

SUKUK – Legal and Practical Application

Dubai

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Historical Background

- Need for liquidity and good liquidity management
- Different periods between maturities of assets and deposits – resulting in either surplus of non performing cash or a shortage of cash to fund investments
- Lack of:
 - active interbank and secondary market (mostly primary market trading)
 - acceptable Shariah compliant instruments
 - acceptable regulatory conditions
 - limited available agency credit ratings
 - unsophisticated market
 - limited information flow

Historical Background

- Development of short-term commodity MURABAHA and short-term trade financing:-
 - partial solution
 - not an efficient mechanism
 - limits ability of Islamic banks to play a more effective role in international capital markets

Development of Market

- Growing consideration of viable mechanisms for developing an interbank market
- “1-6 members”: establishment of forum to develop mechanisms and market
- Spearheaded by Bahrain, Malaysia and Sudan
- AAOFI: 14 different SUKUK types

Shariah Requirements

- Shariah compliance
 - General prohibitions and assumptions
 - RIBA : “interest or usury”
 - JAHALA : “uncertainty and/or lack of full transparency/disclosure”
 - GHARAR : “deception/hazard/undue risk”
- Underlying Asset/Transaction

SUKUK

■ Definitions:

- a) “Participation Securities, coupons, investment certificates”
- b) “Certificates of equal value, representing after closing subscription, receipt of the value of the certificates and the putting to use as planned, common titles to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity”

- **Types of SUKUK:**
 - MUDARABA SUKUK
 - SALAM SUKUK
 - IJARA SUKUK
 - DEVELOPMENT SUKUK (ISTISNA)
 - MUSHRAKA SUKUK

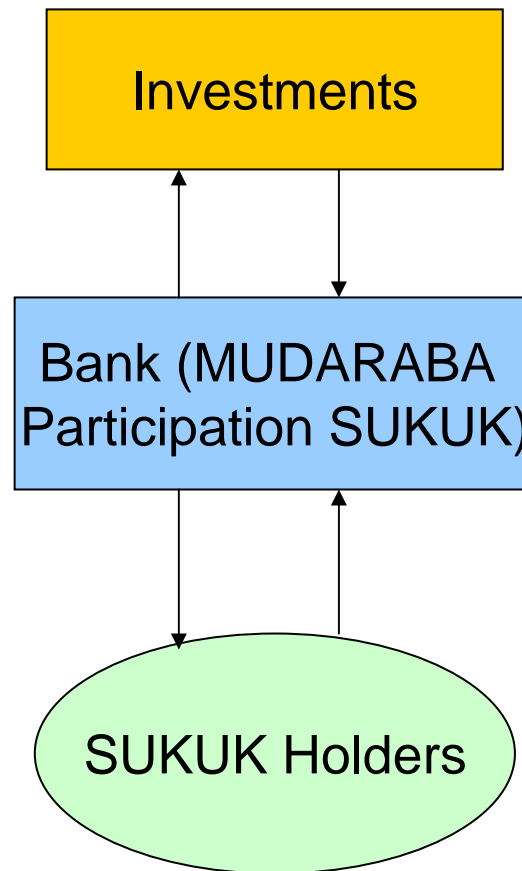
- Other Derivations/hybrids
 - Pure Ijara
 - Pooled/hybrid SUKUK (underlying assets use a variety of structures)
 - Variable rate SUKUK
 - Zero-coupon SUKUK

Common Types of Sukuk

1. MUDARABA SUKUK

- Bank offers MUDARABA participation SUKUK certificates to investors who participate in funds or transactions
- can be structured as a variable capital of a registered investment vehicle
- allows banks to invest surplus cash for a short period without compromising Shariah principles or security quality and can generate cash relatively quickly
- Substantial percentage of underlying investment should be asset based

MUDARABA SUKUK



2. SALAM SUKUK

- short term instruments providing alternative to treasury notes
- special restricted MUDARABA (“trustee finance, partnerships”)
- managed by Bank as MUDARIB (“managing trustee”)
- issued to other banks and investors as a participation SUKUK in this MUDARABA as capital providers
- the special purpose MUDARABA buys a commodity on a SALAM basis
- purchase price will be paid entirely up front and delivery of commodity will be at a specified future date
- additional to the SALAM contract, there will be a promise by commodity provider to buy the commodity from the MUDARABA on the delivery date
- because of limitation on trading in debt, the SUKUK cannot be traded and must be held to maturity therefore only short term solution

