Sukuk

An Introduction to the Underlying Principles and Structure

June 2006

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Dar Al Istithmar

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••• a global think tank for the Islamic finance industry

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Notes from Managing Director

Dar Al Istithmar Ltd offers Sharia-compliant solutions to the institutions offering Islamic financial services. We serve as a think-tank for the Islamic finance industry and we aim to expand the frontiers of the Islamic finance industry through a continuous process of innovation in finance and Sharia advice. To this end we hope this paper will contribute to the continued process of evolution and development within the industry.

This paper was prepared by the team at Dar Al Istithmar Ltd and sincere gratitude is extended to the team for its tireless effort and time invested in producing this document.

Dr Humayon Dar

Managing Director

Dar Al Istithmar Ltd

Executive Summary

Preamble

Sukuk is popularly known as an Islamic or Sharia compliant 'Bond' whilst in actual fact, it is an asset-backed trust certificate. In its simplest form Sukuk is a certificate evidencing ownership of an asset or its usufruct and was developed by Sharia experts for the express purpose of answering the financial world's demand for a Sharia compliant debt instrument. The development of Sukuk was in response to Sharia's prohibition on earning returns from loan contracts which returns are based on interest. Conventional bonds and other derivative instruments that rely on profiting holders by providing returns based on interest are therefore unavailable to Muslims who wish to invest in Sharia compliant investments.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which issues standards on accounting, auditing, governance, ethical, and Shari'a standards has laid down 14 different types of Sukuk. This particular Introduction sets out 7 types which are favoured in the market and explains each structure and set up in great detail. The Sukuk structures set out in this Introduction rely on the creation of a Special Purpose Vehicle (SPV) which responsibility is to issue certificates which represent for example the ownership of an asset, entitlement to a debt or to rental incomes or even accumulation of returns from various Sukuk (a hybrid Sukuk). The return provided to Sukuk holders therefore come in the form of profit from a sale, rental or a combination of both. A distinguishing feature of a Sukuk is that in instances where the certificate represents a debt to the holder, the certificate will not be tradable on the secondary market and instead should be held until maturity. It is evident that Sukuk for the most part fulfils the Islamic financial industry's need for a Sharia compliant debt instrument.

In light of the above Sukuk has become extremely popular in the debt market and has been embraced by the Islamic banking and finance sector with sovereign and corporate Sukuk issuance rising at a rate of 300 % in 2004 alone. So far about US$20 billion worth of Sukuk certificates have been issued. With demands at present, it is expected that the market for Sukuk will continue to grow and that the industry will similarly respond to the needs of the market by developing versions which are tradable in the secondary debt market.

Prohibition

Sharia prohibits the trading of short-term debt instruments at other than face value, or from drawing upon the established interbank money markets as these transactions involve interest and excessive uncertainty (Gharar). This means that Islamic financial institutions tend to have highly liquid balance sheets with limited investment opportunities available for their current assets. Thus Sukuk have, over the past few years, created opportunities for the short and medium term placement of such funds.

Alternative Basis of Financial Instruments

The essence of Sukuk is to provide Sharia compliant instruments for investment which do not involve interest and excessive uncertainty (Gharar). The Sukuk market has been a primary area of growth, providing an avenue for the short and medium-term placement of funds by investors. This development has been fuelled not only by the desire of institutions to raise funds in a Sharia compliant manner but also by investor demand for such products.

Sukuk are entitlement to rights in certain assets inclusive of some degree of asset ownership. These Sukuk are based on Ijara, Salam, Mudaraba, Musharaka, Murabaha, Istisna mode of finance and on the basis of pooled portfolios.

The surge in Sukuk issuance by sovereign borrowers and corporate entities has mainly resulted from the Sharia standardization of the model agreement. The Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) adopted an Exposure Draft of Sharia Standards concerning Investment Sukuk.

Sukuk promises the global financial arena many opportunities for managing the capital needs of the emerging economies of the Islamic world in a manner consistent with Islamic values.

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Sukuk Defined

Sukuk is frequently referred to as an Islamic bond, but a more accurate translation of the Arabic word would be an Islamic investment certificate.

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Standard 17 defines Investment Sukuk as being:

"Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity".

AAOIFI lays down 14 different types of Sukuk.The most popular structure is the Sukuk Al Ijara, based on an Islamic leasing transaction.

Difference between conventional bond and Sukuk

In its simplest form, a bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal. In comparison, under Sukuk structure the Sukuk holders each hold an undivided beneficial ownership in the underlying assets. Consequently, Sukuk holders are entitled to share in the revenues generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of the Sukuk assets.

Similarities between conventional bond and Sukuk

- Marketability: Sukuk are monetised real assets that are liquid, easily transferred and traded in the financial markets
- Rateability: Sukuk can be easily rated
- Enhanceability: Different Sukuk structures may allow for credit enhancements
- Versatility: the variety of Sukuk structures defined in the AAOIFI standards allow for: structuring across legal and fiscal domains, fixed and variable income options etc.

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Introduction

Overview

The issuance of international Sukuk is one of the most significant mechanisms for raising finance in the international capital markets through Islamically acceptable structures. Multinational corporations, sovereign bodies, state corporations and financial institutions use international Sukuk issuance as an alternative to syndicated financing. Sukuk represent an undivided proportionate ownership interest in an asset with the corresponding right to the Islamically acceptable income streams generated by the asset. These current income streams are established and translated into tradable securities, which can be issued in the capital markets for investors' participation.

The Islamic banking and finance market is one of the fastest-growing global niche markets, estimated to be somewhere between USD 500 - 750 billion. The Sukuk market is expanding since the launch of the first Sukuk a few years back. ISI Emerging Market's Islamic Finance Information Service (IFIS) reports that Islamic Bond Issuance grew over 300% in 2004. To date, US$20 billion worth of Sukuk certificates have been issued.

Benefits and Features

- Tradable Sharia-compliant capital market product providing medium to long-term fixed or variable rates of return.
- Assessed and rated by international rating agencies, which investors use as a guideline to assess risk/return parameters of a Sukuk issue.
- Regular periodic income streams during the investment period with easy and efficient settlement and a possibility of capital appreciation of the Sukuk.
- Liquid instruments, tradable in secondary market.

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Sukuk Origination

The origination of Sukuk typically involves the packaging or structuring of pools of Sharia-compliant assets with or without credit enhancement into securities.

The structure is based on a specific contract of exchange that can be made through the sale and purchase of an asset based on deferred payment, leasing of specific assets or participation in a joint-venture business.

