WORLD BANK GROUP
Finance & Markets
Global Islamic Finance Center

Securitization and Structuring *Sukuk*

Workshop on Developing Sukuk Markets
Arab Monetary Fund
World Bank Group

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Roadmap

I. Overview and Structuring of *Sukuk*

What is *Sukuk* (Islamic Bond)?

- The word *Sukuk* (plural of Arabic word *sakk*, meaning "certificate") reflects participation rights in the underlying assets.

- *Sukuk* represent proportionate beneficial ownership of an asset for a defined period when the risk and the return associated with cash flows generated by underlying assets in a pool are passed to the *Sukuk* holders (investors).

- 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"

Sukuk vs. Bond

Sukuk	Bonds
1. Holder owns assets	1. Holder owns cash flow only
2. Use a variety of contracts to create financial obligations between issuer and investors; e.g. Sale, lease, equity partnership, joint-venture etc.	2. Simply use a loan contract to create indebtedness
3. Return linked to profit elements in-built in the sale, lease or partnership	3. Return linked to interest charged out of the loan contract
4. Instrument may be equity or debt depending on underlying contract	4. It is a Debt instrument
5. Tradability of the *Sukuk* depends on the nature of the underlying asset	5. No restriction on the tradability
6. Investment in *Shari`ah*-compliant activities	6. Proceeds are invested in any business without restrictions

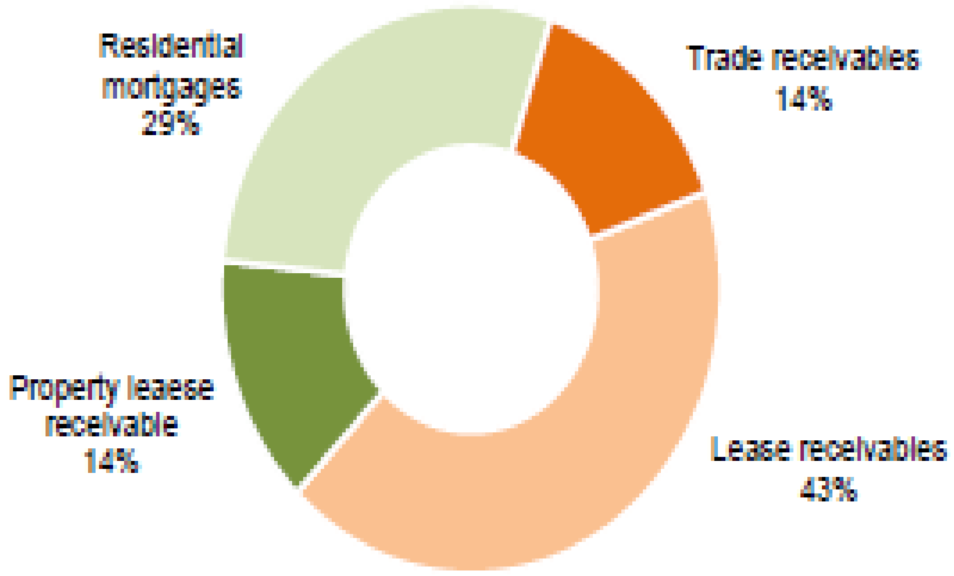
Prerequisites of *Sukuk* Structuring

- The financing should be linked to clearly identifiable assets—real and financial which become underlying assets for securitization.
- Both the investors and the users of funds share in both the risk and return which is clearly defined.
- Pool of assets (collateral) must comply with Shari'ah principles and therefore should be devoid of prohibited elements such as interest (*riba*), excessive risk (*gharar*), unethical business practices or prohibited activities. For example, a pure financial claim such as receivables, debt, or cash would not qualify.
- Payoffs of return or principal redemptions should not be guaranteed as done in case of conventional bonds or securitized assets.
- A sufficient element of ownership must be conveyed to investors;
- The underlying assets and securitized obligations must not be employed for speculative purposes, and turnover should be kept low;
- Since conventional insurance deals with interest, it is advised to utilize Shari'ah-compliant insurance, *takaful* which is based on principles of solidarity.
- Any form of credit enhancement and/or liquidity support and limitations of prepayment risk must be approved by Shari'ah scholars.

Source: Jobst (2007)

Islamic securitization transactions by underlying asset type

Proportion of Islamic securitisation transactions by collateral type (2003-2013)