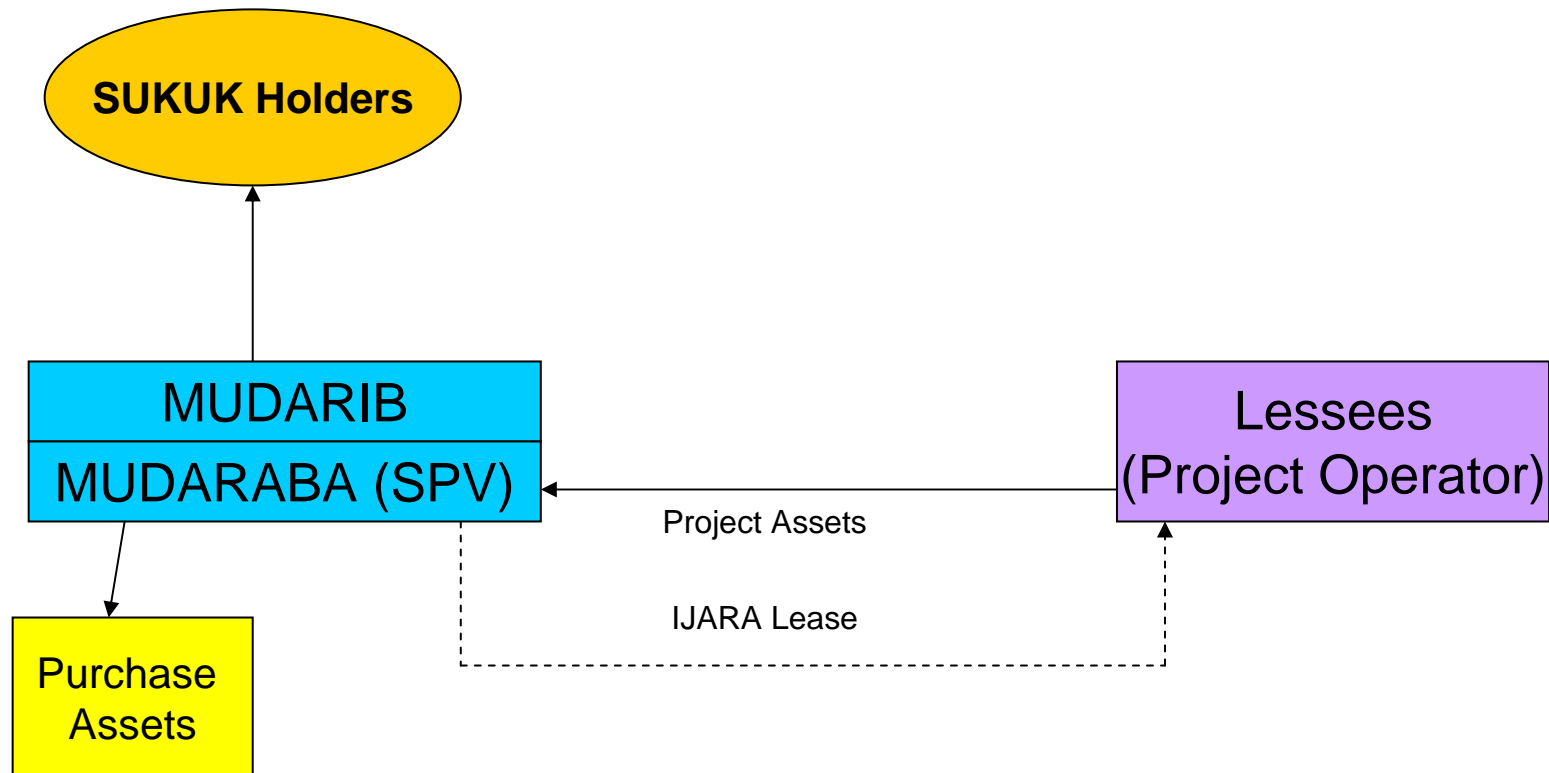
3. Ijara (Leasing) SUKUK

- can be used for long term infrastructure projects by the mobilisation of short term deposits i.e. securitisation of Government tangible assets
- possible use in project financings.
- Works as follows:-
 - sale of tangible assets to a special purpose restricted Mudaraba (SPV)
 - assets are then leased to the interested parties through a Ijara lease
 - the MUDARABA participation SUKUK will be issued and sold to public/investors with a guarantee of payments (usually from Government or international bank)
 - required security will be given to SUKUK holders
 - MUDARABA managed (on behalf of SUKUK holders) by MUDARIB
 - MUDARIB signs and executes all relevant contracts
 - ensures Shariah compliance
 - transparency and efficient operation

