

Capital Market
Development Authority
Republic of the Maldives

Report on developing a Sukuk market in the
Republic of the Maldives

Final Report, April 2013

Contents

1.	Introduction.....	4
2.	Executive Summary.....	5
3.	Sukuk Structures in the existing legal and regulatory environment	7
	3.1 Shariah principles and Islamic finance.....	7
	3.2 Sukuk Principles.....	9
	3.3 Overview of the global Sukuk market	12
	3.4 The geographic distribution of Sukuk issuances.....	14
	3.5 Types of Sukuk issuances.....	14
	3.6 Pricing and payment profiles	27
	3.7 Sukuk case studies	28
	3.8 Assets to support Sukuk issuances	31
	3.9 Regulatory and legal issues	32
	3.10 Sukuk structures for the Maldives.....	35
	3.11 HDFC Sukuk	35
4.	Legal risk in Sukuk Structures	37
	4.1 Shariah non-compliance risk	37
	4.2 Enforceability risk	42
	4.3 Transparency and disclosure	43
	4.4 Liquidity risks.....	44
	4.5 FX risks	45
5.	Sukuk Market Supervision	46
	5.1 Shariah compliance and enforceability	46
	5.2 Mandatory disclosure	47
	5.3 Continuing obligations and enforcement powers	48
6.	Incentives to develop and sustain a Sukuk market	49
	6.1 Taxation	49
	6.2 Capital adequacy recognition	51
	6.3 Benchmark Sukuk and standard documents	51
	6.4 Grants	52
	6.5 Road shows	52
	6.6 Mutual recognition protocols.....	52
	6.7 Executive exchange programmes	53
	6.8 Sukuk guaranteed by the government	53
7.	Overcoming market constraints in the Maldives.....	55
	7.1 Website.....	55
	7.2 White paper.....	55
	7.3 Sukuk documentation.....	56
	7.4 Assistance for potential issuers	56

8. Islamic Capital Market products 57

 8.1 Profit Rate Swaps 57

 8.2 FX options and forwards 61

 8.3 Repos..... 61

9. Conclusions 63

10. Recommended action plan 64

appendix 1 Bibliography 65

appendix 2 Industry Participants 66

1. Introduction

We have been instructed by the Capital Market Development Authority of the Republic of the Maldives (the “**CMDA**”) to advise on developing a Sukuk market in the Republic of the Maldives pursuant to the RFP entitled *Request for Proposals on Consultancy Service for Sukuk Market Development* with Reference No (IUL) 179-4.3/1/2012/65.

We are pleased to present this report based on our discussions with the CMDA, interested public and private institutions in the Maldives (as listed in appendix 2), and a draft framework agreed with the CMDA.

In this report, we analyse the principles underlying Sukuk, the state of the global Sukuk market, as well as the general issues faced by Sukuk as emerging market instruments. We also look at the legal risks associated with Sukuk issuances and the steps that can be taken to supervise a Sukuk market in the Maldives. Later on, we analyse various other Islamic capital markets products.

We conclude with an exploration of the various incentives that the Maldives may employ to develop and sustain a Sukuk market and overcome potential constraints.

This report is given for the sole benefit of the CMDA and the Government of the Maldives. It may not be transmitted to or relied upon by any other person without our prior written consent.

2. Executive Summary

Whereas Sukuk are commonly described nowadays as “Islamic bonds”, this is not an accurate description. Sukuk are however instruments representing a proportionate ownership in underlying assets or usufruct, entitling the Sukukholders to a proportionate share in the proceeds of such assets or usufruct.

The classification of Sukuk as debt or equity instruments therefore depends on the nature of the assets underlying and the structure of the Sukuk. In practice, Sukuk transactions tend to be structured to have debt-like characteristics, although the Sukuk themselves do not represent a debt owed by an issuer to the Sukukholders.

The tradability of Sukuk is a key requirement in the modern Islamic financial market. Whether or not a Sukuk issuance can be traded depends on the type of assets underlying the Sukuk. There is however a difference of opinion amongst Shariah scholars as to whether Sukuk representing debt receivables can be traded at a discount to their face value.

Nonetheless, market research and recent issuances show that Sukuk al Ijara is becoming the favoured structure for Sukuk where returns for Sukukholders are generated by rent payable on a lease granted to the originator. Other structures include Sukuk al Musharakah, where returns for Sukukholders are generated by an underlying business, and Sukuk al Murabaha, where returns for Sukukholders are generated by the synthetic trading of commodities.

Most Sukuk are structured so that the periodic returns are benchmarked against a conventional index such as LIBOR. Sukuk instruments are fairly flexible and allow the periodic returns to be structured according to the needs of the originator. For example, periodic payments may be made monthly, quarterly or annually depending on the nature of the underlying assets.

Given the types of industries and infrastructure requirements that are found in the Maldives, a Sukuk issuance for example by a financial institution of its Shariah compliant business, or in relation to an infrastructure project, are some of the Sukuk structures that may be considered in the Maldives.

There are however a number of legal and regulatory obstacles to the issuance of Sukuk in the Maldives. These include the ability to use bankruptcy remote, special purpose vehicles, land transfer taxes and the recognition of trusts and beneficial ownership under local law.

Sukuk have what can be referred to as “Shariah non-compliance risk”, which can also create reputational risks for the issuer and the authorities in the Maldives. There are contractual solutions in this regard, but these can be further mitigated by legislative changes and guidelines on Shariah compliance.

The uncertainty in respect of the rights of Sukukholders could dissuade potential Sukukholders, particularly in respect of an international issuance. These concerns have resulted in a market practice where many international Sukuk are issued using offshore SPVs that benefit from bankruptcy remoteness.

The differences between Sukuk structures and conventional bonds can confuse potential investors. It is therefore important for regulators to require minimum disclosures in offering documents in order to ensure that investors are duly informed. The need for continuing compliance with Shariah also makes a regular Shariah audit of a Sukuk issuance necessary.

The liquidity of Sukuk is important for many potential investors. In a Sukuk market where there are limited issuances, it is therefore important to structure Sukuk that are tradable amongst the widest range of participants and that the relevant authorities have instruments such as Islamic repo facilities available in order to provide such liquidity.

The existing practices of the CMDA and the draft CMDA Sukuk Regulations enable it to have a framework to supervise Shariah compliance and disclosure. However, recommendations are made with regard to possible enforcement powers for the CMDA.

As a strategic objective of the CMDA, the development of a Sukuk in the Maldives can be incentivised using a number of methods. These include removing potential tax barriers and introducing tax incentives, recognising Sukukholders for the purposes of capital adequacy calculations, creating standard documents, making grants to potential issuers, holding road shows, entering into mutual recognition protocols with other states to encourage foreign listings in the Maldives, and entering into executive exchange programmes.

The progress and future plans of the CMDA may also be promoted on a bespoke website and in a white paper.

3. Sukuk Structures in the existing legal and regulatory environment

3.1 Shariah principles and Islamic finance

The term “Islamic Finance” refers generally to financings structured to comply with the principles of Islamic law (Shariah). “Shariah” is understood to mean the primary rules and principles of Islamic law, derived from two main sources:

The Quran – the sacred book of Islam that Muslims believe records the Words of God as revealed to the Prophet Mohamed.

The Sunnah – the sayings and practices of the Prophet Mohamed, as recorded in Hadith – compilations of Sunnah narrated by the Prophet’s companions.

Since the detail of Shariah can vary from the specific to the general and from the explicit to the implicit, it is subject to a secondary process of interpretation by Shariah scholars. The body of law resulting from interpreting the Quran and the Sunnah is known as Fiqh (Islamic jurisprudence). The Islamic finance industry is therefore concerned with Fiqh as opposed to Shariah, but for simplicity refers to Shariah.

The economic theory of Islam differs quite substantially from other economic theories. According to the contemporary scholar M. Umer Chapra:

"Wealth [in Islamic philosophy] does not actually belong to man. It belongs to God and its human owner is just a trustee, entrusted with it to realise the objectives of God, two of the most important of which are general human well-being and socio-economic justice."¹

Shariah principles in the context of financial transactions seek to reflect these objectives. They are quite broad and there are areas in which Shariah scholars have differences of opinion. Nonetheless, a large body of principles are generally agreed upon, thereby creating certainty for participants in the Islamic finance industry.

The prohibition of *Riba*, or interest, is perhaps the most well-known Shariah principle relating to financial transactions. The prohibition of Riba in Shariah is absolute and applies equally to those to who receive it, those who pay it as well as the draftsman of and/or witness to the contract that gives rise to its obligation.

Other Shariah principles relevant to financial transactions include the following:

- (A) Hoarding - the Islamic economy encourages the free flow of capital, hence the prohibition on hoarding in Shariah.
- (B) *Maysir* – speculative instruments or gambling is prohibited under Shariah.

¹ M. Umer Chapra, *Towards a Just Monetary System*

- (C) *Gharar* – uncertainty or ambiguity as to the terms or subject matter of a transaction can make a contract invalid under Shariah.
- (D) *Haram* (prohibited) goods and services - Investments in activities or assets that are contrary to the ethical norms of Shariah such as arms, alcohol, pork, pornography, gambling institutions and conventional financial institutions etc. are prohibited.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), established in 1990, publish Shariah Standards on the main products and principles in Islamic finance and which have been agreed upon by many of the leading contemporary Shariah scholars specialising in Islamic finance. The AAOIFI Shariah Standards are increasingly used as a benchmark by the Islamic finance industry.

The current Islamic finance industry can be characterised by an emphasis on contracts. Shariah recognises a number of different types of contracts that are permissible for financial transactions. These contracts can be applied or combined in a number of different ways in order to create a financial transaction. The different contracts that are relevant for the purposes of this report are as follows:

Ijara – a lease contract of specified assets for a specified time and for a specified rent.

Istisna – a contract for the manufacture of a specified asset in accordance with the buyer's specification, with delivery on a specified date for a specified and fixed price.

Mudaraba – a limited partnership where one partner (the Rab al Maal) provides the other (the Mudarib) with assets or property to be managed by the Mudarib. The profits are shared between the Rab al Maal and the Mudarib as per their agreement but losses are borne by the Rab al Maal in the absence of any breach of terms, negligence or fraud by the Mudarib.

Murabaha – a contract for the sale of assets where delivery of the assets is immediate and the cost to the seller is disclosed to the purchaser, thereby disclosing the profit of the seller. These contracts typically provide that the purchaser is to pay the sale price on a deferred basis and are therefore a type of credit facility (also referred to as Bai Bithaman Ajil (deferred payment sale) in some countries because of the deferred payment).

Musharakah – a partnership where the profits can be shared as per their agreement but losses must be borne in proportion to their respective capital contributions. There are two general types of Musharakah:

- (a) *Shirkat al Aqd* – a contractual partnership; and
- (a) *Shirkat al Milk* – a partnership of co-ownership in a tangible asset.

Salam – a contract for the sale of assets where delivery of the assets is deferred but the payment of the purchase price is immediate.

Wakala - an agency contract whereby the principal (the Muwakkil) appoints another (the Wakil) as their agent to manage assets or property on behalf of the Muwakkil.

The characterisation of the above contracts as debt or equity from a Shariah perspective is as follows:

Debt	Equity
Murabaha	Musharakah
Ijara	Mudaraba
Istisna	Wakala
Salam	

3.2 Sukuk Principles

Whereas Sukuk are commonly described nowadays as “Islamic bonds”, this is not an accurate description. Essential to an understanding of the concept of Sukuk is an appreciation of how Islamic finance differs from conventional finance.

A number of industry practitioners describe the distinction between Islamic and conventional finance as follows:

- (A) Under a conventional loan, money is lent to a borrower, who pays the lender the principal amount of the loan at a later date. In the meantime, the borrower pays the lender interest on the outstanding amount of principal.
- (B) Under an Islamic financing, the “lender” provides goods and/or services to the obligor. The return earned by the lender depends on the arrangement it has as the provider of such goods and/or services has with the obligor. For example, the obligor may pay to the provider a purchase price where they have purchased goods under a Murabaha contract, rent where they have entered into an Ijara contract, or a share in profits generated by a specified business in a Musharakah contract.

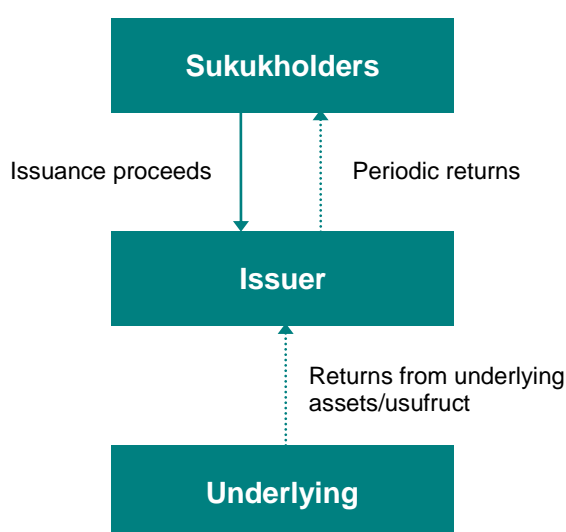
This distinction helps to clarify why Sukuk are not necessarily “Islamic bonds”. There are many different types of bonds, but the most basic version is the issuance of a debt instrument by an issuer who is contractually obliged to pay the holder of that instrument, on certain dates, interest and principal.

Sukuk (written in Arabic as صكوك and a plural of Sakk, written as صك) are however instruments representing a proportionate ownership in underlying assets or usufructs, entitling the holders of such instruments to a proportionate share in the proceeds of such assets or usufructs.

AAOIFI defines Sukuk as follows:

“certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity,”²

The classification of Sukuk as debt or equity instruments therefore depends on the nature of the assets underlying the Sukuk. For example, a Sukuk issuance may be characterised as an equity instrument where the underlying assets of the Sukuk are a business (*Sukuk al Musharakah*). In contrast, a Sukuk issuance may be characterised as a debt instrument where the underlying assets of the Sukuk are receivables from deferred payment contracts (*Sukuk al Murabaha*).



In practice, Sukuk tend to be structured to have debt-like characteristics. Nonetheless, the AAOIFI Shariah Standards state that the Sukuk certificates themselves do not represent a debt owned by an issuer to the Sukukholder.³

The different types of Sukuk structures are examined in more detail in section 3.5 (Types of Sukuk issuances). In practice, Sukuk are identified by their underlying assets. Sukuk al Ijara are therefore Sukuk where the returns for Sukukholders are generated by an underlying Ijara (or lease). Similarly, Sukuk al Musharakah are Sukuk where the returns are generated by a Musharakah (or business partnership).

One important characteristic of Sukuk in the modern Islamic financial market is their tradability. Whether or not a Sukuk issuance can be traded depends on the type of assets underlying the Sukuk. According to the majority of Islamic schools of thought, a contract for the sale of a debt receivable (*Bai al Dayn*) is prohibited unless the debt is sold for its face value. The reasoning for this is that a discounting of debt receivables would recognise the time value of money, which is effectively interest or Riba and which is prohibited under Shariah. This principle has been adopted by most Islamic financial

² Paragraph 2, Shariah Standard No. 17 on Investment Sukuk, AAOIFI Shariah Standards

³ Paragraph 4/2, Shariah Standard No. 17 on Investment Sukuk, AAOIFI Shariah Standards

institutions and their Shariah boards in the Middle East. However, some Shariah scholars following the Shafi'i school of thought believe that debt receivables can be traded at a discount to their face value.

The Malaysian authorities, which generally follow the Shafi'i school of thought, have permitted the trading of debt at a discount,⁴ and we understand that this position has also been adopted by the relevant authorities in the Maldives.

The implications of this difference in opinion are examined further in section 3.5(D) (Sukuk Al Murabaha).

Following certain controversial market practices, AAOIFI issued further Shariah standards on Sukuk in February 2008. The background to this is summarised in section 4.1(B) (AAOIFI Statement on Sukuk, February 2008). The scholars on the AAOIFI Shariah board reiterated that Sukuk representing receivables or debts cannot be traded (although not stated in the resolution, it is presumed that the prohibition applies to the trading at a discount to the face value of such Sukuk).⁵ Significantly, AAOIFI also resolved that the relevant proceeds of a Sukuk issuance should be applied in a Shariah compliant manner.⁶ We understand that a similar provision has been included in the draft Sukuk Regulations prepared by the CMDA.

We understand that, whilst Maldivians follow the Shafi'i school of thought, we noted from our discussions with a number of industry representatives in the Maldives that their Shariah boards comprise Shariah scholars from the Middle East. The relevant authorities in Malaysia also follow the Shafi'i school of thought, which has created a slight divergence in the international Islamic finance market between Shariah standards in Malaysia and that in the Middle East. For the purposes of developing products for the local market, the rulings in the Shafi'i school of thought and the market practices in Malaysia may continue to be taken into account.

Although compliance with the AAOIFI Shariah Standards is not mandatory, we would recommend that the relevant authorities in the Maldives should broadly follow AAOIFI Shariah Standards, particularly if any financial products are intended to be marketed in the Middle Eastern market.

