zawya

Collaborative Sukuk Report

An agenda setting study for the growth and development of the global Sukuk industry

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Special Thanks

A special note of thanks goes to all our survey respondents and thought leadership contributors for their support of this initiative. Without them, the Collaborative Sukuk Report would not have been possible.

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Ihsan Jawad
Zawya

Message from the CEO

Dear reader,

It would be great to have a finance industry that would fuel real economic growth and prosperity as opposed to being a self-centred community that feeds on the hard work of good businesses from across the economy.

The ultimate purpose of Islamic finance is to help others build and improve their livelihoods as opposed to achieving hyper profits and the blind pursuit of growth for its own sake. In return for their help, Islamic finance players should command a fair reward based on their efforts and participation rather than a return on capital at risk. The practical role of Islamic finance is to encourage and institute risk sharing among as many participants as possible in order for new and real economic activities to prosper.

To help Islamic finance claim its rightful role, Zawya aims to empower professionals the world over with the means to identify, assess and monitor true Islamic finance opportunities across the globe.

That is the reasoning behind Zawya's first annual Collaborative Sukuk Report.

Juhaina Kasimali
Islamic finance manager, Zawya

The credit crisis has opened many new avenues for Islamic finance as it has emerged as an ethical and risk-averse investment opportunity for many professionals globally. At Zawya, we are focused on engaging this community of professionals by discussing and debating the current challenges faced by the industry in an online networking group. By gathering together the world's leading Islamic finance professionals, the online group collaborates to find potential solutions to problems hindering the growth of the industry today.

The Collaborative Sukuk Report summarises these contributions in order to promote the sustainable growth and transparency of the industry. The structure of the report consists of a series of thought leadership articles, followed by a comprehensive survey carried out by Zawya and a trend analysis on the Sukuk industry in partnership with Ernst & Young.

We would like to thank our valued contributors for their continuous efforts, patience and constant encouragement without which we would not have achieved the success we have today. We look forward to seeing an even bigger collaborative effort in our next annual issue.

We would also like to invite all Islamic finance professionals to join our online community to strengthen the ongoing dialogue that encourages the growth and development of this promising industry.

Please send us your details to sukuk@zawya.com to join our online community, or visit www.zawya.com/sukuk/report for more information.

Overview of the market for bonds and Sukuk

Paul McNamara
Editorial director, Yasaar Media, Dubai

The market for bonds and Sukuk in 2009

'The biggest problem with the debt capital market in the Middle East is that there isn't one'. This might be something of an oversimplification but it nonetheless holds a grain of truth. Debt capital markets do not simply spring up overnight; they take decades to grow and gain acceptance and traction. And there is a whole raft of infrastructure that underpins a successful capital market including the widespread use of ratings both at a corporate and at sovereign level, internationally recognised exchanges where these debt instruments can be listed and traded, and a complex hierarchy of lead managers, co-lead managers, joint lead managers, arrangers, distribution agents and so on.

The reality is that in the Middle East some governments and central banks, particularly the Central Bank of Bahrain, have been more active in helping the development of an Islamic capital market than others. Many more are now joining the fray and discovering that debt can be a very useful tool in the sensible and prudent management of an economy, even a very rich economy that is fuelled by natural resource revenues.

Trying to build an Islamic debt capital market in such circumstances was always going to be a tricky piece of work. The pipeline for Sukuk issues has been erratic at best. From a very modest start in 2002 the industry reached fever pitch in 2007 before succumbing to the ravages of the global financial meltdown. Any day now we are promised that the industry will spring back to life and that there is a massive heap of new Sukuk issues in the pipeline. Any day now.

And that is why Malaysia could be such a useful template for the Middle East to copy. Malaysia has a well established debt capital market and an equally successful Islamic debt capital market. New issues are frequent and heavily traded. Bank Negara Malaysia takes the issue of Islamic finance very seriously and has the full support and backing of the government in positioning Malaysia as a central hub for Islamic finance globally: the results speak for themselves.

Of course the Sukuk market is a bigger place than simply the GCC and Malaysia. Pakistan, for instance, has been a very active market for Sukuk issuance. Many of these issues have been domestic Pakistan rupee issues, and Standard Chartered through its Islamic brand Saadiq has been a leader in this segment. But there have also been dollar issues aimed at the international market.

And then there is tiny Brunei. Squatting atop the island of Borneo Brunei has the luxury of having vast oil fields and a tiny population. The result is that Brunei never felt the need to issue debt because it was so rich. The lesson for the rest of the world, however, is that it is possible to by-pass the process of developing a conventional debt capital market first and then migrating over to an Islamic capital market. Brunei went straight in and issued Sukuk with no experience in issuing conventional bonds of any sort. The Brunei Sukuk scene is hardly the biggest in the world but it holds valuable lessons for all concerned. After all, culturally Brunei is a part of the great Malaysian hinterland even though politically and economically it stands alone and Malaysia would be a formidable competitor for any nation. And finally Brunei is a mere hop and a skip away from Singapore which is undeniably the financial powerhouse of South East Asia and let us not forget that Singapore too has pretensions to be a regional powerhouse in the Islamic finance arena.

Nor should we forget the ground-breaking Sukuk issue from the state of Saxony-Anhalt in Germany or the East Cameron Gas Sukuk from the USA which show that the Sukuk market is becoming truly global. At present there is talk of Japan, Hong Kong, France, and the UK getting on board the Sukuk bandwagon. But is this the best time to do so?

The credit crisis and what it means for Sukuk

In some ways the global credit crisis is the best thing that could have happened to the GCC as an aid to growing a robust capital market, both conventional and Islamic, and both corporate and sovereign. Corporates suddenly seem to understand that a vibrant and healthy domestic currency bond market can be a tempting and affordable alternative to bank loans. Equally importantly they find that issuing debt is often far more attractive than resorting to the equity capital markets. Sovereign governments, on the other hand, have discovered that a robust sovereign bond or Sukuk market gives them a very useful tool when it comes to managing domestic credit.

Combining conventional debt and Sukuk issued in the MENA region in the first nine months of the year we get a cumulative figure of over $23 billion. We get to $33 billion if we include the $10 billion bond the government of Dubai sold to the central bank of the UAE earlier in the year, but that inclusion may not add clarity to the picture.

Total Sukuk debt still outstanding in the MENA region amounts to $45 billion out of a total of $250 billion in fixed-income debt for the region. Without doubt the Islamic debt capital market is growing in significance but if Sukuk issuances are dwarfed by conventional bond issuance by a factor of 4:1 then there is clearly still much more to go for. Equally importantly the debt market is still dominated by sovereigns and banks. General corporate issuances of bonds or Sukuk are still rare and small. This might mean that measures are needed to spur the growth of more Sukuk issuance, encourage secondary trading, and kick-start the next growth phase of the market. This might be in the form of tax incentives or other lures to make the issuing of Sukuk easier and cheaper than conventional debt.

So, ‘the biggest problem with the Middle East capital market is that there isn’t one’ is not strictly true but the market is not as big, as healthy, or as intrusive as it should be. If total outstanding debt is only $250 billion then it represents only 15 per cent of the region’s GDP which is very low when compared to similarly developed regions of the world.

And then we come to the perennial problem: lack of secondary trading. This afflicts the Sukuk market as well as the conventional debt market in the MENA region in a way that it simply does not in Malaysia. In the MENA region most trading is done by international banks over the counter. MENA must learn from its more sophisticated cousin.

But of course there is more to it than that. There is little in the region by way of institutional demand from insurance companies, pension funds, mutual funds and so on. The reasons for this are fairly easy to fathom: institutional investors, as the guardians of other people’s money, have a duty of care to invest only in instruments that have a high level of transparency and accountability. The MENA region has never scored well on either front, although initiatives such as Hawkamah are going some way to recognising such problems.

This endemic quest for secrecy naturally leads on to the question of ratings. In the Sukuk space in particular there has traditionally never been a need to secure a rating for an issue to be a success. Many unrated, unlisted Sukuk were historically vastly oversubscribed shortly after issue with investors determined to hold their investment to term simply because there were so few Shariah compliant alternative avenues where the investors could park their funds.

Malaysia, by contrast, ensures that every issue has to be rated. Every domestic currency issue in Malaysia has to be rated by either MARC or RAM. No Middle Eastern country has an equivalent agency although Cyprus-headquartered Capital Intelligence makes some attempt to cover the region. The Islamic International Ratings Agency in Bahrain performs rather a different function offering not simply opinions on credit but also on Shariah compliance.

Not all plain sailing

One of the unique aspects of Bank Negara Malaysia is that it actively encourages the issuing of Sukuk over conventional debt through the use of financial incentives. A similar regime could be adopted by governments elsewhere and then the boom in Sukuk that we have been promised could truly happen. Or could it?

Some very large question marks have appeared over the Sukuk market of late. Perhaps not the first but certainly one of the most high profile was the now near-legendary proclamation by Sheik Taqi Usmani of Pakistan that 85 per cent of non-Ijarah Sukuk issues were not actually in compliance with the Shariah. While the press dined out on this for some time the reality is that the real damage done here was not to Sukuk issues but to the credibility of Shariah scholars. Shariah scholars had eased themselves comfortably into the realm of doctors and judges and other professionals who speak with an authority that goes largely unquestioned. Such a public proclamation served only to give investors and issuers alike time ponder why scholars command such high fees when they can then turn around and say that they get it all wrong.

But such worries began to pale when the first Sukuk defaults appeared on the horizon. The Investment Dar of Kuwait failed to meet a profit disbursement and in so doing defaulted on the terms of its Sukuk. At almost the same time East Cameron Partners in the USA filed for Chapter 11 bankruptcy protection which clearly had profound implications for investors in its Sukuk. This in turn was followed by much naval gazing over the $3.52 billion Nakheel Sukuk and whether the government of Dubai would honour its commitments. The resolution of these and similar events caused by the financial crisis will determine how robust the Sukuk market will be in the years ahead and whether the flavour of the month will be Sukuk or bond.

The inaugural Sukuk report from Zawya

This report is aimed at answering some of these questions and perhaps posing some more. The overall intention of the report is to stimulate debate amongst practitioners and observers about how we go about ensuring the growth and survival of a significant icon for the Islamic finance industry. We have attempted to identify thought leaders across the Sukuk sector and ask them to share their candid thoughts with us. The result, we hope, will be the most thought provoking study ever published on Sukuk.

But the debate does not end with the publication of this report. Naturally there will be more reports in this series and in order to make them as relevant as possible it will be important for reader to share their thoughts, opinions, and insights with us.

We would like to thank everyone who contributed thoughts and insights for this report. We hope that next year's report will be even more stimulating and will chart the continued rise of a fascinating sector of this industry.

Some history of the development of Sukuk in different geographies

The Sukuk industry is undoubtedly now a global one, both in terms of new issues as well as in terms of where the investors in Sukuk are. However the undeniable truth is that the two main centres for Sukuk issuance, legislation, marketing, and promotion remain Malaysia and the GCC. Both centres have enormous advantages and a significant track record. Malaysia is often held up as an ideal that the GCC can aspire to. The following contribution looks at some of the pivotal achievements that Malaysia has witnessed since the dawning of the Sukuk era.

Nora M Salim

Islamic Capital Market Department, Securities Commission Malaysia

The Islamic capital market in Malaysia

The Islamic capital market is an integral segment of the financial system in Malaysia and in tandem with the unparalleled growth of Islamic finance globally over the past several years Malaysia has emerged as the single largest Islamic capital market in the world. A full suite of products, infrastructure, institutions, intermediaries and investors and a Shariah screening systems for equities, Sukuk, unit trust, exchange-traded funds (ETFs), real estate investment trusts (REITs) and structured products and derivatives have contributed to the depth and breadth of the Islamic capital market.

Islamic products now account for a significant portion of Malaysia's capital market. A pioneer in global Sukuk, Malaysia launched the first $600 million (RM2.1 billion) five-year global sovereign Sukuk in 2002. Being the largest issuer and representing 60 per cent of global outstanding Sukuk, Malaysia aims to retain its leading position by broadening Sukuk variety from plain vanilla to exotics. The Malaysian Sukuk market has experienced unprecedented growth with Malaysia firmly established as one of the largest issuers of Sukuk over the years.

Sukuk

Sukuk are firmly entrenched in Malaysia's Islamic capital market. In 2006, the Khazanah Exchangeable Sukuk created a new milestone as the first Islamic exchangeable Sukuk in the world. Since then, Malaysia has issued more globally accepted Sukuk, using the contracts and structures of Mudharabah, Musharakah and Ijarah. More than 60 per cent of Sukuk approved by the Securities Commission every year have been a combination of these structures, which are for a variety of economic sectors including infrastructure and utilities, properties and real estate, trading and services, industrial products and plantation.

The global Sukuk market has seen substantial consolidation in the light of the 2008 global financial turmoil and credit crunch, specifically in the last 18 months after growing by around 48 per cent a year during the period 2003-2007. Sukuk issuance in Malaysia fell by almost half in 2008. The difficulty in raising funds locally and globally was inevitable, due to the extensive nature of the financial crisis which had led investors to shun many if not all forms of capital-raising. In 2008, the SC approved more than $12.7 billion (RM43 billion) worth of Sukuk which accounted for 31 per cent of all corporate bonds approved.

We are seeing a positive turnaround in Malaysian Sukuk with the total issued at the end of July amounting to $5.4 billion (RM18.3 billion) compared to $6.2 billion (RM20.8 billion) for the whole of 2008. Similarly, Sukuk outstanding at the end July 2009 totalled $49.8 billion (RM167.73) billion compared with $45.3 billion (RM152.8 billion) at the end of 2008. Then there is the overwhelming success of the $1.5 billion (RM3.5 billion) Petronas Sukuk Al-Ijarah issuance in August 2009. The Malaysian Sukuk market looks set to recover from the lull in 2008.

Shariah Advisory Council for the capital market

Established in 1996 at the Securities Commission, the Shariah Advisory Council (SAC) provided the single most important impetus for the success of other initiatives. As the highest point of reference for all Shariah-related matters in the capital market, many other building blocks were put in place. The extensive powers of the Securities Commission, in the issue and offering of securities in the market, paved the way for issuance of legally binding guidelines and requirements in the Islamic capital market – enabling the Securities Commission, for instance, to impose specific requirements for Islamic unit trust funds and Sukuk.

While Malaysia has the strength of being a single nation, the GCC has the strength of being a widely diversified region with the benefit of vast hydrocarbon wealth to stimulate it. Indeed the Sukuk development story in the GCC could hardly be more different from that of Malaysia. Elements of competitiveness between the various states and emirates have led to the development of a highly fertile breeding ground for new Sukuk structures and transaction types. Although the GCC's history in the Sukuk market is shorter than Malaysia's it is nevertheless rich in diversity and scope.

Yadullah Ijtehadi
Managing editor, Zawya

Rise of Sukuk in the Gulf

The Gulf states may not have pioneered Sukuk but they have played a huge role in orchestrating its rise as a key investment instrument for Gulf governments and corporations. While Malaysia can lay claim to be the first government to launch a sovereign Sukuk way back in 1995, Sukuk's popularity is inextricably linked to the Gulf states' rising debt needs around early to mid-2000.

This decade has seen Gulf states pour billions of dollars into their infrastructure. Oil windfalls from previous booms had either been hoarded in international banks, squandered in ambitious projects, or used to purchase trophy international assets that made millions for the state but hardly benefitted the average GCC citizen.

But rising populations in the Gulf compelled the authorities to plough oil funds back into the regional economies to create jobs. A sense of accountability also started seeping in, especially as many Gulf states began to tap institutional investors for their funding requirements. Not surprisingly, it was the more cash-strapped Bahrain and Dubai governments and their entities that led the way in Sukuk issuance early on.

As these developments unfolded, the hitherto obscure Sukuk industry sprang to life as it appealed to the conservative nature of Gulf governments and corporations. International banks, spotting a multimillion dollar opportunity, worked with regional banks, Islamic scholars and issuers to structure an investment vehicle that was far more Islamic than the Malaysian version, but also transparent enough for international investors to participate in.

The Central Bank of Bahrain (CBB), formerly the Bahrain Monetary Agency, was the first to get off the blocks in the region, building on its status as the regulator of the region's financial hub. The agency created Shariah friendly laws and crafted comprehensive Islamic rulebooks that ensured its lead over other regulators.

To a degree the Bahraini initiative has paid off. Twenty-six Islamic banks with total assets of $26.3 billion (in June 2009) operate in the Kingdom today, in addition to 19 Takaful companies. The government also puts its money where its mouth is by regularly issuing short-term Al Salam Sukuk.

Yet the supremacy of Bahrain in Islamic finance was far from certain. Further down south, the emirate of Dubai needed funding to match its audacious ambitions. Like Bahrain, Dubai's oil revenue were meagre compared to its regional peers, and it jumped on the Sukuk bandwagon, in the process re-energising its Islamic financial services industry.

Of course, Dubai is home to Dubai Islamic Bank, the world's oldest Islamic bank launched in 1975, but the emirate's Islamic financial service industry needed a fresh impetus. It came in the shape of man-made palm islands, massive air and sea ports and jaw-dropping infrastructure projects.

After dipping its toes with a $1 billion Sukuk issue for the Department of Civil Aviation in 2004, Dubai got a real taste for Sukuk. From January 2006 to December 2007, Dubai went on a Sukuk spree: the emirate's real estate company Nakheel launched the biggest issue at the time - a three-year, $3.52 billion Sukuk al Ijarah, followed by Ports Customs and Free Zones Corporation raising $3.5 billion, Jebel Ali Free Zone $2 billion, DP World $1.5 billion and Nakheel $750 million, among others.

Not surprisingly, 2007 was a banner year for Sukuk as issuance crossed $10 billion, of which nearly $7 billion was raised by Dubai government entities. For a brief period the emirate was the epicentre of Sukuk, thanks to its voracious appetite for Islamic funding, all-round infrastructure, the nascent but vibrant DIFC and a can-do attitude.

"Dubai could do no wrong with investors at that time," says an Islamic finance lawyer involved with structuring Sukuk in the emirate at the time. "But of course, Dubai's debt woes have been well-documented since then. This is especially true for the landmark Nakheel Sukuk, which has been in the spotlight for quite some time, and is due on December 14."

Ratings agency Standard & Poor's estimates that Dubai government-related entities have collective debts of $80-90 billion, of which $50 billion is due within the next three years.

Regional aspiration

With Dubai focused on managing its own debt pile, other regional candidates looked to take on the mantle of Sukuk epicentre.

In Kuwait, Sukuk prospects looked bright when Commercial Real Estate Company launched a $100 million Sukuk in 2005, followed by Islamic investment firm The Investment Dar (TID) raising $150 million.

Despite the promising start, Sukuk did not get the traction Kuwait had hoped for, with the biggest Sukuk to date being National Investor Group's $475 million Mudarabah Sukuk. Of course, since then, TID defaulted on its Sukuk, leaving a bitter taste in the mouths of local investors.

And while industrious Kuwaiti companies such as Zain and National Real Estate Company are mulling launching Sukuk, the country is unlikely to become the beehive of regional Sukuk activity in the near future.

Meanwhile, Abu Dhabi, which held back its oil windfall for a long time, finally decided it was time to enter the fray. Listed and government-supported entities such as Aldar Properties, Tourism Development and Investment Corporation and Aabar have since issued Sukuk with international investors piling in. In many ways, the Abu Dhabi story is similar to the Dubai story, with the added advantage of having its master plan underwritten by oil wealth. With such a compelling proposition, few institutions can resist the call of Abu Dhabi corporations.

Despite the euphoria, the emirate is trying to be careful; the government is setting up a public debt management office to ensure that the authorities do not face the same pressures that Dubai government is currently under. A federal debt law is also in the works further to streamline Islamic and conventional debt issuance, and map out a coherent, country-wide debt pipeline.

Many analysts think that Abu Dhabi entities will increasingly head to the market in the next few years to fund their project pipeline which is collectively estimated to be around $100 billion.

Saudi slumber ends

The sleeping giant is also stirring into action. Given its historic ties to Islam, Saudi Arabia would have been the natural place for Islamic finance and Sukuk to flourish, but the enigmatic Kingdom turns out to be one of the last places in the Gulf for Islamic finance to take root.

And this is where it might just stay put. Working at its own pace, the kingdom created the Capital Market Authority in 2004, which in turn has crafted a regulatory market framework for the capital and debt markets that is second to none in the region.

Earlier this year, Tadawul launched the Sukuk and bond market as part of its efforts to boost the kingdom's capital markets. The development is seen as a massive shot in the arm for the Sukuk industry as Saudi Arabia corporations look for alternative sources of financing, and wean themselves off their dependence on banks for funding which could lead to balance sheet mismatches and overexposure.

Clearly, Saudi Arabia's need for non-bank funding is rising. With a population of 25 million people, the kingdom is leveraging its oil wealth to secure long-term funding on favourable terms. Blue-chips such as Saudi Basic Industries Corporation, Saudi Electricity Company, Saudi Hollandi Bank and Dar Al Arkaan Real Estate Development Company, among others, have already issued Sukuk and industry players expect this trend to continue

"The Sukuk market is very much a microcosm of Saudi Arabia's financial market as a whole - it is a sleeping giant," says Imran Mufti, a lawyer focusing on Islamic finance with Lovell's in Riyadh. Mufti expects Sukuk issuance from Saudi Arabia corporations to exceed those from other Gulf countries at least in the next few years.

But the battle for supremacy to be the Sukuk, or indeed Islamic finance hub, is far from over.
Undaunted by its debt woes, the DIFC is collaborating with the World Bank's Multilateral Investment Guarantee Agency (MIGA) to develop the region's bond and Sukuk market. The Bahrain government also launched a $750 million sovereign Sukuk last summer to finance its anticipated budget deficit and reclaim its Sukuk dominance.

As Manama, Dubai and Riyadh jostle for the top spot, others such as Abu Dhabi, Doha and Kuwait also seek to increase their share of the market.

With genuine demand forecast for the regional industry, it hardly matters which country will eventually become the Islamic hub of the region, as long as Gulf entities can raise funds in a transparent way and also deepen the region's capital markets in the process. That is enough to keep faith in Sukuk.

To focus solely on Malaysia and the GCC would be to miss an essential part of the story. Pakistan, for instance, has been a very active Sukuk market. While domestic issues from Pakistan have been denominated in the local currency, the nation has also made brief forays into the dollar denominated international market and has done so with significant results. There are many lessons in Pakistan for smaller countries grappling with the issues of launching themselves into the Islamic debt capital market.

Afaq Khan
Chief executive officer – Islamic banking, Standard Chartered Bank

Development of Sukuk in Pakistan

The Islamic banking market in Pakistan has seen significant growth over the last several years. Regulatory authorities like the State Bank Pakistan (SBP) and the Securities & Exchange Commission Pakistan (SECP) have been actively involved in facilitating various initiatives and introducing favourable policies to promote Islamic banking.

Amongst the most significant developments in the local Islamic banking industry was the creation of the $422 million (PKR 35+ billion) Sukuk programme for the government of Pakistan. Inaugural issuance was completed in September 2008. The Sukuk programme represented the largest Islamic debt capital market deal in Pakistan and its unique features included periodical offerings to local Islamic banks in smaller tranches through auctions conducted by the SBP, in exactly the same manner as that of Treasury Bills and Pakistan Investment Bonds. This Sukuk programme has helped the Islamic finance industry meet the reserve requirements set by the regulators. It allows Islamic financial institutions to participate in the government of Pakistan's overall funding plan for development activities in the country and also enables the central bank to have more direct control over the money supply. This Sukuk programme was made possible by close cooperation between SBP and the ministry of finance with the guidance from Shariah scholars. It has been recognised within the global Islamic banking industry as a significant achievement towards the development of Islamic finance in Pakistan.

At this stage, it is very important to encourage industry players to develop the Islamic debt capital markets by bringing more transactions in Shariah compliant format. As has been seen in other countries, governments and public sector entities have shown an active interest in developing the Islamic markets both through regulatory assistance as well as through issuing sovereign Sukuk. This will help to develop a critical mass within the industry.

In order to develop the market further, and make it a truly viable alternative to conventional financial market with a deep investor pool, more work is required from all market participants. For example, the Sukuk issued to date in the Middle East have primarily used Special Purpose Vehicles (SPVs) as the issuing entity wherein the beneficial ownership of the assets is transferred to the SPV. In Pakistan, SPVs are only allowed to purchase receivables or assets in the nature of actionable claim and cannot own title to tangible assets. This makes the SPV route legally difficult to implement in Pakistan, and it therefore restricts issuance of a publicly listed Sukuk which can be distributed widely to the retail market. So far, all Sukuk transactions have been structured as private placements with distribution limited to banks and institutions. The resolution of this issue will provide great impetus to the development efforts of the Islamic asset management business in Pakistan.

The industry also needs to work with the tax authorities to clarify and amend tax rules to allow the development of Ijara based solutions, which have been achieved quite successfully in other markets including the United Kingdom. For the avoidance of doubt, the Islamic finance industry is not seeking a tax subsidy.

Additionally, as the Islamic banking sector continues to grow there is an urgent need to develop risk management tools including hedging against currency and yield curve movement to ensure that Islamic financial institutions can grow in a prudent and controlled manner. It is a positive sign that the SBP and Shariah scholars are receptive to the growing needs of the Islamic financial sector.

While Pakistan is a Muslim country that has few issues in embracing the gamut of Islamic finance possibilities, there are other less obvious nations that have also identified Sukuk as being potentially very important to them. Canada would probably not feature high on the list of countries ‘most likely to’ issue Sukuk and yet that is precisely what looks like happening.

Omar Kalair, president and CEO, UM Financial Inc
Brian P. Koscak, partner, Cassels Brock & Blackwell LLP

The development of the Canadian Sukuk market

Prior to 2009 there have been some private corporate Sukuk in Canada but they often do not receive media attention. They have largely been real estate based Sukuk transactions made by investors from the MENA Region who want to invest in the Canadian real estate market.

In the summer of 2009, a $380 million Mudarabah Sukuk was proposed by Bear Mountain with Siraj Capital (Dubai) Ltd., as the lead arranger. Bear Mountain is a world-class golf course and residential community with associated commercial and recreational properties and amenities, all situated within a 1,300 acre development property located on the outskirts of Victoria, British Columbia, Canada. A proposed 343 acres will be transferred to a Sukuk asset for development. The deal is expected to close towards the end of 2009. Once completed The Bear Mountain Sukuk will be Canada’s first-ever rated Sukuk and one that will have attracted international investment interest.

Sovereign Sukuk discussions

With Canada being a destination for investments from many countries, there have been governmental discussions to look at the feasibility of offering a sovereign Sukuk in the near future. UM Advisory, a division of UM Financial Inc., has made presentations to government agencies who have been exploring this opportunity. UM Advisory has been working with Cassels Brock & Blackwell and international law firms to advise these agencies on how to structure these transactions. At the moment, government lawyers are looking at amending a number of provisions in certain legislation and identifying unencumbered assets for the purpose of issuing a sovereign Sukuk. Asset identification is important since in certain types of Sukuk structures, such as an Ijarah Sukuk, the sovereign has to transfer the assets to the Sukuk.

Most, if not all, sovereign Sukuk to date involve the transfer of real estate by the sovereign to the special purpose vehicle that constitutes the Sukuk structure for a certain period of time after which it is sold back to the sovereign. Such transfers are not always simple and involve, among other things, taxation issues, such as withholding taxes and GST/HST sales tax issues, which need to be worked out. These are standard issues for any sovereign Sukuk. Having a sovereign Sukuk in Canada would open the doors for many more structured Sukuk, such as corporate Sukuk, which could further enhance Toronto's role as a hub for Islamic finance in North America.

Sukuk structures are not new to Canada's investment banking community. Certain large Canadian investment banks have studied the structures and find them interesting and innovative but it will take investor participation and commitment from the MENA Region to co-invest and work with Canadian investment bankers and other professionals if Sukuk are to become a new asset class in Canada. It is not the structures or Islamic finance that are the problem, rather investment dealers and their issuer clients will do any type of transaction if the costs of funds are competitive and, in the case of Sukuk, if there is also international support for the structure in terms of investment dollars.

In sum, the story in Canada is Sukuk is getting some traction at both the sovereign and corporate levels but it is only just beginning and the expectation is that it will grow rapidly in the coming years.

The core strengths of the Sukuk market

Development of the Sukuk market cannot happen in isolation to the rest of the world. The Islamic finance industry cannot escape the fact that the world has suffered the worst financial blight in decades. But the Sukuk market has managed to withstand many of the worst shocks wrought by the financial crisis. Malaysia in particular has managed to steam ahead with new issues and has also implemented steps to build on the core strengths of the market.

Raja Teh Maimunah
Global head, Islamic markets, Bursa Malaysia Berhad

Sukuk issuance in Malaysia

The Sukuk market was not spared the effects of the global credit crisis. Based on data from Zawya's Sukuk Monitor for H1 2009 global Sukuk issuance in 2008 dropped by 55 per cent to $15.4 billion from 2007. Issuance continued to decline, standing at $7.4 billion for H1 2009, 33 per cent less than H1 2008.

The data shows that the decline is most significant in the GCC. South East Asia is leading in new issues with total issuance reaching $6.25 billion, representing 84 per cent of total global Sukuk issuance for H1 2009. Only 16 per cent of H1 2009 issues came from the GCC with a total value of $1.15 billion.

GCC Sukuk issues picked up in Q3 2009 with Saudi Electricity and Islamic Development Bank issues totalling $2.7 billion. Malaysia retains its lead as top issuer in Q3 2009 with a total of $4.55 billion issued representing 54 per cent of the total issuance in that quarter including the notable $1.5 billion Petronas Global Ijarah Sukuk issued in August 2009.

For the 12 months ended September 2009, Malaysia dominates the global Sukuk market with around 60 per cent of the total issued. The notable Petronas Global Ijarah Sukuk issue reinforces Malaysia's place as one of the leaders of Islamic finance. It is notable for being of a significant issue size and is structurally innovative.

The issue received overwhelming response and was oversubscribed several times with a significant amount being subscribed to by investors from Asia. It is interesting to note that the capacity and appetite of Asian investors for Sukuk have gained prominence as seen with the Petronas issue as well as the $850 million Islamic Development Bank Sukuk which also attracted a significant number of Asian subscribers.

In addition to heightened Asian investor interest, we are also seeing an increase in issuer interest to tap into the Sukuk market from non-Islamic markets especially following the global credit crisis e.g. the UK France and Korea. Though we have yet to see any Sukuk issued from those markets their governments are making changes to their various governing laws and regulations to facilitate Sukuk issuance. We believe that it will not be long before those markets undertake fund raising through the Sukuk market which would add further vibrancy to the global Sukuk market.

Issuance of Sukuk in Malaysia is regulated by the Securities Commission through the framework provided under the Guidelines on the Offering of Islamic Securities with the Shariah component being regulated by the Securities Commission's Shariah Advisory Council. The establishment of a clear and unambiguous Sukuk framework is critical in the development of the Sukuk market which in turn promotes greater market competition. The ringgit Sukuk market in Malaysia now dominates the domestic debt securities market as pricing for Sukuk is more competitive than for conventional bonds.

In the promotion of greater governance and transparency, Bursa Malaysia introduced new rules for the listing of Sukuk on the exchange. Under the new framework, Sukuk denominated in ringgit and foreign currencies issued by local and international listed and non-listed entities will be allowed to be listed on the exchange. Listing a Sukuk on Bursa Malaysia is provided for under an 'exempt regime' which does not provide for the paper to be quoted or traded over the exchange. This is based on a framework that is comparable with practices in other exchanges that provide similar listing facilities.

The main proposition for a Sukuk listing on Bursa Malaysia is to promote transparency and governance which is much sought after by investors in the wake of the global financial crisis. The exchange will monitor the submission of annual financial accounts annually to investors and will be able to query issuers on anomalies, if any. The listing of a Sukuk is also aimed at facilitating greater profiling of the issuer particularly its governance practices and credit worthiness which in turn will facilitate future fund raising initiatives by the issuer. This is especially helpful during these challenging times in the financial markets.

The core weaknesses of the Sukuk market

While the Sukuk market has come a long way since its humble beginnings, there are always observers who will make the case that it could have come on even further. Indeed this is true and the Islamic debt capital market has undoubtedly been held back by some problems that will need to be addressed before the industry can make the top speed that it is capable of. Some of these issues are legal and some are regulatory and some come down to the basic question of how to market Sukuk best.

 

Ayman Abdel Khaleq, partner, Vinson & Elkins
Todd Crosby, associate, Vinson & Elkins

Defaults and the maturing Sukuk market

It has been written that the United States Securities Act of 1933 "did not spring full grown from the brow of any New Deal Zeus". Rather, the act was the culmination of centuries of legislation in multiple jurisdictions. While we do not intend to imply that the maturation of a market for an economic instrument is analogous to the evolution of a regulatory system or that the solution to the recent downturn in the market should be the product legislation, the concept of a system growing over time aptly describes the current state of the Sukuk market. Until recently the growth of the Sukuk market has been driven more by an abundance of financial resources than by legal considerations. The current competition for scarce funds across the globe may highlight the importance of the legal considerations underlying financial products, both Islamic and conventional. How Sukuk structures fare in the face of defaults should clarify what they are in a legal sense. This clarity, in turn, may light the path of the maturation process of the Sukuk market.

In conventional finance and investment markets, the post-default path is well worn. For this reason, much of the process of structuring and documenting transactions, particularly in common law jurisdictions, accounts for the possibility of a worst case scenario. Precedents indicating what such a scenario may entail are readily available in the context of conventional transactions. The same cannot be said for Islamic transactions.

Another factor contributing to the uncertainty surrounding post-default Sukuk is that many are subject to partially or wholly non-Shariah based legal regimes. For example, the legal documents governing Sukuk or the Islamic structures underlying Sukuk are often subject to English law. Moreover, legal documents comprising separate components of the same Sukuk issuance may be subject to different legal regimes. How Shariah based transactions structures will be characterised and treated in various applicable jurisdictions cannot be known with any high degree of certainty prior to the resolution of disputes and enforcement of rights in the relevant jurisdictions.

Certainty with regard to the post-default process in Sukuk transactions is necessary because the potential for a default exists in all types of transactions. Even the most prudently structured products can fail due to circumstances outside investors' control. Consequently, risk is inherent in any transaction, whether Islamic or conventional although an argument can be made that an Islamic investor should be better prepared to assume a higher degree of risk than a conventional investor. This is not to imply that Islamic products are by definition riskier than conventional ones, but within the parameters (ethical and financial) of what Shariah considers to be a compliant investment product, Islamic investors should be prepared to assume the risks inherent in making an investment in such product.

Clarity as to what may reasonably be expected in a default scenario with respect to any financial transaction leads to an enhanced ability to foresee and mitigate the risks inherent to that type of transaction. Until a right is interpreted and enforced, the benefits enjoyed by the person holding that right are limited to the benefits resulting from the obligations that the corresponding obligor is willing or able to perform. In a sense, defaults in a type of transaction reveal the actual rights held by investors in that type of transaction.

