

# *Re-Engineering of Structural & Issuance Procedures of Sukuk*

By,  
*Ijlal A. Alvi*



## *Contents*

- ❖ Introduction to IIFM
- ❖ Industry Overview
- ❖ Global Sukuk Structures
- ❖ Sukuk Issuance
- ❖ Sukuk Developments
- ❖ Sukuk Challenges
- ❖ Recommendations for Way Forward
- ❖ Conclusion

## Evolution of the Islamic Finance Industry & Islamic Capital Markets

- ❖ Islamic finance has followed in the wake of innovations in the global financial services industry
- ❖ A natural progression of the Islamic finance industry – Capital & Money Market
  - competitive retail offerings
  - sophisticated corporate banking products
  - innovative project finance solutions

1970's	1980's	1990's	2000's	2005+
<ul style="list-style-type: none"> <li>• commercial banking</li> </ul>	<ul style="list-style-type: none"> <li>• 1970's services</li> <li>• project finance &amp; syndications</li> </ul>	<ul style="list-style-type: none"> <li>• 1980's Services</li> <li>• equity</li> <li>• Ijarah</li> </ul>	<ul style="list-style-type: none"> <li>• 1990's services</li> <li>• sukuk</li> <li>• structured alternative assets</li> </ul>	<ul style="list-style-type: none"> <li>• 2000's Services</li> <li>• liquidity management tools</li> <li>• Foreign Exchange &amp; Hedging</li> <li>• Securitization (ABS &amp; MBS)</li> </ul>

3

## IIFM

- ❖ The IIFM is an international infrastructure, non-profit organization, established through the collective efforts of five countries and one multilateral institution: Bahrain, Brunei, Indonesia, Malaysia, Sudan and Islamic Development Bank.
- ❖ *IIFM's Principal Objective is to establish, develop, promote and regulate the Islamic Capital and Money Market on the principles of Shari'ah*
- ❖ IIFM's role is that of a developer and catalyst of the Islamic financial market encompassing both the short-term money market and the long-term capital market

4

## *IIFM - Vision & Mission*

❖ Vision:

*Active and well regulated trading and capital flows across the full spectrum of Shari'a compliant financial instruments internationally*

❖ Mission:

*To achieve the Vision by catalyzing both national and international trading infrastructure, product innovation and information flow within strong, transparent and well regulated standards and guidelines. Promoting acceptance and integration with mainstream markets.*

5

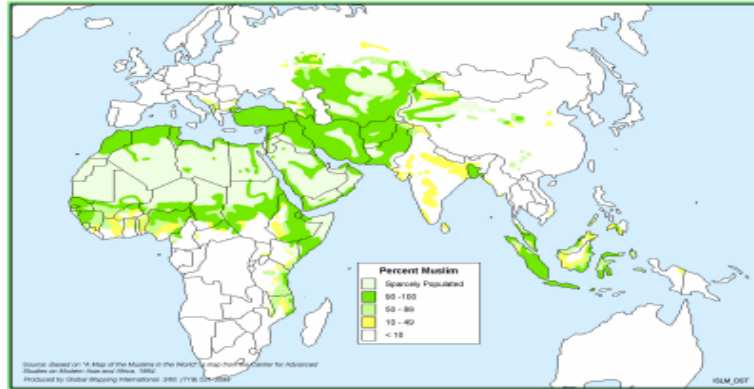
## *IIFM - New Services*

❖ New Services under consideration as per IIFM's mandate are:

- Standardization of contracts, market practices - keeping innovation intact
- IT infrastructure development
- R&D and non-commercial product development
- Information portal & market development initiatives
- Template or working model for asset management etc.
- Islamic Financial Market Association
- Shari'ah Enhancement Services

