



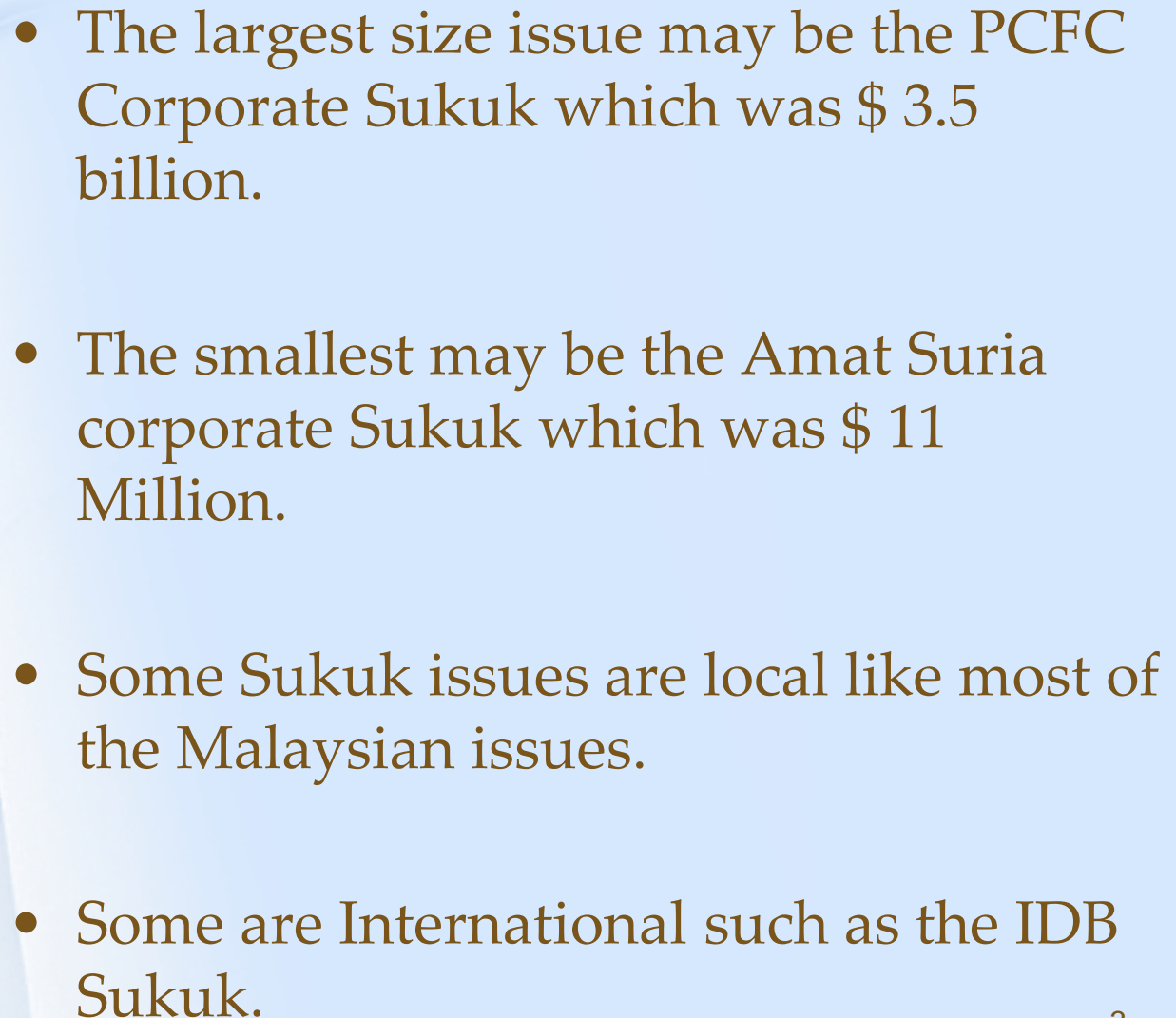
S U K U K


A presentation by:
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An Overview

- The first Sukuk issue dated September 2001 by Bahrain Government.
- Up to October 2006 there are about 80 Sukuk issue.
- The latest is:
 - 31 issues from Malaysia
 - 26 from Bahrain
- The rest from UAE, Kuwait, Qatar, Germany, Pakistan and Saudi Arabia.

