



المعهد الإسلامي للبحوث والتدريب
Islamic Research & Training Institute

A Primer on Sukuk Products for Sovereign Issuers

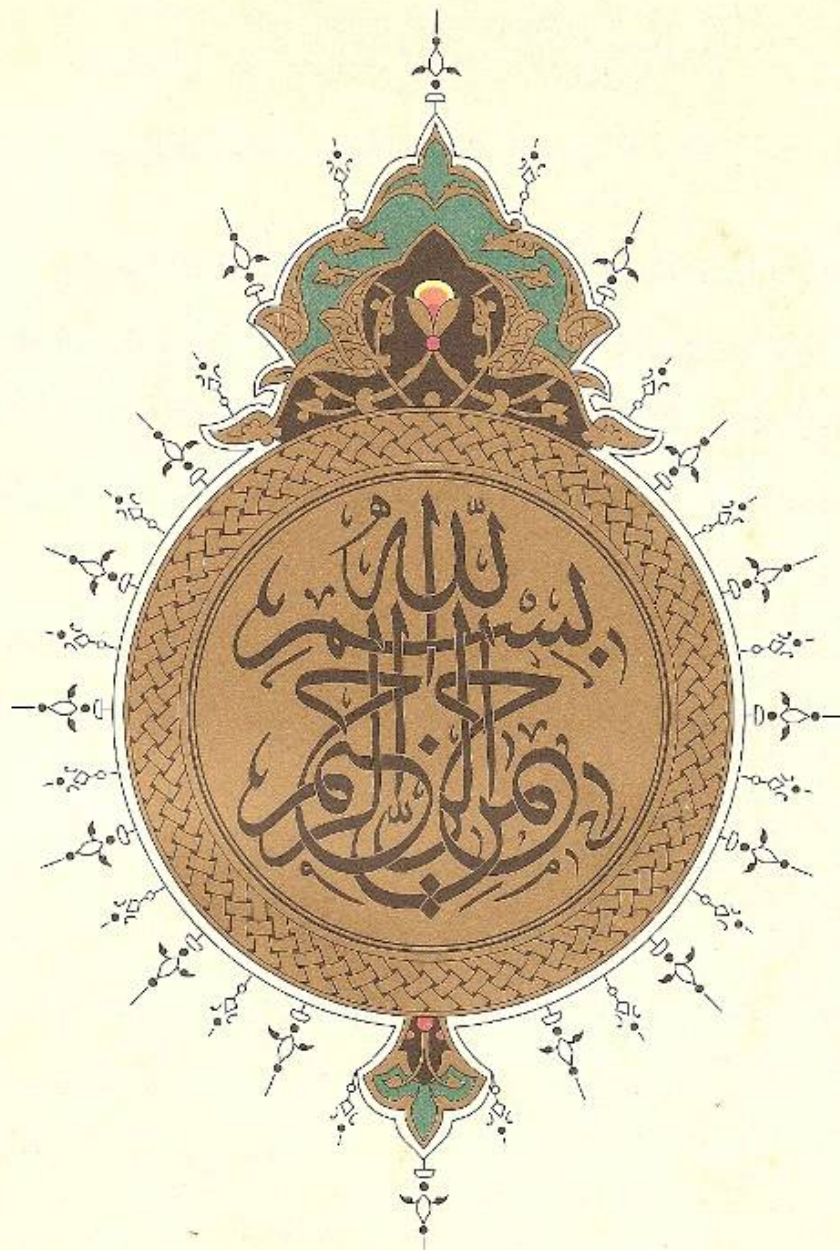
Salman Syed Ali

Acknowledgements: Some slides in this presentation are adaptations from Mr. Nathif Jama Adam's workshop, these are indicated by initials NJA at the bottom. Other sources are also acknowledged when used.



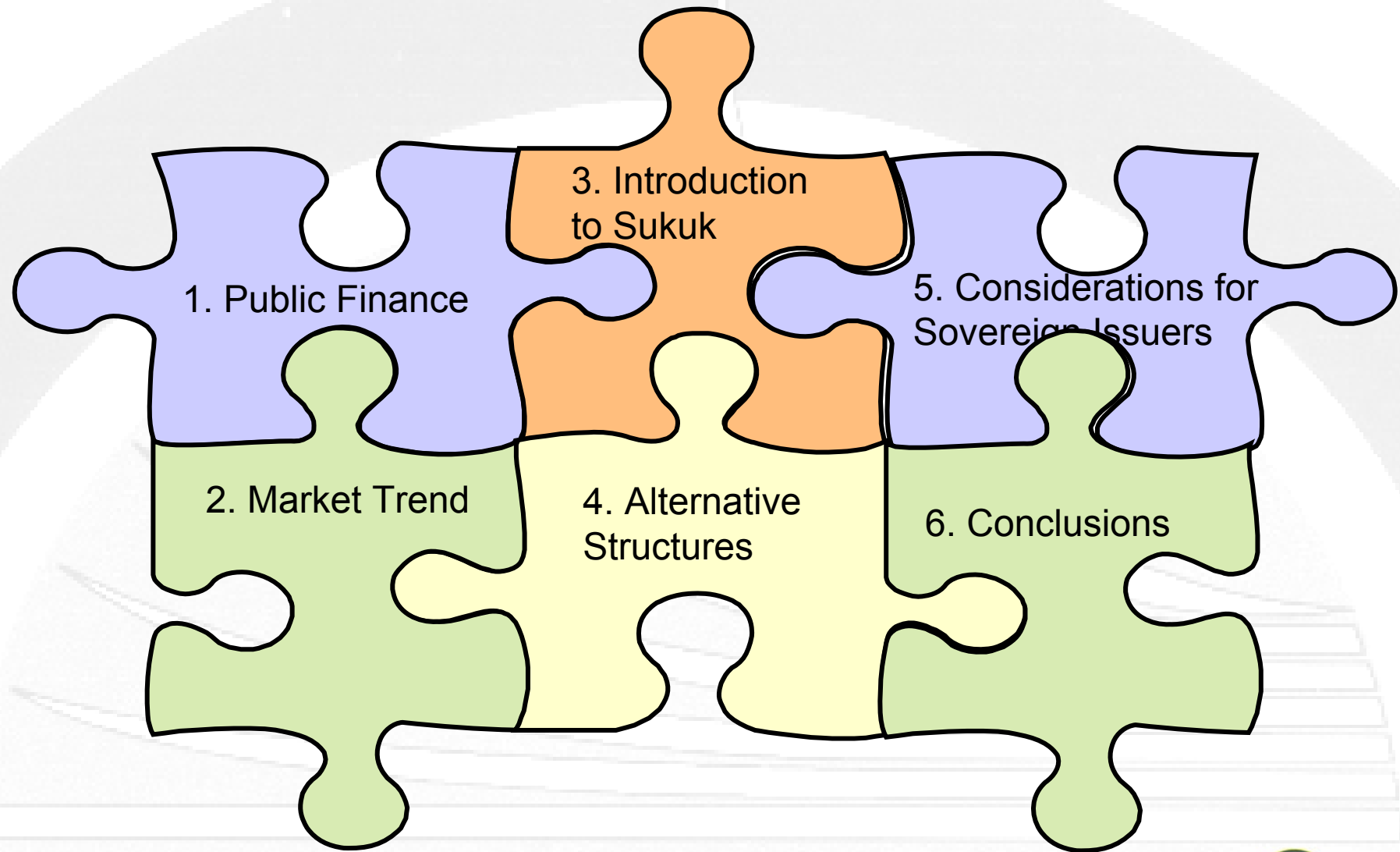
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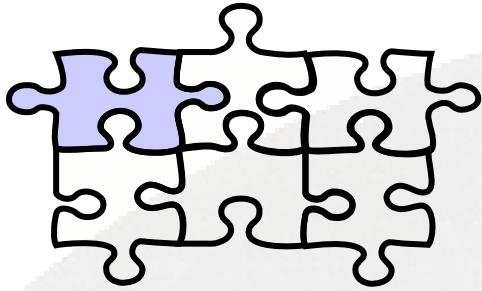




