

THE INTERNATIONAL



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Islamic Banking Training

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Are Sukuk Islamic ?



Sheikh Taqi Usmani
Chairman of the AAOIFI Sharia'a Board

Are sukuk Islamic?

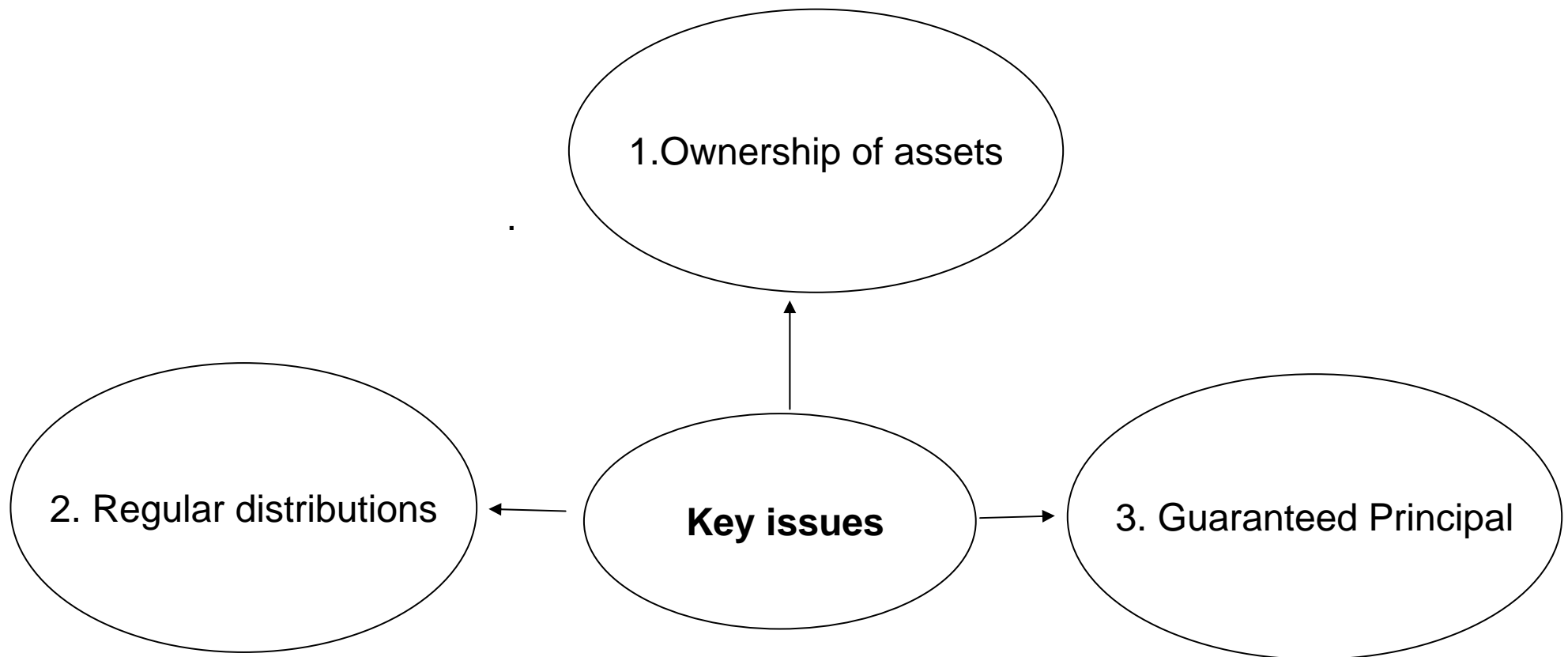
“About 85 per cent of Gulf Islamic sukuk do not really comply with Sharia’a law”

“For current sukuk, risk is not shared and reward is not shared according to the actual venture proceeds. About 85 percent of sukuk are structured this way.”

“You must face the actual consequences of your investment.” Taqi Usmani.

No comment about Malaysian sukuk !!

Three key issues



1. What do sukuk holders own ?

Generally, Sukuk represent ownership shares in assets that bring profits or revenues, like leased assets, or commercial or industrial enterprises, or investment vehicles that may include a number of projects.

The majority of Sukuk are clearly different in this respect from interest-based bonds.

