traded separately.

• Derivatives also trade in rights or claims as well as notional assets. Example – a stock option or warrant relates to the right to acquire a stock under specific conditions of time and price.
DERIVATIVES

• Derivative contracts transfer risk, especially price risk, to those who are able and willing to bear it.

• How they transfer risk is complicated and frequently misinterpreted.

• Derivatives have also been associated with some spectacular financial failures and with dubious financial reporting.
<table>
<thead>
<tr>
<th>DERIVATIVES</th>
<th>SUKUK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Based on rights and claims</td>
<td>Asset based and continue to carry asset risk directly even when traded.</td>
</tr>
<tr>
<td>Have no intrinsic value</td>
<td>Have intrinsic value. Attached to the title or beneficial ownership of an asset</td>
</tr>
<tr>
<td>Multiple generations of distinctive contracts are created from the basic underlying contract.</td>
<td>Sukuk relate to only one contract and maintain asset linkage at all times.</td>
</tr>
</tbody>
</table>
SUKUK AND CONVENTIONAL DERIVATIVES

Derivatives imply:

- Speculation (*Maysir*).
- Uncertainty & ambiguity (*Gharar, jahala*).
- Exploitative - Zero sum game - (*Zulm*).
- High leverage - interest - (*Riba*).
DERIVATIVES AND SYSTEMIC RISK

• Derivatives have also been associated with some of the most spectacular financial shocks & failures in the world

  • The large failures of U.S. savings banks in the ’80s
  • Baring bank - 1995
  • The LTCM (Long Term Capital Management) 1998 - the effect of the fund’s speculative activities was that its capital fell from $4.8 billion to about $600 million. Company’s debacle had such an impact that world stock markets fell by 11% on the announcement of the news. Collapse nearly brought down many counterparties but a FED sponsored rescue plan saved the day with the injection of about US$3.6 Billion into the company by a consortium of banks.

  • Enron – was a large user and promoter of derivative contracts and its demise in 2001 raised significant concerns about counterparty (credit) risk and financial reporting.
Sukuk is different from Bonds, shares and derivatives but is the same as conventional securitization.

Pls comment.
Despite the closeness of overall concept, Sukuk is not also equal to “Securitization” as it is known in its conventional sense.

Securitization:
- Securitization generally relates to the converting of loans of various sorts into marketable securities by packaging the loans into pools and then selling shares of ownership in the pool itself.

Sukuk:
- Investment Sukuk (as defined by AAOIFI) are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services ….
Despite the closeness of overall concept, Sukuk is not also equal to “Securitization” as it is known in its conventional sense.

Securitization:

- Securitization generally relates to the converting of loans of various sorts into marketable securities by packaging the loans into pools and then selling shares of ownership in the pool itself.

Sukuk:

- Investment Sukuk (as defined by AAOIFI) are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services …..
STRUCTURING AND ISSUING OF SUKUK DEALS
CORPORATES TAPPING INTO SUKUK
SLOW MOVE BY CORPORATES INTO SUKUK

Reasons for apparent slow development of corporate Sukuk Market:

- Lack of product awareness and understanding
- Reluctance on the part of the corporates to provide proper transparency and the full disclosure of financials.
- Lacking the mass of Sharia compliant assets to support a good sized issue in the market.
- Most companies are small and can only tap the Sukuk market if supported by excessive credit enhancements.
CORPORATES TAPPING THE SUKUK MARKET

- Broadens a company’s financing base away from traditional sources.
- Usually has longer tenor than traditional bank loans.
- Can serve to raise the company’s profile in the market and,
- Bank lines are saved/freed for other strategic investments.
The impact of rising financing rates tends to be compensated for by better earnings growth – particularly so in emerging markets such as the GCC.

Issue sizes of such companies would usually be smaller in size – hence provides comfort of less speculative activity.

The high yield levels of such issuances would usually be seen as a compensation to any underlying risks.
**SOME CORPORATE ISSUES FLOATED IN THE GCC SO FAR**

