CLIFFORD CHANCE

Briefing note

March 2013

Introduction to Sukuk

According to a recent report by Thomson Reuters, the global *sukuk* market is expected to grow 141% to reach US$292 billion in issuances by 2016, up from US$121 billion in 2012

What are Sukuk?

Sukuk is the Arabic name given to a financial certificate and its origins can be traced back to the Middle Ages where papers representing financial obligations originating from trade and other commercial activities were utilised within Muslim societies. Although *sukuk* are sometimes referred to as Islamic bonds because they essentially replicate interest bearing bonds in a *Shari'a* compliant manner, they are better described as an asset based investment as the investors own an undivided interest in an underlying asset in proportion to their investment and as such take the risk in, and benefit derived from, the underlying asset. This ownership interest is evidenced by *sukuk* certificates held by the investors.

In simple terms, monies raised by the issue of *sukuk* certificates are used to invest in an underlying asset, a trust is declared over that asset as a result of which the certificate holders own a beneficial interest in that asset in proportion to their investment and are entitled to all of the benefits emanating from the asset including a proportion of the economic returns generated by that asset.

As with all Islamic financial transactions, *sukuk* are based on Islamic principles and jurisprudence (the *Shari'a*) which are derived from a number of sources, including the primary source of the Qu'ran (please see our client briefing entitled "*Islamic Finance*" Spring 2012 for further information). The basic Islamic principle is that money is not a commodity and, therefore, it is not possible to earn profit from its simple utilisation as it has no intrinsic value and is merely a means of exchange. Profit must be earned through trade and taking part in the risks of a transaction.

Prior to the development of the *sukuk* product there was a scarcity of Islamic products that could provide a mid to long term investment and which could readily be traded in the secondary market, both from a practical perspective and from a *Shari'a* perspective. The *sukuk* is ideal from the perspective of the Islamic investor and, given that it is typically an ownership interest in a real underlying asset and not just a debt instrument, is a freely tradable instrument.

Some of the most recent, notable examples of *sukuk* transactions on which Clifford Chance has advised on include:

- **Republic of Turkey Sukuk** – advising HSBC Bank plc, Citigroup Global Markets Limited and Liquidity Management House for Investment Company K.S.C.C. as joint lead managers and the dealers on the standalone, debut *sukuk* issuance by the Republic of Turkey of US$1.5 billion certificates.
- **Jebel Ali Free Zone FZE ("JAFZ") Sukuk** – advising JAFZ on refinancing of its liabilities through the use of a hybrid structure comprising an Islamic bank loan facility and issue of a new *sukuk*, with both having the benefit of a wide range of security governed by an intercreditor agreement. The consent solicitation was the first time in the region that a call option had been inserted into a *sukuk*.
- **Qatar Islamic Bank ("QIB") Sukuk** – advising Deutsche Bank AG, London Branch, HSBC Bank plc, QInvest LLC and Standard Chartered Bank as arrangers on the update by QIB of its US$1.5 billion Trust Certificate Issuance Programme.
- **Dubai Islamic Bank PJSC ("DIB") Sukuk** – advising Deutsche Bank, Dubai Islamic Bank, Emirates NBD Capital, HSBC and National Bank of Abu Dhabi, as arrangers and dealers on the update of DIB's U.S.$2.5 billion Trust Certificate Issuance

Key issues

Programme and the subsequent issuance of U.S.$500 million trust certificates thereunder.

