

Securities and structured finance group

SSF market view

Islamic bonds: from the Ijara Sukuk to the Sukuk Master Platform: innovations and directions

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Islamic capital markets have been a hotbed of activity and discussion in the past few years. Sukuk (Islamic capital market instruments) appear in the press on a daily basis and have been the topic of choice at numerous finance conferences worldwide. Like all areas of debt capital markets the Sukuk market has not been immune from the current financial crisis and as expected, new issuance levels have been down compared to market highs. However, the future prospects of the Sukuk market remain very positive and market analysts predict a strong return.¹

How are future structures going to look?

Like any investment product Sukuk structures have evolved over time. Let's look back at how these structures have developed over time and what future structures might look like.

Initial deals used Ijara as the solution

One of the key principles of Islamic finance is the prohibition on charging interest (or "Riba") on money. Conventional capital market instruments such as bonds, commercial paper and medium term notes all have a fundamental interest and principal component. So how can it work? Aren't Islamic capital market instruments a contradiction in terms? Can we structure to get around such a fundamental rule?

A well-established Islamic financing technique, known as the Ijara (Islamic-compliant lease), which has been considered acceptable by Islamic scholars for other financing transactions, overcame this problem in the initial deals that came to the market.

The Ijara (which is a word derived from the term "rental" in Arabic) is a structure that utilises an asset's rental stream to produce a return to the owner of the asset. Economically, an Ijara financing works and operates like an amortising or bullet repayment loan in

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many respects, however, Shari'ah scholars have become comfortable with the arrangement being a sale and an Islamic-compliant lease of an asset, as opposed to a loan under which principal and interest are payable. The traditional Ijara structure has been in use for some time before Islamic capital market instruments started to appear on the scene.

How can the Ijara structure be used and adopted for an issue of instruments that have similar economic qualities to standard bonds? What if the party seeking the finance does not wish to own an asset but needs financing for other purposes?

An example of the successful adoption of the Ijara structure for a truly global capital market issue was the Malaysian Government's issue of Sukuk Trust Certificates in August 2002. The structure used was simple and clean in order to appeal to the broadest possible base of Islamic investors. A special purpose vehicle (SPV) called "Malaysian Global Sukuk Inc." (MGS) was incorporated in Labuan.

MGS (owned by a Malaysian state entity) issued Sukuk to investors. MGS used the funds raised from investors to purchase a number of parcels of land from another Malaysian state entity. MGS then leased those parcels of land to the Federation of Malaysia. At the expiry of the term of the lease the Malaysian Government agreed to purchase the land from MGS at the face value of the initial issue amount of the Sukuk.

Under a declaration of trust the land parcels are held by MGS in favour of the Sukuk holders. All returns made on the land parcels are conveyed to the Sukuk holders (including lease payments and the final

repurchase proceeds). The cash flow produced is similar to any bond. The lease payments are like coupons and the repurchase proceeds paid at the end of the term are like the principal.

The MGS issue was rated by Standard and Poor's and Moody's. The instruments were listed on the Luxembourg Stock Exchange. The lease payments are determined based on a spread over LIBOR. Islamic scholars have been comfortable with the use of LIBOR as a lease pricing reference mechanism and not as a means of calculating interest.

Can you trade Islamic debt instruments freely?

As trading in debt above or below par would obviously breach the Islamic finance principle of not charging interest, and the ability to trade freely in capital market instruments is critical if you would like to create liquidity, there is a potential further problem. However, since the Ijara Sukuk represent an interest in the underlying assets and not debts they can be traded above or below par freely without breaching any Islamic principles.

Can we achieve the convenience and economics of conventional capital markets using leasing?

Islamic scholars have broadly accepted the Ijara structure. However, the structure suffers from some major commercial disadvantages, namely:

- not all issuers have an appropriate underlying asset available for such a transaction;
- the asset is locked up for the term of the transaction, the owner cannot simply sell it;
- even if an issuer does have the underlying asset, depending on the jurisdiction, there could be adverse taxation costs associated with introducing the asset into the structure;

- not all assets can be used for leasing purposes;
- there could be ongoing Shari'ah audits in connection with the asset;
- this type of structure can be time consuming and costly for the Issuer; and
- the structure is not easily usable for programme structures.