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- The background of the slide features a light blue gradient with a faint, semi-transparent image of classical architectural columns on the left side. The columns are white with detailed capitals and are set against a darker blue background. The entire slide is framed by a thin brown border.
- The largest size issue may be the PCFC Corporate Sukuk which was \$ 3.5 billion.
 - The smallest may be the Amat Suria corporate Sukuk which was \$ 11 Million.
 - Some Sukuk issues are local like most of the Malaysian issues.
 - Some are International such as the IDB Sukuk.

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Average break down of subscribers:

25% Central banks & Governments.

23% Asset Mangers

20% Islamic Banks

18% Other banks

47% Middle East


31% Asia

22% Europe

What is Sukuk

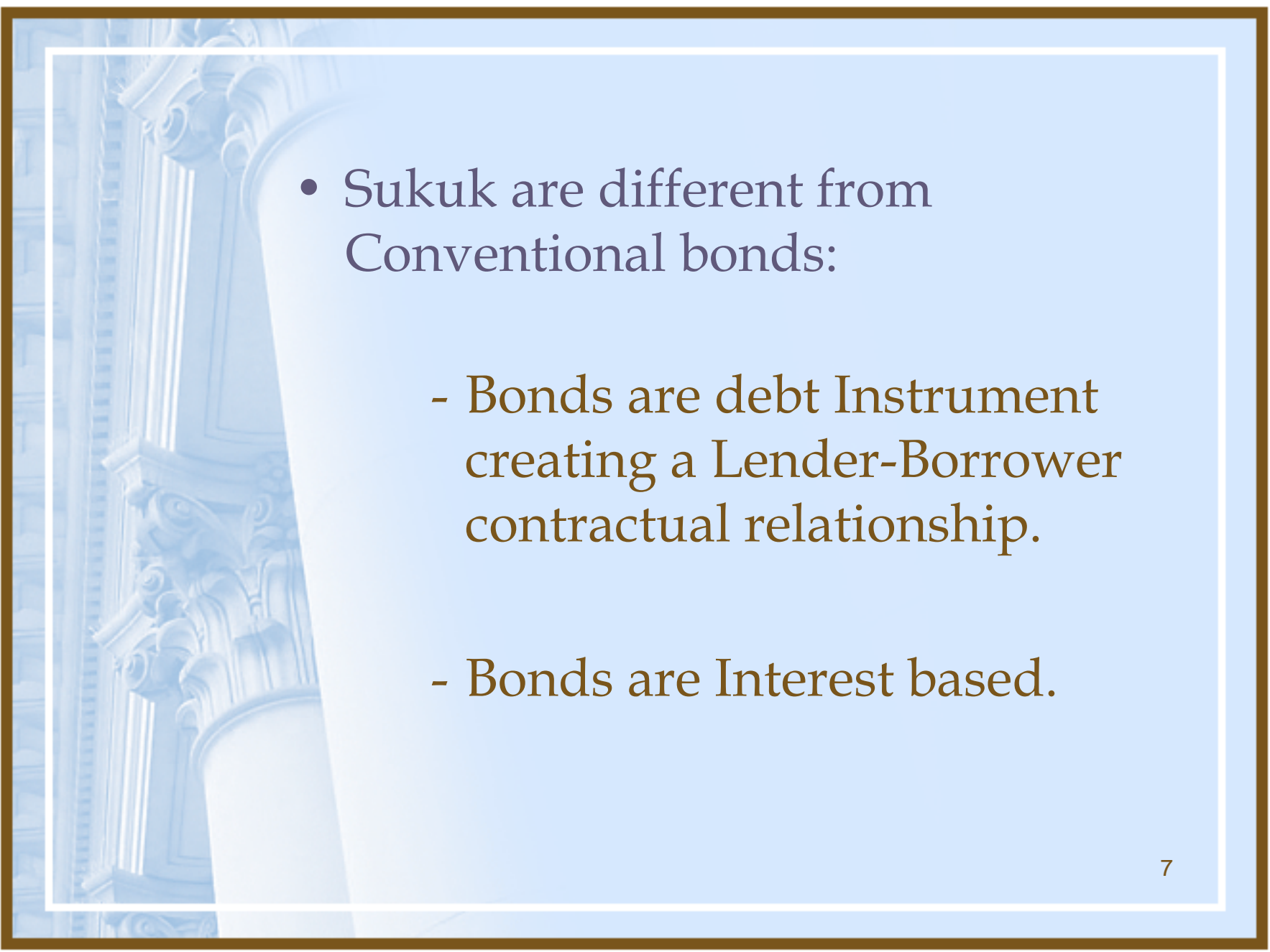
- “Sukuk” is the plural of the Arabic word “SUK”
- A “Suk” in the classical Arabic means:

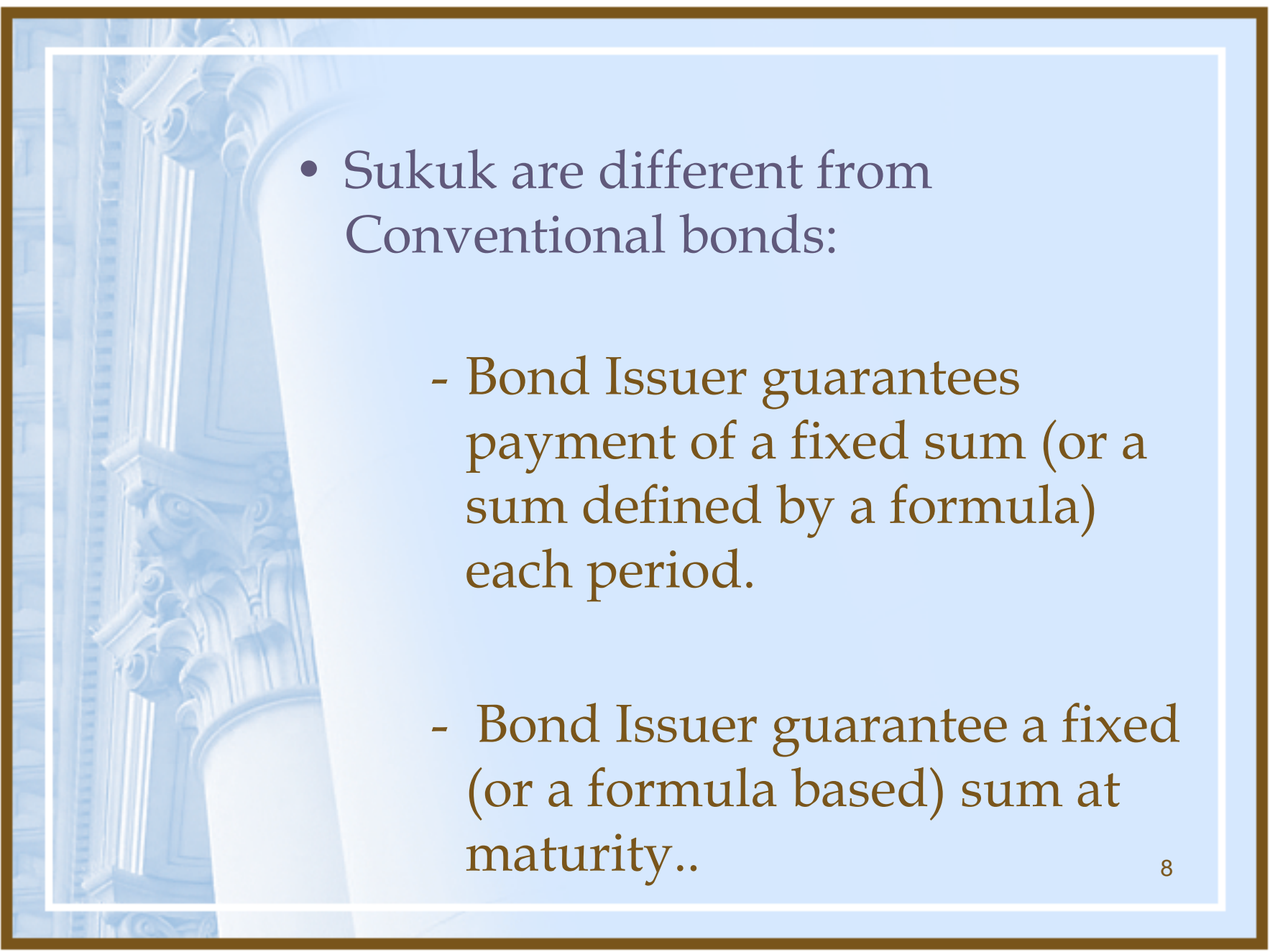
A certificate evidencing financial obligation.