The Islamic Financial Services Board (IFSB) also issues guidelines for regulatory and supervisory bodies. Like the AAOIFI Shariah Standards, compliance with the guidelines published by the IFSB is not mandatory. Nonetheless, the IFSB guidelines are becoming more influential since the membership of the IFSB comprises the central banks of many countries with a majority Muslim population.⁷

⁴ Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia, 2nd Edition, p.16

⁵ Second Resolution, AAOIFI Resolutions on Sukuk, February 2008

⁶ Sixth Resolution, AAOIFI Resolutions on Sukuk, February 2008

⁷ <http://www.ifsb.org/membership.php>

3.3 Overview of the global Sukuk market

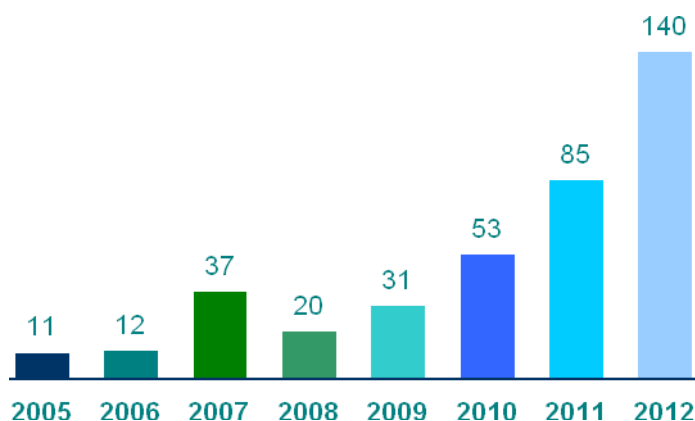
The global Sukuk market has undergone immense change in the last 10 years. Although Sukuk were widely used by Muslim traders in the Middle Ages as a form of promissory note, they have re-emerged and evolved as important financial instruments within the global Islamic financial market.

The first modern Sukuk was a USD 33m Bai Bithaman Ajil issuance in 1990 by Shell MDS Sdb Bhd in Malaysia. In subsequent years, many of the issuances and much of the evolution of Sukuk as modern financial instruments have taken place in Malaysia. Recent years have also witnessed a number of sovereign Sukuk issued by states mainly in the Middle East and South East Asia.

Sukuk are important financial instruments for a number of reasons. Sukuk are strongly demanded by investors that wish to comply with Shariah principles. Tradable Sukuk issued by rated issuers are also essential for Islamic financial institutions to enable them to manage their short-term liquidity requirements. As of very recently, Sukuk have been a cheaper means of obtaining debt for an issuer relative to syndicated borrowing.

According to Ernst & Young, it is estimated that Islamic financial institutions will require USD 400bn in short term Sukuk by 2015 for liquidity and capital management purposes.⁸

As illustrated by the diagram below, the growth of Sukuk has been exponential in recent years. The fall in issuances between 2007 and 2008 can be explained by the onset of the global financial crisis, but the reinforcement of Shariah principles by a leading Shariah scholar during this period (see analysis in section 4.1 (Shariah non-compliance risk)) was also a relevant factor.



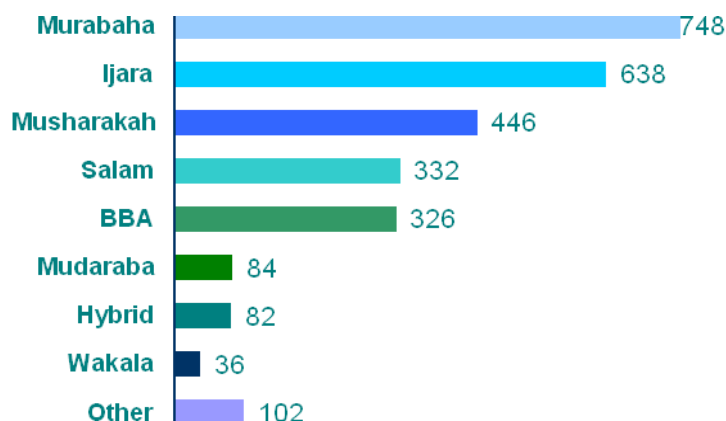
Global Sukuk Issuances (USD bn). Source: Zawya

As noted in section 3.2 (Sukuk Principles), there is a divergence in opinion between the Islamic schools of thought that are prevalent in the Middle East and that adopted by the

⁸ Ernst & Young, World Islamic Banking Competitiveness Report 2013

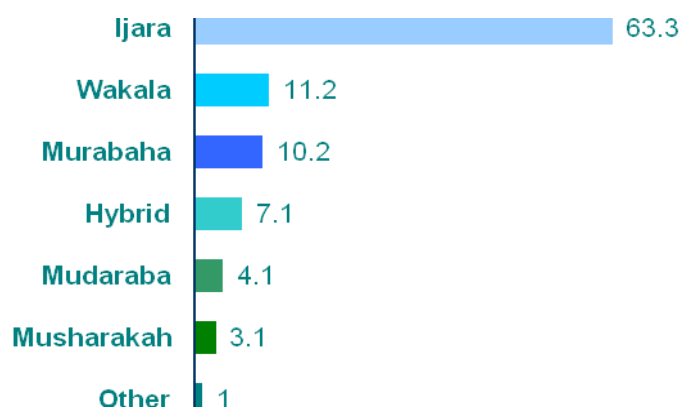
Malaysian authorities. As illustrated by the diagram below, a large number of Sukuk issuances since the 1990s have been Murabaha-based.

However, a Sukuk al Murabaha is a debt instrument that, according to Shariah scholars in the Middle East, cannot be traded other than for its face value. Sukuk al Ijara and Sukuk al Wakala issuances have therefore become more frequent in this region.



Type of Sukuk issuances (number of issuances Jan 1996 to Sept 2012). Source: Zawya

According to research by Thomson Reuters and Zawya,⁹ the majority of investors surveyed expected or preferred Sukuk structured as a Sukuk al Ijara, as illustrated by the diagram below.



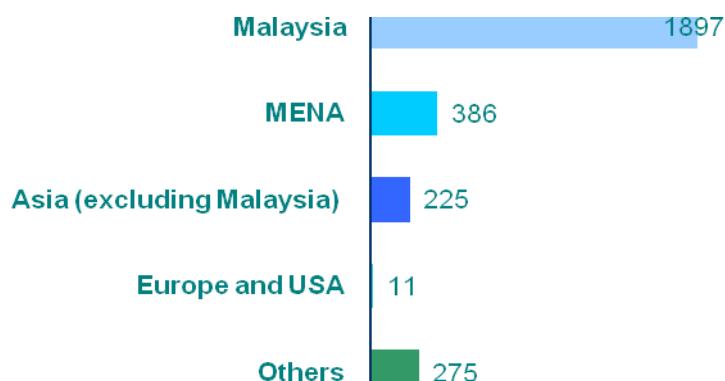
Buy-side expected / preferred structure of Sukuk issuance / investment. Source: Thomson Reuters / Zawya

The research undertaken by Thomson Reuters and Zawya is significant as it identifies Sukuk characteristics that are important to investors and arrangers. The majority of participants in the survey strongly agreed that the listing and rating of Sukuk were important for investors.

⁹ Thomson Reuters Zawya Sukuk Perceptions and Forecast Study 2013

3.4 The geographic distribution of Sukuk issuances

As noted earlier, Sukuk issuances from Malaysia have historically dominated the global Islamic finance market. As illustrated by the diagram below, issuances from Malaysia lead the market by a significant margin.



Global aggregate number of Sukuk issuances (January 1996 to September 2012).

Source: Thomson Reuters / Zawya

Nonetheless, as noted earlier, the value of Sukuk issued has grown exponentially in recent years – with much of the growth driven by debut issuances in the Middle East.

As Sukuk structures and documents become more standardised, and as sovereign issuances pave the way for domestic corporates to issue Sukuk, it is expected that the amount of Sukuk issued will increase, as will the number of issuances from other states with majority Muslim populations. Also significant will be the issuance of Sukuk from states with minority Muslim populations.

3.5 Types of Sukuk issuances

The AAOIFI Shariah Standards describe 14 different types of Sukuk as permissible. Not all of these different types have been commonly used in the public markets, and some types are unlikely to be applied in the modern Islamic finance market (for example, Musaqqa certificates, where the issuer owns land that consists of trees and the Sukukholders are responsible for paying for the irrigation of the land but are entitled to share in the produce of the trees).

In this section, we provide an overview of the main structures used in the modern Islamic finance market. Relevant to each structure are the following parties:

Originator – this is the party that requires the Sukuk proceeds and is typically the issuer in a conventional bond issuance.

Issuer – depending on the structure of the Sukuk, this is typically a special purpose vehicle (an SPV) incorporated specifically for the purpose of the Sukuk issuance.

Sukukholders – these are the investors in the Sukuk.

For each of the structures outlined below, the Issuer would typically publish an offering document like a conventional bond issuance.

As noted earlier, it is the practice of the Islamic finance market to classify Sukuk by reference to the assets underlying the Sukuk.

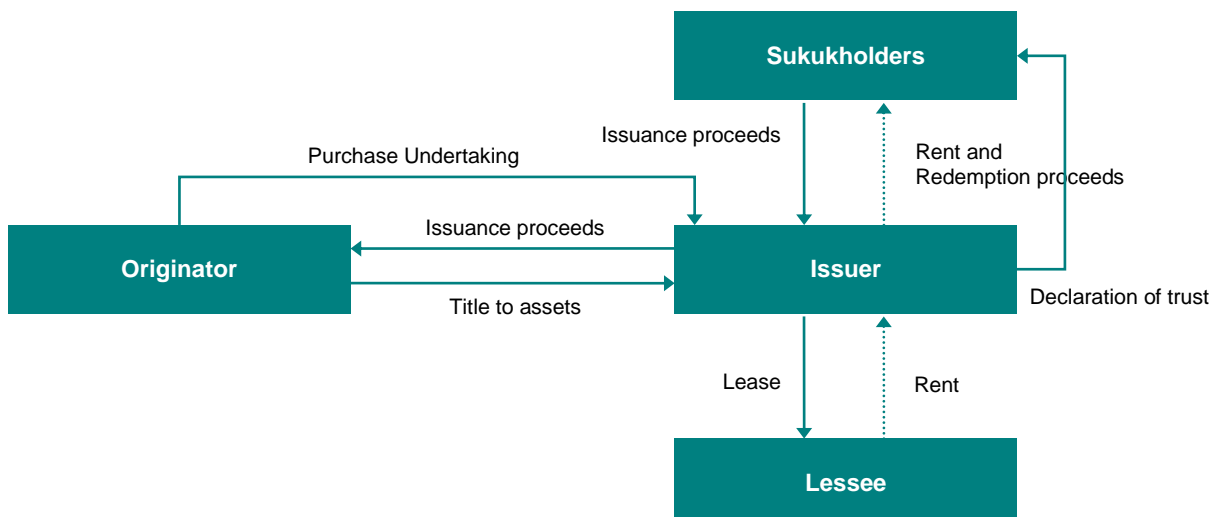
(A) Sukuk al Ijara

The returns for Sukukholders from a Sukuk al Ijara are generated by rent payable on an Ijara. Typically, the Originator would have an existing pool of assets that it would sell to the Issuer then lease those assets back from the Issuer.

The most important steps for the issuance of a Sukuk al Ijara are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Originator sells certain assets to the Issuer. The Issuer pays for the assets using the issuance proceeds.
- (3) The Issuer holds title to the assets on trust for the Sukukholders.
- (4) The Issuer leases the assets back to the Originator for a fixed period of time and for a rent. The rent payable by the Originator under the lease are distributed by the Issuer to the Sukukholders as a periodic return under the Sukuk.
- (5) The Originator promises to purchase title to the assets from the Issuer at maturity or following the occurrence of an event of default. The price payable by the Originator represents the redemption proceeds.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Ijara are as follows:

- (a) A Sale and Purchase Agreement between the Originator as seller and the Issuer as purchaser, pursuant to which the Originator would sell assets to the Issuer in return for the issuance proceeds.
- (b) An Ijara (lease) Agreement between the Issuer as lessor and the Originator as lessee, pursuant to which the Originator leases the assets from the Issuer for a specified term and for a specified rent. The rent may comprise two elements:
 - (i) Fixed Rent, representing an instalment payment of the issuance proceeds
 - (ii) Variable Rent, representing a margin on the balance of the issuance proceeds, invariably linked to a conventional index (e.g. LIBOR)
- (c) A Service Agency Agreement between Issuer as principal and the Originator as service agent. Under Shariah, the owner of an asset is responsible for major maintenance, structural repair and insurance of the asset. In practice, the owner of an asset in an Ijara agreement would appoint the lessee as its service agent to undertake major maintenance, structural repair and insurance on its behalf. The costs of these responsibilities would be added to the rent payable by the lessee under the Ijara agreement and would be set off against amounts payable by the principal under the Service Agency Agreement.
- (d) A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the relevant Ijara assets from the Issuer for an amount equal to the outstanding Fixed Rent (representing the redemption proceeds for the Sukukholders) upon the occurrence of an event of default.
- (e) A Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell the relevant Ijara assets to the Originator for an amount equal to the outstanding Fixed Rent at or prior to the relevant maturity date.

Although the typical payment terms under an Ijara mirror conventional debt payments, and the payment obligations of the Originator under the Purchase Undertaking can be characterised as a debt, a Sukuk al Ijara can be traded other than at face value according to all the main Islamic schools of thought. This is an important factor behind why issuers in the Middle East tend to favour Sukuk al Ijara.

Sukuk al Ijara are typically treated as debt instruments for accounting purposes.

(B) Sukuk al Musharakah

The returns for Sukukholders from a Sukuk al Musharakah are generated by an underlying business. They are no longer common following a pronouncement by AAOIFI in 2008 (see section 4.1(B) (AAOIFI Statement on Sukuk, February 2008)). As noted earlier, there are two types of Musharakah: a Shirkat al Aqd (a contractual partnership) and a Shirkat al Milk (a partnership of co-ownership in a tangible asset).

Summarised below are the principal steps for the issuance of a Sukuk al Musharakah based on Shirkat al Aqd:

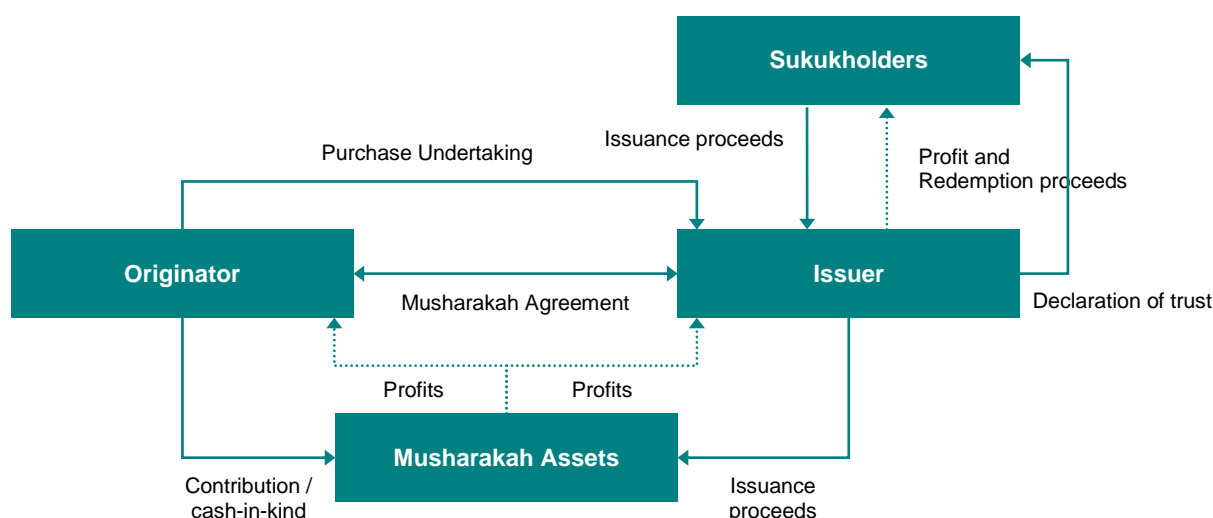
- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer enters into a Musharakah with the Originator. The Issuer contributes the issuance proceeds into the Musharakah and the Originator contributes its own cash (together, the Musharakah Assets), and each receive units in a specified business in proportion to their respective capital contributions.
- (3) The Issuer declares a trust over its share in the Musharakah Assets in favour of the Sukukholders.
- (4) On each agreed distribution date, the Originator pays to the Issuer an agreed percentage of expected profits generated by the Musharakah Assets. Losses are borne by the Originator and the Issuer in proportion to their respective capital contribution to the Musharakah Assets.
- (5) The Originator promises to purchase the Issuer's share of the Musharakah Assets at maturity or following the occurrence of an event of default. The price payable by the Originator for the Issuer's share of the Musharakah Assets has been subject to some controversy. Prior to the announcement by AAOIFI in 2008 (see section 4.1(B) (AAOIFI Statement on Sukuk, February 2008)), it was common to see in such issuances that the amount payable by the Originator was equal to the value of the original issuance proceeds.

However, the conservative position under Shariah is that the price payable by the Originator cannot be fixed in this way (unless the Musharakah was a Shirkat al Milk), and the price payable would be the market value of the relevant share in the Musharakah Assets at the time of sale – which at the time may be greater or less than the issuance proceeds.