- **Saudi British Bank** – advising HSBC as lead manager in relation to the issuance by Saudi British Bank of SAR1.5 billion trust certificates in Saudi Arabia by way of private placement. The proceeds of the issuance comprised tier 2 capital for Saudi Arabian regulatory capital purposes and were used by Saudi British Bank to strengthen its capital base.
- **Saudi Arabian General Authority of Civil Aviation ("GACA") Sukuk** – advising GACA in relation to the issuance in the Kingdom of Saudi Arabia of SAR15 billion (approximately US$4 billion) trust certificates (this was the largest *sukuk* to date in the Kingdom of Saudi Arabia and the first *sukuk* issuance by a Government entity with the benefit of an express guarantee from the Saudi Ministry of Finance).
- **Abu Dhabi Commercial Bank P.J.S.C. ("ADCB") Sukuk** – advising ADCB in relation to the issuance of wakala and mudaraba based US$500 million trust certificates, listed on the London Stock Exchange.
- **HSBC Bank Middle East Sukuk** – advising HSBC Bank Middle East in connection with the update of its London listed US$5 billion *sukuk* issuance programme and a US$500 million *sukuk* issuance under the programme.
- **Emirates Islamic Bank Sukuk Programme** – advising Emirates Islamic Bank on the establishment of its US$1 billion Trust Certificate Issuance Programme listed on the London Stock Exchange, subsequent programme updates and the issuances of US$250 million (now redeemed) and two issuances of US$500 million trust certificates each thereunder.
- **DP World Sukuk** – advising DP World Limited on the US$1.5 billion *sukuk-al-mudaraba*, offered outside the US pursuant to Regulation S and to US institutional investors pursuant to Rule 144A, dual listed on the London Stock Exchange and NASDAQ Dubai.
- **Bank Al Jazira Sukuk** – advising, together with Al-Jadaan & Partners Law Firm, Bank Al Jazira on a subordinated *sukuk* due 2021 callable with step-up in 2016, comprised of a hybrid *mudaraba* and *murabaha* structure and represents the first *sukuk* issuance and the first regulatory capital transaction by a fully *Shari'a* compliant bank in Saudi Arabia.
- **Majid Al Futtaim Holding LLC ("MAF")** – advising the Joint Lead Managers on MAF's US$ 1 billion Reg S *sukuk* programme comprised of a Wakala structure and issuance of U.S.$400 million trust certificates due 2017.
- **Tamweel Sukuk –** advising Citigroup Global Markets Limited, Dubai Islamic Bank P.J.S.C. and Standard Chartered Bank as Joint Lead Managers on the establishment of Tamweel's US$1 billion Trust Certificate Issuance Programme and issuance of Irish Stock Exchange listed US$300 million trust certificates due 2017. This programme comprised a hybrid wakala and mudaraba structure.
- **Nakheel Trade Creditor Sukuk** – advising Nakheel on a AED8.5 billion trade creditor *sukuk* programme, the first *sukuk* programme in the GCC to incorporate tap mechanics.
- **Government of Malaysia Sukuk** – advising CIMB, Citi, HSBC and Maybank as Joint Lead Managers and Joint Bookrunners on the Government of Malaysia's US$2 billion dual-tranche *sukuk-al-wakala* issuance, the largest dual-tranche global sovereign US dollar *sukuk* ever issued and the first global sovereign USD *sukuk* for 2011.
- **First Gulf Bank ("FGB") Sukuk** – advising Citi, HSBC and Standard Chartered on the establishment of FGB's US$3.5 billion Trust Certificate Issuance Programme, listed on the London Stock Exchange.
- **Sharjah Islamic Bank Sukuk –** advising Sharjah Islamic Bank on its US$400 million trust certificate issuance which was listed on the London Stock Exchange.
- **The Government of the emirate of Ras Al Khaimah ("RAK")** – advising Citigroup Global Markets Limited and The Royal Bank of Scotland plc on the region's first ever *sukuk* liability management exercise for the Government of RAK and the *sukuk* programme update.
- **Etisalat sukuk programme** – advising Citigroup Global Markets and The Royal Bank of Scotland on the establishment of a global *sukuk* programme for Emirates Telecommunications Corporation.
- **SBG Sukuk Limited trust certificate** – advising HSBC Saudi Arabia Limited on the

issuance by SBG Sukuk Limited of a *sukuk-al-murabaha* trust certificate to local investors in Saudi Arabia.