6

## The Islamic Sukuk Market

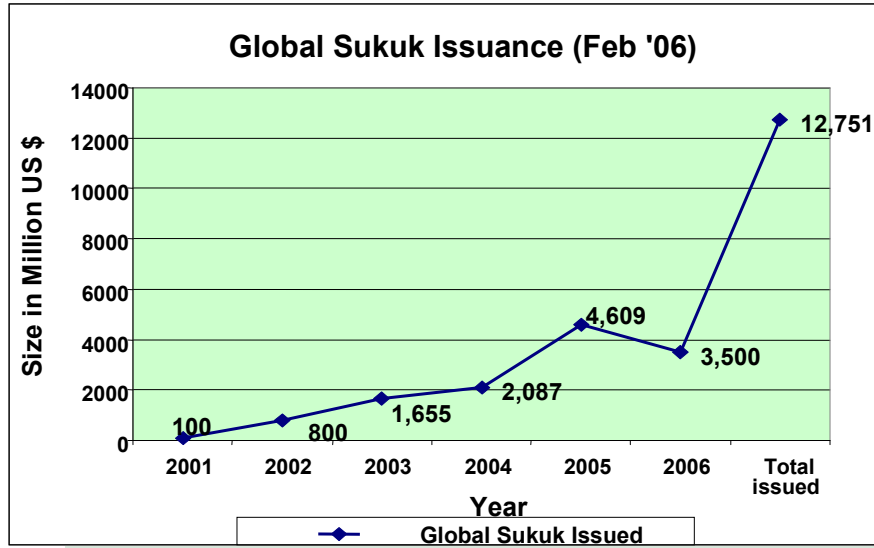


- ❖ The total worldwide Muslim population is 1.3 billion.
- ❖ Sharia-compliant assets, growing over the last 20 years, represent an estimated US\$ 300 billion banking assets & approximately \$400 billion Capital Market
- ❖ Assets are held by over 300 Islamic Financial Institutions.
- ❖ Estimated annual growth for Islamic Capital Market is between 15% to 20%<sup>7</sup>

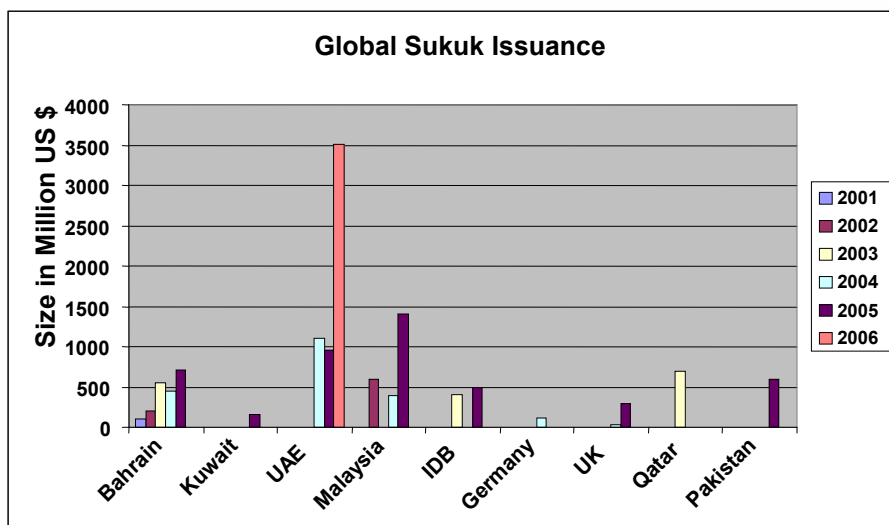
## Malaysian Capital Markets

- ❖ Adopted a parallel Islamic / Conventional approach in 1983
- ❖ Now Islamic Capital Market Leaders
- ❖ As at the end of 2005
  - 857 Islamic Equity Securities – 85% of total market
  - Total Capital Market instruments US \$ 110 billion
    - Islamic Instruments \$31 billion- 28 % of total
  - Total Bond market \$33 billion
    - Islamic bonds account for 49.8%
  - Most issues not accepted in the Arabian Gulf
  - First Global Corporate Sukuk
    - Guthrie \$ 150m in 2001
  - First Global Sovereign Sukuk
    - Malaysian sovereign - \$600m (2002)

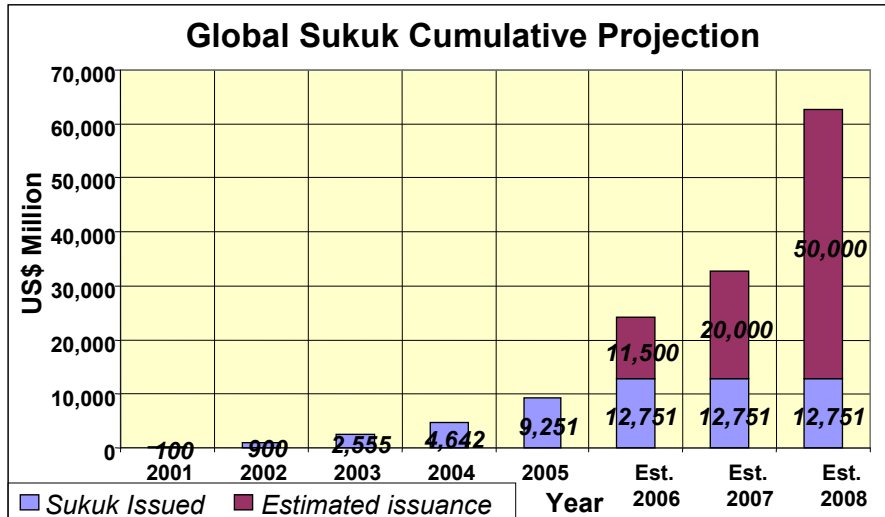
## Global Issuance (Year)



