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HSE – Skolkovo Institute
for Law and Development

Boosting Russian
agricultural exports
and securing food supply
to Islamic countries through
Islamic finance mechanisms



PROJECT BACKGROUND



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Challenges

- Oligopolistic structure of the global food market
- Important role of speculative forces
High dependence on stock exchange trade controlled by speculative capital
- Lack (high cost) of long-term investment and lending for small and mid-sized farmers in Russia
- Legal complexities of obtaining a loan for small and mid-sized farmers in Russia
- Decreasing marginality of Russia's agricultural sector
- Underdeveloped export infrastructure in Russia
- No link between producer and exporter
- Segments which are the most capital intensive and most volatile get smallest profits, and vice versa

Boosting Russian
agricultural exports
and securing food
supply to
Muslim countries

Opportunities

- High demand for food security in Islamic countries
- Availability of uncommitted financial resources in Islamic countries, esp. from conservative investors (e.g., family offices)
- Demand for more stable and less speculative relations with food suppliers, based on the principles and values of Islamic law
- Demand for cheaper grain by eliminating unnecessary middlemen
- Expansion of grain production in Russia subject to stable funding
- Conformity of Russian grain with the quality standards set for Muslim countries' social programmes
- Opportunity to develop new logistic routes to Muslim countries (a range of alternative solutions, including the North-South international transport corridor)

PROJECT GOAL AND OBJECTIVES

Goal

Establish long-term sustainable partnership mechanisms for the supply of Russian agricultural produce to Muslim countries using partnership financial instruments based on the principles of Islamic law



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Objectives

- Lay the groundwork for long-term sustainable financing of Russia's agricultural production and exports
- Contribute to Islamic countries' food security
- Build up food reserves jointly controlled by project participants, which can serve as a collateral for the securities to be issued as part of the project
- Implement partnership financial instruments on the world agricultural market
- Establish new pricing mechanisms in the global food trade
- Build long-term relations Islamic investors
- Develop cross-border logistics infrastructure in Russia and in food importing countries, jointly owned and controlled by project participants

GLOBAL PROBLEMS OF THE AGRIFOOD MARKET. HUNGER



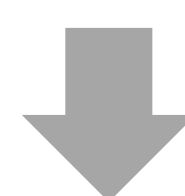
Agriculture is affected by climate change.

+

According to FAO, with demand for grain reaching 2.7 bn tonnes in 2030, grain production will only be as low as 2.1 bn tonnes.*

=

FAO's forecast for combating global hunger is overly optimistic.



Tightening competition



Higher demand

In the near future, the global food system will be under an unprecedented pressure:

- 01 Tightening competition for land, water and energy.
- 02 Population growth to more than 9 bn people by 2050; according to World Bank, global demand for food is projected to increase by around 70% with estimated extra investments of \$80 bn/year needed to meet it. **

|| We are concerned that, after many years of decline, global hunger increased in 2016 and now affects 815 million of the world population, and that about 2 billion people suffer from micronutrient deficiencies.

*2018 Declaration of the G20 Meeting of Agriculture Ministers**

People suffering from hunger in the world (FAO), mln people

Region	2000	2010	2020
South Asia	180	240	300
East Asia	360	400	420
MENA	70	40	40
Latin America	70	60	50
Africa	170	160	50

|| This is the third consecutive year that progress in ending hunger has stalled and now hunger has actually increased (in 2015, 2016 and 2017).

FAO Director General José Graziano da Silva

*[FAO, 2018]. ** [Maram Ahmed].



OLIGOPOLISTIC STRUCTURE OF THE GLOBAL FOOD MARKET

A few companies (ADM, Bunge, Cargill, Louis-Dreyfus, Glencore, etc.)

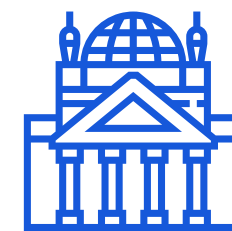
- dominate the global food market
- have departed from the original business model of buying and selling food and have come to resemble 'value chain managers' involved in food production, processing, distribution, financing and investment*
- operate within an oligopolistic global grain market and exert major influence on the world food system, posing a risk to the welfare of consumers**
- traders' vertical and financial integration is tightening with horizontal integration expanding (entering new markets)***
- Russia being #1 exporter globally and having 10% of world's arable land, there are no major Russian players in this circle



imposing prices and terms on smaller producers



affecting people's access to food****



unstable political and social environment in food importing countries



* Clapp J. (2015). ABCD and Beyond: From Grain Merchants to Agricultural Value Chain Managers // Canadian Food Studies — Special Issue: Mapping the Global Food Landscape. 2015. Vol. 2. No. 2, p. 129.
 ** Park H.-I., Kang H.-C., Kim H.-N., Lim S.-H., Moon W.-S. (2011). New Food Security Strategies in the Age of Global Food Crises // Samsung Economic Research Institute Monthly Focus. 2011. No. 4, p. 5.
 *** Clapp, 2015, p. 129–130.
 **** Clapp, 2015, p. 130–131.
 ***** Lybbert T.J., Morgan H.R. (2013). Lessons from the Arab Spring: Food Security and Stability in the Middle East and North Africa // Barrett C.B. (ed.). Food Security and Sociopolitical Stability. Oxford University Press, 2013, p. 366.

SPECULATIVE PRICING



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Commodity prices are increasingly influenced by factors that have nothing to do with physical reserves, while there is at least a short-term impact on food prices as a result of increased financial speculation.*



Increasing financialization of commodity production with hedge funds, private equity funds and others investing directly in land and agricultural production.**



Wheat price and supply volatility (driven by, e.g., financialization, consolidation of TNCs trading wheat, etc.) negatively affect importing MENA countries, which have to work with traders to offset short domestic food supply with imports.***



Most banks finance grain from the moment it is on board of a vessel in an export port, while its domestic production and storage is not or insufficiently financed, giving even more leverage to a small range of trading companies

* Murphy S., Burch D., Clapp J. (2012). Cereal Secrets: The World's Largest Grain Traders and Global Agriculture // Oxfam Research Report. 2012, p. 27–29.

** Ibid., p. 36.

*** Ahmed G., Hamrick D., Gereffi G. (2014). Shifting Governance Structures in the Wheat Value Chain: Implications for Food Security in the Middle East and North Africa // Center on Globalization, Governance and Competitiveness at the Social Science Research Institute. 2014, p. 22.

