Government sterling sukuk issuance: a consultation

November 2007

HM TREASURY

United Kingdom Debt Management Office

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a consultation

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ISBN 978-1-84532-370-7
PU435

Contents

1 PROGRESS TO DATE AND PURPOSE OF CONSULTATION

A. PURPOSE

1.1 The purpose of this consultation is to seek views on the potential for the Government to become an issuer of sterling Islamic financial instruments. Following the assessment undertaken to date, the consultation seeks views on the advantages, disadvantages and risks of the Government becoming an issuer of Islamic financial instruments and on a number of specific and technical areas relating to any issuance.

B. INTRODUCTION

1.2 In April 2007, the then Economic Secretary to the Treasury announced[1] that HM Treasury and the Debt Management Office (DMO) would carry out a feasibility study into the potential for the Government to become an issuer of Islamic financial instruments in the wholesale sterling market, consulting with the Islamic Finance Experts Group (IFEG)[2] and reporting on progress at the time of the 2007 Pre-Budget Report (PBR).

1.3 The objectives of potential issuance of Islamic wholesale financial instruments were set out by the then Economic Secretary, when he said that: “We are determined to do everything we can to deliver greater opportunities for British Muslims – and also to entrench London as a leading centre for Islamic finance in the world”; in line with existing policy on Islamic finance.

1.4 The terms of reference for the study, which were also published in April 2007[3], stated that it would examine the benefits and costs of the case for the Government to become an issuer of wholesale sterling Islamic financial instruments and the practical and legal implications of doing so, taking account of: (i) the Government’s debt management policy objective; (ii) the size and nature of demand; (iii) the potential risks; (iv) any implications for the Government’s financing strategy; (v) the experience of other sovereign issuers of Islamic instruments; and (vi) the impact on markets including the impact on the City of London as an Islamic financial centre.

1.5 It was also announced by the then Economic Secretary in April 2007 that National Savings & Investments (NS&I)[4] would separately examine the feasibility of the Government becoming an issuer of retail Islamic financial products. NS&I will report in Spring 2008.

1.6 Following these announcements, HM Treasury and the DMO have taken forward the feasibility study in consultation with members of the IFEG and others, considering, in particular, the potential for Government issuance of sterling denominated Sharia’a-compliant ‘investment certificates’ or ‘sukuk’.

[1] The feasibility study was announced in a speech by Ed Balls MP to the Financial Services Authority's (FSA’s) Principles-based Regulation Conference, 23 April 2007.

[2] The letter from the Economic Secretary to IFEG about the feasibility study is on HM Treasury’s website at: http://www.hm-treasury.gov.uk/consultations_and_legislation/islamic_financial/consult_islamic_financial.cfm

[3] The full terms of reference for the feasibility study can also be found under the above link.

[4] National Savings & Investments (NS&I) is a Government department and an executive agency of the Chancellor of the Exchequer. It is one of the largest savings institutions in the UK. It has the primary objective of raising cost-effective financing for the Government from the retail sector by offering customers secure savings and investment products that are both attractive and competitive.

C. PROGRESS TO DATE WITH THE FEASIBILITY STUDY

1.7 The 2007 PBR, published on 9 October 2007, contained a progress report on the feasibility study[5]. The Government reported that it had identified a number of potential benefits of sukuk issuance flowing to the City of London and to the wider community. London is already established as a major international finance centre and a gateway for Islamic finance. Issuance of sukuk by the Government would signal the Government's continuing ambition in this area, which could further spur the development of the City as a centre for Islamic finance, enhancing its ability to attract further sukuk structuring activity and activity related to Islamic finance more generally. In addition, the provision of wholesale sterling sukuk by the Government could potentially facilitate the development of a greater range of Sharia'a-compliant retail financial products. These products would be available to all retail customers but would be of particular benefit to those who would otherwise be unable to access routine financial services because of their faith.

1.8 The Government has also identified a number of potential costs, including the costs of both structuring and launching sukuk, as well as other costs that are dependent on the size and nature of the issuance.

1.9 The Government is continuing to examine the risks associated with sukuk issuance, particularly those risks relating to price and demand. In this context, the Government is examining the feasibility of issuing sukuk that would have similar characteristics to either gilts or Treasury bills and would compare favourably with these instruments so that sukuk issuance would be value for money.

1.10 The feasibility study has identified several important structuring issues that need to be resolved prior to any sukuk issuance. These issues include:

- the need for – and content of – any primary legislation to facilitate sukuk issuance;
- the identification of an asset(s) – such as a building(s) owned by the Government or a piece of infrastructure – to be transferred to a special purpose vehicle (on the assumption of an Ijara structure) to facilitate sukuk issuance; and
- the taxation treatment of assets upon transfer to and from a special purpose vehicle (SPV) and any other taxation or regulatory issues.

