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Primer on Shariah Finance

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Primer on Shariah Finance

- Shariah is the legal framework that regulates the social, economic and political life in Islam;
- The basic and fundamental principles of Shariah as applied to the Islamic finance industry, are the following:
 - Money is capital (a means of measuring value)
 - Money is not an asset; All transactions should be asset-backed;
 - Prohibition of 'Riba': any sort of interest;
 - Prohibition of 'Gharar': speculation, conventional futures or forwards, etc.;
 - Suppliers of funds share business risks in return of a share of profits;
 - Financing is limited to those activities which are Hallal (lawful) and not Haram - forbidden - (no pork, no arms, no alcohol, no gambling, etc.);
 - Profit and risk taking/risk sharing are encouraged;
 - Zakat: Islamic Tax

- Differences exist between the various schools of Islamic jurisprudence:
 - For example, in the GCC, “receivables” are considered as being non-Shariah compliant, whereas in Malaysia, it is common to have Islamic financial instruments backed by “receivables”.
 - Shariah compliant derivatives, such as hedges and swaps, exist in the market which do not violate the prohibition of “Gharar”.

➤ Sukuk is plural of: Sakk: striking one's seal on a document or tablet representing a contract or conveyance of rights, obligations and/or monies, which can be by way of participation or interest securities, coupons or investment certificates;

➤ AAOIFI Standard 17: "investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activity[...]"

➤ The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) define 14 types of Sukuk, the main ones are:

- Ijara Sukuk (leasing) ,
- Certificates of ownership of usufructs (e.g. Sukuk Manfa'at Al-Ijara);
- Salam Sukuk (deferred commodity delivery);
- Istisna'a Sukuk (manufacturing or project finance);
- Mudarabah Sukuk (partnership/finance trusteeship);
- Murabaha Sukuk (purchase order);
- Musharaka certificates (Joint Venture);

Istisna SUKUK

Commissioned Manufacturing / Project Finance

Financial Institution finances manufacture or construction of an item either by
prep-payment or installment payments

buildings, equipment, hotels, aircraft

Item is then sold/leased to customer and paid for usually in installments

Often used in conjunction with Ijara structure

MUSHARAKA SUKUK

- Based on MUSHARAKA (“partnership/joint venture where each party contributes to the partnership capital in equal or varying degrees”) also called “equity participation” sukuk
- Considered purest form of Islamic Finance -- more equitable, entails profit and loss sharing between partners and SUKUK holders, not only profit sharing
- Profits are allocated in any pre-agreed ratio. Losses are borne in proportion to contribution to capital.
- Practical steps:
 - SUKUK offered to market for mobilizing the required capital
 - Proceeds used in profit development or can be used to buy and lease equipment/assets through a specially formed MUSHARAKA

Ijara Sukuk (Leasing or Sale-Lease Back)

- Can be used for long term infrastructure projects by the mobilization of short term deposits i.e. securitization of Government tangible assets for possible use in the project financings.
- Popular vehicle Islamic finance because:
 - Asset Backed
 - Lender (Bank or SPV) retains control of asset until maturity
 - Lender shares risks through its responsibility for maintenance and insurance
 - Can use one lease or pool of leases
- Works as follows:
 - Sale of tangible assets to a special purpose restricted Mudaraba (SPV) assets are then leased to the interested parties through a Ijara lease
 - The MUDARABA participation SUKUK will be issued and sold to public/investors for larger infrastructure projects can have a guarantee of payments (usually from Government or international bank)
 - Required security will be given to SUKUK holders
 - MUDARABA managed (on behalf of SUKUK holders) by MUDARIB
 - MUDARIB signs and executes all relevant contracts
 - Ensures Shariah compliance
 - Transparency and efficient operation

Leasing SUKUK

- Practical Application
- Incorporate SPV (MUDARABA)
- Offer MUDARABA participation SUKUK (3 + years) to market
- Receive subscription for MUDARABA
- Purchase tangible assets on a standard sale contract
- Lease (IJARA) assets to lessees
- MUDARIB manages liabilities and assets of SPV
- Trade SUKUK in secondary market
- Liquidate MUDARABA and redeem issued SUKUK at maturity

MURABAHA SUKUK

- Murabaha Sukuk (purchase / resale) -- cost plus financing

- Generally has three parties:

- Purchaser/importer
- Seller/exporter
- Financier

-Financier purchases the desired commodity from the Seller/Exporter and resells it to the purchaser/import at a predetermined higher price payable in installments.