The issuance of Sukuk requires an exchange of a Sharia-compliant underlying asset for financial consideration through the application of various Sharia principles such as Ijara, Salam, Istisna, Murabaha, etc. The structure of Sukuk has to be reviewed and approved by Sharia advisers to ensure compliance with Sharia.

In addition, the structuring process may also involve the provision of additional protection for investors against late payment, pre-payments, potential write-offs and other similar risks. Such protection is often provided in the form of credit and/or liquidity enhancement schemes.

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Common uses of Sukuk funds

Three common uses of Sukuk have emerged in the recent years viz. project, asset, and balance sheet specific.

An example of project-specific Sukuk is the Qatar Global Sukuk issued by the Government of Qatar in 2003 to mobilize resources for the construction of Hamad Medical City (HMC) in Doha. A joint venture special purpose vehicle (SPV), the Qatar Global Sukuk QSC, was incorporated in Qatar with limited liability. This SPV acquired the ownership of land parcel, that was registered in the name of HMC. The land parcel was placed in trust and Ijara-based Trust Certificates (TCs) were issued worth US$700 million due by October 2010 at an annual floating rate of return of LIBOR plus 0.45 per cent.

The use of Sukuk issued by the governments of Bahrain and Malaysia were asset specific. In February 2004, Bahrain announced the launch of its first US$250 million five-year Sukuk al-Ijara issue to fund the extension of the airport. The underlying asset was the airport land sold to an SPV. The arranger of this Sukuk issue was Citi Islamic Investment Bank. In 2002, the Government of Malaysia issued a US$ 600 million Sukuk al-Ijara Trust Certificates (TCs), due for maturity in 2007. Under this arrangement, the beneficiary right of land parcels have been sold by the government of Malaysia to an SPV, which was then re-sold to investors for five years. The SPV kept the beneficiary rights of the properties in trust and issued floating rate Sukuk to investors.

An example of the balance sheet specific use of Sukuk funds is the Islamic Development Bank (IDB) Sukuk issued in August 2003. The need for resource mobilization by the IDB emerged in the wake of expected financing requirements of the member countries. The IDB made its debut resource mobilization from the international capital market by issuing US$ 400 million five-year Sukuk due for maturity in 2008. The IDB Sukuk is intrinsically balance sheet specific because the performance of its pooled securitized assets has been guaranteed by IDB.

Types of Sukuk

Sukuk al-Ijara

Ijara (lease) is a contract according to which a party purchases and leases out equipment required by the client for a rental fee. The duration of the rental and the fee are agreed in advance and ownership of the asset remains with the lessor.

Sukuk al-Ijara are securities representing the ownership of well defined existing and well known assets, that are tied up to a lease contract. This means that Sukuk al-Ijara can be traded in the market at a price determined by market forces.

Characteristics of Sukuk al-Ijara

- Sukuk al-Ijara are subject to risks related to the ability and desirability of the lessee to pay the rental instalments. Moreover, these are also subject to real market risks arising from potential changes in asset pricing and in maintenance and insurance costs.
- The expected net return on some forms of Sukuk al-Ijara may not be completely fixed and determined in advance, since there might be some maintenance and insurance expenses that are not perfectly determined in advance.
- Sukuk al-Ijara are completely negotiable and can be traded in the secondary markets.
- Sukuk al-Ijara will offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, awqaf or any other asset users, private or public can issue these Sukuk. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.
- Sukuk al-Ijara holders, as owners, bear full responsibility for what happens to their property. They are also required to maintain it in such a manner that the lessee may derive as much usufruct from it as possible.

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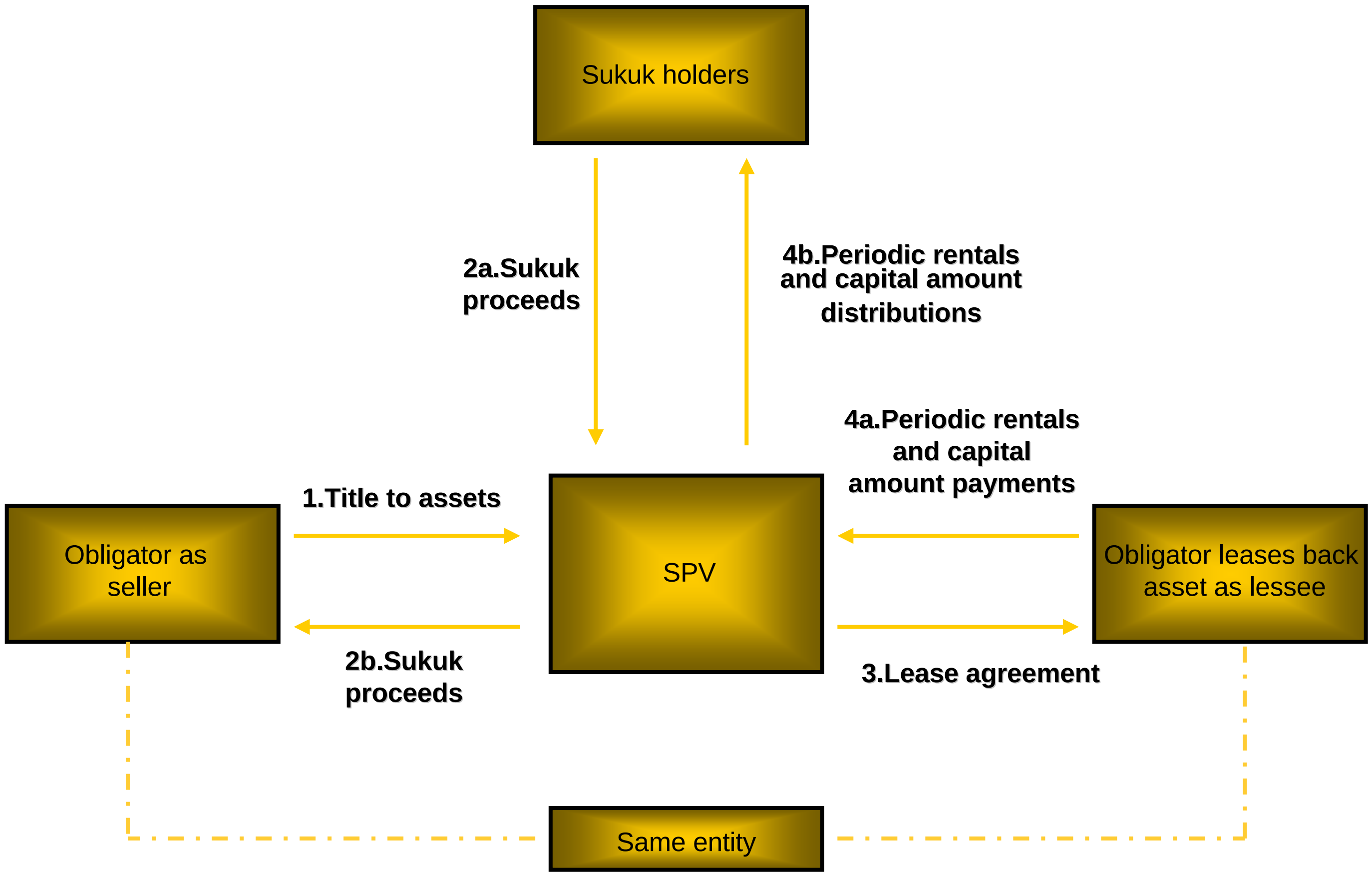
Sukuk al-Ijara transaction structure