- **Nomura Holdings Sukuk** – advising Kuwait Finance House (Malaysia) Berhad as lead arranger in relation to Nomura Holdings' US$100 million two year benchmark *sukuk-al-ijara* certificates. This was the first ever US dollar-denominated *sukuk* issuance by a Japanese corporation.
- **Government of Malaysia Sukuk** – advising Barclays Capital, CIMB and HSBC as lead arrangers in relation to the US$1.25 billion global *sukuk* issuance by the Government of Malaysia.
- **General Electric Sukuk** – advising the joint lead managers on the US$500 million *sukuk* issued by GE Capital Sukuk Ltd. The assets underlying the *sukuk* are interests in a portfolio of aircraft and rental payments from the lease of such aircraft. This transaction was the first investment grade *sukuk* for a US corporate.
- **Tourism Development and Investment Company PJSC Sukuk Programme –** advising on the establishment of Tourism Development and Investment Company P.J.S.C.'s US$1,450,000,000 *sukuk* Trust Certificate Issuance Programme and inaugural issuance.
- **Islamic Development Bank Sukuk** – advising The Islamic Development Bank in relation to the 2009 update of its US$1.5 billion *sukuk* trust certificate issuance programme and the second and third Issuances under that programme.
- **Saudi Bin Ladin Group Sukuk** – advising HSBC Saudi Arabia Limited as lead manager on the issuance of over SAR1 billion *sukuk-al-mudaraba* maturing 2013.
- **Dubai Electricity and Water Authority Sukuk** – advising DEWA in relation to its AED3.2 billion *sukuk* (*sukuk-al-ijara*), DEWA's debut *sukuk* issuance which is listed on NASDAQ Dubai.
- **Aldar Properties PJSC Sukuk** – advising Abu Dhabi Commercial Bank PJSC, Barclays Bank PLC, Credit Suisse Securities (Europe) Limited, Dubai Islamic Bank PJSC, First Gulf Bank PJSC, Lehman Brothers International (Europe), National Bank of Abu Dhabi PJSC and Noor Islamic Bank PJSC as joint lead managers of the issuance of AED3.75 billion *sukuk* (*sukuk-al-ijara*).
- **Issue of the world's first exchangeable Islamic bond** – advising the investment holding arm of the Government of Malaysia on the issue of a US$750 million *sukuk*, the world's first exchangeable Islamic bond. We have subsequently advised on two further issues of *sukuk*, of US$850 million and US$350 million respectively.
- **Government of Ras Al Khaimah Sukuk –** advising Standard Chartered Bank as arranger on the establishment of the RAK Capital US$2 billion *sukuk* trust certificate issuance programme for the Government of Ras Al Khaimah and drawdown thereunder. The *sukuk* is the first ever *ijara sukuk* programme in the UAE and is the first ever rated sovereign issuance in Dirhams.
- **Saudi Electricity Company Sukuk** – advising HSBC Saudi Arabia Limited as Lead Arranger on a SAR5 billion *sukuk* (US$1.33 billion) for Saudi Electricity Company, which was listed on the Saudi Stock Exchange.
- **Jebel Ali Free Zone Authority (JAFZA) Sukuk** – advising the Jebel Ali Free Zone Authority and Jebel Ali Free Zone FZE on a AED7.5 billion Reg S *sukuk* for Jebel Ali Free Zone FZE, the largest dirham denominated *sukuk* issued in the UAE.
- **Aldar Properties PJSC Sukuk** – advising Aldar Properties PJSC on its debut issue of US$2.53 billion convertible *sukuk* certificates listed on the London Stock Exchange. The deal was notable for being not only the third largest *sukuk* issue in the Gulf region but also the largest convertible *sukuk* that can convert into listed shares on an UAE exchange.
- **Saudi Basic Industries Corporation (SABIC) Sukuk** – advising HSBC Saudi Arabia Limited as arranger and lead manager of a SAR3 billion (US$800 million) *sukuk* issue by SABIC. This was the first *sukuk* to have been publicly offered in the Saudi Arabian domestic market and to be admitted to the Official List maintained by the Saudi Capital Market Authority.
- **PCFC Development FZCO Sukuk** – advising the Dubai Ports Authority in connection with its US$3.5 billion

sukuk-al-musharaka which was listed on the Dubai International Financial Exchange. This was the first *sukuk* which is convertible into equity.

