RELEVANT TO ACCA QUALIFICATION PAPER P4

Islamic finance – theory and practical use of sukuk bonds

The growth and popularity of the use of Islamic finance has been exceptional since the Central Bank of Bahrain issued the first sovereign sukuk bonds in 2001. It is estimated that by the end of 2012 Islamic financial assets will have exceeded $1,600bn, which is around 1–2% of global financial assets worldwide.

ACCA recognised the importance of Islamic finance and introduced it in the Paper F9 syllabus two years ago. The ACCA syllabus states students should be able to: 'Identify and briefly discuss a range of short- and long-term Islamic financial instruments available to businesses.'

From this year, Islamic finance becomes part of the Paper P4 syllabus, but at a different level to that which is tested at Paper F9. A successful Paper P4 student must: 'Demonstrate an understanding of the role of, and developments in, Islamic financing as a growing source of finance for organisations; explaining the rationale for its use, and identifying its benefits and deficiencies.'

This article is focused on Islamic finance as a growing and important source of finance. In particular, it looks at the success and failure of the use of sukuk bonds to finance the purchase of assets. However, for the purpose of reference, the attached appendix explains the basic principles of Islamic finance.

Sukuk finance

What is sukuk finance? The official definition provided by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Bahrain-based Islamic financial standard setter, is 'certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity.'

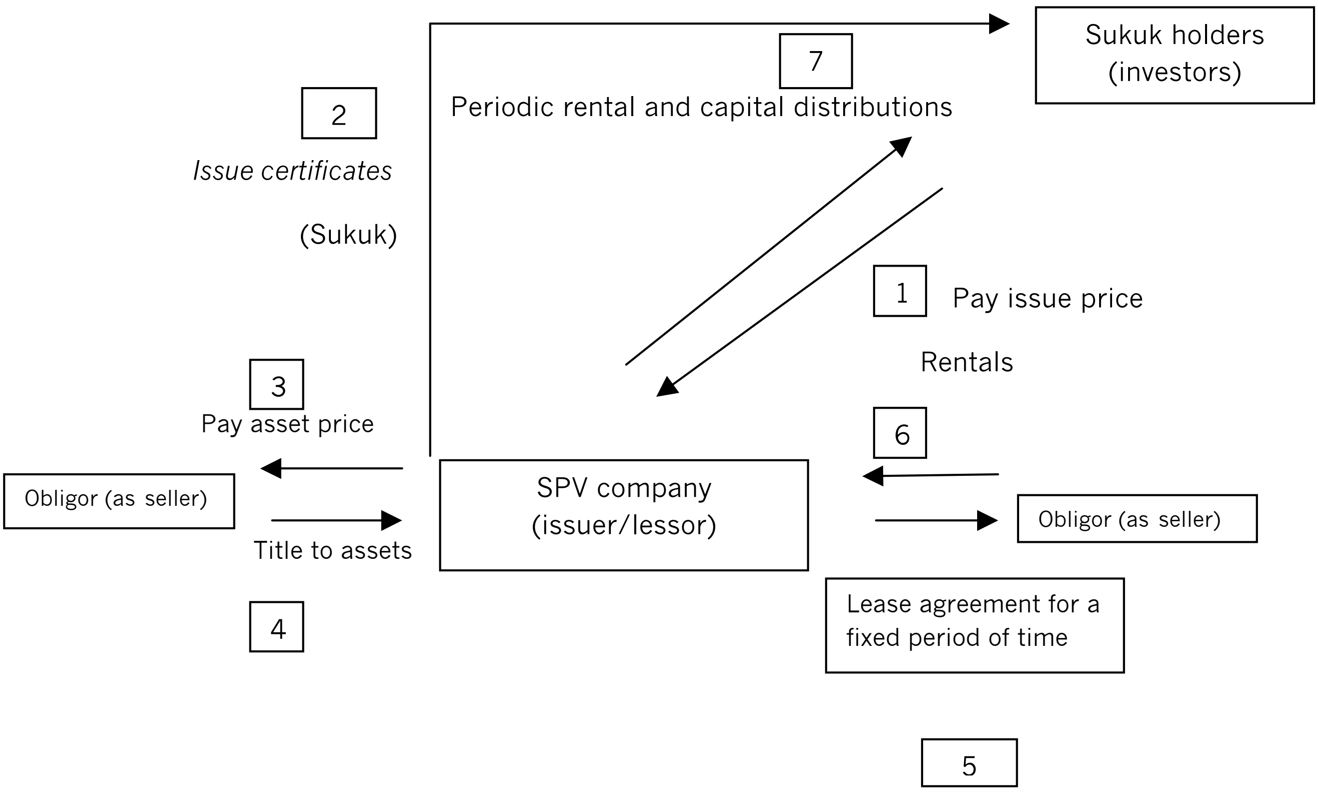
Sukuk is about the finance provider having ownership of real assets and earning a return sourced from those assets. This contrasts with conventional bonds where the investor has a debt instrument earning the return predominately via the payment of interest (riba). Riba or excess is not allowed under Sharia law.

