



# Islamic Finance- Market Update

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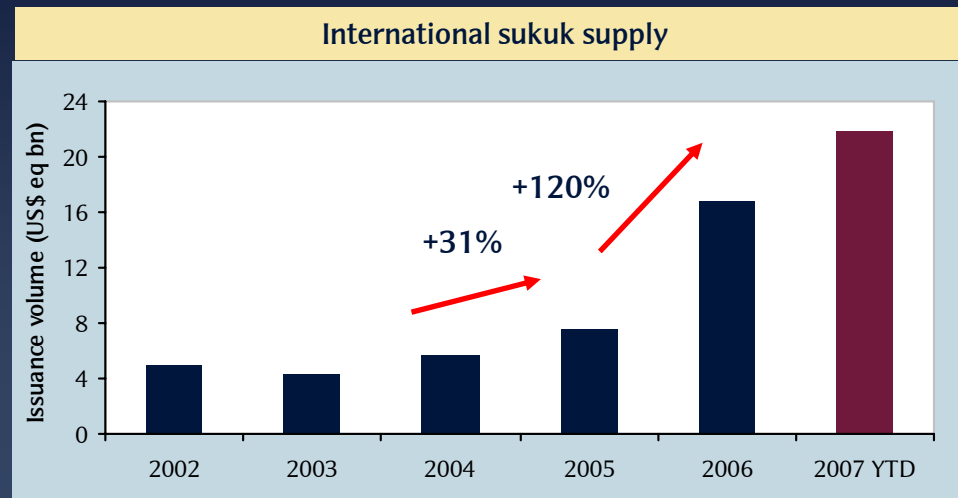
# Why Islamic Finance?

- Post Sept 11 repatriation of funds and high oil prices have led to a revival of Islamic finance
- New and alternative source of funding
  - ▶ Between \$300bn to \$1,000bn of 'Islamic' funds available for investment
- Provides clients/investors with a solution that accords with their beliefs
  - ▶ Initial interest was in predominantly Muslim countries e.g. Malaysia, Bahrain, UAE
  - ▶ Today, Islamic banks and finance houses are found in the UK (Islamic Bank of Britain) and in the US (Lariba)
- Public relations benefit
  - ▶ Particularly when doing business in Islamic countries

# The sukuk market continues to grow...

Exponential growth since 2002

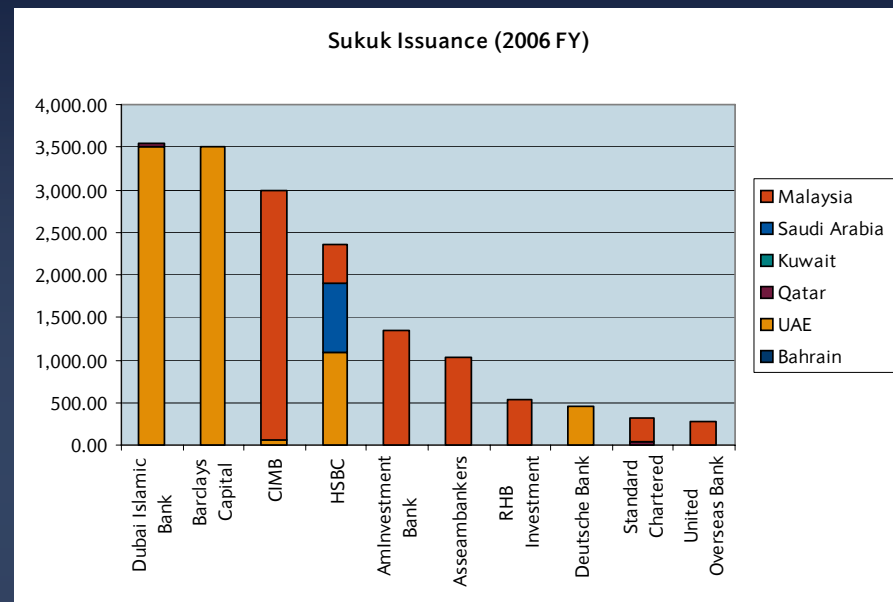
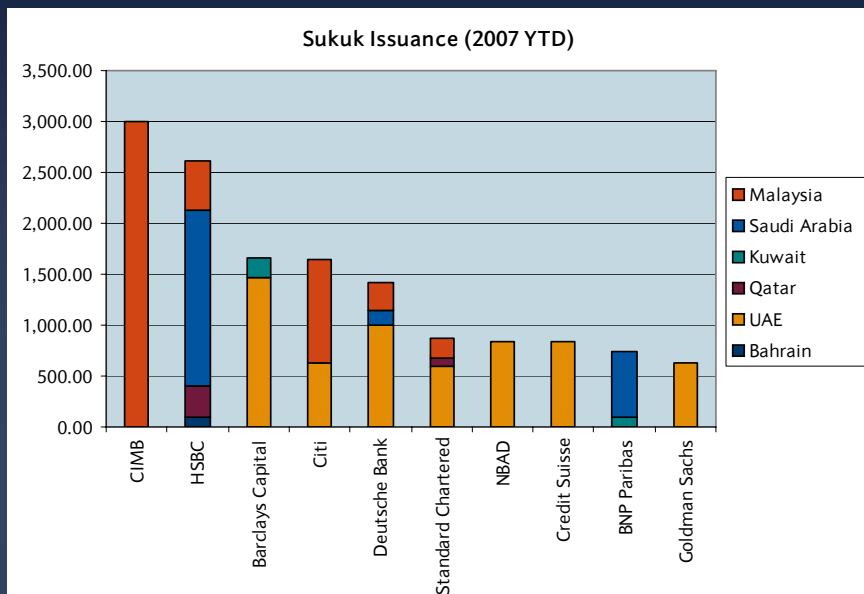
Investor sophistication and demand is growing