Sukuk Structures

In any *sukuk* transaction, the issuance of *sukuk* certificates will simply raise a cash amount required by an originator. The issuance itself will not entitle the investors to a return on their investment and, therefore, must be supplemented with another Islamic financing structure.

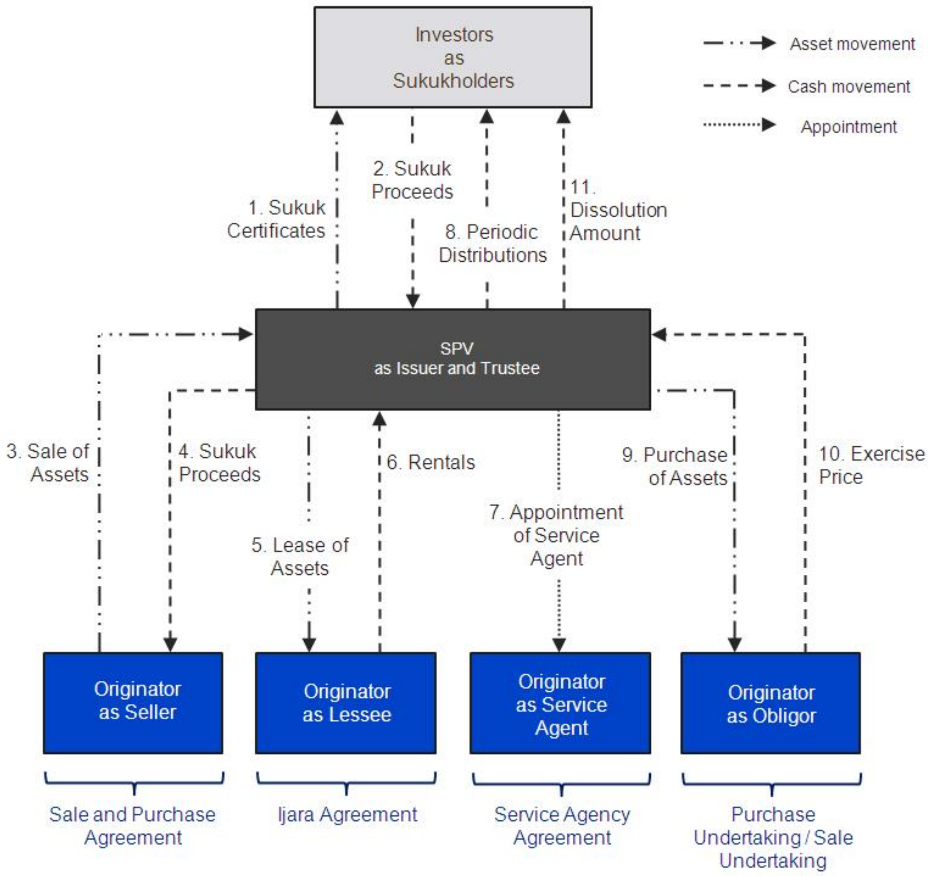
Although it is possible to interpose a *sukuk* issuance onto any Islamic financing structure, historically, the most prevalent structures used in the *sukuk* space were *ijara*, *mudaraba* and *musharaka* structures. However, in 2008, AAOIFI issued a statement criticising the use of fixed price purchase undertakings to guarantee returns in *sukuk-al-mudaraba* and *sukuk-al-musharaka* structures. AAOIFI stated that these structures are intended to be similar to equity-based instruments and therefore any returns to the investors cannot be fixed at the outset – the investors must share any losses arising out of the *sukuk* assets. Subsequently, this led to a significant decline in *musharaka* and *mudaraba* based *sukuk* issuances as investors in the market were not prepared to invest in instruments that exposed them to risks that are not normally associated with debt-based instruments. As a consequence, since 2008, the *sukuk-al-ijara* structure has become the predominant structure with other structures, for example, the *sukuk-al-wakala*, also being increasingly utilised.

