

**ESTABLISHING SINGAPORE AS AN ISLAMIC FINANCIAL HUB
SUKUK MASTERCLASS**

23RD February 2006

THE EVOLUTION OF SUKUK

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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.**

BUSINESS AND FINANCIAL ACTIVITIES WITHIN THE
FRAMEWORK OF THE SHARIA

**IN ISLAM DOING
LEGITIMATE BUSINESS AND
EARNING A DECENT
RETURN NOT ONLY HIGHLY
ENCOURAGED BUT
REGARDED AN ACT OF
WORSHIP**

BUSINESS AND FINANCIAL ACTIVITIES WITHIN THE
FRAMEWORK OF THE SHARIA

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

CONTRACTS – THE ESSENCE OF ALL FINANCIAL ACTIVITIES

- 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

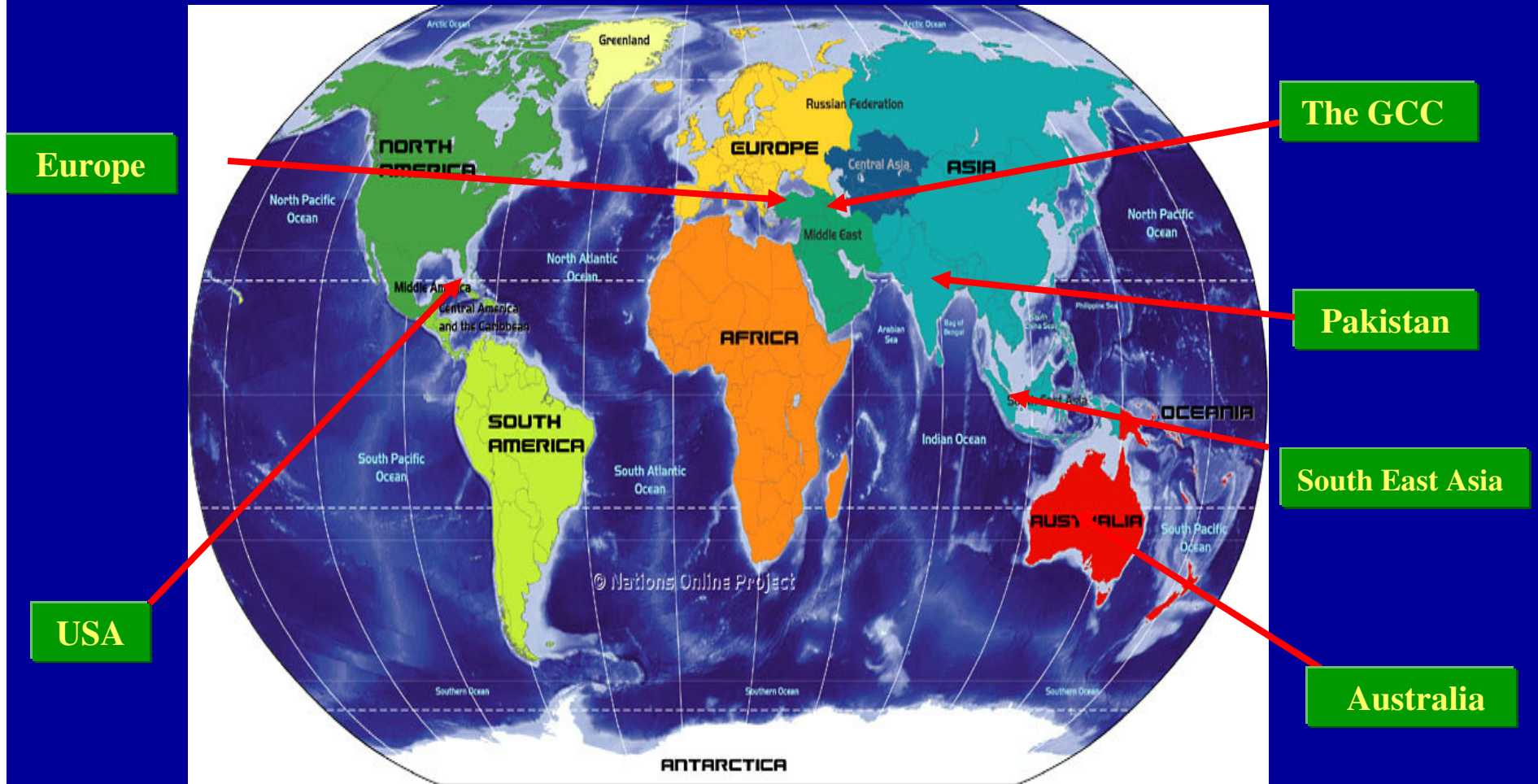
	Uses of contract	Type of financing	Main Risk(s)	Can financier(s) take Collateral?
Murabaha	Trade Finance	Deferred sale “dayn”	Default	Yes
Ijara	Leasing	Lease finance “Dayn”	Default and destruction	Yes
Bei’- salam	Pre-production finance	Foward sale “Dayn”	Default	Yes
Istisn’a	Construction finance	Instalement sale “Dayn”	Default	Yes
Mudaraba	Equity financing	Business (Entrepreneurship) financing	Fraud, negligence, Moral hazard, etc	Yes, but to be exercised only for non-business failures
Musharaka	Equity financing	Joint venture	Fraud, negligence, Moral hazard, etc	Yes, but to be exercised only for non-business failures

