

# Introduction to Sukuk

## Introduction

Islamic banking transactions are based on Islamic principles and jurisprudence (*Shari'a*) which are derived from a number of sources, including the primary source of the Qu'ran. 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 money 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. Following on from this premise there are a number of other Islamic finance principles that must be borne in mind when structuring Islamic compliant deals:

- **Speculation (*maisir*):** Contracts which involve speculation are not permissible (*haram*) and are considered void. Islamic law does not prohibit general commercial speculation (which is evident in most commercial transactions) but does prohibit speculation which is akin to gambling, more particularly, gaining something by chance rather than by productive effort. However, the distinction between speculation in genuine commercial trading and speculation in gambling arrangements is not very clear and in each individual case the commercial substance of the transaction must be analysed to evaluate whether or not it is permissible under Islamic law.
- **Unjust enrichment/Unfair exploitation:** Contracts where one party gains unjustly at the expense of another are considered void. Again it is not clear exactly what would amount to unjust enrichment and in each contract the commercial substance of the transaction must be analysed to evaluate whether or not it would amount to unjust enrichment under Islamic law.
- **Interest (*riba*):** The payment and receipt of interest (*riba*) under Islamic law is prohibited and any obligation to pay interest is considered void. Islamic principles require that any return on funds provided by the financier be earned by way of profit derived from a commercial risk taken by the financier.
- **Uncertainty (*gharrar*):** Contracts which contain uncertainty (*gharrar*), either as to the fundamental terms of the contract, or the actual subject matter are considered void.

## What is a Sukuk?

A number of different Islamic financing techniques and products have been developed in accordance with the above principles and one of these is the Sukuk. Although the Sukuk is sometimes referred to as the Islamic bond it is better described as an asset based investment as the investor owns an undivided interest in an underlying tangible asset which is proportionate to his investment. The Sukuk certificate evidences this ownership interest. Monies raised by the issue of the sukuk note are used to invest in an underlying asset, a trust is declared over that asset and thereby the certificate holder will own a beneficial interest in that asset in proportion to its investment and is therefore entitled to all the benefits that entails including a proportion of the return generated by that asset.

## Key Issues

### What is a Sukuk?

### General Structural Considerations

### Sukuk -al-Ijara

### Sukuk -al-Musharaka

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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 an ownership interest in a real underlying asset and not just a debt instrument, is a freely tradeable instrument. As such it is not surprising there has been a significant increase in the volume, size and frequency of deals over the last few years. Total issues in 2002 reached approximately US\$1 billion but for the twelve months ending with August 2006 total issues are estimated to be in the region of US\$12 billion. Although the overall volumes are still insignificant in comparison to the global conventional bond market, the rate of growth in the market is unprecedented. The early issues were sovereign, most of the recent issues have emanated from the corporate market and given the continuing desire for the corporate sector to tap into the Islamic market as an alternative source of funding this a trend that is likely to continue for the foreseeable future.

The following is a brief list of the main sukuk deals issued over the last few years:

<b>Issuer</b>	<b>Date of Issue</b>	<b>Issue Amount (US\$ millions)</b>
Malaysia Global Sukuk Inc.	June 2002	600
Kingdom of Bahrain	September 2002	80
Solidarity Trust Services (guaranteed by the Islamic Development Bank)	August 2003	400
Qatar Global Sukuk	September 2003	700
BMA International Sukuk	February 2004	250
Stichting Sachsen-Anhalt Trust	July 2004	100 <sup>1</sup>
Dubai Global Sukuk	October 2004	1,000
Sarawak Corporate Sukuk Inc.	November 2004	350
Pakistan International Sukuk	January 2005	600
Islamic Development Bank <sup>2</sup>	May 2005	1,000
Gold sukuk dmcc	May 2005	200
Wings FCZO	June 2005	550
Ports, Customs & Free Zone Corporation (DP World)	January 2006	3,500
Saudi Basic Industries Corporation (SABIC)	July 2006	800
QREIC Sukuk Limited	August 2006	270

Although the issue of the sukuk note will raise the cash, it must be used in conjunction with another Islamic finance technique/product. This additional technique will generate the cash flow required to service the coupon payments to the investors under the sukuk. This article will examine in a little more detail the two main structures that have been used in the Islamic debt capital markets over the last couple of years - The Sukuk-al-Ijara and the Sukuk-al-Musharaka.