-Financier MUST take title to goods

-On its face a Murabaha transaction is an investment not a mode of finance

MUDARABA SUKUK (Profit Sharing or Sweat Equity)

Simply:

- Bank acts as silent partner with entrepreneur.
- Funding is provided for a specific commercial activity
- Entrepreneur provides management expertise and earns agreed portion of the profits (i.e. the “management fee”)
- Profit balance is paid to the bank

More Intricate:

- Bank can offer MUDARABA participation SUKUK certificates to investors who participate in funds or transactions
- Can be structured as a variable capital of a registered investment vehicle
- Allows banks to invest surplus cash for a short period without compromising Shariah principals or security quality and can generate cash relatively quickly
- Substantial percentage of underlying investment should be asset based.

SALAM SUKUK

- Short term instruments providing alternative to treasury notes special restricted MUDARABA (“trustee finance, partnerships”) managed by Bank as MUDARIB (“managing trustee”) issued to other banks and investors as a participation SUKUK in this MUDARABA as capital providers.
- The special purpose MUDARABA buys a commodity on a SALAM basis purchase price will be paid entirely up front and delivery of commodity will be at a specified future date.
- The SALAM sukuk contract cannot be traded and must be held to maturity therefore only short term solution.

Other Variations/Hybrids of SUKUK

- Certificates of ownership of usufructs
 - Existing assets
 - Future assets as per description
 - Services of a specified supplier (present and future)

- General Participation
 - Mushraka
 - Mudaraba
 - Muzara's (Sharecropping)
 - Musa qa (Irrigation)
 - Mugarasa (Agricultural)
 - Concession (see earlier comments on infrastructure/project financings)
 - Salam (commodity)

SUKUK Compared to Bonds

Sukuk	Bonds
<p>Sukuk represent ownership stakes in existing and/or well defined assets;</p> <p>The underlying contract for a sukuk issuance is a permissible contract such as a lease or any of the other 14 categories defined by AAOIFI;</p> <p>The underlying assets monetised in a sukuk issuance must be Islamically permissible in both their nature and use e.g. a truck would always be an eligible asset but not its lease to a distillery;</p>	<p>Bonds represent pure debt obligations due from the issuer;</p> <p>In a bond, the core relationship is a loan of money, which implies a contract whose subject is purely earning money on money (<i>Riba</i>);</p> <p>Bonds, can be issued to finance almost any purpose which is legal in its jurisdiction;</p>

Sukuk	Bonds
Asset-related expenses may attach to Sukuk Holders;	Bond holders are not concerned with asset-related expenses;
Notwithstanding an obligor's creditworthiness, sukuk prices depend on the market value of the underlying asset;	Bonds depend solely on the creditworthiness of the issuer. (In case of an Issuer's failure, unsecured bondholders join the pool of general creditors seeking the assets of a bankrupt company);
The sale of a sukuk represents a sale of a share of an asset;	The sale of a bond is basically the sale of a debt;