INTRODUCTION TO SUKUK AND CURRENT MARKET OVERVIEW

ASSET MONETIZATION

- * ASSET MONETIZATION IS A WELCOME VALUBALE 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* (SUKUK ISSUANCE)

SUKUK - A GLOBAL PRODUCT

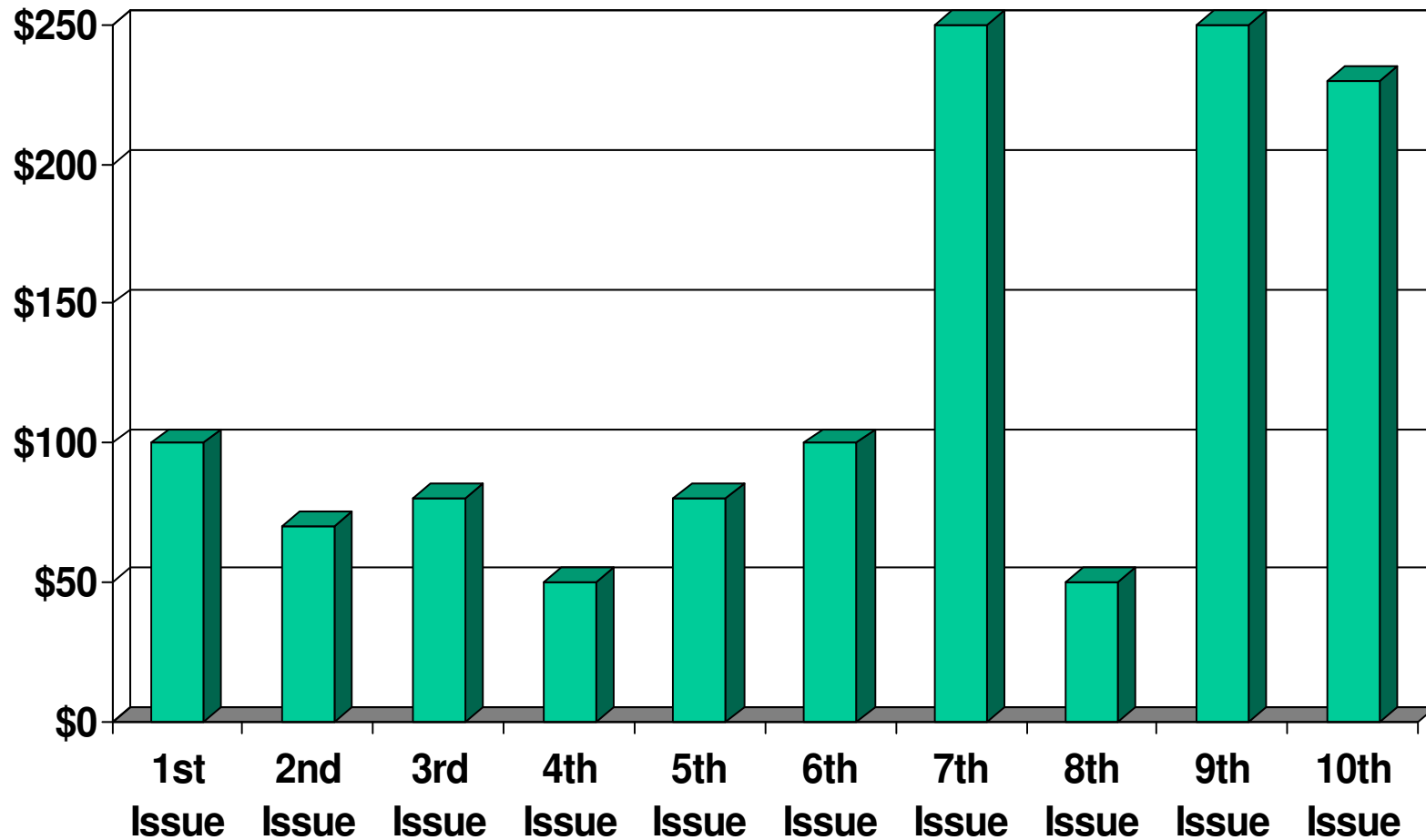


SAMPLE OF GLOBAL SOVEREIGN ISSUES

SUKUK BENEFICIARY	ISSUE AMOUNT	ISSUE DATE
Malaysia	\$ 600 M	June, 2002
IDB	\$ 400 M	August, 2003
Qatar	\$ 700 M	September, 2003
Bahrain	\$ 250 M	February, 2004
Saxony-Anhalt	Euro 100 M	July, 2004
State of Sarawak, Malaysia	\$ 350 M	November, 2004
Pakistan	\$ 600 M	December, 2004
Dubai Civil Aviation (DCA)	\$1 BN	December, 2004

