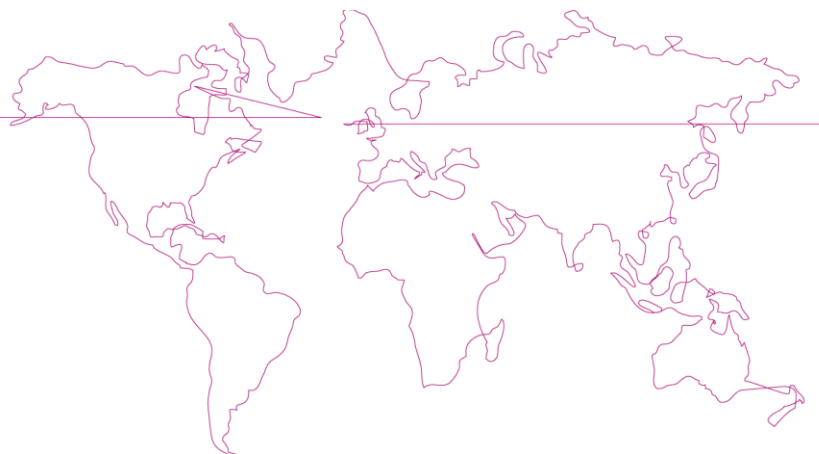


*Shari'a*-compliant Securities (*Sukuk*).

# Linklaters

September 2012



## Table of contents

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What is Islamic Finance?	2
Key Principles for Islamic Instruments	3
Key Types of Islamic Instruments	4
Using Islamic Instruments in <i>Sukuk</i> Structures	6
<i>Sukuk</i> Structuring Considerations	13
AAOIFI and Market Developments	16
Contacts	18

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## What is Islamic Finance?

Islamic finance is financing which conforms to the doctrines of the Islamic law known as “*Shari’a*”. The term *Shari’a* means “way” or “path” which is intended to regulate the relationship between a Muslim and God personally, as well as between dealings with other Muslims socially, economically and spiritually. Hence, *Shari’a* extends to influencing the economic, banking and financial activities of Muslims.

The sources of *Shari’a* (in hierarchical order) are as follows:

- The *Qur’an* (the holy book);
- *Sunna* (the teachings and practices of The Prophet Muhammad (Peace Be Upon Him)); and
- *Ijtihad* and *Fiqh* (Islamic jurisprudence).

*Fiqh* (literally meaning “knowledge” or “understanding of details”) is the interpretation of the *Quran* and *Sunna* by Islamic jurists and Scholars.

There are four schools of thought on which jurists and Scholars base their *Fiqh*. These four schools are:

- the *Hanafi* school which is followed mainly in Lebanon, Iraq, Syria, Turkey, Jordan, Afghanistan, Pakistan, Bangladesh and India;
- the *Maliki* (traditionalist) school which is followed in Africa;
- the *Hanbali* school which is followed in Saudi Arabia; and
- the *Shafii* school which is followed in South East Asia.

## Key Principles for Islamic Instruments

There are a number of key concepts which are central to Islamic beliefs which must be considered when structuring any Islamic finance transaction. The interpretation of these basic concepts may, however, differ according to the school of Islamic jurisprudence followed by particular Islamic investors and/or by *Shari'a* Scholars. Some of the key concepts in Islamic finance are set out below:

### Riba

*Riba* is most commonly understood as the prohibition of charging interest on lending money. However "interest" is only one component of *Riba*. The second component and the more complete definition of *Riba* is the prohibition of any increase or addition to money that is unjustified (for example, a penalty). Islamic law requires that any return on funds provided by the financier be earned by way of profit derived from a commercial risk taken by the financier. Any return on money cannot be for the mere use of money and as such any risk free or "guaranteed" rate of return on a loan or investment will constitute *Riba* and therefore will be prohibited. In essence, there should be no time value ascribed to money.

### Gharar

Contracts containing uncertainty, chance or risk (*Gharar*) are prohibited under *Shari'a* law, particularly where there is uncertainty about the fundamental terms of a contract such as price, time, delivery and each party's obligations and rights. The *Qur'an* prohibits any degree of uncertainty which would encourage speculation. So, for example, the provision of insurance would technically be thought of as *Gharar* as it involves paying a premium for an event which might never happen. However, *Shari'a* Scholars have permitted the use of insurance in modern times pending a more Islamic alternative. The reason for this allowance is that (i) the Islamic alternative *Takaful* is not as developed as conventional insurance (meaning that certain insurable risks are not currently covered by *Takaful* policies); and (ii) Islamic companies providing *Takaful* have smaller balance sheets than those of major conventional insurance companies and are constrained by thinner *re-Takaful* capacity when compared to conventional reinsurance, both of which are required to support substantial levels of *Takaful* policy exposures.