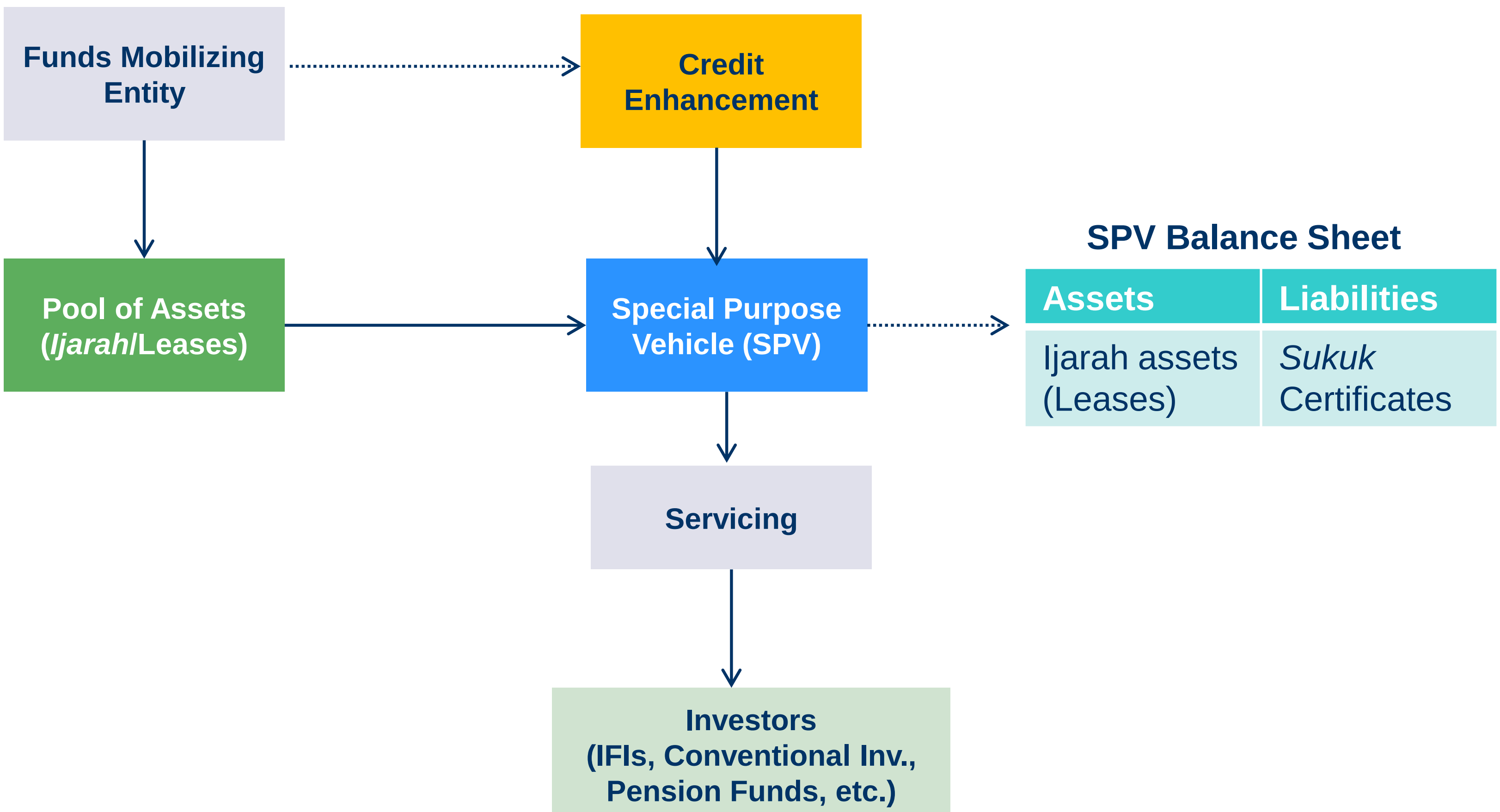


Source: KFHR

The distinction for every Islamic securitized transaction is the underlying collateral which generates the cash flow of the *sukuk*. If compared among the seven Islamic securitized transactions, the most utilised collateral class would be those related to the real estate sector

Source: “Quarterly Global Sukuk October 2014”, Rasameel Structured Finance Co.

Anatomy of *Sukuk*



Structuring Structure is multi-steps process

Step 1: An asset is identified, which is currently held by the entity whishing to mobilize resources and raise funds.

Step 2: The underlying asset is brought onto the asset side of the SPV by issuing Sukuk on its liability side to investors in an amount equal to the purchase price.

Step 3: The SPV either sells the asset or leases it back to a lessee-an affiliate of the seller or the seller itself-in exchange for a future payment or periodic lease payments.

Step 4: Credit enhancement makes the certificates investment-grade securities.

Step 5: During the course of the life of the Sukuk, periodic payments are made by the benefactor of the asset (the lessee), which are transferred to the investors.

Step 6: At maturity the SPV starts winding up by selling the assets back to the original seller/owner at a predetermined price and then paying back to the certificate holders or investors.

Local *Sukuk* Markets

- Some of the countries have local *Sukuk* market. Both the governments and corporates are tapping these markets for financing.

- Issuers are using local Sukuk markets for these purposes:
  - Budget Financing
  - Project Financing
  - Enhancement of Bank's Capital
  - Infrastructure Development

- Malaysia has the biggest domestic *Sukuk* market in the world. In 3Q14 YTD, Malaysia represents 64.9% of total issuances this year to date with more than USD61.4bln in new issuances volume, an increase of 6% in absolute volume compared to the USD58.2bln issued in the same period last year.

- The Malaysian *Sukuk* market has been tapped by a wide variety of issuers including benchmark *Sukuk* of various maturities issued by the Malaysian central bank, Bank Negara Malaysia; capital raising and liquidity management

Local *Sukuk* Markets

- The GCC *Sukuk* market accounted for USD21.4bln or 22.6% market share as at 3Q14 which is an improvement compared to the USD15.5bln or 19% market share in the same period last year (3Q13).

- Bahrain has been the most active market within the GCC region, and also the first government in the GCC to use *Sukuk* as one of its primary tools for raising finance.

- Outside of Bahrain even though the rest of the countries in the GCC have been relatively less active in the local currency based domestic market, there have been some large sized issues from Saudi Arabia and UAE.

- Turkey government has been issuing *Sukuk* in local *Sukuk* market for budget financing. From the beginning in 2012 year-to-date issuance volume in local market up to TL8bn (approximately USD3.7bln). Moreover, especially participation banks are also active players in local *Sukuk* market in Turkey.

II. Types of *Sukuk*

Types of *Sukuk*

AAOIFI recognizes the following different types of *Sukuk*:

1. Certicifates of ownership of leased assets (*Ijarah Sukuk*)
2. Certificates of ownership of right to use; (i) of existing assets, (ii) of described future assets, (iii) of services of specified party, and (iv) of described future services
3. *Salam* Certificates
4. *Istisna*' Certificates
5. *Murabahah* Certificates
6. *Musharakah* Certificates
7. *Mudarabah* Certificates
8. *Muzaraah* (share-cropping) Certificates
9. *Musaqah* (irrigation) Certificates
10. *Mugharasa* (agricultural/seed planting) Certificates

Ijarah Sukuk

Prerequisites for Structuring an *Ijarah Sukuk*

- The leased assets must have some beneficial usage for which the users are willing to pay a rent.

- The maintenance expenditure related to the underlying asset is the responsibility of the owner-in this case, the holders of the Sukuk

