J.P. MORGAN ISLAMIC FINANCE

Islamic Finance Overview

May 2014

J.P.Morgan

Overview of Islamic Finance

Overview of Islamic Finance

- Islamic finance as practised today involves the application of Shariah principles to financial activity
- Shariah is not a codified system of laws but is dependent upon interpretation of the key Islamic principles which are derived from;
  - The Qu'ran (Holy book)
  - Sunna (teaching and practices of the Prophet Mohammed)
  - Ijtihad and Fiqh (Islamic jurisprudence)
- Certain prohibitions exist that dictate how the Islamic economy functions

- Prohibition on **Riba**
  - Based on the view that money has no intrinsic value and therefore should not increase in value just through lending
  - Shariah considers that an increase in value should reflect human effort, initiative and risk in a productive venture
  - Interest is totally prohibited
  - Profit and loss sharing is acceptable provided there is real risk sharing
- Prohibition on **Gharar**
  - Gharar is generally understood to mean undefined risk, uncertainty or speculation
  - Contracting parties must know the subject matter of the contract, the price and the effect of the contract. The aim is to protect weaker parties from exploitation
  - A contract is unacceptable if there is an obligation that is conditional on the occurrence of an uncertain or ill-defined event that is outside of the control of the contracting parties

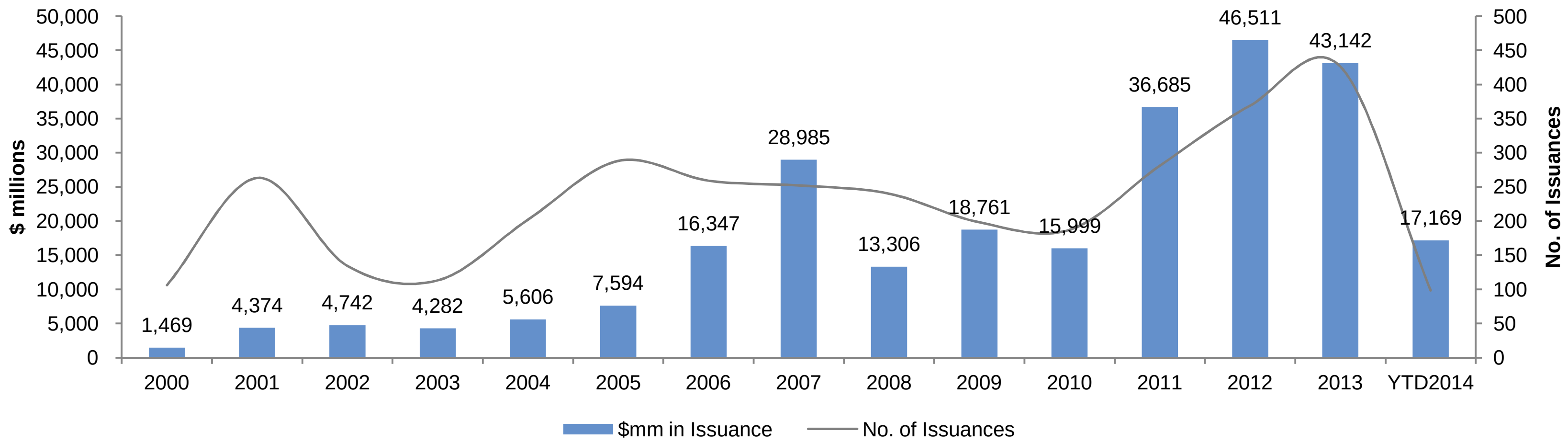
- Prohibition on **Maisir**
  - Gambling (or Maisir) is prohibited, which can result in some contracts, such as futures and options, being considered unacceptable
  - Financing of gambling businesses is prohibited
- Prohibition on **Bay' Al-Dayn**
  - Transfer of obligations or debt is prohibited even if such debt obligations are themselves Shariah compliant
  - For example, promissory notes cannot be traded (although some scholars permit trading at face value)
- Prohibited **Commodities**
  - Muslims cannot deal or trade with certain commodities (e.g. pork, alcohol)
  - Neither can they provide financing for investments that involve prohibited commodities (e.g. hotels, restaurants)