### Maisir

Gambling (*or Maisir*) is prohibited in many religions. However, states have normally divided secular prohibitions and authorisations from religious prohibitions. In Islam, gambling is prohibited which leads to some contracts, such as contracts of futures and options, possibly being considered unacceptable as they could be used for speculative purposes.

### Bay' Al-Dayn

This term relates to the sale of debts or monetary assets. Under Islamic law, the transfer of debt obligations is prohibited, and therefore the buying and selling of debt certificates is generally prohibited. Some Scholars do, however, accept a transfer of debt at par value.

### Bay' Al Inah

Many Scholars disapprove of *Bay' Al Inah*, namely a sale of an asset followed by a buy-back at an increased price of that same asset as it is regarded as a disguised loan.

### "two sales in one"

The Prophet (PBUH) has disapproved of any transaction that is conditional upon another transaction. Contracts must exist independently from one another and cannot conceal a "hidden purpose" behind the contract.

## Key Types of Islamic Instruments

In this section we outline some of the commonly used legal instruments recognised by *Shari'a* which are used as the building blocks for most Islamic structures as well as define some commonly seen terms.

### Wakala

*Wakala* is an agency relationship between the *Wakeel* (agent) and *Muwakil* (principal) whereby the *Wakeel* will invest the *Muwakil's* funds in certain *Shari'a*-compliant assets. The *Wakeel* is entitled to a fee for his services and, in addition, any profit made above an agreed profit rate may be paid to the *Wakeel* as an incentive fee pursuant to the term of a *Wakala* agreement. (See *AAOIFI and Market Developments – Sukuk Criticism.*)

### Mudaraba

*Mudaraba* is a joint venture between two or more parties where one party (the *Mudarib*) contributes his effort and management skills and the other party contributes cash. The parties may share profits but losses can only be borne by the capital provider. A *Mudaraba* contract can be for any period of time, at the end of which the contract is liquidated. The capital provider is not entitled to claim a fixed amount as profit, although the percentage of the profit payable to the capital provider may be stipulated in the financing agreement. Accordingly there should be no guaranteed return for the investors with this type of financing. (See *AAOIFI and Market Developments – Sukuk Criticism.*)

### Musharaka

*Musharaka* is a joint venture between two or more parties with each party contributing to the capital of the joint venture (in cash or in kind). The capital is invested in a *Shari'a*-compliant manner with profits and losses resulting from such an investment shared between the parties.

### Murabaha

*Murabaha* is defined as the sale of goods at cost plus an agreed mark-up. In this type of transaction, an asset is purchased by the purchaser (typically a bank) at the request of another party (the borrower) from a third party (a supplier) and then resold to the borrower at an agreed mark-up for immediate or deferred payment. The mark-up includes any expenses incurred by the purchaser. For the contract to be valid, it must specify the quantity, full description and the terms of delivery of the asset, as well as the cost of the asset, the profit payable to the bank and the payment terms.

### Salam

*Salam* is a sale agreement whereby the seller agrees to deliver goods at a future date in exchange for advance payment of the price in full. Although the goods need not exist at the time of the contract, a full description of the goods would be required at the outset as well as the date and terms of delivery. Further, the goods must also be of a type that is generally available in the market.

### Ijara

*Ijara* is a leasing contract whereby the owner of an asset (bearing all risks associated with the ownership of the asset) leases it to the lessee for a rent which is either agreed in advance or adjusted regularly throughout the lease period, either by consent, by reference to an "expert" or in some cases by reference to an external benchmark (e.g. LIBOR). An *Ijara* can be structured so that the lessor retains ownership of the asset after the termination of the lease period or can include an option for the lessee to purchase the asset on a specified date (*Ijara-wa iqtina*).

**Istisna'a**

*Istisna'a* is a sale contract whereby a party undertakes to manufacture or construct a specified asset according to agreed specifications at a determined price. In order for the contract to be *Shari'a*-compliant, the price of the asset must be fixed at the time the contract is entered into along with the specifications of the asset, and the terms of delivery must be clearly stated.

**Musataha**

*Musataha* is a right *in rem* to use, develop and benefit from land for a specified period, which may be used as the asset underpinning an *Ijara*-based *Sukuk*.

**Usufruct**

*Usufruct* is a right *in rem* to use and derive profit or benefit from property belonging to another, which may be used as the asset underpinning an *Ijara*-based *Sukuk*.

**Wa'ad**

*Wa'ad* means an undertaking or promise by one party in favour of another to do a *Shari'a*-compliant act such as selling or buying an asset on a future date or on the occurrence of a certain event.

**Arboun**

*Arboun* means "advance payment", but is usually taken to refer to a specific sale contract whereby the purchaser pays a deposit forming part of the purchase price for the purchase of a particular asset. The purchaser is granted a period of time to determine whether to proceed with the sale. If the purchaser chooses not to proceed with the sale the deposit is forfeited to the seller.