Knowledge of such rights allows the financial practitioners structuring and documenting that type of transaction greater ability to mitigate the risks inherent to that type of transaction. The foregoing applies to a great extent to the Sukuk market. In fact, the knowledge factor is compounded in the context of Sukuk products as the assets on which such products are based (or by which they are backed) are scattered in multiple jurisdictions which apply different legal systems (Islamic, common law, civil law or hybrid legal systems) and which may vary in terms of the maturity of their judicial systems and enforcement mechanisms. This gives rise to the need for a comparative study of how each default is being handled in the relevant jurisdictions. Such study will be far from complete absent meaningful cumulative feedback on the manner by which Sukuk default scenarios were treated.

The defaults facing various Sukuk in the current market are therefore not entirely negative occurrences. Nor can it be said that those defaults alone represent a maturation of the Sukuk market. Instead, each default represents another incremental opportunity for increased knowledge about the relevant Sukuk and its underlying structures. That increased knowledge will better equip those structuring and documenting Sukuk transactions to understand and address the risks facing those Sukuk transactions. Ultimately, current defaults in Sukuk, though unfortunate in a number of respects, are likely to prove catalysts for the maturation of the Sukuk market rather indications of the achievement of maturity.

Another significant area that needs to be addressed is that of Shariah compliance and whether or not Shariah convergence is something to be aspired to. The reality is that different scholars have different opinions about different products. But perhaps of greatest concern is the tendency of some scholars to have different views on the same subject at different times.

Peter Hodgins
Partner, Clyde and Co.

Shariah disharmony

It is a common criticism of the Islamic financial services industry that it lacks standardisation and that scholars change their minds as to whether an aspect of a product is Shariah compliant or not. These frustrations are understandable as the apparent inconsistency inevitably increases the transaction costs, creates uncertainty for the purchasers of products and creates scope for criticism of the industry. However, would the imposition of some from of malpractice liability on the Shariah scholars rectify these issues or would it create further problems?

The scope of liability for malpractice

Whilst I can empathise with these concerns (and, indeed, occasionally had transactions delayed as a consequence), I do not personally consider that Shariah scholars should be open to liability for malpractice other than in the most serious of cases. The fact that a Shariah scholar has changed his opinion on a matter ought not, in my view, to be sufficient to form a malpractice claim. This is subject to one significant proviso that, at the time the Shariah scholar provided a ruling, he must have genuinely believed in the Shariah compliance of a product. I accept that this proviso could be difficult to prove as it goes to the state of mind of the Shariah scholar. However, what we are concerned with are extreme cases where it could be demonstrated that the Shariah scholar was focused on other concerns (for example, his relationship with the product provider or his financial remuneration) and did not give any genuine consideration to the Shariah compliance of the product. Thankfully such extreme cases are rare, as this type of behaviour would inevitably damage the reputation of an industry based upon ethics. Such extreme cases would, in any event, probably amount to fraud and therefore already be subject to legal sanction in most jurisdictions.

Aside from the extreme case, I do not believe that it is appropriate to expose scholars to allegations of malpractice merely for changing their minds. It would, in my view create many more issues than it resolves.

Deterrent to innovation

A core risk of creating a broad-based malpractice liability for Shariah scholars is that would dampen the spirit of innovation currently exhibited by the Islamic financial services industry. If a scholar could be exposed to liability merely for changing his mind it would potentially damage the future development of Shariah compliant products. The natural tendency, when faced with a potential exposure, is to become risk adverse. The majority of scholars would thus take a very conservative approach to all issues if there is a potential for liability.

Restriction on analogical reasoning

The development of new products is dependent upon the scholars being able to justify their compliance by analogy to existing Shariah compliant products. Many of the products currently being sold, and certainly those under development, did not exist during the time of the Prophet (PBUH). It is therefore necessary for the scholars to determine their compliance by reference to equivalent concepts. The risk of legal liability would inevitably result in a more restrictive approach being taken in their analysis.

Fetter on ethical judgment

More fundamentally, Islamic products are ethical products intended to comply with the tenets of the Islamic faith. Islam is not a codified body of law and relatively few regulators have taken the view that it is appropriate (or necessary) for them to provide detailed regulation on Shariah issues. It is therefore for the Shariah scholars appointed by each Islamic financial services provider to determine, based upon their own ethical judgment, whether a product is compliant or not. In these circumstances it would be inappropriate to expose scholars to allegations of malpractice. To so risks creating a fetter on the freedom of scholars to determine issues as they believe is appropriate.

Lack of Shariah scholars

The shortage of Shariah scholars with the necessary experience of the financial services industry and its products is a perennial complaint repeated at every Islamic finance conference. It is difficult to see how the imposition of a potential legal liability for malpractice will do anything to encourage individuals to take up such roles.

Cost versus benefit

It is necessary to ask whether the imposition of malpractice liability would achieve anything. In the professional services sector such liability exists, but malpractice still occurs. Furthermore, it is fairly clear that there will always be individuals who will deliberately flout the law. The creation of liability may therefore only have limited deterrent effect.

Nor would the imposition of liability necessarily result in the purchasers of the financial products or the Islamic financial services providers obtaining compensation. Very few (if any) individual scholars would have the personal wealth necessary to pay substantial damages.

In order to ensure that compensation was available in the event of malpractice it would be necessary to ensure that the scholars purchased liability insurance. However, whilst obtaining such protections would not be an issue, particularly as Takaful protections are becoming widely available, the cost of contribution (i.e. the premium) would be significant. These costs would ultimately be borne by the entity by which the Shariah scholar is appointed. In addition, it is necessary to consider the additional time and costs that would be associated with any malpractice practice. Therefore, far from resulting in cost savings, the imposition of malpractice liability may well result in additional costs for the industry.

The role of the Shariah scholar

Many of the concerns experienced by the Islamic finance industry arise from the ambiguity of the Shariah scholar's position. There are aspects of the role that could be analysed as analogous to that of a legal advisor, auditor, court appointed expert and regulator. It is this ambiguity that tends to encourage advocates of malpractice liability.

The Shariah scholar should be independent of the Islamic financial services provider by which he is appointed. He should be free to determine the requirements of Shariah and the steps to be undertaken by the Islamic financial services provider to comply with Shariah (as interpreted). Unlike an advisor, whose advice may or may not be accepted, the Shariah scholar can legitimately expect these steps to be performed. This independence that may well be threatened by the imposition of malpractice liability (which encourages the analysis of the scholar purely as an advisor).

The problems of the Islamic debt capital market cannot be viewed in isolation. The proper functioning of such a market requires a complex mix of regulation, transparency, liquidity and confidence. When these elements are woven together in the correct pattern then primary issues flow and secondary trading picks up a brisk pace. Globally the industry still lacks some core elements and these elements need to be addressed before the market can truly take off.

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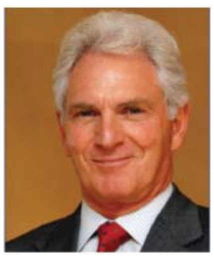


Dr. Nasser Saidi
Chief economist DIFCA, executive director of Hawkamah, the Institute for Corporate Governance

Lack of liquidity in the secondary market

The volume of international debt securities outstanding is estimated at $25,880.98 billion as of June 2009 compared to $25,299.7 in June 2008. (Source BIS)

Despite having a large number of issuers, debt markets are not as liquid as equity markets. Unlike the stock markets or futures and options markets secondary trading in debt securities in most countries remains decentralised and mostly debt instruments are traded 'over the counter' i.e. trading is done through direct interaction of buyers and sellers with the help of dealers.

Although some securities regulators have sought to promote trading by requiring that the debt be listed on stock exchanges, the problem of lack of liquidity still persists and this is true for both conventional as well as the Islamic debt markets.

The secondary market for Islamic instruments lacks certain key features required for efficient functioning of the debt market, such as;

* A consensus Islamic benchmark rate the result of which is that a conventional market benchmark rate (such as Libor) is used as a proxy to determine the pricing of the Islamic instruments

* Low liquidity
* Suboptimal market depth
* Lack of efficiency and relatively small number of participants
* Mitigants to manage and hedge the risk of fluctuations in the market value of instruments on account of movements in the benchmark rate
* Limited choice of assets to be used as collateral

It is very important for the development of capital markets to have a deep and liquid debt market as it provides greater access to global sources of capital, smooth funding of government liabilities, expanded opportunities for domestic investors to fund local economic growth, wider availability of investment choices for global investors and asset managers, more efficient financing of large infrastructure projects and more rigorous cost benefit analysis.

In order to create liquidity in the debt market, the first step is to develop the government bond market by considering the following measures:

* A steady supply of liquid securities with different risk profiles covering a wide range of maturities from a few weeks to a few decades as well a range of credit instruments, risk profiles, types.
* A regulatory environment which promotes a meaningful disclosure of terms, conditions and risks without being a heavy regulatory environment for banks, insurance companies, brokers, primary dealers, pension funds, asset managers.
* An efficient market infrastructure easily accessible by residents and non- resident investors, with a key role in ensuring the success of the issuance assigned to reputable primary dealers.

The central banks on behalf of the government, should therefore commit to a systematic programme of issuances along the maturity spectrum with a stated aim of creating a yield curve and benchmarks, stating in advance the terms and conditions and the amount.
A government yield curve would emerge progressively as sizeable auctions are conducted at regular intervals covering a wide spectrum of maturities. Once a yield curve emerges it will be easy to structure corporate bonds taking into account the maturity spectrum.

Institutional investors are also important for the functioning of a country's domestic government debt market. They are however, not an homogenous group and have varying invest¬ment objectives. Different types of institutional investors follow their own investment guidelines, and as a result the demand for government bonds ranges from short-term treasury bills to long-term instruments. Pension funds and Takaful companies have a predictable funding flow and fairly predictable liabilities for long periods of time. As a consequence, they have a long-term planning horizon and look for assets that generate a stable flow of real income. Mutual funds and investment companies however, focus on the current market value of their portfolios, which is their main indicator of performance. Moreover, the open-ended mutual funds could face redemptions from shareholders at any time and therefore they pay close attention to the liquidity of the financial instruments in which they invest.

It is also very important to hold investor awareness sessions on bonds to encourage retail investors to invest in these instruments as well. A diversity of investor groups with different perspectives, investment orientation and liability structures is necessary for the long term viability of the market and secondary market liquidity.

1. Independence of the board of the SPV from the originator

The issue of having an Independent director on the Board of an SPV arises in the context of bankruptcy remoteness of an SPV.

A securitisation transaction essentially requires a true sale to be achieved in the transfer of assets from the originator to the SPV and is premised on the bankruptcy remoteness concept i.e the ability legally to isolate the assets transferred by the originator to the SPV from bankruptcy risks associated with the entities involved.

It should be ensured that the SPV is an independent entity. The originator is usually restricted from holding any equity stake in the SPV or having any of its directors, officers or employees on the board of the SPV. One of the measures to ensure the independence of the SPV is for it to be managed by directors independent of the originator.

When an SPV director is under the control of various transaction parties there is a risk that such a director may file a voluntary bankruptcy petition against the SPV to serve the interests of these parties when they face a deterioration in their financial standing, regardless of whether events that would trigger the commencement of bankruptcy proceedings have arisen or not. An additional means of ensuring that such an event does not occur is to have the clauses that would trigger bankruptcy stated in the trust deed - this of course requires the trustee to be independent of the transaction parties as well. An independent director has less of an incentive to file a bankruptcy petition against an SPV, and is there to ensure that he or she would act in the interests of the securitisation transaction.

The definition of independent director varies between various corporate governance principles and rules across the different jurisdictions. Standard & Poor's considers the following definition for an independent director while rating SPVs:

'An independent director as a duly appointed member of the board of directors who is not at the time of appointment, and has not in the previous five years been: a direct or indirect owner of the originator, sponsor, or the servicer; a creditor, supplier, employee, director, family member, manager, or contractor for or of the originator, sponsor, or the servicer; and a person who controls or is controlled by (whether directly or indirectly) the originator, sponsor, or the servicer, or any creditor, supplier, employee, director, family member, manager, or contractor for or of the originator, sponsor or the servicer'.

2. Importance of having an independent trustee

The most common reason for appointing an independent trustee is to avoid conflicts of interests and to protect the Sukuk holders' rights. Since independent trustees are neither beneficiaries of the transaction nor directors of the company/originator/prime obligator, their decisions are less likely to be swayed by motives other than the protection of Sukuk holders' interests.

Keeping in view the important role of the trustee, the Sukuk holders are best served when an independent entity manages the transaction related cash flows, tracks and reports transaction breaches and compliance with the covenants stated in the trust deed. In today's demanding and complex Islamic finance market, issuers must select an independent trustee who can assure both international and local investors that every aspect of the securitisation transaction is being handled in accordance with the clauses of the trust deed.

The value of an independent trustee is to bring greater competence, diligence and scrutiny to the conduct of the business. However, having said that, as with any professional appointment, performance needs to be evaluated and the appointment reviewed to ensure the anticipated value is delivered.

One of the lessons learnt from the recent financial crisis and enterprise collapses such as the Madoff ponzi scheme was that the more independent the trustees are, the lower risk of fraud due to independent oversight.

Sukuk structures

As in much of the conventional world, there is a growing need for a wide palette of Sukuk structures to accommodate different kinds of funding needs. Where it is most appropriate for an asset to be leased to create cash flow to fund a Sukuk structure then an Ijarah contract would be most appropriate. But this will not always be the case and there is a need to match the Sukuk structure to the specific task at hand.

Dr. Mohd Daud Bakar
Managing director, Amanie Islamic Finance Consultancy and Education

Sukuk structures

It is incorrect to assume that Sukuk are always of one particular structure. As a matter of fact, Sukuk embrace a number of structures which distinguish them from conventional bonds and from other Sukuk structures in the family of approved Sukuk. Sukuk differ in product design, product offering, pay off to the investors, and rating methodology.

Conceptually Sukuk can be divided into four broad categories. These categories include debt-based Sukuk; asset-based Sukuk; project-based Sukuk; and asset-backed Sukuk. These four categories demonstrate not only various structures but also highlight the chronological developments of Sukuk instruments. As the Sukuk market begins maturing, each new issue represents a step up on the ladder of sophistication. Sukuk issues have begun moving away from the 'bricks and mortar' debt-based issues to asset-based issues such as Sukuk Ijarah to project based issues that pay specific focus to the underlying assets that are being constructed to generate income to the Sukuk investors.

Debt-based Sukuk focuses on securitising Islamic receivables which are the outcome of a few Islamic finance contracts such as Murabahah, Ijarah and Istisna'a. These Sukuk evidence the right of the holder of the Sukuk to receive the payment as stated in the primary and secondary notes of the Sukuk. This structure resembles that of conventional bonds which are simply IOUs except that the receivables in this Sukuk must originate from Islamic approved contracts that create these future receivables. Given this context, the most suitable corporate methodology to provide ratings for the Sukuk is linked to the credit quality of the obligor/issuer. The quality of assets or projects is not relevant to the rating quality of the Sukuk except when these assets are taken as collateral.

In contrast to debt-based Sukuk, asset-based Sukuk investors will have some relationship to, or claim on, assets that are used to facilitate the issuance of Sukuk. However, from a financial obligation perspective, asset-based Sukuk are not different from debt-based Sukuk because the quality of the asset in terms of its income generating capability has no link to the credit rating quality of the issuer of the Sukuk. The rating of this asset-based Sukuk still relies primarily on the quality of credit risk of the obligor/lessee. Irrespective of the actual or potential usufruct of the leased asset, the timely payment of rental to the Sukuk investors, as reflected in the coupon payments, would depend on the credit standing of the obligor/lessee.

The manner of using the leased asset by the lessee and the income arising from using the leased asset by the lessee has no link to the payment of rental to the Sukuk holders under Sukuk Ijarah. The underlying asset which is purchased and leased back under Sukuk Ijarah is present in this structure only to facilitate the sale and lease transactions rather than to serve as a source of profit payment and principal redemption to the Sukuk investors.

Project based Sukuk are a relatively new innovation in Islamic finance as they depart from a typical debt-based or asset-based structure to a kind of profit and loss sharing arrangement seeking to provide the pay-off to the Sukuk investors based on the performance of the underlying projects in which the Sukuk investors have an undivided and proportionate ownership. Under this structure, it is expected the Sukuk investors will need to consider the risk of the venture more than the credit risk of the issuer. Also, it is worth noting that there should not be any guarantee of profit payment or principal redemption in this structure. The rating methodology should be one for project finance rather than a rating method used in the case of debt based and asset based Sukuk.

The two elements that are relevant in project finance rating methodology are the quality of cash flows and the quality of the asset of the project. While the periodic cash flow stream is relied on as the sole source of profit to be distributed to the Sukuk investors, the project assets are usually secured as collateral for the Sukuk investors. Sabic Sukuk Istisna'a could reflect this kind of project based Sukuk which is centred on the marketing services to be provided by the holding company to other subsidiaries companies. The Emirates Airline Sukuk Musharakah is another good example of this project based Sukuk.

Prior to 2008 the rating of this kind of Sukuk still used the credit risk rating simply because the quality of the Sukuk in terms of ability of payment and timely payment of the issuer are essentially based on the credit standing of the issuer pursuant to the Purchase Undertaking by the issuer. This has been the subject of scrutiny by the AAOIFI Shariah Board which led to the prohibition of such practices in February 2008.

Finally, asset-backed securities represent the real form of securitisation as they expose the Sukuk investors to real value and risk of the underlying asset. Under this structure, investors can only expect the returns from the cash flows of the underlying assets and there is no right of recourse to the owner of the assets. This is because asset-backed Sukuk would require the owner of the asset to sell his asset on a 'True-Sale' concept to the Sukuk investors without having any purchase undertaking in the case the asset fails to generate the expected income to the Sukuk investors. In short, asset-backed Sukuk are characteristically non-recourse Sukuk with the underlying assets forming the sole source of profit and principal payments.

Although Sukuk Ijarah look like the most solid form of Islamic fixed income instrument, they do not make other forms of Sukuk redundant. Indeed the introduction of project based Sukuk and asset-backed Sukuk is a normal progression in developing the Sukuk market. This is because more disclosure is needed to inform the Sukuk investors of the inherent risks associated with project based Sukuk and asset-backed Sukuk which are typically not present or relevant in debt based Sukuk such as Murabahah or Istisna'a or asset-based Sukuk in the form of Sukuk Ijarah. The challenge does not lie in the new structure of Sukuk but rather in providing a comprehensive guideline for the various Sukuk instruments to protect investors and to regulate the issuers in a more transparent and 'disclosure-based' environment.

But of course solving one problem can just as easily create a secondary problem. This can happen when different Shariah scholars have different views on the permissibility of a specific structure. While there is one school of thought that believes that such disharmony is good for the industry there are others who believe that it holds the industry back and needs to be addressed as one of the core dilemmas of the industry.

Ijlal Alvi, CEO
Dr. Ahmad Rufai Muhammad, head of Shariah, International Islamic Finance Market

The need for Shariah standardisation in Sukuk issuance

As Islamic finance has grown, differences in rulings on whether or not products are Shariah compliant have surfaced. Although Shariah interpretations and applications are similar, this does not always translate into unified documentation and unified application. Conformity amongst the Shariah supervisory boards of Islamic financial institutions is needed. We believe that standardisation of certain structures and contracts is necessary in order to avoid inconsistencies between different Fatwa rulings and their application by Islamic financial institutions regionally and globally.

The existence of a unified Shariah board through a council representing different Islamic schools of thought worldwide is necessary as this would facilitate the conformity of certain existing wider market product structures such as Sukuk. Sukuk are a vital mechanism for raising money in the financial markets. Hence, continuous improvement of the functions of Shariah boards to achieve a global standard for Sukuk is essential because lack of standardisation in the Sukuk area is a contributory factor to low issuance levels. Moreover, the present financial crisis has raised a number of structural issues in Sukuk such as transfer of ownership and the Sukuk holder's ability to have direct control over the assets in case of default.

The present market conditions have clearly identified the urgent need to revisit the issue of asset based versus asset backed Ijarah Sukuk. The issue has legal and documentation implications but must be studied by Shariah scholars in order to safeguard the rights that holders have perceived at the time of issuance of the Sukuk as well as issues such concerning fair risk and reward in the case of Musharaka and Mudaraba Sukuk (refer Sheikh Taqi Usmani's ruling), needs to be looked at from a convergence point of view. These issues have global significance and universal convergence is absolutely essential.

In our view the establishment of a Shariah Board at a global level will be helpful and can play a major role in convergence as well as in facilitating the development of a robust and unified Islamic financial services Industry. This can be achieved if Shariah scholars from around the globe contribute towards a greater understanding at national and international level of convergence. Such convergence and harmonisation can only happen with greater engagement among regulators, practitioners, Shariah scholars and other stakeholders in the Islamic finance industry.

We believe that collective efforts through cooperation and collaboration between major Islamic financial standard-setting and development bodies such as the International Islamic Financial Market, the Accounting and Auditing Organization for Islamic Financial Institutions, Islamic Financial Services Board and central banks is important in strengthening the fabric of Islamic finance.

Note: The views expressed are those of the authors and do not necessarily reflect the views of IIFM or its members.

The importance of ratings

The need to have Sukuk rated in order to attract investors might seem rather obvious to both issuers and investors in Malaysia but there were many Sukuk issued pre-crisis that were vastly oversubscribed even though they did not have a rating. While ratings are obligatory in Malaysia (which has two home-grown ratings agencies) there is no such equivalent in the GCC. Now that some investors are staring down the barrel of a default it is hardly surprising that the issue has raised its head once again.

Khalid Howladar
Vice president – senior credit officer, Moody's Structured Finance Group

The rating difference between secured and unsecured Sukuk

The complexity of Sukuk structures means there is reduced transparency and understanding of the credit risk of such instruments. The Shariah principle of 'tangible' investments is one of the key concepts underlying this complexity as Sukuk should generally give the investor a share in a tangible asset (e.g. property, land, cars) and hence a share of the associated cash flows.

Sukuk that are asset-backed or secured are a relative rarity in the market. Sukuk that are asset-based or unsecured are much more in demand and therefore more common. However, Moody's has encountered a wide variety of market participants who believe that all Sukuk give the investor a claim to some tangible asset in the event of insolvency. While such concerns may have been remote during the boom years, recent defaults have shown Islamic investors to be just as exposed as conventional unsecured ones.

Tamweel is one of the few issuers that has issued both asset-backed Sukuk and asset-based Sukuk. While similar in 'form', they are very different in 'substance' with the backed or secured Sukuk giving investors a legal claim to cash-generating assets. The asset-based Sukuk, on the other hand, makes a nominal sale of assets to investors but takes none of the legal steps necessary for such a sale to be recognised in the courts. Indeed, the structure explicitly precludes any lien or security over the assets and requires the 'borrower' Tamweel to repurchase the assets at par value and ensure that the profit rate is paid in the event of any shortfall.

The clearest indication of this difference is in the rating of the two types, although this comparison is further complicated by the fact that the asset-backed Sukuk has multiple classes (A, B, C and D) of investors, with each class having a more senior legal claim to the secured assets which is in itself a separate but controversial topic.

In August 2009, Moody's lowered Tamweel's long-term issuer rating to Baa1 from A3. The ratings remain on review with direction uncertain. Given the direct link for an asset-based Sukuk, the rating on Tamweel's $300 million (AED1.1 billion) asset-'based' Sukuk trust certificates due 2013 was also lowered to Baa1 from A3, and also remains on review with direction uncertain.

Meanwhile, the asset-backed Sukuk continues to do well. The properties are legally registered to the investors and they have the first rights to the associated cash flows. Of the $220 million raised, over half has been repaid. Critically, even if Tamweel should become insolvent or be liquidated (highly unlikely given its systemic importance), the investors retain the rights to the assets and Dubai Islamic Bank is on hand to look after the assets for investors. Hence, no rating downgrade from Aa2, Baa1 and Ba1 for the Class A,B and C notes.

Ultimately, Moody's feels the term 'asset-based Sukuk' is misleading. The assets are irrelevant to Sukuk performance, but in substance they are identical to unsecured bonds. Unsecured Sukuk is a description that perhaps better describes the risk, as assets are only relevant in those Sukuk that give investors genuine and legal claim or exposure to the assets.

Another logical requirement for a successful issue might be the listing of Sukuk on an internationally recognised exchange – but such listings have been less common in the past than perhaps they should be. Apart from the obvious advantage of leading to greater transparency from the issuer, listing on an exchange can help in a multitude of other ways.

Jeff Singer
Chief executive, NASDAQ Dubai

Exchange listings in the Sukuk market

A revival of the Sukuk market is looking increasingly likely following a lacklustre performance in 2008, when the value of Sukuk issued globally plummeted by 56 per cent from 2007, to $14.9 billion. A good indicator of growing investor confidence in Sukuk this year is provided by the HSBC NASDAQ Dubai 'SKBI' Sukuk index, which shows spreads have fallen from 12 per cent above LIBOR at the start of 2009 to less than 3.5 per cent today.

This dramatic improvement suggests that issuers thinking of bringing new Sukuk to market will meet with a much warmer reception than they would have done a few months ago. Indeed CIMB Islamic has predicted that issuance could grow to $16 billion this year.

However there will be no return to business as usual. The global economic crisis from which we are now hopefully recovering has fundamentally changed investor attitudes to all types of financial product. Investors want greater transparency than they did in the past. They also want more effective tools to help them assess the quality of an asset and the soundness of the institution that has issued it. In our globalised world, this sea change in investor attitudes applies to all asset classes and all countries.

Issuers of Sukuk can successfully address investors' requirements in a number of ways, including improved communication with the market and enhanced structuring methodology; however on their own these are not necessarily sufficient. I believe that issuers will also increasingly choose to list Sukuk on exchanges, because listing provides investors with many advantages of transparency, visibility, and certainty.

Even before the financial crisis struck two years ago, these advantages had led to dozens of Sukuk worth tens of billions of dollars in total being listed on exchanges ranging from Malaysia and the UK to Bahrain and the UAE. The largest exchange for Sukuk by value is NASDAQ Dubai with 21 listings valued at $21.6 billion.

Listing on a high quality exchange requires Sukuk issuers to publish a detailed prospectus, with clear information about the structure of the Sukuk and the company issuing it. If a Special Purpose Vehicle (SPV) is involved, the exchange will look beyond the SPV to the appropriate entity. It may also assess the characteristics of an issuer's Shariah supervisory board and, in the case of an asset backed security, may require an independent representative to be appointed to look after the interests of the security holders. Once listing has taken place, the issuer must meet the continuing obligations required by the exchange, such as regular publication of audited accounts and timely dissemination of price sensitive news to the market through the exchange's news platform.

These features are highly desirable and in some cases essential to investors and are therefore likely to promote confidence in the securities. An exchange listing can also widen an issuer's investor base significantly, particularly among international funds that require certain criteria to be met before they can even consider investing. The visibility brought by a listing, including the media attention it attracts, also tends to promote fair value.

Exchanges will increasingly offer additional valuable services. One is the opportunity to hold Sukuk securities on an exchange's central securities depositary (CSD), which can be an efficient and cost effective alternative to international CSDs. Trading on-exchange may take some time to develop, as Sukuk, like most conventional bonds, are traditionally traded over the counter and banks have been comfortable with this system. However there are excellent reasons for Sukuk trading to migrate to exchanges in due course, including transparency and efficient price discovery. Some exchanges will also be able to act as central counterparties to trades, providing confidence that the obligations of buyer and seller will be met. This service will prove particularly appealing to investors, as the absence of central counterparties in the trading of many asset types was a major cause of the global financial crisis.

Lessons to be learned from Sukuk defaults

Debt defaults are simply a fact of life – which is one of the reasons that ratings can be so important – but since the Sukuk market is such a new industry it has been spared the embarrassment of defaults until very recently. The fact is that no one yet knows precisely how certain types of default will play out and we have a very thin knowledge base to draw from. One of the few defaults in a maturing market is worthy of much closer examination.

Blake Goud
Principal, Sharing Risk dot Org

East Cameron Gas Sukuk

The growth in Sukuk has largely happened outside of the United States, with significant quantities of new Sukuk issued in the GCC and Malaysia. However, in 2006, the US saw its first entree into the Sukuk markets with a small Sukuk issued by a wildcatter oil firm, East Cameron Partners, which holds oil and gas leases 20 miles offshore of Louisiana. The Sukuk had a number of innovative aspects of its structure, some of which are unique to the circumstances of the Gulf of Mexico leases, but others could serve as a model for future Sukuk.

The East Cameron Gas Sukuk was designed as a way for the issuer to raise money for additional development of the two fields for which it held leases from the US Minerals Management Service (MMS), as well as for buying out an equity stake held by Macquarie Bank that was a part of previous debt financing. The Sukuk, was relatively small by the standards of other Sukuk issued contemporaneously, raising $165.67 million and was structured as a Musharaka (an onshore SPV) between an offshore SPV domiciled in the Cayman Islands and the issuer, East Cameron Partners.

The offshore SPV issued Sukuk and contributed the proceeds to the onshore SPV, while the company made an in-kind contribution of the overriding royalty interest (ORRI) in the lease properties. The unique part of this Musharaka Sukuk is the ORRI, which is recognised legally in Louisiana as real property. The ORRI gives the onshore SPV the right to receive a certain volume of production - oil and gas - over the term of the Sukuk. The oil and gas is then sold and the proceeds are split between the issuer and the offshore SPV, which uses the funds to pay the periodic payments and repayment of principal to the Sukuk investors.

The return on the Sukuk - initially rated by Standard & Poor's at CCC+ - is 11.25 per cent, although these returns are based on the actual production and sale price of the hydrocarbons. Reserve accounts are established to smooth the payout through the term of the Sukuk. In order to hedge against severe price fluctuations in oil and gas markets, there was a Shariah compliant hedge that established a price collar between $7 and $8 per million BTU (MMBtu) on half the expected products gas production and a put option at $6 per MMBtu for an additional quarter of anticipated production.

In addition to its unique structure, the Sukuk also provides guidance of how Sukuk investors are treated in US bankruptcy court after the issuer filed for Chapter 11 bankruptcy in October 2008. The incident that provoked the default of the Sukuk was a hydrocarbon shortfall enforcement event caused by a drop in reserves below a given threshold established in the offering circular.

The bankruptcy filing provided a chance for the courts to decide the fate of the Sukuk holders and, in particular, whether the structure that involved selling the ORRI to the onshore SPV constituted a 'true sale'. The importance of the decision regarding a 'true sale' is that if it holds up - which the court effectively ruled that it did - other creditors of the issuer will not have recourse to the assets owned by the onshore SPV.

The issuer remains in bankruptcy and the Sukuk investors have provided an additional $4 million in debtor-in-possession financing which will finance the company's operations for the remainder of 2009. This will allow East Cameron Partners to continue extraction of oil and gas and potentially provide investors with a recovery of some of their investment.

If East Cameron Partners stops production and enters liquidation, the Sukuk specifies a backup operator to continue operations, although there are issues with the leases from the MMS that could complicate the investors' ability to recover their investment. Until this happens, it appears that the Sukuk structure has held up to scrutiny in US courts, which should provide some confidence for US based companies considering issuing Sukuk.

Paul McNamara
Editorial director, Yasaar Media

Nakheel Sukuk

The announcement by the Dubai authorities on Wednesday 25 November 2009 that it was asking creditors for a moratorium on all Dubai World debts including the repayment of the Nakheel Sukuk on 14 December caused significant ripples across the world. While this announcement did not, in itself, constitute a default, it had the same effect.

The world financial system is rather like a patient that had undergone triple bypass surgery after the global financial crisis. It was slowly recovering and was showing signs of improving health but it was still in intensive care with doctors, in the form of central banks, hovering by the bedside 24 hours a day. Dubai's announcement seems to have been taken as a warning sign that there may be hidden problems across the globe to overcome. The costs of insuring Dubai debt rose, as indeed did the cost of insuring most Middle Eastern and emerging market debt across the globe.

So what does this mean for the Sukuk market?

The fact that Nakheel Sukuk at $3.52 billion is the biggest Sukuk ever issued anywhere in the world, and appeared to be at risk of default, caused panic across world stock markets: UK banking stocks were very badly hit and declined by a total of £14 billion on fears that they were exposed to Nakheel debt.

Gulf International Bank of Bahrain, which was in the middle of a book building exercise for a conventional bond, had to pull the pin on the exercise until stability returned to the market which would suggest that the level of new issuance in the Sukuk market in the Middle East may fall sharply in the near future. While estimates in the west that it may take a decade for the GCC to overcome this setback may prove to be overstated, there remains little doubt that the debt markets, both conventional and Islamic, will most likely remain moribund for some time.

The overall effects on the debt market are likely to fall into the following categories:

1. Sovereigns and corporates in the GCC may find that there is diminished appetite for their debt outside of the region – and possibly within the region itself
2. The cost of insuring new and existing debt in the GCC may increase and will remain high for the foreseeable future
3. Ratings may become more important as investors try to ensure that any debt they are exposed to has been vetted by one of the big three ratings agencies

4. Pricing of all new debt from the GCC may increase significantly in an effort to lure investors into an asset class that is now seen as significantly more risky

The overall effects on the Sukuk market are likely to be significant. One of the growth factors behind the Islamic finance industry has been the growing appeal of non-Islamic investors in Sukuk. It is possible that the negative headlines surrounding the Nakheel Sukuk will scare such investors off in the future – at least until there is more clarity from the courts over what happens in the event of an Ijarah Sukuk default of this size.

Sukuk as a whole may emerge from this situation as a more speculative form of investment until it is established how strong a claim Sukuk holders have on the assets underlying each Sukuk. In the Nakheel case, 'The Sukuk Assets consist of the leasehold interest in all land, buildings and other property known as DWF South and Crescent Lands at Dubai Waterfront'.

The situation surrounding Nakheel is unique and will provide many insights for the Sukuk industry but only after the matters still outstanding are resolved and that may take some time.

The future of the dollar

Another worry that some Sukuk investors might have concerns the long term stability of the US dollar. In Sukuk of a longish tenor (five years and above) it is not an unreasonable question to wonder in what state the dollar will be in five years time. Will it have been supplanted as the currency of choice for international trade and savings? Will the renminbi have taken over? If investors are faced with a currency decline then there is real cause for concern. Thankfully the death of the dollar seems a long way off.

Michael Saleh Gassner
IslamicFinance.de

Sukuk and currency

Which factors affect the choice of currency in which a Sukuk will be issued? And what does the future hold in store? The following tables show the historical trend of currency of issuance over the past three years.

