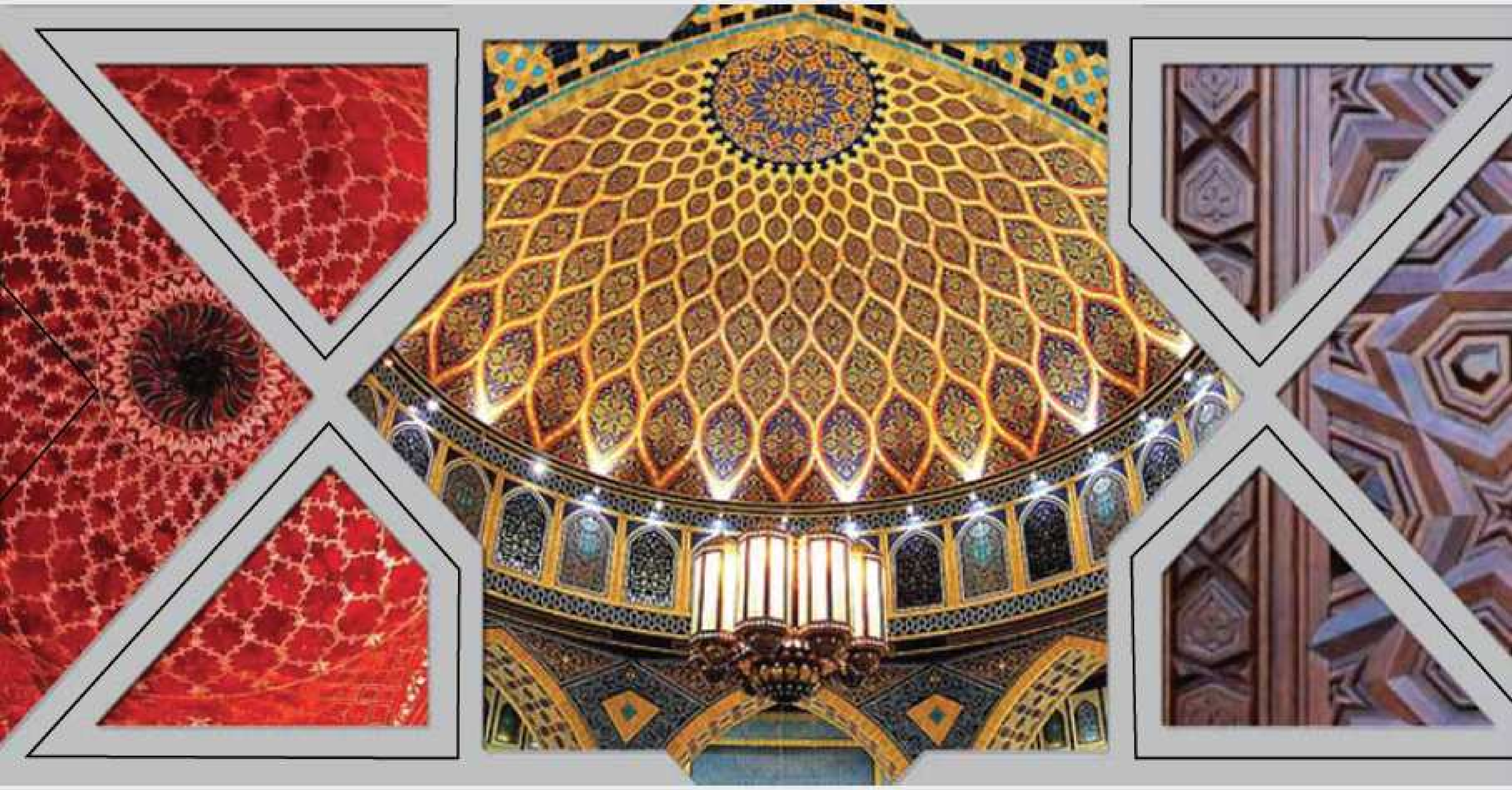
السوق المالية الإسلامية الدولية

International Islamic Financial Market



SUKUK REPORT

2nd Edition

A COMPREHENSIVE STUDY OF THE GLOBAL SUKUK MARKET

FROM THE SAYINGS OF PROPHET MUHAMMAD

(Peace be upon him and the rest of GOD Almighty's Prophets and Messengers)

عَنْ جَابِرِ بْنِ عَبْدِ اللَّهِ رَضِيَ اللَّهُ عَنْهُمَا أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ "رَحِمَ اللَّهُ رَجُلًا سَمْحًا إِذَا بَاعَ وَإِذَا اشْتَرَى وَإِذَا اقْتَضَى". (أخرجه البخاري).

Narrated Jabir bin 'Abdullah: Allah's Messenger (May peace be upon him) said, "May Allah's mercy be on him who is lenient in his buying, selling, and in demanding back his money".

(*Sahih Al- Bukhari*).

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عَنْ جَابِرٍ قَالَ " لَعَنَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ آكِلَ الرِّبَا وَمُؤْكِلَهُ وَكَاتِبَهُ وَشَاهِدَيْهِ وَقَالَ هُمْ سَوَاءٌ". (أخرجه مسلم).

Jabir said that Allah's Messenger (May peace be upon him) cursed the accepter of interest and its payer, and one who records it, and the two witnesses, and he said: They are all equal.

(*Sahih Muslim*).

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ABSTRACT

Sukuk Market represents an affirmation of Islamic Law (*Shari 'ah*) principles in the Islamic Capital and Money Market transactions where the market should be free from any elements or activities that are prohibited in Islam. The strict adherence to Islamic Law principles also implies that all financial instruments used in the Islamic Capital and Money Market must be *Shari'ah* complaint. *Sukuk*, due to their fixed profile and enhanced credit features, are one of the most popular and commonly used financial instruments in the Islamic Capital and Money Market.

Sukuk are the fastest emerging alternative instruments and capital markets tool which are increasingly used by governments, government-held entities and corporations, not only in the Middle East and South East Asia, but in a number of other countries across the globe. The *Sukuk* market is rapidly integrating into the global capital markets and its geographic reach is widening tremendously.

This report, therefore, aims to study growth and development of international and domestic *Sukuk* issuances and also to study different *Sukuk* structures in various jurisdictions active in issuing *Sukuk*. In order to also achieve a deeper understanding of the mechanics of this unique Islamic financial instrument, selected case studies from the international *Sukuk* markets based on widely used structures have been highlighted and analyzed. The report also covers some specific topics such as *Sukuk* defaults and restructuring and *Sukuk* rating approaches.

FOREWORD

FROM THE CHIEF EXECUTIVE OFFICER, INTERNATIONAL ISLAMIC FINANCIAL MARKET (IIFM)

In the Name of Allah, the Entirely Merciful, the Especially Merciful

All the praises and thanks be to Allah Almighty, the Lord of the worlds. The Entirely Merciful, the Especially Merciful. May peace and blessings of Allah Almighty be upon His Messenger Prophet Muhammad the son of 'Abdullah, his family and all his companions. Also peace and blessings of Allah Almighty be upon the rest of His Messengers and Prophets.

IIFM efforts in the 1st Edition of the *Sukuk* Report dated February 2010 were very well received by the practitioners. Considering the value addition provided by IIFM in terms of *Sukuk* issuance database and issues covered in the report, the IIFM Board of Directors have decided to make this report as a regular annual feature.

The 2nd Edition is made possible by contributions received from Islamic Development Bank and Malaysian Rating Corporation. The IIFM *Sukuk* issuance database was further enhanced by contributions provided by Labuan Financial Services Authority (Malaysia), Securities Commission Malaysia, Bank Indonesia, State Bank of Pakistan and Central Bank of Sudan. I also acknowledge the article contributions from Mr. Belaid Abdelssalam Jheengoor, Mr. Husam Khatib and dedicated effort of IIFM team. I am also thankful to European Islamic Investment Bank and Crédit Agricole Corporate and Investment Bank for proof reading the report.

In this edition of the *Sukuk* report, IIFM has added several new features such as Country Focus (Indonesia), global *Sukuk* overview, short-term *Sukuk*, fixed profit rate trend, structural trends and *Sukuk* challenges.

Although *Sukuk* market has seen difficult business environment; however, the trend is once again turning positive and I am confident that lessons learnt from the crisis will make *Sukuk* even better instrument. We may also see some kind of market based standardization in *Sukuk* which will help in making this instrument more robust and transparent hence moving towards active primary and secondary market at international level.

Finally, I am personally thankful to IIFM Board of Directors and members for all their support. A very special thanks to Central Bank of Bahrain (CBB) for continuously supporting IIFM. It is my hope that the reader will find this report useful and of value.

Ijlal Ahmed Alvi

May 2011

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INTRODUCTION

Over the past few years, the International Islamic Financial Market (IIFM) has been in the forefront of global initiatives and efforts to help in establishing a sustainable, viable and feasible global Islamic Capital and Money Market (ICMM) through its comprehensive documentation and product standardization initiatives that cater to the needs of Islamic Financial Services Industry (IFSI). IIFM also tries to ensure that ICMM products and services remain attractive to all investors, creditors and issuers across the globe.

Sukuk play an essential role in the development of ICMM as well as in contributing to the economic growth and prosperity of Islamic and other issuing countries. In an attempt to further strengthen efficiency and awareness, and to enhance competitiveness of the ICMM industry, IIFM, in February 2010, published its first *Sukuk* report (IIFM *Sukuk* Report - 1st Edition) as part of its efforts to help the industry move forward in a comprehensive manner. The 1st Edition covered a number of important issues related to *Sukuk* issuances, for example, *Sukuk* development over the period 2001 to June 2009, sovereign and quasi-sovereign issuances, reason behind the significant decline in the issuance of profit sharing *Mudarabah* and *Musharakah* based *Sukuk*, the impact of the 2008 crisis on *Sukuk* issuances in terms of volume and value etc.

This 2nd edition of the IIFM *Sukuk* Report also aims to meet the needs of those interested in the global (domestic and international) *Sukuk* market by providing them with useful information on the latest developments of *Sukuk* in terms of type, geography and structure. It covers information and relevant details of *Sukuk* issuances during the time period of January 2001 – December 2010.

This report focuses mainly on the structure of the *Sukuk* market over the time period mentioned above. It aims to highlight the development of the *Sukuk* market during this period, and in particular in Asia (represented mainly by Malaysia) and the Gulf Cooperation Council (GCC) countries, by analysing the transition and practices that have taken place. In doing so, some of the relevant issues related directly to *Sukuk* issuances globally during the time period mentioned earlier will be discussed and analyzed. For instance, issues related to asset-based and asset-backed *Sukuk*, *Sukuk* defaults and *Sukuk* restructuring, the shift post 2008 global financial crisis from corporate issues to sovereign and quasi-sovereign issues, the pattern of the recovery after the crisis in Asia and the GCC and the trend to more *Ijarah* and *Wakalah* based structures rather than profit sharing structures such as *Mudarabah* and *Musharakah* based *Sukuk* which had begun to gain momentum in the years prior to the crisis.

This report orients those interested in the *Sukuk* Market to the nature of *Sukuk* field and how it can be useful for those who need to gain some basic as well as more in-depth knowledge and background on the level of research in this field. The report could also be useful and helpful for investors, governments, Islamic financial institutions, decision making and policy formulation.

The nature of this study involves analysis of issues, examining materials and data collection. Both quantitative and qualitative methods have been used in writing this report.

Quantitative research methodology: This mainly involves data collection on various *Sukuk* issuances from January 2001 to December 2010. The main focus in this methodology is to collate data from writing materials relating to the topic of the research. This includes prospectuses, publications, articles, magazines, online research, and information service providers. Data collected was then filtered with respect to different criteria such as chronology, geographic distribution, issuer status, country of origin, etc and depicted in the form of tables and/or charts for better understanding. Moreover, certain jurisdictions as well as institutions have also assisted IIFM in data verification.

Qualitative research methodology: The main focus in this methodology is to collect and analyze materials or data in respect of *Sukuk* issuance acceptability. This includes the types of structures used, legal, innovation and *Shari'ah* issues.

There are numerous books and other materials that provide in-depth analysis of *Sukuk* structures and related issues. In order to maximize the benefit of this report, some case studies and articles on specific *Sukuk* structures and issues have been included.

The remaining report is organized and divided into six chapters as follows:

Chapter One consists of an introduction. Chapter Two is an overview of global *Sukuk* issuances over the period 2001 – 2010. Chapter Three is a case study of selected international *Sukuk* issues such as Dar Al Arkan International *Sukuk* and KT Turkey Limited *Sukuk*. Chapter Four consists of articles and studies on specific *Sukuk* structures, such as *Sukuk* challenges, defaults and restructuring. Chapter Five is a focuses on a specific country. The chapter mainly discusses *Sukuk* issuance in Indonesia as an emerging *Sukuk* market. Chapter Six consists of the conclusion, appendices and references.

CHAPTER TWO
OVERVIEW OF THE GLOBAL *SUKUK* MARKET

2.1 Emergence of *Sukuk*

The development of modern Islamic finance began in the 1970's with the formation of the Islamic Development Bank, Dubai Islamic Bank and Faisal Islamic Bank, to provide *Shari'ah* compliant commercial banking activities. The success of Islamic financial institutions led to a demand for capital market instruments for management of their balance-sheet liquidity. For the purpose of achieving this goal, the Council of the Islamic *Fiqh* Academy of the Organization of Islamic Conference (OIC) in its Fourth Session held in Jeddah, Kingdom of Saudi Arabia from 18 -23 Jumada Al-Thani 1408H (6 – 11 February, 1988)[1] legitimized the concept of *Sukuk* which paved the way for an alternative source of financing to meet the diverse risk-return profiles and needs of Islamic issuers and investors who are not allowed under the *Shari'ah* principles to invest in conventional debt securities.

In the year 1990, the first *Sukuk* was issued in Malaysia by Shell MDS a foreign owned, non-Islamic corporation. It was a Malaysian Ringgit (RM) denominated issue with a modest size of RM 125 million (equivalent to US Dollar 30 million approximately) based on the principle of *Bai' Bithaman Ajil*[2].

In the year 2000, Sudanese Pound (SDG) 77 million domestic sovereign short-term Government *Musharakah* Certificates (GMC's) were issued by the Sudanese Government[3].

In the year 2001, the *Sukuk* market went international with the issuance of the first United States Dollar (USD) denominated international sovereign *Sukuk Al Ijarah* of USD 100 million (5 year tenor) and a series of domestic sovereign short-term (less than 1 year tenor) *Sukuk Al Salam* issued by the Central Bank of Bahrain (formerly Bahrain Monetary Agency) on behalf of the Government of Bahrain. In the same year, the first 5 year international corporate *Sukuk Al Ijarah* of USD 150 million was issued by a Malaysian corporate Kumpulan Guthrie Berhad or Guthrie Group Limited[4]. After that, many sovereign and corporate *Sukuk* issues (domestic and international) have been offered in various jurisdictions such as the United Arab Emirates (UAE), Saudi Arabia, Indonesia, Qatar, Pakistan, Brunei Darussalam, Singapore, Kuwait etc. Since then, the *Sukuk* market emerged as one of the main sections of the IFSI and a lot of innovation took place in its structures such as *Ijarah*, *Musharakah*, *Mudarabah,* Hybrid, Exchangeable and Convertible.

The following table gives a clear picture of the hallmark global *Sukuk* Issues from 2001 – 2010 period:

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[1] Resolutions and Recommendations of the Council of the Islamic *Fiqh* Academy 1985-2000, Resolution No. 30 (5/4), p61.

[2] Malaysian *Sukuk* Market Handbook, RAM Ratings Services Berhad, Malaysia. p5.
[3] Data provided by Economics & Policy Wing, Central Bank of Sudan (2009).
[4] Guthrie Group Limited or Kumpulan Guthrie Berhad was a Malaysian company that primarily dealt with plantations. It merged with three other plantation groups to form the world's largest plantation company with the name of Sime Darby Berhad.

Table 1: Selected Hallmark Global *Sukuk* Issues & Trends – Year Wise (USD 100 million or greater)

Issue Date	Issuer	Highlight	Amount in Millions (USD or USD Equivalent)	Tenor (Months)
June 2001	Government of Bahrain	First of a series of International Sovereign Short-Term *Sukuk (Sukuk Al Salam)* issuances by the Central Bank of Bahrain (formerly Bahrain Monetary Agency)	25 Million	3
Sep 2001	Government of Bahrain	First International Sovereign *Sukuk (Sukuk Al Ijarah)* issuance by the Central Bank of Bahrain (formerly Bahrain Monetary Agency)	100 Million	60
Dec 2001	Kumpulan Guthrie Berhad, Malaysia	First International Corporate *Sukuk (Sukuk Al Ijarah)*	150 Million	60
June 2002	Government of Malaysia	First International Sovereign *Sukuk* issuance from Malaysia (*Sukuk Al Ijarah*)	600 Million	60
Jul 2003	Islamic Development Bank	First International Quasi-Sovereign *Sukuk* and first by a multilateral development financing institution	500 Million	60
Sep 2003	Government of Qatar	First International Sovereign *Sukuk* issuance from Qatar (*Sukuk Al Ijarah*)	700 Million	84
Nov 2003	SKS Power Sdn Berhad, Malaysia	First *Sukuk Al Istisna'* (Domestic issue in local currency)	1,471 Million	160
Nov 2004	Department of Civil Aviation, Dubai, UAE	First International Quasi-Sovereign *Sukuk* issuance from UAE	1,000 Million	60
Dec 2004	International Finance Corporation, World Bank	First *Sukuk* issuance by a conventional multilateral development financing institution	132 Million	36
Jan 2005	Durrat Al Bahrain	First International Hybrid *Sukuk*	152 Million	60
Jan 2005	Government of Pakistan	First International Sovereign *Sukuk* issuance from Pakistan (*Sukuk Al Ijarah*)	600 Million	60
Aug 2005	Cagamas MBS Berhad, Malaysia	First Islamic Residential Mortgage *Sukuk*	540 Million	160
Jan 2006	Dubai Ports Authority, UAE	Largest International *Sukuk Al Musharakah*	3,500 Million	24
Jul 2006	Saudi Arabian Basic Industries Corporation	First corporate *Sukuk* issuance from Saudi Arabia (*Sukuk Al Istithmar*)	800 Million	240
Jul 2006	Government of Brunei Darussalam	Series of Domestic Sovereign Short-Term *Sukuk* (*Sukuk Al Ijarah*) issuances by Brunei Darussalam	104 Million and others less than	3

			100 Million	
Sep 2006	Khazanah Nasional Berhad, Malaysia	First International Exchangeable *Sukuk*	750 Million	60
Dec 2006	The Nakheel Group, UAE	Largest International Corporate *Sukuk* (*Sukuk Al Ijarah*)	3,520 Million	36
Feb 2007	Aldar Properties, UAE	One of the large size international corporate issuances during the year (Exchangeable *Sukuk*)	2,530 Million	60
Jun 2007	Cagamas Berhad, Malaysia	Long tenor and large size domestic corporate (*Sukuk Al Ijarah*)	5,790 Million	480
Jun 2007	Dubai International Financial Center, UAE	International Quasi-Sovereign from UAE (*Sukuk Al Mudarabah*)	1,250 Million	60
Aug 2007	Saudi Arabian Basic Industries Corporation	One of the large size domestic corporate issuances during the year (*Sukuk Al Istithmar*)	2,100 Million	240
Aug 2007	National Industries Group Holding Company SAK, Kuwait	Largest International Corporate *Sukuk (Sukuk Al Mudarabah)* issuance from Kuwait	475 Million	60
Nov 2007	Jebel Ali Free Zone, UAE	One of the large size domestic corporate issuances during the year (*Sukuk Al Musharakah*)	2,042 Million	60
Jan 2008	Government of Sudan	Large size Domestic Sovereign Short-Term *Sukuk* (*Sukuk Al Musharakah*) issuance from Sudan continued despite of financial crisis	2,300 Million	12
Jan 2008	The Nakheel Group, UAE	International Corporate (Exchangeable *Sukuk*) issuance	750 Million	48
Feb 2009	Government of Indonesia	First Domestic Sovereign Retail *Sukuk* (*Sukuk Al Ijarah*) issuance	464 Million	36
Apr 2009	Ministry of Finance, Indonesia	First International Sovereign *Sukuk* (*Sukuk Al Ijarah*) issuance from Indonesia	650 Million	60
Jun 2009	Government of Bahrain	International Sovereign, Fixed Rate (*Sukuk Al Ijarah*) issuance	750 Million	60
Aug 2009	Petroliam Nasional Berhad (Petronas), Malaysia	Post crisis large size International Corporate *Sukuk* (*Sukuk Al Ijarah*) issuance	1,500 Million	60
Nov 2009	International Finance Corporation, World Bank	First International Quasi-Sovereign *Sukuk* (*Sukuk Al Ijarah*) issuance by a conventional multilateral development financing institution	100 Million	60
Nov 2009	General Electric, USA	Largest International Corporate *Sukuk* (*Sukuk Al Ijarah*) issuance by a US company	500 Million	60
May 2010	Saudi Electricity Company, Saudi Arabia	Large size Domestic Corporate *Sukuk* (*Sukuk Al Istithmar*) issuance	1,867 Million	84

