

# SUKUK

## Islamic Bonds

*by*  
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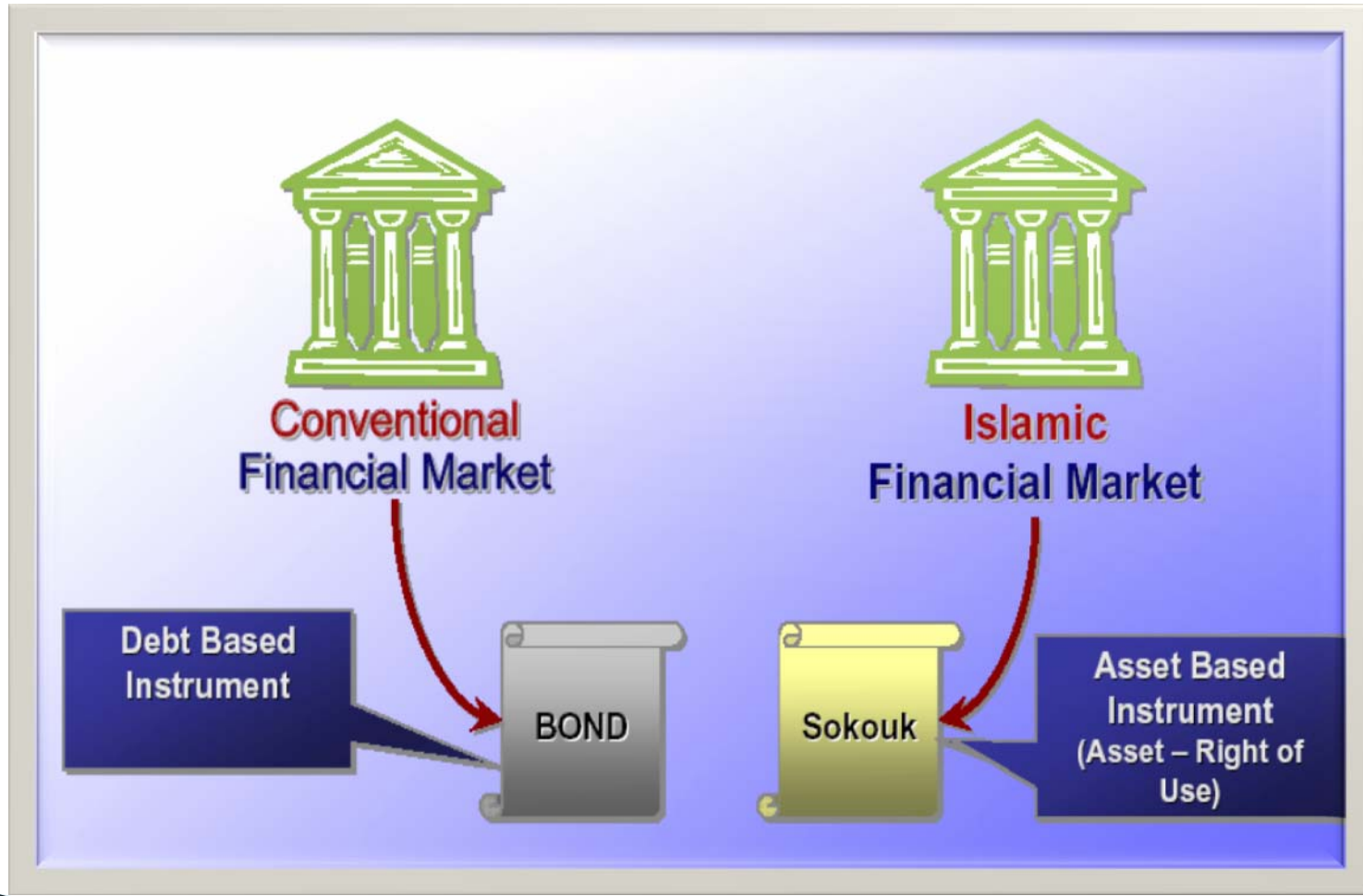
# Defination

Sukuk is the Arabic name for a financial certificate, Islamic alternative to conventional bonds, Sukuk is a Trust certificate in which investor returns are derived from legal or beneficial ownership of assets.