Overview

1. Public Finance – Tax, Debt, and Role of Sukuk
2. Market Trend and Growth Potential
3. Introduction to Sukuk
 - (The basic leasing (*Ijara*) structure, An Example, Comparison of Sukuk with bonds and conventional securitization)
4. Alternative Structures and Evolution of Sukuk
5. Considerations for Sovereign Issuers
 - (Economic Issues, Impact of Sub-prime Crisis, Shariah Issues, Legal and Policy Considerations, The methodology of Sukuk and issuance perspectives)
6. Conclusions





Section-1

Public Finance

Tax, Debt, and Role of Sukuk

Financing needs of government and public entities.

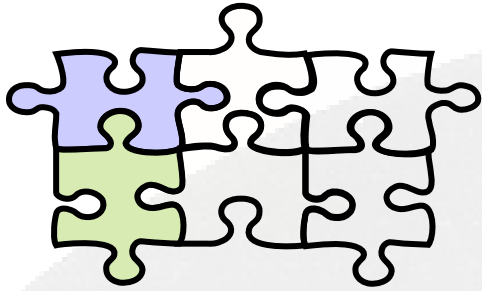
Can sukuk help?

- Taxation:
 - has its limits
 - element of coercion
- Conventional Borrowing:
 - interest based, repugnant to Islam
 - fiscal imbalance if debt not used productively
 - unbridled, can crowd out private investment
 - financial repression

Alternate Solutions

Sukuk and other Islamic Finance contracts offer good alternate funding methods for public finance

- Directly linked to the project
- Provide transparency and specificity of use
- Returns can be made fixed or flexible to suit the appetite of investors
- Safe from unbridled borrowing
- In line with the ethics and norms of society
- Brings in un-tapped and diversified sources of finance