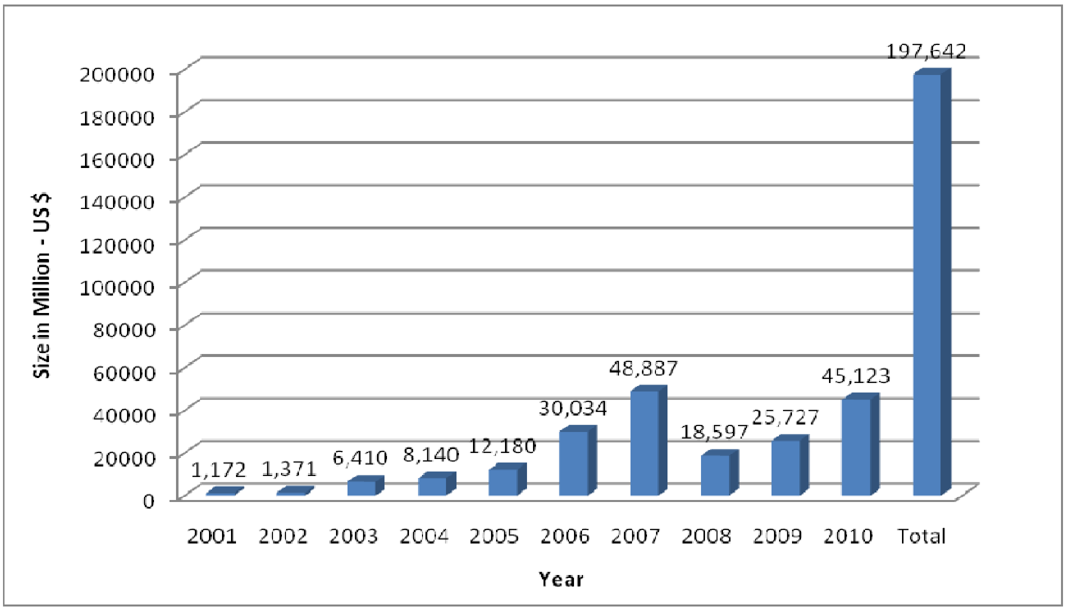
June 2010	National Bank of Abu Dhabi, UAE	Issuance of *Sukuk Al Murabaha* by a foreign issuer in a domestic market i.e. Malaysian Ringgit denominated	155 Million	60
Jul 2010	Nomura Holding, Japan	First International Corporate *Sukuk* (*Sukuk Al Ijarah*) issuance by a Japanese corporate	100 Million	24
Aug 2010	Khazanah Nasional Berhad, Malaysia	Issuance of *Sukuk Al Wakalah* by a foreign issuer in a domestic market i.e. Singapore Dollars denominated	662 Million	120
Aug 2010	KT Turkey *Sukuk* Limited, Turkey	First International Corporate *Sukuk (Sukuk Al Murabaha)* issuance by a Turkish corporate	100 Million	36
Aug 2010	Cagamas Berhad, Malaysia	Domestic Corporate *Sukuk (Sukuk Al Ijarah)* based on innovative structure i.e. *Sukuk Al Amanah Li Al-Istithmar* (ALIM) with auction at redemption feature instead of purchase undertaking	318 Million	36
Oct 2010	Abu Dhabi Islamic Bank, UAE	Large size International Corporate *Sukuk* (*Sukuk Al Musharakah*) issuance	750 Million	60
Nov 2010	Government of Pakistan	Large size Domestic Sovereign *Sukuk (Sukuk Al Ijarah)* issuance	592 Million	36

Source: IIFM *Sukuk* Issuance Database (2001 – 2010)

2.2 Global *Sukuk* Issuances

The record growth rates achieved by the IFSI and the *Sukuk* market in particular during the years preceding the 2008 global financial crisis have been unique with the market attaining its peak during 2007 with total global *Sukuk* issuance amounting to nearly USD 49 billion. In spite of that, the global *Sukuk* market was not spared from the effects of the above mentioned crisis; it indeed witnessed a reversal of growth trend with *Sukuk* issuance declining during the years 2008 and 2009 to USD 18.6 billion and USD 25.7 billion respectively[5]. The following chart displays the total value of global *Sukuk* issues during the period of 2001 – 2010:

Chart 1: Total Global *Sukuk* Issuance (All Currencies)



Source: IIFM *Sukuk* Issuance Database (2001 – 2010)

As illustrated in the above chart, the year 2010 saw a revival occurring in global markets due mainly to government incentives which also resulted in a positive effect on the Islamic financial markets. It is clear that *Sukuk* issuance in 2010 has returned to pre-crisis issuance levels with total global *Sukuk* issuance amounting to just over USD 45 billion[6] largely owing to domestic *Sukuk* issuances in Malaysia. The international *Sukuk* market however, is yet to fully regain its previous momentum.

2.3 Distribution of Global *Sukuk* Issuance by Issuer Status

The global financial crisis came as a reality check for all markets and players, and it resulted in the reshaping of the priorities of banks, issuers and investors as well as governments. The crisis has tested and highlighted a number of issues such as ownership rights in the case of *Sukuk* default and restructuring.

[5] IIFM *Sukuk* Issuance Database (2001 – 2010)
[6] IIFM *Sukuk* Issuance Database (2001 – 2010)

During the pre-crisis period, the *Sukuk* market was driven by corporate issuers. However, since the start of the crisis, corporate issuances, particularly from the GCC countries, were few in number, such as Dar Al Arkan's USD 450 million *Sukuk*, Abu Dhabi Islamic Bank's USD 750 million *Sukuk* and Qatar Islamic Bank's USD 750 million *Sukuk*. Another interesting trend is issuance by corporates in stable and growing South East Asian economies, such as National Bank of Abu Dhabi's RM 500 million *Sukuk* and Khazanah Nasional's Singapore Dollar (SGD) 1.5 billion *Sukuk*.

During the post-financial crisis period, the appetite for corporate risk, especially in the GCC, has been far lower and this impacted on *Sukuk* issuance, however sovereign *Sukuk* issuance, such as from Bahrain, Qatar, Ras Al Khaimah (UAE), Indonesia, Malaysia and Pakistan, has provided support to the *Sukuk* market and kept its growth potential intact. This is welcome news as sovereign *Sukuk* issuance provides more depth to the market which in turn also encourages other sovereigns as well as government owned entities to enter the market.

Quasi-sovereign *Sukuk* issuances (semi-quasi in some cases due to implicit government guarantee) from Malaysia, International Finance Corporation (World Bank Group) and Islamic Development Bank in particular are key drivers of the *Sukuk* market. The following tables give a clear picture about the distribution of the global *Sukuk* issuance by issuer status:

Table 2: Global *Sukuk* Issuances by Issuer Status

Issuer Status	No. of Issues	Value (USD Millions)	% of Total Value
Corporate	1,688	124,152	63%
Quasi-Sovereign	21	6,291	3%
Sovereign	405	67,199	34%
Total	2,114	197,642	100%

Source: IIFM *Sukuk* Issuance Database (2001 – 2010)

Due to the non-existence of implicit government guarantees for certain quasi-sovereign *Sukuk*, this edition has re-classified some *Sukuk* as corporate credit which has resulted in a slight decrease in the share of quasi-sovereign *Sukuk* as compared to the 1st edition of the IIFM *Sukuk* Report. Moreover, during the last 2 years, *Sukuk* issuance by entities with a government shareholding, especially from the UAE, which in the past was the major issuer of government-related issuances, has been lower.

The following table consists of selected value leaders of Quasi-Sovereign *Sukuk* issuances:

Table 3: Global Quasi-Sovereign *Sukuk* Issues – Selected Value Leaders (year wise – latest first, USD 100 Million or greater)

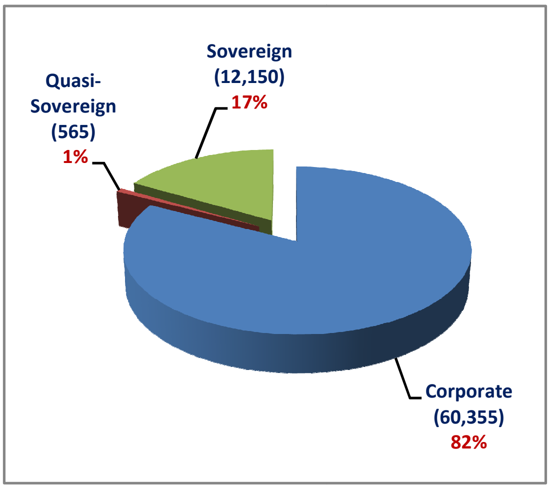
Issue Date	Issuer	International or Domestic	Structure	Amount in Millions (USD or USD Equivalent)	Tenor (Months)
Oct 2010	Islamic Development Bank	International	*Sukuk Al Wakalah*	500	60
Nov 2009	International Finance Corporation (World Bank)	International	*Sukuk Al Ijarah*	100	60
Sep 2009	Islamic Development Bank	International	*Sukuk Al Wakalah*	850	60
Aug 2009	Khazanah Nasional Berhad, Malaysia	Domestic	*Sukuk Al Musharakah*	425.3	120
Aug 2009	Khazanah Nasional Berhad, Malaysia	Domestic	*Sukuk Al Musharakah*	283.5	180
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	184.7	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	184.7	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	184.7	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	184.7	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	170.5	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	170.5	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	170.5	360
May 2009	Terengganu Investment Authority Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	170.5	360
Mar 2009	Penerbangan Malaysia Berhad, Malaysia	Domestic	*Sukuk Al Murabaha*	405.8	60
Mar 2008	Khazanah Nasional Berhad, Malaysia	International	Exchangeable *Sukuk*	550	60
Jun 2007	Dubai International Financial Center, UAE	International	*Sukuk Al Mudarabah*	1,250	60
Dec 2006	Khazanah Nasional Berhad, Malaysia	Domestic	*Sukuk Al Musharakah*	564.9	120
Jun 2005	Islamic Development Bank	International	*Sukuk Al Ijarah*	500	60
Jul 2003	Islamic Development Bank	International	*Sukuk Al Ijarah*	500	60

Source: IIFM *Sukuk* Issuance Database (2001 – 2010)

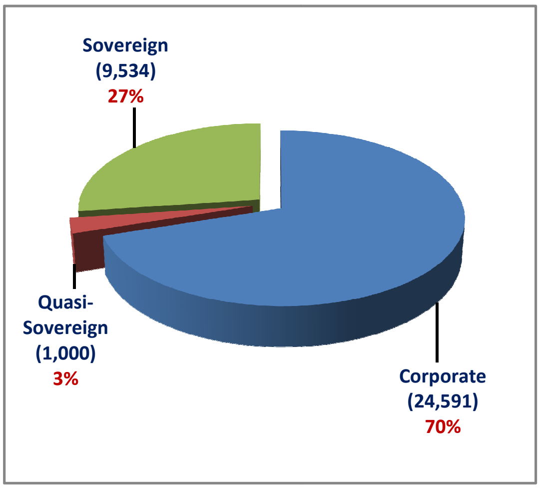
As illustrated in the below chart, the share of sovereign *Sukuk* issuances has increased and this will help the domestic, and indirectly the international *Sukuk* market in developing a yield curve as well as contribute to the development of the secondary market. Another interesting and welcome development is the increase in the number of fixed rate *Sukuk* issuances which again will contribute to the development of the secondary market as fixed-rate instruments provide more trading opportunities and will also help in the development of the yield curve.

Chart 2: Total Global *Sukuk* Issuance (All Currencies) – Breakdown by Issuer Status

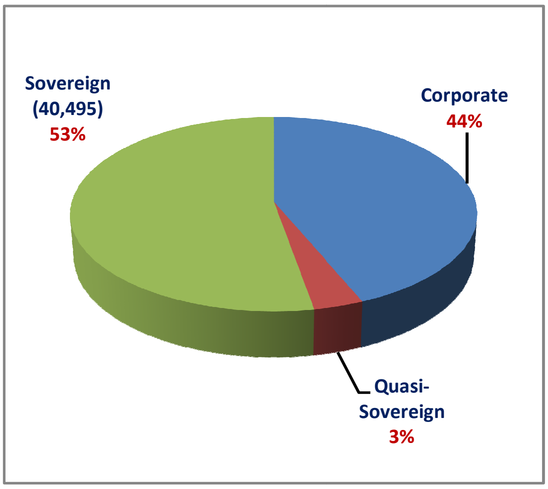
Domestic Issuances (2001 – 2007)



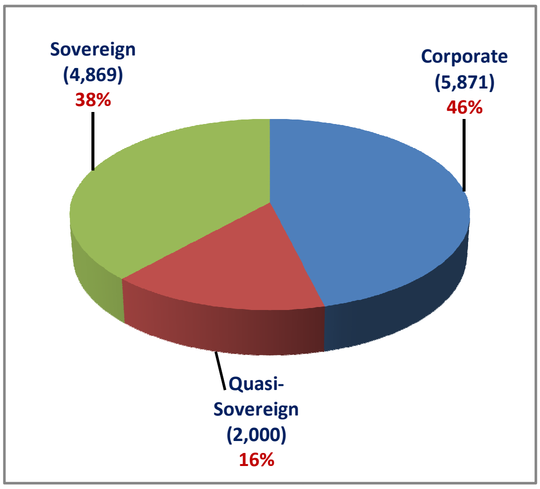
International Issuances (2001 – 2007)



Domestic Issuances (2008 – 2010)



International Issuances (2008 – 2010)



Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

Following the 2008 global economic downturn, the major world economies were forced to bring down their reference rates to record low levels which in turn resulted in an increase in fixed profit rate *Sukuk* issued during 2009 and 2010 as evidenced by the following table. This issuance practice has resulted in more potential for trading opportunities plus the need for instruments hedging the rate of return has also increased, such as the swaps of Dar Al Arkan *Sukuk*, Government of Indonesia International *Sukuk*, Bahrain International *Sukuk* and others.

Table 4: Fixed Rate Global *Sukuk* Issuance – Selected Value Leaders (year wise – latest first, USD 100 Million or greater)

Issue Date	Issuer	Domestic or International	Amount in Millions (USD or USD Equivalent)	Issuer Status	Rate of Return Per Annum
31 Oct 2010	Abu Dhabi Islamic Bank, UAE	International	750	Corporate	3.75%
25 Oct 2010	Islamic Development Bank	International	500	Quasi-Sovereign	3.55%
05 Oct 2010	Qatar Islamic Bank	International	750	Corporate	3.86%
01 Sep 2010	Celcom Transmission Berhad, Malaysia	Domestic	572	Corporate	5.50%
10 Feb 2010	Government of Indonesia	Domestic	862	Sovereign	8.70%
07 Jan 2010	Dar Al Arkan, Saudi Arabia	International	450	Corporate	10.75%
27 Nov 2009	General Electric, USA	International	500.0	Corporate	3.4%
24 Sep 2009	Government of Bahrain	Domestic	437.8	Sovereign	3.75%
09 Jun 2009	Government of Bahrain	International	750.0	Sovereign	6.25%
14 May 2009	Government of Malaysia	Domestic	1,420.8	Sovereign	5%
23 Apr 2009	Government of Indonesia	International	650.0	Sovereign	8.80%
16 Mar 2009	Penerbangan Malaysia Berhad, Malaysia	Domestic	405.8	Quasi-Sovereign	3.85%
25 Feb 2009	Government of Indonesia	Domestic	464.5	Sovereign	12%
13 Sep 2007	Government of Malaysia	Domestic	1060.61	Sovereign	3.58%
05 Jun 2007	Silterra Malaysia Sdn. Berhad, Malaysia	Domestic	529	Corporate	3.90%
12 Mar 2007	Rantau Abang Capital Berhad, Malaysia	Domestic	606.06	Corporate	4.10%
29 Sep 2006	Khazanah Nasional Berhad, Malaysia	International	750	Corporate	5.07%
02 Jun 2006	Aabar Petroleum Investment Company, UAE	International	460	Corporate	6.89%
11 Jun 2005	Islamic Development Bank	International	500	Quasi-Sovereign	3.74%

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

2.4 International *Sukuk* Market

Although the international *Sukuk* market witnessed the entry of several landmark *Sukuk* issuers from Indonesia, International Finance Corporation (World Bank Group), General Electrical (United States), Bahrain and corporate *Sukuk* from Turkey and Japan; international *Sukuk* issuances during 2008, 2009 and 2010 were only USD 2.14 billion, USD 7.45 billion and USD 5.35 billion respectively compared to USD 13.8 billion in 2007[7]. This indicates that the *Sukuk* market as a whole is yet to fully emerge from the declining trend, although confidence is returning due to government led issuance. This issuance trend indicates that Islamic countries will remain as the main drivers of the *Sukuk* market in the coming years while others from Europe, Africa, Central Asian Republics and the Far East may join if they see opportunity and advantage in issuing *Sukuk*. The following table illustrates the regional break-up of the total international *Sukuk* issuance during the period of 2001-2010:

Table 5: Regional Break-Up of the Total International *Sukuk* Issuance

ASIA & FAR EAST	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Malaysia	5,496	12	12%
Indonesia	650	1	1.4%
Pakistan	600	1	1.3%
Brunei Darussalam	200	2	0.42%
Total	6,946	16	15%
GCC & MIDDLE EAST	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Bahrain	5,633	90	12%
Qatar	2,020	4	4%
Saudi Arabia	5,440	9	11%
UAE	25,050	30	52%
Kuwait	1,575	9	3%
Total	39,718	142	83%
AFRICA	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Sudan	130	1	0.3%
Total	130	1	0.3%
OTHERS	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Japan	100	1	0.2%
Turkey	100	1	0.2%
UK	271	2	0.6%
USA	600	2	1.3%
Total	1,071	6	2%
Grand Total	**47,865**	**165**	**100%**

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

[7] IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

Table 6: Selected Value Leaders in International *Sukuk* Market for Period of July 2009 – Dec 2010 (by date – latest first, USD 100 Million or greater)

Date	Issuer	Issuer Status	Structure	Amount in Millions (USD or USD Equivalent)	Tenor (Months)
31 Oct 2010	Abu Dhabi Islamic Bank, UAE	Corporate	*Sukuk Al Musharakah*	750	60
25 Oct 2010	Islamic Development Bank	Quasi-Sovereign	*Sukuk Al Wakalah*	500	60
05 Oct 2010	Qatar Islamic Bank	Corporate	Hybrid *Sukuk* (*Ijarah, Musharkah, Murabaha*)	750	60
24 Aug 2010	KT Turkey *Sukuk* Limited, Turkey	Corporate	*Sukuk Al Murabaha*	100	36
07 Jul 2010	Nomura Holdings PLC, Japan	Corporate	*Sukuk Al Ijarah*	100	24
07 Jan 2010	Dar Al Arkan, Saudi Arabia	Corporate	*Sukuk Al Wakalah*	450	60
27 Nov 2009	International Finance Corporation, World Bank Group	Quasi-Sovereign	*Sukuk Al Ijarah*	100	60
27 Nov 2009	General Electric, USA	Corporate	*Sukuk Al Ijarah*	500	60
09 Sep 2009	Islamic Development Bank	Quasi-Sovereign	*Sukuk Al Wakalah*	850	60
12 Aug 2009	Petroliam Nasional Berhad (Petronas), Malaysia	Corporate	*Sukuk Al Ijarah*	1,500	60

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

2.5 Domestic *Sukuk* Market

As far as the domestic *Sukuk* market is concerned, Malaysia has the lion's share in terms of both volume and value. Malaysia remains as the largest domestic issuer with 72% by value of domestic *Sukuk* issuance with the remaining 28% split between a number of issuers, such as Sudan, Saudi Arabia, UAE, Bahrain, Brunei, Pakistan and Indonesia.

The domestic *Sukuk* market in a number of jurisdictions (as shown in the table 7 below) is becoming active and central banks are providing avenues to Islamic banks to invest their surplus liquidity in government *Sukuk* programs designed to provide level playing fields to the Islamic Financial Institutions (IFI's).

