ISLAMIC BONDS (SUKUK) CASE STUDY (7)

US $ 400 million Islamic Development Bank Sukuk: Hybrid Sukuk

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This case describes the novel features of the IDB sukuk. It is intended to be used as the basis for class discussion. Answers are not provided. It is expected that the course leader will guide participants accordingly.

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Case Abstract

An Islamic bond (*sukuk)* has economic characteristics similar to those of a conventional bond, but is structured so as to be compliant with Shari'a law and can be sold to Islamic investors who are prohibited by Shari'a law from investing in conventional debt securities.

The IDB is a multilateral development financing institution founded in December 1973 by the first conference of the Finance Ministers of the Organization of the Islamic Conference (OIC). It officially began operations in 1975 with the purpose of fostering the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of the *Shari'a*. Mobilisation of resources has remained one of the greatest challenges facing the IDB. The emergence of *sukuk* has provided the IDB a novel dimension through which to face this challenge and in August, 2003 the bank issued US $400 million worth of trust certificates due in 2008.

'Those who take riba (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch.'

Qur'an Sura 2:275-280

Islamic Development Bank (IDB)

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Each of the certificates represents an undivided interest for the certificate holder in the Trust Assets. These assets are held by Solidarity Trust Services Limited which is a bankruptcy remote trustee created solely for the purpose of this *sukuk* issuance.

The unique feature of this arrangement is in the portfolio of Trust Assets. Each certificate holder is granted the right to receive payments arising from the Trust Assets that include *ijarah* (leasing) contracts, *murabah* (conditional sale) contracts, and *istisna'* (conditional sale of item to be manufactured) contracts. These returns are calculated on the basis of a fixed return of 3.635% per annum on 12th of February and 12th of August each year until August 2008 when they will be redeemed in full.

Murabaha and Istisna' – Securitisation problems

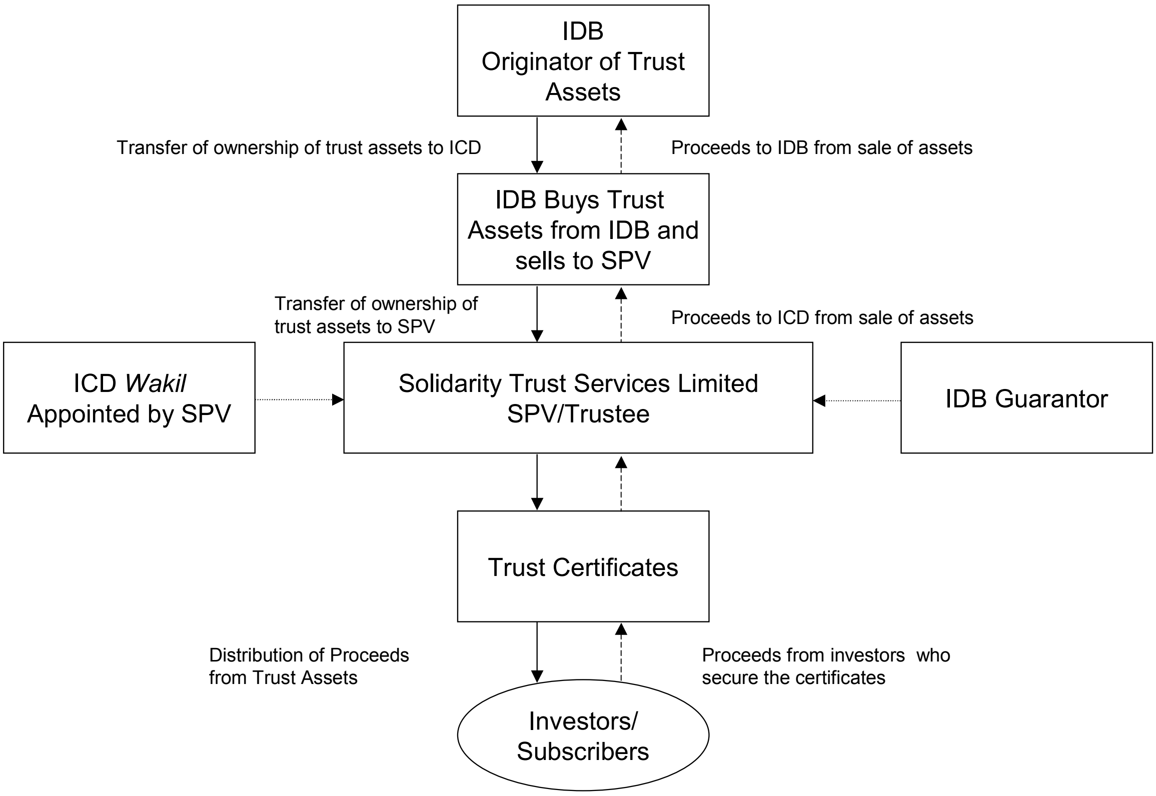
Murabaha and *istisna'* are contracts that cannot be traded on secondary markets as securitised instruments. They represent debt arrangements and the subsequent trading of such contracts would typify the exchange of money. According to *Shari'a* principles, money can only be traded at par value and not for any profit. However, if *murabaha* and *istisna'* are proportions of a portfolio consisting of at least 51% tangible assets, then the securitised certificates of this portfolio may be traded on secondary markets. This is the case with the IDB *sukuk* issuance where *ijarah* contracts make up 51% of the trust assets; a ratio that must be maintained. However, there are provisions for exceptional circumstances where the composition of *ijarah* contacts can be *temporarily* reduced to a minimum of 25% of the total pool of assets. If at any time the proportion of *ijarah* contracts falls below 25% then the arrangement will be dissolved and the IDB will be obliged to purchase all the assets owned by the trustee at the time of the dissolution event. The structure of the *sukuk* assets will vary over the life of the contract as the trustee will employ principal collections for the *sukuk* assets to acquire rights in further *ijara'a* contracts and invest in *murabaha* contracts. However, further investments in *istisna'a* contracts are envisaged.