There has been considerable debate as to whether sukuk instruments are akin to conventional debt or equity finance. This is because there are two types of sukuk:

- Asset based – raising finance where the principal is covered by the capital value of the asset but the returns and repayments to sukuk holders are not directly financed by these assets.
- Asset backed – raising finance where the principal is covered by the capital value of the asset but the returns and repayments to sukuk holders are directly financed by these assets.

There are fundamental differences between these. The diagrams set out below explain the mechanics of how each sukuk operates.

Asset-based sukuk
Sukuk Al-ijarah: financing acquisition of asserts or raising capital through sale and lease back.

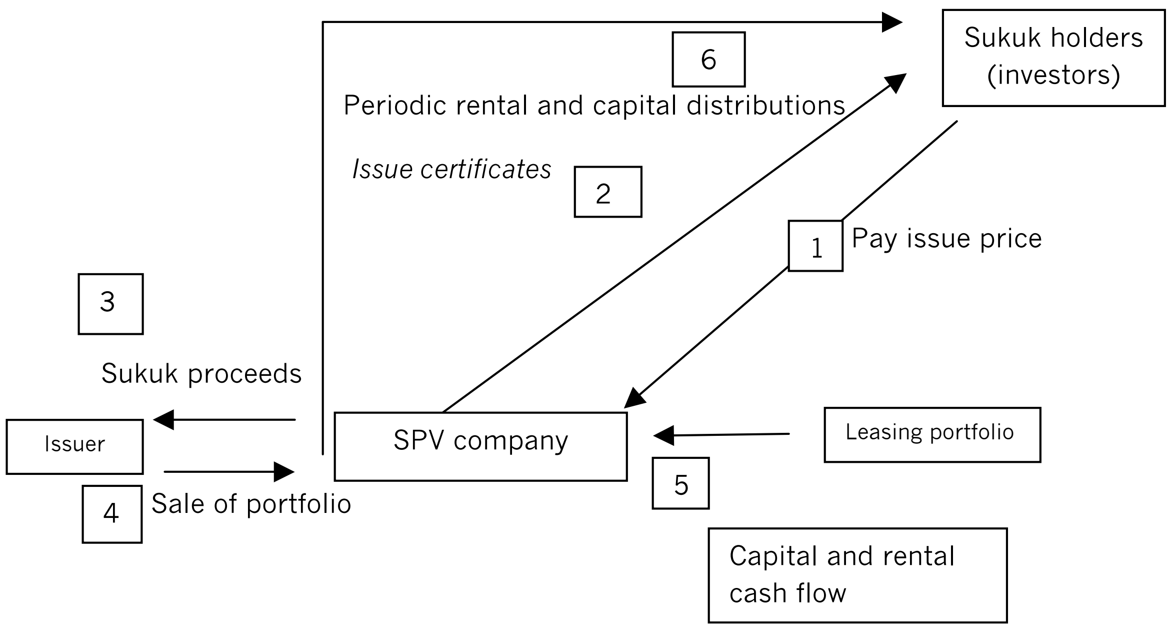


1. Sukuk holders subscribe by paying an issue price to a special purpose vehicle (SPV) company.
2. In return, the SPV issues certificates indicating the percentage they own in the SPV.
3. The SPV uses the funds raised and purchases the asset from the obligor (seller).
4. In return, legal ownership is passed to the SPV.
5. The SPV then, acting as a lessor, leases the asset back to the obligor under an Ijarah agreement.

6. The obligor or lessee pays rentals to the SPV, as the SPV is the owner and lessor of the asset.
7. The SPV then make periodic distributions (rental and capital) to the sukuk holders.

Asset-backed sukuk

Sukuk: Securitisation of Leasing Portfolio



1. Sukuk holders subscribe by paying an issue price to a SPV company.
2. In return, the SPV issues certificates indicating the percentage they own in the SPV.
3. The SPV will then purchase a portfolio of assets, which are already generating an income stream.
4. In return, the SPV obtains the title deeds to the leasing portfolio.
5. The leased assets will be earning positive returns, which are now paid to the SPV company.
6. The SPV then makes periodic distributions (rental and capital) to the sukuk holders.
7. With an asset-based sukuk, ownership of the asset lies with the sukuk holders via the SPV. Hence, they would have to maintain and insure the asset. The payment of rentals provides the return and the final redemption of the sukuk is at a pre-agreed value. As the obligor is the lessee, the sukuk holders have recourse to him if default occurs. This makes this type of sukuk more akin to debt or bonds.

