

# SHIRKAH

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# شركة

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## Ijlal Alvi


*IIFM Chief Executive Officer*



# Shariah governance at work: from asset-based to asset-back Sukuk

by Alberto Brugnoli

> In November 2007 a renowned Shariah scholar issued a statement on the illegitimacy of those outstanding Sukuk issues underpinned by repurchase agreements (the so called Purchase Undertaking Deed) and where, as a consequence, risk and reward are not shared according to the actual venture proceeds. He vowed that it was time to review standards. This statement precipitated a fiery debate amongst the banking community afraid that without a repo at a set price a Sukuk's return would depend solely on the performance of the underlying assets, which may deter issuers and investors looking for



the steady predictable returns typical of bonds. The Sukuk would then become more of a profit sharing instrument from a debt-like instrument and require a change of mindset for investors and issuers. This could deal the industry a severe setback. To address this situation the Shariah Committee of AAOIFI - whose standards are mandatory in Bahrain, the DIFC, Jordan, Qatar, Sudan and Syria whereas regulators in countries including Malaysia, Saudi Arabia, Australia and South Africa use AAOIFI's rules as guidelines - issued in February 2008 the recommendations that will be briefly discussed in this article.

The whole issue is part of an ongoing debate on how to achieve the true objectives of the Shariah by decreasing the Islamic finance institutions involvements in debt-related operations while, at the same time, increasing true partnerships based on profit and loss sharing. It also has been a paradigmatic case of Shariah governance at work and part of the growing up and maturing process of the contemporary Islamic Finance industry. Last but not least, it bears witness to the intellectual honesty and soul searching of both Islamic finance academicians and practitioners that strive to adjust 1500-year-old financial instruments based on a revealed law to modern and challenging conditions with less and less compromise on fundamental spiritual and ethical values.

The importance of the topics explored in the present article is highlighted by the Sukuk being one of the most enabling of Islamic financial instruments to emerge so far. Its versatility has indeed attracted originators ranging from the German Länder of Saxony-Anhalt to wildcatters in Texas to multi-national supermarket chains based in the UK and the International Finance Corporation, of the World Bank. The World Bank itself issued its first Malaysian ringgit-denominated Sukuk in 2005. The traditional sovereign issuers in the Middle East and South-East Asia markets have been joined by countries like China, Japan and Thailand that have established a Sukuk issuance programme. The recent Indonesia's bill on Islamic debt financing (April 2008)



