Sukuk

An inside study of its background, structures, challenges & Cases.

Ahmed Khalid AL-Maghlouth 51070111

Executive Summery

Sukuk is very interesting and importing subject to write on. This importance due to the fact that Islamic financial tools and instruments are replacing conventional financial tools and instruments, and playing a competitive role in providing the liquidity to support the growth of Islamic debt market, Islamic investments, future projects of Islamic private companies and governmental institutions and even the conventional one through Islamic assets such as Sukuk. Therefore the study will focus on describing Sukuk's background, structures, challenges, and some cases of recent Sukuk issuance. So, the research will be divided into fives chapters; introduction, Sukuk structures and profiles, issues in Sukuk, real world examples of Sukuk, and conclusion.

Open University of Malaysia
2009

DECLARATION

Name : Ahmed Khalid AL-Maghlouth

Student's Number : 51070111

I hereby declare that this project paper is the result of my own work, except for quotation and summaries which have been duly acknowledge.

I hereby verify that this research has not been submitted in substance for any other degree.

Signature: ____________________ Date: ___________________

Supervisor Name: Dr. Mohammed AL-Bashir

Signature: ____________________ Date: ___________________

Application to conduct Research Paper

PART A: STUDENT PARTICULAR

1. Name : Ahmed Khalid AL-Maghlouth

   Student's Number : 51070111

PART B: PARTICULAR ABOUT THE PROJECT

1. Title of the project : Sukuk; *an inside study of its background, structures, challenges & Cases.*

2. Research Objective : *Description of Sukuk in details*

3. Proposed Research Method
   Research Design : *Book searching, Article searching, Internet searching.*

PART C: FACULTY'S INPUTS

1. Topic chosen: Accepted / Not Accepted

2. Suggested supervisor for the student: Dr. Mohammed AL-Bashir

RESEARCH PROPOSAL SUBMISSION FORM

Project Paper Title: Sukuk; *an inside study of its background, structures, challenges &Cases.*

Director
Open University of Malaysia (OUM)
Bahrain Branch

Dear Sir,

Attached are the following documents for evaluation and approval:

Chapter1 : Introduction
Chapter2 : Sukuk Structures and Profiles
Chapter3 : Issues in Sukuk
Chapter4 : Real Word Example of Sukuk
Chapter5 : Conclusion
List of References

I have thoroughly cheeked my work and I am confident that is free from major grammatical errors, weaknesses in sentence construction, spelling mistakes, referencing mistakes and others, I have checked with OUM MBA program guidelines for writing project paper and I am satisfied that the project paper proposal satisfied most of its requirements.

Thank you,

Student Signature: ____________________ Date: ___________________

I have read the student research proposal and I am satisfied that it is in line with the OUM MBA program guidelines for writing project proposal. It is also free from major grammatical errors, sentence construction weaknesses, citation and others.

Supervisor's Signature: __________________ Date: ___________________

ACKNOWLEDGEMENTS

First and foremost, all praise is due to Allah *subhana-wa-ta'ala for* bestowing me with health, knowledge and patience to complete this work. The Almighty, Who alone made this accomplishment possible. WE seek His mercy, favor and forgiveness.

Acknowledgements are due to University of Malaysia for the support in carrying out this research. I acknowledge, with deep gratitude and appreciation, the inspiration, encouragement, remarkable assistance and continuous support given to us by our thesis advisor Dr. Mohammed. His guidance and assistance changed our thinking from pessimistic to optimistic one. I greatly appreciate dedication, attention and patience provided by him throughout the course of this study. Working with him was an opportunity of great learning and experience. Thanks are due to our thesis committee members for their constructive guidance throughout the research.

Special thanks are to SIPCHEM especially to the Corporate Finance department as well due to the other employees and colleagues at the company who were always there to help and guide through the research work.

Last but not least we are grateful to my mother Allah mercy her soul, father, brothers and sisters for their extreme moral support, encouragement and patience during the course of our studies as well as throughout our academic career. No personal development can ever take place without the proper guidance of parents. This work is dedicated to my mother Allah mercy her soul and father for their constant prayers and never ending love.

DEDICATION

At the beginning I want to dedicate this work to our dear family members, especially to my mother Allah mercy her soul, and my father Eng. Khalid Ahmed AL-Maghlouth. Their valuable support, sincere advice, and prayers carried me through and helped me succeed!

Ahmed Khalid AL-Maghlouth

Table of Contents:-

Chapter one: - Introduction

In this chapter, there are two parts; background and literature review. This chapter objective is to give strong background of Sukuk in terms of its general overview, concept, the differentiations of Sukuk from bond, and the development upon its market. In part two, my objective is to write about recent studies that talked upon Sukuk.

1.2 Background.

In part one of chapter one "background", this section will be about Sukuk in general overview, its concept, the differences between it and bond, and the recent development on its market.

1.1.1 A general overview of Sukuk

Islamic finance has sometime lost the investment opportunities for Muslims that offer an expected return with low risk. The majority of investment opportunities are based either on stock market with high volatility or on real estate transactions. Since fixed income, interest-bearing bonds are not permissible in Islam, Sukuk are the alternative. Sukuk are asset-based securities while bonds are debt-based securities. Sukuk has developed as one of the most significant mechanisms for raising finance in the international capital markets through islamically acceptable structures. (7)

In old period, Islam Sakk "Sukuk", which is cognate with the European root "cheque", is any document that represents a contract of transference of rights, obligations or revenues earned according to the Shariah. Empirical evidence shows that Sukuk was a product broadly used during medieval Islam for the transferring of financial obligations deriving from trade and other commercial activities. The essence of Sukuk, in the modern Islamic perspective, depends in the concept of asset monetization "securitization" that is achieved through the process of issuance of Sukuk "taskeek". Its great potential is in transforming an asset’s future cash flow into present cash flow. Sukuk may be issued on existing as well as specific assets that may become available at a future date. (9)

1.1.2 The Concept of Sukuk.

Sukuk is the Arabic term for Bonds or securities structured according to Shariah principles and referred to as Sukuk, Islamic bonds, Islamic debt security or Islamic trust certificates (4). In addition, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, paying of interest (5). Sukuk is a certificate of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of the assets of particular projects or investment activity (5).

Moreover, Sukuk is an asset-backed, stable income, tradable and Shariah compatible trust certificates. The primary condition of issuance of Sukuk is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institution or any entity which wants to mobilize the financial resources. The identification of suitable assets is the first and arguably most integral step in the process of issuing Sukuk certificates. Shariah considerations state that the pool of assets should not only be comprised of debts from Islamic financial contracts such as Murabahah or Istisna. (3)(5)

In addition, the Accounting and Auditing Organisation of Islamic financial Institutions "AAOFI" define the Investment Sukuk on The Shariah Standard no.17 "Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in ownership of the asset of a particular project or special investment activity, however, this is true after receipt of the value of the Sukuk, the closing of subscription and the employment funds received for the purpose for which the Sukuk are issued ". Also, the AAOFI listed the types of Sukuk that are mostly used as the Ijarah Sukuk Musharakah Sukuk, Mudarabah Sukuk Murabahah Sukuk, Istisna Sukuk, and combination of some of these types if feasible. (4)

However, the steps involving in the issuance of Sukuk are preparing a detailed feasibility study firstly. Second, set up general framework and organizational structure. Third, work out an appropriate Shariah structure. Fourth, arrange lead manager. Fifth, arrange agreed Shariah legal documentation. Sixth, set up the SPV to represent the investors. Finally, put the Sukuk into circulation. (5)

The model of Sukuk security is derived from the conventional securitization process in which a special purpose vehicle (SPV) is setup to acquire assets and to issue financial claims on the assets. These financial assets claims represent a proportionate beneficial ownership to the Sukuk holders. (3)

1.1.3 The difference between Sukuk and Debt bonds.

Sukuk certificates are intended to replicate the functions of conventional bonds and tradable securities in resources mobilization from markets and injecting liquidity into the enterprise or government and in providing stable resource of income for investors (5). But, there are many differences that distinguish the Sukuk from Debt bonds but among them the most important difference is that Islamic Sukuk are based on a variety of contracts to create financial obligation between Issuers and investors such as lease, Musharakah or other while debt Bonds are based on loan contract to create Indebtedness (4).

Moreover, Sukuk returns to investors are the margin that comes from the intrinsic profit elements in the lease or partnership contracts while debt bond returns to investors are the interest that is an extra amount charged on the loan. Also, In Sukuk, there is a need for tangible assets, whereas in debt bond, simple receivable can be sold to investors. Another difference is that Sukuk prices are market driven and depend on the market's supply and demand and the value of the underlying asset may appreciate or depreciate but in debt bond, the returns from bonds depend only on the creditworthiness of the issuer. In addition, Sukuk is an islamically structured security that the Sukuk holders together actually own the assets they have ownership interest in, whereas the debt bond is security that the investors do not have an ownership interest in the underlying asset. (4)

Furthermore, Sukuk provide a self-controlled mechanism working as a safety valve so that if the issue is being oversubscribed, a Sukuk issuer is aware of its limitation to retain up a certain amount, as the total subscription cannot exceed the value of the leased asset for instance. In contrast, if a debt bond issue is oversubscribed, the issuer actions to retain the maximum possible amount which may prove irresponsible**,** putting the investors interest in danger. Also, given the asset-backed nature of Sukuk even if things go terribly wrong for the Sukuk issue, the investors have the ability to recover a major part of their investment since they will be having an undivided share in the ownership of the Sukuk. (4)

Last but not least, investing in Sukuk issuances involves the funding of trade or production of tangible assets so the Sukuk is directly linked with real sector activities "real economy" and hence these will not create short-term speculative movement of funds and potential financial crises. (5)

Sukuk Structure must be following the basic requirements that must be followed in Islamic Finance so it becomes a Shariah compliant. These basic requirements are the avoidance of Riba "interest" that come from bay' al-Inah which sells and Immediately buys back, Bay al-Dayn at discount and preference among participating investors in term of liquidation or dividend, the avoidance of gharar "uncertainty", the avoidance any form of Maysir "gambling", and the avoidance of Islamically prohibited transactions such alcohol, tobacco, pork-related products, conventional financial services, and immoral entertainment. (4)(5)

The following table 1.1 cans summaries the main differences between Sukuk and Debt bond: - (4)

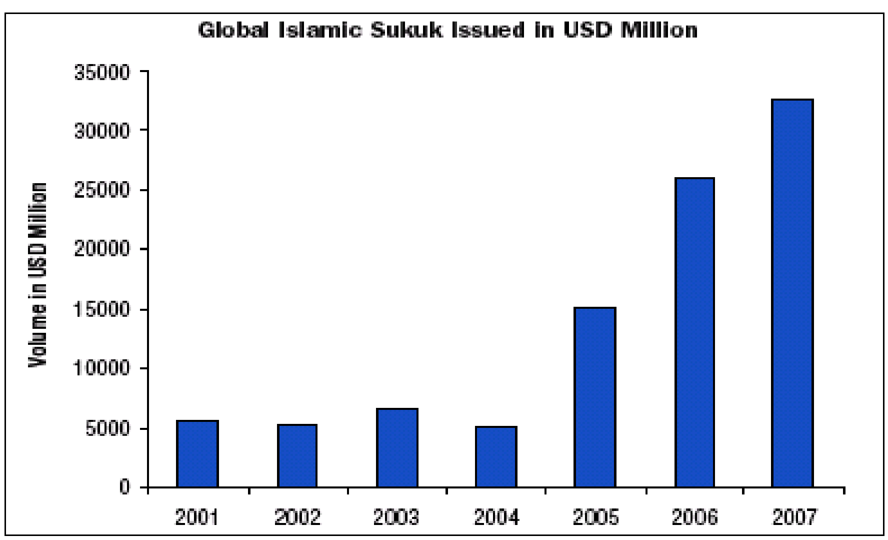
SUKUK	Debt Bond
Sukuk represent ownership stakes in existing and/or well defined assets.	Bonds represent pure debt on the issuer.
The subject of the contract in Sukuk is a contract based on lease or a defined business undertaking between the Sukuk holders and the Sukuk Issuers	Bonds basically create a Lender/Borrower relationship such as a contract whose subject is purely earning money on money (Riba-Usury).
The underlying Sukuk assets, business or project must be of a nature that their (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.

Sukuk and debt bond have some similarities such as marketability upon which Sukuk are monetized real assets that are liquid, easily transferred and traded in the financial markets, ratability in which Sukuk can be easily rated, enhanceability which different Sukuk structures may allow for credit enhancements, and versatility which the variety of Sukuk structures allow for structuring across legal and fiscal domains, fixed and variable income options etc. (10)

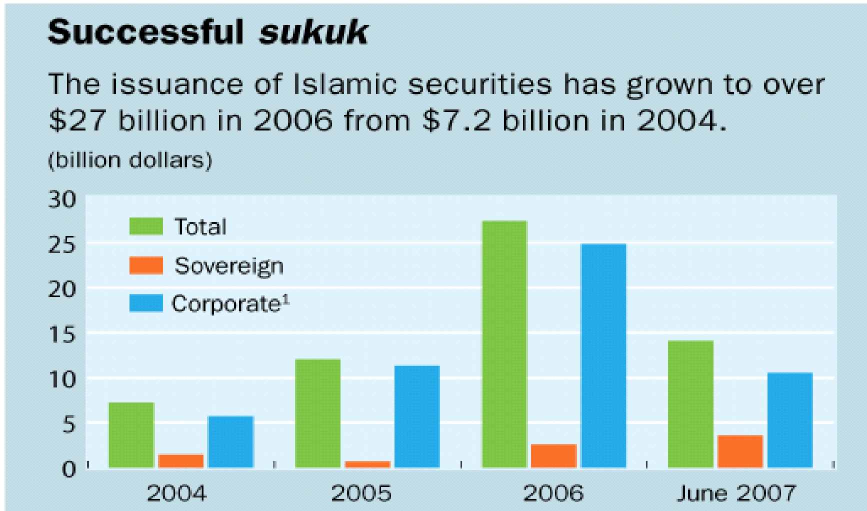
1.1.4 An overview on the development of Sukuk market.

There were early efforts to facilitate issuance of Islamic securities such as Pakistan enacted a law in 1980 enabling issuance of Mudarabah securities (2). In addition, there was a very partial introduction in 1990 and accelerated growth from 2002-2006 but the future of the industry is very bright (4). However, As a result of recent developments in the Islamic financial market there has been great growth in Shariah-compliant sovereign and corporate Sukuk (3). The introduction of Sukuk increased the variety of instruments that can be used to create an efficient Islamic portfolio in line with portfolio theory and financial planning (3). Moreover, the global Sukuk market is growing very fast with a volume of more US$ 100 billion and there positive indicators regarding the global Sukuk market such as over subscription, broad geographical distribution, involvement of conventional financial institutions, non-Islamic borrowers tapping the market and the participation of Islamic banks in the management and arrangement of these Sukuk issues (4). Also, there are more Sukuk either sovereign or corporate already in the pipeline. However, there are many challenges ahead in term of structures, volume, and regulation (4). In addition, the evolution of the Sukuk Market results in Global Sukuk by the Federation of Malaysia in 2002, which was first ever Sukuk transaction by a sovereign, rated and widely distributed, Qatar Sukuk, Bahrain Monetary Agency Sukuk, and Pakistan Sukuk upon which the issuers are comfortable and the pricing is fine achievable (2).