1.11 HM Treasury and the DMO will continue to consider the structural issues identified as part of the feasibility study.

D. PUBLIC CONSULTATION

1.12 In the context of the ongoing analysis of risks associated with sukuk issuance, the Government announced in the 2007 PBR that it would hold further detailed and specific consultation, in particular, regarding the feasibility of issuing:

- 'bond-like' sukuk with a maturity of greater than one year, e.g. 5 years; and
- 'bill-like' sukuk with a maturity of less than one year, e.g. three months.

[5] Progress with the feasibility study was reported in Box B2: "Government sukuk issuance" in Annex B, page 183, of the 2007 Pre-Budget Report and Comprehensive Spending Review, which is on HM Treasury's website at: http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm

1.13 As a consequence, HM Treasury and the DMO have published this consultation document, which seeks the views of all interested parties on the possible issuance by the Government of wholesale sterling denominated sukuk.

1.14 **Written responses[6] should be provided by 21 February 2008 and should be sent to Christopher Goodspeed at HM Treasury, 1 Horse Guards Road, London SW1A 2HQ or by email to christopher.goodspeed@hm-treasury.gsi.gov.uk**. All interested parties are invited to respond. In addition, HM Treasury and the DMO would be ready to meet interested parties at the request of the respondent.

1.15 **If you have any questions about this consultation please contact either Peter Symons at HM Treasury (+44 (0) 20 7270 5329, peter.symons@hm-treasury.gsi.gov.uk) or James Knight at the DMO (+44 (0) 20 7862 6571, james.knight@dmo.gsi.gov.uk).**

1.16 Following the consultation, the Government will announce its decision and next steps including the timetable for any primary legislation.

E. SCOPE OF THE CONSULTATION

1.17 The focus of this consultation is on the potential for Government issuance of wholesale sterling denominated sukuk either in 'bond-like' or 'bill-like' form[7]. These questions raise issues on which HM Treasury and the DMO would particularly like to receive responses.

1.18 Although the questions set out in this consultation document are primarily detailed, technical and specific in nature, they should not preclude respondents from raising other more general issues or, indeed, other specific issues not raised explicitly in the consultation document, if respondents believe that these could have a bearing on the Government's decisions about issuance of sterling sukuk.

1.19 As noted above, NS&I is separately assessing the feasibility of becoming an issuer of retail Islamic financial products and will report in Spring 2008. Therefore, this consultation is not seeking responses on the question of potential issuance by the Government of retail Islamic financial products. However, although the focus of this consultation is on wholesale sterling sukuk issuance, HM Treasury and the DMO are also interested in responses addressing the question of whether wholesale sukuk issuance might facilitate greater provision by retail banks of Sharia'a-compliant Islamic retail products.

F. QUESTIONS

1.20 Some of the issues raised in this consultation apply both to a 'bond-like' and 'bill-like' sukuk issuance (e.g. the structuring of sukuk issuance), whereas others apply to one or other type of issuance. The questions set out in Chapter 3 reflect these distinctions: questions in sections (A-D) that apply to both types of sukuk issuance; in section (E) to questions that apply only to a 'bill-like' sukuk; and section (F) questions that apply only to a 'bond-like' sukuk.

[6] It is important to note that both HM Treasury and the DMO are subject to the provisions of the Freedom of Information Act 2000 and consequently information disclosed in response to requests for information under the Act could enter the public domain. If the information that is provided is commercially sensitive please mark it as such and it will not be disclosed to the extent that such non-disclosure is consistent with the Act.

[7] The terms 'bond-like' and 'bill-like' refer explicitly to the maturity difference between the two instruments, as well as the different structure for regular profit distribution. This is not intended to indicate any other similarity to a debt security.

2 THE WORLD SUKUK MARKET AND RECENT UK POLICY DEVELOPMENTS

A. BACKGROUND

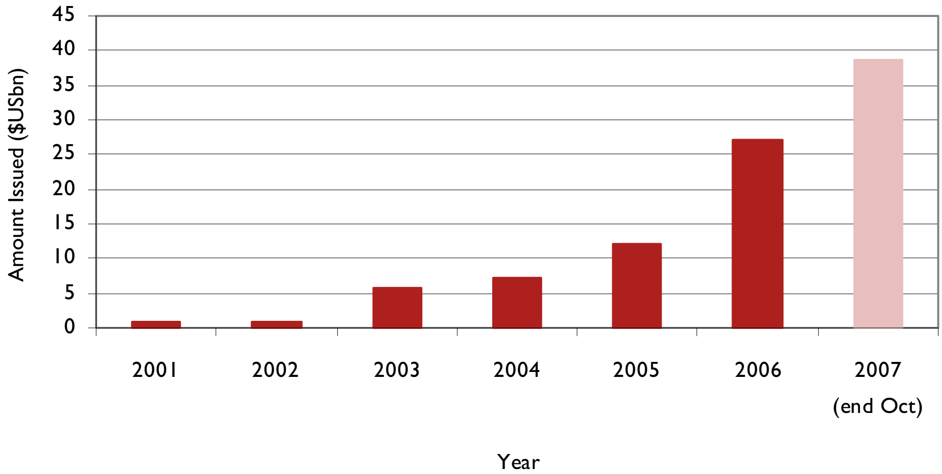
2.1 The world Islamic finance market has grown significantly since the first modern episode in Islamic banking in 1963, when the Mit Ghamr savings project was set up in Egypt[8]. While the period from the 1970s to the 1990s saw development in modern Islamic finance, with the establishment of a number of Islamic banking institutions, it was not until the early to mid 2000s that the world Islamic finance market began to develop a critical mass of activity. Islamic banking and finance is now utilised in over 70 countries, involving over 300 Sharia'a-compliant institutions. The Islamic finance industry is supported by a number of international institutions including, amongst others, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) based in Bahrain and the Islamic Financial Services Board (IFSB) based in Malaysia.