Certificates of equal value representing proportionate ownership of tangible assets or usufructs or services or (of) the assets of a project or in an investment activity. (AAOIFI)

This ownership comes in effect after the completion of subscription and with the investment of received funds.

# Introduction



# A Sukuk represents:

An undivided proportionate ownership interest in an asset

- ✓ The corresponding right to the Islamically acceptable income streams generated by the asset.
- ✓ These current income streams are established and translated into tradable securities
- ▶▶ Trust Notes or Certificates similar to Equipment Trust Certificates (ETCs) and Unit Trusts
- ▶▶ Issuer creates a trust over the leased Assets
- ▶▶ Trustee issues Sukuk to the Primary Subscribers (the beneficiaries under the trust) in the Primary Market

## A Sukuk represents: Contd..

- ▶▶ Sukuk Holders have pro-rata undivided beneficial ownership of the leased Assets / Portfolio held in trust - As beneficial owners the Sukuk Holders are entitled to the income streams from the Leased Assets / Portfolio
- ▶▶ The Primary Subscribers can resell the Sukuk in the Secondary Market
- ▶▶ The Secondary Buyer will be the new pro-rata beneficial owner of the Leased Assets held in trust

# Growth in Sukuks

- ▶ Liquidity Management of Islamic Financial Institutions.
- ▶ Islamic financial institutions are seeking to diversify their portfolio and increase their portfolio size of tradable instruments with fixed income profile
- ▶ The industry requires Sukuk funds for retail distribution.
- ▶ Islamic Inter-Bank or Short term Islamic Finance market can be developed through sukuks.
- ▶ The underlying assets are purely used as a means of transacting and do not constitute a Transaction specific pool of security

# Growth in Sukuks

- ▶ Sukuks are usually issued through special purpose vehicle (“SPV”)
- ▶ In Pakistan a Limited Liability Company has acted as the issuer and is registered with and regulated by SECP
- ▶ Short and long term 5 – 10 Years Tenor
- ▶ There were record number of Sukuk Issues in 2007 Worldwide with a Total volume of US\$32.65 Billion
- ▶ 119 New Issues of Sukuk in 2007 – 26% Sovereign and 74% Corporate (31: 88) with an average deal size of US\$269.8 Million in 07 from US\$175 Million in 06



# Growth in Sukuks

## ▶ In GCC– Gulf Co–operation Council UAE Leads in 2007 Sukuks

- ▶ UAE 58 %
- ▶ Saudi Arabia 30 %
- ▶ Bahrain 06 %
- ▶ Kuwait 04 %
- ▶ Qatar 02 % *Bloomberg , Zavya.com & Moody's*

Qatar in Planning to Issue **US\$ 15 billion** Sukuks in 08

Musharika Sukuks remained popular in 2007 in Amount but Ijarah Sukuks in Global Issues Number of Issues

In Asia Pecific, *Malaysia* is dominating *with 95% share* Pakistan stands second with only 3% Sukuks in Value

**30–35%** Growth expected for next three years 2008–10

# Advantages to Sukuk Issuar

- ▶ Diversification of funding sources
- ▶ Creating and enhancing profile in international markets
- ▶ Secondary liquidity
- ▶ Sizeable financing.
- ▶ Ease of clearing and settlement

# Advantage of Sukuk Investor

- ▶ Diversification in Investment
- ▶ Provides Leveraging Capabilities
- ▶ Secondary Market Liquidity
- ▶ Ease of clearing and Settlement
- ▶ Investment available to Institutional and Retail investors
- ▶ Allows for many computation of Risk – Credit /Mkt. /Duration etc

# Issuance of Sukuk– Factors to be considered

- ▶ Identify the investors
- ▶ Rating – by a Credit Rating Agency
- ▶ Underlying Assets
- ▶ Secondary Market Considerations
- ▶ Applicable laws – SECP rules
- ▶ Costs to the Issuers
- ▶ Drafting of Legal Documents
- ▶ Regularity Framework