The following chart 1.1 illustrates the total volume of Sukuk issues per each year from 2001 to 2007 which show a critical growth: - (11)



Furthermore, the following chart 1.2 illustrates the total volume of Sukuk issues, volume of sovereign, and volume of corporate per each year from 2004 to June 2007 (12)



Furthermore, there are many reasons for the Sukuk market to grow. One of them is that it is new source of funds which is generally at attractive rates (4). Also, it is a solution to a liquidity management that is one of the main struggles having slowed the growth of Islamic finance (4). Moreover, it is critical step in the development of vibrant Islamic capital markets which is the borrowing from an Islamic bank might not be possible but raising money through Sukuk can be done in respect with Shariah (4). From another point of view, Sukuk allows the Islamic investors to invest their excess funds in Shariah compliant tradable instruments and become price takers (2). Besides, the growth of sovereign Sukuk market means a new source of funds for fundamental government infrastructure projects and a way to keep funds working for the benefit of the local economy (4). But not only sovereigns are taping the Sukuk market ,the popularity of Sukuk is also spreading to corporate issuers (4). Although the present volume is too small but it may not take long for the Sukuk market to reach the level where an investor would not be worried about liquidating the Sukuk he is holding for better Sukuk just hitting the market (4). In addition, there is huge surplus cash in Islamic institutions waiting to be tapped by new financial instruments (4). However, Sukuk market is not restricted to Islamic banks but also leading international banks such as HSBC, Citigroup, UBS and BNP Paribas are well in this market with all involved (4). Both Islamic and conventional investors are comfortable with Sukuk because there is no premium demanded on the Sukuk (2).

1.2 Literature review.

In part two, there will be three studies upon Sukuk chosen to write on in this research. The first one is Islamic bonds; your guild to issuing, structuring and investing in Sukuk. The second one is Large Scale Islamic project finance through Sukuk. The last one is Sukuk as Instrument of Change in Islamic Finance.

1.2.1 Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk.

The introduction of this book is written by Professor Rodney Wilson which is an institute for Middle Eastern and Islamic studies at university of Durham in United Kingdom, and rest of book is written by Nadhid Adam and AbdulQader Thomas. In the beginning, the writers give an overview of Sukuk market, the legitimacy of Sukuk, the reasons of having Sukuk, and types of Sukuk. Also, they explain the potential of Mudarabah and Musharakah Sukuk and talks about the Malaysian Sukuk and Bahrain's sovereign Sukuk experience, the scope for sovereign Sukuk, and potential for corporate Sukuk as well as he give a case study of Qatar Global Sukuk. In Chapter 1 "Investment in Islam", the writers examine the major precepts that govern Islamic investing. The primary Islamic concerns relating to Riba and gharar are addressed in a manner to allow readers to compare these concepts with conventional regulations. Then, they examine the rules that distinguish Sukuk from fixed-income instruments ranging from certificates of deposit to bonds and floating-rate notes. Also, they will examine why the approach to the trading of true debt is not shared uniformly between Malaysia and the Arabian Gulf. (6)

In Chapter 2 "Sukuk: origins and distinctiveness", there is a detailed study of Sukuk. The writers outline the important work that has been done by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to develop 14 prototypical Sukuk in its Investment Sukuk Standard and how the AAOIFI standard identifies a unique universe of securities that may be similar to conventional bonds, but the asset-based Sukuk are not asset-backed secured claims on a debt. In chapter 3 "Structuring Sukuk transactions", they establish that Sukuk adjust well to modern western capital market techniques which means that Sukuk often copy bond-like features and benefit from the latest developments in the asset- and mortgage-backed securities markets. They also talk about corporate finance in which Sukuk allows for balance-sheet management and cultural integration and allow for the monetization of assets and dispersion risk in a Shariah compliant manner at an enterprise or bank that mandates this faith-driven imperative. (6)

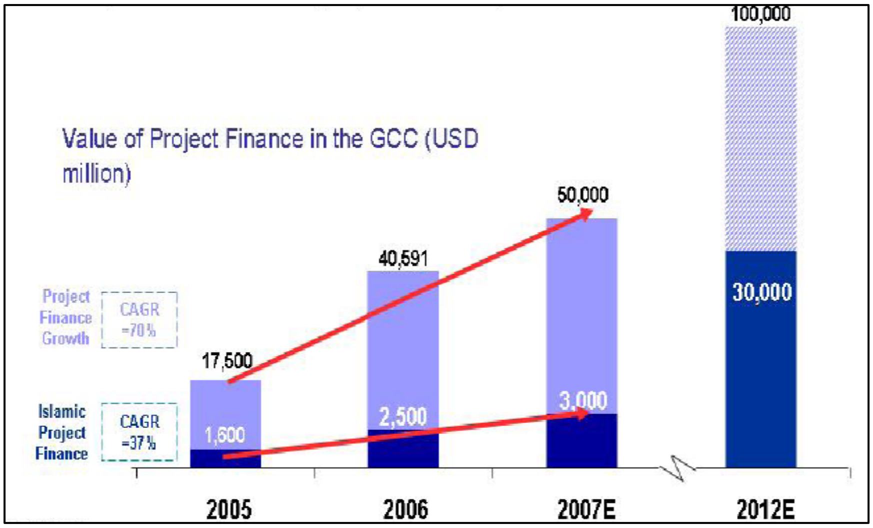
In chapter 4 "Sovereign Sukuk: applications and implications", they state that Although both financial firms and non-investment-grade governments have tested Sukuk concepts since the mid-1980s, the Sukuk market has taken off thanks to investment-grade government issuances which these Sukuk programmers have begun to help Islamic banks transition from the commodity Murabahah trades even so the full range of 14 prototypes has not worked its way into the market. In Chapter 5 "Sukuk applied to corporate finance and real estate", they explore the corporate market as well as the increasingly widespread application of Sukuk in the North American real estate markets, showing the way forward for both corporate users and for the introduction of Sukuk based on the less well-developed contracts including Istisna, even extending to timesharing. In Chapter 6 "Enabling infrastructure" they conclude that Although Sukuk may not necessarily be distinct from other forms of cross-border securities, the Islamic financial services industry is working hard to ensure that any distinctions do not prevent Sukuk from being freely traded in the global capital markets. He also provides a case study of how an evolving civil code in a country that has civil and Shariah courts has managed to achieve a successful international sovereign issuance. (6)

1.2.2 Large Scale Islamic project finance through Sukuk.

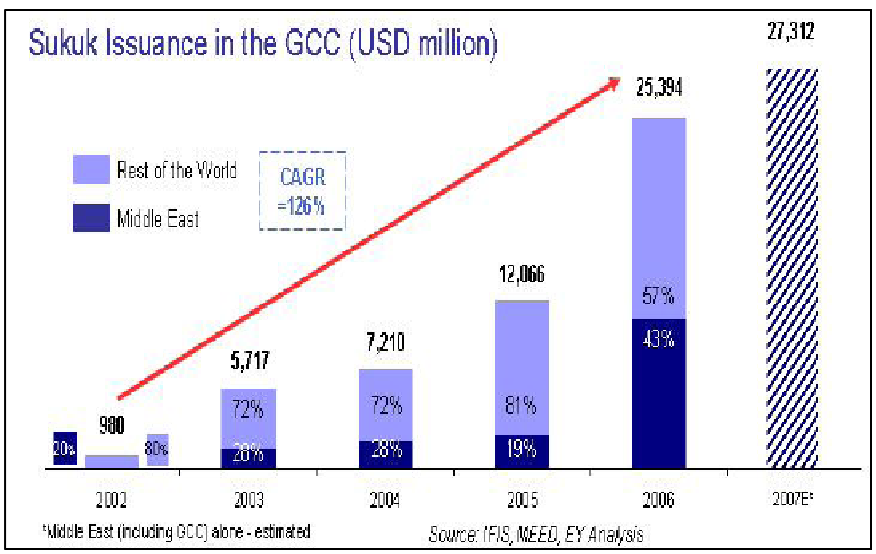
This is presented by Ahmed Adil, which is E&Y Bahrain partner, for the first international conference for Islamic Sukuk at Bahrain on March 2008. The key messages he delivered are flexibility and negotiability of Sukuk as financial instruments presents a big chance, project finance activities in GCC has shown impressive growth with increased participation from Islamic institutions, Sukuk have huge potential but their effectiveness is diminished by certain factors, and solution are likely to emerge as the Sukuk Market evolves. (1)

In addition, he stated some major challenges such as the limitation and depth lack of secondary market activity, the tendency of investors to buy and hold, the higher costs, the pricing difficult in the primary market because of lacks of depth, the unavailability of skilled human capital for structuring solutions, and legal constraints in larger markets such as Saudi Arabia and Kuwait. (1)

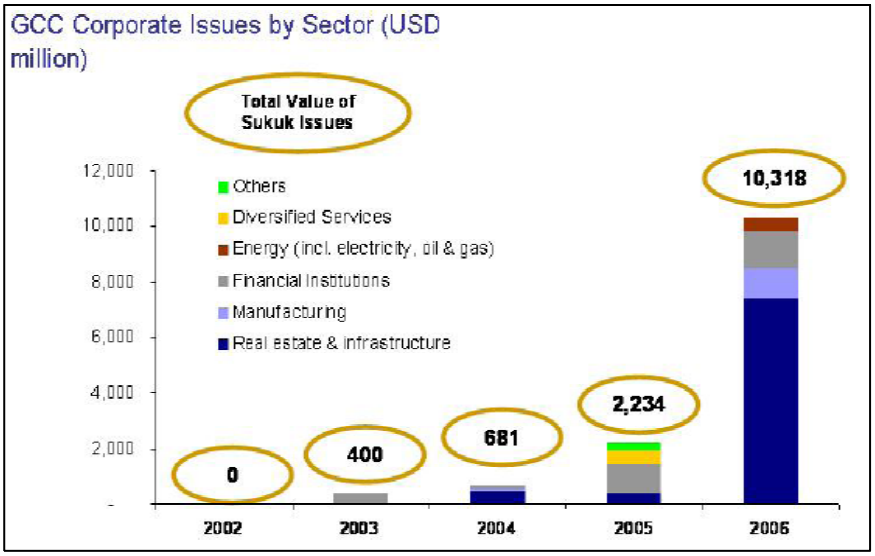
In addition, the presenter presented the following chart 1.3 that illustrates the value of project finance in GCC per each year from 2005 to 2007E and 2012E which shows a good growth of Islamic project finance from 1,600 USD million at 2005 to 3,000 USD million at 2007E. (1)



Also, he presented the following chart 1.4 that illustrates the Sukuk issuance in the GCC per year from 2002 to 2006 which have percentage at 2006. (1)



Moreover, he presented the following chart 1.5 illustrates the corporate Sukuk issues in the GCC by sector per year from 2002 to 2006 which shows that the real estate sector have a big portion in the Sukuk issuance. (1)



1.2.3 Sukuk as Instrument of Change in Islamic Finance.

Also, in the first international conference for Islamic Sukuk in Bahrain, Ayman A. Khaleq a partner in Vinson & Elkins at Dubai presented a presentation regarding the subject of Sukuk as instrument of Change in Islamic finance: Sukuk structuring involving assets in non Islamic jurisdictions. In his presentation, he presented about three topics: general Islamic investment consideration, East Cameron Sukuk, and recent developments. (8)

In general Islamic investment consideration slides, he explained that the asset base will directly impact the Islamic investment mechanism to be utilized. He also explained the issue of acceptable leverage ratio, the control, transparency, and legal documentation. Moreover, he discussed the structural considerations in the appointment of the Shariah scholar and the issue of fatwa. (8)

In the East Cameron Sukuk, he explained the base of this Sukuk that is based on Musharakah upon which East Cameron partner and a Cayman Islands' issuer SPV. The foundation of ECP Sukuk structure involved conveyance of an overriding royalty interest "ORRI" from the originator to the Purchaser SPV which ORRI is defined as a fractional interest in gross production of oil and gas, free of the expense of production. However, this transaction include certain challenges in Islamic Structure, level of disclosure, tax issues, rating, pricing , oil and gas issue, investors, and bankruptcy issue. Nevertheless, there were in the sector, investors, risk-reward opportunity, and S&P rating. (8)

The following graph 1.6 presents an overview of ECP Sukuk structure (8)

In addition, in the last topic, he presented some of the recent developments in Sukuk industry such as the Sukuk industry seems to be focusing on energy, infrastructure, and healthcare industries and energy Sukuk can be structured by Musharakah or Mudarabah instruments. (8)

1.3 References.

1. *Ahmed Adil (2008). Large Scale Islamic project finance through Sukuk, written for the first international conference for Islamic Sukuk at Bahrain on March 2008.*
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4. *Dr. Mohammed AL-Bashir (2008). Structuring Sukuk, a lecture wrote for MBA students www.asiancampus.net.*
5. *Liquidity Management Centre. The guide to Sukuk market www.Imcbahrain.com.*
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7. *University of Bahrain. Sukook - the concept of Sukuk http://staff.uob.bh/files/620922311_files/SUKOOK.pdf.*
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9. *Wikipedia. Sukuk en.wikipedia.org/wiki/Sukuk.*
10. *Sukuk.net. An overview of Sukuk http://sukuk.net/news/articles/3/An_overview_of_Sukuk.html.*
11. *http://www.researchrecap.com/wpcontent/uploads/2008/02/sukuk.gif.*
12. *http://www .imf.org/external/pubs/ft/survey/so/2007/res0919b.htm.*

Chapter two: - Sukuk Structures and Profiles.

In this chapter, there will be brief description the common Sukuk structures which are Musharakah, Istisna, Mudarabah, Murabahah, Ijarah and Salam. Then there will be talked about the natures of each type of Sukuk certificates which are Pure Ijarah Sukuk, Hybrid Pooled Sukuk, Variable Rate Redeemable Sukuk, Zero-coupon non-tradable Sukuk, Embedded Sukuk and Expanded list of Sukuk. After that, there will be clarification about the goals, the ways, the elements, parties involved, the advantages, the steps and elements of evaluation of the Tawreeq (Process and Issuance of Sukuk), and the Ijarah issuance process as an example. However, before proceeding on the sections of this chapter, it should noted that there are prohibitions upon which the Sukuk issuer must avoid which are transactions in unethical goods and services, Riba or interest (earning returns from a loan contract), compensation-based restructuring of debts, Gharar (excessive uncertainty in contracts, Qimar (gambling and speculation games), trading in debt contracts at discount and forward foreign exchange transactions.