BMA'S IJARA SUKUK PROGRAMME MEDIUM TO LONG TERM ISSUANCE

Millions



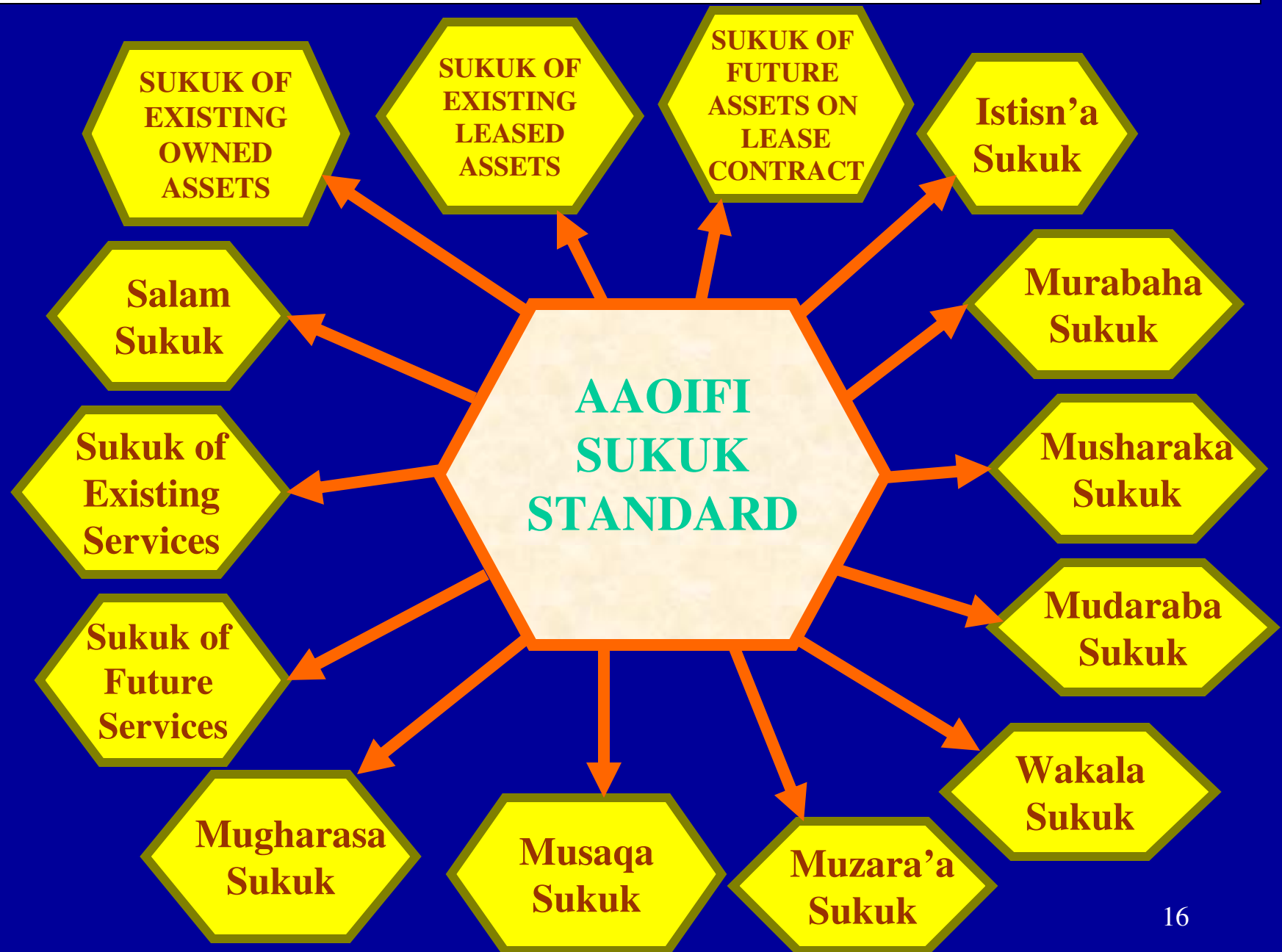
SUKUK – A HISTORICAL PERSPECTIVE

- 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

- 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



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**

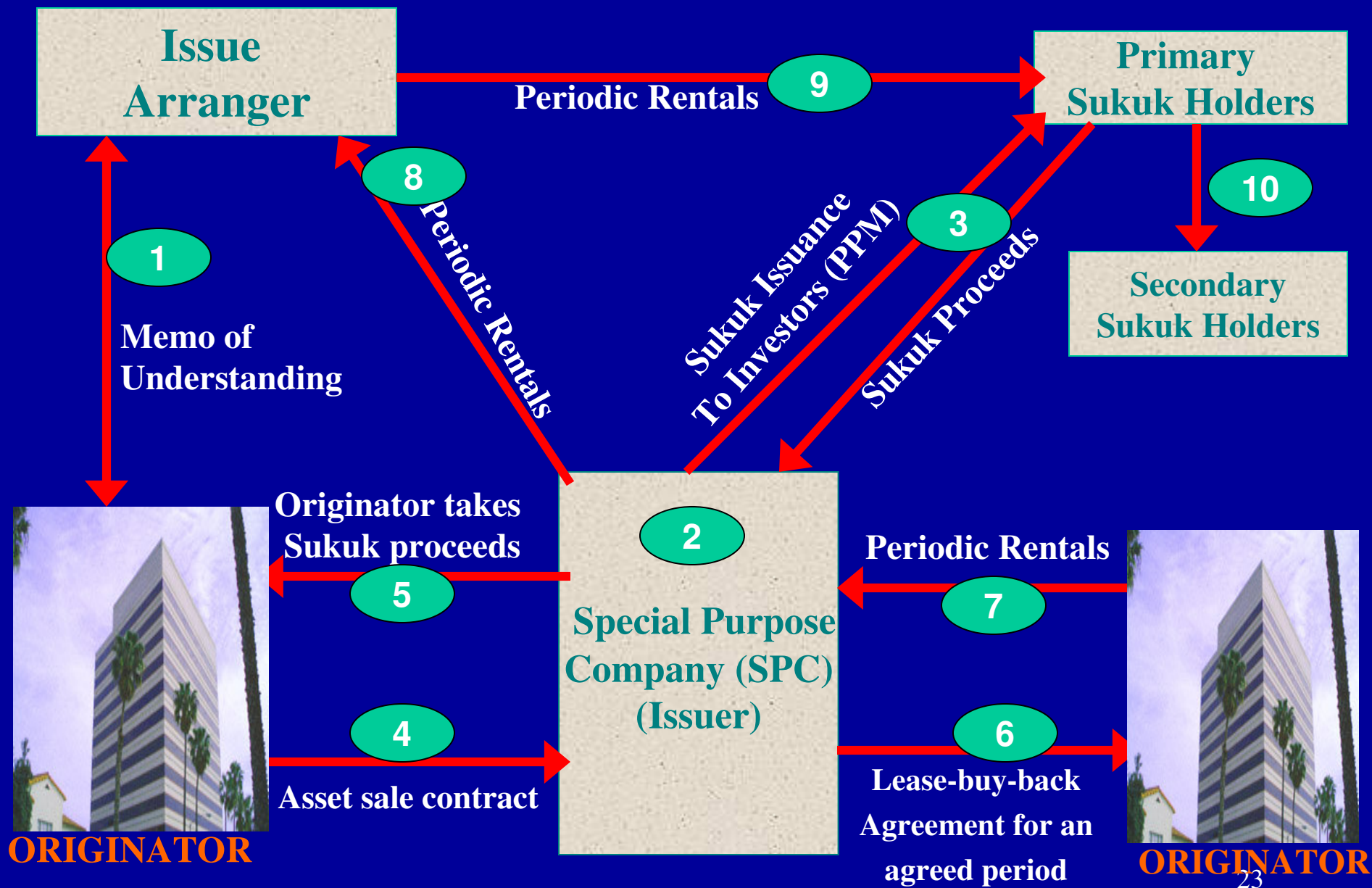
IJARA SUKUK

- **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.**

SUKUK AL IJARA STRUCTURE



**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 offers 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

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graph TD; A[CONVENTIONAL BONDS] --> B[DEBENTURE BONDS  
(General obligations of the issuer)]; A --> C[SECURED BONDS  
(Collateralized by specific assets of the corporation)];
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DEBENTURE BONDS

(General obligations of the issuer)

SECURED BONDS

(Collateralized by specific assets of the corporation)

COMPARISON WITH CONVENTIONAL DEBENTURE BONDS

SUKUK	BONDS
Sukuk represent ownership stakes in existing and/or well defined assets.	Bonds represent pure debt on the issuer.
The subject of the contract in Sukuk is a contract based on lease or a defined business undertaking between the Sukukholders and the originator.	Bonds basically create a Lender/Borrower relationship - i.e. a contract whose subject is purely earning money on money (Riba-Usury).

COMPARISON WITH DEBENTURE BONDS --- CONT.