## Global Issuance (Country)

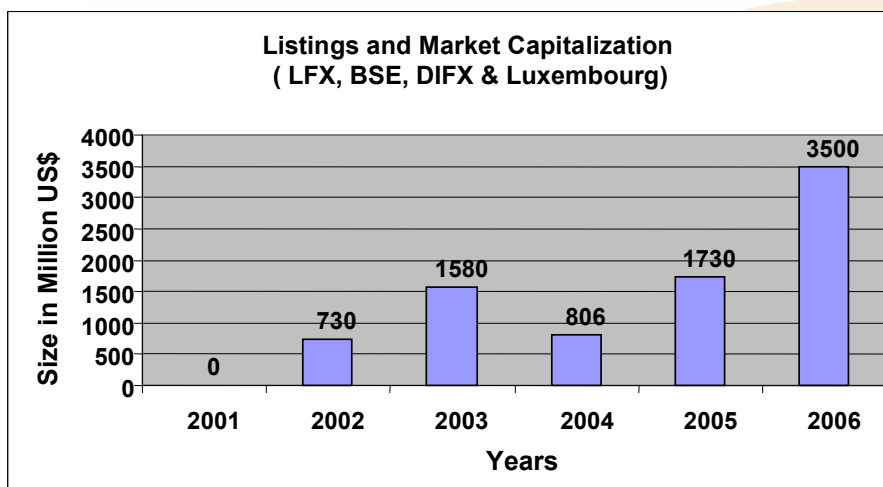


## Global Sukuk Issuance (Estimated)



11

## Listing of Sukuk at LFX, BSE, DIFX & Luxembourg



Cumulative Listed amount = \$ 8,346 million

12

## Global Sukuk Structures



- ❖ Sukuk are more similar to “pass-through certificates”, “equipment trust certificates”, or “investment certificates”, due to ownership attributes
- ❖ Each Sakk (singular form of Sukuk) represents a proportional or undivided ownership in an asset or pool of assets
- ❖ Currently, there are 24 Sukuk structures available based on different contracts
- ❖ The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines 14 eligible Asset classes for Sukuk issuance:
  - *Sukuk Al-Ijarah:*  
The owner of an existing tangible leased asset may sell such assets through Sukuk
  - *Sukuk Ijarah Mowsufa Bithima:*  
The owner of a tangible asset to be acquired and subject to a lease contract may mobilize the acquisition cost of such an asset through sukuk issues

13

## Global Sukuk Structures *cont'd.*

- *Sukuk Manfaa Ijarah:*  
The owner of leasehold rights of existing leased assets may sell the usufruct such assets through Sukuk issues
- *Sukuk Manfaa Ijarah Mowsufa bithima:*  
The owner of leasehold rights of an asset to be acquired and subject to lease contract may sell the usufruct of such an asset through Sukuk issues
- *Sukuk Milkiyat Al-Khadamat:*  
Proprietors wishing to undertake specific services may mobilize the cost of such services by pre-selling the services and their expected benefits through Sukuk issues
- *Sukuk Al-Salam:*  
Proprietors wishing to produce/provide specific goods/commodities at a future date may pre-sell such future delivery goods/commodities through Sukuk issues

14

## Global Sukuk Structures *contd.*

➤ *Sukuk Al-Istisna'a:*

Constructors, manufacturers etc. wishing to construct/manufacture and deliver specific assets at a future date may seek the cost of such future delivery assets through Sukuk issues

➤ *Sukuk Al- Murabaha:*

Proprietors wishing to acquire certain goods/commodities to be on-sold under a Murabaha agreement may mobilize the cost of such goods/commodities through Sukuk issues. The Sukuk holders shall own such goods/ commodities and shall be entitled to the sale price of the same.

15

## Global Sukuk Structures *contd.*

➤ *Sukuk Al-Musharaka:*

Proprietors of a Business partnership may seek capital participations in to the partnership through Sukuk issues. The Sukuk holder share in the risks and rewards of the partnership

➤ *Sukuk Al-Mudaraba:*

An entrepreneur (Mudarib) with a good business idea but without capital or little capital may mobilize sufficient funds for a proposed business/project from capital providers through Sukuk issues. The Sukuk holders share in the risks and rewards of the Mudaraba

16



## Global Sukuk Structures *cont'd.*

➤ *Sukuk Al-Wakala:*

Capital may be raised through Sukuk issues to acquire certain assets or goods or services which are then entrusted to an agent (Wakil) for management of the same on behalf of the owners. The Sukuk holders take the risk of the underlined assets or goods or services and are entitled to any profits generated from the same.

➤ *Sukuk Al- Muzra'a:*

The principal owners of agricultural land (or the owners of the lease hold rights to such land) may mobilize funds for the cultivation of the land through Sukuk issues. The subscribers to such Sukuk are entitled to a share of the produce of the land as per original agreements with the owners.