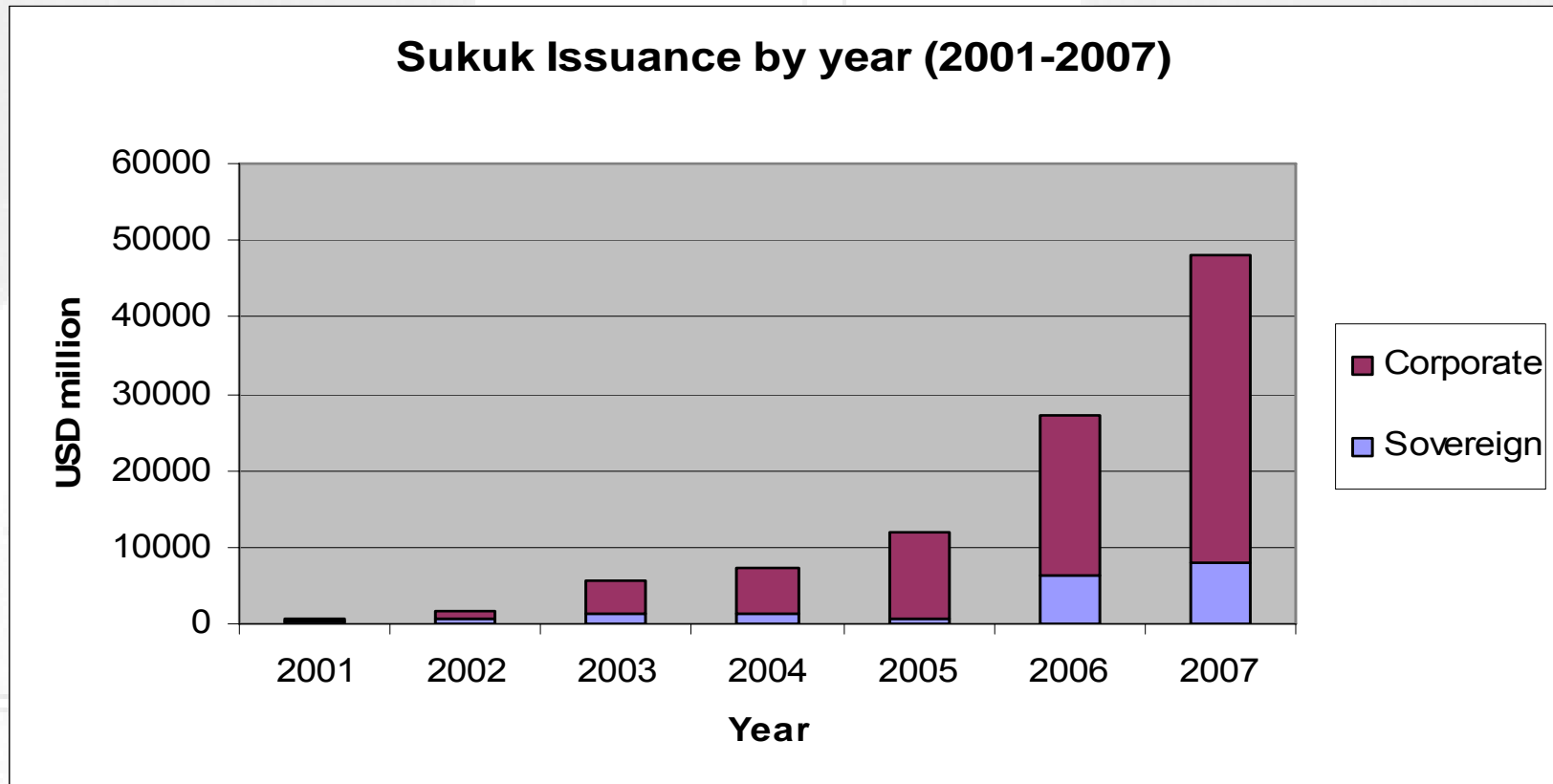
Section-2

Market Trend and Growth Potential

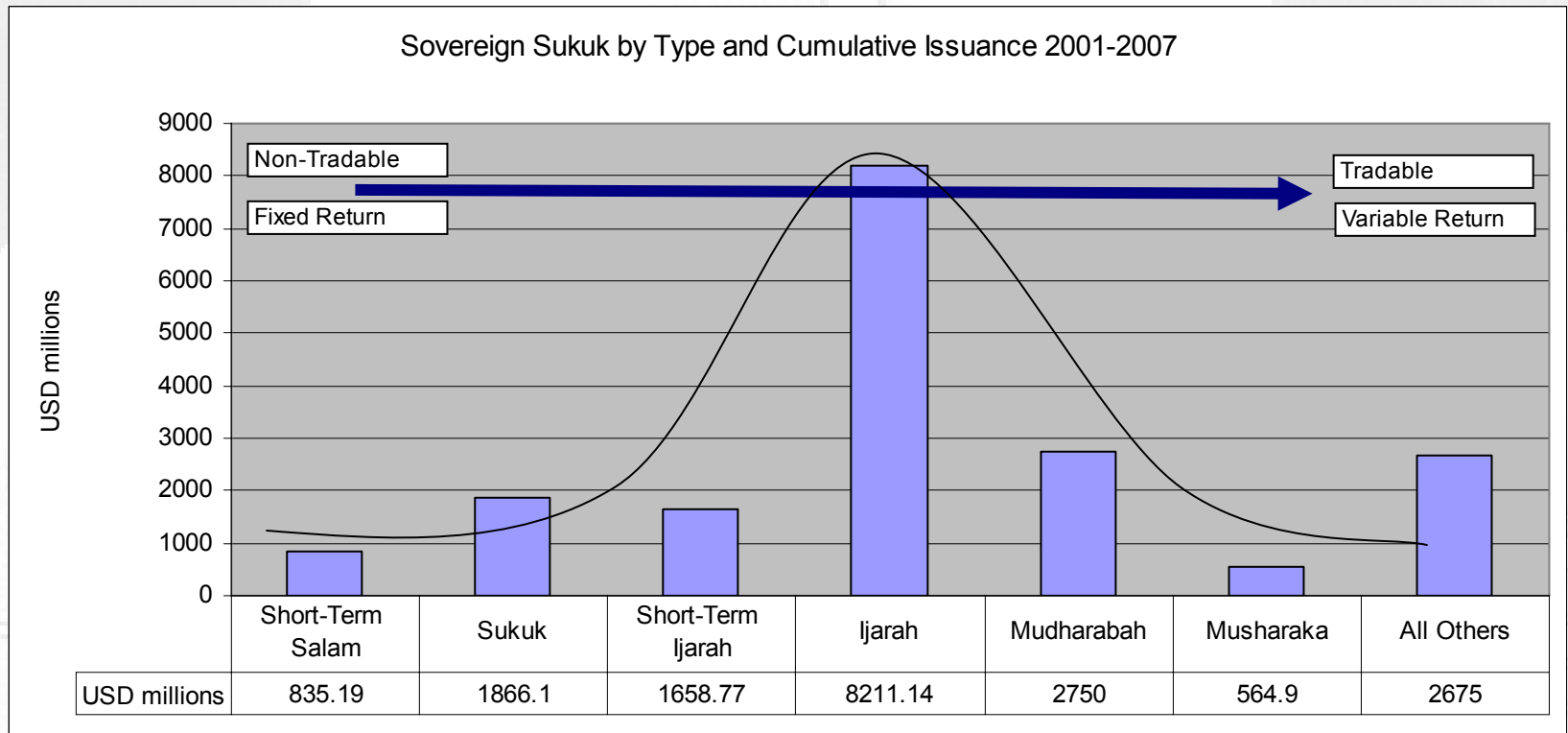
Sukuk Market—Growth and Potential

- Since 2001, average growth rate 45%
- Dubai based USD 3.5 billion PCFC *sukuk* generated orders of USD 11.4 billion with 50% from non-Muslim investors (Jan 2006)
- Currently, 70-80% buyers of ME *sukuk* are Westerners
- Foreign entities issuing *sukuk*
 - German state of Saxony-Anhalt: €100 mill. *sukuk* (2004)
 - East Cameron Gas Co.: \$165.67 mill. *sukuk* (2006)
- Malaysia-Islamic *sukuk* share of total private debt securities market increased from 42% in 2002 to 71.5% in 2005