Asset-backed sukuk certainly have the attributes of equity finance – the asset is owned by the SPV. All of the risks and rewards of ownership passes to the SPV. Hence, should the returns fail to arise the sukuk holders suffer the losses. In addition, redemption for the sukuk holders is at open market value, which could be nil.

Sukuk finance case studies
For Emirates airline, the use of sukuk finance has been a huge success. The company issued its first sukuk (Islamic Bond), with a seven-year term, in 2005, which was listed on the Luxembourg Stock Exchange. The $550m was repaid in full in June 2012.

'The repayment of our first ever sukuk bond is part of Emirates' varied financing strategy and reflects our robust financial position,' said Sheikh Ahmed bin Saeed Al Maktoum, chairman of the Emirates Group and chief executive of Emirates airline.

Emirates' initial injection of equity finance at the time of its creation 24 years ago has been supplemented by a variety of financing options, including operating leases, EU/US export credits, commercial asset-backed debt, Islamic financing, conventional bonds, as well as sukuk.

Tim Clark, Emirates' president, recently stated that the airline had traditionally used European debt to finance purchase of its fast-growing Boeing and Airbus fleet. The French banks were particularly forthcoming with finance solutions.

However, since the global debt crisis in 2008, the traditional debt markets have taken a risk averse position – even with a business like Emirates, which has an unbroken profit-making record.

Clark outlined that obtaining funding for new planes using sukuk could be tricky because Islamic finance, in addition to forbidding payment of interest, prohibits pure monetary speculation and requires deals to involve concrete assets. It would be harder to win a seal of approval from Islamic finance scholars for a sukuk that was based on assets, which the airline did not yet own.

For new aircraft, it is not impossible but it is much more complicated as the cash would have to go from investors through a special purpose vehicle to the manufacturer before a lease-back arrangement is put in place. Hence, using existing assets to obtain sukuk finance is far easier.

Emirates currently has two aircraft-based sukuk instruments that have been issued globally, and is backed by existing aircraft: a $500m issue from GE Capital in November 2009, and a $100m deal for Nomura in July 2010.

