Advancements in Contemporary Islamic Finance: from practice to scholarship

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Main Principles of Islamic Economics

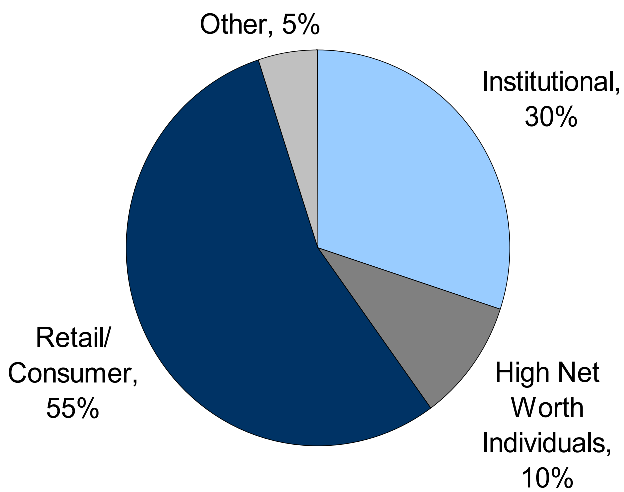
- Money is regarded as a measure of value and not an asset in itself.
- Profiting from the trade of money is regarded as “riba” and not permitted; nor is investment in prohibited industries (e.g. gambling, alcohol, tobacco), or entering into contracts of a purely speculative nature
- Under the principles of Islamic finance, financiers are required to assume the risks related to ownership of the asset or the business itself
- As general guidelines, Islamic investors can participate in profits related to:
  – Asset purchase, sale or leasing transactions
  – Trading of goods (e.g. commodities)
  – Investment in Shari'a compliant enterprises, real estate or other assets
- Example: Murabaha (sale on deferred payment) transaction: The Obligor needs to acquire an asset for its business. Rather than extend the money to the Obligor, the Financier buys the asset from the market and on-sells it to the Obligor at a mark-up, with payment on a deferred basis

The Market

The scale and scope of the application of Islamic finance has grown dramatically over the last few years: it is no longer a single product business limited to one or two geographies

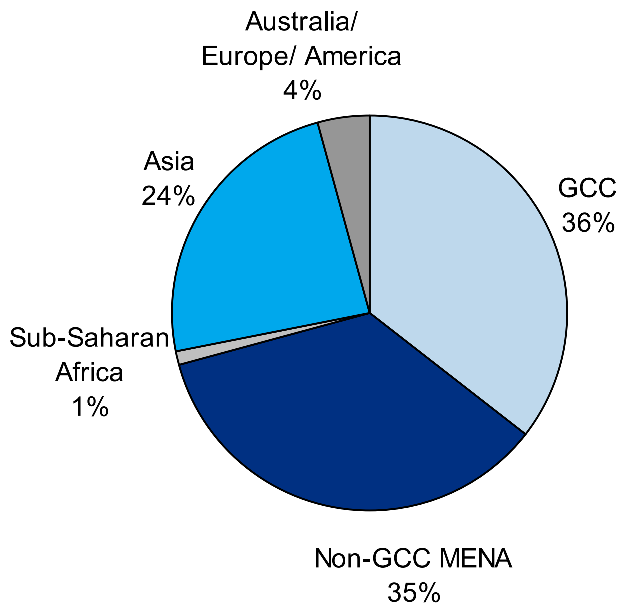
Highlights

- There are an estimated 525 institutions offering Shari'a compliant products in 47 countries around the world
- These include banks, investment banks, and insurance companies; and both pure play Islamic financial institutions and Islamic window operations



Breakdown of Shari'a Compliant Assets (US$ MM)

Region	2007	% Change
GCC	178,130	39.4%
Non-GCC MENA	176,822	28.9%
Sub-Saharan Africa	4,708	54.9%
Asia	119,346	20.9%
Australia/ Europe/ America	21,476	5.8%
Total	*500,482*	*29.5%*