This is a key characteristic that distinguishes Sukuk from conventional bonds

2. Regular distributions to Sukuk holders

Actual profits (AP) = LIBOR = Full return paid to Sukuk holder

Actual profits (AP) > LIBOR = Reward paid to enterprise manager

Actual profits (AP) < LIBOR = Manager pays out difference to Sukuk holders as an interest free loan

Where does the interest free loan fit ?

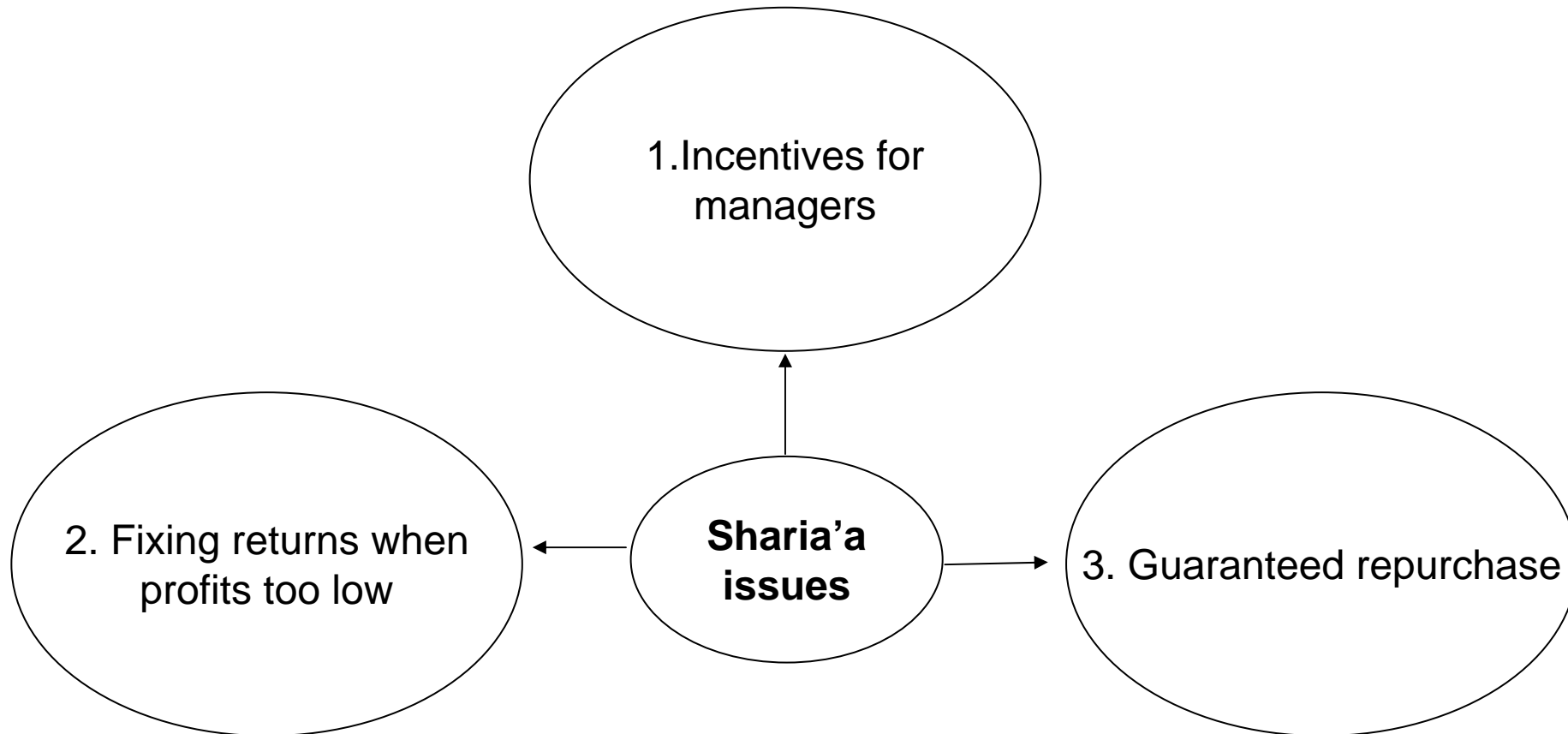
This loan will be recovered by the lending manager either from the amounts in excess of the interest rate during subsequent periods, or from lowering the cost of repurchasing assets at the time the Sukuk are redeemed

3. Guaranteeing the return of principal to sukuk owners

Virtually all of the Sukuk issued today guarantee the return of principal to the Sukuk holders at maturity, in exactly the same way as conventional bonds.