	Sukuk	Bonds	Shares
Nature	Not a debt but undivided ownership share in specific assets/projects/services	Debt of Issuer	Ownership share in a corporation
Asset Backed	A minimum of 51% tangible assets (or their contracts are required to back issuance of <i>Sukuk al Ijara</i>)	Generally not required	Not required
Claims	Ownership claims on the specific underlying assets/project/service...	Creditors claims on the borrowing entity, and in some cases liens on assets	Ownership claims on the company
Security	Secured by ownership rights in the underlying assets or projects in addition to any additional collateral enhancements structured	Generally unsecured debentures except in cases such as first mortgage bonds, equipment trust certificates and so on	Unsecured
Principal and Return	Not guaranteed by Issuer	Guaranteed by issuer	Not guaranteed by company
Purpose	Must be issued only for islamically permissible purposes	Can be issued for any purpose	Can be offered for any purpose
Responsibility of holders	Responsibility for defined duties relating to the underlying assets/projects limited to the extent of participation in the issue	Bondholders have no responsibility for the circumstances of the issuer	Responsibility for the affairs of the company limited to the extent of holding in the company

- Marketable:

- Liquid;
- Easily transferred;
- Tradable;

- Rateable;

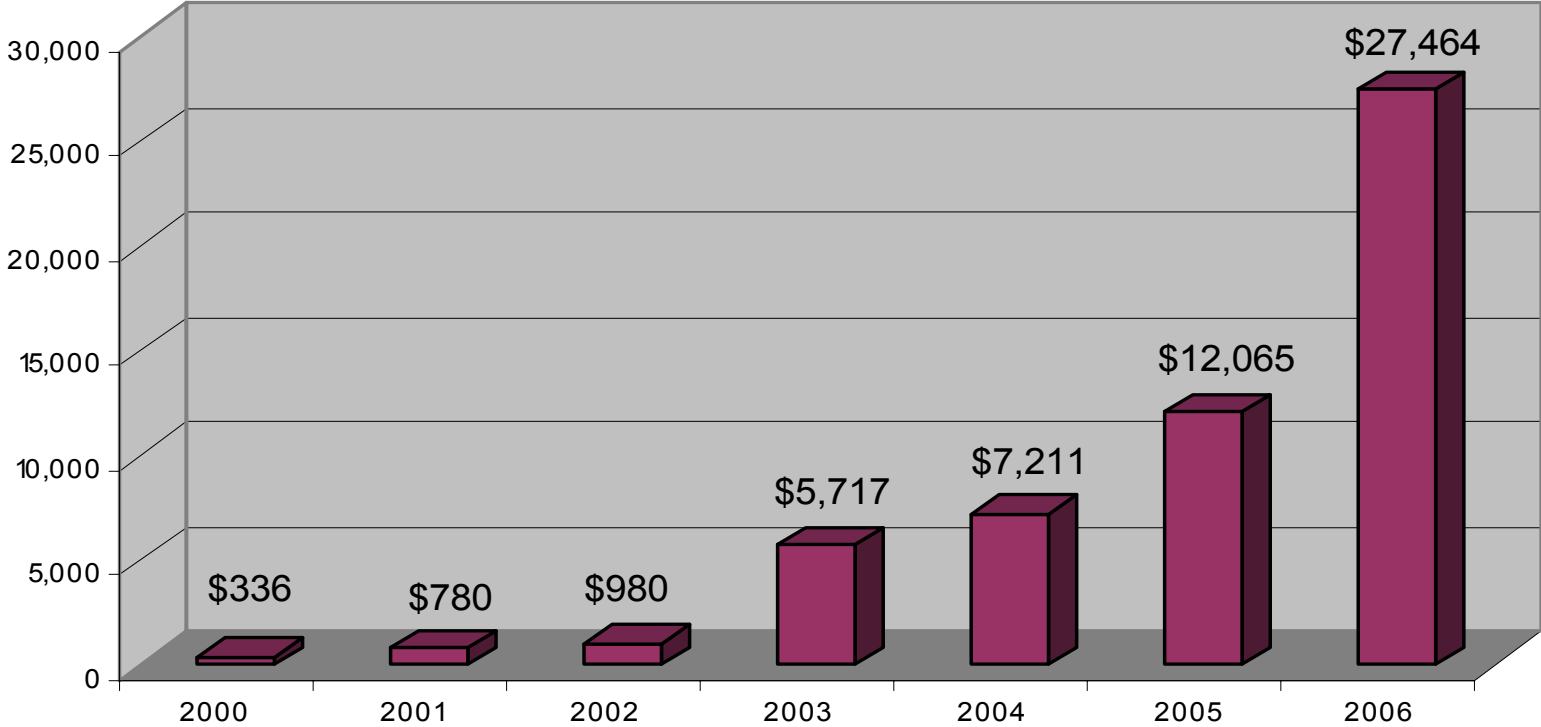
- Able to be credit enhanced;