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- The background of the slide features a light blue gradient with a faint, semi-transparent image of classical architectural columns on the left side. The columns are white with detailed capitals and are set against a darker blue background.
- In the Jargon of modern Islamic Finance, Sukuk can be defined as:

Tradeable Certificates that offer predictable return at low risk.

- Frequently Sukuk are referred to as “*Islamic bonds*”. This may not be correct.

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- The background of the slide features a light blue gradient with a faint, semi-transparent image of classical architectural columns on the left side. The columns are white with detailed capitals and are set against a darker blue background.
- Sukuk are different from Conventional bonds:
 - Bonds are debt Instrument creating a Lender-Borrower contractual relationship.
 - Bonds are Interest based.

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- The background of the slide features a light blue gradient with a faint, semi-transparent image of classical architectural columns on the left side. The columns are white with detailed capitals and are set against a darker blue background.
- Sukuk are different from Conventional bonds:

- Bond Issuer guarantees payment of a fixed sum (or a sum defined by a formula) each period.

- Bond Issuer guarantee a fixed (or a formula based) sum at maturity..

Why Sukuk

There are 3 parties in Sukuk issuance that explain the emergence of sukuk:

- Islamic Investors,
- Issuers
- and the rest of the economy.

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For Islamic Investors:

- Sukuk are instruments needed to help create an efficient portfolio for some Islamic investors and meet the preference of lower risk for others.
- An efficient portfolio is one that provides the greatest expected return for a given level of risk or alternatively carry the lowest risk for a given expected return.

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For Islamic Investors:

- Prior to Sukuk, Islamic investors portfolios were basically stocks and real estate, involving more risk than many investors willing to carry.
- Sukuks fill a gap in Islamic Investment world.



For Corporate Issuers :

- Corporations whose internally generated funds are not sufficient for their expansion, need outside sources of funds.
- Sukuk provide a source of funds cheaper than equity and bank loans.

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For Sovereign Issuers :

- For sovereign issuers Sukuk can be a source of Halal funds. Thus responding to public pressure on Islamic government to rid itself from Riba. They could also be instruments for monetary policy within Shari'ah permissibility.

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For the economy at Large:

- Sukuk help make capital market more efficient.
- An efficient market is one that provide liquidity and functions to allocate resources to their most productive uses at the least possible cost.



The Challenge of Sukuk

- The challenge of Sukuk is:

How can we design a financial paper that, while neither debt nor interest based, it can still fill the gap of “bond” in the capital structure of a corporation and the composition of Islamic Investment portfolio.

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The Challenge of Sukuk

- In Islamic finance loans that create interest based debt are prohibited. However, Murabaha which create profit based debt is permissible.
- We thus substitute Murabaha for loans

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The Challenge of Sukuk

- Murabaha based Sukuk will not be possible because this will create a debt instrument .
- Trading debt instruments (even if debt emanates from sale) is prohibited. It is *riba*

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The Challenge of Sukuk

- We need an innovative structure for an instrument that is not debt yet *behaves* in the market like a fixed income security.
- Sukuk must be asset based.
- This asset must be real not monetary.

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Basic Structure of Sukuk:

- Sukuk are certificates representing undivided shares in a real asset.
- A real asset from Shari'ah point of view can be: a service, a right, usufruct or a tangible asset.