Source: The Banker Magazine

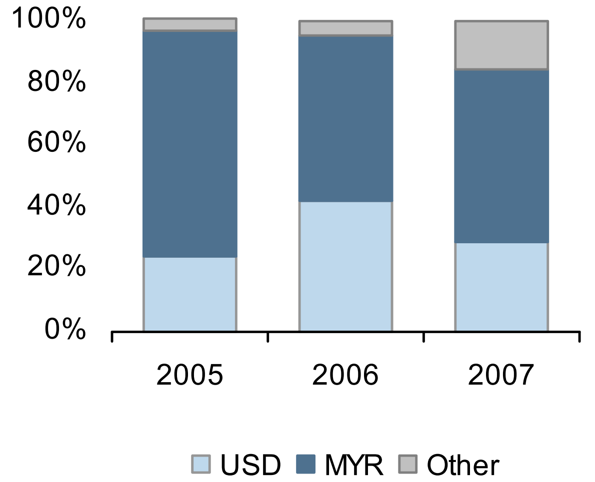
Islamic Capital Markets

Islamic capital activity has been growing at a rate of 100% since 2005

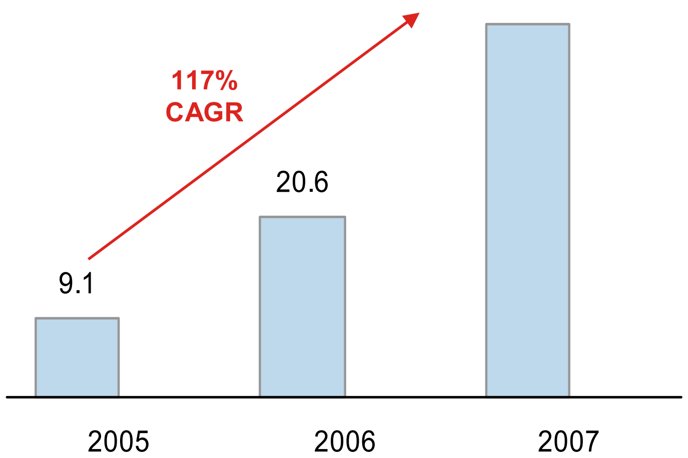
Highlights

- This year again saw significant activity in the Islamic capital markets
- Over US$ 50 Billion of Sukuk issued globally
- Malaysian Ringgit still the dominant currency with 55% of Sukuk issued in Malaysia
- US$ 42 Billion of Islamic syndications (including project finance deals)
- Approximately US$23 Billion in project finance raised in 2007; mostly with long tenors (10+ years)
- More sophisticated product offerings:
  - Equity-linked Sukuk; EMTN Programs
  - Acquisition financings
  - Risk management derivative products
  - Structured Investment Products

Sukuk Issuance – By Currency

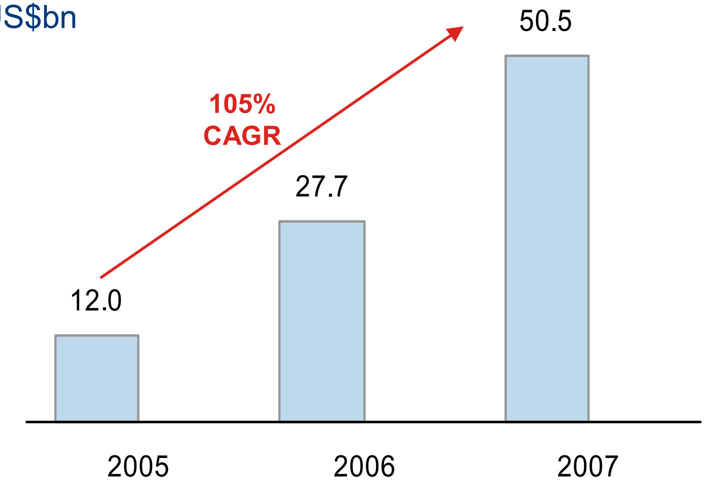


Islamic Syndications & Project Finance
US$bn



Source: Islamic Finance Information Service

Global Sukuk Issuance
US$bn



Source: Islamic Finance Information Service

Why is the Islamic Market Relevant?

With the exponential growth in Islamic assets across the world, and particularly the Middle East, the large pockets of Islamic liquidity have become increasingly important

Middle East Liquidity

- GCC financial markets are experiencing unprecedented growth on the back of petro-dollar wealth, making the Middle East the most capital surplus region of the world
- Unlike the past, Middle East sovereign wealth funds are no longer simply investing in U.S. Treasuries
- Islamic banking represents approximately 25-30% of banking system in the GCC states

Accessing Middle East Liquidity

- Structuring an Issue Islamically is the most inclusive way of tapping the Middle East market
- Both Islamic and conventional banks can and do participate in Islamic transactions

Execution & Pricing

- Islamic structures have become standardized – with costs and time to market comparable to conventional facilities/ issues
- Sukuk issues priced in line with conventional instruments

Increased Relevance in Volatile Conditions

- GCC financial markets have not been impacted by the global crisis arising out of the sub-prime and CDO markets
- While spreads have widened, the Middle East represents a deep, stable demand pool
- More and more issuers are turning conventional borrowing into Islamic to access this market

