US$ 2.5 billion exchangeable mudaraba sukuk by Aldar Properties, UAE

US$ 3.5 billion convertible musharaka sukuk by PCFC, UAE

US$ 4.5 billion musharaka sukuk by Binariang GSM, Malaysia

9.8. The backlash from AAOIFI

In February 2008, the Shari'a board of AAOIFI, having deliberated on the various Shari'a issues raised by the asset-light sukuk, issued a ruling which effectively banned the asset-light sukuk. Unfortunately, the AAOIFI ruling, due to poor drafting, lacks clarity and fails to shed sufficient light on the rationale for the ban.[62]

The AAOIFI ruling is summarized as follows:

in order to be tradable, sukuk must exhibit evidence of the ownership in Shari'a-compliant tangible assets (like real estate) and/or intangible assets like usufruct (e.g., leasehold rights) or services (e.g., toll road concessions);

in order to be tradable, sukuk must not represent any receivables or debt unless the sukuk represents (i) the entire business of a Shari'a-compliant trading company or an Islamic financial institution or (ii) the portfolio of existing Shari'a compatible tangible and/or intangible assets which incidentally also includes some Shari'a compatible receivables;

the sukuk agent cannot offer or procure any liquidity facility if the profits generated are insufficient to service the periodic distributions payable to the sukuk holders; neither the agent nor the partner in wakala, mudaraba or musharaka sukuk is permitted to undertake, at maturity or upon an early dissolution of the sukuk, to buy the shares (or the shares' underlying assets) of the other partner(s) at the initial face value. Such undertaking is however permissible if the price is based on the prevailing market value or fair value (if there is no market value) or at a price to be mutually agreed at that time; and in ijara sukuk however, the lessee is permitted to undertake to buy at the initial face value the leased assets from the leasing company at maturity or upon an early termination of the lease provided the lessee is not acting as a partner, mudarib or an investment agent of the leasing company.

The above ruling has effectively put an end to the dramatic growth of asset-light sukuk issuances. Without an undertaking to buy the shares of the sukuk holders at par value, it is highly impossible to issue an asset-light sukuk. Since the AAOIFI ruling in February 2008, there has not been any asset-light sukuk offering in the market. However, it is not obvious whether the lack of such offering is due to the AAOIFI ban or the unprecedented credit crunch caused by the global financial crisis. It is hoped that the dearth of asset-light sukuk is due to the AAOIFI ban. The sukuk market was rather quiet in 2008 with hardly any significant sukuk offering in the Middle East or the Far East.[63]

9.9. Back to basics

In the first half of 2009, the sukuk market witnessed some green shoots emerging. The Republic of Indonesia successfully issued its inaugural US$ 500 million ijara sukuk which was oversubscribed to the tune of US$ 3 billion. The Kingdom of Bahrain also returned to the market to successfully issue another ijara sukuk which closed at US$ 650 million. And in August 2009, Petronas, the Malaysian national oil company also successfully issued its debut benchmark ijara sukuk issue. The Petronas sukuk was launched at US$ 1.5 billion and was five times oversubscribed. Interestingly, all three sukuk issues were structured as asset-based ijara sukuks, and carried fixed rental rates. Hopefully, the AAOIFI ban had played a key role in shifting the market away from asset-light sukuk. However, it is still too early to declare the demise of the asset-based sukuk and only time will tell whether the market has taken the AAOFI ruling seriously. The success of the Indonesian, Bahrain and Petronas sukuk issues clearly demonstrated that the asset-based sukuk is still the most viable and attractive option to issuers. The shift to asset-based sukuk will certainly add more credibility to the sukuk market and help the industry to gradually progress towards a Shari'a-based financial system. The sukuk industry is still at an early stage and has a long way to go. Hopefully, its future path will be clear of asset-light sukuk issues.

[60] Id. at 63: "Business Plan: it shall do, and not omit to be done, all other reasonable acts and things (including implementation of cash management, debt collection practices and provision of Shari'a compliant funding (solely for the Agent's own account and expressly without recourse to the musharaka or the musharaka assets, except that, for the avoidance of doubt, the Agent shall be entitled to apply all or any of the Incentive Fees received by it towards repayment of such Shari'a compliant funding) to ensure that the cash liquidity set out in the musharaka business plan is at all times achieved) for the execution of the business plan."

[61] Id. at 8: "Additionally, DMCC undertakes to purchase all of the Units then held by the Issuer at the Exercise Price on the second Business Day after the date of the Exercise Notice given following the occurrence of a Dissolution Event." See also Condition 11 thereof.

[62] For more details and background information on the AAOIFI ruling see, MUHAMMAD TAQI USMANI, SUKUK AND THEIR CONTEMPORARY APPLICATIONS, at: www.failaka.com/downloads/Usmani_sukukApplications.pdf

[63] The total volume of new sukuk issues plummeted to US$ 14 billion in 2008 compared to US$ 50 billion in 2007. There were 11 mega-sized sukuk issues (in excess of US$ 1 billion per issue) in 2007 compared to only 2 in 2008.