Table 7: Regional break-up of the Total Domestic *Sukuk* Issuance

ASIA & FAR EAST	Amount USD Millions	Number of Issues	% of Total Value
Malaysia	108,040	1,644	72%
Indonesia	4,009	69	3%
Pakistan	2,847	34	2%
Brunei Darussalam	976	19	1%
Singapore	192	5	0.13%
Total	116,063	1,771	78%
GCC & MIDDLE EAST	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Bahrain	2,951	122	2%
Qatar	480.79	2	0.32%
Saudi Arabia	9,912	13	7%
UAE	7,151	11	5%
Total	20,494	148	14%
AFRICA	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Sudan	12,928	21	8%
Gambia	2.086	7	0.001%
Total	12,930	28	8%
OTHERS	**Amount USD Millions**	**Number of Issues**	**% of Total Value**
Germany	123	1	0.082%
United States	167	1	0.111%
Total	290	2	-
Grand Total	**149,777**	**1,949**	**100%**

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

Table 8: Selected Value Leaders in Domestic *Sukuk* Market for the Period – July 2009 to December 2010 (by date – latest first, USD 100 Million or greater)

Date	Issuer	Issuer Status	Structure	Amount in Millions (USD or USD Equivalent)	Tenor (Months)
31 Dec 2010	Malaysian Highway Authority	Corporate	*Sukuk Al Ijarah*	755.92	330
20 Dec 2010	Government of Pakistan	Sovereign	*Sukuk Al Ijarah*	424.38	36
17 Dec 2010	Malaysia Airports Capital Berhad	Corporate	*Sukuk Al Ijarah*	477.53	144
15 Nov 2010	Government of Pakistan	Sovereign	*Sukuk Al Ijarah*	591.77	36
01 Sep 2010	Celcom Transmission Berhad, Malaysia	Corporate	*Sukuk Al Ijarah*	572.0	120
05 May 2010	Saudi Electricity Company, Saudi Arabia	Corporate	Investment / *Al Istithmar Sukuk*	1,867.0	84
13 Apr 2010	Danga Capital Sdn Berhad, Malaysia	Corporate	*Sukuk Al Musharakah*	652.2	60
10 Feb 2010	Government of Indonesia	Sovereign	*Sukuk Al Ijarah*	862.0	36
24 Sep 2009	Government of Bahrain	Sovereign	*Sukuk Al Ijarah*	437.8	36
27 Aug 2009	Khazanah Nasional Berhad, Malaysia	Quasi-Sovereign	*Sukuk Al Musharakah*	425.3	120

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

2.6 Short-Term *Sukuk* Market

Short-term *Sukuk* (maturity of 1 year or less) are essential for liquidity management purposes. Sudan is the leader in domestic short-term *Sukuk* issuances followed by Bahrain, Brunei & Malaysia. The appetite for short-term *Sukuk* is much greater than longer tenor *Sukuk* as witnessed by these issuers.

The trend towards issuing shorter tenor *Sukuk* is slowly increasing and is again driven by sovereign issuers through central banks. Malaysian corporate issuers are also active and have provided diversity to the local market plus depth which is required for developed capital market.

Bahrain has been the most active market within the GCC region and is a regular issuer of short-term *Sukuk Al Salam* and *Sukuk Al Ijarah* offerings which are always oversubscribed. It is the first government in the GCC to use *Sukuk* as one of the primary tools for raising finance.

The future outlook for short-term paper is encouraging and Saudi Bin Laden Group has shown the way for other corporate issuers from the GCC region to enter the short end of the market. Moreover, it is expected that Bahrain, Brunei, Sudan plus several new entrants will contribute to the development of short end of the market. The following table illustrates the total short-term global *Sukuk* Issuance globally with a tenor of 1 year or less during the period of 2001 – 2010:

Table 9: Total Global Short-Term *Sukuk* Issuance – All Currencies

Issuer Country	No. of Issues	Value (USD Millions)	% of Total Value
Malaysia	905	905	5%
Sudan	12	11,311	66%
Bahrain	159	3,727	22%
Brunei Darussalam	12	640	4%
Indonesia	2	226	1.3%
Saudi Arabia	1	187	1.1%
Singapore	1	36	0.2%
Gambia	7	2	0.01%
Total	1,099	17,034	100%

Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

2.7 Structural Break-up of Global *Sukuk* Market

Ijarah Sukuk structure has been the most dominant and widely used structure for both International & domestic *Sukuk* issuance. At the international level the use of *Musharakah* and *Mudarabah* structures have declined. Domestically *Murabaha* structure is the most used by the market and internationally its share has gone up by 4% compared to pre-crisis levels.

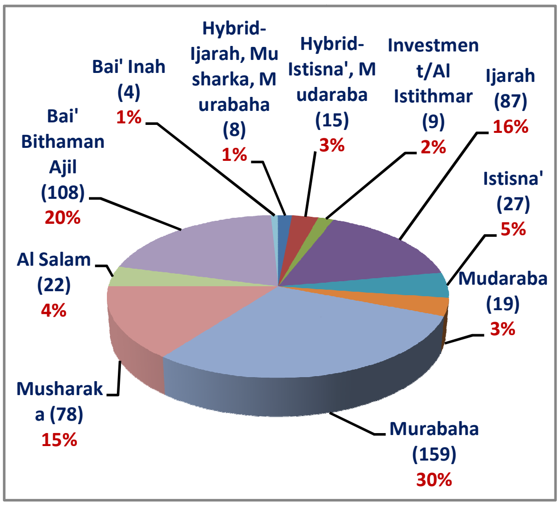
Since the crisis the market has reverted to the plain vanilla *Sukuk* and accordingly the share of *Ijarah Sukuk* has shown an increase since the publication of the 1st edition of the IIFM *Sukuk* Report (February 2009). The other *Sukuk* structure which has seen increased use during this period is the investment type due to the ease of structuring while keeping in mind the credit as well as purchase undertaking requirements.

Another very interesting trend in terms of *Sukuk* structuring and innovation is the use of an auction at redemption structure by Cagamas Berhad of Malaysia. The innovative part of this *Sukuk* structure of *al-Amanah Li al-istithmar* is the use of an auction at the redemption of the *Sukuk* instead of a promise by the obligor. Moreover, there is now an increased trend to use a higher percentage of *Ijarah* assets and less receivables which in turn helps the tradability of *Sukuk* as well as giving the comfort of higher asset coverage.

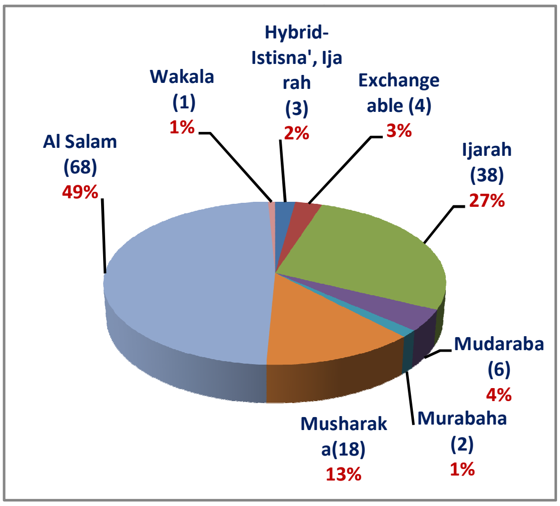
The following chart shows the structural breakdown of global Sukuk issuance by value divided into pre-crisis and post-crisis periods:

Chart 3: Total Global *Sukuk* Issuance by Value (All currencies) – Structural Breakdown

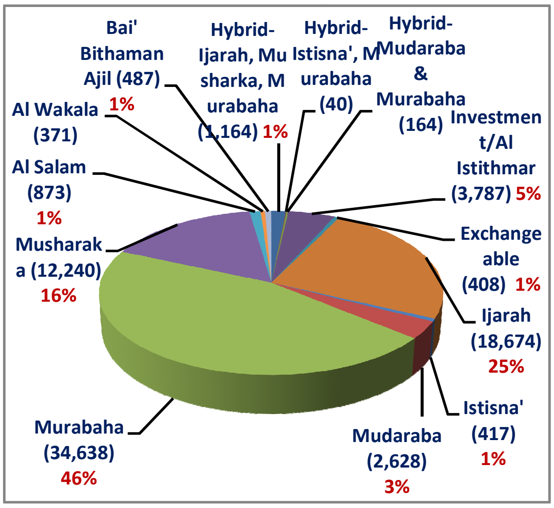
Domestic Issuances (2001 – 2007)



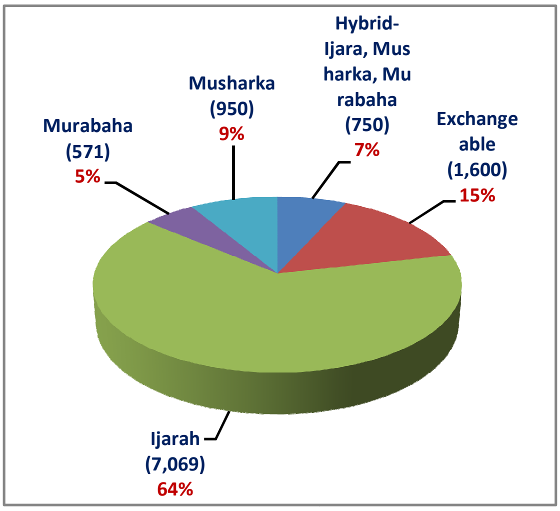
International Issuances (2001 – 2007)



Domestic Issuances (2008 – 2010)



International Issuances (2008 – 2010)



Source: IIFM *Sukuk* Issuance Database (Jan 2001 – Dec 2010)

CHAPTER THREE

CASE STUDY OF SELECTED INTERNATIONAL *SUKUK* ISSUES

3.1 Dar Al-Arkan International *Sukuk*

3.1.1 Basic Information

The Dar Al-Arkan International *Sukuk* was issued by Saudi real estate development company Dar Al Arkan in February 2010 in order to refinance a USD 600 Million *Sukuk* that was maturing in March 2010, and to continue with planned capital expenditures. The dollar denominated five year issue, maturing in 2015, has a face value of USD 450 million although it was issued at a slight discount to face value, hence raising USD 435.8 million for Dar Al-Arkan on a net basis. Initially the *Sukuk* offered a fixed annual rate of return of 10.75% payable semi-annually, however, in June 2010, the company successfully entered a *Shari'ah* compliant fixed-to-floating profit rate swap agreement for the benefit of 50% of the value of the issue. Subsequently, the profit rate on USD 225 million of the total issued amount is linked to the benchmark 3 months SAIBOR with the profit margin being 7.95%. The move is said to have lowered the average financing cost of the company due to a favourable profit rate environment. This is the fourth issue from Dar Al-Arkan, and has the distinction of being the first 144a *Sukuk* issued by a Saudi company, which means that it is regulated under the US Securities and Exchange Commission hence allowing US investors to buy into the issue.

3.1.2 Structure of the Issue

The Dar Al-Arkan *Sukuk* employs a *Wakalah* structure. The structure makes use of a special purpose vehicle (SPV) by the name of Dar Al-Arkan International *Sukuk* Company II, incorporated in Cayman Islands for the purpose of issuance of the *Sukuk* and appointed as Issuer and Trustee on behalf of the *Sukuk* investors. The structure also makes use of another company by the name of Al-Arkan *Sukuk* Company, incorporated in Kingdom of Saudi Arabia and fully owned by Dar Al-Arkan, which is appointed as Investment Manager by the Issuer through an Investment Management Agreement (it is not clear from the prospectus if this is a SPV specifically incorporated for the purpose of this issue or whether it was in existence before, but this is not important for the purposes of this report). The *Sukuk* proceeds are collected from investors by the SPV and passed on to the Investment Manager whose job it is to invest the proceeds in line with a pre-determined investment plan which requires all proceeds to be invested in a single portfolio comprising entirely of other *Ijarah* and *Murabaha* based *Sukuk* contracts between the Investment Manager and other subsidiaries of Dar Al-Arkan. The investment plan requires that at any point in time at least 51% of the investment portfolio must comprise *Ijarah* contracts, thus enabling portfolio valuation and negotiability of *Sukuk* certificates at par. *Ijarah* and *Murabaha* contracts generally provide fixed or relatively stable rates of return. Therefore, the investment plan requires the Investment Manager to invest proceeds such that the rate of return on the portfolio is equal to or greater than the promised rate of return on the Dar Al-Arkan *Sukuk*, thereby facilitating the periodic profit payments. The structure provides for an irrevocable undertaking or guarantee granted by Dar Al-Arkan, the parent company, in favour of the Issuer whereby Dar Al-Arkan agrees to make good any shortfall on a periodic distribution date or the liquidation or redemption date provided that the shortfall is due to negligence on the part of the Investment Manager.

The *Sukuk* carries fixed rate of return and offer high yield. In order to cover mismatch of return in asset and liability some investors have opted to Swap fixed profit rate into floating through Profit Rate Swap mechanism (Islamic Hedging Product). The Dar Al-Arkan *Sukuk* is rated Ba2 by Moody's and BB- by S&P.

3.2 KT Turkey *Sukuk* Limited

3.2.1 Basic Information

The Kuveyt Turk *Sukuk* or KT Turkey *Sukuk* is the first ever *Sukuk* to originate from Turkey. Kuveyt Turk is a subsidiary of Kuwait Finance House. The *Sukuk* issued in August 2010 has a face value of USD 100 million and matures in August 2013. The *Sukuk* offers a fixed annual rate of return of 5.25% payable semi-annually.

3.2.2 Structure of the Issue

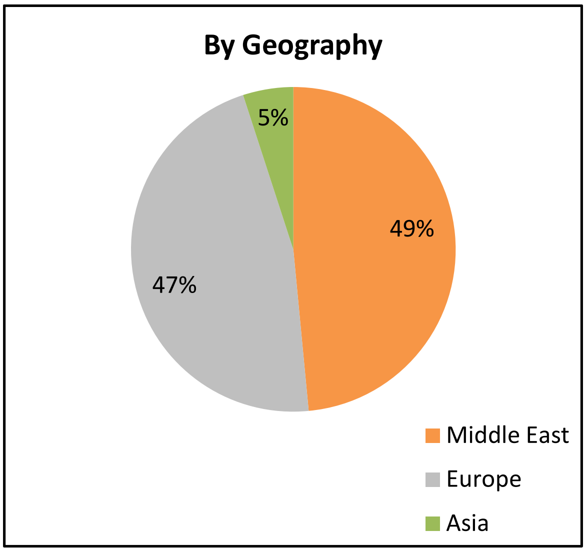
The KT *Sukuk* makes use of a combination of *Murabaha* and *Wakalah* structures, and therefore can be categorised as a hybrid *Sukuk*. The first leg of the issue makes use of a *Murabaha* structure, whereby Kuveyt Turk sells its beneficial rights and obligations to certain leased and *Murabaha* assets through a Purchase Agreement to the special purpose vehicle by the name of KT Turkey *Sukuk* Limited. The SPV raises funds through the certificate holders and holds the assets in trust on behalf of the certificate holders. The *Sukuk* holders are entitled to a fixed profit rate (like installments on a *Murabaha* sale) and the full redemption amount at maturity. Through a management agreement (which is where the *Wakalah* concept comes in), the SPV appoints Kuveyt Turk as managing agent of the portfolio of assets, and Kuveyt Turk is entitled to a management fee in return for providing this service.

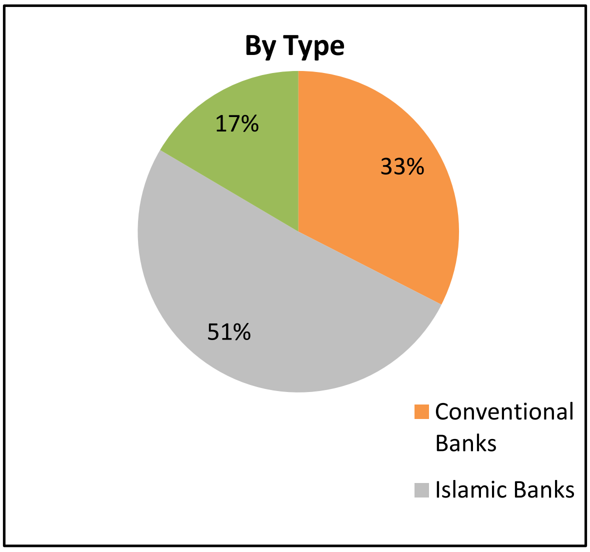
The KT *Sukuk* features an explicit unconditional guarantee from Kuveyt Turk in the capacity of Obligor to make good all payments due to the Trustee in a timely manner. It is not common to find such an explicit guarantee from the originator of the *Sukuk* in *Shari'ah* compliant financing structures.

The structure also makes use of a Purchase Undertaking and a Sale Undertaking that together ensure that principal amount is paid in full on maturity of the issue. Under the Purchase undertaking, Kuveyt Turk is obliged to purchase back the Portfolio assets from the SPV at a pre-determined exercise price, whereas under the sales undertaking, the SPV is obliged to sell the assets to Kuveyt Turk at the same fixed price. The purchase and sale undertakings may come into effect before redemption as well, such as in case of a dissolution event.

Kuveyt Turk, besides its management fee in the capacity of a managing agent, is also entitled to keep as Incentive Fee any surplus amount that accrues on the portfolio assets in excess of the periodic distribution amount payable to the certificate holders. The KT *Sukuk* was rated BBB- by Fitch.

Chart 4: KT Turkey *Sukuk* Investor Distribution





3.3 Khazanah Nasional Berhad (Danga Capital Berhad)

3.3.1 Basic Information

Khazanah is the investment holding arm of the Government of Malaysia entrusted to manage the assets held by the Government and undertake strategic investments. The company is almost fully owned by the Ministry of Finance in Malaysia. Khazanah has been quite active in the international *Sukuk* market. The Khazanah SGD *Sukuk* consists of two tranches, a 5 year tranche comprising SGD 600 Million and a 10 year tranche comprising SGD 900 Million due 2020, together a massive SGD 1.5 Billion or equivalent to USD 1.1 Billion. According to a media statement by Khazanah National, this *Sukuk* achieved several milestones, being both the largest and longest term *Sukuk* issuance in Singapore, the largest SGD issuance by a foreign issuer in Singapore and the first SGD *Sukuk* issuance out of the Malaysia International Islamic Financial Centre. The *Sukuk* have indicative profit rates of 2.615% per annum for the 5 year tranche and 3.725% for the 10 year tranche[8].

3.3.2 Structure of the Issue

The Danga Capital *Sukuk* from Khazanah is based on a *Wakalah* structure. The SPV, Danga Capital, raises the proceeds of the *Sukuk* from certificate holders and passes them on to Khazanah, which acts as *Wakeel* under the *Wakalah* Agreement. Khazanah invests the proceeds in a combination of *Shari'ah* compliant

[8] http://www.khazanah.com.my/

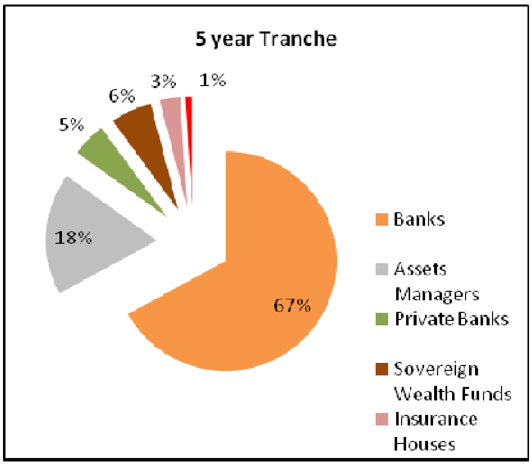
equities and commodity *Murabaha* agreements in accordance with a pre-determined investment plan. For each tranche, 51% of the *Sukuk* proceeds are to be invested in *Shari'ah* compliant equities and the rest in commodity *Murabaha's*. The commodity *Murabaha's* will provide a more or less fixed rate of return on investment whereas the equity portion will result in a gain or loss in the value of the assets. The periodic distribution amount due to the certificate holders will come from both the profit on commodity *Murabaha's* as well as the dividend income from the shares. Khazanah is entitled to receive any excess over the indicative periodic distribution amount as incentive fee for acting as *Wakeel*.

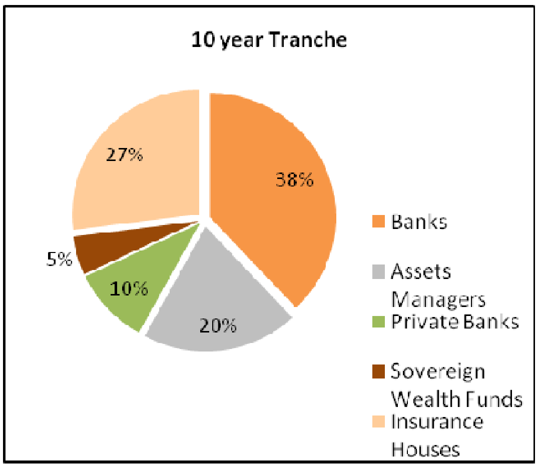
Khazanah acts as Obligor under a Purchase undertaking that comes into effect on redemption or early dissolution. Khazanah undertakes to purchase from Danga Capital all the investments comprising the Trust assets at their 'fair market value'. In case of commodity *Murabaha's*, the fair market value would be the pre-determined deferred sale price of the commodity in question, and will therefore be a fixed amount. However, in case of equities, the fair market value will be the market value of the shares which will be determined in accordance with certain Valuation principles stated in the investment plan. In case the valuation amount is insufficient to meet the full redemption value of the certificates, the certificate holders will have to bear the loss. In case the valuation amount is in excess of the redemption value of certificates, the excess will accrue to the *Wakeel* in the form of Final Incentive Fee.