The Sukuk Al Musharaka generation of structures

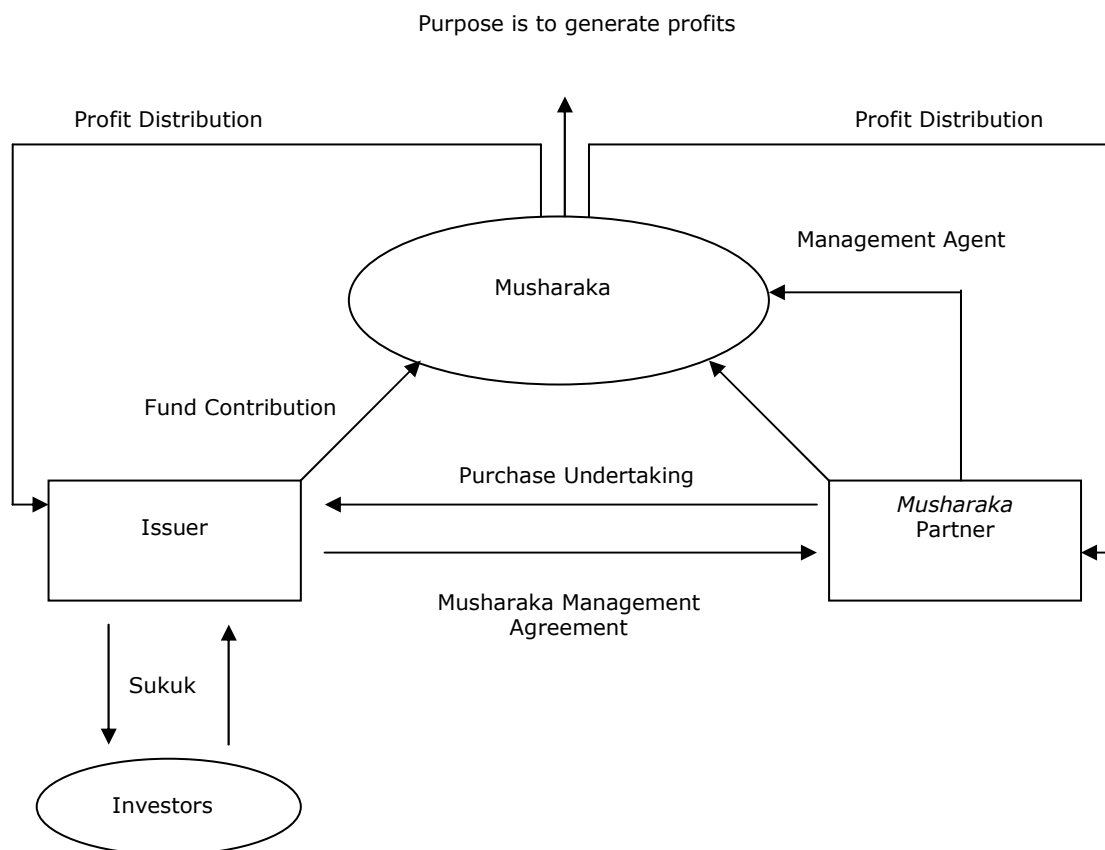
Another structure that gained popularity in the market was the "Sukuk Al Musharaka". This involves an SPV issuer entering into a joint venture "Musharaka" agreement with the finance seeking party (Musharaka Party). The purpose of the Musharaka is to generate profits.

The parties' respective interest in the Musharaka are represented by contractual "Units" held by each party. The issuer will make a funding contribution to the Musharaka from funds it raises from the Sukuk issue. The Musharaka Party will make an in-kind contribution to the Musharaka (usually including some tangible assets).

The issuer and the Musharaka Party also enter into a purchase undertaking pursuant to which the issuer can require the Musharaka Party to purchase a set amount of Units on set dates during the term of the Sukuk. The issuer will receive profit distributions from the Musharaka and proceeds from sales of the Units to the Musharaka Party. The amounts received are distributed to the Sukuk holders in accordance with a set formula.