- Versatility:

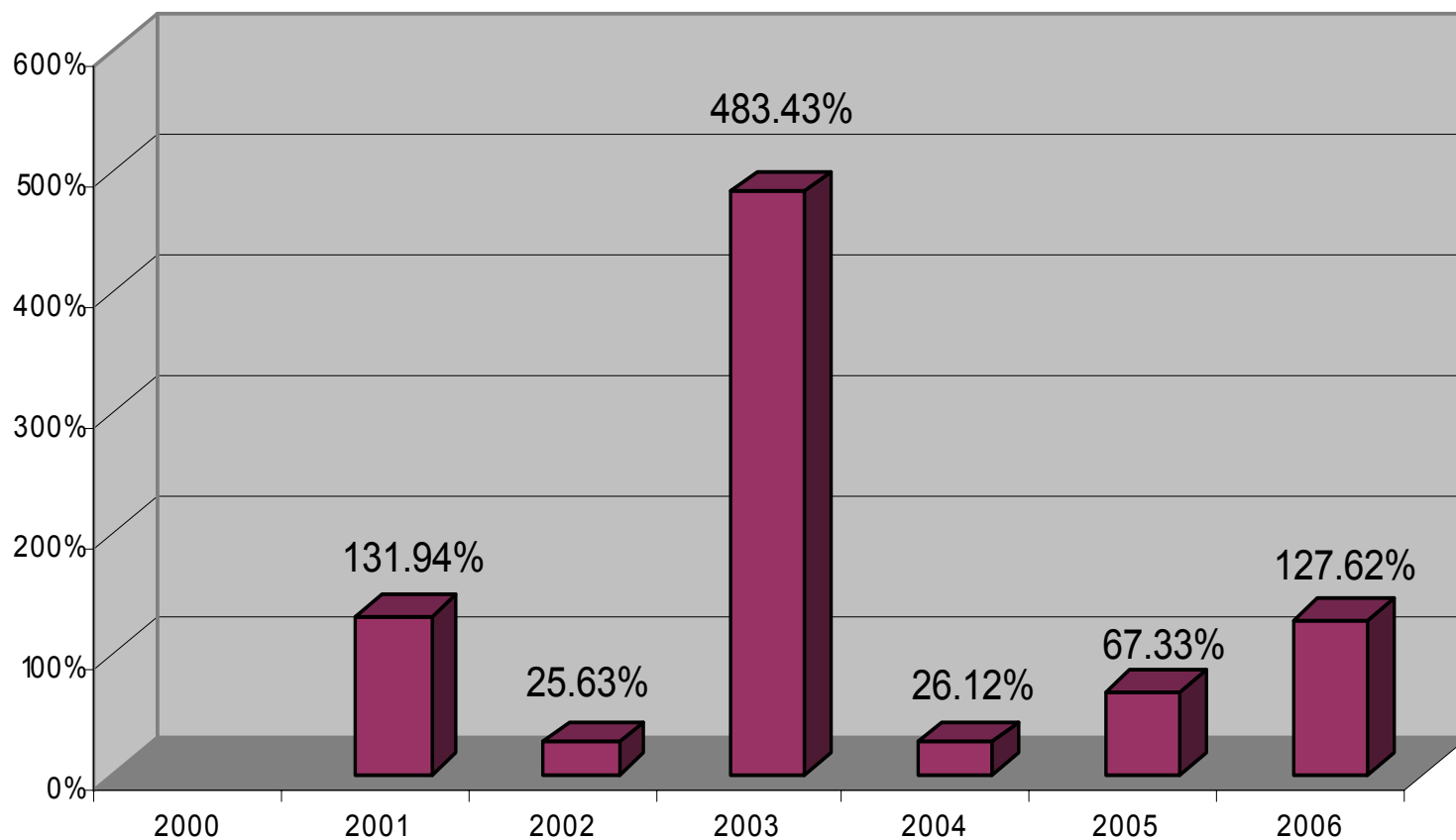
- Different legal and fiscal domains;
- Fixed or variable income;
- Compatibility with Reg S.
- Etc...