2.1 Common structures of Sukuk

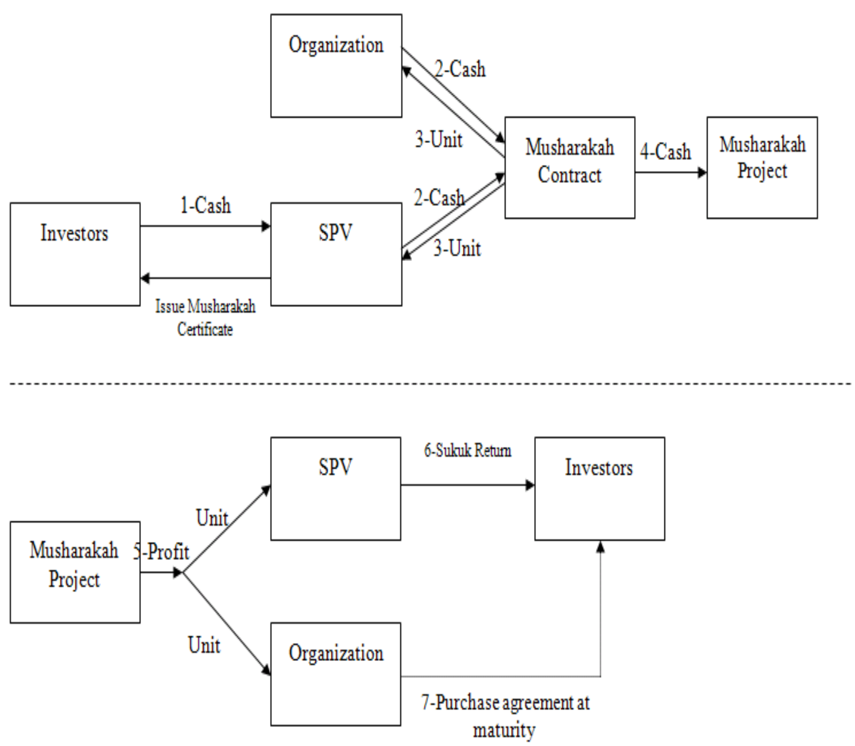
Sukuk can be structured alongside different techniques. Moreover, Sukuk present partial ownership in a debt, asset, project, investment or business while a conventional bond is a promise to repay a loan. In addition, The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued standards for 14 different Sukuk types. Moreover, the most common structure based upon is Ijarah which is based on leasing transactions. Other common structures are Musharakah, Istisna, Mudarabah, Murabahah and Salam Also, the Sukuk of Bithamin Ajil (Murabahah based) in Malaysia is very popular but not so for Arab investors. The suitable classification of the asset classes will also determine the type of certificates to be issued. Moreover, it is essential to note that these assets can be prepared for the issuance of trust certificates in a number of ways in condition to the need of the issuing entity.

2.1.1 Musharakah.

The first one is Musharakah which is Profit and loss sharing. Moreover, it is a partnership where profits are shared as predetermined ratios agreed by partners while the losses are shared in proportion to the capital or investment of each partner. In addition, all partners contribute funds and have the right, but not the obligation, to exercise executive powers in that project. This is similar to a conventional partnership structure and the holding of voting stock in a limited company. It is consider to be widely regarded as the purest form of Islamic financing. (9)

Furthermore, the company intends to issue Musharakah Sukuk will establish Special purpose company (SPV) that will issue Musharakah Sukuk for the investors to finance the project of the company and get the proportion of this project. However, the partners will determine the units of each partner. In Musharakah Sukuk, the partners will get into Musharakah contract (partnership) and will start and run the project, and the profit generated from the project will be shared between the partners according to the predetermined percentage. The profit from the project will represent the Sukuk payments; however, the investors will receive only the profit rate of the Sukuk not the amount of shares of the revenue. In case that the revenue equals the Sukuk profit rate, then the investors will receive the whole profit. If the profit was more than the Sukuk profit rate, then the investors will receive only the profit rate and the excess amount will go to the organization as a management fee. If the profit was less than the Sukuk profit rate, then the organization will be asked to purchase some of the investors units in the project. At maturity, the company will be asked to buy the investors unit on the project. The purchasing price will equals the principal and the interest and the whole authority of the project will move to the organization. The Following Chart 2.1 can illustrate the procedure.

Chart 2.1: Musharakah Sukuk

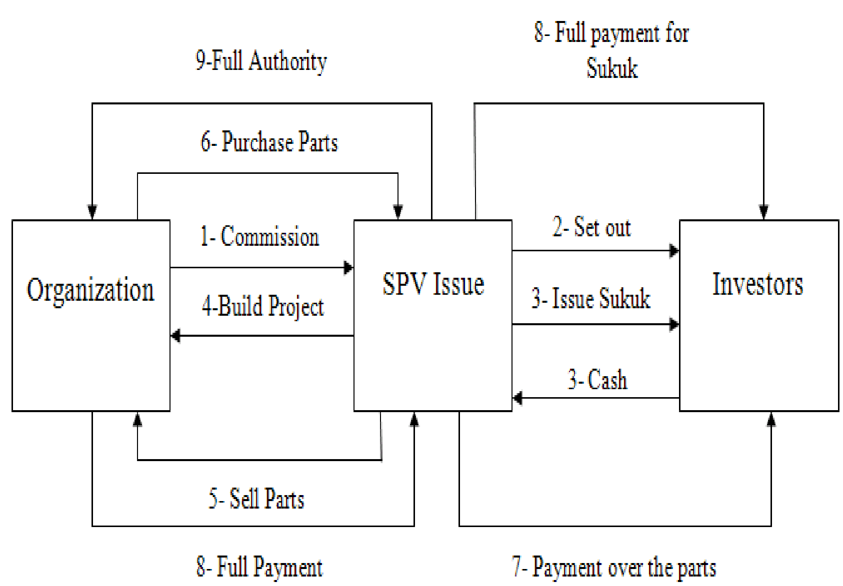


2.1.2 Istisna.

An Istisna is a sale transaction where a commodity is transacted before it comes into existence. Moreover, it is an order to manufacture a particular commodity for the purchaser. Next, the manufacturer, which is our customer, uses its own material to manufacture the required goods. In addition, price is fixed with the approval of all parties involved as well as all other necessary specifications of the finished. (9)

Furthermore, any company want to issue Istisna Sukuk needs to commission the project and define the specifications of the project, and the number of years it requires to repay the price. Then, the SPV then sets out the specification and the time required in the tender documents and issue Sukuk Istisna. The bids will be invited subsequently from contractors or (the investors) who will undertake to construct the project. The contractor (investors) will intended to sell completed parts of the project overtime, and the amount of each payment installment expected. Moreover, the payments over the selling of the completed parts are the payments of Sukuk. At Maturity, when the project will be completed, the ownership of the project totally will be transferred to the company. Also, the selling price will normally cover the construction costs and the profit. The profit is also the return of the Istisna Sukuk. The procedure of the Istisna Sukuk can be illustrated in the following Chart 2.2:

Chart 2.2: Istisna Sukuk

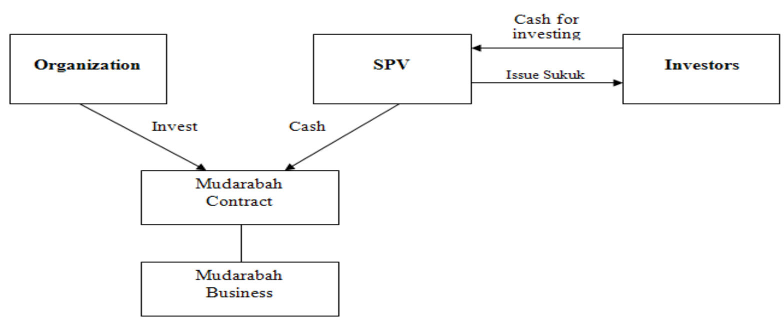


2.1.3 Mudarabah.

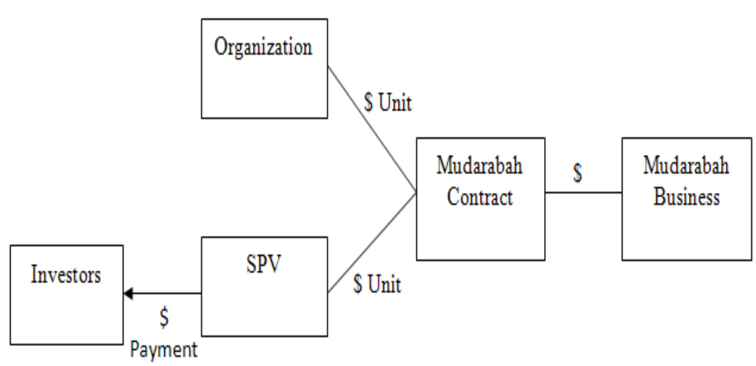
A Mudarabah is an Investment partnership, whereby the investor (Rab ul Mal) provides capital to another party (Mudarib) in order to undertake a business or investment activity. Moreover, the profits of the business or investment are shared on a pre-agreed ratio between them while the losses of investment are bear by the investor only. Therefore, the Mudarib loses its share of the expected profits. (9)

Furthermore, any company intends to issue Mudarabah Sukuk, will issue them to the investors in order to finance its project, Then, it will start working on the project and the profit that is generated from the factory will be divided between the partners according to the predetermined percentage. Revenues generated from the project are considered as the Sukuk payments for the investors. At maturity, if the project generates enough revenue to pay off the Sukuk the Sukuk holder will receive their face value and their interest on time. However, if the project does not generate enough revenue, the Sukuk holders will either receive their principal and interest later or nothing at all. The procedure of the Mudarabah Sukuk can be illustrated in the following Chart 2.3:

Chart 2.3: Mudarabah Sukuk



At the payment and Maturity

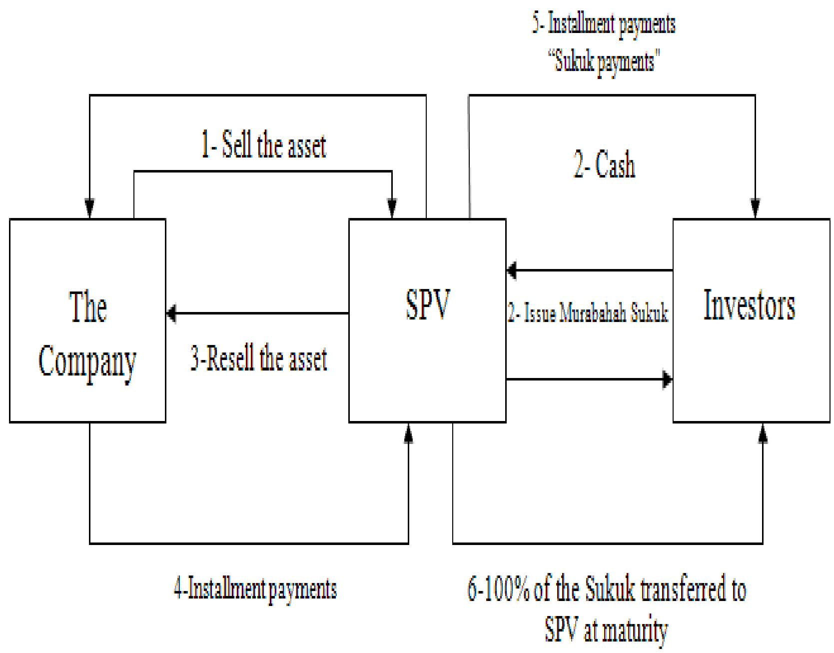


2.1.4 Murabahah.

A Murabahah is a purchase and then resale transactions which is a way of having funds instead of having them through lending. So, the capital provider purchases the desired commodity from a third party and resells it at a predetermined price to the capital user. In addition, the capital user has effectively obtained credit without paying interest by paying the agreed price over installments or through deferral. (9)

Furthermore, any company intends to issue Murabahah Sukuk for 100 m, the company will sell one or some of its assets to a special purpose vehicle (SPV) for its need of money 100 m. The SPV will finance the company and buy the asset by issuing Murabahah Sukuk equal the amount of purchasing the asset (100 million). The investors will share the proportion of that asset as Sukuk holders. After the SPV buy the asset, it will sell it back to the company for predetermined amount of money equal to initial amount and margin. The payment will be through installment payments represent the periodical payments for the investors. At maturity, the investors get their full amount of Sukuk payment and their principal of the Murabahah Sukuk. The procedure of the Ijarah Sukuk is illustrated in Chart 2.4:

Chart 2.4: Murabahah Sukuk

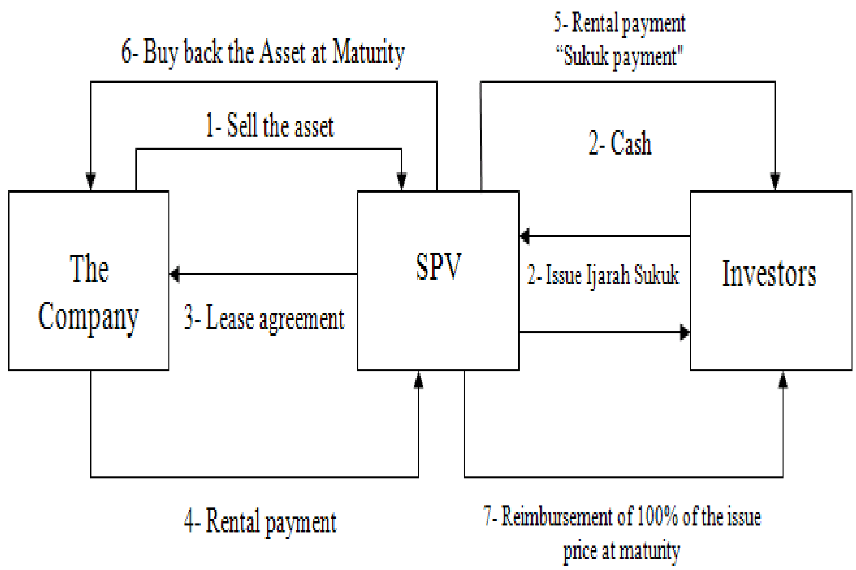


2.1.5 Ijarah.

In Ijarah which is Islamic lease agreement, the Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer instead of lending money and earning interest. In addition, Ijarah Wa Iqtina extends the concept of Ijarah to a hire and purchase agreement. (9)

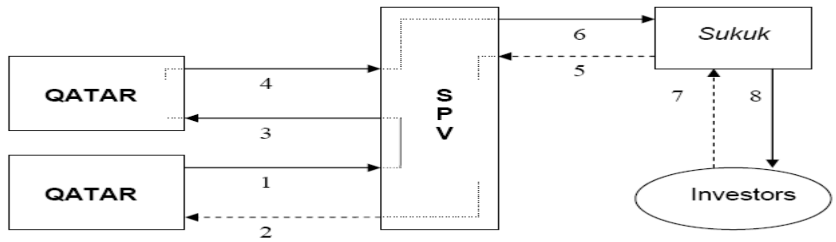
Furthermore, any company intends to issue Ijarah Sukuk for 100 m, the company will sell one or some of its assets to a special purpose vehicle (SPV) for its need of money 100 m. The SPV will finance the company and buy the asset by issuing Ijarah Sukuk equal the amount of purchasing the asset (100 million). The investors will share the proportion of that asset as Sukuk holders. After the SPV buy the asset, it leases it back to the company for predetermined amount of money. The lease rental payments represent the periodical payments for the investors. At maturity, the SPV will sell the asset back to the company for the same amount plus the last payment. The investors will get their full amount of Sukuk payment and their principal of the Ijarah Sukuk. The procedure of the Ijarah Sukuk is illustrated in Chart 2.5:

Chart 2.5: Ijarah Sukuk



The following chart 2.6 is an example of Sukuk structured based on Ijarah (8). First, Qatar government established SPV for their project which is belong to Qatar government because SPV is totally owned by them. Second, SPV issued Ijarah Sukuk to the investors to hold them on its project for money contribution to SPV to run the project in exchange for rental payments for the investors. Third, Qatar government paid rental payments to he investors.

