

Capital Market
Development Authority
Republic of the Maldives

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

Summary Report, April 2013

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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 summary report based on our discussions with the CMDA, interested public and private institutions in the Maldives (as listed in appendix 1), and a draft framework agreed with the CMDA.

This report is a summary of our full report and given for the sole benefit of the CMDA and the Government of the Maldives. It may not be 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. 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	

4. 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.

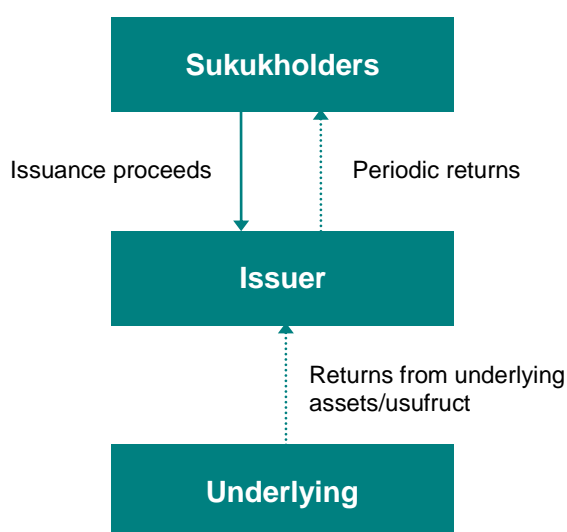
This distinction helps to clarify why Sukuk are not necessarily “Islamic bonds”. There are many different types of bonds, but the most basic version is the issuance of a debt instrument by an issuer who is contractually obliged to pay the holder of that instrument, on certain dates, interest and principal.

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

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 institutions and their Shariah boards in the Middle East. However, some Shariah scholars

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

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.

Following certain controversial market practices, AAOIFI issued further Shariah standards on Sukuk in 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

5. **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.

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

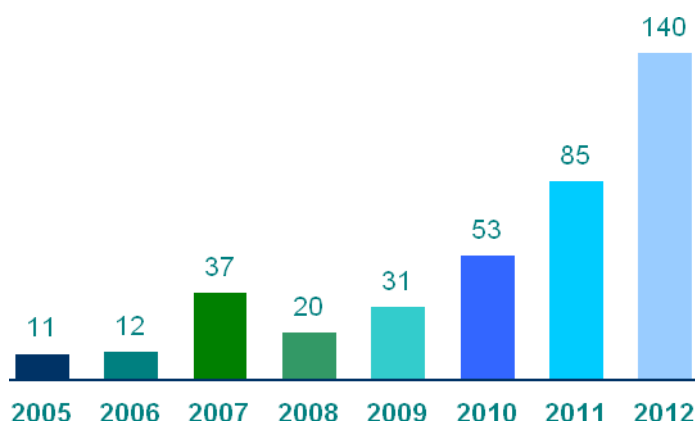
⁷ <http://www.ifsb.org/membership.php>

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 was also a relevant factor.

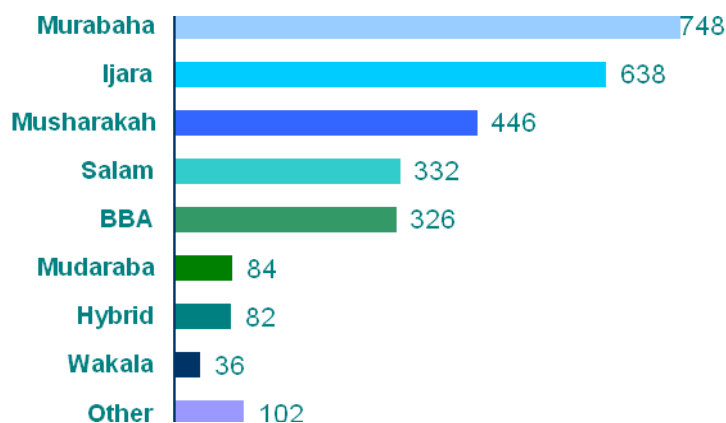


Global Sukuk Issuances (USD bn). Source: Zawya

As noted in section 4 (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 Malaysian authorities. As illustrated by the diagram below, a large number of Sukuk issuances since the 1990s have been Murabaha-based.

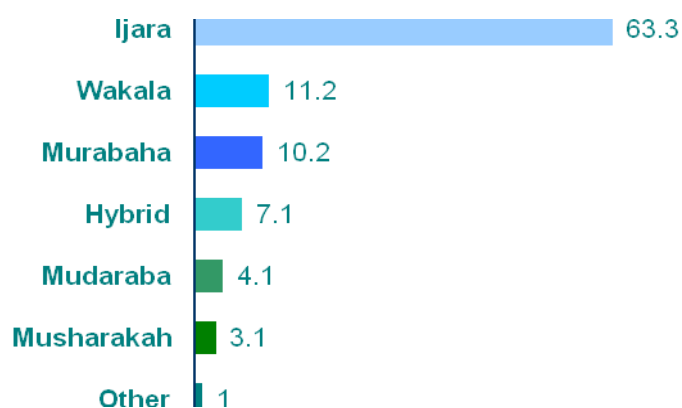
However, a Sukuk al Murabaha is a debt instrument that, according to Shariah scholars in the Middle East, cannot be traded other than for its face value. Sukuk al Ijara and Sukuk al Wakala issuances have therefore become more frequent in this region.

⁸ Ernst & Young, World Islamic Banking Competitiveness Report 2013



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.

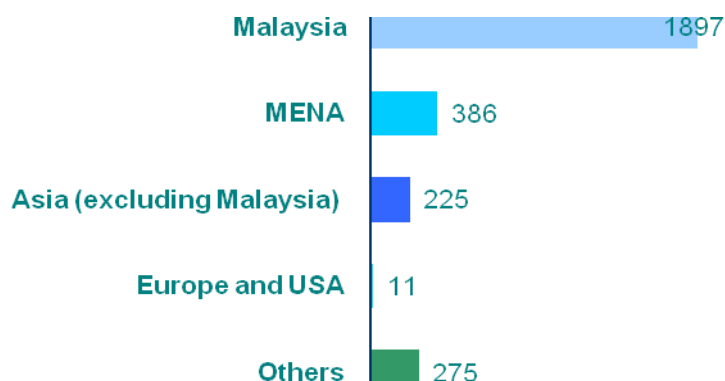


Buy-side expected / preferred structure of Sukuk issuance / investment. Source: Thomson Reuters / Zawya

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.

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.

⁹ Thomson Reuters Zawya Sukuk Perceptions and Forecast Study 2013



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.

6. 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. 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.

7. **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 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (also known as the New York Convention).
- (I) The development by the Maldives Monetary Authority 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

23 April 2013

**APPENDIX 1
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