This article examines these two structures in more detail below.

Sukuk-al-Ijara

The *ijara* is *a Shari'a* compliant lease. It is a hybrid between an operational lease and a finance/capital lease with certain 'ownership' risks, such as the obligation to undertake capital maintenance of the leased asset and the obligation to insure the asset, remaining with the lessor. The lessor may appoint an agent, usually the lessee itself, to carry out these duties on its behalf under a servicing agency agreement. In a simple *sukuk-al-ijara* the originator, or a third party connected to the originator, will sell certain physical assets to a special purpose vehicle (SPV). The SPV will finance this acquisition by cash raised by the issue of *sukuk* certificates. The SPV will then lease the same physical asset to a third party, often the originator itself. The lease rental payments will 'mirror' the coupon payments due under the *sukuk* certificates and the cash flow from the lease rentals will be used to service those coupon payments.

An example of a classic *sukuk-al-ijara* structure would be as follows:



Certain issues arise in the context of a *sukuk-al-ijara* which should be considered:

- the *sukuk* issue requires the transfer of real assets by the originator to the SPV, however, the transfer is often not a 'true transfer' in that the sale is not perfected. Although the transfer may not be a 'true' transfer, the potential tax implications still need to be examined on a transaction specific basis.

- the size of the *sukuk* issue is restricted to the value of the assets which are being transferred by the originator to the SPV. Additionally, once the assets have been used for the purposes of a *sukuk* issuance they cannot be used for any other purpose until the *sukuk* has matured and redeemed; and
- in the event that the assets suffer a total loss, for *Shari'a* reasons the rental payments under the *ijara* must cease and the purchase undertaking would become ineffective. As a consequence, the Investors would have no method of generating a return to fund coupon payments nor are they able to exercise the purchase undertaking in order to redeem the *sukuk* certificates. Both of these concerns can be addressed through the service agency arrangements and in particular the insurance obligations placed on the originator as service agent.

Historically, the *sukuk-al-ijara* structure was frequently used due to its relative simplicity. However, since the AAOIFI statement of February 2008, its most attractive feature is generally considered to be the permissibility of a fixed-price purchase undertaking within the structure. Variants of the basic *sukuk-al-ijara* structure have developed over the years including, for example, instead of selling an asset the originator may be able to transfer a usufruct which is then leased back to the originator provided that such a usufruct is recognised by the relevant legal and regulatory regimes. Within the United Arab Emirates the use of a right to develop land (known as a *Musataha*) has been used within the framework of a *sukuk-al-ijara* transaction on a number of issuances, for example, the *sukuk* programme established by the Tourist Development and Investment Company PJSC was based on a Musataha structure. It is also possible to have the originator grant a head lease instead of selling an asset. For *Shari'a* reasons, the head lease would have to enure for a sufficiently long period of time such that it is considered to be akin to an ownership interest.