2.2 Sukuk, often referred to as 'Islamic bonds', are akin to Islamic 'investment certificates'. Unlike bonds, which are debt-based instruments that pay interest, sukuk are asset-based instruments and represent the ownership (actual or beneficial) by the sukuk holders in the underlying asset. Returns are paid to investors in line with their proportional ownership in that asset. These certificates are designed to be in compliance with Sharia'a law, the divine law in Islam which is based on the Quran and other sources.

2.3 While market estimates vary, dependent on source, it is clearly apparent that the world sukuk market has been growing significantly since the beginning of the decade, with sukuk issuance increasing year-on-year as can be seen in Chart 1. Future growth in sukuk issuance is estimated to be in the range of 10-15 per cent a year for at least the next three to five years.

[8] A savings bank established in Mit Ghamr, which neither paid nor charged interest and was based on a model of profit sharing.

Chart 1: Total world sukuk issuance[9] since 2001 ($USbn)



Source: DMO and Islamic Finance Information Service (IFIS)

2.4 Sukuk have been issued by both corporates and sovereigns, with issuance from sovereigns and their entities including Malaysia, Pakistan, Qatar, Bahrain, the United Arab Emirates and Brunei; there has also been sukuk issuance from the German state of Saxony-Anhalt. However, as Chart 2 shows, the majority of sukuk issues to date have been by corporates.

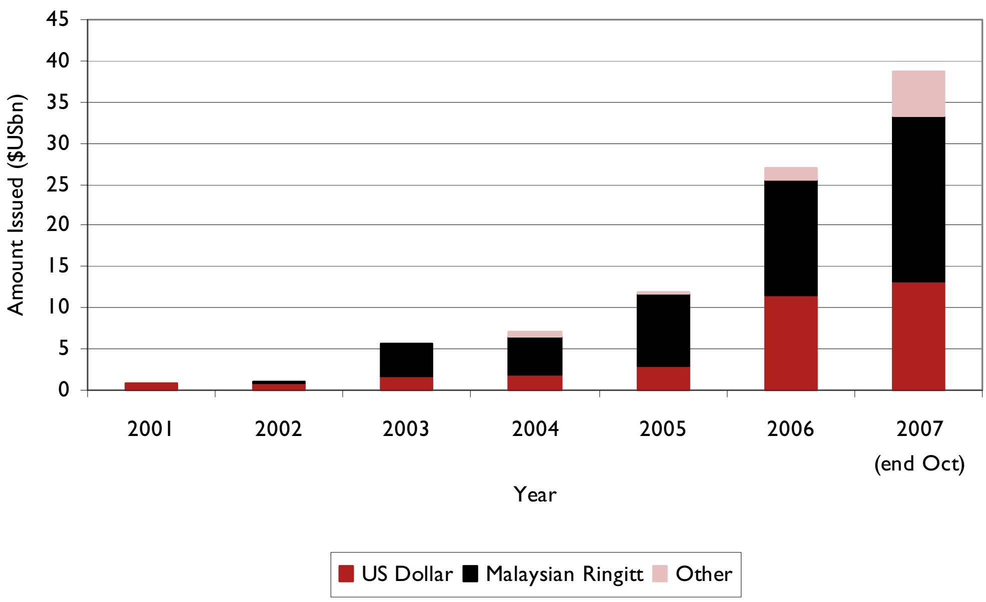
Chart 2: Total sukuk issuance since 2001 ($USbn) by issuer

Source: DMO and IFIS

[9] Including all domestic, international issues, and short-term sukuk.

2.5 Sukuk have been issued in fourteen different countries, and in over ten different currencies, although a large proportion of issuance has been in US dollars and Malaysian ringgit, as shown in Chart 3.