Where however the promise to purchase is granted by a third party, the price payable for the Issuer’s share in the Musharakah Assets may be equal to the value of the original issuance proceeds.

The ability to redeem the Musharakah Assets for a fixed price enabled Sukuk al Musharakah to be characterised as debt instruments. However, as a result of reverting to the Shariah principle that the Musharakah Assets must be redeemed for their market value at the time of sale, they are now characterised as equity instruments.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Musharakah are as follows:

- (a) A Musharakah Agreement between the Originator and the Issuer, pursuant to which they agree to create a Musharakah, contribute to the assets of the Musharakah and agree the distribution of profits and losses.
- (b) A Management Agreement between the Originator and the Issuer, pursuant to which the Issuer appoints the Originator to manage the Musharakah Assets.
- (c) A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer’s share in the Musharakah Assets (representing the redemption proceeds for the Sukukholders) upon the occurrence of an event of default.
- (d) Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell its share in the Musharakah Assets at or prior to the relevant maturity date.

Sukuk al Musharakah would typically be treated as debt instruments for accounting purposes prior to AAOIFI’s statement on Sukuk in 2008. However, in the absence

of a purchase undertaking where the amount payable is equal to the value of the original issuance proceeds, Sukuk al Musharakah are more likely to be treated as equity instruments for accounting purposes.

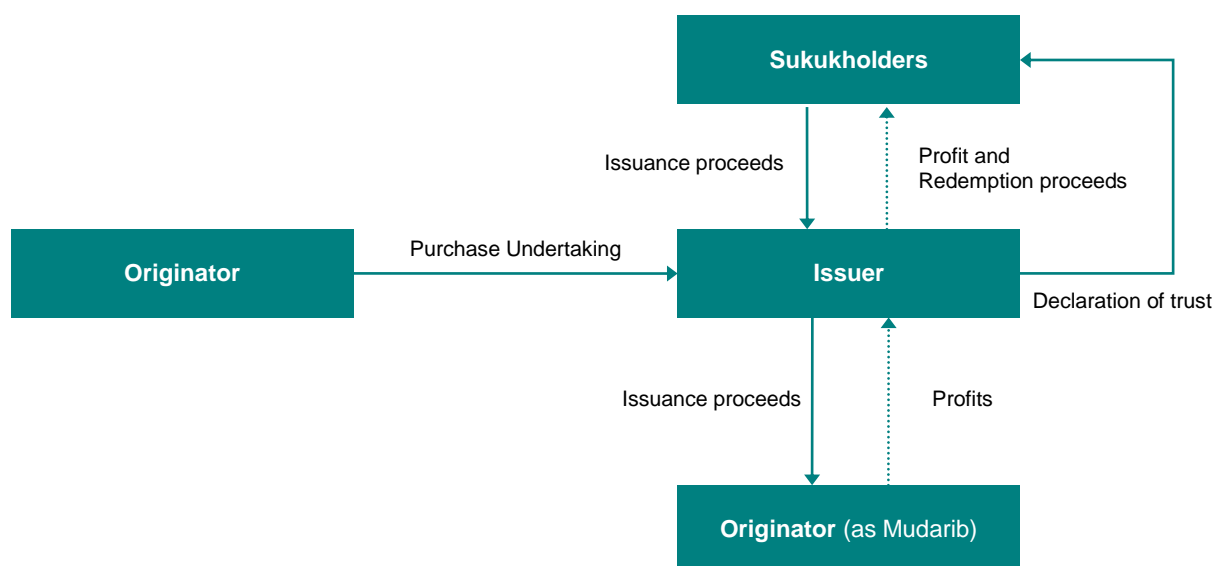
(C) Sukuk al Mudaraba

Similar to a Sukuk al Musharakah, returns for Sukukholders from a Sukuk al Mudaraba are generated by an underlying business managed by a Mudarib. The principal steps for the issuance of a Sukuk al Mudaraba are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer (as Rab al Maal) appoints the Originator as Mudarib. The Issuer contributes the issuance proceeds as the capital of the Mudaraba which will be managed by the Originator in a specified manner.
- (3) The Issuer declares a trust over its interest in the Mudaraba in favour of the Sukukholders.
- (4) On each agreed distribution date, the profits from the Mudaraba are shared between the Originator and the Issuer in agreed percentages based on their respective capital contributions. The Originator as Mudarib is however typically entitled to all profits in excess of a specified rate of return as an incentive.
- (5) The Originator promises to purchase the Issuer's interest in the Mudaraba at maturity or following the occurrence of an event of default.

As with Sukuk al Musharakah, the price that is payable by the Originator for the Issuer's interest has been clarified by AAOIFI. Whereas previously it was common to see that the amount payable was fixed at the value of the issuance proceeds, following AAOIFI's pronouncement in 2008 it was clarified that the price payable should be the market value of the Issuer's interest in the Mudaraba at the time of sale. As with Sukuk al Musharakah, where the promise to purchase is granted by a third party, the price payable for the Issuer's interest in the Musharakah Assets may be equal to the value of the issuance proceeds.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Mudaraba are as follows:

- (a) A Mudaraba Agreement between the Originator and the Issuer, pursuant to which Issuer as Rab al Maal appoints the Originator to act as Mudarib and contributes issuance proceeds to the Mudaraba.
- (b) A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer's interest in the Mudaraba (representing the redemption proceeds for the Sukukholders) upon the occurrence of an event of default.

As with Sukuk al Musharakah, Sukuk al Mudaraba would be typically treated as debt instruments for accounting purposes prior to AAOIFI's statement on Sukuk in 2008. Without a purchase undertaking where the amount payable is equal to the value of the original issuance proceeds, Sukuk al Mudaraba are more likely to be treated as equity instruments for accounting purposes.

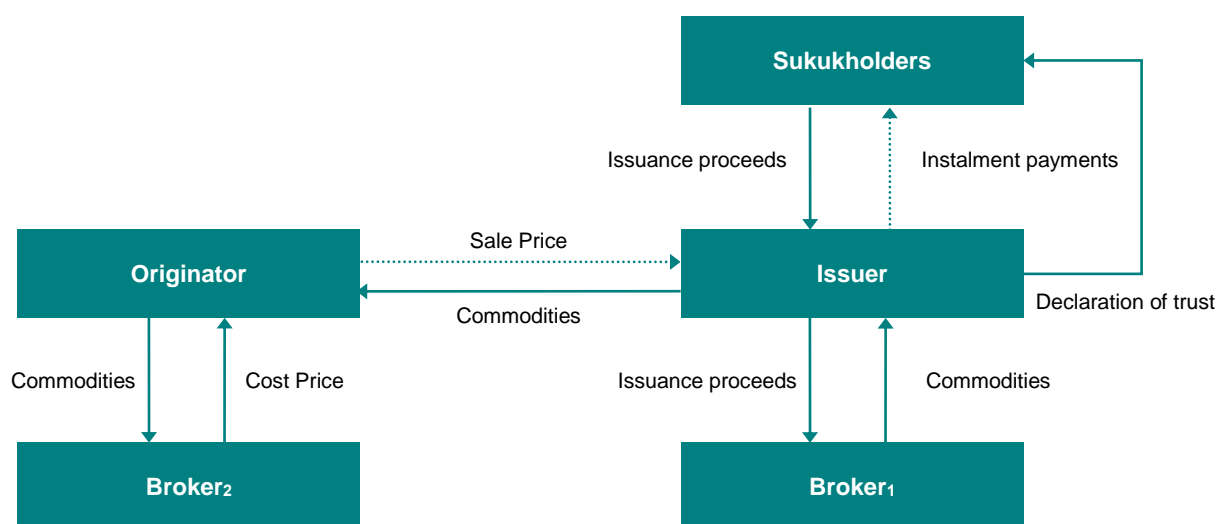
(D) Sukuk Al Murabaha

The returns for Sukukholders from a Sukuk al Murabaha are generated by the synthetic trading of commodities. The principal steps for the issuance of a Sukuk al Murabaha are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer uses the issuance proceeds to purchase a specified quantity of commodities. The commodities are typically metals other than gold or silver.

- (3) The Issuer enters into a Murabaha Agreement with the Originator to sell such commodities for spot delivery but at a higher price with a fixed profit margin (the Sale Price) on deferred payment terms.
- (4) The Originator on-sells the commodities that it has purchased from the Issuer to another broker to realise their cash value (the Cost Price), which is invariably the same amount as the issuance proceeds.
- (5) The Originator pays the Sale Price to the Issuer in instalments on each agreed distribution date.
- (6) The Issuer declares a trust over its interest in the receivables under the Murabaha Agreement in favour of the Sukukholders.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Murabaha are as follows:

- (a) A Commodity Purchase Agreement between the Issuer as purchaser and a commodity broker as seller, pursuant to which the Issuer may purchase commodities from the commodity broker using the issuance proceeds from time to time.
- (b) A Murabaha Agreement between the Issuer as seller and the Originator as purchaser, pursuant to which Issuer may sell the commodities that it has purchased from the commodity broker to the Originator from time to time.

The above arrangement is also known as Commodity Murabaha or Tawarruq. Although widely used in Islamic treasury, working capital and capital markets products, the arrangement is considered controversial by a number of authorities.

For example, according to the AAOIFI Shariah Standards,¹⁰ Commodity Murabaha should only be used by an Islamic financial institution where it faces a liquidity shortage that could interrupt its operations. The OIC Fiqh Academy at its session in April 2009 described it as “deception” that contained elements of Riba.¹¹ The Central Bank of Oman, in its recently published Islamic Banking Regulatory Framework, only permits Commodity Murabaha transactions in very limited situations, such as where an institution’s survival is genuinely threatened.¹²

Furthermore, as noted in section 3.2 (Sukuk Principles), the trading of debt receivables at a discount to their face value is not widely accepted under Shariah. Accordingly, Sukuk al Murabaha are viewed by Shariah scholars in the Middle East as instruments that should either be held to maturity or may only be traded at their face value without a discount or a premium. Nonetheless, such restrictions do not apply in jurisdictions such as Malaysia where Bai al Dayn is a permissible transaction. This explains why Sukuk al Murabaha tend to be issued by originators located in Malaysia.

Sukuk al Murabaha would typically be treated as debt instruments for accounting purposes.

(E) **Sukuk al Salam**

The returns for Sukukholders from a Sukuk al Salam are generated by the disposal of assets delivered to the Issuer by the Originator on agreed dates. The principal steps for the issuance of a Sukuk al Salam are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer enters into a Salam Agreement with the Originator, pursuant to which the Originator agrees to sell specified assets (the Salam Assets) to the Issuer for immediate payment but deferred delivery. The Issuer would pay the issuance proceeds to the Originator upfront as payment for the Salam Assets.
- (3) The Salam Assets would be delivered periodically, with dates aligned with periodic payments dates applicable to the Sukuk issuance. The periodic delivery of the Salam Assets would reflect a proportion of the total Salam Assets, and the balance would typically be delivered at maturity.
- (4) On each periodic payment date and at maturity, the Originator would deliver the agreed quantity of Salam Assets to the Issuer. Pursuant to a Purchase Undertaking, the Originator would buy the Salam Assets back from the Issuer

¹⁰ Paragraph 5/1, Shariah Standard No. 30 on Monetization, AAOIFI Shariah Standards

¹¹ www.isra.my/fatwas/topics/treasury/interbank/tawarruq/item/262-oic-fiqh-academy-ruled-tawarruq-impermissible-in-2009.html

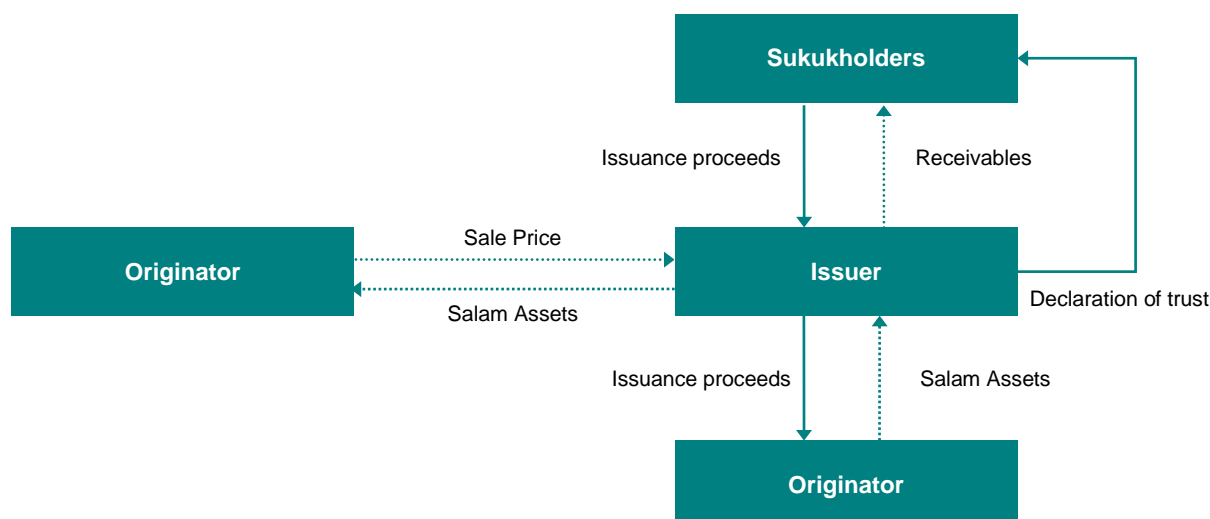
¹² Section 2.5.5, Islamic Banking Regulatory Framework, Central Bank of Oman

for a higher price (the Sale Price). The difference between the price paid by the Issuer for the Salam Assets on the issue date and the price paid by the Originator on the relevant date would be fixed and would represent the profit for the Issuer.

The buy-back arrangement by the Originator (*Bai al Inah*) is, like Bai al Dayn, not widely accepted amongst Shariah scholars. In the Middle East, the difference between the original purchase price and the subsequent sale price is considered to have elements of Riba. The Malaysian authorities have however permitted Bai al Inah.¹³

- (5) The Issuer declares a trust over its interest in the receivables under the Salam Agreement and the Purchase Undertaking in favour of the Sukukholders.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Salam are as follows:

- (a) A Salam Agreement between the Issuer as purchaser and the Originator as seller, pursuant to which the Issuer agrees to purchase Salam Assets from the Originator with the Salam Assets delivered in instalments.
- (b) A Purchase Undertaking granted by Originator in favour of the Issuer, pursuant to which the Originator agrees to purchase Salam Assets back from the Issuer on each periodic payment date, at maturity or following the occurrence of an event of default.
- (c) A Sale Undertaking granted by Issuer in favour of the Originator, pursuant to which the Issuer agrees to sell Salam Assets to the Originator following early

¹³ Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia, 2nd Edition, p.20

delivery of the Salam Assets (representing voluntary early settlement of the Sukuk) for an amount equal to the amount of issuance proceeds outstanding.

As with Sukuk al Murabaha, the Sukuk in a Sukuk al Salam represents a debt receivable. Accordingly, Sukuk al Salam cannot be traded by institutions that conform to the view that Bai al Dyan is not permissible.

Sukuk al Salam would typically be treated as debt instruments for accounting purposes.

(F) Sukuk al Istisna

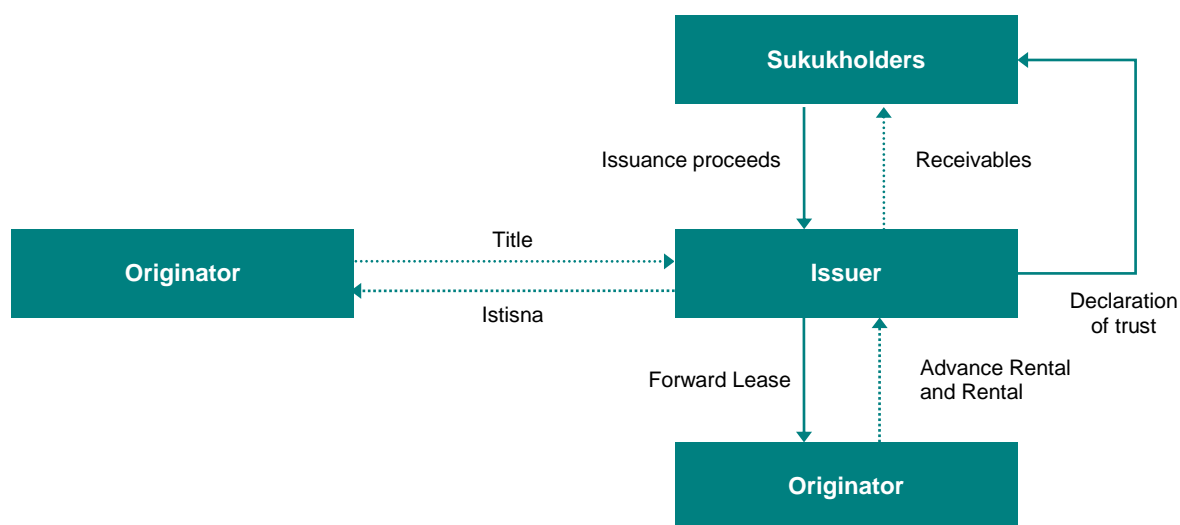
In practice, Sukuk al Istisna combine Ijara and Istisna structures and are particularly well suited for project financings. The returns for Sukukholders are generated from the Ijara structure. The principal steps for the issuance of a Sukuk al Istisna are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer enters into an Istisna with the Originator, pursuant to which the Issuer commissions the Originator to construct specified assets (the Istisna Assets) in return for the payment of the issuance proceeds to the Originator. At the end of the construction period, the Issuer receives title to the assets.
- (3) Under an Islamic forward lease (Ijarah Mawsufah fi al Dhimma) granted by the Issuer as lessor to the Originator as lessee, the Originator pays rent to the Issuer on the relevant periodic distribution dates. The rent payable under the following lease are staged as follows:
 - (a) during the construction period, the Originator pays Advance Rental to the Issuer; and
 - (b) following delivery of the assets, the Originator pays Rental to the Issuer.

