Present Trends & Future Prospects of Sukuk

Presented at IIFM’s International Workshop on Sukuk
by
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Citigroup Asia
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The Development of the Islamic Bond Markets

- Historical records show that in the 7th century AD, public servants were issued with Sukuk al-Badai (commodity coupons similar to warehouse receipts) by the Umayyad government.
- Imam Malik in his Muwatta has recorded that Sukuk al-Badai which evidences entitlement to a certain amount of commodity (like grain) from the treasury was seen traded prior to maturity.
- Malaysia introduced Islamic bonds in the 1990’s and they were termed as Bai Bithaman Ajil Bonds.
- In the Middle East, Bahrain introduced the Sukuk al-Ijara instrument to the Islamic market in September 2001 and Malaysia pioneered the global Sukuk al-Ijara issue in June 2002.
- The Middle Eastern Islamic bond market is evolving gradually with the support of top-tier issuers like the Islamic Development Bank, the State of Qatar, the Department of Civil Aviation, Dubai, the Republic of Pakistan.
- The Islamic bond market provides investment opportunities to a broad range of investors including public pension fund managers, reserve managers, Central Banks and Awqaf managers.
- Islamic investors need to diversify their investment portfolios and Islamic bonds are important to fill the gap in Shariah-compatible fixed income tradable instruments.
- The growth of Islamic bond markets will further fuel the growth of Islamic institutional investors like takaful operators, Islamic asset management houses and Islamic pension funds.
Factors that Fuelled the Growth of Islamic Bond Markets

- “Mainstream” Islamic structures
- Flow of funds from conventional to Islamic institutions in many Islamic countries
- More issuers are strategically positioning to tap the growing Islamic bond market as an alternative source of funding
- Higher demand for Islamic bonds resulting in price advantage for the Issuer at the primary market …..often leading to the Islamic bonds trading at a premium
- Governments are playing an active role in promoting Islamic finance industry ……..some countries providing tax and other incentives
- Malaysia has developed a comprehensive capital market plan to nurture the development of domestic Islamic capital market

Size of Islamic Private Debt Securities Market in Malaysia

Source: http://www.sc.com.my/
The following table lists some of the notable Sukuk transactions arranged in the Islamic Finance Markets:

### Notable Sukuk Deals in the Middle East (2003-2005)

<table>
<thead>
<tr>
<th>Name</th>
<th>Islamic Development Bank</th>
<th>State of Qatar</th>
<th>Kingdom of Bahrain</th>
<th>Saxony-Anhalt State</th>
<th>Tabreed</th>
<th>Dept of Civil Aviation, Dubai</th>
<th>Munshaat al-Bahrain</th>
<th>Arqam</th>
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<th>Arqam</th>
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<tr>
<td>Tenor (years)</td>
<td>5</td>
<td>7</td>
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<td>5</td>
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<tr>
<th>Name</th>
<th>Durrat al-Bahrain</th>
<th>Rep. Of Pakistan</th>
<th>Dubai MCE</th>
<th>Emirates Airline</th>
<th>Islamic Development Bank</th>
<th>The Investment Dar</th>
<th>Amiak Finance</th>
<th>Dubai PCFC</th>
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<tr>
<td>Size (mn)</td>
<td>$152.50</td>
<td>$600</td>
<td>$200</td>
<td>$550</td>
<td>$500</td>
<td>$100</td>
<td>$250</td>
<td>$3,500</td>
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<tr>
<td>Tenor (years)</td>
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<td>5</td>
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<tr>
<td>Country</td>
<td>Bahrain</td>
<td>Pakistan</td>
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BBA Bonds & Sukuk al-Ijara: The First Phase

(i) Bai Bithaman Ajil Bonds

1. Corporate sells certain assets that it owns ("Assets") for MYR500 million (spot payment).

2. The Arranger will sell the Asset back to the Corporate for say MYR500 million (MYR50m payable in 10 equal instalments and MYR500m at the end of 5 years). Corporate evidences the deferred payments by issuing BBA Bonds.