Advantages of *Ijarah* Contract

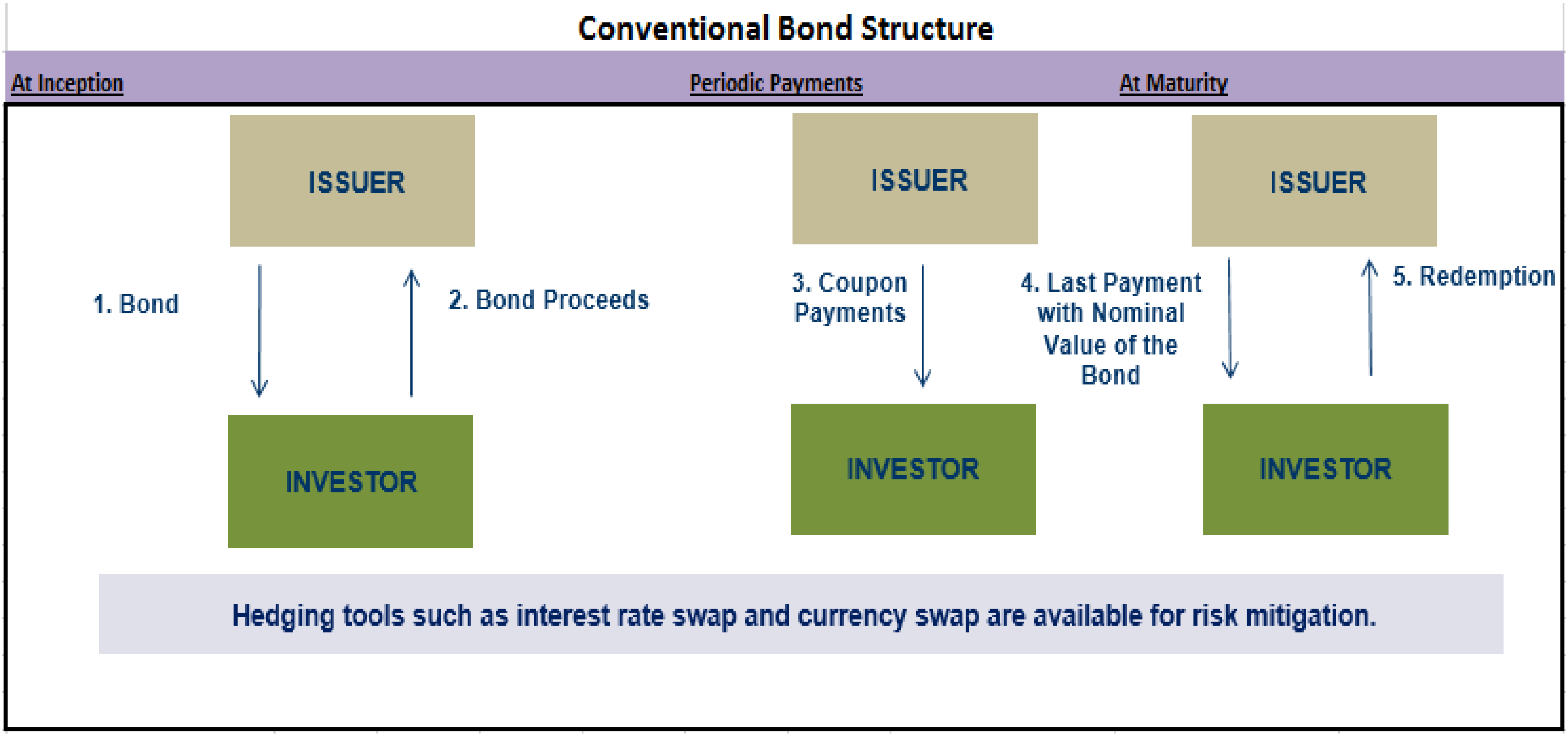
- **Flexibility:** both fixed- and floating rate payoffs are possible

- **Extended Maturity:** The ijarah contract can be of any length as long as the asset remains in existence and the user can draw benefit from it.

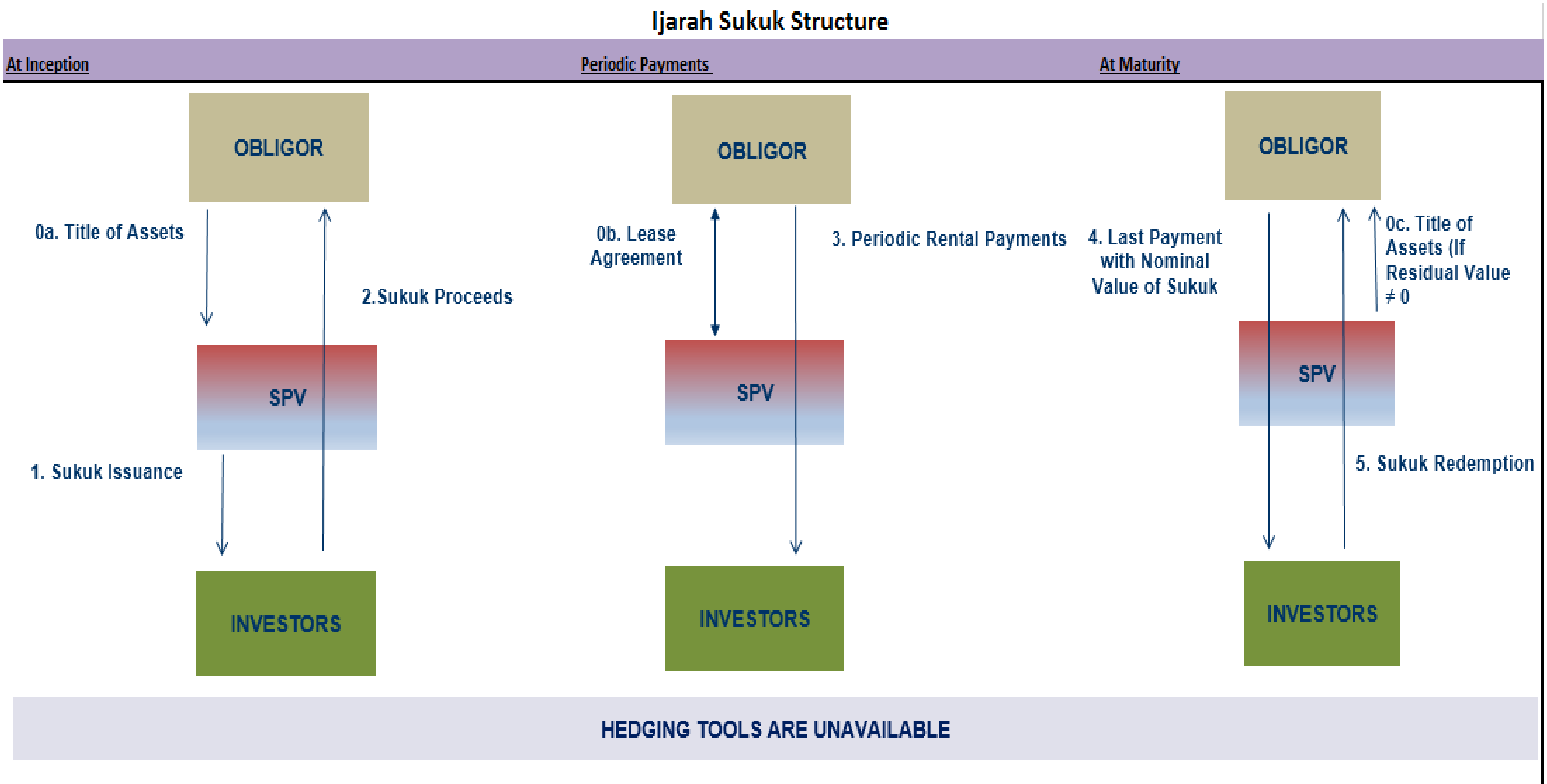
- **Transferability:** Secondary market exchange is allowed.

- **Negotiability:** Completely negotiable capable of being traded in the secondary markets.