Source: Bloomberg, Global sukuk Issuance 26 October, 2007

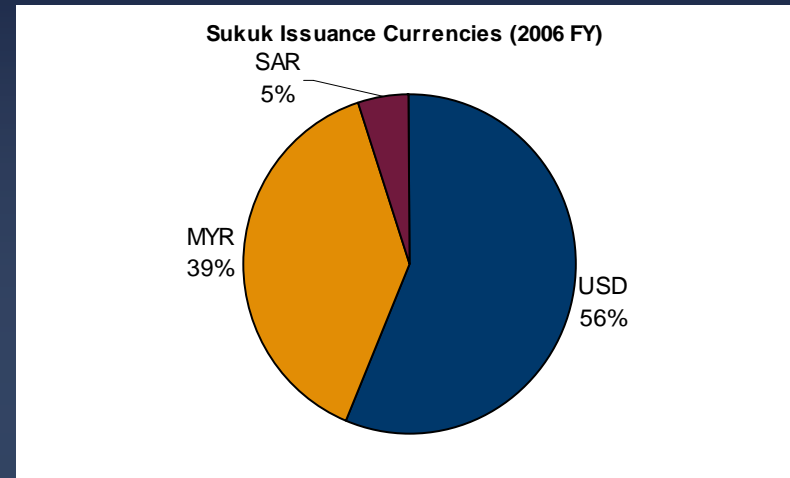
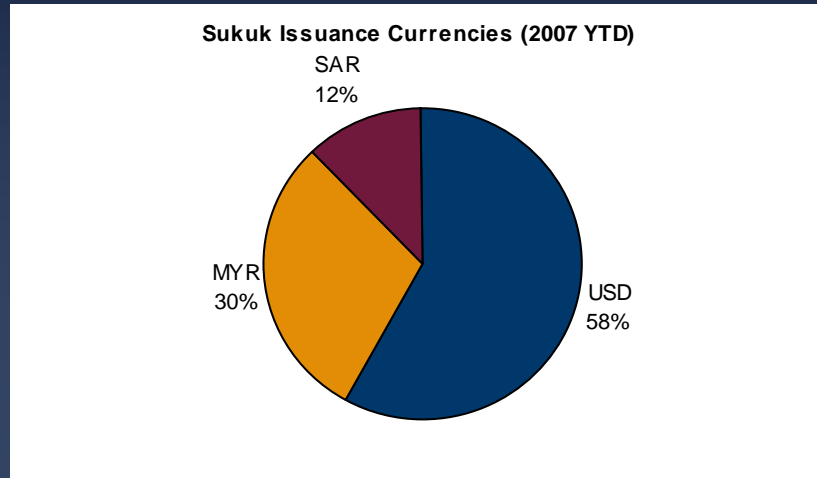
- Recent trends in the Middle East have encouraged development of the sukuk market
  - ▶ Corporate expansion, both organic and M&A
  - ▶ Increased rated sukuk issuance
  - ▶ Perceived reduction in geopolitical risk for the GCC region
- Increased investor demand has led to significant oversubscription and price tension
  - ▶ Estimated US\$ 250-300bn of Islamic funds available for investment
  - ▶ Conventional funds now form the bulk of benchmark size sukuk investors
  - ▶ More international banks active in sukuk issuance