3.3.3 Khazanah Nasional *Sukuk* Investor Distribution

The deal attracted a diverse group of 78 local and international investors comprising financial institutions, asset management firms, statutory bodies and insurance companies from Singapore, Malaysia, Hong Kong, Brunei and Europe[9].

Chart 5: Khazanah Nasional *Sukuk* Investor Distribution





[9] http://www.khazanah.com.my/

CHAPTER FOUR

ARTICLES AND STUDIES ON SPECIFIC *SUKUK* STRUCTURES

4.1 *Sukuk* Challenges: Default & Restructuring

By: Husam El-Khatib
Legal Consultant

4.1.1 Introduction

Sukuk reflect an ownership interest in an underlying asset, transaction, or project. It refers to the process of pooling tangible assets, their usufruct, or beneficial ownership into an entity which issues *Sukuk* certificates reflecting undivided, proportionate ownership.

They are similar to any other financing and investment product, Islamic or conventional, in terms of their exposure to default scenarios. Whilst the business causes leading to *Sukuk* default are varied, the ultimate reason for a default is the Issuer's failure to pay the *Sukuk* investors their dues in accordance with the terms governing the *Sukuk* issuance which may lead to the restructuring of the debt or indebtedness restructuring[10].

However, restructuring of *Sukuk* is not the same as with conventional bonds as they pose a number of additional challenges. For example, the nature of *Sukuk* structures are crucial to how they are to be restructured or unwound. Some *Sukuk* are securities that resemble debt obligations with determinable fixed returns, while other *Sukuk* resemble equity-like investments, containing a variable return (largely *Mudarabah* or *Musharakah* based *Sukuk*). Yet, all have different methods and forms of transferring, applying and dealing with the underlying asset, usufruct, venture or project in order to comply with the precepts under *Shari'ah*. These requirements need to be protected in a default scenario.

4.1.2 Restructuring Objective

The objective of any restructuring is twofold; firstly, to ensure the fair treatment of its creditors; and secondly, to ensure that the obligor can continue to operate as a going concern. Decisions as to whether to pursue a course of restructuring versus enforcing bankruptcy largely depend on how best to extract the highest value for the owed creditors.

Restructuring *Sukuk* from the perspective of the obligors is also preferable. It provides the obligors with the additional time to meet their obligations as well as to save the enterprise. Restructuring involves either extending the payment terms, conducting a debt for equity swap, agreeing to a profit haircut, or

[10] Debt restructuring or indebtedness restructuring is a process that allows a private or public company or a sovereign entity facing cash flow problems and financial distress, to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations.

replacing the original *Sukuk* certificates with new certificates (usually involving a new asset sale transaction but at higher profit rates).[11]

One of the first key steps in any restructuring process is for the obligors to negotiate with the trustee and the *Sukuk* holders to determine: whether there is any potential event of a default; whether a default has in fact occurred; and/or whether the situation can be resolved before making any official announcements. Given the lack of sophisticated insolvency laws and procedures in the GCC, agreeing upon a restructuring course of action with *Sukuk* holders is even more important.

Balancing the interests of all the parties, be it the creditors' expectations, the trustee's role, *Shari'ah* board requirements, and the obligors' obligations and constraints, is a major challenge in of itself.[12] Also, the location of all the parties and gathering them together to convene a meeting can be equally challenging.

4.1.3 The *Sukuk* Trustee

The trustee is essential to any *Sukuk* restructuring. But their powers and authority to represent the *Sukuk* holders' interests has been a matter of intense debate. The trustee is limited both by the authority as set out in the *Sukuk* documentation [13] and by the constraints placed on it due to the particular *Sukuk* structure itself. Some have suggested using a third party delegate, in particular for enforcing any purchase undertaking or guarantees in the *Sukuk* structure.[14]

If the situation warrants, a meeting of the *Sukuk* holders and the trustee may have to be convened.[15] The objective of this meeting is to pass a resolution to allow the *Sukuk* to be amended. Amendments can include changes to the *Sukuk* payment terms, dates and processes. If a resolution is not agreed upon and passed, further negotiations are conducted until a revised resolution is agreed upon. Continued deadlock could lead to a formal default announcement and/or insolvency procedures.

A restructuring is devised through creditors' consent rather than through a court process. Therefore, the obligor engages with the *Sukuk* holders and other creditors through some form of coordinating committee. For conventional bonds, this is through a bond holders committee represented by the trustee. For *Sukuk*, this is through a *Sukuk* holders committee represented by the trustee, or an appointed delegate acting on behalf of the trust.[16]

[11] See Dr. Mohd Daud Bakar. '*Sukuk Restructuring: Issues and Challenges'*. Amanie Islamic Finance Consultancy and Education, LLC, DIFC.
[12] Hessam Kalantar and Owen Delaney. *'Restructuring of Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners,'* Zawya Select 2010. Nov 30, 2010. See http://www.zawya.com/story.cfm/sidZAWYA20101130072143?q=*Sukuk* ownership
[13] The trustee may pursue the remedies available to it under document to enforce and accelerate the rights of the *Sukuk* holders.
[14] For instance, see *Supra* no. 12.
[15] The trustee can convene a meeting for the *Sukuk* holders. In many *Sukuk*, no less than one-tenth of the *Sukuk* holders are required for a resolution's approval.
[16] For an interesting solution to restructuring of *Sukuk* via the use of appointed delegates, please see the presentation provided by Debashis Dey, '*Capital Market Solutions to Restructuring Sukuk,*' 9th Annual Islamic Finance Summit, Euromoney Seminar, London. 23-24 February, 2010.

4.1.4 The Claims

Any restructuring, by way of a scheme of arrangement[17] or other, would begin with an assessment of the claims against the obligors' financial status. For *Sukuk* holders, determining their exact status and interests vis-a-vis other creditors is vital. Are the *Sukuk* holders deemed secured creditors, unsecured creditors, preferential creditors or other?

Whether and how much a *Sukuk* creditor gets back of his investment and distributions depends on his ranking in the payment claims list. The obligors and the creditors will need to agree on the quantum, classification and ranking of the claims.[18] Claims secured against particular assets would have preferential priority over those asset values. To make matters more challenging, the values of all the obligor's assets may have significantly changed since the start of the *Sukuk*.

Even in the event of bankruptcy, the priority of claims, along with the residual valuations of an obligor's assets, are highly contentious.

Unlike conventional bond holders however, the rights and remedies of *Sukuk* holders can vary. Therefore, practitioners have to determine these with respect to the *Sukuk* by reviewing the terms and conditions of the *Sukuk* certificates, the trust deed and consider whether there is any purchase undertaking present by the obligor in favor of the trustee and its enforceability.

Under a *Wakalah Sukuk* for example, *Sukuk* holders do not have recourse to the assets of the *Wakeel*.[19] But they may enjoy some degree of protection if the *Wakalah* contains a specific purchase undertaking or guarantee.

Hence, the importance of understanding whether the *Sukuk* is either asset backed or asset based.

4.1.5 Restructuring of Asset-backed and Asset-based *Sukuk*

In asset-backed *Sukuk*, legal title of the underlying asset will, in most cases, have been transferred by the obligor into a bankruptcy remote special purpose vehicle (SPV) or ring-fenced from the obligor. In securitization parlance, this is known as a true sale. In the use of an SPV, the trustee appointed over the SPV will hold the assets in trust for the *Sukuk* holders. In a default situation, pursuant to the trust deed in place, the *Sukuk* holders can make a claim on the issuer's legal ownership interest just to that asset. If the cash flow of that asset is insufficient to meet the claims of the *Sukuk* holders, they can dispose of the asset. However, they cannot claim against the obligors themselves.

In asset-based *Sukuk*, however, there was most likely only a beneficial ownership transfer or possibly no real transfer of the underlying asset(s). Here, *Sukuk* holders have at best a beneficial interest in the assets. However they do not have ownership of the asset, especially if there is a purchase guarantee in place. They will only have recourse to the obligor as an unsecured creditor with all other similar creditors.

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[17] A Scheme of Arrangement (or a "scheme of reconstruction") is a UK court-approved agreement between a company and its shareholders or creditors (e.g. lenders or debenture holders). See the UK Companies Act 2006, Part 26 (ss. 895-901) and Part 27.

[18] *Supra* 12

[19] This is true unless the *Wakeel* breaches its standard duty of care or the investment guidelines under which it operates.

More details on the distinction between the two can be found in the chapter in this book on *Sukuk* Ownership Rights.

Sukuk holders can determine whether their *Sukuk* investment is asset-based or asset backed from the *Sukuk* prospectus, especially as highlighted in the risk factors section. Despite the availability of this information, many perceived their investment to be linked to the underlying asset performance, rather than simply being de facto debt instruments.[20]

4.1.6 Security Interest

Relevant to arriving at a classification of secured versus unsecured claims is determining whether procedures relating to perfection of security have been duly undertaken.

Perfection of a security interest on the assets is another important determinant in restructurings. Many *Sukuk* creditors mistakenly believed they had, in addition to a claim against the obligor, a security interest over the underlying *Sukuk* assets themselves. In other words, they deemed themselves to be a secured creditor.

If the security interest over the assets was not perfected in the name of the *Sukuk* holders, then the *Sukuk* holders may not have any security rights over them.[21] In a number of *Sukuk*, perfection of the security interest was not made over the underlying assets. Jurisdictional impediments, such as the prohibition of foreign ownership of real estate assets in certain GCC states, played a significant part in this failure to register the ownership.[22] Also, many investors were concerned that they were taking on additional risk (asset risk) along with credit risk. However, *Sukuk* holders will ultimately need to balance the objectives of what the *Shari'ah* is trying to achieve with that of their own investment risk criteria.

4.1.7 Cross Default

Once a *Sukuk* defaults, cross-default provisions in the obligor's financial agreements may kick in. In other words, a payment obligation that is not met under a financial agreement may give rise to claims under other financial agreements. Such cross default scenarios may require renegotiating repayments with all creditors together to avoid unfair preferential treatments.

4.1.8 Restructuring Options

Though a common tactic under conventional restructurings, extending the payment terms is not always possible under *Sukuk*. It largely depends on the *Sukuk* structure used.

Restructuring of asset-backed *Sukuk*, especially when the underlying assets have been transferred on a true sale transaction, is not possible. Under *Shari'ah*, in the absence of any fraud or gross negligence, the terms of an asset sale cannot be renegotiated after the sale has already been concluded. Thus, the

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[20] *Supra* 9.
[21] Security rights include as, such as having possessory control over the asset, the ability to issue notices to the relevant parties, or to make court filings over the respective assets.
[22] *Supra* 12.

payment terms cannot simply be extended. Doing so could also mean that the issuance is no different from a conventional financial debt transaction.

The easiest to restructure however is the *Ijarah Sukuk*. The *Ijarah Sukuk*, given its relative flexibility in terms of adjusting profit levels and repayment terms, as compared with other *Sukuk* forms.[23] *Shari'ah* permits with mutual consent of the parties, the extension of a lease period and the readjustment of the periodic rental payments. Furthermore, the parties can agree to replace the leased assets if required. Investors can exercise their rights on the leased assets. It is no wonder that this has been the favorite structure for most *Sukuk* issuances. However, the *Ijarah Sukuk* does highlight some concerns of its own.[24]

Another restructuring device available in *Sukuk* restructurings is that of a 'haircut'. The concept of the investors taking a reduction on their investment in order to induce early repayment has been approved by AAIOFI.[25] But would a discount be acceptable in all types of *Sukuk*? In *Musharakah* and *Mudarabah Sukuk*, haircuts may not be made if the structure allows for any profit or capital guarantees. However, the AAOIFI pronouncements in February 2008, purchase undertaking of the *Mudarib's* capital could be deemed as an impermissible form of capital and project guarantee. In these cases, new revised securities would have to be agreed to replace the existing *Sukuk*.

Finally, debt for equity swaps is permitted under *Shari'ah* law. In a debt to equity swap, the creditors generally agree to cancel some or all of the debt in the exchange for equity in the borrowing entity. For *Sukuk* holders, this may also involve agreeing on a haircut of their expected profits.[26]

4.1.9 Approvals

Shari'ah board approval of any restructuring plan is critical, the fear being that what was once certified as *Shari'ah* compliant has become non-compliant post-restructuring. In particular, compliance of any new amendments to the financial documentation and the refinancing structure.

Reliance on the issuer's appointed *Shari'ah* board is another issue. Some creditors may choose to rely on the issuer's board, while others may require independent *Shari'ah* verification.

4.1.10 GCC Insolvency Regime Obstacles

Bankruptcy and insolvency laws in some countries, like the GCC, have yet to be properly developed and tested. At the time of writing, a UAE developer has filed for liquidation, one of the first UAE court mandated bankruptcies of a distressed property developer.[27] The *Sukuk* defaults that have occurred

[23] Mohammed Khnifer, '*Stand and Default*,' Islamic Business & Finance: CPI Financial. Oct 2010.
[24] The unsecured Nakheel *Sukuk* restructuring showed that the valuation of the physical assets upon which the *Sukuk* was priced did not match the realization price had it actually defaulted, thus leaving the *Sukuk* holders well out of pocket. See also Blake Goud. '*Should Islamic Finance move Away from Unsecured Debt?*' Zawya. Dec 9, 2009.
[25] *Supra* 23.
[26] *Ibid.*
[27] See http://www.arabianbusiness.com/first-uae-developer-files-for-bankruptcy-363578.html

prompted action on improving insolvency regimes and rules.[28] However, they still suffer from the following key hurdles:

- The lack of proper laws, guidelines and institutions to deal with insolvency;
- Insufficient qualified insolvency practitioners, trustees and advisors in insolvency procedures;
- Insufficient non-court alternatives to deal with insolvency matters;
- Balancing creditor and debtor interests;
- Enforcement of restructuring plans and binding them on all claimants; and
- The staying of litigation in connection with a default during restructuring negotiations.[29]

4.1.11 Enforcement of Decisions

If a *Sukuk* default is litigated in the courts, especially in the GCC states, most cases would be affected by legal risk. For instance, decisions taken by foreign courts, such as in the UK, may not be enforced or respected in the GCC. In the UAE, courts under its federal law are permitted to re-open and examine the merits of a claim, set aside the parties' preference on choice of law (if other than UAE), and may challenge foreign judgments that are perceived to run counter to UAE public policies.[30]

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[28] Ibid. Kalantar and Delaney. Ibid. According to them, Kuwait and the UAE are considering creating new restructuring. In December of 2009, Dubai enacted Decree No. 57 of 2009 following the Dubai World restructuring.

[29] Summarized from issues the highlighted by Hessam Kalantar and Owen Delaney. *'Restructuring of Islamic Finance Transactions in the Middle East: A New Frontier for Practitioners,'* Zawya Select 2010. Nov 30, 2010. See http://www.zawya.com/story.cfm/sidZAWYA20101130072143?q=*Sukuk* ownership

[30] Neil Domonic. *'Islamic Finance: Sukuk Market on Trial as Islamic Bonds Default*,' Euromoney Magazine. July 2009. See http://www.euromoney.com/Article/2245562/CurrentIssue/72526/Islamic-finance-*Sukuk*-market-on-trial-as-Islamic-bonds-default.html

4.2 Islamic Development Bank: *Sukuk* Issuances

4.2.1 Introduction

The Islamic Development Bank (IDB) is a Supranational Developmental Bank, established in 1975 with its headquarters located in Jeddah, Saudi Arabia. IDB is owned by 56 member countries of the Organization of the Islamic Conference (OIC) that span across the Middle East, Africa, Asia and Europe. The IDB's primary objective is to foster the economic development and social progress of member countries and Muslim communities in non-member countries[31]. IDB is also a founding and permanent member of IIFM.

IDB is rated AAA by the three major Rating Agencies (Standard & Poor's, Moody's, and Fitch). It has been designated as a Zero Risk Weighted Multilateral Developmental Bank (MDB) by the Basel Committee on Banking Supervision and the Commission of the European Communities. In a recent rating exercise, Rating Agencies highlighted the IDB's key strengths as follows:

- Exceptionally strong support from member countries that include large oil and gas exporters
- Strong and expanding capital base
- High level of liquidity
- Well performing operational assets

4.2.2 IDB's Funding Strategy

The growth targets for Operational Assets established by the IDB Board of Governors in its Annual Meeting of 2009 were 30% p.a. during the next two years and 15% p.a. in subsequent years.

The primary drivers of asset growth are:

- Through project financing from member countries as part of the new Member Country Partnership Strategy (MCPS)
- International capital markets

As a strategy IDB is becoming an increasingly active issuer in the international capital markets and it relies on equity subscriptions as well. However, IDB, as a policy, always maintains a conservative approach to leverage. IDB raises capital through public markets as well as private placements and during 2009 it has twice tapped the public market.

IDB's capital markets objectives:

- Develop a liquid yield curve as part of IDB's wider strategic objectives
- Enhance its profile in the international capital markets and reach out to new investors
- To become a frequent *Sukuk* issuer to establish a benchmark in the Supranational Market

[31] http://www.isdb.org/

4.2.3 IDB *Sukuk* Issuances under MTN Programme

4.2.3.1 Basic Information

Initially, the IDB's financing needs was mainly funded from the shareholder's equity. However, in order to promote the *Sukuk* market and take an active role in the development of Islamic Capital Markets, the Bank started to mobilize resources through the issuance of *Sukuk* and its first *Sukuk* was launched in 2003.

In 2005, IDB established a Medium Term Note (MTN) program with an initial size of US$1.5billion. The MTN program was updated on 27th September 2010 and its size was increased to USD 3.5billion, which clearly indicates that IDB is becoming a very active and frequent issuer of *Sukuk*.

IDB, being the only AAA rated *Sukuk* issuer, always receive very strong interest from the Far East, GCC and the rest of the world.

Under the MTN Program, IDB has so far issued 6 (six) series of *Sukuk* as follows:

- Series 1, USD 500 million issued in 2005 (matured in June 2010)
- Series 2, SGD 200 million private placement issued in 2009 (maturity in September 2012)
- Series 3, USD 850 million issued in 2009 (maturity in September 2014)
- Series 4 & 5, two tranches of SAR 1.875 billion private placement issued in 2010 (maturity in September 2020)
- Series 6, USD 500 million issued in 2010 (maturity in October 2015)

Furthermore, IDB has also established a Malaysian Ringgit MTN Program with the size of RM 1 billion and so far the Bank has issued two tranches of Malaysian Ringgit *Sukuk* in 2008 and 2009 with a total amount of RM 400 million (USD 130 million approximately).[32] The proceeds were used for funding several projects including two toll roads in Malaysia.

[32] http://www.isdb.org/

Table 10: Funds Raised Under MTN Program / *Sukuk* Issuances

Serial No.	Amount In Millions	Tenor	Date of Issuance	Maturity
1	USD 138.5	3 years	09 Sep 2009	14 Sep 2012
2	USD 100	3 years	25 Aug 2009	26 Aug 2012
3	USD 50	3 years	13 Sep 2009	16 Sep 2012
4	USD 400	5 years	20 Jul 2010	12 Aug 2008
5	USD 500	5 years	11 Jun 2005	22 Jun 2010
6	USD 850	5 years	09 Sep 2009	16 Sep 2014
7	USD 500	5 years	25 Oct 2010	27 Oct 2015
8	RM 300	5 years	20 Aug 2008	20 Aug 2013
9	RM 100	5 years	31 Mar 2009	28 Mar 2014

Source: Islamic Development Bank

Due to the strength of IDB balance sheet and being triple A rated by top rating agencies, the pricing of all IDB *Sukuk* issuances have reflected its premier issuer status i.e. the pricing range has been between 20bp to 40bp above the highly rated reference instruments.

4.2.3.2 Series 6 IDB Trust Services Limited – 2010 *Sukuk*

In October 2010 IDB issued USD 500 Million *Sukuk* under its USD 3.5 Billion MTN Trust Certificate Issuance Programmed. CIMB, Citibank, HSBC Amanah and Standard Chartered Saadiq acted as joint lead managers and joint book runners, and NCB Capital acted as co-lead manager for this transaction. The 5 year, fixed rate *Sukuk* was issued at par priced at par with profit of 40bps over 5 year Treasury Bill.

The capital raised through the *Sukuk* issuance was used for general corporate purposes including financing projects in IDB members' countries such as the financing of infrastructure, agriculture and power sectors. Generally, IDB utilizes the proceeds for financing its medium and long-term projects, for example, such financing has been used for projects in Morocco, Egypt and Senegal.[33]

The Series 6 *Sukuk* issuance makes use of a *Wakalah* structure where IDB acts as *Wakeel* to IDB Trust services. The structure involve a SPV by the name of IDB trust services Ltd incorporated in Jersey and acts as Issuer and Trustee for the purpose of the investors.