Conventional Bond Flow Diagram



Ijarah Sukuk



Salam Sukuk

Characteristics

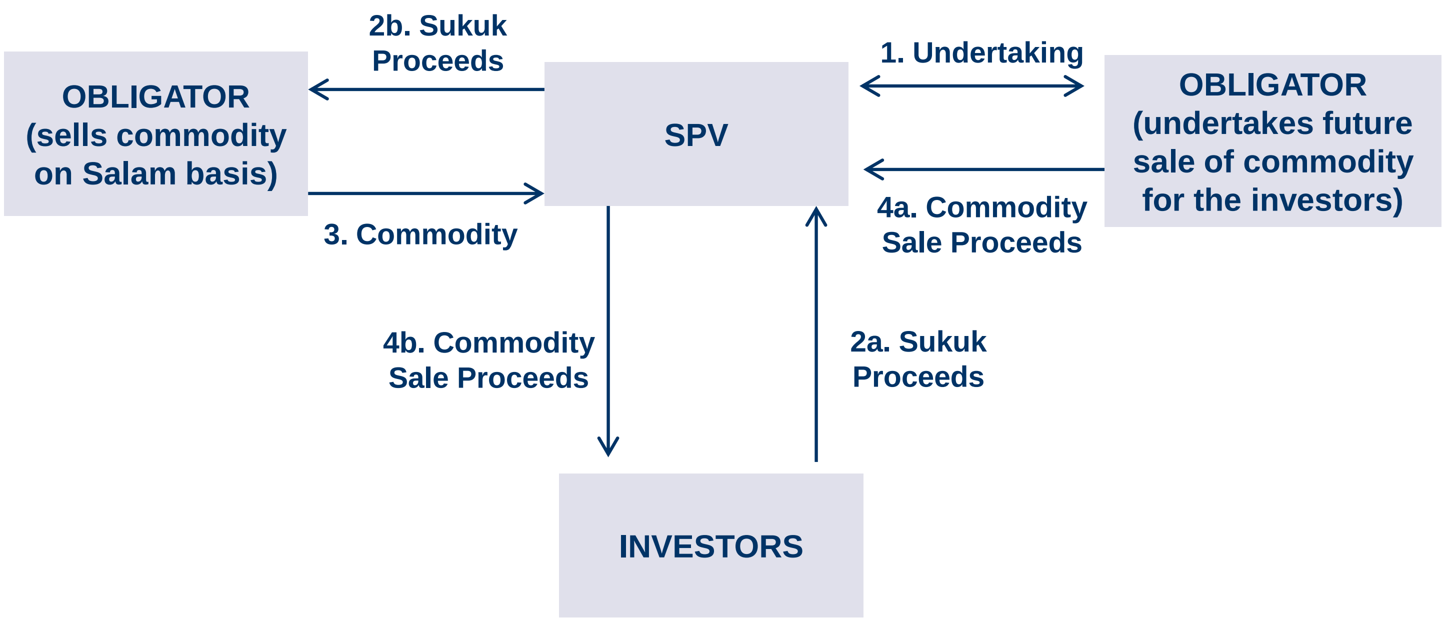
- The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated profit margin.

- Contracts can be based on either spot sale (*Salam*) or deferred payment sale (*Bay'al-Muajjill*) or deferred delivery sale (*Bay'al Salam*).

- It is a useful investment vehicle for short term maturity (from 3 months to 1 year).

- It results in a pure financial claim and is somewhat de-linked from the risk/return of the underlying assets, the *Shariah* treats it as a pure debt security, which **cannot be traded in the secondary market**. Thus, investors must hold salam *Sukuk* up to the maturity if the certificates.

Salam Sukuk



2b. Sukuk Proceeds
OBLIGATOR (sells commodity on Salam basis)
SPV
1. Undertaking
OBLIGATOR (undertakes future sale of commodity for the investors)
3. Commodity
4a. Commodity Sale Proceeds
4b. Commodity Sale Proceeds
2a. Sukuk Proceeds
INVESTORS

Murabahah Sukuk

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

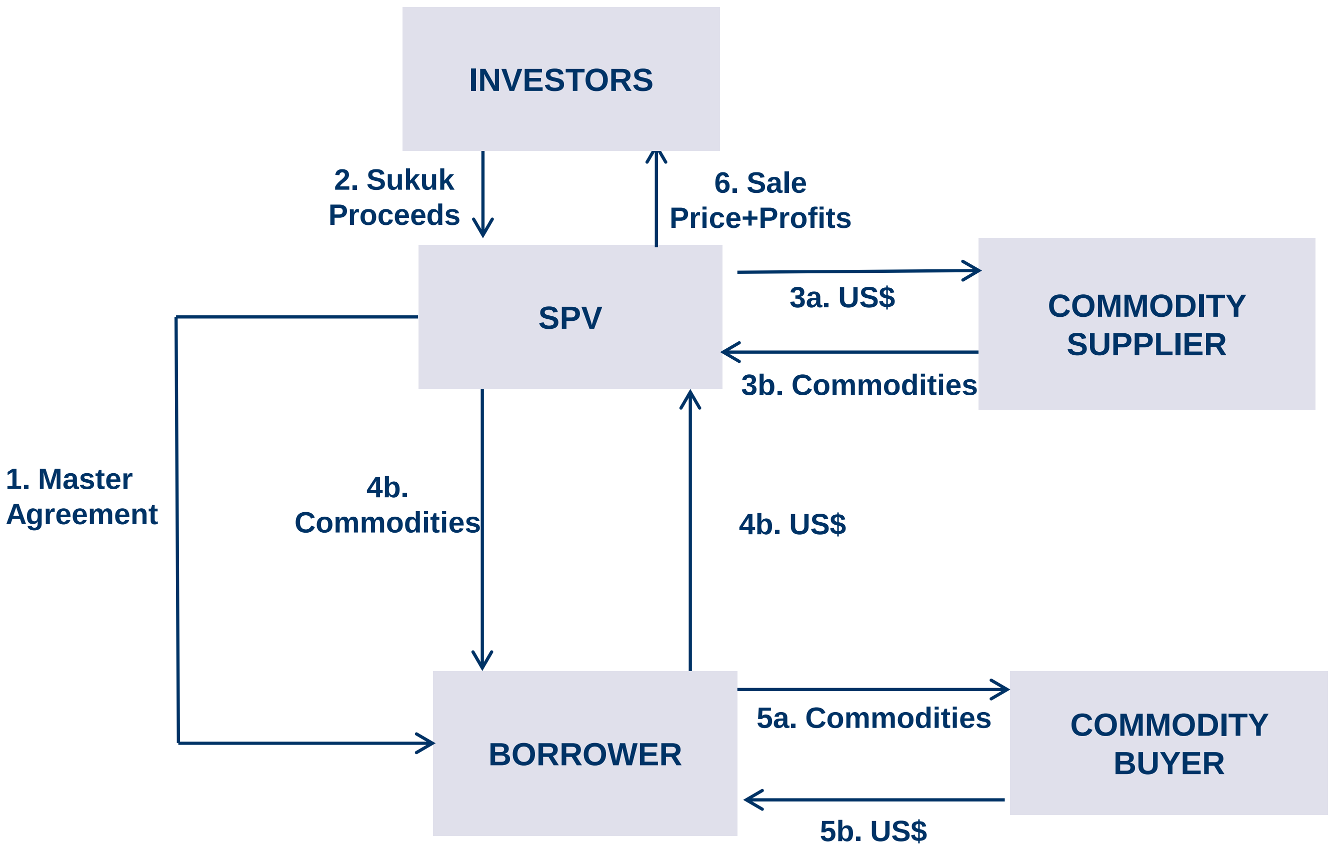
- *Sukuk al-Murabahah* are certificates of equal value issued for the purpose of financing the purchase of goods through *Murabahah* so that the certificate holders become owners of the *Murabaha* commodity.