Chart 2.6: The Qatar Sovereign Ijarah Sukuk Structure

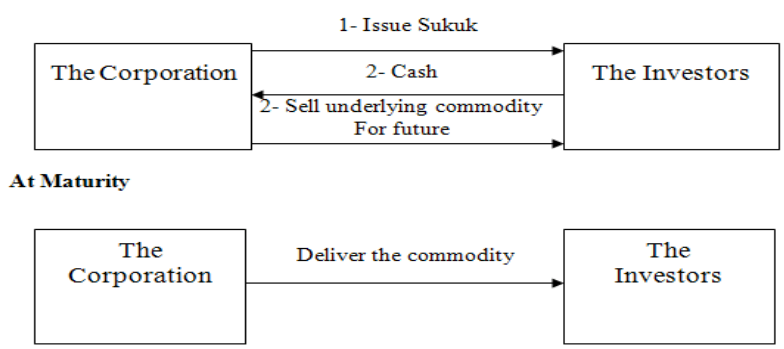


2.1.6 Salam.

In Salam contracts, two parties agree on the sale and purchase of an underlying asset at a future date but at a price determined and fully paid for today. Therefore, the seller agrees to deliver the asset in the agreed quantity and quality to the buyer at a future date. However, this is similar to the conventional forward contract but the principal is different by which the buyer in Salam pays the entire amount in full at the time the contract is initiated. (9)

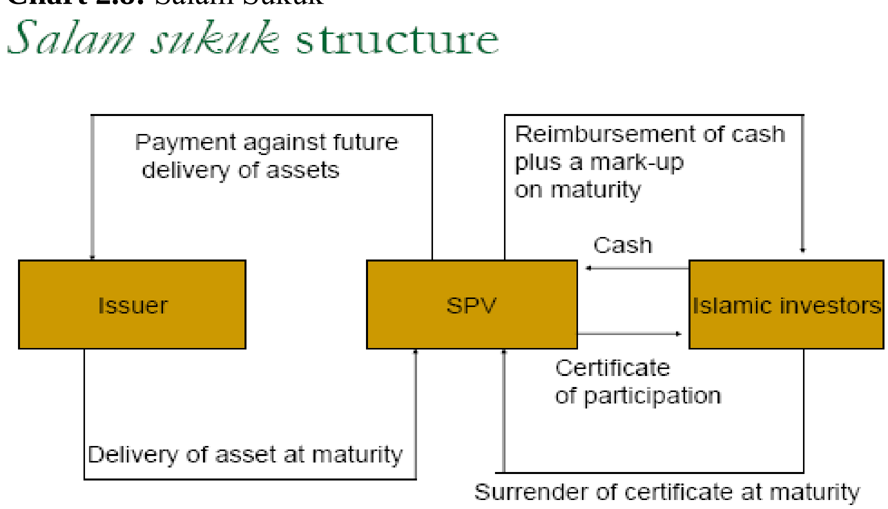
Furthermore, any company intend to issue Salam Sukuk, it will issue Salam Sukuk certificates equal to the amount of company needs ex. 100 million which each certificate represents a Salam contract. The certificate promises that at maturity, the company will deliver to the holder a specified quantity of underlying commodity. The commodity has to be described fully on the back of the certificate or in the prospectus. The company receives the cash after selling the commodity and it can use it for any purpose. At maturity, the company will deliver the sold commodity to the buyers/Sukuk Holders. The benefit for the buyers/Sukuk holders is that they are buying commodities at a discount, and the difference between this and the eventual selling price represents their return. The following chart 2.7 can illustrate the procedures:

Chart 2.7: Salam Sukuk



The following chart 2.8 is another illustrating for Sukuk that based on Salam contract (8). First, SPV is established by the issuer. Second, SPV issued certificates of participation to Islamic investors for cash needed to purchase assets delivered from the issuer in certain future date which the maturity date in exchange for reimbursement of cash plus mark-up on maturity date. Third, the issuer delivered the assets to SPV at maturity, SPV paid to Islamic investors the principle amount plus mark-up on maturity date, and the certificates are expired.

Chart 2.8: Salam Sukuk



2.2 Types of Sukuk certificates.

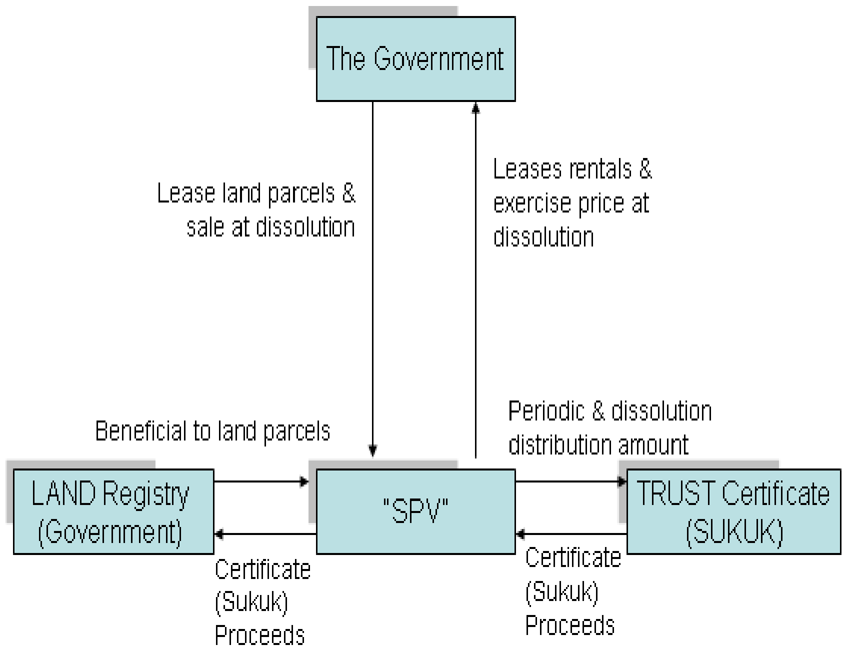
The type of certificates to be issued will be determined base upon the proper classification of the asset classes. Therefore, it is vital to note that these assets can be geared up for the issuance of trust certificates in many ways conditional to the need of the issuing entity. However, the type of Sukuk certificates in today's market are Pure Ijarah Sukuk, Hybrid Pooled Sukuk, Variable Rate Redeemable Sukuk, Zero-coupon non-tradable Sukuk, Embedded Sukuk and Expanded list of Sukuk.

2.2.1 Pure Ijarah Sukuk.

It is issued based on stand-alone assets recognized on the balance sheet. Moreover, the assets can be parts of land to be leased or leased equipment such as air planes, cars and ships. Furthermore, the rental rates of returns on this type of Sukuk can be both fixed and floating depending on the particular originator. (1)

The following chart 2.9 is an illustrating the pure Ijarah Sukuk as a global mode (7). First, SPV is established by the government. Second, SPV issued trust certificates (Sukuk) to the investors in exchange for periodic and dissolution distribution amount. Third, SPV gave Sukuk's proceeds are to Land registry (government) in exchange for beneficial to land parcels. Fourth, SPV rent the land parcels from the government for leases rentals and buy it at dissolution with exercise price.

Chart 2.9: Global Sukuk structures – sovereign

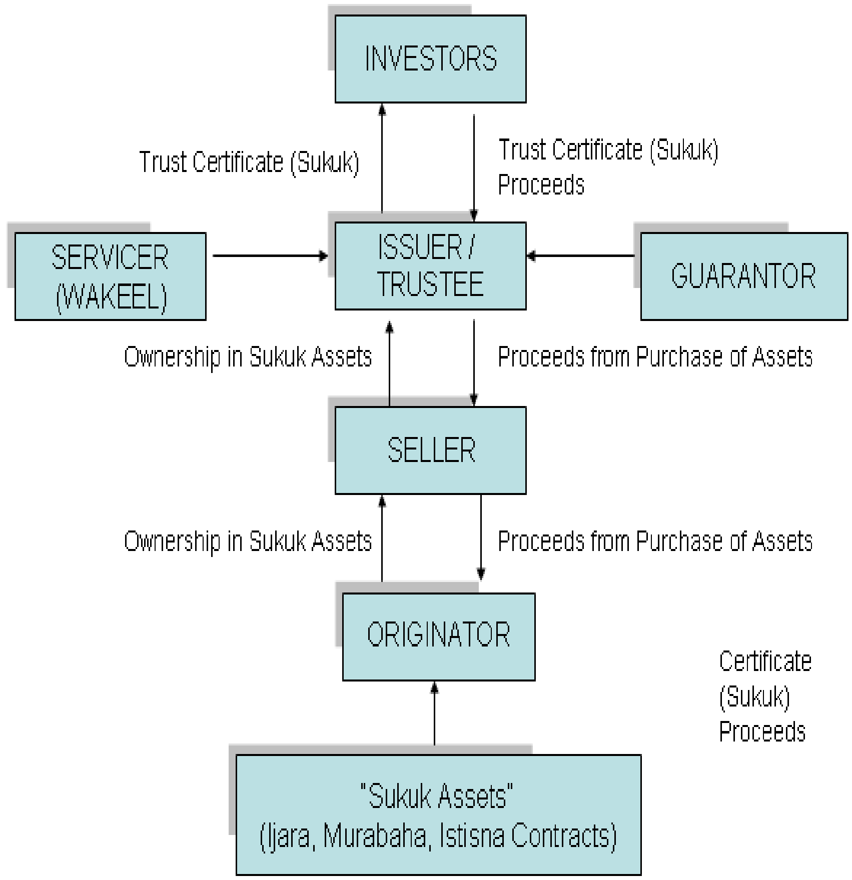


2.2.2 Hybrid Pooled Sukuk.

It is based on a portfolio of assets can consist of Istisna, Murabahah and Ijarah. Furthermore, having a portfolio of assets consisting of different classes allows for a greater mobilization of funds as previously inaccessible Murabahah and Istisna assets can comprise a portfolio. However, 51 percent of the portfolio must at least consist of Ijarah assets because the Murabahah and Istisna, which are part of the portfolio, are certificate receivables upon which the return on these certificates can only be a pre-determined fixed rate of return. (1)

The following chart 2.10 is an illustrating the Hybrid pooled Sukuk based on Ijarah, Murabahah and Istisna structures as a global mode (7). First, originator issued Sukuk assets (Ijarah, Murabahah, and Istisna contracts) to seller which he sold to Issuer/Trustee in exchange for cash contributions. Second, Issuer/trustee issued trust certificates to the investors in exchange for their cash contributions in order to facilitate its cash contributions to the seller for purchasing Sukuk assets. Issuer should have to have a guarantor and servicer (Wakeel) in order to issue its trust certificates.

Chart 2.10: Global Sukuk structures – supranational.



While the following chart 2.11 is an illustrating the Hybrid pooled Sukuk based on Ijarah and Istisna structures only as a global mode (7). First, SPV is established by sponsor/originator which purchased the existing plant from sponsor/originator and lease 51% of the plant and facilities to be constructed and sold at dissolution to sponsor/originator. Second, SPV issued Ijarah's and Istisna's Sukuk to the investors (financiers) in order to facilitate the purchase price of the plant through Sukuk proceeds in exchange for periodic distributions amounts. So, SPV paid the periodic payment to Sukuk holders (financers) through beneficial owner of existing plants and facilities to be constructed, and rentals of 51% of plants from sponsor/originator.

Chart 2.11: Global Sukuk structures – corporate.

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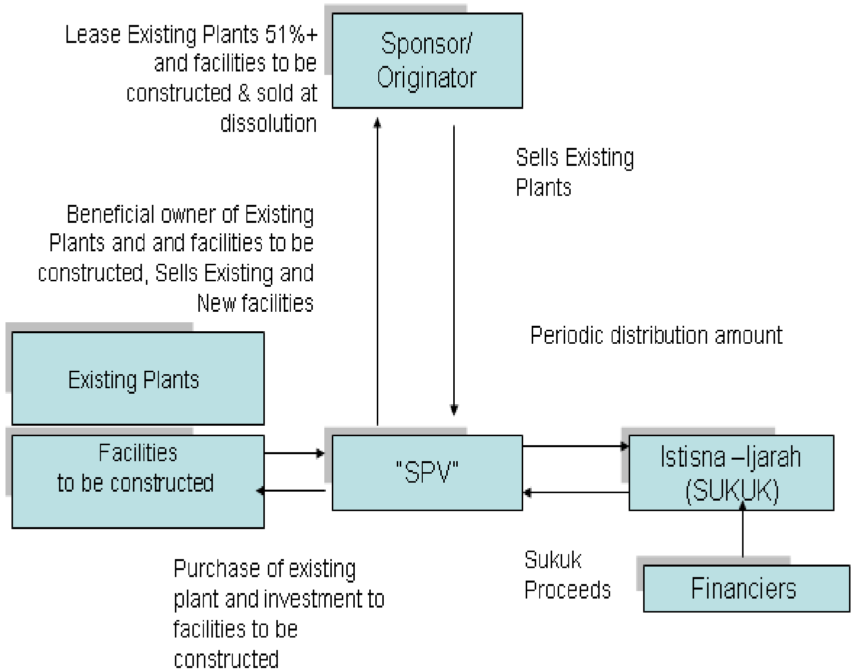
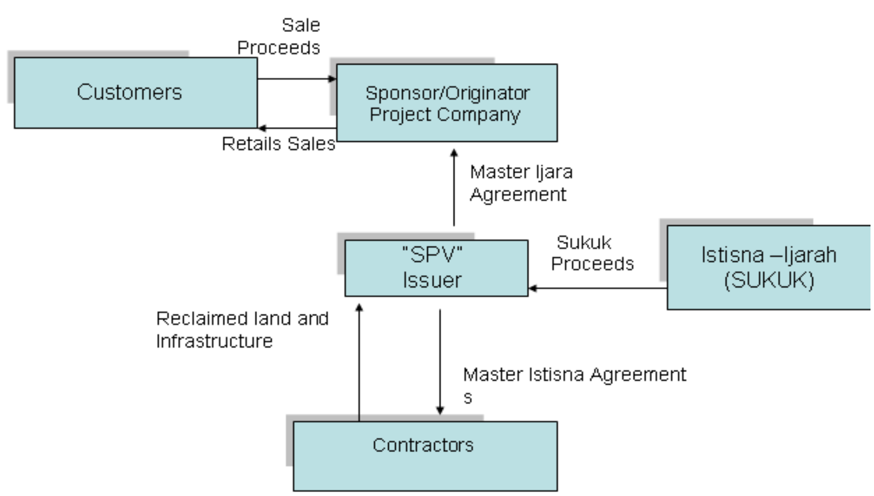


Another way of Sukuk based on Ijarah and Istisna structures is illustrated in the following chart 2.12 (7). First, SPV is established by sponsor/originator of Project Company which there is master Ijarah agreement between them. Second, SPV have master Istisna agreement with contractor for reclaimed land and infrastructure. Third, SPV issued Istisna and Ijarah Sukuk to the investor in exchange with periodic payments through sale proceeds from customers to sponsor/originator of Project Company to SPV in order to facilitate the running of the project.