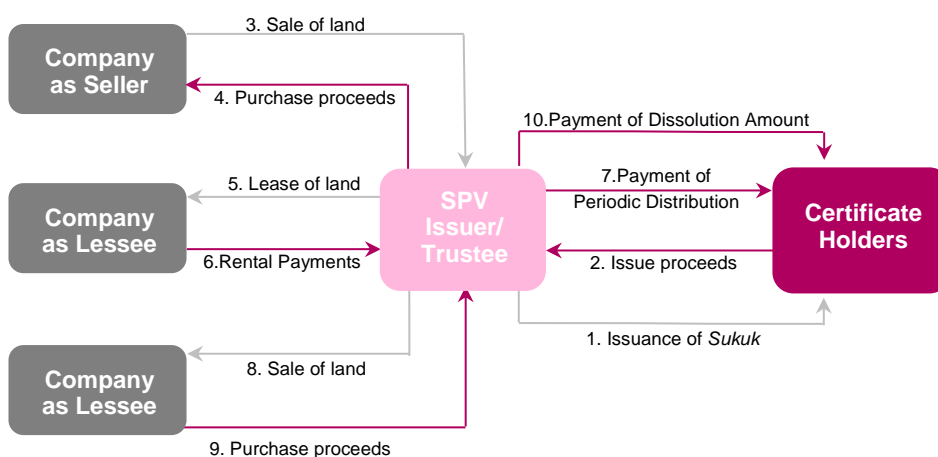
This type of sale agreement is controversial as many Scholars cannot justify the forfeiting of deposit for lack of consideration other than either time or loss of opportunity, both of which cannot be compensated for under *Shari'a*. However, the Islamic *Fiqh* Academy (established by the Organisation for Islamic Conferences) has permitted *Arboun* contracts provided that, amongst other conditions, the timeframe of the option to complete the purchase is set and the deposit is considered as part of the purchase price if purchased.

## Using Islamic Instruments in *Sukuk* Structures

Structuring *Shari'a*-compliant transactions usually requires using one or more of the above instruments or building blocks to achieve the required results. We set out below some of the most common structures used in structuring *Sukuk*.

### A. *Ijara*

Set out below is a simplified structure diagram and brief description of the *Ijara* structure and principal cash flows to assist in understanding the transaction documents relating to such a structure. Assets which are capable of being leased, including land or tangible assets such as plant and machinery, are appropriate for *Ijara* structures. Transactions involving real estate will require analysis as to whether registration or other formalities are required to effect a transfer of real estate or any interest therein.



### Summary of Structure and Payment flows

1. A special purpose vehicle (“**SPV**”) issues *Sukuk*, which represent a right against the SPV to payment of the Periodic Distribution Amount (i.e. profit) and the Dissolution Amount (i.e. principal) on redemption.
2. Certificateholders purchase *Sukuk* and pay the proceeds to the SPV (the “**Principal Amount**”). The SPV then typically declares an English law trust over the proceeds and the assets acquired using the proceeds (i.e. the land and contractual rights) and thereby acts as trustee on behalf of the Certificateholders (the “**Trustee**”). Each Certificate is thereby intended to represent an undivided beneficial ownership interest in the relevant assets underpinning the trust.
- 3 & 4. The Company enters into a Sale and Purchase Agreement with the Trustee, pursuant to which it sells land or other tangible assets to the Trustee in consideration for an amount equal to the Principal Amount.
- 5 & 6. The Trustee leases the land or other assets back to the Company pursuant a lease agreement between the parties (*Ijara*) in consideration for the periodic payment of Rental by the Company (which will be equivalent to the “Periodic Distribution Amount” payable by the Trustee to the Certificateholders).
7. The SPV pays Periodic Distribution Amounts to the Certificateholders using the Rental.
- 8 & 9. Upon (i) the occurrence of an event of default or maturity, or (ii) the exercise of any applicable put or call options (including a tax call), the Trustee will sell, and the Company will repurchase, the land or other assets pursuant to the exercise of a Sale Undertaking or Purchase Undertaking (as applicable). The consideration