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

- The negotiability of these *Sukuk* or their trading at **the secondary market is not permitted** by *Sharia*, as the certificates represent a debt.

- Despite being debt instruments, the *Murabahah 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 *Mudarabah*, *Musharakah*, or *Ijara Sukuk*.

Murabahah Sukuk



Musharakah Sukuk

- *Musharakah* 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.

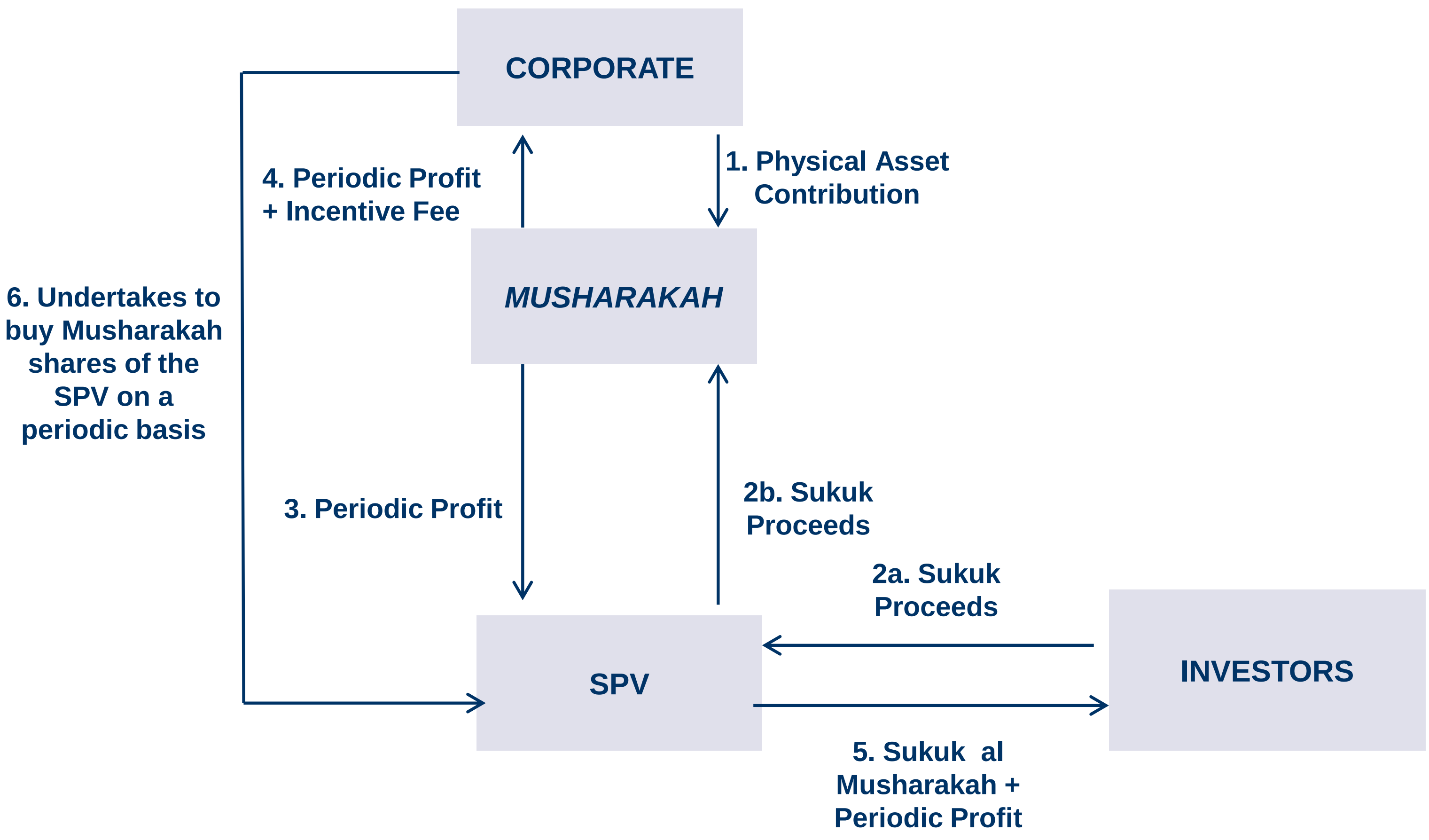
- *Sukuk al Musharakah* are documents of equal value issued with the aim of using the mobilized funds for establishing a new project or developing an existing one or financing a business activity on the basis of one of partnership contracts.

- The certificate holders become the owners of the project or the assets of the activity as per their respective shares.

- *Musharakah* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

- With enhanced monitoring and transparency, and with a reduction of asymmetrical information, *Musharakah Sukuk* could make a greater contribution to the development of Islamic capital markets.