The Sukuk

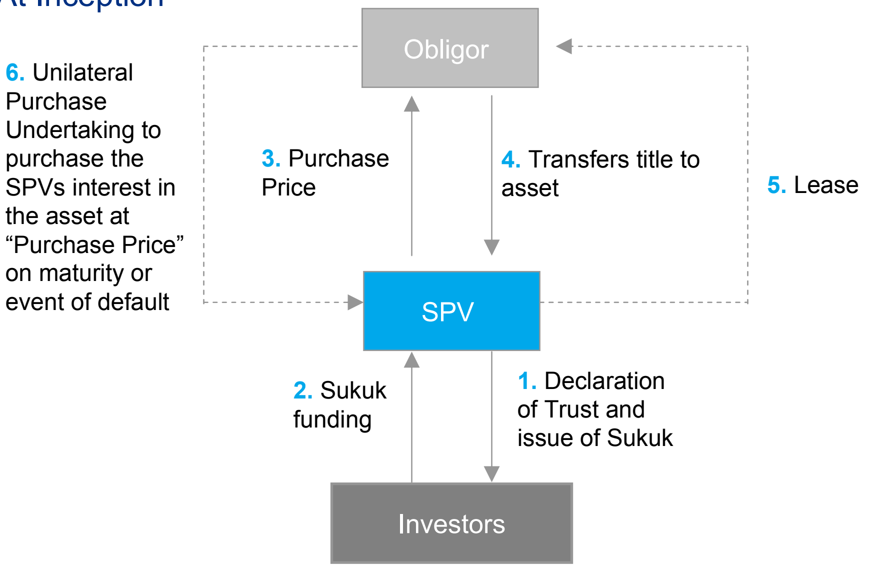
A Sukuk, meaning certificate, is an Islamic variant of a conventional bond. It is structured to comply with Shari'a

- Sukuk are typically issued by Special Purpose Vehicles that act as the investors' trustee. By subscribing to the Sukuk, the investors fund the SPV, which then, on behalf of investors, enters into a set of contracts through which it will earn a Shari'a compliant return for investors
- Investor returns are derived from **legal or beneficial interest in assets** rather than interest-based debt obligations
- The underlying assets, however, **do not constitute a transaction-specific pool of security**. Sukuk assets are purely used as a means of transacting
- Investors expect the Sukuk to represent the full faith and credit of the obligor/ guarantor, notwithstanding the asset-based structure
- Sukuk rank pari-passu with other senior obligations of the issuer
- The most common Sukuk structure is:
  - **Sukuk Al-Ijara**: The SPV purchases an asset from the obligor and leases it back to the obligor. Upon maturity, the obligor buys the asset back from the SPV
- There are many structuring solutions available. Through these structures, we create a cash flow profile which is exactly the same as conventional bonds, with the same level of legal enforceability → **what is different is the way we get there**

Sukuk Al-Ijara

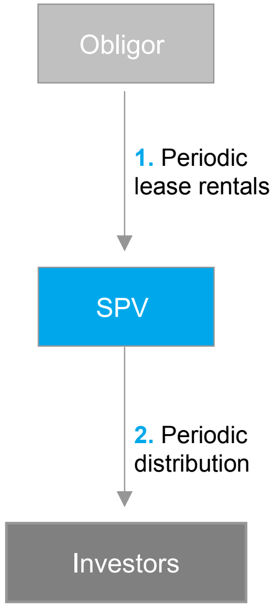
Sukuk al-Ijarah structure is the most widely used structure in Islamic finance. It requires the Obligor to have unencumbered assets roughly equal in value to the financing amount. Requires 100% asset weightage upfront

At Inception

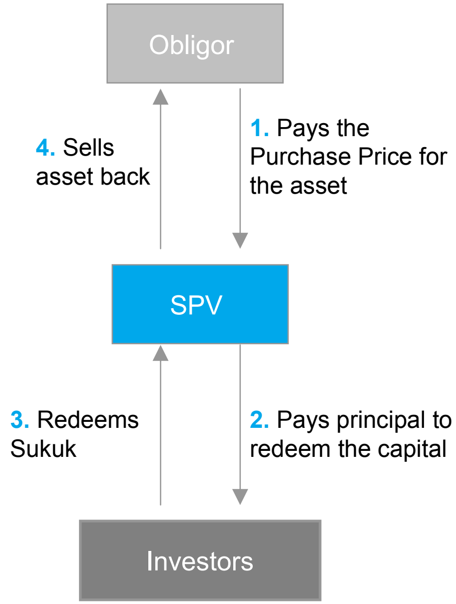


1. SPV declares a trust in favour of Investors and issues Sukuk
2. The Investors fund the SPV for the amount of the issue ("Purchase Price")
3. SPV pays Purchase Price to the Obligor
4. The Obligor transfers title un underlying asset to the SPV
5. The SPV simultaneously leases the asset back to the Obligor against payment of periodic lease rentals
6. The Obligor issues a Unilateral Purchase Undertaking to purchase back SPV's interest in the the asset on maturity or any interim date at the Purchase Price