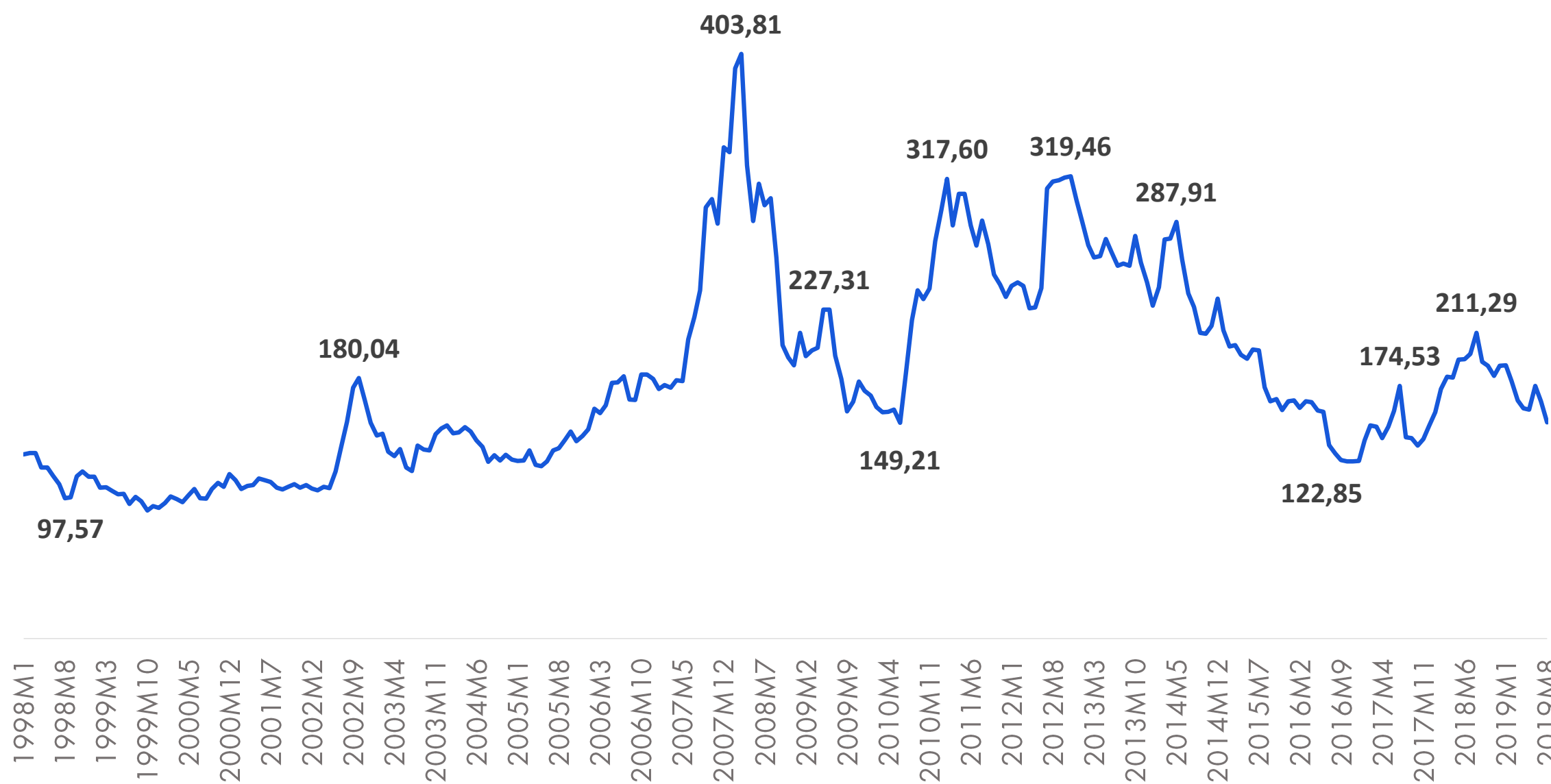
SPECULATIVE PRICING



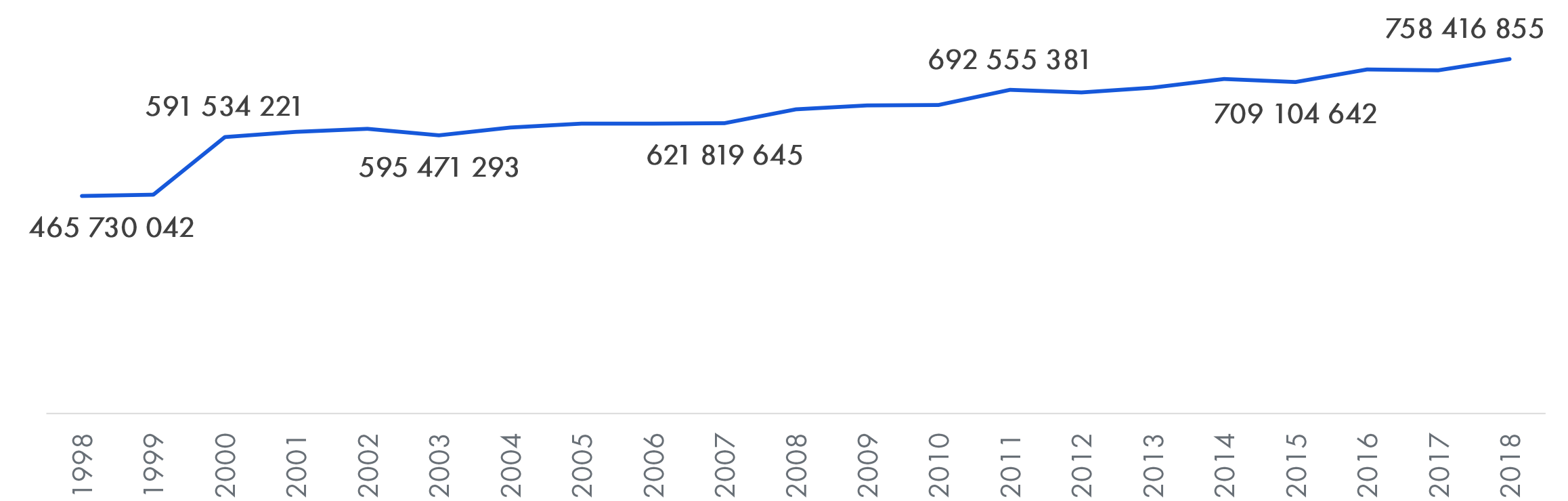
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World wheat prices, 1998-2018



World wheat consumption, 1998-2018



Data on wheat price (wheat, No.1 Hard Red Winter, ordinary protein, Kansas City): IMF Primary Commodity Prices
 Data on wheat consumption: OECD-FAO Agricultural Outlook 2018-2027

GRAIN PRODUCTION IN RUSSIA. EXPORT POTENTIAL



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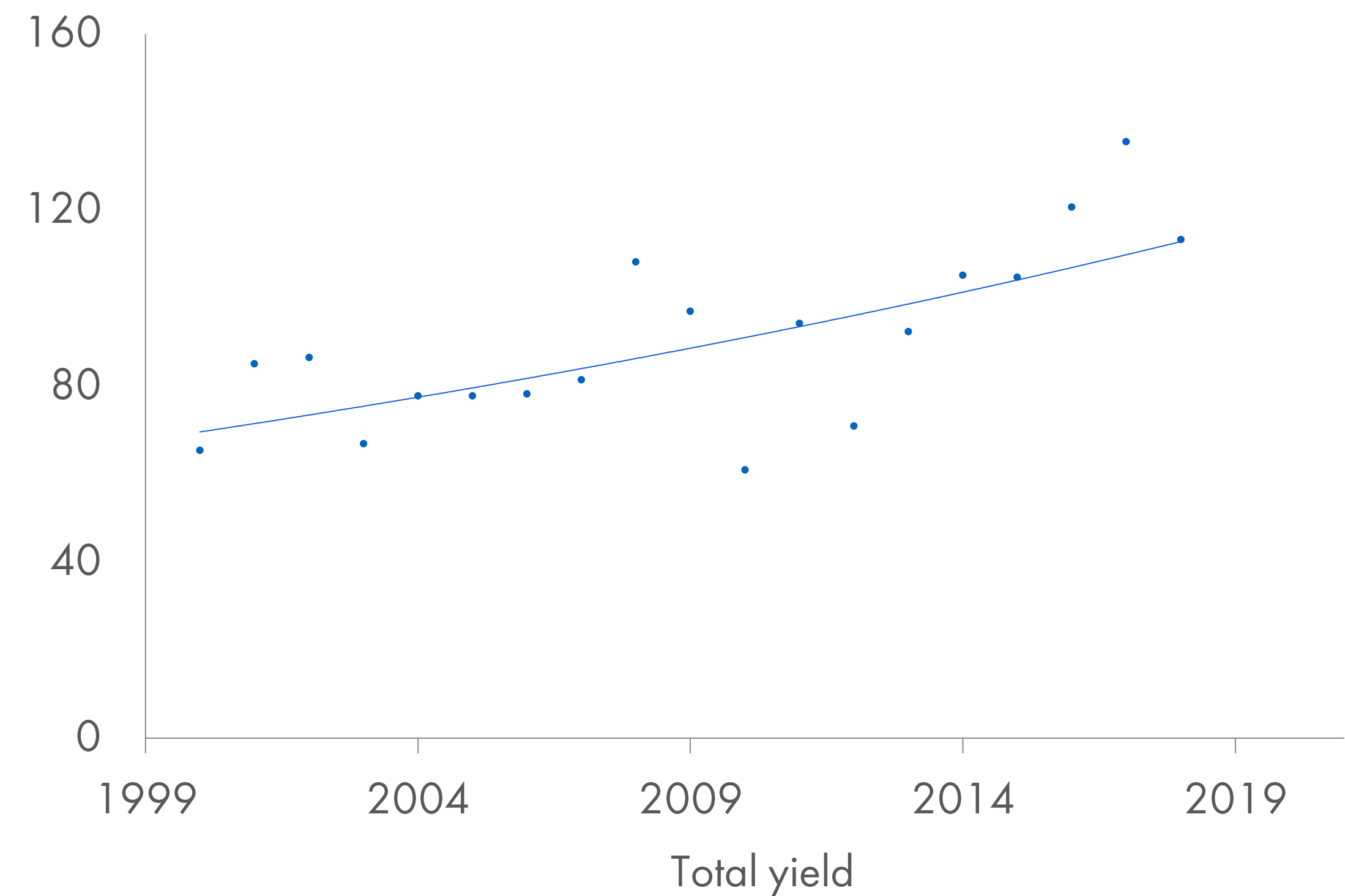


President Putin's May 2018 Decree:
Agricultural exports to reach \$45 bln in 2024
(from \$24 bln in 2018)

With its vast expanses of arable land in areas where climate is conducive to crop farming, Russia is well positioned to be a key supplier of grains to the world markets. Over the last 20 years, the country has achieved a two-fold increase in grain production (from 65.4 mln tonnes in 2000 to 135.3 mln tonnes in 2017) and has converted from a net importer to a net exporter of grain.

Today, Russia's potential for both intensive and extensive growth in this area is far from being exhausted.