This structure is viable when the Musharaka Party can use its in-kind contribution for a profit generating venture.

Musharaka Sukuk



The structure does provide some advantages (especially if the Issuer does not have all of the necessary tangible assets to achieve an Ijara Sukuk issue on day one). However, it does still have the following disadvantages: (i) it requires tangible assets; (ii) the assets are locked up in the structure for the term of the Sukuk; (iii) a profit generating venture/project needs to exist; (iv) the structure is relatively document-intensive compared to a conventional bond issue and (v) there has been some debate about whether the purchase undertaking is Shari'ah-compliant.

The purchase undertaking used in Musharaka structures has been questioned by a number of key Shari'ah scholars recently. The current thinking is that purchase undertakings used for Musharaka structures must not have a fixed purchase price from day one. Rather, they should be based on market value at time of purchase. This of course makes it difficult to achieve certainty as to the principal component of the Sukuk payable at maturity.

Innovations

To overcome the limitations of the current Sukuk structures, innovative structures are being developed by various institutions worldwide. The alternative structures being contemplated are based upon other

well-known Islamic financing structures (such as Mudarabah, Istisna, Musawama, Murabahah or Salam). The biggest challenge that these potential structures face are, firstly producing an instrument that can be traded freely in the secondary market without breaching the fundamental principle of not trading in debt above or below par and, secondly, providing economic certainty as to the return of principal at maturity that is Shari'ah-compliant. The Ijara structure has been the most effective in solving this issue as the instruments produced represent an interest in an underlying asset that can be traded. Other structures being contemplated to solve the tradability issue are extremely complex and document-intensive.

Scholars have recently expressed a preference for structures that are moving towards asset securitisation. One good example of such a structure was the groundbreaking Sukuk programme for Gulf Finance House B.S.C (c).

Sukuk programmes: the new wave

Arranging institutions and issuers usually have the following criteria for potential Sukuk programmes:

- it must be a programme that enables the Issuer to issue Sukuks quickly and efficiently when market

conditions are right (just like a Euro Medium Term Note Programme enables an issuer to take advantage of good market conditions at the right time in the Euro market);

- issues under the programme are not overly document-intensive;
- the programme has a very flexible architecture that enables the Issuer to use a variety of Shari'ah-compliant asset classes for any issue of Sukuk and also enables the Issuer to substitute assets backing the issue efficiently; and
- the structure has broad Shari'ah acceptance.

The asset side of the structure

The GFH programme enables GFH Sukuk Limited, a Cayman Islands special purpose vehicle (Issuer), to issue Sukuk trust certificates in series from time to time. On the occasion of each issuance of Sukuk the Issuer will apply the proceeds of the issue to acquire from GFH a beneficial interest in certain Shari'ah-compliant assets pursuant to a master purchase agreement and a supplemental purchase agreement. Those assets must consist of a pool of Shari'ah-compliant income-generating assets, interests or contracts, which may include, *inter alia*, ijara, real estate, murabaha contracts, istisna contracts, shares, and/or other Shari'ah-compliant assets. The composition of the pool of assets for each series must be approved by the GFH Shari'ah board.

In order to manage those assets the Issuer has appointed GFH as the managing agent to manage the Sukuk assets of each series on its behalf under a management agreement. Profits and returns received in respect of the Sukuk assets of each series will be applied to pay periodic distribution amounts in respect of such Series of Sukuk on the relevant periodic distribution dates. Any amount corresponding to the principal amounts received in respect of the Sukuk assets of each Series of Sukuk will be reinvested by the Issuer in, *inter alia*, acquiring additional Sukuk assets (as the master purchase agreement and master purchase trust deed contemplate and allow for) which will form part of the Sukuk assets of the relevant series.

GFH has further agreed, in the management agreement, to make a Shari'ah-compliant liquidity

facility available to the Issuer to cover any liquidity shortfalls and any costs and expenses incurred by the Issuer in having an interest in the relevant Sukuk assets. No interest is payable in respect of any advances made pursuant to this liquidity facility. The liquidity facility is repaid from Sukuk asset proceeds.