Recent developments in Islamic Finance

Recent Developments in Islamic Finance

- The Islamic economy has grown at a tremendous rate in the past decade with total islamic assets reaching $1.8 trillion in 2013 and expected to reach $2.1 trillion by end of 2014
- This growth is facilitated by both demand and supply along with input from government agencies and financial regulators that have assisted in maturing the Islamic market
- The large demand in the Islamic finance sector has been underpinned by greater participation of Muslim nations as well as increasing demand for Shariah compliant financing solutions
- Advanced Islamic banking markets in both the GCC and Asia are expected to evolve their sophistication in terms of products offerings and regulatory advancement by the financial regulators
- The below table shows how the Sukuk market has grown between FY2000 and YTD2014

Sukuk USD Issuances FY2000 – YTD2014



Source: Bloomberg

J.P.Morgan

Islamic Finance Factsheet

Top 15 Largest Islamic Finance Economies (2012)

Rank	Country	Islamic Finance Assets ($ mm)	Islamic Finance Institutions	Shariah Scholars
1	Malaysia	411,512	92	47
2	Saudi Arabia	269,736	113	40
3	Iran	185,323	44	na
4	United Arab Emirates	118,446	77	28
5	Kuwait	81,455	101	39
6	Qatar	71,062	37	21
7	Bahrain	47,246	55	53
8	Turkey	37,665	4	0
9	Indonesia	33,155	73	9
10	Bangladesh	17,503	23	18
11	Pakistan	13,569	62	21
12	Egypt	12,106	30	11
13	Sudan	8,012	45	6
14	Switzerland	6,575	4	3
15	Jordan	5,463	13	9
	Total	1,318,828	773	305

Islamic Finance Regulatory Overview

Islamic Regulators

- Currently, 30 countries have stand-alone regulations that govern the conduct of Islamic finance within their economies
- Certain bodies are set up to regulate and set standards of how Islamic finance should be conducted and how the treatment of various Islamic finance products and services should be recognized within the finance community and global economy

Notable Regulatory Institutions

Name of Institution	Description
AAOIFI – *Accounting & Auditing Organization for Islamic Financial Institutions*	Created in 1991 to issue international standards on accounting , auditing and corporate governance. Currently has over 200 members from 45 countries, including central banks, Islamic financial institutions and other Islamic participants
IFSB – *Islamic Financial Services Board*	Set up in 2003 with the support of the IMF, central banks and the Islamic Development Bank. Its mandate is to "promote and enhance the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. Currently has 189 members in 44 jurisdictions.
IILM – *International Islamic Liquidity Management Corporation*	Was established by central banks, monetary authorities and multilateral organizations to create and issue short-term Shariah compliant financial instruments to facilitate effective cross-border Islamic liquidity management.
IIFM – *International Islamic Financial Market*	Founded with the collective efforts of the Central Bank of Bahrain, Islamic Development Bank, Autoriti Monetari Brunei Darussalam, Bank Indonesia, Central Bank of Sudan and the Bank Negara Malaysia as a neutral and non-profit organization to standardize islamic financial products, documentation and related processes at a global level

Islamic Finance Concepts

Islamic Finance Concepts

- There are a number of Islamic finance concepts that are commonly used by Islamic counterparties to affect an economic objective

Common forms of Islamic Finance Structures

Murabaha	A sale of a Shariah compliant asset at an agreed cost and profit (mark up) known to the Buyer
Mudaraba	A contract whereby the investor (Rab Al Mal) contributes money to the manager (Mudarib) to invest in a certain asset at a pre-agreed profit share arrangement
Ijara	A exchange transaction whereby the known benefits arising from a specific asset(s) are made available in return for a payment The title of such an asset(s) is not transferred and the structure resembles a lease contract
Wakalah	Structure resembles an Investment Agency whereby an Investor (Muwakil) may appoint a counterparty (Wakeel) to perform an predetermined action on his behalf
Istisna’	A contract of exchange with deferred delivery typically applied to assets that are not yet in existence

Content

Introduction: What is a Sukuk?

What is a Sukuk?

- Sukuk is a Shariah compliant capital market instrument that is used by the Originator to raise funds from regional and international investors
- It typically pays a fixed or floating rate of profit to the investor, and is redeemed in a pre-prescribed tenor
- Due to its nature, it can be comparable in some cases to conventional asset backed securities
- The concept of Sukuk dates back to early Islamic civilization but only recently it has re-emerged as a modern Islamic finance structure
- Sukuk can be issued using various structures. The most widely used and accepted currently are:
  - Sukuk Al-Ijara: this uses an underlying asset pool comprised of leased assets
  - Sukuk Al-Musharakah: this uses an underlying asset pool comprising a combination of capital and other physical assets
- The Issuer (typically an SPV) will issue Sukuk certificates in the primary market, and these can also be sold in the secondary market
- The Sukuk holder will have a pro-rata beneficial ownership in the underlying pool of assets

What is a Special Purpose Vehicle?