Total yield of grains and pulses, mln tonnes



GRAIN PRODUCTION IN RUSSIA. EXPORT POTENTIAL

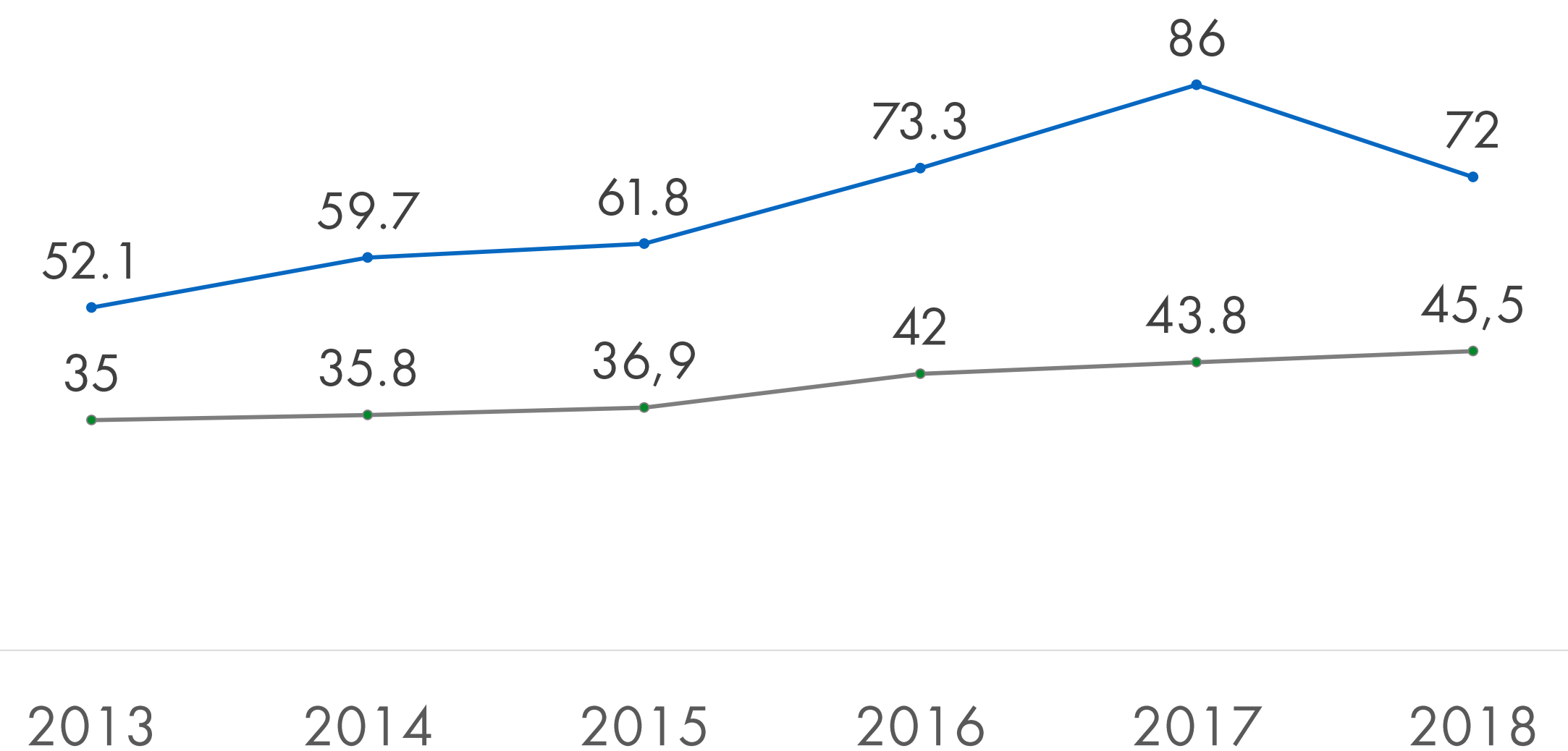


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According to some expert estimates, Russia's grain sector has the potential to produce up to 100 mln tonnes of grain in excess of domestic consumption and to establish itself on the world market as a leading supplier of grain.

Gross yield and domestic consumption of wheat, mln tonnes



Gross yield (Rosstat)

Domestic consumption (IKAR, ProZerno (for 2018))



NEW MARKETS

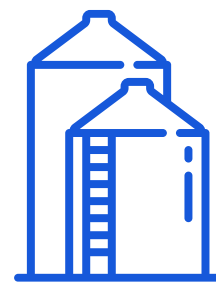
- Afrika – 7,2 mln t
- Vietnam – 2,6 mln t
- Bangladesh – 1,8 mln t
- Indonesia – 1,4 mln t
- Philippines – 1,1 mln t



AGROFINMOST PROJECT CONCEPT



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Create a **grain security fund** in one of the Gulf countries

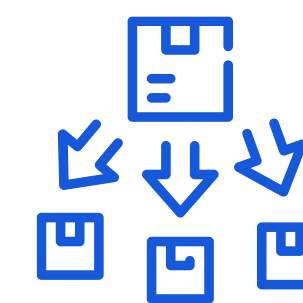


Raise capital using the fund as the underlying asset.



Invest the proceeds in the Russian agricultural sector by **advancing working capital to Russian grain producers** and engaging in other income-generating activities:

- Management of grain reserves outside Russia;
- Management of other assets;
- Grain trading on spot basis;
- Grain trading on deferred payment basis.



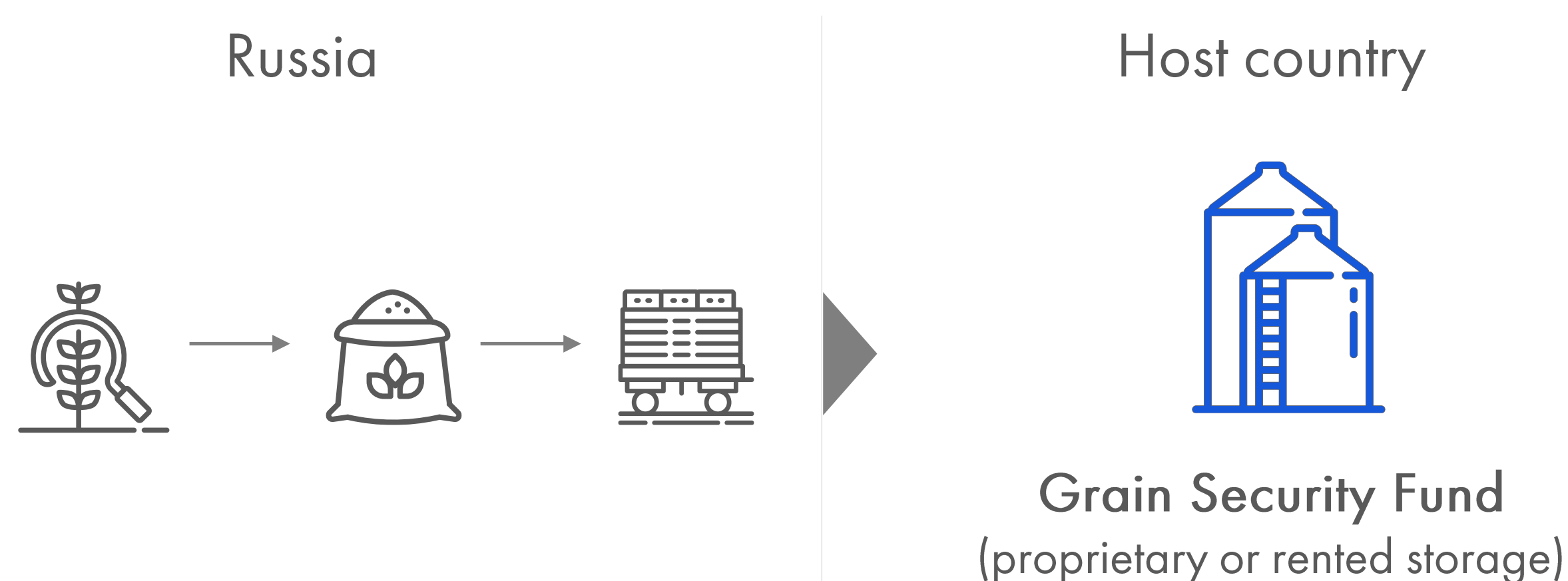
Incorporate the grain security fund in the supply chain of a food processing cluster outside of Russia.



GRAIN SECURITY FUND OUTSIDE OF RUSSIA

The main function of the fund is to **secure grain supplies to the consumers** of the region:

1. When a trigger event arises (disruption of grain supplies, shortage of grain, price exceeding a threshold level, etc.), the fund is used to ensure an uninterrupted supply of grain to the public of the host country and a broader region.
2. At other times, the fund is in constant circulation: it may be sold for processing, etc. Grain that has been disposed of is replaced with new supplies.
3. In any event, a pre-determined minimum stock level is maintained at all times.
4. This minimum stock defines the value of the fund, against which financial instruments may be issued.

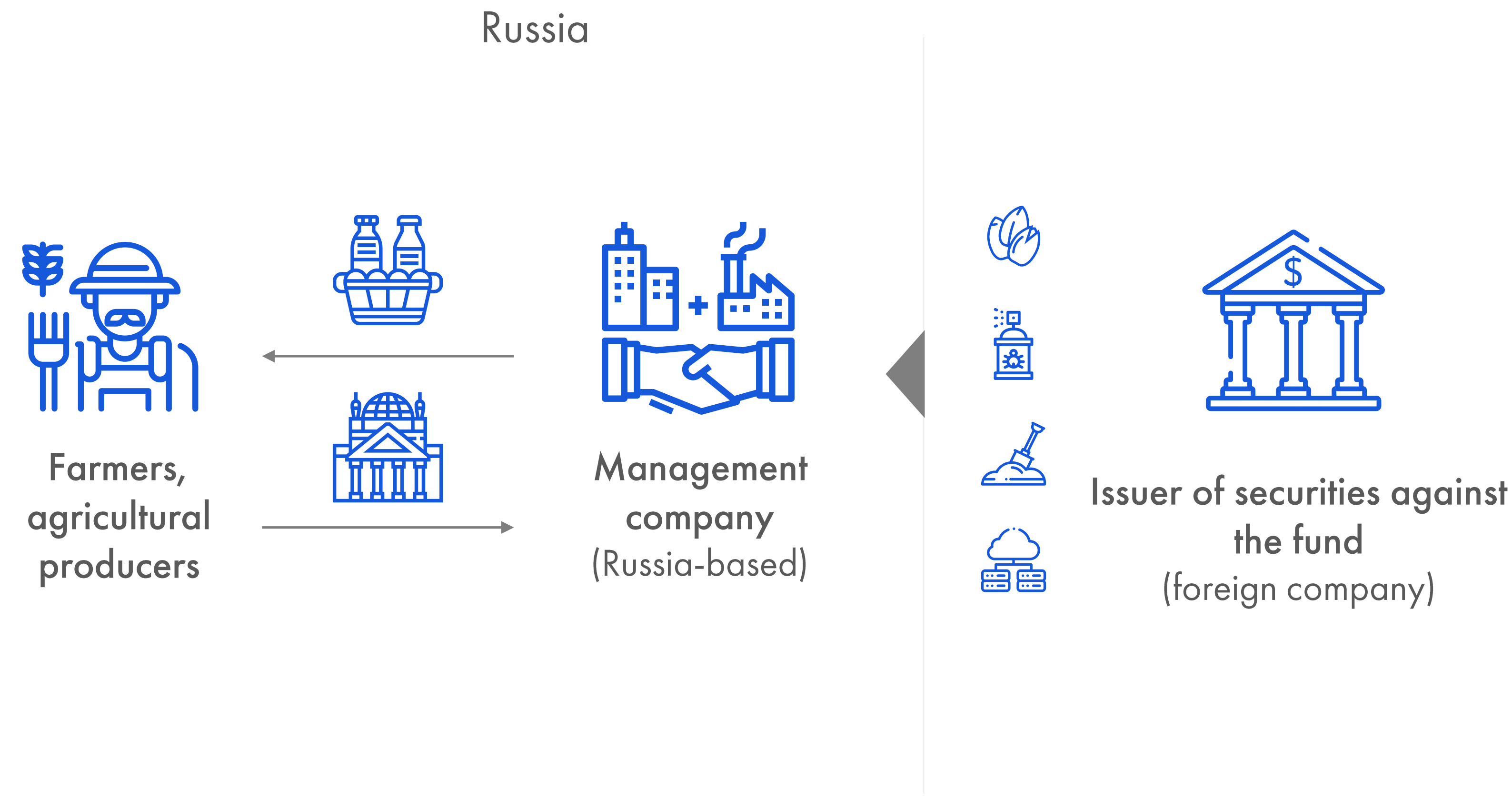


Setting up the fund in a location outside of Russia:

1. Improves grain **availability** for the consumers in the region: the grain from the fund can be shipped for consumption within a short period of time.
2. Increases the value of the grain and transforms it into an **asset** against which capital can be raised.
3. Levels out the export cycle by **smoothing peak loads** on the transport and logistics infrastructure.