Musharakah Sukuk



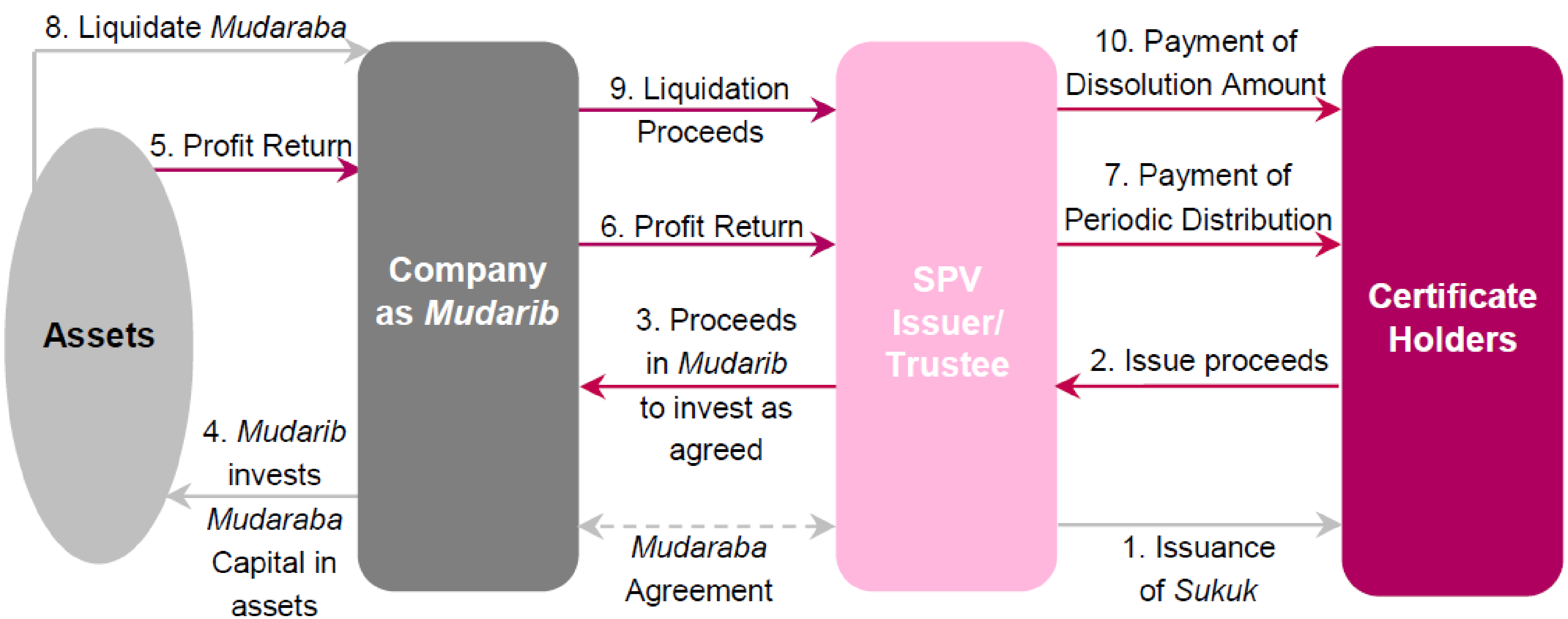
Mudarabah Sukuk

- *Mudarabah* 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.

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

- 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.

Mudarabah Sukuk



Source: "Shari'ah Compliant Securities (Sukuk)", Linklaters, September 2012.

Structuring Considerations

Transfer of Title

Depending on the relevant jurisdiction, the nature of the title to assets held or to be transferred and the *Shari'a* structure used, it may be necessary to consider local law issues pertaining to the transferability of title to the assets underlying a *Sukuk*. These may include any formalities (such as registration and the payment of any associated fees or taxes) necessary for the transfer of title to be effective.

Nature of the Assets

The vast majority of *Sukuk* are structured so as to be "asset-based" rather than "asset-backed" investments. This means that Certificate holders do not typically have recourse to the assets which underpin the *Sukuk* structure. Rather, investors only have an unsecured claim against the obligor for the repurchase price of such assets, which are required to be sold back to the obligor by the SPV issuer on maturity, an event of default or any early redemption

Source: "Shari'ah Compliant Securities (Sukuk)", Linklaters, September 2012.

Structuring Considerations

Tax

The acquisition or purchase of assets, or other transactions under *Shari'a*-compliant structures used to generate profit for *Sukuk holders*, could potentially create exposure to capital gains, value added or income taxes. The ownership of an asset may also be taxable or create tax residency issues.

Governing law

There are differences amongst Scholars relating to the interpretation of various Islamic principles. As such the market practice is that documents be governed by the law of a particular jurisdiction rather than by *Shari'a* law.

Tradability of *Sukuk*

Sukuk must represent an interest in physical assets rather than simply representing debts or obligations. Some Scholars over time have been comfortable with physical assets underlying *Sukuk* structures representing at least 33 per cent. of the face value of the *Sukuk*; other Scholars require between 51 per cent. and 70 per cent. of the assets underlying *Sukuk* structures to be physical assets.

Source: "Shari'ah Compliant Securities (Sukuk)", Linklaters, September 2012.

III. Challenges

Challenges

Limitations of the *Sukuk* Market

1. *Sukuk* market suffers from a lack of frequent sovereign issues.

2. There is almost no secondary market in most *Sukuk* issues.

3. The lack of liquidity of most *Sukuk* issues hampers the growth of the market.

4. Complexity of *Sukuk* structures is another impediment to the development of the market.

5. The lack of uniform interpretations across jurisdictions further hinders the growth of the market.

Challenges for the *Sukuk* Market

1. The *Sukuk* issued so far have been linked to a particular real asset, rather than to a pool of assets.

2. Issuers, investors and intermediaries need to nurture the market patiently.

3. Floating-rate *Sukuk* are often linked to a conventional interest rate benchmark such as LIBOR.

4. “Buy and hold” type investors are the main subscribers.

5. In principle, *Sukuk*-based funding should be cheaper, since it is based on collateralized cash flows, but in reality it is not the case.

IV. Case Studies

Case studies-sovereign

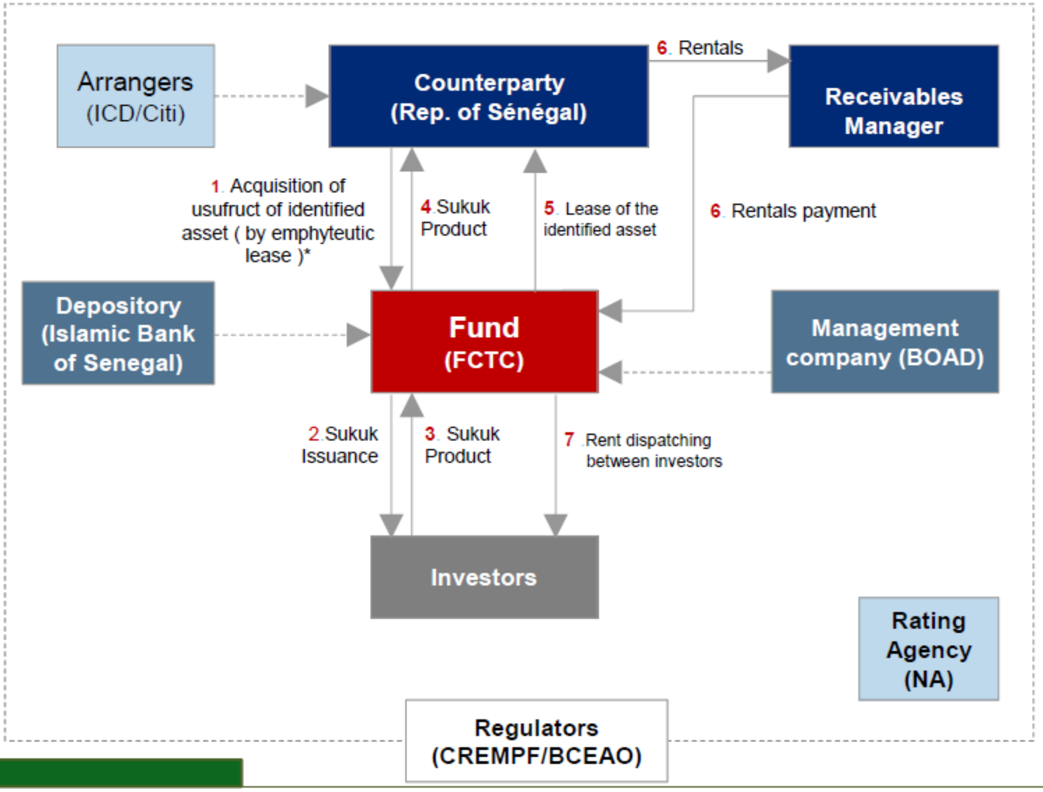
Obligor	**Republic of Senegal**
Issuer	**FCTC Sukuk Etat du Senegal 6.25% 2014-2018 « FCTC»**
Rating of the Obligor	B^{+}/B (S&P), B1 (Moody's)
Profit Rate	6.25% p.a.
Ranking	Ranking *pari passu* with any other sovereign debt obligations
Currency	CFA
Maturity	4 years
Distribution	Public offering
Governing Law	Senegalese law
Repo-admission	The Sukuk are repo-eligible at the Central Bank
Joint Lead Managers	ICD & Citi
Receivable Manager	Islamic Bank of Senegal
Bookrunners	CSWA, Impaxis & CGF Bourse
Manager of the FCTC	BOAD Titrisation
Auditor of the FCTC	Mazars

