

Short paper on sukuk
Mohammed Amin 12 July 2009

1) Purpose

Sadly my diary precludes me attending the first meeting of the Business & Economics Committee's Islamic Finance Experts Group. Accordingly I have written a short paper to share my thoughts on sukuk structures.

As always when I write about Islamic finance, I leave decisions about Shariah compliance to the Shariah scholars.

2) Observations from conventional finance

While conventional finance has a wide range of capital instruments, they fall into three main categories.

Equity, represented in the capital markets by freely transferable ordinary shares of companies carries all of the business risk and all of the rewards.

Debt, represented in the capital markets by tradable bonds, is entitled to a fixed stream of payments and repayment in full on a specified date unless the issuer becomes insolvent.

Hybrid capital is capital which has some of the characteristics of equity and some of the characteristics of debt. A few years ago a number of major corporates issued debt which qualified as hybrid capital. For more information see my article at the following web address:

http://pwc.blogs.com/finance_and_treasury/2006/02/hybrid-capital-a-simple-introduction.html

3) Islamic finance

Islamic finance is finance which complies with the rules of Shariah as set out by recognised Shariah scholars. As discussed below it may be possible to replicate the full range of conventional capital instruments mentioned above.

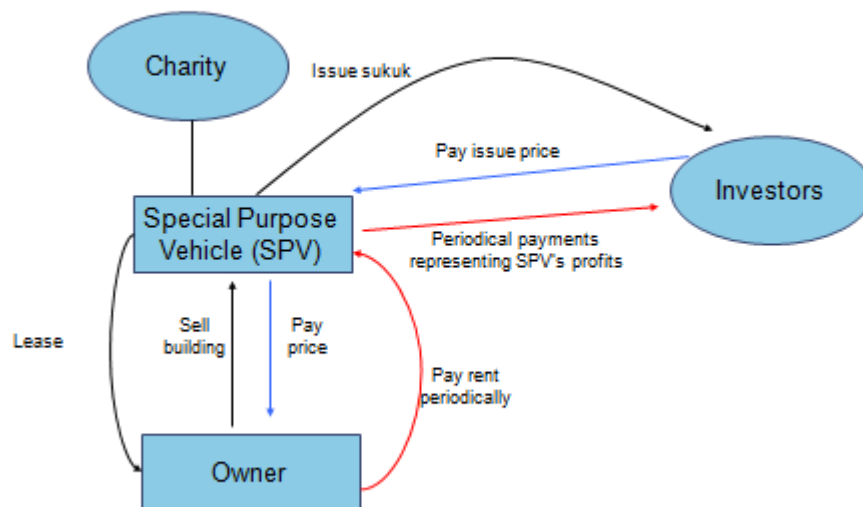
a) Equity

There is universal agreement amongst Shariah scholars that where a company has a single class of ordinary shares, carries on a Shariah compliant business and does not have conventional borrowings or interest earning assets, then its ordinary shares are a permissible investment.

b) Sukuk equivalent to conventional debt

A structure for issuing sukuk using real estate and an ijara contract is illustrated below.

Ijara sukuk



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After the owner has sold the building to the SPV, it is rented back for a fixed period of time at fixed periodic rentals. Furthermore after the fixed time expires, the owner has the right and the obligation to repurchase the building at a predetermined fixed price.

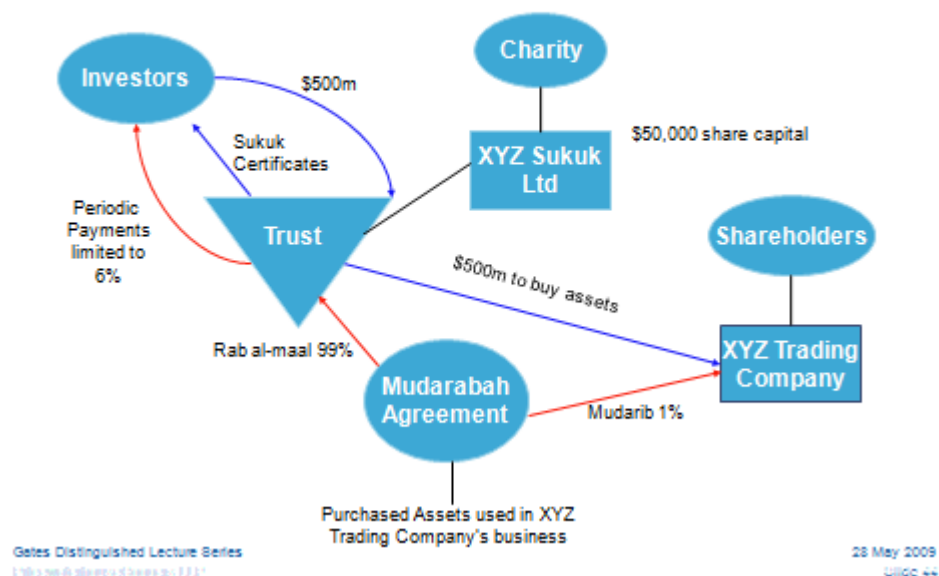
My understanding is that this is a permissible structure even after the AAOIFI ruling of early 2008.

The economics of this sukuk for both the owner and the investors is essentially the same as a fixed rate bond which is secured on the building. If the owner fails to make the periodical payments of rent, the SPV can sue the owner for the rent. Similarly if the owner fails to buy back the building the investors can claim the building or can sue the owner requiring the repurchase to take place unless the owner becomes insolvent.

c) Sukuk with some characteristics of hybrid capital

It is also possible to design sukuk which have the characteristics of hybrid capital. The structure below is based upon an actual transaction a few years ago albeit slightly simplified.

Mudaraba sukuk



In this case the money raised from the investors is used to purchase assets from XYZ Trading Company which are then used to carry on a business managed by XYZ Trading Company as mudarib. 99% of the profits of the mudaraba are payable to the trust, subject to a cap of 6%, which is the amount needed to make the payments to the investors.

The key point is that the maximum amount each year that is payable to the investors is 6% of \$500 million, namely \$30 million. However if there are insufficient profits in the business conducted by the mudaraba then only 99% of that lower profit is payable to the trust and to the investors. Accordingly the investors have downside risk in relation to their periodic income.

Following the AAOIFI ruling of 2008, I understand that it is no longer possible to specify a fixed price at which XYZ Trading Company will repurchase the assets from the mudaraba on the expiry of the sukuk period. Accordingly, the investors will have both upside and downside exposure to the terminal market value of the assets concerned.

This sukuk has characteristics which are intermediate between equity and debt. It is not true equity since there is a maximum limit on the amount that the investors can receive each year. Similarly it is not true debt in economic terms since the investors only receive their periodical payments if the business of the mudaraba makes sufficient profits.

4) Conclusion

Even within the constraints now imposed by the Shariah scholars on the buyback arrangements on the expiry of a sukuk, it is possible to devise sukuk structures which have the same economic characteristics as conventional debt.

It is also possible to devise sukuk that have some of the characteristics of hybrid capital. Given the Shariah constraints, this is the area where the greatest structuring challenges lie and where there is the greatest scope for innovation.

Mohammed Amin