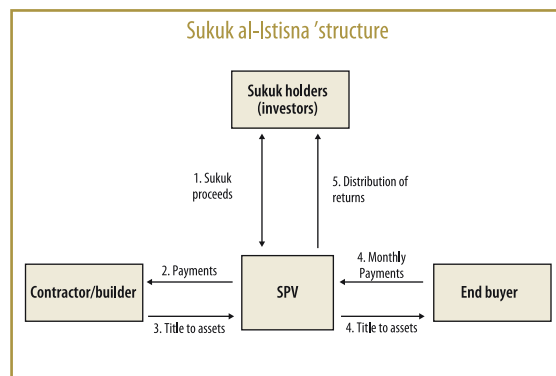
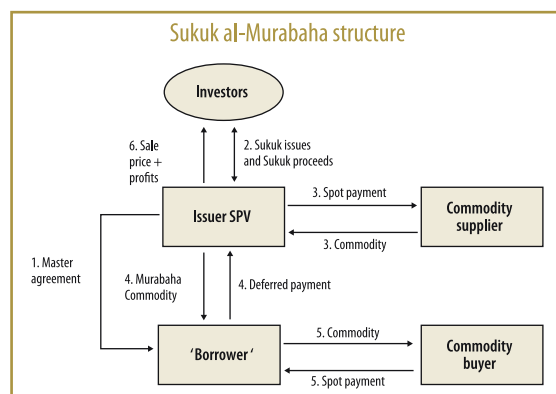
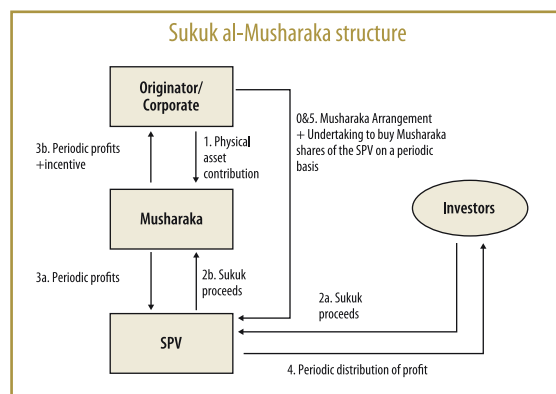
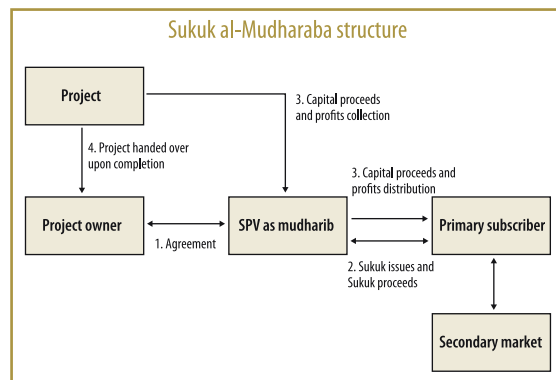
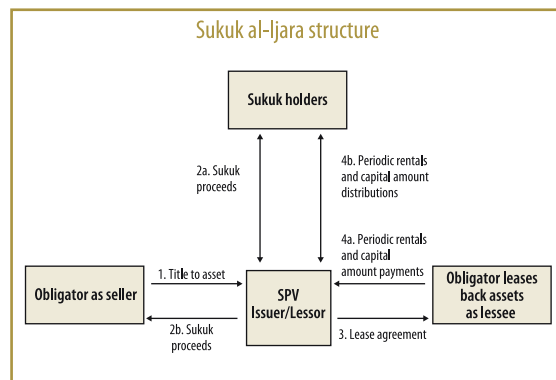
Omayyadi Mosque, Damascus

will enable the government to fund large parts of its budget deficit by issuing Sukuk. Even the UK is considering such a possibility. Nowadays, US\$ 109.7 billion Sukuk are globally outstanding with the market growing at a CAGR of above 42% from '95-'07 and deemed to reach the \$200 billion mark by 2010. Malaysia is the largest player in the market with US\$ 71.8 billion issuance including sovereign issues. Issuance from the MENA region has recorded steady growth with notable prominence in 2006 and 2007 when issues totalled US\$ 16.5 billion; more than US\$ 30 billion is expected during 2008 from this region. The number of Sukuk transactions rose to 119 in 2007 while the average transaction size increased to about US \$270 million. Although the US dollar has been since the beginning the currency of choice there has been a shift towards non-dollar issuance with the share of US dollar-denominated Sukuk dropping from 85% in 2002 to less than 50% in 2007. In this year the other major currencies of issuance have been the Malaysian ringgit, the UAE dirham, and the SAR. Finally, corporates and entities involved in project finance are the main issuers as they find Sukuk an alternative to financing their business or their projects. Banks and financial institutions are increasingly turning to Sukuk to sustain strong lending growth and curb maturity mismatches while sovereigns rank third.

The history of Sukuk began in classical period when Sakk (singular for Sukuk) meant any document representing a contract or conveyance of rights, obligations or monies done in conformity with the Shariah. Its legitimacy was based on Koran 2:282. Empirical evidence also shows that Sukuk were extensively used during medieval Islam for the transferring of financial obligations originating from trade and other commercial activities. Their use then spilled over into Europe and Sakk is at the origin of the world cheque/check.