	YTD 30.9.09	2008	2007
Currencies	Total Size $		
MYR	5129.5	5054.16	13151.22
AED	0	5163.58	2042.48
USD	4150	1527.5	13938
SAR	2066.5	1873.18	3466.3
IDR	869.63	689.56	126.94
BHD	726.6	350.04	556.89
PKR	365.1	436.99	506.47
BND	277.3	202.84	287.23
GMD	16.41	12.97	0
Sum	*13601.04*	*15310.82*	*34075.53*

	YTD 30.9.09	2008	2007
Currencies	Share of each currency		
MYR	37.71%	33.01%	38.59%
AED	0.00%	33.73%	5.99%
USD	30.51%	9.98%	40.90%
SAR	15.19%	12.23%	10.17%
IDR	6.39%	4.50%	0.37%
BHD	5.34%	2.29%	1.63%
PKR	2.68%	2.85%	1.49%
BND	2.04%	1.32%	0.84%
GMD	0.12%	0.08%	0.00%
Sum	100.00%	100.00%	100.00%

30.09.2009
Zawya, own calculations

	$11.6 trillion US national debt in today's dollar value in … years				
Inflation p.a. in %	1	3	7	10	15
1	$11.48	$11.26	$10.81	$10.49	$9.98
2	$11.37	$10.92	$10.07	$9.48	$8.57
3.5	$11.19	$10.42	**$9.04**	$8.12	**$6.80**
5	$11.02	$9.95	$8.10	$6.95	$5.37
10	$10.44	$8.46	$5.55	$4.04	$2.39

These questions can be viewed from different angles: economically, in terms of Shariah permissibility, and whether short-term or long-term views prevail.

The statistics show that during the financial crisis local currency markets proved to be the most stable in terms of overall market size. If we analyse the date provided by Zawya we can see that the market share of Saudi riyal issues has grown since 2007 while Malaysian ringgit issues have been fairly stable. The most volatile issuing currencies have been the US dollar and the UAE dirham.

The drivers to issue in dollars rather than local currencies include access to the international markets for bond investors who want exposure to emerging markets, particularly the GCC. Since the beginning of the financial crisis these issuers have faced substantial redemptions from their investors. The international market as a whole feared any perceived credit risk and invested predominantly in US Treasuries. As a result GCC debt in dollars was no longer in demand and new issues were tailored to a local audience, which also explains the lower volume of issues of Sukuk in total, showing a wide lack of international investors. It also proves that it is worthwhile developing a domestic market for securities and funding rather than relying on international funding, which is less loyal and can easily choose to exit a market and disrupt the local economies of the real world.

After the credit crisis hit the reputation of Dubai, AED interest rates, which are used as a benchmark for Sukuk, went up and at the time of writing are still high much higher than those of US dollar interest rates. As a result the issuance of AED denominated Sukuk dropped to zero during the first three quarters of 2009 and US dollar issuance took over.

Which currencies will be favoured in the future depends on supply and demand, which is substantially influenced by how financially sustainable the currency is. In other words is the use of debt bearable or does it threaten the market if it suddenly or slowly collapses? Looking at the US dollar, everybody knows how much the US government spent on bank bailouts and economic programmes, hence the US total debt increased to $11.7 trillion making people fear that the Chinese and GCC treasuries will dump the US dollar and, over time, the US dollar based capital markets.

Inflation gets rid of government debt. How much inflation is needed to get back to pre-disaster levels of $9 trillion? It would take about 3.5 per cent inflation over seven years to get rid of that amount of debt. The excess liquidity will only go partially in consumer price inflation as the capacity to increase supply to accommodate increased demand is easily catered for. Rather a larger portion goes into fresh price bubbles in financial markets, but for the short term the global economy appears to restart in spite of all risk factors still prevalent.

Hence, there is no immediate likelihood of the death of the dollar as a global currency and it still leaves a substantial place to issue Sukuk in US dollars in the medium term. Of course the role of the dollar will be challenged at some point. France and the UK want to follow Germany with domestic currency Sukuk, but the typical Middle Eastern buyer is a skilled treasury person still thinking in a dollar pegged currency, a fact limiting the success of Sukuk in alternative international currencies.

Also we should not forget that there is no such thing in the world as a financially sustainable state household; they all increase new debts annually and never get rid of it without inflation. Over the very long run such poorly managed state currencies are doomed to fail and lose acceptance as means of exchange. Alternatives must be sought even if the terminal end of the dollar is not yet here it is still time to rethink the whole monetary equilibrium.

From a Shariah perspective currencies are frequently discussed among Muslims. While Shariah scholars accept modern artificial currencies as acceptable and analogue to gold, silver, salt, dates, wheat and barley (the six classical currencies) many Muslims remain doubtful, some arguing it is like a debt paper which cannot be traded under Islamic law. Those critics mostly argue for a currency backed by a commodity such as gold and silver.

A non-Muslim critic of state money was the liberalist F.A. v. Hayek 1937 who proposed free competition among private currencies, considering state currencies as a kind of socialism. This is still considered 'free banking'. Some forms, specifically the debt based forms of free banking, would violate Shariah restrictions, nevertheless the concept can still be appealing and uses commodity backed currencies to compete with other approaches developed and used in situations of financial crisis.

Another alternative is that of complementary currencies as practiced, for instance, in Austria in a village after the 1929 financial crisis where it did economic miracles. Citizens were issued a note stating how much work they did, and this note could be exchanged for other goods and services. The value of the note depreciated as a motivator to keep money circulated. Until today complementary currencies have not been much discussed in Muslim circles, however this kind of parallel currency still exist in Switzerland today (WIR Geld) besides the Swiss Franc and is definitely worth considering.

There is another issue with currency based Sukuk. It affects all those who have currency based liabilities. The man in the street needs a Sukuk to pay for his basic needs, foodstuff, accommodation, clothing and transportation in whatever currencies he will face bills in the future. Perhaps this could be achieved with a consumer price index linked note, but this could heat up inflation in the economy again and is an artificial solution. What is needed is for someone to develop retail investment products matching the basic needs by investing in a low risk portfolio mostly in equity and leasing type transaction geared towards these goods. This would be a unique model for the industry to develop.

Future issues - thought leadership

So much for looking at the past. The future of the Sukuk industry lies in what happens next. What happens after the recent high profile defaults of the Investment Dar Sukuk, the Sukuk from the Saad Group and the bankruptcy filing of East Cameron Partners? Will it spell the end of the industry as some are predicting?

What follows is a collection of thought leadership pieces from key industry figures that should serve to stimulate debate and discussion for the next year. Perhaps one of the most insightful pieces starts the series of discussions and promotes the idea of the setting up of a Central Islamic Trustee to remove the need for multifarious Special Purpose Vehicles. This bold and brave initiative represents the depth of thinking that will be required to bring the industry from the slow burn phase that it is in to the fully fledged top speed that will be required to keep pace with the rest of the financial services industry.

Dr. Armen V. Papazian
Head of Islamic finance, UBS Investment Bank

Sukuk market challenges

The record growth rates achieved by the Sukuk industry between 2001 and 2007 were impressive. The 2008 crisis came as a reality check for all markets and players, reshaping the priorities of governments, banks, issuers, and investors. As a result, the number and value of issued Sukuk has come down significantly and the momentum of past years is yet to be reinvented. Although the 2008 financial crisis created tight liquidity environments in many markets, the key and most daunting challenges of the industry come from within its structures and the institutional architecture of what we have come to describe as the Sukuk market.

Market infrastructure and product cash flow

Following the principles of Islamic finance and the prohibition of interest, Sukuk have been structured in a variety of ways either to overcome or to incorporate this important starting principle. As such, the recent verdicts branding a significant number of Sukuk as 'non-Islamic' have caused a sense of intellectual and practical hesitation in the market. The questions regarding the veracity of Sukuk structures raise an important paradox.

The market infrastructure that has supported, distributed, invested, and managed Sukuk in the past and present has been the debt capital market infrastructure of global, regional, and domestic banks. The investor base of Sukuk has been expanding and growing in terms of geographical origin, but across the board, Sukuk investors have been debt capital market investors.

If Sukuk structures were to become open ended cash flow products without any fixed coupons and a confirmed redemption value a priori, they would no longer have a typical bond cash flow. This implies that the market infrastructure that has helped grow the Sukuk market to date, i.e. the debt capital market desks and the debt market investors, will no longer buy or sell the paper (Sukuk) as it will not be a fixed income investment and will fall outside their mandate. This will be so on the structuring side, as well as the distribution and investment side. Thus, if Sukuk were to depart from a typical bond cash flow, they will be left homeless.

The challenge is compounded by the fact that the equity desks of international, regional, and domestic banks and equity investors in general will also shy away from investing in an open ended cash flow instrument, if Sukuk were to become that. This is because they would also fall outside their mandate, and based on their priorities, they would rather invest directly in equity.

This paradox creates a unique scenario for the industry. Either we find Shariah compliant ways to keep Sukuk fixed income instruments, or we invent and create an alternative market where open ended equity-like (cash flow) Sukuk have a demand and a supply.

It will be extremely difficult to create a market for Sukuk that have an open ended cash flow promise. Moreover, the risk sharing equation that these instruments will have will still be unbalanced because the investor would actually be better off owning equity directly without the intermediation of a Sukuk, if he were to have equity-like cash flow expectations from a Sukuk. Thus, just because a Sukuk has an open ended equity like cash flow promise does not mean that risk is shared or that it is more fairly distributed between investor and issuer.

On the other hand, it is definitely possible to find Shariah compliant ways to structure Sukuk that offer a fixed income. The solution rests in thinking of Sukuk as fixed return investments. The fixing of return based on a pre-agreed equation of risk and reward does not in itself contradict the principles. The unacceptable element within the value framework of Islamic finance is the fixed interest on money plus time. To fulfil the spirit of the principles, we need to ensure that the return is not earned simply on time and capital, but also through real activity, productive resources, and an ethical contribution to society and economy.

This is an important distinction as the essence of the principle rests not in having a fixed, variable, or open ended return, but in ensuring that money is being earned through productive activity. Thus the paradox disappears if Sukuk are built and structured as fixed return investments. The challenge is to make sure that there is actually a return being earned, that there is a real activity involved, that there is more than just time plus capital in the cooking pot.

A number of Sukuk structures aim to achieve exactly that. The complexities of these structures are the direct result of these efforts. However, it seems that Sukuk complexities have remained relevant mainly on the legal level, and the initial purpose of introducing them, i.e. to involve more than just time plus capital, has not always been successfully achieved. This is the second key challenge discussed below.

Product structure and orphan SPVs

It is well known and understood that Islamic instruments, whether Sukuk or otherwise, involve relatively more legal work and preparation than their conventional equivalents. Naturally, some of these additional legal requirements are necessary to ensure Shariah compliance and cannot be avoided. Indeed, much of what we call Islamic finance is predominantly a legal value chain rather than a financial value chain.

Simply put, in their efforts to comply with the basic principles of Islamic finance, Sukuk structures have created an internal contradiction. In order to avoid straightforward debt, Sukuk transactions involve, depending on type, a variety of sub transactions. In order to make these possible, current structures use what is commonly known as an issuer SPV.

Indeed, at the heart of all the Sukuk structures is a Special Purpose Vehicle (SPV). The very objective of such a company is to have an entity that will hold the Sukuk assets on trust or as agent for and on behalf of Sukuk holders. SPVs are usually owned by a trust for charitable purpose. The SPV enters into various transaction documents for and on behalf of Sukuk holders, issues the Sukuk, and holds the Sukuk assets on trust for the benefit of the Sukuk holders. An SPV, in its capacity as issuer and trustee, invests the proceeds of the Sukuk in the project identified in the business plan of the underlying Sukuk structure. The SPV acts as a legal conduit to a Shariah compliant Sukuk structure; it does not have any financial or reporting responsibilities.

The legal entity between the investor and the obligor or originator is an orphan SPV usually created by the initiative of the obligor or originator. The paradox here rests in the fact that the structures undertaken in order to ensure Shariah compliance do not actually bring the value sought when introducing those additional transaction complexities. Instead, they remain legal complexities without any tangible value added when it comes to the financial and economic nature of the transaction. Moreover, the intended distance and third party involvement in the transaction is not achieved except in the legal sense.

The solution to such a concern can be found in the creation of what I have previously called a Central Islamic Trustee (CIT). The mission of CIT is envisaged to be the one of a facilitator, and a source of standardised Sukuk contracts. Most importantly, however, CIT is expected to provide the market with a genuine third party that would be in a better position to safeguard and pursue the interests and rights of Sukuk holders. This is achieved by creating and administering SPVs dedicated to Sukuk structures. The existence of such an entity will give more meaning and authenticity to the SPVs and their role in Sukuk structures (Figure-1 and 2)

Figure-1: CIT Structure

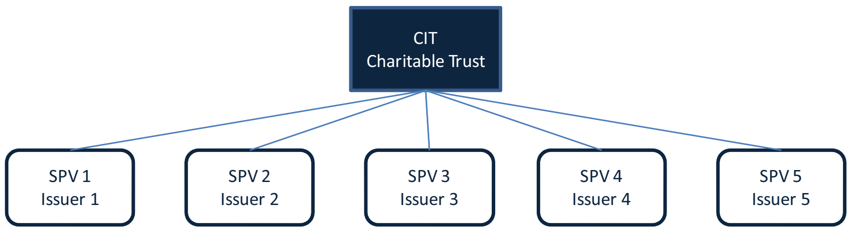
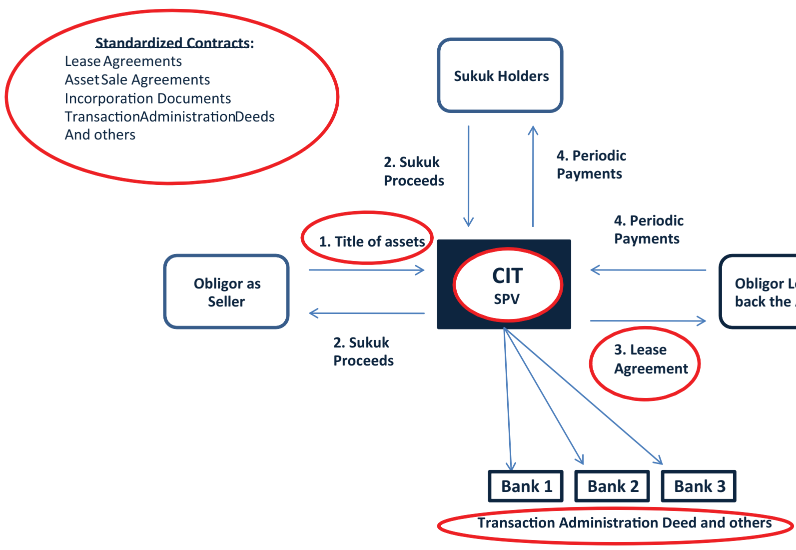


Figure-2: CIT in an Ijara Sukuk Structure



The SPVs created and owned by CIT must be segregated from each other. This is critical in order to avoid the potential systemic risks that could arise from such a central institution acting as a party to so many transactions. Although, as discussed earlier, given the nature of Sukuk, CIT SPVs will not be the actual obligors in these transactions, and thus will not have any ongoing reporting responsibilities. However, they will play an active role in representing Sukuk holders, safeguarding their rights, monitoring the issuance process, coordinating the different functions of the issuer SPV, and be an actively managed independent institution from the obligor or the originator.

Indeed, in many ways, given the functions and services of CIT as described here, the idea is quite close to other conventional SPV providers in the securitisation and structured finance industries. The fundamental differences are three key features: 1) CIT will have to be an Islamic entity organised as a charitable trust that aims at promoting the growth and development of the Sukuk industry; 2) CIT will be acting as a genuine third party in the Sukuk transactions thus ensuring that the link between the Sukuk holders and the obligor is not just a legal entity, and finally 3) CIT will not just be in the business of bankruptcy remoteness, but will be in the business of Sukuk investor representation, protection and monitoring.

The existence of a CIT can play a major role in the future growth of the Sukuk market because it finds a relevant and trustworthy home to all those orphan SPVs used to issue Sukuk. Naturally, the creation of such an institution requires coordinated efforts and support from all players in the industry. Moreover, a sovereign sponsorship might also be necessary to ensure appropriate levels of credibility.

Conclusion

Without downplaying the impact of the 2008 financial turmoil and resulting scarcity of liquidity, the challenges we face in the Sukuk market have far less to do with the crisis, and far more to do with the internal structural and institutional features of the product and industry.

The definition of a Sukuk as a fixed return investment that engages productive resources is important, and the creation of a CIT that acts as a genuine third party in Sukuk transactions is a much needed institutional development.

The future growth of the Sukuk market depends on seeking authentic innovative solutions that aim to make this instrument an accessible and a relatively easy to use and efficient product.

Fawad Hussain

Head of Islamic finance, RBS Global Banking & Markets, Middle East & Africa

How to encourage more Sukuk issuance

International Sukuk issuance has made a strong comeback in the post-Lehman era as regional capital markets have gradually followed the recovery in global markets. Following a dry spell from late Q3 2008 to early Q2 2009, the Bahrain sovereign Sukuk issue of June 2009 finally broke the silence in international Sukuk issuance and has since been followed by a number of issues from sovereign, supranational and corporate issuers, thereby dispelling any doubts over whether this market is here to stay.

Why issue Sukuk?

What differentiates Sukuk from conventional bonds? The most obvious answer is the incremental liquidity generated from the Islamic investor base. However, it is clear from empirical evidence that this is not the only difference since some issues have seen limited participation from Islamic-only investors. This proved that issuer preference is also a key aspect in the growth of this market, which has been supported by Islamic and conventional investors alike. Given that Sukuk have become acceptable across investor classes and geographies globally since the beginning of this decade this should make Sukuk the obvious choice over conventional bonds; however the reality is that conventional issues remain the preferred option for borrowers for longer-dated deals targeted at the US investor base as Islamic liquidity for longer maturities remains limited. Sukuk will therefore remain a viable option to raise liquidity at the shorter end of the curve unless the market evolves to a point where Islamic-only investors can also participate in longer-term issuance i.e. as we see increased participation from Islamic-only state institutions, asset managers, and more prominently from the longer-term investors such as Takaful companies and Islamic-oriented pension funds.

Stakeholder considerations

While looking at the drivers and obstacles relating to Sukuk issuance, it makes it easier to analyse the growth prospects of the Sukuk market if we look at the considerations facing each stakeholder in this market. In this analysis, it is important to focus on issuer and investor considerations but also to remain cognisant of the important role of certain other stakeholders including regulators, rating agencies, Shariah scholars, lead managers and law firms.

Issuers

Traditional Sukuk markets of the GCC and Malaysia continue to lead the way in Sukuk issuance. However some non-traditional names have been cited more recently with some European and Far Eastern sovereigns being quoted in the media as looking at potential issuance. Recently, the International Finance Corporation has announced a $100 million Sukuk which should elicit some interest from non-traditional issuers looking at tapping this market albeit for smaller issue sizes. For the well-established but non-traditional Sukuk credits from the US, Europe and Far East, such issuance will only ever take place if issuers can see either a tangible pricing benefit or a sizeable pool of Islamic-only liquidity that they have not been able to tap via conventional issuance. Since we will see growth in Islamic asset managers and Takaful companies only with the passage of time, it might well be the case that Islamic-only investors have to give up some relative yield upside to lure such well-known issuers to the Sukuk market in the short to medium-term. It will be important for investors to look at the lower yield in the context of the associated diversification benefit resulting from buying into international credits.

Investors

Typical Sukuk investors are split in varying ratios (depending on the nature of Sukuk) between conventional investors in the west and the conventional and Islamic-only investors in the GCC and South East Asia. These investors have always been looking for yield but are now increasingly focused on issuer creditworthiness. Conventional investors remain important from a pricing perspective as they drive the pricing for most international Sukuk issues due to the fact that they are collectively much bigger compared to

the Islamic market. However Islamic-only investors are growing both in value and in number and the advent of investors such as Shariah compliant funds and Takaful companies and the growing allocation of such investors to Sukuk issues bode well for future Sukuk issuance.

Regulators

Regulatory and tax issues seem to be relatively straightforward when it comes to traditional Sukuk jurisdictions covering most of GCC and Malaysia. However they become relatively challenging in the case of non-traditional jurisdictions primarily due to the presence of a legal framework that does not recognise Islamic structures and thus impedes Islamic issuance. In Europe, the UK has been the first country to work on restructuring its regulatory framework to accommodate Islamic financial institutions and products and to offer them an at-par treatment and France has recently announced similar plans – it might be interesting to note though that the Saxony Anhalt Sukuk, arguably the first European Sukuk, was issued out of Germany which has not seen any follow-up issuance. Governments in the Far East such as Korea, Singapore and Thailand have been mentioned in the media as taking up similar changes to their regulatory framework to attract Islamic financial institutions and looking at potential sovereign issuance.

Rating agencies

Following the sub-prime crisis, there has been market talk about reduced investor confidence in the rating agencies. However ratings still remains a key requirement for all investors especially in terms of liquidity, marketability and capital considerations. The international Sukuk market is moving towards rated issuance and an increase in rated Sukuk should bring about increased transparency and comparability among credits from different sectors and geographies, thereby helping the market develop further.

Shariah scholars

It is often mentioned that standardisation is a key requirement for the Islamic finance market in general and the Sukuk market in particular to take off in a major way and, barring this, the market will remain fragmented. However it is a viewpoint of most experts that absolute uniformity in Shariah thought is not a practical expectation. It would be good to see the efforts of entities like the IIFM, AAOIFI and the IFSB, who have been working with their conventional counterparts, bear fruit by reducing the divergence on broader Shariah issues. Subsequently, the increased commonality of thought should give a boost to new issues.

Lead managers

Lead managers perform an important role in educating issuers on the myths and realities surrounding the Sukuk market and assisting them in positioning with the investor base. However they typically also perform an equally important role in market-making post-issuance. As lead managers continue to play an important role in educating issuers and reputed issuers continue to take the Sukuk route, liquidity in the secondary market should continue to grow with time. This should in turn help further primary issuance as investor confidence builds up.

Law firms

Lawyers play a very important role not only in drafting Sukuk documentation but also in assisting the lead managers in discussions with Shariah scholars to structure the transaction on a Shariah compliant basis. Their knowledge of Shariah law and their relationship with the Shariah scholars goes a long way in facilitating a smooth execution.

Other stakeholders

Stock exchanges, paying and clearing agents, trustees and various other parties also play a key role in Sukuk issuance. The track record and expertise of the key players in each of these segments with respect to Sukuk has helped in developing the Sukuk market and should continue to do so in the future.

Some pertinent issues

Certain general considerations such as which format of Sukuk to use, which currency to issue in, whether to issue under a programme or issue a stand-alone are common to all stakeholders. How these considerations are evaluated and decided upon will shape the trends in the Sukuk market as it grows. These are discussed briefly below.

Format

Although we have seen the second 144a Sukuk this year, it seems that the vast majority of Sukuk will remain either as locally focused private placements or in Reg S format. Which format is advised on by lead managers, selected by issuers and preferred by investors will be driven by issuer considerations and the availability of liquidity from the target investor base.

Currency

Malaysia and Bahrain have thriving local currency markets however they differ to the extent that the former is driven by pure corporate issuance whereas the latter is focused more on management of short-term interbank liquidity. Barring these, Saudi Arabia and the UAE are the two countries that have seen a significant amount of local currency issuance to date, primarily driven by captive local liquidity in the case of the former while expectations around revaluation have to some extent been seen in case of the latter. However with the exception of Malaysia, corporate issuance in the GCC has been hampered by an active local currency market. The CMA in Saudi Arabia has taken steps to facilitate trading of Sukuk on the Tadawul, while the UAE has also taken steps in this direction by opting for local currency issuance for sovereign issues. These developments should eventually result in country-specific Sukuk markets with limited initial liquidity which will only grow with time; however it should at least help in giving confidence to more issuers to come to market given that smaller issue sizes would be possible and issuance requirements may be less onerous.

Types

Fixed income Sukuk have been favourites since the advent of Sukuk. Notwithstanding this, there was a burst of activity in the equity-linked space during 2006-07 during which a number of convertibles and exchangeable Sukuk were issued both by GCC and Malaysia. Although this has died down in recent years, it should revive as issuers continue to debate the merits of potential dilution against cheaper cost of funding. International securitisation has not taken off in a big way in the Islamic space in the GCC due to the sudden disappearance of the key investor base from the scene post-sub-prime. However it is expected that they will return sometime in the near future for truly creditworthy originators as a genuine alternative investor base gradually builds up and actively evaluates the merit in taking asset-backed risk instead of investing purely on a corporate basis.

Programmes

The cost of establishing and updating Sukuk programmes needs to be weighed against the frequency of issuance. For regular issuers, establishing a programme makes a lot of sense as they can tap the market frequently and at short notice. A number of issuers have adopted this approach and the number of programmes is on the rise and should continue to increase as the market grows in depth and breadth and issuers are able to access the market at regular intervals.

Covenants

In some cases issuers have existing obligations which limits 'transfer' of assets even in a structural sense and therefore limits Islamic issuance regardless of the jurisdiction. Issuers could save a lot of time when undertaking any subsequent Islamic issuance by simply carving out purely structural transfers pertaining to Islamic finance in conventional financing documentation.

Defaults

Some of the defaults by Sukuk issuers seen in recent times will provide a much-needed precedent to the industry in evaluating future issuance. On a commercial level, senior unsecured asset-based issuance does not give Sukuk investors any preference over conventional investors regardless of the use of an asset for Islamic structuring purposes. Legal opinions do leave jurisdiction-related interpretations open to the extent that there is lack of precedent. This could prove to be the silver lining for future Sukuk issuances from these jurisdictions as decisions on the subject make this point very clear for future issuers and investors.

Ethical investing

Do conventional investors prefer Sukuk over conventional bonds due to their 'ethical' nature? Although asset-based Sukuk might not have won the hearts of these investors when compared to conventional bonds purely on the basis of 'form', they might increasingly become the instrument of choice for ethical investors if Islamic finance starts identifying itself with 'substance' and 'green' issuers start tapping the market. Carbon-credit-linked Sukuk anyone?

Michael Grifferty
President, Gulf Bond & Sukuk Association

A strong base is needed to sustain the Sukuk market

Like many other markets, the Gulf Sukuk market is going through a period of introspection and that is a good thing. We have to ask why issuance volume has been so volatile - first surging to unprecedented levels in 2008 and then braking sharply, even while conventional bond issuance recovered in 2009 and even broken records.

Certainly, some of that has to do with a preference for known, sovereign-linked issuers and vanilla products in these turbulent times. There are also the well-known debates and public comments about Shariah compliance as well as recent issues of priority in case of insolvency. But the underlying reality is that the investor base for Sukuk is not well enough grounded. Sukuk from the region have tended to go into the hands of banks, foreign buyers looking for some regional exposure, high net worth individuals and family offices. In some cases, transactions are tailored for non-institutional buyers who do not expect to trade.

These investor classes are not ideal for an industry intent on strong growth. Why does the Gulf lack consistent investors in term products? Of course, much has to do with historical features. The role of the state as guarantor of social security put private savings on the back burner some time ago. After all, the sovereign wealth funds (SWF) are the ultimate retirement funds. Of course the SWFs play a critical role, but they are mainly outwardly focused and so do not, in the first place, serve to build the local markets or to fund domestic development.

What is lacking so far in the Gulf is the full range of institutional investors characterised by pension funds and insurance companies. Their weakness can be explained only in part by the region's economic profile and history as they have taken root in other countries that previously had no such tradition. In those places specific measures were created that provide a framework within which private savings can flourish. Singapore's compulsory Central Provident Fund provides a multi-purpose savings vehicle. Chile provides a template for a pension system based on private providers and choice for savers. The World Bank promotes the 'three pillars' of a compulsory public programme, compulsory work-related scheme and a voluntary private component. In fact, there is a rich spectrum of possibilities if pensions reform is to be considered.

The same goes for life insurance. Historically, it has been said that life insurance has not been in demand for cultural reasons. Perhaps, but it also true that a framework has not been in place that would see it flourish. Now, Takaful companies are becoming active, but in a small way.

What successful savings markets have in common is a regulatory framework for pensions and insurance would that includes prudential investment guidelines to ensure safety first of all, and secondarily, liquidity of investments. Portfolios, whether publicly or privately run, would have to meet prudential regulations that could include minimum portfolio allocations for highly rated or risk free assets, including Sukuk. To help complete the picture, regulators and market participants should deepen their cooperation on Shariah compliant money market instruments and hedging.

The truth is we have to work on improving the basis for institutional investors in the region for both conventional and Shariah compliant financing. What is needed is a comprehensive look at private savings and a commitment to promoting them. Market associations have a role to play in facilitating this dialogue among government, regulators and industry. If leadership and action can be taken at the GCC level, that would be best. We cannot expect to build a market around retail investors, no matter how high the net worth.

Faisal Hijazi
Business development officer, at Moody's Middle East

Sukuk funds and the role of institutional investors

Institutional investors are well known for their complex investment needs, large capital holdings and longer-term investment horizon. In the relatively short life of the Sukuk market so far, Islamic banks have been the first to invest in this market, in many cases holding their investments until final maturity. However, since the start of the global credit crisis, and faced by the overwhelmingly negative sentiment in the global capital and credit markets, many Sukuk investors resolved to liquidate their Sukuk holdings, securing part of their investment in cash accounts or in the more defensive commodities sector. According to the HSBC/DIFC index, Sukuk yields were trading at above 14 per cent at the peak of the global crisis earlier this year. However, an improving economic environment driven by huge government stimulus, improving investors' appetite and rising oil prices, has led to a surge in Sukuk prices with the index recording a weighted yield of just 6 per cent as at 30 September 2009.

Earlier this year, Sukuk prices declined in reaction to the negative global credit market sentiment; in most cases not driven by specific corporate news that might affect their credit or market profile. Many intermediaries and active investment market participants saw value in launching Sukuk funds for institutional and value-driven investors, including Takaful; while endowment funds and many retail investors did not, until recently, invest in this market. Underperforming global capital markets have justified the value of such funds: indeed, during Q1 2009 some of these funds were producing returns in the range of 10-15 per cent. This has encouraged many issuers gradually to tap the Sukuk market, the power utilities, as well as the financial and to a lesser extent the real estate sectors, which were the first to benefit from the improvement in market sentiment. Over the past nine months, we have seen Saudi Electricity (A1/Stable), Islamic Development Bank (Aaa/Stable) and Tourism and Development Investment Company (Aa2/Stable) tap the market for multi-billion issues that were well received given their sovereign/government ownership and robust business model, with more Sukuk planned out of several jurisdictions as far afield as Russia and the US.

The increasingly important role of fund managers in actively participating in Sukuk investment and secondary market trading will be essential for the long-term sustainability of a dynamic and active Sukuk market, in which different market participants – including new investors and cross-border issuers – can diversify the Sukuk investor base, thereby creating an active secondary Sukuk market in which Sukuk can be efficiently priced. According to HSBC – one of the leading book runners for the IDB $850 million first tranche Sukuk – fund managers have subscribed to nearly 35 per cent of the value of the Sukuk issued, while the remainder went to other institutional investors, including central and commercial banks. This trend was complemented by the establishment of the Tadawul Sukuk platform in the kingdom of Saudi Arabia, which will ease fears among many institutional investors concerning secondary market pricing, liquidity and sector diversification.

Mohieddine N. Kronfol
MD asset management, Algebra Capital

Stimulating retail demand of Sukuk

Surveys suggest that half of the 1.4 billion Muslims worldwide will opt for an Islamic product given the right value proposition. It is estimated that Shariah sensitive investable liquid assets are $700-800 billion worldwide and are concentrated in the GCC and Asia.

Despite the seemingly large potential demand for Shariah compliant asset management, assets under management currently do not exceed $40 billion (i.e. 3-4 per cent of global mutual funds AUM) offered by 750 funds, primarily managed by indigenous banks and small local asset management firms. Therefore, the global competitive landscape is fragmented with two-thirds of all players managing less than $100 million in Islamic funds and with 50 per cent of funds with less than $20 million.

The market reality is exacerbated in Sukuk and Murabaha fund statistics. Globally there are fewer than 60 funds which manage approximately $1.5 billion in Sukuk or blended Sukuk strategies, with only three managing more than $100 million.
Matched up to a global Sukuk market in excess of $100 billion and assuming all fund assets originate from retail accounts it is clear that retail investors play a relatively insignificant role in today's Sukuk market and the asset management industry continues to face serious challenges attracting retail flows.

Should retail investors invest in Sukuk?

Yes they should. I am not going to go into relative pricing, CDS levels, liquidity premiums, the effect of the crisis on issuance, or the effect of recent bankruptcies on long term Sukuk recovery values. I think investors, institutional as well as retail, would do better by increasing their allocation to Sukuk simply because any rational asset allocation must include an appropriate level of less risky Murabaha-based deposits and longer term Sukuk in combination with equity, real estate, and commodity allocations.

The current Sukuk market presents some challenges for investment. It is relatively young and concentrated at $100 billion, but many risks can be mitigated with appropriate asset allocation, a relevant investment process, and an appropriate subscription redemption cycle.

Portfolios can and are being structured that meet the needs of investors. Secondary market prices have demonstrated that Sukuk, like other financial securities, have prices that react to fundamental news at times and trade on technical factors during others. Access to Sukuk through funds will remain one of the primary channels for retail investments as it provides diversification, asset management expertise and liquidity effectively.

So notwithstanding the fact that some challenges continue to affect the markets for Sukuk, products are being created in the marketplace with attributes comparable to conventional counterparts. In fact, there are more Shariah compliant Sukuk and Murabaha funds than conventional fixed income funds in the GCC, and Sukuk represent approximately one third of MENA debt markets.

The challenge therefore is not restricted to developing a retail investor base for Sukuk but a broader, more fundamental, promotion of debt and money markets and their related funds and products as a necessary alternative asset class.

To achieve success, the private and public sectors must collaborate to address critical infrastructure requirements for the development of robust debt and Sukuk capital markets and regulatory regimes that facilitate efficient and effective distribution channels to retail, corporate and institutional investors.

The Global Sukuk and MENA debt markets have been growing at compound annual growth rates in excess of 50 per cent during the past five years and have reached critical mass. MENASIA economies require more than $200 billion of debt annually (including syndicated loans) to finance government budgets and infrastructure projects. These requirements are large and are not going to decrease.

Building a sound infrastructure for GCC debt markets is a challenging but imperative and meaningful objective. If the past year's events have highlighted anything, it is that access to international and domestic debt markets are essential for effective monetary and fiscal policies as well as corporate and banking sector financial stability.

The institutional component of Sukuk markets should technically be addressed and developed sooner than retail demand, and much work needs to be done. This is a broad discussion, and many initiatives are currently underway with various stakeholders to deliver tangible structural enhancements to GCC bond and Sukuk markets. New legislation, government issuance programmes, corporate governance, rating agency coverage, new investment guidelines and pension programmes are just some of the headline agenda items being debated.

Institutional challenges aside, the retail base in the GCC and the broader Muslim community is enormous. Retail activity in the $900 billion MENA stock markets frequently exceeds 60 per cent of trading volumes. Attracting part of that wealth, like any retail business, will require good products, strong regulatory oversight, investor awareness and education, and most importantly, marketing.

The marketing mix of a successful financial retail product is not very different from any other retail product. In the case of Sukuk and regional bond funds, the investor needs to be made aware of the benefits of allocating assets to different asset classes and the specific attributes of marketed products Product providers should be able to access investors efficiently and investors should have comfort in the laws protecting their rights. Successful money market and government bond funds in Egypt, Morocco and Malaysia are good examples of improving retail demand.

Direct marketing of Sukuk to a retail audience can also be very effective, similar to successful retail government bond programmes already established in countries like Lebanon, Egypt and Morocco. Though not frequently highlighted and not included in Sukuk fund data, the National Bonds Corporation in the UAE has raised more than $1 billion through effective marketing and an implicit government guarantee.