- A Special Purpose Vehicle (SPV) is a bankruptcy remote entity whose operations are typically limited to the acquisition and financing of specific assets
- In Sukuk structures, the SPV acquires the relevant assets and issues financial claims on the assets in the form of certificates
- “Sakk” is the Arabic word for certificate and “Sukuk” is the plural
- These financial asset claims represent a proportionate beneficial ownership to the Sukuk holders
- SPVs are typically used for all Sukuk issues
- Usually they purchase assets with the funds raised by issuing the certificates
- Alternatively they use the funds for investment purposes and earn a return for the Sukuk holders that way

Overview of Sukuk mechanics

Overview of Sukuk mechanics

- **Description of Sukuk issues**
  - The Issuer (an SPV) issues Sukuk certificates, and utilises the proceeds to purchase the assets (or to invest in an enterprise)
  - The assets (or investment) are then used to generate revenue for the Sukuk holders and generate redemption payment at maturity
  - A Sukuk represents a proportionate beneficial ownership in an underlying asset (or pool of assets), giving the holder the right to receive an income stream derived by these assets
  - A Sukuk is usually structured to have the same economic characteristics as a conventional bond
  - Sukuk yields are typically linked to a return on an underlying pool as assets through a Shariah compliant structure (e.g. lease transactions)
  - Sukuk are priced, listed and rated similarly to bonds, although legally they are similar to a participation in a Collective Investment Scheme
- Sukuk are also referred to as Islamic bonds, but have the following key differences to a conventional bond
  - Conventional bonds are interest paying instruments
  - Bonds are seen as debt
  - Both trading in debt, and receiving /paying interest is forbidden under Shariah

Sukuk: Key concepts

Important Concepts

- No security or foreclosure rights on assets used for structuring (unless specifically provided for)
  - Investors do not automatically have foreclosure rights on the assets used for structuring (unless a security interest has been granted). The rights of investors would be similar to those of other unsecured creditors
- Asset sale for structuring purposes only
  - Asset sale is for Shariah structuring purposes only and does not constitute a true sale
- Balance sheet treatment same as conventional debt
  - The structure of Islamic facilities does not result in off-balance sheet treatment of assets
  - Obligation created under Islamic finance facilities reflected as financial indebtedness on balance sheet
- Similar treatment by rating agencies
  - Rating agencies treat and rate Islamic facilities in a manner similar to conventional indebtedness

Benefits to Issuers

- Sukuk securities are the most inclusive means of tapping liquidity
  - Attracts both conventional & Islamic demand across different investor classes
  - Islamic issues now globally accepted and sought after
- Develops investor base through deeper penetration into Islamic investors
- Due to scarcity of Islamic Sukuk issuance, many investors take long-term positions on Sukuk issues

Benefits to Investors

- Offers investors Shariah-compliant secondary market liquidity in the international markets
- From a credit perspective, Sukuk represent the same credit risk as that of the underlying Obligor
- Scarcity value, particularly of high-yield issues, prized by many investors
- Investor documentation is as per international standards and usually governed by laws of an internationally accepted jurisdiction

Considerations for Sukuk vs. Conventional Bonds

Considerations

- Compared to conventional bonds, Sukuk
  - returns are derived from legal or beneficial ownership of assets rather than interest-based debt obligations
  - returns can nonetheless be linked to common market indices (e.g. LIBOR, Treasuries)
  - rank pari-passu with other senior, un-secured obligations of the Obligor (borrower) and are structured not to contravene existing negative pledge provisions of conventional bonds
  - do not impact an Obligor’s pricing or ability to issue conventional bonds in future
  - With certain structures, are tradable at par, premium or a discount similar to conventional bonds
- The following structuring and execution differences between Sukuk issuances and conventional bonds should be taken into consideration:
  - **Timing:** The attainment of necessary Sharia approvals and the structuring process of a Sukuk issue requires a longer time period than a conventional bond issue
  - **Expenses:** The complexity and longer period involved in structuring Sukuk issues entail slightly higher transaction expenses
  - **Diversification of investor base:** Islamic investors add an additional component to the target global investor base for Sukuk issues whereas conventional bonds would only be marketed to conventional investors
  - **Execution Risk:** Sukuk issues would require a longer pre-marketing and book building process to allow Islamic investors to complete the necessary Sharia’a and credit approvals, and as a result increase execution risk

