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PRESENTATION FOR
Bloomberg



The principles of IFS



- In Islam doing legitimate business and earning a fair return is an act of worship that will be rewarded in the hereafter
- Therefore any form of creation of wealth should be in accordance with spiritual principles, moral values and public interest. Proper governance of financial activities becomes a priority issue
- The types of contracts that are permissible and valid and the instruments that are not are laid down in great details

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The lively past: sources ...

- The core principles of Islamic Finance are over 15 centuries old
- Such principles form part of *Shari'ah* which is often translated with 'Islamic Law' although it encompasses the general body of spiritual and moral obligations and duties in Islam. Not a positive law!
- *Shari'ah* shares many of its principles with the other two 'western' sacred laws - the Jewish and the Christian ones - and is the only one still applied. Some consequences

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... the lively past: sources

- Its sources are, in order of importance: the Qur'an; the *sunnah*, the way of the Prophet Muhammed; the *hadith*, the narrative records of the Prophet's life, actions and sayings
- Islamic jurisprudence is called *fiqh*
- Two major boundaries (*haram*): *riba* and uncertainty

The lively past: the boundary of *riba* ...

- In *Islam* money has neither intrinsic utility (It cannot be utilized for fulfilling human needs directly), as commodities have, nor has a distinctive quality. Therefore the exchange of a unit of money for another unit of the same denomination cannot be effected except at par value
- As this is true in a spot exchange transaction, it is also true in a credit transaction where there is money on both sides, because if some excess is claimed in a credit transaction (where money is exchanged for money) it will be against nothing but time. And time belongs to God

... the lively past: the boundary of *riba*

- A problem of translation: does it take into consideration the inflation rate?
- Financing should only be raised for trading in, or construction of, specific and identifiable assets
- Trading in indebtedness is prohibited and *riba* exists only where the subject matter is money on both sides. Also, the title representing debt is not a negotiable instrument: it can be traded only at par

... the lively past: the boundary of *riba*

- In practice, is considered *riba* every gain on a loan predetermined and not based on the profit of the investment
- The profit/loss sharing concept

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The lively past: the boundary of uncertainty



- It is widely understood to mean uncertainty in the contractual terms and/or the uncertainty in the existence of an underlying asset in a contract
- This principle and its consequences for Sukuk is currently among the most studied in the context of Islamic finance
- The consequences for derivatives

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The present: the IFS market



- Today's Islamic Financial Services (IFS) market is a subset of the global financial markets. It had three major driving forces
- In terms of risk analysis the performance of any islamic securities is still driven by cashflows regardless of whether they are sourced from assets or a corporate/sovereign obligor. There is an additional legal layer that should be considered
- There is nothing that prevents the conventional investors from participating in the Islamic market. What is happening in reality

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The present: IFS market size



Conservative estimates show:

- \$ 300bn of assets under management at 250 plus Islamic mutual funds
- \$ 250bn of assets deposited at 300 Islamic financial institutions (15% growth per year)
- \$ 200bn held at Islamic windows of conventional banks

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The Sukuk a traditional instrument ...

- In classical period Islam *sakk* (*sukuk*) meant any document representing a contract or conveyance of rights, obligations or monies done in conformity with the shariah
- Empirical evidence shows that *sukuk* were a product extensively used during medieval Islam for the transferring of financial obligations originating from trade and other commercial activities
- *Sakk* is at the origin of the european root 'cheque/check'

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... fit for a modern use. A definition ...

- Sukuk are asset-backed trust certificates evidencing ownership of an asset or its usufruct
- These certificates are, in turn, based on Islamic traditional financial structures that have been in use for the last 1500 years
- Sukuk are not a completely new asset class. They are securities that employ existing financial engineering techniques (securitisation structures) that create ‘asset-backed’ bond that are *also* Shari’ah-compliant

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... and a *key* requirement: tangibility ...

- Returns and cashflows must be linked to assets purchased or those generated from an asset once constructed (project finance)
- Borrowers to raise compliant financing will need to utilise assets in the structure. Borrowers that provide the assets are commonly referred to as Originators
- This requirement has consequential effects for derivatives

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... and more on tangibility ...