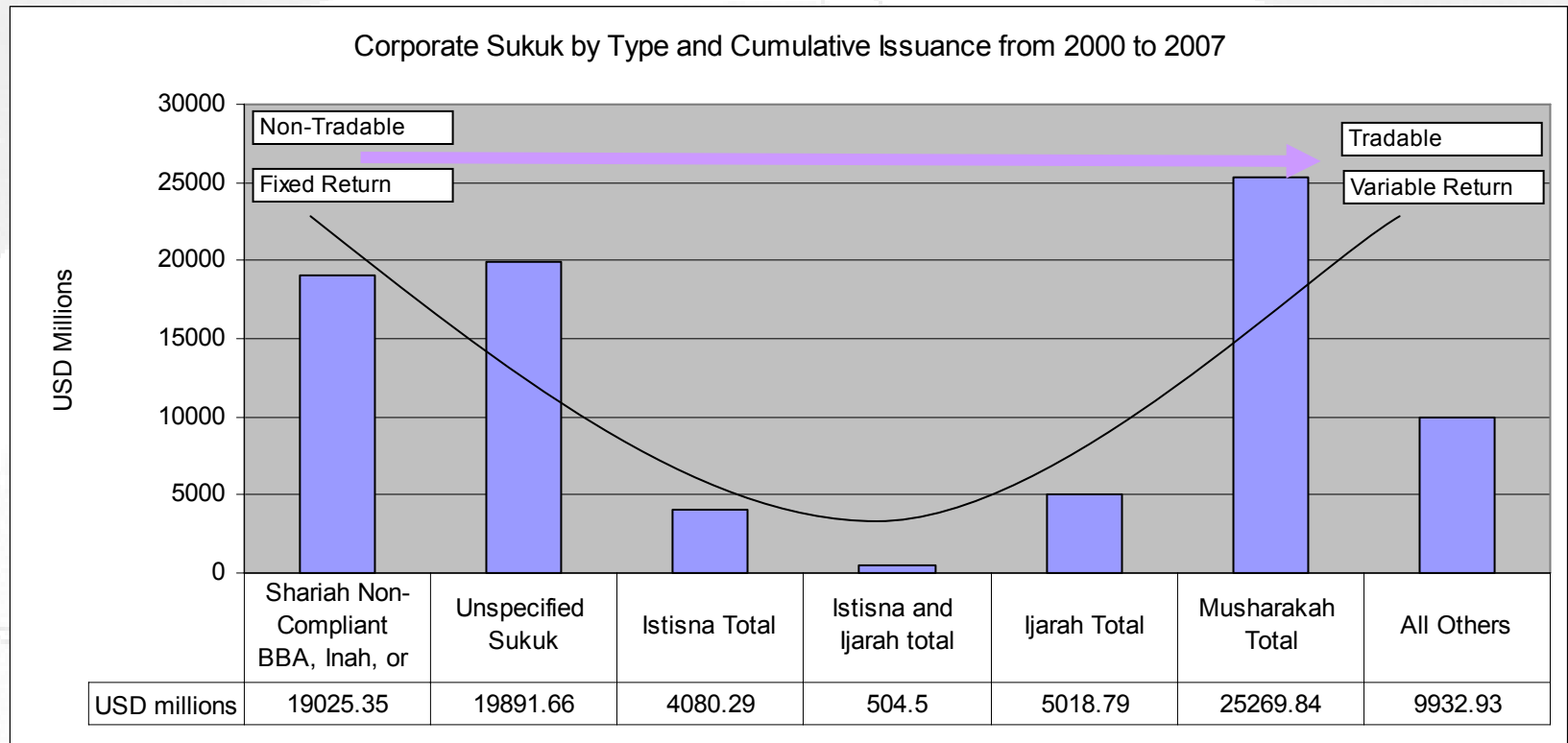
Sukuk Issuance by Year



Sovereign Sukuk: by Type and Cumulative Issuance (2001-2007)



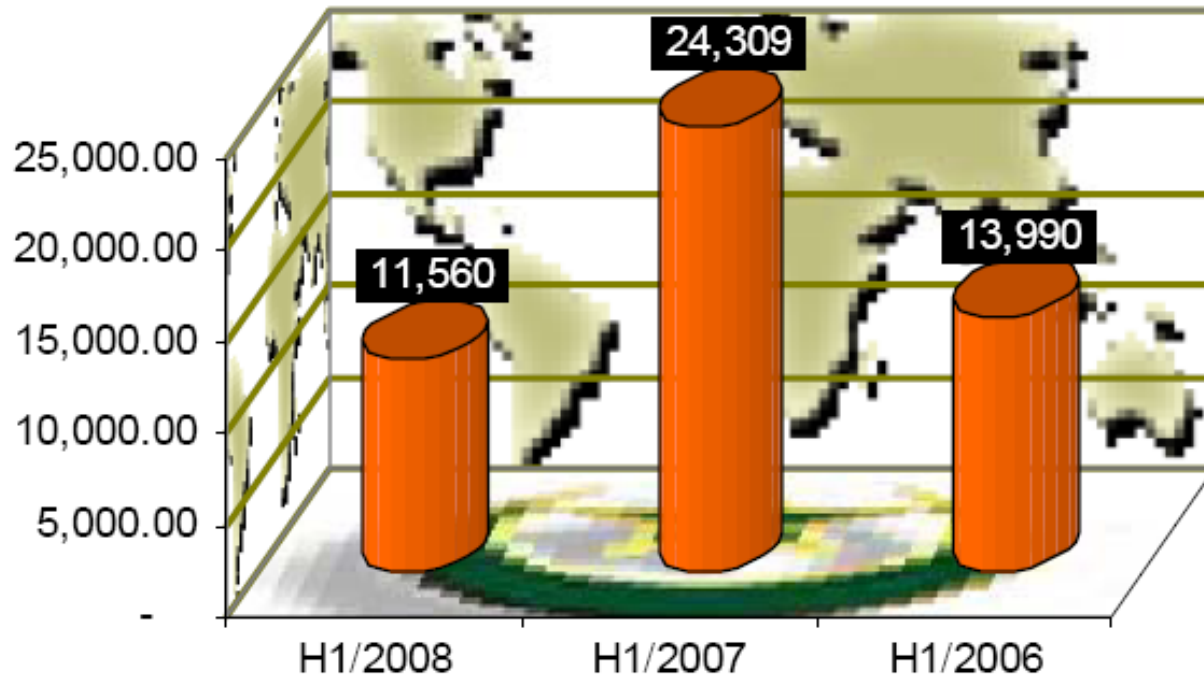
Corporate Sukuk: by Type and Cumulative Issuance (2000-2007)