Sukuk Structures - Overview

One of the main drivers when deciding on the most appropriate Sukuk structure is the availability of appropriate assets

Permissible assets include:

- Land
- Property
- Shariah compliant investments
- Other fixed assets
- Lease assets
- Murabaha / Shariah compliant financing facilities
- Usufruct or rights over tangible / intangible assets

Non-Permissible assets include:

- Interest bearing loans
- Conventional bonds
- Hotels (due to alcohol and non-segregation)
- Casinos

Types of Sukuk

Sukuk Al-Ijara	▪ Sale and lease back of existing assets ▪ Fully tradable
Sukuk Al-Musharakah	▪ Investors' funds combined with assets from Originator and invested ▪ Tradable once cash invested (which is immediate under a Sukuk structure)
Sukuk Al-Mudarabah	▪ Originator uses funds for investment in its own business activities ▪ Tradable once cash is invested (which is immediate under a Sukuk structure)
Sukuk Al-Istisna	▪ Construction of assets, typically for project finance, and combined with Sukuk Al-Ijara ▪ Tradeable once the cash is invested (can be structured to permit immediate tradability)
Sukuk Al-Istithmar	▪ Sale of a mixed pool of assets, and lease back ▪ Tradable depending on components of asset pool
Sukuk Al-Murabaha	▪ Funds used to enter into Murabaha transaction (sale for deferred payment) ▪ Not tradeable
Sukuk Al-Salam	▪ Future delivery of asset ▪ Not tradeable

Sukuk Al-Ijara

Overview

Description

- Islamic lease-based securities

Features

- Issuer purchases assets from Originator
- Issuer creates a trust over the leased assets in favour of Sukuk holders
- Trustees of Issuer issue Sukuk in the Primary Market
- Sukuk owners have pro-rata undivided beneficial ownership of the assets held in trust by the Issuer
- Issuer leases assets to Originator
- Issuer appoints Originator to service/manage the assets
- Originator declares a purchase undertaking to buy back the assets (typically at cost) from the Issuer at maturity, enabling the Issuer to redeem the Sukuk certificates at maturity
- The Sukuk certificates can be re-sold in the secondary market
- Can be structured as 144A / Reg S or Reg S only transaction
- Can be rated by an international rating agency

Suitability

- Mainly used where Originator has significant assets on balance sheet
- Can be combined with Sukuk Al-Istisna structure to finance the development of assets before the Ijara (leasing)