<table>
<thead>
<tr>
<th>COMPANY &amp; COUNTRY</th>
<th>ISSUE SIZE</th>
<th>COMMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guthrie, Malaysia</td>
<td>US$ 250 M</td>
<td>First corporate Sukuk - December, 2002</td>
</tr>
<tr>
<td>FIIB, Bahrain (Now Arcapita)</td>
<td>US$ 75 M</td>
<td>July, 2003</td>
</tr>
<tr>
<td>Hanco, Saudi Arabia</td>
<td>US$ 26 M</td>
<td>Fleet securitization</td>
</tr>
<tr>
<td>Tabreed, UAE</td>
<td>US$ 100 M</td>
<td></td>
</tr>
<tr>
<td>Emaar, UAE</td>
<td>US$ 65 M</td>
<td></td>
</tr>
<tr>
<td>Durat Al Khaleej, Bahrain</td>
<td>US$ 120 M</td>
<td>Development Sukuk</td>
</tr>
<tr>
<td>The Investment Dar (TID)</td>
<td>US$ 50 M</td>
<td>Musharaka Sukuk</td>
</tr>
<tr>
<td>Emirate Airlines, UAE</td>
<td>US$ 550 M</td>
<td>First ever Sukuk by an airline</td>
</tr>
<tr>
<td>Amlak Finance, UAE</td>
<td>US$ 200 M</td>
<td></td>
</tr>
<tr>
<td>Dubai Metals &amp; Commodities, UAE</td>
<td>US$ 200 M</td>
<td></td>
</tr>
<tr>
<td>Bahrain Financial Harbour, Bahrain</td>
<td>US$ 134 M</td>
<td>Development Sukuk</td>
</tr>
<tr>
<td>Commercial real estate company, Kuwait</td>
<td>US$ 100 M</td>
<td></td>
</tr>
<tr>
<td>Al Safeena, Bahrain</td>
<td>US$ 26 M</td>
<td>First ever shipping Sukuk</td>
</tr>
</tbody>
</table>
PARITIES TO A SUKUK TRANSACTION

- Lead arranger
- Lawyers
- Originator
- Issuer (SPV)
- Primary investors
- Service provider(s)
- Secondary investors
- Credit enhancers
- Rating agency
- Trustee
- Auditors
- Regulators
COSTS ASSOCIATED WITH SUKUK ISSUANCE

• Cost of financing (the lease rentals).

• Initial Issue expenses. Thus:
  • Credit enhancement support for the assets
  • Structuring fees payable to bankers
  • Legal, accounting and tax advice fees
  • Rating agencies’ fees
  • System modifications
  • Management time
OFFERING THE SUKUK

• In common with conventional practice offering based on a prospectus.

• Prospectus should be detailed enough to avoid any misunderstandings and misinterpretations by the investors in the Sukuk (Jahala).

• Prospectus stands for Sharia contract between the two parties i.e. issuer and subscriber and represents the offer (Ijab) from the issuer and acceptance (Qubul) from the subscriber.
MONITORING TRANSACTION PERFORMANCE

• The need for disclosure: timely and adequate reporting.

• Surveillance: expectations versus performance through the cycle

• Monitoring the Servicer.

• Counterparty risk: tracking credit quality
SUKUK AL MUSHARAKA
(JOINT VENTURE OR PARTNERSHIP SUKUK)
RISK PARTICIPATION SUKUK

1. Highly encouraged by the *Ulema*’ in view of the ability of these contracts to start-up businesses and venture capital. Thus, such Sukuk create a balance to Ijara Sukuk which only tend to recycle existing assets.

2. Nine contracts out of the 14 contracts covered in AAOIFI Sukuk standard relate to risk participation Sukuk. This include Mudaraba, Musharaka, Muzara’a etc.

3. Can be applied to practically any asset class that can generate legitimate and predictable cash flows.

4. Besides new businesses can also be good as restructuring finance for running businesses etc.

5. Not all originators will have the extent of unencumbered assets for asset-backed Sukuk
MUSHARAKA – SOME NOTABLE ADVANTAGES

• Flexibility of application.

• Can be an excellent mode of finance particularly for short term transactions.

• Prospect of higher than average returns without significantly higher risks.
CASE STUDY TWO

HALATEL is a start up company which has recently been licensed to provide GSM mobile services. The company intends to go for an IPO in two years’ time but would like to start its activities immediately because of the high demand for such services in the country.

As the proprietor of VENTURE INVESTMENTS LIMITED (VIL), you are approached by the MD of the company to discuss his requirement for 20M (local currency) Islamic financing mainly as working capital to start off the company.

Your assistant is of the opinion that this could be a perfect case for Sukuk issuance.