SUKUK	BONDS
The underlying Sukuk assets, business or project must be of a nature that their halal (permissible) use is possible.	Such a condition does not apply under bonds which can be issued for illegitimate purposes
Sale of a Sukuk represents a sale of a share of assets, business activity or project.	Sale of a bond basically represents sale of a debt.

COMPARISONS WITH SHARES

	SUKUK	SHARES
Duration of investment	Limited investment period	Perpetual investment
Rights to company capital gains	Not in Ijara contracts but increased returns may be earned in Mudaraba and Musharaka notes	Yes
Frequency of flow of income from investment	Regular/variable	Variable

SUKUK COMAPRED 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 offshoots 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.

SUKUK AND DERIVATIVES

DERIVATIVES	SUKUK
Based on rights and claims	Asset based and continue to carry asset risk directly even when traded.
Have no intrinsic value	Have intrinsic value. Attached to the title or beneficial ownership of an asset
Multiple generations of distinctive contracts are created from the basic underlying contract.	Sukuk relate to only one contract and maintain asset linkage at all times.

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.

SECURITIZATION & SUKUK

- 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**

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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.

MUCH BETTER OPPORTUNITIES AMONG SME CORPORATE BORROWERS

- 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

COMPANY & COUNTRY	ISSUE SIZE	COMMENTS
Guthrie, Malaysia	US\$ 250 M	First corporate Sukuk - December, 2002
FIIB, Bahrain (Now Arcapita)	US\$ 75 M	July, 2003
Hanco, Saudi Arabia	US\$ 26 M	Fleet securitization
Tabreed, UAE	US\$ 100 M	
Emaar, UAE	US\$ 65 M	
Durat Al Khaleej, Bahrain	US\$ 120 M	Development Sukuk
The Investment Dar (TID)	US\$ 50 M	Musharaka Sukuk
Emirate Airlines, UAE	US\$ 550 M	First ever Sukuk by an airline
Amlak Finance, UAE	US\$ 200 M	
Dubai Metals & Commodities, UAE	US\$ 200 M	
Bahrain Financial Harbour, Bahrain	US\$ 134 M	Development Sukuk
Commercial real estate company, Kuwait	US\$ 100 M	
Al Safeena, Bahrain	US\$ 26 M	First ever shipping Sukuk⁴⁵

PARITES 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 SHEET - MUSHARAKA SUKUK

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

SUKUK AL WAKALA

A LOOK AT A CURRENT DEAL

WAKALA (AGENCY) SUKUK

Type	:	Agent financed to undertake certain activities
Type of activities	:	May be specific or general activities
Return for investors	:	Would usually be an agreed floater
Agent's incentive	:	Any return generated above the agreed return for the investors belongs to the agent
Principal repayment	:	As may be agreed (Bullet or amortizing)
Collaterals	:	Any acceptable collaterals may be taken to cover the eventualities of fraud, negligence, mismanagement, moral hazard.