# Parties Involved

- ▶ Originator : Initial Owner
- ▶ SPV : Set up for the Issue
- ▶ Investors: Subscribers.
- ▶ Servicer: Servicer to the assets.
- ▶ Collection and Paying Agent : Banks
- ▶ Credit Enhancement provider : hedges, Guarantees, Takaful etc Need to be Explored

# Parties Involved

- ▶ Merchant Banker (s) :
- ▶ Credit Rating Agency:
- ▶ Legal & Tax Counsel: a Challenging Role
- ▶ Auditors

# Challenges for the Market

- ▶ Limited number of issues that constrains active trading of these instruments in the secondary market
- ▶ Buy and Hold Strategy by major investors of Sukuks
- ▶ Limited quality of assets available for Ijarah securitization
- ▶ Limited Corporate Focus – Changing

# Ideal models for structuring of Sukuks



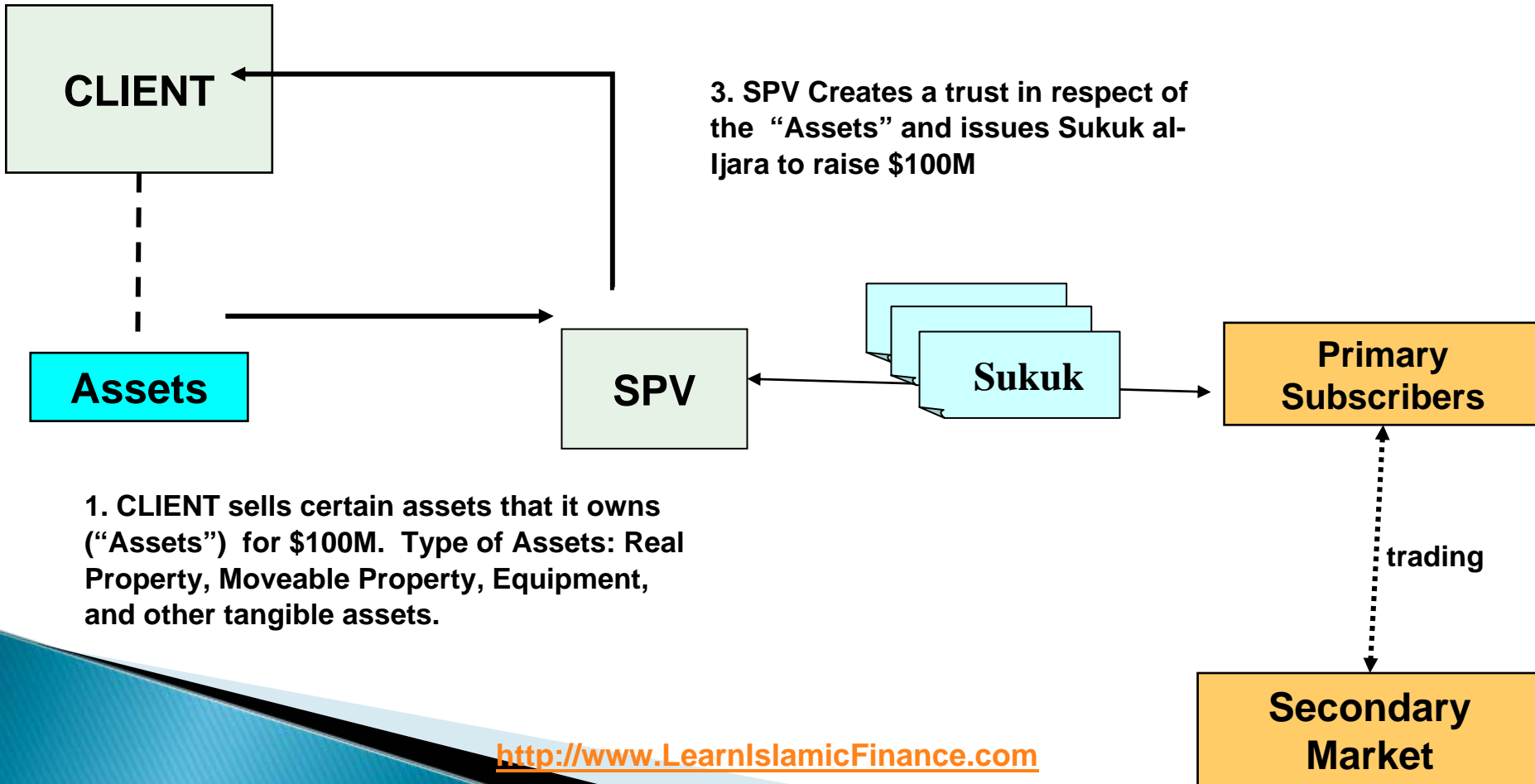
# Sukuk Structure

Sukuk Structuring may based on following modes

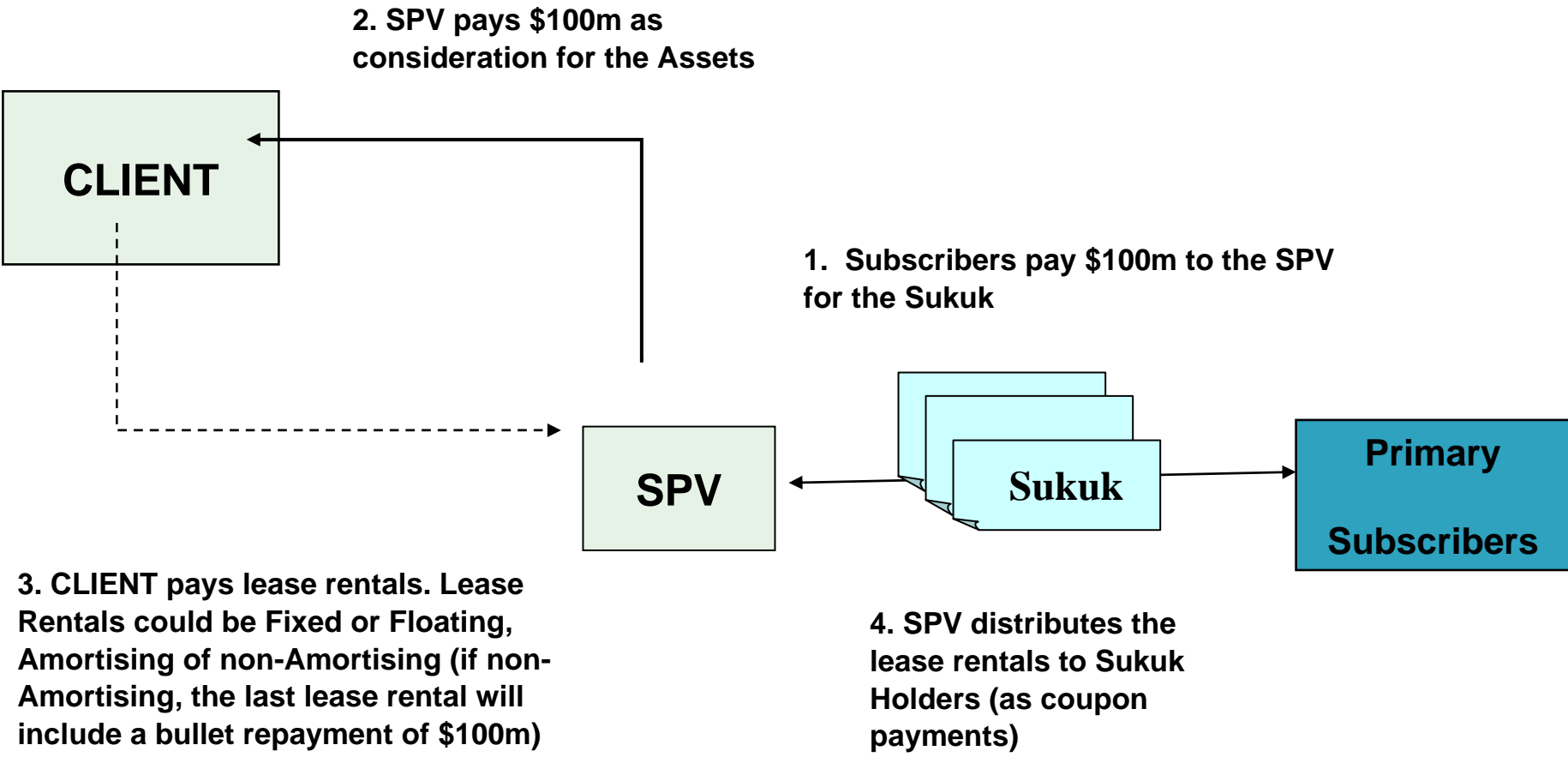
- ▶ Mudarabah (*Trust Financing/Trust Investment*)
- ▶ Murabahah (*Sale and Purchase*)
- ▶ Musharaka (*Partnership, Project Finance Participation*)
- ▶ Istishna (*Purchase by Order or to Manufacture*)
- ▶ Salam (*Upfront Payment Sale*)
- ▶ Ijarah (*Operating Lease Concept*)

