Sukuk
Background Paper

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I. Introduction

The Report is prepared to provide readers with a general overview on Sukuk, a growing investment tool alternative to conventional fixed income instruments vehicle that has exceeded USD 50 bn in Global market offerings. Sukuk were intentionally provided to investors willing to comply with Islamic Shari'ah in their dealings, avoiding Gharar (uncertainty), Riba (interest/usury) and Maisir (Gambling) and complying with Islamic Shariah. Yet, it has grown in popularity among Sovereign entities and non-Islamic Global Corporations given its unique risk and return profile.

The Report is directed specifically to readers with limited investment knowledge or background on Islamic financial tools and products, shedding some light on main topics including the Evolution of Sukuk, their structure, benefits and features. The Report also provides brief comparisons on main Islamic finance contracts and tracks the evident spread of Sukuk in Global markets and the main players involved.

II. Structures of Sukuk

Sukuk can be structured into various types based on different Islamic modes of financing. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which issues standards on accounting, auditing, governance, ethics, and Shariah compliance has laid down 14 different types of Sukuk. The most common types of Sukuk are the Mudarabah Sukuk (partnership / finance trusteeship), Musharaka Sukuk (joint venture), Ijara Sukuk (leasing), Murabaha Sukuk (purchase order), Salam Sukuk (deferred commodity delivery), Istisna Sukuk (manufacturing or project finance) or a hybrid of the above.

III. Benefits and Features

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

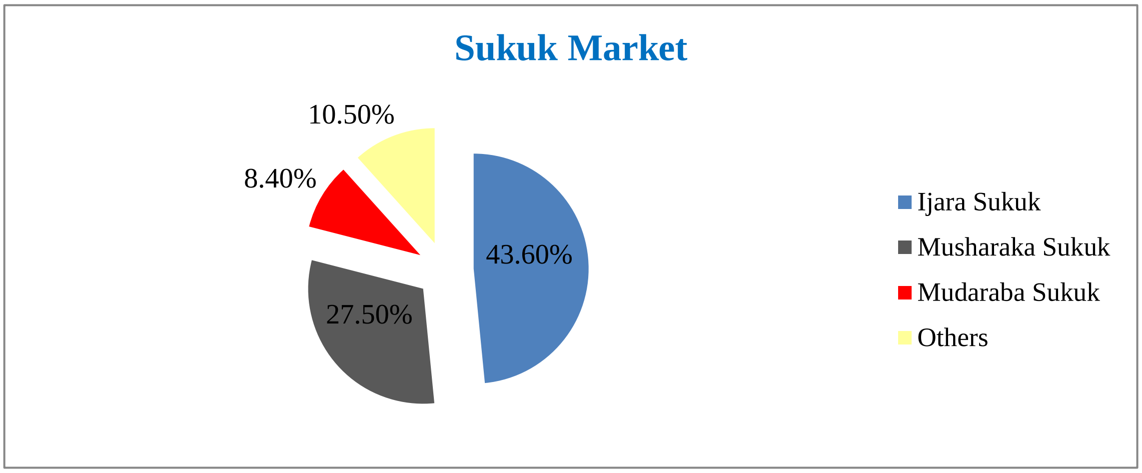
IV. Evolution of Sukuk

In 1990, the world saw its first Sukuk issuance, surprisingly originating from a non-Islamic company, Shell Middle Distillate Synthesis (SMDS), in Malaysia. It was a Ringgit denominated issue with a modest size of RM 125 million (equivalent to approximately US$30 million) and based on the principle of Bai' Bithaman Ajil (deferred payment sale). The number of Sukuk offerings grew slowly and gradually and in September 2001, the Government of Bahrain issued the first Global Sovereign Sukuk Offering through an Ijarah Sukuk with a size of US$ 100 million, a fixed rate of 5.25% and 5 years maturity.

This was closely followed by the first quasi-sovereign global Sukuk by Kumpulan Guthrie, a Malaysian Corporation that produce palm oil. It was a serial Ijarah type of Sukuk sizing US$ 150 million with 5 years maturity and a rate of return equivalent to 6 months LIBOR + 1.5%. The international issue of the Government of Bahrain marked the advent of the GCC based Islamic capital market followed by Qatar, Saudi Arabia and UAE. Thereafter, between July 2003 and March 2004, Saudi Arabia offered Sukuk issuances through the Islamic Development Bank (IDB), the Qatari Government's issued its first Sovereign Sukuk, followed by the Tabreed Sukuk in the UAE with size of 100 million USD. The UAE picked up pace quickly and emerged as the leader in international Sukuk issuance by volume as of 30th June 2009, comprising 55% of total issued value and having offered eight out of ten of the largest Sukuk issues in the history of the Sukuk market.