PROJECT FINANCE SUKUK

CONSTRUCTION SUKUK CASE STUDY

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.

FORWARD LEASE FINANCING CONTRACT

(IJARA MOWSUFA FI DHIMA - IMF)

BECAUSE OF THE LAND CONTRIBUTED BY THE CLIENT, THE PROJECT TAKES THE FORM OF A *JOINT VENTURE* AND THE LEASE CONTRACT WILL ONLY RELATE TO THE PORTION THAT BELONGS TO THE FINANCIER

FORWARD LEASE FINANCING CONTRACT

(IJARA MOWSUFA FI DHIMA - IMFJ)

**ANY PART OF THE PROJECT
WHICH IS COMPLETED
REPRESENTS LEASABLE
VALUE FOR WHICH A
LEGITIMATE RENTAL CAN
BE CHARGED**

IMFD - FINANCING STRUCTURE DURING CONSTRUCTION

PPC	PPC Amount	CUSTOMER CONTRIBUTION	SUKUK AMOUNTS PAID	CUMULATIVE SUKUK FINANCING	RENTAL RATE	NO. OF DAYS	RENTAL DUE TO SUKUK-HOLDERS
PPC 1	20,000,000	0%	20,000,000	20,000,000	6%	180	600,000
PPC 2	20,000,000	0%	20,000,000	40,000,000	6%	180	1,200,000
PPC 3	20,000,000	0%	20,000,000	60,000,000	6%	180	1,800,000
Total				60,000,000			3,600,000

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

IMFD - REPAYMENT STRUCTURE AFTER CONSTRUCTION

CONSECUTIVE LEASE #	Fixed rental Amount for period	Outstanding bank' share	Rental periods	Rental repayment rate	Variable rental amount for period	Total rental amount payable
		63, 600,000				
01	6,360,000	57,240,000	180	6%	1,908,800	8,268,000
02	6,360,000	50,880,000	180	6%	1,717,200	8,077,200
03	6,360,000	44,520,000	180	6%	1,526,400	7,886,400
04	6,360,000	38,160,000	180	6%	1,335,600	7,695,600
05	6,360,000	31,800,000	180	6%	1,144,800	7,504,800
06	6,360,000	25,440,000	180	6%	954,000	7,314,000
07	6,360,000	19,080,000	180	6%	763,200	7,123,200
08	6,360,000	12,720,000	180	6%	572,400	6,932,400
09	6,360,000	6,360,000	180	6%	381,600	6,741,600
10	6,360,000	-	180	6%	190,800	6,550,800
	63,600,000					

SUKUK APPLIED TO REAL ESTATE

DISCUSSION QUIZ

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 (SUKUK 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.

SPV Cont.

- 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.

SPV Cont.