Sukuk Market Growth

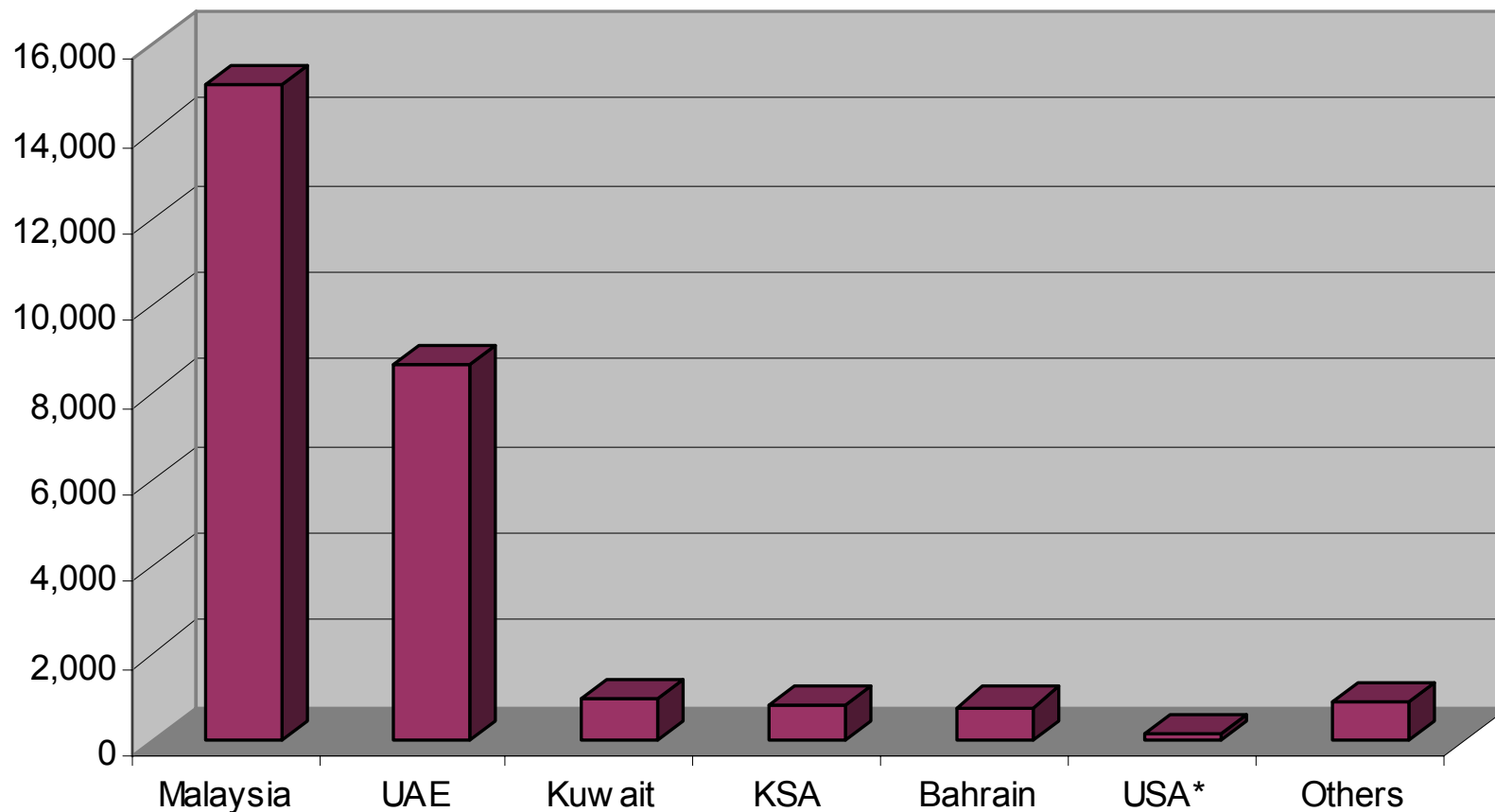
(in USD Million)