Direct marketing is usually restricted to sovereign issuers and should be highly regulated, but in the case of sovereign Sukuk, can be a very effective public awareness and educational exercise that introduces the retail audience to the benefits of less risky asset allocation that pays more than a zero-interest conventional Islamic deposit or a Libor based Murabaha alternative.

The financial services industry in the GCC and many other developing economies with large Muslim populations is dominated by commercial banks. They continue to capture most retail funds and provide most of the credit.

Looking ahead a few years, credit should be provided by a more diversified capital base. The commercial banks do not have sufficient deposits to finance the needed infrastructure and investment spend and they should not be encouraged to do so. Companies and governments should actively seek to issue money market, debt and Sukuk instruments to finance capital expenditures.

We believe that the projected increase in primary market activity will lead to a more diverse and liquid secondary market which, coupled with significant regulatory reform and legislation promoting the development of debt and Sukuk markets, will transform the investment management opportunities for Sukuk investors.

Insurance companies, Takaful companies, commercial banks, asset management firms and other financial service providers will increasingly compete for retail funds and those firms with the best products, service and marketing will succeed in attracting retail investors and ultimately stimulate retail demand for Sukuk.

Nish Popat
Head of fixed income-Middle East, ING Investment Management Dubai

How to stimulate Sukuk trading

During 2009 the Sukuk market has been left in the shadows by the conventional debt market in terms of issuance size as many investors have reverted back to instruments which they understand and for which there is liquidity. 2008 was a year in which all institutions from all industries realised that liquidity was one of the key components that needed to be taken into account when making investments decisions.

The Sukuk market is young and growing and that has tremendous potential over the coming years. People tend to forget that the whole Islamic finance industry is one that has grown rapidly in a short space of time. The Sukuk market only shot to prominence in 2006/2007 as investors' thirst for yield during the boom years created a strong appetite for Sukuk .The industry went through an explosive growth period in 2007 and 2008 before coming to an abrupt halt in the middle of 2008.

We believe that to improve not only trading in Sukuk but also liquidity, the industry needs to resolve the following points:

Rating

Many people in the region believe that this should not be a requirement for Sukuk as the products are Islamically based. In addition, the rating agencies' credibility over the past year has been damaged, reducing their impact as a pre-requisite. This we believe is wrong: if issuers wish to raise money from international investors it will be essential to understand the underlying business and its coverage. Rating agencies remain a critical and integral part of the international investment community.

Transparency

This is an issue that many GCC companies find difficult to overcome. If issuers wish to borrow money from the debt market at a reasonable and fair rate, then investors need to have an insight into the whole financial structure of the company. Bond investors need to know and understand fully what they are investing in.

Standardisation

One of the key concerns investors have with Sukuk is the lack of standardisation of what is a Shariah compliant product. What is defined as Shariah compliant between Asia and the Middle East varies. These different interpretations by different scholars make investors nervous and accordingly decide not to invest in Sukuk until there is further clarity.

Legal coverage/recourse

What law is being applied to Sukuk defaults? The Sukuk market has, until recently, not experienced a default and accordingly no one knows in reality what the position of Sukuk holders is in such circumstances. Recently we have the Investment Dar and the Golden Belt both in technical default and the outcome of these defaults will be watched carefully by investors to ascertain how Sukuk holders are treated.

Cost/fees

Many borrowers who wish to issue a Sukuk have complained that the procedure required to maintain or obtain approval from Shariah boards makes the process lengthy and unprofitable. The fee is no higher than for conventional issues but the time and bureaucracy involved gives little incentive to push Sukuk issuance.

New market

The Sukuk market is barely five years old and remains a young industry that will grow dramatically if the steps needed for development of the product are implemented correctly and with clarity. The market can take strength that the events of 2008 have resulted in many investors re-evaluating their investments and begin looking at alternative structures.

The Sukuk market has a bright future but needs to create a solid foundation first if it is to grow successfully and become a major part of investors' asset allocation.


Jawad I. Ali, partner, King & Spalding
Sheikh Nizam Yaquby, Shariah scholar

Fixing legal loopholes in the Sukuk market

This article provides us with an opportunity to highlight what in our view is the obvious impediment to the development of the Sukuk market and the Islamic finance market in general. The impediment is the desire of market participants to replicate 'tried and tested' conventional finance products rather than creating new and innovative financial instruments based on risk sharing and profit taking.

In our opinion, the Islamic finance market is at a crossroads; either it continues to mimic the conventional market by repackaging and Islamicising conventional financial products or it develops its own financial instruments and becomes a truly alternative financial system based on the principles of Islamic Shariah.

The Sukuk market was turned upside down in the fourth quarter of 2007 when Sheikh Muhammad Taqi Usmani, the chairman of the Shariah council of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), issued a fatwa criticising the prevailing structures used to offer and issue Sukuk. Sheikh Usmani stated that many of the structures currently in use make the Sukuk no different than interest bearing corporate bonds. Although his fatwa focused on a number of issues, which in his opinion affected the Shariah compliance of many Sukuk issued to date, the underlying message behind the fatwa seems to us to be a call to the industry to go back to the basic principles of Islamic Shariah with the ultimate goal of offering Muslims an alternative financial system to that of the conventional.

Regrettably, the debate that ensued after the fatwa focused on 'closing loopholes' and ignored the spirit of his criticism and his call to overhaul the industry. It has been suggested that the Islamic finance market is not yet sufficiently mature to consider a complete overhaul and that the current Sukuk structures criticised by Sheikh Usmani should be permitted until such time as the market has sufficiently matured. Others have added that the reason the Sukuk market experienced rapid growth was because a Sukuk had all the same characteristics of a corporate bond and therefore could be easily understood and priced by investors. Then there have been those who have stated Sukuk should be structured as pure equity instruments and all structures that produce a debt-like Sukuk should be prohibited. In our opinion, the structures that will end up emerging as a result of the current debate will produce Sukuk that are neither pure equity nor debt instruments - rather a hybrid between the two. This will be a step in the right direction of recognising that the Sukuk market should have its own characteristics and not be viewed just as the Islamic equivalent of a conventional bond by the capital markets.

AAOIFI's Shariah council resolutions on Sukuk adopted in February 2008, and the International Council of Fiqh Academy decision regarding Sukuk issued in April of 2009, established a platform for shaping and developing the new Sukuk market. However, financial markets will only respond to change if change is demanded and embraced by all participants in such market. The participants that need to get involved in the shaping of the new Sukuk market include issuers, underwriters, rating agencies, Shariah scholars, lawyers and most importantly investors.

We submit that the fate of the Sukuk market, which is very important to the development of the Islamic finance market, lies not in the hands of issuers, underwriters, ratings agencies or lawyers rather in the hands of the investors guided by Shariah scholars. The investors will choose whether they want to invest in a debt instrument that produces the same economic result as a bond or demand a hybrid instrument that provides them with the chance to earn higher return in consideration for taking a little more risk. After all, is that not the essence of Islamic finance?

Peter Casey
Director policy, DFSA, Dubai

Issues in the regulation of Sukuk

The current financial crisis is throwing up a set of issues around the regulation of Sukuk. Many of these remain unclear, as Sukuk structures are tested in the courts of several countries.

We have seen several high profile defaults or possible defaults of Sukuk. The East Cameron case has been working its way through the courts of the United States for some time. The Investment Dar has defaulted on its Sukuk, and there is currently a creditors' stand-still in place while it attempts a restructuring, and the market is anticipating that the Saad Group will also default. Further defaults may occur as other issuers' finances come under strain. It is not clear, however, how many of these will be resolved in court, rather than through negotiation or regulatory intervention.

The main underlying issue for regulation is that most commercial Sukuk have the basic structural characteristics of an asset-backed (or at least asset-based) securitisation, but the economic characteristics of a corporate bond or debenture. This is typically achieved by surrounding the basic securitisation structure with a set of guarantees, variously structured, and regulation is normally that associated with a debenture.

The actual and impending defaults are likely to test two broad sets of issues:
How firm are the guarantees? That is, if a Sukuk issue fails to deliver the returns expected by the investors, and which the guarantees are intended to support, can the obligations be crystallised into claims against the obligor for whose benefit the Sukuk was issued? If so, how do those claims rank, as compared with those under a normal debenture?

How strong is the asset-backing? Again, if a Sukuk fails to deliver, or if the ultimate obligor becomes insolvent, can the Sukuk holders or their representatives take possession of the relevant assets and sell or operate them to recover their investment? Although in principle ownership of the assets may have been transferred by the Sukuk documentation, it remains to be seen whether this can be made good, for example where there are restrictions on the ability of foreigners to hold property in a particular jurisdiction.

Fundamentally, these are tests of where Sukuk lie in the spectrum between pure securitisations (which some would argue is the Islamic ideal) and traditional corporate bonds (which investors may have believed was the reality). In some cases, especially of Mudaraba and Musharaka Sukuk, they may even be held in some respects to resemble equity investments.

No single test will be decisive. Even where structures are fully tested in court, each case will depend on the particular structure, the particular governing laws and, in some cases, particular circumstances (such as whether parties acted in good faith). However, accumulated jurisprudence should in time give a much clearer picture, though possibly one that will vary depending on the structure chosen.

As this picture becomes clearer, and as market practice adjusts, markets regulators will be able to make clearer decisions. If Sukuk (or a particular type of Sukuk) are indeed very similar to debentures, then their regulation will be like that for a debenture. Both the initial offering disclosures and (especially) the continuing disclosures to the market will focus on the performance of the ultimate obligor. If, however, some or all Sukuk closely resemble asset-backed securities, then disclosure will need to focus on the underlying assets and their performance. In practice, it is likely that some Sukuk will fall between the two, and this will need to be reflected in their regulation.

There will also be issues for prudential regulators. Sukuk are held by many financial institutions, both Islamic and conventional. The regulators of those institutions will need to decide how those investments should be treated within their capital adequacy regimes. In practice, most prudential regulators have treated Sukuk as though they were conventional bonds, and in risk-based capital regimes this has been reflected in the risk weightings. For at least some Sukuk, this treatment may not hold in future. (This may, however, be to the advantage of investors, if it turns out that they benefit both from strong claims against the obligor and from strong claims over the assets.)

These issues will not be resolved quickly, but the questions are now being asked. To some extent they are questions about the whole nature of Islamic finance. Are its most distinctive capital markets instruments effective replications of well-known conventional instruments, or are they something distinctively different, deserving different treatment by both markets and regulators?

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Michael Ainley, head of wholesale banks and investment firms
David Bailey, manager and **Ali Ravalia**, capital markets, Financial Services Authority, United Kingdom

Fixing regulatory loopholes

Maintaining an appropriate regulatory framework for financial markets in the context of rapid evolution, increasing cross-border financial flows and technological sophistication creates challenge for securities regulators, and this issue is perhaps even more pronounced in the nascent Islamic securities industry. Recently these issues have been exacerbated by turmoil in global financial markets which have caused governments and regulators alike to reconsider financial regulation in fundamental ways.

We examine the issues in developing a regulatory framework for Islamic securities products such as Sukuk, outlining some basic principles for regulators to consider. We also set out a case study of the approach adopted by the authorities in the United Kingdom.

Issues regarding the regulation of Islamic finance products

As noted in a recent report by International Organisation of Securities Commissions (IOSCO), in some markets there may be a general lack of familiarity with the concepts, structures and practices in Islamic finance given the recent emergence of this market.
There are a number of reasons for this such as the use alternative transaction structures (due to the prohibition of interest-based financial activity), restrictions on investing in certain prohibited industries and unique market conventions and practices. There is also the issue of ensuring securities are Shariah compliant, which may or may not be a regulatory issue in a particular jurisdiction.

There can be a lack of clarity in regulatory classification of Islamic finance products. Securities legislation has historically been crafted to deal with conventional products, and Islamic securities which are structured to replicate the function of conventional products may be categorised differently, or not captured at all, under existing frameworks, due to differences in their underlying legal, economic or risk structures.

This issue is exacerbated by the fact that within the Islamic securities industry, conceptual definitions can give rise to products with differing risk, legal and economic characteristics. Terms such as Musharaka, Mudaraba and Murabaha are generic categories which originate from the different nominate contracts used in early Islamic history. These terms define types of transaction which underpin specific products – but they are not the products themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly different in terms of their risk profiles and economic substance.

Issues regarding the regulation of Sukuk

Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform with the principles of Shariah. Since in principle most Sukuk have tangible assets as their underlying, one might be inclined to think that Sukuk are instruments similar to classic asset-backed securities. However, a detailed analysis of commercial terms and legal structures shows that Sukuk performance may not be governed by asset performance. In economic terms, there are three common types of Sukuk:

a) Fixed-income Sukuk – risk related to credit risk of originator
b) Asset backed Sukuk (ABS) - risk related to performance of underlying asset; and
c) Hybrid Sukuk (combination of originator credit risk and underlying asset risk)

The question for regulators and practitioners alike is that in the context of securities legislation configured for conventional products, how do instruments such as Sukuk fit under the existing frameworks, this issue is further exacerbated by certain features of the Sukuk market:

Differences in underlying risk: as noted above there are a wide range of Sukuk structures. Some Sukuk are more akin to debt-based instruments, others have equity-like characteristics, whilst others mirror conventional asset-backed structures.

Increasing sophistication of structures: there is a new generation of innovative and increasingly complicated Sukuk. These include convertible, hybrid and index linked Sukuk.

A widening range of acceptable assets: traditionally only tangible assets (real estate, aircraft, plant and machinery etc.) were considered acceptable under Shariah. More recently Sukuk have been based on other types of asset such as intellectual property or rights to certain cash flows from specified activities (e.g. electricity meter reading rights, mobile telephone air time etc.).

Secondary market restrictions: there are Shariah limitations on the trading of debt which impact on the tradability of certain Sukuk in the secondary markets (though there is no consensus about the precise boundaries).

Framework for regulating Sukuk

Given the wide array of structures and the evolving nature of the market it may be difficult to fit these structures within the existing regulatory framework. In developing a framework regulators should also consider the following:

• IOSCO objectives for securities regulations: a) the protection of investors; b) ensuring that markets are fair, efficient and transparent; c) the reduction of systemic risk

• Principle of non-discrimination: The regulatory classification and treatment of Sukuk should be subject to regulatory requirements consistent with those applied to similar instruments

• Focus on the underlying risk and economic characteristics: Regulators should consider the economic and risk characteristics of the contractual arrangements which underpin specific Islamic financial products with a view to providing a consistent and appropriate level of regulation. In practise this may mean fitting Sukuk within existing products classification or creating new regulations, different types of Sukuk may even be regulated differently

• Disclosures standards: the IOSCO guidance to the Core Principles notes that 'full disclosure of information material to investors' decisions is the most important means of ensuring investor protection'. Securities products designed to adhere to a specific set of religious principles may require the communication of a wider set of material information to investors. Certainly more work needs to be conducted in this area to review current practice and identify areas of best practice

• Flexibility and durability: regulations should be flexible and durable enough to withstand the evolving nature of financial markets

• Comprehensive framework: in considering the regulation of new or innovative instruments, regulators should be cognisant of the interaction of regulations throughout the product lifecycle of Sukuk; including regulations relating to issuance, listing, marketing, secondary market trading, investment advisory etc

• IFSB standards: review IFSB standards and guidance

Summary

The primary objectives of ensuring products are regulated in a fair, transparent and consistent manner are relevant for conventional and Islamic financial instruments. In determining an appropriate framework for the regulation of Sukuk, regulators should consider the principles advocated above. Many jurisdictions including Bahrain, Dubai, France, the UK and others have adopted provisions to facilitate the issuance of Sukuk. In spite of some existing initiatives, there is a scarcity of information exchange and a general lack of awareness of the products and practices of Islamic finance. Consequently, enhanced cross-border co-operation and information sharing would be beneficial. This could be facilitated by suitable bodies such as the IOSCO, IFSB and AAOIFI.

Case study - regulating corporate Sukuk in the UK

The structure of certain Sukuk instruments means that for regulatory purposes in the UK they appear to fall within the regulatory definition of a Collective Investment Scheme (CIS). CIS are effectively pooled investment schemes where participants share the profits of the underlying investments. Treating Sukuk as a unit in a CIS would mean Sukuk issuers are treated differently to issuers of conventional debt instruments, thereby a) placing them at a competitive disadvantage and b) ignoring the economic reality of Sukuk where the risks and rewards are equivalent to conventional debt instruments.

In a recent consultation the UK authorities have outlined plans to regulate Sukuk in an equivalent manner to conventional debt securities. To ensure Sukuk are not treated as CIS there will be a specific exemption from the CIS regulations and a new investment type will be created. It is worth noting that in the UK the authorities refer to 'alternative finance investment bonds' rather than Sukuk. This is because the regulations are designed to capture a specific class of Sukuk i.e. those with similar economic and risk characteristics to conventional bonds or asset-backed securities. A review of instruments hitherto issued by the market indicates that the vast majority are structured to be similar in economic nature as debt based instruments.

It is not the purpose of the legislation nor that of the regulatory authorities to determine whether an instrument is Shariah compliant or not. It is also worth noting that publicly issued Sukuk such as those issued by sovereign or municipal authorities will be treated the same way as conventional government securities. The legislation is intended to come into effect in 2010.

Kamal Mian

Building a domestic Saudi Sukuk market

The Kingdom of Saudi Arabia (KSA) is witnessing unprecedented economic growth stimulated by an aggressive public spending plan. This has led to huge financing requirements for both the government and private sectors. KSA also has one of the largest investor bases in the region with total assets under management exceeding $22.7 billion. The increasing requirement of long term financing and huge local investor appetite provides an excellent opportunity to develop a vibrant Islamic debt capital market (DCM) in the country.

Currently the Saudi Sukuk market is small compared to other countries with comparable economic indicators. Though it has seen some large issues, the number of local currency issues listed on Tadawul is only five from two issuers. The size of the total outstanding Sukuk is $8.1 billion.

The need to have a well developed DCM was felt more than ever during the 2008 financial crisis. Bank lending to the private sector slumped to 3.6 per cent in July 2009, its lowest rate in more than six years (SAMBA, Economic Monitor, September 2009). Despite several interventions by the Saudi Monitory Agency (SAMA), banks became very reluctant in providing long term financing and increased their margins across the board. This left businesses with no other option except to abandon or reschedule their projects.

Further development of the Sukuk market in Saudi Arabia requires proactive involvement of the government authorities in addressing some of the key issues faced by the DCM issuers and investors.

Benchmark sovereign Sukuk and secondary market trading

The Saudi DCM lacks one of the basic ingredients of any market, i.e. sovereign Sukuk. Sovereign issues not only provide the much needed pricing benchmark but also act as anchor securities for portfolio management and secondary market trading. The Malaysian Sukuk market is considered the most liquid market in the world. It has been supported by the frequent issuance by the Malaysian government and its central bank. The total value of outstanding sovereign Malaysian ringgit bonds and Sukuk is more than $88 billion. The volume of total trades in the government securities during first nine months of 2009 was $187 billion with total number of trades exceeding 27,000.

Among the recent developments in the Saudi Sukuk market was the launch of an automated Sukuk and bond trading platform by the Tadawul in June 2009. The following table provides details of the trades that have taken place on Tadawul since the beginning of the new trading platform.

Month	SABIC I	SABIC II	SABIC II	SEC I	SEC II
June	2	3	1	20	-
July	7	1	1	6	2
August	1	2	1	2	2
September	0	0	0	0	1
Total	10	6	3	28	5

Not much trade is taking place due to very small number of issues. Moreover, a significant portion of the five Sukuk listed in Tadawul have been purchased by big institutional investors who are 'hold to maturity' investors. The banks, which usually play a major role in secondary market trading, also do not have enough securities for their investment books. Hence, they hardly get to have any allocations for their trading books.

Due to lack of a liquid secondary market, portfolio and fund managers are reluctant to invest in these issues. Though the size of funds under management in the local market is in the billions, many of the investors and their advisors lack the training and the tools required to evaluate and price debt securities. Moreover, there is no independent valuation and pricing agency that could provide regular valuations and market neutral prices. The market also lacks fix income institutional investors and investment funds that usually play an important role in secondary market trading.

Legal and regulatory framework

The issuance of Sukuk in KSA is regulated by the Offer of Securities Regulations (hereinafter 'Regulations') issued by the Capital Markets Authority. The Regulations do not provide a specific framework for the issuance of Sukuk. Although it can be argued that some Sukuk structures would not create a debt obligation on the issuer, currently Sukuk are being issued as a debt instrument under the broad definition of 'Debt Instruments' in the Regulations. The Companies Regulations 1965, on the other hand, allows the issuance of bonds only by joint stock companies. Furthermore, it restricts the maximum size of the bonds issued by a company not to exceed its paid up capital. Many prospective Sukuk issuers do not meet these requirements of the Companies Regulations.

Most of the Sukuk involve either sale of an asset or participation in a business venture. To comply with strict Shariah requirements and, in case of securitisation, to achieve bankruptcy remoteness, the Sukuk assets/business would be owned by a separate legal entity other than the Issuer. As mentioned above, the current Companies Regulations do not provide an efficient mechanism to set up and maintain transaction specific special purpose companies. The establishment of a joint stock company takes anywhere between 4-6 months. In addition the minimum capital required for a joint stock company is $500,000.

A regulatory framework facilitating the establishment of special purpose companies with nominal share capital would greatly help the prospective issuers to access the debt capital markets. Furthermore, the Company Regulators should consider waiving the requirement for an issuer to be a joint stock company. As regards investors' interest, the same could be protected by other measures, for example, limiting such offers to private placements. The Saudi government has taken the initiative of overhauling the Companies Regulations and providing a framework for special purpose vehicles; however, it is not clear when these changes will take place.

Uniform Shariah standards

The unprecedented growth of the Islamic banking business in the Kingdom has been primarily driven by the demand of Shariah compliant products by the general public. The financial institutions have set up Shariah committees consisting of scholars with expertise in Islamic law, who act as independent consultants. These Shariah committees approve the Islamic products offered by the financial institutions and supervise their ongoing compliance with Shariah principles. This practice has its advantages and disadvantages. It has worked well for general banking products as each institution would like to differentiate its products from others. However, the lack of uniform Shariah standards does not help instruments like Sukuk, where distribution to a wider investor base is a key to the success of the transaction.

Among the local Shariah scholars' community, some scholars do not approve any of the existing Sukuk structures. Others only approve Sukuk involving sale and transfer (legal and not beneficial ownership) of assets to an entity other than the Issuer. As mentioned above, setting up of a separate entity is not easy and legal transfer of the assets brings up several other issues.

A dialogue among the Shariah scholars, the regulators and industry practitioners is needed to understand the challenges faced by the local Sukuk market and implement a plan of action to support its development. Such a dialogue could help Shariah scholars have a better understanding of the challenges faced by the industry and the need for a gradual and consistent application of Shariah principles. It is not possible to develop a broad investor base for Sukuk securities without its general acceptance from the Shariah scholars' community.

Credit rating

At present KSA does not have a local credit rating agency. The major foreign rating agencies have been providing rating services to local companies. The high costs and considerable time required for obtaining initial ratings have discouraged many companies. The rating methodologies of the foreign rating agencies tend to benchmark local companies with their peers in other markets. Sometimes such comparisons lead to unfavourable ratings for the local companies.

Since the adoption of Basel II framework for capital adequacy, financial institutions have a natural preference for rated securities. The investment policies of most of the institutional investors require an investment grade rating as a minimum acceptable level for a security to be considered for investment. The issue ratings are also a useful tool to price the security for secondary market trading. The establishment of a local rating agency would not only be helpful to the issuers and the investors but would also facilitate the development of an active secondary market.

Cost of Sukuk issuance and withholding tax

The overall cost of issuance is another area of concern for many issuers. These costs include legal and accounts/auditors fees, rating expenses, Tadawul registration and listing fees and costs of translation of documents. The legal costs have recently shown a downward trend due to increased capacity made possible by the economic downturn and opening of several new law firms offices in KSA. Tadawul currently charges $27,000 annual registration fee in addition to $13,000 system uploading charges. The Tadawul management may consider waiving the registration fee for the first year to encourage listing of more debt instruments.

Foreign investors are subject to withholding tax at the rate of 5 per cent on all payments in the nature of profits (coupon payment) in respect of Sukuk or other debt instruments. The government should consider waiving this tax as an incentive to encourage foreign investors' participation in the local Sukuk market.

Encouraging new issuance

In addition to this, the Saudi government may consider establishing a credit support guarantee program either for all issuers or the issuers who are accessing the DCM for the first time. Such a programme will go a long way in stimulating the DCM and provide a cost effective alternative to bank market funding. For example, as part of its stimulus package to revive the financial markets, the Malaysian government established its first financial guarantee insurer called Danajamin Nasional Berhad with paid-up capital of $300 million. The purpose of this AAA-rated institution is to provide financial guarantee insurance to issues of private debt and Islamic securities. The objective is to facilitate capital-raising by Malaysian companies from the capital markets. It provides financial guarantee insurance to protect the holders of private debt securities against any missed payments or defaults.

Conclusion

During the past year, SAMA took several measures to increase the money supply in the local financial market and encourage banks to continue their financing activities. Despite historically low deposit rates and regular liquidity injections, it was not able to reverse the past 12 months' decline in corporate credit growth. A credit support guarantee programme for DCM issuance could have helped the companies raise long term funds without paying a premium due to adverse market conditions. Such a programme could also provide much needed relief to investors who have been beaten time and again in the jittery stock market. This measure alone however will not increase the number of issues in the market. The issuance of sovereign Sukuk; removal of legal and regulatory constraints; and facilitating the establishment of local rating and valuation agencies are key steps required for the development of a vibrant debt capital market. Unless that happens, a rapid increase in the local Sukuk offerings may not take place in the near future.

Blake Goud
Principal, Sharing Risk dot Org

Sukuk issuance in the North America

The Sukuk market worldwide has experienced remarkable growth in the past five years, despite its virtual shut down in the latter half of 2008. However, there is only one completed Sukuk from North America, the East Cameron Partners Musharaka Sukuk that is proceeding through the courts following the bankruptcy of the issuer. The pipeline for new Sukuk coming from North America is similarly scarce. Bear Mountain Resorts, a resort in British Columbia, Canada, is raising $350 million through a Sukuk issue expected to close in mid-October. The investment banking firm behind the Bear Mountain Sukuk - and whose co-founder Ibrahim Mardam-Bey was involved with the East Cameron Sukuk - is also working on the Shariah compliant securitisation of oil and gas properties in Venezuela for a New York Stock Exchange-listed firm.

This is confounding in many ways because the United States has some of the deepest and most liquid credit markets in the world, notwithstanding the effects of the financial and economic crisis that began in 2007. There are a number of factors that could have contributed to the dearth of Sukuk emerging from the United States. These factors include fears that anything Muslim could be viewed skeptically following the 9/11 attacks, little familiarity of Islamic financial products, lack of government and industry support and possibly the depth and liquidity of the conventional financial markets.

The first factor that many would cite for the lack of Sukuk issuance from the United States, the effects of the 9/11 attacks on sentiment in the US, is perhaps the least likely. To be fair, there was significant repatriation of funds held in the US to the Gulf following the attacks, in part caused by a fear that the efforts to prevent funding of terrorism would ensnare legitimate investor's money held in the United States. However, with few exceptions, this has not occurred and there continue to be investments in the United States from the Gulf, including those structured for Shariah compliance.

The second factor that is partially responsible for the lack of US Sukuk issuance is that most financial professionals in the United States are not familiar with how Sukuk work and what distinguishes them from conventional debt. This problem began to be overcome with the issuance of the East Cameron Sukuk, which had many hedge fund investors involved looking for a 'new' asset class that could provide healthy returns. However, that Sukuk was issued in 2006 and in the wake of the financial meltdown, new innovations have been pared back.

This leads into the lack of government and industry support for growing the Islamic financial industry. In contrast to New York, London has made a public effort to become the western 'hub' for Islamic financial services, including Sukuk issuance and secondary market listings. The Financial Services Authority, the capital markets regulator, has worked to establish a level playing field for Islamic financial services and the International Financial Services, London, an industry body, has also promoted London in the Islamic financial industry.

New York, in contrast, has relegated Islamic finance to a quiet niche position and the US government has done little to understand or support the industry. On the latter case, this is partially because of political concerns, but there are also real constraints on the US government against promoting the establishment of any religion and any explicit decisions to accommodate the Islamic financial industry would be strongly resisted. One example of this is the lawsuit currently proceeding against the government for its involvement in AIG, which launched a Takaful product after it received a government bailout.

Despite these limitations, there has been some effort by the US government to keep abreast of the Islamic financial industry. The Treasury Department held an internal workshop on Islamic finance in 2002 and named Dr. Mahmoud El-Gamal of Rice University as scholar in residence in 2004. Most recently, the Treasury Department held another internal workshop on Islamic finance in early 2008. However, these efforts pale in contrast with other large global financial centres like London, Paris, Hong Kong, Singapore and others in terms of actual significance.

Perhaps one of the largest impediments to the issuance of Sukuk in the US is the depth and liquidity of the capital markets. Aside from the freeze-up in the markets in the second half of 2008 which affected Sukuk markets globally, the US capital markets provide companies with a ready source of financing along conventional lines. This reduces the need for companies to search out alternative sources of financing like Sukuk because it will be difficult for a Sukuk to compete with the conventional debt markets. In the absence of explicit government and industry cooperation to level the playing field between Islamic and conventional financing, there will be little impetus for the development of Sukuk markets.

One area that may indicate greater interest by US-based investors is the issuance of only the third and fourth Sukuk to comply with the Rule 144A, which governs the issuance of securities to institutional investors located onshore in the United States. The Indonesian sovereign Sukuk and Petronas Sukuk, both issued in 2009, were structured to be in compliance with Rule 144A and both of these, as well as the East Cameron Sukuk, were sold to US-based investors.

As the Sukuk markets rebound from their slump following the financial crisis, it is likely that there will continue to be few issues from US-based companies, but there could be a greater number of issuers internationally that structure Sukuk prospectuses to comply with Rule 144A so that they can be sold to US-based institutional investors. This is the most likely avenue for the development of greater familiarity with Sukuk among US-based investors that could then spur domestic companies to consider Sukuk as an alternative to conventional debt offerings.

The market for Sukuk has largely occurred without participation from the United States, despite its status as having one of the deepest, most liquid capital markets. There are a number of reasons for this, but in general it comes down to a general lack of familiarity of US-based investors in the potential for Sukuk to serve as an alternative to conventional debt offerings. As the capital markets recover from the deep recession of 2007 to 2009, there will be a more conducive environment for Sukuk issuers to target investors in the US and also the potential for more US-based companies to look to Sukuk as a way to raise capital outside of the conventional debt and equity markets.

Zawya survey analysis

Introduction

During the months of September and October 2009 Zawya undertook a comprehensive survey of Sukuk market participants. The findings from the Survey follow.

During September and October 2009 Zawya undertook a comprehensive survey of Sukuk market participants and sent out three separate surveys to different sets of participants in the market. This survey is perhaps the most significant survey of Sukuk market participants since the advent of the financial crisis and provides unique insights into the strategy, planning, and motivations of many in the market.

The data gathered from the survey should prove to be of great value to anyone with a professional interest in the Sukuk domain in the coming two years. While many of the findings from the survey are in line with market sentiment, there were some unique views that illustrate that the market is far from being a predictable one. The greatest challenge from this point will be to follow up on this survey in subsequent years to establish how the depth and breadth and 'flavour' of the market have changed, year on year.

Please note that this survey was carried out before the announcement made by the Dubai authorities on Wednesday 25 November 2009 requesting creditors for a moratorium on all Dubai World debts including the repayment of the Nakheel Sukuk.

Methodology

The methodology involved extracting contact data from Zawya's own database and emailing the contacts with a request that they fill in a self-completion survey in order to judge their responses to key questions facing the industry.

The first set of participants included lead arrangers and co-lead arranger. A total of 27 individuals, each from different institutions, responded to the survey. Some basic data on the country of operation and amount arranged by these institutions can be seen in Figure 1 below.

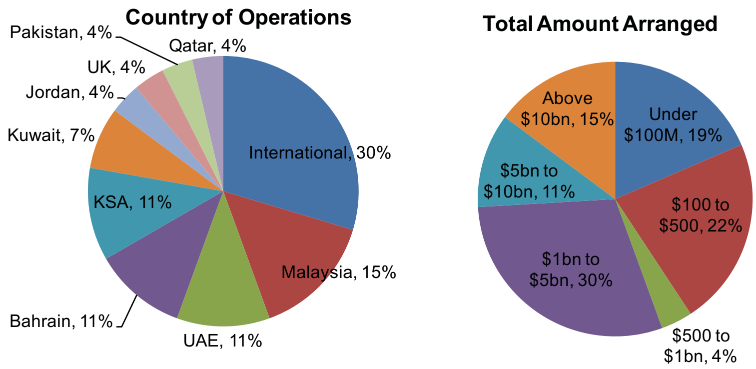


Figure 1. Source: Zawya survey of lead arrangers and co-lead arrangers

The second set of participants included investors in Sukuk. A total of 32 buy side individuals, each from different institutions, responded to the survey. Some basic data on the institutions countries and industries can be seen in Figure 2 below.

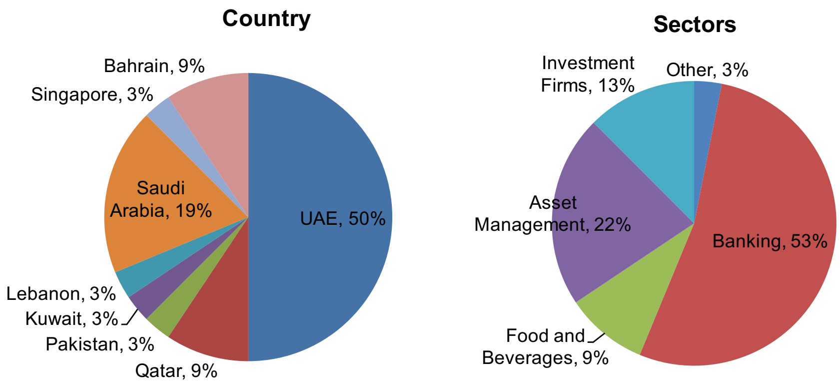


Figure 2. Source: Zawya survey of investors

The third set of participants included treasurers. A total of 21 officers, each from different companies, responded to the survey. Some basic data relating to their activities can be seen in Figure 3 below.