REQUIRED

Do you agree with your assistant’s view? If so how would you proceed?
## ILLUSTRATIVE TERM HEET - MUSHARAKA SUKUK

<table>
<thead>
<tr>
<th><strong>Sukuk type</strong></th>
<th>Musharaka Sukuk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purpose of offering</strong></td>
<td>To finance the working capital needs of the company</td>
</tr>
<tr>
<td><strong>Sukuk tenor</strong></td>
<td>3 years.</td>
</tr>
<tr>
<td><strong>Issue size</strong></td>
<td>20 million (local currency)</td>
</tr>
<tr>
<td><strong>Issuer of Sukuk</strong></td>
<td>SPV</td>
</tr>
<tr>
<td><strong>Arranger</strong></td>
<td>Venture Investments Limited (VIL)</td>
</tr>
<tr>
<td><strong>Profit expected by investors</strong></td>
<td>10% p.a. distributable semi-annually</td>
</tr>
<tr>
<td><strong>Payment guarantee</strong></td>
<td>Guarantee to be provided by company</td>
</tr>
<tr>
<td><strong>Sukuk tradability/listing</strong></td>
<td>Expected to be listed for secondary trading</td>
</tr>
<tr>
<td><strong>Principal amount repayment</strong></td>
<td>Annually</td>
</tr>
</tbody>
</table>
SUKUK AL WAKALA

A LOOK AT A CURRENT DEAL
<table>
<thead>
<tr>
<th><strong>WAKALA (AGENCY) SUKUK</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type</strong></td>
<td>Agent financed to undertake certain activities</td>
</tr>
<tr>
<td><strong>Type of activities</strong></td>
<td>May be specific or general activities</td>
</tr>
<tr>
<td><strong>Return for investors</strong></td>
<td>Would usually be an agreed floater</td>
</tr>
<tr>
<td><strong>Agent’s incentive</strong></td>
<td>Any return generated above the agreed return for the investors belongs to the agent</td>
</tr>
<tr>
<td><strong>Principal repayment:</strong></td>
<td>As may be agreed (Bullet or amortizing)</td>
</tr>
<tr>
<td><strong>Collaterals</strong></td>
<td>Any acceptable collaterals may be taken to cover the eventualities of fraud, negligence, mismanagement, moral hazard.</td>
</tr>
</tbody>
</table>
PROJECT FINANCE
SUKUK
Your client, NEPKEN REALTY LIMITED has had about Sukuk financing and approaches you for a discussion about financing a shopping mall through Sukuk. You are happy with the following terms proposed by the client for the transaction:

- **Total construction cost**: $60,000,000
- **Customer contribution**: The project land
- **Required financing**: 100% funding for the construction
- **Financing margin**: 6 month LIBOR + 3% (6%)
- **Construction period**: 18 months (Payments to contractor will be made semi-annually). Customer shall not make any repayments during this period
- **Repayment period**: 5 years
- **Repayment structure**: Equal semi-annual repayments in arrears.

**Required:**

a) Pls proceed with the deal execution including repayment structure.
BECAUSE OF THE LAND CONTRIBUTED BY THE CLIENT, THE PROJECT TAKES THE FORM OF A \textit{JOINT VENTURE} AND THE LEASE CONTRACT WILL ONLY RELATE TO THE PORTION THAT BELONGS TO THE FINANCIER
ANY PART OF THE PROJECT WHICH IS COMPLETED REPRESENTS LEASABLE VALUE FOR WHICH A LEGITIMATE RENTAL CAN BE CHARGED
### IMFD - FINANCING STRUCTURE DURING CONSTRUCTION

<table>
<thead>
<tr>
<th>PPC</th>
<th>PPC Amount</th>
<th>CUSTOMER CONTRIBUTION</th>
<th>SUKUK AMOUNTS PAID</th>
<th>CUMULATIVE SUKUK FINANCING</th>
<th>RENTAL RATE</th>
<th>NO. OF DAYS</th>
<th>RENTAL DUE TO SUKUKHOLDERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>PPC 1</td>
<td>20,000,000</td>
<td>0%</td>
<td>20,000,000</td>
<td>20,000,000</td>
<td>6%</td>
<td>180</td>
<td>600,000</td>
</tr>
<tr>
<td>PPC 2</td>
<td>20,000,000</td>
<td>0%</td>
<td>20,000,000</td>
<td>40,000,000</td>
<td>6%</td>
<td>180</td>
<td>1,200,000</td>
</tr>
<tr>
<td>PPC 3</td>
<td>20,000,000</td>
<td>0%</td>
<td>20,000,000</td>
<td>60,000,000</td>
<td>6%</td>
<td>180</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>60,000,000</td>
<td></td>
<td></td>
<td></td>
<td>3,600,000</td>
</tr>
</tbody>
</table>