Source: Senegal Investor Presentation

Case studies-sovereign

Republic of Senegal-18 July 2014

- The FCTC will issue asset leasing certificates "Sukuk" to investors in return for cash proceeds
- The FCTC uses the proceeds from the issuance to purchase the Usefruct of the Real Estate Assets (the Sukuk Assets) and to lease it to the Republic of Senegal
- The Republic of Senegal as Lessee will pay rent to the Issuer on Real Estate Assets. The Issuer uses these proceeds to make payments of the Periodic Distributions to the Sukuk holders
- Upon redemption or the occurrence of a dissolution event, the Republic of Senegal buys back the Sukuk Assets from the Issuer as set out in the Purchase Undertaking



Source: Senegal Investor Presentation

Case studies-sovereign

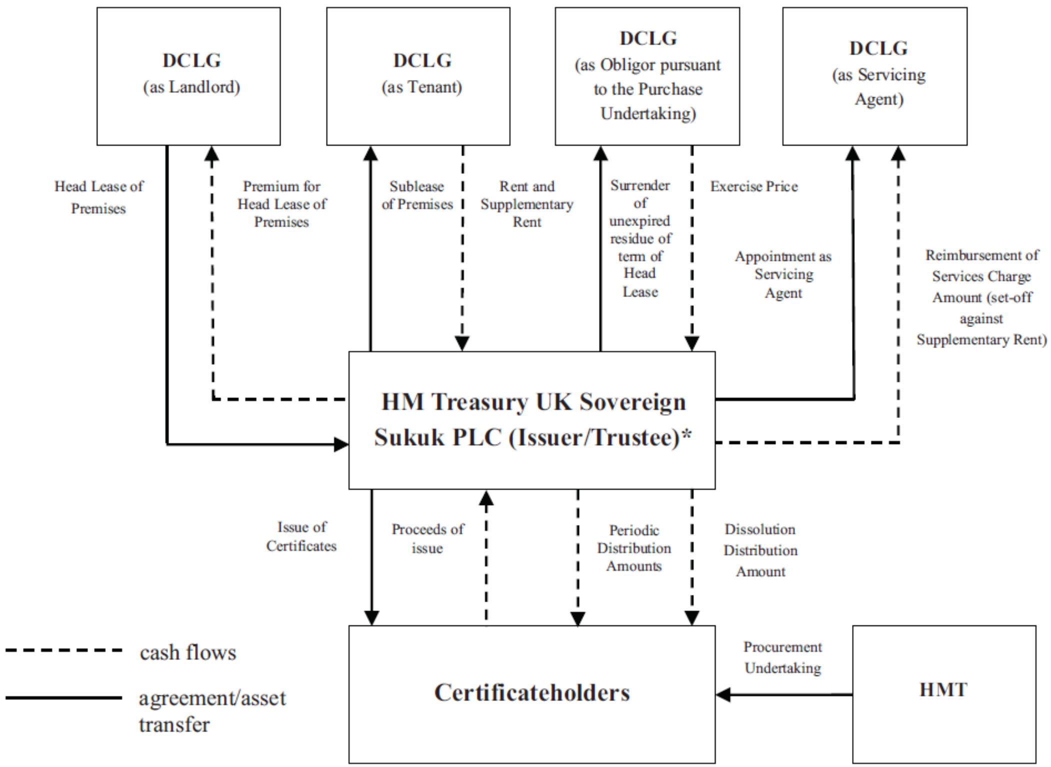
United Kingdom-25 June 2014

- United Kingdom has officially become the world's first non-OIC sovereign state to issue a Sukuk as it raised GBP200mln on 25th June through a Sukuk al-Ijarah.
- The British Treasury (HM Treasury) priced the much awaited sovereign instrument at a profit rate of 2.036%. Total subscription was around GBP2.3bln.
- Final allocations of the issuance were as follows: United Kingdom (39%); Middle East (37%); and Asia (24%).
- By investor type, the allocations were: Banks (59%); Central Banks / Official Institutions (25%) and Fund Managers (16%).

Source: HM Treasury Sukuk Offering Circular

Case studies-sovereign

1- United Kingdom-25 June



* A Second Trustee may be appointed to act as Transferor pursuant to the surrender agreements (as described below).

DCLG: The Secretary of State for Communities and Local Government (Obligor)

Source: HM Treasury Sukuk Offering Circular

Case studies-supranational

1- International Finance Facility for Immunisation (IFFIm)-27 November 2014

- The International Finance Facility for Immunisation Company (IFFIm) is a multilateral institution created to accelerate the availability of predictable, long-term funds for health and immunisation programmes through Gavi, the Vaccine Alliance in more than 70 of the poorest countries around the world.

- IFFIm's financial base consists of legally binding grant payments (approximately US$ 6.3 billion) from its nine sovereign donors (the UK, France, Italy, Norway, Australia, Spain, the Netherlands, Sweden and South Africa), on the basis of which IFFIm is rated AA+ (negative) /Aa1 (stable) /AA (negative) (Fitch/Moody's/S&P). **The World Bank is IFFIm's Treasury Manager.**

- IFFIm issued its inaugural Sukuk on November 27, 2014, raising US$ 500 million for children's immunisation in the world's poorest countries through Gavi, the Vaccine Alliance.

- This landmark transaction is **the first socially responsible Sukuk** with funds to be utilised for this purpose.

- This successful transaction marks **the largest Sukuk al-Murabaha** issuance in the public markets and is also the largest inaugural Sukuk offering from a Supranational.