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Basic Structure of Sukuk:

- Sukuk are not *asset backed* as in the securitization of rental payments. In technical terms, asset backed securities are debt instrument where the assets are used as a collateral to secure a loan.



Basic Structure of Sukuk:

- The assets in “Asset backed securities” are basically receivables.
- Sukuk are *asset based* thus representing ownership of Sukuk holders of the income generating asset.

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Basic Structure of Sukuk:

- This income generating asset can create a cash flow via a contractual relationship of Ijara, Musharakah, Mudarabah...etc.

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Ijara Sukuk, The Most Common Structure:

- The most common Sukuk structure is Ijara based.
- Ijara is the name of rent contract in Islamic law.

Ijara Sukuk, The Most Common Structure:

- Sukuk holders would own an asset which produces usufruct.
- Usufruct sold to a third party via an Ijara contract thus creating a cash flow.



Ijara Sukuk, The Most Common Structure:

- The structure of an Ijara based Sukuk will work as follows:
 - Issuer A needs liquidity of \$ 100 M.
 - Rather than borrow from banks or the market, it can issue Sukuks worth \$100 M .



Ijara Sukuk, The Most Common Structure:

- Issuer A owns its headquarter building which is valued at, say \$100 M.
- An SPV is set up to which the title to the said building is transferred.



Ijara Sukuk, The Most Common Structure:

- SPV will then issue One Million Sukuk worth \$ 100 each for a total of \$ 100 M.
- When the issue is covered, the SPV will have \$ 100 M which will use to pay the purchase price of the building to Issuer A.



Ijara Sukuk, The Most Common Structure:

- The sale contract means the ownership of the building is now held by Sukuk Holders.
- The SPV will then enter into a lease contract with Issuer A to lease the building for say 5 years.

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Ijara Sukuk, The Most Common Structure:

- Periodical lease payments by the Issuer will constitute a cash flow representing Sukuk income..
- Sukuk holders will therefore receive a periodic predictable income similar to coupon payment in a bond.



Ijara Sukuk, The Most Common Structure:

- Lease payments can be fixed or floating depending on the terms of the lease contract. Thus creating a fixed or floating income security.
- In both cases they will render the income of Sukuk holders predictable.

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Ijara Sukuk, The Most Common Structure:

- Issuer A promises the SPV to purchase the building for a determined sale price at end of 5 year period (maturity).
- SPV promises to sell the asset after 5 years

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Ijara Sukuk, The Most Common Structure:

- At maturity the SPV will sell the building back thus availing the SPV sufficient amount of funds to pay to Sukuk holders the face value of the Sukuk.

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Ijara Sukuk, The Most Common Structure:

- Sukuk holders will be taking the risk of issuer because periodic payments are an obligation on the issuer, and principal is secured by promise to purchase.
- Under this structure, Sukuk will be rated similar to the rating of issuer

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Ijara Sukuk, The Most Common Structure:

- Sukuk issued on the basis of this structure can generate fixed or formula based income depending on the form of lease contract.



Shari'ah Compatibility:

- This is the most common Sukuk structure on which close to 80% of sukukuks are issued.
- Shari'ah Boards are divided on compatibility of the Ijara structure to Shari'ah:
 - Outright rejection by some Shari'ah boards.

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Shari'ah Compatibility:

- Other Shari'ah boards accepted promise to purchase at principal provided right of Sukuk holders to sell to third parties is firmly established.
- Yet, other Shari'ah boards do accept the above structure as is



Shari'ah Compatibility:

- For this structure to be Shari'ah compatible (i.e. accepted by majority Shari'ah boards) the following requirements must be met:

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Shari'ah Compatibility:

- 1) The sale contract between the issuer and the SPV must be a true sale contract transferring all rights of ownership to the Sukuk holders. Price paid must be fair market value.

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Shari'ah Compatibility:

- 2) The asset which is the subject of this sale contract (the building in our case) must be one that have a market value thus can be sold to third parties if need be. The building of the “Ministry of defense” may not qualify for this purpose!

Shari'ah Compatibility:

- 3) There must be no obligation on the Sukuk holders (SPV) to sell back the asset to the issuer neither at maturity nor before hence it is for Sukuk holders an option though promise to purchase at the set price is binding on issuer A.