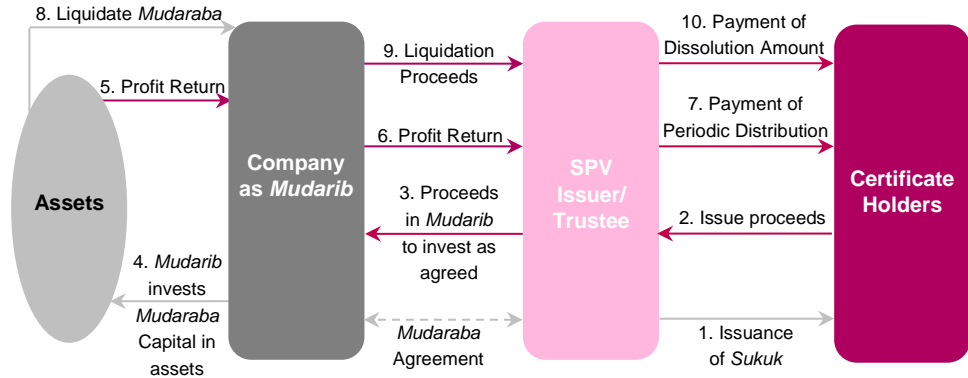
for such sale/repurchase will be payment of the “Exercise Price”, being a sum equal to the Principal Amount plus any accrued and unpaid Periodic Distribution Amounts owing to Certificateholders.

10. The SPV pays the “Dissolution Amount” to the Certificateholders in an amount equal to the Exercise Price.



## B. Mudaraba

Set out below is a simplified structure diagram and brief description of the *Mudaraba* structure and principal cash flows to assist in understanding the transaction documents relating to such a structure.

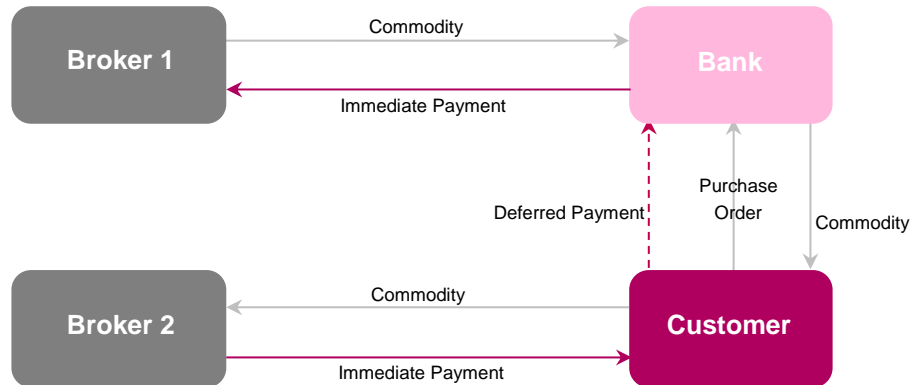


The steps to be followed for a typical *Sukuk al-mudaraba* are set out below.

1. SPV issues *Sukuk*, which represent a right against the SPV to payment of the Periodic Distribution Amount and the Dissolution Amount on redemption.
2. Certificateholders purchase *Sukuk* and pay the proceeds to the SPV (the “**Principal Amount**”). The SPV declares an English law trust over the proceeds (and the assets acquired using the proceeds, i.e. the assets and contractual rights under the *Mudaraba* Agreement) and thereby acts as trustee on behalf of the Certificateholders (the “**Trustee**”). Each Certificate is thereby intended to represent an undivided beneficial ownership interest in the relevant assets underpinning the trust.
- 3 & 4. The Company enters into a *Mudaraba* Agreement with the Trustee, pursuant to which it invests the *Mudaraba* Capital (i.e. proceeds) in certain assets in accordance with an agreed investment plan (to be determined on a deal by deal basis).
- 5 & 6. In accordance with the terms of the *Mudaraba* Agreement, (i) the Company as *Mudarib* applies its skill and knowledge in managing the assets, and (ii) the *Mudarib* makes periodic payments to the Trustee equal to the expected periodic income amount (“**Profit Return**”) which will be equivalent to the “Periodic Distribution Amount” payable by the Trustee to the Certificateholders, and will be payable on (or prior to) the same dates as the Periodic Distribution Amount is payable to Certificateholders.
7. The SPV pays Periodic Distribution Amounts to the Certificateholders using the Profit Return.
8. Upon an event of default, maturity, tax event etc. the *Mudarib* will liquidate the portfolio of *Mudaraba* assets.
9. The “Liquidation Proceeds” will be equal to the *Mudaraba* Capital plus the accrued but unpaid Profit Return, which will in turn be equivalent to the Dissolution Amount due to Certificateholders.
10. The SPV pays the “Dissolution Amount” to the Certificateholders using the Liquidation Proceeds.
11. To the extent the Profit Return is less than the Periodic Distribution Amount, the Company may provide a *Shari’a*-compliant liquidity facility (repayable by the SPV) to satisfy any such shortfall.

### C. Commodity Murabaha

Set out below is a simplified structure diagram and brief summary of cash flows in a commodity *Murabaha* structure. Typically, this structure is used as the basis for many *Shari'a*-compliant banking transactions but it is more recently being used as a component of a hybrid structure for *Sukuk* transactions (see *Hybrid Structures*).