Source: IFFIm Press Release dated 27 Nov. 2014

Case studies-supranational

1- International Finance Facility for Immunisation (IFFIm)-27 November 2014

Issuer:	IFFIm Sukuk Company Limited
Obligor:	International Finance Facility for Immunisation Company (IFFIm)
Obligor Ratings:	AA+ / Aa1 / AA (Fitch / Moody's / S&P)
Issue Rating:	Aa1 by Moody's
Amount:	US$ 500 million
Status:	Senior, Unsecured Trust Certificates
Sukuk Structure:	Murabaha
Format:	Regulation S
Pricing Date:	November 27, 2014
Settlement Date:	December 4, 2014
Maturity Date:	December 4, 2017
Profit Rate:	US$ 3-month LIBOR + 0.15% p.a., payable Quarterly in arrears
Issue Price:	100.00
Listing:	Not listed
Global Coordinator:	Standard Chartered Bank
Joint Lead Managers and Joint Bookrunners:	Barwa Bank, CIMB, NBAD, NCB Capital and Standard Chartered Bank
Co-Lead Managers:	Bank Islam Brunei Darussalam Berhad and Union National Bank PJSC
Delegate:	Citicorp Trustee Company Limited
ISIN:	XS1143356654

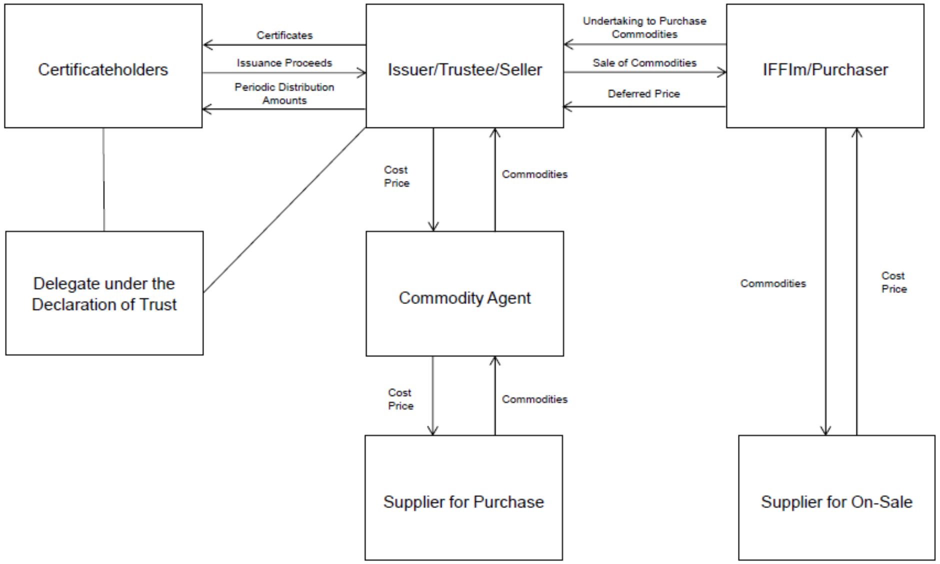
The Sukuk was oversubscribed, even with its unique structure for Sukuk market participants. IFFIm achieved strong diversification in its investor base with 85% of the order book coming from new and primarily Islamic investors.

The regional distribution of investors was 21% based in Asia, 11% in Europe and 68% in the Middle East and Africa. Banks took 74%, and central banks / official institutions took 26%.

Source: IFFIm Press Release dated 27 Nov. 2014

Case studies-supranational

1- International Finance Facility for Immunisation (IFFIm)-27 November 2014



On the Issue Date

1. The Trustee will purchase Commodities through a Commodity Agent from the Supplier for Purchase for an amount equal to the Cost Price.
2. The Trustee will sell the Commodities to IFFIm.
3. IFFIm shall on-sell the Commodities at an amount equal to the Cost Price to the Supplier for On-Sale.

On Each Periodic Distribution Date

1. IFFIm will have the obligation to pay the Deferred Price to the Trustee.
2. The Trustee will use the Deferred Price to (i) enter into a new Murabaha Contract for the purchase of Commodities in an amount equal to the Cost Price and (ii) pay the Periodic Distribution Amount due under the Certificates.

On any Dissolution Date

1. IFFIm will pay the Deferred Price to the Trustee to complete the existing Murabaha Contract and no new Murabaha Contract will be entered into. The Trustee will use the Deferred Price received from IFFIm on the relevant Dissolution Date to pay the Dissolution Amount due under the Certificates.

Source: Prospectus of Issue

Case Studies-Project Finance *Sukuk*

Republic of Indonesia-16 February 2012

Transaction Highlights

- PBS004 is initially issued at Feb 16th 2012 through auction Reopened regularly on each Sukuk Negara auction (Scheduled twice a month)
- Enormous demand on each auction, with average IDR1. 3trillion Current outstanding is IDR4.58trillion.
- Average bid to cover ratio is about 1.81 reflects fair yield by investors
- Attracted Islamic investors most, compared to other series, with average is 8.3%
- Underlying asset is pool of projects such rehabilitation and construction of road, irrigation, drainage and residential.

Summary of terms & conditions

Issuer (SPV)	:	**Perusahaan SBSN Indonesia 2 (PPSI-2)**
Obligor	:	**Republic of Indonesia**
Structure	:	**Ijarah Asset to be Leased**
Underlying	:	**Project**
Normal per Unit	:	**IDR 1 million**
Coupon	:	**6.10% p.a. Paid semi-annually**
Payment	:	**At par (100%) Bullet payment at maturity**
First Issue Date	:	**16 February 2012**
Maturity Date	:	**15 February 2037**
Issuance Method		**Auction**
Listing		**Indonesia Stock Exchange**
Tradability		**Tradable**

Source: "Sukuk and Islamic Capital Markets as Avenues for Long Term Financing", International Islamic Financial Market, presented by Ijlal Ahmed Alvi at AAOIFI World Bank Annual Conference on Islamic Banking and Finance, Bahrain, 18 Nov. 2014

Case Studies-Infrastructure Financing *Sukuk*

Sadara Corp.- 2 April 2013

SPV	Sadara Basic Services Company
Structure type	*Musharakah / Ijarah*
Issue size	SAR 7.5 billion (USD 2 billion)
Issue Date	02-April-2013
Maturity date	02-April-2029
Return	6 month SAIBOR + 95 bps
Fix or Variable	Floating
Return frequency	Semi-annual
Book Runners	Riyad capital, Deutsche Securities, Alinma Investment Company, Albilad Investment Company
Listing	Saudi Stock Exchange (Tadawul)
Rating	None
ISIN RegS	SA13AOP145J6

The Sadara Sukuk was well-received by Saudi investors due to the nature of the Sukuk as well as the strong backing by formidable sponsors. The issue size was increased from the original target of SAR 5.25 billion to SAR 7.5 billion.

Source: "Sukuk and Islamic Capital Markets as Avenues for Long Term Financing", International Islamic Financial Market, presented by Ijlal Ahmed Alvi at AAOIFI World Bank Annual Conference on Islamic Banking and Finance, Bahrain, 18 Nov. 2014

THANK YOU…

Disclaimers