Where the assets are not delivered by the anticipated completion date, it is a Shariah requirement that the Advance Rental paid by the Originator would need to be reimbursed by the Issuer. In practice, the Istisna would provide for liquidated damages so that the Originator would make a payment to the Issuer where the assets are not delivered by the anticipated completion date. The amount of liquidated damages payable by the Originator would take into account the Advance Rental that would have been returned by the Issuer to the Originator.

- (4) The Issuer declares a trust over its interest in the receivables under the Istisna and the forward lease in favour of the Sukukholders.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Istisna are as follows:

- (a) An Istisna Agreement between the Issuer and the Originator, pursuant to which the Issuer commissions the Originator to construct specified assets (the Istisna Assets).
- (b) An Ijarah Mawsufah fi al Dhimma (forward lease) Agreement between the Issuer as lessor and the Originator as lessee.
- (c) A Service Agency Agreement between Issuer as principal and the Originator as service agent (see section 3.5(A) (Sukuk al Ijara)), which applies following completion of the relevant assets under the Istisna agreement.
- (d) A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the relevant Ijara assets from the Issuer upon the occurrence of an event of default and which applies following completion of the relevant assets under the Istisna agreement.
- (e) A Sale Undertaking granted by the Issuer in favour of the Originator, pursuant to which the Issuer agrees to the sell the relevant Ijara assets to the Originator at or prior to the relevant maturity date and which applies following completion of the relevant assets under the Istisna agreement.

Sukuk al Istisna would typically be treated as debt instruments for accounting purposes.

(G) Sukuk Al Wakala

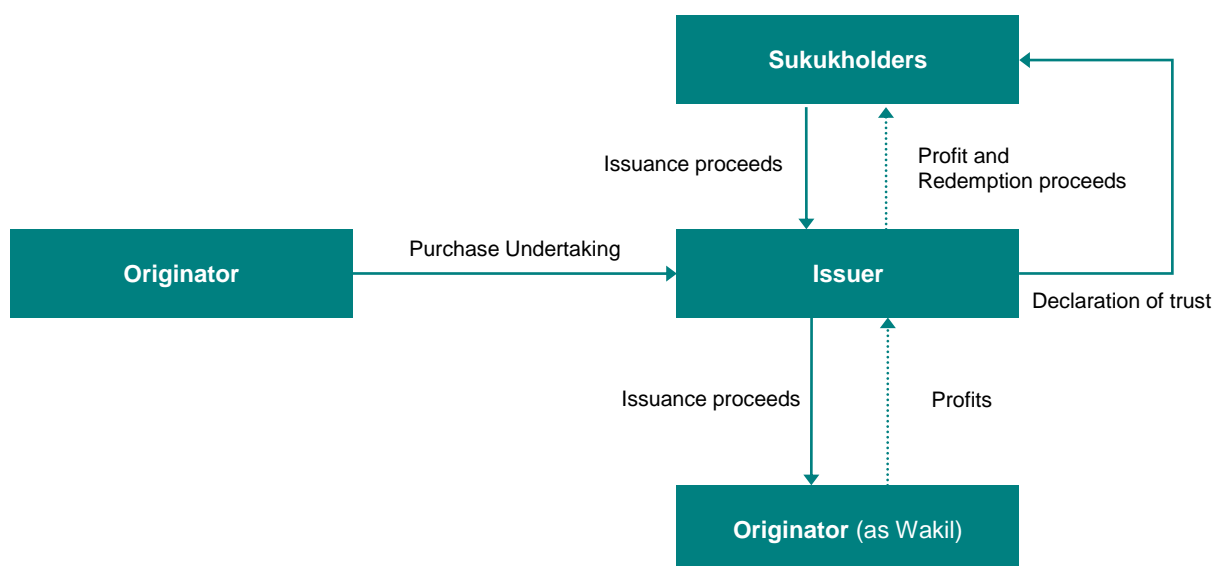
The returns for Sukukholders from a Sukuk al Wakala are generated from a specified pool of assets or investments that is managed by a Wakil. A Sukuk al Wakala is similar to Sukuk al Mudaraba, with the key distinguishing factor being the way in which the Wakil is remunerated. The principal steps for the issuance of a Sukuk al Wakala are as follows:

- (1) The Issuer issues Sukuk certificates to Sukukholders.
- (2) The Issuer (as Muwakkil) appoints the Originator (as Wakil) to invest the issuance proceeds on behalf of the Issuer in a pool of assets or investments within specified parameters.

The assets of the Wakala would typically comprise a mixture of equity and debt instruments.

- (3) The Issuer declares a trust over its interest in the assets of the Wakala in favour of the Sukukholders.
- (4) The Issuer will have agreed with the Wakil that, on each agreed distribution date, any profits up to an agreed rate will be paid to the Issuer (for distribution to the Sukukholders). Any profits in excess of the agreed rate will be retained by the Wakil as an incentive.
- (5) At maturity, the cash value of the investments/ assets of the Wakala are returned to the Issuer (for distribution to the Sukukholders as redemption proceeds). In respect of some Sukuk al Wakala instruments, the Originator would grant a Purchase Undertaking in favour of the Issuer.

The above steps can be illustrated as follows:



The principal documents used in a Sukuk al Wakala are as follows:

- (a) A Wakala Agreement between the Originator and the Issuer, pursuant to which Issuer as Muwakkil appoints the Originator to act as Wakil and pays the issuance proceeds to the Wakil.
- (b) A Purchase Undertaking granted by the Originator in favour of the Issuer, pursuant to which the Originator undertakes to purchase the Issuer's interest in certain assets of the Wakala (see analysis in section 3.7(A) (Financial institutions)).

The treatment of Sukuk al Wakala for accounting purposes would depend on the composition of the assets pool of assets or investments that is managed by a Wakil. For example, where the pool of assets are comprised of mainly debt instruments, the relevant Sukuk would be treated as a debt instrument for accounting purposes.

3.6 Pricing and payment profiles

The main commercial features of a Sukuk that are considered by potential Sukukholders (not taking into account Shariah sensitivities, legal structures and tradability) tend to be the relevant credit risk, the periodic payments and the discount on the Sukuk's capital value where it is traded on a secondary market.

The periodic payment would depend on the structure of the Sukuk. For example, a Sukuk al Musharakah would generally generate returns that cannot be specified in advance.

Sukuk structured as debt instruments such as Sukuk al Ijara and Sukuk al Murabaha typically use conventional benchmarks such as LIBOR in order to determine the rent payable under the relevant lease (in a Sukuk al Ijara) or the profit mark-up under the relevant sale contract (in a Sukuk al Murabaha).

There are no restrictions under Shariah on how frequently the relevant payments are made (e.g. monthly, quarterly, semi-annually etc.) since the Sukuk can be structured in advance depending on the commercial requirements of the Originator.

We noted from our discussions with a number of industry representatives in the Maldives that the policy rate of the Maldives Monetary Authority would be a useful benchmark for pricing periodic payments under Sukuk issued in the Maldives. For Sukuk issuances by the government of the Maldives, the amounts payable under such issuances are likely to be compared to rates payable under government treasury bills.

3.7 Sukuk case studies

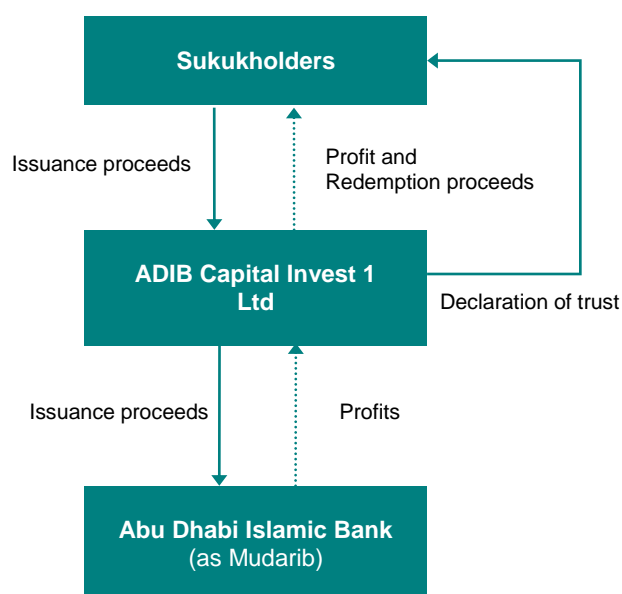
In this section, we describe several international Sukuk issuances to demonstrate how the above Sukuk structures have been adapted in practice. We have only summarised the material documents and cash flows in each case study.

(A) Financial institutions

Abu Dhabi Islamic Bank USD 1 billion Sukuk al Mudaraba, November 2012

The Issuer of the Sukuk was ADIB Capital Invest 1 Ltd, an SPV incorporated in the Cayman Islands and owned under a charitable trust.

The proceeds of the Sukuk issuance were invested in the business activities of Abu Dhabi Islamic Bank (ADIB) in accordance with an agreed investment plan. The profits will be shared between the Issuer (on behalf of the Sukukholders) and ADIB at a ratio of 90:10 respectively. ADIB is entitled to comingle its own assets with the assets of the Mudaraba.



The Mudaraba is a perpetual arrangement with no fixed end date. Subject to certain conditions, ADIB may, at its discretion, liquidate the Mudaraba following year six on any profit payment date or on other dates following the occurrence of specified events.

The subordination of Sukukholders and the conditionality of payments allows the Sukuk to act more like equity than debt. It has also allowed the Sukuk to be treated as Tier 1 capital for the purposes of the bank’s capital adequacy by the UAE Central Bank. Consequently, there has been favourable ideological support for the issuance within the Islamic finance industry. A number of Shariah scholars have indeed been calling for more equity-based products and a departure from debt-based products.

HSBC USD 5 billion Sukuk programme, May 2011

The Issuer of the Sukuk was HBME Sukuk Company Limited, an SPV incorporated in the Cayman Islands and owned under a charitable trust.

The proceeds of the Sukuk issuance were invested by the Issuer as follows:

- (a) a portion was deposited into an HSBC Amanah Mudaraba Term Investment Account; and
- (b) the remainder was applied towards the purchase of non-Mudaraba assets provided that after such application:
 - (i) at least 51 per cent. of the Sukuk assets would be Mudaraba assets, non-real estate Ijara assets and/or any other Sharia compliant assets that have associated with them underlying tangible assets; and
 - (ii) at least 25 per cent. of the non-Mudaraba Assets comprising the Sukuk assets would be non-real estate Ijara assets and/or any other Sharia-compliant assets that have associated with them underlying tangible assets.

HSBC Bank Middle East Limited, as managing agent, would collect all rental and other payments from the contracts in the trust assets and would pay the Issuer an amount sufficient to fund the periodic distribution amounts to Sukukholders on each relevant distribution date.

Pursuant to a Purchase Undertaking, HSBC Bank Middle East Limited promised to purchase by way of assignment and transfer the outstanding non-Mudaraba assets. The promise would become effective at the maturity of the Sukuk or following the occurrence of a specified dissolution event. The amount payable by HSBC Bank Middle East Limited would be determined as follows:

- (a) in the case of Murabaha assets, the outstanding face value at the relevant time;
- (b) in the case of Istisna assets, the outstanding face value at the relevant time;
- (c) in the case of a non-real estate Ijara assets, the aggregate of all unpaid and/or unamortised fixed rental payments payable by the lessee to the bank; and
- (d) in the case of any other Sharia-compliant asset, the outstanding face value at the relevant time.

Ratings agencies determined the rating of the Sukuk based on the purchase undertaking provided by HSBC Bank Middle East Limited and that Sukukholders would not be exposed to the risk of the underlying assets.

(B) Project financing

TDIC USD 1.45 billion Sukuk al Ijara, October 2009

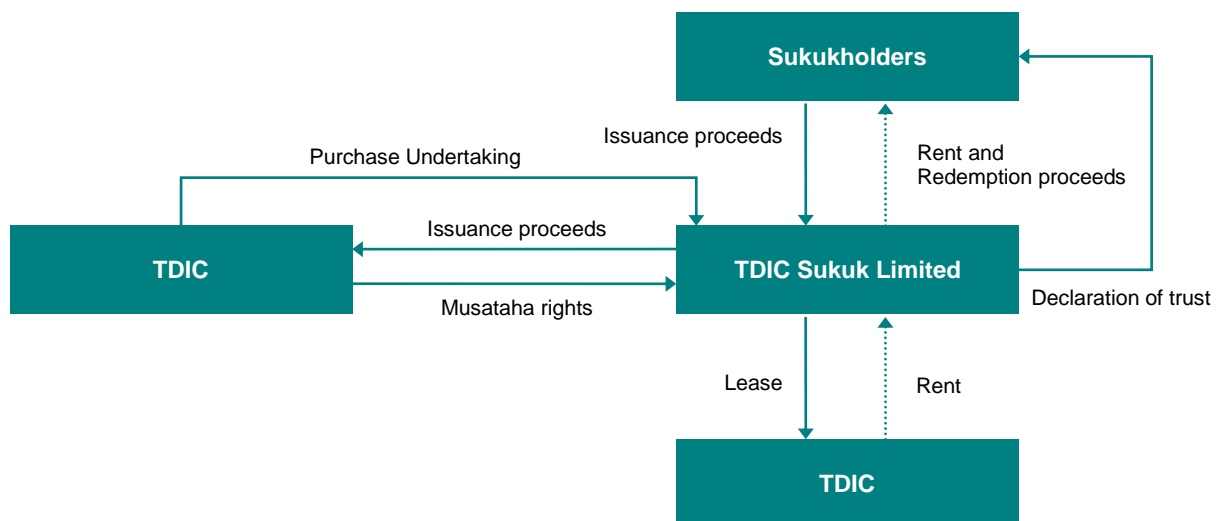
Tourism Development & Investment Company (TDIC) is a master developer of tourism destinations in Abu Dhabi, wholly owned by the government of Abu Dhabi.

The Issuer of the Sukuk was TDIC Sukuk Limited, an SPV incorporated in the Cayman Islands and owned under a charitable trust.

The proceeds of the Sukuk issuance were used by the issuer to fund the purchase of *Musataha* rights (the right to use and develop) in respect of certain land owned by TDIC. The land comprises areas in Sadiyyat Island near Abu Dhabi, renowned for being the location of the planned Guggenheim and Louvre museums.

By virtue of its acquired *Musataha* rights and under a form of lease agreement, the Issuer leased the land to TDIC. The rent payable by TDIC to the Issuer under the lease was distributed to Sukukholders.

Pursuant to a Purchase Undertaking, TDIC promised to purchase the residual value of the *Musataha* for an amount equal to, amongst other things, the aggregate of the outstanding face value of the Sukuk and all accrued but unpaid rent. The promise would become effective at the maturity of the Sukuk or following the occurrence of a specified dissolution event.



Significantly, particularly in the context of a Sukuk issuance in a developing economy, there was no system to register the *Musataha* and *Ijara* agreements with the relevant authorities in Abu Dhabi. Accordingly, they were potentially unenforceable against the rights of third parties.

Given the high profile nature of the projects and the Abu Dhabi government's history of support for government related entities, rating agencies reviewed the credit risk of TDIC under the Sukuk to be equivalent to that of the Abu Dhabi government and rated the Sukuk accordingly.¹⁴

The issuance demonstrates that, notwithstanding the uncertainty surrounding the enforceability of the contracts underlying the Sukuk in asset-based issuances, the credit risk of the Originator or any relevant guarantor will be most relevant to the rating and therefore to the market.

(C) **Sovereign Sukuk issuance**

Republic of Turkey USD 1.5 billion Sukuk al Ijara, September 2012

The Issuer of the Sukuk was Hazine Müsteşarlığı Varlık Kiralama Anonim Şirketi, a wholly owned company of the Government of Turkey and incorporated in Turkey solely for the purposes of the Sukuk issuance.

The proceeds of the Sukuk issuance were used by the issuer to fund the purchase of certain land owned by the Government of Turkey. The proceeds received by the Government of Turkey were stated to be used for its general financing purposes, which may include the repayment of debt.

Under a lease agreement, the Issuer leased the land back to the Government of Turkey. The rent payable by the Government of Turkey to the Issuer under the lease was distributed to Sukukholders.

Pursuant to a Purchase Undertaking, the Government of Turkey promised to purchase the land that is leased to it for an amount equal to, amongst other things, the aggregate of the outstanding face value of the Sukuk and all accrued but unpaid rent. The promise would become effective at the maturity of the Sukuk or following the occurrence of a specified dissolution event.