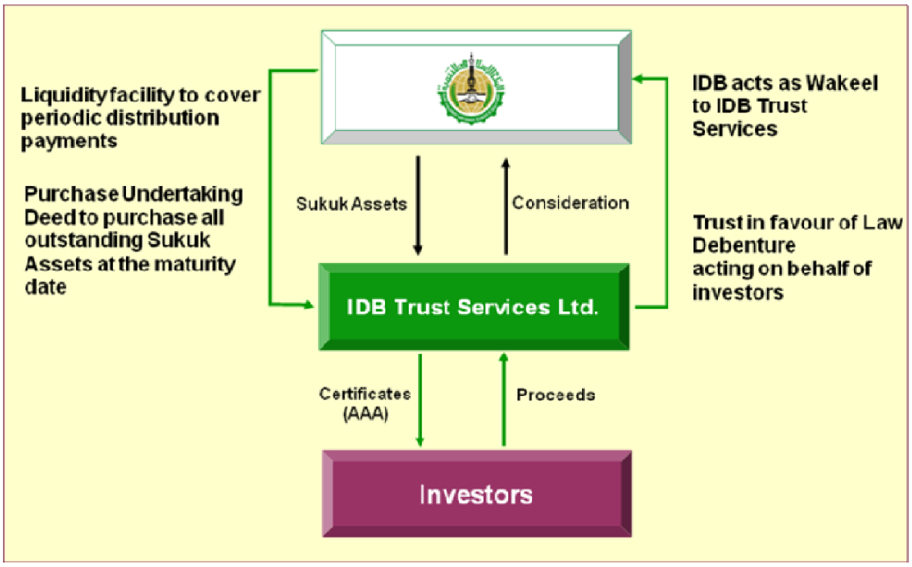
The Issuer, IDB Trust services Ltd used the net proceeds of the issue to purchase separate and independent of assets from IDB comprising of:

[33] Trust Certificate Issuance Programme, Base Prospectus, 27 September 2010

- at least 51 per cent. tangible leased Assets, Shares and/or *Sukuk*; and
- no more than 49 per cent. intangible assets comprising of *Istisna'a* Receivables and/or, *Murabaha* Receivables,

IDB trust services Limited appointed IDB to perform limited actions in order to manage the Portfolio pursuant to the *Wakalah* agreement. Profit received in respect of the Portfolio, after paying the expenses of the relevant Trust, is to be applied to periodic distributions to *Sukuk* holders.

Chart 6: Series 6 *Sukuk* Structure



Source: Islamic Development Bank

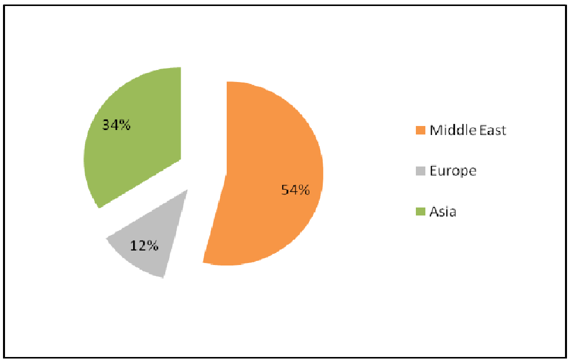
Moreover, The IDB has confirmed it will make available to IDB Trust Services Limited sufficient funds to ensure timely payment of Periodic Distribution Amounts.

The IDB has undertaken to purchase the outstanding Portfolio on the relevant Maturity Date or following the occurrence of the Dissolution Event pursuant to a Purchase Undertaking Deed and a relevant Repurchase Agreement. IDB Trust Services Limited has agreed to sell the outstanding Portfolio, upon the occurrence of an early dissolution pursuant to a Sale Undertaking Deed and a relevant Sale Agreement. The purchase price payable will be an amount equal to (a) the Aggregate Nominal Amount of the relevant Trust Certificates and (b) the amount of accrued but unpaid Periodic Distribution Amounts on such date.

4.2.3.3 Investor Distribution

Although investors from the Middle East have purchased the largest share in this *Sukuk* issuance, investors from the Far East and Europe have shown keen interest and appetite in IDB's highly rated *Sukuk*.

Chart 7: IDB Trust Services Limited – Investor Geographic Distribution



Source: Islamic Development Bank

4.2.4 Conclusion

Given IDB's leading role in the Islamic Industry, strong balance sheet and its commitment, IDB will remain as one of the key drivers of the *Sukuk* market not only as the primary market issuer but will also play a major role in market making of its *Sukuk* and eventually as an active player in the secondary market as well.

4.3 *Sukuk* Ownership Rights

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Legal Consultant

4.3.1 Introduction

One obvious but overlooked aspect of *Sukuk* its investors discovered following recent defaults: Not all *Sukuk* are alike, especially upon a default.

To comply with Islamic legal principles, *Sukuk* certificates have been structured to represent ownership interests in the underlying assets. Yet, the concept of 'ownership' of the assets and their associated respective 'rights' has proven confusing for many. Some investors believed to have held the title to the underlying assets, when they did not. Others incorrectly believed they held the disposal rights and/or were preferential creditors to those underlying assets, in addition to being able to claim against the obligor upon a default scenario.

Some even mistook the requirement of ownership of the assets under *Shari'ah* law as a form of additional protection, or that their investment would be safer or more secure than that of conventional bonds.

Are investors really to blame for not understanding their own rights and risks? After all, these buyers should have been aware of all their risks at the time of purchase. *Sukuk* risks are spelt out for them in the risk factors of their *Sukuk* prospectus. But, is there something amiss if perceptions of what an 'ideal' *Sukuk* should be or how it 'should' function is not congruent with what is contained in the fine print? In other words, is there a genuine disconnect between what investors thought they were purchasing and what they were actually buying?

After all, this is not the first time the actual application of *Shari'ah* compliant products in form have highlighted awkward disconnections with their intended application in substance. The combination and application of national financial laws and regulations with *Shari'ah* concepts and principles has not always been an easy fit.

4.3.2 *Sukuk*

Before attempting to answer some of the above questions, let's take a step back and clear up some important definitions.

First being *Sukuk* themselves. AAOIFI define *Sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, assets of particular projects or special investment activity"[34]. IFSB define *Sukuk* as "certificates with each sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *mudarabah*)[35]. From these definitions we can extrapolate that *Sukuk* certificates must represent undivided shares in the *Sukuk* and must represent a form of ownership of its assets, usufruct or service.

Sukuk have adopted a number of *Shari'ah* compliant forms. The most commonly used forms being *Ijarah*, *Mudarabah*, or *Musharakah Sukuk*, or a combination of such. However, how their assets were legally or beneficially transferred and owned by the respective parties remained unclear, especially with respect to the national laws and regulations applying the *Shari'ah* conditions.

In 2009, the IFSB took one step further to clarify the above definitions by categorizing all forms of *Sukuk* under three structural categories, namely: asset-backed, pay-through asset-based and pass-through asset-based *Sukuk*[36]. This categorization attempted to define, through the use of conventional financial jargon, the acceptable parameters in which assets could be transferred and owned.

Conventional bonds, on the other hand, do not represent ownership in an asset, usufruct or service. Instead, they are simply certificates representing debt obligations owed to its bondholders. Bondholders do not receive and are not entitled to any profits of an underlying venture or asset being financed by the bond. In other words, they do not benefit from any profit upside. The principal of the bond is paid back on maturity or on an early termination date.

Given investor demands, however, the majority of issued *Sukuk* have been structured so that they have similar risk profiles and pricing to that of conventional debt bonds. Though still *Shari'ah compliant*, they have essentially become debt obligations. In order to meet such comparable pricing and risk requirements, these *Sukuk* have largely taken on asset-based ownership structures. Unlike asset-backed *Sukuk*, asset-based debt *Sukuk* instruments usually do not provide direct title ownership and the associated risks of the underlying assets to it *Sukuk* holders. But before discussing these forms of asset-based *Sukuk*, what do we exactly mean by 'ownership'?

4.3.3 Ownership

Under English law, one of the more commonly used governing laws for *Sukuk*, 'ownership' as a concept, comes in a number of forms. English law maintains an assorted classification of rights, each representing a form of ownership, to a particular object, estate or property, be it moveable or immovable and whether owned in conjunction with or reverting to others.

Of relevance to *Sukuk*, English law groups these ownership rights as legal interests or as equitable interests. A legal interest or legal ownership usually carries title to the assets, although rights to the

[34] *Shari'ah* Standard 17(2) of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). 2008.
[35] Section 1.1 of the *Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate Investment*. Islamic Financial Services Board (IFSB). January 2009.
[36] Ibid.

property may be separated, such as the right of possession. Beneficial ownership, a form of equitable interest, provides rights to the assets normally associated with owning the assets, but does not give legal title to them.

When a *Sukuk* investor invests in a *Sukuk* certificate carrying ownership of an asset, it is therefore important that they understand who has legal title to the assets and who has the beneficial ownership, if any. It is this ownership distinction that helps determine who has priority or what rights they hold to the underlying assets upon a *Sukuk* default.

The transfer of the ownership is evidenced by recording the transfer in the seller's books. Any *Sukuk* assets that are actually sold onto the *Sukuk* holders must not appear on the balance sheet of the seller.

4.3.4 Ownership under *Shari'ah*

As mentioned above, AAOIFI guidelines advise that a *Sukuk* must represent ownership in the underlying real assets (be it real assets, their usufruct, and/or their services). But then again, what do we exactly mean by "represent ownership in the underlying real assets"? Does it mean that the *Sukuk* holder holds sole title to the assets, full rights of disposal, unrestricted rights of possession, and unlimited rights to its use? Is this what we believe or understand to hold when we say 'ownership' under *Shari'ah* law?

Under *Shari'ah*, like conventional English law, ownership of an asset can and does come under different classifications. These classifications are important as they define the distinct capacities in which an asset is transferred and then owned under this law. Ownership can consist of the following:

Table11: Classification of Ownership Under *Shari'ah*

Classifications of Ownership under *Shari'ah*[37] (*al-mīlkīyyah*[38])			
1	Private[39]	*Sharikat al-mīlk* Co-ownership	Communal or Public[40]
2	*mīlkīyyah al-kāmilah or mīlkīyyah al-tammah* Complete Ownership. Owner has all rights and control over the entire physical asset	*mīlkīyyah al-nāqisah* Incomplete Ownership. Such as beneficial ownership (i.e., leases and permissions)	
3	*'ayan*[41] Legal title to an asset	*manfa'ah*[42] Usufruct of an asset	
4	*mīlkīyyah al-raqabah* Proprietary rights of ownership of the physical assets	*mīlkīyyah al-intifa'* Ownership right from the usufruct of the physical benefits of an asset	*mīlkīyyah al-yad* Possession

Ownership of the assets, either partial or full, is required in all forms of *Shari'ah* compliant structures. The sale of an asset which one does not own is strictly prohibited. This explains for example *Shari'ah* disapproval of short sales.

For *Sukuk*, it is important to understand whether the ownership is a form of physical ownership or beneficial ownership.

In 2008, Sheikh Taqi Usmani, the influential scholar in this field, stated that "the assets in the *Sukuk* may be shares of companies that do not confer true ownership, but which merely offer *Sukuk* of companies that do not confer true ownership"43.

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[37] This classification is not meant to be comprehensive of all *Shari'ah* forms of ownership, but rather a quick summary of the main forms.
[38] Article 125 of the *Majallah el-Ahkam-Adliya* states that '*Mulk* is a thing of which man has become the owner, whether it be the physical things themselves ('*Ayan*), or whether it be the use (*Manafi*)'.
[39] Under *Shari'ah* law, ultimate ownership of assets lies with the Creator, not simply with the state.
[40] *Waqf* is also another form of public ownership, specifically in the form of an Islamic trust. For an explanation of the differences between a waqf and a modern financial trust, see Hossein Esmaeili. "*The Relationship between the Waqf Institution in Islamic Law and the Rule of Law in the Middle East*". Islamic Business Researches Center.
[41] Article 159 of the *Mejelle* states '*Ayn* is a thing which is fixed and individually perceptible.
[42] Article 125 of the *Mejelle* refers to (*Manafi*), being the ownership of the use of an asset, deriving benefit from the asset. The application of the word '*menafi*' is equivalent to the financial concept of 'usufruct' or the concept of 'beneficial ownership'.
[43] Taqi Usmani. '*Sukuk and their Contemporary Applications'*

Furthermore, many others have voiced their opinion that an asset-backed structure is more preferable from a *Shari'ah* perspective, as that transfers clear legal ownership, their reasoning being that an asset-backed *Sukuk* is deemed closer to the intended *maqasid* (objectives or spirit) of *Shari'ah* law as compared with asset-based *Sukuk*.

4.3.5 Asset-backed and Asset-based *Sukuk*

Given this relative unease with *maqasid al-shari'ah*, why do obligors go for such asset-based structures as opposed to the more *Shari'ah* preferred asset-backed structures? Simply, obligors can access unsecured funding. They do not have to part with their asset to raise the capital needed for their business or ventures. Furthermore, there are few or no costly disclosure obligations on the assets. Investors have sought to be treated simply like that of conventional bondholders. They do not want to take on additional risk, only the credit risk. Any additional risk also affects the pricing of the *Sukuk*.

On each periodic distribution date, the obligor pays the *Sukuk* holders money from any of its operations to meet the distribution liabilities. Thus, distributions are not simply restricted to the cash flows generated by the assets themselves. If there is a shortfall from the cash flow of the assets, the obligor provides a liquidity facility to meet the distribution payments. At maturity, the obligor pays back the investors' capital like a conventional bond.

In asset backed *Sukuk* transactions, however, assets are sold from the obligor to the issuer SPV in the form of a 'True Sale', using securitization parlance. A true sale transfer leads to the removal of the asset from the originator's balance sheet and accounting requirements. The originator no longer becomes the legal owner to those transferred assets. Importantly, the originator's creditors cannot claim against those sold assets[44]. Legal title is wholly transferred to the *Sukuk* holders.

For banks, transferring ownership frees up their capital adequacy requirements against those originally held assets. *Sukuk* holders on the other hand gain the market risk as well as the credit risk of the transferred assets.

Most importantly, ownership under an asset-based *Sukuk* is normally that of a form of beneficial ownership, with no rights of title to the assets.

Asset-backed *Sukuk* are therefore structured similar to conventional securitizations. A true sale of the assets to a bankruptcy remote entity underlies most securitizations: the transfer of the assets off the balance sheet of the originator to avoid claw-back. Investors become the owners of the assets, which remain protected from the originator.

Based on a recent study by ISRA, only 11 assets out of a total of 560 *Sukuk* were issued as asset-backed *Sukuk*. This result indicates the strong preference for asset-based structures, despite the preferences in *Shari'ah* law for the former.

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[44] There may be a claw back claim by the creditors if the transfer was deemed to be made under bankruptcy laws for fraudulent transfers or preferential transfers.

However, the main stumbling block for asset-backed *Sukuk* is the underdeveloped regulatory framework for securitization. GCC states for example have restrictions on the foreign ownership of certain assets, like real estate. This poses problems for offshore SPVs attempting an *ijarah wa iqtina* (sale and lease back) of real estate assets. The requirements for a true sale are not clear in many of these states.

One alternative to these two forms which has been suggested is a dual recourse structure. Similar to how a covered bond works, this alternative uses a combination of recourse both to the obligor and to the pool of designated *Sukuk* assets upon a *Sukuk* default[45].

Table 12: Asset-backed and Asset-based *Sukuk*

Sukuk Type[46]	Benefits	Negatives
Asset-Backed	▪ Asset owned by *Sukuk* holders ▪ *Sukuk* holders can enjoy a share in the upside of any revenues and realizations from the underlying assets ▪ Recourse to the *Sukuk* assets ▪ Preferential position of *Sukuk* holders over the assets compared to unsecured creditors ▪ *Sukuk* credit rating based on the performance of those pool of assets, not the corporate credit-worthiness of the originator ▪ Assets ring-fenced from originator's financial plights; no claw-back of the assets ▪ For banks, capital adequacy requirements reduced following the true sale of the assets ▪ Preferred over asset-based from a *Shari'ah* perspective	▪ Can only look to asset value for realizations upon returning the capital or upon default ▪ No recourse to the originator for unpaid investments if assets insufficient to meet realizations on sale ▪ *Sukuk* holders take on asset and market risks as well as credit risk ▪ *Sukuk* holders will bear any losses due to impairment of the asset values ▪ Detailed legal and financial due diligence required on the asset transfer from obligor ▪ Issuers must be ready to part with their assets ▪ Requires compliance with true sale, bankruptcy remoteness and enforceability securitization rules ▪ Asset transfer may require lengthy registration and security perfection requirements, like the sale of land ▪ Regulatory framework for true sales not permitted in all jurisdictions ▪ Insolvency and bankruptcy laws not developed in many jurisdictions
Asset-Based	▪ *Sukuk* holders have recourse to the originator via a purchase undertaking or to the issuer via a guarantee, not restricted to the asset value ▪ Take on only credit risk of obligor ▪ Obligor can raise unsecured funding without tying up assets ▪ No legal or financial due diligence required on asset transfer ▪ Assets can remain on the books of the obligor ▪ Purchase undertaking takes away risk of loss to *Sukuk* holders ▪ *Sukuk* credit rating based on the corporate credit of the originator, not the performance of the underlying pool of assets ▪ *Sukuk* holders effectively enjoy guaranteed capital and periodic returns, depending on credit risk of obligor/originator ▪ True market value of the underlying assets is irrelevant for *Sukuk* holders	▪ *Sukuk* holders are simply unsecured (unless there is a security interest in the assets) ▪ *Sukuk* holders do not have direct recourse to the underlying assets ▪ Even if the assets are secured, *Sukuk* holders can not benefit from any upside in the sale of the assets once liabilities paid off ▪ Restrictions on the right of disposal of the assets, prompt *Shari'ah* concerns ▪ Purchase Undertaking effectively turns *Sukuk* into a pure debt instrument ▪ Purchase Undertaking ranks parri passu with other unsecured creditors on the originator's unsecured obligations ▪ *Sukuk* holders are no different from any unsecured creditors of the originator ▪ Any security granted by obligor to the issuer not necessarily related to the underlying assets

[45] Debashis Dey and Gregory Man. *'Sukuk – A Secured Investment?'* in Islamic Finance News, Vol 7, Issue 29, 21 July 2010, pp. 25-26.
[46] Extrapolated from a number of sources.

4.3.6 Transfer Restrictions

For most *Sukuk*, regulatory, tax and jurisdiction requirements affect the transfer of the underlying asset. Credit rating decisions affect the choice in which assets are retained or transferred.

Some jurisdictions do not recognize 'true sales', as in true sales of the assets from the originator to the issuer, as within securitization parlance.

Others restrict foreign ownership of assets. *Sukuk* certificate holders are usually a mix of foreign as well as local investors. Usually for tax purposes, the issuer is a foreign established SPV entity.

In the Gulf, registration requirements for ownership transfer are cumbersome and the restrictions on foreign ownership, especially of land, make true asset sales in *Sukuk* difficult. For some jurisdictions, title transfer of an asset is not deemed complete until the transfer is registered, which in some jurisdictions can take lengthy periods of time[47]. For others, tax rules make an asset sale transfer economically prohibitive.

When a transfer of ownership takes place, one does have to question whether all the liabilities, risks and obligations are also transferred along with its title or beneficial ownership. To evidence that, most practitioners and scholars look to what rights have been transferred, and look to what has been officially registered in the transfer.

Exceptions have been made whereby the sale transfer of the asset in a particular jurisdiction has been particularly financially onerous. In this situation, legal title remained with the seller so long as an agreement was entered into providing the buyer with a guarantee of all the ownership liabilities and risks, as if the buyer were the true owner[48].

So why did this transition occur. Again, pressure on practitioners from investors seeking returns and levels of risk familiar in the conventional markets has played a significant role. Also, pressures to reduce margins to compete with global bond market pricing, the fixed returns sought by investors in conventional debt, the comfort with the risk factors associated with conventional structures, early leniency to controversial features as agreed by the scholars as well as market influences have all shaped many modern *Sukuk* to adopt more of a resemblance to conventional debt instruments rather than to the more idealistic equity like features espoused by its proponents.

Sukuk, to be tradable, should contain the ownership of an underlying asset. Ownership is curtailed to such an extent in some instruments that cause the *Sukuk* to be classified as unsecured debt. Had the owner real ownership rights in the *Ijarah* assets, they would in effect have the rights and obligations to do transact the asset to third parties in the event of default as well as at the end of the lease, including retention of the asset rather sale of it (as in an *ijarah wa iqtina*).

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[47] Michael Saleh Gassner. *"Revisiting Islamic Bonds: Are 85% of Sukuk Haram?"* www.islamica-me.com. April 2008 http://www.failaka.com/downloads/Gassner_RevisitingIslamicBonds_Apr08.pdf

[48] See Dr. Mohammad Akram Laldin, "*The Sukuk Controversies*," International *Shari'ah* Research Academy for Islamic Finance, Malaysia. Jul/Aug 2008 edition.