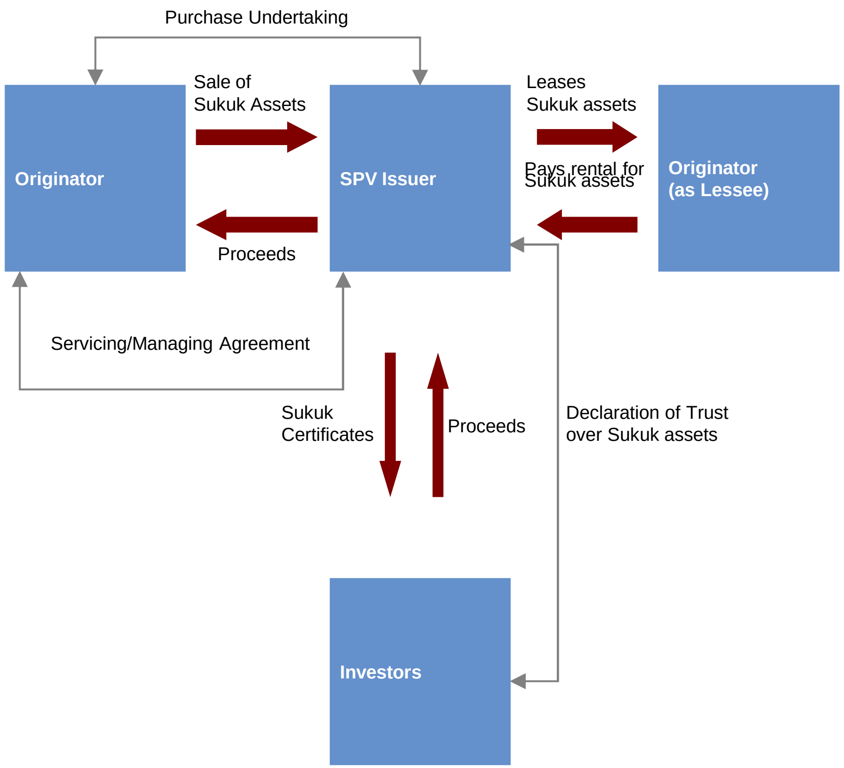
Conclusion

- This could be an appropriate structure for the Originator, as long as sufficient assets are identified
- Can be combined with Sukuk Al-Istisna to enable the construction of new assets first

Examples

- Republic of Indonesia
- State of Qatar
- Kingdom of Bahrain
- Department of Civil Aviation, Dubai
- Durrat al-Bahrain
- Republic of Pakistan
- Emirates Airline

Structure



Availability of assets

- Typically requires Originator to identify assets equal to the value of the Sukuk issue
- These are usually land or property
- Sometimes combined with Istisna structure to fund construction of the assets prior to the lease

Sukuk Al-Musharakah

Overview

Description

- Business Partnership— joint ownership of assets

Features

- Originator contributes assets to the Musharakah entity —can be land, property, factories, machinery etc.
- Issuer sells Sukuk certificates and contributes the proceeds to the Musharakah entity
- Originator and Issuer will be joint owners of the pool of assets in the agreed proportions—they are Musharakah Partners, and each will own units of the Musharakah entity
- Trustees of Issuer issue Sukuk in the Primary Market
- Sukuk owners have pro-rata undivided beneficial ownership of the units held by the Issuer in the Musharakah entity
- The Musharakah entity appoints the Originator as Managing Agent to employ the Musharakah assets in order to generate a cash return
- Musharakah Entity can lease assets to originator if applicable
- Cash returns/profits generated in excess of the profit payments required by the Sukuk holders can be retained by the Managing Agent
- Originator declares a purchase undertaking to buy back the units in the Musharakah Entity owned by the Issuer (typically at cost) at maturity, enabling the Issuer to redeem the Sukuk certificates
- The Sukuk certificates can be re-sold in the secondary market—as long as the assets of the Musharakah entity are not majority cash
- Can be structured as 144A / Reg S or Reg S only transaction
- Can be rated by an international rating agency

Suitability

- Mainly used where Originator does not have significant or appropriate assets on balance sheet

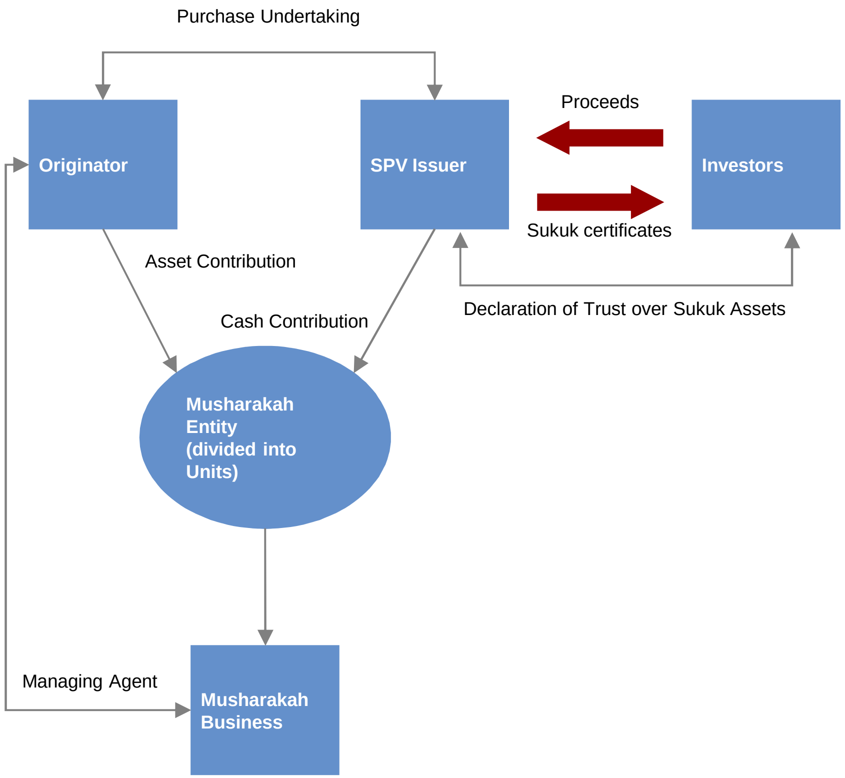
Conclusion

- This could be an appropriate structure for the Originator
- **However** some Sharia'a scholars have reservations because the Musharakah structure should be equity based, yet the debt type enhancements seen in the market contravene this