ADVANCING WORKING CAPITAL TO FARMERS

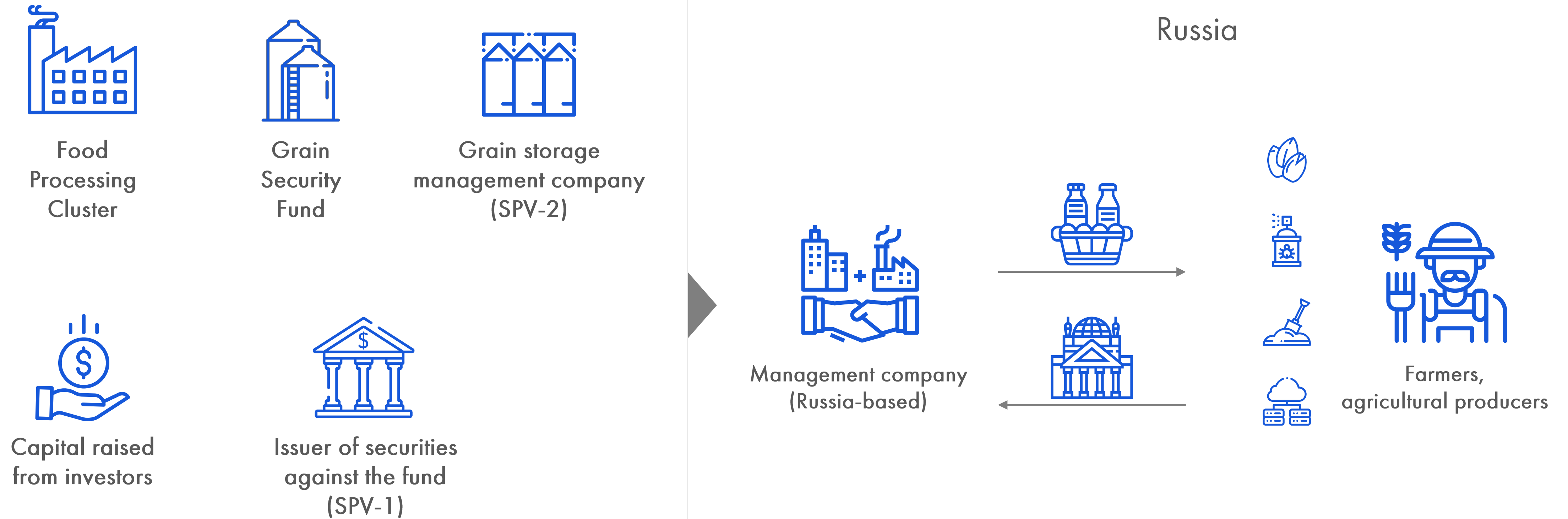


The capital raised against the fund is used to advance working capital to Russian ag grain producers:

1. The foreign issuer of securities transmits the capital to the Russian management company as advance payment for future grain
2. The management company advances to grain producers (under a deferred delivery contract):
 - High-yield grains
 - Agrochemicals
 - Fuels
 - Fertilizers (blends)
 - Digital services
3. On maturity, the grain producers supply grain of stipulated quality to the management company



GENERAL PROJECT CHART



AGROFINMOST PROJECT CONCEPT (1/2)



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■ Stage 0

Preliminary agreements with potential project partners, investors and contractors.
Legal formalities

■ Stage 1

Grain Security Fund

Implementation:

1. Purchase ca. 0.5 mln t (~\$100 mln worth) of wheat on the spot market and place it in a storage facility outside of Russia
2. Establish a grain security fund, define its rules of operation, including:
 - The minimum stock level;
 - The stock rotation method (FIFO);
 - A contract for physical protection of the stock with an independent security services provider.
3. Potential host countries: Egypt, Turkey, Lebanon, UAE, Iran



AGROFINMOST PROJECT TIMELINE (2/2)

■ **Stage 2** Capital raising outside Russia (SPV-1)
The grain security fund to serve as the underlying asset of the issue.
Pilot issue size: from \$200 to \$500 mln.

Income generating activities:

- Advancing of working capital to Russian grain producers
- Spot purchases of Russian grain and its sale in importing markets
- Grain storage and processing plants in importing countries (Egypt being the first target country)

Potential guarantees for investors :

- Minimum balance of grain security fund
- Government guarantees
- Personal guarantees of producers
- Producers' land
- Joint responsibility and common assets of cooperatives

■ **Stage 3** Further project expansion



- Spot wheat trading (Russia and Muslim countries)
- Wheat processing plants in Muslim countries
- Advancing working capital to grain producers in Russia

Income generating activities for SPV-2

ISLAMIC FINANCE: POTENTIAL ROLE IN BOOSTING GRAIN EXPORTS (1/2)





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Benefits of Islamic financial instruments

 Countries of the Islamic world are among the key importers of Russian agricultural produce

 Islamic investors are interested in humanitarian supplies of food to the region to secure social peace

 Opportunity to attract a wide range of investors from destination countries, including the most conservative ones

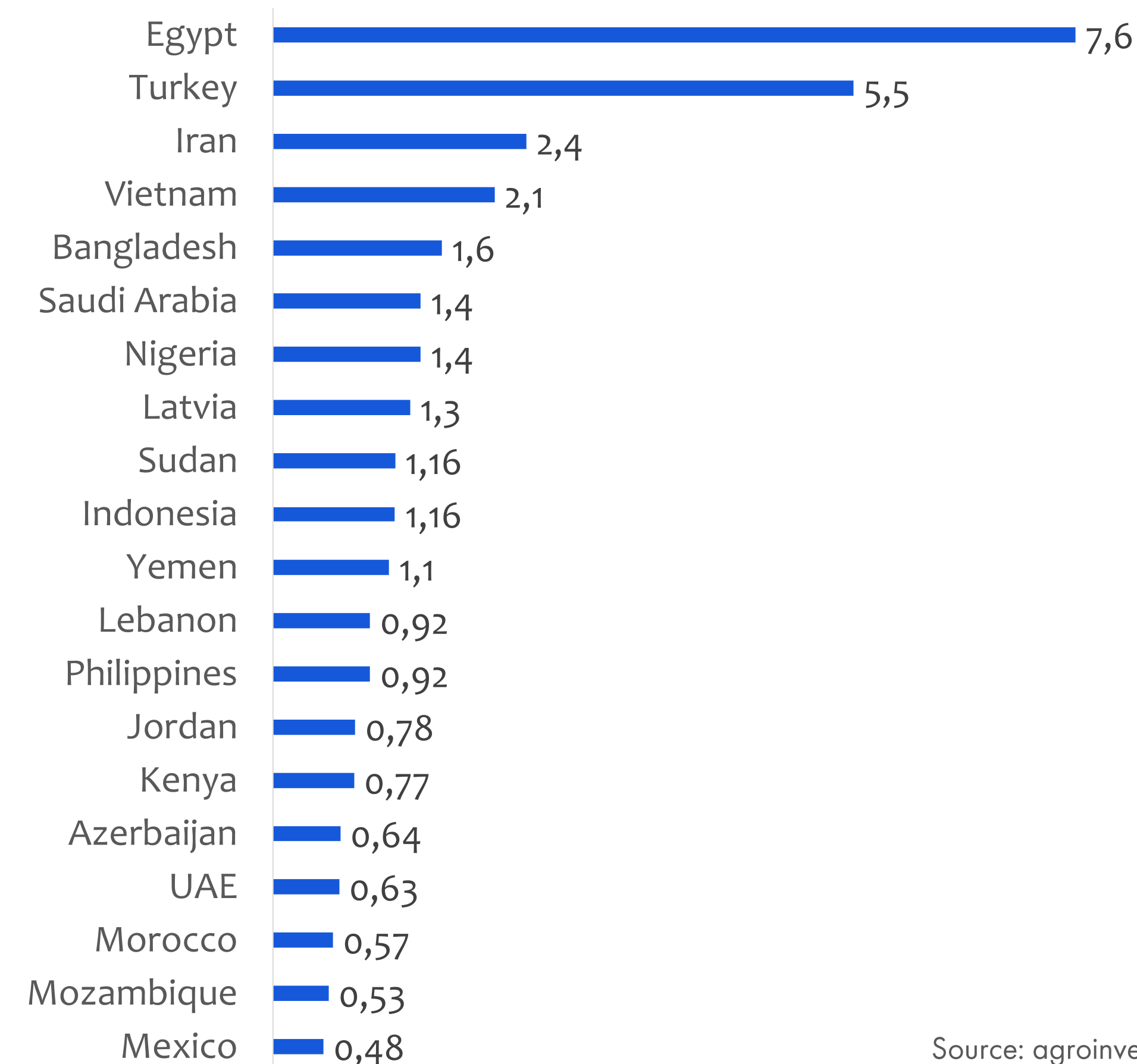
 Broader range of investors, including Islamic and conventional ones

 Broad spectrum of instruments that can be used depending on transaction objectives

|| The main export destinations are Middle East countries (including Egypt, Saudi Arabia, Iran, Lybia, etc.)