The legal entity between the investor and the obligor or originator is an orphan SPV, owned by a trust for charitable purposes. Though created to protect the interests of the *Sukuk* holders, in reality, this entity is created and overseen by the obligor or originator. Therefore, it is unclear whether it is truly independent. One possible solution as proposed by Dr. Armen V. Papazian is the creation of a Central Islamic Trustee, to act as independent third party trustee in the interests of the *Sukuk* holders for all standardized *Sukuk*[49].

4.3.7 The Role of Purchase Undertakings and Guarantees on Ownership

Most of the issued asset-based *Sukuk* had a form of guaranteed capital protection, which also sat uneasily with *Shari'ah* law. Guaranteeing the return of the principal to the *Sukuk* holders negates the profit/loss element of *Mudarabah* and *Musharakah* compliant structures.

The use of a purchase undertaking in a *Sukuk* can also create a form of indebtedness on the obligor. The obligor incurs the indebtedness when it fails to purchase the *Sukuk* assets or the *Sukuk* holders' interests in the venture at maturity or at a predefined early termination point.

Shari'ah does not allow trading of debt or liabilities at market value especially in *Sukuk* based on *Murabaha*, *Istisna'a* or *Salam*.

This method of capital protection has been that the issuer, as *mudarib*, *sharik* or agent, issues an undertaking to achieve the face value for the *Sukuk* issue. This practice is declared impermissible. A number of scholars allowed it previously in two cases:

Sheikh Taqi Usmani noted his concerns on the use of purchase undertakings in *Mudaraba*, *Musharakah* and *Wakalah* based *Sukuk*. From a *Shari'ah* standpoint, guaranteed returns undermine the purpose of the 'profit and loss' nature of these named structures by guaranteeing the expected return. His comments also prompted a general revisit of the relationship between assets that were presumed to back the *Sukuk* certificates and those structures whereby the assets were merely beneficial owned by the *Sukuk* holders.

An undertaking to purchase *Sukuk* at maturity or on default at book value, in effect guarantees the price of the asset, negating any possibility of loss. However, does this really amount to a guarantee of the capital or rather a document simply enabling the *Sukuk* holders to dispose of the assets at maturity. Some have made a distinction between a "Purchase Undertaking" and a "Guarantee", whereby the later is a full, unconditional guarantee and indemnification in all instances, whereas for the former, there is still an element of discretion on the promissor, such as in instances of total loss of the assets, or even to sign the sale (though prompting the promissee to sue for damages).

1) When the purchase undertaking was meant for the underlying assets and not the units of the *Sukuk* being a sort of joint ownership and not a guarantee for monetary contribution.

[49] See Dr. Armeen V. Papazian, "Central Islamic Trustee: Meeting *Sukuk* Market Challenges," Keipr, 2010.

2) When the assets would be destroyed, the purchase undertaking would not take place and could hence be differentiated from a general guarantee of the principal. The majority of the AAOIFI scholars opined that obviously, the purchase undertaking had the character of a restricted guarantee of capital and is therefore impermissible.

4.3.8 Assets and the Real Economy

Core to the teachings of Islamic finance is the emphasis on the link between finance and the real economy, promoting profit and loss structures, and the absence of interest bearing debt[50]. Yet, the focus of most issued *Sukuk* is on ensuring the success of their marketability, namely, that the *Sukuk* investors receive a product that performs competitively in line with conventional bonds, with little or no risk other than that of credit risk, while at the same time, is *Shari'ah* compliant[51]. Such investor requirements have made way to the discussion between asset based and asset backed *Sukuk*. Some have felt that the distinction may be indicative of the widening gap between the ideals championed by Islamic finance and the economic realities of the products being offered.

What is clear is that perhaps investors now need to be sure and enquire upon the purchase of a *Sukuk* investment: Not only what type of *Sukuk* structure they hold, but what type of asset ownership structure do they have? This way, it becomes less of a surprise as to what rights they hold upon a default scenario.

[50] For example, see Umra Chapra. '*The Global Financial Crisis: Can Islamic Finance Help Minimize the Severity and Frequency of such a Crisis in the Future?*' IRTI, a paper prepared for presentation at the Forum on the Global Financial Crisis to be held at the Islamic Development Bank on 25 October 2008. See http://www.isdbforum.org/presentationPapers/5-M_Umer_Chapra.pdf
[51] For instance, see Nathif Jama Adam, '*Sukuk: A Pancea for Convergence and Capital Market Development in the OIC Countries*' King Abdul Aziz University, Islamic Economics Research Centre. Vol 2. pp. 371 – 403.

4.4 General Electric Capital *Sukuk* (Bermuda)

4.4.1 Introduction

The GE Capital *Sukuk* (Bermuda) (offered under Regulation S and structured using a Bermuda limited liability exempted company), *Sukuk* offerings in the US capital markets and US securities offering exemption rules have been selected as case studies in this chapter. The GE Capital *Sukuk* represents a significant development for the global *Sukuk* market for the following reasons:

- First *Sukuk* issued by a US corporation ranking in the top 10 Fortune 500 companies
- First *Sukuk* to be based on ownership interests in aircraft assets and rights under the aircraft assets leases

Table 13: GE Capital *Sukuk* Limited - Highlights

Issuer	GE Capital *Sukuk* Ltd, a limited liability exempted company incorporated under the laws of Bermuda
Obligor/Servicing Agent	*Sukuk* Aviation Leasing Inc.
Guarantor	General Electric Capital Corporation
Rating (Moody's/S&P)	Aa2 / AA+
Format	Regulation S only
Pricing Date	November 19, 2009
Tenor	5 year (scheduled termination November 26, 2014)
Issue Size	USD 500 million
Coupon	3.875%
Global Coordinators	Citi /Goldman Sachs
Joint Bookrunners	Liquidity House / National Bank of Abu Dhabi
Joint Lead Manager	Bank Islam Brunei Darussalam
Co-Manager	Standard Chartered Bank
Type of *Sukuk*	*Al Ijarah*
Governing law	English law and New York law

Source: GE Capital *Sukuk* Limited prospectus

4.4.2 GE Capital *Sukuk* Limited Description

The *Sukuk* assets primarily consist of ownership interests in aircraft assets and rights under the lease agreements entered into regarding the aircraft assets. *Sukuk* Aviation Leasing Inc. (SAL), a fully owned subsidiary of General Electric Capital Corp. (GECC) sold its beneficial interests in aircraft assets to the issuer, acts as the servicing agent of the transaction, and undertakes to purchase the underlying assets at maturity. The obligations of SAL to GE Capital *Sukuk* Ltd. are unconditionally and irrevocably guaranteed by GECC.

The issuer used a maximum of 90% of the *Sukuk* proceeds to enter a purchase agreement with SAL to purchase beneficial interests in a pool of aircraft assets originated and owned by various subsidiaries of GECC and managed by GE Capital Aviation Services (GECAS), a wholly owned subsidiary of GECC. The issuer holds beneficial interests in the pool of aircraft assets on behalf of the *Sukuk* holders. The issuer paid the remaining proceeds to SAL, which holds them in a funded reserve account (FRA) through deferred payment commodity *Murabaha* transactions.

As the servicing agent, SAL collects the rent payments on the leased assets, which form the basis for the periodic distribution payments of the trust certificates. SAL retains any excess cash flow above the periodic distribution amount in an unfunded reserve account (URA) for the benefit of the issuer. The URA is used to pay an advance incentive fee to SAL.

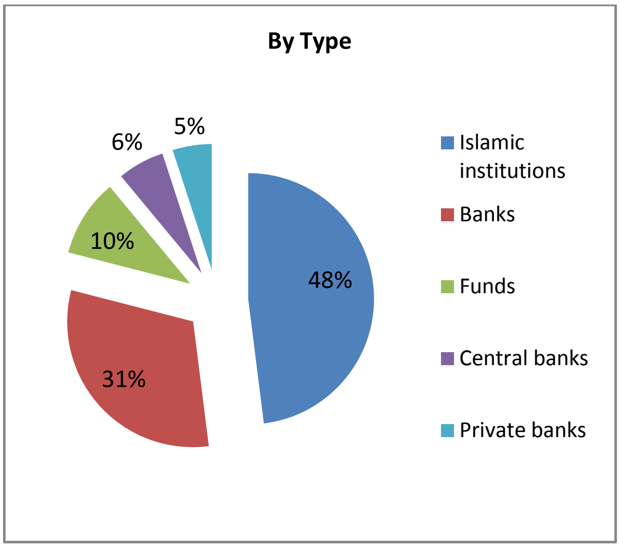
In the event of the total loss or destruction of one or more, but not all, of the aircraft assets forming the underlying pool of assets, a replacement aircraft account (RAA) would be credited by the insurance proceeds collected by SAL, on behalf of the issuer in its capacity as servicing agent.

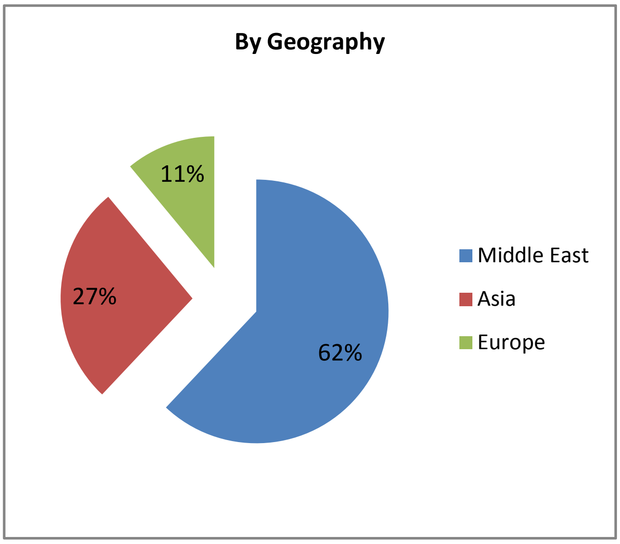
In addition, SAL, in its capacity as servicing agent, would pay any difference if the insured amount is less than the value ascribed to the aircraft assets representing outstanding *Sukuk*.

If the rent payments fall short of the periodic distribution amount, the transaction benefits from three layers of enhancement,

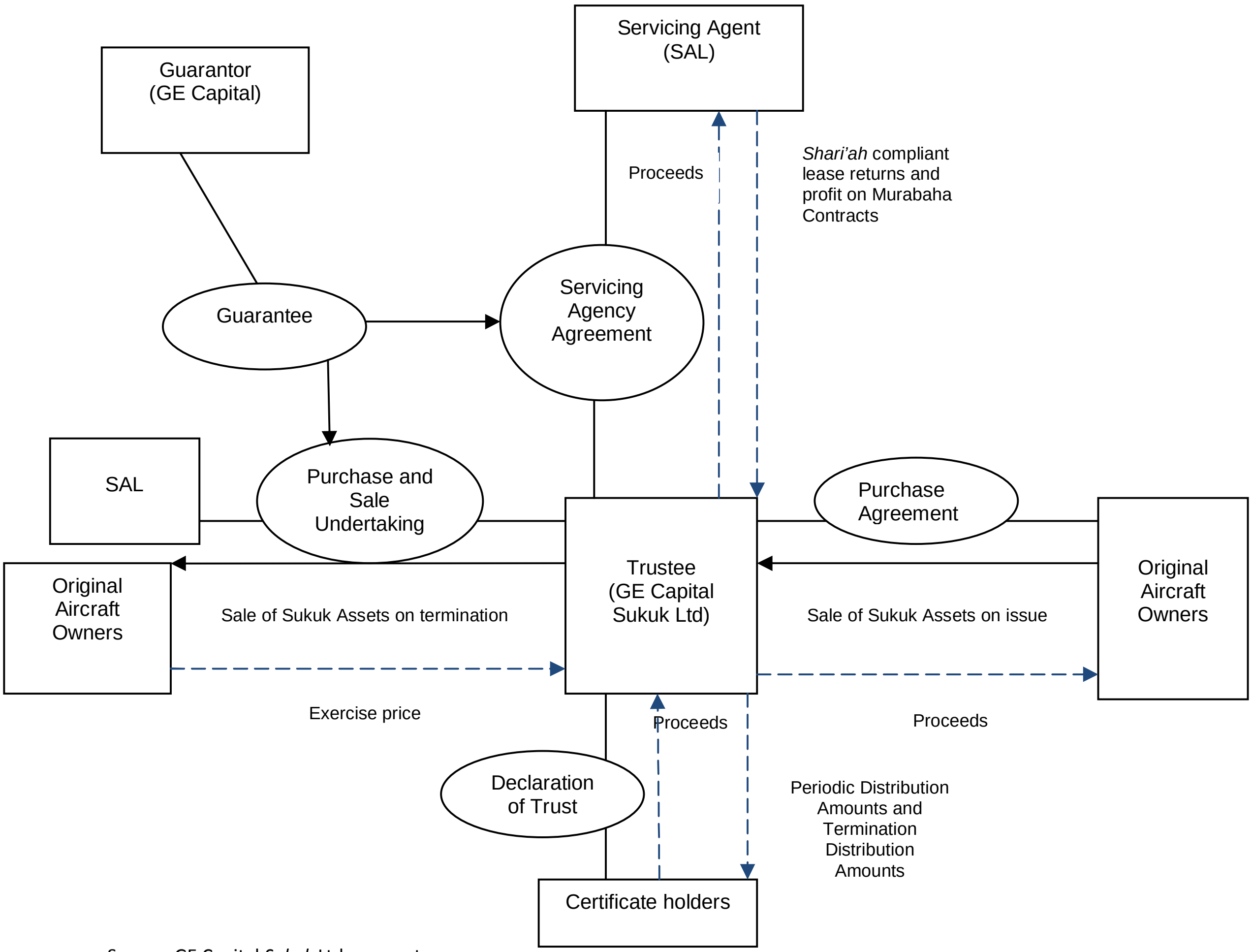
- SAL will credit back the advance incentive fee to the URA and draw on it;
- If funds available in the URA are insufficient, SAL will draw on the FRA;
- In the event of inadequate funds in these two accounts, SAL can choose to extend an interest free loan to the issuer.

Chart 8: GE Capital *Sukuk* Limited - Investor distribution





4.4.3 Structure diagram and cash flows – GE Capital *Sukuk* Limited



Source: GE Capital *Sukuk* Ltd prospectus

4.4.4 Other fundamental aspects of the GE Capital *Sukuk*

In this section of the chapter we analyse other fundamental aspects of the GE Capital *Sukuk*:

- Choice of domicile - Bermuda
- Attractiveness of *Sukuk* offerings to US capital markets
- US securities offering rules and exemptions

4.4.4.1 Choice of Domicile - Bermuda

Bermuda vehicles are suitable for financing structures for the acquisition of global portfolios of assets, for example the GE Capital *Sukuk*, structured as an *Ijarah Sukuk* was issued to finance a global portfolio of aircraft leases. Other fundamental reasons for structuring *Sukuk* in Bermuda are as follows:

Table 14: Choice of Domicile - Bermuda

Government	▪ Political and economic stability. ▪ Bermuda's government is avowedly business-friendly, understanding the importance of a well regulated international business sector. ▪ The Bermuda government welcomes Islamic finance and promotes the highest standard of integrity and honesty in the economy. ▪ Bermuda is on the "white list" of the Organization of Economic Cooperation and Development ('OECD'). ▪ Bermuda has executed over 20 Tax Information Exchange Agreements.
Laws and regulations	▪ Bermuda law is based on common law principles with English common law having a persuasive role. ▪ Transparent and very well-regulated jurisdiction. Bermuda's financial sector regulator, the Bermuda Monetary Authority ('BMA'), adopts a 'principle-based' regulatory regime. ▪ Bermuda has modern corporate and trust legislations which are attractive for *Sukuk* structures. ▪ Bermuda companies may adopt a secondary name in non-roman script such as Arabic with the approval of the Registrar of Companies. ▪ Bermuda's private trust company legislation is attractive for Islamic finance structures.
Cross-border movement of funds	▪ No exchange control for non-resident undertakings. ▪ No restriction on repatriation of funds.
Taxes	▪ Bermuda is a tax neutral jurisdiction. ▪ Extension of the Tax Exempt certificate until 2035. ▪ There is no stamp duty on any instrument affecting or relating to international businesses in Bermuda.
Double tax agreement	▪ Double tax agreement signed with the Kingdom of Bahrain provides structuring opportunities for investors accessing the GCC region.
Listing of *Sukuk*	▪ The Bermuda Stock Exchange ('BSX') adopts a non-discriminatory, religion neutral regime for *Sukuk* listing under its Specialized Debt listing rules. ▪ Bermuda offers administrative and cost efficiencies in that issuers may structure and list *Sukuk* in a single jurisdiction.
Infrastructure	▪ High concentration of intellectual capital. ▪ Modern infrastructure and amenities.
Accessibility	▪ Bermuda's situation geographically (with easy access to and from New York and London)

Table: Bermuda attributes

4.4.4.2 Attractiveness of *Sukuk* offerings to US capital markets

The GE Capital *Sukuk* exemplifies two value propositions for capital market players using Bermuda as a platform for cross-border *Sukuk* transactions originating from and/or accessing US capital markets.

An independent study carried out in May 2010 by Albright Stonebridge Group ('US – Bermuda Economic Relations: Economic Impact Study – 2010') confirmed that Bermuda's international business environment provides competitive advantages for US businesses striving to compete globally. This report can be found in its entirety on the Business Bermuda website at www.businessbermuda.org

First value proposition: US access to global capital markets

The first value proposition is for US-based corporations seeking alternative ways of raising capital globally (mainly from GCC and South East Asia) for debt refinancing and /or financing global portfolio of assets.

For corporations such as GE, a *Sukuk* issue can diversify their funding base and boost their profile in the increasingly important Middle East and South East Asia regions.

It is also attractive to investors such as sovereign wealth funds, institutions and private wealth investors from GCC and South East Asia regions seeking to diversify their global Islamic investment portfolios and access the US markets by investing in US *Sukuk* issuances.

According to a Financial Times report, there has been an influx of money into the US capital markets, the biggest in the world, from Middle Eastern investment groups, particularly in the past decade. Gulf-based institutions have been making large investments in US real estate and private equity. Banks and lawyers in the US have had to come up with innovative structures which are suitable for Islamic investments. These deal flows are less visible, though large, because they are done privately.

Second value proposition: Global access to US capital markets

The second value proposition is for *Sukuk* issuers from GCC and South East Asia seeking to raise capital from the US capital markets to finance growing infrastructure projects and other ventures. For instance, infrastructure financing needs remain significant within the GCC. According to The Middle East Economic Digest about $2 trillion of planned and anticipated project and infrastructure financings will be undertaken in the region by 2020, and a significant number of these projects will be financed by *Sukuk* issuances.

This is appealing to US investors seeking geographic and product diversification to invest in GCC and South East Asia *Sukuk* issuances either directly or via *Sukuk* funds:

- Provides access to alternative asset class in emerging markets.
- Attractive to US ethical investors seeking access to socially-responsible investments in emerging markets.
- Attractive to US investors seeking global Islamic investments diversification.

4.4.4.3 US securities offering rules and exemptions

All securities offerings in the global marketplace must be structured with at least one eye on the US securities laws. In its Regulation S, the US Securities and Exchange Commission ('SEC') stated that any offering made "outside the United States" need not be SEC-registered. Assuming, therefore, that the offering is an "offshore transaction", that there are no "directed selling efforts" in the US, and that there is no "substantial market interest" in the US for the securities, an offering can proceed with merely a few disclaimers in the offering document. However, to the extent that *Sukuk* seek to attract US investors, or if a US corporation is involved, close attention must be paid to ensuring that the transaction falls within the scope of at least one exemption from the registration requirements of Section 5 of the US Securities Act of 1933.

The two main exemptions relevant for US *Sukuk* transactions are provided under Rule 144A and Regulation S. The GE Capital *Sukuk* was offered under Regulation S, and a number of recent *Sukuk* have been structured to meet the requirements for "resales" to US investors under Rule 144A. These examples could signal the beginning of a trend to attract US investors and issuers to the emerging global *Sukuk* market.

When it drafted Regulation S, the SEC did not define the concept of “outside the United States”, but it did establish two carefully defined “safe harbors”. The first (Rule 903) applies to sales by issuers, distributors and their affiliates; the second (Rule 904) applies to resales by other investors. One fundamental requirement is that “US Persons” must not be able to buy securities issued by US companies under Regulation S during a “distribution compliance period,” which is one year in the case of equities. The Mezzanine Market operated by the Bermuda Stock Exchange is one of few, if not the only market in the world to have put in place a fully electronic method of assuring compliance with this requirement, including electronic settlement of all trades in the normal course.