<sup>1</sup> This issue was denominated in Euro

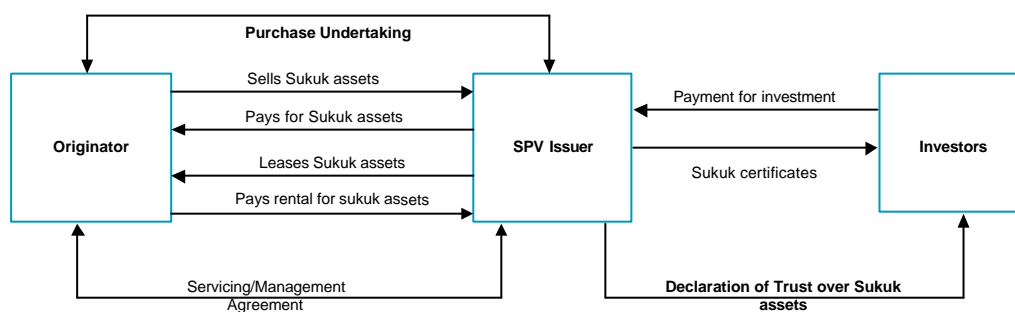
<sup>2</sup> Sukuk term note programme with only US\$500 million sukuk notes issued to date

## 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 agreement. In a simple Sukuk-al-Ijara 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 notes. The SPV will then lease the same physical asset to a third party, often the originator itself or a third party connected to the originator. The lease rental payments will 'mirror' the coupon payments under the sukuk and the cash flow from the lease rentals will be used to service the coupon payments under the sukuk. This structure, given its relative simplicity and ease of understanding, has been used in a number of earlier sovereign sukuk issues. As there may be legal and public policy considerations involved in a sovereign or quasi-sovereign disposing of public assets there has been a preference for sovereigns and quasi-sovereigns to use an underlying headlease - sublease structure rather than a sale-lease structure.

The critical issue from a shari'a perspective is that the SPV should have ownership rights prior to granting the lease (or sub-lease), a sufficiently long headlease will be deemed, from a shari'a perspective, as akin to ownership. Each investor would therefore own a proportionate interest in the underlying asset and any revenue being generated by that asset.

An example of a classic Sukuk-al-Ijara structure would be as follows:



Certain issues arise in the use of the Sukuk-al-Ijara which also require further consideration:

- the sukuk issue requires the transfer of real assets by the originator to the special purpose vehicle; however the transfer is often not a 'true transfer' in that the sale is not perfected. Therefore the sukuk note is not an asset backed bond (hence it is better described as asset based issue).
- the size of the sukuk issue is restricted by the value of the assets which are being transferred by the originator to the special purpose vehicle. This means that the Sukuk-al-Ijara structure issue is inherently inflexible. Additionally once the assets have been used for a sukuk issue they cannot be used for any other purpose until the sukuk issue has matured; and
- although the transfer may not be a 'true' transfer, the potential tax implications of such imperfected asset transfer still need to be examined on a case by case and jurisdiction by jurisdiction basis.

Given the relative simplicity of the Sukuk-al-Ijara structure this has been used on a number of the earlier sukuk issues including the sovereign sukuk issues by Malaysia and Bahrain in 2002 and Pakistan in early 2005 when Clifford Chance acted as international counsel to the issuer.