The steps to be followed for a typical commodity *Murabaha* banking facility are as follows:

1. The Customer (i.e. the borrower) requests that the Bank (i.e. the lender) purchase a specified amount of Commodities by submitting a Purchase Order.
2. The Bank purchases the required amount of Commodities from Broker 1 for the Purchase Price (i.e. for the principal amount of the facility together with any taxes or other costs) on immediate payment terms.
3. On the same day as step 2 above, the Bank and the Customer enter into a *Murabaha* Contract (by the exchange of offer and acceptance notices) whereby the Customer purchases the Commodities from the Bank (i.e. the same Commodities purchased by the Bank from Broker 1) on deferred payment terms. The deferred payment will include a pre-agreed mark-up on the price paid by the Bank to Broker 1 for the Commodities.
4. On the same day as steps 2 and 3 above occur, the Customer sells the Commodities to Broker 2 for the Purchase Price, for immediate payment. The Bank usually acts as the agent of the Customer in selling the Commodities to Broker 2 and directs the immediate payment of the Purchase Price to the Customer.
5. On the same day as steps 2, 3 and 4 above, Broker 2 on-sells the Commodities in the market (often back to Broker 1) for the Purchase Price, for immediate payment.
6. On the pre-agreed date(s), the Customer pays the deferred payment to the Bank.

AAOIFI approves of this structure provided that there is a second broker involved. It is also important to note that actual commodity transfers (albeit across accounts of London Metal Exchange or other recognised brokers) must take place.

The deferred payment must be agreed on the date of each *Murabaha* contract - there can be no additional amounts payable on the deferred payment date. As a result, increased costs/break costs, as seen in a conventional banking facility, are treated differently in an Islamic facility and are not recoverable or payable in the same way (albeit these are not typically reflected in *Sukuk* documentation at all, given such features are not normally seen in conventional bond documentation):

- Increased costs can generally only be recovered by adding them to future deferred payment amounts payable at the end of the next *Murabaha* contract (corresponding to the next interest period in a conventional floating rate facility).

- Break costs generally need not be separately recovered by the banks in a prepayment scenario since the full deferred payment amount (including the mark-up which is calculated on the full principal amount at the beginning of the Murabaha contract) remains payable on the relevant deferred payment date.

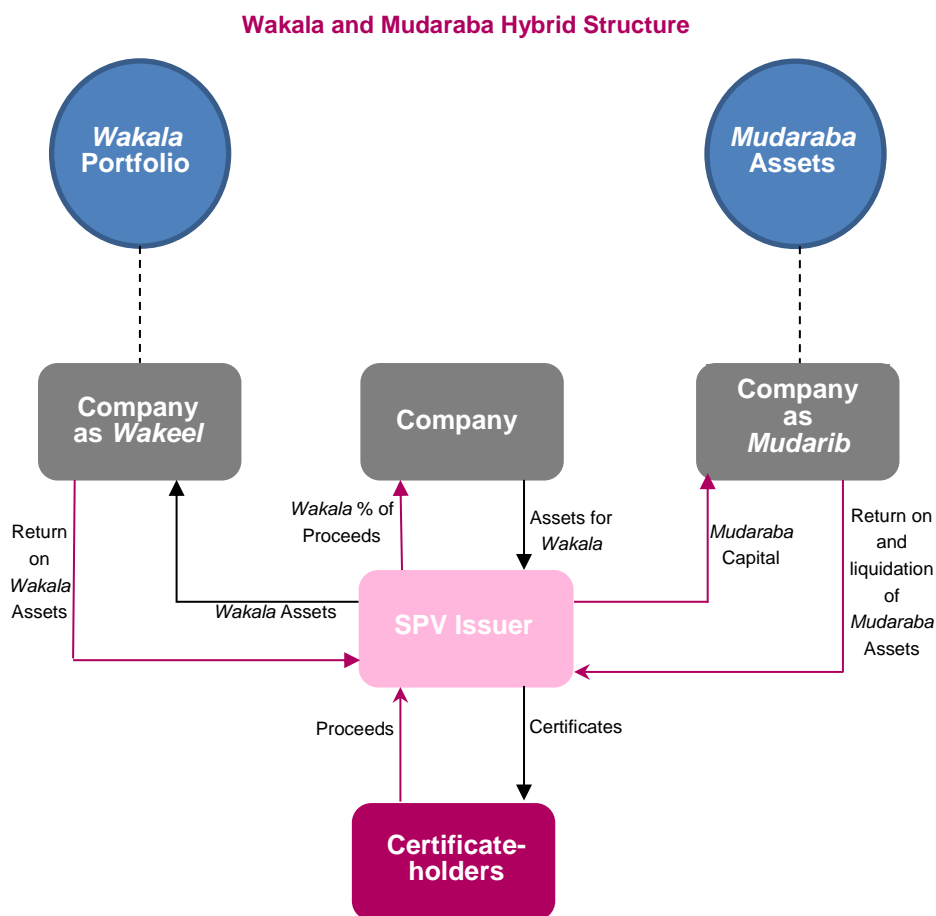
#### D. Hybrid Structures

Each structure pertaining to a *Sukuk* is transaction-specific and is determined, in particular, by reference to the relevant assets available to underpin the *Sukuk*, the relevant jurisdiction in which such assets are located and (if different) the relevant jurisdiction in which the obligor is incorporated. It may also be influenced by the demands of the investor base and their requirements as to Islamic structuring.