3. The Arranger will sell the BBA Bonds to the investors at a discount of MYR500m.
(ii) Sukuk al-ijara: Sale and Lease-back

Steps:
- SPC will buy the assets from Corporate at say USD500m.
- SPC will lease the assets back to Corporate for, say, 5 years.
- Lease Rentals will be payable 6-monthly in arrears and will be benchmarked on USD Libor plus a credit spread.
- To raise USD500m, SPC will issue Sukuk at par value of USD500m.
- Investors will subscribe to the Sukuk as primary subscribers (similar to the primary subscription in a bond issue).
- SPC will collect the Lease Rentals and distribute pro rata to the Sukuk holders.
- The Sukuk can be listed, rated, cleared through Euroclear / Clearstream and traded in the secondary market.
- The Kingdom of Bahrain Sukuk issues, the Federation of Malaysia, the State of Qatar and the Republic of Pakistan Sukuk issues were structured based on this concept.

Sukuk al-Istismar & Sukuk al-Musharakah: The Second Phase
3. SPC creates a trust in respect of the Assets and issues 5-Year Sukuk to raise $400 million

2. Sells the Assets to SPC for $400m

4. SPC appoints ICD (a 3rd Party Buyer) as agent to collect the receivables from the Assets

5. ICD (as 3rd Party Buyer) “delegates” the agency role to IDB

6. IDB provides certain ‘guarantees’ in respect of the Assets

IDB ‘bundles’ certain Ijarah assets (min 51%), istisna assets and murabaha receivables that it owns (“Assets”) and sells the Assets as a pool for $400 million.

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1. IDB ‘bundles’ certain Ijarah assets (min 25%), istisna and Murabaha receivables that it owns (“Assets”) and sells the Assets as a pool for $500 million.

4. IDB Trusts appoints IDB as Agent to collect the receivables from the Assets in return for a fixed fee and an incentive fee.

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A Bankruptcy-remote Trust Vehicle established in Jersey

IDB Trusts Services Ltd

Investors

Shirkat al-Milk or Aqd?

Sukuk

Investors
(iii) Sukuk al-Musharakah Structure

- Corporate and the Special Purpose Company (“SPC”) enter into a Musharakah arrangement for a period of say, 5 years – Profit-sharing ratio is between the SPC and the Corporate is 80:20
- Corporate (as Musharik) contributes land or other physical assets to the Musharakah
- SPC (as Musharik) contributes cash (i.e.) the Issue Proceeds to the Musharakah
- The Musharakah appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharakah and sell/lease the developed assets on behalf of the Musharakah
- In return the agent (i.e., the Corporate) will get a fixed agency fee plus a variable incentive fee payable say, semi-annually. The Net Profit is divided in to 80:20 and from the 80% profit share, the agent will disburse to the SPC an amount equal to Issue Proceeds*Libor+Margin pa and the surplus (if any) would be kept by the agent as Incentive Fee
- The Corporate irrevocably undertakes to buy at a pre-agreed price the Musharakah shares of the SPC on a periodic basis and at the end of 5 years, the SPC would no longer have any shares in the Musharakah
- The USD300m Dubai Metals & Commodity Exchange Sukuk was structured based on this concept.

(iv) Sukuk al-Musharakah: an Alternative Structure

- Corporate and the Special Purpose Company (“SPC”) enter into a Musharakah arrangement for a period of say, 5 years – Profit-sharing ratio between the SPC and the Corporate is 99:1
- Corporate (as Musharik) transfers usufruct rights over land and other physical assets to the Musharakah
- SPC (as Musharik) contributes cash (i.e.) the Issue Proceeds to the Musharakah
- The Musharakah appoints Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharakah and lease the assets to Corporate for say, 5 years. The Lease Rentals payable by Corporate would be benchmarked on USD Libor plus the credit spread.
- The net profit of the Musharakah (viz. the Lease Rentals) is divided between the SPC and Corporate in the ratio of 99:1 and the SPC will then distribute the Net Profit as Sukuk Distribution to the investors.
- Corporate also irrevocably undertakes to buy at a pre-agreed price (viz. the Issue Price) the Musharakah shares of the SPC at the end of 5 years or upon any default under the Lease to Corporate. Upon such exercise, the SPC would no longer have any shares in the Musharakah
- The USD550m Emirates Airline Sukuk was structured based on this concept.
Hybrid Structures: The Third Phase

(i) Murabaha-based Investment Certificates

1. A Special Purpose Company (as Investment Agent) buys, on a spot basis, USD 250 million worth of LME metal warrants (“Commodity”) from Broker A.