CHAPTER 10
The Sukuk Industry

10.1. Key sukuk data

The first sukuk ever was issued by Shell MDS in 1990 for MYR125 million (US$ 33 million). Since then, the progress of the market depended heavily on efforts of the Malaysian government that had made the world's first sovereign US$ 600 million sukuk issue in 2002. Malaysia's Cagamas MBS has issued US$ 540 million worth of residential mortgage-backed securities. Malaysia has also seen issuance by corporations, including a pioneering US$ 2.86 billion issue by the PLUS highway concessionaire in 2006. The government's investment arm, Khazanah Nasional, issued the first exchangeable sukuk the same year.

Emulating the Malaysian example, other Islamic countries started issuing sovereign sukuks. Bahrain issued a sovereign sukuk worth US$ 100 million in 2001. Qatar issued a global sukuk of US$ 700 million in 2003, and Pakistan came out with US$ 600 million sukuk issue in 2005. In the Gulf, Bahrain remains the most active sukuk market. The country regularly issues short-term sukuk for liquidity management. In 2002, Islamic Liquidity Management Centre was established in Bahrain in order to boost sukuk issuances.

The world's first global corporate sukuk issuance for US$ 150 million was made by Kumpulan Guthrie, a Malaysia-based company, in 2001. Since then, sukuks have not only grown in size but in product sophistication and structure. Bai bithaman ajil was initially the most popular form, accounting for 77% of total issues in 2001. However, efforts aimed at standardization, notably by AAOIFI, have now made ijara the dominant structure. Sukuks have attracted considerable attention in recent years. Although the onset of the financial crisis and efforts to standardize the market temporarily reversed the progress, restrictions on bank credit and depressed stock markets have renewed attention. Global sukuk issuance grew from US$ 5.8 billion in 2003 to US$ 33 billion in 2007. The strong growth in sukuk issuance can be attributed to sukuks being perceived as a 'less risky' investment proposition when compared to conventional bonds, in part because they are backed by physical collateral. Moreover, the huge public and private investments being undertaken in the Middle East, particularly in infrastructure, have boosted funding requirements. Leading Middle Eastern sukuk issuers include companies such as the petrochemicals giant SABIC and the Saudi Electricity Company, as well as a growing number of real estate developers.

The progress made in recent years was abruptly reversed in 2008, when total global sukuk issuances declined to US$ 15 billion, as debt markets dried up globally. In terms of types of sukuk issuances, corporate

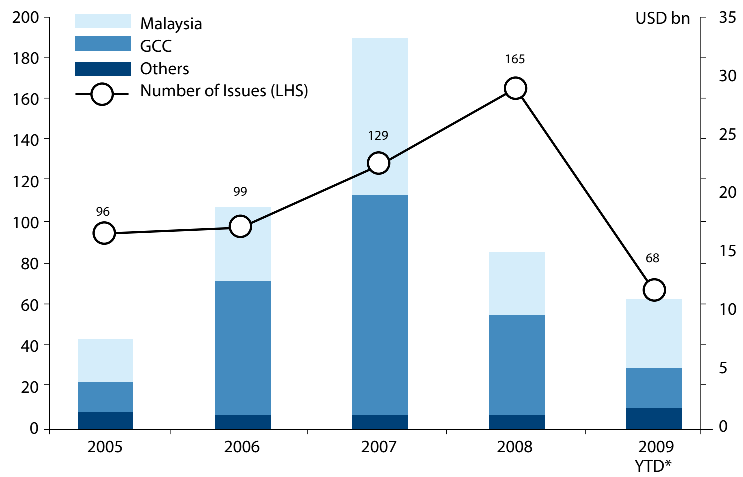

Figure 61: Global sukuk issuance (US$ m)
Source: Zawya, NCBC Research

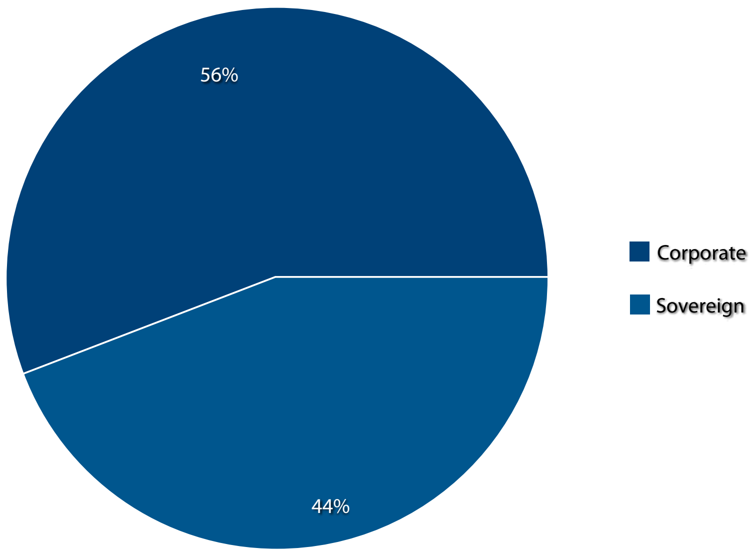

Figure 62: Sukuk issuance by type in EMEA & Asia Pacific (2008)
Source: IFIR 2009, Ernst & Young, NCBC Research