17

## Global Sukuk Structures *cont'd.*

➤ *Sukuk Al-Musaqa:*

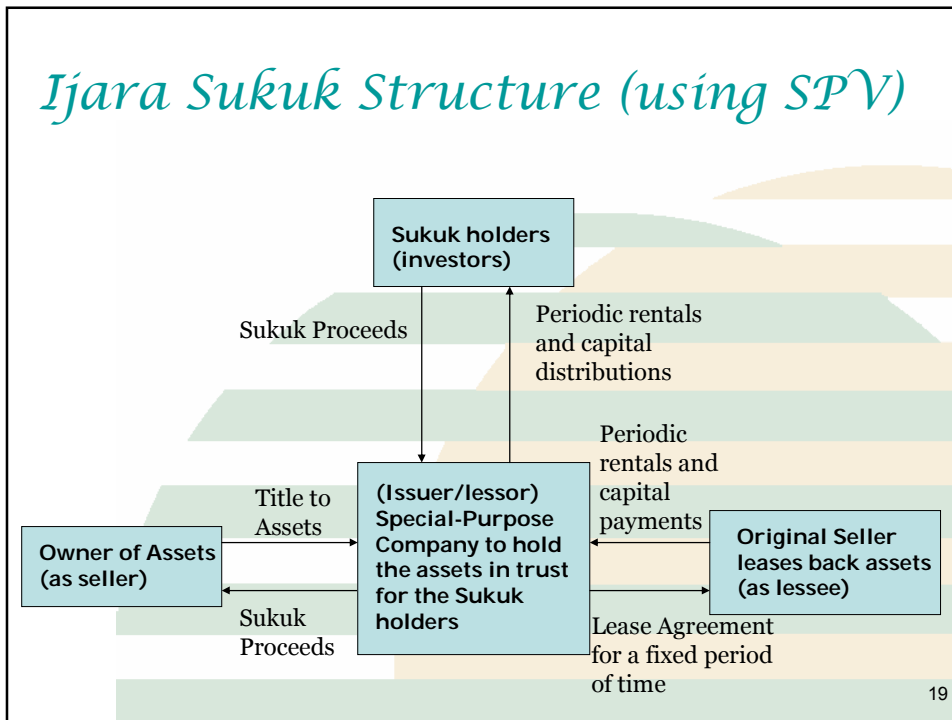
The owners of mature farm trees (Orchards) may mobilize funds for their irrigation, maintenance, etc., through Sukuk issues. The subscribers to such Sukuk are entitled to a share of the produce of the trees as per original agreements with the owner.

➤ *Sukuk Al- Muqarasa:*

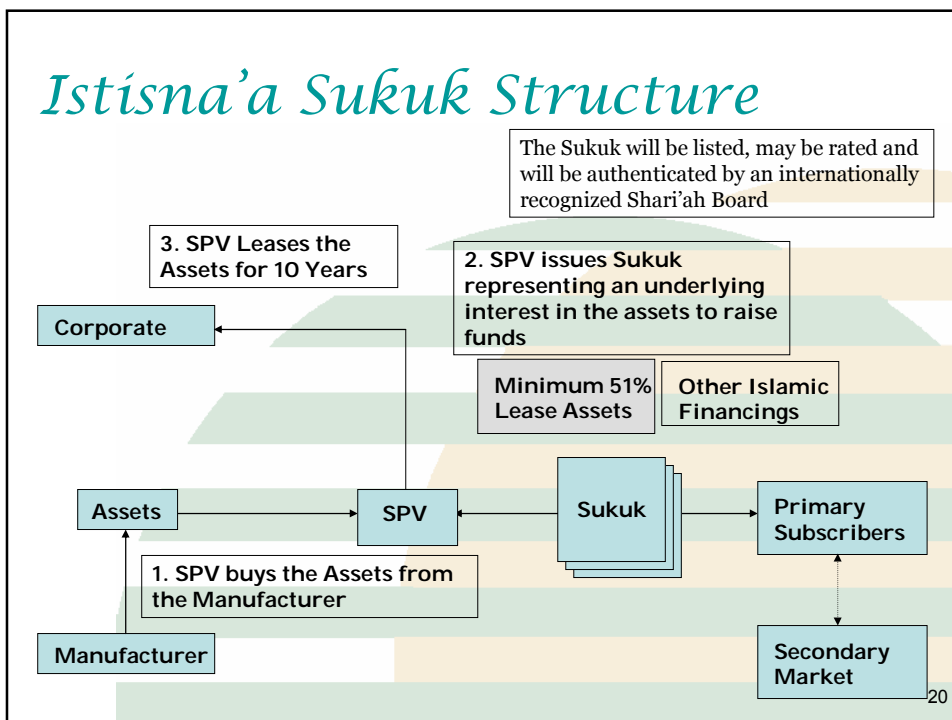
The owners of a farm land with trees/crops thereon may mobilize funds to maintain the land as well as the trees/crops through Sukuk issues. The subscribers to such Sukuk are entitled to a share of the produce of the land and of the trees as per original agreements with the owners.