The rental amount due to the Sukukholders from construction period shall be capitalized and this together with the bank’s cumulative financing amount will, upon completion of the project, be accumulated as one amount to form the value to continue to be leased out under the IMFD.
<table>
<thead>
<tr>
<th>CONSECUTIVE LEASE #</th>
<th>Fixed rental Amount for period</th>
<th>Outstanding bank’ share</th>
<th>Rental periods</th>
<th>Rental repayment rate</th>
<th>Variable rental amount for period</th>
<th>Total rental amount payable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>63,600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>01</td>
<td>6,360,000</td>
<td>57,240,000</td>
<td>180</td>
<td>6%</td>
<td>1,908,800</td>
<td>8,268,000</td>
</tr>
<tr>
<td>02</td>
<td>6,360,000</td>
<td>50,880,000</td>
<td>180</td>
<td>6%</td>
<td>1,717,200</td>
<td>8,077,200</td>
</tr>
<tr>
<td>03</td>
<td>6,360,000</td>
<td>44,520,000</td>
<td>180</td>
<td>6%</td>
<td>1,526,400</td>
<td>7,886,400</td>
</tr>
<tr>
<td>04</td>
<td>6,360,000</td>
<td>38,160,000</td>
<td>180</td>
<td>6%</td>
<td>1,335,600</td>
<td>7,695,600</td>
</tr>
<tr>
<td>05</td>
<td>6,360,000</td>
<td>31,800,000</td>
<td>180</td>
<td>6%</td>
<td>1,144,800</td>
<td>7,504,800</td>
</tr>
<tr>
<td>06</td>
<td>6,360,000</td>
<td>25,440,000</td>
<td>180</td>
<td>6%</td>
<td>954,000</td>
<td>7,314,000</td>
</tr>
<tr>
<td>07</td>
<td>6,360,000</td>
<td>19,080,000</td>
<td>180</td>
<td>6%</td>
<td>763,200</td>
<td>7,123,200</td>
</tr>
<tr>
<td>08</td>
<td>6,360,000</td>
<td>12,720,000</td>
<td>180</td>
<td>6%</td>
<td>572,400</td>
<td>6,932,400</td>
</tr>
<tr>
<td>09</td>
<td>6,360,000</td>
<td>6,360,000</td>
<td>180</td>
<td>6%</td>
<td>381,600</td>
<td>6,741,600</td>
</tr>
<tr>
<td>10</td>
<td>6,360,000</td>
<td>-</td>
<td>180</td>
<td>6%</td>
<td>190,800</td>
<td>6,550,800</td>
</tr>
<tr>
<td></td>
<td>63,600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SUKUK APPLIED TO REAL ESTATE
Aqarat SPC is a member of another group of companies in your country. Your assistant is approached by the Manager of the company for possibilities of funding support to meet payment of a major obligation which will be due for settlement shortly. The manager mentions that the main asset of the company is a commercial property which is mortgaged to a conventional bank but is leased out to a creditworthy international institution.

Your assistant is of the opinion that a sukuk offering may help the company but is not quite sure of the *modus operandi*

**Required:**

What advise will you give your assistant?
HEAD-LEASE SUKUK (SUUK AL MANAFI’)

“These are certificates of equal value issued by the owner of the usufruct of an existing asset (lessee) either on his own or through a financial intermediary, with the aim of sub-leasing the usufruct and receiving the rental from the revenue of the subscription so that the holders of the certificates become owners of the usufruct of the asset”

AAOIFI SUKUK STANDARD CLAUSE 3/2/1/2

“The issuer of these certificates is the seller of usufruct of an existing asset, the subscribers are the buyers of such usufruct, while the funds mobilized through subscription is the purchase price of the usufruct. The certificate holders become joint owners of the usufruct sharing its benefits and risks”

AAOIFI SUKUK STANDARD CLAUSE 5/1/5/2(a)
USUFRUCT SUKUK

“A lessee may invite co-lessees to share with him in the usufruct to which he has a right by assigning them shares in the usufruct ........”

AAOIFI SHARIA STANDARD NO. 9 CLAUSE 6/1
CHARACTERISTICS OF REQUIRED ASSETS

• Underlying assets should exist in a form that is well defined and legally enforceable.

• Assets should have volume which is sufficiently large and homogenous to facilitate statistical analysis.

• Assets should have sufficient diversification for example, geographic and socio-economic to reduce vulnerability to economic stresses.
ASSET TRANSFER

• It is important, both from a Sharia and legal perspectives, that the transfer of assets by the originator has the spirit of a genuine transfer.

• The transfer of assets should not be seen merely as a borrowing on the security of the assets.

• Under the Sharia, ownership of an asset is possible under a sale contract even if the title is not registered in the purchasers name.

• Hence, constructive transfer is acceptable.
CONDITIONS ENABLING SEPARATION OF THE ASSETS

- The transfer must be a true sale, or its legal equivalent. A simple pledge is not acceptable.