Steps involved in the structure

1. The obligator sells certain assets to the SPV at an agreed pre-determined purchase price.

2. a. The SPV raises financing by issuing Sukuk certificates in an amount equal to the purchase price.

   b. This is passed on to the obligator (as seller).

3. A lease agreement is signed between SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee.

4. a. SPV receives periodic rentals from the obligator;

   b. These are distributed among the investors i.e. the Sukuk holders.

5. At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. That value should be equal to any amounts still owed under the terms of the Ijara Sukuk.

Sukuk al-Ijara in practice

- US$150 million Serial Islamic Lease Sukuk by First Global Sukuk Inc

The US$150 million Islamic Lease Sukuk is part of a US$395 million Serial Islamic Sukuk issuance that Bank Islam (Labuan) Limited has been mandated to arrange by Kumpulan Guthrie Berhad (Guthrie). In December 2000, Guthrie was granted a RM1.5 billion (US$400 million) Al-Ijara Al-Muntahiyah Bit-Tamik by a consortium of banks. The original facility was raised to re-finance Guthrie's acquisition of a palm oil plantation in the Republic of Indonesia. The consortium was then invited to participate as the underwriter/primary subscriber of the Sukuk Transaction.

- US$250 million Sukuk Trust Certificate by BMA International Sukuk Company

The Kingdom of Bahrain, acting through the Ministry of Finance and National Economy (in such capacity, the Head Lessor), will lease by way of head lease for a term of 100 years a certain land parcel to the Issuer pursuant to the Al-Ijara Head Lease Agreement. The Kingdom of Bahrain, acting through the Ministry of Finance and National Economy, (in such capacity, the Sub-Lessee), will lease by way of sub-lease from the Issuer the Land Parcel on the terms set out in the Al-Ijara Sub-Lease Agreement for a period of 5 years commencing on the Closing Date and terminating on the Periodic Distribution Date falling in June 2009. The sub-lease is subject to earlier termination if the trust is dissolved early.

- US$350 million Sukuk Trust Certificates by Sarawak Corporate Sukuk Inc. (SCSI)

Sarawak Economic Development Corporation (SEDC) raised financing amounting to US$350 million by way of issuance of series of trust certificates issued on the principle of Sukuk al-Ijara. For purposes of the proposed Sukuk, SCSI was incorporated on 23 November 2004 as a special purpose company, under the Offshore Companies Act (OCA), 1990 in Labuan. The certificates were issued with a maturity of 5 years and under the proposed structure, the proceeds will be used by the issuer to purchase certain assets from 1st Silicon (Malaysia) Sdn Bhd. Thereafter, the issuer will lease assets procured from 1st Silicon to SEDC for an agreed rental price for an agreed lease period of 5 years. The rental payable by SEDC will be supported by the State Government of Sarawak via a letter of support.

Sukuk al-Salam

Salam is the sale of a specific commodity, well defined in its quality and quantity which will be delivered to the purchaser on a fixed date in the future against an advanced full payment of price at spot.

Sukuk al-Salam are certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to the ownership of the certificate holders.

The issuer of the certificates is a seller of the goods of Salam, the subscribers are the buyers of the goods, while the funds realised from subscription are the purchase price (Salam capital) of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a parallel Salam, if any.

Salam-based securities may be created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. SPV can also appoint an agent to market the promised quantity at the time of delivery perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the Sukuk.

All standard Sharia requirements that apply to Salam also apply to Sukuk al-Salam, such as, full payment by the buyer at the time of effecting the sale, standardized nature of underlying asset, clear enumeration of quantity, quality, date and place of delivery of the asset and the like.

One of the Sharia conditions relating to Salam, as well as for creation of Sukuk al-Salam, is the requirement that the purchased goods are not re-sold before actual possession at maturity. Such transactions amount to selling of debt. This constraint renders the Salam instrument illiquid and hence somewhat less attractive to investors. Thus, an investor will buy a Salam certificate if he expects prices of the underlying commodity to be higher on the maturity date.