Emirates is not the only success story when it comes to the use of sukuk finance. Dubai shopping mall developer Majid Al Futtaim decided against issuing a conventional bond because of pricing concerns. It mandated its banks to set up a separate sukuk programme. Turkish Airlines has followed suit and will finance the purchase of its expanding fleet with Islamic bonds.

The sukuk market has been relatively resilient during the instability in global financial markets, which has made it more difficult for even highly rated companies around the world to issue conventional bonds. That is partly because Islamic investors in the Gulf remain cash-rich, partly due to the limited supply of sukuk, and partly since sukuk investors tend to hold the bonds until maturity. If these bonds are not being sold on to other investors, there is little or no chance of the bond value fluctuating.

Recent events have shown the same is not true for conventional bonds. The influence of the credit rating agencies with their regular reassessment of government and corporate credit ratings has caused downward movement in prices. As one commentator recently stated: 'Equities are the only game in town – bonds carry more risk.'

However, the story of Dubai World, the sovereign investment fund of the Dubai royal family, gives the other side of the story when it comes to the use of Islamic finance. On 25 November 2009, the financial world was shocked when Dubai World requested a restructuring of $26bn in debts. The main concern was the delay in the repayment of the $4bn sukuk, or Islamic bond, of Dubai World's developer Nakheel, which was especially known for construction of the Dubai Palm Islands.

The Nakheel sukuk was quite a complicated instrument. It was broadly based on the aforementioned Ijarah structure. In theory, the SPV has legal ownership over the asset in this sale and leaseback arrangement. However, in this case the SPV only had a long leasehold interest for a period of 50 years. The issue is that leasehold right is not seen as a real right or property right under UAE law as applicable in Dubai. What may have seemed secure was not.

Nevertheless, the Nakheel sukuk was backed by a few additional guarantees that should have provided sukuk investors with some recourse. As such, these guarantees gave investors the confidence to invest in the sukuk. A guarantee from the state-owned parent company, which implicitly provides a government guarantee for the sukuk (despite the fact that the prospectus clearly stated otherwise), had reassured investors. This misplaced assumption misled investors in their risk–return decision on the investment.

The issue, however, did not end there; the complications worsened when the parent company that acted as guarantor found itself in a situation that made it no better placed than Nakheel to repay the sukuk. Dubai World is also just a holding company for a number of other companies beside Nakheel. However, all of Dubai World's subsidiaries have their own creditors and their own debts to service, and the important thing for Nakheel sukuk-holders is that the creditors of Dubai World, through the guarantee, are subordinated to the creditors of the subsidiaries of Dubai World.

A public statement on 30 November 2009 by the Dubai Finance Department director-general, that the Dubai World debts are 'not guaranteed by the government', appears to correctly reflect the legal position, as the Dubai government was not required by the lenders, and nor did it provide, any contractual guarantees in respect of the Dubai World debt.

As history tells us, Nakheel did not default on its Islamic bond. The well reported $10bn bailout, including providing $4.1bn to assist Nakheel directly from Dubai's rich neighbours Abu Dhabi, calmed the markets. But this was only part of the solution. Nakheel also issued new sukuk bonds to some of its creditors in lieu of amounts due to them. This was a key part of the company's restructuring.

In a prospectus attached to the new sukuk, Nakheel revealed that it wrote down the value of its property and project portfolio by almost Dh74bn (US$20.14bn) in 2009 as its fortunes flagged. The company also said it changed tactics in response to the financial crisis, forging ahead with a selection of its projects and putting others on hold.

Conclusion

The global debt crisis sent shockwaves through the financial markets and, at the time of writing this article, the western banks remain reluctant to loan cash to the business community. Islamic finance, and in particular sukuk, has to some extent filled the gap left by the traditional debt markets.