from a presentation of Novorossiysk Grain Products Company (Russia)

TOP 20 importers of Russian grain (mln tonnes, 2018/2019 season)



Source: agroinvestor.ru

ISLAMIC FINANCE: PARTNERSHIP AND REAL ASSETS



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Universal human values at the core



Prohibition
on interest



Prohibition
on speculation
and speculative instruments



Prohibition on excessive
uncertainty in transactions
(including derivatives)



Real asset-based
contracts



Principles common
to all world religions
and universal human morals

SOME FORBIDDEN AND DISLIKED ELEMENTS IN CURRENT COMMODITY TRADING



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PHENOMENON & ARABIC TERM

Riba (ربا) Usury

- Interest based financing
- Repo transactions

Gharar (غرر) Uncertainty with regards to one of the contract pillars:

- sale of unidentified and non-quantified goods
- sale with voidable condition
- sale without stipulating certain price
- other types of gharar (see below)

Short selling (بيع قبل القبض) and other types of unsecured transactions:

- sale of goods before possessing it
- sale of good before they appear
- future and forward selling

Maysir (ميسر) Gambling

Approaching the sellers (producers) before they enter the city (market)
(تلقى الجلب) (makrooh)

Najash (نجش) Use of the information asymmetry in order to speculate with the price (makrooh)

Ihtikar (إحتكار)

Buying out and retaining products that results in raising prices

CONSEQUENCE IN COMMODITY TRADING

Companies use commodity repo transaction in order to get short term financing

High level of uncertainty related to price and terms of delivery of food commodities.

Selling of grain before possessing it is a popular transaction on the market

Traders are speculating on price on commodity exchanges resulting in price violation, including the use of derivatives

Huge difference in ex-works and FOB price, the food producers are unable to take part in commodity food trading at large markets

Sometimes small producers are unaware of real market price of the products

Some traders buy out and hold food commodities during the upward price trend that results in raising prices

FORBIDDEN

DISLIKED (SINFUL)

RUSSIA ON THE ISLAMIC FINANCE MARKET



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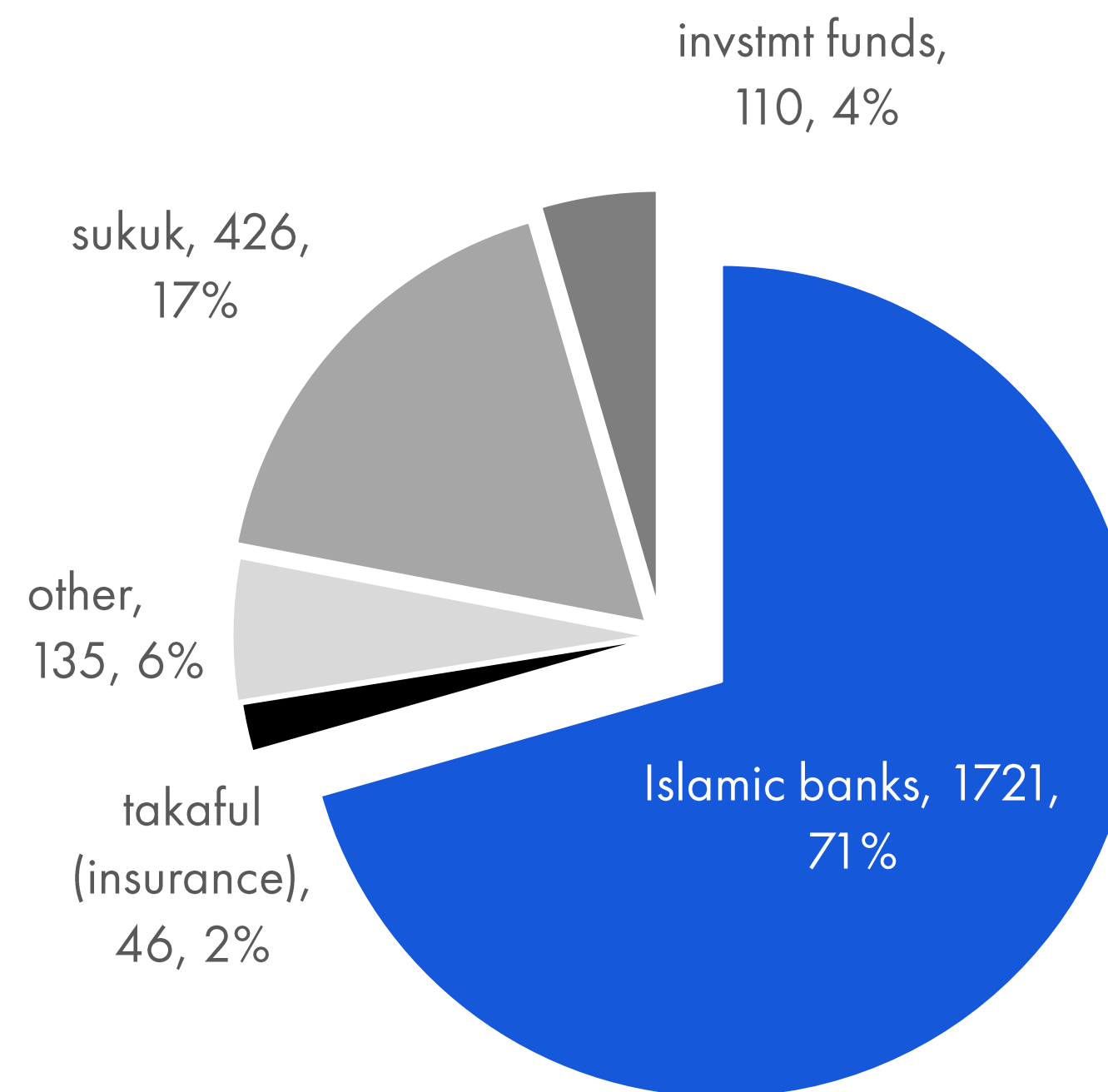


Islamic finance in the world

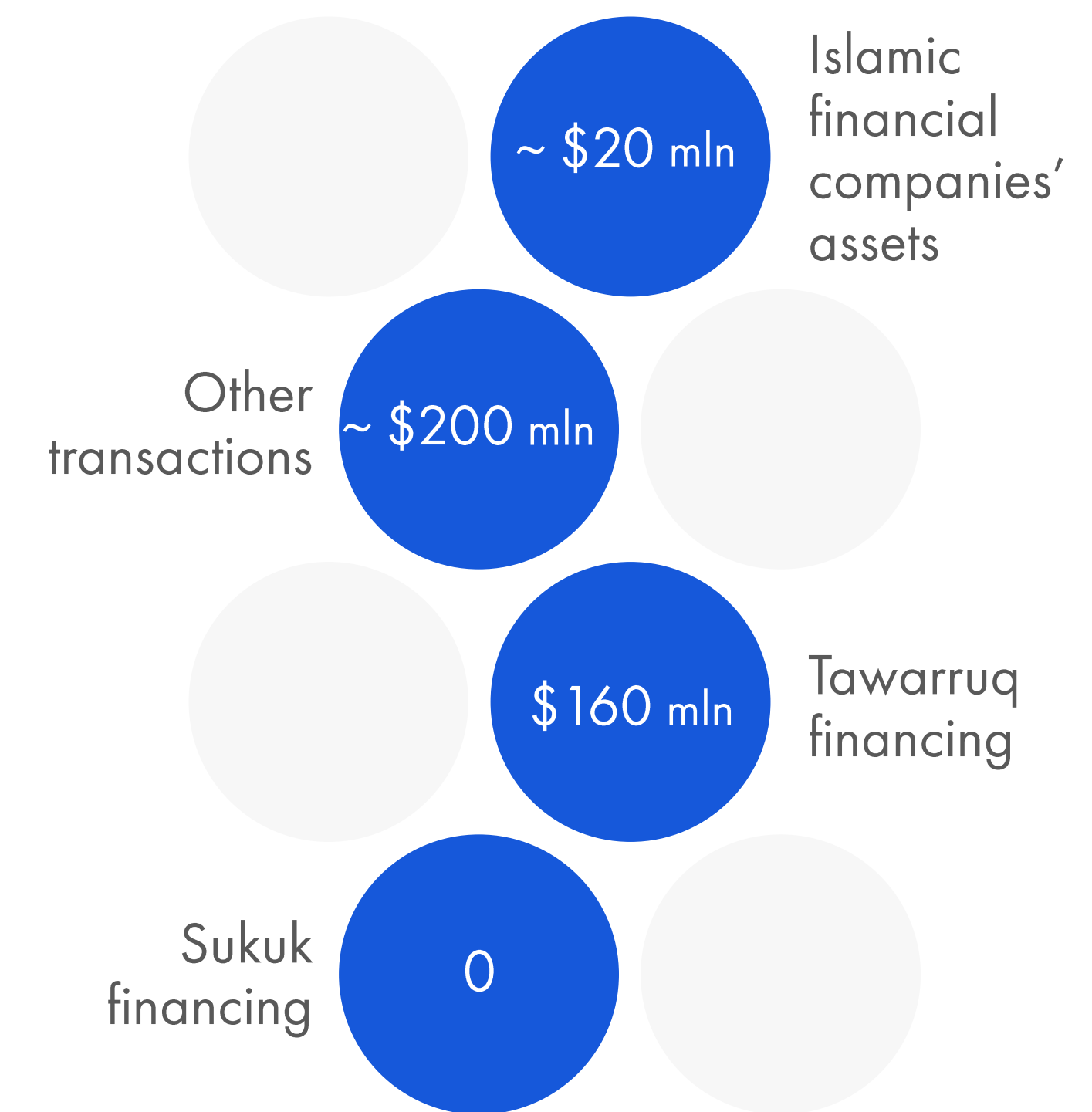
Parameter	World
Assets of Islamic banks	\$1,765 bn
Nr of Islamic financial companies	1,407
Total worth of sukuk	\$426 bn
Nr of sukuk outstanding	2,590
Total worth of funds managed	\$110.1 bn
Nr of Islamic funds	1,410
Regulation of Islamic finance	-
Nr of Sharia scholars	1,162
Rating as per published reports	33.11
Educational programmes	688
Research works	2,542

Source: HSE, based on zawya.com 2017 data

Islamic finance assets, \$bn (world)



Russian market: untapped potential?