- 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

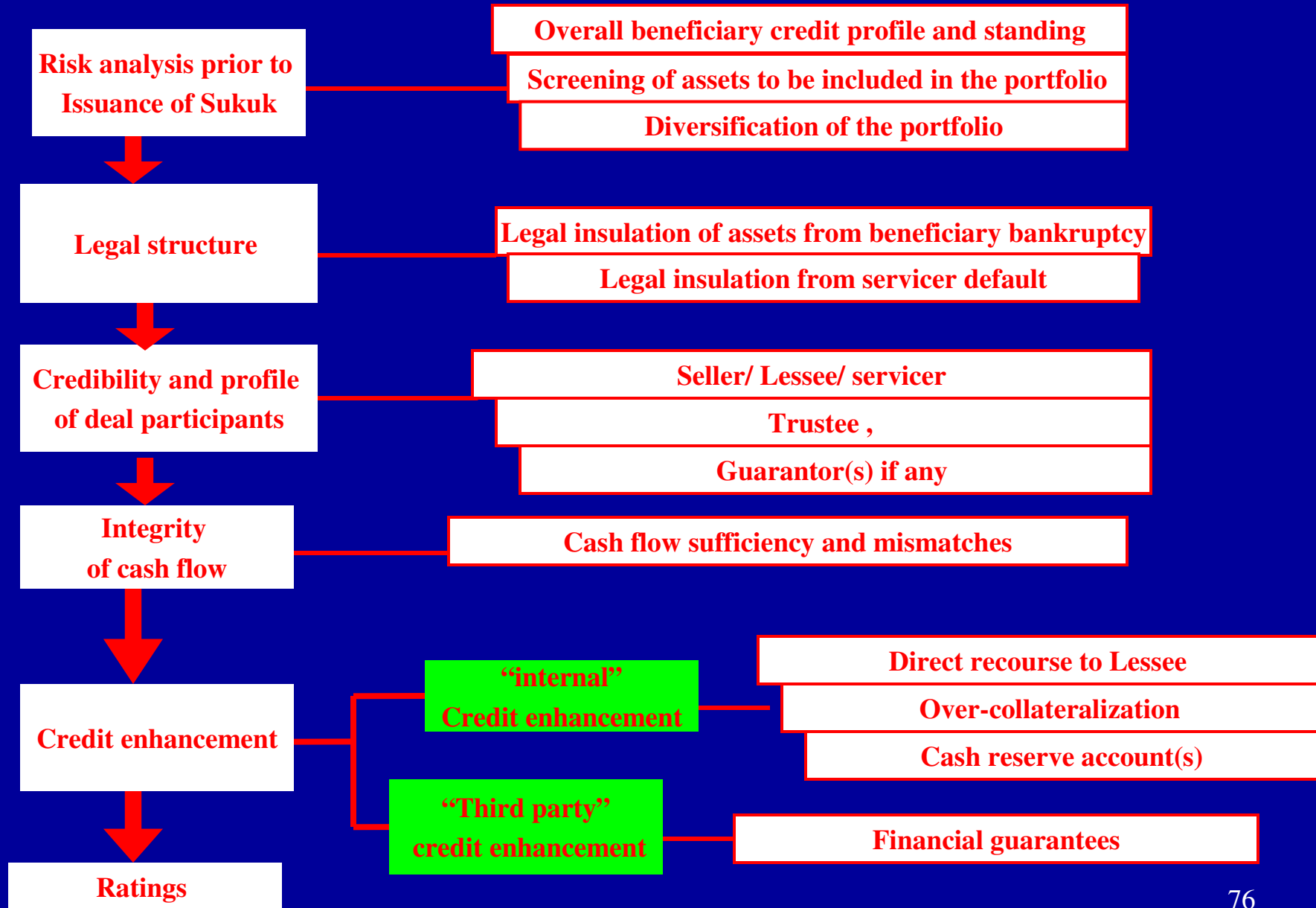
- Usually issued as global certificates
- Ownership interests of, and transfers of ownership by, investors are reflected solely by appropriate books and records entries.
- The certificates are lodged in the facilities of a securities depository or other book-entry agent and kept safely by the agent until 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.

SUKUK RATING ANALYSIS



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

SUKUK BENEFICIARY	ISSUE AMOUNT	DATE RATED	RATING GRANTED
Malaysia	\$ 600 M	June, 2002	A-
IDB	\$ 400 M	August, 2003	AAA
Qatar	\$ 700 M	September, 2003	A+
Bahrain	\$ 250 M	February, 2004	A-
Saxony-Anhalt	Euro 100 M	July, 2004	AA-
Loehmann	\$ 110 M	September, 2004	CCC
Sarawak	\$ 350 M	November, 2004	A-
Pakistan	\$ 600 M	December, 2004	B+

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 upto 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

TRANSACTION INNOVATIVE IN MANY RESPECTS.