18

## Ijara Sukuk Structure (using SPV)



## Istisna'a Sukuk Structure

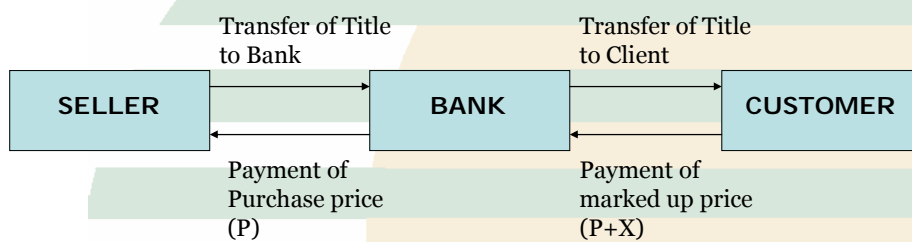


## Commonly Used Contracts- Sukuk Issuance

### I. Murabaha Contract

#### ❖ Murabaha: (cost plus sale)

A sale contract whereby the purchase price is determined on a cost plus a predetermined profit basis and such purchase price is payable either by installments or through a single payment



21

## Commonly Used Contracts- Sukuk Issuance

### I. Murabaha Contract

❖ Murabaha is the most widely used instrument of Islamic finance with 75% of total contracts being Murabaha based. It is widely used in consumer and corporate financing as well as in subordinated or term financing. The responsibilities of the various parties to a Murabaha contract are set out below:

- The bank buys asset from the vendor at P
- The customer then buys the asset from the bank at marked up price (P+X), which is payable on a deferred payment basis.
- The period covering the deferred payment is effectively the period of financing
- The title to the assets is transferred to the customer at the time of the customer's purchase of the asset.

22

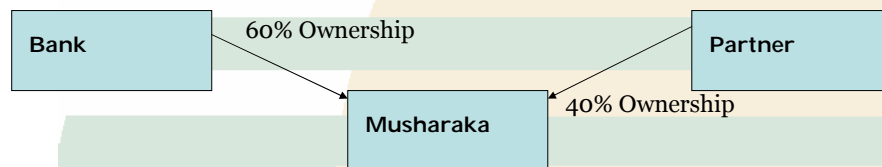
## Commonly Used Contracts- Sukuk Issuance

### II. Musharaka Contract

#### ❖ *Musharaka*: (equity participation)

A Musharaka is a partnership between the FI and an enterprise in which the FI supplies working Capital. The FI and its partner share the profits which may be different from the proportions of capital contributed .

Alternative: “Diminishing Musharaka” whereby the partner agrees to buy out the Bank’s share over a period of time



23

## Commonly Used Contracts- Sukuk Issuance

### II. Musharaka Contract

#### ❖ The responsibilities of the various parties to a Musharaka contract are given below:

- Both the investor and the enterprise contribute towards the capital
- Under a “diminishing” Musharaka, the enterprise buys out the investor’s share over a period of time.
- The enterprise and the investor share in the profits according to the agreed proportions, which may be different from the proportions of capital contributed. Any losses of the enterprise will be borne by the investor and the enterprise according to their contributions

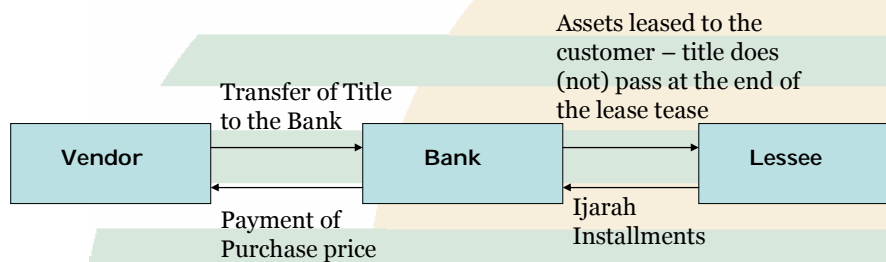
24

## Commonly Used Contracts- Sukuk Issuance

### IIIa. *Ijarah Contract*

#### ❖ *Ijarah*: (leasing)

*Ijarah* is a lease purchase contract in which a FI purchase equipment or property and lease it to a Company (Operating Lease)



25

## Commonly Used Contracts- Sukuk Issuance

### IIIb. *Ijarah Wa-Iqtina Contract*

❖ *Ijara wa-Iqtina* is the same as *Ijara* except that the lessees can acquire ownership of the asset by making installment payments. The responsibilities of the various parties to an *Ijara wa-Iqtina* contract are given below:

- The bank buys the assets from the vendor
- The bank then leases the asset to the customer
- The bank collects periodic rentals
- The title of the asset remains with the bank under an operating *Ijara*.
- Title passes to the customer under an *Ijara muntahia bittamleek*, either gradually over the period of the contract or at the end.