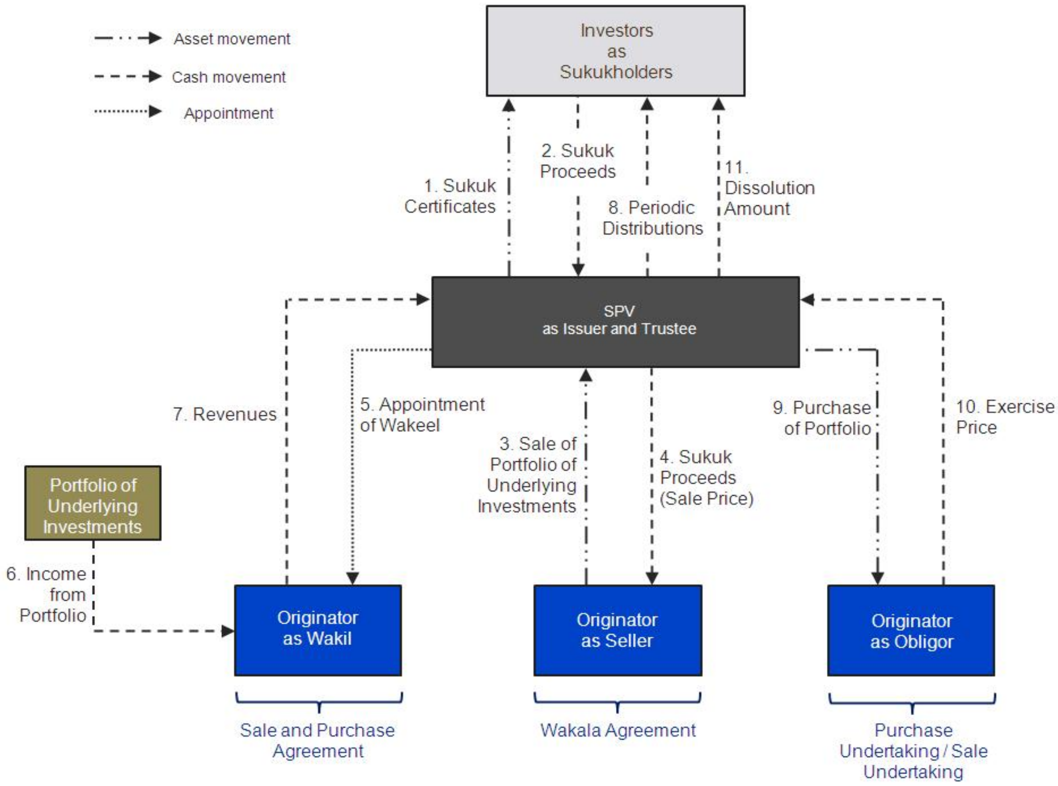
Sukuk-al-Wakala

It is not always possible to identify a tangible asset of sufficient value that can be used for the purposes of a *sukuk* issuance and indeed it is for this reason that *sukuk-al-musharaka* and *sukuk-al-mudaraba* structures were so prevalent pre-2008. As discussed earlier, the use of these structures has become problematic for investors since it is no longer possible to guarantee a return to them through a fixed-price purchase undertaking. An alternative structure that has been used recently, particularly by Islamic financial institutions acting as originators, is the *sukuk-al-wakala* structure.

In a simple *sukuk-al-wakala*, it is permissible for the originator to "package" its underlying investments and sell them to the issuer in return for a purchase price. An Islamic financial institution is therefore able to package, for example, its *ijara* contracts, *murabaha* receivables and any shares or *sukuk* certificates held by it into a portfolio which is then sold to the investors. The income derived from the portfolio is used to service the coupon payments due under the *sukuk* certificates.

The trustee will typically appoint the originator as its agent (*wakil*) to manage the portfolio. Unlike a *musharaka* or a *mudaraba* where the managing partner or the mudarib has some investment discretion, the *wakil's* role in a *sukuk-al-wakala* is generally limited to collecting income generated by the portfolio, maintaining the underlying assets comprised in the portfolio and acting on the instructions of the Trustee to replenish the portfolio with additional underlying assets from time to time. Given the limited nature of the *wakil's* role, the *wakil* is not held to be a partner or a mudarib in the arrangement for *Shari'a* purposes and therefore does not need to share the risk of loss in the arrangement. As a consequence of this, the originator in its corporate capacity is permitted, under *Shari'a*, to grant a fixed-price purchase undertaking to purchase the portfolio on redemption of the *sukuk* certificates.

An example of a simple *sukuk-al-wakala* would be as follows:



Certain issues arise in the context of a *sukuk al-wakala* which should be considered:

- the underlying investments may amortise over the life of the *sukuk* and therefore the value of the *sukuk* assets will decline over time. In order to maintain the value of the *sukuk* assets additional assets will need to be substituted into the portfolio from time to time;
- the income from the underlying investments is used to service the periodic distributions under the *sukuk* certificates. There is a residual risk that there may be a customer default under the underlying investments which could lead to a shortfall on any given periodic distribution date. A number of additional mechanics can be introduced into the structure, such as the provision of a *Shari'a* compliant liquidity facility, in order to mitigate this risk; and
- the rate of return generated by the underlying investments may not necessarily mirror the rate of return under the *sukuk* certificates. At times it could be less than or in excess of the periodic distribution amount. In order to cater for excess returns a reserve account can be introduced into the structure. The reserve account would also serve as a source of funding in the event of a shortfall.