In modern times the Islamic Jurisprudence Council decision n° 5/1988 to uphold the issuance of Sukuk by authorizing the representation of assets in a written note or bond and their salability allowed Malaysia to reintroduce Bai bi-thaman Ajil bonds in the 90'. AAOIFI, in turn, issued its "Shariah standards on investment Sukuk" in May 2003 at the time when Bahrain had introduced anew the Sukuk al-Ijara instrument (September 2001) and Malaysia had pioneered the global Sukuk al-Ijara issue (June 2002). The Middle Eastern Islamic bond market then evolved gradually with the support of top-tier issuers like the Islamic Development Bank, the States of Qatar and Dubai and the Republic of Pakistan.

The AAOIFI Standard n° 17 defines investment Sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activity however, this is true after the receipt of the value of the Sukuk, the closing of the subscription and employment of funds received for the purpose for which the Sukuk were issued". The investment of Sukuk proceeds and the conversion of the proceeds into assets must use one of the Shariah compliant methods of investments.



The AAOIFI investment Sukuk definition includes fourteen possible different structures of which the seven in bold characters have been implemented.

**Sukuk al-ijarah:** securitization of existing tangible leased assets;

**Sukuk ijarah mowsufa bi-thima:** mobilization of the acquisition cost of tangible to-be-leased assets;

**Sukuk manfaa ijarah:** securitization of the usufruct of existing leased assets;

**Sukuk manfaa ijarah mowsufa bi-thima:** securitization of the usufruct of assets to be acquired and leased;

**Sukuk al-mudharaba:** mobilization of funds from capital providers;

**Sukuk al-wakala:** mobilization of capital to acquire certain goods that are entrusted to an agent;

**Sukuk al-muzra'a:** mobilization of funds for the cultivation of land;

**Sukuk al-musaqa:** mobilization of funds for the irrigation and maintenance;

**Sukuk-al-muqarasa:** mobilization of funds for the maintenance of land and crops.

The first and the most integral condition for a bond to be called a Sukuk is therefore its tangibility, i.e. the identification of suitable assets on the balance sheet of the originator/borrower (government, monetary authority, corporate



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**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:** mobilization of the cost of construction and manufacturing of specific assets;