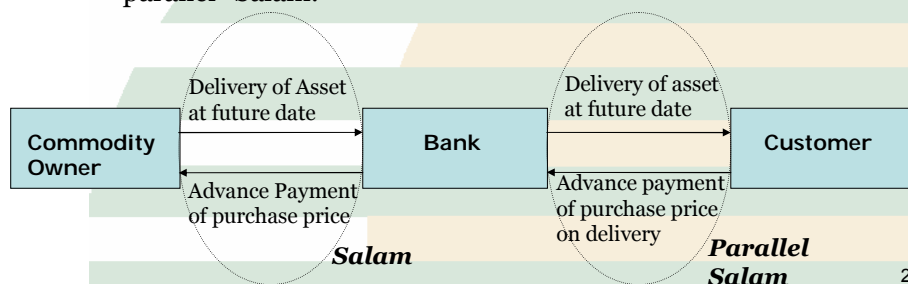
26

## Commonly Used Contracts- Sukuk Issuance

### IV. Salam Contract

#### ❖ Salam:

A Salam is a short term agreement in which a FI makes full prepayments for future delivery of a specified quantity of goods on a specified date. A Salam is primarily a deferred delivery sale contract usually used for commodity finance. It is similar to a forward where delivery is in the future in exchange for spot payment. To mitigate the asset risk the FI can enter into a “parallel” Salam.



27

## Commonly Used Contracts- Sukuk Issuance

### V. Istisna'a Contract

#### ❖ Istisna'a:

A progress payment facility where the price is paid by the financiers to the contract/supplier in accordance with the progress being undertaken or goods being manufactured for selling the project/goods to the buyer (borrower).

The payment by the borrower to the financiers could be a lump sum or be paid over a period in various installments (similar to a *murabaha* contract).

An *istisna'a contract* is a conditional sale contract where the borrower generally starts paying the installments even before the goods/project are transferred where as in a *murabaha contract* the goods already exist at the time of the draw down.

28

## Examples

### I. IDB's Solidarity Trust Services Limited

- ❖ Issuance: 2003
- ❖ Maturity: 2008
- ❖ USD 400 million
- ❖ Listing: Luxembourg & Labuan
- ❖ Sukuk Assets: Comprise a portfolio of rights in *Ijarah contracts* (and the relevant underlying assets), installment sales (*murabaha contracts*) and *istisna'a* contracts originated by IDB.
  - The *Ijarah* contracts comprise contracts where IDB as lessor has leased property to a lessee in respect of which regular payments are due from the lessee.
  - The *Murabaha* contracts comprise sale contracts whereby IDB has sold assets to an obligor for a purchase price which is determined on a cost plus a predetermined profit basis and such purchase is payable in installments



29

## Examples

### I. IDB's Solidarity Trust Services Limited

- The *istisna'a* contracts comprise contracts of progress payment facilities where the price is paid to IDB (as financier) to a supplier in accordance with the progress of a project being undertaken or goods being manufactured and where such project or goods are then sold by IDB to a buyer who pays the purchase price in installments.
- The composition of the Sukuk Assets will change over the life of the transaction as the Trustee will utilise principal collections for the Sukuk Assets to purchase rights in additional *Ijara* contracts and invest in *Murabaha* contracts after the closing date. No purchases of, or investment in, any *istisna'a* contracts will be made after the closing date.

30

## Examples

### II. Government of Qatar



- ❖ Issuance: 2003
- ❖ Maturity: 2010
- ❖ USD 700 million
- ❖ Listing: Luxembourg & Labuan
- ❖ Sukuk Al-Ijara
- ❖ Structure & Mechanism:
  - The Issuer will purchase certain landed properties from the Government of Qatar. The issuer will first execute the Agency and Trust agreement before entering into the Purchase agreement
  - The Issuer will lease the properties to the Government of Qatar (Lessee) for a period of 7 years
  - The Issuer will appoint the Lessee as the Servicing Agent to provide Major Maintenance for the properties on behalf of the Issuer

31

## Examples

### II. Government of Qatar

- The Government of Qatar will separately grant an irrevocable unilateral undertaking to the Issuer to purchase, at the Exercise price, the properties from the Issuer if there is any default by the Lessee. The Exercise price will be an amount equal to the initial cost of the properties less the amounts paid under the lease rentals.
- The Issuer will separately grant an irrevocable unilateral undertaking to the Government of Qatar to sell, at the Exercise price, the properties to the Government of Qatar at the maturity of the lease. The Exercise price will be an amount equal to the USD 100 plus the total costs incurred by the Issuer or its service agent to service the properties.
- The Issuer will then issue the Sukuk representing, inter alia, the pro rata undivided ownership of the properties and the rights under the Ijara Agreement and related documents.