3.8 **Assets to support Sukuk issuances**

There continues to be a debate in the Islamic finance industry as to whether Sukuk are asset-based or asset-backed instruments. There is a belief that Sukuk that are asset-backed are closer to Shariah principles than Sukuk that are asset-based.

The ratings provider Moody's Investors Service has described¹⁵ a clear distinction:

- (A) Asset-backed Sukuk are Sukuk where their ratings are "primarily dependent on a risk analysis of the assets" and that the "the key securitisations elements are in

¹⁴ S&P: *Abu Dhabi's TDIC Sukuk Ltd. Assigned preliminary rating 'AA'*, 1 October 2009

¹⁵ *Shari'ah and Sukuk: A Moody's Primer*, Moody's Investors Service, 31 May 2006

place to ensure that Sukuk holders have beneficial and realisable security over the assets”.

- (B) Asset-based Sukuk are Sukuk where their ratings are “primarily dependent on the riskiness of the borrower/sponsor/originator/lessee”. The ability of the Originator to make payments under the relevant contracts of asset-based Sukuk is therefore the main consideration from a credit perspective, rather than the flow of payments from the asset itself.

It is therefore possible for Sukuk to be either asset-backed or asset-based depending on how they are structured. Most international Sukuk are structured on an asset-based basis in order to create a cash flow that is Shariah compliant.

The use of assets to generate cash flows can however create problems for Issuers. The first issue is to identify unencumbered, Shariah compliant assets that can be used to support the Sukuk issuance. Some international Sukuk al Ijara issuances have a Substitution Undertaking granted by the Issuer in favour of the Originator which allows the Originator to substitute the assets underlying the Sukuk for similar assets in scenarios such as where the original assets are no longer Shariah compliant or are subsequently encumbered.

There may be instances where an Issuer has appropriate assets but they are restricted (perhaps for legal or policy reasons) from transferring title to those assets to third parties or to companies incorporated outside of the local jurisdiction. In these circumstances, a Sukuk al Intifa or Sukuk al Manafa may be more appropriate (similar to a Sukuk al Ijara, but the underlying assets of the Sukuk are in the usufruct of an asset, such as a sub-lease).

Depending on the structure of the Sukuk issuance, such as in a Sukuk al Salam or Sukuk al Istisna, the assets delivered at maturity must conform to the agreed specification, which may be difficult to ensure in practice.

In the context of many developing economies, there may be uncertainty as to what rights the Sukukholders have in respect of assets that are provided as security for the Sukuk issuance. For example, can mortgaged properties be liquidated in practice by the relevant security trustee?

3.9 Regulatory and legal issues

(A) Special purpose vehicles and trusts

As noted earlier, many public Sukuk are issued by an Issuer that is a special purpose vehicle, often incorporated in an offshore jurisdiction.

The main benefit with the use of SPVs is that they are bankruptcy remote, meaning that the SPV would not be affected by the bankruptcy of an Originator. They also enable the effective creation of Sukuk structures such as Sukuk al Ijara and Sukuk

al Murabaha that require the creation of an obligation by the Originator pursuant to an Ijara or Murabaha contract that can be passed onto the Sukukholders using Sukuk certificates.

The Issuer in a Sukuk issuance would typically declare a trust in favour of Sukukholders in respect of the assets of the Sukuk including any receivables payable by the Originator to the Issuer and any security granted by the Originator in favour of the Issuer. The Sukukholders would accordingly have a pro rata beneficial interest in the underlying assets of the Sukuk, thereby complying with the basic requirements for a Sukuk issuance.

However, under the current law in the Maldives, the creation of local SPVs is not permissible, and the principle of beneficial ownership is not recognised in the absence of a trusts law in the Maldives.

Creditors and other investors in debt are also generally accustomed to benefitting from priority over equity investors in the bankruptcy of a company. However, we understand that under Maldivian law no distinction is made between secured and unsecured lenders in the event of a company's bankruptcy.¹⁶

These uncertainties could create difficulties for potential investors in and issuers of Sukuk. We have therefore considered alternatives for a Sukuk issuance based on the current legal environment in the Maldives.

As noted above, some Sukuk structures necessarily require the Sukuk issuance to be made by a third party issuer rather than the Originator in order to generate the relevant cash flows. An Issuer could consider an issuance using an SPV incorporated in an offshore jurisdiction. We understand that local law is silent on the usage of offshore SPVs. The SPV would typically be owned under a charitable trust and managed by a corporate trust services company.

Relative to the size of a local Sukuk issuance in the Maldives, the costs for establishing and maintaining offshore SPVs could be prohibitive. We understand that the recent Wakala Bil Istithmar papers issued by Maldives Ministry of Finance and Treasury had a ticket size of MYR 150 million. Similarly, we understand that the Sukuk al Mudaraba issued by Housing Development Financing Corporation Plc had a ticket size of MYR 50 million. However, the costs of establishing an SPV in an offshore jurisdiction can exceed USD 2,500 (approximately MYR 38,700) and the costs of maintaining that SPV can exceed USD 2,500 per annum.

Where the Maldivian government is considering a Sukuk issuance intended for international markets, the use of an SPV would be almost a necessity given the current bankruptcy laws and the lack of a trusts law in the Maldives. For a local Sukuk issuance, the certainty over bankruptcy remoteness with an offshore SPV

¹⁶ Section 91, Companies Act of the Republic of the Maldives 1996

for investors in what will be a relatively untested instrument may outweigh the potential costs of establishing and maintaining the SPV.

(B) Transfers of land

In many developing countries, there are legal restrictions on the transfer of land or real estate to non-nationals. Where a Sukuk issuance involves land, the restrictions under local law on the transfer may limit the assets that can be used for a Sukuk issuance, particularly where the Issuer is an offshore SPV and the Sukuk structure (such as a Sukuk al Ijara) requires that title to the land must be transferred from the Originator to the Issuer.

We understand that the foreign investment laws in the Maldives prohibit foreigners from purchasing land. This would have implications for Sukuk where the underlying assets include land in the Maldives, the issuer is an offshore SPV and/or such Sukuk are offered to foreign investors.

However, we also understand that land in the Maldives can be leased for up to 35 to 50 years. Sukuk tend to have tenors of 3 to 7 years (although some Sukuk have had much longer tenors). Therefore, rather than structure a Sukuk as a Sukuk al Ijara where land is transferred by the Originator to the Issuer, the Sukuk could be structured as a Sukuk al Intifa or Sukuk al Manfaa.

A Sukuk al Intifa is a certificate representing an interest in land at specific times for a specified period (i.e. a time share). Sukuk al Intifa were used in respect of the ZamZam Tower, one of the towers in the Abraaj Al Bait development in Makkah, Saudi Arabia.

A Sukuk al Manafa is similar to a Sukuk al Intifa but applies in respect of a lease (i.e. an interest in land for a specific period rather than at specific times in a specific period). The Golden Belt 1 BSC Sukuk in 2007 was structured as a Sukuk al Manafa. The underlying assets were land located in Al Khobar in Saudi Arabia which were leased to the issuer by Mr Maan Al-Sanea, a well-known Saudi businessman. Payments to Sukukholders were generated by the rent payable under a sub-lease granted by the issuer.

An Originator would not however be able to lease land to an Issuer and then take that same land on lease from the Issuer, since lease and leaseback is prohibited under Shariah unless the rent payable under both the superior and the subordinate lease are paid on a spot basis.¹⁷

A Sukuk al Manafa would therefore work as an alternative to Sukuk al Ijara in the Maldives in light of the applicable foreign ownership restrictions where the Originator and the lessee under the sublease granted by the Issuer are different entities.

¹⁷ Paragraph 3/4, Shariah Standard No. 9 on Ijara and Ijara Muntahia Bittamleek, AAOIFI Shariah Standards

3.10 Sukuk structures for the Maldives

Despite the constraints in the current regulatory and legal environment in the Maldives, there are still several Sukuk structures that are feasible. It is worth noting that the most significant constraint is the use of SPVs. As noted in the case studies in section 3.7 (Sukuk case studies), rating agencies have largely determined their rating of Sukuk based on the purchase undertakings granted by Originators in favour of the Issuer (with the Issuer typically being a bankruptcy remote SPV incorporated in an offshore jurisdiction).

In the absence of a local SPV framework, Sukuk al Mudaraba and Sukuk al Wakala could be used in the local market.

Where issuers are prepared to bear the costs of using offshore SPVs, other structures such as Sukuk al Murabaha become available for use in the local market. Because of the restrictions on foreign ownership of land in the Maldives, Sukuk al Intifa and/or Sukuk al Manafa could be used in lieu of Sukuk al Ijara in the Maldives with the use of an offshore SPV as the issuer of the relevant Sukuk and where the land is owned by a party other than the Originator.

We understand that the CMDA is considering a Sukuk structure for raising working capital for the government of the Maldives. A Sukuk al Mudaraba structure could be used for this purpose. The Abu Dhabi Islamic Bank USD 1 billion Sukuk al Mudaraba of November 2012 demonstrated that there was investor appetite for such structures – we understand that the issuance was oversubscribed by 30 times, despite its equity characterisation. The main challenge in this regard would be for government of the Maldives to identify Shariah compliant receivables that may underlie such an issuance.

A Sukuk al Murabaha may also be considered for raising working capital for the government of the Maldives, although the ability of some institutions in the Maldives to trade such instruments on the secondary market may be restricted given their alignment with the AAOIFI Shariah Standards. The tradability of Sukuk al Murabaha may not however be an issue for such institutions where they intend to hold onto such Sukuk until the maturity of such Sukuk.

3.11 HDFC Sukuk

We have reviewed the draft prospectus dated January 2013 in respect of the Sukuk al Mudaraba issued in the Maldives by Housing Development Finance Corporation Plc (HDFC).

The Sukuk is structured as a Sukuk al Mudaraba (see section 3.5(C) (Sukuk al Mudaraba)). The issuance proceeds would be used by HDFC to provide Shariah compliant home financing facilities to its customers. Sukukholders are entitled to 65% of the profits earned by HDFC from such facilities.

The prospectus is silent as to how the redemption proceeds would be determined, although it states that losses would be borne by the Sukukholders other than where the Issuer has been negligent, inefficient or in breach of the terms and conditions. In our view, the HDFC Sukuk therefore has equity characteristics.

The HDFC Sukuk will be significant as we understand that it will be listed in the Maldives and would be rated. Potential investors in the Maldives could therefore treat the issuance as a benchmark for Sukuk issuances in the Maldives. Also significant is that the Issuer is also the Originator – an SPV has not been used to issue the Sukuk and a trust has not been declared by HDFC in favour of the Sukukholders in respect of the underlying assets. These characteristics overcome the legal issues identified in section 3.9 (Regulatory and legal issues). In light of this, the HDFC Sukuk illustrates how a Sukuk can be structured in the existing regulatory and legal environment in the Maldives.

As a result of the Sukuk being characterised as an equity instrument, some potential investors more interested in a debt-like instrument may have concerns with the risks associated with equity investments. We note however that the Sukuk would be rated as having “a high degree of safety regarding timely servicing of financial obligations, in Maldives, with very low credit risk” (section 14 of the prospectus) and there is a suggestion of a government guarantee (section 19 and 20.1 of the prospectus). Such a rating and a government guarantee may help to address the concerns that some potential investors have with equity risk.

4. Legal risk in Sukuk Structures

4.1 Shariah non-compliance risk

(A) **Governing law and ultra vires**

It is market practice for Shariah-compliant institutions to have a Shariah board/committee that issues pronouncements on the conformity of the documents, transactions and processes of that institution with Shariah.

Parties to Islamic finance contracts are keen to avoid the risk of the other party arguing that the relevant agreement and transactions are not Shariah compliant, and therefore that party is not bound by its obligations under the agreement. Another risk to be avoided is having a court re-visiting the compliance of the contracts with Shariah principles after the contracts have been executed by the parties. Indeed, the uncertainty of how a court may interpret Shariah principles would be a factor deterring parties from entering into Shariah compliant contracts.

In order to mitigate against these scenarios, well-drafted Islamic finance contracts typically contain a representation by the parties that they are satisfied that the agreement conforms to Shariah and that (if required) they have obtained an appropriate pronouncement from their respective Shariah board/committee. Below is an example of such a clause:

It has entered into [this Agreement] after having reviewed [this Agreement] for the purposes of compliance with Shariah principles and with, to the extent it has considered this necessary, independent advice from advisors specialising in matters of Shariah.

It is satisfied that the provisions of [this Agreement] and the transactions contemplated thereunder do not contravene Shariah principles.

The contracts would also typically contain an undertaking from the parties not to contest the compliance of the contract with Shariah. Below is an example of such a clause:

It will not contest the validity of [this Agreement] and the transactions contemplated thereunder on the grounds of [this Agreement] and the transactions contemplated thereunder not being in compliance with Shariah principles.

We would recommend that the Shariah advisors licenced by the CMDA should be responsible for ensuring that contracts reviewed by such Shariah advisors include provisions like those suggested above.

The issue of non-compliance with Shariah was examined by the English Court of Appeal in the case of *Beximco Pharmaceuticals and others v Shamil Bank of Bahrain*.¹⁸ The obligor in a Murabaha contract argued that it was not obliged to repay its debt. The governing law of the contract was stated as follows:

“Subject to the principles of Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England.”

The obligor sought to argue that a Murabaha contract was not, in its view, compliant with Shariah and therefore it was not obliged to repay its debt.

The English Court of Appeal upheld the ruling of the lower court that Shariah was not a recognised body of law on which there was general agreement, and the court concluded that the contract was governed by English law only. The contract was therefore enforceable as drafted under English law principles. The court noted that a Shariah board had reviewed the documents in question, and that an English court would not second-guess the determination of that Shariah board. Indeed, it was noted by Justice Morison in the High Court that:

“There is clearly great controversy as to the strictness with which principles of Shariah law will be interpreted or applied. The English court, as a secular court, is not suited to ascertain or determine highly controversial principles of a religious-based law and it is unlikely that the parties would be satisfied by any such ruling; that is not what they were wanting by their choice of law clause.”

There is also a risk that a Shariah board/committee did not review the relevant agreements before they were executed but, after its review, concludes that the agreements were not compliant with Shariah. In the case of *The Investment Dar Company K.S.C.C v Blom Developments Bank S.A.L*,¹⁹ the English High Court was presented with a Wakala contract that was drafted in a way that gave rise to a clear debt obligation. The judge saw through this and noted that the contract was “an indirect practice of a non-Shariah compliant activity.” The obligor argued that the contract was not Shariah compliant and was therefore ultra vires for a Shariah compliant institution. In considering an appeal against a summary judgement, the High Court ruled that this was an arguable defence for the obligor. The case was however settled out of court and never made it to a full trial.

The risk of this scenario occurring would be mitigated where a party that is constitutionally required to comply with Shariah principles is required to provide a written pronouncement (the fatwa) from its respective Shariah board/committee prior to the agreements becoming effective.

¹⁸ [2004] EWCA Civ 19

¹⁹ [2009] EWHC 3545 (Ch)

In contrast, the Malaysian case of *Affin Bank Berhad v Zulkifli bin Abdullah* (2005) highlights how a judge can make a ruling contrary to Shariah. The case concerned the rebate payable by the bank on a fixed term contract, which at the time in Malaysia was only discretionary under Shariah. The judge considered the bank's discretion over the rebate to be irrelevant and ordered a lower amount to be payable by the customer. The case caused concern in the Malaysian Islamic finance industry as the judge's ruling conflicted with Shariah.

In the context of the Maldives, we understand that there is a concern with whether the local courts have the technical knowledge and experience to adjudicate on Islamic finance contracts. Furthermore, we understand that although the Maldives constitution takes Shariah into consideration,²⁰ there is uncertainty as to how judges in the Maldives courts may interpret Shariah.

There are however several ways in which this issue could be addressed, including the following:

- (1) Islamic finance contracts in the Maldives can reflect market practices following the ruling in the English court whereby Shariah matters are determined by a Shariah board / committee prior to executing the relevant contracts, leaving the courts to enforce the contracts as drafted.
- (2) The Central Bank of Malaysia Act 2009 states that rulings from the Shariah Advisory Council of Bank Negara Malaysia prevail over other Shariah committees and are binding on courts and arbitrators. This practice could be adopted in the Maldives whereby Shariah rulings by the CMDA's Shariah Advisory Council may be binding on courts and arbitrators in the Maldives.
- (3) The CMDA may create an arbitration board comprising experts to arbitrate on Islamic finance contracts. However, this would only be effective provided that Islamic finance contracts nominate the relevant arbitration board to resolve disputes relating to such contracts.

We understand that one proposal considered by the CMDA is whether the CMDA's Shariah Advisory Council may act as the relevant arbitration board in respect of Islamic finance contracts. However, we would recommend that the CMDA's Shariah Advisory Council's role be limited to matters of Shariah. As discussed above, any issues as to the compliance of contracts with Shariah should be resolved before the contracts are executed. An arbitration board should comprise qualified and independent arbitrators who would look to resolve commercial disputes. To the extent that there are any issues as to whether the parties to an Islamic financing performed their obligations in accordance with Shariah principles, the relevant arbitration board may refer to guidelines prepared by the CMDA's Shariah Advisory Council.

