From PLI’s Course Handbook

*Islamic Financing: A Comparative Analysis of Sukuk and Conventional Bonds and Securitizations*

#15105
Islamic and Conventional Bonds

Andrew Metcalf
Partner
King & Spalding LLP
1185 Avenue of the Americas
New York, New York 10036
Telephone: 212-556-2111
Email: ametcalf@kslaw.com

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Comparison of Islamic and Conventional Bonds
Similarities

- Periodic income stream payments
- Periodic payments can be based on fixed or floating rate
- Tradeable instruments (subject to certain restrictions for sukuk)
- Effectively based on the credit of an entity, despite asset-backed structure of sukuk
- Subject to rating and credit enhancement
Comparison of Islamic and Conventional Bonds
Differences
(Distinct Attributes of Islamic Bonds)

• Sukuk must be based on underlying assets (cannot, strictly speaking, be a general obligation of issuer); payments must be derived from these assets
• Business of issuer must be Shari’ah-compliant
• Sukuk represents an undivided beneficial ownership interest in underlying assets; conventional bond is a debt obligation for future payment
• Payment elements cannot be based on interest
Comparison of Islamic Bonds and Asset Securitization

- Both Islamic bonds and asset securitizations based on cash generated by underlying assets
- Both represent an undivided beneficial ownership interest in underlying assets
- Issuer of both Islamic bonds and asset securitization sukuk must be Shari’ah-compliant
- Both use special purpose vehicles as part of their structures, though not required for Islamic bonds
- Asset securitizations subject to more rigid requirements, making them more difficult to structure; guarantees of Islamic bonds remove much structuring uncertainty
Two Illustrative Sukuk Structures

- **Ijara Structure**: Sukuk based upon *ijara* (lease) rentals
- **Murabaha Structure**: Sukuk based upon *murabaha* payments
Principal Parties

- **Sponsor**
- **Issuer**: Usually a newly-established special purpose vehicle
- **Guarantor**: To date, guarantors have tended to be sovereigns
- **Investors**: Islamic institutions and high net worth individuals desiring a Shari’ah-compliant bond investment
- **Placement Agent**
- **Sukuk Registrar, Paying Agent & Custodian**
**Ijara – Backed Sukuk**

- Using the proceeds from the issuance of the *sukuk*, the Issuer acquires Equipment from the Master Lessee or third party and leases the Equipment to the Master Lessee.
- The rent payments under the Equipment lease (*ijara*) are the basis for the *sukuk* payments.
- The residual interest in the Equipment can be transferred from the Issuer to the Master Lessee for a nominal payment or a fair market value payment.
Principal Parties

- Master Lessee
- Islamic Investors
- Placement Agent/Paying Agent
- Issuer (Master Lessor)
- Corporate Services Company (GSS)
- Sponsor/Guarantor
- Purchaser

[Sole Shareholder]
[Alternative Owner if Sponsor cannot own the Issuer]
The Issuer agrees to purchase the Equipment pursuant to the Equipment Purchase Agreement. The Sukuk is then issued and the proceeds are paid to the Issuer and by the Issuer to the Master Lessee in payment of the purchase price for the Equipment. The guarantee of payment is also shown.
The Issuer leases the Equipment to the Master Lessee pursuant to the Equipment Lease. The Managing Contractor Agreement addresses Shari’ah leasing issues and responsibilities. Rentals on the Equipment Lease are paid to the Issuer who then pays them to the holders of the Sukuk.
Master Lessee can purchase the Equipment at the end of the lease term for a nominal amount or for fair market value.
Murabaha – Backed Sukuk

- Using the proceeds from the issuance of the sukuk, the Issuer acquires Equipment from the Equipment Vendor and sells the Equipment to the Equipment Purchaser on an installment sale basis.

- The Equipment Purchaser enters into a murabaha arrangement whereby it requests the Issuer to purchase the Equipment from the Equipment Vendor and sell that Equipment on an installment sale basis to the Equipment Purchaser. The Equipment Purchaser specifies the type and nature of the Equipment, or the precise Equipment, to be purchased.

- The installment payments under the Equipment purchase agreement (murabaha) are the basis for the sukuk payments.
Principal Parties

- **Equipment Purchaser**
- **Goods Purchaser**
- **Equipment Vendor**
- **Issuer**
- **Placement Agent/Paying Agent**
- **Sponsor/Guarantor**
- **Islamic Investors**

Key Points:
- **Supply Agreement**
- **Payments for Goods**
- **Sole Shareholder**
The Issuer agrees to purchase the Equipment pursuant to the Murabaha Equipment Purchase Agreement and submits a Request for purchase.

The Sukuk is then issued and the proceeds are paid to the Issuer and by the Issuer to the Equipment Vendor in payment of the purchase price for the Equipment.

The guarantee of payment is also shown.
**Murabaha Payments and Sukuk Payments**

*Murabaha* installment purchase payments are paid by the Equipment Purchaser to the Issuer, who pays such payments on to the holders of the *Sukuk*.
Common Structural Features

• **Shari’ah Compliant:** Will be approved by the *Shari’ah* supervisory board of Placement Agent or a sub-placement agent appointed by Placement Agent.

• **Capital Protection Guaranteed:** Guarantor will guarantee the Issuer’s obligations to make payments to the Investors on the *sukuk* at maturity.

• **Target Yield**

• **Tenor**

• **Supply Agreement:** Master Lessee will supply goods to Purchaser/Goods Purchaser, and Purchaser/Goods Purchaser will make payments to the Master Lessee/Equipment Purchaser in respect of those goods. These payments will be made to an account with Paying Agent, to the extent that the payments relate to the rent or payments payable under the Lease Agreement or Murabaha Equipment Purchase Agreement.

• **Rent or Murabaha Payment Account:** The Lease Agreement or Murabaha Equipment Purchase Agreement will provide that all rent payments or payments in respect of the *murabaha* agreement will be paid into a payment account opened in the name of the Issuer with Paying Agent. Paying Agent will make payments in respect of the *Sukuk* from the Rent Account or *Murabaha* Payment Account.

• **Tax Matters:** If necessary, the Issuer and the Master Lessee/Equipment Purchaser will enter into the a Tax Matters Agreement that will characterize the lease transaction as a financing transaction or murabaha transaction with ownership of the Equipment in the Master Lessee/Equipment Purchaser.