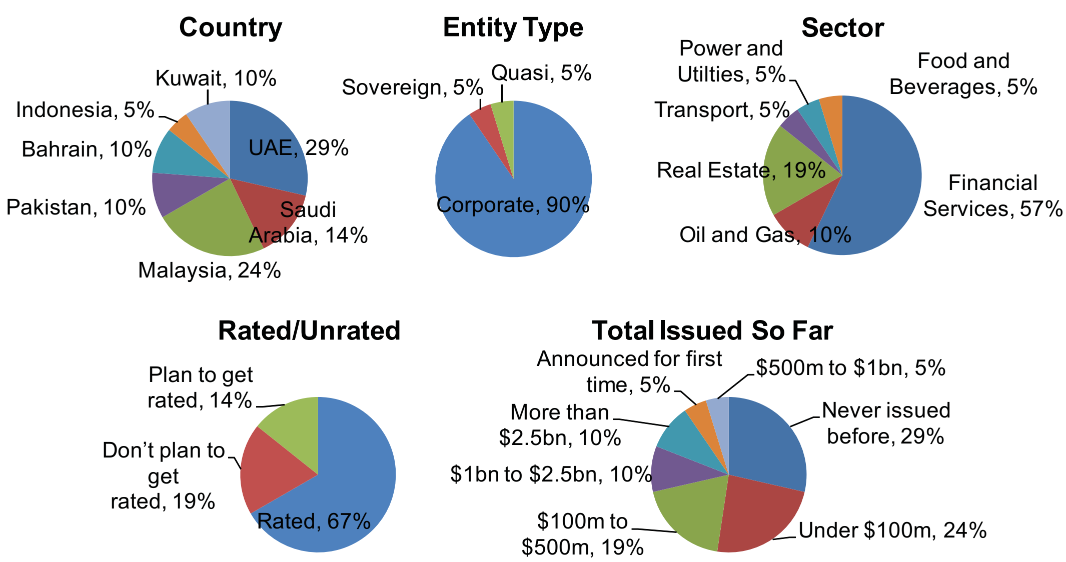


Figure 3. Source: Zawya survey of treasurers

Matching supply and demand

Investors were asked if they had any intention of investing in Sukuk at present and 87.5 per cent indicated that they were interested. Of the 12.5 per cent who indicated that they had no interest, some of the reasons for their lack of interest were cited as being due to low yields, lack of transparency surrounding the Sukuk market, and lack of clarity over payback periods. Of those who expressed an interest in investing in Sukuk, 90 per cent were based in the GCC.

The treasurers were asked whether they had any current need for financing and for those who indicated that they had such a need we asked whether they would consider using Sukuk. This question yielded 93 per cent of responders willing to use Sukuk for their funding needs. Of the 7 per cent who were not considering Sukuk for fund raising the most popular reason for not using Sukuk was that the amounts the treasurers needed to raise were too small to make Sukuk issuance cost effective. (See slide 9 for update)

Does potential demand for Sukuk match the potential supply?

Country

As Figure 4 shows there could be some potential mismatch of supply and demand within the GCC. While both Saudi Arabia and Malaysia seem fairly well matched, both UAE and Bahrain could find that supply will not meet demand.
The currency in which the Sukuk are issued will determine the audience for the Sukuk. While issues in dollars may find an international audience, issues in local currencies will tend only to find a market domestically. The figure below gives a useful snapshot of the appetite and intentions for new Sukuk issues over the next two years.

Lead Arrangers	Investors
Over the next two years, where do you see the dominating supply in terms of country?	What is your investment appetite in terms of country?
27 Respondents | 54 Votes	28 Respondents | 78 Votes

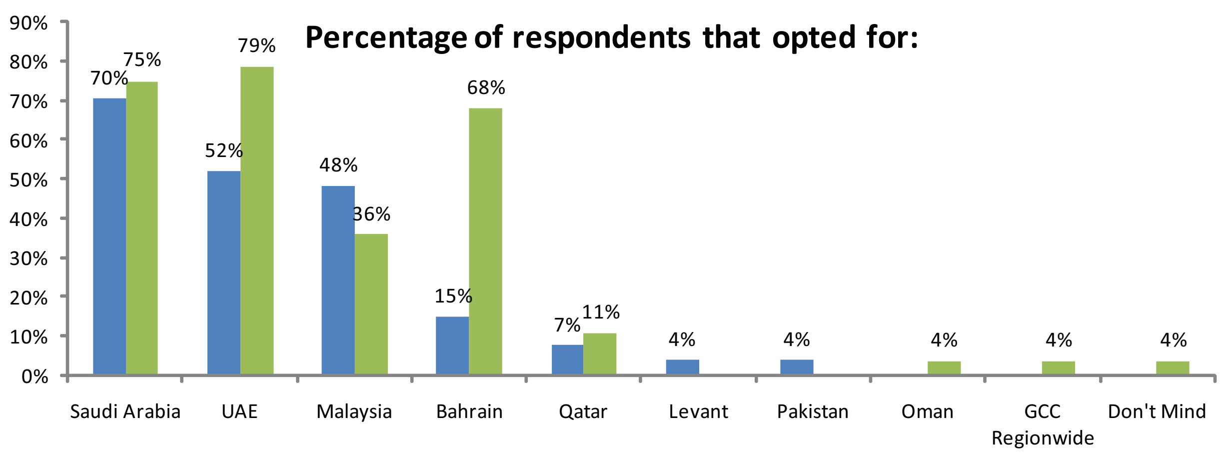


Figure 4. Source: Zawya survey – preference of country of Sukuk issuance

Currency

The currency in which the Sukuk are issued will determine the audience for the Sukuk. While issues in dollars may find an international audience, issues in local currencies will tend only to find a market domestically. The figure below gives a useful snapshot of the appetite and intentions for new Sukuk issues over the next two years.

Lead Arrangers	Investors	Treasurers
Over the next two years, where do you see the dominating supply in terms of currency?	What is your investment appetite in terms of currency?	What are your issuer preferences in terms of currency?
27 Respondents | 55 Votes	27 Respondents | 57 Votes	13 Respondents | 15 Votes

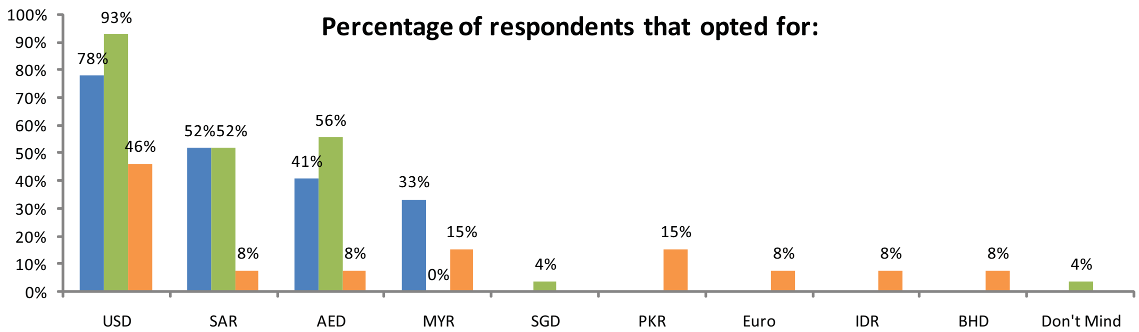


Figure 5. Source: Zawya survey – preference for currency of Sukuk issuance

Issuer type

While experience and common sense suggest that corporate issues are easier to get hold of than sovereign issues, this was not borne out by the respondents to the survey. As the figure below shows, all types of issue seemed to be welcomed by the investing community.

Lead Arrangers	Investors
Over the next two years, where do you see the dominating supply in terms of issuer type?	What is your investment appetite in terms of issuer type?
27 Respondents	27 Respondents | 33 Votes

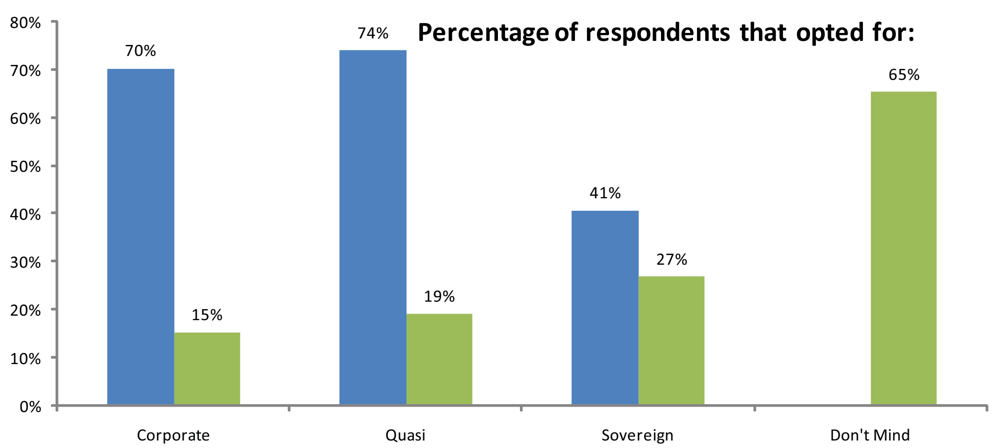


Figure 6. Source: Zawya survey – type of Sukuk preferred

Tenor

Tenor of Sukuk proved to be a fairly predictable area with tenors of between 1-5 years proving to be the most popular segment by far. Those who preferred tenors of between 5-10 years still made up a significant part of the community as the figure below shows. A significant proportion of treasurers were also keen on very long tenor Sukuk – presumably reflecting the fact that they were looking for a spread of maturities in order to match their liabilities.

Lead Arrangers	Investors	Treasurers
Over the next two years, where do you see the dominating supply in terms of tenor?	What is your investment appetite in terms of tenor?	What are your issuer preferences in terms of tenor?
27 Respondents | 33 Votes	27 Respondents | 39 Votes	13 Respondents | 15 Votes

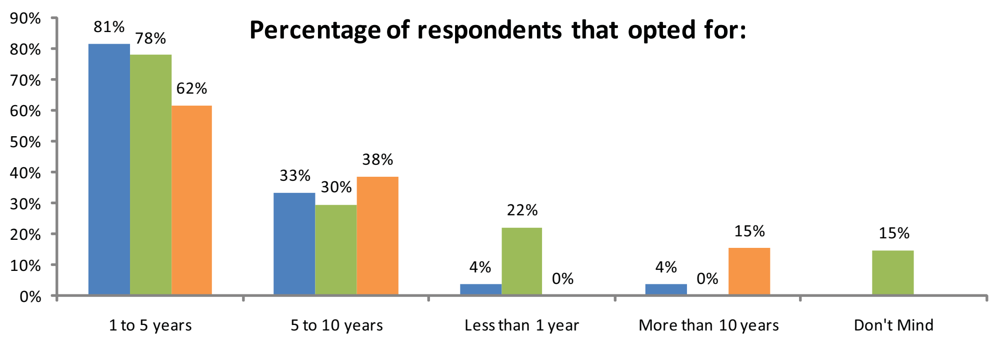


Figure 7. Source: Zawya survey – preference of Sukuk tenor

Structure

The most favoured Sukuk structure was the Ijarah or leasing structure. Apart from being the most common type of structure this is also the structure that came out as being least controversial after the negative press that Sukuk received early in 2008.

Lead Arrangers	Investors	Treasurers
Over the next two years, where do you see the dominating supply in terms of structure?	What is your investment appetite in terms of structure?	What are your issuer preferences in terms of structure?
26 Respondents | 40 Votes	27 Respondents | 43 Votes	13 Respondents | 15 Votes

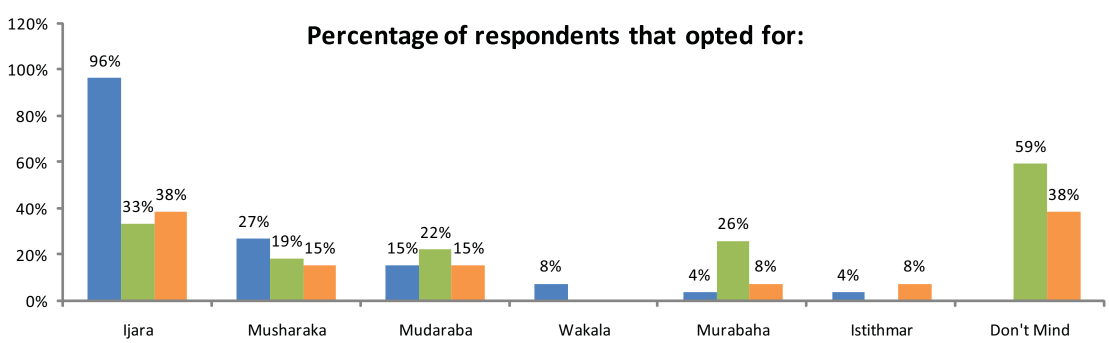


Figure 8. Source: Zawya survey – preference of Sukuk structure

Asset-backed versus asset-based

Considering the current angst and debate surrounding the question of asset-backed versus asset-based Sukuk at present, it is perhaps surprising to see that this supposed dichotomy is not reflected in the marketplace's acceptance of these different kinds of Sukuk. It seems as if the market either does not fully understand the difference between these kinds of Sukuk or does not care too much about them.

Lead Arrangers	Investors	Treasurers
Over the next two years, where do you see the dominating supply in terms of asset backing?	What is your investment appetite in terms of asset backing?	What are your issuer preferences in terms of asset backing?
27 Respondents | 27 Votes	26 Respondents | 26 Votes	11 Respondents | 11 Votes

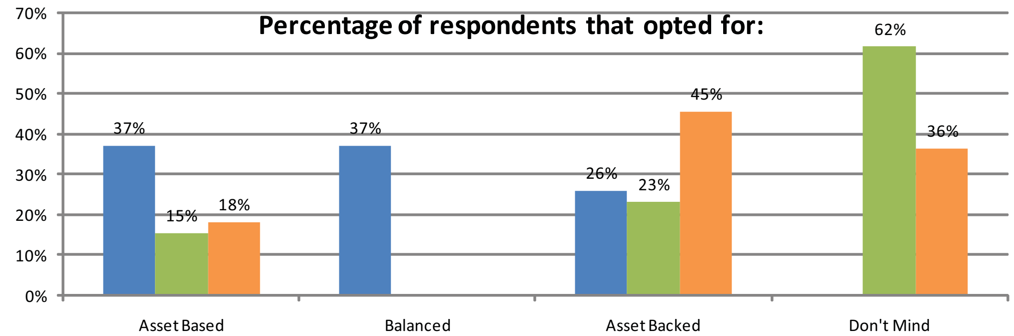


Figure 9. Source: Zawya survey – asset-backed versus asset-based Sukuk structures

Rated versus unrated

The overwhelming majority of Sukuk market players expressed a preference for rated Sukuk which we would expect to see in the light of current defaults. One of the characteristics of the credit squeeze was a flight-to-quality and this is borne out by future expectations from the Sukuk space.

Lead Arrangers	Investors	Treasurers
Over the next two years, do you see the dominating supply of Sukuk to be rated?	Do you have preferences towards rated Sukuk?	What are your issuer preferences in terms of getting your issue rated?
26 Respondents | 26 Votes	28 Respondents | 28 Votes	12 Respondents | 12 Votes

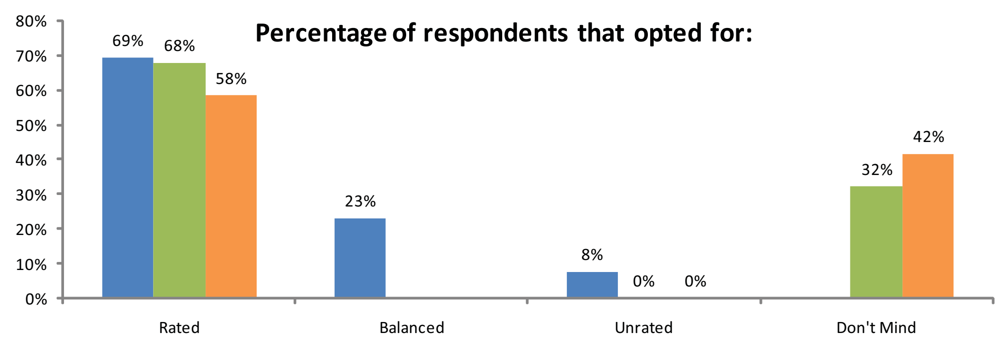


Figure 10. Source: Zawya survey – preference for rated Sukuk issues

Listed versus unlisted

The corollary of this, of course, is that Sukuk should be formally tradable rather than simply on the OTC market. The preference for Sukuk listed on recognised exchanges was very strong and indicates that exchanges will become an increasingly important venue for both issuers and investors alike.

Lead Arrangers	Investors	Treasurers
Over the next two years, do you see the dominating supply of Sukuk to be listed?	Do you have a preference towards listed Sukuk?	What are your issuer preferences in terms of getting your issue listed?
26 Respondents | 26 Votes	26 Respondents | 26 Votes	13 Respondents | 13 Votes

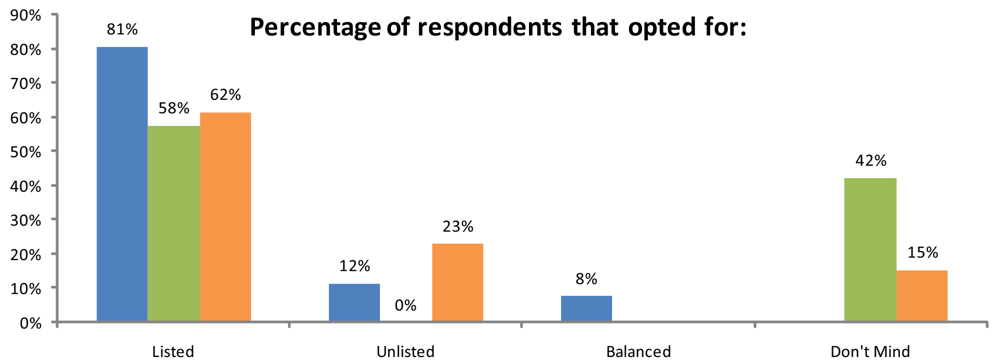


Figure 11. Source: Zawya survey – preference for listed issues

Issuance timing

There is much talk about a potential tsunami of Sukuk issues waiting to hit the market, with some estimates guessing that up to $50 billion worth of issues is ready and waiting. The survey indicated that treasurers foresee an immediate but ongoing need to issue Sukuk – with such a need extending into the foreseeable future.

Treasurers
When do you prefer to issue your Sukuk?
12 Respondents | 16 Votes

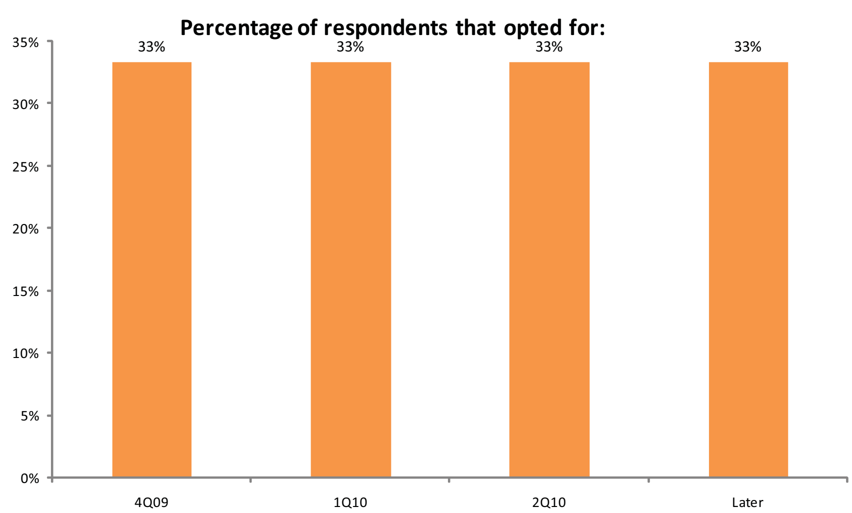


Figure 12. Source: Zawya survey – treasurers' preference for when they will issue a Sukuk

Conclusions

There are a variety of conclusions that we can draw from the survey analysis. The first and obvious conclusion is that there is still tremendous interest in Sukuk and that we can expect to see a significant uptick in Sukuk activity once markets return to normal. While estimates of a $50 billion pipeline of Sukuk issues waiting in the wings may prove to be overblown there is no denying the fact that there should be a significant level of issuance throughout 2010 and 2011.

Perhaps not all market participants showed the kinds of level of sophistication that might have been expected – particularly from the investors' side – this may have more to do with the relative infancy of the market coupled with the plentiful supply until very recently than anything else.

In terms of GCC debt in particular we are likely to see a resurgence in the importance of ratings from one of the big three agencies as a prerequisite prior for a roadshow. It is also possible that more GCC players may adopt more practices from their Malaysian cousins in an effort of achieve sophistication ahead of the natural level of progression that we have witnessed from the GCC to date.

Opinions and insight

The Zawya Sukuk survey included a number of open-ended questions that revealed some fascinating insights from the main market players

Lead arrangers

The survey asked lead arrangers about the reasons that issuers preferred Sukuk for raising capital as opposed to conventional means. The overwhelming response concerned diversification through increasing the investor base. This was seen as a win-win: 'investors get a better deal as it is asset based and Islamic investors also accept it due to Shariah compliance'.

Another reason cited was the increased level of publicity that Sukuk attract: 'increased awareness leads to a wider distribution base and increased and diversified investment'. One natural follow-on conclusion from the greater investor pool was the effect this has on the pricing of Sukuk issues.

We also asked lead arrangers to list the challenges they felt the Sukuk industry faced. Some of the main problems were identified as involving transparency of institutions, legal loopholes and understanding Islamic principles and documentation.

More general problems identified covered the general credit environment, standardisation, and the resolution of doubts around process during eventual insolvencies. Perhaps most worrying of the lot was identified as 'shifting Shariah interpretations' or 'lack of unified Shariah rules'.

Time and again the same issues arose covering Shariah standardisation, documentation standardisation and legal 'enforceability under Shariah principles whereas the governing laws for documentation are mainly under English law with very few case precedents'. Lack of liquidity and lack of secondary trading as well as lack of depth of demand from insurance companies, pension funds and so on were also identified.

Some respondents rather cynically felt that one of the problems was that Sukuk offered 'returns lower than equity while risk is much higher than for conventional bonds'.

Investors

The survey also asked investors to list the challenges they felt the Sukuk industry faced. The responses were in line with what we might expect from sophisticated investors and involved lack of transparency in terms of payback periods, lack of clear accountability if and when issues occur, and the dominance of sovereign or quasi-sovereign Sukuk.

Other issues centred on the lack of retail participants either at the point of issuance or on an exchange and more clarity on the assets being pledged when the Sukuk structure is being created and what would happen to those assets if timely payback does not occur. But perhaps some of the harshest criticism was aimed at Shariah scholars: 'We do not want a situation that we witnessed last year when the Bahrain based AAOIFI made statements that most of the Sukuk in the market were not Shariah compliant'.

More general comments asked for the establishment of a well-regulated secondary Sukuk market, greater acceptance of Shariah compliant structures and the limited knowledge among investors about the benefits of Sukuk as an investment instrument together with legal hassles surrounding default of Sukuk, and whether investors would have security over the assets on which the Sukuk was based.

We then asked these same investors about the challenges they faced when participating in Sukuk investment. Some responses identified that 'liquidity can be an issue in the secondary market and of course the Sukuk needs to be fully recognised by the various scholars that review the market' again repeating the jibe at Shariah scholars.

Defaults and potential defaults were also seen as a big issue: 'take the Nakheel Sukuk that is due for maturity in December 2009. A few months ago the Sukuk was selling at a heavy discount; however we chose not to jump in due to it not being clear if the Sukuk will be paid back on maturity or whether it will be restructured' also 'at the moment a given investment whether it be in the Sukuk market or in other debt capital market products has come down to investor gut feel rather than a rigorous analytical approach'. These are serious issues for an investor to grapple with.

Sometimes the Sukuk documentation comes in for a thrashing too: 'information is not always forthcoming, there are too many assumptions, too many disclaimers – it gets difficult to get permission from the management as it takes a lot of explanations to make up for the lack of clarity on figures and information'.

Pricing is also seen as a big obstacle. There was often seen to be a difficulty in obtaining pricing as there are limited pricing sources, a huge spread between bid and asking price, and limited information available on yield benchmarks for Sukuk.

Issuers

The survey asked issuers the reasons for their preference for Sukuk for raising capital. Some answers were very straightforward: 'we are an Islamic bank'. Less straightforward reasons included better pricing and Shariah compatibility for a tradable instrument for an international investor base as well as 'the financial market is saturated with conventional interest based financing'.

However many of the reasons are the same as those we have read about throughout this entire Sukuk survey and involve better pricing, more liquidity, larger investor base, and wider distribution since Reg S.

We also asked the investors to list the challenges they felt the Sukuk industry faced. They shared the same worries as other market players including the need for more players, liquidity, lack of detailed understanding of structures and pricing methodology, and lack of secondary market. Shariah scholars once again came in for a drubbing: 'the changes in Shariah's stand with regards to the principles currently used' and 'no uniform standards among religious committees; you see one saying halal and the next one saying haram'.

They were also concerned about the lack of standardised documents, agreement procedures, rules and regulations, less demand for Sukuk in the market, limited number of investors, regulation and compliance worries, and secondary market liquidity.

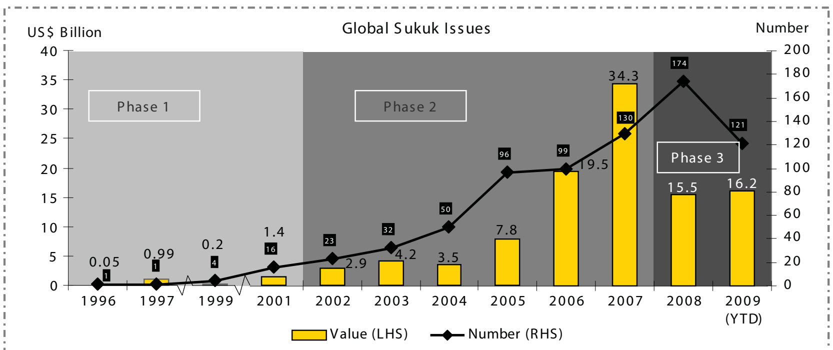
Market makers

We asked this group if they had any other comments regarding the Sukuk market. Their responses can be summed up in one comment: 'the Sukuk market is a relatively nascent market with few players limited to the GCC, and Malaysia and Indonesia. Most of the market participants can be classified into trading (which would include banks and financial institutions that hold Sukuk to make market in them) and investment (essentially retail investors or Shariah compliant funds). Lack of liquidity can be primarily assigned to the lack of tradable stock as once it reaches the retail level it becomes difficult to source them as the investors hold them to maturity. With more and more Sukuk issues now hitting the market it seems that the market is getting more liquid'.

Trend analysis from Ernst & Young

Executive summary

- Global sukuk issuance totaled a cumulative 747 issues with a total value of US$106.6 billion from December 1996 to 30 September 2009. Activity has been concentrated in two regions, South East Asia (mainly Malaysia) and the Middle East (mainly the GCC countries). Malaysia accounted for 46% of issues by value, becoming the single largest issuer by country while the GCC accounted for 49% of issues by value. The remaining 5% issues originated from the rest of the world.
- Analyzing three distinct phases of sukuk issues, the first phase from 1996 to 2001 accounted for only a small portion of total issuance. The phase 2002 to 2007 accounted for the largest value and number of issues since it coincided with the oil bull run and rapid economic growth in the GCC countries. The third phase from 2008 to 2009YTD witnessed the global financial crisis and Shari'a compliance issues, leading to a marked slowdown in issuance.
- Corporate issuers accounted for 53% of issuance (US$57,2 billion). Analyzing sectors, the real estate and construction sector received the largest amount of funding (US$26.4 billion), while governments (US$23.7 billion) and financial institutions (US$15.9 billion) were major issuers.
- Investors in the GCC and South East Asia, the two main Sukuk markets, hold different appetites towards Sukuk. Sukuk issued in the range of US$250 million and US$500 million represent the largest portion of issuance in the GCC while South East Asian issues have tended to be lower, between US$100 million and US$250 million in size.
- Ijarah, which is similar to leasing, remains the dominant structure for sukuk issuance, accounting for 33% of issuance by value due to investor acceptance and greater perceived Shari'a compliance.
- Sukuk have predominantly functioned as domestic financing instruments; 89% of sukuk issues have been domestic issues. The Malaysian ringgit accounted for 46% of issues while a large number of GCC issues tended to be denominated in US dollar due to the peg of most GCC countries to the dollar. The dollar, being the currency of choice internationally, is expected to feature in upcoming sukuk issues as international borrowers tap the sukuk market.



- The absence of a Shari'a based pricing benchmark has led to the majority of issues being fixed return issues. Regular sukuk issuances by governments and multilateral financial institutions are an attempt to create a yield curve for future pricing of sukuk issues but are only in their initial stages. The governments of Bahrain and Gambia have been active in this regard while the Islamic Development Bank and the International Finance Corporation have also issued sukuk.
- Sukuk have generally been used as short to medium term financing instruments, the majority of issues ranging between 1 to 3 years (47.1% of issuance by value). The absence of longer term sukuk issues is noticeable - the lack of quality securitizable assets and an illiquid interbank market are hindrances in this respect.
- Almost half (49%) of the sukuk issued thus far have been rated. The majority of rated issues have emanated from Malaysia, where compulsory requirements exist for sukuk issues to be rated by a local ratings agency, while GCC sukuk issues largely remain unrated. Large international corporate and sovereign issuances, usually denominated in dollars, are rated by international ratings agencies.

- Trading in sukuk remains limited in GCC, although Malaysia has an active secondary market. The differences in trading can be pinned down to differences in Shari'a interpretations between the two regions but the fact still remains that only 14% of total sukuk issuance till September 2009 has been listed on exchanges. Larger issues are generally listed but most investors prefer to hold on to sukuk till maturity. The Indonesian Stock Exchange accounts for the highest number of listed sukuk.
- Major international investment banks (or their Islamic subsidiaries) are the most active in advising on sukuk issuance. League tables for sukuk advisory contain a majority of international banks while standalone Islamic banks only consist of a small minority. The absence of a large Islamic investment bank which can underwrite large sukuk issues is evident.
- The sukuk pipeline remains healthy, US$31 billion of sukuk have been announced up to September 2009, with another US$3.1 billion rumored to be issued in the future. Although this is below the record levels seen in 2007, it bodes well for the future development of the market as new borrowers aim to tap Islamic funds. Potential issuers comprise a diverse geographic split from countries such as South Korea, China, Hong Kong, Thailand, Kazakhstan, Russia and India among others. Governments are among the largest proposed issuers, indicating the drive by global governments to tap Shari'a compliant funding sources.
- Future directions for the sukuk market include regular sukuk issuance by governments and multilaterals to create a yield curve, initiatives to increase trading which still remains limited in the GCC (example is the Saudi Tadawul market's new trading platform), and greater legal clarity on investors' rights for sukuk investments.

Introduction and methodology

Ernst & Young obtained data from the Zawya Sukuk Monitor, which contains a database of 747 sukuk issued from December 1996 to September 2009. The data was analyzed according to the following fields:

- Sukuk Status (Open, Closed, Matured, Announced, Rumored)
- Issuer
- Sukuk structure
- Country of issuer
- Currency of sukuk issue
- Subscription date
- Size of sukuk issue
- Pricing
- Tenor
- Lead Arranger/Advisor
- Market Type – domestic/international
- Entity Type – sovereign/quasi sovereign/corporate
- Sector

This report is divided into the following sections.

Consolidated Observations

This section includes findings on a consolidated basis, covering the entire period under review (December 1996 to September 2009).

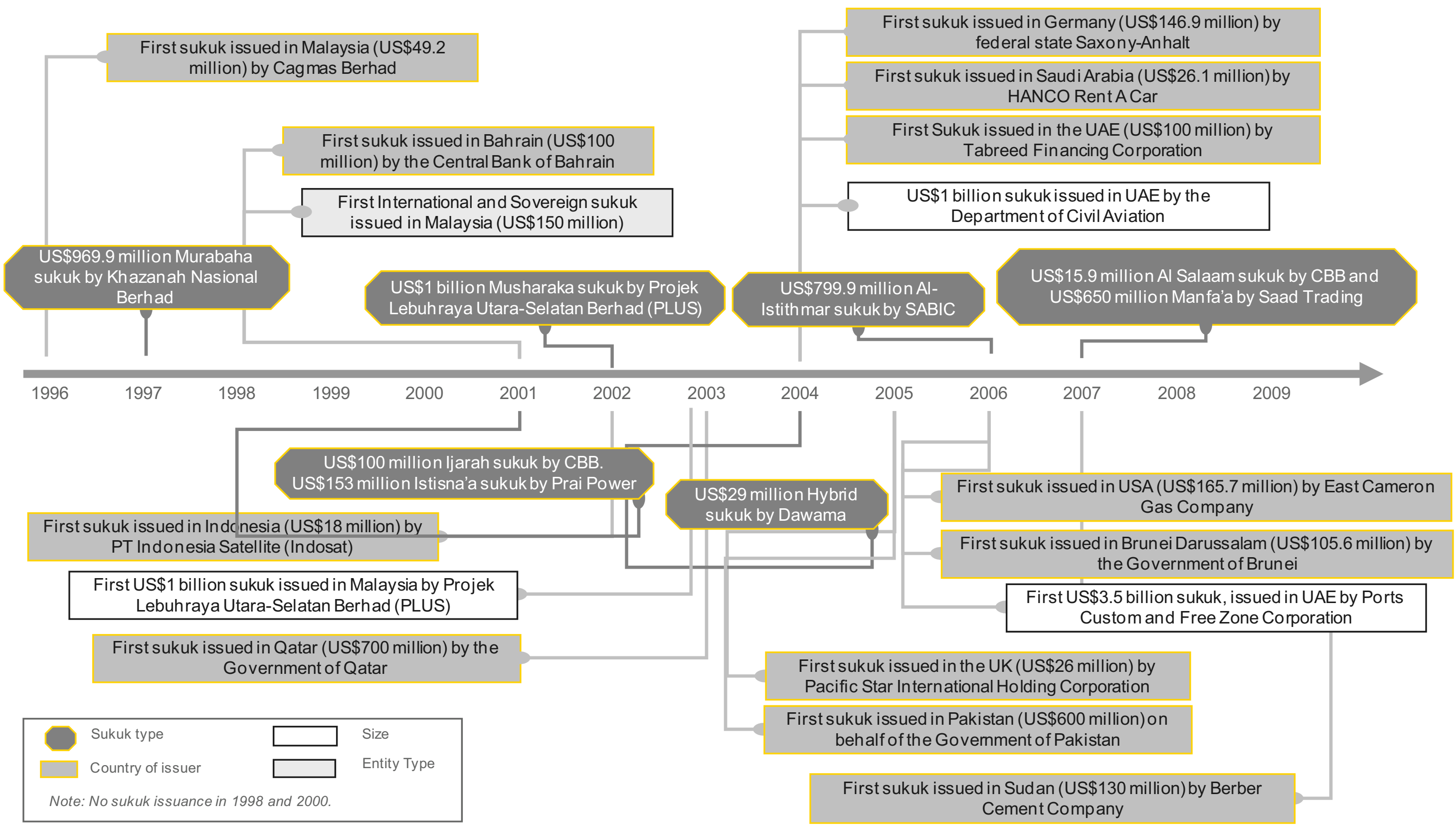
Trend Analysis

This section divides the consolidated analysis into distinct time periods, each covering a different time phase of the sukuk market.

Future of the sukuk market

This section illustrates the anticipated growth in the sukuk market through an analysis of the recent announcements with regards to new sukuk issues and some expected trends in the future.