Under the conditions of the prospectus, the trustee purchases the portfolio of assets from The Islamic Corporation for the Development of the Private Sector (ICD). The ICD serves as a *wakala* and delegates its servicing undertakings to the IDB. A *wakala* agreement serves to designate the business of the originator (IDB) to another agency (ICD) whose primary objective is to abate the consequences of information asymmetries. The principal and the agent are bound by equivalent contracts to the same *wakil* (agent).

The trust certificates have been given a rating of AA by Fitch Ratings Ltd, and a AAA by Standard and Poor's Rating Services. These ratings highlight the probability that certificate holders will obtain all the relevant payments they have subscribed for.

The structure of the IDB *sukuk* issuance is described in Figure 1.

Figure 1: Arrangement of IDB Trust Certificate Issuance



Islamic Development Bank (IDB) Trust Certificates

Country	Issuer	Type	Value	Maturity
Multilateral Institution	The issuer: Solidarity Trust Services Ltd. Guarantor: (Islamic Development Bank (IDB)	Combination of Ijara, Murabaha and Istisna Sukuk, (with minimum 51% Ijara Sukuk)	US$ 400 Million	July 2008

The structure

To implement the transaction, the IDB sold a portfolio of Islamic-compliant assets (at closing approximately 66% of the assets were ijara contracts) to The Islamic Corporation for the Development of the Private Sector (ICD), which is a member of the IDB group. The ICD in turn assigned the portfolio to Solidarity Trust Services Limited (Trustee). The Trustee purchased the portfolio with the proceeds of the issue of certificates.

The innovation of this transaction is the inclusion of murabaha contracts and istisna contracts, which traditionally have not been assignable in accordance with Shari'a principles, as they are contracts which represent an interest in a stream of payments unlike ijara contracts which represent an interest in the underlying assets.