Examples

- Ports, Customs & Free Zone Corp
- Abu Dhabi Islamic Bank
- Dubai Metals Commodity Centre (DMCC)
- The Investment Dar
- Lagoon City, Kuwait
- Sharjah Islamic Bank
- Emirates Airline

Structure



Availability of assets

- Requires Originator to contribute some assets to the Musharakah Entity
- Value of fixed assets / usufruct must at least be equal to 1/3rd of total Musharakah assets
- This is suitable for Originator that is unable to identify assets to cover the full value of the Sukuk issue

Sukuk Al-Mudarabah

Overview

Description

- Islamic investment–based securities

Features

- Trustees of Issuer issue Sukuk in the Primary Market
- Issuer is Rab-ul-Maal (owner of capital) and authorises the Originator to use these funds for investment purposes in role of Mudarib
- Sukuk owners have pro-rata undivided beneficial ownership of the assets of the Mudarabah
- Originator (as Mudarib) invests the capital in originator's business activities in accordance with an investment plan
- Mudarib is entitled to percentage of profits (typically a small %)
- Cash returns/profits generated in excess of the profit payments required by the Sukuk holders can be retained by the Mudarib
- Originator (or related group party) declares a purchase undertaking to buy back the Mudarabah assets (typically at cost) from the Issuer at maturity, enabling the Issuer to redeem the Sukuk certificates at maturity
- The Sukuk certificates can be re-sold in the secondary market
- Can be structured as 144A / Reg S or Reg S only transaction
- Can be rated by an international rating agency

Suitability

- Can be used where Originator does not have significant or appropriate assets on balance sheet —or does not wish to contribute assets

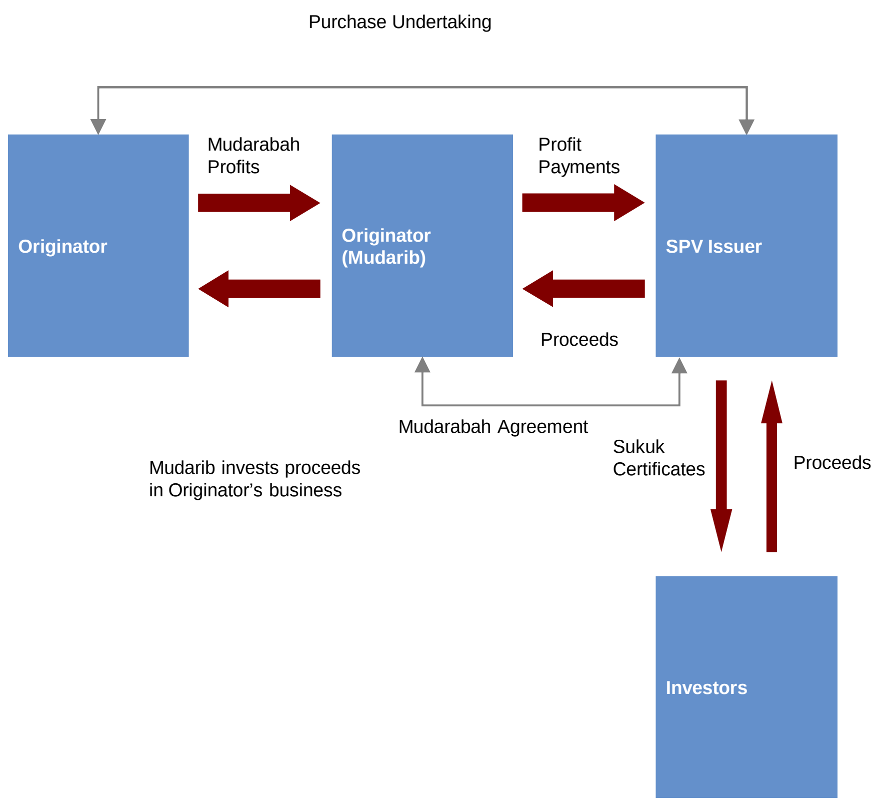
Conclusion

- This could be an appropriate structure for the Originator

Examples

- Aabar Petroleum
- NIG, Kuwait
- International Investment Group, Kuwait
- DP World