History of Sukuk issues



Source: Zawya Sukuk Monitor

Consolidated analysis

Ernst & Young
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Conventional banks (and Islamic arms of conventional banks) are more active in arranging sukuk than standalone Islamic banks

Eight of the top ten sukuk lead arrangers are conventional banks (or the Islamic arms of conventional banks). Standalone Islamic banks are notably absent and the key reasons attributed to this are:

- **Capital base:** the majority of Islamic banks do not possess a large capital base to support underwriting activities for large sukuk issues.
- **Track record and network:** the majority of Islamic banks do not have the required track record to successfully arrange large sukuk issues.
- **Human resources:** the required investment banking expertise is absent in most standalone Islamic banks.

Multinational banks continue to hold a larger share of the sukuk market due to their larger capital base, well developed network and expertise. The only standalone Islamic bank which has been active is Dubai Islamic Bank.

Top Ten sukuk Lead Arrangers
(Dec 96 – Sep 09)

Top Ten sukuk Lead Arrangers
(Dec 96 – Sep 09)

Lead Arranger	Number of Arrangements	Country
CIMB Investment Bank Berhad	88	Malaysia
HSBC Bank Middle East	77	UAE
Maybank (Aseambankers)	47	Malaysia
Am Investment Bank (AmMerchant)	46	Malaysia
OCBC Bank	44	Malaysia
Standard Chartered Bank (Middle East and N. Africa)	34	UAE
Citibank	29	UAE
Dubai Islamic Bank	28	UAE
Amanah Capital Partners	29	Malaysia
AAA Sekuritas	16	Indonesia

Conventional Bank
Islamic Bank

Note: Sovereign entities that have been excluded from this list are the Central Bank of Bahrain and the Central Bank of Gambia.

Amanah Capital Partners represents its subsidiary Amanah Short Deposits Bhd.

Source: Zawya Sukuk Monitor

Ernst & Young
Quality In Everything We Do

Almost half the sukuk issued have been rated, although this figure is skewed due to a higher number of issues originating from Malaysia, where mandatory requirements exist for rating sukuk

Compared to conventional bonds, where it is a norm to obtain ratings, only 364 (48.7%) of the sukuk issued were rated in the period under review.

Malaysian rating agencies such as Malaysian Rating Corporation Berhad (MARC) and RAM Ratings (RAM) are dominant in Malaysia, while global credit rating agencies such as Standard & Poor's, Moody's and Fitch are active in rating international issues.

MARC is the leader in terms of the number of sukuk issues rated due to the fact that obtaining a credit rating from a local credit rating agency in Malaysia (MARC or RAM in this case) is an obligatory requirement for issuing any debt. The same rule is applied to Pakistan, which justifies the involvement of the Pakistan Credit Rating Agency (PACRA) and JCR-VIS Credit Rating (JCR-VIS).

The absence of mandatory rating requirements for issuing sukuk in the Gulf Cooperation Council (GCC) countries has limited the number of rated sukuk.

Rated and Unrated Sukuk (Dec 96 – Sep 09)

Type	Number
Rated	364
Unrated	383

List of Credit Rating Agencies that have rated Sukuk (Dec 96 – Sep 09)

Credit Rating Agency	Number of Sukuk Rated*	Headquarters
MARC	139	Malaysia
RAM	123	Malaysia
S&P	44	USA
Moody's	24	USA
PEFINDO**	23	Indonesia
Fitch	16	USA
PACRA	10	Pakistan
JCR-VIS	8	Pakistan
Capital Intelligence	7	Cyprus
Total	394	

Note: The sum of "Number of sukuk Rated" is larger than the number of actual rated Sukuk (table left) due to some Sukuk issues being rated by more than one credit rating agency.

** PT Pemeringkat Efek Indonesia.

Source: Zawya Sukuk Monitor

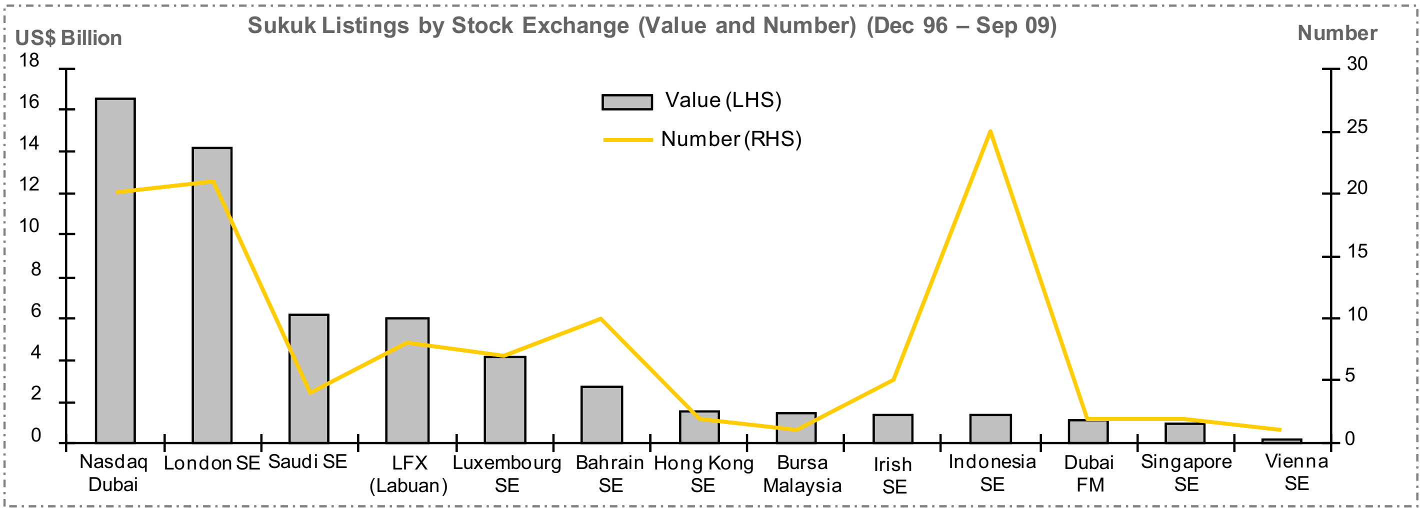
Large issues are usually listed on exchanges, although trading remains limited, especially in the GCC. In contrast, Malaysia has an active secondary market in sukuk

Sukuk listed on exchanges amounted to US$58 billion. In terms of number, only a few sukuk have been listed (12% of total sukuk issued), but the reason for the large value of listed sukuk is that larger issues are generally listed by issuers.

Indonesia was home to the first sukuk listing in 2003. The following years recorded strong increase in sukuk listings, reaching 35 in 2007; dropping in following years to 24 in 2008 and 16 in 2009 (YTD). Currently, Indonesia Stock Exchange holds the highest number of sukuk listings (25) but Dubai is the leader in sukuk listings by value with US$16.8 billion sukuk listed on Nasdaq Dubai. London, which is aiming to becoming a hub of Islamic finance in Europe has a substantial share of listed sukuk as 21 issues are listed on the London Stock Exchange with a total value of US$14.2 billion. Luxembourg has also emerged as a popular destination to list sukuk, hosting the Dubai Global sukuk FZCO, the first sukuk to be listed on a European stock exchange.

Even though a large number of sukuk have been listed, trading remains limited, especially in the GCC, since most sukuk are held to maturity by investors and not all sukuk are tradable in nature (based on underlying Islamic contracts).

In contrast, Malaysia has a liquid secondary market for sukuk even though not all issues are listed there.



Source: Zawya Sukuk Monitor

Sukuk market overview

The following is a summary of the sukuk market during the consolidated period under review.

Consolidated Analysis (December 1996 to September 2009)

Market Size	► From December 1996 to 30 September 2009, 747 sukuk were issued with a total value of US$106.6 billion.
Sukuk Markets	► Sukuk issuance is concentrated in Malaysia and the GCC. ► Malaysia issued the first sukuk and originated 41% of all sukuk issued by number with a value of US$48.8 billion (46% of total value). ► The GCC originated 25% of sukuk issued globally by number, with a total value of US$48.9 billion (48% of the total amount issued).
Sukuk Outstanding	► US$94 billion of sukuk remain outstanding, only US$12.6 billion have matured thus far.
Sukuk sizes	► The majority of sukuk (74%) were under US$100 million in size.
Sector	► The real estate and construction sector received the largest amount of funding from sukuk, which reached US$26.4 billion, followed by governments (US$23.7 billion) and the financial services sector (US$15.9 billion).

Source: Zawya Sukuk Monitor

Consolidated Analysis (December 1996 to September 2009)

Sukuk Pricing	► Sukuk have mostly carried fixed percentage returns as opposed to floating rates. Some 289 sukuk have unknown pricing information.
Lead Arrangers	► Conventional international banks (or their Islamic subsidiaries) such as CIMB Investment Bank Berhad , HSBC Middle East and Maybank (Aseambankers) are on the top of the arranger list, highlighting the absence of pure Islamic banks in arranging sukuk.
Sukuk Rating	► Almost half the issued sukuk have been rated (48.7%); signifying the importance of ratings for this new asset class. Majority of rated issues originated from Malaysia where rating is mandatory.
Sukuk Listing	► Only 108 (14%) of total sukuk issues were listed on stock exchanges. The Indonesian Stock exchange has the highest number of listed sukuk (25), while Nasdaq Dubai has the highest value of sukuk listings (US$16.5 billion).

Source: Zawya Sukuk Monitor

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Sukuk market overview

Consolidated Analysis (December 1996 to September 2009)	
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Source: Zawya Sukuk Monitor

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League tables
Global Sukuk market

Largest Issues (Single)

Issuer	US$ Billion
Binariang GSM Sdn. Berhad	3.56
Nakheel Development Limited	3.52
Ports Customs and Free Zone Corporation	3.50
Aldar Properties	2.53
Saudi Arabia Basic Industries Company	2.10
Rantau Abang Capital Berhad	2.06
Jabal Ali Free Zone	2.04
Cagamas Berhad	1.90
Saudi Electricity Company	1.86
Petroliam Nasional (Petronas)	1.50
Department of Civil Aviation (Dubai)	1.00
Central Bank of Bahrain	0.75
Bank Negara Malaysia	0.74
Government of Qatar	0.70
Government of Indonesia	0.65

Largest Issuers (by value)

Issuer	US$ Billion
Central Bank of Bahrain	6.58
Nakheel Development Limited	5.25
Binariang GSM Sdn. Berhad	4.55
Khazanah Nasional Berhad	4.59
Cagamas Berhad	4.32
Saudi Arabia Basic Industries Company	4.27
Government of Malaysia	3.70
Projek Lebuhraya Utara-Selatan Berhad (PLUS)	3.65
Aldar Properties	3.55
Saudi Electricity Company	3.20
Government of UAE	1.99
Government of Indonesia	1.93
Islamic Development Bank	1.75
Government of Pakistan	1.40
Syarikat Prasarana Negara Berhad (SPNB)	0.61

Highest Issuers (by number)

Issuer	Number of Sukuk Issued
Central Bank of Bahrain	164
Central Bank of Gambia	76
Government of Brunei	29
Government of Malaysia	12
Tradewinds Plantation Capital Sdn Bhd	10
Kwnatas	9
Cagamas Berhad	8
Midas Plantation Sdn Bhd	8
R.H. Capital Sdn. Bhd	8
Menara ABS Berhad	8
Projek Lebuhraya Utara-Selatan Berhad (PLUS)	8
Khazanah Nasional Berhad	8
Government of Pakistan	7
PT Indonesia Satellite (Indosat)	4
Perusahaan Listrik Negara (PLN)	4

Source: Zawya Sukuk Monitor

Quasi Sovereign   Sovereign   Corporate

Trend analysis - Phase 1
Global Sukuk issuance (1996 - 2001)

Between 1996 and 2001, there were 22 sukuk issued with a total value of US$2.6 billion, of which US$900 million have matured

1996-2001

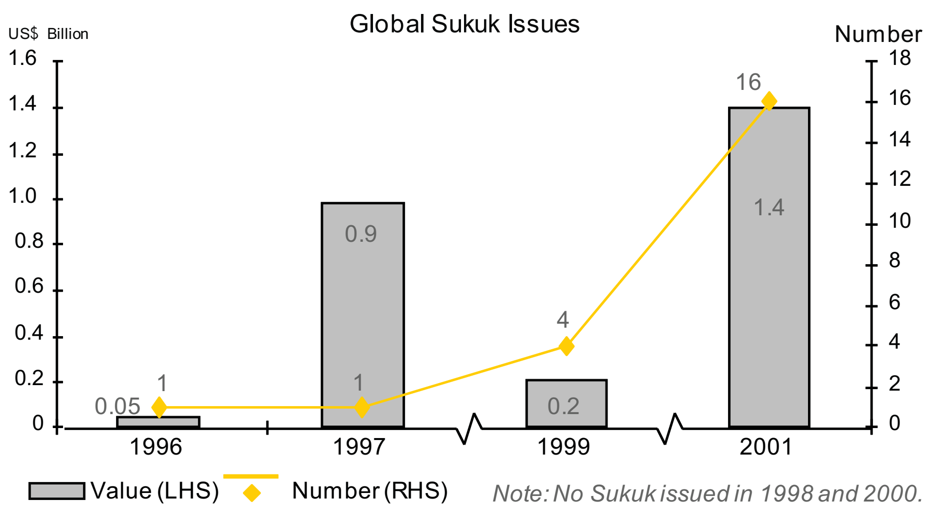
The sukuk market was launched by Cagamas Berhad - the Malaysian National Mortgage Corporation which issued the first sukuk with a value of US$50 million. The Cagamas Sukuk was the only issue to be recorded in 1996 and was followed by 21 issues in the next five years.

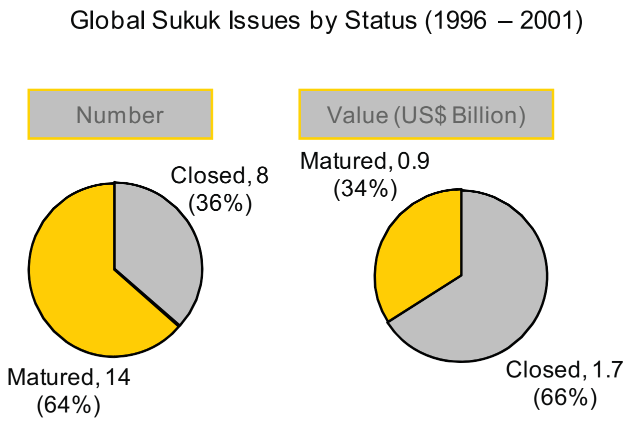
Annual sukuk issues nearly exceeded the US$1 billion mark in 1997 when Khazanah Nasional Berhad, the investment holding arm of the Government of Malaysia issued sukuk with a value of US$985.6 million. Malaysia continued to be the only active nation in the sukuk market in 1999 with the issuance of four sukuk with values ranging between US$40 million and US$60 million.

It was not until 2001 when Bahrain joined Malaysia in the sukuk market. The Central Bank of Bahrain became the first sukuk issuer in the Gulf region with a US$25 million sukuk issuance. Increasing activity in the Malaysian capital markets increased sukuk issues to 16 in 2001 and the cumulative value of sukuk issuance in this phase to US$2.4 billion.

Of the total value of sukuk issued in this phase, only US$900 million have matured while the remainder are still outstanding, highlighting the fact that the majority of sukuk issued in this phase carried tenors of more than ten years.

The early years of sukuk development were mainly based in Malaysia; GCC participation was non-existent except from Bahrain due to the lack of Islamic finance infrastructure and under-development of Islamic capital markets.





Source: Zawya Sukuk Monitor

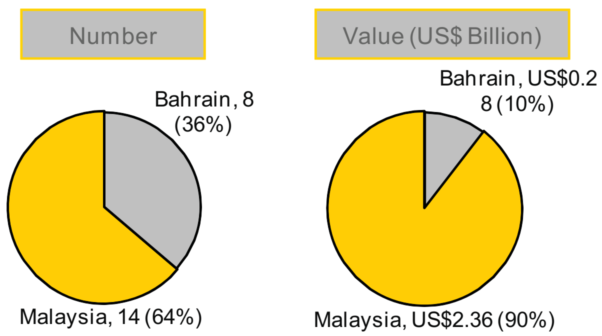
Sukuk were issued from only two countries, Malaysia and Bahrain; Malaysian sukuk dominated issuance

1996-2001

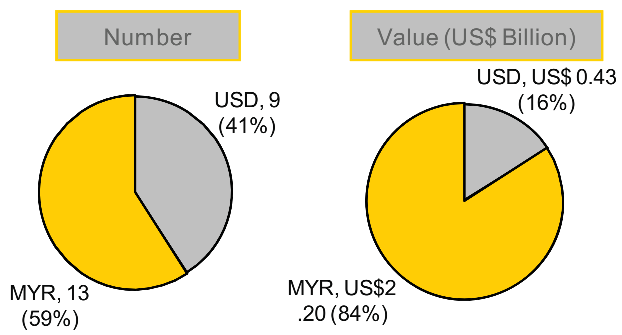
Considering the fact that issuers from Malaysia were the most active in the sukuk market in this phase, 13 out of the 21 sukuk issues were denominated in the Malaysian Ringgit. The sukuk program that was launched in 2001 by the Central Bank of Bahrain introduced US Dollar denominated sukuk to investors. Only one other US Dollar denominated issuance was recorded outside the GCC region, which was the First Global Sukuk from Malaysia.

Compared to sukuk, the value of conventional bond issuance in Malaysia reached US$9.0 billion in the same time period, signifying the underdevelopment of the sukuk market.

Global Sukuk Issues by Country of Issuer
(1996 – 2001)



Global Sukuk Issues by Currency (1996 – 2001)



Source: Zawya Sukuk Monitor

Corporates were more active than sovereign entities and primarily used sukuk as domestic financing instruments

1996-2001

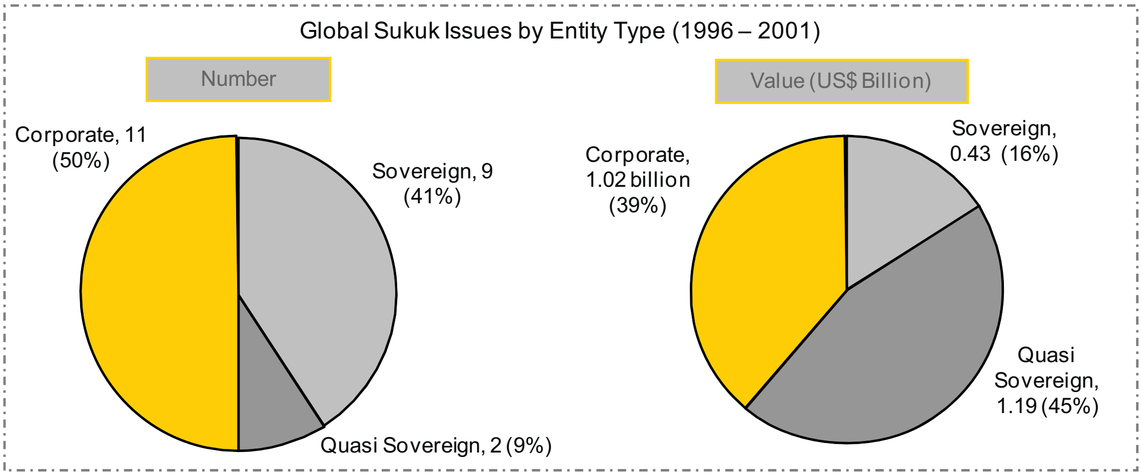
Out of the 22 sukuk issuers in this phase, 11 (50%) were corporate issuers and the remaining were sovereign and quasi sovereign. The sukuk market comprised primarily of local issuance at this point in time and with the exception of one international issue, all the issues were domestic in this phase.

Even though corporate issuers were more in number than sovereign entities, the value of corporate issuance was approximately US$1.0 billion, comprising 39% of the total value of issuance at this phase. Quasi sovereigns on the other hand only issued two sukuk with a total value of US$1.2 billion in Malaysia (by Khazanah Nasional Berhad and Telekom Malaysia). Sovereign issuance, led by the Central Bank of Bahrain held the remaining share of nine issues worth US$425 million in total.

The only international sukuk issuance which took place in this period was the First Global Sukuk issued by Kumplan Guthrie Bhd from Malaysia.

Global Sukuk Issues by Market (1996-2001)

Type	Number	Value (US$ billion)
Domestic	21	2.48
International	1	0.15



Source: Zawya Sukuk Monitor

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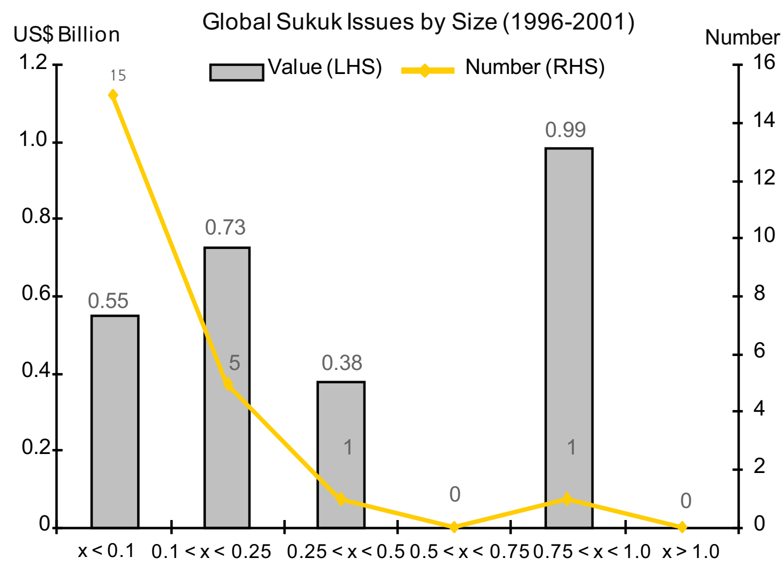
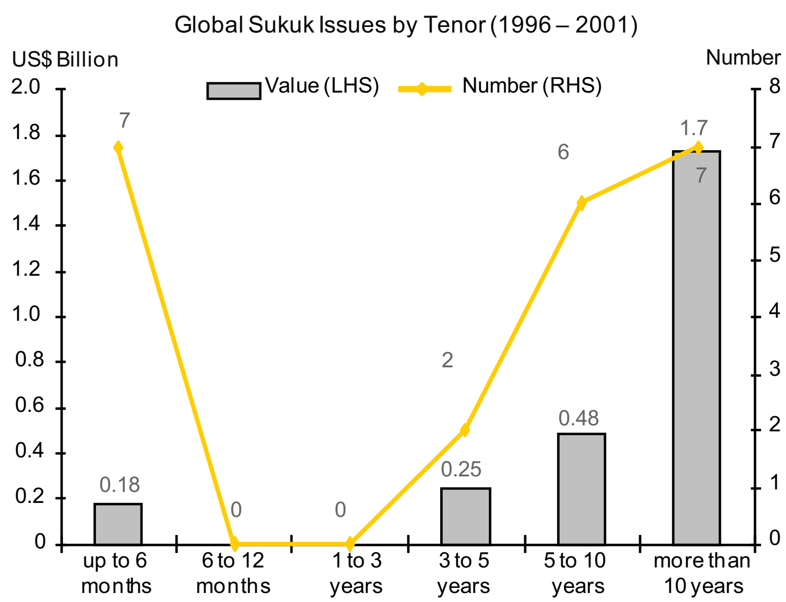
The majority of sukuk issued were less than US$100 million each with maturity exceeding 10 years

1996-2001

The nascent stage of the sukuk market led to relatively small sukuk size in this period – an average size of US$120 million. The highest number of sukuk issues fell in the US$100 million or below category. Several issues were between US$100 million and US$500 million while there was only one sukuk issued above the US$500 million mark, the Khazanah Nasional Berhad Sukuk.

Sukuk were generally used for medium to long term financing in this phase, the number of sukuk having tenors in excess of ten years accounted for the largest issuance. Noteworthy mention here is the Cagamas Berhad Modarabak sukuk, carrying a tenor of forty years, longer than any other sukuk issuance in this phase.





Source: Zawya Sukuk Monitor

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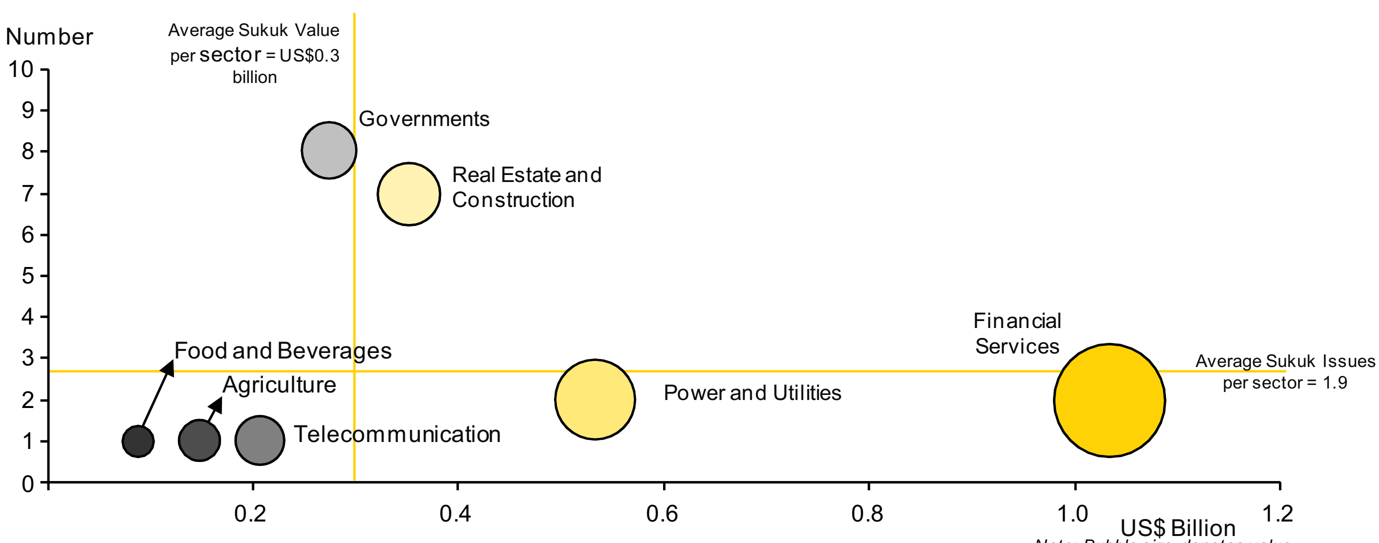
The financial services sector accounted for the largest issuance by value in this period

1996-2001

Even though the sukuk market was in its early stage, participation was witnessed from a number of sectors. The government sector witnessed the issuance of eight sukuk, the highest in this period. It was followed by the real estate and construction sector (7) and power and utilities (2).

By value, however, the Khazanah Nasional Sukuk, which raised US$985.6 million, made the financial services sector the largest receiver of funds from sukuk in this period. The financial services sector was followed by the power and utilities sector with US$532 million worth of sukuk issues and the real estate sector with US$352 million. Other sectors such as agriculture, food and beverages, and telecommunications held a limited share with only one sukuk issuance per sector, and values ranging between US$88 million and US$210 million.

Global Sukuk Issues by Sector (1996-2001)



Note: Bubble size denotes value.

Source: Zawya Sukuk Monitor

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During this period, product innovation was limited; only a few Islamic structures were employed to issue sukuk

1996-2001

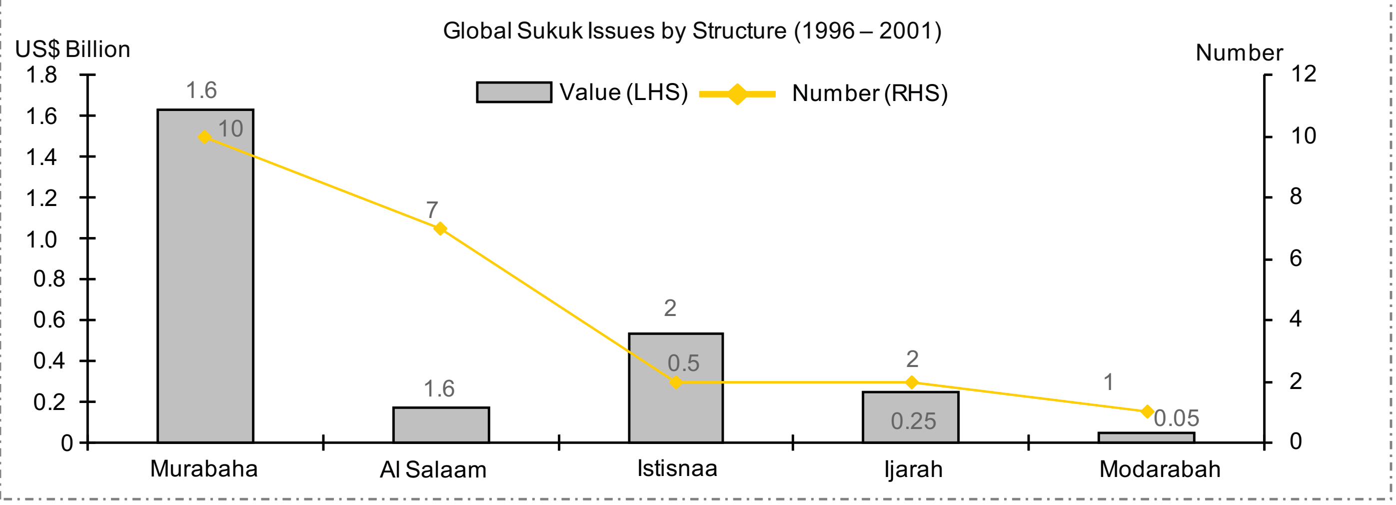
Pricing information was unavailable for the majority of issues in this phase; only two Ijarah Sukuk issued in 2001 displayed pricing data.

This period witnessed the first international sukuk offering, First Global Sukuk Inc, which was a floating rate sukuk priced at LIBOR plus 150 basis points.

Product development was in its initial stages, the Islamic contracts used in structuring sukuk were Murabaha, Al Salaam, Istisna'a, Ijarah and Modarabah. The Murabaha structure was utilized to structure sukuk for the real estate sector in this phase.

Global Sukuk Issues by Pricing (1996-2001)

Type	Number	Value (US$ billion)
Fixed	8	0.28
Floating	1	0.15
Unknown	13	2.20



Source: Zawya Sukuk Monitor

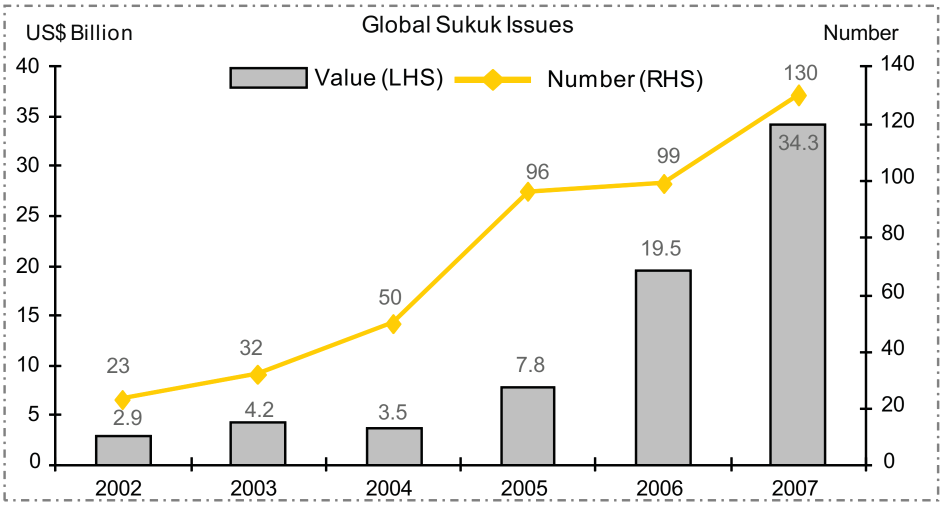
Trend analysis - Phase 2
Global Sukuk issuance (2002-2007)

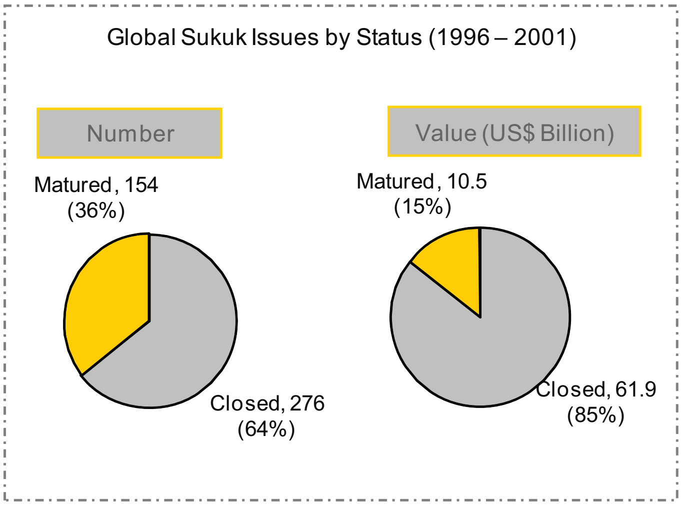
A total of 430 issues were recorded in this phase, totaling US$72.3 billion, of which US$61.9 billion remained outstanding at the end of September 2009

2002-2007

430 sukuk were issued during 2002 and 2007, totaling US$72.3 billion. US$61.9 billion of these issues remained outstanding at the end of September 2009. This period (2002-2007) witnessed boom in sukuk issuance. Economic resurgence in the Far East and rapidly rising oil prices in the Middle East drove issuance to new highs; at a CAGR of 66% from 2002 to 2007, reaching a peak of US$34 billion in 2007.

Sukuk issuance captured significant attention from all market players in this phase. The GCC's rising hydrocarbon revenues due to high oil prices and the real estate boom led to a significant number of large issues and attracted the attention of global investors to this emerging asset class.





Source: Zawya Sukuk Monitor

Thirteen countries issued Sukuk with the majority originating from Malaysia and the GCC

2002-2007

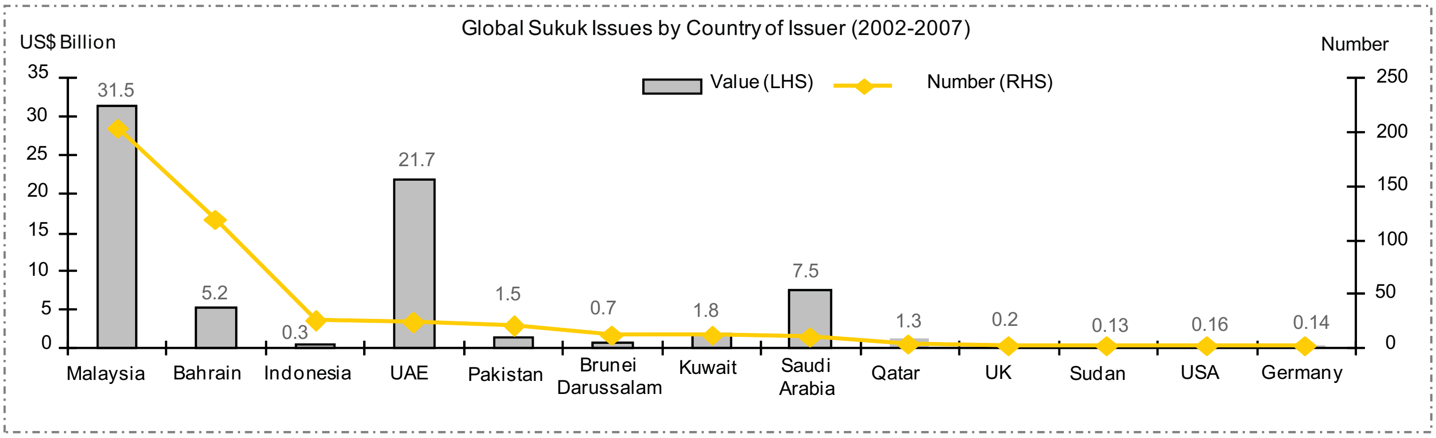
Compared to the previous phase (1996-2001), this phase witnessed participation from a number of countries.