Chart 2.12: Global Sukuk structures – corporate.



2.2.3 Variable Rate Redeemable Sukuk.

The pervious Sukuk's types would partially represent the strength of the balance sheet of the issuer. However, it is beneficial to implement Sukuk by representing the full strength of the balance sheet of the issuer. Furthermore, several corporate entities refer to this Sukuk as Musharakah Term Finance Certificates (MTFCs) which will be considered as an alternative to Sukuk because of its seniority to the issuer's equity, its redeeming nature and its relatively stable rate as compared to dividend payouts. However, MTFCs have a few advantages. First, the floating rate of return on these certificates would depend on the firm's balance sheet actualities and not on benchmarking with market references such as LIBOR. Secondly, employing Musharakah returns is preferred from the viewpoint of jurists as such an arrangement would strengthen the paradigm of Islamic banking that considers partnership contracts as the embodiment of core ideals. (1)

2.2.4 Zero-coupon non-tradable Sukuk.

It is based on the assets to be mobilized which do not exist yet. Furthermore, the objective of the fund mobilization would be to create more assets on the balance sheet of company through Istisna. However, certificates of this type would not re be tradable because of Shariah restrictions. Moreover, the primary asset pools to be generated would be of the nature warranted by Istisna and installment purchase/sale contracts that would create debt obligations. The certificate on these debt arrangements can be termed as fixed rate zero coupons Sukuk. (1)

2.2.5 Embedded Sukuk.

It could be Sukuk of either r zero-coupon, pure-Ijarah or hybrid, with the embedded option to convert into other asset forms depending on specified conditions. (1)

2.2.6 Expanded list of Sukuk.

As the emergence of concern in issuances of Islamic asset-backed financial instruments, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) released an exposure draft of its Shariah standards concerning Sukuk in November 2002. According to the exposure draft: "*Investment Sukuk are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible* *assets, usufructs, and services, or equity of a given project or equity of a special investment activity."* So, the different types of investment Sukuk identified in the exposure draft are certificates of ownership in leased assets, certificates of ownership in usufructs, certificates of ownership of services of a specified supplier or of services to be made available in the future, Salam certificates, Istisna certificates, Murabahah certificates, Participation certificates, Muzara'a (sharecropping) certificates, Musaqa (irrigation) certificates, Mugarasa (agricultural) certificates, and Concession certificates. (1)

2.3 Process and Issuance of Sukuk (Tawreeq).

This section will clarify the goals, the ways, the elements, parties involved, the advantages, the steps and elements of evaluation of the Tawreeq (Process and Issuance of Sukuk), and I will provide the Ijarah issuance process as an example.

2.3.1 The goals of the Tawreeq.

There are several goals and motives of making banks and financial institutions to carry out the Tawreeq for both issuers of Sukuk and investors that can be summarized in the following elements.

<u>The goals and motives for the issuers of Sukuk:</u>

1. Freedom from the constraints of the balance sheet which provides financial and accounting rules into account the principle of capital adequacy, and management of provision for doubtful debts that would hamper the activities of finance in general, necessarily slow down of the capital cycle, and reduces the profitability of banks. Therefore, in the Tawreeq, the situation is allowed to substitute an appropriate a large part of the liberalization of bank funds, which requires her to meet the allotment of such debt.
2. Raise the efficiency of the financial cycle, productivity and the rate of rotation through the conversion of non-liquid assets to liquid assets to re-employ them again, thus it would help to expand the size of the facilities without the need to increase the rights of ownership.
3. Minimize credit risk through the distribution of financial risk on a wide range of different sectors.
4. The Tawreeq allows credit rating companies with low capital base and low capital access to finance small rates obtained by the segments of the excellent. (2)

The goals and the motives for the investors:

1. Decline in risk of the dangers of financial investors, and the recovery of the capital market.
2. Revitalize some economic sectors of primary markets such as real estate or cars. Moreover, revitalize the capital markets through providing new investment and financing tools, diversify the supply of financial products, and stimulate the circulation of market instruments.
3. Tawreeq operations help to achieve transparency, improve the structure of the information in the market, and the entry of many institutions in the financing process, which provides more information on the market.
4. Attract a variety of segments of the Tawreeq investors, which leads to the expansion of the size of capital markets and the recovery.
5. Provide foreign exchange to banks and financial institutions creditors in the case of cross-border Tawreeq, since the buyer of the asset in this case is the bank or a foreign financial institution who will pay the local bank the value of the deal by foreign currency, which lead to an increase in domestic bank assets in foreign currency. (2)

2.3.2 The elements of Tawreeq.

Elements and components of the process Tawreeq are beneficiaries, assets, previous steps, and assets management.

1. *Beneficiaries:*
   Involving all parties benefiting from the Tawreeq process, namely: the source of financing, the buyer which is the bank or financial institution by which the purchase of income-generating asset of the original owner, and the financial institution of a special purpose SPV, where they will be paid in return for a commission or managing the process of issuance. (2)
2. *Assets*:
   This may be kind of tangible assets, or benefits resulting from the leasing operations, or services such as: education and health services, or rights of access, such as resulting from the contracts under the BOT. (2)
3. *Previous steps:*
   Precede Tawreeq there is a process of multiple steps ended up with bank or financial institution agreement that wishes to transfer its assets to liquidity compared to a rapid transfer of ownership of such assets, including

the preliminary steps to that end: a realistic assessment of the value of assets, determine appropriate pricing of securities to be offered for public subscription, planning for programs to promote the subscription, and the preparation of studies on the cash flow securitization of assets replaced, and others. (2)

4. *Asset Management:*

   With regard to receivables Tawreeq religiously accepted, despite the transfer of ownership of the assets securing the fulfillment of the value of the stock exported from the source to the new creditors represented by the Tawreeq holders. In most deals, the management functions are to be for the source of this portfolio of assets in addition to guarantees during the completion or implementation of the Tawreeq. (2)

2.3.3 The parties of Tawreeq.

The parties to the Tawreeq process are source of investment Sakk, Issuing agent, buyer or investor, secretary of investment, and ratings agencies.

i. *Source of investment Sakk:*

   He uses the proceeds from the subscription in sharia form. Moreover, the source of the investment may be an individual, a company, a government or financial institution. Also, it can be financial institution that are special purpose SPV been acting as organizing the issuing in behalf of the source for a fee or commission identified in the prospectus. (2)

ii. *Issuing agent:*

   A financial institution and intermediary that is specific purpose of issuance SPV will take all actions on behalf of the source in Tawreeq for a fee or commission identified in the prospectus. The relationship between the source and the release agent is on the basis of the agency paid. (2)

iii. *The buyer or investor:*

   He may be a bank or financial institution, local or global major with a high financial solvency, as such institutions may have higher rates of untapped liquidity, which encourages them to engage in Tawreeq in order to take advantage of this excess liquidity in the high returns relatively compared to the revenue on the investment opportunities available in the global financial markets. (2)

iv. *Secretary of investment:*
It is the intermediary financial institution, which protect the interests of bondholders and supervision of the manager. Also, it maintains documentation and guarantees which is on the basis of the agency contract wage identified in the prospectus. (2)

v. *The rating agencies:*
These agencies play a key role in the classification of the financial issues raised in the capital markets, and to determine the fair price of the stock exported. Moreover, the most important of these agencies: Moody's, Fitch, Standard & Poor, as well as at the present time Islamic rating agencies provide Islamic service Quality Rating compliance, such as: the Islamic International Rating Agency, a Bahrain-based IIRA, as well as the Rating Agency Malaysia's RAM. (2)

It shall be noted that among to the parties to Sukuk, there are also custodian, lead managers, book running, register, payments administrator, legal advisors, Sukuk holders' agents, auditors to the issuer.

2.3.4 The advantages of Tawreeq.

Islamic banking faces many challenges in front of the traditional banking business competition. Moreover, Because of the prohibition of interest on the money to reap, the Islamic banking focuses strongly on the initial assets and not only in the circulation of money in exchange for waiver of the cash flow. However, there are many advantages provided by Tawreeq.

In term of investment banks; the diversification of funding sources to be translated into a number of benefits., funding to reduce the risk by reducing their reliance on a limited number of sources of funding, and ensure their future is a product of the benefits mentioned above, in addition to being a result of the withdrawal of such assets from the balance sheet. (6)

Secondly, in term of investors; the Tawreeq through banks enable investors to take investment decisions independently of their credit (their credit rating), in contrast, focus on the degree of protection afforded by the structure of securities and assets transferred to the ability of securities to meet cash flow promised, and give them an outlet in the past investment that was the preserve of a few companies only. (6)

While in term of the consumers; when the finance institutions or banks are able to diversify its sources of funding, the lower the cost of capital will be, and it is likely in this case to reflect the decrease in quotations to consumers. However, If it is not voluntarily submitted, it will be imposed by the forces of competition due to the increase in sources of presentation. (6)

Finally, in term of the financial sector:; Tawreeq contribute to the creation of the securitization market more through the introduction of new categories of financial assets that fit the wishes of the risks to investors, and through increased investors' access to the benefits of diversity to meet the needs of different market segments. Also, it is Likely to increase the market potential and opportunities growth, because the growth will not be limited to the size of financial institutions. Moreover, it tends to result in a competitive environment, as a result of increased sources of supply. (6)

2.3.5 The steps of Tawreeq.

The steps of Tawreeq are necessary approvals from the authorities concerned, marketing and sales, declaring ways of exit or recovery including in the secondary market, and depreciation and liquidation. (5)

2.3.6 The elements of evaluations step of Tawreeq.

There are fives elements for evaluation the steps of Tawreeq. First, identify the goal from Tawreeq operation that would put in consideration the required financing size, issuing cost, and the required guarantees. Second, identify assets type and sizes. Third, prepare elementary feasibility studies which include Sharia study, legal study, marketing study, technical study, and financial study. Fourth, classify the financial assets of Tawreeq by the international rating agency role. Finally, evaluate and treat the financial assets risks. (4)

2.3.7 An example: Ijarah Sukuk and Shariah legitimacy of its issuance.

The idea of the principle of Ijarah Sukuk is based on Altaskik (or bonding or securitization), which means the issuance of securities available for trading in the secondary market. It based on the investment project generates income, and the purpose of the instruments is to transfer lease objects and benefits related to the lease contract into financial securities that can be traded in the secondary market. Therefore it is defined as bonds of equal value, representing shares in the ownership of objects or the benefits of income. (3)

However, Ijarah Sakk is not a specific amount of money, or not a debt whether a natural person or legal entity it is the financial securities that are common part of the used property appointed such as real estate, aircraft, ship, or group of same or different. If they are leased, yielding a specific holding of the lease. (3)

Moreover, Ijarah Sukuk can be nominal, meaning they carry the name of the instrument, and transfer of enrollment in a particular record, or write the name of the new holder as it changed ownership. It can also be the bearer bonds, so as to move the delivery of property. Also, it can represent the ownership of the leased objects and trading those if the conditions in which objects can be the subject of the lease contract such as a real estate, and so on, as long as the Sukuk is a real ownership of leased objects. (3)

Ijarah Sukuk holder can sell it in the secondary market to any buyer in the price agreed upon, whether equal, less or more than the price he bought it given the fact that the prices are based on supply and demand. Moreover, He deserves his share of the return (Ijrah) at the time specified in the terms of the issue less the expense of the lessor according to the provisions of the lease contract. (3)

In addition, a tenant has a right to lease the subleasing to issue Ijarah Sukuk represents common shares of benefits he owned through lease with the intention to sublease it. it is required to issue Ijarah Sukuk before finalize the lease contracts with tenants whether such lease or rental lease less than the first lease or more, but if he entered into contracts with the tenants, he can not issue the Ijarah Sukuk because it represent will debts. Moreover, he can not guarantee that the source of Ijarah Sukuk, its director or the return value. Also, if the objects leased lost in whole or in part, the Sukuk holder will bear that loss. (3)

2.4 Summery

At the end, this chapter talked about common Sukuk structures which are Musharakah, Istisna, Mudarabah, Murabahah, Ijarah and Salam. And end up the recognition of that Ijarah Sukuk is most suitable Sukuk especially for existing projects because there are existing assets to based upon the issue of Sukuk and as well generate fixed periodic payments determined from the beginning easily due to fact that are treated as rentals which is similar to normal rentals. Also, It is not complex to monitor and manage the process of the Ijarah Sukuk is whether follow totally Shariah compliance or not as other Sukuk structures.

Then, it talked about the natures of each type of Sukuk certificates which are Pure Ijarah Sukuk, Hybrid Pooled Sukuk, Variable Rate Redeemable Sukuk, Zero-coupon non-tradable Sukuk, Embedded Sukuk and Expanded list of Sukuk. So, extended to my favor of Ijarah Sukuk, I prefer always to diversify the risks of either investments or financings which it will be better to mix the Ijarah with Istisna and Murabahah in structuring the Sukuk to have Hybrid Pooled Sukuk. This is due to fact that having a portfolio of assets consisting of different classes allows for a greater mobilization of funds.

After that, it clarified the goals, the ways, the elements, parties involved, the advantages, the steps and elements of evaluation of the Tawreeq (Process and Issuance of Sukuk), and I provided the Ijarah issuance process as an example. Moreover, it is goo to mention that again the necessary approvals from the authorities concerned, marketing and sales, declaring ways of exit or recovery including in the secondary market, and depreciation and liquidation are must follow comprehensively when doing issue of Sukuk through Tawreeq especially necessary approval from authorities concerned which is Shariah scholars through Shariah board in order to ensure that the Sukuk is complained to Shariah and no questionable about it later.