V. Comparative analysis of main Islamic Finance Contracts

	Uses of Contract	Type of Financing	Main Risk(s)	Can Financer take collateral?
Murabaha	Trade finance	Deferred sale "Dayn"	Default	Yes
Ijara	Leasing	Lease finance "Dayn"	Default and destruction	Yes
Bei'-Salam	Pro-production finance	Forward sale "Dayn"	Default	Yes
Istisn'a	Construction finance	Installment sale "Dayn"	Default	Yes
Mudarabah	Equity financing	Business (Entrepreneurship) financing	Fraud, negligence, moral hazard, etc.	Yes, but to be exercised only for non-business failures
Musharakah	Equity financing	Joint venture	Fraud, negligence, moral hazard, etc	Yes, but to be exercised only for non-business failures



Source: Size of Sukuk Market (Global Investment House 2008)

VI. Uses of Sukuk Funds

The most common uses of Sukuk can be named as project specific, asset-specific, and balance sheet specific.

- **Project-Specific Sukuk**

Under this category money is raised through Sukuk for specific project. For example, Qatar Global Sukuk issued by the Government of Qatar in 2003 to mobilize resources for the construction of Hamad Medical City (HMC) in Doha. In this case 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. The annual floating rate of return was agreed at LIBOR plus 0.45 per cent.

- **Assets-Specific Sukuk**

Under this arrangement, the resources are mobilized by selling the beneficiary right of the assets to the investors. For example, the Government of Malaysia raised 600 million USD through Ijara Sukuk Trust Certificates (TCs) in 2002. Under this arrangement, the beneficiary right of the land parcels has 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.

Another example of Asset-specific Sukuk is 250 million USD five-year Ijara Sukuk issued to fund the extension of the airport in Bahrain. In this case the underlying asset was the airport land sold to an SPV.

- **Balance Sheet-specific Sukuk**

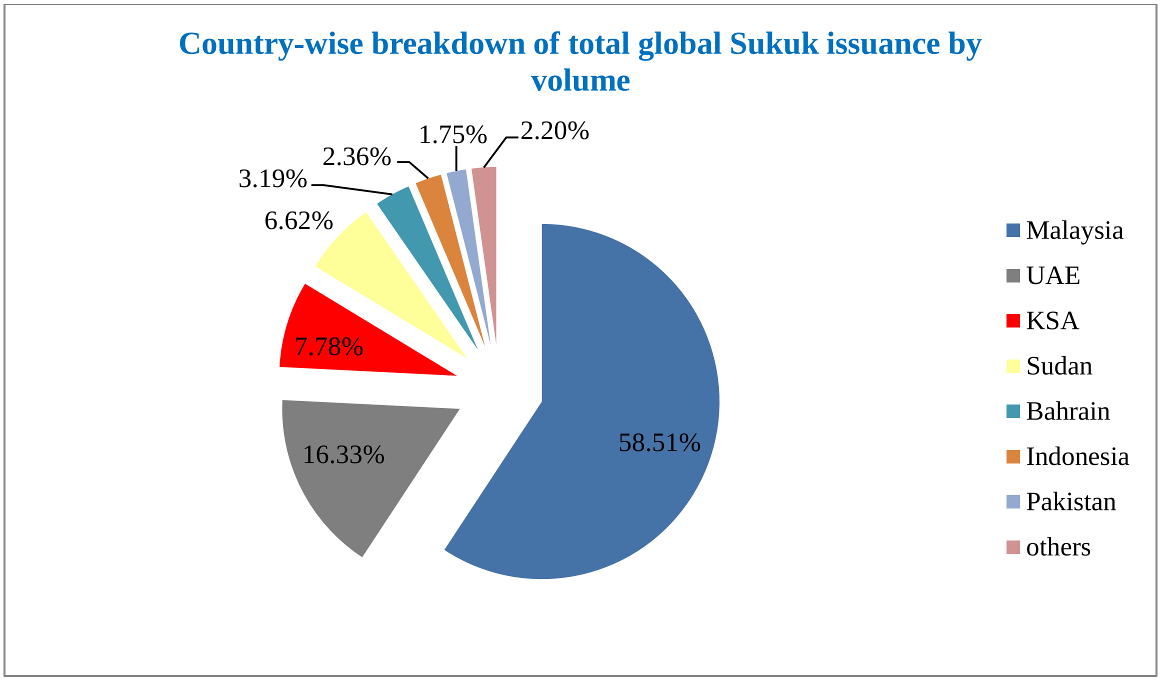
An example of the balance sheet specific use of Sukuk funds is the Islamic Development Bank (IDB) Sukuk issued in August 2003. The IDB mobilized these funds to finance various projects of the member countries. The IDB made its debut resource mobilization from the international capital market by issuing 400 million USD five-year Sukuk due for maturity in 2008.