**Sukuk al-murabaha:** mobilization of the acquisition cost of goods to be sold under a murabaha;

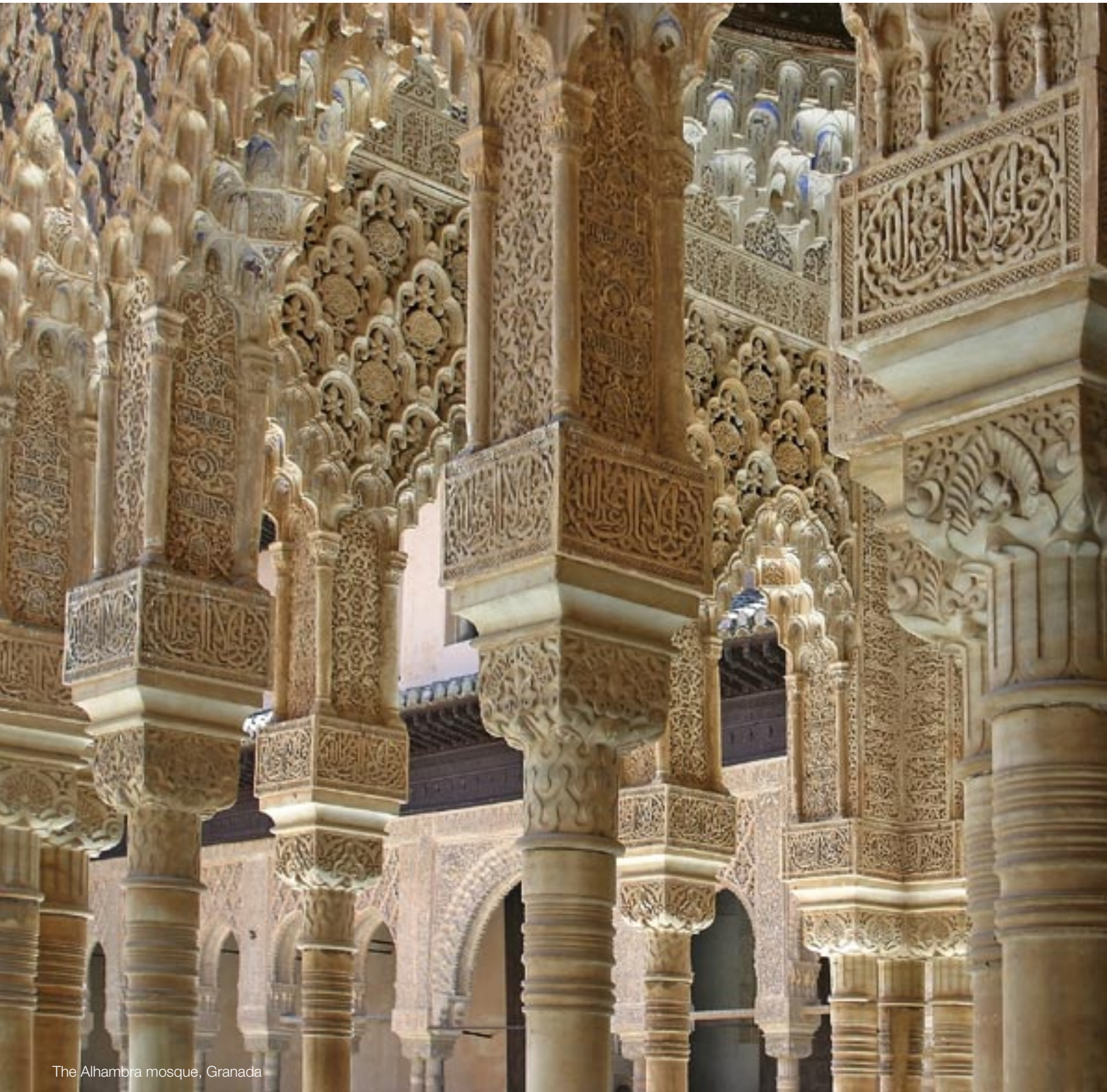
**Sukuk al-musharaka:** sale of capital participations into a partnership;

body, the banking and/or financial institution) that wants to mobilize financial resources. Borrowers to raise compliant financing need to provide and utilize assets in the structure. In other words, the funding raised through Sukuk issues shall be hypothecated or earmarked - the technical term is 'assets backed' - rather than used for general unspecified purposes. In this latter case they are deemed to be 'assets based'. Either identifiable existing assets or specific assets that may become available at a future date can be used to back Sukuk. A second condition is that these assets must be suitable. For example, Shariah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts as murabahah or istisna'. Also companies that are highly leveraged

with bank debt may seek refinancing through issuing bonds but such companies are not regarded as suitable for Muslim investors. From the above follows a third fundamental condition: that returns and cash flows must be linked to assets purchased or those generated from an asset once constructed (project finance) and that the principle can not be guaranteed.

What happened in practice is that a number of Sukuk issued to finance physical assets through a profit-sharing venture (mudharaba

or musharaka) were sold with a repurchase undertaking: a promise that the borrower will pay back their face value at maturity or in the event of default, thus mirroring the structure of a conventional bond and creating a fixed income for investors. This promise to pay back capital, irrespective of whether the assets made or lost money, violates the principle of risk- and profit-sharing on which the Sukuk are based. It was nevertheless overlooked by some Sharia boards to allow the industry to develop. For the sake of the argument it must also be said that a number of issuers shun Sukuk with repurchase agreements.



The Alhambra mosque, Granada

The Shariah Committee of AAOIFI, after meeting in Medina, Mecca and Bahrain, said a definitive word by issuing the following golden rules:

- Investors/holders of the Sukuk must become the legal owners of the assets whether tangible, usufructs or services rather than nominal holders, with all rights and obligations of ownership. The manager issuing Sukuk must certify the transfer of ownership of such assets in its Sukuk books, and must not keep them as

his own assets. In this way the Shariah requirement that buyers and sellers share profits or losses from their transactions is satisfied. The new rules force issuers of Sukuk to legally transfer the ownership of assets to bondholders. Also the assets must be tangible rather than a cash flow.