²⁰ Article 10, Constitution of the Republic of the Maldives 2008

Under Maldivian law, parties to a contract may refer disputes to arbitration.²¹ We understand that an Arbitration Bill is currently being debated in the Maldivian parliament and is expected to incorporate UNCITRAL rules. However, we also understand that the Maldives is not a signatory to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”). By not acceding to the New York Convention, international investors in Sukuk issued by Maldivian issuers may be deterred.

(B) AAOIFI Statement on Sukuk, February 2008

In November 2007, the prominent Shariah scholar and president of the AAOIFI Shariah council, Mufti Muhammad Taqi Usmani, was quoted in the media to have stated that 85% of Sukuk did not comply with Shariah.²² The quotation was not quite accurate, as he was referring to 85% of Sukuk al Musharakah (see section 3.5(B)) and Sukuk al Mudaraba (see section 3.5(C)). He was concerned with the undertakings being issued by Originators in order to fix the principal amount payable under such Sukuk. He believed that this practice was contrary to the core principles of Musharakah and Mudaraba which were meant to be equity instruments.

The reporting of Mufti Usmani’s comment lead to an almost standstill of issuances of Sukuk al Musharakah and Sukuk al Mudaraba. As noted in section 3.3 (Overview of the global Sukuk market), the value of Sukuk issued in 2008 fell, although this may be partly attributable to the onset of the global financial crisis as well as the reported comments of Mufti Usmani. Much commentary and discussion followed within the Islamic finance industry, resulting in the publication of a statement by AAOIFI in February 2008 intending to clarify its rules on Sukuk.

As a consequence of AAOIFI’s statement in February 2008, the number of Sukuk al Musharakah and Sukuk al Mudaraba issuances has receded and investors in the Middle East have since tended to favour Sukuk al Ijara issuances.

The comments of Mufti Usmani and the subsequent statement by AAOIFI were triggered by several Shariah scholars and financial advisors interpreting Shariah principles differently to the rest of the industry. Although the AAOIFI Shariah Standards are not mandatory, they are increasingly influential. The events illustrated the importance of aligning international Sukuk issuances with industry best practices, even if they are certified as compliant by qualified Shariah scholars.

(C) Goldman Sachs sukuk

In October 2011, Goldman Sachs established a Sukuk al Murabaha programme (see section 3.5(D) (Sukuk Al Murabaha)) that was approved for listing on the Irish stock exchange.

²¹ Article 18(c) The Law of Contract 1991

²² Reuters, 22 November 2007, *Most sukuk 'not Islamic', body claims*

Having differing views as to Shariah compliance is not uncommon amongst Shariah boards. However, this Sukuk al Murabaha programme attracted unusually passionate commentary from freelance journalists in the Middle East that evolved into a much wider debate over the nature of the instrument used by Goldman Sachs.

The episode illustrated how the perceived Shariah non-compliance of Sukuk issuances can lead to reputational risks, again reinforcing the need to align issuances with current industry best practices.

(D) **HDFC Sukuk**

We have reviewed the draft prospectus dated January 2013 in respect of the Sukuk al Mudaraba issued in the Maldives by Housing Development Finance Corporation Plc.

Sukuk prospectuses typically contain a number of statements regarding the compliance of the Sukuk with Shariah principles.

The prospectus for the HDFC Sukuk states that a declaration of the Shariah Advisor and an endorsement from the HDFC Shariah Committee are appended to the prospectus. Although Sukuk issuances are invariably certified as compliant with Shariah principles by a committee of specified Shariah scholars, the Sukuk prospectus would typically limit reliance by investors on such certification. Below is an example of a statement that is often included in a Sukuk prospectus in the “Risk Factors” section of the prospectus:

The Shariah advisory board of [*the arranger*] has issued a Fatwa in respect of the Certificates and the related structure and mechanisms described in the [Transaction Documents] and their compliance with Shariah principles. However, a Fatwa is only an expression of the view of the Shariah advisory board based on its experience in the subject and is not a binding opinion.

There can be no assurance as to the Shariah permissibility of the structure of the issue and the trading of the Certificates and none of the [*relevant advisors to the issuer*] makes any representation as to the same.

Sukukholders are reminded that, as with any Shariah views, differences in opinion are possible. Sukukholders are advised to obtain their own independent Shariah advice as to whether the structure meets their individual standards of compliance and make their own determination as to the future tradability of the Certificates on any secondary market.

4.2 Enforceability risk

As noted in section 3.7 (Sukuk case studies), many Sukuk are issued by SPVs incorporated in an offshore jurisdiction such as the Cayman Islands. The jurisdiction of incorporation of the SPV is an important consideration in the structuring of a Sukuk issuance. The choice of jurisdiction has largely been driven by investors that require bankruptcy protection.

A useful case study is the USD 3.5bn Sukuk al Ijara issued by Nakheel Development Limited in December 2006 (the “Nakheel Sukuk”). Nakheel is a government-related real estate developer in Dubai, famous for developing the Palm Jumeriah island in Dubai. The issuer was an SPV incorporated in the one of the free zones in Dubai, owned by a trust company located in the Cayman Islands. The obligors under the relevant lease and purchase undertakings were various members of the Nakheel group incorporated on-shore.

On 25 November 2009, the Government of Dubai announced its intention to request a standstill on the debt obligations of Dubai World, another governmental-related entity and owner of Nakheel, until at least 30 May 2010.²³ However, the Nakheel Sukuk was due to mature on 14 December 2009 and Dubai World was a guarantor of the Nakheel Sukuk. This triggered fears in financial markets that Nakheel may default on its obligations under the Nakheel Sukuk.

The issue here was the assumption by the financial markets that the Sukuk issuance was sovereign backed. However, the prospectus of the Nakheel Sukuk stated the following:

“The Government of Dubai does not guarantee any indebtedness or any other liability of Dubai World.”

Furthermore, the Nakheel Sukuk prospectus also stated that, as a holding company, Dubai World was:

“... dependent on the operations of and cash flows generated by its subsidiaries. Therefore any claim that may be made by a creditor on Dubai World will effectively be structurally subordinate to any claims made by creditors directly on Dubai World’s subsidiaries.”

Lastly, the guarantee issued by Dubai World was stated to be governed by English law. The prospectus of the Nakheel Sukuk stated the following in this regard:

“Under current Dubai law, the courts are unlikely to enforce an English judgment without re-examining the merits of the claim and may not observe the choice by the parties of English law as the governing law of the transaction”.

²³ Reuters, 25 November 2009, *Dubai World, Nakheel seek standstill in revamp, govt says*

Such a position is not uncommon in a number of developing economies. In any event, it was announced on 14 December 2009 that the Government of Abu Dhabi would provide support to the Government of Dubai, which enabled Nakheel to meet its obligations under the Nakheel Sukuk that was maturing on the same day.²⁴

Nonetheless, the enforceability of contracts and security in developing economies is a particular concern for international investors. Some commentators used the above events to question the viability of Sukuk rather than consider the situation as a credit issue. As a consequence of the above, international investors are more likely to pay attention to the enforcement risks of Sukuk and the enforceability of contracts against domestic obligors. This issue would be particularly relevant where the Maldives issues a Sukuk from a domestic company rather than an offshore SPV.

4.3 Transparency and disclosure

The enforcement risks of securities issued from developing economies are not unique to Sukuk and apply equally to conventional bonds. However, investors in Sukuk (who may not be familiar with the various Sukuk structures) have the added complexity of trying to understand the different obligations and cash flows in a Sukuk issuance. It is therefore essential that Sukuk are structured in a robust manner with a high level of disclosure in the relevant offering documentation of any risks.

There are currently no international standards on what must be disclosed in the offering documents for a Sukuk. Nonetheless, market practices have developed so that public Sukuk offering documents largely follow the same structure.

As noted earlier, potential investors in Sukuk may not be familiar with relevant differences between Sukuk and conventional bond instruments. Unless there is a material Shariah requirement to the contrary, the regulatory requirements for disclosures in a Sukuk prospectus (such as management structure of the Issuer / Originator, financial history and projections, business plan etc.) should reflect the regulatory requirements for disclosures in a conventional bond prospectus. Any differences in the applicable requirements that are not related to Shariah principles could confuse potential investors.

Although there are no international standards on the disclosure requirements specific to Sukuk, local regulators are starting to examine this area more closely. The Dubai Financial Market, one of the three stock exchanges in the United Arab Emirates, has recently started a consultation on its *Standard for Issuing, Acquiring and Trading Sukuk*. One requirement to note in the draft standard is that the Sukuk prospectus must detail the appointment of a committee of Shariah auditors, who would provide periodic reports to Sukukholders. The draft also states that the Shariah audit committee will have the right to summon Sukukholders or their representatives:

²⁴ Bloomberg, 14 December 2009, *Dubai World Gets \$10 Billion from Abu Dhabi*, Haris Anwar

“... to take the appropriate action in case of a flagrant infringement of Shari’a rules, procrastination or refusal of the project or venture manager to follow the Shari’a committee’s instructions or to remedy any violations.”

It is presumed that the draft intended to refer to the Originator rather than the Sukukholders in this context, but in any event the provision goes beyond what is market practice and “appropriate action” is a fairly ambiguous provision, the uncertainty of which may not appeal to potential issuers and investors.

Nonetheless, the continuing obligation to comply with Shariah is an important principle that is reflected in the AAOIFI Shariah Standards and reiterated in its statement on Sukuk of February 2008. We understand that the draft Sukuk Regulations prepared by the CMDA also require the Shariah advisor to continually monitor a Sukuk issuance.

We understand that one proposal considered by the CMDA is whether the CMDA should have a separate Shariah audit committee or whether this function shall fall within the scope of activity of the CMDA’s Shariah Advisory Council. This presumes that the Shariah audit would be performed by a third party other than the Shariah advisor licenced by the CMDA. According to AAOIFI²⁵ and IFSB,²⁶ the audit of compliance with Shariah principles may be undertaken internally by the relevant institution, since it is already a recommendation by AAOIFI and IFSB that the relevant Shariah advisors are independent of that institution. Whether the Shariah audit is centralised by the CMDA would be a policy determination for the CMDA. In light of the relatively undeveloped nature of the local Sukuk market, the centralisation of Shariah auditing in the Maldives could help the market to grow by standardising Shariah principles. Provided that members of the CMDA’s Shariah Advisory Council are independent in respect of a particular Sukuk issuance, it could perform the Shariah audit in respect of that Sukuk issuance. Such third party Shariah audit could also reassure retail investors that are Shariah sensitive in respect of that issuance.

However, it would be important to ensure that the Shariah Advisory Council have sufficient resources to ensure timely audits, therefore avoiding the creation of a bottleneck.

4.4 Liquidity risks

As noted in section 3.2 (Sukuk Principles), some Shariah scholars consider certain types of Sukuk (such as Sukuk al Murabaha and Sukuk al Salam) to be non-tradable because of the prohibition on Bai al Dayn. However, it was noted in section 3.3 (Overview of the global Sukuk market) that part of the appeal of Sukuk was their tradability and their use by institutions as short term liquidity instruments.

²⁵ *Governance Standard for Islamic Financial Institutions No. (4), Audit & Governance Committee for Islamic Financial Institutions, AAOIFI*

²⁶ *IFSB-10: Guiding Principles on Shari’ah Governance Systems for Institutions offering Islamic Financial Services, Islamic Financial Services Board*

We noted from a number of industry representatives in the Maldives that the liquidity of Sukuk is an important issue for them. Although we understand that the CMDA follows the practice in Malaysia of permitting Bai al Dayn, the scholars of a number of institutors in the Maldives follow the Middle East practice of considering Bai al Dayn a prohibited transaction.

The challenge in the Maldives will therefore be to structure instruments that can be traded amongst the widest range of participants.

Additionally, as there is a relatively small number of players in the market, there is likely to be a greater number of investors that will hold Sukuk to their maturity, rather than to actively trade them on a short term basis. In the event that an institutional investor needs to liquidate their holding in a Sukuk in order for them to meet an obligation to a third party, the lack of an active secondary Sukuk market may place them in a liquidity constraint.

It is therefore essential for the Maldives Monetary Authority to provide Shariah-compliant repo facilities to institutional investors in Sukuk in order to help them manage their liquidity. A possible repo structure is examined in section 8.3 (Repos).

4.5 **FX risks**

We noted from a number of industry representatives in the Maldives that the demand for local currency and US dollars denominated Sukuk varied. Whilst a benchmark, sovereign Sukuk issuance by the Maldives to fund an infrastructure project would most likely be denominated in US dollars, potential local investors such as the Zakat funds managed by the Ministry of Islamic Affairs and pension funds managed by the Maldives Pension Administration Office would require Sukuk to be denominated in Maldivian rufiyaa. We understand that the Maldivian rufiyaa floats on a managed basis, which would expose local investors in US dollar issuances to foreign currency risk. Local investors could therefore be uninterested in a US dollar international Sukuk issuance. Similarly, international investors would be reluctant to invest in Maldivian rufiyaa Sukuk issuances.

Islamic FX products are an emerging area in Islamic finance that could enable local investors to hedge themselves against the risk of investing in US dollar issuances. The products are however more suited to institutional counterparties rather than retail investors. A possible Shariah compliant FX product is examined in section 8.2 (FX options and forwards).

5. **Sukuk Market Supervision**

A number of the risks that were identified in section 4 (Legal risk in Sukuk Structures) can be mitigated by the CMDA and other authorities in the Maldives. Some of these strategies were examined in section 4 (Legal risk in Sukuk Structures). However, the strategies are summarised below as a framework to be considered by the CMDA:

5.1 **Shariah compliance and enforceability**

The risk of non-compliance with Shariah is a risk for Shariah-sensitive investors in Sukuk and Shariah-sensitive issuers. It is also a potential reputational risk for the Originator of a Sukuk and the relevant authorities in the Maldives. To some extent these risks are mitigated against by the draft regulations developed by the CMDA on Shariah Screening, Shariah Advisors and Sukuk.

Ways in which the CMDA can ensure the compliance of Sukuk with Shariah include the following.

- (A) Sukuk should be certified as Shariah compliant by a qualified Shariah advisor/committee.
- (B) Shariah advisors based in the Maldives should be registered with the CMDA.
- (C) The assets underlying the Sukuk should be Shariah compliant.
- (D) The Shariah advisor, or a third party Shariah advisor/committee, should undertake a periodic audit of the Sukuk.
- (E) Originators issuing Sukuk in the Maldives should obtain prior authorisation from the CMDA.
- (F) Shariah rulings by the CMDA Shariah Advisory Committee should be binding on courts and arbitrators in the Maldives.

We understand that the recommendations in paragraphs (A) to (E) above can be addressed in the existing legal and regulatory framework in the Maldives. In particular, we understand that the existing practice of the CMDA in respect of a Sukuk issuance is as follows:

- (1) The potential Originator/Issuer would first send an expression of interest to the CMDA and the CMDA would provide assistance if required.
- (2) The potential Originator/Issuer would then send the proposed Shariah structure to the CMDA for approval.
- (3) The CMDA send the proposed Shariah structure to the CMDA Shariah Advisory Committee for approval.

- (4) The CMDA Shariah Advisory Committee would communicate any recommendations to the potential Originator/Issuer.
- (5) The potential Originator/Issuer would then send a first draft of the Sukuk prospectus to the CMDA for approval.
- (6) Upon the CMDA's recommendation, when the final draft of the Sukuk prospectus is sent by the potential Originator/Issuer, it would be sent to the CMDA Shariah Advisory Committee for their final approval.

In light of the above steps, any structural or Shariah issues applicable to an issuance can be identified and rectified by the CMDA and the CMDA Shariah Advisory Committee before the final Sukuk prospectus is published.

However, the recommendation in paragraph (F) above may require a statutory basis in the Maldives. Nonetheless, in the absence of a law being passed in the Maldives stating the rulings by the CMDA Shariah Advisory Committee shall prevail over court and arbitrators in the Maldives, the prospectus for a Sukuk issuance could contain the following statement:

The [*Sukukholders*], the [*Issuer*] and the [*Originator*] agree that the rulings of the Shariah Advisory Committee of the Capital Markets Development Authority of the Republic of the Maldives as to matters of Shariah shall be adhered to in the settlement of any dispute that may arise out of or in connection with the [*Transaction Documents*].

It is difficult to foresee how a local court or arbitrator in the Maldives would interpret the above provision in the absence of a test case. However, the inclusion of such a provision in a contract would at the very least state the intention of the parties for a court or an arbitrator to consider.

5.2 Mandatory disclosure

Sukuk structures can be fairly complicated compared to conventional bond offering documents. In order to assist investors, additional disclosures should be made in the relevant Sukuk offering documents relating to the Shariah aspects of the issuance. These would include the following:

- (A) Disclosure of the relevant Shariah advisors.
- (B) Description of the relevant Islamic financing documents.
- (C) An explanation of how the Sukuk proceeds will be applied by the Issuer / Originator.
- (D) An explanation of how profits and redemption proceeds will be generated from the underlying assets.

- (E) A copy of the written pronouncement from the relevant Shariah advisors is also included with the offering documents.

We understand that these requirements are already specified in the draft CMDA Sukuk Regulations.