Periodic Payments



At Maturity / Dissolution Event



- The Obligor pays periodic lease rentals to the SPV that are utilised to make the periodic distribution payment to Investors under the Sukuk
- At maturity, the Obligor buys the SPV's interest in the asset back from the SPV at the Purchase Price and the Sukuk are redeemed

Case Study: DP World Dual Tranche US$3.25bn Capital Markets Financing

Global marine terminal operator DP World on Thursday 21 June, 2007 priced a US$1.75 billion conventional bond and a US$1.5 billion Islamic bond, or sukuk. The capital raising exercise was launched to refinance existing acquisition finance facilities set in place for the purchase of P&O and CSX.

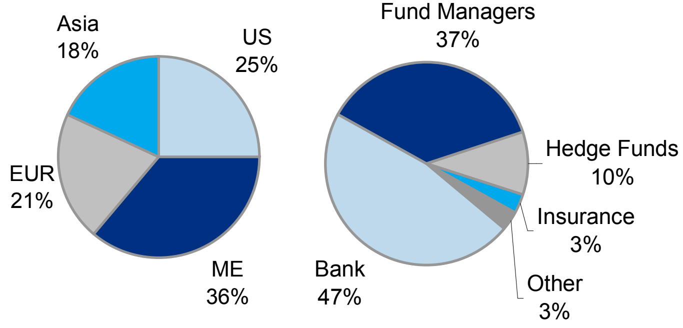
موانئ دبي العالمية DP WORLD

Issuer	**DP World Sukuk Limited**	Issuer	**DP World Limited**
Obligor	**DP World Limited**	Obligor	**DP World Limited**
Type	Fixed Rate Mudarabah Sukuk	Type	Fixed Rate Note
Maturity Date	July 2, 2017	Maturity Date	July 2, 2037
Size	US$1.5bn	Size	US$1.75bn
Format	Reg S / 144a	Format	Reg S / 144a
Status	Senior Unsecured	Status	Senior Unsecured
Issue Ratings	Moody's: A1 / S&P: A+	Issue Ratings	Moody's: A1 / S&P: A+
Benchmark	UST 4.5% 05/17 (yield: 5.132%)	Benchmark	UST 4.5% 02/36 (yield: 5.257%)
Coupon (s.a.)	6.250%	Coupon	6.850%
Spread vs. UST	+115bps	Spread vs. UST	+160bps
Listing	LSE / DIFX	Listing	LSE / DIFX

Deal Achievements

- Capital raising exceeded the target of US$3 billion
- Biggest rated non-convertible Islamic bond (sukuk)
- Largest long-dated bond issue from Middle East region
- First UAE company to launch a sukuk in US market

Sukuk Distribution



Final Orderbook: US$2.1bn, from 68 investors

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Case Study: Mobily

The Mobily financing was one of the most innovative Islamic financings ever structured. Financing a GSM operator in a Shari'a compliant manner raised certain structuring challenges that were overcome

Background:

- Mobily license was initially financed through equity (share capital including IPO, subordinated debt) and an Islamic bridge facility
- The company required that the long-term financing also be concluded in a Shari'a compliant manner
- With its strong operating & financial performance Mobily was financed more on a "corporate" basis

Key Considerations:

- Islamic financing is typically done on the back of tangible assets
- For a telecom company, its main asset is its license which is intangible
- In addition, usage of the license in financing structures is constrained/regulated by the authorities
- Its fixed assets (base stations' switches, etc) are large in number, individually low in value and widely dispersed
- This makes it difficult to structure a financing Islamically on the back of such assets

Structuring Solution:

- Citi acted as Financial Advisors to Mobily, working closely with the company and its Shari'a scholars to develop a path-breaking solution based on the intangible asset – "Minutes of Airtime Usage"
- This is widely considered as one of the most innovative Islamic facility and is also the largest Shari'a compliant facility in the world.
- Based on competitive bids, Mobily received underwritten offers from a wide range of banks ranging between Saudi, Regional and International banks at competitive rates
- First phase of the US$ 2.845 billion of financing was concluded end of March 2007 and is currently in syndication

Misconceptions

- The lack of Shari'a standardization is a hindrance to growth and innovation
- Islamic Finance is simply form over substance or is form just as important as substance

Current Debates

- Does the capital guarantee implied by the Purchase Undertaking contravene Islamic principles?
- Is Islamic Finance fundamentally an equity business ?