sukuks continued to dominate, accounting for 56% of all sukuks issued in 2008. Sukuk issuances have been subdued in 2009 as well. The total size of issues stood at US$ 10.9 billion at the end of August 2009.

More and more issuers from different countries are employing sukuk for financing. In the current sukuk issuance market, Malaysia and the UAE are in the lead. Bahrain has been pursuing a deliberate policy of creating a Shari'a-compliant sovereign sukuk market and issuance program. Malaysia and the GCC countries together accounted for 91.6% of the total market in 2008. Going forward, 20 new governments have expressed interest in issuing sukuk, with Indonesia having already launched its first international sovereign sukuk issue worth US$ 650 million in April 2009. The issue was oversubscribed and received strong interest from both Islamic and conventional investors. Qatar and Jordan also plan to issue sovereign sukuk in 2009 to finance their development plans. Turkey, home to around 72 million Muslims, is another key emerging market for Islamic finance.

In the GCC, facilities for listing sukuks are limited. Currently three exchanges in the Gulf list debt instruments, Bahrain, NASDAQ Dubai (formerly Dubai International Financial Exchange – DIFX), and the Saudi Tadawul. NASQAQ Dubai is the world's largest exchange in terms of value of the listed sukuk. Currently, 20 sukuk are listed on the exchange. A new sukuk and bond platform on the Saudi Stock Exchange (Tadawul) was introduced in June 2009. The new platform is being seen as a major milestone for the development of Islamic capital markets.

10.2. Current state and emerging trends

Although Islamic finance has had a relatively long history the sector has seen phenomenal growth in the past five years. The total value of Islamic financial assets has grown at an average of 15-20% since 2004. The growth

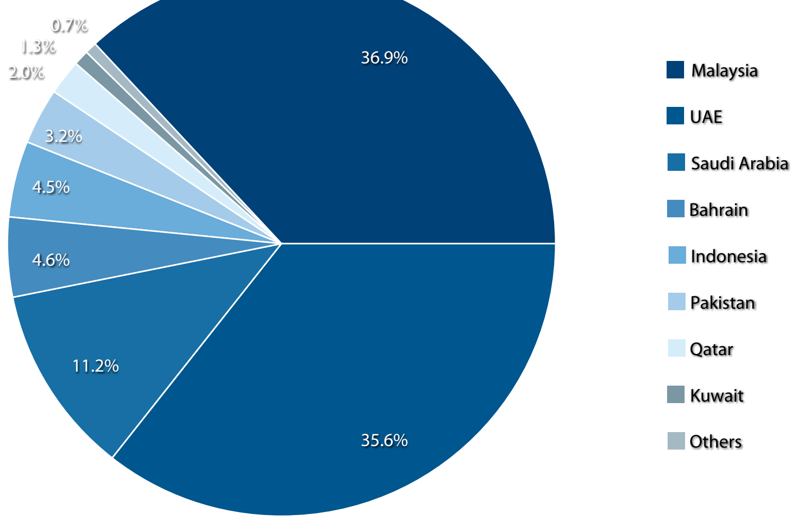

Figure 63: Geographic distribution of sukuk issuance in 2008
Source: Standard & Poor's, NCBC Research

has been primarily driven by the rapidly growing acceptance of financial services in Islamic countries and recognition of the effectiveness of Shari'a-compliant products and services in bringing new segments of the population within the ambit of formal finance. Another factor that contributed toward the rapid expansion of Islamic finance is the growing wealth of Middle Eastern and other oil-producing countries. These countries have benefited immensely from the high oil price environment that prevailed from 2003 to the first half of 2008. This allowed them to boost their savings and sustain economic growth over these years. This, in turn, led to a notable rise in the income levels of individuals and corporations. As a result, per capita Gross Domestic Product (GDP) of Saudi Arabia, Lebanon, Jordan and Malaysia grew at a CAGR of 9-10% in 2000-2008, while those of Kuwait, Qatar and Indonesia expanded at more than 14% during the same period. The increased income and saving levels in these countries boosted the capitalization base of Islamic banks and takaful companies as they benefited from increased consumer interest. Given their mandate to invest in Islamic capital market products, these institutions were able to provide a ready market for Islamic products. Moreover, windfall surpluses generated by Middle Eastern and certain Asian countries encouraged fund managers worldwide to capitalize on the excess liquidity by offering Islamic finance products.