In 2001, the Malaysian Finance Minister introduced the "Capital Markets Masterplan", a set of objectives linked with a series of initiatives and recommendations aimed at developing the capital markets in Malaysia within the next ten years. The blueprint paved the way for a remarkable increase in sukuk issuance from Malaysia in this period. Asian issuers from countries such as Brunei, Indonesia and Pakistan were also active, increasing Asian sukuk issues to 259 with a total value of US$34.2 billion. In the GCC, the Central Bank of Bahrain was the major issuer in this period; issuing 64% of total GCC sukuk issues.

The largest sukuk issuance to date was recorded in this phase, the US$3.56 billion issue from Binariang GSM Sdn Berhad in Malaysia.

This period also registered participation from European, American and African issuers. Stiching Sachsen-Anhalt Trust, a special purpose vehicle owned by the German State of Saxony-Anhalt issued the first sukuk in Europe in 2004. The East Cameron Gas Company, a Texas based oil company, issued the first American sukuk in 2006 while Berber Sukuk Company issued the only African sukuk in 2007.

Malaysia remained active and dominant in Sukuk issuance during this phase with over 200 Sukuk issues valued at US$31.5 billion, UAE followed at US$21.7 billion with a few large issues.



Source: Zawya Sukuk Monitor

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US Dollar issuance dominated this phase due to a larger number of international issuances and the preference of GCC issuers to borrow in dollars

2002-2007

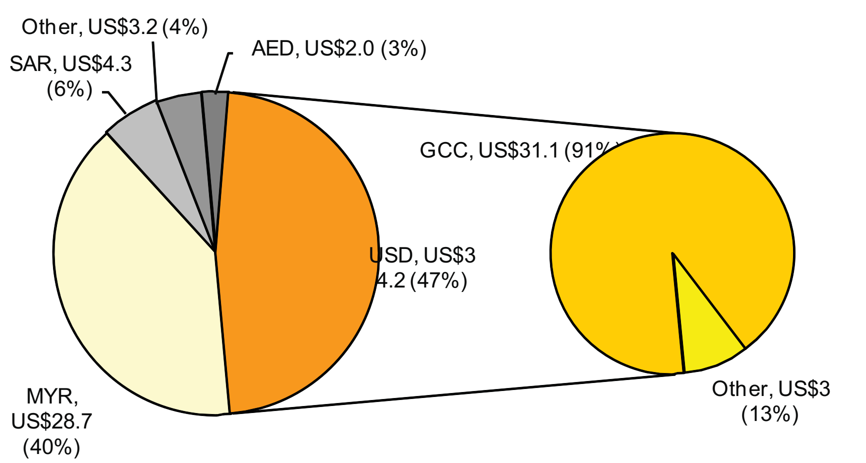
Sukuk issuance crossed Muslim borders in this phase and gained international acceptance.

The US Dollar was the dominant currency, as this was mainly favored by GCC issuers; 91% of US Dollar denominated sukuk were from the GCC. The US Dollar has traditionally been favored by regional investors due to the peg of GCC currencies (except Kuwait) to the US Dollar. A large number of international issuers also favored the US Dollar due to its acceptability to international investors. Other major currencies such as the Euro and British Pound have only been visible in a few issues due to the lack of issuances from their respective regions.

Number of Global Sukuk Issues by Currency
(2002-2007)

Currency	Number of Issues
Malaysian Ringgit (MYR)	198
US Dollar (USD)	138
Bahraini Dinar (BHD)	33
Indonesian Rupiah (IDR)	25
Brunei Dollar (BND)	11
Pakistani Rupee (PKR)	17
Saudi Riyal (SAR)	4
Euro (EUR)	2
United Arab Emirates Dirham (AED)	1
British Pound (GBP)	1

Value of Global Sukuk Issues in US$ billion by Currency (2002-2007)



Source: Zawya Sukuk Monitor

Average issue size rose to US$168.3 million, up 40% from the previous phase

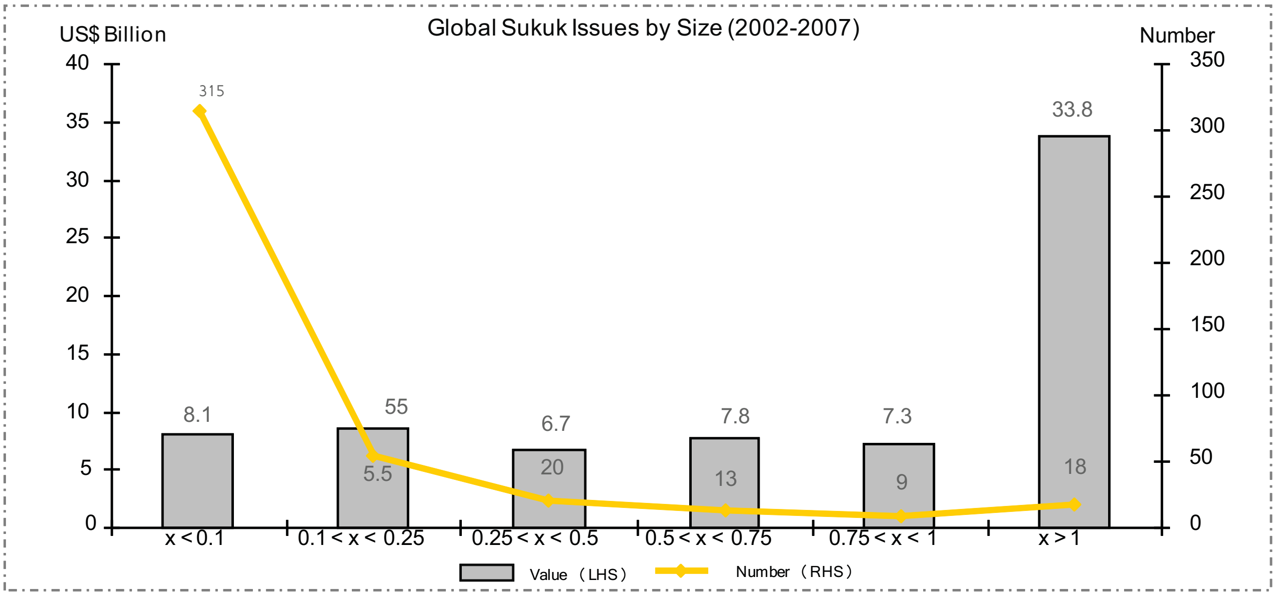
2002-2007

The increase in sukuk issues along with their values raised the average size of sukuk from US$119.9 million (1996-2001) to US$168.3 million in this phase.

Most issues were small (73%), ranging less than US$100 million in size. A small number of large issues increased the average size of sukuk in this phase to US$168.3 million. The rapid development of Islamic finance and the shift towards Shari'a compliant financing by a large number of issuers prompted the jump in small issues.

In terms of value, sukuk exceeding US$1 billion accounted for approximately half of the value of sukuk issuance. It is worth mentioning that three sukuk exceeded US$3.5 billion in value, issued by:

- Nakheel - UAE
- Ports Customs & Free Zone Corporation (PCFC) - UAE
- Binariang GSM Sdn Berhad - Malaysia



Source: Zawya Sukuk Monitor

Corporates were still the main contributor to sukuk issuance, although sovereign issuers were also active

2002-2007

Corporates continued their dominance in this phase, accounting for 64% of total sukuk issuance by number and 59% by value. In terms of number of issues, Malaysian corporates were the most active in the market. The vibrancy of the Malaysian sukuk market is due to well developed regulations, trading facilities and overall government support. Prominent Malaysian corporate sukuk issued in this period included:

- Binariang MTN Sukuk (US$3.5 billion)
- Cagamas IMTN Sukuk (US$1.9 billion)
- Tanjung Bin Power Sukuk (US$1.6 billion)

GCC corporates also contributed their share to global corporate sukuk issuance. The economic boom that occurred in the GCC allowed a wide range of corporates operating in different sectors to issue sukuk. These include:

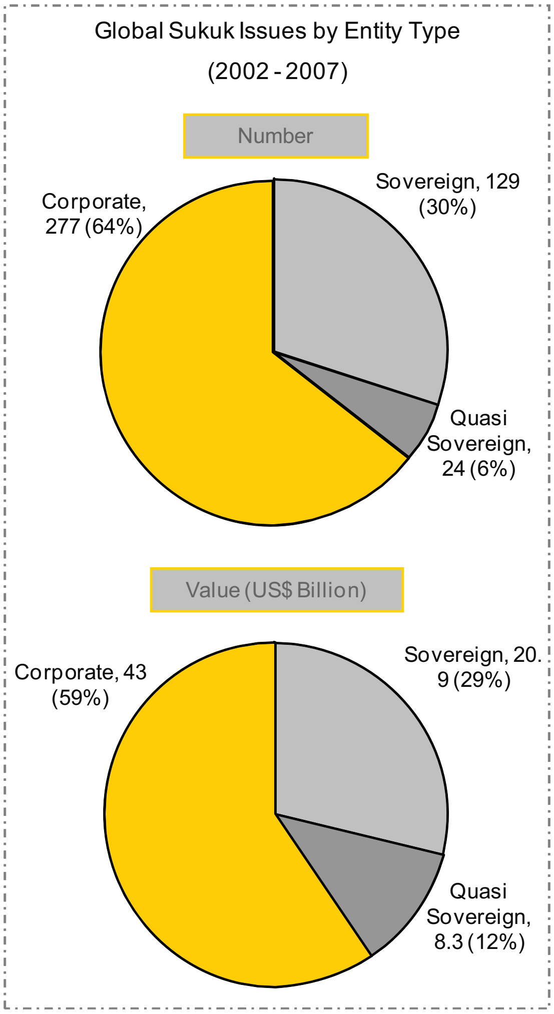
- Aldar Properties Sukuk (US$2.5 billion) in the real estate sector
- SABIC Sukuk II (US$2.1 billion) in the oil and gas sector, and
- DP World Second Sukuk (US$1.5 billion) in the transport sector

This phase also witnessed the issuance of quasi sovereign sukuk, mainly from Malaysia and the GCC. Such government backed sukuk have satisfied investor appetite for low risk investments and stable returns and have been a conscious attempt by governments to add depth to the sukuk market. Major quasi sovereign sukuk from Malaysia in this phase include:

- Rantau Abang Capital IMTN Sukuk (US$2.0 billion)
- PLUS Senior Sukuk (US$1.0 billion) and
- Khazanah Nasional Exchangeable Sukuk II (US$850 million)

The major quasi-sovereign sukuk which originated from the GCC were:

- Nakheel Sukuk (US$3.52 billion) and
- PCFC Sukuk (US$3.5 billion)



Source: Zawya Sukuk Monitor

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The real estate and construction sector accounted for the largest issuance, totalling US$20.6 billion, followed by government issues

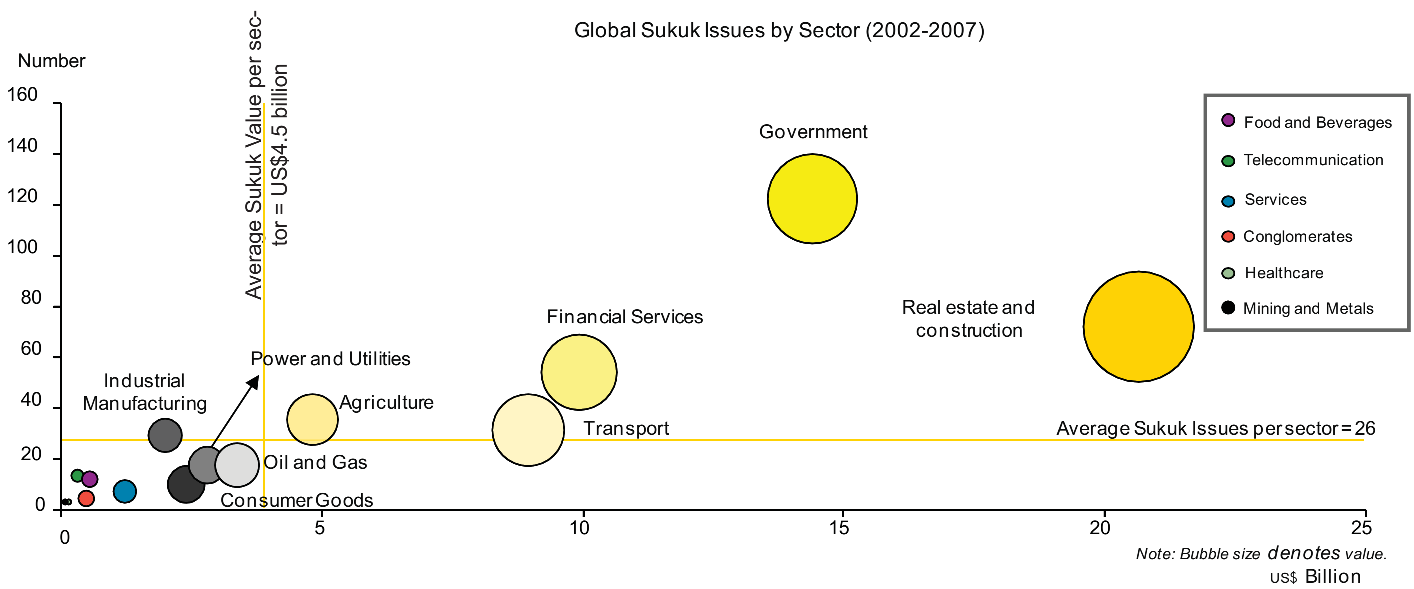
2002-2007

Compared to the previous phase (1996-2001) where participation was witnessed in only a few sectors, sukuk issuance during 2002 to 2007 was broad based, indicating participation from a multitude of economic sectors.

The government sector, dominated by the Central Bank of Bahrain (59% of issuance in this sector), recorded the highest number of sukuk issuance in this phase. The real estate and construction sector was the largest in terms of value due to the real estate boom in the Gulf and the ease of real estate in asset backing, which is a requirement for all sukuk. The largest real estate sukuk issuances were in the GCC, namely the:

- Nakheel Sukuk (US$3.52 billion)
- Aldar Properties Sukuk (US$2.53 billion) and
- JAFZ Sukuk (US$2.0 billion)

Sukuk issuance in the real estate and construction sector reached US$20.6 billion, followed by the government sector (US$14.4 billion) and the financial services sector (US$9.9 billion).



Source: Zawya Sukuk Monitor

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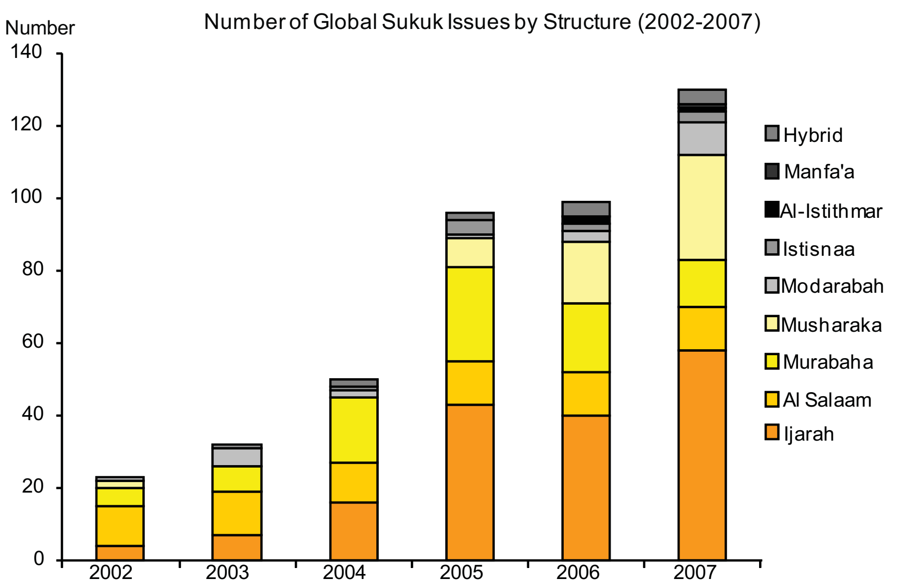
Musharaka was the dominant structure by value and Ijarah was the highest by number in this period compared to Murabaha, which dominated by value and number in the previous period

2002-2007

A diverse range of Islamic structures was utilized in structuring sukuk in this phase, which also saw the introduction of hybrid sukuk by Dawama. The US$29.4 million Dawama Sukuk comprised of a combination of Ijarah and Murabaha structures and was the first time a combination of structures was used for a sukuk issue.

In the previous phase (1996-2001), Murabaha remained the dominant structure. In this phase, the Ijarah structure, which is easily understood by investors due to its similarity to leasing and adaptability for different sectors, gradually increased in popularity, reaching approximately 39% of total issuance by number. Murabaha (20%) and Al Salaam (16%) also had significant shares. The Istithmar structure, based on the agency contract also gained in popularity in 2006 and 2007.

In terms of value however, Musharaka sukuk held the largest share of US$26.3 billion (36%) of the total value of sukuk issuance in this phase, followed by the Ijarah (US$20.4 billion) and Modarabah (US$8.0 billion) structures.



Value of Global Sukuk Issues by Structure (2002-2007)

Structure	Value (US$ billion)
Musharaka	26.3
Ijarah	20.5
Modarabah	8.0
Murabaha	4.9
Istisna'a	4.1
Al-Istithmar	2.9
Hybrid	2.8
Al Salam	1.9
Other	1.0

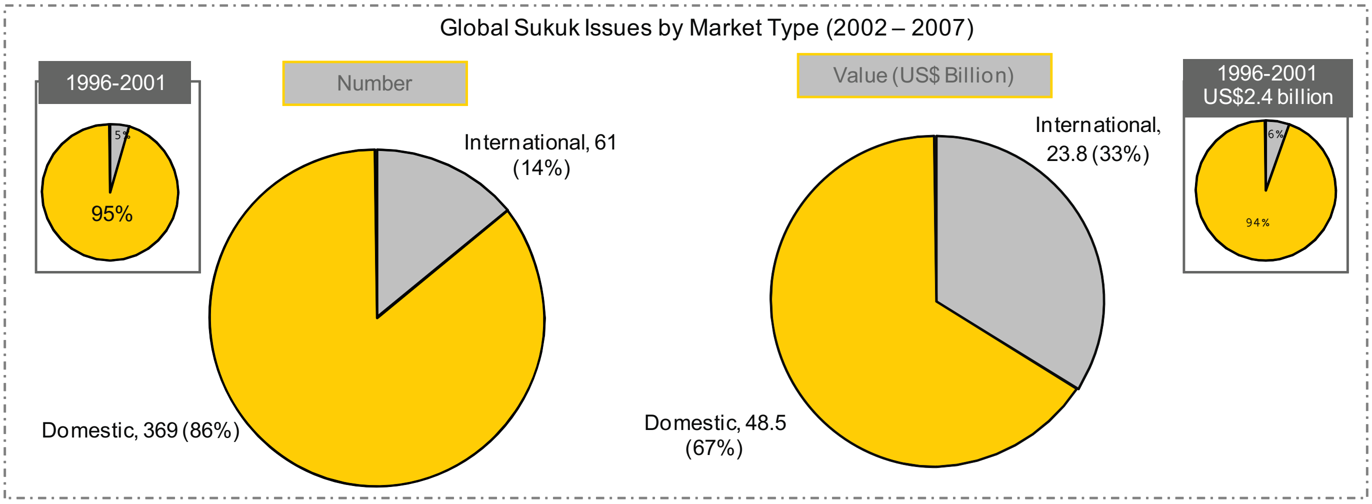
Source: Zawya Sukuk Monitor

Sukuk have predominantly been domestic financing instruments, but a slight shift is being witnessed towards international issuance

2002-2007

Compared to the previous phase (1996-2001) in which 95% of the issues were domestic, 86% of issues were domestic in this phase as issuers started accessing international investors along with tapping their domestic markets. In terms of value, the foreign share increased more dramatically – from 6% in the previous phase to 33% during 2002-2007.

The increase in international issues coincided with increased investor understanding of Islamic finance and the desire to gain exposure to the fast growing Gulf region. The issuers in this phase comprised a number of foreign governments, who were keen to explore the Islamic finance space.



Source: Zawya Sukuk Monitor

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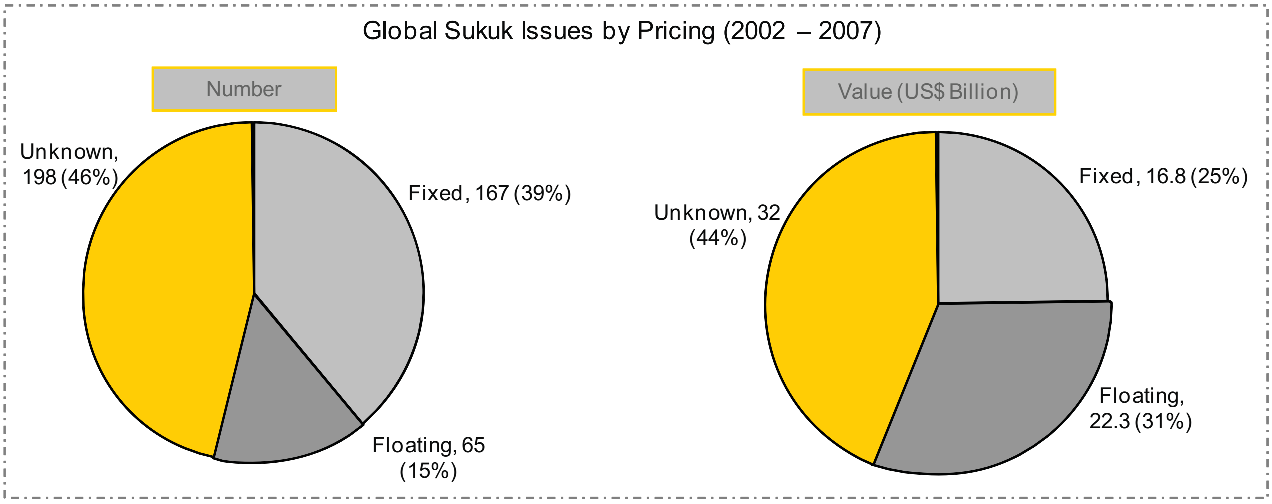
The absence of an Islamic pricing benchmark remains a challenge faced by the sukuk market

2002-2007

Pricing information was missing for 198 sukuk issues in this phase. Of the 232 issues for which pricing data was available, the majority carried fixed returns as opposed to floating rates.

The floating rate sukuk were associated with global as well as regional benchmarks. Approximately 70% of floating sukuk were priced using LIBOR as the benchmark. Others were associated with global as well as regional benchmarks such as KIBOR, SIBOR, EURIBOR and EIBOR. The majority of sukuk with unknown pricing originated from Malaysia.

The absence of an Islamic yield curve has hampered the pricing of sukuk and the recent issuances from sovereigns and multilateral agencies are attempts to create a yield curve which may help in pricing of subsequent issues.



Source: Zawya Sukuk Monitor

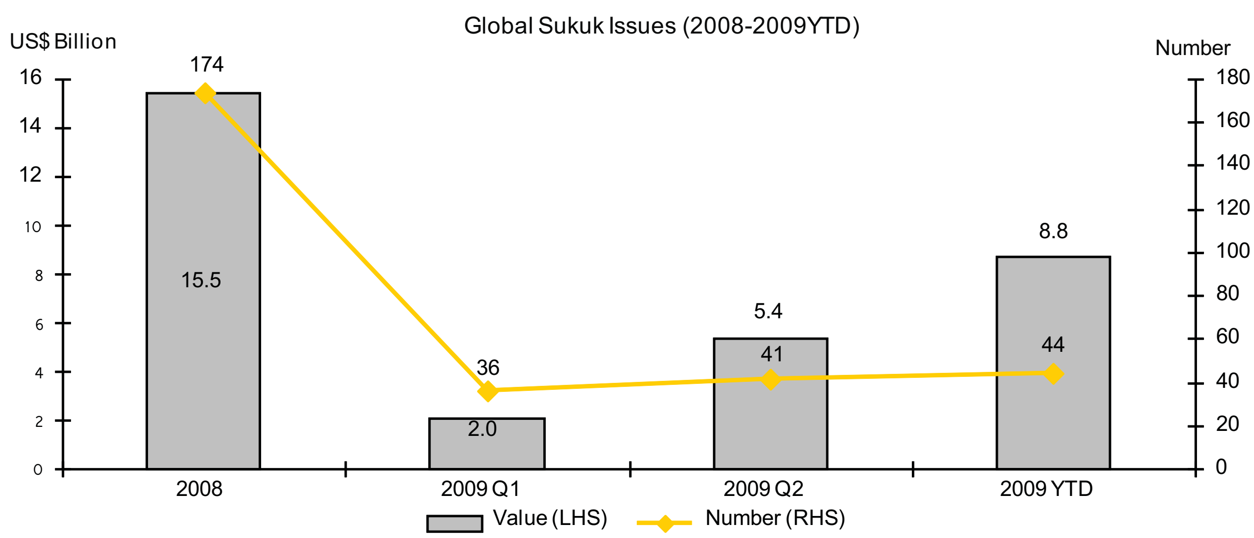
Trend analysis - Phase 3
Global Sukuk issuance (2008-2009 YTD)

The sukuk market was affected by the global financial crisis, issuance fell to US$15.5 billion in 2008 but rebounded in 2009 YTD to US$16.2 billion

2008-2009 (YTD)

The global financial crisis affected the sukuk market adversely. Sukuk issuance fell sharply from a peak of US$34.2 billion in 2007 to US$15.5 billion in 2008. The reasons for the fall were numerous, falling oil prices and depressed economic conditions were obvious while Shari'a issues concerning Musharaka sukuk after a statement from AAOIFI on Shari'a compliance also had negative repercussions on the market. Another reason for the slowdown the first sukuk default which opened up many legal questions regarding rights of sukuk holders. Several planned sukuk issuances were cancelled or postponed such as the National Bank of Abu Dhabi's US$1.7 billion sukuk program.

The first nine months of 2009 saw a revival in sukuk issuance brought about mainly by issues from sovereign and quasi-sovereign entities. One of the issues that stood out in this phase was the US$1.4 billion Terengganu Investment Authority Sukuk, issued on behalf of the Malaysian government. The Dubai government, Islamic Development Bank and the International Finance Corporation also issued sukuk in this phase to raise finances and add depth to the sukuk market. Issuance in 2009 YTD has already crossed total 2008 issuance and is expected to grow further as more issuers tap the sukuk market.



Source: Zawya Sukuk Monitor

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Not all sukuk issues have survived the economic downturn, several sukuk defaults have been announced, raising the issue on the rights of sukuk holders in the event of a default

2008-2009 (YTD)

The financial crisis served as a test for the Islamic finance industry, particularly for sukuk, which as an asset class had not experienced a single default.

As a consequence of the crisis and poor economic conditions, the sukuk market witnessed a few defaults and this has raised a number of issues with regards to the rights of sukuk holders vis-a-vis other creditors. A number of issuers are experiencing financial difficulties and have initiated restructuring exercises. Nakheel has been under financial stress and the Dubai government is expected to assist the real estate developer in meeting payments to creditors. Nakheel announced that it will be revising its terms of payments on its US$750 million sukuk and would restructure its debt. The other Nakheel issue, the flagship US$3.5 billion issue is also due soon and Nakheel is exploring options with regards to meeting obligations.

A lot also hinges on courts' interpretation of sukukholders' rights. The issue of asset based versus asset backed sukuk has come to the fore and the rights of sukukholders regarding ownership of the underlying assets used to issue sukuk will play an important role in the development of the sukuk market.

Notable sukuk defaults are shown below:

East Cameron Gas Company

- The American oil and gas company, issuer of the US$165 million sukuk filed for chapter 11 Bankruptcy under US laws in October 2008.

Investment Dar

- The Kuwaiti investment company, part owner of British car maker Aston Martin, defaulted on its US$100 million sukuk in May 2009.

Golden Belt

- A special purpose vehicle owned by Maan Al Sanea (Saad Group) defaulted on a US$650 million sukuk in August 2009.

Source: Zawya Sukuk Monitor

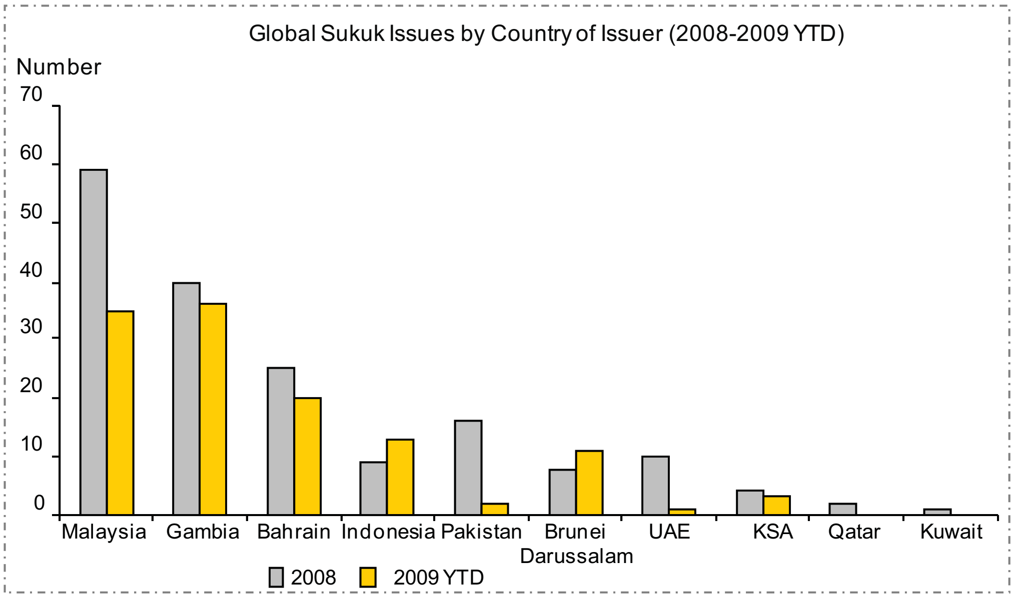
The Malaysian sukuk market had the largest value of sukuk issues post the financial crisis followed by Bahrain and Indonesia

2008-2009 (YTD)

Malaysia issued the largest value of sukuk in this period. Issuance till 2009 (YTD) even surpassed the total issuance in 2008, displaying the strong rebound in the Malaysian market.

The strongest post crisis comeback was in Indonesia. Even though the number of sukuk issues dropped by 2009 (YTD), the value of Indonesian sukuk issuance reached US$1.52 billion, which included the Government of Indonesia Retail Sukuk with a value of US$487.2 million.

Gambia and Bahrain accounted for a large number of issues due to their respective central banks issuing sukuk regularly. Gambia issued a large number of sukuk, but each issue was quite small thus the total value of issuance from the African nation was small compared to other countries. Other GCC nations such as the UAE only accounted for a small portion of issuance in 2009 (YTD) but recent issues announced by the Dubai government and state linked entities are expected to provide some impetus to the market.



Value of Global Sukuk Issues in US$ Billion

	2008	2009 (YTD)
Malaysia	5.75	9.21
UAE	5.30	0.40
KSA	1.87	2.92
Bahrain	0.70	1.48
Indonesia	0.69	1.52
Pakistan	0.44	0.37
Qatar	0.30	-
Brunei	0.21	0.28
Kuwait	0.19	-
Gambia	0.01	0.02
Total	**15.5**	**16.2**

Source: Zawya Sukuk Monitor

The Malaysian Ringgit was the dominant currency of issuance in this period due to the large number of sukuk issues originating from Malaysia

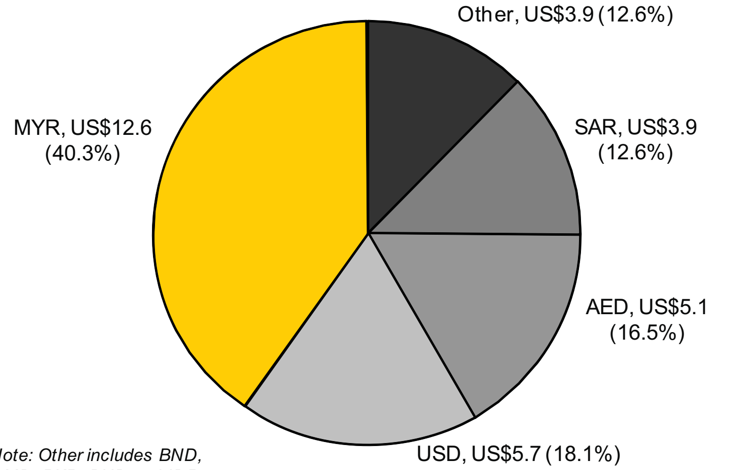
2008-2009 (YTD)

Unlike the previous phase (2002-2007), the share of US Dollar issuance in the sukuk market declined during the last two years. Only ten sukuk issues were denominated in the US Dollar in this phase, with a total value of US$5.7 billion. The decline in value of the US Dollar pushed GCC issuers to issuing sukuk denominated in their local currencies such as the UAE Dirham and Saudi Riyal to attract investors. The increase in domestic issues has led the Malaysian Ringgit to regain its leading position as the dominant currency for issuing sukuk. The amount of sukuk issued in the Gambian dollar is high due to heavy involvement of the Central Bank of Gambia.

Number of Global Sukuk Issues by Currency (2008-2009 YTD)

Currency	Number of Issues
Malaysian Ringgit (MYR)	92
Gambian Dalasi (GMD)	76
Bahraini Dinar (BHD)	43
Indonesian Rupiah (IDR)	21
Brunei Dollar (BND)	19
Pakistani Rupee (PKR)	18
US Dollar (USD)	10
UAE Dirham (AED)	10
Saudi Riyal (SAR)	6
Total	295

Global Sukuk Issues by Currency in US$ Billion (2008–2009 YTD)



Note: Other includes BND, GMD, PKR, BHD and IDR.