VII. Global Market status of Sukuk

Global Sukuk issuance market has grown from 600 million USD in 2001 to 50.5 billion USD in 2010 and 47.1 billion already in the first half of 2011.

Country-wise breakdown of total global Sukuk issuance by volume

Country	Number of Issues	Volume (US $ Million)	% of total Value
Malaysia	1,592	115,394	58.51%
UAE	41	32,201	16.33%
KSA	22	15,352	7.78%
Sudan	22	13,058	6.62%
Bahrain	125	6,292	3.19%
Indonesia	70	4,659	2.36%
Pakistan	35	3,447	1.75%
Qatar	6	2,501	1.27%
Kuwait	9	1,575	0.80%
Brunei Darussalam	21	1,176	0.60%
USA	3	787	0.40%
UK	2	271	0.14%
Singapore	5	192	0.10%
Germany	1	123	0.06%
Turkey	1	100	0.05%
Japan	1	100	0.05%
Gambia	7	2	0.00%
Grand Total	**1,963**	**197,228**	**100.00%**



VIII. Sukuk in Egypt

The passing of Egypt's first Sukuk law in May 2013 marks a major milestone in the development of the Islamic finance industry at the national and regional levels. However, the actual value that may result from passing the Sukuk law will depend on the adequacy of the regulatory framework in which it will be implemented.

The law's drafting and passing were met with several political hurdles. It has been argued by the opposition's figures that the mere fact of passing of such law by a Shura Council, dominated by Islamic parties, particularly the Freedom and Justice Party, is a testament to the Islamic parties' reliance on funding sources from the GCC countries, where Shariah-compliant financial instruments are more popular and developed than they are in Egypt.

Such reliance is seen by part of the opposition as opening the door to political influence from the Gulf. It could be argued that the reason for such unpopularity of Shariah-compliant instruments in Egypt is the suppression of Shariah-compliant finance under the regime of Hosni Mubarak, which contributed in part to the creation of a negative attitude towards Islamic finance.

Some of the critical aspects of the new Egyptian Sukuk law are: a) the law's drafting process; b) Sukuk issuance under the law and its limits; and c) key provisions regarding Shariah supervision over Sukuk issuance and settlement of Sukuk disputes.

Finally, the current political situation in Egypt and the displacement of President Morsi make the future of Sukuk issuance in Egypt remains vague.

IX. Challenges Facing Sukuk:

Perhaps the largest immediate challenge facing Sukuk is the mismatch between supply and demand. Surveys suggest that nearly 50% of Muslim investors would opt for an Islamic product with the right value proposition over a conventional product.

This rise in retail demand is reflected in double digit growth in the Islamic banking industry, and the increased appetite for investment-grade, Shariah-compliant, liquid securities among corporate treasurers, as well as fund managers and high net-worth individuals. In fact, an International Monetary Fund (IMF) working paper found that Islamic financial institutions have experienced credit and asset growth at least twice as high as that of conventional banks since the global financial crisis.

The gap between supply and demand is beginning to be addressed. A number of multinational companies (including HSBC, GE Capital and Nomura) and sovereign issuers outside the Muslim world (for example, Luxembourg, Japan, Australia, Ireland and France) have launched or are considering Sukuk issues, and will hopefully fill the supply gap in the medium term.

X. Future of Sukuk:

- Despite the challenges, the future of Sukuk looks bright due to the nature and utility of the instruments
- Secondary market tradability is improving.
- Tax and regulatory conditions are being put in place.
- There is active development of hedging techniques and other necessary conditions for its proliferation.

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