32



## Examples

### III. PCFC (Dubai Port) Sukuk

- ❖ Issuance: 2006
- ❖ Maturity: 2008
- ❖ USD 3.5 Billion
- ❖ Listing: DIFX
- ❖ Musharaka Sukuk



- ❖ The PCFC sukuk is the largest and also the first-ever convertible sukuk issue. It is convertible to 30 per cent equity shares of the PCFC entities when they go for the IPO.
- ❖ The unique structure of the sukuk, with its convertible element, along with the attractive yield of 7.25 % per annum have made this a highly sought after instrument. If the IPO does not happen, then the yield of the Sukuk will become over 10 per cent per annum.

33

## Examples

### IV. IDB's ENTM Sukuk

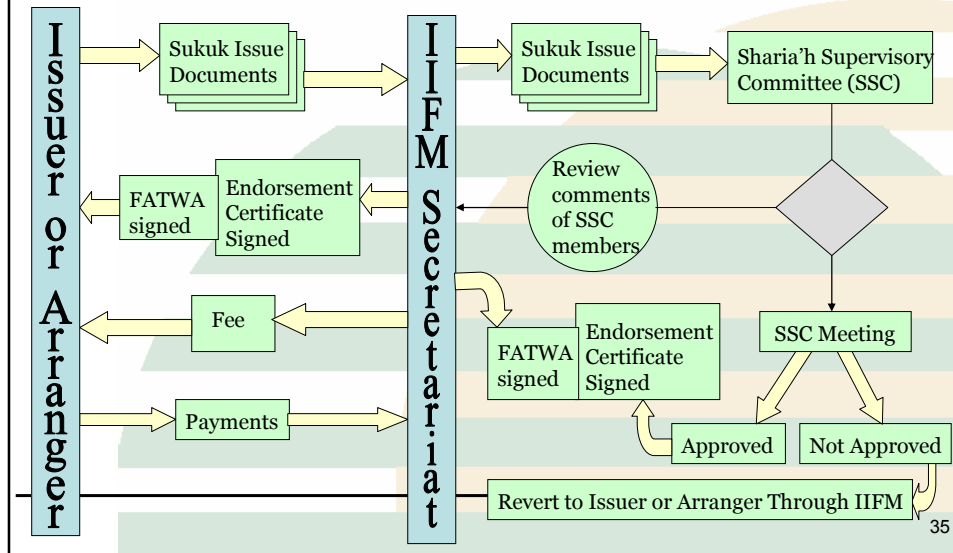
- ❖ Issuance: 2005
- ❖ Maturity: 2010
- ❖ USD 500 million
- ❖ Listing: Luxembourg, Bahrain & Labuan



- ❖ The transaction marked the first time that an issuance programme, similar to an EMTN (Euro Medium-Term Note) programme, has been established for Islamic Sukuk (securities).

34

## Sukuk Issuance- wider Shari'ah Acceptibility



## Sukuk Issuance- wider Shari'ah Acceptibility *Contd*

**IIFM to be involved right from the beginning of the transaction**

### **Steps to Follow:**

1. The issuer/Arranger will contact the IIFM Secretariat to get the Sukuk endorsed.
2. IIFM Secretariat will inform the Issuer/arranger to send the relevant documentation (Note 1)
3. Once the relevant documents on the Sukuk Issue received, IIFM will send the documents to the Shari'ah Supervisory Committee (SSC) for initial review
4. IIFM Secretariat will receive initial review comments (if any) on the documents

### **Note (1):**

**In order to achieve wider acceptibility from Shari'ah Point of view**

**(Draft + Final)**

- \* Fatwa of the Issuer's Shariah Board
- \* The Prospectus or Offering Circular
- \* The Certificate of Sak or Trust
- \* Purchase Agreement
- \* Sale Agreement
- \* Lease Agreement
- \* Promise to Buy Agreement

## Sukuk Issuance- wider Shari'ah Acceptibility *Contd*

5. IIFM secretariat will arrange for SSC meeting and will inform the outcome to the Issuer/Arranger
6. If the Sukuk Issue is approved by SSC, IIFM will issue the following documents and dispatch to the Issuer/Arranger:
  - a. IIFM Fatwa duly signed by all SSC members
  - b. IIFM Endorsement Certificate signed by the Chairman/Deputy Chairman of SSC
  - c. Invoice for the Endorsement fee
7. If the Sukuk Issue is not approved by the SSC, IIFM will revert back to the Issuer/Arranger