The terms of the master purchase agreement and the master purchase trust deed also enable the Issuer to replenish the pool of assets from time to time as and when necessary and allow for substitution of assets (if certain Shari'ah tests are met).

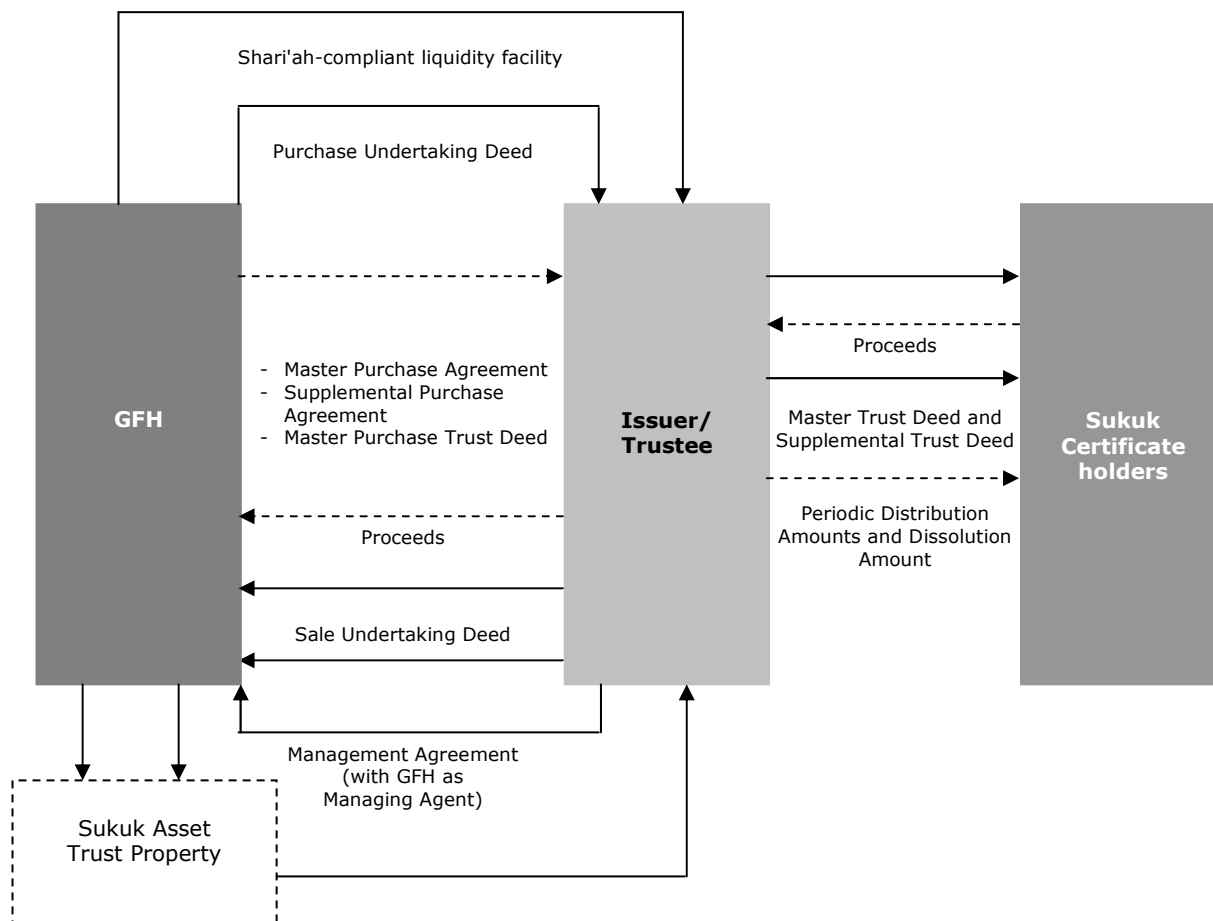
GFH has undertaken to acquire the Sukuk assets of the relevant series of Sukuk on the relevant maturity date or, as the case may be, on the relevant dissolution date arising from the occurrence of specified dissolution events pursuant to a purchase undertaking deed poll made by GFH in favour of the Issuer. Pursuant to a sale undertaking deed poll, the Issuer has also undertaken to sell the relevant Sukuk assets to GFH (at GFH's option) in certain early dissolution circumstances only. The purchase price payable by GFH for such assets will be an amount equal to the sum of the aggregate nominal amount of the relevant series of Sukuk, the amount of accrued but unpaid Periodic Distribution Amounts on such date and any outstanding amounts due to GFH under the liquidity facility.