Since raising funds from conventional banks is becoming more challenging in the current economic scenario, companies and governments will increasingly turn to Shari'a-compliant options such as sukuks. Furthermore, several Middle Eastern, North African and Asian countries have currently embarked on massive infrastructure expansions as part of their efforts to diversify the economy away from oil. The MEED Projects (a premium subscription-only service that offers the most in-depth project tracking database in the market across the Middle East, North Africa and India) estimated that approximately US$ 2 trillion worth of projects are at various stages of planning or completion across the GCC. However, following the global credit crunch, banks in many GCC and Middle Eastern markets have strengthened their lending norms, resulting in the drying up of project finance. Developers and buyers are struggling to cope with the increase in financing cost in a tighter lending environment. Volatility in the conventional equity market has ensured that primary issues are no longer a viable option for raising funds, thus increasing the possibility of greater reliance on sukuk as an alternative means of financing.

Driven by these factors and a strong demand from both individuals and corporations, the global market for Islamic financial services based on Shari'a-compliant assets was estimated at US$ 729 billion in 2007, as per the data provided by International Financial Services London in its report Islamic finance 2009. The Islamic finance industry is currently dominated by commercial Islamic banks that account for majority of its Islamic assets (74% in 2007), followed by Islamic investment banks (12%), sukuk (11%), takaful (11%), and Islamic funds (2%). In non-Muslim countries, UK dominates the Islamic financial industry with assets worth US$ 18 billion.

Despite growth rates at least twice as high as those recorded on global conventional financial markets, the Islamic financial industry remains fraught with diversity and heterogeneity. The current excess liquidity in Gulf economies since 11 September 2001, has fuelled both sustained demand for the products supplied by IFIs (Islamic financial Institutions) and the booming expansion of the market for sukuk (see Figure 66 below), while contributing to the creation of a very close link between Islamic banks and what remains to date a relatively illiquid compartment of the bond market. Nevertheless, liquidity in the sukuk market should improve gradually as the variety of sukuk issuances widens. Not only are volumes expected to exceed US$ 150 billion by the end of the current decade, but the nature, geographic location and credit quality of future issuers are also expected to considerably evolve and diversify.

The Islamic finance industry, particularly the sukuk market, faced unprecedented challenges in 2008 – namely the global credit crisis, the rising cost of borrowing and lack of investor commitment to capital market securities, as well as debates over the Shari'a compliance of some sukuk structures.

By the end of 2008, global sukuk issuance had declined by more than 50% compared to 2007, a marked re-

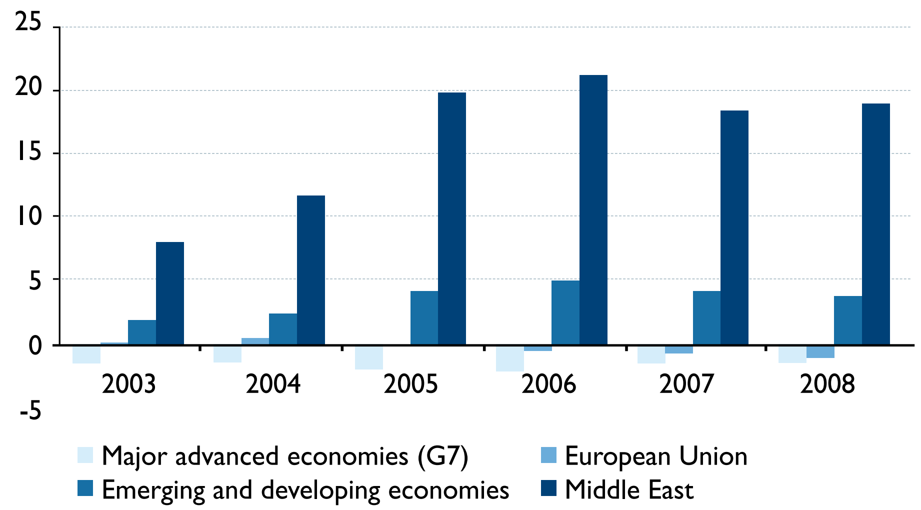

Figure 64: Current account balance as percentage of GDP
Source: International Monetary Fund, World Economic Outlook Database, April 2009, NCBC Research