**Note (1): Inorder to achieve wider acceptability from Shari'ah Point of view**

- \* Wakala/ Musharaka/ Mudarabaha Agreement
- \* Trust Deed Transaction
- \* Transaction Administration Deed
- \* Beneficiary Deed
- \* Service Agency Agreement
- \* Underwriting Agreement
- \* Sale Undertaking Deed
- \* Any other relevant documents

37

## Sukuk Issuance - Key Considerations



- ❖ Sukuks are tradeable Islamic instruments, equivalent to conventional bonds.
- ❖ Provides access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base
- ❖ Structure now well established with five sovereign/supranational issues ; initial R&D phase over
- ❖ Wide Shariah acceptability achieved for the underlying Ijarah structure - both in the GCC and the Malaysian markets
- ❖ Conventional investors in Europe and Far East now quite comfortable with Sukuks - as they consider it on par with conventional bond issuance.

38

## Sukuk Issuance *Contd.*

- ❖ Demand pull from Islamic banks – Shari’ah scholars prefer Sukuk investments for liquidity management over Commodity Murabaha
- ❖ Pricing is on par with conventional bond issuance with similar terms
- ❖ Secondary market liquidity will develop gradually, as issuance picks up and investors get the option to trade in their existing ‘hold’ positions for new issues
- ❖ The issuance of International Sukuk is one of the most significant mechanisms for raising finance in the international capital market through Islamically acceptable structures

39

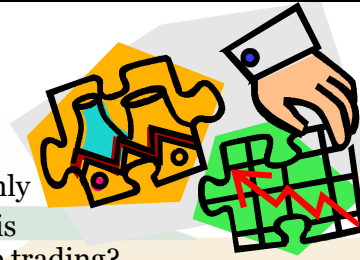
## Sukuk Development

- ❖ Growth rate of Islamic Capital Market is estimated to be 20%+ is expected to maintain the rate in a foreseeable future
- ❖ Sukuks are now issued by Corporate sector for example DP World and by many other by GCC corporate
- ❖ Sukuk are now being looked at as a source of financing for Infrastructure projects
- ❖ Growing number of new Sukuk structures and acceptability of new idea by Shariah scholars
- ❖ Sukuk has a potential to play a major role in the development of Takaful segment of the industry
- ❖ Sukuk primary issuance is phenomenal as compare to conventional issuance e.g. Malaysia



40

## *Sukuk Challenges*

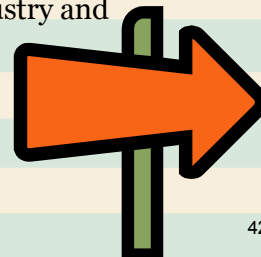


- ❖ Non existence secondary market mainly due to the lack of critical mass. What is the critical Mass required to stimulate trading?
- ❖ Few or no market makers
- ❖ Pricing the secondary market issues - area of inefficiency and requires more transparency
- ❖ Benchmarking marking and absence of Islamic Yield Curve which should have no relations to LIBOR
- ❖ Limited awareness and flow of information Standardization of Contracts & market practices but keeping innovation alive
- ❖ Usage of Sukuk as a monetary management tool by regulatory bodies
- ❖ Lack of Shariah harmonization

41

## *Recommendations For Way Forward*

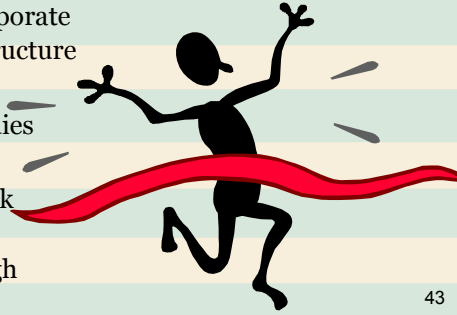
- ❖ Formulation of widely acceptable and appropriate accounting and reporting principles
- ❖ Continue innovating structures such as convertible feature
- ❖ Establishment of regulatory framework
- ❖ Development of infrastructure required for secondary market including refining payment and settlement procedures
- ❖ Allocation of funds and resources by the industry and multilateral institutions for Research and Development
- ❖ Awareness and understanding drive and widely available information



42

## Conclusion

- ❖ In order to achieve the objective of a developed Sukuk secondary market, there should be:
  - Greater cooperation among the industry players
  - Better coordination between Regulatory bodies and industry players
  - Greater participation from corporate sector and financing of Infrastructure projects
  - Key support by Regulatory bodies and regulatory framework
  - Creation of International Sukuk Fund
  - Shariah Harmonization through Endorsements



43

# Thank You

السوق  
المالية  
الإسلامية  
الدولية



International  
Islamic  
Financial  
Market

Phone No: +973 1750 0161 Fax: +973 1750 0171 Email: [iifm@bateclo.com.bh](mailto:iifm@bateclo.com.bh)  
P. O. Box 11454, Manama, Kingdom of Bahrain

44