*Sukuk* structures continue to develop with the market and those investor demands. For many financial institutions issuing *Sukuk*, a hybrid structure (using a *Wakala* and *Mudaraba*) has recently been used. Although more complex than the structures described above (given the fact that they typically adopt multiple components within the structure), these hybrid structures may be structured in such a way as to facilitate the use of real estate assets without the need to register a legal transfer of real estate.

Depending on the particular circumstances, a hybrid structure may be created to include both “tangible” and “non-tangible” assets. This has the additional advantage of allowing issuers to issue *Sukuk* on a more “asset efficient” basis than previously, for example by allowing a commodity *Murabaha* transaction to form part of the asset base. However, the *Bay' Al-Dayn* principle relating to tradability (see *Sukuk Structuring Considerations - Tradability of Sukuk*) means that the proportion of the asset base that can be represented by non-tangible assets, such as a commodity *Murabaha* transaction, is limited.

Set out below is a simplified structure diagram which illustrates a hybrid structure (using *Wakala* and *Mudaraba*) which has recently been used principally by financial institution issuers.



The proceeds of the issuance are used (i) to purchase assets for the purpose of the *Wakala* Portfolio and (ii) as capital for a *Mudaraba*. The relevant split of proceeds and requirements as to tangible assets in each of the *Wakala* Portfolio and *Mudaraba* will depend on the views of the particular scholar as to tradability (see *Sukuk Structuring Considerations – Tradability of Sukuk*).

The *Mudaraba* Assets can include real estate assets (most commonly real estate *Ijara* assets). As mentioned above, the advantage of such a hybrid structure is that it may be structured in such a way as to allow the issuer to use real estate assets in the financing structure without the need to register a legal transfer of real estate.

The *Wakala* Portfolio can include non-real estate *Ijara* assets and receivables (including receivables under a *Murabaha* contract).

The periodic returns on the *Wakala* Portfolio and *Mudaraba* Assets fund the periodic distribution amounts payable on the Certificates. The redemption amounts payable in respect of the Certificates are generated from (i) the liquidation proceeds of the *Mudaraba* and (ii) the exercise price payable under either the purchase undertaking or sale undertaking upon the sale of the *Wakala* Assets back to the Obligor.

## Sukuk Structuring Considerations

There are many issues that arise in relation to *Sukuk* structures and transactions. We set out below some of these issues:

### Transfer of Title

Depending on the relevant jurisdiction, the nature of the title to assets held or to be transferred and the *Shari'a* structure used, it may be necessary to consider local law issues pertaining to the transferability of title to the assets underlying a *Sukuk*. These may include any formalities (such as registration and the payment of any associated fees or taxes) necessary for the transfer of title to be effective.

### Nature of the Assets

The relevant assets intended to underpin the *Sukuk* structure must be used by the obligor for *Shari'a*-compliant purposes. Activities or businesses relating to alcohol, pork-related products, conventional finance, gambling etc. are prohibited.

The relevant assets must be unencumbered as at the issue date of the relevant *Sukuk*. Their market value on the issue date must equal or exceed the principal amount of the *Sukuk* being issued. The valuation methodology and the timing thereof must therefore be carefully considered.

Although *Sukuk* can be structured as secured instruments, the vast majority of *Sukuk* are structured so as to be “asset-based” rather than “asset-backed” investments. This means that Certificateholders do not typically have recourse to the assets which underpin the *Sukuk* structure. Rather, investors only have an unsecured claim against the obligor for the repurchase price of such assets, which are required to be sold back to the obligor by the SPV issuer on maturity, an event of default or any early redemption (variations of this mechanism include the liquidation of *Mudaraba* assets and payment of the liquidation proceeds thereof in the case of a *Sukuk al-mudaraba*).

### Tax and Zakat

The acquisition or purchase of assets, or other transactions under *Shari'a*-compliant structures used to generate profit for *Sukukholders*, could potentially create exposure to capital gains, value added or income taxes. The ownership of an asset may also be taxable or create tax residency issues.

In some jurisdictions (for example, Saudi Arabia) *Zakat* (a fixed portion of a Muslim's wealth which is required to be donated to charity in accordance with Islamic law) must also be paid and should be considered at the structuring phase of the *Sukuk* where applicable.