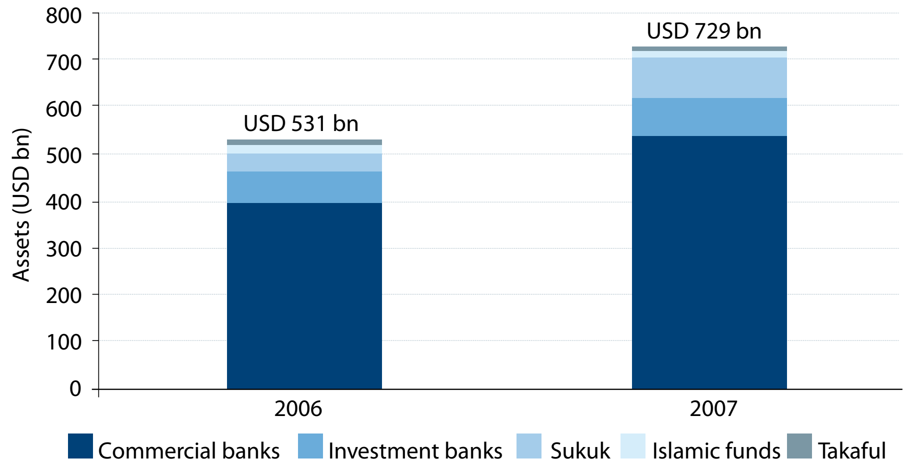

Figure 65: Total global Islamic finance assets
Source: International Financial Services London, NCBC Research

versal of the strong growth trend witnessed in recent years since this market came into being. Globally, credit markets underwent a significant decline in debt issuance, mainly driven by the lack of global economic visibility, pricing issues and a shortage of committed investors. The GCC and Malaysia have been the hardest hit, experiencing declines in sukuk issuance of 55% and 59%, respectively.

Over the past year, ijara sukuk has become the dominant sukuk structure in terms of issuance volume, replacing mudaraba, which had been the dominant structure in 2007. This development followed a recommendation by AAOIFI in early 2008 that Islamic finance market participants should refrain from issuing sukuk structures that have a purchase undertaking or guarantee from the sukuk issuer to repurchase at a future date at a specific price (i.e. almost all structures except ijara). In AAOIFI's view, this structural mechanism is not compliant with a fundamental principle of Shari'a, namely profit and risk sharing. However, although AAOIFI standards are widely followed (without obligation) across many countries, they are only adopted by Bahrain, the Dubai International Financial Centre (DIFC), Jordan, Lebanon, Qatar, Sudan and Syria.

10.3. Market developments in challenging times

Sovereign and local currency sukuk issuances have recently increased in popularity across the GCC and Asia-Pacific. Speculation has been rising as to whether GCC currencies will de-peg from the US dollar, which was weakened for most of 2008 and which has historically been the most favoured currency for debt issuance in the GCC. As a result, issuers in the region have resorted to issuing sukuk denominated in Saudi riyals or UAE dirhams. This trend has also been seen in Asia, where the Malaysian ringgit, Pakistani rupee and Indonesian rupiah have been the most common currencies used.

A growing number of institutional and retail investors have been seeking local-currency-denominated sukuk in a bid to reserve profit yields under the difficult credit market conditions and declining US dollar. The HSBC/DIFX sukuk index (SKBI), representing the weighted-average credit spread over LIBOR of the individual constituents underlying the relevant index, has increased by over three times since the global credit crisis started in August 2007, trading at just over 400 bps. As the crisis deepened further in October 2008, the weighted spread increased to 900 bps.

In 2007/2008, issuers in the GCC and Asia-Pacific announced over US$ 30 billion in sukuk that were due to close in 2008, accounting for over 88% of globally announced deals. Given the unfavourable credit conditions, the rising cost of borrowing and widening spreads, most of these deals failed to materialise in 2008. Had it not been for the closure of the debt markets and a decreasing investor appetite for debt securities, we estimate that 2008 issuance would have reached US$ 45 billion, compared to actual issuance of US$ 15.1 billion (see Figure 67).

However, market conditions were not the only difficulty issuers faced in 2008. In February, AAOIFI issued a statement of six guidelines containing advice relating to sukuk tradability, the corporate responsibility of the sukuk manager, the purchase of certain sukuk structures at their net rather than nominal value, and the duty of the SSB to oversee the implementation of funds and investments in a Shari'a-compliant manner and not to limit their involvement to issuing fatwa at the time of the sukuk issuance.

These are doubtless among the reasons why ijara sukuk emerged as the lead structure in 2008 in terms of sukuk issued: In 2007, mudaraba had been the form of sukuk most frequently issued. The increased popularity of ijara sukuk reflects not only its simple structure, the abundance of assets with which it can be structured with, and liquidity in the secondary market, but also, more recently, the AAOIFI statement, which made ijara sukuk the most acceptable form of repurchased asset due to the lease agreement element.

Against this backdrop, we have also seen sukuk issued through securitisation becoming a more mainstream financial vehicle. One of the key fundamental objectives of Shari'a is the sharing of profit and losses. This can be practised through many sukuk structures including mudaraba, musharaka and investment partnership. These structures have been proven to be successful and favourably accepted by SSBs when structured around a true sale securitisation. Sukuk holders can and will be able to trade them in accordance with Shari'a principles, if they have ownership rights and obligations for assets, including usufruct or title rights.