2. SPC (as Investment Agent) sells the Commodity to Corporate for USD 250 million.

3. Corporate sells, on a spot basis, the Commodity to Broker B for USD 250 million.

4. SPC issues Investment Certificates to the Primary Subscribers for USD 250 million.

A leading Islamic investment bank, First Islamic Investment Bank (known as ARCAPITA Bank now) in Bahrain, has offered two issues (termed as FIRSAN) based on the above structure for USD100 million in 2003, €75 million in 2004, and USD155 million + €46 million in 2005. All these issues were well received in the market.
(ii) Mudaraba Bond

1. Arranger invests IDR100bn in Corporate and Corporate issues investment certificates (Mudaraba Bonds) with face value of IDR100bn.
   [Concept:Mudaraba (as interpreted in Indonesia)]

2. The Mudaraba Bonds will provide that the net profit of Company will be shared between Corporate and Arranger on a ratio of say 90:10 per annum. This arrangement will continue for 10 years. At the end of Year 10, Corporate will buy the Mudaraba Bonds at par value of IDR100bn.

This structure was used by PT Indosat and PT Berlian Laju Tanker and is only suitable for corporates with identifiable cash flows which can be dedicated for profit and loss sharing with the Mudaraba Bondholders.

(iii) Sukuk al-Musharakah
Islamic Convertible Sukuk
Transaction Summary

Issuer: PCFC Development FZCO ("PCFC Development"), owned 90% by PCFC and 10% by Dubai Islamic Bank as agent for the Sukuk holders

Size: USD 3,500,000,000

Musharaka Partners: The Issuer and Ports, Customs & Free Zone Corp. ("PCFC")

Musharaka Assets: Issuer contributes USD3.5bn cash (35mln units) and PCFC contributes the usufruct rights of 53 cranes valued at USD1.5bn (15 mln units)

Facility Structure: PCFC is appointed as Managing Agent to manage the Musharaka

Redemption: PCFC undertakes to purchase the Issuers 35mln units at US$3.5bn plus Distribution Amount of 10.125% pa or if a Qualifying Public Offering occurs at 7.125% pa

Tenor: 2 Years

JLMs: Barclays Capital and Dubai Islamic Bank

Security: Senior & Unsecured claim against PCFC and pledge of 49% shareholding of Thunder FZE (Bidco of P&O Group)

Profit Ratio: 30%: PCFC & 70%: Issuer. If profit payable to Issuer is greater than the Distribution Amount, the surplus is distributed to the Managing Agent (PCFC) as incentive fees

Convertibility: If a QPO occurs, 30% of the Sukuk Repayment Amount will be paid in QPO shares (based on the QPO share price) & 70% Cash

Convertible Sukuk Structure

Issuer: PCFC Development, 90% owned by PCFC and 10% owned by DIB acting as Share Agent for Investors

PCFC Development will invest the proceeds of the Sukuk into a Musharaka formed between PCFC Development and PCFC

PCFC will manage Musharaka’s assets, pursuant to the terms of a management agreement

PCFC will also enter into a purchase undertaking with PCFC Development and pledge 49% of the shares of Thunder FZE, the company that would acquire P&O
Convertible Sukuk Structure if QPO occurs

- In case of a Qualifying Public Offering of PCFC and/or subsidiaries (QPO), 83% of the QPO gross proceeds will be used to redeem the Sukuk.
- Sukuk will be redeemed at their principal plus accretion in value, based on 7.125% pa.

Convertible Sukuk Structure at Maturity

- Any outstanding amount at maturity will be redeemed at their principal plus accretion in value, based on an enhanced yield of 10.125% pa which is 3% higher than QPO Yiel.

Note: In case QPO proceeds are insufficient to redeem all the Sukuk, a partial redemption will take place. Several rounds of redemption may take place until all Sukuk are redeemed or mature.
(iv) Sukuk al-Mudaraba
Islamic Convertible Sukuk

Transaction Summary

<table>
<thead>
<tr>
<th>Issuer/Rab al-Maal</th>
<th>Aabar Sukuk Limited, a charitable trust-owned company incorporated in Cayman Islands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size</td>
<td>USD460,000,000</td>
</tr>
<tr>
<td>Mudarib/Obligor</td>
<td>Aabar Petroleum Investments Company PJSC (“Aabar”)</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>Issuer contributes USD [ ] as capital for the Mudaraba and the Mudarib invests the capital in Aabar’s business activities in accordance with an investment plan prepared by Mudarib</td>
</tr>
<tr>
<td>Redemption</td>
<td>At the end of 4 years, Mudarib/Obligor undertakes to purchase the Issuer/Rab al-Maal’s Mudaraba/Trust Assets for a sum equal to USD460,000,000</td>
</tr>
<tr>
<td>Tenor</td>
<td>4 Years</td>
</tr>
<tr>
<td>JLMs</td>
<td>Deutsche Bank and Abu Dhabi Commercial Bank</td>
</tr>
<tr>
<td>Periodic Distribution</td>
<td>6.894% pa on a quarterly basis</td>
</tr>
<tr>
<td>Profit Ratio</td>
<td>1%: Mudarib &amp; 99%: Issuer (if profit payable is greater than Periodic Distribution amount, the Mudarib is entitled to keep the excess as incentive fees)</td>
</tr>
</tbody>
</table>
### Transaction Summary