- The assets must be owned by a special purpose corporation, whose ownership of the sold assets is likely to survive bankruptcy of the seller.

- The special – purpose vehicle that owns the assets must be independent
SPECIAL PURPOSE VEHICLE (SPV)

• Also known as Special Purpose Entity (SPE) or Special Purpose Company (SPC) created solely for the purpose of the transaction since it is impossible to transfer such assets to the investors directly.

• Is the issuer of the certificates and is formed as a “TRUST” on the basis of Declaration of Trust through which the Issuer declares that it will hold certain assets upon trust solely for the holders of the certificate(s) held by each certificateholder.

• It is a bankruptcy remote entity with the aim of shielding the assets from any risks associated with the originator. By its very nature, an SPV must be distanced from the sponsor both in terms of management and ownership, because if the SPV were to be owned or controlled by the sponsor, there is no difference between a subsidiary and an SPV.
• Reputable institutions should be selected to form and manage the trust.

• Choice of appropriate jurisdiction with strong legal infrastructure important.

• The parties involved with the trust need to be different from other service providers to avoid conflict of interest.

• The trust documentation should not embody any matters repugnant to the Sharia.
Domiciled in 'offshore' capital havens;

Have a specified life; its powers are limited to what might be required to attain its purpose and its life is destined to end when the purpose is attained.

May take any one of a number of legal forms: corporation, partnership, trust, unincorporated entity or a multi-user structure. However, Sukuk SPVs are commonly formed as trusts through the use of Charitable trusts as intermediary owner of the SPV.

By inducting the charitable trust as owner, the SPV becomes an Orphan company - a company which has no identifiable shareholder/owners - e.g., if the trust is a public charitable trust, there is no identifiable beneficial owner of the SPV.
SUKUK CERTIFICATES

• Limited recourse certificates - represent entitlements solely to the trust assets.

• Pari Passu – Each certificate represents an undivided beneficial ownership in the trust assets and ranks Pari Passu without any preference with any other certificates.

• Not bonds or debt obligations of the issuer.
SUKUK CERTIFICATES

• Usually issued as **global certificates**

• Ownership interests of, and transfers of ownership by, investors are reflected solely by appropriate books and records entries.

• The certificates are lodged in the facilities of a securities depository or other book-entry agent and kept safely by the agent until maturity.

• The securities are available to the investors (as beneficial owners only in book-entry form, and no certificates can be obtained.)
RATING THE SUKUK

Why a rating?

• Determine level of risk inherent in a transaction.

• To help in the pricing of the transaction.

• To help in the marketability of the Sukuk

• The rating is assigned to the Sukuk and not on the lessee.
SUUK RATING ANALYSIS

Risk analysis prior to Issuance of Sukuk

Legal structure

Credibility and profile of deal participants

Integrity of cash flow

Credit enhancement

Ratings

Overall beneficiary credit profile and standing

Screening of assets to be included in the portfolio

Diversification of the portfolio

Legal insulation of assets from beneficiary bankruptcy

Legal insulation from servicer default

Seller/ Lessee/ servicer

Trustee ,

Guarantor(s) if any

Cash flow sufficiency and mismatches

“internal” Credit enhancement

“Third party” Credit enhancement

Direct recourse to Lessee

Over-collateralization

Cash reserve account(s)

Financial guarantees
RATING PROCESS

Large corporations can benefit from the due diligence process by:

a) Either demonstrating operational excellence and/or

b) Identifying operational risk
## Rating of Sukuk

### Sample of Ratings by S&P

<table>
<thead>
<tr>
<th>Sukuk Beneficiary</th>
<th>Issue Amount</th>
<th>Date Rated</th>
<th>Rating Granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>$ 600 M</td>
<td>June, 2002</td>
<td>A-</td>
</tr>
<tr>
<td>IDB</td>
<td>$ 400 M</td>
<td>August, 2003</td>
<td>AAA</td>
</tr>
<tr>
<td>Qatar</td>
<td>$ 700 M</td>
<td>September, 2003</td>
<td>A+</td>
</tr>
<tr>
<td>Bahrain</td>
<td>$ 250 M</td>
<td>February, 2004</td>
<td>A-</td>
</tr>
<tr>
<td>Saxony-Anhalt</td>
<td>Euro 100 M</td>
<td>July, 2004</td>
<td>AA-</td>
</tr>
<tr>
<td>Loehmann</td>
<td>$ 110 M</td>
<td>September, 2004</td>
<td>CCC</td>
</tr>
<tr>
<td>Sarawak</td>
<td>$ 350 M</td>
<td>November, 2004</td>
<td>A-</td>
</tr>
<tr>
<td>Pakistan</td>
<td>$ 600 M</td>
<td>December, 2004</td>
<td>B+</td>
</tr>
</tbody>
</table>
DEALING WITH RISKS IN SUKUK

RISKS IN SUKUK

ASSET RISK

COUNTRY RISK

CREDIT RISK

THIRD PARTY LIABILITY RISK

TOTAL LOSS RISK

CURRENCY RISK

DEALING WITH RISKS IN SUKUK
FORMS OF CREDIT ENHANCEMENT

- A credit wrap by a third party which undertakes to step in to meet the obligations of the SPV to investors if the SPV is unable to do so.