The funding side of the structure

Under a master trust deed which is supplemented, on the occasion of the issue of each Series, by a related supplemental trust deed, the Issuer will declare a trust over the relevant Sukuk assets. Each such trust will be declared for the benefit of the relevant certificate holders of the relevant Series.

The Issuer will only act upon the instructions of the certificate holders in carrying out the activities of the trust. To facilitate the giving of such instructions by the certificate holders, it is a term of the Sukuk that a Transaction Administrator is appointed pursuant to a transaction administration deed between the Issuer and the Transaction Administrator to act as agent for the certificate holders and to be solely entitled to provide instructions to the Issuer on their behalf.

GFH Sukuk Programme



The key advantages of the GFH Sukuk programme structure are:

- the flexibility it provides to GFH by allowing the bank to inject different kinds and classes of Shari'ah-compliant assets into the structure (including Shari'ah-compliant shares);
- the structure allows for extraction and substitution of assets in a Shari'ah-compliant manner;
- the programme structure enables GFH to go to the market very quickly compared to having to structure, implement and list one-time Sukuk issues;
- due to the modular master/supplemental structure of the documentation, going to the market is not a document-intensive process compared to one-off Sukuk issues; and
- the GFH programme structure has some similarities to asset securitisation structures. Prominent Shari'ah scholars have recently expressed a preference for these types of

structures rather than Musharaka-based or Mudarabah-based structures.

The Milestone PCC Sukuk Master Platform (SMP): the new benchmark and new model?

The Milestone Sukuk programme arranged by Gatehouse Bank is one of the most recent programme structures to come to the market. It uses off-shore cell company technology (enabling robust segregation of assets). It is the first true Sukuk Master Platform (SMP). This structure is the next logical evolutionary step in the development of the Sukuk market. It has the following key advantages:

- allows for robust segregation of assets;
- enables different borrowers to use the SMP (therefore an institution can offer the use of its platform to clients and other institutions);
- it is a scalable structure;
- the structure used for the underlying Islamic financing is not hard-wired into the platform.

- Therefore different underlying structures can be used for different issuances and borrowers providing maximum flexibility for the platform; and
- the platform can be reused for future issues if an underlying structure is no longer considered in line with new Shari'ah standards (as a different structure can be used for the future issuances under the Programme).

The SMP concept seems to provide much needed flexibility and efficiency to the Sukuk market without hindering innovation (as new structures can be introduced using the same platform).

The future of the Sukuk market

Given the recent growth and potential of the Sukuk market and the attraction of this market to Islamic and non-Islamic institutions and corporates as a potential source of funds and liquidity, it is only a matter of time before more refined structures are developed that do not suffer from some of the commercial disadvantages of current structures. The Sukuk programmes coming to the market are a good example of innovation in the Islamic finance market that is overcoming the limitations of earlier structures. Certainly, the SMP concept seems to have been received very positively in the market.

Note:

- The author has used some text and diagrams from his own article published on Bloomberg European Business Law Review, Quarter 1, 2008.

Widening access to GCC equities

Chris Whiteley, Michael Logie, Adair Gordon-Orr



Following a period of sharp decline in Middle Eastern equity markets, we

have seen a renewed interest in the region's equities, with particular focus on the markets that form the Gulf Cooperation Council (GCC), namely Saudi Arabia, the United Arab Emirates, Oman, Kuwait, Qatar and Bahrain.

Regulators are seeking to open domestic markets to foreign capital

Although these jurisdictions restrict foreign ownership of certain GCC equities, recent trends reveal regulators' desire to open the markets to foreign capital. In particular, last year Saudi Arabia's Capital Market Authority (CMA) passed a resolution to open its equities market to foreign investors by granting them access to Saudi shares listed on the Saudi Stock exchange (TADAWUL) via CMA-approved swap

arrangements. Under such arrangements a Saudi CMA-regulated entity retains the legal ownership of the Saudi shares and enters into a swap agreement with an international investor under which the economic return on the shares is passed to the international investor.