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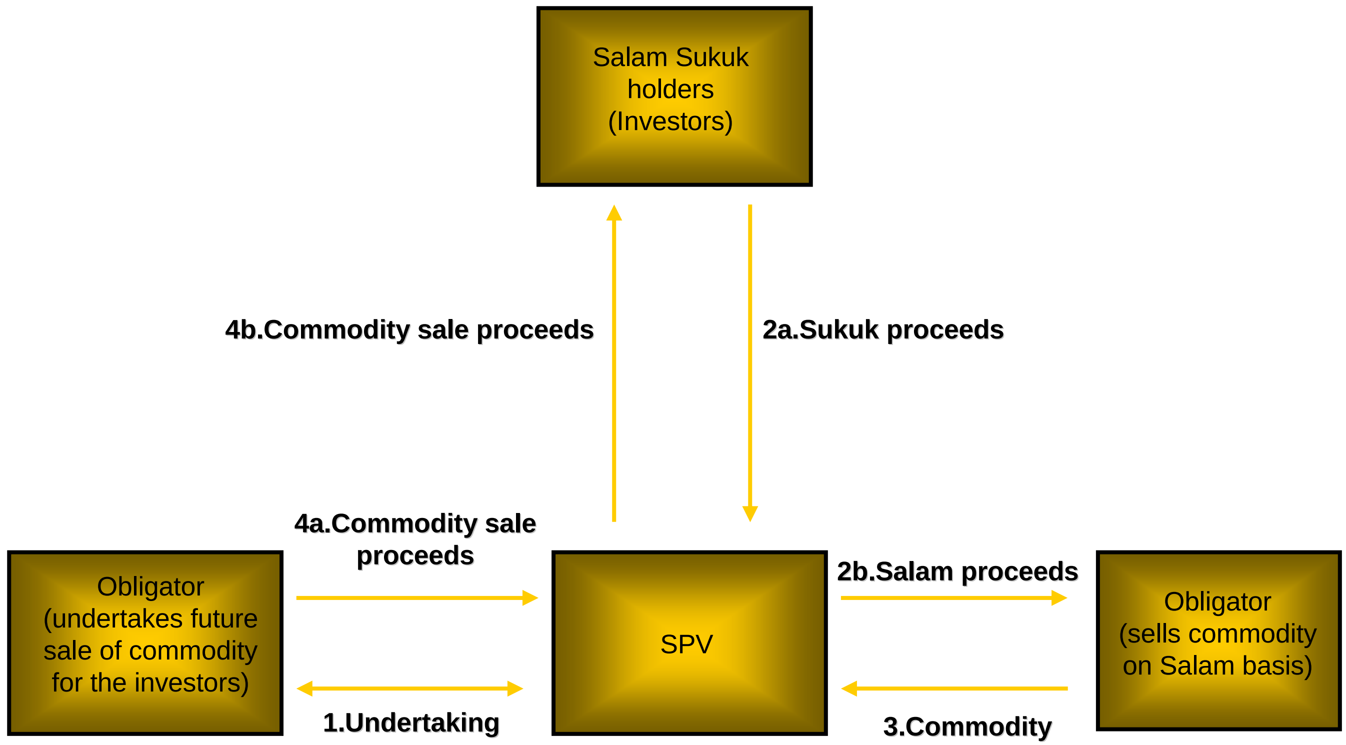
Sukuk al-Salam transaction structure



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Steps involved in the transaction:

1. SPV signs an undertaking with an obligator to source both commodities and buyers. The obligator contracts to buy, on behalf of the end-Sukuk holders, the commodity and then to sell it for the profit of the Sukuk holders.

2. a. Salam certificates are issued to investors and SPV receives Sukuk proceeds.

   b. The Salam proceeds are passed onto the obligator who sells commodity on forward basis

3. SPV receives the commodities from the obligator

4. a. Obligator, on behalf of Sukuk holders, sells the commodities for a profit.

   b. Sukuk holders receive the commodity sale proceeds.

Sukuk al-Salam in practice

- Aluminium has been designated as the underlying asset of the Bahrain Government al Salam contract, where by it promises to sell aluminium to the buyer at a specified future date in return of a full price payment in advance. One bank, namely the Bahrain Islamic Bank (BIB), has been nominated to represent the other banks wishing to participate in the Al Salam contract. BIB has been delegated to sign the contracts and all other necessary documents on behalf of the other banks in the syndicate. At the same time, the buyer appoints the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution. The Government of Bahrain provides an additional undertaking to the representative (BIB) to market the aluminium at a price, which will provide a return to al Salam security holders equivalent to those available through other conventional short-term money market instruments.

Sukuk al-Murabaha

Murabaha is basically the sale of goods at a price comprising the purchase price plus a margin of profit agreed upon by both parties concerned.

Sukuk al-Murabaha are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha so that the certificate holders become owners of the Murabaha commodity.

The issuer of the certificate is the seller of the Murabaha commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the Murabaha commodity and are entitled to its final sale price upon the re-sale of the Commodity.

The possibility of having legally acceptable Murabaha-based Sukuk is only feasible in the primary market. The negotiability of these Sukuk or their trading at the secondary market is not permitted by Sharia, as the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt on a deferred basis, which will result in Riba.

Despite being debt instruments, the Murabaha Sukuk could be negotiable if they are the smaller part of a package or a portfolio, the larger part of which is constituted of negotiable instruments such as Mudaraba, Musharaka, or Ijara Sukuk.

Murabaha Sukuk have, however, become popular in Malaysian market due to a more liberal interpretation of fiqh by Malaysian jurists permitting sale of debt (bai-al-dayn) at a negotiated price.

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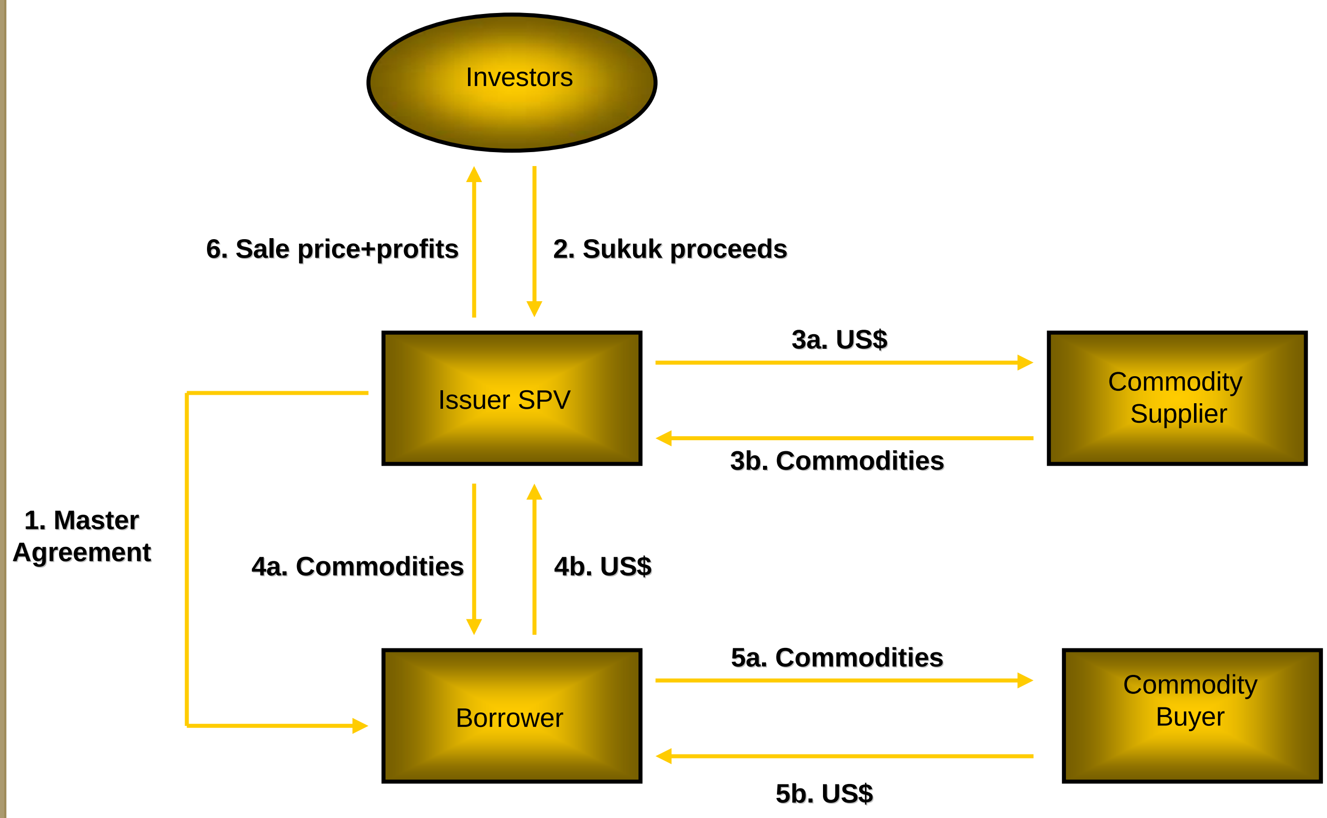
Sukuk al-Murabaha transaction structure