Chart 3: Total sukuk issuance 2001 ($USbn) by currency



Source: DMO and IFIS

2.6 As a major international finance centre, with strong ties with Asia and the Middle East, London has naturally developed as a gateway for Islamic financial activity, particularly structuring and listing, with thirteen sukuk currently listed in the UK[10].

B. GOVERNMENT POLICY ON ISLAMIC FINANCE

2.7 As part of the Government's policy on City competitiveness to facilitate innovation in the financial services sector, Islamic finance has been identified as an important, high-growth area. The Government's objective for Islamic finance is two-fold:

- to entrench London as a global gateway for Islamic finance; and
- to ensure that all British citizens, regardless of their faith, have access to competitive financial services.

2.8 Since 2003, the Government has worked steadily towards its aim to ensure a 'level playing field' for both retail and wholesale Islamic finance products to compete alongside other financial products. The Government is continuing to deliver changes to facilitate growth in this area.

2.9 In Budget 2007, the Government announced a package of measures reflecting market developments over the past twelve months, including a new framework for listed sukuk, which allows sukuk to be held, issued and traded in the same way as corporate bonds. A summary of changes to taxation and regulatory policy on Islamic finance is provided in the Box.

[10] There are eleven sukuk listed and two programme listings.

Box: Changes to the taxation and regulation of Islamic finance since 2003

2003

- The first tax legislation catering specifically for Islamic finance arrangements was introduced in the Finance Act 2003, relating to stamp duty land tax (SDLT). This legislation removed a major obstacle to the marketing of certain types of Sharia'a-compliant mortgages by introducing reliefs to prevent multiple payments of SDLT for these transactions.

2005

- The concept of alternative finance arrangements was introduced in the Finance Act 2005. Regulations were laid in December 2005 to make them qualifying investments which included Islamic savings schemes for Individual Savings Accounts (ISAs), Personal Equity Plans (PEPs) and Child Trust Funds (CTFs).
- In the Finance Act 2005, the Government created a 'level playing field' for tax purposes for *Mudaraba* and *Murabaha* products.
- The Government also introduced further changes in the Finance Act 2005 to SDLT legislation to extend relief from multiple stamp duty to a newly available shared ownership product known as *Diminishing Musharaka* (reducing partnership share-based products).
- In December 2005, the Financial Services and Markets Act 2000 (FSMA) was amended to enable Home Purchase Plans (HPPs – also known as Islamic mortgages) to be regulated by the Financial Services Authority (FSA).

2006

- In the Finance Act 2006, the Government extended the concept of alternative finance arrangements to include the use of *Diminishing Musharaka* products in place of standard loans, and confirmed the tax treatment of *Wakala* contracts to ensure that the return to a customer is treated as interest for tax purposes.
- The Government made further changes in the Finance Act 2006, introducing a measure which extended to all entities, including companies, the reliefs from multiple SDLT that were previously only available to individuals. In addition, as part of the leasing reform, the Government enabled the use of *Ijara wa'Iqtina* (Islamic lease) for asset finance.
- In October 2006, secondary legislation to bring HPPs into the FSA's regulatory scope received Parliamentary approval. The regulations were aimed at ensuring consumer protection and other relevant rules are comparable to those for mortgage products.

2007

- In the Finance Act 2007, the Government introduced legislation to establish the tax treatment for Islamic securitisation known as sukuk. To support this legislation, regulations were laid in July 2007 detailing recognised stock exchanges for the purpose of sukuk.

3 CONSULTATION QUESTIONS

A. THE GOVERNMENT ISSUING SUKUK

3.1 This chapter sets out in boxes below the questions on which the Government would welcome respondents' views. However, the Government would also welcome any more general views that respondents have on the potential for Government sukuk issuance that go beyond the questions set out below.

> 1. Sukuk issuance would be an innovation by the Government. What are the advantages, disadvantages and risks associated with the Government becoming an issuer of sukuk?

B. PROVISION OF SHARIA'A-COMPLIANT RETAIL PRODUCTS BY RETAIL FINANCIAL INSTITUTIONS

3.2 The Government's policy is to ensure that all British citizens, regardless of faith, have access to competitive financial services. Some Sharia'a-compliant retail financial products are already available in the UK including home purchase plans and current accounts that do not pay interest. These products are provided directly or indirectly by some of the largest British retail financial institutions. In addition, some of these institutions have begun to extend the number of Sharia'a-compliant retail financial products that are available. However, the range of Islamic finance products remains below those that are available for the vast majority of British citizens. An increase in the diversity of financial products would lead to more choice for all citizens. The provision of a greater diversity of Sharia'a-compliant retail financial products, and by a greater number of providers, is one of the potential benefits resulting from Government sukuk issuance.

3.3 The questions in this section are particularly directed at British retail banks (especially the 'Islamic windows' of these banks), Islamic retail banks and any other retail financial institutions, both British and foreign, that either currently, or in the future, could offer Sharia'a-compliant retail financial products.