- Sukuk must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, were included unintentionally.
- It is not permissible for the manager of Sukuk, whether he acts as an investment manager (mudarib), partner (sharik) or agent for investment (wakil) to offer loans to Sukuk holders, when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible. It is not objectionable to distribute expected earnings on account or to obtaining project financing on account of the Sukuk holders
- It is not permissible for the mudarib, sharik or wakil to undertake to re-purchase the assets from Sukuk holders for its nominal value, when the Sukuk are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase. It is also known that a Sukuk manager is a guarantor of the capital at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether he is a mudarib, sharik or wakil.
- It is permissible for a lessee in a Sukuk al-Ijarah to undertake to purchase the leased assets when the Sukuk are extinguished for its nominal value, provided he is not also a mudarib, sharik or wakil.
- Shariah Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of Sukuk. All relevant contracts and documents related to the actual transaction must be carefully reviewed by them, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with Shariah guidelines and requirements as specified in the Shariah Standards.

*Under the outlawed structure Sukuk holders received an irrevocable third-party guarantee, usually by a parent or original owner of the underlying assets. The guarantor provided shortfall amounts in case the SPW cannot make payment. With the allowed structure the pool of underlying assets serves as the sole basis for coupon and principal payment. The underlying assets should have the ability to generate sufficient cash to meet the SPW's obligations in a timely manner.*

To sum up, what the scholars aimed to do with their recommendations was to give comfort to those investors who had shown concern about current structures by clearly indicating which direction the market should take to call itself Islamic. By making Sukuk 'asset-backed' rather than 'asset-based' their choice, they have put Shariah consideration in front of market-share consideration. The absence in the allowed structure of such features as repayment guarantees, credit enhancements, and liquidity support mechanisms; asset management practices (i.e. the trading of debt securities) and payment structures (i.e. no discounted issues



and pay-through mechanisms) that are standard in conventional bond is a clear message for the Sukuk market to move away from guaranteed returns to more risk-sharing structures based on Islamic securitizations. The absence of these features should not be seen as a hurdle but rather as an opportunity to commoditize the proceeds from asset transfers between capital providers and users of different Islamic finance contracts in an alternative way. Currency, interest rate and credit-risk Shariah-compliant management instruments are, though slowly, being developed to facilitate the use of this opportunity.

The AAOIFI recommendations will not have a retroactive effect and originators will not have to restructure Sukuk already sold to comply with the new guidelines. On the other hand, the issuers that for financial considerations (the new rules will mean slightly higher costs on Sukuk) or marketing considerations should choose to continue with existing structures would be perceived as non Shariah-compliant and lose in the long run credibility. In general these recommendations are likely to introduce more standardization and encourage innovation.

The real hurdles in the development of Sukuk lie elsewhere, in the market itself. The most significant one is the difficulty to identify underlying reference assets that meet the requirements and, at the same time, offer attractive returns to both the users and suppliers of capital. This applies in consumer finance (auto leases, unsecured consumer loans); commercial and residential real estate; infrastructure assets (toll roads, bridges, tunnels). Secondly, the typical 'buy-and-hold' investment strategies and limited diversity of Sukuk investors has produced illiquid secondary markets and inhibit efficient price discovery. The development of a liquid secondary market is in fact a strategic issue and will depend on that of Sukuk as inter-bank money market instruments and Shariah-compliant short-term liquidity facilities. The only Muslim countries that have developed an active inter-bank are Malaysia and Bahrain, the latter having issued short-term Sukuk with a cumulative value of US\$ 287 million of three or six-month maturities. A third hurdle is that limited historical performance data on Shariah-compliant assets and untested stress scenarios limit confidence when estimating likely recovery rates used in pricing and rating of such securities.