This *sukuk-al-wakala* structure has been used on a number of recent transactions including most notably the US$1.5 billion *sukuk* programme update for the Islamic Development Bank where Clifford Chance acted as international counsel to the issuer and MAF's US$ 1 billion Reg S *sukuk* programme where Clifford Chance acted as international counsel to the Joint Lead Managers.

General Structural Considerations

Mitigating Asset Recourse Risk

Given that most originators have no desire to actually lose the physical asset in question, that is of course assuming that the initial transfer is a perfected sale in the first place, rather than permitting the investors to have recourse to the physical asset upon a default, certain procedural safeguards are built into the structure so as to ensure that the possibility of asset recourse is mitigated. The preferred route for doing so is for the originator to grant a purchase undertaking, or put option, in favour of the SPV enabling the SPV to put its interest in the *sukuk* assets back to the originator for a pre-determined price upon either an originator default, a default by the SPV (with the latter being exercised by a delegate appointed to monitor the interests of the *sukuk* certificateholders) or the maturity of the *sukuk*. The pre-determined price would be an amount equal to the principal amount to be redeemed under the *sukuk* certificate plus the coupon amount outstanding at the time the purchase undertaking was exercised. Interestingly, this changes the risk profile of the transaction from the asset risk of the underlying asset to the credit risk of the entity to which the assets can be put in a default. Following rating conventions, a *sukuk* with a purchase undertaking would not have a rating higher than the rating given to the entity to which the *sukuk* assets can be put as the primary risk to the investor is not the asset risk but the credit risk of the originator.

Credit Enhancements

Although the preferred route for credit enhancement is the use of a fixed-price purchase undertaking, for reasons outlined earlier in this briefing, this is not always possible. As such, a number of structural enhancements have been introduced into many *sukuk* structures in recent transactions including, for example, additional mechanics that provide for funded and unfunded reserve accounts and the provision of *Shari'a* compliant liquidity facilities.

Special Purpose Vehicle (SPV)

As most *sukuk* issues involve the use of an SPV as the issuing entity, consideration ought to be given to the jurisdiction of incorporation of the SPV. In addition to the usual concerns of creditor protection and bankruptcy remoteness, the jurisdiction of incorporation of the SPV may be driven by factors such as the nature of the assets that will form the *sukuk* assets. By way of example, in some Gulf States non-nationals may not own real estate and, therefore, in those instances the special purpose issuing vehicle will need to be incorporated onshore.

Acceleration

As discussed above, a *sukuk* is not a debt instrument but is a certificate that represents an ownership interest in an underlying asset. So what would happen if there was an Issuer default? In a conventional bond the bondholder would simply accelerate the debt so that the full amount would become immediately due and payable. In the context of a *sukuk* however, there is no debt to accelerate. To try and replicate the economic equivalent, upon an Issuer default the Issuer (or delegate which is usually appointed to safeguard the interests of the note holders) can typically exercise the purchase undertaking (for all amounts outstanding) and would then have a debt claim against the originator which is due and payable. In structures where a fixed price purchase undertaking is not acceptable other avenues for crystallising a claim in an amount equal to the debt amount would need to be explored, for example, through the use of insurances or by claiming for breach of contract.

Conclusion

Although the *sukuk* market did suffer as a result of the wider global economic crisis, in 2011 the total *sukuk* issued reached US$84.4 billion, up 62% from 2010, with the total issue for 2012 exceeding US$100 billion and the global *sukuk* market expected to see demand reach US$900 billion by 2017, according to a recent report by Ernst & Young.

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