> 2. Some Sharia'a-compliant retail financial products are already available to retail customers. What is the potential for growth of the market for Sharia'a-compliant retail financial products in the UK? Are there any factors constraining the provision of these products?
>
> 3. What impact would issuance of sukuk by the Government have on the number and range of Sharia'a-compliant retail financial products made available? Are there key features (e.g. maturity, liquidity and size) that Government sukuk should have to facilitate greater provision of, and innovation in, Sharia'a-compliant retail financial products?

C. STRUCTURAL ISSUES

3.4 A number of sovereign and corporate sukuk issues have been facilitated through use of an Ijara contract. Under an Ijara contract, sukuk are linked to an underlying asset which is leased to generate a return. The sukuk, in effect, provide evidence of partial ownership (actual or beneficial[11]) in the underlying asset. In purchasing a sukuk, an investor purchases a share of the beneficial ownership of the underlying asset, receives a return and bears the risk on that share. The underlying asset must be compatible with Sharia'a law, that is, that haram (forbidden) activities (for example gambling, alcohol or pork production) cannot form part of the activities for which the asset is used. In order that the sukuk can be traded by Islamic investors, the underlying asset should typically be well defined and tangible.

3.5 The Government has so far assumed as a default position that any sukuk issuance would be structured using Ijara as the underlying contract. However, HM Treasury and the DMO recognise that a diversity of contracts have been employed as the global sukuk market has continued to mature. Annex A to this document sets out two examples of contract structures that could potentially be used for Government wholesale sterling sukuk issuance: (i) Sukuk al-Ijara (using a lease contract); and (ii) Sukuk al-Mudaraba (based on a partnership contract).

3.6 An Ijara contract would involve the transfer of a Government asset (using a head-lease or sale) to an SPV. The Government would subsequently lease or sub-lease the asset back from the SPV. The asset could be, for example, a building(s) or a piece of infrastructure. These types of assets have been used by other sovereign issuers of sukuk. This lease or sub-lease generates rental payments that form the basis of the periodic return to sukuk holders. At the end of the life of the sukuk, the Government would undertake to purchase this asset (by buying it back, or obtaining the surrender of the head-lease) which would result in a transfer of proceeds to the SPV generating the redemption payments to sukuk holders.

3.7 The creation of an SPV therefore facilitates the structuring and issuance of certificates to investors. The SPV typically also acts as a trustee for the holders of the sukuk. The structure can create 'bankruptcy remoteness' for the assets so that, in the event of bankruptcy, other creditors do not have any rights to the assets held in the SPV. The structuring arrangements used to facilitate sukuk issuance need to be Sharia'a-compliant. These arrangements will need to clarify issues relating to: the independence of the SPV from the Government, the appointment of the directors/administrators of the SPV, the powers granted to the SPV, restrictions placed on changes to the form or use of the asset once it is transferred to the SPV and the rights granted to sukuk holders to cover a 'default event'. Typically, day-to-day use of the asset remains with the (sub-) lessor, in this instance, the Government.

[11] Beneficial ownership confers the benefits of owning an asset without formal legal ownership.

4. An Ijara contract has been used to date in other sovereign and corporate sukuk issues. What are the merits of using an Ijara contract? Is there benefit in the use of an alternative structure that would be consistent with the activities undertaken by the Government?

5. Sukuk issuance requires that the Government transfers an asset to the SPV. This asset may be a building(s) or a piece of infrastructure. Are there any issues relating to the transfer of an asset by the Government to an SPV?

6. The structuring arrangements used to facilitate sukuk issuance need to be Sharia'a compliant, and clear about the rights of the Government, SPV and sukuk holders. What features and rights are needed to ensure Sharia'a compliance of the structural arrangements?

D. TAXATION, REGULATION, LISTING, REGISTRATION AND SETTLEMENT

3.8 In successive Finance Acts since 2003, the Government has taken steps to ensure a 'level playing field' between Islamic financial products and other financial products. Since 2000, the Financial Services Authority (FSA) has authorised three Sharia'a-compliant Islamic banks in the UK as well as several 'Islamic windows' of existing retail and investment banks.

3.9 The Government seeks to continue to minimise any remaining differences between sukuk issuance and bonds and bills, particularly if differences could affect investment in Government sukuk or replication by corporate issuers of the structure used in that issuance. These differences may relate to the regulatory, taxation or listing treatment of sukuk that could make them less attractive as an investment, or less replicable by corporate issuers. In addition, any comments on particular issues surrounding the registration and settlement of sukuk relative to bonds and bills are welcomed.

7. The Government seeks to continue to minimise any differences between any sukuk issuance and bonds and bills. Are there any issues relating to taxation, regulation, listing, registration and settlement that apply to the purchase and issuance of sukuk in 'bond-like' or 'bill-like' form (i.e. in the latter case, a deeply-discounted instrument) in the UK that do not apply to gilts or Treasury bills?