# Sukuk issuance by Country



- 2006 issuance was dominated by UAE and Malaysia
- 2007 has seen more diversified issuance, particularly from Saudi Arabia, Kuwait and Qatar
- Turkey, Pakistan, India and Indonesia are likely to be new markets in 2008 given rumours of deals in pipe

# Sukuk issuance by Currency



- MYR likely to dominate full year 2007 issuance due to upcoming mega sukuk in Malaysia (Maxis)
- SAR growth likely to continue as more Saudi businesses tap the sukuk market

# Sukuk structures

- The table below shows the three most common Islamic structures used for Sukuk
- When properly structured, there is no economic / pricing impact from any one structure over another
- The difference for the issuer lies in the degree of flexibility allowed for use of proceeds and requirement for asset contribution

	Ijara	Musharakah	Mudarabah
Pros	<ul style="list-style-type: none"> <li>• All funds raised through the sukuk issuance can be freely utilised</li> <li>• No need to account for returns or use of funds</li> </ul>	<ul style="list-style-type: none"> <li>• Borrower would not face any restriction on the use of proceeds, for an amount equal to the value of the assets being contributed to the Musharaka.</li> </ul>	<ul style="list-style-type: none"> <li>• No need for asset contribution</li> </ul>
Cons	<ul style="list-style-type: none"> <li>• Need for asset contribution equal to the value of Sukuk being raised</li> <li>• Assets are effectively encumbered for the duration of the Sukuk issue</li> </ul>	<ul style="list-style-type: none"> <li>• Any proceeds above that amount would have to be applied per the Investment Plan to generate periodic returns to Sukuk holders</li> <li>• Need for asset contribution by borrower, but less than an Ijara</li> </ul>	<ul style="list-style-type: none"> <li>• Funds of the Mudarabah must be applied per the investment plan</li> <li>• Need to account for returns and use of funds</li> </ul>

# Historically, sukuk have been issued using Ijara (sukuk 1G) and Musharaka (sukuk 2G) structures.....

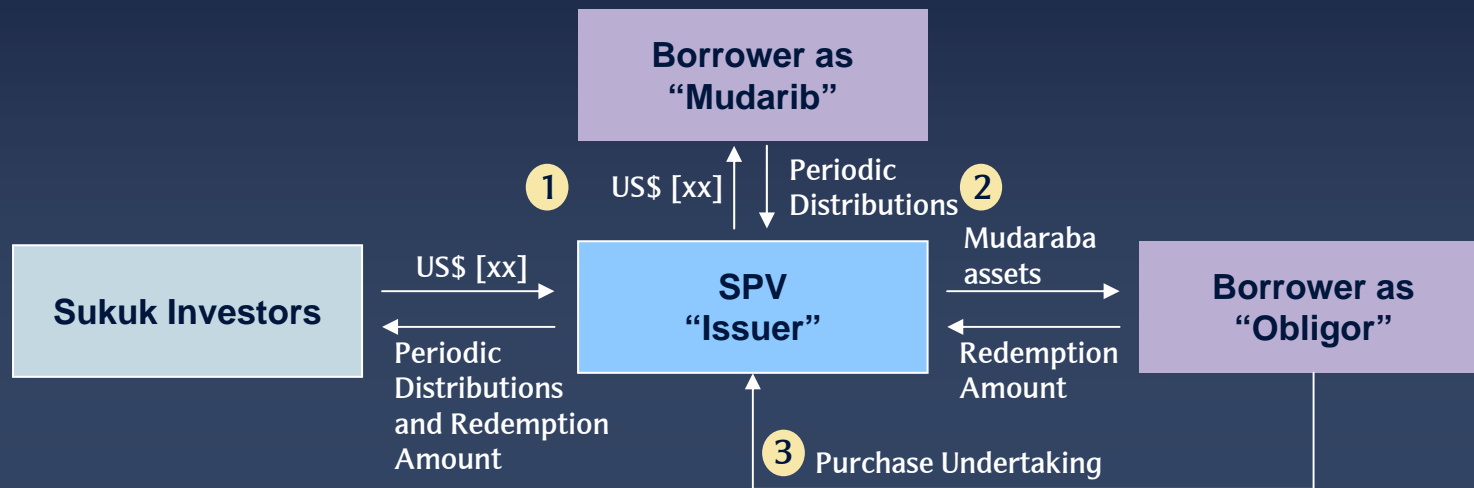
Issuer	Date	Structure	Size
Govt of Malaysia	June 2002	Ijara	US\$600m
Govt of Qatar	October 2003	Ijara	US\$700m
Dubai Global Sukuk	Nov 2004	Ijara	US\$1,000m
Wings FZCO	June 2005	Musharaka	US\$550m
PCFC Sukuk	January 2006	Musharaka	US\$3,500m
QREIC	September 2006	Musharaka	US\$270m
Nakheel Sukuk	December 2006	Ijara	US\$3,520m