- A third party, such as a well-rated bank may provide a letter of credit that promises to cover losses of the SPV up to a maximum amount.

- Insurance cover may be taken out on the underlying assets of the Sukuk transaction.
FORMS OF CREDIT ENHANCEMENT - 2

- A cash reserve (Cash collateral) may be created where part of the Sukuk proceeds are maintained to absorb losses which may arise as a result of cashflow delays and/or defaults.

- Over-collateralization where the value of the underlying pool of assets may exceed the value of the issued Sukuk.
TRUE SECURITIZATION SUKUK

Vehicle-Backed Ijara Sukuk:

A Case Study of:

HANCO SUKUK, SAUDI ARABIA
The first corporate Sukuk from the Kingdom (excluding IDB).

The first to be based on the receivables of leased movable assets – thus, not immovable assets as in previous ijara Sukuk.

The first Sukuk by a private family-owned business in the GCC. This is expected to open the way for more similar businesses as they migrate from private to public businesses.
TRANSACTION HIGHLIGHTS

• **Originator**: Fathi Taleb & Sons commercially known as Hanco Rent-A-Car (Kingdom of Saudi Arabia)

• **Sukuk type**: Inventory Fleet Securitization

• **Underwriter & Placement Agent**: Shamil Bank of Bahrain

• **Structurer & Arranger**: BEMO, Lebanon

• **Transaction Size**: SR 98 million (i.e., US$ 26.13 million)
TRANSACTION HIGHLIGHTS

• **Use of Proceeds**: Settlement of bank loans to un-encumber existing assets and purchase new ones (SR 102 million)

• **Assets**: 2,344 vehicles including cars, trucks, minivans, and buses

• **Term**: 3 years starting March 2004 with an average life of nearly 22 months

• **Profit Rate**: Expected 6% per annum on the Sukuk principal outstanding balance (Variable rate)

• **Repayment**: Reducing amortization
LEGAL RISKS
IN SUKUK
In the event of Hanco’s bankruptcy, possibility of a Saudi court concluding that the assets were mere security for a loan to Hanco and are, therefore, available for the creditors of the company.

Can that be avoided?

• Absence of a clear bankruptcy regime in SA.
• Absence of any binding precedent.
BANKRUPTCY REMOTENESS – AREAS OF CONCERN

- Title risk
- Consolidation risk
- Claw back
A) Proper perfection of legal interest in the fleet

- Actual purchase of vehicles from Hanco. Traffic (Murur) registrations.

- Ensuring that vehicles were not pledged or encumbered in favour of any of Hanco’s creditors.
A) **Ensuring the distinctiveness of the SPC**

- That the SPC is a separate legal entity and there is no ownership/shareholding relationship between the Hanco and the SPC.

- That the SPC has paid off the price for the purchased assets in consideration for the transfer of ownership/title.

- That the SPC was/is not managed by Hanco.

- That the vehicles are not operated as part of Hanco’s business.

- That the shareholders of the SPC are not indemnified by Hanco against any losses or liabilities of the Spc
DEALING WITH BANKRUPTCY REMOTENESS –
MITIGATING THE “CLAW BACK” RISK

The risk that a court in the Kingdom may disregard the transfer of the assets to the SPC and claim (claw) Back the assets under the pretext that this was done prior to or in contemplation of a bankruptcy.

Mitigant:

- The SPV should be structured in such a way as to make it bankruptcy remote and therefore ensure that the pool of assets is not placed at risk by an insolvency of the SPV or of the borrowing company.