Source: Zawya Sukuk Monitor

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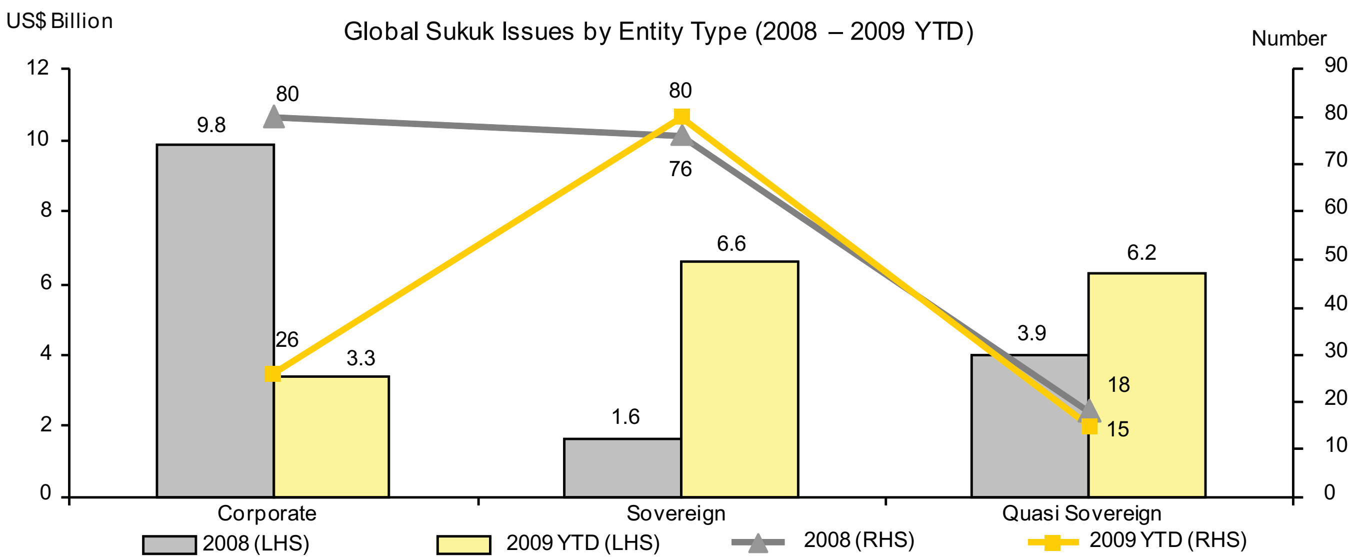
The financial crisis made way for sovereign entities to become more active than corporate issuers in this phase

2008-2009 (YTD)

The financial crisis produced difficult market conditions for issuing debt by corporates. The demand for sovereign issuance has increased as investors became more comfortable with sovereign issues due to their better risk profile.

The number of corporate issues significantly dropped in 2009 as investors became more cautious due to defaults. The market share of corporate sukuk issues decreased from 46% in 2008 to approximately 21% by September 2009. On the other hand, sovereigns and quasi sovereigns which are enjoying a stronger position than corporates have seen their share in issuance increase. In 2008, sovereigns accounted for 44% of issues in terms of number and 10% (US$1.6 billion) in terms of value. This changed in 2009 as sovereigns held 66% of the market share and 41% of the total value of issued Sukuk as of September 2009. Meanwhile, the number of quasi sovereign sukuk dropped from 18 issues in 2008 to 15 in 2009 but the value increased by almost 56% to US$6.2 billion. Examples of prominent sovereign issues are the Dubai government, the Islamic Development Bank and the International Finance Corporation issues (multilateral agencies possess a similar risk profile to sovereigns).



Source: Zawya Sukuk Monitor

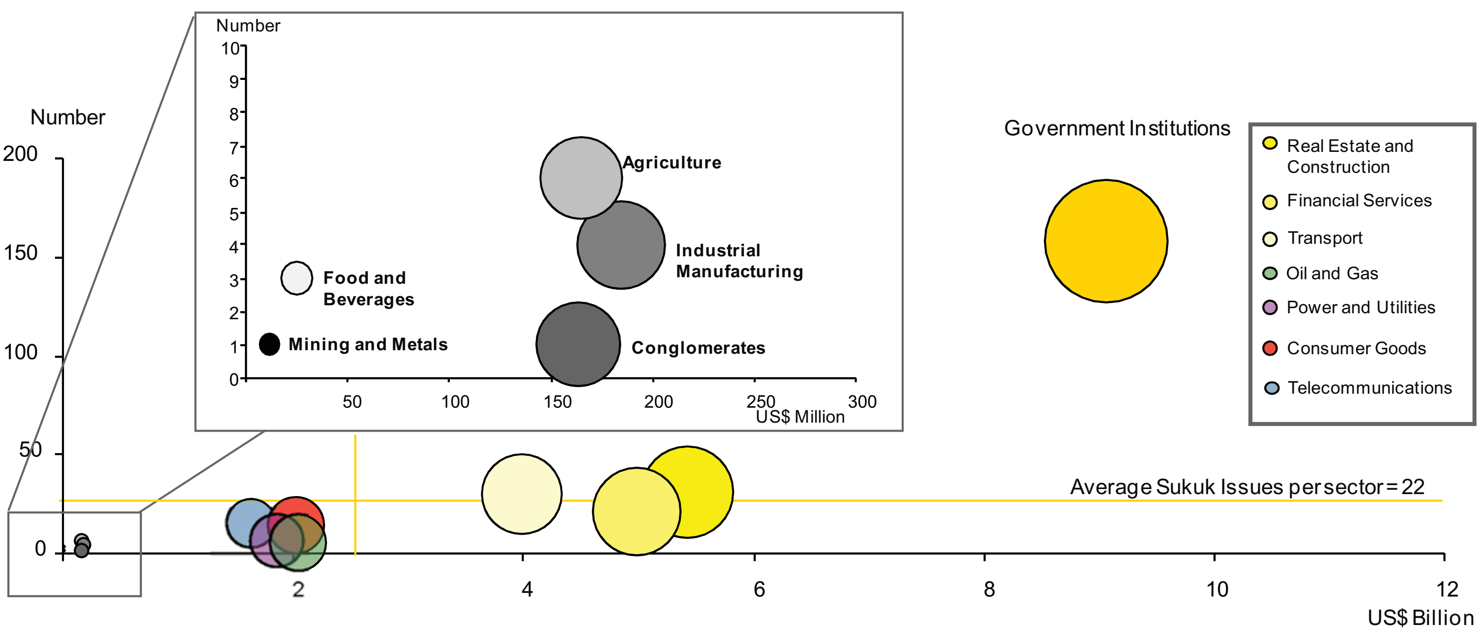
Sukuk issued by governments were the highest in terms of both value and number in this period

2008-2009 (YTD)

As mentioned before, governments have been more active in the sukuk market in this period. Large issuances from the Dubai government and multilateral agencies have dominated the market as investors have displayed increased risk aversion due to the prevailing economic circumstances. As signs of a rebound start appearing, more corporates may enter the market but as it stands, government issues will dominate in the near term.

The Dubai government has announced a US$6.5 billion debt issuance program, of which approximately US$ 2.5 billion is to come from sukuk issuance. This will further lead to skewing of sukuk issues towards the government sector. The increase in activity by governments is a positive sign for the sukuk market and there is a focused attempt to increase issuances to develop a yield curve.

Global Sukuk Issues by Sector (2008-2009 YTD)



Source: Zawya Sukuk Monitor

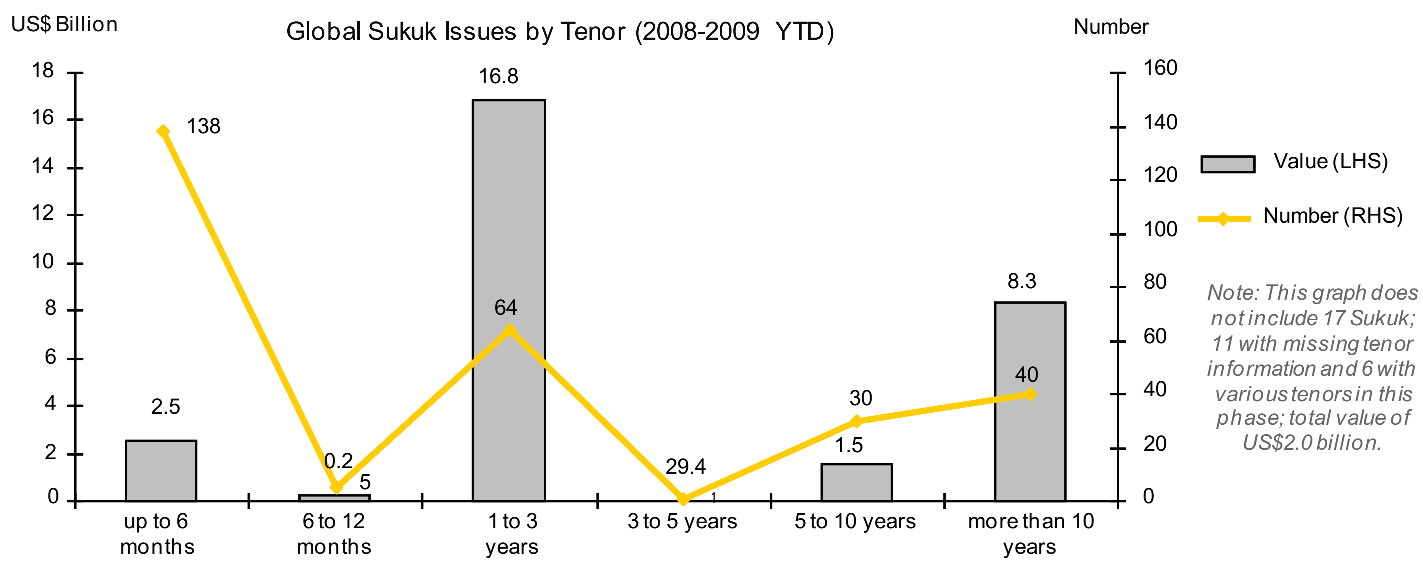
Sukuk tenors are gradually spreading out over the entire maturity range, although medium term issuances account for the majority of issues

2008-2009 (YTD)

The financial crisis decreased corporate sukuk issuance, which usually carry medium or long tenors.

Tenors of less than six months, which are mostly preferred by sovereigns stand for 48% of the total number of sukuk issuance in this phase. Yet, they only represent 13% of the total value of sukuk issuance. Sukuk with short to medium tenor (one to three years) form the largest portion of sukuk values, amounting to US$8.3 billion.

Similar to the previous phase, which had more than 40 sukuk issues carrying tenors of more than ten years, this phase also recorded a large share of sukuk issuance in this tenor category in both number and value. Sukuk carrying tenors of more than ten years stand for US$7.2 billion in value from 40 issues. These include the prominent SABIC Sukuk III (US$1.3 billion) carrying a tenor of twenty years.



Source: Zawya Sukuk Monitor

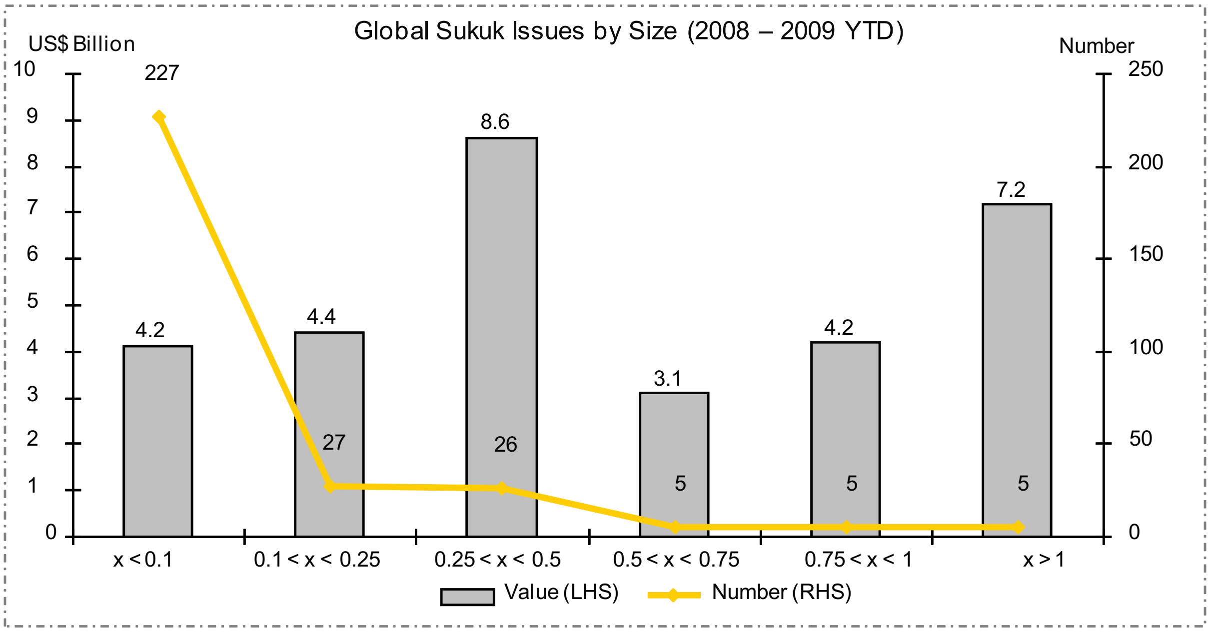
Driven by sovereign issuances, a large percentage of sukuk issuance was under the US$100 million mark

2008-2009 (YTD)

As corporate issuance dropped, allowing sovereign issuance to take the lead, sukuk sizes of less than US$100 million recorded the largest share in terms of number of sukuk issued in this phase (77%).

The majority of sukuk issuance under US$100 million has been from sovereigns, reinforcing the objective of sovereign sukuk issuance, which is liquidity management for Islamic banks and the establishment of a yield curve. Sovereigns comprised 60% of the total number of sukuk issuance under US$100 million. Even though there were a number of large issues, the small issue sizes brought down the average sukuk size for this period to US$107.3 million, down by approximately US$60 million from the previous phase (2002-2007). Even though smaller issues have originated from governments in the past, sovereign issuance is expected to account for the largest issues in the future as evidenced by the Dubai government's recent announcement regarding a sukuk issue worth a US$2.5 billion sukuk issuance programme.

Sukuk issuance between US$250 million and US$500 million represents the largest share by value. This category includes weekly sukuk issuance by Bank Negara which started in August 2009 and ended a month later; each sukuk was valued at US$294.2 million and carried tenors of six months and less.



Source: Zawya Sukuk Monitor

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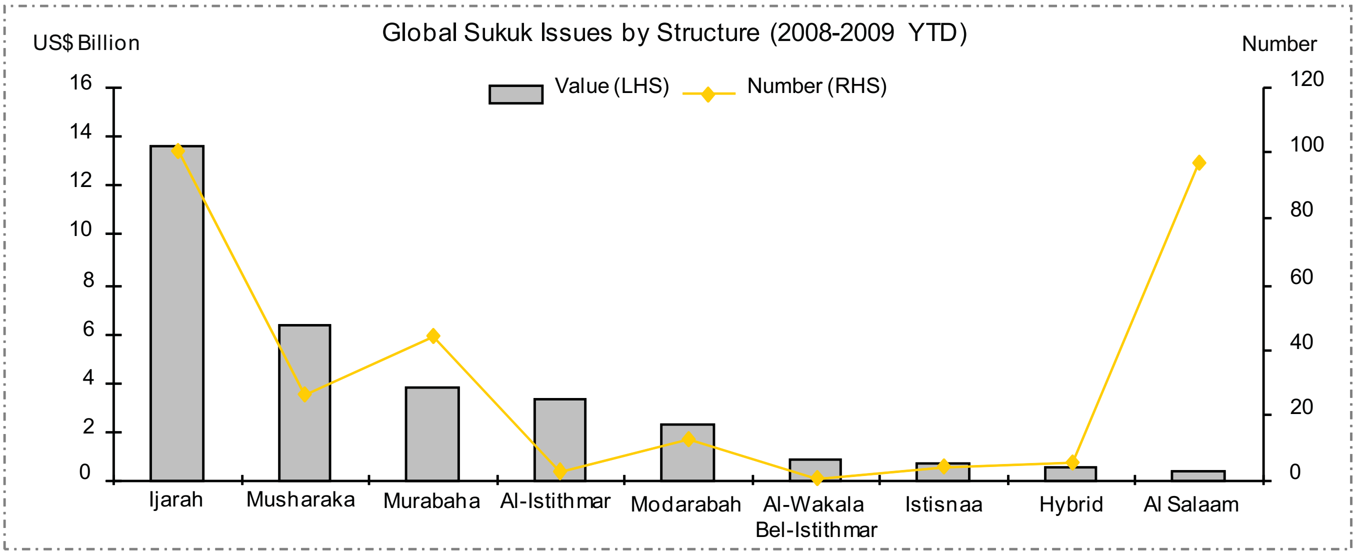
The Ijarah structure's widespread acceptability led to its dominance in this period

2008-2009 (YTD)

Sukuk issuance in 2008 took another hit when Sheikh Taqi Usmani, Head of AAOIFI's Shari'a committee, announced that 85% of sukuk were not Shari'a compliant. The announcement was generally misquoted as it was not intended to be a broad notation on all issued sukuk, but only related to Musharakah and Modarabah sukuk – two structures that were contributing heavily to issuance in 2007. Sheikh Usmani declared that sukuk based on these two structures were in violation of Shari'a as they guaranteed principal to investors. In his opinion, this was in contrast to the rules of Shari'a, which state that principal guarantee is prohibited; only risk sharing is permissible to justify profits earned by investors.

The effects of Sheikh Usmani's announcement were clearly visible. There was a marked slowdown in the issuance of Musharaka and Mudaraba sukuk compared to other structures in 2008 and year to date 2009. The fall in sukuk issuance was also due to generally dismal economic conditions. Ijarah, with its leasing structure (which is easily understood), gained prominence and was used by a large number of issuers; the ease of asset backing with this structure also contributed to its popularity.



Source: Zawya Sukuk Monitor

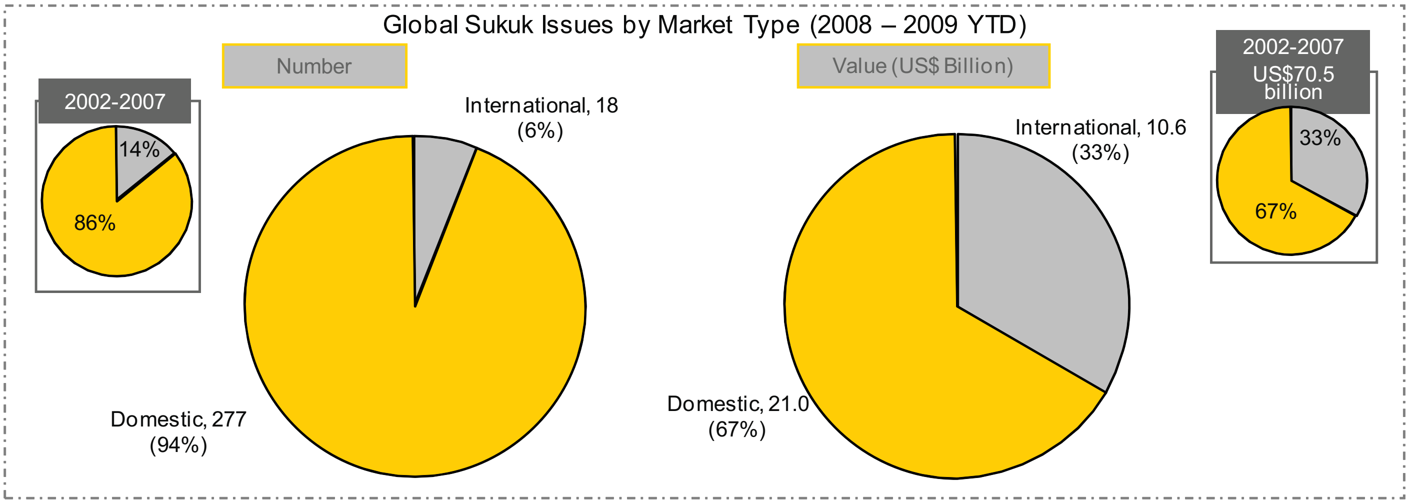
The majority of issuance remained domestic (by number) in this phase while issuance by value maintained the same parity

2008-2009 (YTD)

The share of international sukuk issuance fell from 14% (2002-2007) to 6% in this phase by number, however their share in value remained unchanged at 33%.

The proportion of domestic issues rose in this period but the larger issuer size of international offerings resulted in maintaining parity in the overall split by value compared to the previous phase.

Issuers are preferring to opt for local currency issues and are raising funds from home markets, due to greater liquidity compared to Western economies.



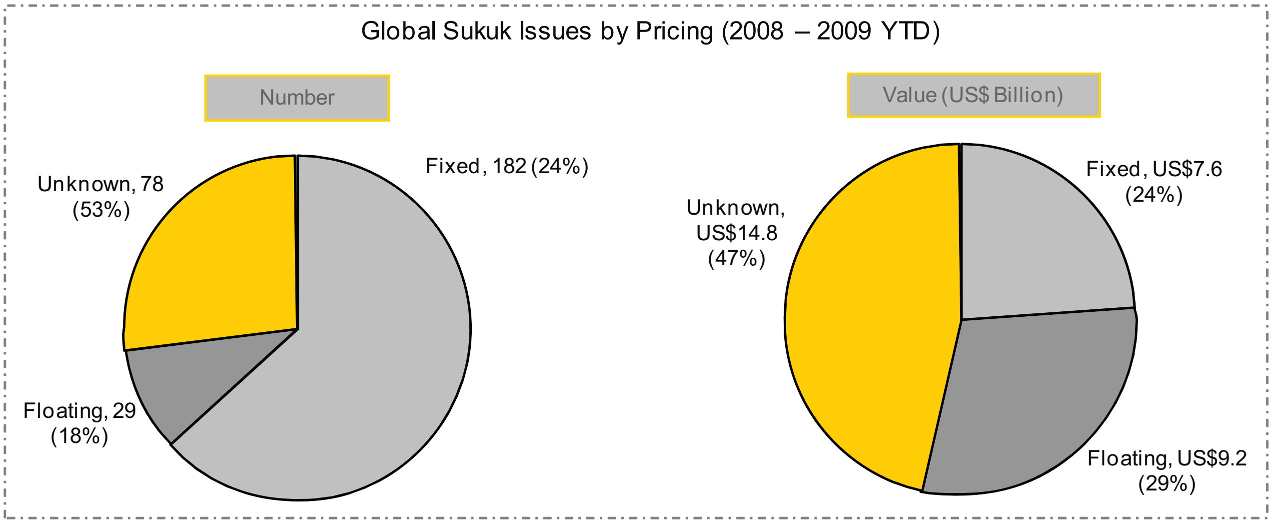
Source: Zawya Sukuk Monitor

Pricing still remains skewed towards fixed rates in the absence of an Islamic benchmark

2008-2009 (YTD)

The absence of an Islamic yield curve, which has been mentioned earlier as a hindrance for pricing sukuk still presents an issue in the current period. The majority of issuances in this period were fixed in nature, only a few were floating, although by value, floating rate sukuk comprised a bigger share.

Attempts to create an Islamic yield curve are being made presently. The entry of institutions like the International Finance Corporation and the Islamic Development Bank is a positive move in this direction. The Islamic Development Bank is also in the process of creating a mega Islamic bank which will aim to finance large scale projects and assist in the creation of a global Islamic inter-bank market. An Islamic benchmark rate will greatly enhance depth (in terms of tenors) and pricing in the sukuk market.



Source: Zawya Sukuk Monitor

The future of the Sukuk market

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Sukuk Pipeline: US$31 billion worth of sukuk issues have been announced, with another US$3.1 billion rumored

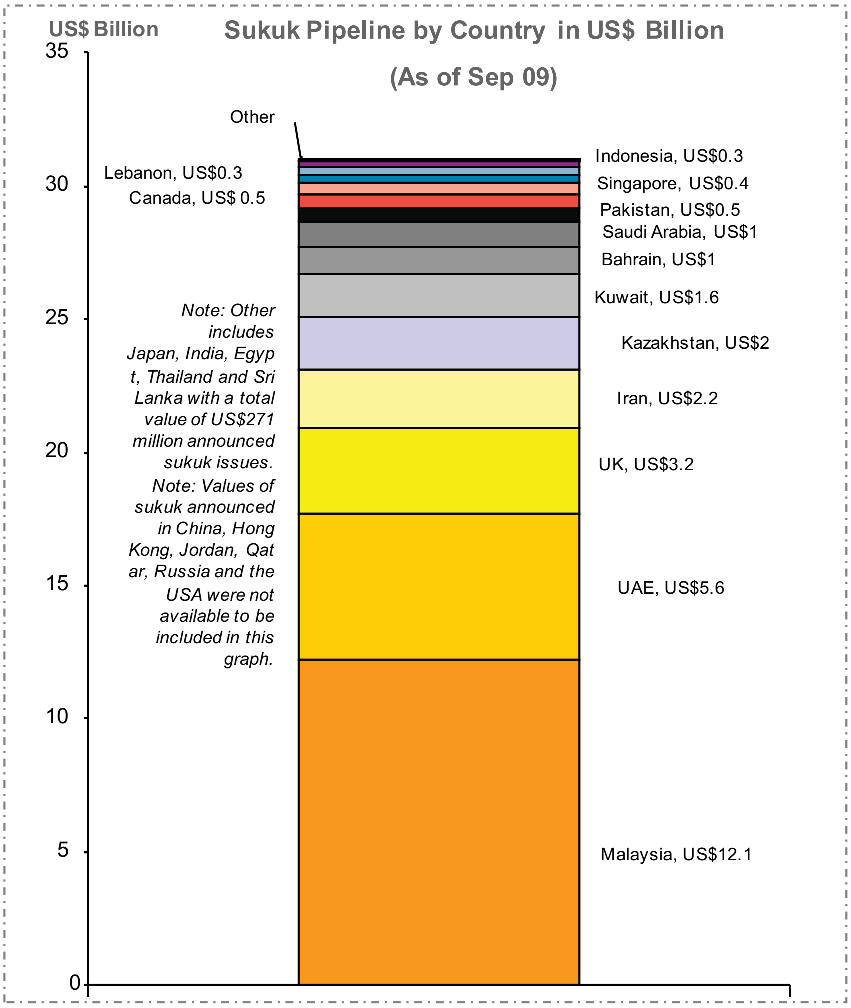
Investors' confidence is expected to rise with the start of the new year as US$31 billion worth of sukuk have been announced by the end of September 2009. Another US$3.1 billion are rumored and yet to be confirmed.

The sukuk market is expected to receive a boost with new sukuk announcements from Canada, China, Egypt, South Korea, Hong Kong, India, Japan, Singapore, Jordan, Kazakhstan, Russia, Sri Lanka and Thailand.

The Indonesian government will join the list of countries issuing sukuk on a regular basis for Islamic institutions to manage liquidity and raise funds to meet the budget.

Another major announcement pertains to the Islamic Republic of Iran, which has also announced that it is planning on issuing US$12.3 billion worth of sukuk within the next three years.

- US$5.8 billion by Pengurusan Aset Air (Malaysia);
- US$3.1 billion by the UK government;
- US$2.2 billion by Pars Oil and Gas Company (Iran);
- US$2.0 billion by the Government of Kazakhstan; and
- US$2.0 billion by Emaar (UAE)



Source: Zawya Sukuk Monitor

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Future of Sukuk
Directions towards the future

Greater foreign and sovereign participation

Sukuk are expected to grow in importance on the radar of global investors as more government issuers jump on the bandwagon. Sovereign issuers from European and Far East Asian countries (UK and South Korea are notable examples) are considering issuing sukuk. This is in addition to the already established sukuk programs of many Islamic countries.

Establishment of a yield curve

Sovereign and multilateral issuers are also attempting to establish a yield curve by instituting regular sukuk issuance programs as witnessed by the International Finance Corporations Hilal sukuk issue, which is the first of many proposed by the multilateral agency. Governments, such as the Dubai Government are also planning on issuing large sukuk to help develop a benchmark encompassing several tenors and different risk profiles.

Development of a secondary sukuk market

Sukuk trading remains low in the GCC while Malaysia has an active secondary market for sukuk. Saudi Arabia is one of the first GCC countries to aim at establishing a sukuk market by introducing sukuk trading on the Tadawul exchange. Such moves will help in the development of an active secondary market. This will have broader implications for sukuk as a financial instrument in the eyes of both investors and issuers.

Another attempt to develop a secondary sukuk market is the Islamic Development Bank's proposed establishment of a billion dollar investment bank, focusing on creating an Islamic interbank market.

Default rights

The first sukuk defaults, notable examples being the East Cameron sukuk, Golden Belt sukuk and Investment Dar sukuk, opened up a new debate regarding the rights of sukuk investors. Asset based versus asset backed sukuk issue has come into the limelight and the resolution of this issue will have significant effect on the future growth of Sukuk.

Disclaimer

Ernst & Young is working with Zawya on the Global Collaborative Sukuk Report and is assisting in the documentation of the "Trend Analysis" section.

The contents of the Trend Analysis are based on a quantitative analysis of the Zawya Sukuk Monitor. Data was made available from the Sukuk Monitor by Zawya. Information has also been assimilated from secondary sources for further analysis. Whilst every care has been taken in the preparation of this report, no responsibility is taken by Ernst & Young as to the accuracy or completeness of the data used or consequent conclusions based on that data, due to the respective uncertainties associated with any assumptions that have been made.

Ernst & Young does not express any assurance on the accuracy or completeness of the information obtained. Although this report has been documented based on our understanding of Islamic financing activities to include only those activities that are deemed Shari'a compliant, no Shari'a opinion whatsoever has been taken on this report. Hence, the contents of this report, in terms of the activities to be carried out, might not necessarily be consistent with Shari'a in all cases, and the opinion of at least one Shari'a scholar should be taken before any further steps are taken to implement any findings contained in the Report.

About Zawya

Zawya focuses on developing a business and investment environment in the Middle East. The company provides professionals with the means to identify, assess and monitor business and investment opportunities in both private and public markets. Thousands of premium members utilise Zawya's information resources, technology applications and online network to better connect to opportunities across the GCC, Levant, Iraq and North Africa. Headquartered in Dubai, Zawya has a presence in Saudi Arabia, Bahrain and Lebanon.

Its flagship service, Zawya Investor, provides paid members access to insights that are "from the region, to the region" to help them identify the best investment opportunities in the Middle East. With high profile Zawya Dow Jones journalists breaking the most important stories and Zawya's own team of financial experts providing in-depth analysis, Zawya Investor offers unique coverage of the region's IPO, Public & Private Equity, Funds, and Global Sukuk industries.

In the Islamic space, Zawya has a dedicated team of analysts that focus on highlighting opportunities in the global Islamic finance sector, with particular emphasis on Sukuk, by bridging the buy side, sell side and all relevant players in the industry. All members can register for the Zawya Network, an online network enabling them to forge valuable relationships with fellow professionals, and share in the knowledge and experience of the business and investment community. In the Zawya Network, over 500 members are part of the Islamic finance and Sukuk groups.

For more information visit www.zawya.com/sukuk or contact sukuk@zawya.com

Supporter profiles

Unicorn
Investment Bank

Unicorn Investment Bank BSC (c)

Founded in 2004 and headquartered in Bahrain, Unicorn Investment Bank (Unicorn) is an Islamic financial services group, with an international presence in the United States, Malaysia, Turkey and Saudi Arabia (through its majority shareholding in Unicorn Capital Saudi Arabia). The Bank is also a major shareholder in Dawood Islamic Bank, Pakistan. Unicorn seeks to deliver exceptional value to clients and shareholders through a focus on innovation, professionalism and integrity – the shared values that drive the Bank's endeavour to be a leading global provider of Shari'ah-compliant investment banking products and services.

Unicorn's integrated business model is built around six core business lines: Asset Management & Real Estate, Capital Markets, Corporate Finance, Private Equity, Strategic Mergers & Acquisitions and Treasury. The Bank leverages its resources and expertise across each of these business lines to provide clients with a comprehensive range of investment solutions tailored to meet their specific requirements.

Unicorn's integrated product offering and financial engineering skills are closely intertwined with a strong capacity to distribute the Bank's products and services to a broad client base across the GCC region, the wider Middle East region, Southeast Asia, the USA and Europe. The Bank's Investment Development & Distribution team caters to high net worth individuals, family businesses, financial institutions, corporations, governments and quasi-governmental organizations, offering a client-driven service platform focused on meeting the particular requirements of each client.

All Unicorn products and transactions are governed by two essential principles: that they fully comply with Shari'ah principles; and that they are benchmarked against international financial best practices. The Unicorn Shari'ah Supervisory Board ensures that all investment policies, structures, products and financial services and activities that the Bank is involved in are in conformity with Shari'ah principles, while the Bank's stringent corporate governance standards ensure that the Bank, its directors and its employees follow the highest standards of ethical conduct and adhere to the principles of fairness, transparency, accountability and responsibility in all day-to-day operations.

Unicorn has completed several landmark transactions since its inception, including the establishment of T'azur, a regional Takaful company; the acquisition of Bahrain Financing Company, the oldest and one of the leading foreign exchange and remittance houses in the GCC; and the successful launch of the Strategic Acquisition Fund, a US$1 billion fund to acquire strategic stakes in commercial banks globally. The Bank has achieved consistent growth since its inception and has received widespread industry recognition for excellence and vision.

ITS Group

(ITS Group) is the Global leader in Ethical Banking solutions for Islamic banks and Islamic finance organizations for over two decades, and is a member of AAOIFI and IFX. The ITS Ethical Banking solution is 100% Shariah compliant, and specifically designed to fulfill the needs of the Islamic banking and finance sector.

ITS's Ethical Banking solution is based on the first award winning "Islamic Instrument Definition Engine" which allows Financial organizations to create their own Shariah compliant products, workflow, and processes. In addition, it is based on Service Oriented Architecture & is adopting IFX Massaging Protocol.

The ITS Ethical banking solutions covers Consumer Financing, Trade Finance, Retail Islamic Banking, Ejarah Card Product, Treasury/ Investment, Internet Banking, Risk Management with BASEL II Compliance, and Banking Delivery Channels.

ITS has a keen understanding of what its customers really need from an ICT partner; in short, to enable technology utilization in order to allow your business to grow.

ITS implements cutting edge solutions for numerous valued clients in the Middle East, North Africa and East Asian regions, through our resource pool of over 2400 skilled IT professionals based in 24 offices worldwide.

For more information, please visit: www.its.ws

HAWKAMAH
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The Hawkamah Institute for Corporate Governance

(www.hawkamah.org)

The Hawkamah Institute for Corporate Governance (Hawkamah) is an international association of corporate governance practitioners, regulators, and institutions advancing home grown but globally integrated corporate governance best practices in the region.

Hawkamah's mission is to promote corporate sector reform and good governance, assist the countries of the region in developing and implementing sustainable corporate governance strategies adapted to national requirements and objectives. Regional cooperation will facilitate exchange and allow countries to learn from successful experiences, combine efforts, move towards harmonization of corporate governance frameworks, and build on synergies resulting from national actions and initiatives.

Hawkamah is currently shaping the development of corporate governance in the Middle East, North Africa, and Central Asia. By promoting its core values of transparency, accountability, fairness, disclosure, and responsibility, Hawkamah works on policy and practical aspects of corporate governance reform in the region.