## Sukuk-al-Musharaka

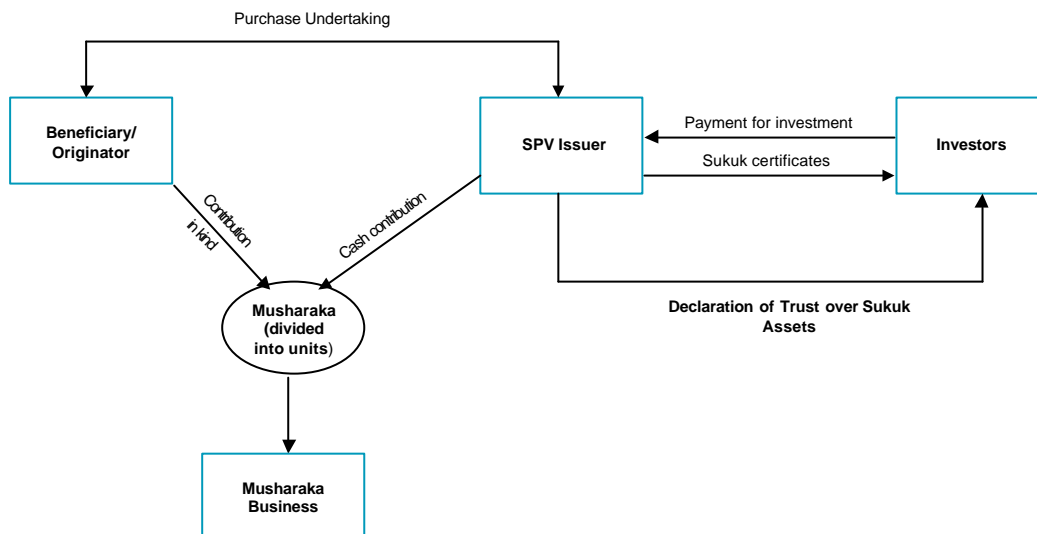
Given the lack of flexibility inherent in the Sukuk-al-Ijara, another sukuk product known as the Sukuk-al-Musharaka has been developed. This sukuk variant permits greater flexibility in the asset transfer to cash to be raised ratio as the amount of cash to be raised does not need to correspond to the value of the assets available for transfer into the musharaka.

A Musharaka constitutes a form of a joint venture and may, depending on its precise terms, also be a partnership. Although the *Shari'a* perceives the musharaka as an independent entity it is not a legal entity in its own right under English law and would simply be construed as an agreement between two parties. In a musharaka two

partners/sponsors will agree to combine their resources for a joint enterprise, often with one party contributing the cash and the other contributing the expertise or some other contribution-in-kind.

In a simple Sukuk-al-Musharaka the two partners would be the originator and a SPV. The originator will contribute assets to the musharaka and the SPV will contribute cash raised from the issue of sukuk notes. As the musharaka is not a legal entity, the partners will appoint a managing agent to act on behalf of the musharaka and this managing agent will often be the originator itself. The contributed assets, also known as the musharaka assets, are then employed by the managing agent to generate a cash return to service the coupon payments. The originator upon maturity of the sukuk may retain any cash generated in excess of the coupon payments.

A classical example of a Sukuk-al-Musharaka would be as follows:



This Sukuk-al-Musharaka structure has been used on a number of recent transactions including most noticeably US\$3.5 billion sukuk for Ports, Customs & Free Zone (DP World) earlier this year where Clifford Chance acted as international counsel to the issuer.

## General Structural Considerations

### Credit Enhancement

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. This may be, for example, by way of the originator providing some kind of financial assistance or other credit enhancement to the SPV in the event of the asset revenue stream drying up, such as a liquidity facility or guarantee. However the preferred route is for the originator to grant a purchase undertaking, or put option, in favour of the SPV enabling the SPV to put, in the case of a Sukuk-al-Ijara, the sukuk assets, and in the case of a Sukuk-al-Musharaka, its musharaka units, 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 transaction administrator appointed to monitor the interests of the sukuk noteholders) 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 notes 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 a credit risk on the originator.

### Special Purpose Vehicle (SPV)

As most sukuk issues involve the use of a SPV as the issuing entity, consideration would need to be given to the jurisdiction of incorporation of the SPV entity. 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 nature of the assets that are to form the sukuk assets. By way of example, as in some Gulf States non-nationals may not own real estate the special purpose issuing vehicle will need to be locally incorporated.

### 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 transaction administrator which is usually appointed to safeguard the interests of the note holders) can exercise the purchase undertaking (for all amounts outstanding) and would then have a debt claim from the originator which is due and payable.

### Conclusion

The sukuk market has grown, both in terms of size and sophistication, fairly rapidly over the last few years but is still, comparatively speaking, in its embryonic stage. We would expect there to be more structural developments and for the size of the market to continue to grow for the foreseeable future.

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