- If the SPV stands on its own feet in terms of ownership, funding and management, it achieves an arms length relation with the originator and may therefore be treated on that basis by the courts.
SUMMARY OF LEGAL ASPECTS IN SUKUK

• Legal agreements for Sukuk

• Legal title transfer and legal ownership

• Purchase and sale undertakings

• Events of default

• Liquidated damages
SUMMARY OF LEGAL ASPECTS IN SUKUK

• Termination

• Insolvency

• Governing law and jurisdiction

• Special reference to English Law and civil laws of the Arab Gulf

• Taxation
SUMMARY OF FINANCIAL REGULATION IN SUKUK

• US and UK financial regulation

• Sukuk capital weighting under Basel II

• Listing Sukuk issues on a stock exchanges

• Mitigating exposure to financial risks in Sukuk
CASE STUDY

CAGAMAS SUKUK – MALAYSIA

(Securitization of residential mortgage-backed securities)
## CAGAMAS SUKUK

<table>
<thead>
<tr>
<th>Amount</th>
<th>US$ 540 M.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer</td>
<td>CAGAMAS MBS</td>
</tr>
<tr>
<td>Maturity</td>
<td>3 –15 years</td>
</tr>
<tr>
<td>Sukuk type</td>
<td>Sukuk Al Musharaka</td>
</tr>
<tr>
<td>Underlying assets</td>
<td>Portfolio of government Mortgages</td>
</tr>
<tr>
<td>No. of tranches</td>
<td>6</td>
</tr>
<tr>
<td>Rating</td>
<td>AAA (by both MARC &amp; RAM)</td>
</tr>
</tbody>
</table>
FUTURE RECEIVABLES AND SUKUK
AIRLINE CORPORATE SUKUK
DISCUSSION CASE STUDY

ROLLA Airways in Nepal is undergoing a huge growth phase particularly as the company continues to serve the large Nepalese expatriate community in the GCC countries. The company currently needs about US$ 100 Million as part of its expansion plans but its local credit lines are not quite helpful. The financial director of the company approaches you as an institution based in the GCC for advice.

REQUIRED
- Do you think a Sukuk issue would be helpful for the company? If so what are the main risks that may apply in this case and how may such risks be mitigated?
• What are the main collateral backings for the transaction?

• It is difficult investing in such projects because of the high political risks of the host countries. Pls confirm true/false and justify.

• The only problem is that such structures may not be of interest to many risk-averse foreign investors because they cannot be rated by the rating institutions in view of the poor sovereign ratings of the host countries. Pls comment.

• The expected receivables are tradable and the Sukuk are thus easily traded. Pls confirm true/false and justify why.
BUILD OPERATE AND TRANSFER (BOT) SUKUK
FINANCIAL CONSIDERATIONS

✓ That the underlying operations generate sufficient enough receivables that can pay off the SPVs obligation

✓ That the timing of expected receivables match the payment terms of the Sukuk Certificates

✓ The risk profile of the obligor.
SUKUK SUMMARY AND THE WAY FORWARD
VALUE PROPOSITION----TO INVESTORS

• Relatively a safe form of investment - asset backed.

• Could offer superior forms of returns than other investment avenues.

• Can choose between fixed and variable returns depending on future market perceptions.

• Liquidity - can be traded in both the primary and secondary markets.
VALUE PROPOSITION -- TO ISLAMIC BANKS/FINANCIAL INSTITUTIONS

• An ideal tool for liquidity management.

• A tool for mobilization of fresh funds.

• Existing asset-backed transactions can be bundled together and transformed into new Sukuks.

• Generate good fee incomes as arrangers, lead managers etc.
POTENTIAL GAINS TO THE ECONOMY

- Capital market development
- Source of funds for banks, finance companies and individual companies
- Expand source of financing for residential home ownership.
- Potential for financing of infrastructure projects.
- Cost savings to borrowers (e.g. the consumer finance)
THE IMPACT OF SUKUK OF THE CAPITAL MARKET

- Sukuk reduces transaction costs in the capital market by creating a market for assets, which otherwise, would have remained illiquid, i.e. limited trading.

- Sukuk promotes saving since it offers a security to investors with regular/periodic payments of principal and return together with the added assurance of credit quality and safety nets in the form of trustees.
UNBRIDLED DEBT

• In Islamic financial culture, there is a strong aversion to high levels of debt;

• A Sakk is not sold separately but with its share of the underlying asset;

• This essentially implies financial prudence and encourages a greater asset orientation;
POTENTIAL BENEFITS FOR THE ECONOMY

• Capital market development

• Source of funds for banks, finance companies and individual companies

• Expand source of financing for residential home ownership.

• Potential for financing of infrastructure projects.