The Boards were prepared to accept the inclusion of such assets in the pool assigned to the ICD as long as the pool was primarily made up of ijara contracts. Compliance with this requirement was achieved by including, as a dissolution event (which would trigger the IDB's repurchase obligation) the circumstance where ijara contracts cease to constitute more than 25% of the portfolio held by the Trustee. It was generally contemplated that ijara contracts will at all times constitute more than 50% of the portfolio, although they can in very specific cases and for very limited durations drop to as low as 25%.

Having assigned the portfolio of assets to the ICS, the IDB guaranteed to the Trustee, through the ICD, the performance of the obligors under the various contracts constituting the portfolio assets. It should be noted that IDB does not guarantee the payment by the Trustee of the profit participation to the certificate holders. The IDB also promised to repurchase the Trustee's portfolio (which may not be identical with the portfolio originally sold to it) for the original sale price upon the maturity date of the certificates or following certain "dissolution events". The certificates are not redeemable except at maturity or upon a dissolution event.

The IDB also provides a liquidity facility to the Trustee to ensure that the Trustee is able to make the required periodic distributions of profit shares to the certificate holders. If the IDB is required to provide funds to the Trustee under this facility, repayment to the IDB is made prior to further distributions to the certificate holders.

The ICD was appointed by the Trustee as Wakeel or agent to manage the portfolio and the ICD in turn sub-delegated its obligations as Wakeel to the IDB. The IDB does not have a direct relationship with the Trustee with respect to the management or servicing of the portfolio.

In addition to the original portfolio, the Trustee is expected to acquire further Shari'a-compliant assets with profits in excess of required distributions to certificate holders and funds required to meet other costs. These assets are expected to principally be additional ijara contracts purchased from the IDB, through the ICD. However, if the IDB has insufficient ijara contracts that it can assign to the Trustee at any particular time, the Trustee may, on the advice of the ICD, directly enter into further murabaha contracts. The Trustee will not purchase murabaha contracts or istisna contracts from the IDB after the closing date.

A groundbreaking transaction

The IDB sukuk was groundbreaking in a number of ways. Not only was the IDB sukuk only the second global securities issue that took a Shari'a-compliant form, it was also IDB's first foray into the global capital markets and the first issue that included a range of instruments in the pool of assets supporting the sukuk.

Both the Kingdom of Malaysia offering and the offering by the State of Qatar relied for cash flow on the revenue from leases of real estate assets. These assets were purchased from the relevant State and then leased back under ijara (lease) contracts.

In the case of the IDB sukuk, the asset base includes ijara contracts, interests in murabaha (cost plus profit sale) contracts and istisna (construction or manufacture) contracts. This structure was approved by the Shari'a Boards of the IDB, Citi Islamic Investment Bank and The Islamic Corporation for the Development of the Private Sector. In their pronouncement approving the structure, the Shari'a Boards expressly took into consideration "(i) the legal constraints under which [this] product is being developed; (ii) the need to further develop the emerging Islamic finance industry as an alternative and viable financing system; (iii) the need to facilitate and bring ease to Islamic financial institutions and others who are determined to raise financing according to Shari'a principles …"

IDB Hybrid Sukuk: Case Study questions

Following the recent string of successful Sukuk issues, and the fact that they are a relatively new concept in corporate finance, your employer, an Investment Bank, has selected your group to make presentations to the Board regarding the key issues involved.

Your group must consider the following questions and you must present your findings to the whole class. Please be ready to explain any technical concepts to the class. You will be expected to defend your answers.

Remember that "time is money" and that your responses must be succinct and not overly descriptive. In other words – get to the point!!

1. Outline the role of the IDB.

2. Describe the exact nature of the IDB Sukuk

3. What Islamic modes of finance underpin the IDB Sukuk?

4. Describe how these modes of finance work and the exact relationship they have with the IDB Sukuk

5. What Sharia Board requirements were put in place?

6. Are issues of corporate governance relevant to this issue?

7. What was innovative about this issue?

8. How was the issue rated and by whom?

9. What risks for investors are associated with investing in sukuk?

10. Was the issue a success?

11. What lessons can be learnt for the issue of future sukuk? How do the critical factors for IDB Sukuk compare with those for the other Sukuk issued.?