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Possible Flows of Funds with Islamic Structures attached

- From Europe to Arab World
  Exporter / Importer driven and so far not many transactions

- From Arab World to Europe
  Significant Relevance in Real Estate Markets Growing Importance in Participation Capital

- Islamic Finance in Islamic Countries
Islamic Finance | Definition

- Is an alternative way to look at things
- Is not the salvation of the Financial Industry

Requirements ➔ Interest in the Product
  ➔ Tangible Private Sector
  ➔ Credit worthiness

Obstacles ➔ High Liquidity
## Examples

<table>
<thead>
<tr>
<th></th>
<th>Interest</th>
<th>PS</th>
<th>credit</th>
<th>Excess liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Libya</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Syria</td>
<td>NO</td>
<td>YES</td>
<td>?</td>
<td>NO</td>
</tr>
<tr>
<td>Sudan</td>
<td>YES</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>Saudi</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES / But</td>
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Islamic Finance / Practical Examples

- Compliance with Sharia

- Interest NO - Profit YES

- Title based - Assets move from one party to another

- Documentation - More - Volume
  More - Detail

- Common roots - usury law
  - “Riba” (literal meaning “increase” is prohibited
    Practical implication: interest is forbidden)
(True) Murabaha = Price deferred sale

- Murabaha is very commonly used by Islamic Banks in the Middle East for short and medium term financing
- A good example re ABC Islamic is a corporate wanting to purchase plant & machinery (P&M).
- Disclosure of mark up required.
- An illustrative structure of P&M financing arrangement under Murabaha is set out below:

1. Customer indentifies the required P&M

BANK

2. Approaches the bank For Finance

SUPPLIER / MANUFACTURER

3. Purchase of P&M for $5m

4. Immediate Payment

CUSTOMER

5. Sale of P&M for

6. Cost – plus deferred payment
Simple Commodity Murabaha
(used for general funding or receivables financing)

1 – Spot Commodity Purchase

2 – Sells commodity + mark up on deferred basis (takes security for deferred payment)

3 – Spot Commodity Purchase

4 – Receives cash to use for general working capital

5 – Deferred payment

- Used when unpractical to use underlying asset
- No underlying asset → create one
- Brokers are members of the London Metal exchange
**STEPS**

**ABCIB** would contact DD & Co. (our chosen commodity trader) informing them we wish to transact in a commodity trade for x amount. DD will inform us of the quantity of metals and the unit price of the metal (equalling the amount of debt)

- Exporter signs a utilisation notice, promising to purchase the specified metals from ABC and will make payment on a deferred basis (the length of the facility)

**ABCIB** sends Exporter a Client Seller Offer – outlining

- the quantity and unit price of metal
- the amount that we have purchased it for (the debt)
- the amount we will sell the metal to the client for
- the profit element
- the dates of settlement and maturity

- Exporter confirms they agree to terms set out through a Purchase Acceptance

**ABCIB** sends a Purchasers Request to DD & Co requesting them to provide **ABCIB** with an offer to sell metals on specified terms agreed above

- DD & Co. offer to sell **ABCIB** x metals at x price per unit

- **ABCIB** accept terms through Purchasers Acceptance

- **ABCIB** sell commodity to the Exporter under terms in Client Seller Offer
**STEPS**

**ABCIB** notify DD& Co. that metals have been sold to client under Notice of Sale

Exporter appoints **ABCIB** as agent to sell commodity on their behalf

**ABCIB** as agent request Richmond Commodities Ltd. to provide an offer to purchase metal

Richmond Commodities offer to purchase commodities from client

**ABCIB** as agent accept offer and credits the exporter account with amount of debt

The exporter pays to **ABCIB** on a deferred basis the amount agreed under Client Seller Offer
**Example III**

**ABCIB / Company A**

**Revolving Murabaha Facility**

Exporter provides ABCIB with BOE as security (will be endorsed to ABCIB)

1. Commodity Murabaha for an amount equivalent to total of discounted BOE
2. BOE are due every six months and the proceeds will be paid into a collection A/C company A will open with ABCIB (these are fixed payments).
3. The Murabaha facility will be repaid from the proceeds in the collection A/C.
4. A side security letter between ABCIB and exporter will be signed separately to the Murabaha agreement.
Example IV

MASTER MURABAHA STRUCTURE (using the underlying assets)

1. Issue Standby L/C
2. Master Murabaha Agreement
   - Acceptance Notice
3. Agency Agreement
   - Invoice Copy
4. Buyer negotiates price / terms of goods
5. Utilization notice with promise to purchase
6. Invoice to the Agent (Buyer being the Agent of the Seller)
7. Payment – Cost Price
8. Payment – Cost Price with undertaking to pay supplier
9. Payment – Cost Price
10. Offer notice
11. Acceptance Notice