This is accomplished by means of a binding promise from either the issuer or the manager to repurchase the assets represented by the Sukuk at the stated price at which these were originally purchased by the Sukuk holders at the beginning of the process, regardless of their true or market value at maturity

3. Sharia'a Issues



1. Stipulating an incentive for the manager

Management fee should not be based on the difference between Actual Profits and LIBOR.

3 cases:

1. $AP = MEP$ and $AP > LIBOR$
2. $AP < MEP$ and $AP > LIBOR$
3. $AP > MEP$ and $AP > LIBOR$

Assume Poor management performance : AP < MEP

AP	MEP	LIBOR	Management fee paid AP-LIBOR	Sharia'a basis AP-MEP

What is the message ?

Management has performed below what was expected

Yet a performance fee has been paid. Why ?

Incentive fee is linked to LIBOR not management performance

Is this acceptable in the Sharia'a ?

Return should be based on expected profits (MEP)

Sukuk returns are now linked to financing costs

The prescribed percentage rates used in Sukuk are not linked to the expected profits from the enterprise, but to the prevalent rates of interest in the market.

There is no connection between these interest rates and the profitability of the commercial enterprise.

2. Second Sharia Issue .

Stipulating returns when profits fall below prescribed percentages

There is nothing in the Sharia to justify a return when actual profits are less than the prescribed percentages.

Sukuk prospectuses often stipulate that the manager will make loans to the Sukuk holders at times (for distributions) when actual returns fall below the (promised) rate of return.

3. Third Sharia'a Issue

The manager's promise to repurchase assets at face value

Where the Sharia is concerned, the return of investors' capital cannot be guaranteed.

In Sharia compliant dealings, reward always follows the acceptance of risk.

The legal presumption with regard to Sukuk is that there can be no guarantee that capital will be returned to investors.

Instead, investors should have a right to the true value of the [Sukuk] assets, regardless of whether their value exceeds that of their face value or not

Conclusion

1.

2.

3.

4.

5.

AAOFI Press Release March 2008

Key points

1. “Sukuk must represent ownership”

“Tradable Sukuk must represent ownership for Sukuk holders, with all of the rights and obligations that accompany ownership, in real assets, whether tangible or usufructs or services, that may be possessed and disposed of legally and in accordance with the Sharia’a.”

Comment

This means that a Sukuk with a True Sale rather than a Purchase Undertaking are now the only form of acceptable sukuk.

This would have dramatic implications, particularly for Sovereign sukuk. Potential loss of strategic assets

Does this decision matter?

Any decision by AAOIFI to prohibit repurchase agreements explicitly could deal the industry a severe setback

Without a repurchase agreement at a set price, a sukuk's return would depend upon the performance of the underlying asset, which may deter issuers and investors looking for the steady predictable returns of bonds.

Sukuk would become more of a profit sharing instrument, equity-like instrument rather, than a debt-like instrument.

In addition it would change the approach of the rating agencies

That is a fundamental change of mindset for investors and issuers

2. “Loans to sukuk holders are forbidden”

“It is not permissible for the manager of Sukuk to undertake to offer loans to Sukuk holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same be mentioned in the prospectus”

Comment

This does not seem to deal with Usmani’s criticisms. If there is a shortfall, Usmani would argue, that should be reflected in the payout to the sukuk holder in line with Sharia’a principles

A reserve fund is acceptable but where does the reserve come from?

If it is from capital then investors should be told that a proportion of their investment will not go towards potential returns based on PLS.

If it is based on returns then what if only losses have occurred?

3. “Purchase undertakings”

“It is not permissible to agree to purchase assets from Sukuk holders or from whoever represents them for a nominal value of those assets at the time the Sukuk are extinguished at the end of their tenors.

It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase.”

Comment

This ruling is unclear

With regard to purchase undertakings if you have a clause which says “for a price agreed at the time of purchase” is this not tantamount to a potential guarantee?

4. Sharia'a boards

“Sharia boards must not consider their responsibility to be over when they issue a fatwa on the structure of Sukuk.

They must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with Sharia guidelines and requirements as specified in the Sharia Standards.”