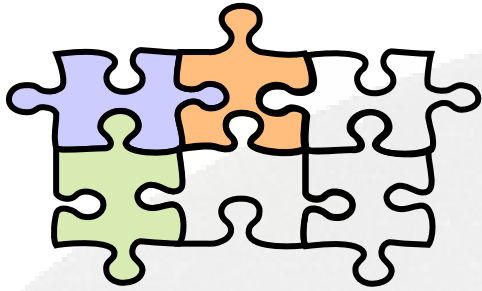
Total Sukuk Issued (USD millions)

Comparison of First-Half Years 2006, 2007, 2008

[A possible impact of sub-prime crisis]



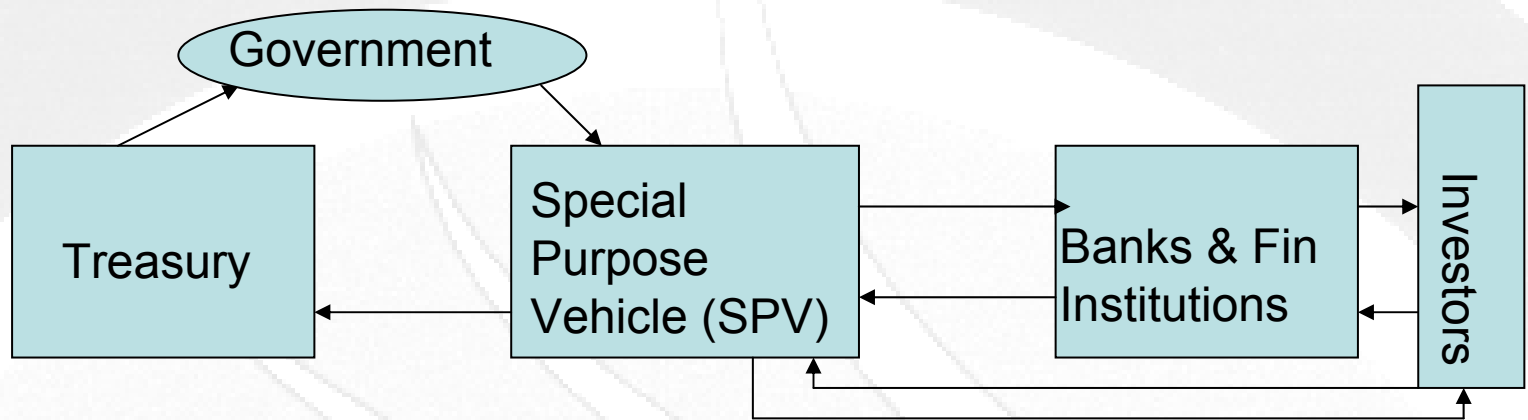
Source: Beard, Charles. "Sukuk in H1-2008 – Key Trends and Market Highlights", Sukuk Research, IFIS.



Section-3

What are Sukuk and How do they Work

Government Sukuk Financing



Special Purpose Vehicle (SPV, SPE, SPC)

Bankruptcy
Remoteness

Functions
of SPV

Issuance of
Sukuk

Ownership of
Assets (Trust)

Benefit or Purpose = Investor Protection, Credit enhancement of asset

What are Sukuk?

- Singular: Suk, Plural: Sukuk, a certificate
- In their simplest form sukuk are time limited, income earning certificates (can be similar to bonds) but (like equity) represent ownership claims in specific asset (or a pool of assets) or its usufruct.

Definition of Sukuk

as per Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Standard no. 17

- Sukuk are:
 - *“Certificates of equal value representing undivided shares in the ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.....”*