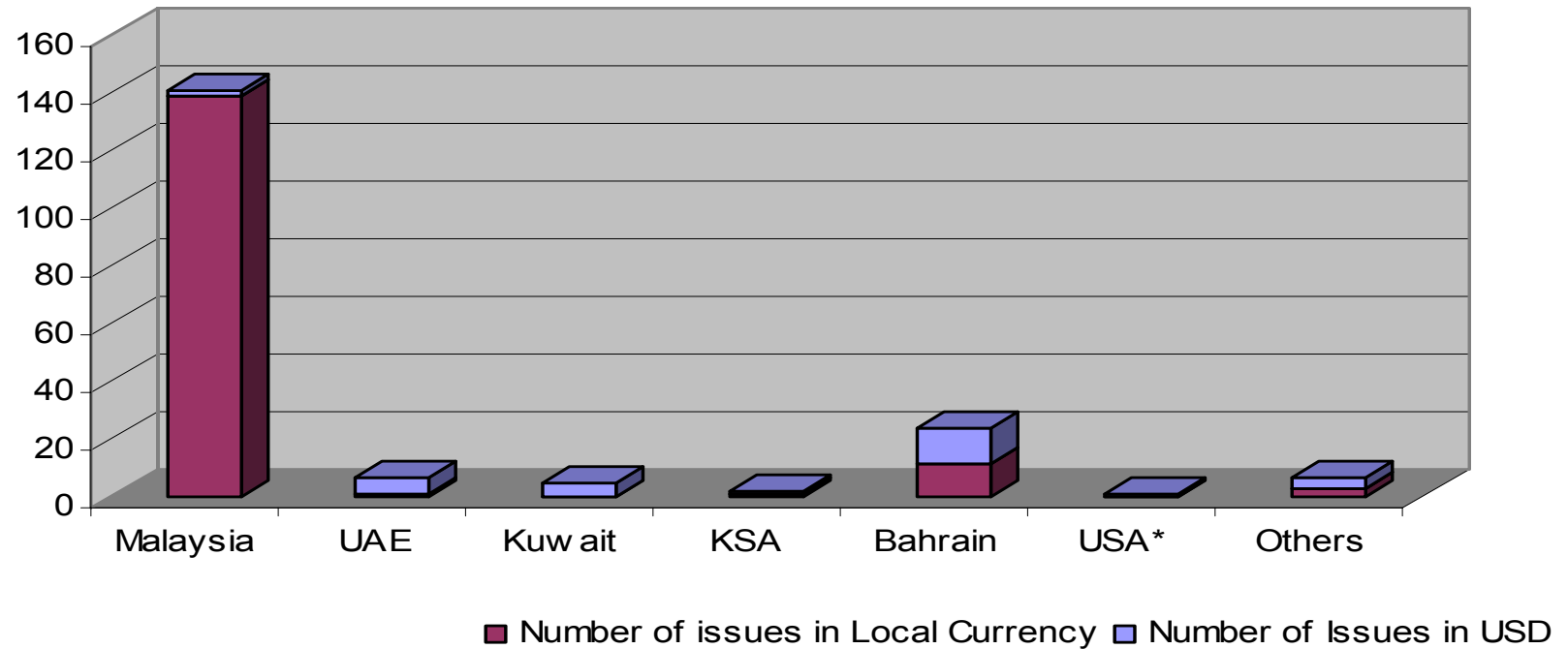
Sukuk Market Growth (from previous year)