Participation access securities are increasingly popular

We have also seen an increase in the issue of participation access securities, often in the form of participation notes or certificates and typically issued by banks. These allow foreign investors to gain access to the GCC equities markets synthetically so as to avoid breaching any local foreign ownership restrictions. Even where no foreign ownership restrictions apply foreign investors often prefer to invest in GCC equities by this route to avoid having to setting up local custody and brokerage accounts.

Participation notes or certificates are structured so as to replicate a real investment in underlying local shares. The holders of participation securities, therefore, receive any dividends payable on the underlying shares and are exposed to any movements in the market value of the underlying shares, although they generally do not control voting rights. The securities may also reference a basket of shares, and some structures include an outperformance payout.

The Issuer will hedge its position by holding the underlying shares. In order to attract international investors, participation access securities are often denominated in US dollars. Further, the securities are usually cleared through an international clearing system and listed on an established stock exchange, such as the Luxembourg Stock Exchange or the Irish Stock Exchange, though the listing may actually take place on the relevant exchange-regulated market.

CDS clearing: the European picture falls into focus...

James Coiley, Patrick Chamberlain



The principal CDS dealers in Europe have met the end of July deadline agreed with the European Commission earlier this year to start clearing credit

default swaps in Europe. The earlier commitment, made to ward off the threat of increased EU regulation or direct legislation, was satisfied when a group of dealers including Bank of America, Barclays, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan, Morgan Stanley and UBS began clearing

CDS's linked to iTraxx® indexes on ICE Clear Europe's central counterparty system.

CDS clearing has started relatively slowly (in its first three weeks ICE Clear has cleared CDS with a notional of €51bn), with many dealers preferring to ramp up gradually, given the new operational requirements and on-going regulatory concerns (see below). In particular the potentially complex "small-bang" settlement of the Thomson restructuring credit event has left some dealers unwilling to clear iTraxx® series in which Thomson was referenced. In addition, the details of procedures relating to physical settlement have not yet been finalised. (Very much as an aside, the introduction of small-bang has added further complexities to the interplay between CDS contracts and restructuring proposals, which we may cover in a future article.)

The front runner in the European CDS clearing market, ICE Clear Europe, is part of the same group as sole US CDS clearing house ICE Trust. Eurex AG's offering, Eurex Credit Clear, also launched at the end of July but has not yet achieved the same momentum as ICE, with a number of legal, commercial and operational issues to be resolved. The CME Group is also in negotiation with CDS dealers but has not yet received approval from the FSA. Although ICE has first mover advantage, each clearing house has a different economic proposition, including fee structure, margin requirements and ownership model.

...but plenty of details still to be resolved

The current regulatory format for European CDS clearing houses is to receive approval from the FSA in the UK and an exemption from the SEC in the US to

allow US and UK based firms to participate.

Differences still exist as ICE Clear Europe, based in London, is a Recognised Clearing House under FSA rules whilst Eurex Credit Clear organised in Germany is also subject to the BaFin's oversight. Dealers generally are or should be keen to limit discretionary powers as they could give rise to unavoidable and unhedgeable basis risk, and discussions are ongoing in this context.

Future developments in the CDS clearing landscape will include clearing single name CDS's as well as indices, the development of robust client clearing capabilities and a move to real-time clearing, rather than the current weekly cycles. ICE has targeted an aggressive October launch for single-name clearing, though it remains to be seen if operational and legal issues can be resolved in time. Issues that dealers and clearing houses will have to address in developing a client clearing model include the legally effective segregation of client and participant trades and how to make client positions (including margin) "portable" in the event of an insolvency of the relevant dealer.

Despite a background of academic discussion as to the benefits of clearing – and particularly of multiple clearing systems and/or clearing which is limited to particular asset classes – political and regulatory pressures mean that the volume and scope of European CDS clearing is only going to increase. That said, potential participants should be aware of the requirements that membership of each clearing house brings, as well as the potential for basis risk against their remaining OTC transactions and in particular against funded transactions.

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