Buyers Bank
Supplier Company B
Agent Company A
Seller (Bank)
Buyer Company A
1. Customer’s (Buyer) bank issues a Standby L/C in favour of ABCIB (Seller) as a guarantee in the event of non-payment by the customer.
2. Seller signs a Murabaha Agreement with the buyer. The Murabaha will be to finance stock for the Buyers retailing business.
3. Seller appoints Buyer as his agent to receive the goods and pay for them on behalf of the Seller under a Murabaha Agency Agreement which they both sign. The basic provision should be that the customer (Buyer) receives the proceeds from the Murabaha Facility to his account (local legislation).
4. Buyer negotiates with the Supplier the purchase of goods and once agreed →
5. Buyer gives Seller a Utilisation Notice under the Murabaha Agreement.
6. Seller issues an Offer Notice under the Murabaha Agreement to the Buyer.
7. Buyer issues an Acceptance Notice under the Murabaha Agreement to the Seller.
8. Supplier issues an invoice to the Agent who is acting on behalf of the Seller.
9. Agent presents a copy of the invoice to the Seller.
10. Seller pays cost price to the Agent to pay the supplier on its behalf. Since the Agent and the Buyer will be the same entity, the cost price instead of being paid directly to the Supplier will be first transferred to the Agent, who will be obliged by the Seller (Bank) to make the payment to the Supplier. All responsibility of the payment to the Supplier will be with the Agent/Buyer. This arrangement should be reflected in the Murabaha Agency Agreement which in addition to authorising the Agent to buy goods on behalf of the Seller (Bank) will give him the power to make a payment on his behalf. Having Buyer as Agent gives Bank more security (quality control of assets).
11. At the same time the Seller sells goods to the Buyer on deferred basis, to include the Sellers mark up.

**Note**

- The invoice will be in the name of the Agent (or Buyer).
- Although the Agent will be acting on behalf of the Bank, the ownership of the goods will in no document be in the name of Bank.
Real Estate Transactions (Arab World Funds to Europe)

A) 45 MM £ 3 years facility to finance student accommodation in the UK

- Kuwait based Fund and ABCIB fund SPV at 50/50
- Funds raised through Murabaha agreement
- Lease agreement with university
- Opt out concession after 3 years with upside participation for Bank

B) Residential development deal with British Bank

- ABCIB provides 36 MM £ as “Islamic Tranche”
- Tenor 3 – 5 years
**Sukuk ~ Islamic Bond?**

- It is a legal instrument, deed, cheque.
- Comply with Sharia / Islamic Law.
- They are asset based securities having stable income and are tradable.
- Governed by legal contracts approved by Sharia Scholars.
- Most common are:
  - Mudarabah (partnership / Finance trusteeship)
  - Musharakah (joint venture)
  - Ijarah (leasing)
- The Islamic Sukuk structure involves an acquisition of an asset by special purpose company (SPC).
- The company funds itself by the issue of the Sukuk, declaring a trust in favour of the Sukuk holders.
- The Sukuk holders receive a return based on the income received from the asset.
### Differences between Sukuk & Conventional Bonds

**“Islamic Bond”**

<table>
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<tr>
<th>Sukuk</th>
<th>Bonds</th>
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<tbody>
<tr>
<td>Sukuk represent ownership stakes in well defined assets;</td>
<td>Bonds represent pure debt obligations;</td>
</tr>
<tr>
<td>Sukuk holders may be affected by asset related expenses;</td>
<td>Bond holders are not affected by asset related expenses;</td>
</tr>
<tr>
<td>Selling a Sukuk is basically the sale of a share in an asset;</td>
<td>Selling a bond is basically the sale of a debt;</td>
</tr>
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</table>
Sukuks are primarily asset-based (possible, in theory also asset-backed, convertible or exchangeable).

Asset based Sukuk: In the first instance the holders rely on the company seeking to raise finance (the originator) for repayments (same as corporate bond).
**Sukuk al Ijarah**

- **Obligator (as sellers)**
  - Title to assets
  - Sukuk proceeds

- **Sukuk-holders**
  - Sukuk proceeds

- **Issuer**
  - Rent
  - Lease
  - Rent and redemption proceeds

- **Lessee**
  - Sukuk proceeds
Sukuk al Mudarabah Example

Client: National Industries Group Holding ("NIG), $1.5bn, 5 years, proceeds used to provide working capital for NIG

1. SPV (NIG Sukuk Ltd.) collects contributions from the investors by issuing Sukuk certificates.
2. The funds in the SPV constitute the capital of the Mudarabah and NIG (the Mudarib) will invest the capital in its business in accordance with an agreed investment plan.
3. NIG will distribute the profits generated as agreed between itself and the SPV (NIG Sukuk Ltd.). Upon maturity, NIG Sukuk Ltd. will have the right to require NIG to purchase the relevant Mudarabah assets – but this cannot be fixed in contract.
4. Loss borne by entrepreneur/investor
Investment in Sukuk
Types of Sukuk by Asset Recourse

• **Credit backed/asset based**
  The investor’s recourse is to the creditworthiness of the ultimate obligor. These are also sometimes called asset-based Sukuk and can be issued through debt (Murabaha) or asset (Ijarah) based contract structures.

• **Project backed**
  The investor’s recourse is to the assets/proceeds of project and sometimes to the creditworthiness of the ultimate obligor by means of a credit enhancement feature such as a guarantee. These Sukuk rely on the value of future cash flows arising out of project completion and production/sale, the assets of the issuing vehicle and the credit of the obligor;

• **Asset backed**
  The investor’s recourse is to the assets of the issuing vehicle and the Sukuk investors bear any losses in case of the impairment of the Sukuk;
Sukuk al Musharakah

**Originator**
- Cash contribution / Contribution in kind

**Issuer**
- Cash contribution

**Sukuk-Holders**
- Sukuk proceeds

**Joint venture**
- Share in profits / At agreed upon ratio
- Share in loss according to share in capital
- Periodic distribution
Conclusions / Expectations

• Established market in certain regional markets (Arab Gulf more than North Africa). This will change most likely as result of “Arab Spring”.

• Overall growing ~ 15% p.a. – was more a result of oil price development than number of players – This will change as well

• 500 Islamic Financial institutions in over 75 countries

• May facilitate funding

• May improve chances to close a transaction

• Proof of cultural partnership and understanding

• “Choice of law” and “dispute settlement clauses” included in contracts (English law)