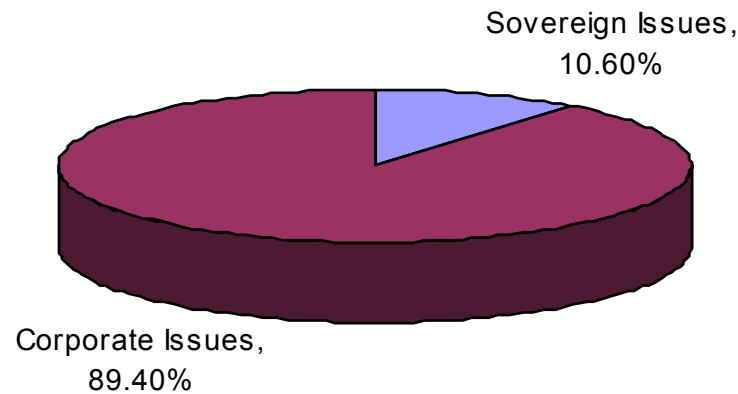
Sukuk Issuances by Country (2006) (in USD Million)



Sukuk Issuances by Country (2006) (in number of issuances)



Sovereign Sukuk vs. Corporate Sukuk (2006) (in USD equivalent)



Glossary of Islamic Terms

- **Adl** -- A trusted and honourable person, selected by both parties to a transaction. Somewhat analogous to a trustee.
- **amana/amanah** -- Literally means reliability, trustworthiness, loyalty, honesty and is an important value of Islamic society in mutual dealings. It also refers to deposits in trust, sometimes on a contractual basis.
- **bai/bay** -- Contract of sale, sale and purchase.
- **bai al-salam** -- Advance payment for goods. Whilst normally the goods would need to exist before a sale can be completed, in this case, the goods are defined (such as quantity, quality, and workmanship) and the date of delivery fixed. Usually applied in the agricultural sector where money is advanced for inputs to receive a share in the crop.
- **fatwa (pl. fatawa)** -- An authoritative legal opinion based on the Shari'ah.
- **Fiqh** -- Practical Islamic jurisprudence. Can be regarded as the jurists' understanding of the Shari'ah.

Glossary of Islamic Terms (con't)

- **Gharar** -- Uncertainty in a contract or sale in which the goods may or may not be available or exist, also ambiguity in the consideration or terms of a contract - as such, the contract would not be valid
- **.hadith** -- The narrative record of the sayings, doings and implicit approval or disapproval of the Prophet.
- **Halal** -- Permissible. In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (haram) by the Qur'an or the Sunnah. Barring these, all others are halal. An activity may be economically sound but may be allowed in Islamic society if it is not permitted by the Shari'ah.
- **Hanifite laws** -- An Islamic school of law founded by Iman Abu Hanifa (currently the dominant school of thought). Followers of this school are known as Hanafis.
- **Haram** -- Unlawful. (see halal) Describes activities, professions, contracts and transactions which are explicitly prohibited by the Qur'an or the Sunnah.
- **Hawala** -- Bill of exchange, promissory note, cheque or draft. A debtor passes on the responsibility of payments of his debt to a third party who owes the former a debt. Thus the responsibility of payment is ultimately shifted to a third party. Hawala is used in developing countries as a mechanism for settling international transactions by book transfers.