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Shari'ah Compatibility:

- 4) The asset should not be sold back to the issuer at the same purchase price. Consideration to changing market conditions and waning off of the building must have an effect on the sale price.

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Shari'ah Compatibility:

- If all these requirements are met, then almost all Shari'ah boards will approve this Sukuk structure. An issue of Sukuk meeting all these requirements will be standing on solid Shari'ah ground.
- Very few Sukuk issues meet these requirements.

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Shari'ah Compatibility:

- The most difficult requirement to meet is the last one: Sale price.

Without some form of guaranteed pay back of principal, Sukuk will not “behave” like a “bond” hence will not fill the gap.

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The Salam Sukuk :

- Salam is a sale contract where price is paid at time of contracting while sold item are deferred to a future date.
- Salam is a forward sale except that it is not permissible to defer the price or any portion of it.

The Salam Sukuk :

- The subject of the Salam contract must be fungible or close to fungibles like wheat, oil...etc
- Sukuk had been structured on the basis of the Salam contract where an SPV can issue Sukuk and then enters with company A into a Salam contract purchasing say cement to be delivered 90 days from today.

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The Salam Sukuk :

- Clearly the purchase will be at a discount from the going market price.



The Salam Sukuk :

- The SPV may appoint company A to sell the cement in the open market after delivery has been complete and title is transferred to the SPV after the said 90 days.
- This can be done at a fee to company A.
- This structure has two problems which rendered its use very limited.

The Salam Sukuk :

1. High risk for Sukuk holder will bear the full risk of changing market price.
2. This type of Sukuk cant be traded. To majority of Shari'ah scholars, it is not permitted to sell goods purchased on Salam except after delivery.
3. Trading of the Salam Sukuk effectively means that.

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The Salam Sukuk :

4. The Maliki school firmly permit such sale hence there is room for acceptability.
5. There has been few non traded Salam Sukuk issues in Bahrain.

Musharaka Sukuk:

- Musharakah is a contract of partnership.
 - Sukuk can be based on Musharakah.
 - The issuer and Sukuk holders become share holders of the underlying assets.
 - The return is then shared at a preset formula.




Musharakah Sukuk:

- Loss must be shared pro-rate.
- The structure will include a promise to purchase the assets offered by the issuer to the Sukuk holders.
- An example is the Khaznah Sukuk.

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Mudarabah Sukuk

- Mudarabah is an agency & management contract whereby Rub Almal (financier) provide funds to Mudarib (agent) to invest for a share in profit.
- Loss is born by financier and Mudarib is entitled to no compensation.
- It is not permitted in Shari'ah for Mudarib to idemnify financier against loss, except in cases of misconduct or negligence.


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- Burden of proof is on the financier.
 - Without such conditions the paper will not function as substitute for “bond”.

Furthermore, the underlying assets, must not be debt.

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Validity, binding effect and enforceability of Sukuk.

- Would the provisions of the Sukuk be given effect by the courts?
- Would the contractual undertakings enforceable under the designated governing law.

- 
- For the Sukuk to be legally valid have binding effect and enforceable they should be:
 - Issued under a law.
 - Regulated by a government agency.
 - Sophisticated courts

These conditions are rarely met.



Examples of Sukuk

1) Sovereign Sukuk

Pakistan Sukuk

Issuer: Government of Pakistan
Date: March 2005

Lead Manager: HSBC Amanah & Citi
Group

Issue: USD. 600 Million 5 Year

Price: 6 month US\$ LIBORr + 220bps
Shari'ah board: HSBC Amanah



Khazanah Convertible Sukuk

Date: October 2006

Issuer: Khazanah Nasional Bhd
(Malaysia)

Size: US\$ 750 Million

Tenure: 5 Years

Shari'ah board: UBS Noriba



Qatar Global Sukuk

\$ 700 M Oct 2003 Due 2010.

To construct Hamad Medical
City in Doha.

SPV was granted partial of land
to issue Sukuk.

SPV then lease land to
Government.