# However, these structures had disadvantages.....

- In an Ijara (leasing) sukuk, there is a need to transfer title to underlying assets equal to the sukuk value from the Obligor to the sukuk holders
- In a Musharaka (joint investment partnership) sukuk, there is a need for a partial transfer of title to underlying assets from the Obligor to the sukuk holders
- The transferred assets are encumbered for the duration of the sukuk
- In certain countries there may be adverse tax, accounting and legal implications (e.g. capital gains tax, property transfer tax etc.)
- An obligor may not have assets of sufficient value relative to the amount of sukuk being raised



# This led to the Mudaraba sukuk (sukuk 3G) being developed



Mudaraba is an investment partnership between a manager (mudarib) and provider of funds (rab ul maal)

Sukuk proceeds are invested in accordance with a sharia compliant Business Plan

Returns to sukuk holders are derived from application of the Mudaraba Assets

# Mudaraba and Equity-linked sukuk

	PCFC	Aabar	Nakheel	Aldar	IIG	Dana Gas
Location	Dubai	Abu Dhabi	Dubai	Abu Dhabi	Kuwait	Sharjah
Industry	Ports & Free Zones	Oil & Gas	Property	Property	Investment Company	Oil & Gas
Size	US\$3.5bn	US\$750m	US\$3.52bn	US\$2.53bn	US\$200m	US\$1.0bn
Launched	Jan 2006	June 2006	Dec 2006	Feb 2007	Apr 2007	Oct 2007
Structure	Musharaka	Mudaraba	Ijara	Mudaraba	Mudaraba	Mudaraba
Rated	No	No	No	No	No	No

- Globally the equity-linked market is used by corporates at all stages of development (from pre-IPO to long established corporate) and size (from tens of millions to tens of billions of dollars)
- Even at this early stage in its development the ME equity-linked sukuk market is demonstrating the same strength and diversity
- Equity linked sukuk has spurred the growth of the sukuk market

# Items for Consideration



# Legal Issues

- Why structure Islamically?

- ▶ Investor base?

- Apart from real estate/private equity and a few project finance deals, most of the large Islamic financings have had very limited participation from ‘pure’ Islamic investors

- ▶ Belief

- E.g. Islamic banks, some corporates: Al Shaya, Abdulatif Jameel

- Countries/sovereigns e.g. Malaysia, Pakistan, Bahrain, Qatar

- Government linked companies e.g. Khazanah, Nakheel, Telekom Malaysia

- ▶ Marketing and Publicity

- Importance of maintaining Shari’a compliance

- ▶ A Shari’a financing will expressly state in the relevant contracts that is it to be “construed in light of the principles of the Shari’a” (or similar). It is important to note that if the parties state that their intention in this way, the transaction must actually be Shari’a compliant – if it is not there is a risk that transaction will be declared void.