2.5 References

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Chapter three: - Issues in Sukuk

This chapter will clarify the types of risks facing the Sukuk industry; market risk, credit and counterparty risk, Shariah compliance risk, operational risk, and institutional rigidity. Also, it will state the challenges facing the management of financial risks of Sukuk that are challenge of institutional reorganization. In addition, it will talk about the argument said that most of Sukuk implementation are not followed the Shariah rules.

3.1. Risks of Sukuk.

Unfavorable risks affect the competitiveness of the pricing of assets. Therefore, the innovation of Sukuks essentially involves a higher exposure to certain market and financial risks. These risks are market risk, credit and counterparty risk, Shariah compliance risk, operational risk, and institutional rigidity.

3.1.1 Market Risk.

It is an important that is defined as the risk on instruments traded in well-defined markets. Moreover, there are two categories of market risks are identified; general (systematic) and firm specific (unsystematic). Furthermore, Systematic risks can arise due to governmental and economic policy shifts whereas unsystematic risk arises because different firm specific instruments are priced out of correlation with other firms' instruments. Market risk is composed of profit rate risks, foreign exchange risks, equity price risks and commodity risks. (1)

The profit rate risk is rate of return risk upon which Sukuk is based on fixed rates that are exposed to this risk in the same manner as fixed rate bonds are exposed to the profit rate risk. Moreover, an increase in market profit rates leads to a decrease in the fixed-income Sukuk values. However, all fixed return assets either from Ijarah, Istisna, Salam or any other origin will face this risk. This also involves reinvestment risk and an opportunity cost of investing at the new rates, particularly if the asset is not liquid as in case of the zero-coupon non-tradable Sukuk. Also, undesirable changes in market rates will also unfavorably affect the credit worthiness of the issues and will lead to the increase in the credit risk of the issue. Furthermore, Sukuk certificates are exposed indirectly to profit rate fluctuations through the widespread benchmarking with LIBOR in their financing operations. (1)

While the foreign exchange risk is a currency risk arises from unfavorable exchange rate fluctuations which will have an effect on foreign exchange positions. The challenge for Sukuk issuing corporate entities and sovereigns becomes to devise an effective exchange risk management strategy congruent to Shariah principles. (1)

The following table 3.1 illustrates the risk characteristics of each Sukuk structures. (1)

Types of Sukuk	*Description of Sukuk structure*	*Credit Risk*	*Rate of return (Interest rate risk)*	*FX risk*	*Price risk*	*Other risks*
Zero coupon Sukuk	Istisna', Murabahah debt certificates **– non-tradable**	Unique basis of credit risks exist, see, Khan and Ahmed (2001)	Very high due to fixed rate, remains for the entire maturity of the issue	If all other conditions are similar, FX risk will be the same for all cases of Sukuk. However, those Sukuk which are liquid or which are relatively short term in nature will be less exposed. The composition of assets in the pool will also contribute to the FX risk in different ways. Hence this can be very useful tool to overcome the FX risk by diversifying the pool in different currencies.	Price risk relates to the prices of the underlying commodities and assets in relation to the market prices. Ijara Sukuk are most exposed to this as the values of the underlying assets may depreciate faster as compared to market prices. Maintenance of the assets will play an important part in this process. Liquidity of the Sukuk will also play an important part in the risk. Salam is also exposed to serious price risks. However, through parallel contracts these risks can be overcome	**Liquidity** risk is serious as far as the non-tradable Sukuk are concerned. **Business** risk of the issuer is an important risk underlying Sukuk as compared to traditional fixed incomes. ***Shari'ah* compliance** risk is another one unique in case of Sukuk. **Infrastructure rigidities**, i.e., non-existence of efficient institutional support increases the risk of Sukuk as compared to traditional fixed incomes, see *Sundararajan, & Luca (2002)*
Fixed Rate Ijara Sukuk	Securitized Ijara, certificate holder owns part of asset or usufructs and earns fixed rent - **tradable**	Default on rent payment, fixed rate makes credit risk more serious	Very high due to fixed rate, remains for the entire maturity of the issue			
Floating Rate Ijara Sukuk	Securitized Ijara, certificate holder owns part of asset or usufructs and earns floating rent indexed to market benchmark such as LIBOR – **tradable**	Default on rent payment, floating rate makes default risk lesser serious – see previous case	Exists only within the time of the floating period normally 6 months			
Fixed rate Hybrid/ Pooled Sukuk	Securitized pool of assets; debts must not be more than 49%, floating rate possibility exists – **tradable**	Credit risk of debt part of pool, default on rents, fixed rate makes credit risk serious	Very high due to fixed rate, remains for the entire maturity of the issue			
Musharakah Term Finance Sukuk (MTFS)	Medium term redeemable musharakah certificate based on diminishing musharakah – **tradable** as well as **redeemable**	Musharakah has high default risk (see Khan and Ahmed 2001), however, MTFS could be based on the strength of the entire balance sheet	Similar to the case of the floating rate. This is however, unique in the sense that the rate is not indexed with a benchmark like LIBOR, hence least exposed to this risk			
Salam Sukuk	Securitized salam, **fixed-rate and non-tradable**	Salam has unique credit risk (see Khan and Ahmed 2001)	Very high due to fixed rate			

3.1.2 Credit and Counterparty Risk.

The Credit risk is the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements while the counterparty risk is the probability that the counterparty retracts on the conditions of the contract if the relationship involves a contractual arrangement. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inbuilt in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of the Sukuk asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shariah considerations. (1)

3.1.3 Shariah Compliance Risk.

The Shariah compliance risk is the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with Shariah. For example, if the Sukuk is based on a hybrid of Ijarah and Istisna assets, Ijarah must always be more than Istisna' in the pool, otherwise the Sukuk deed will dissolve. Thus broadly speaking, Shariah compliance risk must be defined as a rate of return foregone in comparison to the market rates, as a result of complying with the Shariah. (1)

Moreover, fixed rate Sukuk faces serious market risks. So, to match the market requirements of Sukuk to be floating rate, and the Shariah requirements of rents to be fixed rate, the Ijarah Sukuk are based on a Master Ijarah Agreement with several subordinate Ijarah agreements. However, the investors could still face profit rate risk to a certain extent and since the originator can only guarantee the fixed return on the underlying asset pools, the issue of floating rate returns still remains contentious, particularly, in pooled/hybrid Sukuk. Therefore, the association of Shariah supervisors with Sukuk issues will ensure investor confidence (1)

3.1.4 Operational Risk.

The operational risk is in the sense that is inherent to the structure of the issuances rather than the underlying Islamic principles. Furthermore, the risks related specific to the operation are mirror to those existent in conventional bond markets these risks are Default Risk, Coupon Payment Risk, Asset Redemption Risk, Investor Specific Risks, and Risks Related to the Asset. (1)

First, Default Risk is when each party has provisions for the termination of the certificate in the event of a default by the obligor. Second, Coupon Payment Risk is when the obligor may fail to pay the required coupons on time. Third, Asset Redemption Risk is when the originator has to buy back the underlying assets from the certificate holder. Fourth, Investor Specific Risks is when the certificate holder is rendered to several risks relevant to Sukuk structures such as liquidity management issues in Islamic finance. Fives, Risks Related to the Asset is when the underlying assets of the Sukuk certificates are subject to numerous risks such that the risk of loss of the assets. (1)

3.1.5 Institutional Rigidity.

The financial infrastructure is weak in most emerging economies' countries but the financial infrastructure in some of these countries such as Bahrain and Malaysia are well developed However, Sukuk require unique Shariah compliant structures which create a state that can be termed as one of institutional rigidity and that cannot be removed in the short run and always increasing the risks of Sukuks. Furthermore, the features of this state are lack of hedging and financial engineering processes, non-existence of inter-bank money markets, lack of best practice uniform regulatory standards and regimes, weaknesses in litigation and legal framework support, particularly, in the treatment of default, non-uniform accounting, auditing and income and loss recognition systems, non-robust investment appraisal, promotion and monitoring infrastructure, ineffective external credit assessment systems, rudimentary state of financial markets, and weak inter-segmental support and linkages. (1)

3.2. Challenges in Managing the Financial Risks of Sukuk.

Sukuk certificates serve to replicate the functions of conventional bonds and tradable securities in resources mobilization from markets and injecting liquidity into the enterprise or government and in providing stable resource of income for investors. Moreover, investing in Sukuk issuances involves the funding of trade or production of tangible assets. So, this section will state the challenges facing the management of financial risks of Sukuk that are the challenge of institutional reorganization.

3.2.1 Challenge of Institutional reorganization.

This study will underline a number of pointers for institutional reorganization that will have a bearing on the competitiveness of Sukuk structures. First, Public Debt Management upon which the fixed income markets in developing countries is dominated by government bonds. Therefore, the single most important reorganization of the markets can come from the reorganization of the public debt management. Second, the introduction of derivative markets has further consequences on market and financing dynamics. Furthermore, markets stabilizing role of futures and options markets depends on the speculator's information Futures and options markets can also serve to stabilize the value of underlying assets by acting in an insuring role and this can occur if these markets allow investors to pool risks more efficiently and share them. Therefore in short, the evolutionary changes of financial innovation, deregulation, globalization of financial services and introduction of novel financing instruments warrants the adoption of supporting risk management mechanisms, viable secondary markets and relevant regulatory bodies. (1)

Third, securitization, the emergence of the market for asset backed securities over the past two decades has permitted banks around the world to free their capital by re-packaging and re-selling portfolios of loans, assets and other receivables. This adjusts the criteria for lending by forcing financial institutions to meet the market's standards for loan quality and sufficient pricing for risk. It helps decrease funding risk by diversifying funding sources. Financial institutions also employ securitization to purge profit rate mismatches. Also, it creates more complete markets by introducing formerly remote asset classes that better suit investor risk preferences and by increasing the potential for investors to achieve the benefits of diversification. Therefore, by meeting the needs of different market segments, securitization transactions can generate gains for both originators and investors. The same benefits can be attributed to Sukuk certificates. They allow the institution to manage balance sheet mismatches to securitize longer term assets. Moreover, investors are also given the option to invest in asset grades that are suitable for their investment needs. Also, financial markets are more complete as previously and untapped assets are now available for public sector resource mobilization. (1)

Fourth, Liquidity and secondary markets, Islamic savers and investors, like conventional ones, portray varying risk preferences and a secondary market should be developed to reflect this. Sukuk certificates are unique in that the investor becomes an asset holder and is directly tied in to the nature and functioning of the underlying asset pools so Sukuk certificate holders carry the burden of these unique risks. The primary concern of an Islamic secondary market is its marketability. All things being equal, a certificate holder would rather participate in a well structured and well regulated secondary market instead of trading in a poorly run market. However, the challenges remain to provide increased risk management mechanisms, increase market liquidity, create a truer bond yield benchmark as well as widening the issuer and investor base. (1)

3.3. Argument that most of Sukuk implementations are not followed the Shariah rules.

Mr. Mohammed Taqi Othmani stated that 85 % of Sukuk at GCC is not followed the Shariah Standards. For that, AAOIFI may change the rules of Sukuk issuing industry (2). Moreover, AAOIFI may put more restrictions on rules in order to make borrowers avoiding signing agreements for buy back upon which the issuing of most Sukuk that attract investors from word wide looking for opportunities in GCC (2). I believe these restrictions will govern the structures of Sukuk very well but it will need time to attract those foreign investors who looking for opportunities in our region. Furthermore, most of Sukuk sold with a promise to buy back from the borrowers “Sukuk issuers” which is a promise from the borrowers to give back the initial value “capital” of Sukuk in case either of due date or fail of paid the payments that represent a traditional bonds which is questionable in following the Sharia rules and standards because it break the concept of sharing the risk and return. Mr. Mohammed Taqi Othmani said that the promise of give back the Sukuk capital is disagreeing with the idea of sharing risk and return that must be a base for Sukuk so the risk is unshared and the return is unshared according to the agreed standards of Sukuk and for the 85% of them are like that (2).

Moreover, bankers said that any Fatwas prohibit the buy back promise will make serous troubles for Sukuk Industry since the buy back promise or purchase undertaking at fixed price is not there, the returns will be based on underling assets’ profits of Sukuk which will make some of Sukuk issuers and investors looking for fixed returns not buying Sukuk (2). As I said it will take time to attract investors and it is something we should to implement in order to follow Shariah compliance. In addition, Mr. Mohammed AL-Qarri said that some of supervisory board let the promise of buy back to pass in order to develop the Sukuk industry before but now they will agree on alternative mostly to a promise to buy back soon instead of prohibiting it. Therefore, this alternative will encourage more Islamic investors to purchase Sukuk (2). These two decisions based on Fatwas, which are letting the Sukuk issuance with promise to pass and search for alternative now, I respect them I believe it is the cause of the problem because if the basis for House is weak, the risk of house to be collapsed is very high which is the same story of Sukuk when the scholars let Sukuk to be issued and they knew Sukuk are including this promise and now 85% of these Sukuk is prohibited because of this promise. The said that let the promise of buy back to pass in order to develop the Sukuk industry and now search and agree on alternative mostly to a promise to buy back soon instead of prohibiting it will not work with Muslims investors who seek for compliant products and invest their money in them in the beginning because it is followed the Shariah and surprised now from this recent declaration of prohibiting 85% of their investments.

In contrast, Islamic Fiqh Academy in its resolution 30(5/4) pertaining to Muqaradah Sukuk stated that "there is no Shariah objection to mention in the prospectus of the issue or in the document of Muqaradah Sukuk the promise of a third party, who is independent personally and in term of financial liability from the two parties to the contract, to volunteer an amount of money for no consideration to be allocated to make good a loss on a particular project. However, this is circumscribed with a condition that such a promise should be an obligation independent from the Mudarabah contract. In other words, the third party performance of his obligation should not be a condition for the enforcement of the contract and the conditions and liabilities of the parties to the contract. As such, neither the bond holders nor the manager of the Muqaradah would be entitled to claim that they may fail to honor their obligations relating to their contracts because the volunteer failed to fulfill his promise and the performance of their obligations takes into consideration the promise from the volunteer" (4). Therefore, if the issuer wants to give assurance to the Sukuk holders that the Sukuk will buy back and their principles are guaranteed, it should establish SPV through which the Sukuks are issued to the investors in order for the company/original issuer to guarantee theirs investors' capital, which I agree with that tactic to over come the guaranteeing of capital obstacle of letting Sukuk to be purchased.