5.3 Continuing obligations and enforcement powers

As the authority responsible for regulating Sukuk in the Maldives, the CMDA should have specified powers to obtain information from Originators. In practice, requiring Originators to obtain prior authorisation from the CMDA in respect of a Sukuk issuance would allow the CMDA to request the information that it needs before granting authorisation for a specific issuance. However, the CMDA should have the right to obtain further information from Originators after an issuance if required.

For example, if the CMDA suspects that a Sukuk or its underlying assets are no longer Shariah compliant, it should have the right to inspect the relevant contracts and assets in order to satisfy itself whether or not this is the case. The continuing obligation on Originators to provide information to the CMDA would include delivering the periodic Shariah audit reports to the CMDA for its review.

Where Originators are found to be in contravention of the relevant regulations and/or guidelines, the CMDA should have powers to intervene. The Maldives Securities Act 2006 grants the CMDA “all such powers as are necessary to enable the Authority to achieve its objectives”.²⁷ However, it is suggested that in the context of the Sukuk Regulations to be issued by the CMDA, the CMDA should reserve certain enforcement powers for itself, such as powers to:

- (A) Withdraw an authorisation in respect of a Sukuk issuance.
- (B) Prohibit an Originator from issuing Sukuk.
- (C) Suspend an Originator from issuing Sukuk for a specified period.
- (D) Censure an Originator through a public statement.
- (E) Impose financial penalties.

We would recommend that the CMDA should specify such enforcement powers in the CMDA Sukuk Regulations.

²⁷ Section 5, Maldives Securities Act 2006

6. Incentives to develop and sustain a Sukuk market

We understand that developing a Sukuk market in the Maldives is one of the strategic objectives of the CMDA. In this section, we suggest a number of incentives that may help to develop and sustain a Sukuk market in the Maldives. It is worth reflecting on the experiences of other countries such as Malaysia and United Kingdom in this regard. The challenges that each faced in promoting Islamic finance were quite different, but these countries have managed to become leading centres for Islamic finance in their respective regions.

6.1 Taxation

As noted in section 3.9 (Regulatory and legal issues), the transfer of land in the Maldives attracts land tax. We understand that under the Maldivian Land Act,²⁸ transfers of land attract a tax of 15% on the relevant purchase price. Where Sukuk structures such as Sukuk al Ijara and Sukuk al Istisna involve the transfer of land, this would result in an additional imposition of land tax. For example, in a Sukuk al Ijara, the transfer of the land to the Issuer would attract land tax. Upon the return of the land to the Originator pursuant to the Purchase Undertaking or the Sale Undertaking, land tax is applicable again.

By way of comparison in the United Kingdom, land transactions attract Stamp Duty Land Tax (SDLT). In recognition of the double-levy of SDLT on Ijara transactions and Murabaha transactions involving land, the UK government passed a law in 2003 providing relief from SDLT on property sold to a financial institution that was then transferred on to an individual.²⁹ The relief was extended to institutions in 2006, and in relation to Sukuk issuances in 2009.

Similarly, the French Tax Administration has issued a statement of practice on the taxation of Sukuk.³⁰ Other countries that have clarified the taxation of Sukuk include Japan³¹ and Singapore. Australia recently consulted on the taxation of Islamic finance products including Sukuk³² and Hong Kong has recently proposed to provide tax and stamp duty relief for transactions underlying Sukuk issuances.³³

We understand that the provision of tourism goods and services in the Maldives is taxed at a rate of 8% from 1 January 2013 and the provision of other goods and services in the Maldives has been taxed at a rate of 6% since 1 January 2012.³⁴ Since some Sukuk structures involve the transfer of goods from the Originator to an Issuer (such as Sukuk al Murabaha or Sukuk al Salam), there is a risk that these transfers may trigger a payment of goods and services tax (GST) in the Maldives. As with land tax, we would recommend that

²⁸ Section 18(e), Maldivian Land Act 2002

²⁹ Finance Act 2003

³⁰ *Regime Applicable Aux Sukuk D'investissement*, Direction Générale Des Finances Publiques, 24 August 2010

³¹ *Taxation of J-Sukuk*, Financial Services Authority, April 2012

³² *Review of the Taxation Treatment of Islamic Finance*, The Board of Taxation, Australian Government, October 2010

³³ Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012

³⁴ Sections 15 and 16, Goods and Services Tax Act 2011

relief from GST be extended to goods and services transferred for the purposes of a Sukuk issuance in the Maldives.

Furthermore, once legislation in the Maldives allows the creation of bankruptcy remote SPVs that can act as issuers of Sukuk, the profits from any underlying business of that SPV should be exempt business profit tax. This would enable the Sukuk to be taxed on an equal footing with a conventional bond issuance, since the underlying business of the Sukuk (e.g. in a Sukuk al Musharakah) would have already been subject to business profit tax.

Removing the tax disadvantages to Islamic financings in this manner can help the Islamic finance and Sukuk markets grow in the Maldives.

In Malaysia, a number tax incentives have been introduced to encourage the growth of the Islamic finance industry. Amongst a number of tax incentives, these include full tax relief for financial institutions for income derived from Islamic banking and takaful business in international currencies until 2016. Furthermore, profits to non-residents from Islamic securities denominated in Malaysian ringgit are exempt from withholding tax. Expenses incurred on the issuance of Islamic securities are also tax deductible until 2015.

These incentives clearly favour Islamic finance over conventional finance. They would be controversial in a country like the UK where Muslims are only a small minority of the population and the government has pursued the creation of a “level playing field” strategy for the taxation of Islamic financial products. However, such incentives may for policy reasons be more attractive in countries with a majority Muslim population.

We understand that potential investors in Sukuk such as the Maldives Pension Administration Office are restricted to investing in listed securities. The Maldivian government could therefore introduce tax incentives to encourage potential issuers to list their Sukuk in order to make their Sukuk available to this potentially important investor.

Such incentives could include:

- (A) The ability of an Issuer/Originator to deduct the costs of listing a Sukuk from its taxable profits.
- (B) Full or partial relief from income tax for a limited period for Sukukholders that invest in listed Sukuk.
- (C) Full or partial relief from business profit tax for a limited time for advisors, arrangers or underwriters etc. in respect of income derived from advising, arranging or underwriting etc. in respect of a listed Sukuk issuance.

6.2 Capital adequacy recognition

Following the global financial crisis, the capital adequacy of financial institutions is becoming an increasingly important area for financial regulators, particularly in light of Basel II and Basel III.

The appetite amongst financial institutions in the Maldives to hold Sukuk may be increased where, subject to compliance with Basel principles, holdings by financial institutions in the Maldives of Sukuk may count towards their capital adequacy requirements.

The Basel Committee recently recognised that Sukuk could be used by Islamic banks for liquidity coverage purposes.³⁵ National supervisors have the discretion to define Shariah compliant financial products such as Sukuk as alternative “HQLA” applicable to Islamic banks, provided that the banks meet the minimum required Liquidity Coverage Ratio - intended to promote short-term resilience of the liquidity risk profile of banks.

HQLA are unencumbered, high-quality liquid assets that can be converted easily and immediately in private markets into cash, at little or no loss of value, to survive a significant stress scenario lasting for 30 calendar days.

The emphasis on the liquidity of the assets reinforces the importance of a secondary market for Sukuk, and the availability of Islamic repo facilities in the market. Nonetheless, the Basel Committee recommends that assets in respect of which there isn't a deep and active repo market, or where there are impediments to sale, should be excluded from the stock of HQLA.³⁶

6.3 Benchmark Sukuk and standard documents

As noted in section 3.10 (Sukuk structures for the Maldives), a Sukuk issuance by the Maldives government could act as benchmark for other issuers in the Maldives. A successful issuance that is transparent as to the structuring and documentation would give potential issuers the confidence to issue their own.

In particular, by releasing standard documents to the public for Sukuk (such as offering circulars and underlying Islamic finance documents) that have been approved by the CMDA, the costs and time taken to issue a Sukuk could be reduced quite substantially. We noted from our meetings with a number of industry representatives in the Maldives that standard documents published by the CMDA would be of great benefit.

³⁵ Basel III: *Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013, paragraph 68

³⁶ Basel III: *Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013, paragraph 38

6.4 Grants

The uncertain costs of structuring Sukuk can dissuade potential issuers, particularly when they do not have prior experience of issuing any type of security – whether it is Islamic or conventional.

To encourage the growth of a Sukuk market in the Maldives, the CMDA may consider making grants to institutions that wish to issue Sukuk to cover the legal, accounting, Shariah and other advisory costs of a Sukuk issuance.

6.5 Road shows

After a number of Sukuk have been issued in the Maldives, the CMDA may organise road shows in the various islands of the Maldives to promote the Sukuk as potential investments, explain how they are structured and encourage further issuances. We understand that the CMDA currently organises training programmes to educate the general public in the Maldives about Islamic finance – these programmes may be extended to discuss opportunities to invest and issue Sukuk in the Maldives.

6.6 Mutual recognition protocols

We understand that the Maldives Stock Exchange allows the listing of foreign securities on its exchange provided that the securities comply with relevant rules of the Maldives Stock Exchange and the CMDA. To enable the growth of the domestic Maldives market, it could agree mutual recognition protocols with other exchanges. For example, the Maldives Stock Exchange and the CMDA could permit a Sukuk listed on Bursa Malaysia that are regulated by Securities Commission Malaysia to be listed on the Maldives Stock Exchange through a fast-track process.

This would be similar in principle to the UCITS (Undertakings for Collective Investment in Transferable Securities) regime in the European Union. The principle behind the regime is to allow investment funds that have been authorised in one member state of the European Union to be sold to the public in other member states of the European Union without further authorisation. This has been made possible through the adoption of uniform legislation in member states of the European Union.

Nonetheless, since the Maldives Stock Exchange allows the listing of foreign securities, the agreement of appropriately drafted mutual recognition protocols between the Maldives and other states should in principle be possible in the existing legal environment in the Maldives. The protocol may state for example that provided that the required disclosures for Sukuk issuances, applicable Shariah governance requirements and regulatory powers in the counterpart state are in conformity with regulations and practices in the Maldives, the Sukuk may be listed in the Maldives more quickly.

The main advantage of this proposal is that it would enable a greater number of Sukuk to be made available to Maldivian investors. However, it is likely that such Sukuk would be

denominated in a currency other than Maldivian rufiyaa, which may expose Maldivian investors to foreign currency risk. There may also be a limited appetite in the counterpart state for Sukuk denominated in Maldivian rufiyaa.

Nonetheless, we noted from our discussions with a number of industry representatives in the Maldives that some financial institutions provided trade finance facilities denominated in US Dollars and that there was a limited supply of US Dollars in the Maldivian economy. We would recommend that further research be undertaken in the Maldives to ascertain the demand for Sukuk denominated in US Dollars, particularly by foreign issuers.

6.7 Executive exchange programmes

Islamic finance structures can be fairly complicated to newcomers. The complexity of the contracts and varying market practices often requires advisors with technical expertise and experience. In order to develop a workforce that is technically proficient in Islamic finance with hands-on experience, the CMDA could create an executive exchange programme enabling Maldivian professionals to visit leading centres for Islamic finance and work on actual Sukuk issuances. Such institutions could include the regulatory authorities in such centres, law firms and accountancy firms with specialist Sukuk practices, leading arrangers of Sukuk and supranational institutions such as the Islamic Development Bank.

Maldivian professionals would return with the knowledge to further develop the Sukuk capital market in the Maldives. In return, leading institutions in foreign countries might also second their executives to be embedded with Maldivian institutions to assist with the structuring and issuance of Sukuk.

6.8 Sukuk guaranteed by the government

We noted from our meetings with a number of industry representatives in the Maldives that there would potentially be demand for Sukuk from investors in Maldives in the pensions industry and at the Ministry of Islamic Affairs, which is starting to manage an increasing amount of funds. This class of investors are less likely to be concerned with liquidity but would be more interested in regular returns but with low risk. We had discussed with industry representatives the possibility of tranching issuances so that certain classes of investors would, subject to appropriate Shariah structuring, benefit from priority payments under the Sukuk. However, it was felt that the Sukuk market in the Maldives was not developed enough at this stage to introduce the concept of tranching.

A feature of Sukuk structured as debt instruments is that their rate of return can at times be low compared to other investments such as equities. However, equity instruments tend to be more volatile and the investors' capital is at risk. Although the returns from an equity Sukuk such as Sukuk al Musharakah or Sukuk al Mudaraba may be attractive to this class of investors, a capital loss could affect investors on a personal level, and could give rise to a serious reputational risk for the Originator, the regulatory authorities and the Sukuk market in general. In these circumstances, and provided that it is financially viable, the

returns and redemption amounts under the relevant Sukuk could be guaranteed by a third party.

Where the Sukuk issuance is a private issuance not related to the government, a guarantee from the Maldivian government would comply with the AAOIFI Shariah Standards on providing guarantees for Sukuk al Musharakah or Sukuk al Mudaraba and satisfy the risk appetite of such investors.

7. **Overcoming market constraints in the Maldives**

We noted from our meetings with a number of industry representatives in the Maldives that the concepts of Islamic finance are still relatively unknown to citizens in the Maldives. The potential for a Sukuk market is therefore depended on the appetite of Maldivians for Islamic finance in general.

In this section, we suggest a number of strategies to overcome market constraints in the Maldives to create awareness in the Maldives of the principles of Islamic finance, the distinguishing characteristics of Sukuk and the environment for issuing Sukuk in the Maldives.

7.1 **Website**

The CMDA currently has a website detailing progress made in the development of an Islamic capital market in the Maldives:

<http://cmda.gov.mv/islamic/explore-maldivian-islamic-capital-market/>

We would suggest, as a next stage of the development of the website, that detail be provided on the current and planned regulatory framework for the issuance of Sukuk in the Maldives, with copies of standard or template documentation that can be downloaded.

A good example of promoting the Islamic finance offering of a state is the website of the Malaysia International Islamic Finance Centre:

www.mifc.com

The website includes detail on Malaysia's value proposition as well copies of speeches and relevant regulations, a directory of institutions in Malaysia specialising in Islamic finance and specific information for investors and issuers. The website also has a useful section detailing the tax incentives in Malaysia for Sukuk³⁷ and procedures for issuing Sukuk.³⁸

7.2 **White paper**

A white paper on the Sukuk market in the Maldives would help to clarify to domestic and international participants the status and regulatory environment for Sukuk. The white paper should contain the key messages of the relevant industry players and regulators, and outline the key activities that clients are looking for from a legal, regulatory and tax perspective, including how any potential barriers have been or will be addressed by the CMDA.

³⁷ http://www.mifc.com/index.php?ch=seg_inv_suk&pg=incentives2

³⁸ http://www.mifc.com/index.php?ch=seg_iss_suk&pg=applicationprocedures

The paper would also be useful reference point going forward to ensure that any marketing messages regarding the promotion the Sukuk market in the Maldives are consistent

Various countries have published white papers outlining the steps that they are taking or intend to take to support the growth of a domestic Islamic finance industry, with extensive research into the compatibility of Islamic finance products and institutions with their current systems. For example, Australia,³⁹ France,⁴⁰ Hong Kong,⁴¹ Luxembourg,⁴² Malaysia,⁴³ Malta,⁴⁴ Nigeria,⁴⁵ Singapore,⁴⁶ the UK⁴⁷ and the UAE⁴⁸ have all published official guides and policy statements on Islamic finance. It would be advisable for the CMDA to do the same for the Maldives.

7.3 Sukuk documentation

As noted in section 6.3 (Benchmark Sukuk and standard documents), making standard documentation for issuing Sukuk available to the market would assist Issuers in the structuring and issuance of Sukuk. It would also help to create an element of standardisation and embed best practice within Sukuk documentation.

7.4 Assistance for potential issuers

As noted in section 6.3 (Grants), lowering the costs of issuing Sukuk may encourage potential issuers to consider a Sukuk issuance. The CMDA may also consider providing potential issuers with other types of support such as connecting them with experienced advisors, providing guidance on the structuring the Sukuk, and publishing CMDA-approved procedures for issuing.

As noted earlier, we understand that potential investors in Sukuk such as the Maldives Pension Administration Office are restricted to investing in listed securities. Again, providing specific guidance on the procedure for listing Sukuk and publishing standard documents would encourage issuers to list their Sukuk in order to appeal to this important potential investor.

³⁹ Australian Trade Commission (Austrade), *Islamic Finance*

⁴⁰ Paris Europlace, *French Sukuk Guidebook*

⁴¹ Hong Kong Monetary Authority, *Islamic Finance in Hong Kong: Supervisory Issues*

⁴² Luxembourg for Finance, *Luxembourg Vehicles for Islamic Finance Structures*

⁴³ Malaysia International Islamic Financial Centre, *Malaysia, Your Business Connection to Global Islamic Finance*

⁴⁴ Malta Financial Services Authority, *Islamic Finance in Malta*

⁴⁵ Central Bank of Nigeria, *Framework for the Regulation and Supervision of Institutions Offering Non-interest Financial Services in Nigeria*

⁴⁶ Monetary Authority of Singapore, *Guidelines on the Application of Banking Regulations to Islamic Banking*

⁴⁷ HM Treasury, *The development of Islamic finance in the UK: the Government's perspective*

⁴⁸ Dubai International Financial Centre, *Guide to Islamic Finance – in or from the DIFC*

8. **Islamic Capital Market products**

As noted earlier in this report, Sukuk issuers and investors will require a number of instruments to manage the liquidity of their Sukuk and to hedge against risks.