- **Equity.** It is an asset: equity financing is Shari'ah compliant and fits well with the risk/return concepts
- **Receivables.** Their trading for anything other than par is not permissible. However, some Shariah boards have accepted that, as long as such receivables are a small (?) portion of the overall income flows, their presence is acceptable in Sukuk
- **Malaysia** does not place receivables in the category of money and hence allows Sukuk to be 100% backed by receivables. This is a major difference with GCCs

Tangibility: asset-backed Sukuk ...

- Sukuk can be considered to be asset-backed or asset-secured, and therefore sharia compliant, *only if the key securitisation elements are in place*. These elements should ensure that the Sukuk holders have beneficial title and realizable security over the assets with no encumbrances (no claw back ...). This is usually achieved through a SPV
- The credit risk ratings of these Sukuk depends solely on the underlying assets. The standard methodologies on securitisable assets apply (Asset Cashflows, Credit Risk, Liability Structure, Expected Loss ...)

... tangibility: unsecured Sukuk ...

- Such analysis becomes irrelevant if the legal structure does not support Sukuk holders' rights to the underlying assets and to their cashflows
- In fact, an analysis of the commercial terms and legal structures shows that for some Sukuk performance is not governed by the assets and that *the credit risk is really that of the Originator*. This is the case when the SPV is owned by the originator thus preventing the de-linkage between the Originator and his assets

... tangibility: unsecured Sukuk

- Are they really sharia compliant?
- The ratings of these Sukuk depends on the riskiness of the Originator

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Its contemporary use: their added value ...

- The essence of this product, in the modern Islamic perspective, lies in the concept of asset monetisation - the so called securitisation - that is achieved through the process of issuance of *sukuk* (*taskeek*)
- His great potential is in transforming an asset's future cash flow into present cash flow

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... and their legal background ...

- The Islamic Jurisprudence Council decision to uphold the issuance of *sukuk*, Jeddah 1988
- AAOIFI's (Accounting & Auditing Organisation for Islamic Financial Institutions) shariah standard named 'Investment *sukuk*', Bahrain May 2003
- The fourteen eligible assets classes

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... and their legal background ...

Sukuk may be issued on existing as well as specific assets that may become available at a future date. This non-exhaustive list includes:

- *Sukuk al-ijarah*: securitisation of existing tangible leased assets
- *Sukuk ijarah mowsufa bi-thima*: mobilisation of the acquisition cost of tangible to-be-leased assets
- *Sukuk manfaa ijarah*: securitisation of the usufruct of existing leased assets

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... and their legal background ...

- *Sukuk manfaa ijarah mowsufa bi-thima*: securitisation of the usufruct of assets to be acquired and leased
- *Sukuk milkiyat al-khadamat*: pre-sale of the cost of services and their expected benefits
- *Sukuk al-salam*: pre-sale of future delivery of goods or commodities
- *Sukuk al-istisna'a*: mobilisation of the cost of construction and manufacturing of specific assets

... and their legal background ...

- *Sukuk al-murabaha*: mobilisation of the acquisition cost of goods to be sold under a *murabaha*
- *Sukuk al-musharaka*: sale of capital participations into a partnership
- *Sukuk al-mudharaba*: mobilisation of funds from capital providers
- *Sukuk al-wakala*: mobilisation of capital to acquire certain goods that are entrusted to an agent

... and their legal background

- *Sukuk al-muzra'a*: mobilisation of funds for the cultivation of land
- *Sukuk al-musaqa*: mobilisation of funds for the irrigation and maintenance
- *Sukuk-al-muqarasa*: mobilisation of funds for the maintenance of land and crops

Sukuk share similarities with bonds ...



- **Marketability:** *sukuk* are monetised real assets that are liquid and easily tradeable
- **Rateability:** *sukuk* are easily analysed and rated by international and regional agencies
- **Enhanceability:** different *sukuk* structures may allow for credit enhancements or wraps that broaden their appeal to risk-averse investors

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... Sukuk share similarities with bonds ...