In addition, it should be understood that the Sukuk manager acts as guarantor of investor's capital at its nominal value in cases of negligence or non-compliance with stated conditions in the beginning, regardless of whether the manager is a Sharik/partner, Wakeel/agent, or Mudarib /investment manager. However, If the assets of Musharakah Sukuk, or Mudarabah Sukuk, or Wakalah Sukuk are of lesser value than assets leased by means of a lease ending in possession/Ijarah Wa Iqtina, then it will be permissible for the Sukuk manager to agree to purchase those assets at the time the Sukuk are extinguished for the remaining lease payments on the assets, by considering these payments to be the net value of those assets. Moreover, it is permissible for the lessee in Ijarah Sukuk to agree to purchase the leased assets when the Sukuk are extinguished for their nominal value, as long as the lessee is not also an investment partner, Mudarib, or agent. (5)

The other issue is the current practice of profits of Sukuk is linked it to the LIBOR indicator as benchmark if the profits lower than agreed percentage of LIBOR, the profits totally given to Sukuk holders, if the profits exceed the agreed percentage of LIBOR, some portion of the exceeded amount will be given to employees as incentives, and Sukuk is sold back for initial price mostly not market price, net price, or book price even. Moreover, Dr. Mohammed Al-Boti agreed the declaration from AAOIFI and clarified that the reasons for this issue are one: Sukuk is sold mostly for initial price not the market price and two: The Sukuk must subject to profits what ever the profit is which is not as the current practice because these profits connecting with LIBOR and if the profits exceed LIBOR, a portion of it is giving to employees as incentive and if it lower than the LIBOR, all profits are giving to Sukuk holders therefore this practice make the Sukuk subject to Riba and in order to avoid the Riba, the Sukuk must subject to profits what ever the profit is which is and Sukuk holders must sale it for the market price not initial price (3). Therefore, the scholars must agree on developed mechanism that is substitute for selecting LIBOR as indicator whether through fix the percentages in the beginning in the prospective, subject it to the profit whatever the profit is, or develop Islamic indicator on some how.

In order to avoid same this prohibition later on, the Shariah supervisory boards must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with Shariah guidelines and requirements as specified in the Shariah Standards, and that the investment of Sukuk proceeds and what those proceeds are converted to takes place in accordance with one [or another] of the approved Shariah methods of investment as stated in Shariah Standard (17) on the subject of Investment Sukuk. It must not consider its responsibility to be over when they issue a fatwa on the structure of Sukuk. (5)

3.4. Summery

At the end, this chapter clarified the types of Unfavorable risks facing the Sukuk industry such as market risk, credit and counterparty risk, Shariah compliance risk, operational risk, and institutional rigidity that affect the competitiveness of the pricing of assets which lead to fact that is the innovation of Sukuks essentially involves a higher exposure to certain market and financial risks. However, I believe that we should take care most on unsystematic market risk and Shariah compliance risk in certain manner because they are related to each other in sense of that market risk will increase if the Shariah compliance risks increase. Furthermore, the current Sukuk margin/profit based on LIBOR as indictor only but still we depend on it which leads us to violate the Shariah compliance that will cause the market risk increase because most of Sukuk holder/investors are Muslims who search for Shariah compliant products to invest and avoid investing in non-compliant product or questionable products, and in our case it could be questionable product unless we try avoid this risk. This can be through set fixed percentages not related to any thing even if as indicators. It is true that the Sukuk issuers in some periods will face problems on their projects due to crises of economy or complexities on their project but they should do and sacrifice in order to avoid violating in Shariah compliances. Moreover, in order to develop the market of Sukuk an avoid the risks of Shariah compliance, capital authorities of all Muslims countries should establish and create Sukuk Authority Institution that report to organization of Islamic conference (OIC), and unified the rules and regulations of Sukuk issuing; price of Sukuk (margin/premium) is one of them.

Also, it stated the challenges facing the management of financial risks of Sukuk that are challenge of institutional reorganization. So, it underlined a number of pointers for institutional reorganization that will have a bearing on the competitiveness of Sukuk structures. These are Public Debt Management, the introduction of derivative markets, securitization, and Liquidity and secondary markets. However, in continuing to my concern before, the securitization is most important challenge among the others to face in managing the financial risks of Sukuk because it is the base for Sukuk specifically but the other are assisting the Sukuk and other financial tools as their roles to do.

In addition, it talked about the argument said that most of Sukuk implementations are not followed the Shariah rules. it believe they should be more restricting on the Sharia rules and if they wanted to develop the market of Sukuk, they should not do this approval. Instead of that, they should develop the Sukuk Market through establishing a controller agency take care of Sukuk such what it Suggest to create Sukuk Authority Institution that report to organization of Islamic conference (OIC), and unified the rules and regulations of Sukuk issuing; price of Sukuk (margin/premium) is one of them. Also, it advise the private companies and governmental institutions to decrease their exposure to debt-related operations and to concentrate more on operations based on true partnerships, the sharing of risk and reward, and thereby achieve the higher purposes of the Shariah.

3.5. References

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Chapter four: - Real word examples of Sukuk

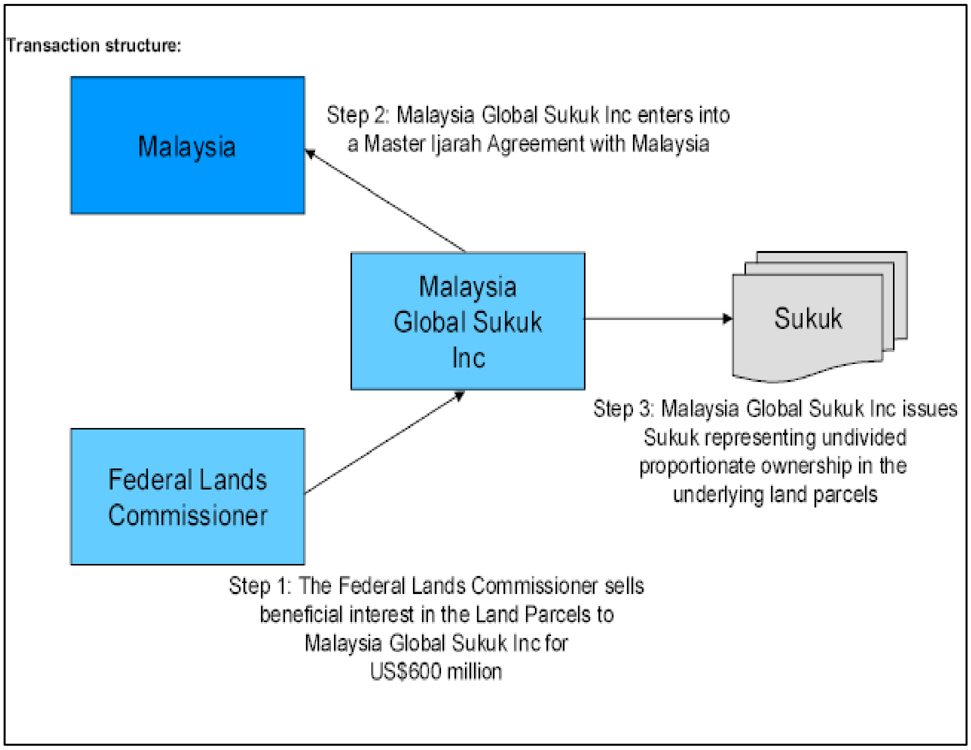
Sukuk Market status, the size of global Shariah-Compliant assets is estimated at about $400 billion to $500 billion (4). Moreover, the potential market for Islamic financial services is closer to $4 trillion based on institutions like Standard & Poor's Ratings Services believe which is mean the Islamic finance currently has only achieved about 10% of its potential and therefore still has a long way to go (4). Also, the market share of Islamic financial institutions is estimated to stand at 12 per cent in Malaysia and 17 per cent in the six GCC countries where it is growing faster than anywhere else (4). In addition, this chapter brought some of latest Sukuk Issued as examples describe it here. It will talk about one example on Malaysia which is Malaysian Global Bank. The other two examples are in Saudi Arabia which is Islamic development bank and SABIC.

4.1. Malaysian Global Sukuk.

On July 3, 2002, the government of Malaysia issued Sukuk worth US $ 600 million that were due in 2007. Each of the Sukuk represents an undivided beneficial ownership of the trust assets that are land parcels. The proceeds from the issuances were implemented to develop the land parcels that consisted of four areas of construction which they are Selayang Hospital and Tengku Ampuan Rahimah Hospital that are government owned hospital operated by the Ministry of Health, Government living headquarters in Jalan Duta, and Jalan Duta Government Office Complex including Ministry of Finance, Ministry of International Trade and Industry, and Inland Revenue Board offices. (2)

The Malaysia Global Sukuk was integrated in Labuan, Malaysia as a SPV solely for the purpose of participating in the Sukuk issuance transactions. The SPV is created to buy the land parcels from the government which is funded by both Islamic and conventional Investors and then leased back to the government which pays out rental payments matching the semi-annual distribution amounts to the Sukuk. In fact, this is the common arrangement of Ijarah Sukuk issuances. See chart 4.1 for more illustration of this process. (2)

Chart 4.1: Malaysian Ijarah Sukuk



In addition, the rental return is guaranteed by the government of Malaysia, and the trust certificates are thus equivalent to floating rate Malaysian sovereign debt instruments. The certificates were rated "Baa2" by Moody's Investor Services and "BBB" by Standard & Poor's rating services. Moreover, the lead manager of the issuance was HSBC and the co-managers included ABC Islamic Bank, Abu Dhabi Islamic Bank, Bank Islam, Dubai Islamic Bank, Islamic Development Bank, Maybank International and Standard Chartered Bank. The applications were made to list the certificates on the Luxembourg Stock Exchange and the Labuan Financial Exchange. (2)

To summary the Malaysia global Sukuk, the country on which the Sukuk is based on is Malaysia, the Sukuk's issuer is Malaysian ministry of finance, the Sukuk's type is Ijarah Sukuk, the Sukuk's total issuance value is US$600 million, the coupon rate is LIBOR +0.95%, the date of issuance is July, 2003, and the maturity date is on June, 2007. (2)

4.2. Islamic Development Bank Sukuk.

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 Sharia.

However, mobilization 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. 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 contracts, Murabahah contracts, and Istisna 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. (1)

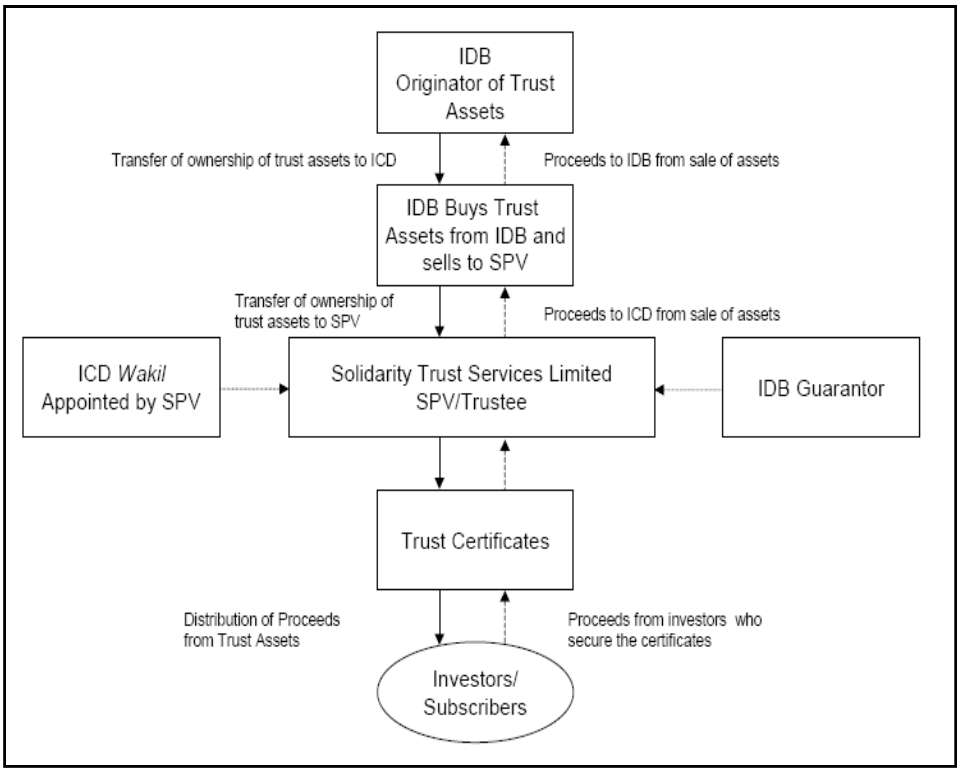
In addition, under the conditions of the prospectus, the trustee purchases the portfolio of assets from the Islamic Corporation for the Development of the Private Sector (ICD). The ICD serves as a Wakalah and delegates its servicing undertakings to the IDB. A Wakalah agreement serves to designate the business of the originator (IDB) to another agency (ICD) whose primary objective is to decrease the consequences of information asymmetries. The principal and the agent are bound by equivalent contracts to the same wakeel (agent). The trust certificates have been given a rating of AA by Fitch Ratings Ltd, and an 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. (1)

In order to implement the transaction, the IDB sold a portfolio of Islamic-compliant assets, which are at closing approximately 66% of the assets were Ijarah 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. 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 of the profit participation to the certificate holders. The IDB also promised to repurchase the Trustee's portfolio for the original sale price upon the maturity date of the certificates or following certain dissolution events. 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. In addition to the original portfolio, the Trustee is expected to acquire further Sharia-compliant assets with profits in excess of required distributions to certificate holders and funds required to meet other costs. See chart 4.2 for more illustration of this process (1)

Chart 4.2: Arrangement of IDB Sukuk Issuance.



To summary the IDB Hybrid Sukuk, the country on which the Sukuk is based on is Multilateral institution, the Sukuk's issuer is Solidarity Trust Services Ltd., the Sukuk's Guarantor is IDB, the Sukuk's type is combination of Murabahah, Istisna and Ijarah Sukuk with minimum Ijarah Sukuk of 51%, the Sukuk's total issuance value is US$400 million, the coupon rate is 3.635%, the date of issuance is August, 2003, and the maturity date is on July, 2008. (1)

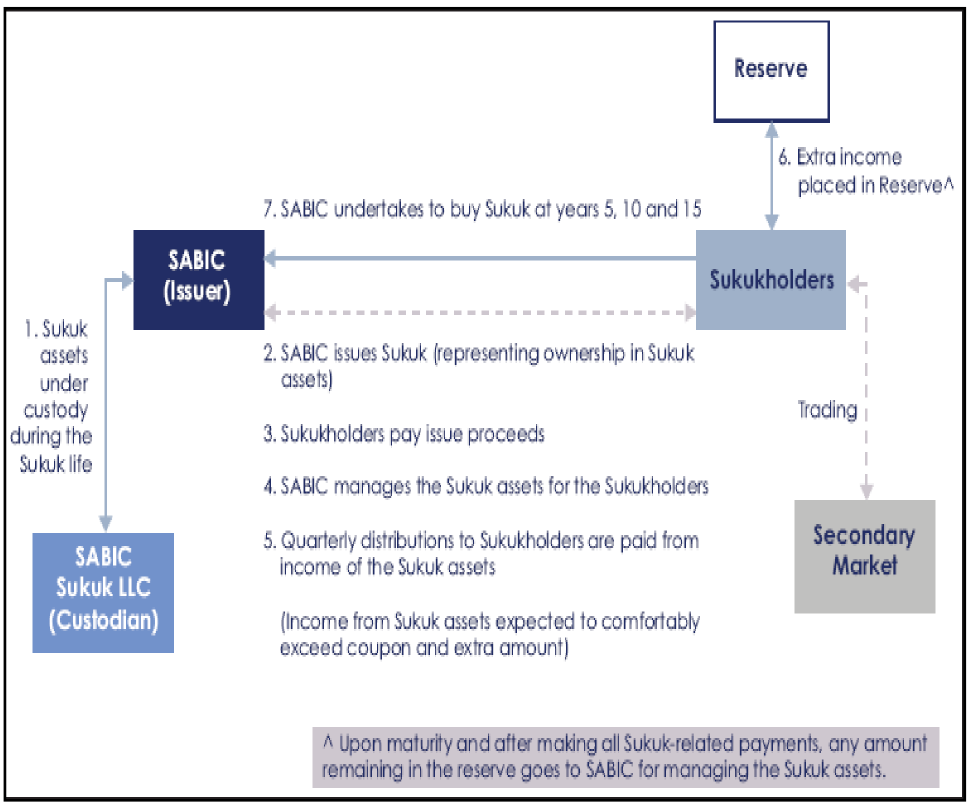
4.3. 1st SABIC Sukuk.