Comment

This seems to suggest that Sharia'a board responsibilities are to become far more onerous regarding scrutiny than in the past.

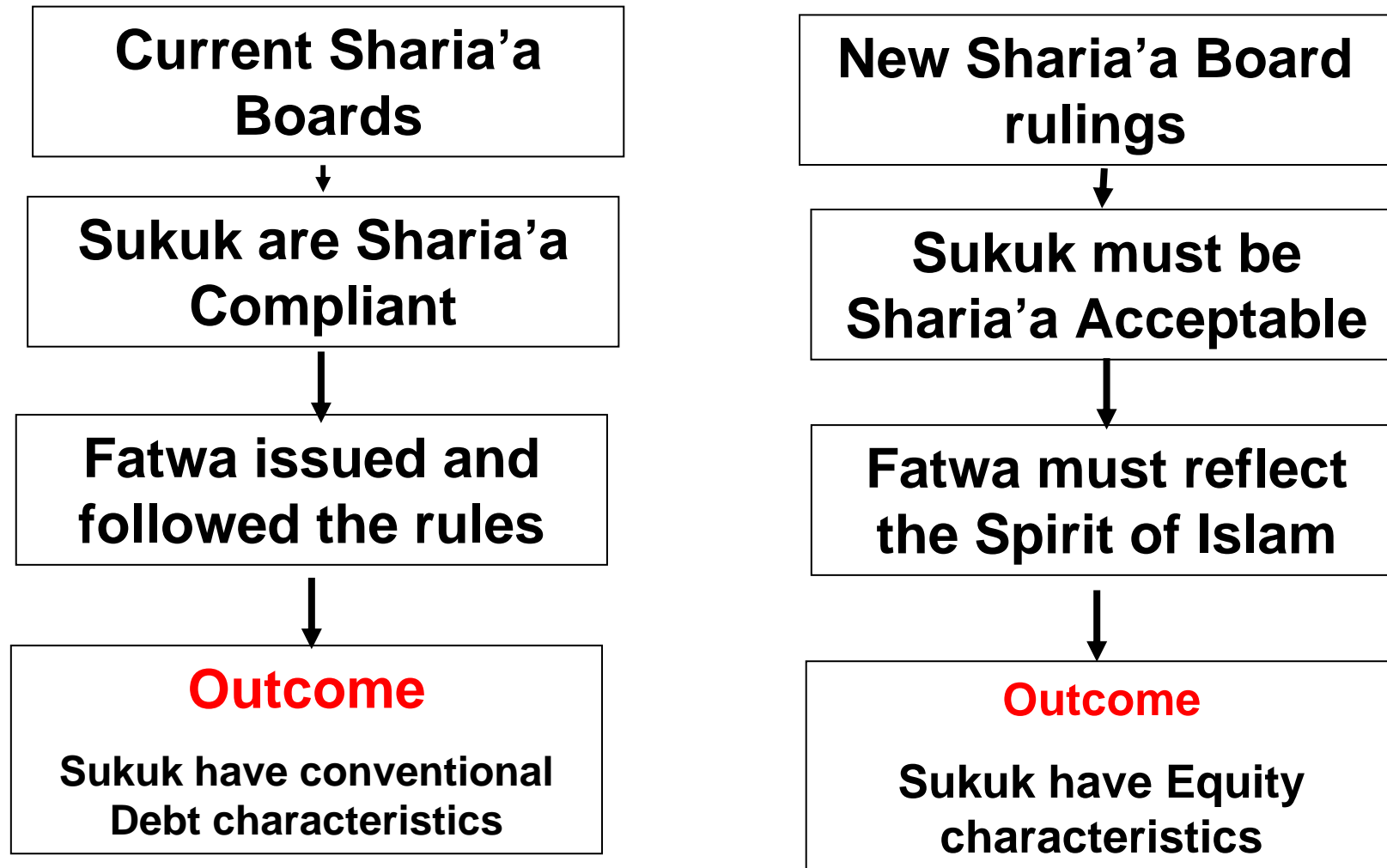
This may be highly desirable.

However given the shortage of scholars this seems to potentially slow down the industry, possibly substantially

Sukuk : Sharia'a Compliance versus Sharia'a Acceptability

Form

Substance



Do you have any questions please ?