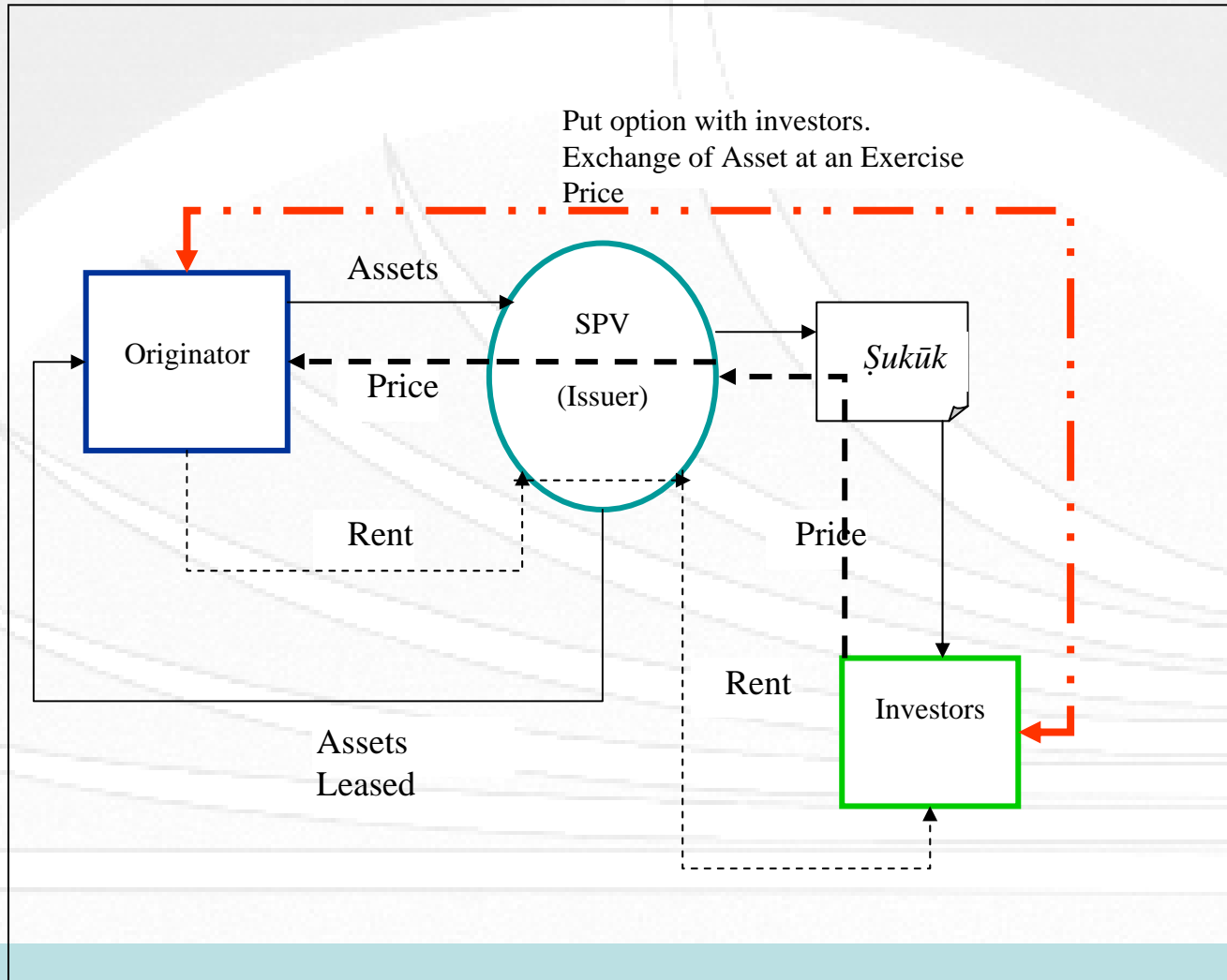
Section-3a

Basic Ijarah Sukuk: An Example

Ten flexibility features of *Shariah* nominate leasing (*Ijarah*) contract:

1. Flexibility of sale
2. Independence of ownership:
3. Flexibility in timing of inflows and outflows
4. Flexibility in initiation
5. Flexibility in length of term
6. Flexibility in determination of rent
7. Possibility of hybrid with agency (*wakalah*)
8. Restriction on liability for maintenance
9. Leasing contract is amiable to securitization
10. It can be combined with other pooled assets for securitization

Structure of a generic *Ijarah-Sukuk*



Section-3b

Comparison of Sukuk with Bond and Conventional Securitization

Sukuk—Features

Sukuk are different from traditional conventional financial instruments

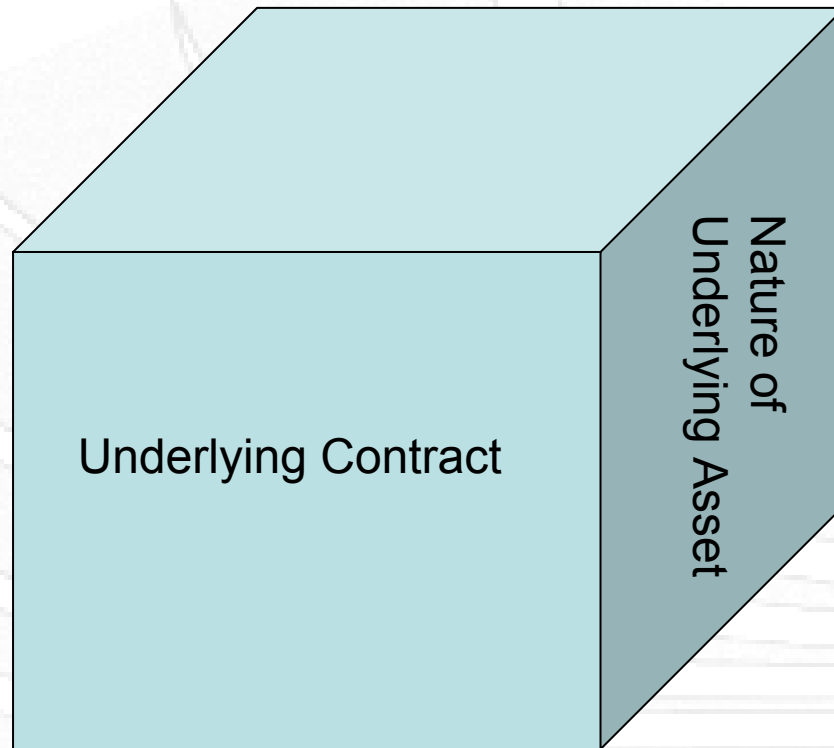
<i>Sukuk</i>	Represents ownership of asset, business, or project for fixed time period
Bonds	Tradable debt obligations for fixed time period
Stocks	Perpetual ownership of shares in business with control rights
Derivatives	Based on rights and claims of other assets, may not have intrinsic values

Sukuk are different from Conventional Securitization

Sukuk	Conv. Securitization
Investment Sukuk (as defined by AAOIFI) are certificates of equal value representing undivided shares in <u>ownership of tangible assets, usufruct and services.....</u>	Securitization generally relates to the converting of <u>loans</u> of various sorts into marketable securities by packaging the loans into pools and then selling shares of ownership in the pool itself.
Receivables cannot be securitized to convert them into tradable instruments.	Receivables can be securitized.