Sukuk are gaining popularity worldwide but to take off and establish themselves firmly in countries with conventional financial systems continued efforts are required to overcome the following legal and regulatory issues:

- Islamic finance transactions often incur, due to their asset-backed structure, in double taxation without tax deductions on interest expenses as is the case with conventional debt funding. The only non-Islamic country that has successfully address this issue is the UK whereas other countries (for example France and Japan) are following suit
- in Sukuk, the need to satisfy both commercial law and Shariah in the underlying reference assets and the transaction structure, can generate inconsistencies concerning asset control and bankruptcy resolution for investors in Islamic and non-Islamic countries alike. The legal environment remains uncertain and largely untested by actual cases, and there are concerns about the legal transfer of title and foreclosure in case of default.
- Islamic jurisprudence is neither definite nor bound by precedent and rulings in one jurisdiction may not be uniformly enforced in others. A case study is the different opinion that Malaysian and GCC's Sharia scholars have on the tradability of Sukuk based on murabaha structures
- similarly, regulatory standards pertaining to Shariah compliance vary considerably. Greater standardization would enhance the valuation and efficient pricing of Sukuk. It would also improve secondary market liquidity within regulatory frameworks flexible enough to adapt to the characteristics of new Islamic capital market securities while preserving universal standards of market supervision and financial surveillance.

As a conclusion, one can say that the same forces that have fuelled the expansion of the Sukuk market over the last decade are still exerting their influence and that the market continues to generate strong interest by new issuers both in Muslim and non-Muslim countries. Given the intensifying interest in Shariah-compliant assets, the potential of sukuk remains intact despite the fallout of the U.S. sub-prime markets crisis and the legal uncertainty surrounding the recent AAOIFI ruling. Sovereign Sukuk, especially, are likely to gain popularity as more governments in both Muslim and non-Muslim countries explore options to diversify their traditional debt portfolios. ■



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 Presidente e socio fondatore ASSAIF, Arabista, ha una laurea in relazioni internazionali dell'università di Ginevra, ex-direttore di Merrill Lynch Bank Suisse. E' consulente internazionale di finanza islamica ed etica. Partecipa regolarmente ai principali forum di finanza etica e islamica internazionali.

> Sukuk have matured into a diversified, internationally accepted instrument to raise corporate finance for acquisitions or working capital purposes, to refinance existing debt or to finance the transportation sector, real estate, construction and petrochemical projects in several countries. In response to the demands of issuers and investors Sukuk have evolved rapidly from plain vanilla type commodity-trading murabaha transactions to sale and leaseback structures, to trust finance Sukuk structures. Below are some representative issues.

### **Non-Islamic country sovereign al-Ijara Sukuk**

In 2004 a €100 million Sukuk with an ijara structure was issued in the federal state of Saxony-Anhalt whose debts are guaranteed by the Federal Republic of Germany. The underlying transactions are a certain number of specified buildings owned by the Ministry of Finance. The master lease was sold for 100 years to a special purpose vehicle, incorporated in the Netherlands for tax reasons, which in turn rented it back for 5 years to the Ministry of Finance. The certificate holders receive a variable rent benchmarked to the EURIBOR over the rented period. The Sukuk is listed on the Luxembourg Stock Exchange.

### **Islamic countries sovereign Sukuk**

Bahrain routinely issues Sukuk al-Ijara and Sukuk al-Salam to finance various domestic infrastructure projects. Malaysia's Global Sukuk, launched in June 2002, was similarly backed by an Ijara lease on a single piece of government property. The money raised by Qatar through the \$700 million Qatar Global Sukuk has been used partly to finance the construction of the Hamad Medical City. In 2005, Pakistan issued a US \$600m Sukuk to finance the Lahore-Islamabad motorway with a listing on the Luxembourg Stock Exchange.

### **Airlines Sukuk**

The first Sukuk issued by Dubai's Emirates Airlines, closed in July 2005 with a US \$550m subscription. The Sukuk has a seven-year tenor and is structured as a Musharaka. The proceeds of the issue, which is listed on the Luxembourg Stock Exchange, will be used to finance the new Emirates Engineering Centre and their headquarters building in Dubai.