E. QUESTIONS RELATING TO DEMAND AND CHARACTERISTICS OF 'BILL-LIKE' STERLING SUKUK ISSUANCE

3.10 The questions in this section relate to 'bill-like' sukuk; i.e., sukuk with maturities of less than one year, for example three months to maturity. The Government intends that any sukuk issuance should be attractive and available to all investors. Therefore, the questions in this section seek views on the characteristics required in 'bill-like' sukuk issuance that would minimise any differences between sukuk and Treasury bills so that the sukuk could be treated as equivalent to bills while not compromising their Sharia'a compliance.

3.11 Relative to 'bond-like' sukuk issuance, short-term sukuk would be akin to a Treasury bill. It would be structured in the same way as a longer-dated sukuk, i.e., based on the transfer of an asset to an SPV. However, its maturity would be considerably shorter, at somewhere in the region of three months.

> 8. The Government intends that any sukuk issuance should be attractive and available to all investors. Are there any key characteristics of Treasury bills that, if not replicated in 'bill-like' sukuk, could cause a difference in pricing between 'bill-like' sukuk and Treasury bills? How would pricing 'bill-like' sukuk comparably with Treasury bills affect the attractiveness of sukuk as an investment, particularly for Islamic investors?

3.12 Demand for any 'bill-like' sukuk issue is clearly important in the consideration of the appropriate amount of any Government sukuk issuance that could be supplied. As a comparator, at the end of the financial year 2006-07, there was £15.6bn in Treasury bills outstanding.

> 9. The Government seeks to identify the size and determinants of current and future demand for 'bill-like' sukuk. What is the estimated size of the total market demand for 'bill-like' Government sukuk? What is the potential for future growth in demand and what are the determinants and sources of potential future growth?

3.13 As is the case for all banks, Islamic banks have to address their liquidity needs in order to ensure their smooth operation. However, given the need for such institutions to avoid the payment and receipt of interest (or riba), they have an additional constraint relative to other banks in meeting their liquidity management needs. There is a well-developed interbank market, which offers a variety of products to meet the liquidity management needs of most banks, but not Islamic banks. These dealings can be unsecured or secured in a range of maturities from overnight borrowing out to one-year maturity. However, these instruments are not permissible for Islamic banks because they are interest based.

3.14 To address this liquidity management issue, most Islamic financial institutions use Commodity Murabaha. Commodity Murabaha are transactions in which an Islamic bank buys commodities and sells these to a counterparty on a Murabaha basis to another broker, i.e. spot delivery with deferred payment incorporating a mark-up. Some attempts have already been made to develop alternatives to Commodity Murabaha.

> 10. Most Islamic financial institutions use Commodity Murabaha to manage their liquidity. To what extent would 'bill-like' sukuk be a more useful alternative than Commodity Murabaha for the liquidity management of Islamic banks?
>
> 11. What maturity of 'bill-like' sukuk (e.g. 1 month, 3 month etc.) would best meet the needs of market participants and other investors? As there are few tradable short-term money market instruments in Islamic finance currently available, to what extent could the provision of a short-term 'bill-like' sukuk by the Government foster the development of the market?

3.15 The Government needs to determine the best method for any issuance of 'bill-like' sukuk. As a comparator, sterling Treasury bills are currently issued on a competitive basis via tenders, held by the DMO on the last business day of each week. Treasury bills can also be sold to the market bilaterally.

12. The Government is considering a variety of issuance methods for any 'bill-like' sukuk issuance. What issuance method should be used to sell 'bill-like' sukuk?

13. Is there a minimum size of issuance required to generate investor interest in 'bill-like' sukuk?

F. QUESTIONS RELATING TO DEMAND AND CHARACTERISTICS OF 'BOND-LIKE' STERLING SUKUK ISSUANCE

3.16 The questions in this section relate to 'bond-like' sukuk; i.e., sukuk with maturities of greater than one year, for example, five years to maturity. As noted above, the Government intends that sukuk issuance is attractive and available to all investors and, therefore, the Government is also concerned to minimise the differences between bond-like sukuk and gilts if these differences would reduce their attractiveness to potential investors. The aim is to ensure that 'bond-like' sukuk would be treated by investors as equivalent to gilt issuance, whilst not compromising the Sharia'a compliance of any sukuk issue.

14. The Government intends that sukuk issuance should be attractive and available to all investors. Are there any key characteristics of gilts that, if not replicated in 'bond-like' sukuk issuance, could cause a difference in pricing between 'bond-like' sukuk and gilts? How would pricing the 'bond-like' sukuk in line with gilts affect the product's attractiveness as an investment, particularly for Islamic investors?