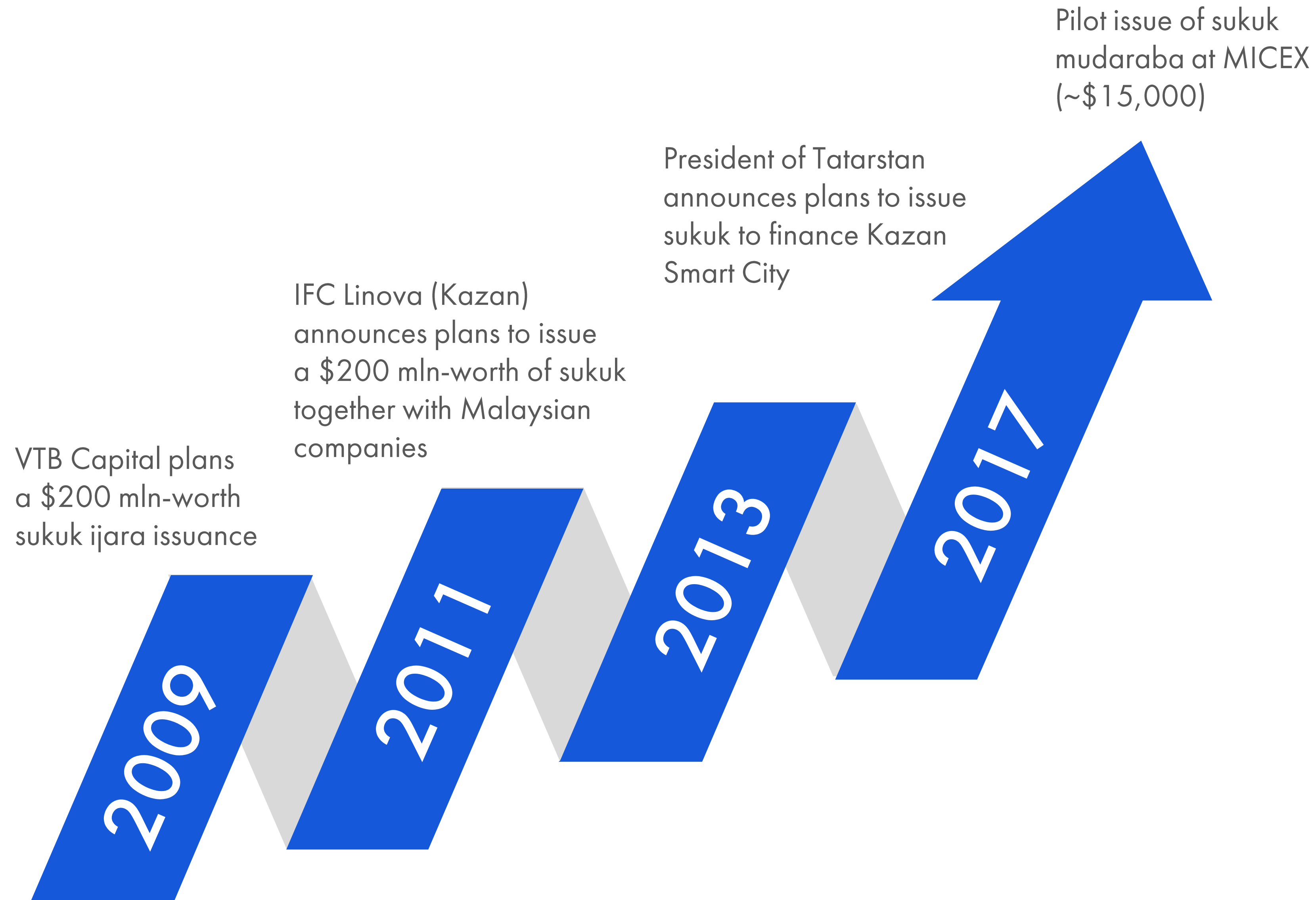


Source: HSE, based on RAEIF 2017 data

SUKUK IN RUSSIA: LACK OF SUSESSEFUL STORIES



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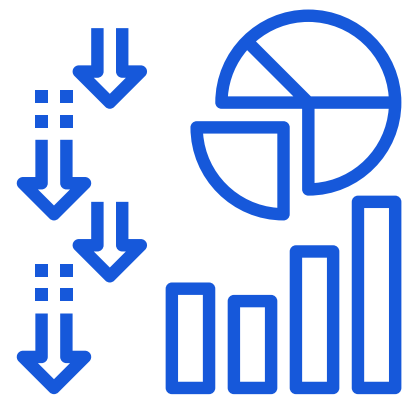
SUKUK IN RUSSIA: MARKET OVERVIEW



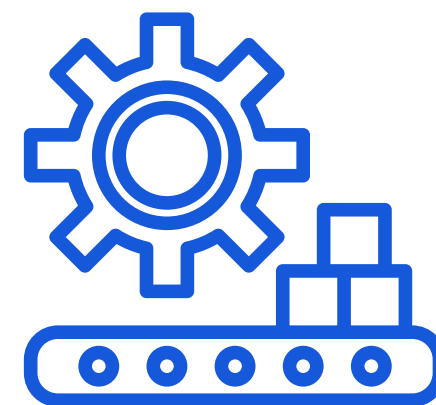
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Why Russia lacks positive experience on the sukuk market



General decline
in investor activity due
to 2007-2008 crisis



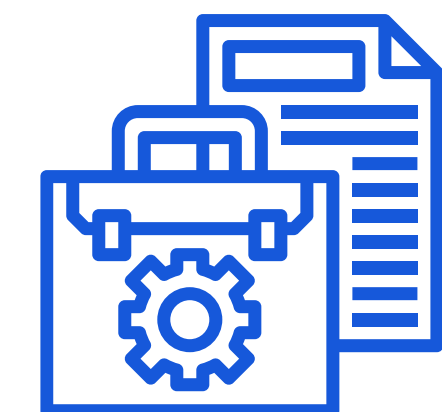
The sukuk structures
were not mature
enough until recently



Lack of stable cross-cultural
communication between
Russia and the Islamic world.
Deficit of trust



Lack of positive history
of interaction with conservative
Islamic investors



Scarcity of projects
strategically interesting
to investors



SELECTION OF SUKUK STRUCTURE

Structure	Type of income	Tradable
Sukuk Salam	fixed	no
Sukuk Murabahah	fixed	no
Sukuk Musharakah	not fixed	yes, if no less than 33% of sukuk assets are illiquid assets
Sukuk Mudarabah	not fixed	yes, if no less than 33% of sukuk assets are illiquid assets
Sukuk Istisna	pre-determined pricing formula	yes, after the asset has been produced
Sukuk Wakalah al-Istithmar	pre-determined pricing formula	yes, if no less than 33% of sukuk assets are illiquid assets

FINANCIAL AND INVESTMENT TOOLS: SUKUK SALAM*



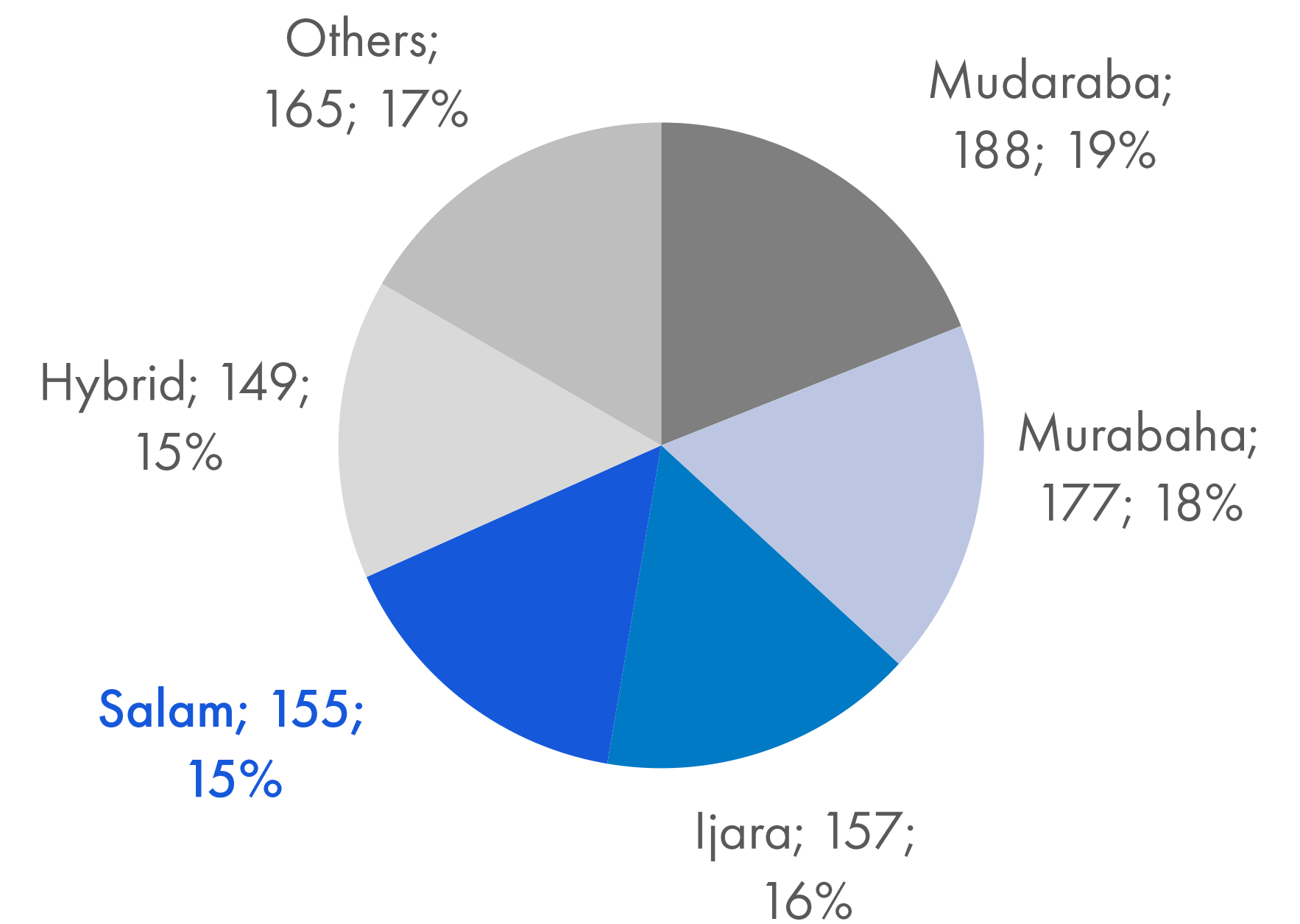
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The issuer of such certificates ('food bonds' or 'agribonds') sells goods to buyers, i.e. sukuk subscribers, on deferred delivery terms; the proceeds from subscription constitute the purchase price (*salam* capital) of the goods.