- **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

DEALING WITH LEGAL RISK - BANKRUPTCY REMOTENESS

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**

DEALING WITH BANKRUPTCY REMOTENESS – MITIGATING THE TITLE RISK

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.**

DEALING WITH BANKRUPTCY REMOTENESS – MITIGATING THE CONSOLIDATION RISK

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 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

Amount	US\$ 540 M.
Issuer	CAGAMAS MBS
Maturity	3 –15 years
Sukuk type	Sukuk Al Musharaka
Underlying assets	Portfolio of government Mortgages
No. of tranches	6
Rating	AAA (by both MARC & RAM)

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?**

QUIZ

- **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 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

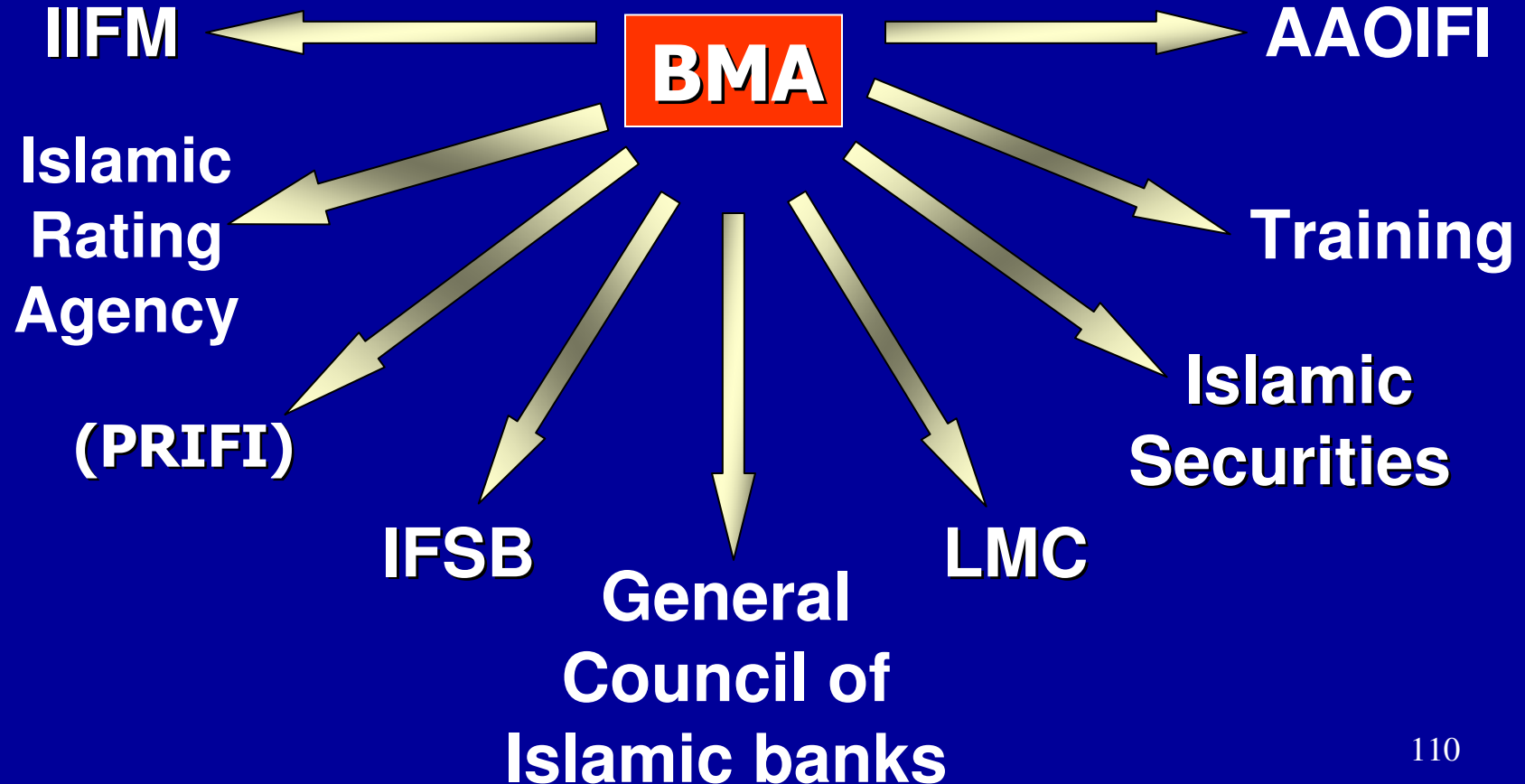
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GLOBAL OFFERING PERSPECTIVES

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

KINGDOM OF BAHRAIN

“Leading in Islamic Financial Infrastructure”



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