**Exchangeability**
- If an Exchange Condition has been met (15 days before maturity of 4 years) the Issuer (on behalf of Aabar) can elect for the Mudarib/Obligor to purchase the Mudaraba/Trust assets by either (i) physical settlement of Exchange Shares; or (ii) cash settlement of Redemption Reference Price (volume weighted average trading price of the Exchange Shares) multiplied by the number of Exchange Shares.

**Exchange Condition**
- Exchange Condition is satisfied if the Redemption Reference Price is greater than the Current Exchange Price (i.e., USD460,000,000 divided by number of listed ordinary shares of Aabar in existence).

**Exchange Shares**
- 422,212,024 listed ordinary shares of Aabar

**Early Redemption**
- If Mudaraba does not yield any profit and consequently the Issuer fails to pay a Periodic Distribution (or other Dissolution Events occur) the Mudarib/Obligor undertakes to purchase the Issuer/Rab al-Maal’s Mudaraba/Trust Assets for a sum equal to USD460,000,000 plus the unpaid Periodic Distribution Amount. If an Exchange Condition has been met (15 days before Early Redemption Trigger Date) the Issuer can elect for the Mudarib/Obligor to purchase the Mudaraba/Trust assets by (i) physical settlement (at the option of Aabar) up to 50 per cent of the Exchange Shares (“Early redemption Shares”) and (iii) payment of an amount (in U.S. dollars) equal to the Redemption Reference Price multiplied by (x) the number of Exchange Shares less (y) the number of Early Redemption Shares.

### (iii) Transaction Structure

- **Aabar (Obligor)**
  - Mudaraba Returns
  - Issue Proceeds
  - Periodic Distribution after deducting Incentive Fee and Mudarib’s 1% Profit Share

- **Aabar Sukuk Ltd (Issuer/Rab al-Maal)**
  - 1a. Issues Sukuk al-Mudarabah
  - 1b. Issue Proceeds
  - Periodic Distribution

- ** Investors**
  - Sukuk
  - 4. Undertakes to buy the Musharakah Assets for USD460m plus unpaid Periodic Distribution Amount

- **Mudarabah or Shirkat al-Milk?**
Do we need a Shift from “Mainstream” to “Pure-stream” Islamic structures?

The Steps Toward The Future

**The Conforming Stage**
- Need to conform to conventional Risk & Return profile to gain market share

**The Improvement Stage**
- Significant Market Share will lead to improvements in the product range and Risk & Return profile

**The Innovation Stage**
- Dominant Market Share will lead to new products and practices that conform to the higher ideals of Islamic economics
Glossary

- Sukuk (Sakk. singular): Certificate of Title
- Istismar: Investment
- Bai Bithaman Ajil (sale on credit): The financier purchases assets/goods from a third party or the client at the request of the client. The financier then immediately resells the assets/goods to the client at a higher price on deferred payment terms.
- Murabaha (cost-plus financing): The financier purchases assets/goods from a third party at the request of the client (who acts as the financier’s undisclosed agent). The financier then immediately resells the assets/goods to the client at a higher price on deferred payment terms.
- Mudarabah (Partnership/Trust Financing): A form of partnership where one partner provides capital and the other labour/expertise only. Profits arising from the partnership are shared between the partners on a pre-agreed ratio while any losses are born entirely by the capital provider unless such loss arises out of the negligence or misconduct of the managing partner or other violation by him of the partnership agreement.
- Musharakah (Partnership Finance): This is similar to Mudaraba with the difference that in Musharakah all the partners provide some capital. Profits are shared in the pre-agreed ratio while losses are shared in the proportion of the capital contributions.
- Ijara (Leasing): Similar in most aspects to an operating lease. If there is an undertaking by the client to purchase the leased asset at a pre-agreed price at the end of the lease period, this is known as Ijara wa-lIqtina (hire purchase or finance lease).