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Steps involved in the structure:

1. A master agreement is signed between the SPV and the borrower

2 a & b. SPV issues Sukuk to the investors and receive Sukuk proceeds.

3 a & b. SPV buys commodity on spot basis from the commodity supplier.

4 a & b. SPV sells the commodity to the borrower at the spot price plus a profit margin, payable on instalments over an agreed period of time

5 a & b. The borrower sells the commodity to the Commodity buyer on spot basis.

6. The investors receive the final sale price and profits.

Sukuk al-Murabaha in practice

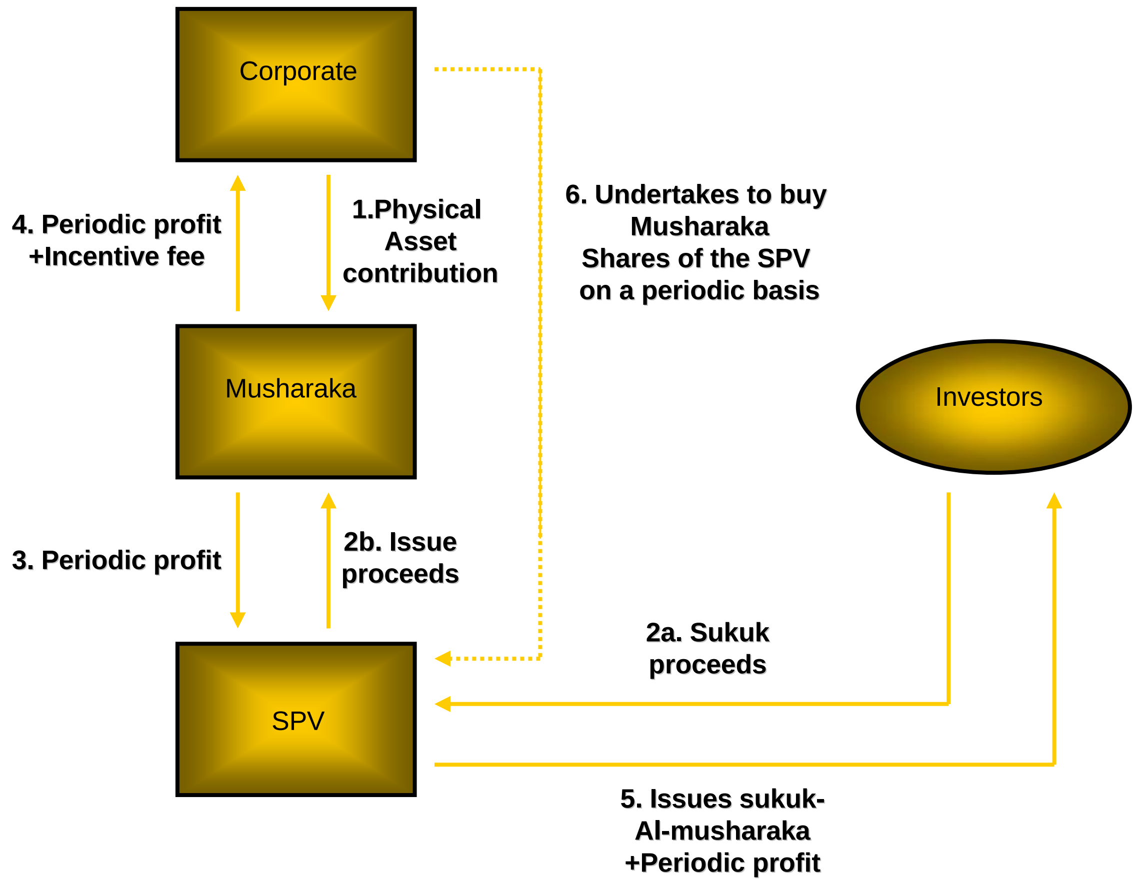
Arcapita Bank, a Bahrain-based investment firm has mandated Bayerische Hypo-und Vereinsbank AG (“HVB”), Standard Bank Plc (“SB”) and WestLB AG, London Branch (“WestLB”) (together the “Mandated Lead Arrangers”), to arrange a Five Year Multicurrency (US$, € and £) Murabaha-backed Sukuk. Sukuk will have a five year bullet maturity and proposed pricing three month LIBOR + 175bps.

Sukuk al-Musharaka

Musharaka means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Sukuk al Musharaka are documents of equal value issued with the aim of using the mobilised funds for establishing a new project or developing an existing one or financing a business activity on the basis of one of partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. These Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

Sukuk al-Musharaka transaction structure



Steps involved in the structure:

Corporate and the Special Purpose Vehicle (SPV) enter into a Musharaka Arrangement for a fixed period and an agreed profit-sharing ratio. Also the corporate undertakes to buy Musharaka shares of the SPV on a periodic basis.