Structure



Availability of assets

- Typically requires the Originator to contribute no assets
- Requires a specific investment plan to show how proceeds will be utilised

Sukuk Al-Istisna and Sukuk Al-Istithmar

Sukuk Al-Istisna

Description	■ Islamic securities to finance construction
Features	■ Trustees of Issuer issue Sukuk in the Primary Market ■ Funds are used to finance the construction of property, infrastructure etc ■ Originator undertakes to lease or buy the completed assets from the Issuer in the future ■ Lease rentals can be paid in advance before completion of construction ■ Originator also provides an undertaking to purchase the assets (typically at cost) from the Issuer at the maturity of the Sukuk ■ Funds are paid direct to contractors/developers ■ Completed assets are delivered to the Issuer once completed ■ Typically in tranches, as each stage of development is completed ■ Assets are then leased or sold to Originator or a third party ■ At maturity, assets are sold and Sukuk certificates are redeemed ■ In the market, this is combined with an Ijara structure, hence you see Sukuk Al–Istisna and Ijara issues ■ The Sukuk certificates can be re-sold in the secondary market ■ Can be structured as 144A / Reg S or Reg S only transaction ■ Can be rated by an international rating agency
Suitability	■ Can be used where construction of specified assets or projects need to be funded ■ These assets are leased to Originator or sold to end buyers
Conclusion	■ This could be an appropriate structure for the Originator ■ These are Sukuk Al-Istisna and Ijara issues
Examples	■ Durrat Al Bahrain ■ Kingdom Install Company, Saudi

Availability of assets

- Typically requires the Originator to contribute no assets initially
- Requires specific project or development to be identified
- Assets must then be leased or sold once completed

Sukuk Al-Istithmar

Description	■ Islamic securities on a mixed pool of assets
Features	■ Issuer purchases assets from Originator ■ Issuer creates a trust over the leased assets in favour of Sukuk holders ■ Trustees of Issuer issue Sukuk in the Primary Market ■ Sukuk owners have pro-rata undivided beneficial ownership of the assets held in trust by the Issuer ■ The assets can be a combination of ■ Ijara (lease) contracts ■ Murabaha (cost plus) contracts ■ Istisna (construction) contracts ■ Issuer appoints Originator to service/manage the assets ■ Originator declares a purchase undertaking to buy back the assets (typically at cost) from the Issuer at maturity, enabling the Issuer to redeem the Sukuk certificates at maturity ■ The Sukuk certificates can be re-sold in the secondary market ■ Can be structured as 144A / Reg S or Reg S only transaction ■ Can be rated by an international rating agency
Suitability	■ Mainly used where Originator has significant assets on balance sheet ■ More suitable for Financial Institutions who have various financing agreements on their balance sheet
Conclusion	■ This is unlikely to be an appropriate structure for the Originator due to the nature of underlying assets required
Example	■ IDB

Convertible Sukuk

Overview

- Redemption of the Sukuk certificates occurs when the assets owned by the Issuer are purchased, typically by a party providing a purchase undertaking
- It is possible for these assets to be purchased by Shares as well as cash
- This can be used to effect a convertible or exchangeable issue for the Originator
- It is also possible to have a cash settlement based on a reference share price
- This permits the Investor to benefit from equity upside
- The formula for calculating the price of the conversion can be agreed at the time of issue of the Sukuk
- This structure has been used in the market recently
  - PCFC
  - Nakheel
  - Aabar Petroleum
  - Aldar Properties
  - Khazanah
  - Dana Gas
- Conversion is typically at the option of the Investors

Pre-IPO Sukuk

- Conversion can be linked to an IPO
- The proceeds of the IPO can be used to redeem the Sukuk certificates
- Redemption can be partly in cash and partly in shares of the Originator
- This structure was used for PCFC Sukuk

Conversion not linked to IPO

- Conversion can also just be linked to the average share price at maturity of the Sukuk
- If the share price at maturity is above a benchmark, then
  - Investors can elect for the Sukuk to be redeemed in exchange for shares
  - Or redeemed by cash settlement of the share price
- This structure was used in the Aabar Sukuk