



London 2008 Sukuk Summit

Challenges in Structuring Sukuk Issues Practitioner's View

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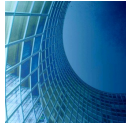
بنك المؤسسة العربية المصرفية الإسلامية (E.C.)
ABC Islamic Bank (E.C.)



Growth of Sukuk Market

- It all started with the issuance of sovereign Sukuks by Malaysia, Bahrain and Qatar – benchmark / standard setting
- Geopolitical situation impacting the Muslim world (Sep 11, 2001, war in Iraq)
 - Increase in Oil prices
 - Repatriation of Muslim money from abroad
 - Excess liquidity, demand for alternate asset classes from Investors
 - Infrastructure projects & high growth of corporate sector – development of capital markets
- Growth of Islamic Financial Institutions
 - Sukuk Issuance to reduce maturity gap in asset/liability
 - Sukuk Investments – lack of other attractive Islamic investment classes
- Fair to say that rapid growth of Sukuk market has played a key role in the overall growth of Islamic Finance and has also served as a very effective publicity tool





Growth of Sukuk Market

- **Total size of Sukuk market (end 2007): \$ 97 billion**
 - International Sukuks: \$ 33 billion
 - Local Sukuks: \$ 64 billion (mainly in Malaysian Ringgit)
- **Slowdown in 2007 / 2008**
 - AAOIFI ruling on Shariah compliance of Sukuk Issues
 - Weakened US\$ and liquidity squeeze
 - Impact of Sub prime credit markets crisis
- **Will the Sukuk market slow down? Or is it a temporary halt?**
 - Development of Local Sukuk Markets (GCC Currency Issuances)
 - Growth impetus to come from Corporates and IFIs

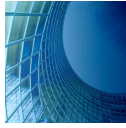
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Future of Sukuk

- **Despite current constrained liquidity, growth in Sukuk market will remain high**
 - GCC businesses are robust and cannot afford to slow down their momentum
- **While the future is promising, the product faces many challenges, some of which are:**
 - Shariah structuring issues in light of recent AAOIFI guidelines
 - Lack of regulatory support and legislation in most GCC states
 - Has been the biggest hurdle in development of local Sukuk markets

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Structuring Challenges

Challenge No. I: Asset backed versus Asset Based

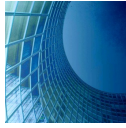
- **Asset Based:** Risk on the guarantor, who is generally the originator or the Issuer
- **Asset Backed:** Legal transfer of assets is essential. Risk is not guaranteed by the Issuer. Pool of underlying assets serves as the sole basis of principal and profit repayment
 - Issues related to transfer of title / foreclosures in GCC countries
 - Sovereign issuers: inability to transfer title due to sovereign nature



Structuring Challenges

Challenge No. II: Promise to Purchase Assets at Face Value

- **Commitment by Mudarib**
 - Mudarib is only a manager/trust holder/amin - cannot have a dual role as a guarantor
- **Commitment by Sharik**
 - One partner cannot guarantee the return of capital to the other partner(s).
 - A partner can purchase assets of partnership but at market value or at a price agreed at that time.
- **Commitment by Investment Agent**
 - No guarantees except as regards negligence or malafides.



Structuring Challenges

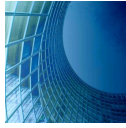
Challenge No. III: Loans to Sukuk Holders

- When the manager makes a loan to Sukuk holders at times when the actual return fall below the promised rate of return, the transaction becomes a sale with credit (which is prohibited).
- Can establish a reserve for the purpose of covering such shortfalls to the extent possible.



Regulatory Challenges in GCC

- **Creation of Special Purpose Vehicles**
 - Non existence of SPV laws or Trust laws
 - High minimum share capital requirement for creation of limited liability or joint stock companies to serve as a proxy SPV
 - Tax / Zakat implications
 - Calculation of Zakat on Total Assets or Assets net of liabilities ?
 - Lack of precedence
- **Off-shore SPV is the only alternative**
 - Withholding tax implications
 - Inability to list on local exchange, hence hinders development of local Sukuk markets



The Way Forward

- **Basic Shariah Principles need to be complied. The mandate is not to replicate conventional banking but to promote Islamic Finance.**
 - the ban on riba,
 - the ban on “gharar” (uncertainty) and “maysir” (speculation),
 - the ban on haram sectors,
 - the obligation to share profits and losses
 - the obligation to back any financial transaction with assets

- **While the Shariah scholars should have acted earlier, but “better late than never”**
 - Allowed leniency for Islamic finance to get time to reach optimal size, not to compete with conventional counterparts as per their rules



The Way Forward

- **Choices available**
 - Stick to the basic and proven structures (Sukuk Al-Ijara)
 - Take Asset and Market Risk, which should reflect in pricing
 - Will require more due diligence of the underlying assets
 - Role for independent rating agencies (conventional or the new Islamic rating agencies)

- **Regulatory Reforms**
 - GCC regulators to provide level playing field for Islamic products
 - Effective legislation required for property, SPV and trust laws
 - Follow the UK example

- **Sukuk going increasingly global, but critical to develop the local GCC Sukuk market to have longer term protection from adverse global markets impact, like the current sub prime crisis.**



Thank You