3.17 The size of demand for Government 'bond-like' sukuk issuance is important in the consideration of the amount of any potential sukuk issue that could be supplied, as well as the impact any supply could have on the liquidity of the secondary market for sukuk. By comparison, in 2006-07, the DMO issued £62.5bn of gilts, in maturities ranging from 5 to almost 50 years. Compared with the secondary market turnover of gilts, the liquidity in the secondary market for sukuk is currently very low or negligible.

15. The Government seeks to identify the size and determinants of current and future demand for 'bond-like' sukuk. What is the estimated market demand for 'bond-like' Government sukuk assuming it replicates the characteristics of gilt issuance whilst not compromising the Sharia'a-compliance of the issue? What are the determinants and sources of future growth?

16. The liquidity of the sukuk secondary market is much lower than that for gilts. In view of the illiquidity of the sukuk secondary market, what issuance size would be needed to generate secondary market liquidity in 'bond-like' sukuk?

17. What maturity of 'bond-like' sukuk would best meet the needs of investors?

3.18 At present, gilts are sold by auction - conventional gilts by competitive price auction and index-linked gilts by single-price auction - although the Government has, exceptionally, held one syndicated offering of a gilt[12]. Gilts are sold in auction sizes in the range of £0.5-£4bn (cash)[13].

[12] The first issue of 1¼% Index-linked Treasury Gilt 2055 in September 2005.

[13] For further information on the gilt market and DMO operations, see "UK Government Securities: a Guide to 'Gilts'", http://www.dmo.gov.uk/documentview.aspx?docname=publications/investorsguides/mb310507.pdf&page=investor_guide/Guide

19. The Government is considering different issuance methods for any 'bond-like' sukuk. What issuance method would be most appropriate to use to sell 'bond-like' sukuk?

20. Is there a minimum size of issuance needed to generate investor interest in any Government 'bond-like' sukuk?

G. CONCLUSION

3.19 Views on any of the questions listed above, and comments on any other issues respondents feel could have a bearing on consideration by HM Treasury and the DMO of potential sukuk issuance by the Government are welcomed.

A THE STRUCTURE OF SUKUK

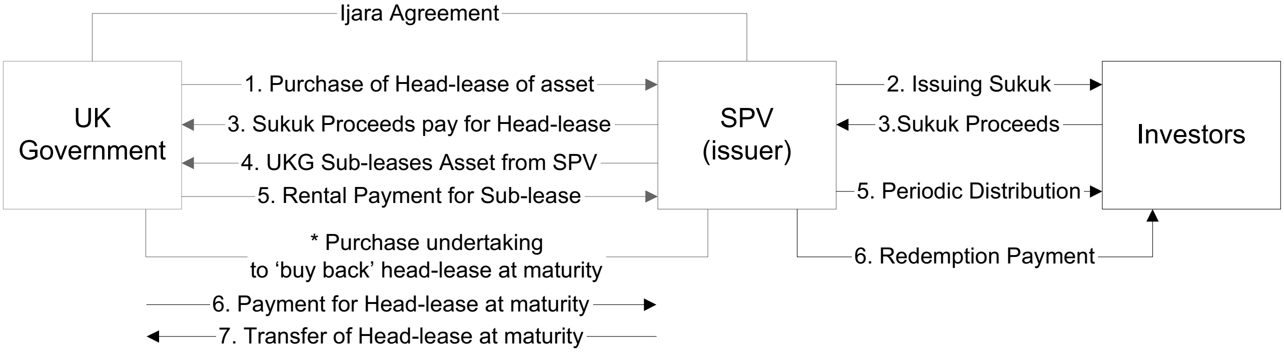
A.1 This annex outlines two possible contracts that could form the basis of any Government sukuk issue. Sukuk differ according to the underlying nominate contract used (e.g. Ijara, Mudaraba, Murabaha, Salam, Istisn'a[14]). The precise contract used depends on the nature of the asset and the activities that are to be undertaken using that asset. Sukuk al-Ijara and Sukuk al-Mudaraba are two possible structures and are explained below.

SUKUK AL-IJARA

A.2 An Ijara contract allows the transfer of usufruct (usage) of an asset in return for rental payments; as such it is similar to a lease contract. An Ijara sukuk uses this leasing contract as the basis for the returns paid to investors, who are part owners (either actual or beneficial) of the underlying asset and as such benefit from the lease rentals as well as sharing in the risk.

A.3 Figure 1 below illustrates the relevant parties and how the funds might flow in a Sukuk al-Ijara.

Figure 1: Sukuk al-Ijara structure



A.4 After the establishment of an SPV, the following steps take place:

Purchase of head-lease of asset

1. The SPV purchases the head-lease to the underlying asset for a nominal value from the original owner of the asset (e.g. the Government).

Issuing sukuk

2. To finance this purchase of usufruct, the SPV issues Sukuk al-Ijara to investors, these sukuk are quite similar to bonds, but are based on the underlying asset that the SPV has acquired rather than being debt securities.