Rule 144A, by contrast, was intended to permit sales of unregistered securities to US investors, but it is limited to large institutions, defined as “Qualified Institutional Buyers” or “QIBs”. Generally, a QIB is an institution that has at least $100 million in investable assets. Rule 144A has become the principal exemption on which non-US companies rely when accessing US capital markets. In fact, many transactions are structured with two “tranches”, one addressed to US QIBs under Rule 144A, the other targeted to non-US investors under Regulation S. Because neither tranche is registered with the SEC, all the offered securities are “restricted” and can be traded only under Regulation S or Rule 144A. Generally speaking, after one year, the securities become “unrestricted” or “seasoned” and can be traded freely.

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4.5 MARC'S Rating Approach To *Sukuk*

By: Malaysian Rating Corporation Berhad[52]

4.5.1 Introduction

Structured based on *Shari'ah* compliant contract(s) to provide *Sukuk* holders with an undivided beneficial ownership in certain underlying assets, *Sukuk* can possess the characteristics of debt or equity or both. *Sukuk* are primarily issued by governments, corporates and special purpose vehicles to raise funding for government budgets, projects and contracts and to finance working capital and capital investments. Returns to investors arise from *Sukuk* holders' entitlement to share in the revenues generated by the *Sukuk* assets and proceeds from the monetisation of the *Sukuk* assets. *Sukuk* may be viewed as investment certificates evidencing ownership of a particular pool of underlying assets. The ownership claim sets *Sukuk* apart from conventional bonds and other Islamic capital market instruments.

Depending on the transaction structure and Islamic financing, a *Sukuk* issuance could exhibit debt and/or equity characteristics as well as elements of securitisation/asset-backed securities (ABS). The principal methodologies employed by MARC in rating a particular *Sukuk* offering may reflect the analytical frameworks used in rating conventional corporate debt, project finance, structured finance, ABS or a combination of these.

The *Sukuk* offerings in Malaysia to date have all been structured to offer a fixed return not unlike that of a conventional bond. MARC's assigned ratings on fixed income *Sukuk* essentially reflect MARC's opinion on the likelihood of full and timely payment of obligations with respect to the bonds issued. The assigned rating(s) are differentiated from ratings on conventional debt offerings and other fixed-income Islamic capital market instruments. MARC adds 'IS' as a subscript to the eight rating category long-term scale ranging from 'AAA' to 'D' and the 'MARC-1' to 'MARC-D' short-term rating scale to differentiate its *Sukuk* ratings. As in the case of MARC's ratings on conventional debt securities, MARC's ratings employ the concept of probability of default as opposed to loss-given default.

From an analytical standpoint, MARC's rating of *Sukuk* involve (i) evaluating the underlying structure as well as assessing key transaction parties; (ii) analysing the income or cash flow generation ability of the underlying asset, project or business activity financed; (iii) the strength of available credit enhancement, if any; (iv) assessing the adequacy and robustness of structural protection; and (v) the impact of key legal issues on the *Sukuk* structure.

[52] Malaysian Rating Corporation Berhad (MARC) is a domestic credit rating agency incorporated in October 1995. MARC commenced full operations in June 1996 and has successfully rated Islamic-based securities worth RM173.73 billion or approximately USD56 billion as of end-October 2010.

4.5.2 A summary of *Sukuk* structures commonly found in MARC's rating universe

Table 15: *Sukuk* structures commonly found in MARC's rating universe

Type of *Sukuk*	Description	Issuer	Subscriber	Requirements/ Mobilised Funds	Certificate-holders	Key risk(s)
Ijarah	Usufruct type of contract based on the Aqd (contract); a lessor (owner) leases out an asset or equipment to the lessee at an agreed rental fee and pre-determined lease period, through sale-and-leaseback arrangement	SPV or Lessor	Lessee	Periodic rental payments matched to the periodic distributions under the *Sukuk*	Entitled to undivided beneficial ownership of the asset or equipment as per contract	Default on rental payment. Usually greater risk on fixed rate as opposed to floating rate
Istisna'a	A contract to manufacture a specific product at a determined price and deliver on a fixed date	Manufacturer or SPV	Buyer	Manufacturing costs	Entitled to the manufactured goods or the sale price of the goods	Default on failure to deliver product as specified and on schedule
Murabahah	A contract involving sale and purchase transactions for the financing of an asset, subject to the cost and profit margin made known and agreed upon by all parties involved	*Murabaha* asset/ commodity owner or SPV	Buyer	Purchasing cost of the asset or commodity. Settlement for the purchase can either be on a deferred lump sum basis or installment basis as specified in the agreement	Entitled to ownership of the asset or commodity	Credit or counterparty risk*
Musharakah	A joint venture in which partners share the profit and loss of the enterprise	Inviter of the partnership or SPV	Invited partners	Share contribution of the partners	Entitled to the assets of the partnership and profit, if any, according to the agreed proportion	Business risk and credit or counterparty risk*
Mudarabah	A partnership where one partner provides the capital to the *Mudarib* to manage a project or investment	*Mudarib* or SPV	Capital providers	*Mudarabah* capital	Entitled to the assets of the operations and profit share as per agreement. Bearer of any losses	Business risk and credit or counterparty risk*

Note * - risk of asset not being recoverable due to a default or delay in settlement

Some notable domestic (MARC-rated) *Sukuk* issuances between mid-2009 until November 2010 are listed below:

Table 16: Domestic (MARC-rated) *Sukuk* issuances (mid 2009 – Nov 2010)

Date	Obligor	Type of Issued *Sukuk*	Sector	Amount (RM)	Tenure (years)	Rating
Nov 2010	TTM *Sukuk* Bhd	*Murabaha*	Utilities-gas	600 million	5 to 15	AAA
Oct 2010	Konsortium Lebuhraya Utara-Timur KL Sdn Bhd	*Musharakah*	Toll road	820 million	8 to 19.5	AA-
Jun 2010	Maju Expressway Sdn Bhd	*Musharakah*	Toll road	550 million	5 to 15	AA-
Mar 2010	Haluan Gigih Sdn Bhd	*Musharakah*	Toll road	240 million	6 to 10	AA-
Nov 2009	Sime Darby Berhad	*Musharakah*	Conglomerate	2 billion	3 to 7	AAA
Sep 2009	MISC Berhad	*Murabaha*	Transportation	1 billion	1 to 3	AAA
Aug 2009	Makro Utama Sdn Bhd	*Istisna'a*	Construction	100 million	2 to 4	A+
Jul 2009	MISC Berhad	*Murabaha*	Transportation	1 billion	1 to 3	AAA
Jul 2009	TSH *Sukuk* Ijarah Sdn Bhd	*Ijarah*	Plantation	up to 300 million	Up to 15	AA-

4.5.3 Analysis of the basic structure of the *Sukuk*

MARC's evaluation of a *Sukuk* structure aims to determine whether an issue is structured as an asset-backed transaction (in which case it would reflect the performance of the securitised assets) or to achieve a flow-through of the rating of the originator/borrower or third-party obligor(s) or guarantor to the *Sukuk*. Asset-based *Sukuk* can be distinguished from asset-backed *Sukuk* on the basis of ownership of the assets and the extent of recourse to the originator.

The structure of the *Sukuk* will have significant impact on the risk profile of the *Sukuk* and determines the rating methodology to be used, i.e. corporate debt, project finance, ABS, structured finance or a combination of these.

4.5.4 Assessment of key transaction parties

MARC considers the roles of key participants in the transaction: originator/borrower, lessee or obligor, guarantor, agent (*wakeel*), contractor, servicer/back-up servicer as well as the credit quality of each participant and ability to perform their roles, and the corresponding implications of such for the risk profile of the *Sukuk*. A shadow rating may be performed on key participants where MARC believes their credit quality to be an important rating driver.

4.5.5 Asset and cash flow analysis

This analysis is the most important driver of the ratings assigned to 'asset-backed' and non recourse or limited recourse project finance *Sukuk*. Some *Sukuk* are structured with external liquidity support and/or reserve accounts to mitigate interim deficiencies in returns from the assets.

In most of MARC's existing 'asset-based' *Sukuk* transactions, potential deficiencies and/or liquidity support have been addressed by way of direct and irrevocable obligation of the originator. In instances where a higher rated third party provides liquidity support or credit enhancement, the rating may be notched up from the standalone rating. Additionally, the valuation of the asset forms an important part of MARC's review where redemption of *Sukuk* is to be partially or wholly derived from refinancing or disposal of the asset to third parties.

4.5.6 Assessment of credit enhancement and structural protections

MARC would assess the internal credit enhancements such as reserve accounts, payment waterfalls and collateral value in addition to external credit support which may be provided by the originator/borrower or third party guarantor.

4.5.7 Legal analysis

For asset-based or asset-backed issues involving transfer of ownership and recourse on the originator/borrower, MARC would review and sometimes seek legal opinion on, amongst others:

- whether perfection of legal interest in the underlying assets becomes a requirement;
- the insulation of the assets from insolvency in the context of securitisation, i.e. bankruptcy remote status; and
- impact of the originator/seller from the perspective of secured financing.

In *Sukuk* structures involving an SPV issuer, MARC will also consider the bankruptcy remote status of the SPV and the limitations on the business activities of the SPV.

4.5.8 *Sukuk* structures rated by MARC

The main contracts commonly used are rental-based contracts, various types of sale and purchase contracts and contracts based on profit-and-loss sharing (PLS) in venture-based partnerships. MARC takes cognisance of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) *Shari'ah* Board's advice to reduce participation in debt-related operations and to increase true partnerships based on PLS in order to achieve the *maqasid-al-Shari'ah*, or the objectives of the *Shari'ah*. As such, *Sukuk* structures which have been rated by MARC are mostly asset-based or venture-based partnerships.

4.5.8.1 *Sukuk Ijarah*

Ijarah involves usufruct type contracts - a lessor (owner) or the originator leases out an asset or equipment to the lessee at an agreed rental fee and pre-determined lease period. The ownership of the leased equipment remains with the lessor. This concept could be extended to involve a contract which begins with an *Ijarah* contract and at the end of the lease period, the lessee purchases the asset at an agreed price from the lessor by executing a purchase (*bai*) contract known as *Ijarah Thumma Bai* (lease to purchase).

Sukuk Ijarah structures rated by MARC predominantly involve sale-and-leaseback transactions. An issuer via a special purpose vehicle (SPV), usually a wholly-owned subsidiary of the originator or seller of the assets, funds the purchase of the assets by issuing *Sukuk* which represent beneficial ownership in the assets. These assets are leased back to the seller or entities owned or linked to the seller in exchange for periodic rental payments which are matched to the periodic distributions under the *Sukuk*. In order to retain priority over the assets, the seller usually issues a purchase undertaking to repurchase the SPV's interest in the assets on maturity or any interim date at a pre-determined price. Based on the terms of issuance, either at maturity or upon a dissolution event, the SPV sells the assets back to the seller and redeems the *Sukuk*.

Based on AAOIFI's ruling, the undertaking to purchase the assets at a pre-determined fixed price is acceptable for *Ijarah*-based structures but unacceptable for PLS-based structures such as *Musharakah* and *Mudarabah*. AAOIFI's ruling with regard to potential discrepancies between *Shari'ah*-compliance and the governing law on beneficial rights also seems to imply that the assets have to be "legally" transferred and must be off the balance sheet of the originator under the purchase agreement, such that the *Sukuk* holders become owners and thus have binding legal rights on the assets.

4.5.8.1.1 Asset-based *Sukuk Ijarah*

Typically, an SPV issuer is incorporated to facilitate the sale-and-leaseback of certain identified assets for the *Sukuk Ijarah* issuance, in which the seller/originator and the lessee are inter-linked. Under the terms of the issuance, the rental or periodic lease payments must be fulfilled by the lessee while potential shortfall in these payments would be met by the originator who belongs to the same group of companies.

Although the *Sukuk* holders hold undivided proportionate beneficial ownership of the assets, the *Ijarah* structure provides recourse to the originator through an undertaking to repurchase the underlying assets at a price representing the face value of the *Sukuk* at the respective maturity date or upon occurrence of a dissolution event or an event of default.

In most cases, the rating would usually mirror the credit rating of the lessee which mainly reflects its ability to meet the periodic lease payments, and to some extent the purchase and sale undertaking mechanism which can be exercised by the originator and the SPV under prescribed conditions.

4.5.8.1.2 Asset-backed *Sukuk Ijarah*

Where elements of securitisation are involved, an SPV is typically structured to be "bankruptcy remote". The SPV would issue *Sukuk* and the proceeds are used to acquire identified assets from the originator/seller. The SPV then enters into a long-term lease agreement which entails the lessee paying specified rentals. Periodic distributions or lease payments are satisfied through the cash flow generated by the acquired assets or sale of those assets to third parties prior to the *Sukuk* scheduled redemption and/or its final legal maturity.

MARC will apply the ABS or structured finance methodology on account of elements of securitisation which can be identified in the transaction, including achieving "true sale" with respect to the identified assets. Generally, when applying the ABS methodology, MARC would firstly estimate the net cash flow (NCF) generated by the securitised assets on a sustainable basis, based on actual income previously generated by the identified assets as well as other dependable data or supporting contracts or documents. Once the sustainable cash flow is determined, MARC would then apply a certain capitalisation rate to arrive at the discounted cash flow (DCF) valuation of those assets. The DCF valuation will then be used to size the higher rated or senior *Sukuk* tranches, based on applicable loan-to-value (LTV) limits. The amortizing structure of the *Sukuk*, meanwhile, would significantly reduce refinancing risk.

4.5.8.2 *Sukuk Musharakah/Mudarabah*

Musharakah or venture-based partnerships embody the principles of risk and reward sharing. Profits are distributed according to a pre-agreed profit-sharing ratio derived from the venture while losses are borne in proportion to capital contribution.

MARC has rated a number of *Sukuk Musharakah* transactions, the majority of which have involved SPV issuers. In Malaysia, the application of the *Musharakah* structure can be found in a wide range of *Sukuk* transactions, including receivables-backed issuances, project financing and contract financing.

The typical transaction configuration of *Sukuk Musharakah* in MARC's rating universe involves investors entering into one or a series of partnership agreements to finance the *Musharakah* venture. Most of the *Musharakah* ventures MARC has rated to date were set up to mobilize funds to undertake contracts to supply equipment and services in return for deferred payments and to finance the construction of assets in return for a fixed stream of lease payments or deferred payments contracted through lease and/or sublease agreements.

The analytical framework for *Sukuk Musharakah* requires an assessment of the business venture invested in or investments made by the *Musharakah* partners. The strength of returns/cash flows from the investments essentially drives the rating of the transaction. The assessment would focus on the project or contract awarder's financial capacity to meet contractual payment obligations. Where certainty of the payment stream that will service the *Sukuk* hinges on the contractor's (or originator) ability to deliver the project or works as to the agreed schedule and within budget, MARC would assess the financial and technical capacity of the contractor.

MARC has observed that in most *Musharakah* transactions, a *wakeel* or agent is appointed to carry out the venture. The capital contribution is channeled to the *wakeel* who issues *Sukuk* in return for the capital contributions. Where the issuer is an SPV and the transaction involves the financing the construction of assets, there could be a back-to-back arrangement with a corporate related to the SPV which is contracted for the construction activity. The *Sukuk* issuance proceeds are used to fund the construction, and upon completion, the assets will be leased to the corporate. Typically, the lease payments would match the return calculated on the *Sukuk* and the *Sukuk* principal redemption. Given the importance of the assets, the corporate would typically issue an irrevocable undertaking to purchase the *Sukuk* upon occurrence of a scheduled dissolution or dissolution event.

MARC has also rated a transaction in which the completed asset would be sold to the corporate in exchange for deferred payments. As *Musharakah* entails a partnership, an assessment of events that could result in the partnership being dissolved is essential. Based on its rated transactions, MARC has observed that these events are identified and appear similar to events of default in other conventional issues, including non-payment of *Sukuk*, covenant breaches not cured, winding-down of business and so on. Additionally, the *Musharakah* partners will at least have beneficial ownership in the identifiable or trust assets. Hence, MARC will have to perform an independent legal review which entails, among others, determining the enforceability and/or recovery against the security in the event of default.

4.5.8.3 *Sukuk Murabaha*

The structure of the *Murabaha* contract is relatively straightforward. The contract is between a buyer who is in need of financing to buy from a seller on credit, i.e. the future payment date has already been agreed with the seller. The deferred price can be higher than the spot price. The price deferred sale must state the declared mark-up or profit which can be integrated or incorporated into the selling price. MARC has observed that *Murabaha* financing is mostly preferred for working capital purposes given its short-to medium-term nature.

From a risk perspective, the risk-bearing period for the financier/investor is shorter than in other financing techniques. *Murabaha Sukuk* have become a very popular instrument with Islamic financial institutions given that the financier is able to recognise its profit as soon as the sale-purchase transaction is completed. *Murabaha Sukuk* suffer from one main drawback, they cannot be traded in the secondary market as the *Sukuk* represent a debt owing from the subsequent buyer of the commodity to the certificate holders.

Another kind of innovation which has become increasingly popular in the domestic *Sukuk* scene is the use of a commodity *murabaha* structure under which the SPV issuer of *Sukuk* receives future payments generated by a strong creditworthy entity or returns from an investment that utilised the *Sukuk* funds, and transfers them to the investors for the *Sukuk* redemption. To comply with the *Shari'ah*, the *Sukuk* holders have ownership of the underlying assets. MARC has rated a transaction wherein the proceeds from the *Sukuk* are utilised to fund an unsecured debtor and cash flow for repayments are generated from profitable investments in tangible and *Shari'ah*-compliant real economic activity.

4.5.8.4 *Sukuk Istisna'a*

Sukuk Istisna'a structures rated by MARC involve contracts designed to reflect funds advanced to pay for the cost of manufacturing specific products or supplies and/or labour costs, at a determined price and a fixed delivery date. Alternatively, for project financing, a parallel *Istisna'a* contract can be used whereby the financier enters into a contract with a subcontractor who builds the facility being financed (but the funds disbursements are directly controlled by the financier). In the case of concession-based project finance, an SPV issuer may issue a hybrid *Sukuk* using both *Istisna'a* and *Ijarah* contracts. For the construction phase, it may enter into a parallel *Istisna'a* contract with details of the specifications and timing of commissioning the project. The contract documents will specify how the contractor receives payments and the milestones/installments will also include the profit element over the construction duration. Upon completion and commissioning of the project, the SPV will have beneficial ownership of the asset through the *Ijarah* contract in which the periodic rental payments are matched to the periodic distributions under the *Sukuk*. Essentially, the *Sukuk* or certificates are issued based on the expected income streams and the redemption will be satisfied through these future payments over a specified period.

4.5.8.5 Other types of *Sukuk*

Within MARC's rating universe, however, there are some rated transactions which have been categorised as *Sukuk* although the underlying transactions do not consist of any Islamic contracts mentioned previously, particularly in relation to capital-raising activities for issuers that belong in the Islamic financial institution category.

4.5.9 Outlook and Conclusion

MARC expects more innovative Islamic investment products to be gradually introduced to cater for those in need of *Shari'ah*-approved investments, and continued internationalisation of *Shari'ah*-compliant securities in the global economy. However, as the complexities of the transactions grow in this evolving field, there is bound to be challenging practical and legal issues, including banking and securities law, bankruptcy law, tax and such. These include the terms of the *Sukuk* issuance which may specify certain "trigger", insolvency, default-connected events or covenants; the respective occurrence or breach of which would cause the transaction to be wound down and thus may present legal ramifications. Other challenges include *Shari'ah* harmonisation in the areas of product development, documentation, processes as well as legal opinion or issuance of *fatwa*.

Malaysian Rating Corporation Berhad (MARC) is a domestic credit rating agency incorporated in October 1995. MARC commenced full operations in June 1996 and has successfully rated Islamic-based securities worth RM173.73 billion or approximately USD56 billion as of end-October 2010.

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CHAPTER FIVE

SUKUK ISSUANCES IN INDONESIA: A COUNTRY FOCUS

5.1 Indonesian *Sukuk* Market

The Republic of Indonesia entered the *Sukuk* market with its first domestic issue in 2002, structured as a *Mudarabah* issued by PT Indosat Tbk, and since then has played an active role domestically issuing Rupiah-denominated *Sukuk* . Although Indonesia has been issuing *Sukuk*, all of the issuances by Indonesia have been domestic issues, with only one global *Sukuk* issued in 2009 for USD 650 Million (IDR 7030 billion) which was structured as *Sukuk Al Ijarah* providing 8.80% rate of return per annum and having a 5 year maturity[53].