# Arul's Unscientific Take on Sharia Opinions

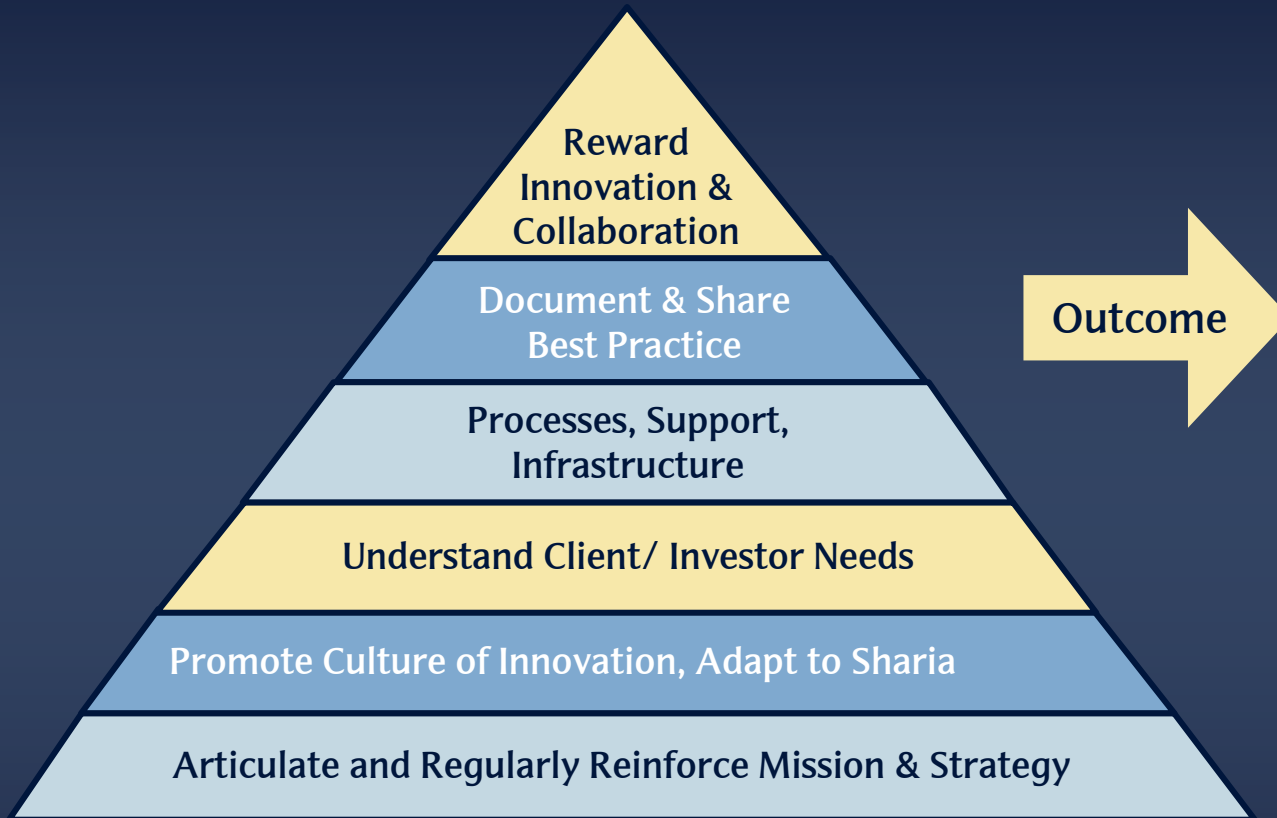
MODERN FINANCE IS WRONG. ONLY CLASSICAL CONTRACTS ARE ALLOWED

MODERN FINANCE IS OK. USE SHARIA BUILDING BLOCKS TO REPLICATE RISKS/REWARDS

IF MODERN FINANCE IS OK, THEN WHY NOT JUST USE CONVENTIONAL STRUCTURES??



# How to Promote Innovation?



- New ideas e.g. PCFC US\$3.5bn convertible sukuk with 'look back option'
- Increased profitability-first mover advantage
- Opens new products and markets e.g. convertibles/ exchangeables
- Convergence with global financial system

# Issues for Consideration

- **Lack of standardisation**
  - Of products and of documentation
  - Good progress made by ISDA/IIFM
- **Sharia Issues**
  - Need national/regional regulations to spur adoption given the stance taken by sharia boards, particularly in the Middle East
- **Accounting treatment**
  - On or off balance sheet? Form over substance?
  - Balance sheet inflation?
- **Tax, legal and regulatory treatment**
- **Complexity and unnecessary, particularly for corporates**

# Suggested Next Steps

- Greater interaction between product developers, sharia scholars, regulatory authorities, accounting bodies and standard setters
- Increase client education and awareness of Islamic alternatives
- Increase expertise of practitioners/product developers to develop creative solutions
- Explore the notion of using 'most efficient solution' even though it may not be strictly sharia compliant



# Questions & Answers