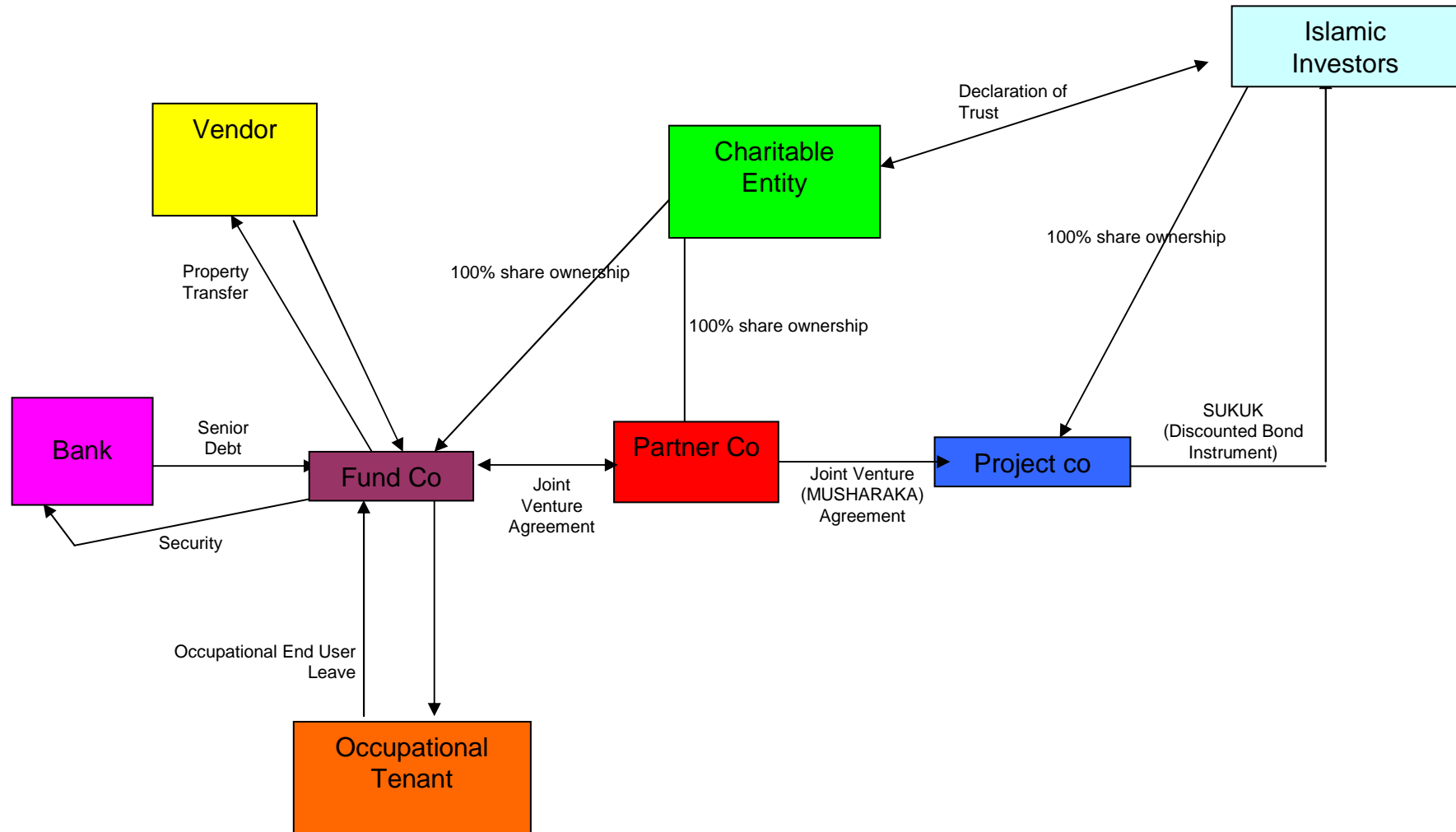
■ Leasing SUKUK (Cont'd)

- Practical Application
- incorporate SPV (MUDARABA)
- offer MUDARABA participation SUKUK (3-5 years) to market
- receive subscription for MUDARABA
- purchase tangible assets on a standard sale contract
- lease (IJARA) assets to lessees
- MUDARIB manages liabilities and assets of SPV
- trade SUKUK in secondary market
- liquidate MUDARABA and redeem issued SUKUK at maturity

Leasing SUKUK



Equity Input Structure



- Experience
 - Developing Capital Markets
 - Government/Public Sector Issues
 - Financial Institution Issues
 - Corporate Issues
 - Transaction Based Issues
 - Property development (equity input)
 - Project & “Co” financings

4. Development SUKUK

- Use of ISTISNA and IJARA (possibly other structures)
- Practical Steps:
 - incorporate SPV (MUDARABA)
 - offer MUDARABA participation SUKUK (5-15 years) to the market
 - receive subscription capital of the SPV
 - contract or build infrastructure or building through an ISTISNA contract
 - lease asset by IJARA to lessees
 - MUDARIB manages liabilities and assets
 - trade issued certificates (SUKUK) in secondary market
 - liquidate MUDARABA and redeem the issued SUKUK at maturity

5. MUSHARAKA SUKUK

- Based on MUSHARAKA (“partnership/joint venture where each party contributes to the partnership capital in equal or varying degrees”)
- Considered more equitable, entails profit and loss sharing between fund manager and SUKUK holders, not only profit sharing
- Practical steps:
 - SUKUK offered to market for mobilising the required capital
 - proceeds used in profit development or can be used to buy and lease equipment/assets through a specially formed MUSHARAKA

■ Other Variations/Hybrids of SUKUK

- Certificates of ownership of usufructs
 - existing assets
 - future assets as per description
 - services of a specified supplier (present and future)
- General participation
 - Mushraka
 - Mudaraba
 - Muzara'a (Sharecropping)
 - Musa qa (Irrigation)
 - Mugarasa (Agricultural)
 - Concession (see earlier comments on infrastructure/project financings)

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