Table17: Indonesia Total *Sukuk* Issuance (2002 – 30th June 2010)

Year	Total issued	Amount(USD Millions)
2002	1	19
2003	5	65
2004	7	75
2005	3	68
2006	1	21
2007	4	113
2008	10	772
2009	21	1,705
2010	16	1,759
Total	**68**	**4,597**

Source: IIFM *Sukuk* Issuance Database (USD 1 = IDR 9.044)

The table above shows the total issues by Indonesia since the beginning of 2002. It is clear from the table there has been growing demand for *Sukuk* and with each year we have a seen surge in the number of issuances in Indonesia. The first ever *Sukuk* issued out of Indonesia by PT Indosat Tbk was structured as *Sukuk Al Mudarabah* with a tenor of 5 years for the amount of USD 19 Million (IDR 175 Billion). In 2008 Indonesia adapted the law on sovereign *Sukuk*. The Republic of Indonesia issued two sovereign *Sukuk* on the 26th of August 2008 namely SBSN Seri IFR0001 and SBSB Seri IFR0002. The USD 295 Million (IDR 2.714,70 Billion) SBSN Seri IFR 0001 structured as *Sukuk Al Ijarah* offered 11.80% rate of return with a maturity period of 7 years. Similarly USD 16 Million (IDR 1.985,00 Billion) SBSB Seri IFR0002 offered 11.95% rate of return with 10 year maturity also structured as *Ijarah*, the proceeds from these issuances

[53] IIFM *Sukuk* Issuance Database (2001 – 2010) and information provided by Bank Indonesia

would be implemented towards the promotion and development of Islamic finance industry and to cover the state budget deficit. So far, in H1 2010 Indonesia has 16 issues providing a total of USD 1,759 Million, compared to the previous year 2009 where the total issuance amounted to USD 1,669 Million for the whole year.

Table18: List of Total Sovereign *Sukuk* issued by Indonesia (till 30th June 2010) (Including Domestic, International & Retail *Sukuk*)

Date	Name of Sovereign *Sukuk*	*Sukuk* Structure	Amount (IDR Billions)	Rate of Return	Tenor (Months)
26-Aug-08	SBSB Seri IFR0001	*Sukuk Al Ijarah*	271,470	11.80%	84
26-Aug-08	SBSB Seri IFR0002	*Sukuk Al Ijarah*	198,500	11.95%	120
26-Feb-09	*Sukuk* Ritail Seri SR-001	*Sukuk Al Ijarah*	555,629	12.00%	36
23-Apr-09	Global *Sukuk* SNI 14 *	*Sukuk Al Ijarah*	586,430	8.80%	60
7-May-09	SDHI-2010-A	*Sukuk Al Ijarah*	150,000	8.52%	-
24-Jun-09	SDHI-2010-B	*Sukuk Al Ijarah*	85,000	7.83%	-
24-Jun-09	SDHI-2010-C	*Sukuk Al Ijarah*	33,600	7.89%	-
29-Oct-09	SBSB Seri IFR0003	-	20,000	9.25%	72
12-Nov-09	SBSB Seri IFR0003	-	52,700	9.25%	72
12-Nov-09	SBSB Seri IFR0004	-	55,000	9.00%	48
19-Jan-10	SBSB Seri IFR0005	-	10,500	9.00%	84
19-Jan-10	SBSB Seri IFR0007	-	79,000	10.25%	180
21-Jan-10	SBSN Seri IFR0003	-	5,500	9.50%	72
10-Feb-10	SBSN Ritail Seri SR-002	-	803,386	8.70%	36
3-Mar-10	SDHI--2012-A	*Sukuk Al Ijarah*	334,200	7.61%	-
11-Mar-10	SBSN Seri IFR0003	-	52,500	9.25%	36
11-Mar-10	SBSN Seri IFR0005	-	1,400	9.00%	48
11-Mar-10	SBSN Seri IFR0007	-	46,000	10.25%	180
1-Apr-10	SBSN Seri IFR0003	-	30,000	9.25%	36
1-Apr-10	SBSN Seri IFR0006	-	32,000	10.25%	240
15-Apr-10	SBSN Seri IFR0003	-	15,000	9.25%	36
15-Apr-10	SBSN Seri IFR0006	-	67,500	10.25%	240
15-Apr-10	SBSN Seri IFR0008	-	10,000	8.80%	120
29-Apr-10	SBSN Seri IFR0003	-	20,000	9.25%	72
Total	**15**		**3,515,315**		

Source: Bank Indonesia (*Global *Sukuk* amount USD 650 Million, exchange rate 1USD=IDR 9.022 at issuance)

5.2 Indonesia Sovereign Retail *Sukuk* (Seri SR-001-2009 - Seri SR-002-2010)[54]

The above mentioned *Sukuk* are a *Shari'ah* compliant financing instrument for the government which can be owned by Indonesian citizens, any non citizen individuals can own this retail *Sukuk* as well by buying it from the secondary market. Republic of Indonesia issued its First Retail *Sukuk* Series (SBSN Ritail Seri SR-001) on 26th February 2009 which carried a 12% coupon rate amounting to USD 464.50 Million (IDR 555,629 Billion). Under retail *Sukuk* the compensation is paid either on a monthly or annual basis. Due to its popularity amongst investors and oversubscription to the first retail *Sukuk*, the second *Sukuk* Series 2 (SBSN Ritail Seri SR-002) was issued on the 10th of February 2010. This *Sukuk* (Series2) offers 8.70% rate of return with a maturity period of 36 months amounting to USD 862 Million (IDR 803,386 Billion). Both Series 001 and 002 of the retail *Sukuk* are based on *Sukuk Al Ijarah*.

5.3 Snap Shot of Indonesia Global[55] *Sukuk* (USD 650 Million)

5.3.1 Basic Information

The Republic of Indonesia (ROI) issued its Global *Sukuk* in April 2009. The *Sukuk* was launched under a separate legal entity, the "Perusahaan Penerbit SBSN Indonesia 1", which acts as a trustee on behalf of the ROI; it was issued on the back of a Special Purpose Vehicle (SPV) and the assets identified under this vehicle consist of approximately 66 real properties used for government purposes, including buildings, improvements and fixtures thereon, located in Bandung and Jakarta. These properties could be replaced by a substitution under the "Substitution Agreement." The government will use the proceeds from the planned *Sukuk* to help plug the deficit in its budget. The *Sukuk* is US-dollar denominated with a size of USD 650 Million; its tenure is 5 years that will mature in April 2014 with semi-annual payments at a rate of 8.8%. The lead managers and book runners for this *Sukuk* are Barclays Bank, HSBC and Standard chartered whereas the principal paying agent is Bank of New York Mellon. The *Sukuk* is listed on Singapore Stock Exchange.

5.3.2 Structure of the Issue

The issuance uses the *Sukuk Al Ijarah* sale and lease-back scheme in which one party solely acts, or through its representative, sells or leases its beneficial rights to an asset to the other party based on an agreed price and duration, without the transfer of asset ownership. The *Sukuk* is issued against that SPV under "Purchase agreement" at the time of issuance and the seller (the issuer) sells the "Beneficial *Sukuk*-holders. In this case, ROI sells the beneficial title of the asset to a SPV.

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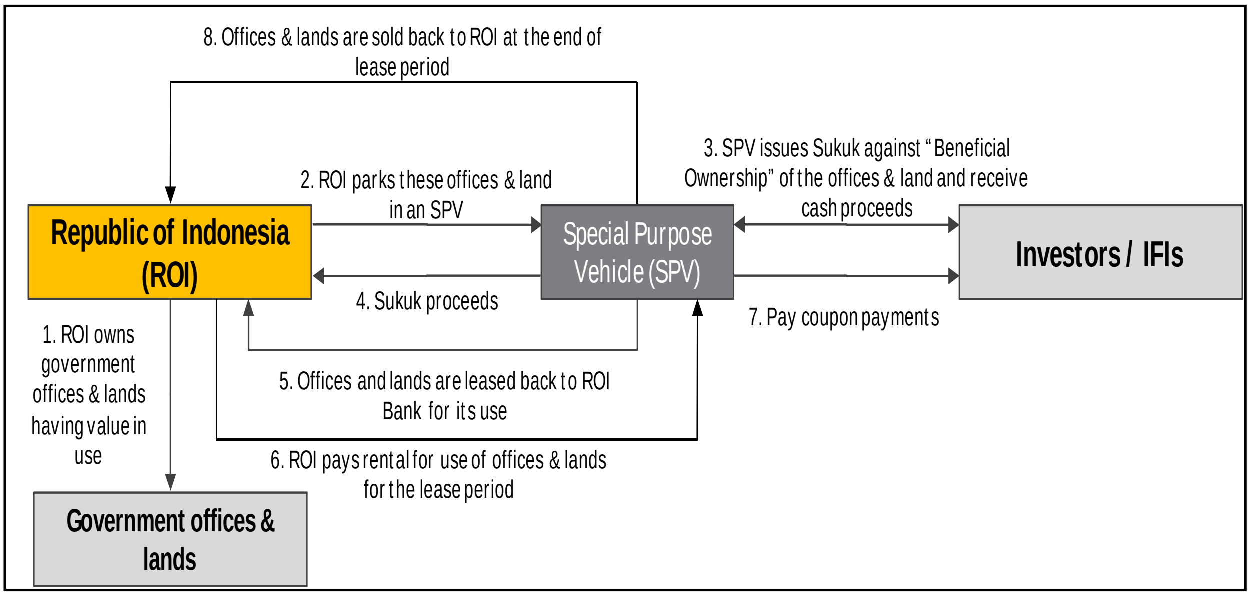
[54] Information extracted from Indonesia prospectus on Retail *Sukuk*.
[55] First ever global *Sukuk* out of Indonesia issued on 23rd April 2009.

Chart 9: Process – Asset specific *Sukuk* based on *Ijarah* (Sale & Lease Back)



The establishment and administration of the SPV for this SBSN is regulated by Government Regulation Nos. 56 and 57 (2008). Subsequently, the SPV offers the *Sukuk* for sale to investors. The government secures the funds from the sale of assets to investors through the SPV. SBSN acts a trustee and leases the asset to ROI (in its capacity as a lessee) for a lease period that matches the *Sukuk* tenor.

The periodic lease rental payments are predetermined and calculated based on a fixed percentage. ROI as lessee shall pay the lease rental payments on certain Periodic Distribution Dates, which shall be paid out by the Trustee to the *Sukuk*-holders as periodic distribution amounts of the *Sukuk*.

The Trustee, SBSN (on behalf of the *Sukuk* holders, and in its capacity as a Lessor) appoints ROI as its "Service Agent" to carry out, or procure the carrying out of, all Major Maintenance of the *Sukuk* Assets and to procure insurance of the *Sukuk* Assets on behalf of the Lessor.

Through a Purchase Undertaking, ROI undertakes to purchase the *Sukuk* Assets, in case of the occurrence of a dissolution event or at the maturity of the *Sukuk* tenor, at an Exercise Price. This exercise price is used by SBSN (The trustee) to pay off the redemption amount in return of the *Sukuk* certificates.

The *Sukuk* may be purchased by any party and is easily tradable. At the time of issuance, it was rated BB- by Standard & Poor's, whereas Moody's rated it as Ba3.

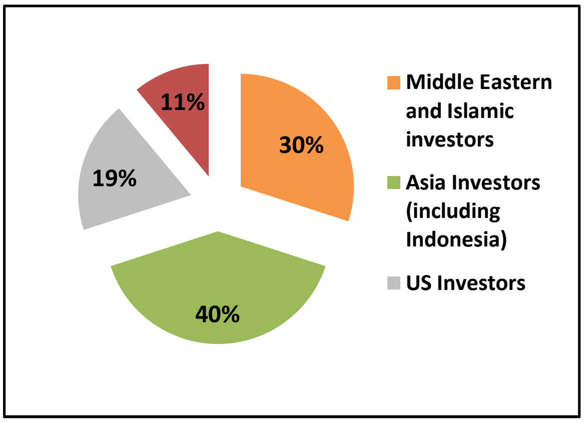
Table 19: Indonesia Global *Sukuk* Highlights

ISSUER	Perusahaan Penerbit SBSN Indonesia
GOVERNING LAW	Law No 19, year 2008 regarding SBSN
***AKAD* (AGREEMENT)**	*Ijarah* — sale and leaseback
MATURITY	5 years
YIELD	Fixed rate at 8.8%
NOMINAL VALUE	Nominal value is at par value i.e, USD 650 million
USE OF PROCEEDS	The net proceeds from the SBSN *Ijarah* — sale and leaseback (*Sukuk* Issuance) will be used by the government of Indonesia to fund the government state budget
SBSN REDEMPTION	The SBSN will be redeemed at par value
***IJARAH* PAYMENT FREQUENCY**	Paid periodically every six months
SBSN ASSETS	Government properties such as land and buildings in Bandung and Jakarta
PAYMENT/ ADMINISTRATION AGENT	Bank Indonesia
LISTING	Singapore Stock Exchange

5.3.3 Geographical Distribution of the *Sukuk* investors

A significant share of Indonesian sovereign *Sukuk* is held by Asian investors followed by Middle East based investors since concentration of *Shari'ah* compliant financial institutions are more prevalent in these regions.

Chart 10: Indonesian Global *Sukuk* Geographic Distribution



CHAPTER SIX

CONCLUSION

6.1 Conclusion

The International *Sukuk* market started in 2001 and it quickly gained momentum in terms of not only issuances but also structural innovation. The *Sukuk* market witnessed record growth rates between 2004 to 2007 and several milestones were achieved both in international and domestic issuances by corporates, semi-government and sovereign issuers. The 2008 financial crisis impacted the *Sukuk* market and we saw a reversal of high growth trend in international corporate issuances to a limited appetite mainly due to credit and liquidity issues. During late 2009 & 2010 period most of the international *Sukuk* were sovereign and semi-government issuances from Bahrain, Indonesia, UAE and Qatar. At the domestic level there has been turn around in corporate, semi-government and sovereign issuances in several jurisdictions led by Malaysia, Indonesia, Pakistan and Saudi Arabia.

The crisis came as a reality check for all markets and players, reshaping the priorities of banks, issuers, investors as well as governments. The crisis has tested and highlighted a number of shortcomings in some *Sukuk* structures particularly equity type *Sukuk*; however, lessons learnt from these adverse events will make *Sukuk* a better instrument. Moreover, the recent *Sukuk* restructuring cases have shown us the way to tackle such situations given the fact that *Sukuk* is not totally like conventional bonds.

The issue of enabling regulatory environment remains to be tackled in many jurisdictions both new and existing. There is a need for enhancement in solvency laws and appropriate legal protections, such as ownership and title transfer rights for *Sukuk* holders. The *Sukuk* rating is also one of the key determining factor for creditors and investors.

During the *Sukuk* high growth period which ended in early 2008 the corporate issuers especially from GCC were leading the market while the role of sovereigns was limited. However, in last two years sovereign issuances have increased which is good sign for long term growth perspective of the market. Another trend observed, could be due to record low reference rates, is increase in fixed profit rate *Sukuk* which will create more secondary market trading opportunities and also hedging of rate of return risk.

Although structuring wise the International market has returned to more plain vanilla *Ijarah Sukuk* and there is slight increase in share of investment type *Sukuk*. The role of purchasing undertaking is continued to be debated and efforts are being made to innovate and replaced it with either Letter of Credit by banks or recent attempt by Cagamas Berhad to use market bid method at the time of the redemption of *Sukuk*.

Finally, several issuers from new jurisdictions entered the market such as from Japan and Turkey while a number of other issuers from Kazan (Russia), Jordan, Kazakhstan, Yemen, Iran, Thailand etc. are considering issuing *Sukuk*. The overall outlook for *Sukuk* market remain positive and we may see several landmark issuances in coming years and it seems that the main driver of the *Sukuk* market will be Islamic jurisdictions due to huge infrastructure development requirements as well as population growth.

6.2 Appendix A: Glossary of the *Sukuk* Report – Major Islamic finance instruments definitions

Term	Meaning
Shari'ah	Islamic Law
A *Shari'ah* compliant product	Product meets the requirements of Islamic law
A *Shari'ah* board	Is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of *Shari'ah* compliant products
A *Shari'ah* advisor	Is an independent Islamic trained scholar that advises Islamic institutions on the compliance of the products and services with the Islamic law
Sukuk	An 'Arabic name for financial certificate, it can be seen as an Islamic equivalent of the conventional bonds. It is defined as "Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity".
Bai al Salam	**Advance purchase.** Advance payment for goods which are to be delivered at a specified future date. Under normal circumstances, a sale cannot be effected unless the goods are in existence at the time of the bargain. However, this type of sale is an exception, provided the goods are defined and the date of delivery is fixed. The objects of sale must be tangible goods that can be defined as to quantity, quality and workmanship.
Istisna'a	**Advance purchase of goods or buildings.** A contract of acquisition of goods by specification or order, where the price is paid in advance, or progressively in accordance with the progress of a job. For instance, to purchase a yet to be constructed house, payments would be made to the builder according to the stage of work completed.
Murabaha	**Cost-plus financing.** A form of credit that enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and sells it to the customer on a deferred basis. The price includes a profit margin agreed by both parties. Repayment, usually in installments, is specified in the contract.
Musharaka	**Joint venture, profit and loss sharing.** An investment partnership in which all partners are entitled to a share in the profits of a project in a mutually agreed ratio. Losses are shared in proportion to the amount invested. All partners to a *Musharakah* contribute funds and have the right to exercise executive powers in that project, similar to a conventional partnership structure and the holding of voting stock in a limited company.
Mudarabah	**Trust financing, profit sharing.** An investment partnership, whereby the investor (the *rab al maal*) provides capital to the entrepreneur (the *mudarib*) in order to undertake a business or investment activity. While profits are shared on a pre-agreed ratio, losses are born by the investor alone. The *mudarib* loses only his share of the expected income.
Ijarah	**Leasing.** A lease agreement whereby a bank or financier buys an item for a customer and then leases it to him over a specific period, thus earning profits for the bank by charging rental. The duration of the lease and the fee are set in advance. During the period of the lease, the asset remains in the ownership of the lessor (the bank), but the lessee has the right to use it. After the expiry of the lease agreement, this right reverts back to the lessor.

6.3 Appendix B: Glossary of the *Sukuk* Report – Investment *Sukuk* definitions

Term	Meaning
Salam Sukuk	Are certificates of equal value issued with the aim of mobilizing *salam* capital (mobilizing funds) so that the goods to be delivered on the basis of *salam* come to be owned by the certificates holders. (*Salam* is a sale, whereby the seller undertakes to supply a specific commodity to the buyer at a future date in return for an advanced price paid in full on the spot. The price is in cash but the supply of the purchased good is deferred)
Istisna'a Sukuk	Are certificates of equal value issued with the aim of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the certificates holders. (This type of *Sukuk* has been used for the advance funding of real estate development, major industrial projects or large items of equipment such as: turbines, power plants, ships or aircraft (construction/manufacturing financing)
Murabaha Sukuk	Are certificates of equal value issued for the purpose of financing the purchase of goods through *murabaha* so that the certificate holders become the owners of the *murabaha* commodity. (This is a pure sale contract based *Sukuk* which based on the cost plus profit mechanism)
Musharakah Sukuk	Are certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, financing a business activity etc on the basis of any of partnership contract so that the certificate holders become the owners of the project. (*Musharakah Sukuk* is an investment partnership between two or more entities which together provide the capital of the *Musharakah* and share in its profits and losses in pre-agreed ratios)
Mudarabah Sukuk	Are certificates that represent project or activities managed on the basis of *Mudarabah* by appointing one of the partners or another person as the *mudarib* for the management of the operation. (It is an investment partnership between two entities whereby one entity is mainly a provider of capital and the other is mainly the manager)
Al-Ijarah Sukuk	An Islamic certificate for the buying and leasing of assets by the investors to the issuer and such *Sukuk* shall represent the undivided beneficial rights/ownership/interest in the asset held by the trustee on behalf of the investors

6.4 Appendix C: Glossary of the *Sukuk* Report – Technical Terms

Term	Meaning
International *Sukuk* **(for the purpose of this report)**	A *Sukuk* issued in hard currency such as USD
Domestic *Sukuk* **(for the purpose of this report)**	A *Sukuk* issued in local currency
Global *Sukuk* **(for the purpose of this report)**	Both international and domestic *Sukuk*
Convertible or exchangeable *Sukuk*	Convertible or exchangeable *Sukuk* certificates are convertible into the issuer's shares or exchangeable into a third party's shares at an exchange ratio which is determinable at the time of exercise with respect to the going market price and a pre-specified formula.
Hybrid *Sukuk*	Hybrid *Sukuk* combine two or more forms of Islamic financing in their structure such as *Istisna'a* and *Ijarah*, *Murabaha* and *Ijarah* etc.
Sovereign *Sukuk*	Are *Sukuk* issued by a national government. The term usually refers to *Sukuk* issued in foreign currencies, while *Sukuk* issued by national governments in the country's own currency are referred to as government *Sukuk*.
Quasi-sovereign *Sukuk*	Are *Sukuk* issued by a public sector entity that is like sovereign *Sukuk*. It may carry explicit or implicit government guarantee.
Corporate *Sukuk*	Is a *Sukuk* issued by a corporation as opposed to those issued by the government. It is a major way for companies to raise funds in order to expand its business or for a specific project.

6.5 References

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