In July 2008, the Abu Dhabi-based Sorouh Real Estate PJSC launched the first Islamic securitisation of land and associated rights to payment, from a pool of GCC obligors. These were primarily GCC real estate developers which pay scheduled instalments to purchase land plots, concentrated within two real estate developments - Shams and Saraya within Abu Dhabi, the capital city of the UAE (rated Aa2). The purchase contracts were originated by Sorouh, one of the three key real estate master developers in Abu Dhabi that has been granted land on preferential terms by the government.

10.4. Global issuance: 2008 decline reverses recent trend

In 2008, global sukuk issuance decreased by over 50% compared with 2007, reversing the trend seen in recent years. Of the most common sukuk structures, murahaba issuance increased by nearly 60%, whilst ijara witnessed a moderate decline of 8%, largely due to the global credit environment. However, musharaka and mudaraba sukuk declined by 83% and 68%, respectively. This sizeable decrease was witnessed across many of the key issuance markets, including the GCC and Malaysia.

Ijara and murahaba have clearly emerged as the most popular sukuk structures for both investors and issuers. This is likely due to their simple contractual terms and the comfort of Shari'a scholars in approving their compliance. Musharaka, mudaraba and wakala for investment sukuk tend to be more complex and involve a form of partnership (mudarib), joint venture (sharik) or investment partnership (wakil istithmar) between sukuk holders and the sukuk manager.

AAOIFI has argued that musharaka, mudaraba and istithmar sukuk are profit- and loss-sharing partnerships that in economic upturns lead to profit-sharing and in downturns may lead to loss-sharing. In the statements it released in early 2008, it therefore stressed the importance of the profit and loss sharing aspects of sukuk and advised that the purchase undertaking commitment by the sukuk manager/issuer at its nominal value should be dismissed, as this commitment represents a form of guarantee that does not adhere to the principles of