Sukuk Types

Various ways to classify



Sukuk—Types

(1. based on underlying contracts)

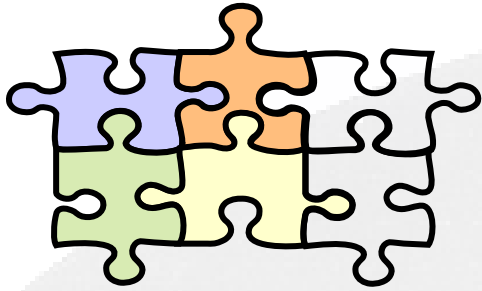
AAOIFI identifies 14 types—can be broadly classified as asset-, debt-, equity, and agency- based

Asset Based	<i>Ijarah</i> (existing owned, existing leased, and future assets), <i>manfah</i> (existing and futures assets)
Debt Based	<i>Istisna</i> , <i>salam</i> , <i>murabahah</i>
Equity Based	<i>Murabahah</i> , <i>musharakah</i> , <i>Muzara'a</i> , <i>Musaqa</i> , <i>Mugharasa</i>
Agency Based	<i>Wakala</i>

Sukuk—Types

(2. based on nature of asset)

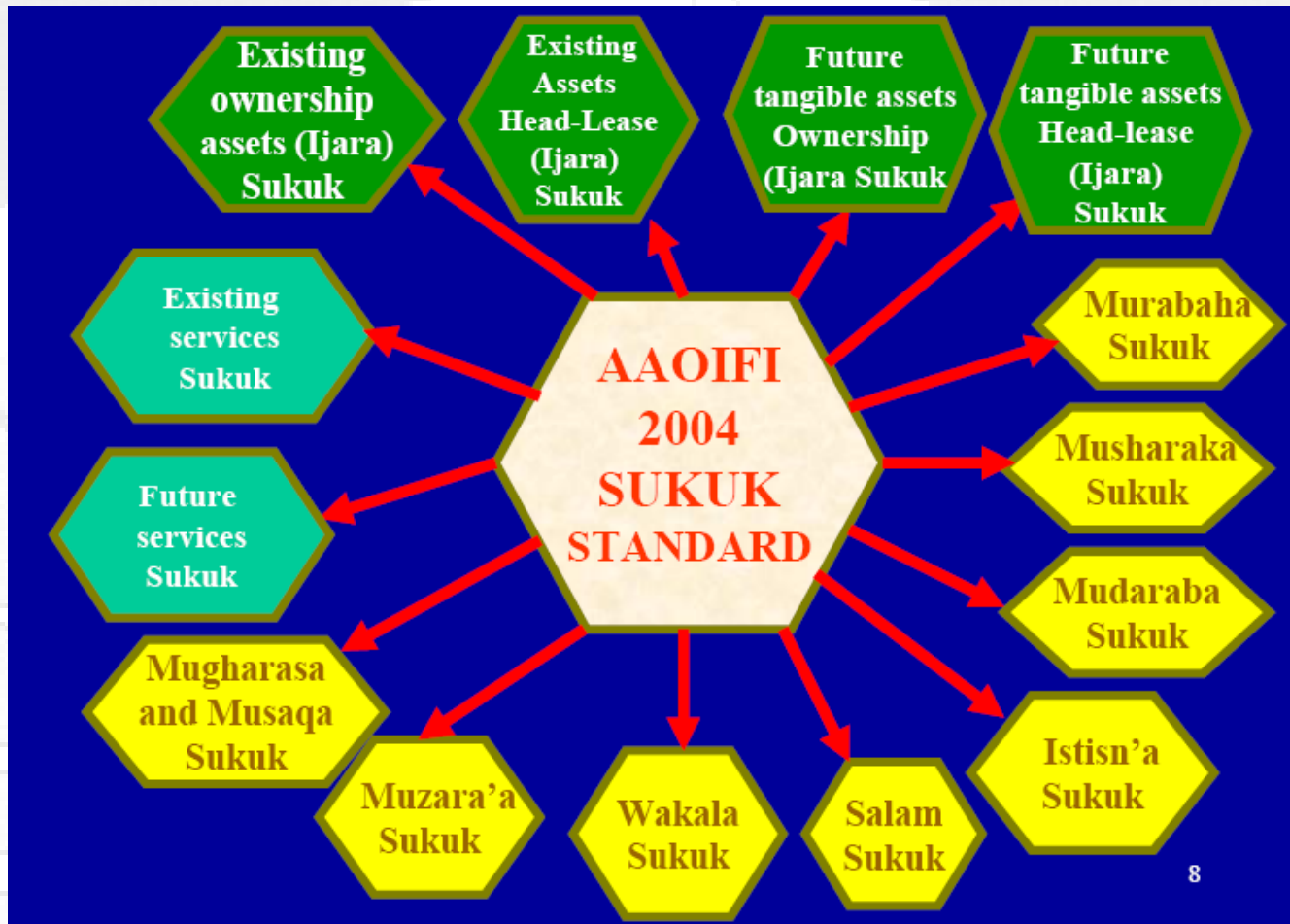
Project Specific	<i>To be constructed project, i.e., future asset</i>
Asset Specific	<i>Existing asset(s)</i>
Balance Sheet Specific	<i>Pool of real and monetary assets</i>