1. Corporate (as Musharik) contributes land or other physical assets to the Musharaka

2 a & b. SPV (as Musharik) contributes cash i.e. the issue Proceeds received from the investors to the Musharaka

3. The Musharaka appoints the Corporate as an agent to develop the land (or other physical assets) with the cash injected into the Musharaka and sell/lease the developed assets on behalf of the Musharaka

4. In return, the agent (i.e. the Corporate) will get a fixed agency fee plus a variable incentive fee payable.

5. The profits are distributed to the Sukuk holders.

6. The Corporate irrevocably undertakes to buy at a pre-agreed price the Musharaka shares of the SPV on say semi-annual basis and at the end of the fixed period the SPV would no longer have any shares in the Musharaka.

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Sukuk al-Musharaka in practice

- US$550 million sukuk transaction for Emirates, Dubai's national airline, the seven year deal was a structured on a Musharaka contract. The Musharaka or joint venture was set up to develop a new engineering centre and a new headquarters building on land situated near Dubai's airport which will ultimately be leased to Emirates. Profit, in the form of lease returns, generated from the Musharaka or joint venture will be used to pay the periodic distribution on the trust certificates.
- Sitara Chemical Industries Ltd, a public limited company, made a public issue of profit-and-loss sharing based term finance certificates (TFC's) worth Rs 360 million which were subscribed on 19 and 20 June 2002. The TFC's had a fixed life tenor of five years and profit and loss sharing was linked to the operating profit or loss of the Chemical Division of the company. The Musharaka contract stipulated semi-annual profit distribution on account payment (provisional) on the basis of projections irrespective of profit and loss and the final profit payment was to be determined on the basis of annual audited accounts of the company and adjustments made accordingly.
- Kuwait Finance House (KFH), Liquidity Management Center B.S.C. (LMC) and Al Muthanna Investment Company (MIC), the mandated lead arrangers, have launched the $125 million Lagoon City Musharaka Sukuk in support of the Lagoon City residential and commercial real estate development as part of Kheiran Pearl City project. The 2-year Musharaka Sukuk which is structured as a reducing Musharaka will offer a return of 200 basis points over 6 months US$ LIBOR payable semi-annually and has an average maturity of 1.25 years.

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Sukuk al-Mudaraba

Mudaraba means an agreement between two parties according to which one of the two parties provides the capital (capital provider) for the other (Mudarib) to work with on the condition that the profit is to be shared between them according to a pre-agreed ratio.

Mudaraba certificates: The issuer of these certificates is the Mudarib, the subscribers are the capital providers, and the realised funds are the Mudaraba capital. The certificate holders own the assets of Mudaraba and the agreed upon share of the profits; losses, if any, are borne by capital providers only.

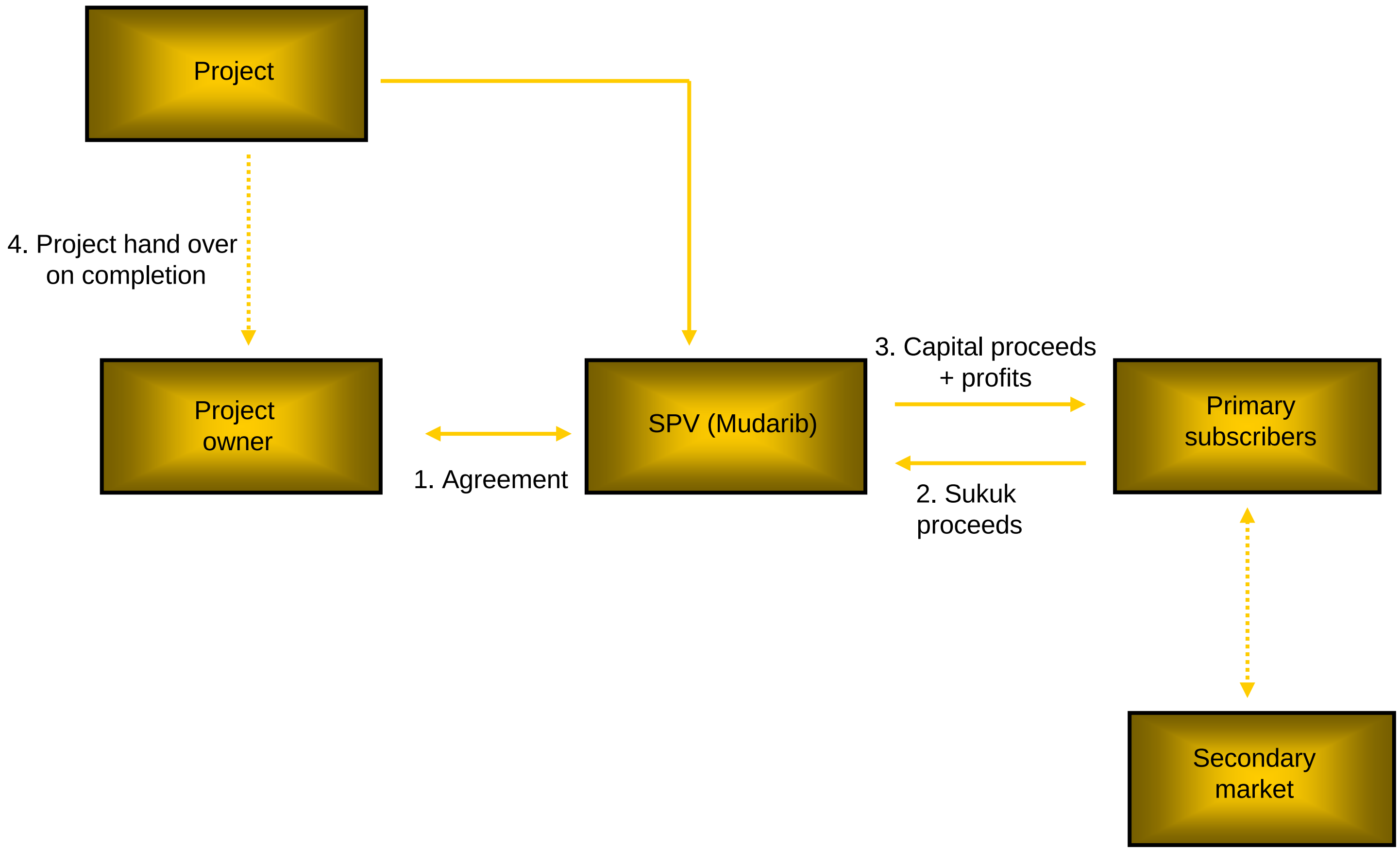
Mudaraba Sukuk give its owner the right to receive his capital at the time the Sukuk are surrendered, and an annual proportion of the realised profits as agreed. They play a vital role in the process of development financing, because it is related to the profitability of the projects.