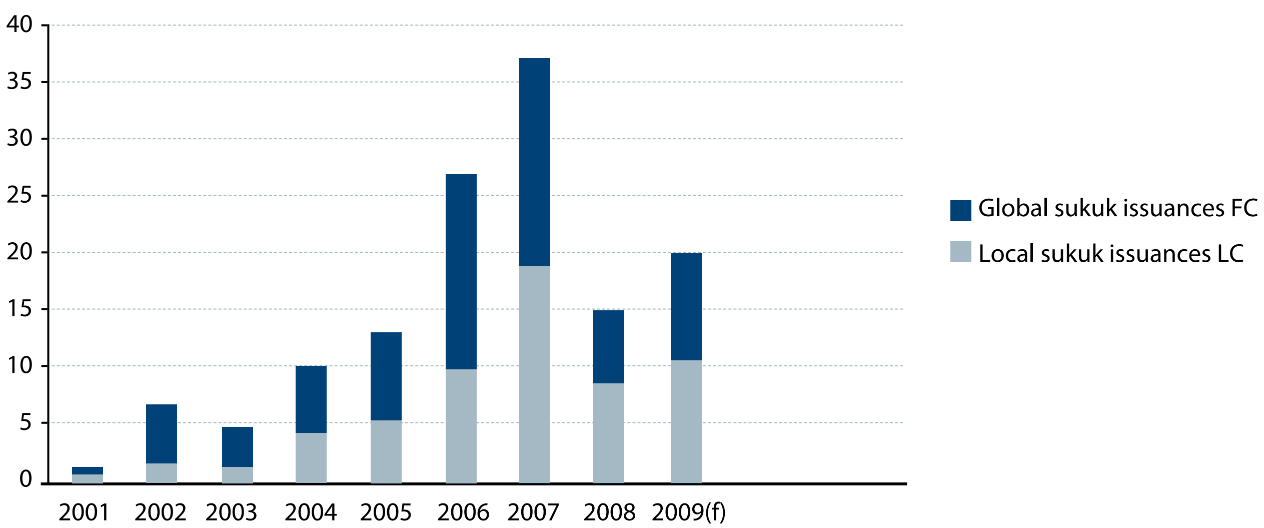

Figure 66: Issuance of global and local sukuk

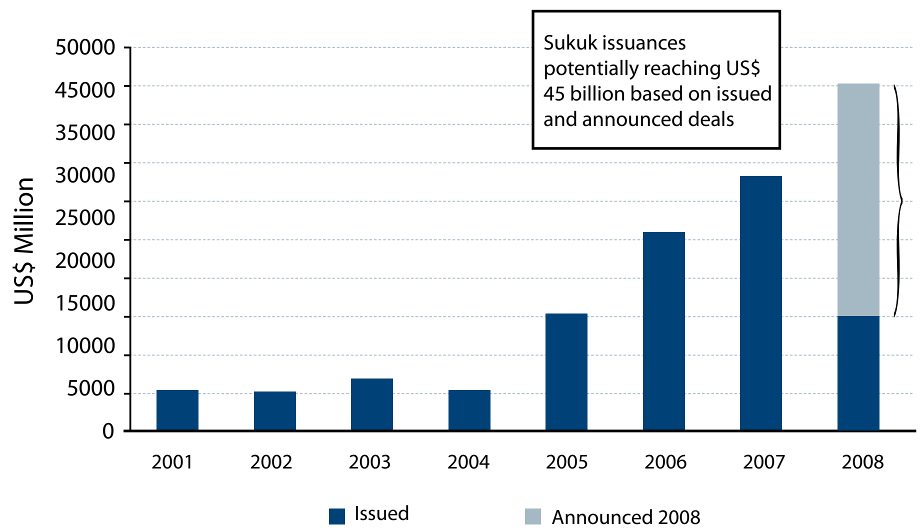

Figure 67: Global Islamic sukuk issued in US$ m

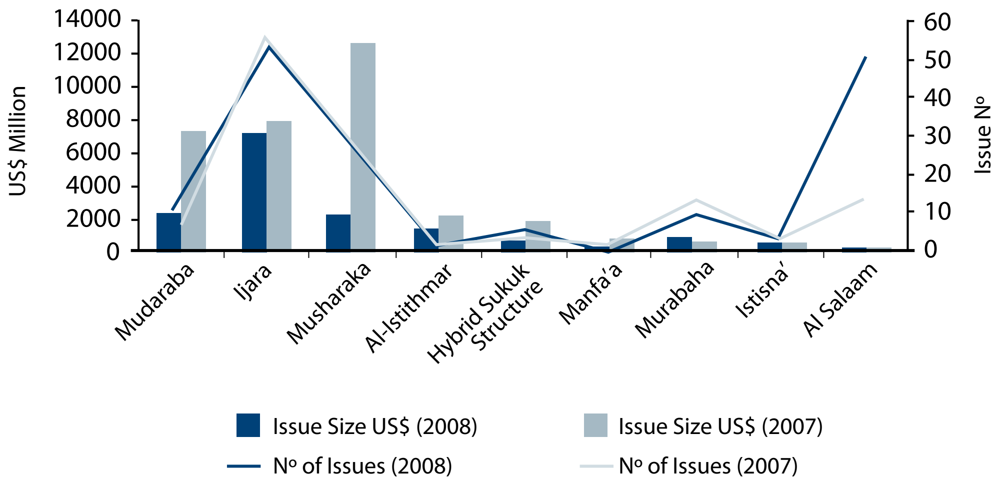

Figure 68: Structure and number of global sukuk issued

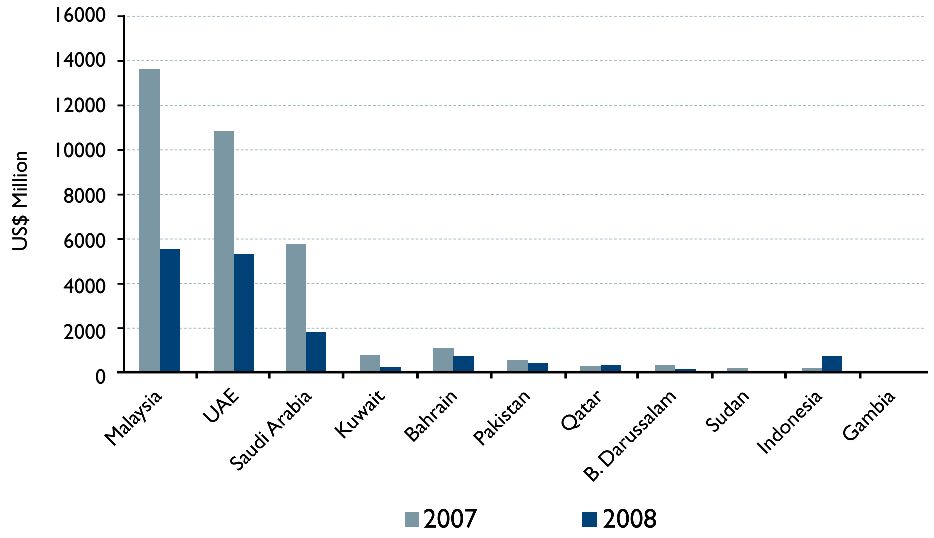

Figure 69: Volume of global sukuk issued

Shari'a, regardless of whether the manager is a mudarib, sharik or wakil for investments.

Despite this, diminishing musharaka has emerged as an accepted structure, incorporating both Shari'a compliance consistency and a profit- and loss-sharing partnership.[64]

The Malaysian market, a key issuer of corporate, financial institution and sovereign sukuk, experienced a decline in issuance of 59% compared with 2007. One could argue that, as Malaysian issuers have not formally adopted AAOIFI standards, the issuance decline should have not been that severe, especially if we include local currency sukuk, which would still be favoured and issued in the local ringgit market. This raises again the question of how much this slowdown is a function of global credit market conditions and how much is due to issues of Shari'a compliance. Bahrain and United Arab Emirates (UAE) sukuk issuances (represented by those issued out of the DIFC) also declined, by 36% and 51%, respectively.