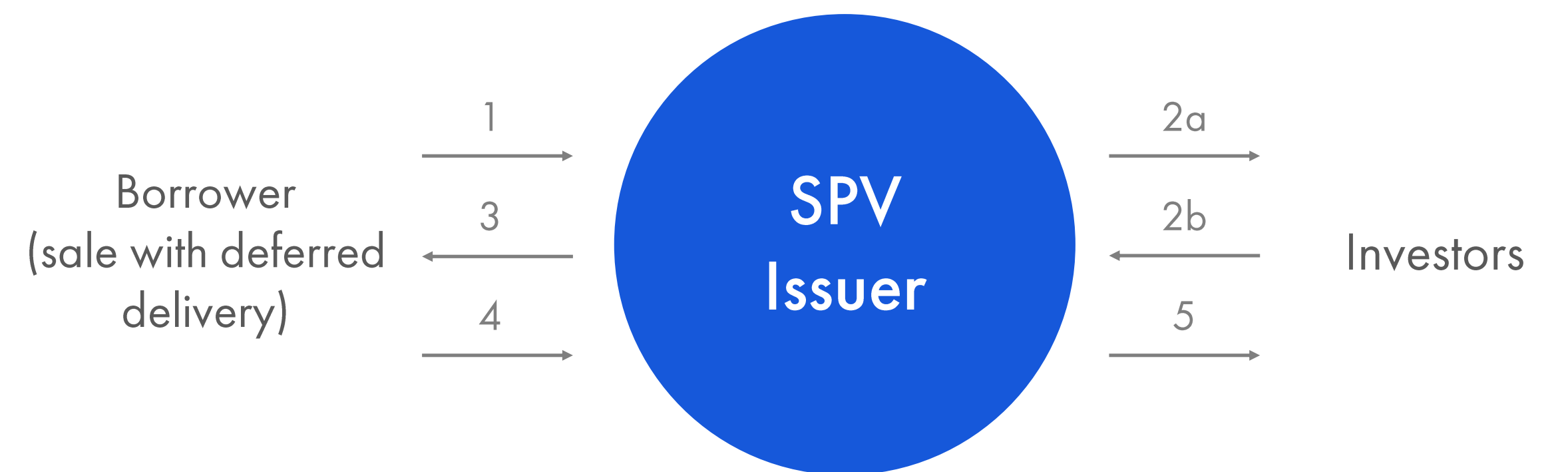
The holders of *sukuk* (investors) are the owners of the goods and are entitled to the sale price of the goods.

Types of sukuk, nr of issues, 2017



Source: Thomson Reuters

* This is but one example of a sukuk transaction structuring. In practice, sukuk may as well be based on other contracts, including hybrid ones.



1 liability

2a sukuk certificates

3 proceeds from salam transaction

2b proceeds from sukuk certificates

4 goods

5 goods

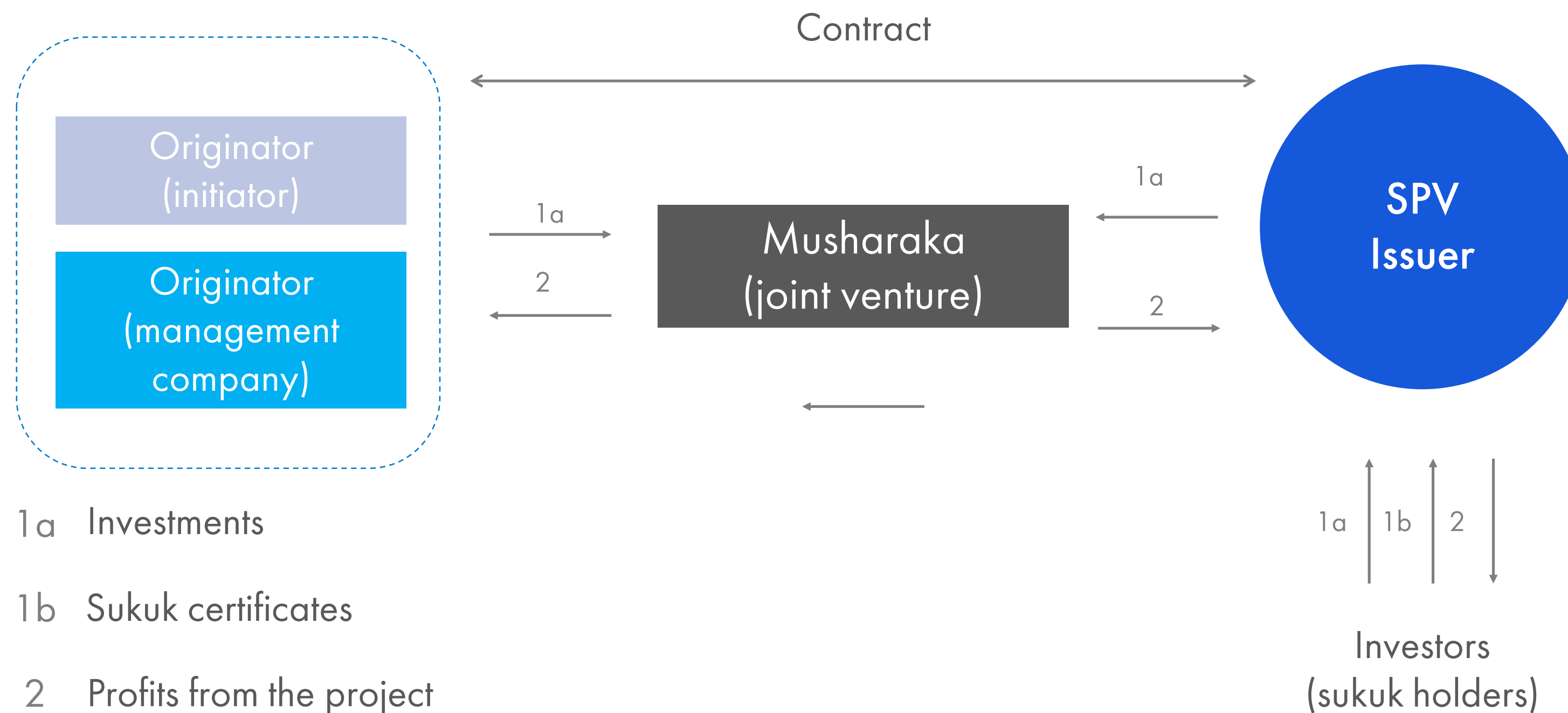
FINANCIAL AND INVESTMENT TOOLS: SUKUK MUSHARAKA*



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Equal value certificates, issued for using the funds received to establish a new or develop an existing project on the basis of any of the partnership contracts. The certificate holders become the owners of the project or of the assets of the activity as per their respective shares. The musharaka certificates are structured on the basis of participation, or fiduciary management, or an investment agency.



Benefits of sukuk musharaka structure

- Sukuk musharaka certificates can be traded on the secondary market (unlike, e.g., sukuk salam)
- Moderate risks for the investors
- More options for deal structuring depending on contract and project specifics

FINANCIAL AND INVESTMENT TOOLS: SUKUK WAKALA BIL ISTITHMAR



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Participation certificates managed on the basis of investment agency

The issuer of these sukuk is an investment agent, the subscribers are the principals and the realised funds are the subject matter of investment under an agency agreement. The holders of sukuk own the assets represented by the certificates with its benefits and risks and are entitled to profits from the partnership, if any

Share of Sukuk al Wakala in different issuances by issue size, 2018 (international issues)