### Governing law

There are differences amongst Scholars relating to the interpretation of various Islamic principles. As such the market practice is that documents be governed by the law of a particular jurisdiction rather than by *Shari'a* law. This is supported by the English court decision in *Shamil Bank v Beximco* [2003] EWHC 2008 (Comm) where the English courts refused to apply principles of *Shari'a* to the contract in question. One of the primary reasons for the Court reaching its decision was the considerable controversy and difficulty in applying *Shari'a* law to contracts and consequently the Court found that it was “improbable in the extreme, that the parties were truly asking [the Court] to get into matters of Islamic religion...” (see *AAOIFI and Market Developments*).

### Capacity and Authority

In the recent *TID v. Blom* case, an Islamic finance institution, TID, (which by its objects could only enter into *Shari'a*-compliant transactions), having suffered liquidity problems, sought to argue that the deposit-like economic arrangement it had entered into with Blom (under a *Wakala* structure) was in fact not *Shari'a*-compliant and therefore *ultra vires*.

This was despite the fact that TID had previously obtained approval of the transaction from its own *Shari'a* board. The Court, in summary judgment, found that there was at least an argument to be had as to whether the payment of the profit (“interest”) element was *Shari'a*-compliant. TID appealed the summary judgement and the High Court Judge allowed the appeal accepting there were issues requiring consideration at full trial. Following this case, some Islamic financing transactions pertaining to an Islamic finance institution or *Shari'a*-compliant entity have incorporated representations and warranties (amongst other things) to mitigate against any such claim being made by such institution or entity.

#### **Tradability of Sukuk**

Due to the impact of *Bay' Al-Dayn*, in order to enable tradability of *Sukuk* in the secondary market in accordance with *Shari'a* principles, the *Sukuk* must represent an interest in physical assets rather than simply representing debts or obligations. Some Scholars over time have been comfortable with physical assets underlying *Sukuk* structures representing at least 33 per cent. of the face value of the *Sukuk*; other Scholars require between 51 per cent. and 70 per cent. of the assets underlying *Sukuk* structures to be physical assets.

#### **Differences between structures in the Middle East and East Asia**

*Shari'a*-compliant financing structures adopted in the Middle East can differ considerably from those adopted in East Asia. There are many reasons for these distinctions, including the difference in the interpretation of *Shari'a* between Middle Eastern Scholars and Asian Scholars. Middle Eastern investors in the past have been of the view that the interpretation of Islamic *Shari'a* in Asia is less conservative than that of the Middle East. Other reasons include different local laws and, more importantly, different tax treatments. For example, tax (such as VAT or income tax) in the Arabian Gulf countries is almost non-existent and therefore *Sukuk* structures are typically not tax driven. This is not the case in East Asia where VAT, income tax, capital gains tax, stamp duties and other forms of taxation could have a significant impact on structures.

#### **Liability Management**

In order to undertake a liability management exercise of *Sukuk*, it will be necessary to consider the continued acceptability of the existing *Sukuk* structure (particularly for *Sukuk* which were launched prior to AAOIFI criticisms of certain *Sukuk* structures – see further *AAOIFI and Market Developments*) and underlying assets available to undertake a liability management exercise including rescheduling, extending or exchanging existing *Sukuk* outstanding. Early discussions with *Shari'a* Scholars in relation to the nature of the liability management exercise will also be required.

As a result of the complexities associated with undertaking any liability management exercise in respect of outstanding *Sukuk*, it would be prudent when structuring a new issue of *Sukuk* to ensure that the legal documentation allows for liability management exercises to be conducted. In particular, issuers would benefit from being able to repurchase the *Sukuk* in the market and cancel them, with an associated proportionate “unwinding” of the underlying assets if the legal structure allows.

#### **Types of Sukuk**

The majority of *Sukuk* have been issued in a manner which creates an economic effect similar to bonds. However, *Sukuk* documentation can be adapted for more complex structures, and as a result have been used in:

- > hybrid and lower tier two transactions;
- > convertibles and exchangeables (both public and private);
- > private equity; and
- > project financing.

A number of structures can be used to achieve the desired returns to investors. The most appropriate structure will depend principally on the type of asset available to the obligor and the applicable legal regime in the country of incorporation of the obligor and (if different) in the country in which the asset is located.



## AAOIFI and Market Developments

AAOIFI is the Accounting and Auditing Organisation for Islamic Financial Institutions. It is established in Bahrain and is supported by a membership that includes central banks, Islamic financial institutions and other participants from the international Islamic banking and finance industry. Over the past few years, AAOIFI has laid down more than 20 accounting standards for Islamic banks. These accounting standards are not binding on AAOIFI's members unless they specifically choose to apply them.

Nevertheless, weight is often given to AAOIFI's opinions by virtue of the prominence of the Scholars who sit on its board. Many of these Scholars also sit on the *Shari'a* boards of many banks and financial institutions in the Middle East. As a result, the principles and opinions set forth by AAOIFI may impact on the Scholars' views in relation to the various Middle Eastern banks and financial institutions on whose *Shari'a* boards they sit.