10.5. Latest issuance trends: More local currency and sovereign issues

As the US dollar has historically been the most favoured currency for debt issuance in the GCC, its weakening over most of 2008 has meant that issuers in this region have resorted to issuing sukuk denominated in local currencies, mainly in AED and SAR. With speculation increasing throughout 2008 on the prospect of a de-pegging of GCC currencies from the US dollar, the outlook for local currency issuances has become increasingly significant.

As global US dollar issuance declined to less than US$ 2 billion from over US$ 14 billion in the same period of 2007, local currency issuance increased in the UAE to nearly AED 19 (US$ 5.17) billion in 2008, an increase of over 150% from 2007.

A corporate issuer's decision to tap the sukuk market is usually dependent on its ability to achieve favourable pricing and on the robustness of the capital market environment. These two factors were missing for most of 2008, leading many sukuk issuers to postpone announced issues, awaiting better credit and market conditions. We estimate that over US$ 30 billion of sukuk value had been announced in 2007-2008 for issuances in 2008 that did not materialise in 2008. If we incorporate both announced and closed sukuk issuances, the total volume would have risen to US$ 45 billion, a healthy growth of 35% over 2007.

By contrast, sovereigns and supranational institutions are less likely to slow down their issuance. On the contrary, in periods of slower growth and uncertain credit and capital market conditions, governments will need to increase their borrowings to compensate for revenue shortfalls from taxes and other sources of income, including lower oil and natural resource prices. Indonesia, Bahrain and Gambia have all seen an increase in their sovereign sukuk issued.

In 2008, the number of sovereign sukuk deals issued increased to 72, representing over 44% of total deals issued and an increase from 23 in 2007. In addition, previously planned and announced sukuk issues by Kuwait, Turkey, Japan and Thailand are likely to tap the market once there is some stability on the credit and capital markets.

[64] AAOIFI Shari'a Standard (12), Article (3/1/6/2)

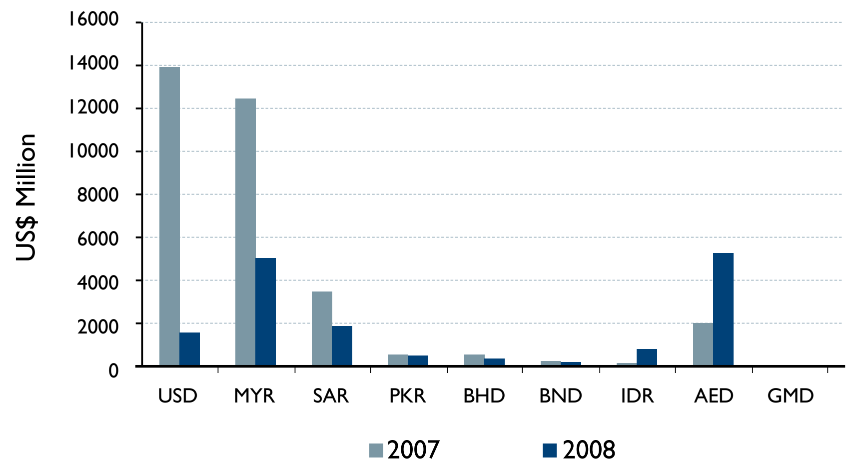

Figure 70: Sukuk issuance by currency

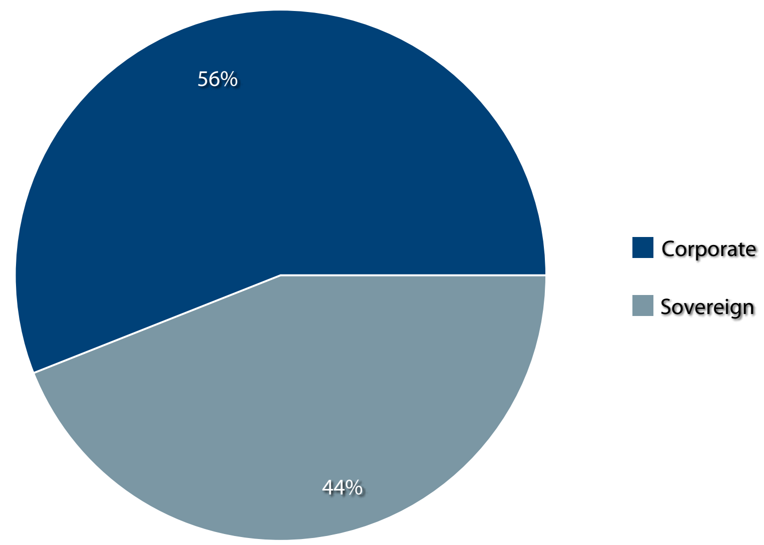

Figure 71: Corporate versus corporate sukuk