The products that are available in the Islamic capital market are evolving rapidly. Only a few years ago, the concept of an “Islamic derivative” was considered contrary to Shariah. More recently, there is an increasing acceptance amongst Shariah scholars that these instruments can be used by parties to hedge against risks. As is clear from their use in conventional finance, derivatives can be used speculatively – in some cases leading to the collapse of institutions. The use of these Islamic capital markets products should therefore be carefully monitored by Shariah advisors and the CMDA to ensure that they are genuinely used to hedge risk.

A summary of several types of Islamic capital market products that can be introduced in for a Sukuk market in the Maldives is set out below.

8.1 **Profit Rate Swaps**

The method by which an Islamic Profit Rate Swap (a “PRS”) is transacted continues to evolve and is achieved in different ways. There are generally two types of PRSs that are used in the market: first generation products and second generation products. These are outlined below. Each type of PRS uses an underlying Commodity Murabaha transaction. A PRS can be used where, for example, the Issuer of Sukuk wishes to pay a fixed return to Sukukholders but receives a floating rate of return from the assets underlying the Sukuk.

To assist in the explanation of both types of PRS, the following example will be used:

- The principal value of the Underlying Assets (e.g. a Sukuk) is USD 1,000 (the Principal Amount).
- The Sukuk pays an annual coupon (the Periodic Return) and has a term of 10 years (the Term).
- Each payment date of the Periodic Return is a Swap Date.
- The Underlying Assets pay a Variable Rate.
- The Issuer wishes to fix the rate payable under the Sukuk at 5.00% (the Fixed Rate).
- At any time, the difference between the Variable Rate amount and the Fixed Rate amount is the Rate Difference.

(A) **First generation PRS**

The Issuer enters into a single Commodity Murabaha on deferred payment terms.

The Swap Counterparty enters into a Murabaha on spot payment terms on each swap date.

For example:

The Sukukholder enters into a Commodity Murabaha (the Fixed Rate Murabaha) to purchase Commodities from the Swap Counterparty on a deferred payment basis.

- (1) The Swap Counterparty will purchase Commodities with a Cost Price equal to a Principal Amount (i.e. USD 1,000) from a broker.
- (2) The Issuer will purchase such Commodities from the Swap Counterparty for USD 1,500. The Mark-Up is equal to the aggregate of the Fixed Rate payments payable over the life of the Underlying Assets (i.e. 10 x USD 50).
- (3) After having on-sold the Commodities for their market value, the Issuer will use such proceeds to settle that amount of the Sale Price equal to the Cost Price (i.e. USD 1,000) on a spot basis.
- (4) The Mark-Up element of the Sale Price is deferred and payable in fixed and equal instalments (i.e. USD 50) on each Swap Date.

The Issuer is therefore due to pay USD 50 to the Swap Counterparty on each Swap Date pursuant to the arrangement referred to above. Note that only one Fixed Rate Murabaha is entered into during the Term of the swap.

On each Swap Date, the Swap Counterparty will enter into a Commodity Murabaha (each a Variable Rate Murabaha) to purchase commodities from the Issuer on a spot payment basis. On a particular Swap Date, the Variable Rate is 7.00%:

- (1) The Issuer will purchase Commodities with a Cost price equal to the Principal Amount (i.e. USD 1,000) from a broker.
- (2) The Swap Counterparty will purchase such Commodities from the Issuer for USD 1,070. The Mark-Up is equal to the Variable Rate amount (i.e. USD 70).
- (3) After having on-sold the Commodities for their market value, the Swap Counterparty will use such proceeds to settle that amount of the Sale Price equal to the Cost Price (i.e. USD 1,000).
- (4) The Mark-Up element of the Sale Price is payable spot (i.e. USD 70) on the Swap Date.

On each Swap Date, the reciprocal payment obligations (i.e. the Issuer owes USD 50 to the Swap Counterparty under the Fixed Rate Murabaha, and the Swap Counterparty owes USD 70 to the Issuer under the relevant Variable Rate

Murabaha) are set off against each other. The net result in this example is that the Swap Counterparty will owe USD 20 to Issuer (i.e. the Rate Difference), achieving the economic purpose of the swap.

Depending on the Rate Difference, the economic effects of a conventional rate swap are achieved (i.e. if the Variable Rate is less than the Fixed Rate, the Issuer makes a payment to the Swap Counterparty). A new Variable Rate Murabaha is entered into with respect to the subsequent Swap Date.

The typical documents for this product are as follows:

Common Terms Agreement, containing common boiler plate provisions, representations and covenants etc. and provisions for close out.

Master Murabaha Agreement, between the Swap Counterparty as seller and the Issuer as purchaser, pursuant to which the Fixed Rate Murabaha is transacted.

Purchase Undertaking, granted by the Swap Counterparty in favour of the Issuer, pursuant to which the Swap Counterparty undertakes to purchase commodities from the Issuer on each Swap Date.

Agency Agreement, between the Issuer as principal and the Swap Counterparty as agent, pursuant to which the Swap Counterparty shall purchase and/or sell commodities on behalf of the Issuer from time to time.

(B) Second generation PRS

The second generation PRS replaces the Fixed Rate Murabaha with a Purchase Undertaking granted by the party with a fixed rate obligation, pursuant to which it undertakes to purchase commodities from the other party on spot delivery and spot payment terms.

The mark-up payable under such spot Murabaha contacts would be calculated using the Fixed Rate.

For example:

On each Swap Date, the Issuer will enter into a Commodity Murabaha (each a Fixed Rate Murabaha) to purchase commodities from the Swap Counterparty on a spot payment basis:

- (1) The Swap Counterparty will purchase Commodities with a Cost price equal to the Principal Amount (i.e. USD 1,000) from a broker.
- (2) The Issuer will purchase such Commodities from the Swap Counterparty for USD 1,050. The Mark-Up is equal to the Fixed Rate amount (i.e. USD 50).

- (3) After having on-sold the Commodities for their market value, the Issuer will use such proceeds to settle that amount of the Sale Price equal to the Cost Price (i.e. USD 1,000).
- (4) The Mark-Up element of the Sale Price is payable spot (i.e. USD 50) on the Swap Date.

On each Swap Date, the Swap Counterparty will also enter into a Commodity Murabaha (each a Variable Rate Murabaha) to purchase commodities from the Issuer on a spot payment basis. On a particular Swap Date, the Variable Rate is 7.00%:

- (1) The Issuer will purchase Commodities with a Cost price equal to the Principal Amount (i.e. USD 1,000) from a broker.
- (2) The Swap Counterparty will purchase such Commodities from the Issuer for USD 1,070. The Mark-Up is equal to the Variable Rate amount (i.e. USD 70).
- (3) After having on-sold the Commodities for their market value, the Swap Counterparty will use such proceeds to settle that amount of the Sale Price equal to the Cost Price (i.e. USD 1,000).
- (4) The Mark-Up element of the Sale Price is payable spot (i.e. USD 70) on the Swap Date.

On each Swap Date, the reciprocal payment obligations (i.e. the Issuer owes USD 50 to the Swap Counterparty under the Fixed Rate Murabaha, and the Swap Counterparty owes USD 70 to the Issuer under the relevant Variable Rate Murabaha) are set off against each other.

The typical documents for this product are as follows:

Common Terms Agreement, containing common boiler plate provisions, representations and covenants etc. and provisions for close out.

Issuer Purchase Undertaking Agreement, granted by the Issuer in favour of the Swap Counterparty, pursuant to which the Issuer undertakes to purchase commodities from the Swap Counterparty on each Swap Date.

Swap Counterparty Purchase Undertaking, granted by the Swap Counterparty in favour of the Issuer, pursuant to which the Swap Counterparty undertakes to purchase commodities from the Issuer on each Swap Date.

Agency Agreement, between the Issuer as principal and the Swap Counterparty as agent, pursuant to which the Swap Counterparty shall purchase and/or sell commodities on behalf of the Issuer from time to time.

8.2 FX options and forwards

FX options may be used by Issuers to hedge themselves against currency risk. An FX option is a fairly simple product and works as follows:

Pursuant to an undertaking issued by an Option Counterparty, the Option Counterparty promises to purchase a specified amount of one currency from the Issuer at a specified exchange rate at a future date. The Issuer would have the discretion to exercise its rights under the undertaking at the relevant date.

For example, the Issuer requires an option to purchase MAR with USD at a Fixed Exchange Rate on an Exercise Date.

The Option Counterparty would undertake to purchase USD from the Client with MAR on the Exercise Date at the Fixed Exchange Rate. The Issuer may/may not exercise its rights under the undertaking on the Exercise Date.

There are differences of opinion under Shariah as to whether the Option Counterparty may charge the Issuer a fee for issuing the undertaking.

FX Forwards are achieved by using two parallel undertakings. The Issuer promises to purchase the First Currency for the Second Currency from the Option Counterparty at a specified exchange rate at a future date. The Option Counterparty would promise to purchase the Second Currency for the First Currency from the issuer at the same rate and on the same date.

Some Shariah scholars take the view that, together, the parallel undertaking constitute a forward transaction which is prohibited under Shariah. In order for such a structure to work under Shariah, Shariah scholars may insist that the rates of exchange under each undertaking are slightly different or that there is some conditionality to the undertakings, such as follows:

- (A) The Issuer shall purchase the First Currency for the Second Currency if the spot market rate is greater than the Fixed Exchange Rate.
- (B) The Option Counterparty shall purchase the Second Currency for the First Currency if the Fixed Exchange Rate is greater than the spot market rate.

8.3 Repos

As noted in several places in this report, repurchase facilities (or “repos”) will be essential for Sukukholders in order to create a more liquid market for Sukuk in the Maldives.

Conventional repos are problematic under Shariah since the liquidity provided to the institution selling the securities earns interest and the agreement to repurchase the securities at a later date is a sale-and-buy-back (*Bai al Inah*) transaction which is generally prohibited under Shariah.

In this example, a Sukukholder wishes to enter into a repo for six months in respect of its holding of in a Sukuk, and it is assumed that the Maldives Monetary Authority (the MMA) would provide the relevant Islamic repo facility.

The liquidity for the Sukuk in an Islamic repo is typically provided using a Commodity Murabaha. The assets that are the subject of the Commodity Murabaha would typically be base metals listed on the London Metal Exchange other than gold or silver. However, because of the time difference between the Maldives and London, the MMA could consider using the Bursa Suq Al-Sila in Malaysia that was established at Bursa Malaysia specifically to facilitate commodity Murabaha transactions and trades in palm oil. The MMA could also consider using local commodities for these transactions provided they are sufficiently liquid, available in suitable quantities and are unencumbered.

The Sukukholder would collateralise its obligations under the Commodity Murabaha with the charge over the Sukuk in favour of the MMA, and the parties would agree a “Collateral Requirement”.

For the duration of the credit facility under the Commodity Murabaha, the Sukukholder must ensure that the market value of collateralised Sukuk is greater than or equal to the Collateral Requirement. Where the market value of the collateralised Sukuk falls below the Collateral Requirement, the MMA may issue a Margin Call for additional cash/securities in order to meet the Collateral Requirement.

If the term of the Commodity Murabaha facility is shorter than the term of the Sukuk, the Sukukholder would discharge all amounts due at maturity under the Commodity Murabaha facility and the Sukuk would be released from its charge. Where a Sukuk is redeemed prior to the end of the Commodity Murabaha facility, there would typically be a provision in the documents stating that the redemption proceeds would first be used to discharge all amounts due at under the Commodity Murabaha facility, with any balance then being transferred to the Sukukholder.

In summary, the following agreements would be entered into by the relevant parties:

Master Murabaha Agreement between the MMA as seller and the Sukukholder as purchaser, pursuant to which the Commodity Murabaha is transacted.

Agency Agreement between the Sukukholder as Principal and the MMA as agent for the on-sale of commodities.

Charge Agreement between the MMA and the Sukukholder pursuant to which the Sukuk is charged in favour of the MMA as security for the obligations of the Sukukholder under Master Murabaha Agreement.

Collateral Support Agreement between the MMA and the Sukukholder, pursuant to which the Sukukholder shall pay margin to the MMA depending on the market value of the Sukuk.

9. Conclusions

In this report, we have noted that Sukuk markets have grown exponentially in recent years. Sukuk are very much in demand amongst investors (especially Shariah-sensitive investors) looking for relatively secure income-generating instruments compared to risky equity investments. Islamic financial institutions also find them particularly useful for liquidity management purposes. Sukuk markets are also an alternative way for issuers to raise finance. They are therefore an important part of the overall Islamic financial market.

Although market practices have developed in the international Sukuk market, there are few international standards. Regulators are however becoming more prescriptive as to the structures and procedures relating to Sukuk in order to avoid the risk of Shariah non-compliance and reputational and systemic risk. The relative complexity of Sukuk make them comparatively opaque to potential investors, thus necessitating a higher level of disclosure and a greater reliance on the reputation of the advisors involved. We have therefore suggested a framework for the CMDA to supervise the process of structuring and issuing Sukuk in the Maldives and their practices after they have been issued. The draft regulations that have been prepared by the CMDA in this regard meet many of the recommendations that we make in relation to such framework.

Whilst we have identified a number of potential legal obstacles in the Maldives to the issuance of certain types of Sukuk, there are still a number of Sukuk structures that can be adapted for the current legal environment in the Maldives. Nonetheless, in order to help the Sukuk market realise its potential in the Maldives, we have made a number of suggestions for legislative changes, incentives to encourage the issuance and investment in Sukuk in the Maldives. We have also suggested ways in which the CMDA may educate potential investors and issuers on the potential for Sukuk in the Maldives. The experiences of other countries in these regards are a useful precedent.

However, Sukuk cannot be considered in isolation from the rest of the market. Sukuk may carry a number of risks such as price volatility, currency risk and the lack of a liquid secondary market. In recognition of these risks, the Islamic finance market has started to develop instruments to hedge these risks in a Shariah compliant manner. Although these products have yet to become standardised, there is greater acceptance of and need for these structures and we have outlined how these products can be structured and documented.

10. Recommended action plan

In light of our findings, we have summarised below a suggested action plan for the further development of a Sukuk capital market in the Maldives. The suggestions are based on recommendations made earlier in this report and are not listed in any particular order.

- (A) The passing of legislation to enable the creation of bankruptcy remote special purpose vehicles in the Maldives.
- (B) The passing of legislation removing tax impediments to the issuance of Sukuk such as in respect of land tax and GST, and introducing tax incentives for the issuance and listing of Sukuk.
- (C) The specification of enforcement powers of the CMDA in the proposed Sukuk Regulations.
- (D) The issuance of sovereign Sukuk by the Government of the Maldives with varying maturities to create a pricing and documentation benchmark.
- (E) The development by the CMDA of a dedicated website outlining the current regulatory framework and incentives for the issuance of Sukuk in the Maldives and containing sample documents.
- (F) The publication by the CMDA of a white paper clarifying the status and regulatory environment for Sukuk in the Maldives.
- (G) The development by the CMDA of a standard Sukuk prospectus and standard underlying documents for Sukuk.
- (H) Ascension by the Maldives to the New York Convention.
- (I) The development by the MMA of facilities such as Islamic repos to enable greater liquidity in the local Sukuk market.
- (J) Undertaking a market analysis in the Maldives amongst potential retail and institutional investors in relation to the appetite for equity and/or debt Sukuk, pricing and maturity profiles and currencies of denomination for Sukuk issuances.

Simmons & Simmons

**APPENDIX 1
BIBLIOGRAPHY**

AAOIFI Shariah Standards

CMDA, *Current Market Constraints and Impediments for Issuance of Shari'ah Compliant Products in the Maldives*

CMDA, *Draft Operational Regulation of Capital Market Shariah Advisory Council*

CMDA, *Draft Shariah Advisor Regulations*

CMDA, *Draft Shariah Screening Regulations*

CMDA, *Draft Sukuk Regulations*

Companies Act of the Republic of the Maldives 1996

Ernst & Young, *World Islamic Banking Competitiveness Report, 2013*

Islamic Banking Regulatory Framework, Central Bank of Oman

Maldives Securities Act 2006

Resolutions of the Shariah Advisory Council of the Securities Commission Malaysia, 2nd Edition, p.16

Taylor Wessing, *Report on Developing a Corporate Bond and Sukuk Market in the Maldives*, 2008

Thomson Reuters Zawya, *Sukuk Perceptions and Forecast Study*, 2013

Wahbah Al Zuhayli, *Financial Transactions in Islamic Jurisprudence* (2001)

**APPENDIX 2
INDUSTRY PARTICIPANTS**

- Bank of Maldives
- Capital Markets Development Authority
- Housing Development Finance Corporation
- Maldives Islamic Bank
- Maldives Ministry of Finance & Treasury
- Maldives Pension Administration Office
- Maldives Stock Exchange and Maldives Securities Depository
- Maldives Transport and Contracting Company
- Ministry of Economic Development
- Ministry of Islamic Affairs