• Cost savings to borrowers (e.g. the consumer finance)
# GLOBAL OFFERING PERSPECTIVES

<table>
<thead>
<tr>
<th></th>
<th>Reg. S. Eurobond</th>
<th>Eurobond with 144A Tranche</th>
<th>US 33 Act (Registered Global Bond)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed/float Rate</td>
<td>Both</td>
<td>Both, Fixed preferred</td>
<td>Both, Fixed preferred</td>
</tr>
<tr>
<td>Maturity</td>
<td>1-10 Years</td>
<td>1-30 Years (Fixed)</td>
<td>10-30 Years</td>
</tr>
<tr>
<td>Main Currencies</td>
<td>US$, Euro</td>
<td>US$</td>
<td>US$</td>
</tr>
<tr>
<td>Investor Base</td>
<td>Europe / Middle East / Asia</td>
<td>Europe / Middle East / Asia &amp; US Qualified Institutional Buyers</td>
<td>Adds ability to sell US retail investors and retail funds as well as world wide institutional investors</td>
</tr>
<tr>
<td>Rating(s) Required by Investor Base</td>
<td>At least one rating, two preferred</td>
<td>One minimum, two preferred for large size issues</td>
<td>S&amp;P or Moody’s</td>
</tr>
<tr>
<td>Future Issuer Requirements</td>
<td>Very little after initial offering</td>
<td>Very little once issued</td>
<td>Ongoing SEC disclosure requirements</td>
</tr>
<tr>
<td>Timing Flexibility</td>
<td>Quickest execution</td>
<td>More intensive due diligence process</td>
<td>SEC review process adds at least 2 weeks to the Eurobond process</td>
</tr>
<tr>
<td>Disclosure Required</td>
<td>Lowest</td>
<td>Higher level of due diligence and disclosure required</td>
<td>SEC level disclosure required - Highest</td>
</tr>
</tbody>
</table>

- **Reg. S. Eurobond**
  - Both Floating Rate
  - 1-10 Years Maturity
  - US$, Euro Main Currencies
  - Europe / Middle East / Asia Investor Base
  - At least one rating, two preferred Rating(s) Required by Investor Base
  - Very little after initial offering Future Issuer Requirements
  - Quickest execution Timing Flexibility
  - Lowest Disclosure Required
- **Eurobond with 144A Tranche**
  - Both, Fixed preferred Floating Rate
  - 1-30 Years (Fixed) Maturity
  - US$ Main Currencies
  - Europe / Middle East / Asia & US Qualified Institutional Buyers Investor Base
  - One minimum, two preferred Rating(s) Required by Investor Base
  - Very little once issued Future Issuer Requirements
  - More intensive due diligence process Timing Flexibility
  - Higher level of due diligence and disclosure required Disclosure Required
- **US 33 Act (Registered Global Bond)**
  - Both, Fixed preferred Floating Rate
  - 10-30 Years Maturity
  - US$ Main Currencies
  - Adds ability to sell US retail investors and retail funds as well as world wide institutional investors Investor Base
  - S&P or Moody’s Rating(s) Required by Investor Base
  - Ongoing SEC disclosure requirements Future Issuer Requirements
  - SEC review process adds at least 2 weeks to the Eurobond process Timing Flexibility
  - SEC level disclosure required - Highest Disclosure Required
KINGDOM OF BAHRAIN

“Leading in Islamic Financial Infrastructure”

IIFM
Islamic Rating Agency
(PRIFI)
IFSB
General Council of Islamic banks
LMC
AAOIFI
Training
Islamic Securities
REFORMS IN LAND LAWS

Reforms needed in *LAND* laws of many countries of the Muslim world to enable Ijara financing:

- At the moment, in many countries, ownership of assets by the financing institutions is not allowed – thus making *Ijara* financing problematic
REFORMS IN TRUST LAWS

Reforms needed in *TRUST* laws of many countries of the Muslim world to enable registration of SPVs:

- At the moment, in many countries, common law of trust is not recognized – A key requirement of Sukuk structuring
REFORMS IN TAX LAWS

Reforms needed in TAX laws of many countries of the Muslim world particularly with regard to transfer of assets at end of lease period:

• At the end of the lease period, there should be an exemption of:
  • Stamp duty or other taxes for the re-transfer of assets to the original seller
  • Registration fee for the re-transfer
  • Capital gains or other taxes for the re-transfer
REFORMS IN REGULATORY ISSUES

Regulatory perspectives: *a need to create a level playing field for the product*

- Definition – to give Sukuk a distinct definition or align it within existing definitions of either bonds or equities

- Risk weighing issues – Sovereign Sukuk to be granted equal “0” risk-weighing as is true for conventional sovereign bonds.
WORKSHOP RECAP

Islamic law (Sharia) and its interpretation with regard to Islamic financial contracts

The practicality of Islamic contracts in meeting modern financial needs of society

The emergence of Sukuk as a viable global instrument of alternative finance

The potential of Sukuk in structured finance and balance sheet management
THANK YOU