Mudaraba Sukuk neither yield interest nor entitle owners to make claims for any definite annual interest. This shows that Mudaraba Sukuk are like shares with regard to varying returns, which are accrued according to the profits made by the project.

Mudaraba Sukuk must represent a common ownership and entitle their holder to shares in a specific project for which the Sukuk have been issued to fund. A Sukuk holder is entitled to all rights, which have been determined by Sharia upon his ownership of the Mudaraba bond in matters of sale, gift, mortgage, succession and the like.

On the expiry of the specified time period of the subscription, the Sukuk holders is given the right to transfer the ownership by sale or trade in the securities market at his discretion.

Sukuk al-Mudaraba structure



Steps involved in the structure:

1.Mudarib enters into an agreement with project owner for construction/commissioning of project.

2. SPV issues Sukuk to raise funds.

3. Mudarib collects regular profit payments and final capital proceeds from project activity for onward distribution to investors.

4. Upon completion, Mudarib hands over the finished project to the owner.

Sukuk al-Mudaraba in practice

Shamil Bank of Bahrain B.S.C. raised 360 million Saudi riyal investment capital through the Al Ehsa Special Realty Mudaraba, representing an investment participation in a land development transaction with a real estate development company in the Kingdom of Saudi Arabia. The investment objective of the Mudaraba is to provide investors with annual returns arising from participation in the funding of a land financing transaction Profits due to investors will be accrued on the basis of returns attained from investing the subscriptions.

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Sukuk al-Istisna

Istisna is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder agrees to produce or build a well described good or building at a given price on a given date in the future. Price can be paid in instalments, step by step as agreed between the parties. Istisna can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads and highways.

Sukuk al-Istisna are certificates that carry equal value and are issued with the aim of mobilising the funds required for producing products that are owned by the certificate holders.

The issuer of these certificates is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realised from subscription are the cost of the product. The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a parallel Istisna, if any.

Istisna Sukuk are quite useful for financing large infrastructure projects.

The suitability of Istisna for financial intermediation is based on the permissibility for the contractor in Istisna to enter into a parallel Istisna contract with a subcontractor. Thus, a financial institution may undertake the construction of a facility for a deferred price, and sub contract the actual construction to a specialised firm.

Sharia prohibition of Riba precludes the sale of these debt certificates to a third party at any price other than their face value. Clearly such certificates, which may be cashed only on maturity, cannot have a secondary market.

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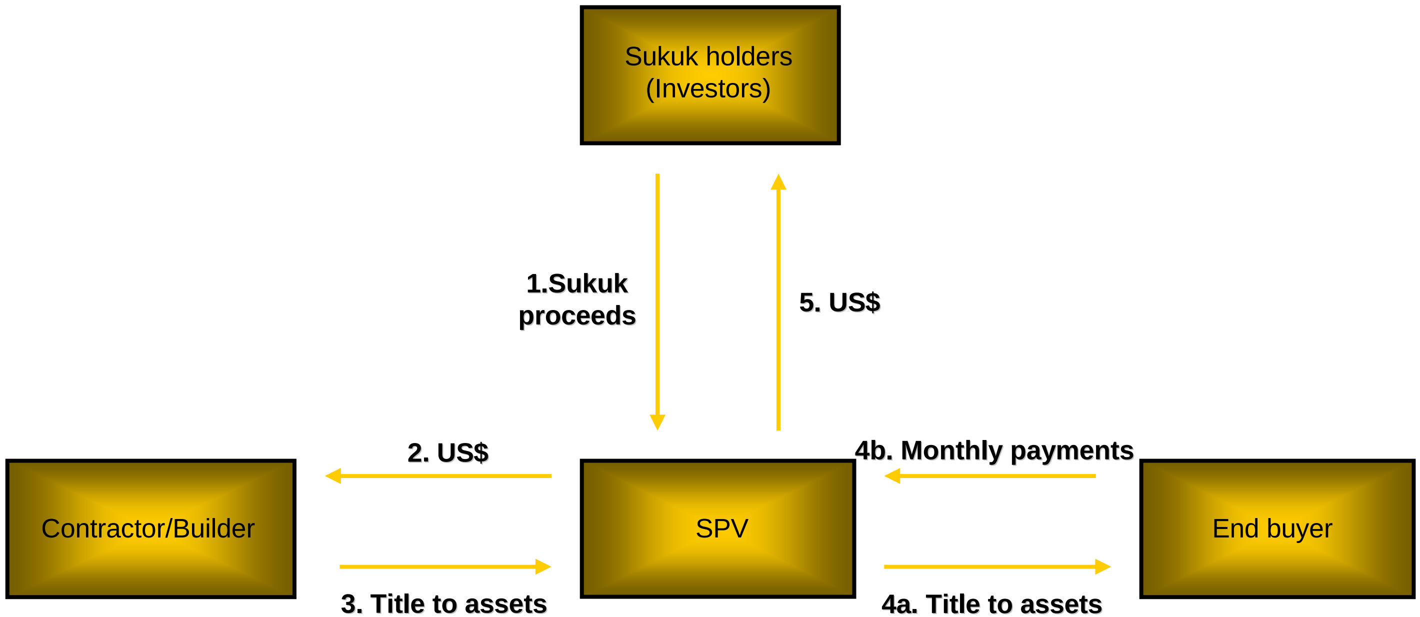
Sukuk al-Istisna transaction structure



Steps involved in the structure:

1. SPV issues Sukuk certificates to raise funds for the project.

2. Sukuk issue proceeds are used to pay the contractor/builder to build and deliver the future project.

3. Title to assets is transferred to the SPV

4a & b. Property/project is leased or sold to the end buyer. The end buyer pays monthly instalments to the SPV.

5. The returns are distributed among the Sukuk holders.

Sukuk al-Istisna in practice

- Tabreed's five-year global corporate Sukuk (on behalf of the National Central Cooling Company, UAE) provided a fixed coupon of 5.50%. It is a combination of Ijara Istisna and Ijara Mawsufah fi al dhimmah (or forward leasing contracts). The issue was launched to raise funds to retire some existing debt, which totals around US$136 million, as well as to finance expansion.
- The Durrat Sukuk will finance the reclamation and infrastructure for the initial stage of a broader US$ 1 billion world class residential and leisure destination known as 'Durrat Al Bahrain', currently the Kingdom of Bahrain's largest residential development project. The return on the Sukuk is 125 basis points over 3 months LIBOR payable quarterly, with the Sukuk having an overall tenor of 5 years and an option for early redemption. The proceeds of the issue (cash) will be used by the Issuer to finance the reclamation of the land and the development of Base Infrastructure through multiple project finance (Istisna) agreements. As the works carried out under each Istisna are completed by the Contractor and delivered to the Issuer, the Issuer will give notice to the Project Company under the Master Ijara Agreement and will lease such Base Infrastructure on the basis of a lease to own transaction. If the Sukuk is listed during the Istisna period, the Istisna receivable (amounts held as cash) shall be traded only at par value.