# Typical Sukuk Structure for Sale and Leaseback

2. SPV Leases back the Assets

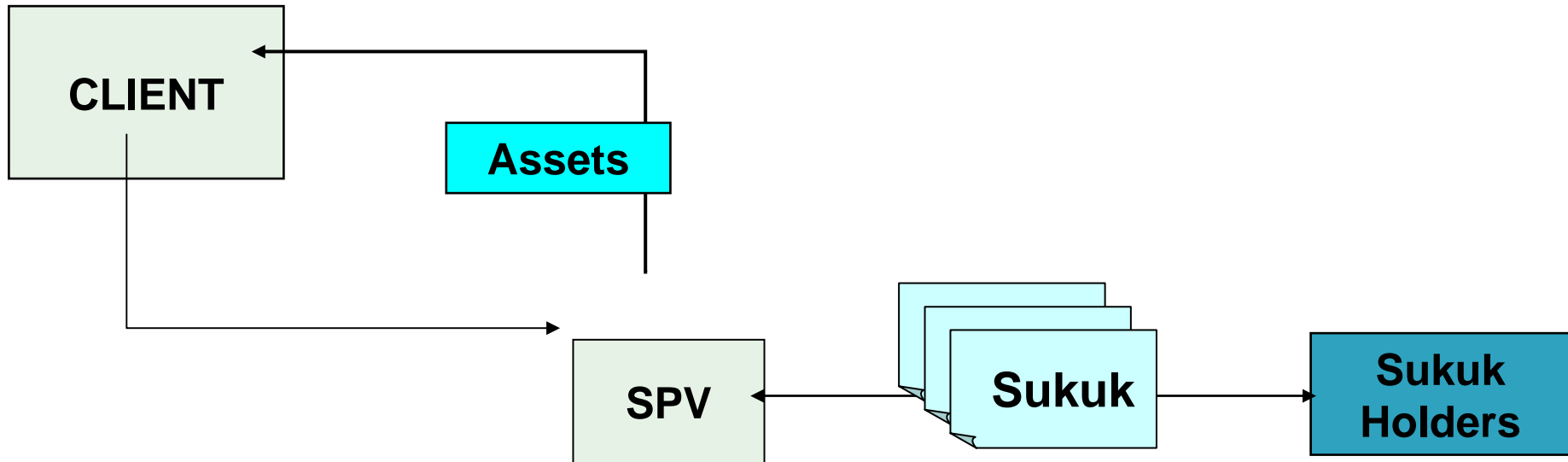


# Flow of Funds - Acquisition & Rentals



# Flow of Funds - Repayment & Maturity

1. SPV will “Put” the Assets to CLIENT



2. CLIENT will pay a nominal amount.  
Result: ownership of Assets revert back to CLIENT

# Typical International Sukuk Mechanism – Step by step