The Sharia principle on which it is based is fundamentally important and should ensure it is a safe and sensible finance option for both the company needing the finance as well as the sukuk holder. Clearly, companies like Emirates have shown the way on how to make sukuk one part of their finance portfolio.

However, the Nakheel story paints a different picture. A complicated Ijarah structure and a lack of legal clarity as to ownership of the underlying asset have clouded the water. If the Abu Dhabi bailout failed to materialize, then the story may have been significantly different.

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APPENDIX – THE BASIC PRINCIPLES OF ISLAMIC FINANCE

The Islamic economic model has developed over time based on the rulings of Sharia on commercial and financial transactions. The Islamic finance framework is based on:

- equity, such that all parties involved in a transaction can make informed decisions without being misled or cheated
- pursuing personal economic gain but without entering into those transactions that are forbidden (for example, transactions involving alcohol, pork-related products, armaments, gambling and other socially detrimental activities). Also, speculation is also prohibited (so options and futures are ruled out)
- the strict prohibition of interest (riba = excess).

As stated above, earning interest (riba) is not allowed.

In an Islamic bank, the money provided in the form of deposits is not loaned, but is instead channeled into an underlying investment activity, which will earn profit. The depositor is rewarded by a share in that profit, after a management fee is deducted by the bank.

A typical illustration would be how an Islamic bank may purchase a property from a seller and resell it to a buyer at a profit. The buyer will be allowed to pay in instalments. Compare this to a typical mortgage where the bank lends money to the buyer and charges interest.

Hence, returns are made from cash returns from a productive source – for example, profits from selling assets or allowing the use of an asset (rent).

In Islamic banking there are broadly two categories of financing techniques:

- ‘fixed Income’ modes of finance – murabaha, ijara, sukuk
- equity modes of finance – mudaraba, musharaka.

FIXED INCOME MODES

(a) Murabaha

Murabaha is a form of trade credit or loan. The key distinction between a murabaha and a loan is that, with a murabaha, the bank will take actual constructive or physical ownership of the asset. The asset is then sold to the ‘borrower’ or ‘buyer’ for a profit but they are allowed to pay the bank over a set number of instalments.

The period of the repayments could be extended, but no penalities or additional mark-up may be added by the bank. Early payment discounts are not within the contract.

(b) Ijara
Ijara is the equivalent of lease finance. It is defined as when the use of the underlying asset or service is transferred for consideration. Under this concept, the bank makes available to the customer the use of assets or equipment such as plant or motor vehicles for a fixed period and price. Some of the specifications of an Ijara contact include:

- the use of the leased asset must be specified in the contract
- the lessor (the bank) is responsible for the major maintenance of the underlying assets (ownership costs)
- the lessee is held for maintaining the asset in proper order.

An Islamic lease is more like an operating lease, but the redemption features may be structured to make it similar to a finance lease.

(c) Sukuk
Companies often issue bonds to enable them to raise debt finance. The bond holder receives interest and this is paid before dividends.

This is prohibited under Islamic law. Instead, Islamic bonds (or sukuk) are linked to an underlying asset, such that a sukuk holder is a partial owner in the underlying assets and profit is linked to the performance of the underlying asset. So, for example, a sukuk holder will participate in the ownership of the company issuing the sukuk and has a right to profits (but will equally bear their share of any losses).

EQUITY MODES

(a) Mudaraba
Mudaraba is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner (who is called ‘rab ul mal’), while the management and work is an exclusive responsibility of the other (who is called ‘mudarib’).

The Mudaraba (profit sharing) is a contract, with one party providing 100% of the capital and the other party providing its specialist knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio. In a Mudaraba only the lender of the money has to take losses.

This arrangement is therefore most closely aligned with equity finance.

(b) Musharaka
Musharaka is a relationship between two or more parties that contribute capital to a business, and divide the net profit and loss pro rata. It is most closely aligned with the concept of venture capital. All providers of capital are

entitled to participate in management, but are not required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to their respective capital.