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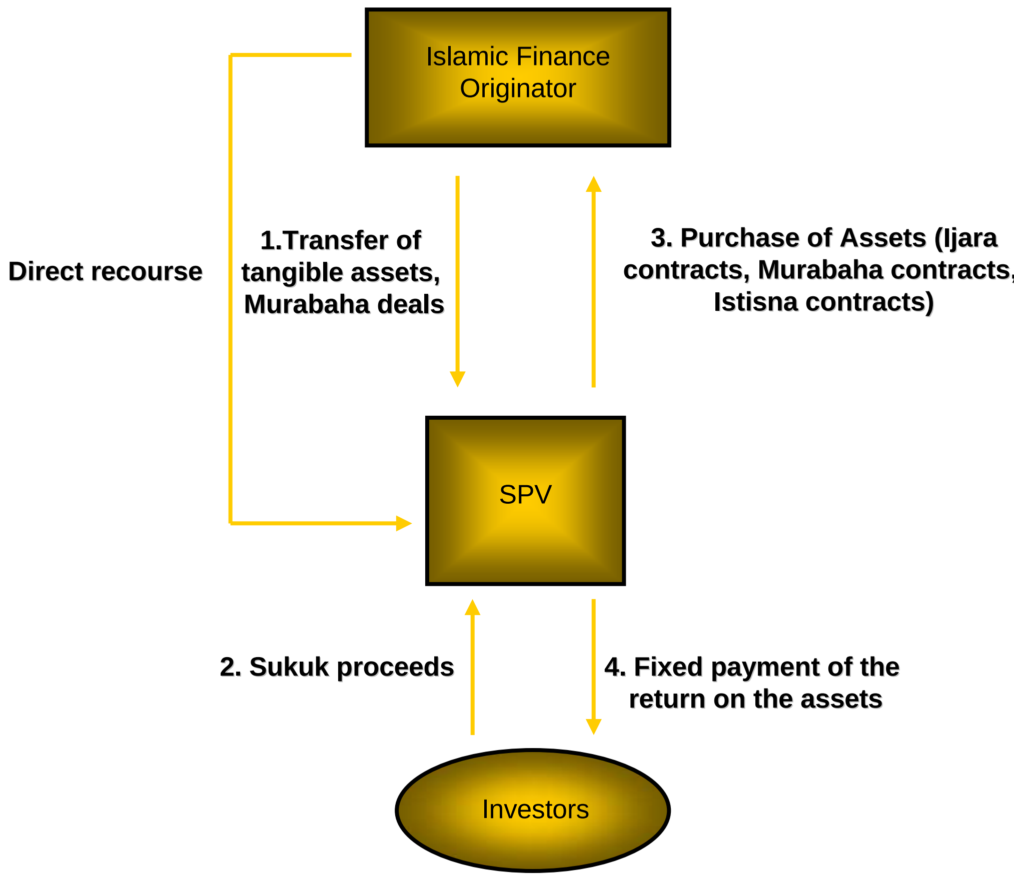
Hybrid Sukuk

Considering the fact that Sukuk issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified Sukuk - hybrid or mixed asset Sukuk - emerged in the market.

In a hybrid Sukuk, the underlying pool of assets can comprise of Istisna, Murabaha receivables as well as Ijara. Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds. However, as Murabaha and Istisna contracts cannot be traded on secondary markets as securitised instruments at least 51 percent of the pool in a hybrid Sukuk must comprise of Sukuk tradable in the market such as an Ijara Sukuk. Due to the fact the Murabaha and Istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

The hybrid Sukuk have yet to make headways in the market, the structure nevertheless represents the potential of new structures and benefits to the investors.

Structure of a Hybrid Sukuk



Steps involved in the structure:

1. Islamic finance originator transfers tangible assets as well as Murabaha deals to the SPV.
2. SPV issues certificates of participation to the Sukuk holders and receive funds. The funds are used by the Islamic finance originator.
3. Islamic finance originator purchase these assets from the SPV over an agreed period of time.
4. Investors receive fixed payment of return on the assets.

Hybrid Sukuk in practice

- Islamic Development Bank issued the first hybrid Sukuk of assets comprising 65.8% Sukuk al-Ijara, 30.73% of Murabaha receivables and 3.4% Sukuk al-Istisna. This issuance required the IDB's guarantee in order to secure a rating and international marketability. The $400 million Islamic Sukuk was issued by Solidarity Trust Services Limited (STSL), a special purpose company incorporated in Jersey Channel Islands. The Islamic Corporation for the Development of Private Sector (ICD) played an intermediary role by purchasing the asset from IDB and selling it to The Solidarity Trust Services Limited (STSL) at the consolidated net asset value.

Conclusion

- The market for Sukuk is now maturing and there is an increasing momentum in the wake of interest from issuers and investors. Sukuk have confirmed their viability as an alternative means to mobilise medium to long-term savings and investments from a huge investor base.
- Investors are able to focus on the underlying asset and viability of a project and not just on the credit of the issuer.
- Different Sukuk structures have been emerging over the years but most of the Sukuk issuance to date have been Sukuk al-Ijara, since they are based on the undivided pro-rata ownership of the underlying leased asset, it is freely tradable at par, premium or discount. Tradability of the Sukuk in the secondary market makes them more attractive.
- Although less common than Sukuk al-Ijara, other types of Sukuk are also playing significant role in emerging markets to help issuers and investors alike to participate in major projects, including airports, bridges, power plants etc.
- The sovereign Sukuk issues, following Malaysia's lead, are enjoying widespread and positive acclaim among Islamic investors and global institutional investors alike.
- In general corporate Sukuk tend to have lower credit rating than sovereign Sukuk and are also smaller in size.
- As the universe of investors becomes more diverse, so too will their appetites, and with these there will be issuances beyond the currently prevalent Ijara and Salam contracts into more profit-and-loss sharing contracts.

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