Sukuk proceeds

3. The proceeds from investors are used by the SPV to pay for the grant of the head-lease by the Government.

[14] Ijara is a type of leasing contract. Mudaraba and Musharaka are different forms of partnership contract. Murabaha is a contract for sale at cost plus mark-up usually on spot delivery and future payment, while Salam is a contract for deferred delivery and spot payment. Istisn'a is a contract allowing manufacture of goods or an asset.

Purchase undertaking

* After the purchase of the head-lease, the Government would separately give a purchase undertaking (a one-sided promise or Wa'ad which is not conditional on any other contract) to "buy-back" the head-lease from the SPV in the future.

The Government sub-leases the asset from SPV

4. The SPV then sub-leases the asset back to the Government.

Rental payment for the sub-lease

5. This sub-lease generates a stream of rental payments that are paid to the SPV. These rental payments form the periodic return to the investors who own a share in the underlying asset.

Payment for the head-lease at maturity

6. At the end of the sub-lease period, the Government exercises the purchase undertaking and "buys back" the head-lease. This allows the sukuk certificates to be redeemed and for the capital to be returned to the investors.

Transfer of the head-lease at maturity

7. The head-lease to the asset transfers back to the Government.

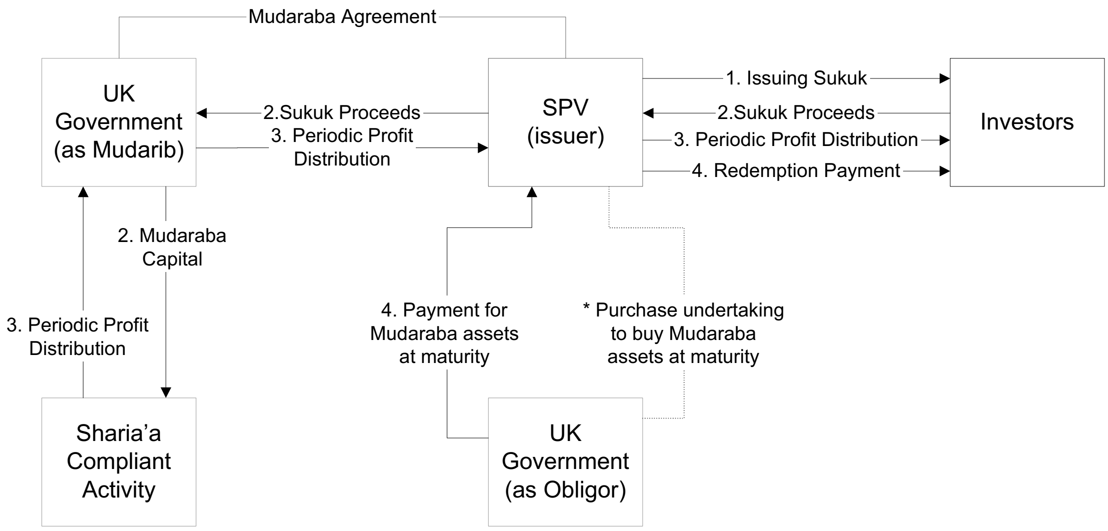
SUKUK AL-MUDARABA

A.5 A Mudaraba contract is a partnership contract between investor(s) (Rab al Mal, plural Arbab al Mal) and an entrepreneur (Mudarib). The investors provide the capital and the entrepreneur provides his expertise in using the capital to generate a return. Returns are shared in a pre-agreed ratio.

A.6 Sukuk al-Mudaraba therefore allow the pooling of investors' funds with the sukuk holders having a common share of the Mudaraba capital. As such they are entitled to returns in proportion to their investment.

A.7 The following stylised diagram shows the relevant parties and flows of funds in a Sukuk al-Mudaraba.

Figure 2: Sukuk al-Murdaraba structure



A.8 After the establishment of an SPV, the following steps take place:

Issuing sukuk

1. The SPV issues Mudaraba sukuk to investors.

Sukuk proceeds

2. The SPV collects the proceeds from investors for placement with the Government. In doing so it also acts as Rab al Mal (investor) with the Government acting as Mudarib (or entrepreneur). The proceeds pass from the SPV to the Government, which invests the capital in a Sharia'a-compliant project as specified in the terms of the prospectus.

Purchase undertaking

* The Government, acting as the obligor, separately gives an undertaking to purchase the Mudaraba assets at maturity (this is a one-sided promise or Wa'ad, and is not conditional on any other contract).

Periodic profit distribution

3. The periodic returns from the project are paid to the Mudarib, who retains a percentage as his fee. The remainder passes through the SPV to investors in the form of periodic profit distributions.

Redemption payment

4. At maturity of the sukuk, the Government exercises its purchase undertaking and buys the Mudaraba assets. The proceeds are used to redeem the sukuk certificates.

ISBN 978-1-84532-370-7

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