### **Ship Finance Sukuk**

In 2005 ABC International Bank jointly with Abu Dhabi Commercial Bank arranged, structured and jointly underwrote a pioneering Islamic ship finance transaction through the issuance of a \$26m al-Safeena Ijara Sukuk (al-Safeena in Arabic means ship). At that time, al-Safeena Sukuk was the first issue that combined Islamic equity with conventional debt for the same asset, which in this case was the VLCC 'Venus Glory', owned by a Saudi Aramco subsidiary.

### **Dubai Civil Aviation Authority Sukuk**

The Dubai Civil Aviation Authority, a quasi-sovereign entity issued in 2004 a \$1 billion Sukuk. It has been structured as an Ijara asset-based Sukuk. The proceeds were used to finance the

# Sukuk Emissions

by Alberto Brugnoli

*Sukuk, a diversified internationally accepted instrument to raise corporate finance or working capital*



building of a new international terminal and for the expansion of existing engineering and other infrastructure. A Musharaka was set up to develop a new engineering centre and a new headquarters building on land situated near Dubai's airport that will ultimately be leased to Emirates. Profit, in the form of lease returns, generated from the Musharaka will be used to pay the periodic distribution on the trust certificates.

#### **Bahrain Financial Harbour**

The Istisna'a-Ijara Sukuk, known as the al-Marfa'a al-Mali Sukuk, has been structured by the Liquidity Management Centre. The Sukuk has a 5 year term maturing in 2010 offering a quarterly profit distribution with the proceeds used to finance the development and construction of the Financial Centre which represents the first phase of the Bahrain Financial Harbour project.

#### **Dubai World Sukuk**

In 2006 Dubai property developer Nakheel Group issued a US \$3.52 billion Sukuk, the largest at that time. It will use cash from this Sukuk to fund construction and real-estate developments projects in Dubai. The Sukuk has been listed on the Dubai International Financial Exchange.

#### **DP World Sukuk**

In 2007, global marine terminal operator DP World priced a \$1.75 billion conventional bond and a \$1.5 billion Sukuk. It is the first issuer to list both conventional and Islamic debt securities on the Dubai International Financial Exchange. The \$1.5 billion, 10-year Sukuk attracted demand globally, including for the first time from the United States. It is also the first convertible instrument in the Islamic finance market as it is partly convertible to shares in the event the ports group lists through an initial public offering.

#### **East Cameron Gas Sukuk**

It is the first and only Sukuk to have originated from the United States in 2006. It was also the first ever Shariah compliant gas backed securitisation and was the first-ever Islamic securitisation rated by Standard and Poor's. The \$165.7 million Sukuk originated from Houston based East Cameron Partners, whose reserves are located in the shallow waters off the shores of the State of Louisiana. The Sukuk was structured as a Musharaka in terms of the management of the assets and then a funding agreement between the issuer and the purchaser.

#### **Aldar Properties Convertible Sukuk**

Aldar Funding Limited issued a \$2.53 billion convertible trust certificates in March 2007 and due in November 2011 and provided the proceeds to Aldar Properties as the mudharib. The funds are invested in real estate development projects but with legal title to the underlying properties not being transferred. This is therefore an asset-based Sukuk. The interesting element is that the Sukuk holders can convert their Sukuk certificates into shares of Aldar Properties or into cash.

#### **Tamweel Sukuk**

The Sukuk has been issued in July 2007 by Tamweel, an Islamic finance company based in the UAE which provides financing, primarily for residential properties. This has been the first securitisation of residential financing to be carried out in the UAE and also the first rated 'multi-classed'. Tamweel acquired title to the property and then entered into an Ijara (lease) with the customer. The customer paid fixed rent, this being the amortised amount of the purchase price paid by Tamweel, together with a variable rent. If the customer paid all of the rental amounts required by the Ijara, Tamweel would transfer title to the customer. The instrument is a true asset-backed Sukuk in that Tamweel has sold title to the properties along with the leases to an SPV. In this instance, the Sukuk holders could look only to the properties and the Ijara with the underlying customers to generate the revenues needed for the return of their investments and the profit return. ■