Section-4

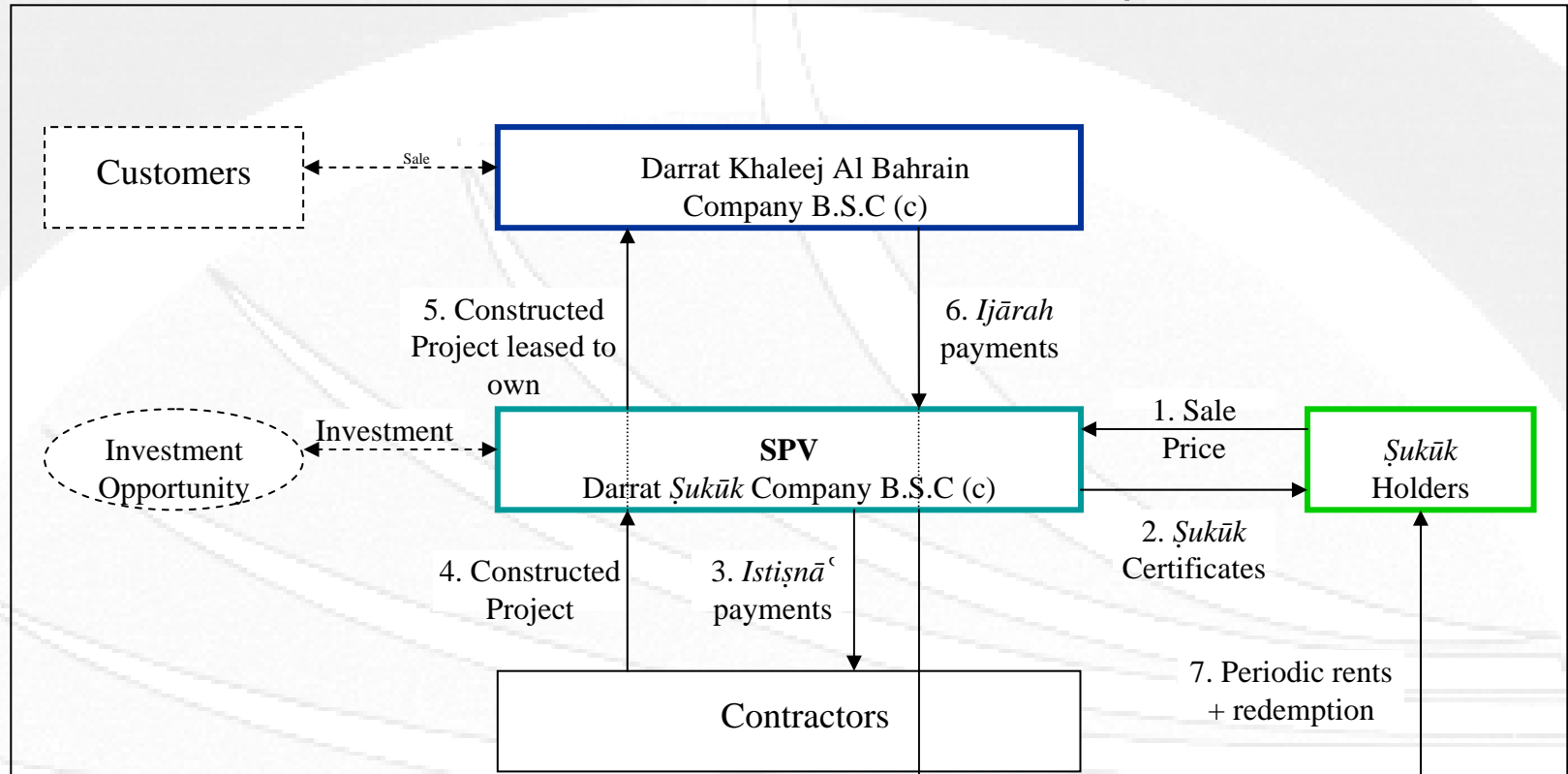
Alternative Structures and Evolution of Sukuk

Sukuk of different types



8

Istisna based Ijarah Sukuk (Construct and Lease) Example of Darrat Sukuk)



Notes:

The numbers on each arrow represent the sequence of steps.

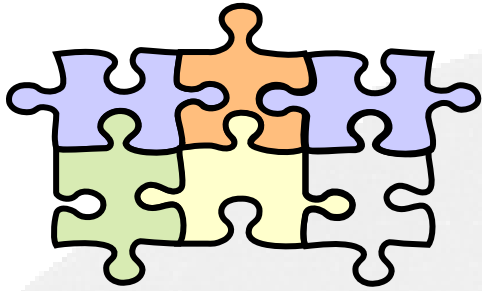
The dashed lines show non-essential parts of the *şukūk* structure but are utilized to increase earnings or payment capacity.

More recent variants

Also utilize:

- Hybrid assets
- Intangible assets
- Mudarabah and Musharakah contracts
- Convertibility options
- Waterfall structures

However, not all are fully Shariah compliant



Section-5

Considerations for Sovereign Issuers

Costs and Benefits to Sovereign Issuers

Benefits

- Growing institutional and geographical diversity
- Shariah compliance
- Enhanced resource mobilization due to inclusion of Islamic investors
- Broader investor base
- Asset backed structure
- Ability to address broader policy issues

Costs

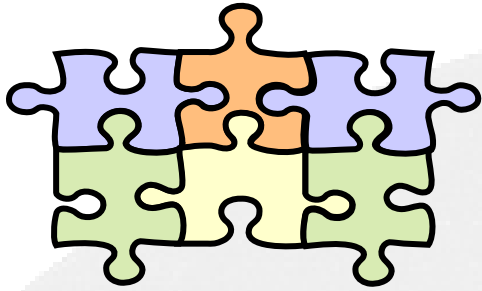
- Administrative costs may be high
- Limits fiscal flexibility
- Currently limited secondary market implies higher cost of issuance
- Legal risks associated with bankruptcy laws and Shariah compliance
- Currency risks associated with foreign issuance

Economic Challenges & Policy Considerations for Sovereign Issuers

- To what extent the recent surge in sukuk issuance is related to cyclic developments?
- How sustainable is the market growth?
- What aspects of sukuk market reforms will be most difficult to implement?
- What institutional changes will be needed to support regular sukuk issuance?
- How to manage currency risks in case of issuance of obligations in foreign currency?
- What are operational implications of using sukuk for monetary management?

Shariah and Regulatory Challenges

- Ownership transfer should be complete
- No guarantee on capital, only third party guarantee without fee is permissible
- No loan/liquidity facility from the issuer/manager to investors
- Ensure that sukuk are not securitization of revenue streams
- Incentive payments only as incentives
- Many sukuk marketed as mudaraba sukuk, musharaka sukuk etc. are misnomers



Section-6

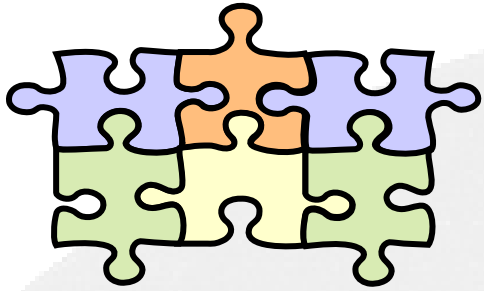
Conclusions

Success Factors

- Keep the sukuk simple for general public
- Keep it transparent
- Follow a prudent fiscal policy
- Develop necessary financial infrastructure
- Promote appropriate legal environment
- Closely comply with Shariah, since the products launched today will set the course and trend for the future.

Summary

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Thank You