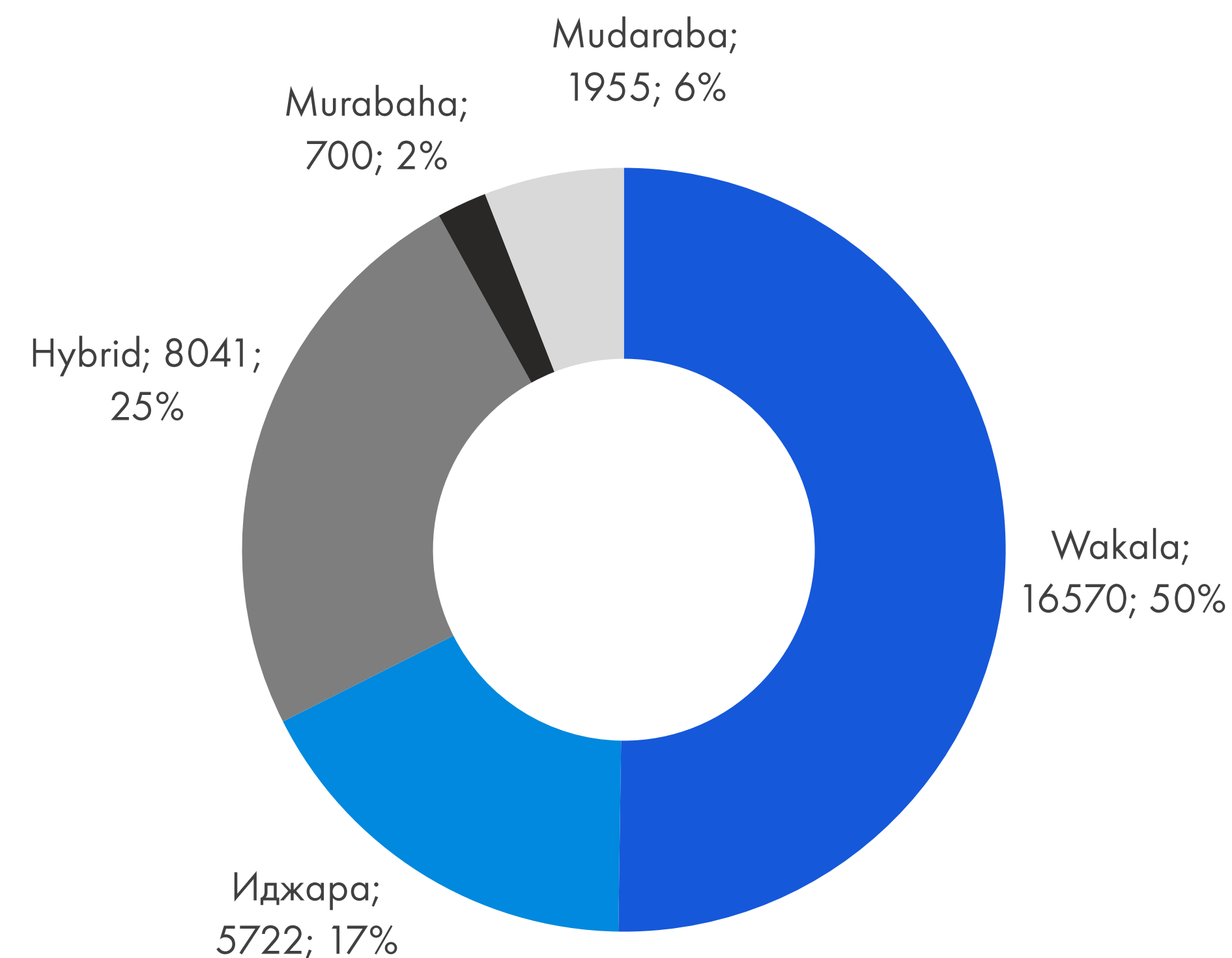
- Sovereign issuances – 34% (top 1)
- Quasi-Sovereign issuances – 92% (top 1)
- Corporate issuances – 31% (top 2)2
- Islamic financial companies' issuances – 25% (top 1)

Sukuk wakala issuances in 2018 (individual landmark issuances):

- IDB (3 issuances)
- Central Bank of Qatar (4 issuances)
- First Abu Dhabi Bank (1 issuance for 650 mkn USD)
- Noor Bank, Dubai (1 issuance for 500 mln USD)
- Medco Power, Indonesia (1 issuance for 426 mln USD)
- .

Source: IIFM, 2019

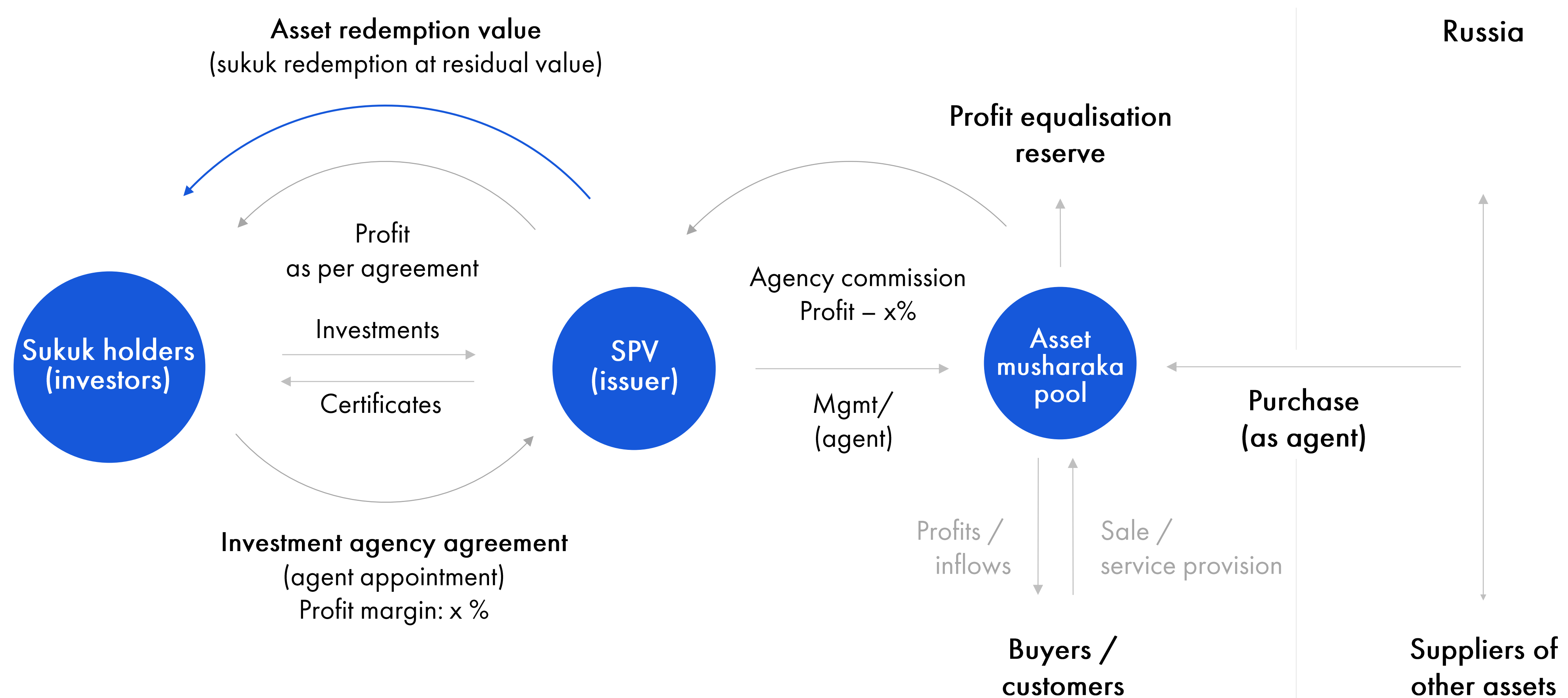
International sukuk issuances, mln USD, 2018



SUKUK STRUCTURE FOR AGROFINMOST (WAKALA BIL ISTITHMAR)



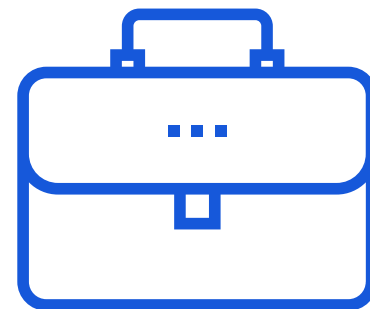
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NOTES ON SUKUK STRUCTURE (1/3)

Investment agency agreement



Sukuk holders appoint a management company as an agent to set up and manage the investment portfolio (asset pool). The contract must specify the nature of the assets, e.g.:

- Real estate
- Property to lease out
- Goods for sale (e.g., grain)



The investment agent must ensure that the asset time ratio is maintained: illiquid assets must be above 33% of the portfolio. (All cash and receivables are liquid assets)



The income generated by each asset type in the portfolio is divided between investors and the management company.

The management company:

- is entitled to all the profits in excess of the pre-determined rate stipulated in the contract;
- receives a fixed agency fee.

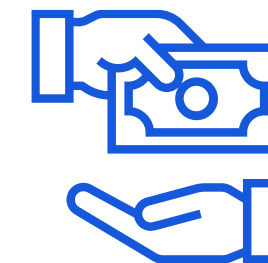


NOTES ON SUKUK STRUCTURE (2/3)

Lease asset management



Such assets, together with other illiquid assets, are purchased under an Asset Purchase Agreement. They must represent 33% or more of the portfolio value (for sukuk to be tradeable on the secondary market: AAOIFI Standard 21, item 3.19)



Upon maturity of sukuk, the assets are bought out from sukuk holders at residual value under an **Undertaking to Purchase (UTP)**



After purchase, such assets are leased out under a **Lease Agreement**. The size of lease payments must meet a pre-define criterion



If the assets were purchased from the issuer (the borrower) and then leased back to the issuer, at the end of the lease the issuer repurchases it, then minimum period of lease must be 1 year (as per AAOIFI standards)

NOTES ON SUKUK STRUCTURE (3/3)



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Current asset management (grain)

The proceeds of the sukuk issue are invested in grain trading contracts (no more than 67% of contract price).



- The management company seeks to achieve the pre-determined profit margin stipulated in the business plan and agreement. If the actual profits exceed the pre-determined margin, the company may keep the excess profits (fixed agency fee plus incentive).
- Every six or four months (depending on the documentation), the management company makes distribution of profit to investors. After financial statements are out, the disbursements are reassessed. Reserves can be created to adjust any variation at the end of the year.

SUKUK ISSUE DOCUMENTATION



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Investment agency agreement
(between Investment Agent
and Participants)



Lease agreement
(between Investment Agent and
Sukuk Issuer)



Agency agreement
(between Investment Agent
and Sukuk Issuer)



Undertaking to Purchase
(by Sukuk Issuer)



Asset purchase agreement
(between Investment Agent
and Sukuk Issuer)



**Security documents,
guarantees**

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