German Sukuk

Date: September 2004

**Issuer: Federal State of Saxony Anhalt,
Germany.**

Rating: AAA Fitch, AA-S&P

Lead Manager: Citigroup



German Sukuk

Structure:

Master lease for 100 years. Buildings owned by the state are leased to SPV for say \$100. \$100 is collected from Sukuk holders and paid to the state. SPV as owner of 100 years of usufruct will sublease the buildings back to state for 5 years. Thus receiving Libor based rentals every quarter. After 5 years lessee pay back the rent of 95 years to SPV, if decides not to renew.



German Sukuk

Return: Variable rentals.

Shari'ah board: Citi Islamic Investment Bank.

2) Corporate Sukuk

Sarawak Sukuk

Issuer: Sarawak Corporate Sukuk Inc.
(Labuan).

Lead Manager: UBS (Noriba)

Rating: Baa3 Moody, A-S&P

Size: 350,000,000

Tenure: 5 Years



Sarawak Sukuk

Return:

110 bps + 6 month USD LIBOR

Listing: Luxembourg Stock Exchange
& Labuan Stock Exchange.

Shari'ah board:

Noriba Shari'ah board.



Sarawak Sukuk

Distribution:

Hong Kong 23%, Singapore, Middle
East 9%, Europe 20%

Type of Investor:

Asset Manager 46%, Banks 54%



SABIC Sukuk

Date: July 2006

Issuer: Saudi Basic Industries
Corporation (SABIC)

Size: \$ 800 Million

Lead Manager: Saudi British Bank
(SABB)



SABIC Sukuk

Structure:

SABIC has exclusive marketing agreement for the production of partially owned subsidiaries. Rights were sold to Sukuk holders for 5 years. SABIC appointed as agent to manage marketing and share proceeds with Sukuk holders. SABIC promised to buy back the marketing rights after 5 years.

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The IDB first Sukuk.

- IDB has built a large portfolio of leased equipment as well as another of receivables for installment sale receivables.



The IDB first Sukuk.

- IDB wanted to use these assets to issue Sukuk with guidance from Citi Islamic Investment bank Shari'ah board a structure was designed for this purpose on the following:



The IDB first Sukuk.

- A pool of leased equipment and receivables was formed consistently 51% min equipment and 49% max receivables.
- Pool was sold to a subsidiary which IDB owns less than 100%



The IDB first Sukuk.

- For say \$ 100 The subsidiary (ICD) then issues Sukuk worth \$ 100 and received same from Sukuk holders.
- Now Sukuk holders own the pool of receives a quarterly return from the cash flow of the assets.



The IDB first Sukuk.

- Such cash flow is divided in two portions one paid as quarterly return, and the other is used to create more assets upto a point then retained.
- At maturity (5years) principal will be paid from hopefully from the retained earning.
- IDB issued a guarantee to purchase the pool at maturity for \$ 100 from Sukuk holders.



The IDB first Sukuk.

- This guarantee was accepted by the Shari'ah board since IDB is actually a third party.
- The guarantee made it possible for the Sukuk to have a high rating: AAA by S&P,
AA by Fitch

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Dow Jones Citigroup Sukuk Index

- The Global Sukuk Index is designed to represent the growing Islamic sukuk market.
- Since the introduction of the first Islamic global sukuk issued in July 2002 by the Government of Malaysia, the amount of issuance has grown since then.

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Dow Jones Citigroup Sukuk Index

- The index includes investment-grade US dollar denominated Islamic bonds issued in the global market.
- It also includes non-rated government-guaranteed issues if the government is rated investment-grade.

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Dow Jones Citigroup Sukuk Index

- The Global Sukuk Index is part of the Citigroup Fixed-Income Index family with consistent design criteria and calculation assumptions.



Dubai National Mudarabah Sukuk

- National Mudarabah Sukuk issued by Dubai government for financing development projects. They are based on the concept of Mudarabah.
- The innovation is that these Sukuk's are issued on the basis of specific feasibility studies forecasting a rate of profit. If Mudarib fails to generate profit it is considered mismanagement.
- An offer to purchase the Sukuk at par reduces risk and assures a high rating.
- In addition, a monthly draw on a one million dirham.