Glossary of Islamic Terms (con't)

- **ijarah/ijara** -- Lease, hire or the transfer of ownership of a service for a specified period for an agreed upon lawful consideration. An arrangement under which an Islamic bank leases equipment, a building or other facility to a client for an agreed rental.
- **ijara wa iqtina / ijarah munthla bittamleek** -- A leasing contract used by Islamic financial institutions which includes a promise but the lessor to transfer the ownership of the leased property to the lessee either at the end of the lease or by stages during the term of the contract.
- **Ijtihad** -- Literally effort, exertion, industry, diligence. As a legal term, it means the effort of a qualified Islamic jurist to interpret or reinterpret sources of Islamic law in cases in which no clear directives exist
- **istisna'a** -- A contract of sale of specified goods to be manufactured with an obligation on the manufacturer to deliver them on completion. Is a condition in istisna'a that the seller provides either the raw material or the cost of manufacturing the goods.
- **maisir/maysir** -- The forbidden act of gambling or playing games of chance with the intention of making an easy unearned profit.
- **mudaraba/mudarabah** -- A form of contract in which one party (the rab-al-maal) brings capital and the other (the mudarib) personal effort. The proportionate share in profit is determined by mutual consent, but the loss, if any, is borne by the owner of the capital, unless the loss has been caused by negligence or violation of the terms of the contract by the mudarib. A mudaraba is typically conducted between an Islamic financial institution or fund as mudarib and investment account holders as providers of funds.

Glossary of Islamic Terms (con't)

- **Mudarib** -- The managing partner or entrepreneur in a mudaraba contract (see above).
- **musharaka/musharakah** -- An agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and maybe others. All providers of capital are entitled to participate in management but are not necessarily obligated to do so. The profit is distributed among the partners in a pre-determined manner, but the losses, if any, are borne by the partners in proportion to their capital contribution. It is not permitted to stipulate otherwise.
- **Murabaha** -- A contract of sale with an agreed profit mark-up on the cost. There are two types of murabaha sale in the first type, the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase them and this is termed a normal or spot murabaha; the second type involves a promise from a customer to purchase the item from the bank and this is called murabaha to the purchase order. In this latter case, there is a pre-agreed selling price that includes the pre-agreed profit mark-up. Normally it involves the bank granting the customer a murabah credit facility with deferred payment terms, but this is not an essential element.
- **qard al hasana/qard hassan** -- A virtuous loan in which there is no interest or mark-up. The borrower must return the principal sum in the future without any increase.
- **rab-al-maal** -- The investor or owner of capital in a mudaraba contact (see above)
- **rahn** -- A mortgage or pledge.

Glossary of Islamic Terms (con't)

- **Riba** -- Simplistically interest. Sometimes equated with usury, but its meaning is broader. The literal meaning is an excess or increase and prohibits the generation of income from money
- **riba al-fadi/riba al-buyu** -- A sale transaction in which a commodity is exchanged from the same commodity but unequal in amount or quality; or the excess over what is justified by the counter-value in an exchange/business transaction.
- **Salam** -- A contract for the purchase of a commodity for deferred delivery in exchange for immediate payment.
- **Shari'ah/Shari'ah** -- In legal terms, the body of Islamic law as extracted by the mujtahids from the sources of law - the Qur'an and the Sunnah; however, the Shari'ah rules do not always function as rules of law as they incorporate "obligations, duties and moral considerations that serve to foster obedience to the Almighty."
- **Sukuk** -- Participation securities; coupons; investments certificates.

Glossary of Islamic Terms (con't)

- **Sunnah** -- The way of the Prophet Mohammed (PBOH) including his sayings, deeds, approvals and disapprovals as preserved in the hadith literature. It is the second source of revelation after the Qur'an.
- **Takaful** -- A Shari'ah-compliant system of insurance based on the principle of mutual support. The company's role is limited to managing the operations and investing the contributions.
- **Ummah** -- The community or nation. Used to refer to the worldwide community of Muslims.
- **Wakala** -- Agency; an agency contract which generally includes in its terms a fee for the agent.
- **Zakah/Zakat** -- A tax that is prescribed by Islam on all persons having wealth above an exemption limit at a rate fixed by the Shari'ah. It's objective is to collect a portion of the wealth of the well-to-do and distribute it to the needy. The way it is distributed is set out in the Qur'an. It may be collected by the state, but otherwise it is the responsibility of each individual to distribute Zakat.