- **Versatility: structuring across legal and tax domains of products that meet diverse financing need:**
 - may offers fixed or variable income options
 - may achieve cross listing capabilities
 - compatibility with global bond regulations

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... but their differences lie in complying with Shari'a rulings ...

- *Sukuk* represent actual and legal ownership stakes in assets and services and are *not* monetary documents relating to receivables
- The *sukuk* holder share the return and bear the losses and he is *not* a creditor
- *Sukuk* are valid only *if issued* after receipt of the value of the *sukuk* and the employment of the funds

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... but their differences lie in complying with Shari'a rulings

- *Sukuk* are issued and traded according to shari'a nominated contracts
- The prospectus document should provide complete transparency

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Their enforceability: civil code ...

- Most GCC have a Civil Code and commercial disputes tend to fall before a commercial court
- As in any new jurisdiction, there may be a lack of precedent and uncertainty regarding matters of law. The legal framework in many countries remains untested. No precedent with regards to bankruptcy practices
- Country's domestic risks: political risks, legal uncertainties and the efficiency of the local financial markets
- Many of existing transactions are governed by UK or New York law due to their creditor friendly nature

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... and Shariah

- While Shari'ah is acknowledged as one source of law, it is not the law enforced in the courts. Shari'ah takes usually precedence only for personal matters
- The only operational Shari'ah court exists in Saudi Arabia. It is unlikely that such court would be familiar with such complex financial structures which first require all documents to be translated into Arabic
- The problem of Sharia'a non-compliance: the secondary market issue

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Sukuk Structures: *Ijara*

It shares similarities with a Sale and Leaseback structure

1. The Originator seeking financing make a true sale of its asset to the Sukuk SPV for a value equal to the financing provided
2. The SPV issues Sukuks and with the proceeds pays the Originator. Sukuk holders become beneficial owners of the asset
3. The Originator leases the asset back and makes Lease & Repurchase payments to the SPV. By doing so it repurchases over time its asset

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Sukuk Structures: *Ijara* ...

4. The SPV makes periodic payments (lease flows plus principal)
5. By doing so it provides a 'fixed income' stream which may be benchmarked to an index

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... Sukuk Structures: *Ijara*

Here comes the truth:

- It is an asset-backed Sukuk if there is a correspondence of the income streams with the actual rental and the market value of the asset
- It is an unsecured Sukuk if this correspondence does not exist. In this case the asset only exists to facilitate its Shari'ah compliance

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Sukuk Structures: *Musharaka* ...

It shares similarities to a Joint Venture (JV) structure

1. It is a JV (itself a SPV) between the Originator which contributes some specific assets and management skills and the Sukuk Issuer (usually a SPV) which contributes the investor's Sukuk proceeds
2. The Originator runs the JV, operates the assets and invests the funds
3. The JV makes profit distribution to the Sukuk issuer over the duration of the transactions. Or at maturity via the redemption amount

... Sukuk Structures: *Musharaka*

4. Sukuk holders are entitled to the Issuer's rights in the JV whatever they are
5. In application of the Purchase Undertaking Agreement the nominal amount initially raised is redeemed either through a number of prescheduled instalments or at maturity

... Sukuk Structures: *Musharaka*

Here comes the truth:

- The precise description of the profit distribution and business plan is key part of the offering documentation
- Should the cash flows generated by the assets under the business plan of the JV not be sufficient to fund these payments, the Issuer may have the option to call the purchase undertaking

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Final considerations ...



- The issuance of Sukuk is a relatively recent phenomenon
- It began in Malaysia in 1990 with the small issuance of RM120mm (\$30mm) from a Shell Malaysia subsidiary and has progressed to a recent RM10bn (\$2.7bn) RACB transaction
- Impressively for what began as a conventional financial system, around 75% of all Malaysian corporate borrowing was Islamic in 2005

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... final considerations

- Where we stand now
- G7 Sovereign issue in the pipeline
- Sukuk in the West: a bright future?



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Next major international event

**“Sukuk: Exploring the Phenomena”
Dubai, 25 April 2007**

More on:
<http://www.middleeastbusinessforum.com/sukuk/>

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