The 1st SABIC Sukuk was issued on the 29th July 2006 (6). It was the first Saudi Arabia corporate bond (3). As it was the first time that Saudi nationals and residents were able to invest in a local currency, fixed income instrument that had been verified by the Shariah Supervisory Committee of a Saudi Arabian Bank (SABB Amanah) (6). As would naturally occur with a first-time issuance, SABIC and its lead manager HSBC had set the platform for Sukuk issuance in the Saudi Arabian market (6). It was worth SR3bn ($800mn), the bond was priced at 40bps over the three-month Saudi interbank offered rate (SIBOR) (3). Its final maturity date is July 2026, in order to comply with the specifics of Sharia law, but an individually exercisable investor gives the bond an effective tenor of five years and it was accordingly priced as five-year paper (3). In lunching the Sukuk, SABIC was looking to diversify away from bank funding, which it has used extensively, and as a result allocations are expected to favor other groups, which include government entities, corporations, funds and high net worth individuals (3). Issuance was limited to domestic financial institutions and major companies, although Saudi nationals were permitted to participate through funds (3). The Sukuk can be traded over the counter and cleared through the Tadawul (Saudi stock exchange), with local HSBC affiliate Saudi British Bank acting as market maker (3). HSBC was the Sukuk's book runner and lead manger (3). The Sukuk is not only the first domestic corporate bond, but also the first to be listed on the Tadawul, and the first issued under the auspices of the kingdom's Capital Market Authority (CMA). SABIC is rated with high ratings (A long term and A-1 short term from Standard & Poor's, and A senior and short term F1 from Fitch.

Furthermore, the unique structure that was tailor-made for SABIC is a Sukuk Istithmaar (Investment Sukuk). This Sukuk structure is not based upon the structure of any previous Sukuk, although an investment Sukuk is one of the main categories of Sukuk types included in the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standards. The Sukuk assets represent an investment, for 20 years, in limited rights and obligations of SABIC in certain marketing contracts that underpin the marketing services that SABIC provides to its manufacturing affiliates. In addition, SABIC as holding company, manage and coordinate its investments. Its marketing unit undertakes the service of marketing and selling the products of certain of its affiliates to companies located in Saudi Arabia and across the globe to over 100 countries. This marketing unit incurs certain costs, which is the costs of marketing and selling products to thousands of global customers, and receives fees in return for conducting these services. The marketing unit has an established history of providing exemplary service and earning significant net revenues for SABIC, as marketing fees earned are based upon sales levels achieved. As the SABIC group's own net income is based upon sales of the group, the marketing services income represents a good proxy for SABIC corporate risk. (6)

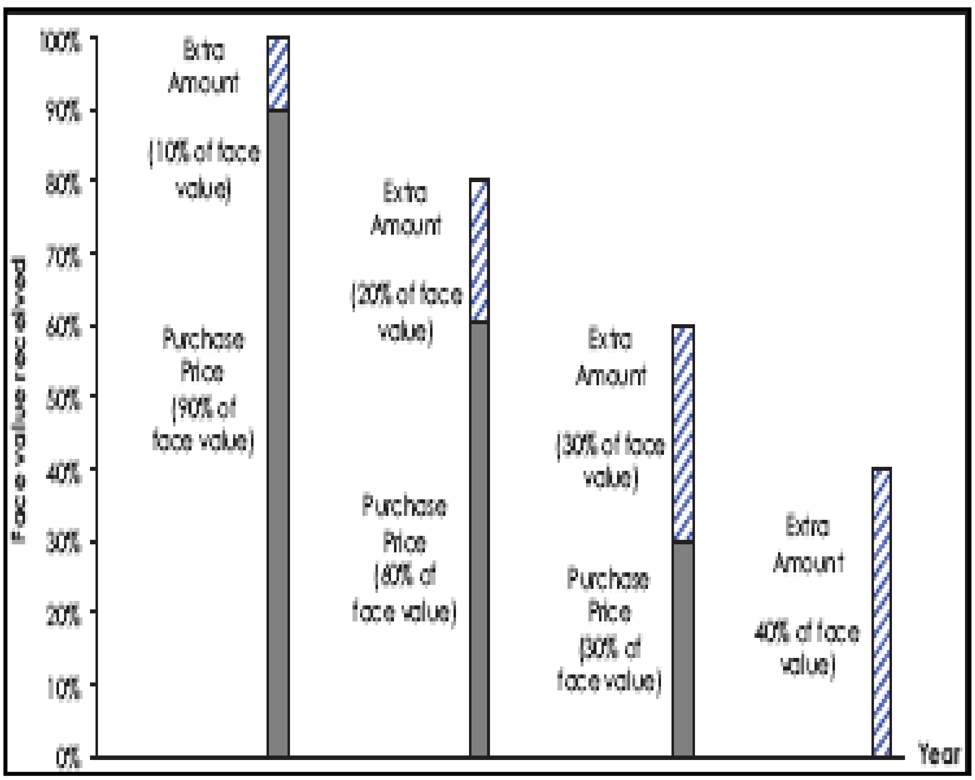
The structure of the Sukuk entitles Sukuk holders, for 20 years, with a right in the defined net income from these marketing services subject to certain terms and conditions outlined in the Sukuk offering circular. The net income derived from this investment is paid quarterly to Sukuk holders, up to a specific amount (based on a benchmark linked to SIBOR) and surplus income is kept as a reserve. The reserve is used as a buffer protection to safeguard Sukuk holders in the unlikely event that net income for any period unexpectedly falls below the specific amount. In addition to acting as a buffer, money accruing to the reserve is used to pay, every 5 years throughout the 20-year life of the Sukuk, an extra amount equal to 10% of the face value of the Sukuk. Thus, by the end, an amount of 40% of the face value as well as the quarterly return would have been paid to Sukuk holders. Also, at the end of the Sukuk's life, whether 20-years or earlier if the Sukuk is purchased by SABIC before then, any remaining balance in the reserve is paid to SABIC as an incentive. The rationale for paying this is to provide SABIC with a strong incentive to continue providing the marketing services to a high and profitable standard. In addition to the 10% extra amount paid to Sukuk holders every five years, SABIC provides Sukuk holders with a purchase undertaking under which it undertakes as direct SABIC credit risk, to purchase the Sukuk for a specific amount on each date. See chart 4.3 for more illustration. (6)

Chart 4.3: 1st SABIC Sukuk transaction structure



The purchase undertaking is both irrevocable and individual so that Sukuk holders may individually exercise their option requiring SABIC to purchase the Sukuk from them. The purchase price decreases over time, representing the remaining life of the Sukuk as it is a 20-year financial instrument. The price decreases from 90% of the face value at the end of year 5 to 60% in year 10 and 30% in 15; at the end of year 20 the Sukuk has no value as its life has expired. Therefore, if the Sukuk holders exercise their option for SABIC to purchase the Sukuk at the end of year 5, they will receive an aggregate of 100% of the face value; 90% as a purchase price and a 10% extra amount. If Sukuk holders choose not to sell to SABIC at the end of the first five, the aggregate amount receivable declines to 80% in year 10, 60% in year 15 and just 40% in year 20. Therefore, the expectation that Sukuk holders would naturally elect to sell to SABIC at the end of year 5, thereby achieving a 100% return of the face value and earning a quarterly return reflective of SABIC risk during these 5 years. Although, importantly, SABIC does not have a call option to prepay the Sukuk and investors are not compelled to exercise their put option. See chart 4.4 for more illustration. (6)

Chart 4.4: 1st SABIC Sukuk's repayment profile



To summary the 1st SABIC Investment Sukuk, the country on which the Sukuk is based on is Saudi Arabia, the Sukuk's issuer is SABIC., the Sukuk's Guarantor is SABIC, the Sukuk's type is Istithmaar, the Sukuk's total issuance value is US$800 million, the coupon rate is 3-month SAR SIBOR + 40 bps, the date of issuance is July, 2006, and the maturity date is on July, 2026. (5)(6)

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Chapter five: - Conclusion

The most important definition of Sukuk is that disclosed by AAOIFI which The Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in ownership of the asset of a particular project or special investment activity, however, this is true after receipt of the value of the Sukuk, the closing of subscription and the employment funds received for the purpose for which the Sukuk are issued. Also, the most important difference is that Islamic Sukuk are based on a variety of contracts to create financial obligation between Issuers and investors such as lease, Musharakah or other while debt Bonds are based on loan contract to create Indebtedness. Moreover, It is noticed the global Sukuk market is growing very fast with a volume of more US$ 100 billion and there positive indicators regarding the global Sukuk market such as over subscription, broad geographical distribution, involvement of conventional financial institutions, non-Islamic borrowers tapping the market and the participation of Islamic banks in the management and arrangement of these Sukuk issues. Furthermore, I expect the Sukuk market will be the future for private companies and governmental institutions to manage their liquidity of cash as well as fund their project through it, and my expectation will take place if Muslim countries through organization of Islamic conference (OIC) establish and create Sukuk Authority Institution that report to organization of Islamic conference (OIC), and unified the rules and regulations of Sukuk issuing; price of Sukuk (margin/premium) is one of them.

The Ijarah Sukuk is most suitable Sukuk especially for existing projects because there are existing assets to based upon the issue of Sukuk and as well generate fixed periodic payments determined from the beginning easily due to fact that are treated as rentals which is similar to normal rentals. Also, It is not complex to monitor and manage the process of the Ijarah Sukuk is whether follow totally Shariah compliance or not as other Sukuk structures. Moreover, the diversification of the risks of either investments or financings is required and it will be better in case of Pooled Hybrid Sukuk because it mix Ijarah that are generating cash flows with Istisna and Murabahah, which are on assets, in structuring the Sukuk. This is due to fact that having a portfolio of assets consisting of different classes allows for a greater mobilization of funds. Also, it is good to mention that again the necessary approvals from the authorities concerned, marketing and sales, declaring ways of exit or recovery including in the secondary market, and depreciation and liquidation are must follow comprehensively when doing issue of Sukuk through Tawreeq especially necessary approval from authorities concerned which is Shariah scholars through Shariah board in order to ensure that the Sukuk is complained to Shariah and no questionable about it later. Furthermore, in continue to my suggestion of having Sukuk Authority Institution, the Tawreeq will be unified and systemize later on through the suggested Sukuk Authority Institution upon which they will take care of setting rules and regulation to Sukuk issuance and market (primary and secondary), validating the proposed Sukuk to be issued in complained with the Sharia, monitoring the Tawreeq process of proposed Sukuk before, during and after issuance till to expiry, managing the Sukuk secondary market, and developing the Sukuk rules and markets date up to date.

The unfavorable risks facing the Sukuk industry that affect the competitiveness of the pricing of assets which lead to fact that is the innovation of Sukuks essentially involves a higher exposure to certain market and financial risks. However, I believe that we should take care most on unsystematic market risk and Shariah compliance risk in certain manner because they are related to each other in sense of that market risk will increase if the Shariah compliance risks increase. Furthermore, the current Sukuk margin/profit based on LIBOR as indictor only but still we depend on it which leads us to violate the Shariah compliance that will cause the market risk increase because most of Sukuk holder/investors are Muslims who search for Shariah compliant products to invest and avoid investing in non-compliant product or questionable products, and in our case it could be questionable product unless we try avoid this risk. This can be through set fixed percentages not related to any thing even if as indicators. It is true that the Sukuk issuers in some periods will face problems on their projects due to crises of economy or complexities on their project but they should do and sacrifice in order to avoid violating in Shariah compliances. Moreover, in continuing to my concern before, the securitization is most important challenge among the others to face in managing the financial risks of Sukuk because it is the base for Sukuk specifically but the other are assisting the Sukuk and other financial tools as their roles to do. In addition, I believe Scholars should be more restricting on the Sharia rules and if they wanted to develop the market of Sukuk, they should not do this approval. Instead of that, they should develop the Sukuk Market through establishing a controller agency take care of Sukuk such what I Suggest Sukuk Authority Institution that report to organization of Islamic conference (OIC), and unified the rules and regulations of Sukuk issuing; price of Sukuk (margin/premium) is one of them. Also, I advise the private companies and governmental institutions to decrease their exposure to debt-related operations and to concentrate more on operations based on true partnerships, the sharing of risk and reward, and thereby achieve the higher purposes of the Shariah.

In addition, this study mentioned three real world example of Sukuk issuance. One of them was based on Ijarah which is Malaysia global Sukuk with total value of US$600 million and coupon rate of LIBOR +0.95%. The other one was based on Pooled Hybrid Sukuk which is IDB Hybrid Sukuk with total value of US$400 million and the coupon rate of 3.635%. Last one was based on Istithmaar which is 1^{st} SABIC Investment Sukuk with total value of US$800 million and the coupon rate of 3-month SAR SIBOR + 0.4%. Among all of them, I prefer the IDB Hybrid Sukuk because of tow reasons; the first one is that the Sukuk is based on a variety of Islamic contracts for the diversification purposes, the second reason is that the coupon rate, which is margin/profit to be paid the Sukuk holders, is fixed and did not fix to any variable related percentage even as indicator so they avoid the questionable of compliance with the Sharia. Furthermore, the IDB Sukuk is suggested mentor and example to be followed by the coming Sukuk issuances.

At the end, this research is a descriptive type of research on Sukuk depending on the current situations and stages of Sukuk in the market, and on the available information. Because of that I believed in this time we need descriptive research to clarify to the reader about it in more details. So, it will be beneficial as source for the other researchers intend to write about Sukuk in term of Descriptive research that based on more available and suitable information in that time than now or even in term of Causal research when the Sukuk market is developed and the rules and regulation is unified and implemented governable so the expected trends of the Sukuk market of affection different variables will be absorbs and determents through this type of research enshallah.

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