### **Sukuk Criticism**

During the course of 2007, Sheikh Taqi Usmani, the chairman of the *Shari'a* board of AAOIFI, criticised a number of *Sukuk* structures used in the market, in particular *Mudaraba*, *Wakala* and *Musharaka* on the basis that, in his view, they are not *Shari'a*-compliant.

For example, in *Sukuk al-mudaraba*, in order to achieve the economic result of the investors receiving a predetermined amount on redemption and periodic profit distributions in the interim, a combination of a purchase undertaking and liquidity facility was used. The liquidity facility received criticism as it was felt to run contrary to the principle that the investor (the "*Rabulmal*") should solely bear the loss on the investment. In effect, they serve to grant a guarantee in favour of the *Rabulmal* and therefore negate the risk to which the *Rabulmal* should be exposed. There was also criticism of the "incentive fee" for the *Mudarib* being linked to a benchmark, rather than to profits based on the skill exercised by the *Mudarib* with respect to investments made.

Criticism was also extended to the use of purchase undertakings from the obligor in other *Shari'a* structures for the same reasons regarding negating risk, because the purchase price is pre-agreed on the issue date of the *Sukuk* instead of it being determined at the time of sale in the future by reference to the market value of the asset.

Sheikh Taqi also disapproved of the *Mudaraba* structure: without the investment plan specifying that the proceeds are required for the purposes of investment in physical assets, the money invested by the *Rabulmal* amounts to a loan.

For a period of time there was uncertainty as to the *Shari'a* ruling in respect of *Sukuk* that had previously been issued in the market. However, AAOIFI soon clarified in discussions with market participants that *Sukuk* which had been approved previously, together with the *Fatwa* relating to such *Sukuk*, remained intact.

Furthermore, in February 2008 the AAOIFI *Shari'a* board, having met on various occasions, among themselves and with a number of market participants, issued the following guidance on *Sukuk* issuance:

- > *Sukuk* must represent ownership in real or physical assets which may also include services or *usufruct*. The originator/obligor must be able to prove the transfer of title in its records and may not retain title to its assets sold or transferred under the *Sukuk* structure;
- > *Sukuk* may not represent receivables or debts unless as part of a sale of all assets by a financial or commercial institution;
- > The obligor (be it *Mudarib*, partner in a *Musharaka* or agent/*Wakeel*) may not provide a liquidity facility;

- > A *Mudarib*, partner in a *Musharaka* or agent may not undertake to purchase the *Mudaraba* or *Musharaka* assets at the face value of the *Sukuk* but such purchase must instead be at the market value or a value to be agreed upon at the time of purchase; and
- > A lessee in an *Ijara Sukuk* may redeem the *Sukuk* by purchase of assets at a pre-agreed price provided the lessee is not a *Mudarib*, partner in a *Musharaka* or agent.

### **Markets today**

The capital markets as a whole (including *Sukuk*) were badly affected by the financial crisis in 2008 and 2009. A number of market participants were of the view at the time that the AAOIFI guidance compounded this by making it more difficult to structure *Sukuk*. Furthermore, whilst the AAOIFI standards, as discussed above, have persuasive influence they are not binding on Islamic financial institutions (unless so incorporated into their respective articles of association or such institution is established in Bahrain) and Islamic Scholars are free to express their own opinions as to compliance with *Shari'a*.

Notwithstanding the prior slowdown in *Sukuk* volumes, the second half of 2011 and 2012 to date has seen a significant increase in global *Sukuk* issues, and in particular in the Middle East. Borrowers have been attracted to the *Sukuk* market as a result of significant liquidity in the region (in particular from Islamic banks), which has taken on greater significance in 2011 and 2012 due to reduced liquidity in other markets as a result of global (and in particular European) economic conditions. *Sukuk* have also typically been purchased by "hold to maturity" investors, which has meant that the secondary market performance of *Sukuk* trading prices has generally been more stable, despite the wider economic instability. Finally, and most importantly, most prospective issuers of *Sukuk* are currently able to achieve tighter pricing in the *Sukuk* market as compared to an equivalent issue in the conventional bond market.

In terms of structures being adopted for *Sukuk* issues, we are beginning to see a revival of structures designed to adhere more stringently to the AAOIFI principles and guidance. As discussed above, the market has seen a shift away from the once-prevalent *Ijara* structure towards hybrid structures to give more flexibility with respect to the types of assets that can be used. These have the additional advantage of allowing a commodity *Murabaha* transaction to form part of the asset base (up to a maximum percentage of the total asset value) and hence meaning that issuers are able to issue *Sukuk* on a more "asset efficient" basis than previously.

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